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What's with this market? The expansion continues...- by Bill Pastuszek

November 08, 2019 - Appraisal & Consulting

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The expansion continues (Part VI, or something like that). I've been having discussions with appraisers, lenders, investors, experts and pretty much anyone who will engage in conversations, casual or formal. I continue to be amazed – amused is a word that comes to mind, but that doesn't seem quite right – by the length and breadth of this real estate market's legs, while constantly searching for a better understanding as to the strengths and weaknesses of the broader market and various sectors and sub markets.

Broadly, the economy is doing well enough. There is continued concern about weird things going on in financial markets and geo-politically, but generally there is relief that there are not strong signals of an end to the country's expansion. But, let's talk in 6 months. While this extraordinary real estate expansion continues, we can only wonder what signs would point to its end, moderation, or other changes. Here are a few that have been collected.

• Increased reliance on price (or rent) appreciation to bail out insufficient current cash flow. This is a potential mistake that can be made by lenders, developers, and appraisers and seems to be a symptom of late stage acquisitions and development projects.

• Paying too much going in. A basic economic concept. Pay too much upfront and an investor will be struggling to make good from that point forward.

• Really low going in rates. (related to the preceding but worth considering separately.) In a strong market like Boston, investors, appraisers, and lenders can be caught in the trap of the ever more sinking cap rate. A recent deal maker stated: "If 5% is what historical caps are showing, what's the harm of going to 4.75%? It's a great market!"

• Cost overhangs, where cash flow come close to not covering costs. With projects that don't have costs locked in, labor shortages and price fluctuations in materials can destabilize a project's budget that doesn’t have enough stretch in it.

• Permitting. By-right projects are fine, but there are often some hidden (and unexpected) costs that need to be accounted for. (The factor for contingency & misc. should not be minimized)

• Lenders wiling to underwrite at really aggressive ratios. That was another discussion with a loan officer. A lender expressed frustration and incredulity in losing a deal to another lender’s “quixotic” terms.

• Outlying, thin, markets. As the core markets have been pretty picked over (which is not really true, there are always deals to be had for persistent and aware investors), secondary and tertiary markets all of a sudden look like great deals. In a mature phase of the market, it doesn’t take much to end up with a bad deal: the concept of the last to go are the first to flop still applies.

• “If it won’t cash flow, we can condo it.” There are many markets out there where condos are a tough sell. And, overpriced condos in an effort to set the market aren’t going to sell well, no matter how good the market. Buyers are pretty well-informed today.

• Appraisals that rely too much on developer supplied information with respect to cost, absorption, and pricing.

• Appraisals that squish down already really low cap rates and make aggressive assumptions about rent growth.

• Investment analyses (and appraisals) that build in strong and unsupported assumptions about strong rent growth and weak expense growth in discounted cash flow analyses.

• Market analyses that include large quantities of information easily obtainable on-line without any cogent analysis or conclusions drawn from the data. (A recent report reviewed made the statement: “based on the preceding, market conditions can be considered to be good.” Brilliant!)

• Finally, lenders, investors and appraisers making assumptions that price appreciation will continue forever, or at an unsustainable rate, and that costs won’t go up faster than inflation

• Appraisals that assume everything is average and typical, when it’s not

My father, a smart real estate investor and a wise observer of real estate and economic behavior, strongly believed that governments generally would do what they could to stay in office. Thus, much of what goes on before elections can be attributed to that strong tendency toward self-preservation. So, let’s talk about a year from now and see how things look, big picture and on the ground.

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