

Commercial Real Estate's Bid-Ask Spread

In the stock trading world “Bid-Ask Spread” is the term traders use to describe the difference between the highest price that a buyer is willing to pay for an asset and the lowest price for which a seller is willing to sell it. This term perfectly describes the current real estate investment market. Sellers are emotionally tied to the market conditions that existed last year. Buyers, on the other hand, are fixated with the dire economic forecasts being generated by the popular media. The result . . . a “bid ask spread” in commercial real estate.

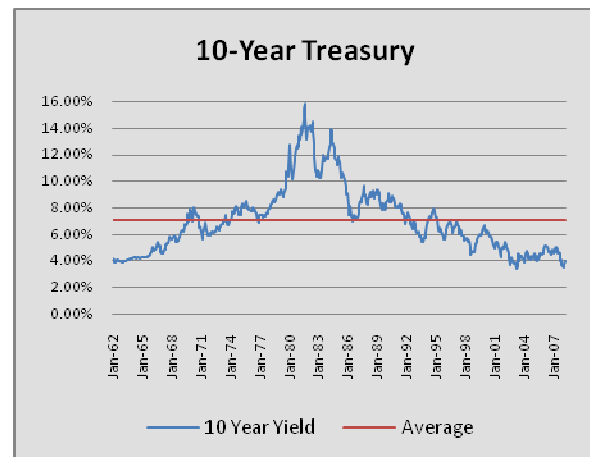
Only 12 short months ago, commercial real estate cap rates had reached what many market participants perceived as an all-time low. The historically low cap rates in the first half of 2007 were a function of the free flow of plentiful, low-cost debt capital provided by conduit lenders (i.e. CMBS). The low cap rate environment that existed last year was further fueled by optimistic views about the potential for real rent growth. This is the market environment that exists in the minds of many sellers.

At present, we are being inundated by prognostications of impending economic doom. Rising oil and gas prices, the declining value of the dollar relative to other currencies and the fear of a domestic recession all add fuel to this perception. The expectation of further economic crisis gives real estate investors the belief that sellers will HAVE to sell at highly discounted prices. This is the view that permeates the mindset of buyers.

The result of these two vastly different perceptions of the commercial real estate world is the textbook definition of a “bid ask spread”. Sellers want and expect 2007 pricing. Buyers want and expect excess return premiums with limited downside risk. The end result is a dramatic slowdown in transaction volume.

So who is right, buyers or sellers? The correct answer is likely NEITHER. The capital environment that led to the compressed cap rate environment in 2007 is over, and thus sellers’ expectations of 2007 pricing in 2008 is unrealistic. Similarly, buyers’ expectations of achieving “ginormous” premiums above the risk rate, while at the same time embedding highly conservative underwriting assumptions into their cash flow forecasts, are fallacious.

Putting the situation in more simple terms, sellers expect too much and buyers will not pay enough. Owners that bought assets at the top of the market with high levels of debt, who are now unable to refinance these debt obligations, will likely be forced to sell their position at a discounted price. While the pain of buyers may be less acute, there remains a need to place capital. Buyers must decide whether the risk adjusted returns offered by real estate are



warranted. Alternatively they can invest their capital in the paltry returns offered by treasuries and bonds, or buyers can place their capital in equities (stocks) where the daily volatility of pricing can bring a whole new meaning to the word “pain”.

So what will change this situation? Answer: a large dose of rationality. The stock market can provide a great example of the dispassionate rationality that is sorely needed in commercial real estate. As much as I would like to sell my 100 shares of United Airlines at the October 2007 price of \$48 per share the market tells me that that the price TODAY is \$7.52 per share. Similarly, I would love to buy shares of Visa at the IPO price of \$42 per share, but that market price TODAY is \$76.35. The ability of both buyers and sellers to understand and accept current pricing will go a long way toward eliminating the “bid ask spread” that exists in commercial real estate.

So the “bid-ask spread” that currently exists will go away. The difference in perception and expectations amongst buyers and sellers will be bridged. Equilibrium in the real estate investment market will return. As participants in this market it is our responsibility to advise our clients, both buyers and sellers, as to the reality of today’s market. Efficient markets theory tells us this spread cannot and will not last!