NEITHER A LENDER NOR A LENDER BE

by Samuel Zell

The 1980s will present the greatest structural changes in real estate financing since World War II. Major changes will occur in the availability and sources of financing as well as its terms and conditions. A realigned real estate industry, significantly different from that of the past 35 years, will develop as a consequence.

Shortage Of Available Capital

The most important alteration relates to the availability of funds. The industry in the '80s will experience a shortage of available capital, resulting in a de facto allocation system. Deferral of capital expenditures over the past 15 years combined with new challenges will result in a demand for funds much greater than the supply. In such a marketplace, funds will move toward that portion of the economy providing the greatest degree of profitability while maintaining security. This criterion will discourage lending institutions from advancing funds to questionable projects or advancing a high percentage of the total value of the project.

The '80s will be a time when capital is allocated according to a system of priorities with security and stability at the top of the list. In a business climate of capital shortages, lenders are unwilling to take much risk. The attraction of high-risk, high-yield loans pales when profitable moderate spreads are available. Less than top-quality credit will find the marketplace inhospitable. Funds will be allocated within the credit market based upon rate only — not risk. Only minimal levels of risk will be acceptable.

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Real estate lending will see a major reduction in the loan-to-value ratio. Past development loans have ranged from 75 percent to 100 percent of capital requirements. Developers encouraged lenders to make "full loans," because more funds were available than there were opportunities. As funds become short, lenders will have no incentive to advance higher proportions of the total cost. Lenders will perceive correctly that advancing funds and taking risks in development situations is the equivalent of owning, and will happily be owners. Along with this transition will come the disenfranchisement of the small real estate borrower and the less-than-totally creditworthy corporate customer. The availability of profitable loan business will result in a greater diversification and a gradual movement by lenders away from a concentration of investment.

Creative Approaches To Financing

The future orientation and form of real estate financing will reflect new approaches. Funds will be borrowed on short-term, fixed-rate loans — 90 to 180 days — or for longer terms at some increment to prime or the London Interbank rate. Long term will be defined as 5 to 10 years interest-only loans of no more than 50 percent of value. Loan criteria will become so conservative that all but the most creditworthy and heavy equity opportunities will be precluded from the market. A new array of debt instruments carrying equity characteristics will meet equity requirements:

- convertible debt instruments in real estate companies or trusts;
- debt instruments with fixed rates adjusted by the Consumer Price Index;
- debt offerings made to the public or institutions and
- rights offerings relating to specific real estate,

or to companies or combinations thereof, will replace the shrinking debt element in real estate ownership.

As interest rates have moved from 6 percent to 18 percent, the cost of construction financing as a percentage of total project cost has tripled over the last 10 years. The increase in construction interest as a factor in the construction budget requires innovative efforts to reduce the cost of money during the development period. An obvious method for reducing interest costs is increasing equity investments. Another method will be for real estate companies to go into the commercial paper market and issue short-term paper backed by bank letters of credit or surety bonds. This reduction emanates from the tendency of commercial paper rates to float from 200 to 300 basis points below prime. Since the cost of construction financing is a greater portion of total cost, bringing innovative ideas and equity into this phase of the business becomes even more critical when competing against developers such as insurance companies and pension funds, which have a much lower cost of money.

Creative financial thinking will be required to make real estate transactions in the '80s feasible. Layered financing such as ground leases, fixed-payment schedules with variable underlying interest rates, master leases and other fragmentations of the various factors inherent in the structure of transactions will be used in attempting to reduce the debt service requirement of new development projects. This type of segmentation is advantageous in matching diverse interests with portions of a project that achieve their respective goals. An example of same is the subordinated ground lease and the leasehold position.

The nontaxpaying entity which owns a nondepreciable segment of a project such as the ground makes available the leasehold to a tax-conscious investor who will accept a lower yield to achieve tax benefits.

Joint Venture Participation

Sources of real estate financing throughout the '80s will differ only in the form and willingness of participation and in the expected yield for the effort. Traditional sources of lendable funds such as savings banks, savings and loan associations and banks will alter materially their role in the real estate economy. Instead of being prime sources of lendable funds, they will be active participants as joint venture and equity partners. They will adjust to using less of their own capital while playing the role of conduit for other people's capital. Consequently, a bank, originally very conservative, will enter into construction loans that will be joint-ventured with pension funds, taking a small piece of the transaction and laying off most of the loan to a pension fund. The bank will then provide equity funds at the higher risk levels for commensurate ownership rewards. The nature of the bank's role as a conduit requires a reduction in the risk quotient of lending. Consequently, there will be additional momentum toward lower percentage of value loans with other branches of the same institution participating on the equity side.

