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Bid and Ask Will Converge in 2011

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While the commercial real estate market is not yet seeing the velocity of transactions it did a few years ago, buyers and sellers are starting to find a happy medium.

As the market begins to reset, particularly in gateway cities like New York, Washington, D.C. and San Francisco, for example, the commercial real estate sector is seeing some closure of the bid/ask spread. This is allowing transactions to occur, and the stalemate of recent years is beginning to loosen.

But because there is no large sample of sales to look at for indication of a fair price, the selling process has become more inquisitive and each sale has become sort of a case study of itself. Both parties to a commercial real estate deal are now taking more time to thoroughly understand the transaction and are taking into consideration such factors as their risk tolerance, tenant retention, existing contract income and the prospects for slow income growth. Gone are the days of rapid appreciation and optimistic assumptions.

In fact, according to a survey conducted in December 2010 by FTI Schonbraun McCann Group among more than 170 commercial real estate professionals, when asked which risk factors present the greatest risk to future real estate values, 47% said market condition changes affecting NOI. Another 39% said capital market changes affecting refinancing present the greatest risk to future real estate values.

The industry is also seeing a renewed commitment to the "Golden Rule" -- where he who has the gold, rules. Today, cash investments are required and investors are keeping skin in the game, indicative of a return to the fundamentals and a more disciplined approach to real estate investing. As a result, buyers are adopting a longer-term view.

Another valuation trend for 2011 is the trifurcation of the commercial real estate market, which includes a growing demand for the top level core assets such as office buildings in global cities; weak but growing demand for second tier assets in secondary markets; and little-to-no demand for tertiary assets in weak markets such as the desert Southwest and Florida.

For example, in January 2011, RXR Realty LLC acquired 1330 Avenue of the Americas for just $400 million, (it had previously been acquired by Harry Macklowe for $498 million in 2006 in anticipation of rent spikes of about 30 percent in the next 24 to 36 months.) The building, which was 70% leased as of January 2011 was acquired for about $750 per square foot and at a capitalization rate of 5.9%, indicative of the belief among some investors that premier New York City office buildings have recovered some of the value lost during the credit crisis and that top end markets are showing signs of stabilization.

Google's acquisition of 111 Eighth Avenue for a reported $1.8 billion or $620 per square foot in December 2010 at a reported cap rate of 5.25% further reflects a renewed confidence in the New York City market and is evidence of the willingness of buyers to settle for lower rates of return than in the recent past. Reports indicate that Google outbid more than ten other interested buyers.

But discipline might be pushed to the upper limits of reason in the top tier of the market if an investor wants to get into the best properties. As a result, while property values will in general continue to reset to levels below the 2007 peaks, some investors will overpay for premier assets because of increased competition, and we might see a mini asset valuation bubble in some markets that become overheated in 2011.

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