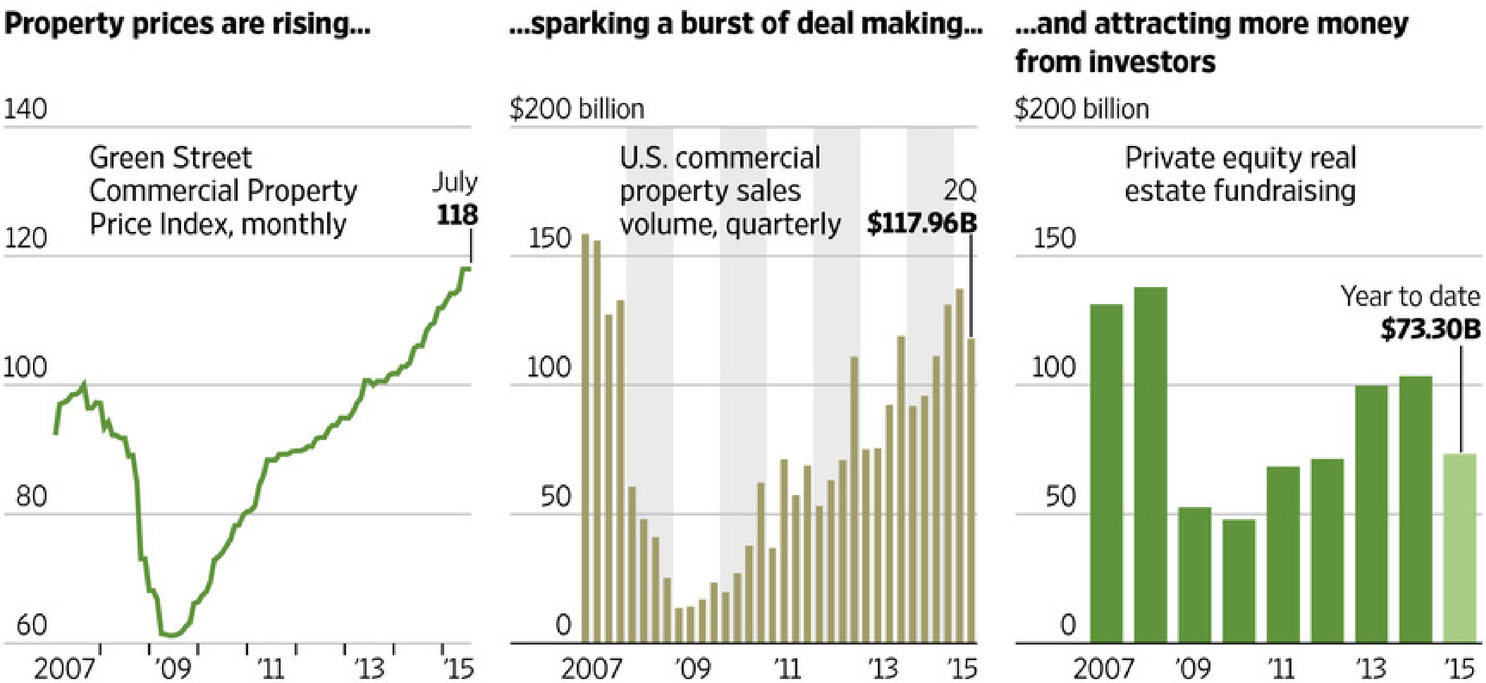
Surge in Commercial Real-Estate Prices Stirs Bubble Worries

By Art Patnaude and Peter Grant

Property Boom Redux

Commercial real estate sales and prices are surging, prompting concerns about a possible bubble.



Sources: Green Street Advisors (index); Real Capital Analytics (sales); Preqin (fundraising)

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Investors are pushing commercial real-estate prices to record levels in cities around the world, fueling concerns that the global property market is overheating.

The valuations of office buildings sold in London, Hong Kong, Osaka and Chicago hit record highs in the second quarter of this year, on a price per square foot basis, and reached post-2009 highs in New York, Los Angeles, Berlin and Sydney, according to industry tracker Real Capital Analytics.

Deal activity is soaring as well. The value of U.S. commercial real-estate transactions in the first half of 2015 jumped 36% from a year earlier to $225.1 billion, ahead of the pace set in 2006, according to Real Capital. In Europe, transaction values shot up 37% to €135 billion ($148 billion), the strongest start to a year since 2007.

Low interest rates and a flood of cash being pumped into economies by central banks have made commercial real estate look attractive compared with bonds and other assets. Big U.S. investors have bulked up their real-estate holdings, just as buyers from Asia and the Middle East have become more regular fixtures in the market.

The surging demand for commercial property has drawn comparisons to the delirious boom of the mid-2000s, which ended in busts that sunk developers from Florida to Ireland. The recovery, which started in 2010, has gained considerable strength in the past year, with growth accelerating at a potentially worrisome rate, analysts said.

