A Message from the Chairman

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What's Driving Investment Sales—And Holding Them Up

Market for properties over $100 M. chugging along; under-$50 M. market anemic; pessimistically hopeful on interest rates, debt ceiling debate

During the first half of 2011 (1H11), the dollar volume of investment-sale transactions in the New York City market was $12.6 billion. On an annualized basis, activity is on pace to increase by 74 percent over the 2010 total of $14.6 billion.

At face value, this number leads to an extremely optimistic perspective regarding the market's performance. However, it is important to take a much closer look at the data, and realize that the market, while trending positively, remains uneven.

In the first quarter of 2011 (1Q11), there was approximately $4 billion of investment sales activity. We were pleasantly surprised by this number, having expected it to be more muted given the extraordinary activity in the fourth quarter of 2010.

Transactions which normally would have closed in 1Q11 were accelerated into 4Q10 based on lenders wanting to clean up balance sheets by year-end and a significant number of discretionary sellers who pulled the trigger last year in anticipation of a rise in the capital gains tax.

In 2Q11, there was a whopping $8.6 billion of transactions closed. This was the best quarter in 15, going back to the fourth quarter of 2007. Annualizing the 1H11 total shows $25.22 billion of expected activity for the year, which, as stated earlier, would be up significantly from the $14.6 billion in 2010.

A sector that has had a significant impact on the market's performance is the larger transaction segment and, specifically, the number of $100 million and larger sales.

If you're a frequent reader of Concrete Thoughts and you read my quarterly market overviews, you know that we look much more closely at the number of properties sold, as opposed to the dollar volume, to get a true feel for market activity. This is due to the fact that the dollar volume of sales can be skewed very significantly by a few large transactions. If an asset like Stuyvesant Town / Peter Cooper Village sells for $5.4 billion, it can have a very significant impact on the marketplace. Similarly, last year's $1.8 billion sale of 111 Eighth Avenue to Google represented over 12 percent of 2010's annual city total.

If we consider the number of properties sold, we see that in 1H11, 960 properties were sold which, if annualized, would yield only about a 15 percent increase over the 1,667 properties sold in 2010.

Comparing the two volume metrics, we see a projected increase of 74 percent in dollar volume, while on a number-of–properties-sold basis the increase is only 15 percent. Larger transactions account for this disparity.

If we look at the number of transactions which took place in excess of $100 million, we see that in 2009 there were only seven. In 2010, there were 29 of these sales and in the first two quarters of this year there have been 31, already eclipsing last year's total. If we consider that these 31 transactions totaled $8.5 billion in sales activity, this represents about two-thirds of the $12.6 billion total of all 1H11 dollar volume.

Simultaneously, these 31 transactions, out of the 960 total, represent only about 3.2 percent of all properties sold. The activity in the over-$100 million market is also on pace to more than double last year's total of $8.2 billion, as annualizing 1H11 activity results in a projection of approximately $17 billion for this year.

While the over-$100 million market is booming, with a projected increase in the number of sales on pace for a 114 percent annual increase, the under-$100 million market is not nearly keeping pace. In 1H11, the pace of sales under $100 million was set to produce an increase of just 13 percent and, if we look at the under-$50 million market, the contraction is even more severe.

Properties selling for less than $50 million saw 237 sales in 1H11 compared with 507 in 2010. Annualizing the 1H11 total, we extrapolate 474 sales for the year, a decrease of 7 percent from last year's totals. This result was unforeseen and has been an eye-opener.

Additional data reinforces the trend of larger transactions gaining traction. In fact, in 1H11, the average property sold in New York City had a price of $13.125 million, shockingly exceeding the $12.4 million average in 2007, and setting a new all-time record for this statistic! (This average property price had dropped as low as $4.4 million in 2009.)

Clearly, dollar volume is increasing rapidly based upon the pace of mega-deals, while the number of properties sold is simply

limping along, seemingly shadowing the molasses-like growth in our national economy. Notwithstanding the lackluster growth in properties sold, overall market activity, whether we look at dollar volume or number of properties sold, clearly demonstrates that 2Q09 was the bottom of the market in terms of the volume of sales.

