

The Investment Sales Mini-Bubble

Demand still outpaces supply, despite more sales— what to expect as we near 2011

EXECUTIVE SUMMARY:

- The supply side of investment sales has improved via distressed and discretionary sellers.
- But demand still significantly outpaces supply.
- Properties are therefore selling for more than their economics would suggest they're worth—a sort of mini-bubble.
- Interest rate and tax increases are the biggest threats to investment sales.
- Midyear 2010 stats expected to show strength, but that may not hold into 2011.

When it comes to today's investment sales market, the biggest question on everyone's mind is the sustainability of the market's present momentum. Can the currently elevated price levels continue on their current trajectory, or are we in a mini-bubble at a low point in this cycle? In order to answer this question, we shall look at present conditions and what they might say about where the market is headed.

Perhaps the dynamic having the most significant impact on the investment sales market today is good old-fashioned supply and demand. The marketplace is always highly dependant upon the supply-demand relationship, whether discussing retail space, office space or investment sales. Today, more than at any time I can remember in the 26 years I have been brokering investment properties in New York, the market is being influenced by what is an extraordinarily acute imbalance between supply and demand.

We currently have excessive demand, which has been created by an aggressive appetite from all investment sectors. Simultaneously, we also have a very low supply of available properties for sale.

On the supply side, recent history helps us to understand where we are today. In 2009, the turnover of properties sold hit its lowest level that we have seen since 1984, when we began tracking the Manhattan sales market. Only 1.17 percent of the total stock of Manhattan's 27,649 properties sold last year. This was well below the previous low of 1.6 percent, which was achieved in 1992 and again in 2003 (the 26-year average has been 2.6 percent).

Many people believe that the reason for the low turnover in 2009 was

caused by either a lack of demand or the oft-mentioned bid/ask spread. In reality, the reason for the low volume was due to supply constraint—i.e., an extremely low supply of available properties for sale. This supply is normally fed by discretionary sellers who willingly decide to sell their properties. When values start to fall, as we saw beginning in 2008 and continuing into 2009, these discretionary sellers withdraw from the market. Typically, distressed sellers move in to fill the void.

Unfortunately for those of us who rely on transaction volume, during this cycle, everything that has occurred from a regulatory perspective has provided distressed sellers the ability to avoid having to dispose of their distressed assets. Many have taken advantage of this opportunity, which left the market with an extraordinarily low supply of available properties. This has been the main reason for the anemic volume of sales.

On the supply side today, we have seen some improvement. Distressed assets are coming to market with greater frequency as sellers are moving assets through the system and recoveries are better than they had originally anticipated. In 2009, Massey Knakal obtained only 16 distressed-asset assignments out of more than 1,000 valuations completed for lenders or servicers on distressed assets. Thus far in 2010, we have obtained 82 distressed-asset assignments. My colleagues at other brokerage firms are seeing the same increase in distressed-asset flow. However, the amount of distressed assets coming to market is still only the tip of the iceberg relative to the total amount of distressed assets that exist in the system.

Additional help to the supply side is the return of discretionary sellers to the market. We have seen these

sellers decide to sell for various reasons. These include portfolio reallocation, lifestyle decisions and tax motivations; the latter has become increasingly important during the past few months. Capital gains taxes are scheduled to escalate significantly in 2011, and, given pending changes on carried-interest taxes, we have several clients that have put properties on the market to try to monetize their assets prior to this anticipated tax increase.

Even though the supply side outlook is getting a little rosier, there is still significantly more demand than there is supply of properties for sale at the moment.

On the demand side, we have seen investors coming into the market from all directions. When we started to first tangibly feel the impact of the credit crisis in the summer of 2007, the institutional capital that helped inflate the asset bubble in the 2005-2007 period essentially evaporated from the marketplace.

