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The Rationality behind the Exuberance—A Look at Real Estate Investment in this Cycle

by
Hugh F. Kelly, CRE

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"Are investors putting their capital into real estate without getting paid for the increase in market risk?"

Experts in educational psychology call it "cognitive dissonance" when our minds are asked to hold two seemingly contradictory pieces of information simultaneously. We like our facts to be consistent and our theories tidy. When they are not, we become uncomfortable and tend to take one of two actions. Those determined to hold on to old ideas resist or devalue the new information that calls accepted "facts" into question. Others are willing to examine the whole range of data through the hard work of learning. Such people are rewarded by a greater assimilation of the information and a higher level of understanding of the way facts relate to one another. Unfortunately, the psychologists tell us, most people opt for the easier assumption that "someone else has made a mistake."

Since the commercial office markets across the United States started to soften in 2000, cognitive dissonance has made itself felt in real estate investment discussions. The most visible property market statistics—vacancy rates and asking rents—have almost universally weakened. Because investment values are predicated on earning potential, many commentators have felt that there should be a prima facie case for reduced sales prices. Since leasing contracts in place provide for more stable cash flows than the quarter-to-quarter change in market conditions might indicate, most recognize that there is a lagging relationship between the broadly reported statistics and actual values. However, there is still an expectation that weakening conditions should affect prices buyers are willing to pay. And now, nearly four years into the cycle, we are finding prices not only holding their own, but rising in many markets across the country.

Are We Experiencing a Disconnect between Value and Price?

In the industry, the term describing this situation is "disconnect," and the word is meant to suggest that something is wrong with today's pricing. Calling upon memories of the real estate markets of the eighties, it is suggested that prices are being inflated by the sheer volume of capital being committed to commercial properties and that the

phenomenon of "too much money chasing too few goods" has pushed prices far above reasonable levels. Most often, the vigorous activity of the Federal Reserve in driving down interest rates, and then holding them at historically low levels is mentioned as the basic trigger for the flood of capital. Taken together, such conditions set off alarms for everyone who was burned in the stock market bubble that burst in March 2000, especially those mindful of the collapse of Japanese real estate values over the course of the past dozen years.

It is a serious issue and one that bears scrutinizing. Hard questions need to be asked.

- Are prices unreasonably high? How would you measure this claim?
- Did investors indiscriminately throw money into the real estate arena during the bear market in stocks? And will a rising stock market shift the tide in the other direction?
- Is real estate overpriced because it is over-leveraged?
- Are investors putting their capital into real estate without getting paid for the increase in market risk?

These are legitimate, serious questions and worth the hard work it takes to discover answers.

Today's Astronomical Building Prices

Are today's prices high? It seems useless to quarrel about that question. Just to take a few representative Manhattan transactions from the recent past, the office building above the Grand Central post office at 450 Lexington Avenue brought a price of $340 per square foot; 875 Third Avenue sold for $487 per square foot; and 450 Park Avenue traded at $552 per square foot. These were not aberrant deals, but describe the mainstream of market transactions in 2002 and early 2003. The trend was capped by the startling price paid for the General Motors Building last fall, $1.4 billion for a single property, or $788 per square foot.

Prices in the $300 per square foot and higher range are not restricted to New York City. Boston, Washington, DC, and Chicago all have seen high-rise towers sell at such prices, despite predictions that trophy properties in major CBDs would go begging for tenants and for investors after September 11. And 2004 started with a bang, as Boston's One Lincoln Street sold for more than $700 million, or $670 per square foot, to American Financial Realty Trust. Bids from the Wells REIT and RREEF/Deutsche Bank reportedly were in close competition. There can be no denying that such prices represent a lot of money.

Are such prices historically high? It helps to keep in mind the effect that overall inflation has on purchase prices over time. In the mid-eighties, for example, well-located Manhattan office buildings often sold at prices of $250 per square foot or more. Even though inflation has been moderate for most of the time since then, a 1985 price of $250 per square foot is equal to $430 per square foot in today's dollars. To look specifically at some landmark deals of the past, in 1969 the Borden headquarters building on Madison Avenue sold for $100 per square foot; in today's dollars, that price would be $502 per square foot. The Seagrams Building on Park Avenue fetched $135 per square foot in February 1980—or $314 per square foot in 2003 terms. A few months later, the Pan Am Building at 200 Park Avenue (now the Met Life Building) realized a $177 per square foot price which would be equivalent to a price of $393 per square foot now.

