THE REAL ESTATE CAPITAL MARKET: HISTORICAL PERSPECTIVES, EMERGING TRENDS AND FUTURE DIRECTIONS

A comparison of today's United States real estate capital market with previous markets shows the changes of the past and points to the trends of the future.

by John McMahan, CRE

America's real estate capital market is as immense and complex as the industry it serves. During the last 17 years, over one trillion real dollars were invested in real estate investment properties, which amount to almost 60% of the total private investment capital raised in the United States. This capital flow was 4.7 times the capital raised for common stocks and 2.1 times that raised in the bond market during the same period.[1]

The United States real estate capital market also is exceedingly dynamic, as individuals and firms respond to a series of external shocks rippling through the economy. As a result, there are new players, new vehicles and new expectations.

This paper examines the major changes that have occurred in the traditional United States real estate capital market since 1970 and the characteristics of the new market that appear to be emerging. The marginal flow of capital by major players is examined, and the real estate market of the last five years is compared with the market during the 1971-75 real estate boom.

The "Traditional" Real Estate Capital Market—1945–1970

The real estate capital market of 1970 mirrored the postwar real estate expansion and the dominance of large financial institutions in providing required capital. It also reflected the relatively local nature of real estate markets and the role played by small entrepreneurs.

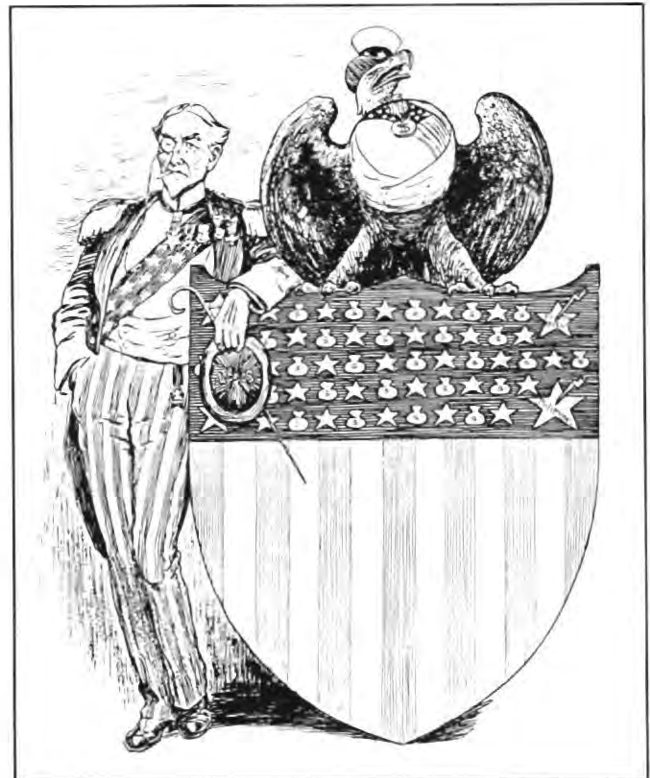


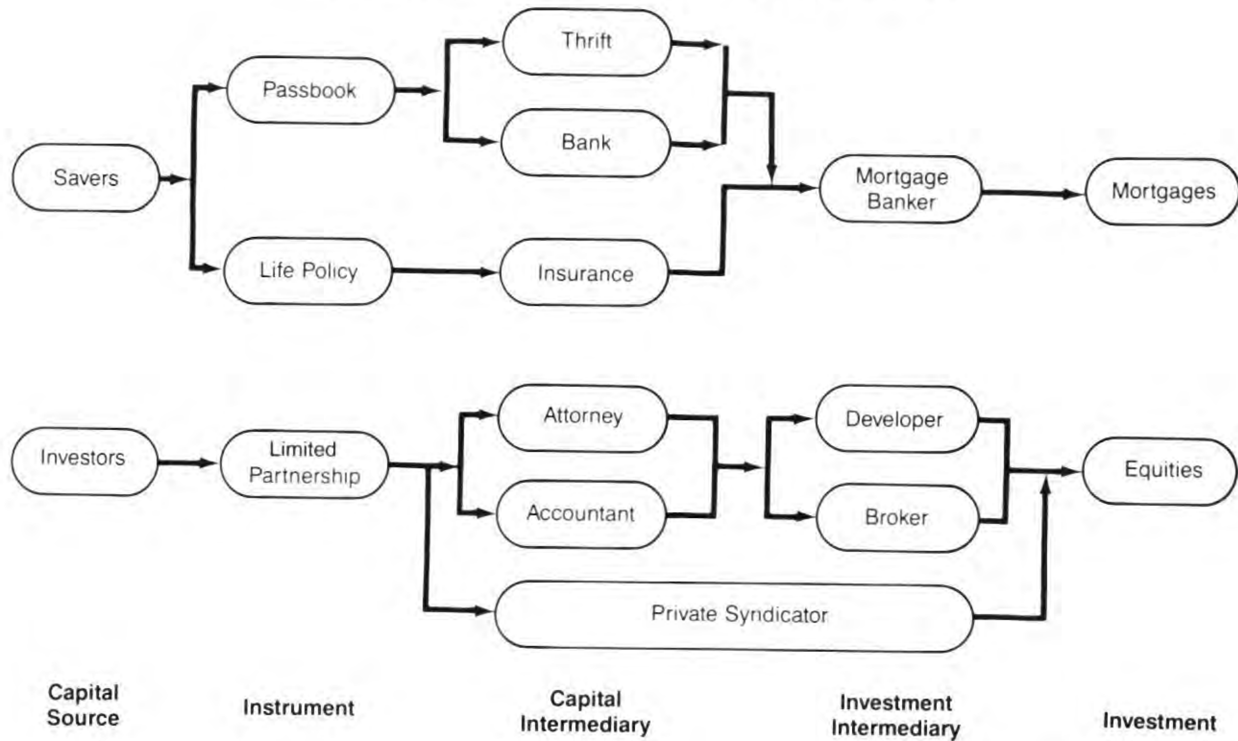
Exhibit I illustrates the flow of capital in the traditional real estate market. Basically, there were two distinct streams that served mortgage and equity investments. For mortgages, savings were aggregated by banks, thrifts and insurance companies through savings passbooks and whole life policies. Since financial institutions seldom were situated in the community where the mortgaged property was located, the institutions developed extensive correspondent relationships with local mortgage bankers and brokers to originate suitable mortgage opportunities. As the 1950s and 1960s were a period of

