SHRINKING VALUES, GROWING ANXIETY

By Matt Hudgins
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Since the onset of the credit crunch last August, many investors have watched with dismay as their commercial real estate holdings have fallen in value. Predictions from Wall Street are downright alarming, with J.P. Morgan Securities projecting a 20% slide in commercial property values from peak to trough. That's a conservative estimate compared with Goldman Sachs' prediction that market-wide prices could decline as much as 26%.

"Wall Street does panic better than anybody I know," quips investment banker John B. Levy, president of John B. Levy & Co. "The same guys that were saying nothing can go wrong [before the credit crunch] are now saying nothing can go right."

Levy isn't alone in his skepticism. While a recent survey conducted by PricewaterhouseCoopers found signs of weakening fundamentals across the property types other than apartments and industrial, the researchers suggested that forecasts calling for prices to drop 20% or more across the industry are overstated.

"Theoretically it is possible for commercial real estate values to drop by the degree forecasted by these analysts," the March 17 report stated. "Practically, it may not be."

Of course, one huge variable is the U.S. economy, which grew at a measly 0.6% in the fourth quarter of 2007, preliminary figures show. What's more, non-farm payrolls also dipped 63,000 in February, the worst performance in five years.

Just how far prices have already dipped also is a matter of debate. Brian Corcoran, executive vice president with Cushman & Wakefield, estimates that prices have decreased by 10% to 15% since the summer of 2007. Moody's Investors Service, on the other hand, reports that based on January data, sales prices across the major property types have dropped 2.4% since October.

So far, the drop in prices reflects changes in the capital markets, chiefly higher borrowing costs that limited buyers' spending power. Properties in smaller markets have suffered to a greater degree because today's conservative underwriting by lenders favors stable assets in major cities, according to David Rosenberg, managing director at mortgage broker Meridian Capital Group LLC in New York. "Secondary and tertiary markets have probably seen values come down 10% to 20% in the last six to nine months," says Rosenberg, who runs the company's capital markets group.

The clearest sign that something is amiss in pricing has been plummeting transaction volume, as buyers and sellers try to reconcile yesterday's prices with today's capital constraints. The $6.8 billion in office sales tracked by Real Capital Analytics in January and February is but one-tenth of the $68 billion that traded in the same period of 2007.

Making the best of it

By the end of the first quarter this year, some investors were closing deals by negotiating asset prices down to match their leverage and equity. "We're seeing more buyers be successful with

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that because there just aren't as many buyers," says Rosenberg, who runs Meridian's capital markets group.

Those investors who choose to postpone placing their properties on the market until a better day can put that waiting time to good use by executing a property improvement program. Anything that increases marketability will help to counteract the effects of marketwide repricing, according to Jim Amorin, vice president of Atrium Real Estate Services in Austin and president- elect of the Appraisal Institute.

An appraiser familiar with competing properties in the local market can often suggest cost-effective ways to boost a building's appeal to tenants. In a recent example, Amorin's company appraised an office property that had small, high windows in an area where competing buildings touted glass curtain walls and attractive views of the Texas Capitol Building.

"When you sat at a desk you couldn't see out the window," Amorin recalls. Acting on a suggestion from the appraisal company, the landlord re-skinned the building with more glass and was able to bring in higher-paying tenants as a result. "They almost doubled the value of the building by investing a few million dollars," he says.

Property owners who aren't prepared to weather a lengthy hold period may do better to cut their losses before things get worse. "We are telling clients now that if there's a bit of a gap between the bid and the asking price, they ought to think hard about closing that gap before we go further into this uncertainty," says Peter Hauspurg, chairman and CEO at investment brokerage Eastern Consolidated Inc. in New York.

Hauspurg believes many property owners are burning through cash reserves on short-term, high-interest mezzanine loans obtained before the credit crunch. That will create buying opportunities when those reserves run out later this year and some owners are forced to sell.

Vultures begin to circle

In Seattle, real estate developer The Schuster Group is counting on the price correction to create buying opportunities this year, according to Jeff Feinstein, the group's president. The company has raised $30 million among high net-worth investors toward a $100 million goal for a new private real estate investment fund intended to acquire undervalued properties in promising locations.

As of late March, the fund's managers had already placed under contract a two-story, single-tenant building with development rights for vertical expansion as a residential condominium. Feinstein declines to specify the location, but says the agreed upon price is 25% less than the property appraised for a year ago. How does Feinstein separate good buys from bad ones when prices are still falling? His approach is to seek properties at or below replacement cost, he says. So far, that has required a great amount of searching to find the right deal. "If you can be patient, you should be," he says, "but that requires a lot of staying power."

Apartment developments offer the potential for strong returns going forward as adjustable-rate mortgages force many homeowners back into the rental pool, according to projections by appraisal services giant Integra Realty Resources. Investors across the country are also snapping up land where necessary entitlements, utilities and infrastructure are already in place, according to Ben Loughry, managing partner of Integra's Dallas/Fort Worth and Miami offices.

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"They're buying the land at a significant discount," Loughry says. Anticipated holds on those tracts vary from 12 to 36 months, depending on when investors expect local demand for quality sites to recover.

Variance by market

Price declines in specific markets will depend on supply and demand. "If you've got a region that is having job loss and/or migration out of the area, then they're going to be affected much more dramatically," Loughry says. "Likewise an area that's been way overbuilt in some product types is going to be way more affected."

Las Vegas, San Francisco, San Diego and Florida are poised for severe deterioration in commercial real estate fundamentals this year as deflating housing bubbles drag down local consumer and business spending and single-family housing stock competes with apartments for renters. "Anytime there is a softening in general home prices, it ripples through the other property types," Loughry says.