So if prices are high today, it does help to understand that there is some precedent for such values in real, inflation-adjusted dollars. Commercial property prices are, of course, subject to cyclical fluctuations and do not serve as an inflation hedge at all times. But the impression that today's prices are stratospherically high is, I believe, colored by short memories that recall only the run-up from the depressed markets of the early nineties and that lack both the perspective that comes from looking over several cycles and the discipline of doing constant-dollar analysis.

Adding Capitalization Rates into the Equation

Another point of view on pricing is to look at capitalization rates. Cap rates, or the relation between a property's net operating income (before debt and capital expenditures) and its sale price, are a measure of investor requirements for going-in yields and an indication of investors' expectation of future performance. High cap rates generally indicate that investors want to weight "current dividends" heavily in their overall return. Low cap rates indicate that buyers are purchasing "futures," expecting rents and values to increase over their holding period. As the real estate markets strengthened from the mid-nineties into 2000, cap rates gradually declined as investors had more confidence in office market performance. When vacancy rates started to rise in late 2000, cap rates at first remained firm, but the steady downward pressure on interest rates exerted by the Federal Reserve pushed rates down about 100 basis points between early 2001 and early 2003.

Where are cap rates today? Again, to turn to the high-profile Manhattan sales of recent years, the initial returns for these properties are considerably more aggressive than the national "average" cap rate range of 8.75 percent to 9.75 percent. Paramount invested funds for its German clients at 1177 Sixth Avenue at a going-in cap rate of 5.7 percent. Global Holding's acquisition of 875 Third Avenue was priced at a 6.9 percent rate. Walton Street Capital purchased 717 Fifth Avenue at a 7.5 percent cap rate. So clearly the competition for top quality office assets has bid cap rates to fairly low levels. Are they unreasonably or "unrealistically" low? Again, history can teach us some perspective. For the Seagrams Building acquisition in 1980, for instance, TIAA-CREF priced its purchase at a 7.1 percent cap rate. TIAA also bought 750

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To put such cap rates into a wider investment context, it might be useful to convert them into a pricing multiple. A 5.7 percent cap equates to a 14.7 times multiple of price over current income; a 7.5 percent rate indicates a 13.3 times multiple. The national average "band" of cap rates from 8.75 percent to 9.75 percent converts to multipliers of 10.25 to 11.4 of initial income. So the range from a "conservative" rate of nearly 10 percent to an "aggressive" rate of less than six percent puts real estate earnings multiples roughly between 10 and 15 percent. Compare this range to the stock market P/Es that jumped from 15 to 40 during its "bubble" period, and the risks being taken by real estate investors look very defensible.

Investors Savvy When Choosing Markets for Their Investment Dollars

There is further persuasive evidence that investors are distributing their real estate dollars very selectively, not in an indiscriminate pursuit of deals merely to "put capital to work" in a bearish cycle for stocks. We have examined a database containing 1,564 office building sales that closed between the fourth quarter 2000 and the first quarter 2003, with an aggregate value of $68.6 billion.

Arraying the office investment directed toward 14 of the nation's largest MSAs against a scale of vacancy rates as of the second quarter 2003 indicates the transaction preferences in the recent marketplace. By and large, cities with vacancies ranging from 10 percent through the teens had far higher transaction activity than those with 20 percent and higher vacancies. Investors are apparently selecting such cities not only because of superior current occupancy, but because the time period to return to equilibrium will presumably be shorter. New York and Washington are highest on the list, but Los Angeles, Chicago, and Boston are also doing well. Investors are considerably more cautious about Phoenix, San Jose, Atlanta, Denver, and Dallas. The "regression line" on the chart presents the general trend of lessening investment as the vacancy rate rises (New York, as a statistical outlier, is excluded from the trend line). So, at a profound level, a look at a major sample of deal activity shows there is much more of a "connect" than the critics would have us believe.

Another key illustration of investor attention to economic fundamentals has been the rise of retail investment over the course of this market cycle. One of the remarkable features of this recovery has been the ability of U.S. consumers to sustain their spending, despite the chronic weakness seen in the national employment figures. Much of the credit, again, must go to Fed interest rate policy, this time in its stimulation of home equity lending and mortgage refinancing. The accompanying graph, prepared using Mortgage Bankers Association data, shows the absolutely extraordinary volume of refinancing in the past several years.

