CONCRETE THOUGHTS

Supply and Demand

In this week's column, we will examine the current condition of supply-and-demand drivers that are impacting the commercial real estate investment sales market in New York City.

We will be discussing supply and demand from a macro perspective and the nature of its impact on today's market without getting too granularly into the numbers. We are presently in the process of finalizing third-quarter 2011 (3Q11) statistics and will have a very detailed statistical analysis for you in two weeks.

It is easy to understand that supply-and-demand dynamics impact the value of something, in this case commercial real estate properties. But it is also true that supply-and-demand dynamics impact the volume of transactions as well. Volume and value are the two metrics we watch most closely to determine how the market is performing. They are also the two things that must be addressed to answer the most frequently asked question in our industry, "How is the market today?"

Clearly, we are experiencing a very interesting time, as there has been a tangible impact on the market over the past four to six weeks given uncertainties based, primarily, upon European economic conditions. Most economic indicators are trending downward, creating stresses in the global capital markets. For commercial real estate, these conditions have led to disconnections within the financing markets, particularly the C.M.B.S. market, which has impacted transaction volume, particularly in the larger property sector. There are still transactions occurring, but it would not be surprising to see the dollar volume of sales dip below expectations. Whether the number of properties sold increases or decreases, in a quarter-over-quarter analysis, will be largely dependent on the supply of available properties.

Many market participants tie market activity to demand but the activity level is much more sensitive to supply than to demand, especially in New York. It is interesting to note that supply, more than any other factor, impacts the number of properties sold in the city. This is particularly true in New York City, which is arguably the most sought-after destination for real estate investment capital worldwide.

Robert Knakal

Going back to at least 1984, there has never been a time (with the possible of exception of 1992) when demand has not significantly exceeded the supply of available properties in New York.

If you are a frequent reader of Concrete Thoughts, you know that I like to use the Manhattan submarket as a barometer of New York City's market in general. Since 1984, the average turnover rate of the total stock of approximately 27,600 buildings in Manhattan (south of 96th Street on the East Side and south of 110th Street on the West Side) has averaged 2.6 percent. In other words, the average holding period for an asset is a remarkable 40 years.

The highest turnover we have ever seen was 3.9 percent, achieved in 2007, and the lowest turnover we have ever seen prior to 2009 was the 1.6 percent experienced in 1992 and again in 2003. These were both years at the end of recessionary periods and years in which we had peaks in cyclical unemployment.

In 2009, the turnover ratio dropped to an anemic 1.17 percent, a figure that we believe is an all-time low for the city (we're still researching 1975 and 1976, when the city almost went bankrupt). The general perception is that the reason for 2009's low volume is either that buyers were not interested in buying properties at that time or that the infamous "bid-ask spread" was too large.

We believe the reason turnover was so low in 2009 was primarily due to supply constraints. In a typical market, the supply of available properties for sale is fed by discretionary sellers who decide, for one reason or another, that now is the time to sell. Generally, in a consistently appreciating market, discretionary sellers come and go based on changes in investment objectives, reallocation of capital within portfolios, the implementation of different investment strategies or simply for personal reasons.

When the market cycle turns and values drop, these discretionary sellers generally exit the market, as they choose not to sell today for a lower price than they could have obtained yesterday. Distressed sellers will typically move in to fill this void but that entrance into the market does not occur overnight. We observed a period in 2009 when discretionary sellers were all but extinct and distressed sellers had not yet progressed to the point where they were ready to act.

By 2010, we saw a significant flow of distressed asset sales, particularly in the note-sale area, which added greatly to the available supply of properties. In fact, we believe note-sale activity rivaled the dollar volume of property sales, many of which slid into the distressed category.

Most of this distressed activity emanated from banks trying to clean up balance sheets. In 2010, approximately 75 percent of the note-sale activity came from banks while 25 percent came from special servicers. In 2011, it appears that these percentages have inverted and most of the activity is coming from special servicers, although they are not being nearly as aggressive as banks were in 2010. This observation is absent the $10 billion Anglo Irish Bank transaction, a significant portion of which was collateralized by New York City properties.

We believe the reason special servicers are not adding to the supply of available properties as quickly as we anticipated is the fact that we are operating in an extraordinarily low-interest-rate environment. Variable-rate 2006 and 2007 vintage loans may be floating at as little as 100 or 150 basis points over LIBOR, which means that debt-service payments may be based on an interest rate of less than 2 percent today. This leaves hundreds of New York City properties in a zombie position where they have significant negative equity but positive cash flow. These assets are more likely to come to market precipitated by mortgage maturity rather than a lender or special servicer taking proactive action.

