



Realty Services

Message from the Chairman:
Forecasting for Investment Sales
October, 2010

In many of my “Concrete Thoughts” columns for *The Commercial Observer* and in many of the market reports produced by Massey Knakal, we not only report on what has happened in New York's investment sales market but forecast what we believe will occur in the future.

In this article, I will give an overview of the indicators that we rely on to make our forecasts. Some of these are very big-picture in nature, but connecting the dots between macroeconomic factors and our local real estate market is what we are constantly attempting to accomplish.

The two main metrics we discuss when talking about the relative health of the investment sales market are the volume of sales and the level of values. These two indicators provide the best snapshot illustrating how the market is currently performing, particularly relative to past performance. The volume of investment sales in the New York City marketplace has clearly been improving steadily since early 2009 (although third-quarter 2010 performance looks like it may have suffered a setback). Additional activity in the distressed-asset market, from both banks and special servicers, has helped with volume increases.

Reaction to tax policy, namely the anticipated increase in the federal capital gains tax, and a return to more normal levels of activity, have helped boost volume in the marketplace.

With regard to value, since hitting what appears to be a bottom in 2009, the trends have been far less clear. After dropping approximately 32 percent on a price-per-square-foot basis on average, we have seen volatility in value as some product types in some submarkets are increasing slightly, and other product types in some submarkets are decreasing slightly. This volatility on the value side is a clear indication of a market that is trying to establish its footing.

The direction and magnitude of volume and value fluctuations are dependent upon many factors. Clearly, fundamentals are a significant component of these factors, and there are several indicators we consistently examine as we try to determine how these underlying real estate fundamentals will be impacted.

Below is a summary of things we keep a close eye on to try to gain insight as to where the market may be headed.

Employment

Perhaps the metric that has the most profound effect on real estate fundamentals is the level of employment. The more people who are working, the better for our economy. Simply put, working consumers spend more than nonworking consumers.

As jobs are created and companies grow, the need for more office space is obvious. As more office space is needed, developers must buy land and construct buildings, putting thousands of construction workers to work. This, in turn, puts more consumers in spending mode, thereby further expanding the economy. This is what economists referred to as a positive feedback loop. As the economy grows, people look to upgrade their living conditions, and household formation expands.

For this reason, last Friday's disappointing jobs report was another setback for those looking for a sustainable recovery in the short term. In September, U.S. payrolls were reduced by 95,000 jobs; private-sector employers added 64,000 workers, but governments and municipalities shed 159,000 workers. As we predicted, state and local governments have been reducing their workforces significantly in reaction to massive deficits that nearly all municipalities are running. Of the 83,000 workers who lost their job from these segments, many were schoolteachers from budget-constrained school districts. This was not surprising given that, for most, the school year begins in September.

Although the economy lost 95,000 jobs, the unemployment rate was unchanged at 9.6 percent. This is due to the fact that the participation rate has decreased as discouraged workers continued to drop out of the search for a job.

A broader measure of the unemployment rate, U-6, rose to 17.1 percent from 16.7 percent. U-6 includes those who have stopped looking for work, and those who are working part-time jobs that desire full-time employment. In another troubling trend, the employment-to-population ratio remained at 58.5 percent. This ratio has been a focus of the Fed and is near its lowest level in more than 30 years.

While an average of approximately 96,000 private-sector jobs have been added each month in 2010, this figure does not even absorb new people entering the job market simply based on population growth. It has done nothing to regain any of the 8.5 million jobs lost during this recession.

In New York, we are much better off than the rest of the nation when it comes to employment. Over 10 percent of the private-sector jobs created in the United States this year have been in New York. This bodes well for our real estate market moving forward. Let's hope that the City Council uses some common

sense when negotiating legislation that could potentially be job-killing, such as the new paid-sick-day initiative that is being discussed.

The magnitude of job growth dictates what is likely to occur with economic activity and, consequently, space demand

Government Policy

As I have often written, we are living at a time when the relationship between politics, economics and real estate has never been closer. For this reason, what government does can have a tangible effect on our marketplace. There has been a tremendous amount of uncertainty caused by government action, which is creating an unsettling feeling for the business community. This pertains to both potential policies that are being discussed as well as the ramifications of policy that has been enacted.

