# The Value of a Building These Days

## Regulated apartments best bet; offices with market exposure—look out! '09 vs. peaks

One of the most frequently speculated about and most difficult statistics to quantify in our marketplace has been the drop in Manhattan's commercial real estate sales values. Thus far in 2009, a lack of abundant data points makes this difficult, and I have read estimates ranging from 20 percent to 70 percent. Ironically, both ends of this range are partially correct. The reason for this is that we must conduct this analysis utilizing market segmentation in order to get a real sense of how different product types are performing.

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It is important to realize that value is predicated on two volatile items: revenue and yield expectation (operating expenses are fairly consistent on a property-to-property basis). We have seen across-the-board reductions in market rents across all sectors of the marketplace. We have also seen increases in the capitalization rate, or yield, demanded by investors in the marketplace. The combination of these two metrics affects prices per square foot, which, ultimately, determines the relative price fluctuations in the market.

Let's take a look at how each Manhattan property type has performed year-to-date and how this performance compares with peak levels achieved in either 2006 or 2007. The year in which the peak occurred is dependent upon the property type.

• The rent-regulated apartment building sector is, clearly, the best performing. Thus far in 2009, walk-up apartment buildings have had an average capitalization rate of 5.28 percent, up 128 basis points from its low in the first half of 2007, of 4 percent. This increase in cap rate (without taking into consideration revenue fluctuation) equates to approximately a 24 percent reduction in value.

Interestingly, if we look at price per square foot, walk-up buildings are averaging $511 per square foot this year versus their peak of $605. This represents only a 16 percent reduction in value. The reason that this percentage reduction is lower than the cap rate expansion would dictate is because the revenue in the rent-regulated sector (unlike in any other sector) has continued to increase on a building-wide basis even though market-rate rents have declined. This illustrates one of the advantages of rent-regulated buildings in that there is significant embedded upside potential based on the artificially low rents that regulation caps and an owner's ability to increase rent-regulated rents to unlock this potential. This analysis is reflective of this unique dynamic.

• In the elevator building sector, average capitalization rates this year have been 4.08 percent, also up, coincidentally, 128 basis points from their low point in the first half of 2006, of just 2.8 percent. The 2.8 percent cap-rate average in 2006 is reflective of the condo conversion craze during which these buildings were, essentially, selling on a price-per-square-foot basis with little attention paid to yield.

Because we are working off a lower base, this 128-basis-point increase in cap rates corresponds to a 31 percent reduction in value. Similar to walk-up buildings, the price-per-square-foot analysis shows a much more modest reduction in value. The average elevator building in 2009 has sold for $426 per square foot, down from a peak of $532. This is reflective of a 20 percent reduction in value.

• Mixed-use properties are those apartment buildings in which there is a retail component accounting for at least 20 percent of the square footage of the building. Average cap rates in this sector have increased to 6.51 percent in 2009, up from a low of 4.7 percent in the first half of 2006. Here, the cap-rate expansion has been 181 basis points, which corresponds to a reduction in value of 28 percent.

If we look at the average price per square foot for these mixed-used buildings, it's $583 versus a peak of $1,135. This is a reduction value of 49 percent. Here we see that the difference between the imputed reduction based on cap rate is significantly less than the actual price-per-square-foot reduction. This is due to the compounding effect of significant reductions in the market level of retail rents.

• In the retail property sector, average cap rates have increased to 7.44 percent from a low point of 5.39 percent. This increase of 205 basis points would indicate a reduction in value of 28 percent. However, retail properties have seen a drop in average price per square foot from a 2007 peak of $1,987, down to $1,071, a 46 percent drop. This is, again, indicative of the softness in the retail leasing market caused by weak consumer confidence, resulting in anemic consumer spending.

• The office building sector is more difficult to analyze. If we simply look

at the average price per square foot at the peak of $886 and compare it to the 2009 average of $337, we see office buildings, on average, have experienced reductions in value of 62 percent.

However, a clear trend has emerged in this marketplace. Two years ago, office buildings with significant vacancy or short-term lease rollovers were highly sought after by investors in the marketplace wanting to take advantage of skyrocketing office rents. Today, office buildings that possess this market exposure have been trading on a very different basis from those properties with long-term, stable cash flow. Of the handful of office buildings that have sold thus far in 2009, those that had relatively stable occupancy and less market exposure have averaged $663 per square foot. This represents a reduction off the peak of 25 percent.

For properties that had substantial vacancy and/or market exposure caused by significant short-term lease rollover, the average has been a mere $271 per square foot, a drop of 70 percent. Clearly, the market is placing a premium on in-place cash flow today, given the reductions in office rents during this downturn. Recent months have shown positive absorption, which could help to stabilize rent levels.

The office condominium market has performed fairly well. We have seen reasonable activity in the office condo market, where sales prices have averaged $776 per square foot.

• The market for developable land has experienced significant reductions in sales volume. Thus far in 2009, there have been only seven development-site sales, consisting of a total buildable square footage of approximately 207,000 square feet (to put this into perspective, in 2006, Massey Knakal itself sold 53 development sites in Manhattan). Surprisingly, the average price per square foot for these sales is $401. Of the seven, four sites were purchased by users to construct buildings for their own use. The challenges faced by developers in obtaining construction financing is the main contributing factor to the lack of activity in this sector.

• Finally, we will look at what we refer to as "specialty use" properties. These are smaller, vacant buildings that are appropriate for institutional users, such as schools, nonprofit organizations, foreign governments, foundations and the like. In this sector, there were five sales that averaged just in excess of $1,000 per square foot.

Based upon this analysis, easy to see clearly a significant ference in value reductions ba upon the segment of the market. range is substantial: Walk-up apa ment buildings have, on a price-p square-foot basis, only dropped 16 percent, creating one end of range; and office buildings with s nificant vacancy or market exposu have dropped by 70 percent.

It appears there is at present m downside risk than upside in the direction of prices as move forward. As always, we watching unemployment very ca fully and are making the assur tion that our fundamentals, in ter of market-rent levels, will hit a point around the same time that employment hits its cyclical pe Most economists project that peak will be reached in the first of 2010. It is at this point that va should stop going down.

After a bottom has been est lished, how quickly we rise from t bottom will be dependant upon battle between all of the capital ting on the sidelines waiting for portunities (which will create ward pressure on pricing) ver

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the massive de-leveraging that market must go through because the distress that is tangibly emb ded in so many of our overlevera properties (which will continue exert downward pressure).

We also need our debt markets come back to life. The incredible mand for refinancing between n and 2013, which is estimated by so to be as much as $2 trillion, can be satiated by the banking and surance industries, even if they operating at full throttle. Access public capital is the only way we come close, meaning that CMBS, one form or another, must be aw ened from its hibernation. With this, the slogging could go on mu longer than any of us would like.

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