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Core property transactions still remain active

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By Tyler Brown, MAI

As we reached the end of a turbulent August, a month that has seen mercurial changes in the stock market, it's somewhat surprising that pricing for institutional-grade real estate has remained largely unaffected. Following a brief period of wait-and-see, institutional equity is, generally speaking, still closing on committed deals and actively looking for new opportunities.

To be clear, the assets to which I refer include the highest quality and best located properties in the country. Many are in gateway cities like Boston, New York and DC. And virtually all have appreciated significantly over the last year, driven by low financing rates, strong equity demand and an overall decline in cap rates.

By comparison, during the same period, secondary markets and product have languished. Without stable cash flows to support debt service, these deals have not benefitted from favorable financing. And now, with the new economic reality of an extended unemployment crisis, even fewer value-added plays are attracting institutional equity.

With the benefit of hindsight, the "flight to core" in commercial real estate began in the second half of 2010 and has continued through 2011. At times, the group-think mentality and resultant cap rate compression had seemed irrational. Wouldn't value-added deals have offered huge return potential given any degree of economic recovery? Why so much focus on core?

As it turns out, the core focus from institutional investors had it right. They were deliberately trying to avoid the domestic and global economic risks that have since materialized to shake economic confidence and the stock world. Institutional real estate investors were right to shy away from risk.

With those comments as the backdrop, we can delve deeper into the status of the core and core-plus markets as we move into fall. The best dichotomy for consideration being the two relatively primary dimensions real estate analysis: capital demand and supporting underwriting.

With regard to capital demand, it's never easy to capture its existence or absence, especially over a short period of time (a month, for instance). Anecdotally, however, transaction participants and brokers alike will tell you that as of late-August, investors are closing on committed deals.

As to "why" they are closing despite this new spate of capital markets concerns, we might speculate on several possibilities. First, the more stodgy valuation of bulky real estate might be viewed as stabilizing to their portfolios. Second, the tangible quality of the assets themselves might make these core deals more attractive compared to alternative investment classes. Third, debt remains cheap and may never be cheaper. And finally, good locations are scarce, and for a long term hold, now may be as good a time as any to get into prime locations, before an actual recovery adds further to price point.

And so, the all-important driver known as capital demand remains intact as we continue to match what investors are "willing" to pay with what investors "have" to pay. Cap rates have not spiked upward, re-trades remain at typical levels, and deals are continuing to close. In other words, institutional capital sources are not slowing down, which is good news for the market overall.

But what about supporting underwriting? How can we "bake in" the European debt crisis, a sluggish U.S. economy or an always-possible Asian market slowdown? In every market condition, appraisers and market participants alike are tasked with forecasting cash flows and converting those financial projections to present worth using pricing assumptions. What can we say about the investment assumptions that will support transactions in the last months of 2011?

All indications are such that the primary pricing tools for commercial real estate, IRR and exit cap rate, have not shown much retrenchment. Specifically, the debt component of a blended IRR does not appear to have changed considerably. With treasuries on the decline, many lenders are once again instituting rate floors, as opposed to letting defined spreads produce atypically low rates. The net effect is that debt pricing has not changed wildly, and given continued equity demand, blended IRRs have not changed significantly.

Despite surprisingly steady IRRs, analytics are certainly more cautious in one area: market rent and market rent growth rates. The common expressions in the investments arena dialing back these assumptions include "greater caution from economists" and "sub-markets losing steam". While expectations had started to bubble pre-August with regard to positive rent spikes, we now must admit the probability of achieving them is diminished. Despite having only a small impact on total pricing conclusions, investment models have clearly trimmed back forecasts for the timing and magnitude of upside from future rent growth.

So, in conclusion, despite a staggering display of stock market turbulence during August, core property transactions remain active and still very pricey in terms of low cap rates. As we leave heated summer activities behind and focus on cooler breezes of Autumn, these continually warring factions of capital pressure and market risks will continue to play out. Let's see what the future holds, but for now, I am pleased to report that we still have a fairly active institutional market for core property.

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