Businesses and individuals have no idea what their tax and cost burdens will be moving forward. It is unclear whether the present tax rates will continue or be raised. A significant component of this, for the real estate industry, is the capital gains tax rate. Some sellers have already acted based upon the anticipated increase in rate, putting properties on the market for sale to take advantage of today's rates.

Other policies that are creating significant uncertainty include the new national health care program, and the new financial regulation package. It is unclear whether there is a single person in the country who knows exactly what the true costs of Obamacare will be. When pressed, the administration vigorously defended the program's economic ramifications, indicating that it would reduce the deficit. Within months, the Congressional Budget Office indicated that the costs would be significantly higher than anticipated, and there would be no deficit reduction. Many believe that it is only a matter of time before it is proven that the program will add greatly to the deficit.

Some believe that the program will force private insurers out of business, leaving the government as the sole provider of health care. Skeptics believe this was the veiled intention of the program from the beginning. Others believe that the sheer amount of red tape created by the program will drive health care costs up significantly. They say that providing coverage for an additional 32 million people has to be paid for by somebody.

Regardless of your political stance on this issue, one thing many agree on is that the lack of transparency around its creation and a lack of understanding about its economic impact has created an uncertain environment, which is unfriendly to businesses.

The new financial regulation package also has created a significant amount of regulatory red tape to deal with. When Sarbanes-Oxley was passed by the Congress, corporate America bemoaned the paperwork, procedures and regulations that had to be complied with. There were 12 rules and regulations that companies had to maneuver through. The new financial regulation package has more than 200 of these requirements. Once again, no one can truly quantify the impact of this policy on business.

Companies are currently sitting with trillions of dollars of cash on their balance sheets and are suffering from incredible inertia due to the uncertainties in today's environment. The best thing government can do for business, and, therefore, the real estate industry, is to provide some certainty with regard to what the rules of the game will be. Once established, businesses will be able to adapt and move forward with confidence. As this occurs, companies will be more confident in making decisions about buying or leasing retail, office and industrial space.

Federal Reserve Bank Policy

During the past couple of years, the Fed has implemented an unprecedented level of intervention. They have doubled their balance sheet by purchasing in excess of \$1 trillion worth of mortgage-backed securities and Treasury bills. They have dropped interest rates to near-zero in an attempt to stimulate the economy.

Today, the amount of quantitative easing bullets left in their gun has been greatly reduced. Based upon the disappointing jobs report released by the Department of Labor last Friday, many economists believe that the Fed will resume its asset-buying program, which ceased last March. Economists are referring to this next phase as QE2.

Another tool available to the Fed, which was mentioned as a possibility by Chairman Bernanke, is to stop paying interest on nearly \$800 billion worth of excess banking reserves held by the Fed. It is thought that by not paying interest on these reserves, this will create motivation for banks to pump more money into the economy, putting it to work productively. Several bankers I have spoken to indicate that, because the interest paid on reserves is so minimal, this tactic would have little impact on the market.

Figuring out what the Fed is likely to do and what ramifications their actions could have are a significant factor to consider when trying to determine future movements within the marketplace. Much of what the Fed does impacts our interest rate environment, which has obvious implications for the investment sales market. As rates rise, the cost of borrowing increases, exerting downward pressure on value. This is due to the fact that as debt service costs rise, capitalization rates normally increase, and as cap rates increase, values drop.

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, while the 10-year Treasury closed last Friday below 2.5 percent. These low rates are allowing lenders to keep borrowing rates low.

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 which 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 which 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 homebuyers 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 homebuyers 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 over 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.

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

Lastly, we will look at good old-fashioned supply and demand. In order to try to determine 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 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.

Sincerely,
Bob

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Read Mr. Knakal's periodic market analysis at www.masseynakal.com/blog under the "Chairman Commentary" archive.

You can also read Mr. Knakal's weekly article in The Commercial Observer entitled "Concrete Thoughts" at www.observer.com/commercial.