Retail is the most worrisome sector nationally, says Hessam Nadji, managing director of research at brokerage Marcus & Millichap. Large retailers are cutting back on expansion plans even as new space is delivered, resulting in an oversupply that will stifle rent growth and income to investors. "We're going to be experiencing an overhang of inventory in retail for the next 18 months," he says.

Apartments, viewed by many investors as a safe haven during economic turmoil, are poised to retain their value through the downturn. Fundamentals for office and industrial are beginning to soften, Nadji says. "A lot of companies that were about to sign leases have stepped back and moved to the sidelines, so leasing activity has slowed because of corporate caution."

Elusive market data

Appraisers looking for sales comparables and investors trying to map out a strategy to deal with price declines have been handicapped by the lack of deals in recent months. Compounding the uncertainty is a peculiar lack of movement in new indices designed to track commercial real estate values.

Indices published by both Moody's and Standard & Poor's registered the halt in price appreciation that occurred in August, but neither index has shown a pronounced decline. One reason is that 90-day rolling averages used in both sets of indices reflectedpre-credit-crunch transactions through October. Even some transactions that closed after August carried terms that were negotiated before the credit crunch.

The main reason the indices have been slow to show declining values, however, is a flight to quality that has resulted in a disproportionate number of high-quality, high-cost investment deals, according to Dan Fasulo, managing director at Real Capital Analytics. "The only thing that's trading is the good assets," says Fasulo, who collects the data used in the Moody's indices.

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Investors should be aware that the properties selling at any given time can skew indices in the short run, observes Dr. Sam Chandan, chief economist at Reis Inc. In a reversal of the flight to quality seen today, indexes may well understate value once transaction volume begins to pick up again.

That's because sellers who sell during a period of weak demand are more likely to be distressed, and may accept prices a typical investor would reject. "You're getting a larger number of people who are selling assets but who don't have a lot of power in their pricing negotiation," he says.

Investors can get a better handle on any price correction affecting their holdings by examining their own portfolios and local markets rather than national indexes.

Specifically, investors must consider how much of their perceived property value is based on cash flow and how much is a result of bygone investor frenzy.

Price vs. value

Up until the new millennium, commercial real estate values generally reflected a property's cash flow. After the recession of 2001, however, investment capital from around the globe poured into commercial real estate and the ensuing competition for assets drove down capitalization rates.

A cap rate is the return an investor receives based on the purchase price and the rental income in place. Cap rates on office assets, for example, had fallen to 6.4% last November from a peak of 7.9% in February 2005, according to Real Capital Analytics.

As a result, many investors began to depend on price appreciation and bought at prices that couldn't be justified by existing cash flows, says Chandan of Reis. "If you're talking about the value of the asset's underlying cash flow stream, then pricing completely decoupled from values and now is deflating," he says. That means the current correction is largely a return to values derived from cash flow.

Going forward, the slowing economy is expected to exacerbate price declines by softening demand for commercial space, which dampens prospects for rental growth and could reduce income streams as vacancy rates increase.

Buyers waiting for fire sale prices on commercial properties may harbor unreasonable expectations for price declines, however, according to Nadji of Marcus & Millichap. What's different this time around is the absence of widespread overbuilding that put downward pressure on rents in previous downturns, so owners are in a good position to hold onto their assets until values recover.

The idea that the most significant price deflation has already occurred dovetails with a more conservative projection of price declines published in December by Integra Realty Resources, which predicts overall commercial real estate prices will soften 5% to 10% in 2008.

The chief threat to property values in the near term is the prospect of recession, which would stymie job growth and the corporate expansion that drives demand for commercial space. "If

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that doesn't happen, then there will be a whole lot less worry about all of this cutback from the commercial sector and the leasing activity," says Levy, the investment banker.
That isn't to say the price correction has run its course. Levy concedes that further price declines are entirely possible. "But does that mean we'll have blood on every street corner? I don't know if that's the case."

Appraisers set value on three-legged stool

How do appraisers balance the national trend of declining commercial real estate values with the characteristics of a specific property? The same way they determine value at any point in the real estate cycle — with a three-pronged approach based on direct capitalization, discounted cash flow and comparable sales.

"Appraisers use those methodologies in a consistent way," says Brian Corcoran, global head of valuation services at Cushman & Wakefield. "What changes are the inputs." Here's how it works:

1. *Direct capitalization* — This approach uses an investor's initial rate of return based on a property's income stream to arrive at a value. Cap rates have been rising since last fall because the credit crunch increased the cost of capital for leveraged buyers. Based on cap rates alone, a retail property that appraised for $50 million in early August at a cap rate of 6.55% would be worth only $48.2 million in February, when the average retail cap rate was 6.79%, according to Real Capital Analytics.

2. *Discounted cash flow* — This process adds a property's projected net income over a seven- to 10-year hold period to the price the investor could expect to fetch in a subsequent sale. Then the appraiser discounts the overall return back to a price in today's dollars. In most U.S. markets, the discounted cash flow model would anticipate less appreciation during the buyer's hold period because highly leveraged buyers are no longer bidding up prices like they were a year ago. That means the asset would get a lower price on today's market, even if the property's net income is unchanged from a year ago.

3. *Comparable sales* — The third leg of the appraiser's stool, this approach to determining value has hit a snag of late. Nationwide, just $6.8 billion in major office properties traded in the first two months of 2008, equivalent to 10% of the $68 billion that changed hands in January and February 2007, according to Real Capital Analytics.

"Our projections about rent in future years' cash flow is more conservative today than it was six months ago and our discount rates and cap rates are higher," Corcoran says. "Those combined factors lower appraised values."

— Matt Hudgins, National Real Estate Investor

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