Water and Diamonds and ...

How big supply-and-demand imbalance has upended pricing—and what could right it

BY ROBERT KNAKAL

Do you remember college? Do you remember Economics 101? In Econ 101, we studied Adam Smith's famous Paradox of Diamonds and Water. Even though life cannot exist without water and can easily exist without diamonds, diamonds are pound for pound vastly more valuable than water. While marginal-utility theory of value resolves this paradox, scarcity of goods is what causes humans to attribute value. If we had an unending abundance of both water and diamonds, we probably wouldn't value either very much.

The diamonds and water analogy is representative of quintessential supply-and-demand fundamentals. An acute supply-and-demand imbalance in New York's building sales market is creating dynamics that are perplexing to many of us active in the building-sales sector, as properties are currently selling for more than they probably should be.

In 2009, the volume of investment sales in New York City had fallen to $6.3 billion from $62.2 billion in 2007, a 90 percent contraction. The number of properties sold fell to 1,439 from 5,018, a 71 percent drop. Many people who track the market felt that the reason volume was so low was because investors did not have interest in purchasing properties given the stresses that were obvious to all of us. Nothing could be further from the truth. We believe the overwhelming reason why volume was so low was because of a severely supply-constrained environment. Dollars were water and buildings for sale were diamonds. This dynamic continues into 2010, as significant stockpiles of capital sitting on the sidelines continue to fight over a very scarce supply of available properties for sale.

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To fully appreciate the extent of our supply-constrained environment, we must consider that there is rarely a plentiful supply of available properties for sale in New York. Going back 26 years, the average turnover rate, within the statistical sample of approximately 165,000 buildings, has been only 2.6 percent. This is a remarkable statistic that indicates that, when a property is purchased, the average holding period of that asset is approximately 40 years. The 2009 turnover rate fell to 0.87 percent, representing an average holding period of about 115 years.

The supply of available properties is typically fed by discretionary sellers—i.e., those who are not forced to sell for any reason. When value falls, as we witnessed in 2008 and 2009, discretionary sellers withdraw from the marketplace and, as when this has happened in the past, the supply of available properties is fed by distressed sellers. Thus far in this cycle, this dynamic has not occurred.

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Everything that has happened from a regulatory perspective has allowed distressed sellers to avoid acting. These regulations consist of modifications to the FASB mark-to-market accounting rules; bank regulators allowing banks to hold loans on their balance sheets at par even if they know the collateral is worth much less; and modifications to the REMIC guidelines providing some leeway in how servicers and special servicers deal with securitized loans.

These reasons, coupled with the fact that highly accommodative monetary policy from the Fed is allowing for a substantial recapitalization of the banking system, has created a disincentive for distressed sellers to place assets on the market, thus constraining the available supply.

While supply has been constrained, the demand side has been booming. During the bubble-inflating years of 2005 to 2007, much of the run-up in prices was caused by the massive amount of institutional capital that was seeking real estate investments. When we started to tangibly feel the credit crisis in the summer of 2007, this institutional capital all but evaporated from the market.

In fact, more than 95 percent of the transactions we have closed, since the summer of 2007, have been purchased by high-net-worth individuals and the old-line New York families that have been investing in New York City properties for decades. After a noticeable hiatus from the landscape, institutional capital has seen a resurgence, as many of these investors have formed distressed-asset-buying funds or opportunity funds to acquire real estate at our new, lower price levels.

We have seen this institutional capital actively participating in the bidding process on a majority of the more than 500 assets that we currently represent exclusively for sale on the market. At the same time, the high-net-worth individuals and families continue to actively pursue purchasing opportunities.

Additionally, we have seen high-net-worth foreign investors come into the marketplace in numbers not seen since the mid-1980s. Demand from this sector has been stimulated by the perception that everything in New York is cheap, relative to where the values have been, and the fact that the U.S. dollar is low relative to many foreign currencies.

