The Details of Investment Sales Going Forward

City's past bottom in sales volume; 1031, institutional activity up

EXECUTIVE SUMMARY

➤ Investment sales volume has picked up recently. In Manhattan, there have been five consecutive quarters of volume increases.

➤ In terms of pricing, the first half of 2010 will very likely represent the market's bottom.

➤ The market's psyche has shifted, evidenced by institutional and 1031 activity.

➤ Government actions, including those overseas, have and could still impact the market.

➤ Unrest in Europe, particularly Greece, has prompted flight to quality investment in the U.S.

Robert Knakal
Columnist

Last Tuesday evening, May 18, I gave a speech to the Hellenic-American Chamber of Commerce, whose membership includes many of my clients and good friends. The event was held at the Harvard Club and a portion of that speech appears below.

Thank you, it's a pleasure to be here this evening. I've been asked to provide an overview of what's happening in the commercial real estate sales market today as well as touching on some economic conditions and how the political landscape is impacting today's market and could impact it moving forward.

From a real estate sales market perspective, there are two metrics that we monitor very closely. The first is the volume of sales and the second is pricing.

With regard to volume, it is very apparent that we are past the bottom in terms of a low point in the volume of sales. This is particularly true in the Manhattan submarket, where we have seen five consecutive quarters of volume increases.

In Manhattan, the 26-year average sales volume of the total stock of buildings has been 2.6 percent, with the lowest volume ever experienced being 1.6 percent in 1992 and 2003. Those were both years at the end of recessionary periods and were also both years in which we saw peaks in cyclical unemployment. In 2009, the volume of sales in Manhattan reached a new low at 1.17 percent.

As I mentioned, however, on a quarter-over-quarter basis throughout 2009, volume increased incrementally and, in the first quarter of 2010, volume reached 1.4 percent. While volume is still on the decline in the boroughs, the rate of decline is decreasing, and we believe that, as is always the case, the Manhattan market will lead the city out of the bottom, with the boroughs lagging behind.

We expect that turnover in Manhattan will exceed 1.6 percent in 2010 and that we will start to see positive volume growth in the boroughs before the end of the year.

With regard to pricing, there are also compelling arguments that indicate we are at the bottom in terms of price. If you have been reading any of my writings over the past couple of years, I have always indicated that we felt a bottom, in terms of value, would be achieved shortly after employment trends reversed and job growth began. We've started to see this occur within the past two months, so indications are, based on that perspective, that things are turning.

The empirical data thus far in 2010 supports this thesis. For some property types, in some locations, values are increasing and for some property types, in other locations, values are decreasing. This divergence in direction indicates a market which is in the process of achieving its bottom. Consequently, we firmly believe that 10 years from now, a look back at price-per-square-foot trends will clearly show the first half of 2010 as representing the bottom of the market.

Probably the most notable change in our sales marketplace has been the extent to which optimism has been creeping into participants' psyches. It appears that a tangible, positive impact has been felt within the past four to six weeks, and real transaction flow is occurring.

We have seen the resurgence of 1031 transactions, which present a very palpable trend, demonstrating that discretionary sellers are returning to the market. Distressed sellers, generally, do not have any equity available after a transaction to reinvest. Therefore, the activity in the 1031 tax-deferred exchange market is indicative of the fact that discretionary sellers are returning to the market and are deciding to reinvest equity, which is generated at the closing.

If we are indeed at the bottom of the market, where will prices go from here? The downside risks in the economy revolve around interest rates, which present the biggest downside risk, in our opinion.

Inflation, thus far, has been kept in check and it is expected that this Thursday's inflation report will show a very modest increase in consumer prices. As long as inflation stays below 2 percent, it remains within the Fed's comfort zone and there will not be an impact on interest rates. However, to the extent inflation rises above 2 percent, it may force the Fed to raise rates which will have a negative impact on commercial real estate.

The Fed's exit from the marketplace is also something that could have a negative impact on interest rates. The Fed ceased its asset buying program at the end of March of this year. Shortly thereafter, we saw 10-year Treasury rates escalate from around 3.5 percent to over 4 percent. Those rates came down slightly but remained in the high 3's as the Fed announced it would start to sell some of the $1.3 trillion of assets that they have purchased.

It is important to note that the Fed's balance sheet has doubled within the past year, and its exit strategy includes the sale of these assets. As it decides to sell, the supply of these assets goes up, which drives the price down and increases the implied interest rate.

What we have seen overseas in Portugal, Italy, Ireland, Spain and, particularly, Greece is that the uncertainty, created by economic conditions, is driving a flight to quality and safety and there is no better investment for quality and safety than U.S. Treasuries. This has 10-year Treasury rates back down well below 3.5 percent and it is expected that they could stay even lower as the uncertainty abroad continues to grow.

Another factor that could exert downward pressure on value moving forward is the de-leveraging process that the market must still go through. Distressed assets have been coming to the marketplace in greater numbers recently; however, those that are available still only represent a very small fraction of the distressed assets that actually exist in the system. We have not seen the tsunami of distressed assets that almost everyone was anticipating a year and a half ago.

These assets have come to market very slowly and have been precipitated mainly by either the evaporation of advantageous mortgage terms (such as interest-only periods, interest reserves or loans floating over LIBOR) or by mortgage maturity. Given these are all based on specific timelines rather than events, it is likely that, although we are very optimist about the future and expect that real estate fundamentals will continue to gradually improve as we move forward, we will see distressed assets coming to market consistently over the next two to three years before our de-leveraging process is completed.

It is expected that private sector job growth will outpace public sector cutbacks. From real estate's perspective, we hope this is the case.

We have already absorbed over $15 billion in losses in the New York City marketplace and we estimate that there are another $15 to $25 billion of losses which much be incurred before our de-leveraging process is completed.

On the other side of the coin, the one factor exerting significant upward pressure on prices moving forward is the tremendous amount of capital that is currently searching for real estate opportunities.

There is an acute supply-demand imbalance which is currently in operation. I mentioned earlier the very low volume of sales that the marketplace has seen. There is no doubt that this low volume is more a function of supply constraint than a lack of buying demand.

Demand drivers are at extraordinary levels. High-net-worth individuals and New York families have been the dominant players in the marketplace over the last two years as institutional capital all but evaporated from the marketplace after we tangibly started to feel the credit crisis in the summer of 2007. That institutional capital has now reemerged and is extremely active, looking for both distressed opportunities and core assets.

Joining them is a significant amount of demand from foreign-based high-net-worth individuals who have appeared in New York City in numbers not seen since the mid-1980s.

Additionally, the 1031 activity which we have seen lately is the icing on the cake of this excessive demand, which is continuing to significantly outpace the limited, but growing, supply.

From a political perspective, uncertainty surrounding state and city budgets should be a concern to all of us. Clearly, there will be significant municipal layoffs, as tax increases will not be sufficient to meet budget deficits. As this plays out, it will be interesting to see what the implications of these labor force reductions are in the public sector versus growth and job creation in the private sector. It is expected that private-sector job growth will outpace public-sector cutbacks. From real estate's perspective, we hope this is the case.

Generally, there are, for the first time in quite a while, reasons for optimism. Volume is on the upswing and, based upon job growth, fundamentals are improving. Rent concessions are evaporating and values appear to be reaching a bottom. New York continues to attract foreign capital, as uncertainty abroad is diverting investment capital increasingly to New York.

For these reasons, we are extremely bullish on the future of New York's commercial building-sales market. Notwithstanding the risks I've expressed tonight, we believe that the market is poised for growth and that activity will continue to increase as we move forward.

New York is the greatest city in the world, and I could not be more confident about its future and the future of our industry.

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