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The impact of the current lending environment on the Manhattan office market

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Many experts are predicting that the Manhattan office market will collapse due to on going weakness in the financial services sector and the economy as a whole. Underlying statistics, however, reveal that the office market is actually poised to weather the current conditions, resulting in little pain for building owners. While the Manhattan office market will not completely fail, there have been substantial changes in the lending environment that will make it harder for office buildings to secure financing. Lenders have tightened their underwriting standards, which has subsequently impacted the amount a buyer is willing to pay for the same cash flow.

Manhattan's low office space vacancy rates have helped to buffer economic downturn in the city. According to statistics released by the CoStar Group, Inc., the overall vacancy rate at the end of the first quarter 2008 was a surprising 5.4%. One of the key reasons rates have remained in check is because of the limited amount of new space being added to the market. In Midtown, the largest of the city's submarkets, there are 3.2 million s/f currently under construction, representing only 1% of Midtown's existing supply. Interestingly, 83% of this newly constructed space is already pre-leased by tenants like Bank of America who are freeing up old leased space and moving into these new properties.

While the fundamentals of the office market remain strong, there are still several significant threats. The financial service sector is continuing to lay off employees, increasing the possibility that firms will start offloading excess space. Also, loan proceeds in the current market have been substantially reduced. Over the past year, interest rates for commercial properties have increased while underwriting standards have become tougher. It is interesting to analyze how loan proceeds and debt service have changed over the past year and how they are impacting property pricing. Below, I have outlined two loan scenarios: one that describes market conditions in early 2007 and one that represents today's market. Both scenarios assume the building owner is looking for a ten-year fixed-rate loan and the cash flow is $1 million.

In February, 2007, the ten-year treasury was approximately 4.72% and spreads were as low as 100 basis points over with payments based on a 30-year amortization schedule at a 1.20X debt service coverage. According to these parameters, the loan amount would be approximately $11.9 million ($1 million/6.98% constant/1.20X) with annual debt service of $833,333.

Today, the ten-year treasury is approximately 3.87%, but spreads have increased to 300 basis points over with payments based on a 30-year amortization schedule at a 1.25X debt service coverage. With these parameters, the loan amount would be $10.1 million ($1 million/7.88% constant/1.25X) with annual debt service of $800,000.

Even though the property cash flow and amortization period have remained the same, the higher interest rates (due to the increased spreads) in addition to a higher debt service coverage ratio have decreased loan proceeds by a startling $1.8 million. Also, in the current market environment, the required cash on cash return that investors demand has increased to 8% from 7%, reducing the price an investor is willing to pay for the property by approximately $1.7 million.

This quick analysis shows that in just one year, we have seen a 13.2% decrease in loan value and an approximately 1% change in the cap rate.

Many borrowers are in a state of shock when they run the numbers and comprehend the significant decrease in borrowing capacity the same property cash flow affords them. Clearly, office property owners who are thinking about refinancing or getting a loan on office space need to understand the new parameters in the current lending environment.

Daniel Lisser is managing director of Johnson Capital, New York, N.Y.