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Question of the Month: Valuations for the highest-quality shopping centers are on fire - so where is all the product?

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As we reach the halfway mark of 2014 it's clear that valuations for the highest-quality shopping centers have reached a new peak, outpacing the records set in 2006/2007. Today's market is characterized by an excess of aggressive equity capital, a steady supply of inexpensive debt and a level of confidence that enables significant investments in the future of our market. From a demand and pricing perspective, today's market is the strongest New England has ever seen.

With valuations on fire, one might justifiably expect that 2014 would see a highly liquid market as owners take advantage of the significant run-up in values. Instead, investors have been left confused and often frustrated by the shortage of high-quality properties coming to market.

The challenge facing our market today is a dramatic disconnect between what most investors want to buy and what most owners are willing to sell. With a little flexibility on both sides, however, there is still a window of opportunity to make 2014 the banner year it ought to be.

Retail Investor Demand - Laser Focused and Tightly Defined

A unique characteristic of demand in 2014 is that nearly every investor, from private capital to the largest institution, is looking for the same thing - and that box is very tightly defined. With few exceptions, investors are laser focused on 'generational quality' assets, meaning grocery-anchored shopping centers located in strong demographics with little near-term roll and increasing tenant sales.

Fueling demand is a broad spectrum of lenders eager to put money to work. Buyers of high quality product are rewarded with a ready supply of inexpensive, high-leverage debt often with a few years of interest only. With interest rates in the mid- to high-4s, it's no surprise that pricing for properties that fit the mold has never been better. In New England, cap rates for the highest-quality centers have compressed squarely into the 5% range with some even dipping into the 4%s. Similarly, IRRs have fallen into the 6%s with several institutions reporting that they would accept total returns in the high-5%s for "must have" core product. The few core deals that have come to market this year have attracted multiple offers in this yield range.

Clearly we are in thin air in the current pricing environment - which begs the question: where is all the product?

Constrained Supply -
A Vicious Cycle

Given the depth and aggressiveness of today's buyer pool, one might expect a high-velocity market in which owners seek to capitalize on record pricing. Instead - 2014 has seen little high-quality product offered for sale.

There's been a lot of speculation over the cause of the current stalemate, but the primary explanation seems to be a lack of compelling reinvestment opportunities. It's a common story today - given the run-up in valuations, private owners of the highest-quality shopping centers are unwilling or unable to sell if they will be forced to pay the taxes. That said they would be interested in selling if they could find an exchange property that offered a similar or better credit profile, cash flow, upside potential or location. However, because of the lack of compelling exchange opportunities, many private owners opt against selling - thereby creating a self-perpetuating cycle of product being held back from market. Many institutions are behaving similarly, reasoning that it makes no sense to sell the type of core properties they are having so much trouble trying to buy.

Owners - Keep Today's
Opportunity in Context

With essentially no yield to be found across the asset spectrum, it's easy to conclude that today's heady valuations for core product are here to stay, or will perhaps even increase further. It's important to remember, though, that real estate valuations move in cycles. While it is impossible for anyone to say where we stand relative to a market peak, we can say for sure that current pricing for core properties is stronger than it has ever been. To the owners out there who are considering a sale "within the next several years," who have an upcoming lease expiration or capital requirement - or who just want to take some chips off the table, a long-term view of the market suggests that now is the right time.

Investors - Class B and "Secondary Core" Deserve More Attention

In a typical strong market, intense competition for the highest-quality assets pushes a portion of investors into secondary markets. This was certainly the case in the last market peak, where investors piled into secondary geographies and pushed cap rates to within 75 BPs of core pricing. In contrast, 2014 has seen thin demand for secondary geographies, where yields are currently 125 to 175 BP higher than core. Many view this risk premium as a dramatic market inefficiency rather than an accurate reflection of additional risk. It should also be noted that debt for high-quality class B properties is nearly as aggressive as for core - resulting in strong levered yields. Investors - there is attractive yield and significantly more deal flow in secondary geographies, this sector deserves more attention.

The CBRE Dark Pool

Our team has established an informal "Dark Pool" in an effort to assist buyers and sellers remain active despite the supply constrained market. Instead of running a conventional auction, in this process we provide a "round trip" service. A client comes to us with a property to sell and a corresponding need to buy. We then match that client's buy/sell requirements with those of other clients in the network. Of course, all participants must have property to sell and a desire to reinvest. Many recognize that 'manufacturing' transactions in this manner is the only way to acquire high-quality properties in today's market, and we currently have upwards of $50 million of property available for trade.

The good news is that 2014 can still become the high-volume year many feel it should be. Success will be driven by buyers' and sellers' willingness to moderate their focus and take a long-term perspective.

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