

## THE PROPERTY REPORT

## Commercial Real Estate Shows Bubble Signs

*Values Rose 3% to Record  
In 2nd Quarter, Study Says,  
Aided by Increasing Rents*

By RYAN CHITTUM

Residential real estate has been the focus of much of the bubble talk around the U.S. But some of the same forces inflating home prices are at work in commercial real estate, too, and a new study from Reis Inc. has found that investors may be paying too much for office buildings.

The value of office buildings surged 3% in the second quarter to a record \$145.18 a square foot, helped by falling vacancy rates and rents that are rising for the first time in more than four years, according to the study of the top 50 U.S. office markets by Reis Inc., a New York-based commercial real-estate research firm.

But investors' continued willingness to accept lower initial returns for office buildings also contributed to the jump. Investors paid an average \$192.74 a square foot for office buildings they bought in the second quarter—a record by far. That represents a 32.8% premium over the actual value of office space as calculated by Reis, also a record by a wide margin.

Reis calculates value based on the income buildings generate divided by the capitalization rate, or the return on investment the property provides in the first year of ownership. The cap rate slipped to 7.5% in the second quarter from 7.6% in the first. Like residential real estate, commercial space has been flooded with cheap money as investors seek sure returns in a low interest-rate environment. Also, investors burned by the market crash earlier this decade, and spooked by recession, terrorism and war, have poured money into real estate, which provided what they saw as a relatively safe haven. As a result, asset

prices and stock prices for real-estate investment trusts have soared.

Reis Chief Executive Lloyd Lynford notes that part of the premium comes because investors are seeking higher-quality buildings and the sure income streams that such well-leased trophy

The so-called flight to quality has been a consistent trend over the past few years.

buildings can provide. That's not the whole story, though; the so-called flight to quality has been a consistent trend over the past few years, when most buildings were hemorrhaging tenants and rents were falling. Investors have increasingly been willing to take on second-

tier assets, but the average price per square foot rose 3% to a record \$145.18, more than previous

Nonetheless, things differ at the Cleveland office market, which is tied by the recovery in that economy. Factored in new office "Land is a try and to cult," he says recovery makes pro

Still, the economy has so far

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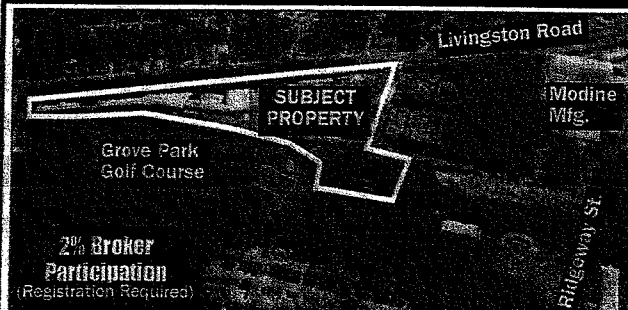
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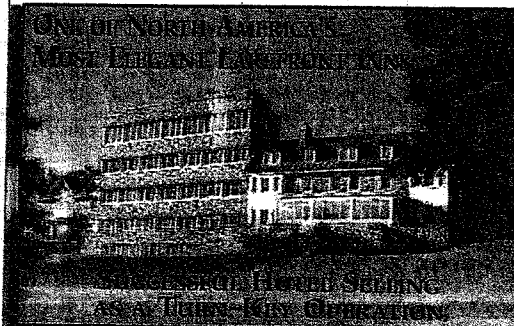
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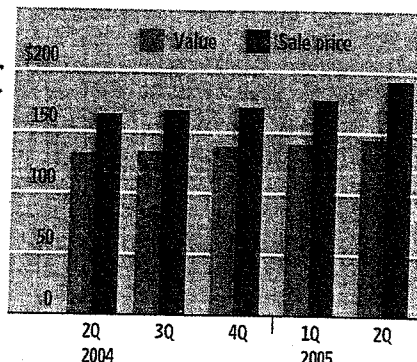
tier assets in search of better returns, but the average price paid for office buildings rocketed 9% in the second quarter to \$192.74 from \$177.31 a square foot in the previous quarter. "Buyers are paying more than they should for some of these assets," Mr. Lynford says.

Nonetheless, some analysts see things differently. Rich Moore, an analyst at KeyBanc Capital Markets in Cleveland who follows real-estate investment trusts, says the prices can be justified by the bet that the office-market recovery still has a long way to go and that income will increase as long as the economy supplies steady job growth. Factored into his view is the dearth of new office buildings in the pipeline. "Land is at a premium across the country and to build something new is difficult," he says. "If we're starting to see recovery in rents and occupancy, that makes properties attractive."

Still, the prices being paid assume the economy will add more jobs than it has so far in the recovery, and that out-

## Overvalued?

U.S. office buildings, per square foot



Source: Reis Inc.

side forces like an oil shock or a terror attack don't stifle growth. "If the U.S. ever produces lots and lots of jobs again [like the late 1990s] I'd say these office buildings are cheap," Mr. Moore says. "But it's a question whether within the new world economy we'll do that. I don't know."

Apartment values rose even more

than office values, according to the study, though the disparity between actual value and prices paid wasn't as great. Apartment values rose 3.8% in the second quarter to \$75,395 a unit. The average sale price per unit was \$94,262 in the second quarter, up 6.2%. The premium paid by investors over value as calculated by Reis was 25% in the second quarter, up from 22.1% in the first.

The multifamily sector has been helped lately by the wave of condominium conversions across the country. The rush to convert apartments to condos has helped take supply off the market and led to a declining vacancy rate. But, if anything, investors are even more willing to take lower returns on apartments, thinking they can make big money on the conversion to condos. Cap rates for apartment complexes fell to 6.2% in the second quarter from 6.4% in the first and are down a full point from a year ago.

"There are a few examples in the apartment sector where I would say we have gone crazy," says Mr. Moore, including South Florida, Las Vegas and Chicago. Some complexes are trading for 3.5% cap rates, and the market is especially heated in South Florida, he says.

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