THE RETURN OF THE GRAVE DANCER

by Samuel Zell

Like Rip van Winkle, the Grave Dancer hibernates from one real estate cycle to the next. He emerges from his long sleep when the real estate community violates George Santyana's 1906 admonition, "Those who do not learn from the past are condemned to relive it."

The emergence of the Grave Dancer reflects an alteration in the risk reward ratio of real estate investment. The classic motivation for real estate investment is passive reflecting a desire for stability, security, inflation protection and growth. However the Grave Dancer is an active investor seeking greater risk by acquiring property in distress, and even greater reward by earning the economic benefit from successful resurrection. The Grave Dancer's measure of reward is reflected by improving the value of real estate, which if successful far outpaces the performance of the economy.

The current state of the U.S. real estate market reflects an orgy of development that has followed the high inflation era of the early 1980s. Supply of space has been fueled by excess availability of funds, misreading of demand, hedging against inflation and geographic concentration of supply. The degree to which supply exceeds demand rivals, and in some cases, surpasses the conditions that existed from 1973 to 1975. During that era, oversupply caused widespread financial distress for banks, insurance companies and equity owners of real estate. This situation was aggravated by the creation of short term mortgage real estate investment trusts. These trusts infused approximately $20 billion dollars of new funds into the real estate market. This infusion of capital, along with conventional sources, led to excess speculation and an oversupply of space. The current situation and anticipated results are reminiscent of that era.

Availability Of Funds

Funds available for real estate expanded dramatically as a result of financial deregulation, the growth of syndication, pension fund participation, and institutional involvement in the development and ownership of real estate equities.

Expansion of the powers of savings and loans and the encouragement of their conversion from mutual to stock associations increased the funds available for real estate investments. In the past, as interest rates rose, Regulation Q ceilings created disintermediation and the withdrawal of funds seeking higher yields. Disintermediation reduced funds available for lending, thereby throttling excess development. Deregulation allowed continued access to funds, but at a higher cost. The advent of broker insured deposits also eliminated previous geographic barriers to the flow of funds.

__Samuel Zell__ is founder, principal stockholder and chairman of the board of Equity Financial and Management Company, a Chicago-based nationwide real estate organization which owns and operates a national portfolio of residential and commercial properties. He is also chairman, president and chief executive officer of Great American Management and Investment, Inc. Mr. Zell is a frequent contributor to various real estate publications as well as a speaker and panelist. He is a graduate of the University of Michigan and the University of Michigan Law School.

As rates rose beyond historical precedent, the savings and loans with fixed rate portfolios saw their net worth eroded at an alarming pace. Federal policy encouraged conversion of mutual savings and loans to stock corporations. This replenished their capital, but also infused massive liquidity because each dollar of new capital could be leveraged into $33 of assets.

Additional liquidity emanated from the creation of mortgage backed securities. These mortgage backed securities provided the savings and loans with a secondary market in which to unload their existing portfolio of single family mortgages. The combination of new equity and liquidity within existing portfolios pressured the institutions into national expansion in commercial real estate.

This set of circumstances is fraught with danger and reminiscent of the REIT experience of 10 years ago. As the ability to raise funds out-stripped the ability to make local, profitable investments, it sought national opportunities. The results have been predictable—too much money chasing too few deals.

Loan underwriting has suffered from pressure to invest funds. Higher levels of risk have been necessary to generate a positive spread over the cost of money. The accrual of significant portions of interest obligations defers those obligations into the future, the assumption being that inflation will increase cash flow to cover the shortfall. However since these are floating rate loans, future inflation will only increase the spread between the interest owed and the cash flow earned.

Syndications

The public syndication of real estate, from a base of $200 million in 1970, will grow to $6 billion in 1984. This exponential growth and the pressure to invest this tremendous flow of funds emanated from the acceptance by the general public of real estate as the best form of inflation hedging. Today's real estate market is driven more by the ability to sell the product than the user's demand for occupancy.