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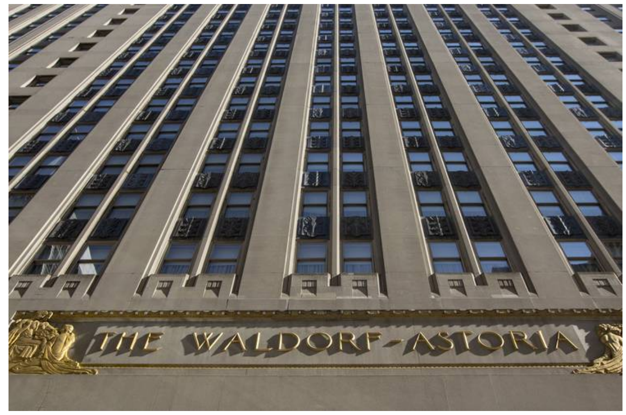

China's Anbang Insurance Group in February paid $1.95 billion for New York's Waldorf-Astoria, a record price for a U.S. hotel. Photo: Brendan McDermid/Reuters

"We're calling it a late-cycle market now," said Jacques Gordon, head of research and strategy at Chicago-based LaSalle Investment Management, which oversees $56 billion of property assets.

While it isn't time to panic, Mr. Gordon said, "if too much capital comes into any asset class, generally not-so-good things tend to follow."

Regulators are watching the market closely. In its semiannual report to Congress last month, the Federal Reserve pointed out that "valuation pressures in commercial real estate are rising as commercial property prices continue to increase rapidly."

Historically low interest rates have buoyed the appeal of commercial real estate, especially in major cities where economies are growing strongly. A 10-year Treasury note is yielding about 2.2%. By contrast, New York commercial real estate has an average capitalization rate—a measure of yield—of 5.7%, according to Real Capital.

By keeping interest rates low, central banks around the world have nudged income-minded investors into a broad range of riskier assets, from high-yield or "junk" bonds to dividend-paying stocks and real estate.

Lately money has been pouring into commercial property from all directions. U.S. pension funds, which got clobbered in the aftermath of the crash, now have 7.7% of their assets invested in property, up from 6.3% in 2011, according to alternative-assets tracker Preqin.

Foreign investors also have been stepping on the gas. China's Anbang Insurance Group in February paid $1.95 billion for New York's Waldorf-Astoria, a record price for a U.S. hotel. Another Chinese insurer, Sunshine Insurance Group Co., in May purchased New York's glitzy Baccarat Hotel for more than $230 million, or a record $2 million per room. China Life Insurance Group Co. and Ping An Insurance Co. in April bought a majority stake in a $500 million development project in Boston.

China is looking to other markets as well. Last month, its sovereign-wealth fund bought nine office towers in Sydney and Melbourne, as well as 10 shopping centers in France and Belgium.

"What has been fascinating has been their speed of deployment," said Iryna Pylypchuk, director of global research at global real-estate services firm CBRE Group Inc.

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In Europe, buyers are venturing into markets like Madrid and Dublin, where property values haven't regained precrisis peaks. U.K. firm M&G Real Estate last month made its first investment in Spain, paying €90 million for a vacant 35,000 square meter (376,740 square feet) office building in central Madrid that it will refurbish and rent to

U.K. advertising agency WPP PLC.

“We’re still buying at the low point in Spain,” said Simon Ellis, manager of M&G’s European core property fund, which has spent €360 million in Denmark, Italy, Germany and France since March.

The turbocharged activity is a far cry from the depths of the bust. Commercial real-estate prices and sales volume plummeted after the 2008 crash. They began to rebound in a few office markets like New York City and Washington, D.C. in 2010. Investors also began buying multifamily buildings on the correct assumption that the carnage in the housing market would result in surging demand for rental apartments.

RXR Realty, which began buying Manhattan office buildings in 2009, earlier this year sold a roughly half of its stake in six buildings to Blackstone Group LP in a deal that valued the buildings at $4 billion, more than twice what RXR paid for them.

A valuation index compiled by Green Street Advisors fell to 61.2 in 2009 from 100 in 2007. It crossed 100 again in 2013. Last week it was at a record 118.

Analysts warn that property values could fall if interest rates rise sharply. The Federal Reserve has signaled it’s moving toward interest-rate increases later this year. A surge in rates could have repercussions throughout global financial markets, especially if falling prices trigger a wave of defaults on mortgages.

But bulls counter that even if interest rates rise, property values might not necessarily be hurt if higher interest rates are accompanied by higher inflation, which typically allows landlords to raise rents. They also point out that so far this cycle hasn’t seen the kind of overbuilding that has destabilized real-estate markets in the past.

The Fed and others have noted that banks have been loosening their lending standards. In all, banks had $1.7 trillion worth of commercial real-estate loans outstanding at the end of the first quarter of this year, just 2.6% shy of the record hit in the first quarter of 2009, according to Trepp LLC, a real estate data service.

New issues of commercial mortgage backed securities are on pace to clock in at about $110 billion this year, a postcrash high and a 17% jump from 2014, according to Commercial Mortgage Alert, an industry publication.

Moody’s Investors Service also has sounded the alarm about loosening credit standards.

“We would have hoped the lessons from the financial crisis would have been more durable,” said Tad Philipp, Moody’s director of commercial real-estate research.

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Corrections & Amplifications:
The value of U.S. commercial real-estate transactions in the first half of 2015 totaled $225.1 billion. An earlier version of this article misstated the amount. Also, valuations of office buildings reached post-2009 highs in New York, Los Angeles, Berlin and Sydney. An earlier version of this article incorrectly said post-1999 highs. (Aug. 15, 2015)