PENSION FUNDS AND THE FUTURE OF THE INDEPENDENT DEVELOPER: WILL AMERICA FOLLOW THE BRITISH EXPERIENCE?

by Charles F. Floyd and Nicholas Wakeley

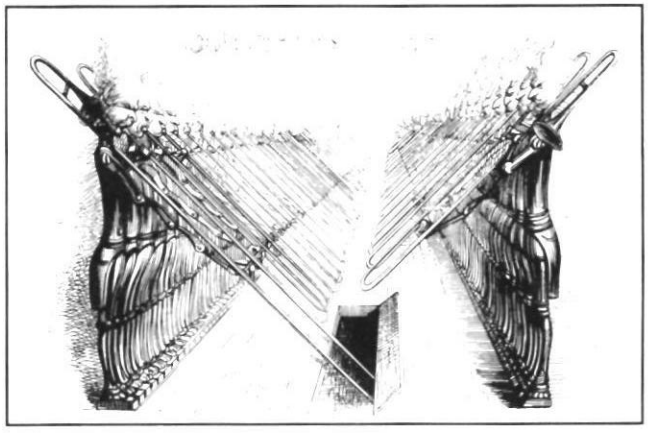
With the dramatic changes that have occurred in the financing of commercial real estate in recent years, the development industry is justifiably concerned about its future. Where will the money come from to finance its projects, and on what terms? Will the pension funds move heavily into real estate, and will this move signal the end of the independent real estate developer?

In answering these questions, it is helpful to examine how the British property market in the past has adapted to problems which are similar to those currently facing U.S. investors and developers, principally, high interest rates and, historically, high rates of inflation. Will the U.S. follow a similar pattern in coping with these twin challenges?

An examination of the British developer's experience is not encouraging for his/her American counterpart. However, a number of differences between the real estate and financing markets in the two countries leads to the conclusion that the U.S. developer is unlikely to follow a comparable path.

Changes In United Kingdom Property Markets

Until the early 1960s real estate developers in the United Kingdom (U.K.) normally could obtain fixed-rate mortgage financing for their commercial projects. Often the completed development would be appraised at a sufficient margin above costs for the developer to avoid the need to actually put cash into a project. Then, however, a combination of high interest rates and rising inflation led to a change toward equity investment by financial institutions, particularly the large



pension funds and life assurance companies that were the major real estate lenders in the U.K.

Rising inflation had led to substantial growth in property values, but this increase was going only to the developer who held the equity ownership. The institutions eventually realized that if they were to capture part of this growth in value, they would need to acquire an equity stake in the projects financed. Furthermore, when a number of highly leveraged development companies defaulted on mortgages, the institutions recognized that they were carrying much of the risk without gaining commensurate profit opportunities. As a result, they began to demand a share in the equity through such devices as participating mortgages. They soon moved from this intermediate stage to full equity investment.

Institutional purchases of real estate have tended to follow an evolutionary cycle. Property unit trusts, similar to open-ended commingled funds in the U.S., have offered a relatively low risk introductory step for the institutions to enter the market. Many institutions moved directly to purchase completed and leased buildings. As their experience grew, they began to give forward com-

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mitments on development projects, where they would agree to purchase a completed project from the developer, subject to certain specified conditions such as successful leasing. In these cases, the funds would sometimes agree to provide construction financing at lower than prevailing market rates.

Direct development is the final stage in this cycle. The Coal Board Pension Fund and the Prudential Assurance Company are examples of two of the largest institutions which have followed this route. Although direct development is still relatively uncommon, it has resulted in the independent developer losing a significant portion of the institutional market.

Changes in the Role of the Developer

The development industry in the U.K. has undergone some fairly radical changes in the past two decades. Essentially, the developer has changed from an owner/borrower to, in many instances, a fee developer. Correspondingly, the funds have switched from being lenders to being owners.

In contrast to the U.S., where the development company usually retains at least part of the equity in its projects, most U.K. developers operate largely as project managers. They find a site, obtain the necessary governmental planning approvals, and then sell the project to an institution. A sale may be in advance of construction or after the development is built and leased.

Few opportunities remain for independent developers to build up equity portfolios. The tax system is quite unfavorable for public development companies; they must compete with tax-exempt pension funds without such advantages as depreciation allowances used to shelter income from taxation in the U.S.

U.S. Institutional Investment In Real Estate

A review of the recent U.K. experience raises three questions of great importance for the American developer:

1) Will the U.S. pension funds significantly increase their real estate investments?
2) Will these investments continue to contain an element of debt, or will the funds move toward full equity ownership?
3) What will be the impact of an increase in pension funds investment on the future role of the developer?

