CONCRETE THOUGHTS

Further Forecasting for Investment Sales

Rates, housing, deleveraging and, yes, supply and demand—what to watch for

EXECUTIVE SUMMARY:

- → Low interest rates are the most important factor in a strong investment-sales market's pricing.
- → The housing market recovery means healthier consumer spending; this is good for investors.
- → The speed of the deleveraging process will impact the market. The faster, the better.
- → Demand is picking up. The supply side must be closely watched as deleveraging continues.

Last week, we began our examination of the different indicators we are consistently observing in the broader marketplace. We do this in order to try to determine the likely direction and magnitude of fundamental fluctuations in the investment-sales market. These indicators impact our underlying real estate fundamentals and have profound impacts on our two most important metrics, the volume of sales and the relative level of property values.

Last week, we looked at employment as well as government and Federal Reserve policy. This week we will examine inflation and interest rates; housing; deleveraging; and supply and demand.

Inflation and Interest Rates

Inflation is always a concern because if the rate of inflation exceeds the 1 percent to 2 percent range, which represents the Fed's comfort zone, it would exert pressure on the Fed to raise interest rates.

Perhaps the most important factor in the investment sales market's relatively strong pricing is that the interest rate environment has remained at or near historic lows (supply-demand dynamics is the other one, which we will discuss later in this column). If interest rates were 150 or 200 basis points higher, the level of distress in the market would be significantly higher than it is today. LIBOR has been hovering around 25 to 30 basis points, and the 10-year treasury closed last Friday below 2.5 percent. These low rates are allowing lenders to keep borrowing rates low.

Robert Knakal
Columnist

Many distressed assets with significant negative equity positions are hanging on by a fingernail based upon extremely advantageous mortgage terms obtained in many of the 2006 and 2000 vintage loans. Today's low rates, particularly for loans that are floating over LIBOR, are allowing distressed assets to throw off positive cash flow even though their equity positions are severely negative. Owners in this position have no option but to wait out the market to see if appreciation can possibly bail them out. This, of course, assumes that these owners do not have, or do not have the desire to inject, the additional equity required to effectuate a refinancing, taking advantage of today's low rates.

Two weeks ago, the chief economist at Merrill Lynch issued a forecast indicating that he believes the 10-year treasury yield will drop to 1.75 percent in 2011. This is an extraordinarily bearish forecast for the broader economy, but indicates that lending rates should be very low for real estate investors looking to refinance or obtain acquisition loans. It also indicates that, with yields on alternative investments at very low levels, modest returns on real estate investment will be viewed very positively by the investing community.

Housing

Another market we keep close tabs on is the housing market. The reason for this is that 70 percent of the U.S. gross domestic product is consumer-based, and for most consumers, their house is their major asset. As perceived equity levels in their homes rise or fall, it creates a wealth effect that impacts consumer behavior. As perceived equity rises, consumers are more willing to spend, injecting adrenaline into the economy.

The biggest concern in the housing market is that artificial influences have increased the likelihood of further decreases in housing values. The first-time home buyers tax credit stimulated activity in the marketplace but, unfortunately, has potentially negative implications for the housing market.

The credit did not allow housing to reach its natural bottom, as the government was literally paying people to buy homes. The $8,000 credit exceeded the down payment on the average U.S. home by a significant margin given the low 3.5 percent down payment requirement for most FHA loans. Due to trouble experienced by Fannie Mae and Freddie Mac, most home buyers turned to FHA for residential financing. Not only were purchasers buying homes with no money down, the credit often exceeded the down payment amount, allowing purchasers to "cash out" when purchasing a home. Wasn't this the same dynamic that got the housing market into trouble in the first place?

The housing market must be allowed to clear and to begin to heal. For this reason, the current foreclosure moratorium implemented by major banks will further delay a sustainable recovery within the housing market. This moratorium has been the result of the discovery that perhaps a clerical paperwork error could nullify the foreclosure process. In 23 states, judicial foreclosures require lenders seeking to seize property from a delinquent borrower to file a summary judgment motion in court. If the wrong person at the bank signed the foreclosure documents, it could jeopardize the validity of the lender's claim.

If any evidence emerges that lenders are dislocating people from their homes improperly, the violators should be investigated and prosecuted. However, no one is aware of a single case, so far, where someone has been evicted from their home without proper cause. This foreclosure moratorium is yet another setback for the housing market, which desperately needs to find a natural bottom. The clearing of excess inventory and processing foreclosures as quickly as possible will allow for the sustainable recovery the market requires. The moratorium will do nothing to delay the inevitable and add to the already substantial amount of uncertainty in the market.

