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Breakfast seminar: High valuations hamstring CRE transaction activity

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Samantha Rowan 1 hour ago

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The commercial real estate market is seeing an imbalance between transaction activity and the amount of capital that's been raised for investment, according to panelists at *Real Estate Finance & Investment*'s breakfast seminar on valuations, interest rates, and where the market is in the current cycle. The event, held at the Lamb's Club in New York on Wednesday, was moderated by **Dan Lisser**, a senior director with **Marcus & Millichap Capital Corp**. Rounding out the panel were **Matt Galligan**, president of **CIT Real Estate Finance**, and **David Blatt**, ceo of **CapStack Partners**.

The spirited discussion, punctuated by questions and comments from a lively audience, raised the point that the prospect of higher interest rates aren't the biggest problem for commercial real estate right now. "There have been increases in rates but they've been pretty benign. As far as I'm concerned, the key issue here is the lack of transaction volume," Galligan said. "Transaction volume is off 10-20% and without prices decreasing, a log jam has developed. Until prices decrease and some sales happen under the new reality, you won't have price discovery and without that, it is hard to make an argument based upon revised value."

Galligan noted that while there's often a slow start to the year, he doesn't see any signs that this will change. This is due in part to high valuations that have topped the peaks seen prior to the last recession. "Until prices decrease, you won't have price discovery and without that, it's hard to make an argument about why it's a good idea to buy something," he said.

With the prospect of higher rates, Lisser asked if more investors are looking to lock in fixed rates. "If you're talking about a group that's looking to own for the long-term, it makes sense," Blatt said. "But if you're thinking short-term, fixing doesn't make sense. There's also the option that if you're not thinking long-term, you can use a rate cap as a very cost-effective method [of hedging against rate risk]." Galligan noted that CIT, with a book that's largely comprised of shorter-term loans, typically requires borrowers to take out rate caps.

Lisser pointed out that the markets had a good, six-year run, with rising real estate values and a benign interest rate environment. "Rates have certainly increased and the Fed will do another one or two rate hikes this year. So what's happened with the cycle? Are we at the end? Will we continue to see this rise in values? There's an inflow of capital as we've discussed, with hundreds of billions of dollars that need a home. How does this all come together?" he asked.

For his part, Galligan believes the shift is happening now to a harder real estate market. "We're experiencing the air coming out of the balloon as we speak. I see reports that the flow of business isn't what it was, that there's massive amounts of capital on the sidelines – but I don't think we're going to see an adjustment in pricing for six to 12 months," he said. Another factor that may be affecting transactions is turmoil in the **Trump** administration and a lack of clarity around key legislative initiatives, including planned healthcare and tax reforms, panelists said.

The panel eventually turned to the much-discussed, much-maligned, and much overbuilt retail sector, with Lisser noting that the historical image of people going to the mall and walking out with a product has changed substantially. "Retail is definitely getting hammered – it's the most expensive rent and the driver, that a tenant was generating a certain number of sales per square foot to justify asks, isn't there anymore," Blatt said. "I don't remember the last time I went to a department store – I'm not saying this ironically, it's just the way I am. But there are definitely companies like **Apple**, who don't care how they sell a product, who have stores that are jammed and there are definitely dog malls that have fallen behind on the times. Retail has always been a trend-driven asset class and I think that where it used to be anchor-driven, owners are now saying to restaurants and gyms, 'Please come to my location.' We're definitely going through a period where we're redefining what [retail] is."

The panel – and the audience, if murmurs of agreement were any judge – was optimistic about the potential for experiential retail properties. That said, there have been a lot of failed or semi-failed concepts, including the long-delayed American Dream Meadowlands, one panelist noted. "The retail sector will survive, there'll be some pruning, and there'll be some consolidation," Lisser said.

In general, there was a consensus among the panelists and attendees *REFI* spoke to that the **Federal Reserve** is likely to raise rates this year – but the number of times is anyone's guess. One attendee asked what the panel thought about the Fed's eventual plans to unwind its balance sheet. Lisser believes this will be done calmly and orderly. "They've already been laying the groundwork and have made a concerted effort to alert the market," he added.

Another attendee picked the panel's brain about valuations for lower-quality multifamily product in non-gateway cities. "We're seeing Class C product [in these markets] trading at 5-6% caps. Does anyone think there will be a correction? And do you think job growth will be sustainable in these markets?" he asked. Galligan noted that many smaller markets have strong economic prospects but also don't have high barriers to entry, which makes it more difficult for CIT to get comfortable with the risk. “It’s decent product. Painted and papered with new appliances, these deals have better rents than the market, which is allowing owners to keep them filled. We like the affordability of this workforce housing.”

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