Bid-Ask Transaction Gap Puts Potential Pressure on Cap Rates

When moving rents up to prevailing markets were a constant positive, things were easier. Now, many eyebrows are rising.

By Erik Sherman | January 11, 2023

During the fall, many sources told GlobeSt.com that the **general forecast for commercial real estate (https://www.globest.com/2022/12/27/2023-cre-vision-uncertainty-with-heavy-unrealistic-expectations/)** was uncertainty and more than the odd person or institution holding onto unrealistic expectations. As Barry Saywitz, president of national brokerage The Saywitz Company, said at the time: “You have a seller who wants yesterday’s number, and you have a buyer who slings low-ball offers and sees who’s desperate.”

More than one person said that price discovery would be a crying need so landlords, operators, developers, and investors would have some realistic sense of what valuations and pricing should be.

A new report from Hines looked at, among other things, disparities between fundamentals and the bid-ask gap. Going into and continuing through much of 2022, buyers kept pumping capital into purchases, with lease trade-outs and the prospect of increasing rents providing the rationale for falling cap rates.

“Lease trade-outs have stoked net operating income (NOI) growth expectations in many U.S. apartment markets but with rents beginning to soften on more normalized levels of absorption amidst record-high completions and rising concessions, those expectations may prove a bit optimistic,” the report said. “Heady, and in many cases record-breaking, rent growth in recent years has generated a similar phenomenon in the industrial sector more broadly, particularly for assets with shorter weighted-average lease terms (WALTs) where buyers can see a clearer path to marking in-place rents up to higher market rents upon lease expirations.”

Those dynamics work so long as both sides of a transaction agree to the values and while lenders are open to the potential of negative leverage. According to Moody’s Analytics back in November 2022, negative leverage had mostly vanished from CRE for decades but had again become a trend because of increased financing costs, increasing cap rates, and inflation driving up the cost of operations and putting tenants into worry over the cost of everything.

“In the early part of the year, lenders were willing to participate in this thesis on the basis of a path to positive leverage within 18 to 24 months,” Hines wrote. “As the year went on, that timeframe was reduced to 12 to 18 months and is likely continuing to shorten, given economic uncertainty and regulatory pressure in some jurisdictions.”

In multifamily, lease trade-outs have been falling to normalized levels, so even with shorter WALTs, valuations may feel a negative impact making lenders unwilling to continue supporting the practice.

For longer term **WALTs in industrial (https://www.globest.com/2023/01/11/investors-eye-industrial-assets-with-shorter-walts-as-capital-costs-rise/)**, and rent escalators often below inflation, there's more upward pressure on cap rates. "Anecdotally, a new industrial asset with a 10-year lease to a good credit tenant and 2.5% rent bumps would have traded for a cap rate in the 4-4.25% range in the first quarter of 2022 but was pricing in the mid-5% range by October," Hines said.

It also seems likely that retail could feel similar pressures, as inflationary pressures on consumers could eventually mean pressure on many retailers and their ability to continue paying higher rents.