Recently much has been written about the new "joint venture deals" being done with insurance companies, and commonly referred to as 50 - 50 JVs. In these deals, the insurance companies put up all the money in a combination of debt and equity. For example, a lender will provide 65 percent to 70 percent of the total cost of the project in the form of a fixed-rate mortgage of 5 to 10 years. A kicker to this mortgage will require the borrower to give the lender 20 percent of the net as additional consideration. The insurance company provides the remaining 30 percent to 35 percent of the funds as equity. This equity carries with it a 10 percent to 12 percent cumulative preferred return and 50 percent of the ownership. The developer is responsible for completing the project and usually for meeting deficit cash flow requirements needed to fill up the project. The developer retains a 50 percent ownership position.

Despite the nominal description of a 50 - 50 transaction, the developer in reality has less than 20 percent. The impact of a cumulative yield on an equity of 35 percent of the total cost of the project defers the benefits of ownership to the developer joint venture partner for at least five years. During the life of the partnership, if there are dislocations or other reasons for reduced cash flow from the project, the developer, who may have spent five years catching up, can go into the hole quickly.

This form of joint venture represents a transition from the insurance company as lender to the insurance company as developer/owner. In the last decade, insurance companies have gained experience and confidence in the area of development. Companies such as Prudential Life Insurance Company, Metropolitan Life, Northwestern Mutual Life Insurance Company, Safeco Insurance, Equitable, Aetna and others have been participants in joint ventures in many major development projects. They have been forced to take over and complete many ill-conceived or undercapitalized joint ventures, thereby gaining valuable experience. There are numerous examples of major insurance companies beginning projects with no developer/partner. Another alternative is for the developer to put the transaction together and then sell it to the insurance company. In the future, as insurance companies realize that the most important commodity required for successful development is low-cost, available dollars, the transitional 50 - 50 deals will disappear.

Pension Funds As Source Of Capital

The biggest potential source of funds by far is pension funds, a growing armada of capital needing to

diversify in real estate. To date, pension funds have dabbled in the market and gained some experience by buying mortgages, participating in insurance company blind pools and investing with insurance companies directly in specific investments. In the '80s pension funds will continue to pursue these routes, de-emphasizing mortgage portfolio acquisition and becoming more aggressive. They will continue to pursue joint ventures with major insurance companies which are responsible for investment and development. Banks will become a major factor in brokering transactions to pension funds. They will also joint venture them through various equity investment arms, either already established or being built by most of the major banking institutions.

As available capital becomes dearer, pension funds will exercise more influence in structuring and participating in joint venture transactions, commensurate with the number of dollars available. While insurance companies are already set up to be owning entities, pension funds have not done so yet. Both to protect their tax-free status and because of their fiduciary responsibility, pension funds probably will not create their own real estate investment departments, but will continue to rely on third party advice, participation and partnerships.

Advent Of Public Real Estate Company

A new, major factor — the public real estate company — will begin to play in the market of the '80s. An integral part of its success will be its ability to sell various forms of participations, debt instruments and equity involvement to pension funds. Pension funds will find this form of investment group both a diversification and an opportunity to produce a better yield than participating with the insurance companies and banks in broader, conservative investments.

In England, Japan and Hong Kong, capital for the international real estate market is provided through public ownership of stock. Ownership of entities which in turn own real estate assets has been the preferred method of participation, reflecting both a high degree of sensitivity to liquidity and a customary method of access for small investors. The sole exception to this has been the United States where the stock market has been earnings-oriented rather than cash flow and asset-oriented. Examples of unsuccessful attempts to change this orientation include Tishman, Monmouth Properties, The Hahn Company and General Growth Properties. These companies had to announce liquidations in order to get the market to reflect their true value. Other companies such as Rouse are encouraging asset valuation by reporting market value as well as historic cost.

In the next five years, a limited number of public real estate companies will be created that will compete directly in size and sophistication with major insurance companies and foreign real estate companies. Publicly-owned and traded real estate companies will use that status both for credibility and for the ability to issue various kinds of financial instruments to raise capital such as convertible debentures, equity participations in various specific real estate ventures convertible into share ownerships or asset ownership, and other forms of quasi debt/equity. These instruments will provide major sources of capital such as the pension funds with access to the real estate market.