A clear and sustainable recovery in housing will be positive for the economy and, consequently, for the commercial real estate investment sales market.

Deleveraging

Given the shifts that have occurred in the marketplace since the peak in 2007, no one doubts that the market must persevere through a massive deleveraging process. In New York City alone, we estimate that at one time there were more than 15,000 properties with negative equity positions. These properties represented approximately 9 percent of the total stock of buildings in the city.

Through additional equity payments, loan modification or foreclosure, these properties must be recycled, resulting in reduced debt amounts.

The speed with which this deleveraging process occurs will have a significant impact on the marketplace. As banks and special servicers become more aggressive, this deleveraging process will quicken, adding significantly to the supply of available properties. This additional supply exerts downward pressure on value. To the extent banks and special servicers move more slowly, it reduces the available supply of properties, exacerbates pent-up buying demand, and exerts upward pressure on value. Unfortunately, this delays the inevitable recycling that must occur for those assets.

> *The housing market must be allowed to clear and to begin to heal.*

To some extent, the speed of this deleveraging process will be based upon mortgage maturity. Vintage loans from 2006 and 2007, which are those that are the most distressed, predominantly have maturity dates in 2011 and 2012. While many of these assets have significant negative equity positions, they have maintained positive cash flows based upon the extremely advantageous loan terms that were available during the boom years. Interest-only periods and interest reserves are evaporating regularly as loans mature. Floating mortgage rates, which are indexed to LIBOR, are unlikely to be extended given the rates available to lenders on mortgage debt today.

Therefore, mortgage maturity will precipitate the flow of distressed assets and is likely to determine the speed with which this deleveraging process occurs.

Supply and Demand

Last, we will look at good old-fashioned supply and demand. In order to try to determine in which direction the market is headed, we must look at trends within the supply of available properties and must also consider what the demand side of the equation looks like.

In 2007, we had $63 billion worth of investment-sales transactions in the New York City marketplace. This amount dwindled to just $6.2 billion in 2009. Many people blame this 90 percent reduction in transaction volume on either a lack of buyers in the marketplace or the oft-mentioned bid/ask spread.

The first of these reasons is clearly not appropriate, as throughout the worst points during the recession, there was still significant buyer interest in New York City investment properties. As to the second reason, there may have been a slight bid/ask spread dynamic; however, supply constraint had much more to do with the reduction in volume than anything else.

The supply constraint condition is easy to understand when we look at the market from a macro perspective. The supply of available properties for sale is normally fed by discretionary sellers. When value drops, as it started to in 2008, discretionary sellers withdraw from the marketplace, as they could have sold their properties for higher prices previously. As discretionary sellers withdraw, distressed sellers normally swoop in to fill the void.

However, during this recession everything that has happened from a regulatory perspective has allowed distressed sellers to delay facing their problems. Whether they were changes in FASB mark-to-market accounting rules; bank regulators allowing lenders to hold loans on their books at par, even though the collateral is worth substantially less; or changes to REMIC guidelines for dealing with securitized loans, each of these have provided distressed sellers with cover not to take action.

We are now seeing distressed assets come to market with greater frequency as lenders and special servicers seek to clean up balance sheets. We're also seeing discretionary sellers come to market with assets, as there has been significant pent-up selling demand. Discretionary sellers are also reacting to the anticipated increase in capital gains rates, adding properties to the available supply for sale.

Thus far, this added supply has not exerted significant downward pressure on value. A regulatory change impacting how banks handle their loan portfolios could have a significant impact on supply. We do not believe that this will occur, however, as it could have devastating repercussions for hundreds of banks across the country.

On the demand side, we've seen significant buying interest from all segments of the marketplace. In the summer of 2007, when we first started to tangibly feel the impact of the credit crisis, the institutional capital that inflated the asset bubble in the 2005 to 2007 period evaporated from the marketplace. Most of our transactions since that point in time were acquired by high-net-worth individuals and New York families who have been active purchasing properties here for decades. Recently, we have seen a reemergence of institutional capital, which is back in the marketplace with distressed asset buying funds and opportunity funds. They are joined by foreign high-net-worth investors who have come to the New York marketplace in numbers we haven't seen since the mid-1980s.

Therefore, the demand side of the equation is in high gear. We will be focused on monitoring the supply side to try to determine what volume trends will look like as we move forward. The available supply of properties for sale is likely to have more of an impact on the future of the investment sales market than any other factor.

rknakal@masseyknakal.com

Robert Knakal is the chairman and founding partner of Massey Knakal Realty services and in his career has brokered the sale of more than 1,100 properties, having a market value in excess of $6.8 billion.