What Is "*Market*" When There Is No Market?

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We all read the headlines, so we know the economy is a mess. It appears that the commercial real estate market is not far behind. Transactions are rare, many tenants are struggling, and financing is scarce. So what is "Market" for commercial properties in this environment? The answer is more than just a cap rate, as we also need to consider the quality and duration of the income stream.

What's the Cap Rate?

It seems clear that cap rates are rising, but how far and how fast? The cap rate question is particularly challenging since buyers and sellers have not yet come to terms with today's environment. 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.

How Solid Is The Income Stream?

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 clearly gone, as today the risk of a vacant space is substantial. Many commercial tenants are cutting back on staff and thus on their space needs. Troubled retail tenants are in the news today, particularly boutique, specialty big box and mom-and-pop retailers. Office buildings that cater to softening industries also have tenancy challenges, as unemployment grows.

The need for manufacturing and warehousing space is declining as commerce is slowing down, resulting in reduced space demands. Even apartment properties are feeling the pinch as tenants are losing their jobs, while the inventory of units is increasing due to broken condo developments repositioning themselves as rentals. Lease rollover, traditionally an essential topic, has today taken on even greater importance. With many tenants struggling and more space becoming available, the risk of losing a tenant upon lease expiration continues to rise. Properties with a substantial proportion of leases rolling will present unique challenges to investors and lenders in today's uncertain environment.

Beware of Falling Market Rents

In light of reduced tenant demand, there is real evidence that market rents are softening in many property sectors. Distressed tenants are not shy about asking their landlords to share their economic pain. While rental rates in many sectors are falling, rental concessions are on the rise. Free rent or excessive TI 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?

In the go-go days, the presence of abundant, high-leverage, low-cost debt

CONTINUED ON PAGE 13

COMMERCIAL NEWS CONTINUED FROM PAGE 6

helped to fuel low cap rates and rising property values. Today the converse is true, as scarce, low-leverage, high-cost debt is helping to raise cap rates and depress property values. Tighter underwriting standards exacerbate the situation. It is no longer common for loans to be underwritten based on Pro-Forma NOI, which allowed property owners to monetize upcoming rental increases. Typically loans are underwritten today based on current income, and as noted above, 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.

Conclusion

So what is "Market" when there is no market? The answer remains elusive, but it will evolve as the markets themselves evolve. As long as sellers want to achieve yesterday's prices while buyers are constrained by today's capital availability, the markets will remain stalled, and "Market" will be difficult to pin down. Once sellers embrace the new market fundamentals, either willfully or through distress, and/or once the capital markets loosen up, then the bid-ask gap will close, we will see more transactions, and our sense of market clarity will return.