For these reasons, foreign-sector demand has been extraordinarily high. These investors, typically not real estate people but those who have made money in other industries, have been looking at New York City properties as if they are safety deposit boxes, purchasing, in almost all cases, on an all-equity basis. They also believe that over time, the U.S. dollar will appreciate at a faster rate than their own currency, thus providing a currency arbitrage as well as a real estate opportunity.

For these reasons, supply-and-demand dynamics are completely imbalanced today. This is the main reason why dozens of offers have been obtained on every income-producing property we have sold recently and why we have obtained more than 50 offers on every note sale that we have completed, which has been collateralized by New York City properties.

These reasons are also why properties are trading for more than their economic fundamentals would dictate. On the notes that we have sold, we believe pricing has been 95 percent—or more—of collateral value. While these prices represent varying discounts to par, it is clear that investors are paying almost as much for the notes as the properties are worth. Competitive bidding is the reason for this.

Another reason why properties are selling for seemingly high prices is the relatively low yield available on alternative investments. Keeping cash in the bank today will likely yield less than 50 basis points of return, in most cases. Based on the perception that many investors have that interest rates are going to rise, the bond market has not been a favored destination for investment dollars. For instance, investors are fleeing the municipal bond market out of fear of municipal defaults and the massive amounts of unfunded pension obligations carried by most jurisdictions.

Additionally, many investors view the stock market as being overbought, as earnings have surpassed expectations in many cases. However, the majority of these earnings have been created by cost cutting as opposed to top-line revenue growth. These earnings are not sustainable over the long term, as it is impossible to cut expenses to zero and still produce revenue. For these reasons, modest returns on commercial real estate investments are being accepted by participants in the marketplace.

We do believe, however, that the supply of available properties for sale will increase as we move throughout 2010, and into 2011 and 2012. We have seen an increase in the flow of distressed assets. During this cycle, Massey Knakal has done more than 1,000 valuations for lenders and special servicers to let them know the value of their underlying collateral. From September 2008 to September 2009, we were retained on only 12 occasions to dispose of these distressed assets. Since October 2009, we have received 57 assignments.

While we are seeing a significant increase in the number of distressed asset availabilities, what has come to the market is still only a drop in the bucket compared to the number of distressed assets that exist in the system.

We believe that, in New York City alone, there are 15,000 properties that have mortgage balances in excess of the property value. On these underwater assets, there is approximately $165 billion of leverage. Taking into consideration today's value levels and the underwriting standards employed by lenders today, there should be only about $65 billion in leverage on these assets. This means that there is approximately $100 billion of excess leverage in the market today.

Clearly, not all of this leverage will be extracted from the marketplace. Some properties will be able to cash flow even at 90, or 100, or 110 percent loan-to-value ratios. Other assets that owners want to hold long term will be serviced as owners take capital from alternative sources to feed properties that are in a negative equity position. Other transactions will be worked out between the lender and the borrower. However, we believe that before the dust settles in this cycle, the marketplace will have to absorb $30 billion to $40 billion in losses.

This will occur not via the tsunami that was expected to occur a year ago, but rather in the form of small, rolling waves that occur based more upon mortgage maturity dates than anything else. Some of these properties are hanging on by a fingernail, as mortgages may still be in interest-only periods, are surviving based upon interest reserves that were established at the origination of the loan, or because they are floating over LIBOR, which is miniscule today.

We believe supply will increase as these distressed assets come to market, and also as discretionary sellers start to come back into the market, realizing that significant appreciation, in the short term, is not likely. With properties selling at relatively good prices, given current market conditions, we believe discretionary sellers will, once again, start to feed the supply of available buildings for sale. As these properties join the distressed assets that are coming to the market, supply will increase, and this dynamic will lower prices.

Without a doubt, it will be very interesting to see what happens to prices as supply inevitably increases. Whether dollars continue to be water and buildings for sale continue to be diamonds will help determine the direction and magnitude of pricing in the future.

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