Making sense of uncertain markets - by Bill Pastuszek

March 29, 2024 - Spotlights

Bill Pastuszek

This New England winter has been less than satisfactory. It's New England, right? What about the noble winters of yesteryear: snowstorms, freezing rain, skiing, epic shoveling, staking out parking spaces in the city, and dead batteries? Instead, the weather never made up its mind. Thus, the weather serves as an apt metaphor for current real estate markets.

What should appraisers, analysts, lenders, and investors make of these markets? It's never easy meeting the challenge of understanding seller behavior in the best of times. In this low transaction environment, it's even more difficult.

Some points and observations follow about appraising in these markets and what the data is telling us.

Appraiser Due Diligence. In markets with less transaction volume, appraisers need to be careful to turn over as many rocks as possible and not be surprised as to what may be found under those stones. Particularly true with property classes that don't show a lot of activity, knowing what is not happening (and why) informs valuers' opinions about what is happening! Often. Interviews of knowledgeable participants become useful as does careful market and marketability analysis and diligent, property specific highest and best use analysis.

Market Analysis vs. Marketability Analysis. Macro trends in terms of supply and demand are useful and are a legitimate part of market analysis. More critical is marketability analysis, defined by the Dictionary of Real Estate Appraisal as "the study of how a specific property is expected to perform in a specific market. A marketability …analysis expands on a market analysis by addressing a specific property." Much of appraisal takes on market analysis but doesn't do the harder work of drilling down deep enough to the property specific issues.

The Appraisal Process. Appraisers strive to simulate market behavior in their valuation. The appraisal process is different from the process a buyer or seller might determine value, cash flow, expenses. Appraisal is systematic analysis that models market behavior but does not necessarily mimic it.

The Effect of Interest Rates. Markets adjust. And markets continue to adjust to this interest rate scenario as the Fed has indicated that rates will be at these levels for a while longer.

Overall. Several well-respected CRE surveys tell us that prices declined across property types on an annual basis. Institutional assets are affected more than non-institutional sectors. Even solid property sectors like self-storage are seeing "deceleration" in revenues. Net lease sectors have seen cap rate increases and much lower transaction volume.

Prime industrial markets performed less well than non-institutional markets. Smaller industrials are in shorter supply and are less affected by market "headwinds."

Office markets are considered to be especially troubled particularly in CBD locations. Using the Boston market as an example, both discount and cap rates have both increased by over 50 basis points, according to one survey, with marketing times increasing dramatically.

Cap Rates. Care needs to be taken in cap rate selection. Most sources suggest that 2024 will show deterioration — or “uncertain stability” — in most investor markets. Most all sectors showed cap rate increases. The effects of higher cap rates in many property sectors are offset to a degree by rents that are still rising. Most observers would caution that where rents are rising, the rate of increase has slowed.

Using older comparables for cap rate derivation is a potential problem area. Those aged rates present a danger in today’s changed markets. If recent cap rates are lacking, those older cap rates probably need adjusting. The same goes for sales. Avoiding overreliance on averaging is a sound analytical principle. An average is one of several possibly relevant data points. It’s an easy calculation which is why it seems so attractive. Where the subject falls within a range of data is probably more important than the average, or the median, for that matter.

Appraisers. Smaller banks are less able to absorb the effects of bad loans. Appraisals are a vital risk management tool for lending. Lender underwriters and analysts rely heavily on appraisals and on appraiser expertise in crafting loan decisions. In a low volume appraisal services environment, it’s more important than ever for appraisers to consider carefully their level of competency when considering an assignment. Saying no might hurt in the short term but be highly beneficial in the longer run. Appraisal quality is of paramount importance in getting out of this muddy, directionless winter.

Bill Pastuszek, MAI, ASA, MRA heads Shepherd Associates LLC, Needham Mass.