Today we have conditions where the institutional capital is plentiful, high-net-worth individuals and families are competing and foreign capital is being injected into the market in significant amounts given the uncertainty that envelops the global markets.

We have seen significant price appreciation, particularly for Manhattan properties, which is encouraging discretionary sellers to return to the market as they view opportunities to realign portfolios and take advantage of distressed assets, which we believe will continue to come to the market throughout this year and next, and possibly well into 2013. We also see some price appreciation in various asset classes in some neighborhoods in the outer boroughs, which is encouraging discretionary sellers there to return to the market as well.

Therefore, the supply side seems to be increasing nicely, which will directly impact sales volumes on a number-of-properties-sold basis.

With respect to demand, I am often asked who the buyers are in the marketplace today.

To have a better perspective on the condition of demand today, it is important to take a look back on how the typical buyer profile has changed over the past several years.

In the asset-bubble-inflating years of 2005–'07, much of the activity was driven by the massive amounts of institutional capital raised by hedge funds, opportunity funds and private equity funds to purchase commercial real estate. Much of this capital was raised in the hopes of finding properties in prime Manhattan locations. However, the amount of capital raised was far in excess of the supply that existed. Therefore, this capital expanded its geographical parameters and we saw, for the first time, institutional capital attracted to properties in northern Manhattan and the outer boroughs (particularly the Bronx).

This capital also was able to take great advantage of the C.M.B.S. market, which was absolutely on fire in 2007 as it hit an all-time peak of $230 billion of issuance nationally. This very aggressive institutional capital squeezed out private operators and families who had long been a staple in many of these neighborhoods.

By mid-2007, we started to feel the first tangible signs of the credit crisis and the overwhelming majority of the institutional capital—which had been aggressively buying—essentially evaporated from the marketplace. By late 2007 through 2009, most of the properties we sold were acquired by high-net-worth individuals or the old New York families that had found significant challenges trying to compete with the institutional capital previously.

In 2009, we also saw a tremendous resurgence of foreign high-net-worth individuals who were looking to acquire properties

in New York that they believed were being sold at fire sale prices. By 2009, the average price per square foot in Manhattan was 32 percent below where it was at the peak, and through 2010 that drop had grown to 38 percent below peak.

By 2010, institutional capital players who had been quiet for a couple of years returned to the market. While the amount of dollars raised for distressed-asset-buying funds and opportunity funds has been significant and has impacted the sales market, this capital has not been nearly as dominant as it had been in the 2005–'07 period, allowing private operators and families to compete. This is due to a combination of that institutional capital's being less aggressive than in previous years and the fact that leverage is not available at the loan-to-value ratios that we had seen during those asset-bubble-inflating years. Institutional capital was attracted to the returns on the equity that highly leveraged properties provided.

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While counterintuitive, it's also interesting to see that after S.&P. downgraded the credit rating on long-term U.S. debt, the 10-year Treasury rate plunged as a flight to safety was observed. Foreign investors, high-net-worth individuals and institutional capital players have been scouring the city looking for properties to acquire. From foreign sources, we have seen significant direct investment in commercial and non–rent regulated properties and significant investments in the rent-regulated sector in the form of equity financing more than from direct investment.

This foreign capital is plentiful, and it's coming from all over the world. Brokers at Massey Knakal are currently working with investors from Canada, Israel, Germany, China, Argentina, Brazil, Russia and countries throughout the Middle East. Very surprisingly, we have seen private individuals from countries that are suffering economic problems much worse more than our own such as Greece, Italy, Ireland, Portugal and Spain who are looking to acquire assets here. Perhaps it is not strange to think that high-net-worth individuals in these countries are looking for relatively risk-averse investments and relatively safe assets to acquire in the U.S., as opposed to keeping net worth tied to local assets.

Current market conditions dictate that demand remains far in excess of supply. This condition, mixed with historically low interest rates, prompts the question, "Are the prices being paid today inflating yet another asset bubble?" It is indisputable that a low-interest-rate environment creates asset bubbles and only time will tell if investors buying today are being too aggressive. Sellers who believe this are taking advantage of these conditions and are electing to sell today.

In two weeks, we will provide empirical data relative to how 3Q11 activity compares to the second quarter and how activity thus far in 2011 is comparing to last year and the peak of the market. Until then ...

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