OAK INVESTMENT MANAGEMENT GROUP

APRIL (2) 2012: ‘Off-market’ deals in Real Estate

Selling ‘off-market’ is one of the magic words of real estate. Agents use it to boast of their first touch access, real estate private equity firms use it as their ‘special source’ for their vintage and soon-to-be-opened funds and investors hope for it assuming that a truly ‘off-market’ deal is underpriced relative to the open market.

The problem is that there is no such thing as completely ‘off-market.’ The reason is that no reasonable, responsible or rational seller would sell below what they consider fair or decent value for the asset that they hold. No matter how close they are to an agent (which can be very close) and no matter how much they might compliment the purchaser (which might be very sincere), as long as the transaction is at arm’s length, the economics of a sale is a zero sum game for the vendor and the purchaser.

What vendors will do is exchange some of the premium, or if one prefers – offer a discount – to those who have a demonstrable and clear ability to transact. On an asset level, this can be because of a need for a speedy execution of the sale agreement (which in real estate can last a long time), or because the vendor has got themselves into a large bulky position (which can be measured in absolute or relative terms to the market) that is hard to unload on the open market at the full value of all the constituent parts. That is to say colloquially a purchaser they might benefit from a ‘bulk discount.’ On a finance level, a discount might be offered for liquidity in an illiquid environment. Through no fault of the asset or of the vendor it might just be that liquidity become prohibitively expensive or dries up completely.

On a relationship level (and this is where the off-market moniker has most relevance) the vendor might offer a ‘friendly transaction’ not commonly available in the market for their preferred bidder i.e. the time and forbearance to collect equity backers, financing facilities and due diligence process. This is a huge boon for the interested purchaser but it is hardly as if they will be getting something for nothing. The investor will still need go through their own investment process, justifying the value and ultimately taking the risk and reward for well timed buying of an asset. Also, it is important to emphasise that even in a ‘friendly transaction environment’ no rational investor will sell blind or deliberately misprice the asset without informally testing the market or looking at comparables.

Of course, anything that makes a real estate asset more opaque such as mortgages or second liens, unpaid tax liabilities, or embedded environmental risks makes the calculation of what a real estate asset is worth more difficult. Quite rationally a vendor who wanted a sale might err on the side of caution making an allowance for the time and effort required to sort these situations out. The cost of sorting them out is affected by the a) risk that they won’t be, and, b) that costs will be compounded by the discount rate in the time taken to do so. But this is not the same as deliberately selling cheap on the private market. Even a straight forward collection of assets can be marked down by as much as 25% (in the case of wholesale bulky disposal) all the way through to the cost of the transfer tax (between 2% and 5%) for a quick and effective sale, but this is not consequence of it being ‘off market’ but a cause of it being ‘off-market.’

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