This growth has also encouraged a growing number of sponsors whose real estate expertise is second to their marketing capabilities. Although public syndication of real estate has proven to be a viable and intelligent investment alternative within a broader spectrum of financial and estate planning, excesses by sponsors have been and continue to be prevalent and have encouraged the escalation of prices and the creation of product for which there is insufficient demand. The creation of these organizations has been rapid and resulted in overhead burdens which require the constant creation of new funds in order to support the structure. Failure of the market to distinguish quality sponsors will continue to encourage over-investment.

Pension Funds

The pension funds, having been burned significantly in the 70's with heavy emphasis on bonds and common stock, have looked to real estate as an obvious area for diversification. This pool of funds, which represents the largest and fastest growing source of new capital, is slowly altering its objectives to reflect a specified proportion of total assets in real estate. These funds have been invested in commingled pools run by sophisticated real estate sponsors as well as through advisors with extensive real estate background. Although pension funds have adopted very conservative criteria for investment, the sheer size of the pool applies pressure to the market especially on "brochure" buildings where competition has driven yields down.

Economic Viability

The economic viability of the development process is dramatically different when the developer has the role of being a creator of the product to be sold as opposed to the creation of the product for long term ownership and management. When a real estate product is pre-sold prior to construction, with relatively minor lease-up responsibility, the supply-demand scenario within the market place is less of a consideration and leads to oversupply. This is particularly true in post-inflationary periods where rents have risen dramatically and the high point on the rental scale became the point of reference for new projects. Rents rise in response to scarcity of supply. New supply tempers or reduces rates, making viability assumptions suspect. Owner concessions, which materially reduce cost of occupancy, must be factored into achievable rates. Capitalization of income without such a discount distorts the rate of return and encourages oversupply. The conversion of real estate analysis, from capitalized rates on existing cash flow to internal rate of return, distorts the value of the property. Internal rates of return include inflationary assumptions which justify new development without adjusting them to the supply-demand situation in the marketplace.

The creation of new real estate projects and the financing thereof do not include any presupposition of need. Developers are creating a product that meets the developer's test of profitability, not necessarily the marketplace's test of economic viability. If the developer believes the creation and presale of the product assure him a profit, then the discipline of the marketplace disappears and oversupply follows.

The other element of economic feasibility reflects the type of product constructed. The type of product to be constructed has historically been economic rather than market driven. For example, unlimited markets exist for low-cost housing because developers are unable to economically build units that can be rented or sold at the low end of the scale. Consequently, the oversupply in the market not only reflects more square footage than can be absorbed, but is targeted toward the luxury or first-class end of the economic spectrum. This bias occurs because the rental rate differential between premier real estate and secondary real estate is greater than the costs related to such upgrading. Therefore, economic viability is further endangered by the greatest supply being in the smallest segment of the user market.

Inflation

The political and economic decisions of the 1960s and 1970s generated a period of very high inflation in the 1970s and early 1980s. The United States was facing double-digit inflation in an economy not prepared for the adjustment.

Despite the severe reduction of inflation, the expectation of its re-ignition continues. During the inflationary period, the consumer most visually recognized this phenomenon on his daily life by the escalation in single family costs and the monthly announcement of the Consumer Price Index. Just as those involved in the oil industry predicted the continued escalation in the price of oil, so too did the investor-consumer presume that double-digit inflation was only temporarily impeded and bound to return. The investor-consumer presumes that if everyone's portfolio includes real estate ownership, the benefits will continue from inflationary pressures as in the past. The natural outgrowth of this alteration in thinking has been the dedication of more funds to the ownership of real estate. This has contributed markedly to the seller's market in real estate and inevitably will lead to economic loss and market oversupply.