Most of the property sales that we have closed since the summer of 2007 were purchased by high-net-worth individuals and the old-line New York families that have been investing here for decades. This segment of the market is still very strong and, recently, we have seen a reemergence of institutional capital. These investors, after taking what essentially amounted to a three-year vacation, have resurfaced with distressed-asset buying funds and opportunity funds that are aggressively looking to acquire properties today.

Joining this demand are foreign-based high-net-worth individuals who have come back to the marketplace in numbers we haven't seen since the mid-1980s. All of this demand has been descending on New York at a time when there is very little supply. This has created conditions under which properties have been selling—and continue to sell—for more than their fundamental economics would dictate they should.

This has effectively created the mini-bubble scenario in which we are at present. It is anticipated that these conditions will remain through the end of this year. But what are we looking at in 2011 and beyond?

Given the uncertainties in the economy, a growing percentage of economists believe that the likelihood of a double dip is increasing. The employment num-

bers have been disappointing, and consumer spending is not nearly at levels anticipated at this point in a recovery. One of the most substantive factors impacting these metrics are the anticipated tax increases that are expected next year. Not only will federal taxes be increasing substantially, it is hard to imagine that state and local taxes are not going to escalate significantly as our legislators struggle to close ever-widening budget gaps.

Add to this the fact that many of the distressed assets that exist are underwater due to 2006 and 2007 vintage loan originations. Many of these will mature in 2011 and 2012. Given the extremely advantageous loan terms that were embedded in these financings, the real problems may not surface until mortgage ma-

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turity. These advantageous terms include significant interest-only periods, interest reserves and floating-rate loans indexed to LIBOR. LIBOR today is about 53 basis points. If a loan is floating at 150 over LIBOR, the mortgage rate is essentially 2 percent. A property with significant negative equity may still have positive cash flow under this scenario. Upon mortgage maturity, these loans are unlikely to be extended by the lender.

Therefore, we believe that mortgage maturity will precipitate more distressed-asset availability than other factors. Consequently, we could have a scenario in which distressed assets continue to come to market over an extended period of time, as it is unlikely that fundamentals will improve quickly enough or to an extent at which they will bail out property owners with significant levels of negative equity.

The two biggest risks that the building sales market faces moving forward are interest rate increases and tax increases.

On the interest rate side, we have been extremely lucky that rates have remained as low as they have. It was anticipated that rates would increase when the Federal Reserve began to exit the market. In 2009, the Fed's balance sheet was doubled, and it was anticipated that the Fed would start to withdraw from the market in 2010. This withdrawal began in early April, when the Fed ceased its asset-buying program. In the prior year, the Fed had acquired roughly \$1.3 trillion of mortgage-backed securities and treasuries. The 10-year T-bill had been hovering around 3.5 percent for an extended period of time. As soon as the Fed stopped its asset-buying program, the 10-year shot up to more than 4 percent.

At this point, the significant economic trouble in Europe (particularly in Portugal, Ireland, Italy, Greece and Spain) precipitated a flight to quality and safety. Tremendous amounts of capital flowed into the U.S. treasury market. This caused a reduction in T-bill rates, dropping the 10-year below 3.25 percent, which is where it stands now. An increase in interest rates would have a significant negative impact on our marketplace. Unfortunately, interest rate increases are certain to be in our future. It is not a question of if—it is simply a question of when.

Our first-half 2010 statistics will be coming out in the next few weeks, and we are anticipating a significant increase in the number of buildings sold, and the dollar volume of those sales, compared to 2009 levels. We also expect to see cap-rate compression continue, exacerbated by the current supply-demand imbalance. We anticipate these positive volume and pricing trends continuing for the balance of the year.

It is, however, unclear if they will continue into 2011. Economic indicators are presenting a puzzling path to navigate. We certainly hope those who believe the economy will double-dip are wrong, but to our dismay, there is more support for this perspective coming to light each month. All of this presents a clear understanding of why so many discretionary sellers are deciding to pull the trigger. Stay tuned. ...

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