Real Estate Forefront

Emerging Developments in the NYC Marketplace, #12

Office Sales Prices to Asking Rents: A Critical Ratio

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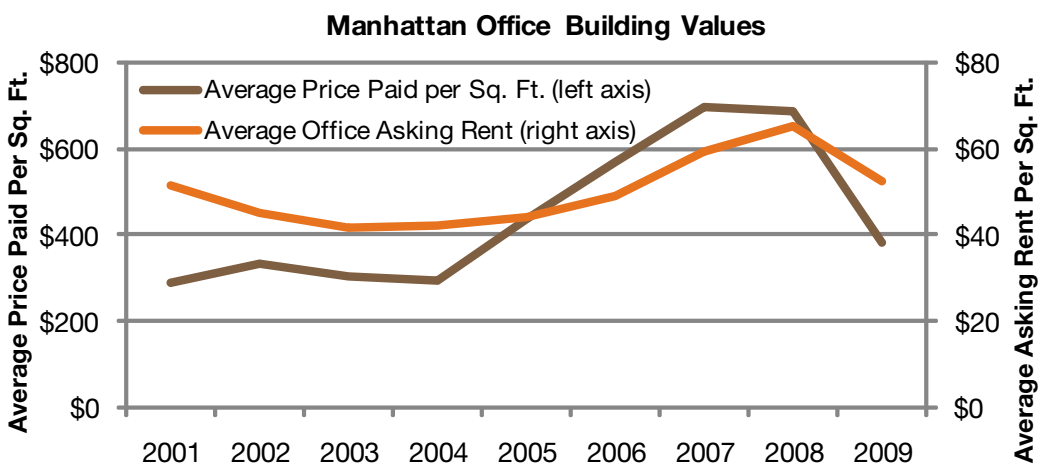
EASTERN CONSOLIDATED

Real estate investment services

The correction in Manhattan's office property sales market looks painfully obvious in retrospect. Prices per square foot climbed from an average of $300 to $700 per square foot in the course of four years before correcting nearly 50% in 2009. The price escalations were driven in part by soaring office rents which were following the laws of supply and demand. Rents accelerated in 2005 through 2007 as vacancy dropped and very little new supply came onto the market. It was difficult to predict if or when the bubble would pop.

But there are lessons that can be learned from the implosion in real estate values aside from the obvious evidence of too much easy money, overly generous loan-to-value ratios and other weak lending standards. If office building values are determined by rents or rent potential, the ratio of average sales prices per square foot to asking rents should hold relatively steady over a period of time. In fact, a simple look at the ten-year Manhattan data tells a compelling story: this ratio did hold steady at 7 from 2002 through 2004 but after increasing to 10 in 2005, the ratio jumped to 12 in 2006 and 2007, 70% higher than in 2002-2004. Aside from being a clear indication of irrational expectations in those years, this ratio should serve as an industry rule-of-thumb for the future.

The chart below showing the trend lines for all of Manhattan's office sales and office asking rents shows that while rents had accelerated in 2005 through 2007, clearly prices rose faster those years presumably because the market had anticipated rents to accelerate even faster. Other forces were likely playing a role in this ratio's rise including the eagerness of new players buying into the market, easy money and securitization. The point of this analysis is to recognize this ratio and determine how it should be applied in the future.



Ratio of Average Sales Price to Average Asking Rent:								
2001	2002	2003	2004	2005	2006	2007	2008	2009
6	7	7	7	10	12	12	11	7

Source: Eastern Consolidated, CoStar, Property Shark and NYC Department of Finances

