Market uncertainty bites in the US

In an uncertain market, US commercial property is being repriced write **Charles Lansden** and **John Curry**

New York city from the Brooklyn Bridge: the city will remain one of the prime targets of overseas investors

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The third quarter of 2007 can now be viewed as a cyclical peak in the US commercial property market, one that marks the end of an era of capitalisation rate compression, aggressive lending and large-scale real estate returns.

The lending excesses evident in 2006 and the first half of 2007 are currently being wrung out of the system and the repricing of commercial property is underway.

Although 2008 begins with a great deal of uncertainty – particularly amidst concerns of a potential recession – traditional cash rich investors, specifically those holding euro, will have opportunities to benefit from the trends currently affecting the US commercial property market.

The most significant trend is the continuing decline in capital values from the frothy levels of earlier in the year. According to research firm Real Capital Analytics (RCA), the average sale price for office properties in October 2007 was about $2,420 per square metre, compared to $2,960 per square metre during the previous summer, a decline of about 18 per cent.

Accompanying the decline in value is a dramatic reduction in the number of transactions. The volume of office properties transacted plummeted 70 per cent in the 12 months to October 2007, according to the same research. Among the reasons for this decline are the reluctance of sellers to move off inflated price expectations, and a reduction in the availability and favourable pricing of credit.

This "value gap" between the expectations of sellers and purchasers should gradually close during the course of 2008. The availability of commercial mortgage loans has been limited since August last year, as the market for commercial mortgage-backed securities (CMBS) virtually dried up and balance-sheet lenders contended with portfolio allocation constraints and the reduction in capital resulting from the well-publicised write downs of assets.

The Mortgage Bankers Association stated that loan originations for the third quarter of last year were 30 per cent lower than in the second quarter. The largest reduction, moreover, was noted among CMBS lenders (down by 66 per cent), while life insurance companies and commercial banks increased their originations by 27 per cent and 9 per cent, respectively. While life insurance companies have benefited from the shift to more stringent underwriting standards, the ability (and willingness) of such companies to fill the financing void appears limited – CMBS lenders made about $186 billion worth of loans in 2006, while life insurance companies lent only $50 billion over the same period.

Thus, a key development to watch during 2008 is whether CMBS lending programmes returns to pre-2006 levels.

The repricing of US commercial property is happening despite the fact that certain fundamentals remain fairly healthy. Although the possibility of a recession looms, the vacancy rate is expected to rise only modestly across all property segments this year.

The increase in office vacancies appears to be the dual result of an influx of newly developed space into the market and potential tenants' unwillingness to sign new leases during a slowing economy.

For now, the US commercial property market is largely weathering the credit crunch with relatively well-balanced supply and demand in most markets, increasing rents (albeit at a slowing rate), and stable replacement costs.

The wild card this year, of course, is whether a recession will occur. In the absence of a recession, the prospects for 2008 are uncertain, although there are still some positives for long-term investors in commercial property.

Pricing will decline, with cap rates increasing anywhere from 25 basis points for Class A properties in supply-constrained coastal markets, to 100 basis points for lower-quality properties in secondary and tertiary markets.

Returns will also back-off from 2001-2007 levels, with average returns over the next few years – at perhaps 8 per cent per annum – reflecting the income-producing component of real estate investments.

The inability of highly-leveraged property owners to refinance could lead to a significant increase in defaults (from historically low levels) and, as a consequence, acquisition opportunities. Information technology centres such as San Francisco, Seattle and Austin could be cyclical plays and medical office buildings and university student housing are emerging investment classes.

New York City is anointed as the "hottest" commercial property market, and other "24-hour" cities – having international gateways, an educated workforce, pedestrian-friendly residential areas and revitalised business districts – such as Seattle, Boston, San Francisco and Washington DC are noted as prominent markets for investment.

We are largely in agreement with this perspective and expect that long-term opportunities will be available to potential investors this year.

While acknowledging that the maturing property markets in Asia and the geographically familiar markets in Europe contain competitive projects for consideration by Irish investors, we maintain that, with its transparency, depth and solid legal foundations, the US property market will offer attractive risk-adjusted returns in "core" investments.

This is particularly true given the dollar exchange rate and reduced competition from highly-leveraged players who have been squeezed out by more stringent financing terms.

Of course a significant obstacle for potential investors is the requirement to sift through numerous local property markets. Our view is that, while the prime property markets such as New York, Boston and Chicago will remain prominent targets of overseas investors, certain smaller markets in the so-called Sunbelt, such as Raleigh-Durham and Charlotte in North Carolina, and Nashville in Tennessee, merit serious consideration.

Each of these markets exhibits many characteristics of the 24-hour mega-cities, while prospering from inward migration, increasing income levels and the relocation of corporate headquarters and facilities from high-cost areas.

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