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Office market movement - A wake up call to the real estate appraisal industry

March 24, 2010 - Spotlights

There are times in the real estate business when markets move instantaneously. Key dates that come to mind are:

* June 30, 1990 - the start of the 1990-1992 recession

* January 1, 2001 - the start of the 2001-2003 recession

The appraisal business is particularly prone to the missing of market movement. There are those who accuse appraisers of studying property by "driving down the street looking in the rear view mirror". To the appraisers' defense, 70%Â± of their business is typically bank related where they are retained after the fact.

This article will have three parts:

1. To outline instant change in the Boston office market that occurred January 1, 2010;
2. To report what year end 2009 real estate investor surveys showed then for Boston;
3. To advise as to what is truly occurring in Boston.

My business is broad and I have access to market evidence as it unfolds.

Change - January 2010

Much has been written about the size of supply of capital in the wings waiting for the time to invest. That capital came to market on the key date of January 1, 2010.

One Brigham Circle is in process of closing and the results are now known. There were four highly competitive finalists all clustering at similar levels with small differences in price. By definition, this was a core asset with major credit medical and long term credit retail leasing in place.

In the study of core assets, the key to their value is what is called the terminal (or residual) capitalization rate and the discount rate. Discounted cash flow studies (DCF) are typically conducted over 10 years and while growth rate assumptions for income and expenses may vary, they are tightly tied to the economics found in the market.

In the Brigham case, the bids clustered around a 6.5% terminal capitalization rate and a 7.5% discount rate. To be clear, these rates apply only to the best real estate in an LMA, Boston, Downtown, or East Cambridge/MIT location.

What do Boston Year End 2009 Surveys Say?

To begin, Boston surveys are a compilation of opinions from professional in a particular market. They typically vary widely.

The problem is the word "average". Appraisers typically grasp onto the term "average" and do not do what they should do. Appraisers should do their own survey to match their property under study to the market.

For core assets like One Brigham Circle, average residual cap rates and discount rates are worlds apart from what major players in the market are saying. A recent five investor surveys I completed confirms the Brigham findings.

A market gap exists. Any valuers who grasp at averages just do not know that market surveys are behind the times for best in class product. Those with money have now jumped and the core market has moved.

Advise on Boston's Core Markets

Those in the office building business must listen to the tuning fork. There are two distant hums out there.

For Rte. 495 product and the vast array of Grade B product, there is no hum. This product has suffered and will continue to suffer. The front page of recent Banker and Tradesman issues feature a number of foreclosures or short sales.

Basic economics dictate that the B product will suffer for a long time.

When studying core property that is multi-tenanted, the proper way to analyze is to obtain stacking charts and leasing reports. For one property I recently studied, I found 34 active prospects for effectively 8 different floors of both occupied and unoccupied Class A space. A movement of certain tenants would be required to occupy.

Let there be no mistake, it is not just location that makes an asset a core product. It is what is there. Core product attracts like a swarm of bees. It is in great demand despite what else might be going on around it.

Conclusion

One of the never ending questions is "When will the market hit bottom?" The answer is that for core product, it has.

Ancient history can just not be relied upon as markets move quickly.

There is a scarcity value in place for assets that can not be duplicated and are well below replacement cost.

In the market place, look at where "bees are buzzing" and it is with those properties that you will find true residual/discount rates to be applied in the decision making process involving core asset values.

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Rate	Range
Residual Rate	6-10.5%
Discount Rate (IRR)	7.75-12%

Various sources compiled by CBRE

Boston Office Year End 2009

Rate	Range
Residual Rate	8.50%
Discount Rate (IRR)	9.50%

Various sources compiled by CBRE