United States pension funds currently hold three to four percent of their total assets in real estate, mostly in the form of mortgages. On the other hand, the U.K. pension funds hold approximately 20 percent of their assets in real estate, the vast majority as equity ownership. These holdings increased from only $2 billion in 1974 to $110 billion in 1982.

A number of U.S. pension funds have set targets similar to those reached by the U.K. funds, and some already have reached these levels. The real issue is whether the majority of U.S. pension funds will increase the proportion of real estate holdings in their portfolios to a significant degree.

The entire concept of investing in real estate is relatively new to many funds. The recent rise in rates of inflation undoubtedly helped focus fund managers' attention on real estate as an inflationary hedge. They also seem to have recognized the merits of real estate as a means of diversifying their portfolios.

Historically, the institutions have lent money to developers on fixed-rate mortgages. The change to a blend of debt and equity and to full equity ownership is comparatively recent. Perhaps the most important reason for the funds staying with mortgages is that a debt instrument is readily understandable to a financial mind trained in dealing with stocks and bonds.

Mortgage lenders often place proportionately greater emphasis on the mechanics of a loan and the financial strength of the borrower than on the location and quality of the project. Successful equity investment, on the other hand, requires extensive knowledge and understanding of the latter two considerations, a different type of expertise to that traditionally found in the ranks of the pension funds. A shortage of this expertise would seem to be one of the main barriers to the expansion of real estate equity investment by pension funds.

Institutional investors have realized that it would be unwise to rush headlong into extensive real estate equity investment without first gaining more knowledge of real estate markets. Many funds currently are absorbing information and keeping a watchful eye on the market. Once they have overcome these educational constraints, it seems likely that they will gradually move more and more of their assets into real estate. It would be imprudent to predict whether the U.S. institutions will reach the level of investment attained by the U.K. funds; much will depend on returns available from alternative investments.

The Future Role Of Pension Funds

Will the U.S. pension funds follow a similar path to that taken by their counterparts in the U.K.? Fixed-rate mortgages for commercial projects have almost completely disappeared. In this respect, both markets are similar. The main issue, therefore, is whether the funds will eventually drop the mortgage element entirely and move exclusively to equity investment. Although a number of funds have already gone to full equity investment, it appears likely that some will choose to remain with a mixture of debt and equity such as participating and convertible mortgages.

With these features, institutional investors may feel that they are less exposed to risk than they would be with an all-equity transaction. The mortgage philosophy is well engrained in the minds of many funds managers, and they may initially feel more comfortable with retention of an element of debt. It seems probable, therefore,

that a significant number of pension funds will remain with the debt/equity mix over the next few years.

As funds managers build up their experience of the real estate market, an increasing number may wish to follow the equity route. As long-term investors, they will be able to reap the benefits of rental growth directly and be more in control of their own destiny.

Investment Options For Pension Funds

In securing equity positions in real estate, the pension funds have four options:

- Purchase existing properties
- Enter into joint ventures
- Employ the developer for a fee
- Develop directly themselves

Each option carries an increasing amount of risk and offers a higher potential return. Deciding upon the route to follow largely depends upon the investor's attitude toward risktaking. As they obtain experience in real estate and gain confidence in the market, funds managers may be prepared to accept an increasingly higher level of risk.

One of the key issues in this debate is the availability of expertise. Although a small number of funds have already undertaken direct development, most will be content to use the services of an independent developer, at least in the near future.

Comparison of Options

Institutions usually gain their initial exposure to real estate equity investment through commingled funds, enabling them to purchase a share in a well-diversified real estate portfolio for a relatively small outlay. Once funds begin to step up their investment in real estate, they may decide to invest in specific projects. Initially, to minimize their risk exposure, they purchase completed and leased buildings in prime locations.

Once investors have established a diversified portfolio of completed buildings, they may consider investing in new projects. To many funds with limited experience in development, the joint venture enables the funds to make full use of the developer's expertise. In a potentially risky area of real estate investment, the funds may feel more confident with an experienced partner. With fiduciary liability concerns on the minds of some funds managers, an outside partner to share the blame for unsuccessful projects may be attractive.