A key element in the creation of these entities is the credibility that comes with being a major-sized, public New York Stock Exchange entity. This credibility allows for the issuance of both privately-placed and public securities, a task more difficult for a privately held company of comparable size. These entities will represent the last entrepreneurial participation in what is rapidly becoming an institutional real estate investment environment. Equally important in encouraging public companies is the increasing trend toward recourse financing, which encourages growth of large monolithic companies that provide major balance and diversification to cover difficult periods in various geographical areas. The existence of large real estate net operating loss carry forwards will provide an ideal opportunity for building equity in a major public entity. These net operating losses, primarily in REITs of the '70s, could add net worth without dilution by combining them with income-producing activities such as condominium conversions and land development.

Impact Of Changes

Having assumed that these major changes are either occurring or will soon occur, it is necessary to attempt to determine their impact. A distinction is required between real and apparent risk. Permanent, secured real estate lending primarily has been nonrecourse. With minimal or limited equity, the risk is on the lender and the reward inures to the borrower. Construction financing is recourse, but there have been rare examples of deficiency judgments. Although the borrower is legally responsible for the debt, lenders have often been willing to release the borrower and take a deed in lieu of foreclosure. This nonaccountability emanates from a debtor-oriented legal system that provides ample opportunity for dilatory tactics. The new bankruptcy laws further imperil the lender with cram-down authority to the judiciary. In the past real estate lenders assumed the problems of bad debts as a cost of doing business to achieve a prescribed volume level. In periods of capital shortage, lenders will be able to reorient the risk-reward ratio by the ultimate form of discipline — equity investment.

In reviewing their past performance and benefiting from hindsight, lenders will be less willing to under-

take workout arrangements on projects in difficulty. They have found that a material percentage of their previous real estate losses could have been recouped by taking title and reselling the property. In an inflationary climate, defaulted real estate loans will be viewed as an opportunity rather than a problem. This changed perception increases the risk to the borrower, who had been confident that in difficult times aid was available from lenders. These changed circumstances will require better capitalized owners with deeper pockets. The owner who ultimately looked to the lender as a partner will have to adjust to the new realities.

The combination of more equity and less debt reduces leverage to the real estate investor. Fixed-rate leverage in particular has an impact on investment return. This yield curve is accelerated by double-digit inflation, which rewards the investor at the expense of the economic system. As available debt decreases as a percentage of total investment, and as the interest rate becomes variable rather than fixed, this measure of reward will shrink.

The role of the entrepreneur is undergoing major modification. Entrepreneurs throughout history have participated in the origin, implementation and ownership of real estate projects. The availability of long-term, nonrecourse and fixed-rate debt reflected the surplus conditions of the money markets. Lenders were satisfied with a perceived spread between money costs and the yield generated. A casualty of this transition period will be the ownership role of the entrepreneur. Although ample opportunity exists to assemble and package future projects for institutional ownership, the institutions will opt for long-term 100 percent ownership. Entrepreneurs will also assist by providing development and management services to institutional owners. The passing of the entrepreneur as a real estate owner is likely to decrease the efficiency of real estate development. As corporate accountability increases and overhead becomes significant, the chain of command will become more bureaucratic and costly. This diminution in profitability will not discourage participants since the remaining yields will still exceed alternatives.

Perhaps the most profound impact on real estate in the '80s will be the reduction in development. New construction will increase initially as many new players sample the water. But a shakeout will follow as various institutions make commitments to long-term, owned real estate. A corollary to capital shortage conditions is a reevaluation of the underlying premise of development. Whereas development historically has been for future demand, development will be a response to pent-up demand. Both vacancy factors and the occupancy risk of the development process will decline in importance. Elimination and/or reduction of this risk makes real estate more attractive to institutions. Reduction in available alternatives and economic strength of ownership will result in a much greater cost of occupancy in a buyer's market. Available space will command premium rents.

Summary

The structural alteration in the real estate financial system probably will have a major and long-term impact on future growth and development in this country. The lending function has been downgraded in both importance and impact. The ownership mantle is drifting to the source of capital, and the capital requirements to participate in the industry are increasing exponentially and will preclude ease of entry.

Mirror, Mirror On The Wall
Will There Be Any Loans At All?

Will Deals Be Done Based On Leverage?
Or Will Equity Be The Only Beverage?

Turn This Decade And You Will See,
An Institutionally-Owned Industry.