OAK INVESTMENT MANAGEMENT GROUP

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Transaction Premium in Real Estate

Transaction premium in real estate refers to the additional payment required in order to win a bidding competitive process. Arbitrators (owners or retained agents) of competitive processes can rely on two factors: the quality or the quantum of the bid. Clearly, while the first element is a subjective criterion the latter is an objective criterion on which an optimal assessment is base.

Being able to ascertain a credible and strong bid is the first role of owners or of retained agents, if they have decided to sell a real estate asset. There is no point getting the highest bid that fails (eventually) to materialise. As a result, a competitive field is usually narrowed down to a restricted field of 'qualified' bidders. There is justification in this approach but there is also a danger in restricting qualified new entrants from displacing an established order.

During the debt fuelled times the transactional premium was not a hard concept for speculators to grasp. Now, on the contrary, during the constriction of that same debt it is a harder for long-term investors to appreciate. But the principle stays the same: If you are serious about getting into the real estate market you need to a) swallow the large transactional costs associated but also b) need to accept the real deal premium required to get a deal done. This premium can be substantial in real or relative terms.

What does this mean in practical terms? What it means is that you cannot rely on comparables to compose the quantum of a bid. Although a comparables based bid has sense of security from an 'analytical' point of view it is false because in practical terms this will always be 'behind' the market. Being behind the market is usually failing to bid enough on the way up, but, occasionally, it is also about bidding too much on the way down. Either way, an investor ends up losing money and credibility by applying the wrong value to winning the asset in question.

At this stage in the cycle the institutional market complain about private investors acting irrationally – and bidding over and beyond what is necessary to win an asset. But the truth of the matter is that the complaining of the institutional market is more irrational than the private investors. Institutionals follow comparable as opposed to fundamental value which the private market intuitively feels. This happens during the full economic cycle but is hidden by debt and exuberance in the markets during the boom times but only becomes naked during the down times.

Transactional premium goes to the heart of what makes real estate special amongst the asset classes – it is so completely dominated by the marginal entrant into the market. The entity with the least exposure and the least pricing power is the last to come to market and therefore price the market itself. As a result, because real estate takes so long to create and lives for so long, this fosters booms and busts in its own right. An investor must always steer clear of these extremes.

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