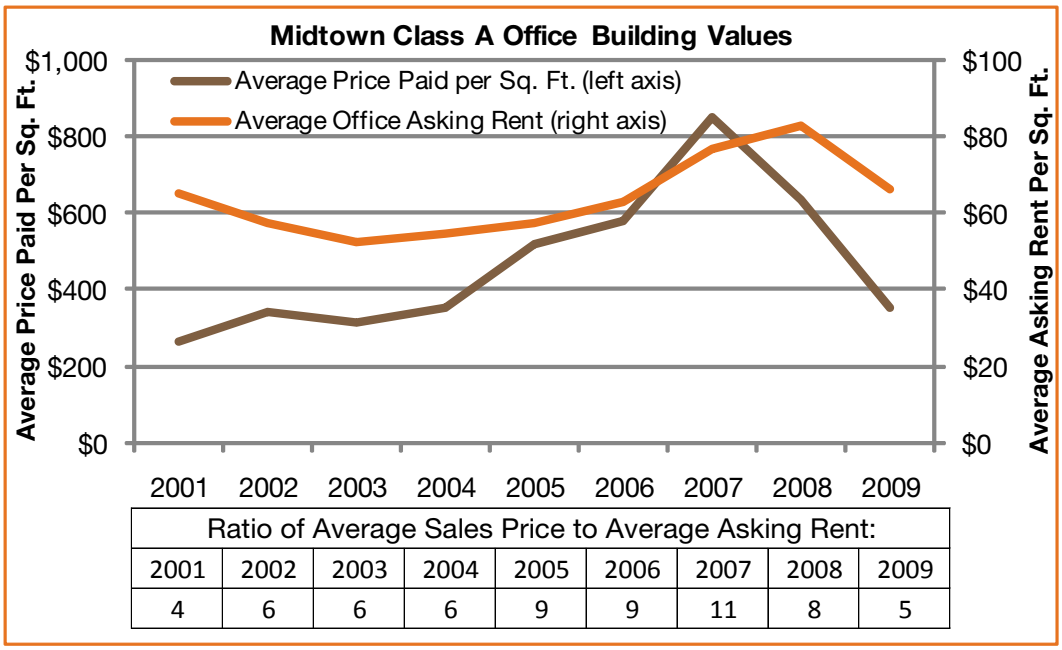
Interestingly, the handful of building sales in 2009 shows that this ratio reverted back to 7 which suggests that 7 could serve as the conservative or baseline rule-of-thumb ratio. Indeed, rents have corrected nearly 30% from the peak of $67 per square foot in the second quarter of 2008 to the current quarter which is $45 per square foot.

But office prices have corrected more than 50%. It is safe to assume that the market remains in a declining rent period but whether this translates into further reduced prices remains to be seen.

Tracking this ratio for the Manhattan market yielded significant results, but it invites the obvious question of which submarket had a more stable price-to-rent ratio, and whether or not the market for Class A properties was any better or worse.

Midtown Class A

The results for Midtown Class A shown below are consistent with the Manhattan overall results, but interestingly, the baseline ratio for this subcategory of buildings was lower: 6 instead of 7. And when the ratio did climb, it climbed later than the rest of Manhattan and was consistently lower in every year.



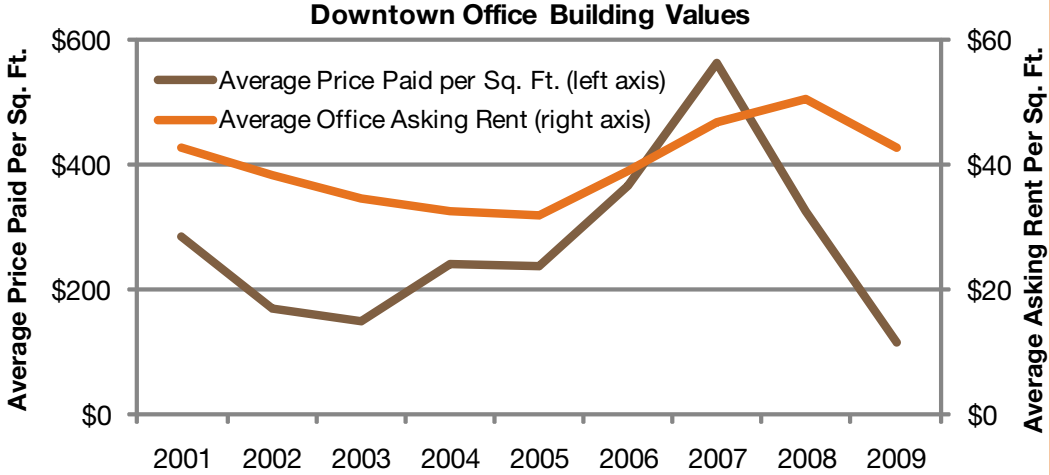
Ratio of Average Sales Price to Average Asking Rent:								
2001	2002	2003	2004	2005	2006	2007	2008	2009
4	6	6	6	9	9	11	8	5

Source: Eastern Consolidated, CoStar, Property Shark and NYC Department of Finances

One could conclude that the Midtown Class A market was more stable; vacancy was so low because most Midtown Class A tenants were locked into long-term leases that made for a more transparent market. Alternatively, it suggests that outside of Midtown Class A, investors believed rents would accelerate at a faster rate than Midtown Class A. Nevertheless, the ratio's drop to 5 in 2009 suggests that investors do not think rents will turn around in the foreseeable future.

Downtown

The Downtown results are also consistent with Manhattan but show that prices were more stable than in either Midtown or Midtown South except in 2007 when the ratio spiked. Indeed the top price paid for a Downtown building in 2007 was at 60 Wall Street which fetched $721 per square foot. The deal, however, involved a sale-lease-back for Deutsche Bank from new owner, Paramount Group. Asking rents at 60 Wall Street's "peer" buildings, or top-tier Class A Downtown buildings at the time were approximately $70 per square foot which would put the ratio at just over 10.