If we turn our attention to property values, we see that the unevenness within the market remains, particularly in the outer-boroughs and northern Manhattan.

In past articles, we have discussed the divergence between the fundamentals within the Manhattan submarket (south of 96th Street on the East Side and south of 110th Street on the west) and the other submarkets of New York City. These trends, while generally improving, continue.

In Manhattan, capitalization rates compressed for all product types in 1H11 versus 2010; however, if we look at average prices per square foot, we see that seven product types have experienced increases over 2010 levels and three product types have seen decreases. It seems counterintuitive to see cap rates falling and price per square foot falling simultaneously, but this dynamic can be explained by reductions in net operating incomes. If rents are falling or stagnant (or even rising slightly as they are in some sectors) value per square foot can drop, especially with the increases in operating costs that we have seen on a year-over-year basis. These market conditions can easily produce these seemingly strange results.

In northern Manhattan and the outer-boroughs, cap rates are mixed with those on some property types compressing, while increasing on others. On a price-per-square-foot basis, cumulatively we see that 15 product types in the outer-boroughs are up and 14 are down, demonstrating that these submarkets are still having difficulty finding a consistent recovery.

At the beginning of the year, we projected a 12 percent appreciation rate on a blended basis within the Manhattan submarket and expected to see values stabilize, i.e. stop falling in the boroughs. We believe that what we are seeing from the market thus far in 2011, demonstrates that we remain on pace for these projections to hold.

In terms of number of properties sold, the Queens submarket demonstrated the most improvement in 1H11, with 164 properties sold, representing a 21 percent increase versus the 136 sales in 2H10. The northern Manhattan market improved the least, with 69 properties sold, representing just a 13 percent increase versus the 61 sales in 2H10.

By dollar volume, the Manhattan submarket improved the most, given the overwhelming number of $100 million-plus transactions here, with a 56 percent increase in activity in 1H11 versus 2H10 and a 124 percent increase versus 1H10. Northern Manhattan, again, improved the least, showing a 4 percent decrease in the dollar volume of sales in 1H11 versus 2H10 and a whopping 50 percent decease versus 1H10.

As I have stated for several quarters now, the biggest potential landmine within the investment-sales market is a potential increase in interest rates. The extraordinarily low interest-rate environment that has benefitted us for quite some time has allowed for an orderly deleveraging of the market.

Properties that have significant negative equity positions have, in many cases, been able to maintain positive cash flow, thus treading water as owners and lenders hope for a viable exit strategy. Mortgage maturity is currently the biggest challenge for these assets as refinancing in today's market cannot produce the same proceeds that were available in 2006 and 2007. Additionally, rates were so low at that time, mainly due to minuscule spreads over LIBOR, that extending these loans at anywhere near the old rate is not palatable for lenders today.

To the extent interest rates rise sharply, it could have a devastating impact on these properties, which are hanging on by a fingernail. We have seen distressed-asset sales continue but at a slower pace than last year. Through 1H11, in the note sale market, we estimate that there has been about $2.2 billion in activity, which would result, if annualized, in $4.4 billion for the year, well below the $6 to 7 billion that we believe occurred in New York City last year.

At the time of this writing, Congress has yet to approve a debt ceiling increase and the implications of a possible default on the country's credit rating are significant. If interest rates are to remain at, or near, their historically low levels, it is important that Congress demonstrate leadership and an ability to control itself fiscally.

Now that the Fed has ended its QE2 asset-buying program, it will be very interesting to see the performance of upcoming Treasury auctions. At several of the last auctions, the Fed purchased as much as 70 percent of all Treasuries sold. If they don't show up at the table, it could be mean significant reductions in the price of these bonds, which would exert significant upward pressure on rates.

We remain pessimistically hopeful that our interest rate environment will stay low, buoying the marketplace for investment properties. If it doesn't, it will create even more issues for those who took advantage of all the leverage the market had to offer.