Herd Instinct

The current status of the real estate market is different than previous periods of oversupply. Along with the inflationary pressures of the late 1970s came a new perception that the future growth of the country was in the sunbelt. Consequently, a massive disproportion of new developments and construction occurred in a series of limited geographic areas. Investors in real estate directed their efforts toward these limited geographic areas, as did lenders and developers. Therefore, some of these cities are facing five to eight years of oversupply in housing and office space, whereas the rest of the country has a much smaller inventory.

Office Market

It is within this framework that one must assess and evaluate a standard approach to taking advantage of opportunities from those less fortunate. Real estate is unique, and despite significant weakness and oversupply in any given market, it does not preclude the possibility of existing opportunity. Perhaps at no time in any previous period of oversupply has the statement "no generalizations are relevant" been more applicable. The post 1973–1975 recovery made almost any acquisition in the prior period economically viable. Escalation of demand in a period of minimal construction rapidly filled the oversupplied markets. The absorption rate this time is likely to be the most critical element in any Grave Dancing scenario. Reliance on historic perspectives must be tempered by individual market analysis. For example, the energy boom impacted on office absorption in cities like Dallas, Houston, Denver and Oklahoma City. If one looked at those markets and presumed an absorption rate predicated on the past five years, he would see a distorted view of the needs for future space. Even after making adjustments for economic aberration, one would be prudent to study the markets looking for other telltale signs that could impact on future needs.

As a broker recently commented, a major consideration must be the "sublet curse". Many firms committed themselves to significantly more space than was immediately required. The logic for such moves was to protect against further rate increases and guarantee availability of expansion space. These tenants now find a diminished need and are adding this extra space back to the inventory.

The 1982 recession forced corporate management to evaluate and reduce overhead, with particular focus on reduction in middle management personnel. Although this reduction is most glaringly exemplified by the automobile manufacturers, it is a situation that is prevalent throughout corporate America, resulting in a reevaluation of space requirements and the creation of sublet requirements. The rise in cost of services and occupancy to service firms has also lead to a reevaluation of personnel requirements and space needs. The business community has made a permanent shift toward less strata of management.

Any review of the market must also include an assessment of the developable sites. In many parts of the country, land assemblages are currently being carried at high cost awaiting the next opportunity to develop. Identifying these land holdings is a critical element in assessment of the absorption rate. High cost assemblages will be developed at the first sign of recovery in those markets, usually before the strength of such recovery is confirmed. Thus, these assemblages should be included in any evaluation of future supply.

The Grave Dancer's greatest ally is time. Aggressive negotiation with existing tenants for lease extensions, even at concessionary rates, is preferable to seeking new occupancy. The leasing focus should be current income to bridge the trough in the current market of oversupply.

Any market assessment must include the nature of competing ownership. The office market today primarily reflects institutional ownership. Market timing and quick decisions are not the hallmark of ownership by committee. Nimble movement and creative pricing give the Grave Dancer a definite market advantage which is necessary in order to overcome the deep pockets of institutional capital. Institutional deals have been sold using internal rate of return calculations. These calculations presume a sale in 10–15 years. Thus a rent-up philosophy reflects short term give-ups for long term "market rates". In competing, the Grave Dancer must tailor his approach to the market by seeking alternatives to the institutional competition.

The Grave Dancer also has the opportunity to lower operating costs. Properties acquired at a sharp discount or with extensive below market financing can achieve reductions in real estate taxes based on the purchase price as opposed to original cost. Further expense reductions can be achieved by controlling where space in the

building is rented, or in multiple family projects, which building may be occupied. Concentration of partial tenancy can materially reduce the cost of operations during periods of extensive vacancy.

In assessing the advisability of any project, its competitive position is as important as the condition of the market. The number one criterion must be replacement cost. It is now possible for new buildings to be created at a total cost that is less than identical structures built two or three years ago. This phenomenon exists because land prices and interest rates were inflated during the development phase. Thus, competitive position evaluation must be based on current experience rather than historical costs. Potential tenant mix impacts competitive position. New jobs and therefore, new demands for space are more likely to be created in areas of entrepreneurial activity than those dominated by major corporate users. Buildings with large square footage per floor are less suitable to multiple small users than small floor buildings which have more window space and lend themselves to executive rather than clerical use.