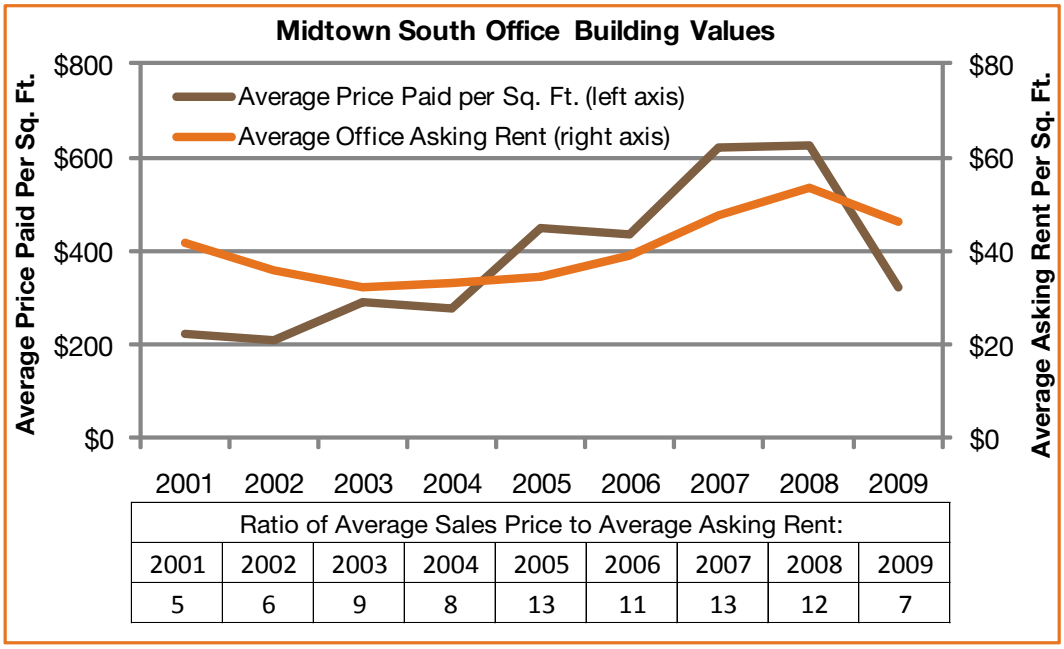
Ratio of Average Sales Price to Average Asking Rent:								
2001	2002	2003	2004	2005	2006	2007	2008	2009
7	4	4	7	7	9	12	6	3

Source: Eastern Consolidated, CoStar, Property Shark and NYC Department of Finances

It is no surprise that the ratio for the Downtown market corrected in 2009, but arguably it may have over-corrected. The largest trade last year was for 70 Pine Street and 72 Wall Street that sold for $105 per square foot. Owners, A.I.G., were beholden to buyers that had ready cash, yet this low price sent shudders through the market. The average asking rent in 2009 for Class A and B buildings was $43 per square foot, but the taking rents were likely much lower which would effectively make the ratio higher.

Midtown South

The results for Midtown South buildings are less consistent with the Manhattan results and yield few conclusions. The pool of office buildings in Midtown South includes a far more eclectic mix of buildings. Most of these buildings are smaller than the traditional Downtown and Midtown office inventory and have a more prominent retail component that would likely skew this ratio considerably.



Ratio of Average Sales Price to Average Asking Rent:								
2001	2002	2003	2004	2005	2006	2007	2008	2009
5	6	9	8	13	11	13	12	7

Source: Eastern Consolidated, CoStar, Property Shark and NYC Department of Finances

Conclusion

The charts above looking back into the history of transactions and rents show how sales prices got ahead of rents in 2006 and 2007. The near doubling of the sales-price-to-asking-rent ratio from 2002 to 2007 suggests that investors believed that rents would accelerate beyond a reasonable rate.

Those that did buy at inflated 2007 prices not only did not see an acceleration in rents, they saw a decline in rents which suggests that many of the loans taken out for those purchases are likely in special servicing.

Recent statements from Federal Reserve Chairman Ben Bernanke and others have mentioned their particular concern for the commercial real estate market, and the charts above explain why. Janet Yellen, President and CEO, Federal Reserve Bank of San Francisco recently gave a speech to the Burnham-Moores Center for Real Estate School of Business Administration at the University of San Diego and said “commercial real estate remains a bleak spot and investment in nonresidential structures is likely to stay depressed for some time.” Until the economy starts to add jobs, rents and prices will stay low, but their ratio should remain stabilized.

This is a simple analysis of a simple ratio but it yields a fruitful lesson, when sales prices get beyond 10x the market’s current asking rent, it is likely that something is amiss.

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