

What Time Is It? (We Mean Right Now)

One question on everyone's mind these days is where we are in the investment sales market cycle in New York City.

There is a significant divergence of opinion on this topic. The most popular perspective is that we are in the late stages of the cycle. Some feel we are at the very end of the cycle. And an even smaller percentage believe the opinion I have expressed in these pages, which is that the old game is over and we are in the early stages of an entirely new cycle.

Today, we take a look at this issue, and I will present some information from which you can draw your own conclusions.

The Great Recession began to take hold in late 2007, causing significant disruption in the market. In 2008 and 2009 the volume of sales in New York, both from a dollar and number-of-properties-sold perspective, dropped extraordinarily. By 2009, the number of properties sold had fallen by 76 percent, and the dollar volume had dropped by an astounding 90 percent. As is typically the case, values

didn't bottom out until 2010, during which volumes began to rise.

Starting in 2010, the market saw steady improvement in volume metrics as well as values. In 2014, the number of properties sold,

which is the metric most indicative of market activity (the dollar volume metric can be skewed by a few large transactions), hit a cyclical peak and an all-time record of 5,534. This was a record by more than 10 percent. Dollar volume reached its all-time record in 2015 at \$77.1 billion.

While 2015 was a record year in dollar volume, by the beginning of the fourth quarter, stresses were

being felt. These were the same conditions that played out in 2007.

By the beginning of fourth-quarter 2015, the land and hotel markets began to turn as they normally do at the beginning of market corrections. Heading into 2016, our forecasting was that dollar volume and the number of properties sold would drop significantly, and values would end the year lower than

they started the year. Citywide, the number of properties sold dropped by 16 percent (30 percent in Manhattan), and dollar volume fell by 25 percent (34 percent in Manhattan)

Meanwhile, values, on an annual basis, finished 2016 9 percent higher than 2015's average on a price-per-square-foot basis. The troubling fact about values—although they finished the year at record highs—was that they declined quarter-over-quarter throughout the year, exactly as they did in 2007.

Throughout 2016, underlying fundamentals degraded. Residential rents were the first to fall and have been in decline for about a year. Retail rents are falling in all 11 retail submarkets that Cushman & Wakefield tracks, and office rents have started to fall after six to nine months of ballooning concession packages. At the same time, we have seen upward pressure on interest rates. This combination does not bode well for property values.

However, even in light of these dynamics, there is a counterintuitive, yet tangible, optimism seeping into the market. Recent activity on land offerings has been better than we have seen in about 18 months. The supply of

available properties is dismally low, and while a number of investors are “waiting these conditions out,” the flow of capital locally, domestically and internationally is expanding.

The promise of tax reform could be an explanation. This is, however, potentially a double-edged sword. Tax reform could be extremely positive for commercial real estate capital markets but could also be devastating. Tax rates, capital gains taxes, 1031 exchanges, depreciation schedules, carried interest tax treatment and interest deductibility could all have profound implications for the investment sales market.

From my perspective, the “new game” began in the fourth quarter of 2015. This downturn appears to be mild, just as the recession in the early 2000s proved. Others believe the game is still going and has a few innings left.

One thing is for certain, the ingredients in tax reform will tell us a lot about how the game will play out whether we are in a new game or the old one is still ongoing.



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