Residential Market

Many of the same considerations that apply to the office market are also applicable to the residential market. Evaluation of the current state of occupancy must not only include multiple family statistics but also condominium and single family construction. Although the disparity in after-tax cost of occupancy between the multi-family rental and home and condominium ownership continues to be great, the urge to own bridges that gap and makes both forms of ownership very competitive to the rental market. The residential market is the most cost sensitive and thereby the best able to attract additional tenants using price as the inducement. Residential real estate marketing sells square footage and atmosphere. This provides the opportunity for superior marketing to create a competitive edge. Amenities and ambiance can often keep a rental project filled against a very weak market. Tenant satisfaction often overcomes price competition. Residential absorption analysis must include sources of potential growth in tenants. In the post 1973–75 era, cities like Atlanta and Orlando recovered slower than the rest of the country because a high proportion of rental tenants were directly related to the construction boom. Consequently, the cessation of new development, which should have accelerated the pace of fill-up, accelerated the vacancy rate.

Retail Opportunities

The retail aspects of the Grave Dancer's opportunities are much more limited. Large regional shopping centers do not commence construction until major anchor tenants have signed long term leases. Thus the anchors instill discipline on the market creating few examples of oversupply. The neighborhood, off-price or community centers present a very different picture.

There has been tremendous growth in off-price retailing in the last four years. This retailing concept is predicated upon the discounting of name-brand merchandise. The viability of these malls is dependent on price maintenance by the majors, a dubious assumption at best. It is unlikely that major retailers will be willing to merchandise goods that establish a base for the off-price retailer. Casualties among these retailers will be high, suggesting surplus retail space in off-price malls.

The number of strip centers has grown exponentially in the last three years. This growth has been fueled by investor demand rather than tenant demand. Current construction is in anticipation of growth rather than in meeting existing demand. Inadequate consideration is being given to competition already established.

Traffic is the only consideration relevant to a retailer. Whereas office and residential are, to varying degrees, price elastic, this is not true in the retail area. Concessions in the cost of occupancy can not overcome a lack of traffic. Pioneering attempts or off locations, provide little hope for justifying the Grave Dancer's efforts. Reliance on site selection by majors, rather than by demand, is not prudent policy. Majors often designate sites for future development with the expectation that the rest of the chain will carry the new stores until they mature.

The Time Frame

Grave Dancing is not for the faint of heart. Opportunities arise from the distress of others, but such distress does not assure success for the Grave Dancer. Careful assessment of the risk/reward ratio will increase probability of success. The institutionalization of real estate has brought many investors to real estate. The short term perspective of today's lenders materially reduces the size of any potential reward which may be achieved by a successful effort. In past periods, lenders were willing to alter the terms of their loans and leave them for 15–20 years. Now concessions are achievable, but only in a short term perspective of five to seven years.

Institutional Investor

Many distressed properties are owned by well funded investors. Pension funds and insurance companies are more willing to take a longer perspective on the real estate. Rather than accepting a short term loss, they are willing to hold for recovery. Faith in the future is as much motivated by confidence as it is a reflection of fear in acknowledging a mistake. The institutional influence should make distressed markets more stable and able to avoid panics and severe price cutting. Quick reaction to market opportunities and creative approaches should give the entrepreneur Grave Dancer a distinct advantage. Staying power is often substituted by the discipline of a present value analysis. Previous experience by institutions of selling too early and seeing the Grave Dancer's profit is likely to encourage over-holding of property.

