Hot Sheet

Figuring Prices in Today's Market

We all know the economy is a mess, and it appears that the commercial real estate market is not far behind. Transactions are rare, many tenants are struggling, and financing is scarce. So, is there still a market for commercial properties in this environment? David M. Rosenthal, president and CEO of real estate appraisal consulting firm Curtis-Rosenthal Inc. in Los Angeles, believes the answer goes beyond basic questions like pinning down the cap rate. Rosenthal discussed the market with *Real Estate Southern California* editor Don Jergler.

What are cap rates today and how do you determine them when there are so few transactions happening?

David Rosenthal: It's clear cap rates are rising, but how far and how fast? The cap rate question is even more challenging because buyers and sellers have yet to come to terms with today's environment.

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DAVID ROSENTHAL
Curtis-Rosenthal Inc.

Property operating fundamentals are challenged today, so the cap rate question must include questions about the stability of the cash flow to be capitalized. Just how secure is the income stream? Dramatic change in the capital markets has also put upward pressure on cap rates, as available debt is lower leverage, more expensive and less available than it was a short time ago. So, where are cap rates today? They are in transition from lower to higher. How high they will go remains to be determined in the marketplace … and it will happen over time. A likely catalyst for movement may be the looming wave of distressed and REO properties that will likely hit the marketplace as more property owners find themselves in distress. Only when more transactions occur will the marketplace clarify the cap rate question.

What factors do you need to consider when evaluating the income stream?

Rosenthal: When rents were rising rapidly, a tenant default could enhance a property's value by allowing an owner to increase rent to market. Those days are gone—today the risk of a vacant space is substantial. Many commercial tenants are cutting back on staff and as a result of that, they are cutting back on their space needs. Troubled retail tenants are in the news today, particularly boutique, specialty big box and mom-and-pops. Office buildings that cater to softening industries also have tenancy challenges as unemployment grows. The need for manufacturing and warehousing space is dropping as commerce slows, which results in reduced space demands. Even apartment properties are feeling the pinch as tenants lose their jobs, while the inventory of units is rising because of broken condo developments repositioning themselves as rentals. Lease rollover has today taken on even greater importance. Properties with a substantial proportion of leases rolling will present unique challenges to investors and lenders in today's environment.

If a property is fully leased, how important is it that market rents are falling?

Rosenthal: In light of reduced tenant demand, there is real evidence that market rents are softening in landlords to share their economic pain. While rental rates in many sectors are falling, rental concessions are on the rise. Free rent or excessive tenant improvement allowances translate to lower effective market rents. Many commercial real estate lenders now underwrite to market not contract rents as they did not long ago. As a result, a stabilized property with above-market rents in place may find that loan availability would be based on declining market rents, not their existing leases. Lower market rents combined with tighter underwriting means less loan dollars available, which results in lower prices that investors can afford to pay for properties …much to the dismay of sellers.

What financing is available out there in this market?

Rosenthal: In the go-go days, the presence of abundant, high-leverage, low-cost debt helped to fuel low cap rates and rising property values. Today the converse is true, as scarce, low-leverage, high-cost debt is helping raise cap rates and depress property values. And tighter underwriting standards exacerbate the situation. It's no longer common for loans to be underwritten based on Pro-Forma NOI, which allowed property owners to monetize upcoming rental increases. Loans are typically underwritten today based on current income, and many lenders currently underwrite based on the lower of market or contract rents. Lower loan-to-value ratios, higher debt-service-coverage ratios, and higher pricing are the order of the day. Interest-only loans seem to be a thing of the past. The result of this tighter underwriting, lower leverage and higher pricing for commercial mortgage loans, is that buyers need more equity. Lower leverage means a lower achievable yield, which puts upward pressure on cap rates and downward pressure on pricing. —SOCAL