nerej

Where are you on the central Conn. comm'l. RE roller coaster?

November 19, 2008 - Connecticut

A recent survey of real estate professionals, along with buyers, sellers and investors active in the central Connecticut commercial real estate market, revealed that there is some disagreement over where the market is going in terms of commercial real estate values. With all of the external adverse information pouring in on the national and global economies, there appears to be some misconceptions as to how these uncontrollable factors are and/or will impact local commercial real estate values. The net effect is a bit like being on a roller coaster.

Value is perception, and real estate appraisers estimate market value as of a point in time. Estimating current market value in a market where the supply and demand curves are constantly shifting the point of equilibrium poses a number of challenges. However, when perception of economic uncertainty increases to the point that participants do not want to act (i.e. buy or sell), appraising requires a lot more effort than just reviewing sales. It requires a more detailed review of the motivations of the few players still making investments, more analysis of investor's expectations and opportunity costs, more time to locate a sufficient amount of comparable data, more focus on listings and pending sales, and being more conscientious to the impact of available credit in the market.

Brokers are reporting that deals are taking more effort to close. Demand for owner occupied property is still evident in central Connecticut; however the supply of available property is still low, giving buyers fewer options compared to the past few years. Vacancy rates are not significantly changing in the industrial, office or apartment market, but the retail market is beginning to see the impact from store closings and consolidating retailers. Though there has been little sales activity that reflects a downward trend in value, what sales have closed were either negotiated in the first part of 2008 or are showing the flattening value trend witnessed in most commercial real estate market segments in central Connecticut over the past 18 to 24 months.

So what has changed? There has been a real paucity of commercial land sales. In addition, a good portion of speculative development has stalled and listing prices of available land are showing signs of a decline. In theory, the contributory value of surplus or excess land affiliated with a commercial property is now worth less than when development trends are strong. Since improved investment property consists of land plus building value, the perception is that overall property values are declining. However, unless sellers are willing to lower their asking prices, and buyers cease to expect future declines and get off the sidelines, there will be little activity to determine supportable price levels.

Lenders are aware of these trends and have tightened their credit terms. Most surveyed have decreased their loan-to-value ratios. A commercial real estate investment that would have received an 80% loan-to-value ratio last year may now only receive a 65% or 70% loan. An investor who has

$20,000 may have been able to purchase a $100,000 property last year - borrowing 80%, but now, with only 65% of the price available in the form of a loan, has to secure either another investment partner to acquire the same $100,000 property or find an alternative investment for less.
Lenders are also increasing their Debt Service Coverage requirements. Ratios that were in the range of 1.10x to 1.20x are now 1.25x to 1.35x or more. This change correlates with the reduction in loan-to-value ratios and places more emphasis on existing cash flows as opposed to speculation that cash flow/net incomes will increase in the near future due to increases in rents or reductions in operating costs. In addition, "recourse", or the requirement of a guaranty as a third source of repayment is a requirement that is back in the market (cash flow of the property being the first source - collateral the second and a guarantee the borrower will use other assets to pay the loan if necessary being the third). Though these are sound lending principals, the perception is that it will further reduce the pool of buyers. However, if sellers are reluctant to sell, keeping a low inventory of property available for sale, these credit contractions may have little impact on pricing.
One of the bigger changes is the perception of a value shift caused by an increase in spreads now being charged by lenders. Lenders are increasing their spreads (the amount added to their cost of funds) from 1.25% - 1.50% to 2.25% - 2.75%. These rates are no longer being tied to the fluctuating Libor index rate, Treasuries, or other indexes, but to the Federal Home Loan Bank of Boston (FHLBB) rate or their Classic Credit rate of the similar term. For most loans, this is the 5-year rate.
The move to the FHLBB rate is why commercial mortgage rates are not going lower though the cost of the lender's funds is declining. For example, the FHLBB 5 year rate has declined over 1.0% in the past month, down to 4.18% as of the date of this writing. Adding 2.25% to 2.75% to this reflects an overall mortgage rate that is still below 7%. Regardless, the perception is that because spreads are increasing, overall capitalization rates have to increase. This perception is not always true.
An overall capitalization rate is a weighted average of the cost of funds to an investor for a specific commercial real estate investment. It is a rate used to capitalize net income into a value sum. In theory, if all else remains the same, increasing the spread charged by banks and lowering the percentage of the investment funds that can be leveraged by financing should increase the overall rate. The second part of the weighted average formula is the rate of return required by investors - investor's expectations. Since more of the investor's funds are being consumed by the increased credit terms, and because of national and global economic conditions, in theory, investors should be expecting a higher return. But if there is very little inventory of available property on the market (low supply), even though the increased credit terms may reduce the pool of buyers, there is no guarantee the market will allow investors to increase their expected return.
With Wall Street having its up and downs, and the commercial real estate market in other geographic areas of the country experiencing dramatic value swings caused by residential foreclosures and the decline in consumer spending, the opportunity cost of investing elsewhere in the county may mitigate the risk of investing in the central Connecticut commercial market to the point that overall rates may not change as much as many expect, particularly with the low inventory of improved commercial property available for sale - meaning, at this point in time, the perceived value trend that is anticipated to impact commercial markets in central Connecticut may be short lived.

John Galvin, MAI is with Andrews & Galvin Appraisal Services, LLC, Farmington, Conn.