Despite the "deeper pockets" of institutional owners, opportunities will abound. The Grave Dancer will trade expertise and some capital for ownership and control. These arrangements, mostly in the form of joint ventures,

will also transfer tax benefits. Since the IRS no longer allows an allocation of profits and losses, the arrangements will require conversion of institutional equity into debt. This conversion will make available tax benefits to subsidize the economics of Grave Dancing.

Syndications

Syndications represent an opportunity different from institutions. Real estate syndications raise a finite amount of money for investment. Even though most funds provide reserves, these reserves are not sufficient for major market weakness. The staying power of institutions allows them to ride-out periods of difficulty by committing additional funds. Public syndications do not have the ability to go "back to the well". Grave Dancing opportunities in the syndication area are commensurate with the amount of leverage. The more leverage, the more likelihood of cash flow deficits and Grave Dancing opportunities. The Grave Dancer's role is the funding of operating deficits and market and management skill in return for an ownership position in the project. Dilution in ownership is much more appealing to a syndicator than the prospect of selling the property at a loss.

Real estate knowledge and expertise cannot overcome poor financial structure. The success or failure of the Grave Dancer is dependent upon the financial structure of the transaction. Grave Dancers taking on distressed properties with short bullet loans, high accruals and inadequate capital for rehabilitation or marketing, are unlikely to reap the rewards of their efforts.

One must not forget that all debt must ultimately be repaid, prior to realization of any profits. Accruing of interest without adequate regard for the consequence of compound accruals on debt is not a sound premise. Projections with built-in rate escalations must reflect individual market conditions, not anticipated escalation in the Consumer Price Index. In an over-built market there is a minor correlation between existing rates and national inflation rates. Inflation's impact on rental rates will be more affected by supply and demand than the Consumer Price Index. The impact of inflation tends to be a lagging factor on the rental scale. It raises rates when new supply, built with escalated cost, sets new thresholds in the market.

Grave Dancing is not limited to individual properties. Some of the best opportunities will occur in savings and loans, home builders and commercial real estate companies. Oversupply can distress companies as well as individual properties. Real estate companies have replaced long term fixed rate debt with floating rates and short maturities. The most rewarding opportunities are likely to emanate from Grave Dancing with distressed owners. This requires being able to undertake multiple assets and locations simultaneously.

Conclusion

The above admonitions reflect the most significant risk in the Grave Dancer's role at this time. In many respects, the complex conditions have made the potential risks to the Grave Dancer far greater than in previous oversupply cycles. The huge federal deficit has made the monetization of the currency much more difficult to achieve, thereby making an inflation bail-out highly unlikely. Without the engine of inflation absorbing supply and raising rates, the recovery will be much slower and not as uniform as in the past.

This set of conditions will require a higher level of sophistication than was previously necessary. In a period of low inflation, appreciation in real estate will come much more from intense management and intelligent acquisition than from the benefit of time.

The silver lining, namely the reward for the risk, is likely to be further in the future but none the less worth the effort. The current distressed situation is not likely to be repeated in the near future. The institutionization of the real estate business will reduce the volatility of the real estate market. Institutions are more likely to hold property longer. The lack of a supply of available acquisitions will ultimately raise prices.The future will see fewer participants in the business due to the damage wrought by this cycle of oversupply. The general level of activity is likely to slow down as the expectation for quick return disappears. Real estate has historically been a safe and secure harbor for long term funds. As the current excesses in the market eliminate the short term players and recent entrants, the remaining participants will be fewer, larger and more sophisticated. This will lead to a more orderly market with better information flows among the participants. Better information and perception of risk will stabilize the supply-demand scenario and avoid the current excesses.

The lack of discipline that creates the Grave Dancer's opportunity is contagious. The undisciplined Grave Dancer can easily become a victim rather than the savior. Taking risks today for tomorrow's reward is both the most challenging and difficult of tasks. Unbridled optimism must be tempered with reality. The Grave Dancer's motto must always be, "I suffer from knowing the numbers". His success will emanate from an understanding of supply and demand, the basic premise of Economics 101.