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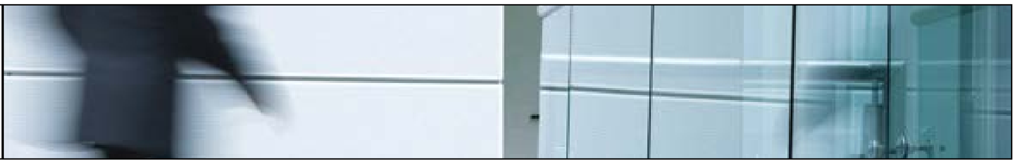

Seeking Balance Between Capital Supply and Space Demand

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The U.S. commercial property market is facing an unprecedented wave of investment capital that portends increased competition for existing properties and capital for new development. That bodes well for the commercial real estate sector in the next few years. But as investors ride the rising tide of property values, it's important to remember that waves eventually crash, and can wipe out the unwary.

In an ideal market, property values rise because availability of capital is balanced by increased demand for space. Investment professionals are often concerned about economic factors that can reduce or shut off the supply of capital. By contrast, almost nobody ever worries about an oversupply of capital. But history has shown that too much money chasing too few viable deals can lead to "irrational exuberance" that often ends badly.

Proper valuation and due diligence is essential to a successful investment strategy. We thought it would be helpful to share our thoughts on how best to mitigate some of the risks associated with making bank portfolio acquisitions in a fast changing market and perhaps provoke some thought, discussion and insight. That's why Summer Street Advisors is sponsoring a series of articles examining various aspects of underwriting and valuation.

Those of us who remember the incredible pace of speculative development in the late 1980s as foreign capital flooded into the U.S. also remember the market crash that followed, reducing property values by half virtually overnight. The tech boom and bust at the start of the 21st Century is another example of a capital-driven bubble that eventually burst. Although today's real estate market is a long way from these examples and may never become as overheated as past markets, investors and their advisors should keep these cautionary tales in mind as we analyze and underwrite deals.

'Wall of Money'

The fourth quarter of 2013 was the most active ever for global property sales, as $210 billion transaction volume surpassed the previous peak in 2007, according to a report from JLL. 2014 volume is expected to increase another 20 percent, with heavy concentration of transactions in the U.S. JLL reports that property investment in the Americas reached $62 billion in the first quarter of 2014, 63 percent higher than the same period in 2013.

According to a recent CBRE report, property companies globally raised more than $50 billion in equity in 2013, up from $36 billion in 2012, with more than half of the new money coming in the form of U.S. based REITs. This "huge 'wall of money' targeting real estate continues to push up prices, with capital values on prime office assets…accelerating to 8.2 percent year-on-year" in the first quarter, the report states. "U.S. cities showed the largest yield compression during the first quarter, with Chicago (30 bps) and Boston (20 bps) the standout markets."

The consensus of these and other sources is that global investment sales in 2014 will rise to $650 billion or more, with the U.S. getting the most attention by far. REITs clearly are contenders for properties and portfolios that meet their investment criteria, but prime assets in gateway markets are likely to end up in the hands of foreign investors willing to accept low current yields.

U.S. real estate is widely considered to be among the safest bets for long-term investors, second only to U.S. Treasury bonds. Geopolitical conflicts in Eastern Europe and the Middle East have accelerated the trend of investors seeking a safe haven in the U.S. property market. Anecdotally, we hear about new investors in the U.S. market who place competitive bids that are 10 percent higher than the next-highest bidder. This may result from poor market knowledge, but in some cases, foreign capital sources are simply willing to accept current yields that are close to zero, on the idea that values will increase over their anticipated long hold period. Some sources have suggested that one-quarter of the foreign capital in the U.S. market is from investors more interested in wealth preservation than yield.

Sovereign wealth funds in some Asian and Middle Eastern countries currently have about 2 percent of their capital invested in U.S. real estate; if they double this allocation to just 4 percent, as JLL's Jay Koster predicted at a recent industry meeting, the result would be an influx of $50 billion to $60 billion into the property market over the next couple of years.

Some U.S.-based pension funds are increasing their allocations to real estate as well, but these tend to be established players who understand market nuances and seek going-in yields of 4 to 5 percent. Those yields are low by historical comparison, but with interest rates also at historic lows, the spread between rates and yields still makes real estate a viable play. For investment advisors, the number-one concern right now is the impact on values if interest rates were to rise quickly—the common assumption being that cap rates would rise in response, resulting in a corresponding drop in property values.

What are the possible impacts of an oversupply of capital pushing up prices of existing properties and potentially bringing speculative development back to the market? The real estate investment market may be celebrating its success for a few years, only to awaken with a hangover after the market corrects itself. That's the normal outcome of a hot market driven by financial opportunism rather than real estate fundamentals such as net absorption and rent growth. So the question is which of these two scenarios we are facing today.

Saved by the Economy?

Despite concerns that too much money could push yields to artificially low levels, so far we've seen little evidence of this happening. New development has been increasing year by year, but the pace of construction is still well below the average over the past 30 years, and follows a period of virtually no new product. So, while it's important to beware of over-reaching, there's little actual evidence of it today.

There's also the good news that occupier demand is on the rise again, based on solid fundamentals. U.S. corporate profits are high, and job growth has been strong, even beating analyst predictions in recent months. In most markets, rent and occupancy levels are rising. GDP growth has been slow but steady over the past several years, and some market watchers believe this pace can be sustained for at least a few more years.

Net absorption in the U.S. reached 13.9 million square feet in the second quarter of 2014, the best performing quarter since the recession, according to JLL. Leasing levels are up 6.2 percent over the first quarter, and national vacancy rates dropped a remarkable 30 basis points.

A predictable slow-growth economy, resulting in a modest increase in occupancy and rent, could add a vital counterweight of demand to balance out the rising wave of capital from foreign and domestic sources. Rising property values based on increasing cash flow is the ideal scenario for growth of our business. As long we in the investment advisory business make sure that underwriting terms and speculative development do not extend the market into dangerous territory, there's a good chance that, this time around, what goes up will not come crashing back down.

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