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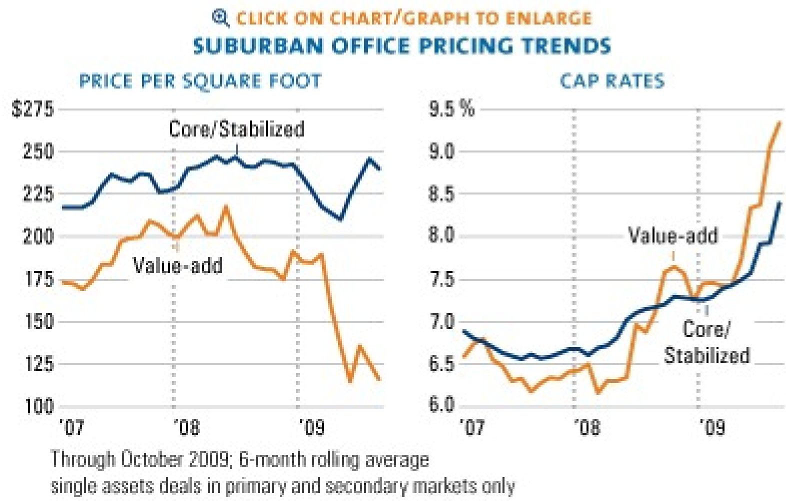
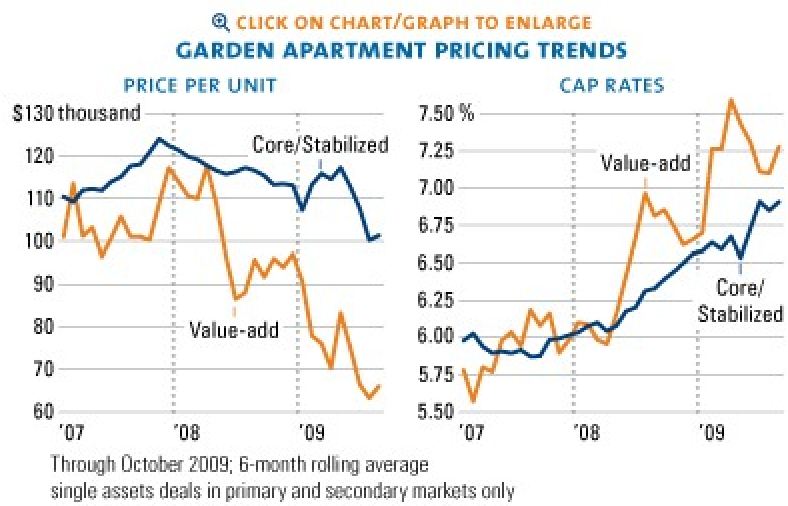
The New Two-Tiered Market

Stabilized assets are drawing higher prices

As the market was rising, pricing for all property types and quality converged and increased in tandem. Property prices were also highly correlated on the rapid descent, but that is beginning to change. Two vastly different markets are emerging for properties dependent largely on their ability to provide secure, stable cash flows - or not. Properties considered “core/stabilized,” or well-leased assets in top markets that have been recently developed or renovated are achieving some surprisingly high prices. However, properties with vacancy, roll-over issues or deferred maintenance, the “value-add/opportunistic” plays, continue to be deeply discounted.



The two-tiered market is best illustrated in the pricing of suburban office and apartment properties in primary and secondary markets. The average price of core/stabilized suburban office buildings over the past six months of $240/sf is almost unchanged since the peak of the market while average prices for value-add/opportunistic properties have plummeted to $125/sf from over $200/sf. Cap rates on core/stabilized office are up 180 bps while those on value-add have jumped 310 bps. It is a similar story for apartments. Prices for both core/stabilized and value-add apartments peaked at near $120,000/unit, and while core/stabilized assets still command over $100,000/unit, prices on recent value-add sales have dropped to $65,000/unit. Cap rates follow similar trends, with those on core/stabilized apartments up 100 bps while those on value-add properties are up 170 bps.



A look at capital flows easily explains this phenomenon, one that is likely to persist well into 2010. The increasing availability of debt for core/stabilized properties is a significant factor, particularly since interest rates are now so low. Financing for value-add deals is far more difficult to obtain and much more costly. These deals also often require expensive mezzanine debt for the additional capital expenditures required to improve and lease the property.

The motivation of buyers is also causing the dichotomy in pricing. Buyers of core/stabilized properties are not as discouraged by the poor outlook for fundamentals since their assets are already well-leased, insulating them from most near-term market troubles. They also realize that the opportunity to buy at relatively high cap rates with conservative but cheap financing is one that will surely not last. On the flip side, value-add/opportunistic buyers are still on the sidelines, waiting for sellers to become more realistic, frustrated that so few distressed assets have been sold by lenders, content that the recovery won’t be too quick and that plenty of opportunities lie ahead.

The motivation of sellers is also part of the dynamics that have lead to a two-tiered market. Sellers of core/stabilized properties have little motivation to sell currently. Even if they face a looming mortgage maturity, it is probable that the loan will be extended now. Conversely, sellers of value-add/opportunistic plays are almost certainly distressed.

The recent policy statement from the regulators, "Prudent CRE Loan Workouts" will further promulgate the two-tiered market. It makes extensions and modification easier for assets with cash flow, even if the borrower is under water (the loan balance exceeds property value). However, those assets with little to no cash flow are much more likely to face foreclosure and liquidation. Thus, the supply of value-add/opportunistic properties available for sale is anticipated to grow substantially while the number of cash flowing assets that must be sold will be limited.

Thus, competition for core/stabilized properties is resulting in a firming of prices, and cap rates on this select group of properties may even drift lower soon. Buyers have already priced in a poor outlook for fundamentals, and the drop in interest rates combined with an improving economic climate may allow investors to stretch further and pay more for the right property.