What's Next

On employment; building supply and demand; financing and refi; and life after de-leveraging

As we approach the end of 2009, I thought it would be worthwhile to take a look at some of the most pronounced trends that we are seeing in the New York City investment sales market. We will take a look at fundamentals, supply, demand and credit, and how they are affecting our marketplace.

Fundamentals

It has been clear that our fundamentals, in terms of rental rates and occupancy levels, have degraded as the recession continues to chug along and, most importantly, unemployment continues to climb. Notwithstanding the positive jobs report on Friday, it is clear that unemployment is, and will remain, at elevated levels for the foreseeable future.

Robert Knakal
Columnist

This is particularly true when you take into consideration those who have stopped looking for work and are no longer counted as unemployed and those who are underemployed, meaning they are working part time but would like to be working full time. With 11,000 net jobs lost in November, the only way the unemployment rate could have declined from 10.2 percent to 10.0 percent would be if significant numbers of people simply stopped looking for work.

These conditions have exerted significant downward pressure on rents across all sectors. Clearly, the reductions in rent levels vary market to market and building to building, but here is what we are seeing and hearing. In the multifamily housing market, we have seen residential rents for free-market apartments drop 20 to 25 percent if rent concessions and promotions are taken into consideration (rent-regulated rents continued to rise, helping the performance of this sector). In the retail sector, we have seen reports showing retail rent declines from as low as 25 percent to as much as 35 percent. In the office sector, reports show declines in rent of 33 to 40 percent, again including concessions that are at present extensive. The negative impact on building revenue has resulted in lower net operating incomes and lower values.

In addition to net-income declines, we have seen cap-rate expansion across all property segments. This cap-rate expansion has affected multifamily properties the least, with increases of 123 basis points for walk-up buildings and 145 basis points for elevator properties. Mixed-use and retail properties have seen expansions of 189 and 205 basis points, respectively. Cap-rate expansion in the office building sector has been 189 basis points from the low point. The combination of reduced revenues and cap-rate expansion has lowered values by 34 percent through the first week in November of 2009 from their peak.

Real estate taxes are something we are watching very closely. The new tax rates for 2009 and 2010 have been announced recently, indicating increases of 9.1 percent for multifamily properties and 0.6 percent for commercial properties. These increases do not seem overly onerous given the fiscal position of the city. We must, however, keep in mind that due to the way they are calculated, tax assessments are continuing to rise even with the reductions in value that we have seen. We believe that an even greater increase in real estate taxes will be unavoidable moving forward.

Supply

The volume of sales has been extraordinarily low, with volume, on an aggregate sales price basis, down 92 percent from the peak, and the number of buildings sold down 74 percent (the differential clearly shows a bias towards small transactions, which are much easier to finance). It is widely thought that the low volume of sales is based upon a lack of buyer demand or a significant gap in what is referred to as the bid-ask spread.

We believe that these miniscule volumes have been created by supply constraint much more so than by a lack of demand. Discretionary sellers have been reluctant to put properties on the market, and those that are selling today have some compelling reason to do so.

We have also seen very few distressed assets coming to market, as everything that has happened legislatively is allowing lenders to keep bad loans on their balance sheets without bringing them to market. This dynamic has started to shift, as we have seen an increasing interest on behalf of lenders to sell REO properties (which they are just beginning to do, as the foreclosure process is longer today than it has ever been) and to sell notes based upon a desire to monetize the asset without going through a prolonged foreclosure process. As this trend continues, we expect to see gradual increases in supply.

As the Bush tax reductions expire at the end of 2010, and capital-gains taxes are constantly targeted as a source of more revenue for government initiatives like health care, the potential increases in capital-gains taxes could create added supply in 2010 as sellers try to sneak in under the wire.

