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Commercial markets update

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To the surprise of few, the commercial investment markets have begun to feel the effects of current conditions in the financial markets. The problems in the residential finance market, initiated by the subprime market collapse earlier this year, have begun to show up in the commercial RE markets.

As reported by Michelle Hillman in the Boston Business Journal, "Boston commercial RE transactions are far behind last year's pace even amid some indications the credit crunch is not as severe as observers thought just weeks ago."

She bases this conclusion on a nearly 12% drop-off in transaction volume in the local office property market. She does note, however, that although there are fewer deals, the dollar volume for 2007 may ultimately meet or exceed that of 2006.

The major impact affecting the office investment market locally is the drop-off in investor purchasers who rely on leverage. The availability of mortgage financing for these deals has tightened. In particular, financing for deals in secondary markets or "value added" transactions has become hard to find.

One impact of this changing investment market is that some sellers are more reluctant to place their properties on the market. Their concern seems to be that the leveraged buyers who have provided significant competition for the better deals are no longer bidding. Some in the brokerage community feel this is a short-term phenomenon and are advising their clients to hold off selling into the current market.

As a result of this shifting buyer pool, nationally a number of "re-trades" are occurring. This is a situation where deals that had been negotiated with highly leveraged buyers have fallen apart prior to closing. The properties are then re-offered to the open market or to the next highest bidder.

As reported in the third quarter Korpacz R.E. Investor Survey, an active market participant notes, "A lot of properties that we bid on and didn't win in the last 30 days have come back to us for reconsideration even though we didn't have the highest original bid." In many instances, sellers of re-trades are asking buyers to simply holding their prices and not necessarily trying to increase them to match the original winning bids.

Although some observers feel that this is the beginning of a longer period of negative market circumstances, a more widely held opinion is that this is a needed and overdue market correction. This market correction will likely be expressed in terms of changes in cap rates (some feel in the neighborhood of 25-50 basis points) and a return to more normal competitive financing conditions.

It is my opinion that we are going through a market correction, but that it is healthy and appropriate. We have been through a period of easy money and generous financing terms which may have pushed prices beyond reasonable levels. The fourth quarter of this year and first quarter of next year will provide more clarity as to who is correct.

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