Some developers may fear that funds managers will learn the tricks of the trade from them and then drop them at a later stage when the funds begin to develop directly for their own account. However, in development one cannot underestimate the value of local knowledge and experience. Development is a risktaking business, and the entrepreneurial flair of a developer is often essential in recognizing and exploiting development opportunities. Institutional investors who recognize this may be content to remain at the joint venture stage. Careful selection of the developer and the project should enable them to do at least as well as they would as the direct developer.

In some cases an institution may be prepared to agree to buy the completed project before construction starts. In this case the developer is working for a fee and has the security of knowing he/she can obtain long-term financing.

The main issue a fee developer faces is deciding at which stage in the development process an institution is willing to commit money to the project. Some funds may be prepared to give forward commitments to buy regardless of leasing progress. Others may agree to purchase only after the project is completed and fully leased. In this case, the developer must assess whether he/she is able and prepared to accept the construction and leasing risks. Developers may decide that the potential return in the form of a fee and perhaps a small slice of the equity is insufficient to justify carrying these risks.

Large developers with a proven track record will probably be in great demand and able to dictate terms to avoid full risk exposure. The less experienced developer may have to accept a higher degree of risk in order to obtain long-term financing.

Direct development is currently undertaken by a relatively small number of institutional investors. Typically these funds have extensive experience in real estate investment and have developed confidence in both their advisers and the future of real estate markets. Once the institutions have reached this stage, they often desire to play a more active role in managing and developing their portfolios. Experience in the U.K. has shown that this notion of independence may be stronger in funds with an in-house team of real estate professionals.

Outlook For The U.S. Developer

The possibility of a growing trend toward direct development by the institutions would seem to indicate a narrowing market for the independent developer. However, it is unlikely that even the funds engaged in direct development will sever all contact with developers. Developers with extensive local knowledge and contacts often have an advantage over institutional investors in recognizing opportunities, securing the better locations, and gaining zoning approvals. Furthermore, the local developer is in a more advantageous position to manage the development process and lease the completed project than is an institutional investor who may be operating out of regional or national offices miles away. However, a joint venture partnership combining the developer's entrepreneurial flair and local knowledge and the institution's cautiousness may prove to be the ideal combination.

Perhaps the developer faces a bleak future of curtailed freedom and increasing dependence on institutional investors. When U.S. developers look at the fate of

their U.K. counterparts, they may be concerned about their continuing ability to build up equity portfolios.

Certainly developers are unlikely to ever again have the freedom afforded them with fixed-rate mortgages. Yet in a market where the availability of financing often had a far stronger influence on new development than did supply and demand, the forward thinking developer may welcome the added stability from institutional investors.

Even in the days of easily obtainable fixed-rate mortgages, developers were still painfully dependent on obtaining adequate financing. Developers currently seeking a source of permanent financing to refinance their construction loans are only too aware of this point. A dependence on institutional investors committed to real estate as a long-term investment medium probably makes the developer more secure today than during the heyday of fixed-rate mortgages.

Finally, working with institutions will not preclude developers from building up an equity portfolio. Most funds will desire the developer to put up a portion of the equity to ensure his/her interest in the continuing success of the project. Fee developers may also be able to accumulate some equity by reinvesting part of their fees. Furthermore, partnerships with tax-exempt investors should enable the developer to make efficient use of depreciation allowances.

Conclusions

If the pension funds become the dominant force in financing commercial real estate, developers will be forced to rely, to a large extent, on earning a significant part of their income from projects financed by institutional investors. Institutional respectability will be the key to their long-term survival.

In practice this means that developers must have a proven track record and have sufficient financial standing to avoid being a risk in their own right. It is inevitable that some form of discrimination against the smaller unproven developers will occur. The big will probably grow bigger and become more corporate in nature.

Smaller developers are likely to find it harder to gain a foothold without the availability of fixed-rate mortgage financing. In addition, they will be operating from a weaker bargaining position than some of their larger and more experienced colleagues. As a result, institutional investors will expect them to carry a larger amount of risk, a factor which may eventually preclude the smaller developer from the institutional market.

Most developers have already seen the need to forge closer links with the funds. They realize their activities will come under increasingly close scrutiny from institutions. Developers have always tended to live by their reputations, but this is likely to become an increasingly crucial factor in the future.

Many developers have already proven themselves to be worthy institutional partners. The institution's need for their expertise and the quality of the service provided would seem to indicate that the developer is unlikely to be forced exclusively into the role of fee developer, or indeed, forced out altogether by the institutions. In a country where entrepreneurial spirit is woven into the fabric of society, one must conclude that reputable developers will continue to be in strong demand as providers of expertise and as development partners to institutional investors.