Demand

We have seen significant shifts in demand drivers in the marketplace over the past several years. The bubble that was created in the 2005-2007 period was exacerbated mainly by massive amounts of institutional capital that were seeking real estate investments. When the credit crisis tangibly started to take hold in the summer of 2007, this institutional capital all but evaporated from the marketplace. Since August of 2007, more than 95 percent of our transactions were sold to high-net-worth individuals and old-line New York families, which have been investing in the city for decades. Recently, we have seen a reemergence of institutional capital coming back to the marketplace in the form of distressed-asset-buying funds.

We have also witnessed the resurgence of foreign capital in numbers unlike anything we have seen since the mid-1980s. This foreign capital is coming predominantly from high-net-worth individuals who are not typically full-time real estate professionals. These investors have made money in other industries and are using Manhattan properties as safe deposit boxes for their capital. Recently, we have sold three properties to foreign investors who have used little or no debt. The building at 115 West 57th Street was sold to a Japanese investor for $5.8 million; 901 Broadway was sold to a Spanish investor for $24.6 million ($1,700 per square foot); and, just last week, we closed on the sale of 33 West 46th Street, a 37,000-square-foot office building for $11 million, or approximately $300 per square foot.

Given how strong demand has been, we have been able to get 25 to 35 offers each on the majority of the income-producing properties we are selling. Each note that we have sold this year, whether performing, sub-performing or nonperforming, has generated more than 50 offers. These tremendous numbers are due to the fact that there is very little for sale and there are many investors competing over a very thin supply of available properties.

We are advising clients—and it is very difficult to do without sounding completely self-serving—that if a sale is contemplated within the next year or two, now is an excellent time to sell given the lack of supply on the market. It is our belief that, one year from now, the supply of available properties will be significantly greater, as lenders will be more aggressively dealing with troubled loans on properties that will fall victim to the massive de-leveraging that the market must go through before correction can begin.

Credit Markets

We have been encouraged recently by the performance of the credit markets. Clearly, our regional and community banks have benefited from rent regulation, which exists in the majority of the properties that these lenders provide capital for. Across the nation, these very banks are the ones that are being taken over by the F.D.I.C. (130 year-to-date), as some of them have well over 100 percent of their risk-based capital tied up in commercial real estate development projects. That has not been the case here, as the community and regional banks have been consistently lending, particularly in the multifamily sector, throughout this crisis.

Large commercial and money center banks have, however, either been out of the commercial real estate lending business completely or have scaled back their lending platforms significantly.

The demand for refinancing that will exist over the next two to three years exceeds the capacity of the commercial banking and insurance industries combined. The shadow banking system provided approximately 40 percent of the leverage on commercial real estate transactions during our last cycle. This shadow banking sector, led mainly by CMBS, has all but evaporated from our marketplace. Issuance declined to only $12 billion in the first six months in 2008—it was a $230 billion industry in 2007—and there had been no CMBS issuance from July 2008 until recently.

The recent $400 million Developers Diversified Realty transaction was a tremendous shot in the arm to get this securitization market flowing again. While this was done at a very conservative 50 percent loan-to-value ratio, there is another transaction in the pipeline, which will be securitized by JPMorgan for about $600 million, that is projected to close at approximately 75 percent loan-to-value.

While the TALF and PPIP programs have not produced nearly the numbers that were anticipated, it is clear that credit spreads have been brought in considerably just based upon their sheer existence. These programs, which were well intended and based upon market conditions at the time they were conceived, would have been much more beneficial to the marketplace if those conditions still existed. Their positive impact on credit spreads, however, cannot be denied.

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While our commercial real estate market has a long way to go to get back on its feet, we are clearly heading in the right direction. Our fundamentals appear to be approaching a bottom, and with that, the downward trajectory of value will reverse as well. We expect supply will rise as lenders increasingly seek to resolve troubled loans. This will satiate the excessive demand that is prevalent in the market and continues to grow day by day. Access to public capital will be a key to our ability to meet the demand for refinancing, and recent activity in the CMBS market is encouraging.

Our market is clearly cyclical, and the sooner we are able to get through our de-leveraging phase, the sooner we will be on the road to recovery.

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