The consequence has been a sustained rise in the aggregate volume of investment flowing into the retailing sector. While office building mega-deals continue to capture headlines, sophisticated observers of the commercial investment trends will tell you that offices are actually losing share on a nationwide basis, with shopping centers being the real winners. A collateral indication of this is the performance of retail REIT stocks. Overall, REITs provided a total return of 37.1 percent in 2003. This sector outperformed the broad market indexes by a wide margin. Retail REITs did even better, with enclosed malls

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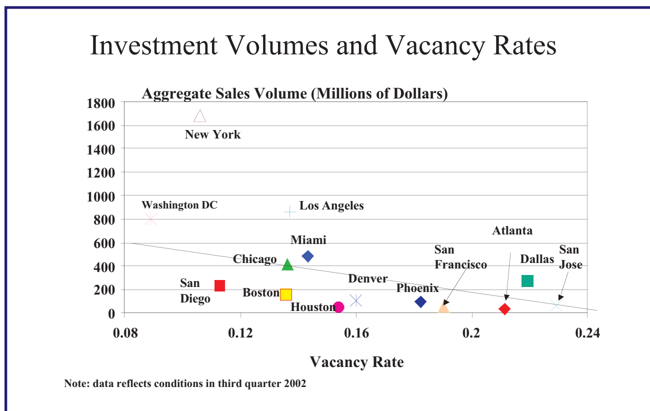

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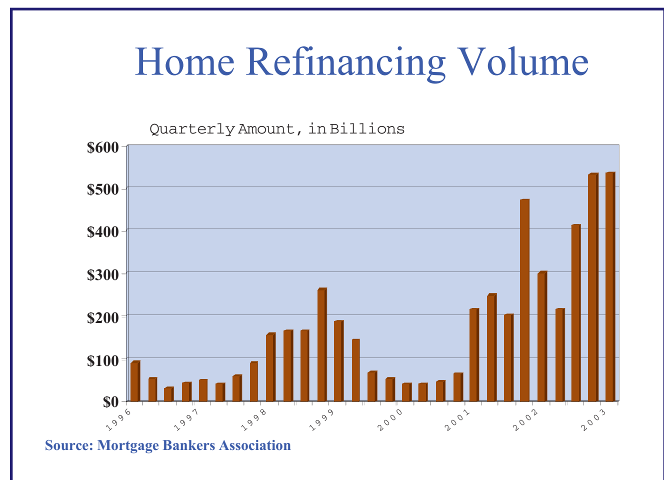
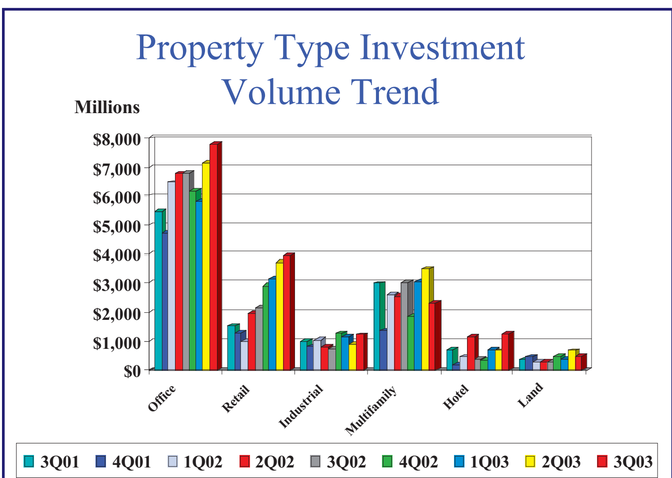
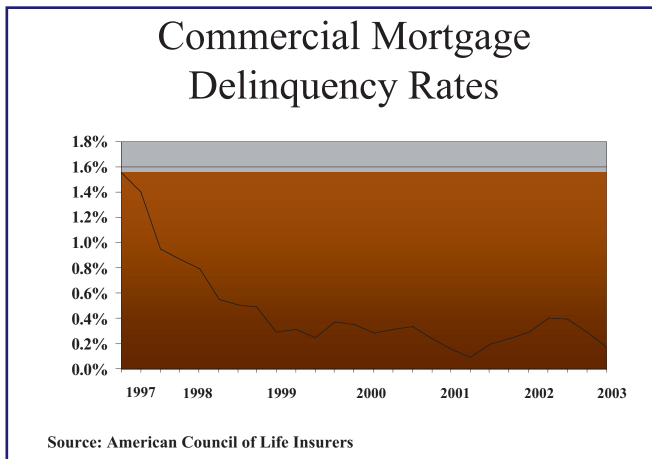




Consumer Spending and Housing Loans

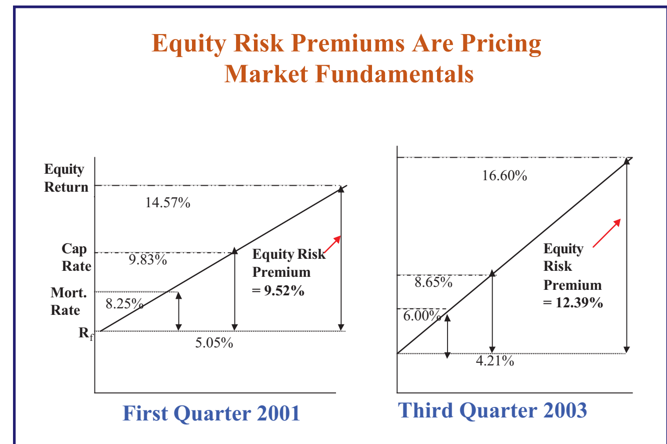
Personal consumption should remain the leading driver of American economic performance in 2004, according to the February National Association of Business Economists' survey. Consumer gains of 3.8 percent are projected this year, and a 3.5 percent rise in real (inflation-adjusted) spending is anticipated in 2005. The expectations embedded in such a forecast mean that investors have been very reasonable in the allocation decisions being made across property types.

quarter 2003, after going as low as 0.12 percent in late 2001. By the end of the third quarter 2003, the delinquency rate had again dropped to 0.18 percent. This is a far cry from the catastrophic experience of the early nineties when delinquencies increased to more than seven percent. As the graph below indicates, today's mortgages are performing far better than the ACLI portfolio did in 1997 and is in about the same delinquency range as typical since 1999. If over-leverage is a problem, it has not yet hit the numbers. And if, as current data suggests, we are seeing the cyclical peak in vacancies in 2004, pressure on the debt holders should be easing. Right now, it is unlikely that a wholesale erosion of equity cushions will prompt the levels of default that might trigger a pricing crisis.



All that is very well, a skeptic might say, but if investors have to buy properties with lower cap rates even though the market has been worsening, isn't the risk-reward relationship moving in the wrong direction? Maybe good underwriting protects lenders from undue risk, but the equity stakeholder will have to pay his mortgage no matter what (unless he is ready to give back the keys) and still faces the uncertainty of re-leasing space and the unpredictable timing of a recovery. How can a lower cap rate be justified under such circumstances?

Here, too, doing the hard work of analyzing the numbers pays off in helping to clear up some confusion and reveals that investors are neither blithely shrugging off risk nor taking it on without appropriate compensation. Our final illustration takes the levels of cap rates and mortgage rates, found in the Investment Trends Quarterly database, and applies the 10-year Treasury bond as the "risk-free rate" (R^f) at two periods of time: first quarter 2001 and third quarter 2003. Using a 75 percent loan-to-value ratio at each period, we can calculate the implied return to the 25 percent equity position derived by using the positive leverage available when cap rates are higher than mortgage rates. The first result we find is that, because mortgage rates fell more than cap rates, the equity return rose from 14.57 percent to 16.6 percent over the 30-month period—even though overall cap rates dropped by more than a full percentage point. But beyond that, the Equity Risk Premium grew even more, because the "risk-free" rate declined from a little more than five percent to a little less than four percent. On average, investors received a spread of 12.39 percent above Treasuries to put funds into commercial properties earlier this year, an increase of 287 basis points over the risk premium required just two years earlier.



What explains the increase in premium? In all likelihood it was the conscious realization on the part of market participants that risks had indeed risen and that capital needed to be compensated for taking on that additional risk. The financial relationships displayed in these graphics are not at all surprising. They are exactly what investment theory predicts would occur in such a risk-reward tradeoff.

So, as it turns out, there is a neat resolution to the "cognitive dissonance" introduced into the real estate discussion by the trends in market fundamentals and pricing. The answer is not that investors are irrational or that pricing is somehow "wrong." Rather, it is evident that purchasers are making selections of where to buy, what to buy, how to finance, and what price to pay that provide an equity return approaching 17 percent for existing, tenanted properties. For most folks, that should look like a reasonable, rational deal. ❖