The author is indebted to Douglas A. Kessler for his assistance in developing the statistical model and other helpful insights.

***John McMahan,** CRE, is founder and president of John McMahan Associates, Inc., San Francisco. McMahan directed early strategic research in real estate asset management. His findings have been published and provide a systematic approach to real estate investing. In addition to writing and speaking on this subject, McMahan is a member of the faculty of Stanford Graduate school of Business.*

Copyright 1987: John McMahan, CRE

EXHIBIT I



SOURCE: John McMahan Associates

relatively low inflation and generally positive future expectations, mortgages typically were fixed in rate and had relatively long maturities.

This benign view of the future, coupled with the sheer pressure to invest, resulted in mortgage underwriting policies that were highly favorable to the equity investor. In instances where equity capital was required, it was raised by local developers and brokers through attorneys and accountants who formed private limited partnerships for their clients and friends. It's probably a fair statement that most of the investors in these partnerships knew and trusted one another.

The investment policies of the institutions tended to nudge local real estate markets toward equilibrium and avoid major episodes of over- or underbuilding. Long-term lenders, such as insurance companies, generally required new building projects to have 25%–50% of the space preleased before proceeding. If vacancy in a local market increased significantly, institutions stopped lending in that market until the oversupply was reduced. Construction lenders, such as banks, generally required take-out commitments by permanent lenders before providing construction funds. Thrifts were restricted largely to residential lending.

This simple framework served the nation well in the relatively calm years after World War II. Strong economic growth, coupled with low inflation, produced an environment in which most of the players prospered, and therefore, were generally uninterested or unwilling to alter the cozy world in which they operated.

A Period Of Change—1970–1986

During the next 17 years, the United States real estate capital market went through a dramatic change as the result of several major events that occurred in the economy or society at large.

Inflation

Probably the single most important factor influencing the real estate capital market was the emergence of double digit inflation in the mid-1970s. For the first time since World War II, inflationary expectations influenced investor attitudes. Savers became less interested in fixed-rate passbook accounts or life insurance policies with seriously eroding face values. Mortgage lenders watched in dismay as long-term real interest rates turned and stayed negative for over two years (i.e., 1979-80).[2]

Inflation also decimated the stock and bond markets and forced investors to look elsewhere for an investment that would provide a hedge against inflation. Creative real estate attorneys began tying operating costs and rents to inflation indices and this, coupled with rapidly rising

construction costs, made real estate the preferred hedge. Large amounts of new capital, most notably from pension funds, began pouring into real estate equities.

Inflation also introduced a way of thinking to the real estate community: i.e., projects that were not initially considered to be feasible proceeded in expectation of future inflationary rental increases. This attitude would have an impact on the overbuilding cycle of the early 1980s.

"Spread" Financing

Largely as a result of inflation, many financial institutions began restructuring their investment portfolios in the late 1970s. This strategy involved an attempt to match not only various levels of risk but the maturity of assets and liabilities as well. The result was profit made on the spread between the return of the asset and the cost of the liability. If individual match-ups were successful, the thinking went, the overall performance of the portfolio also would be successful.

The impact of this strategy on real estate was to tie the availability and terms of mortgage financing to the broader capital market. This introduced greater volatility to real estate financing, ending real estate's sequestered position. In terms of permanent financing, the maturity and rate charged for a mortgage loan often became linked to the maturity and rate paid on a Guaranteed Investment Contract (GIC). Construction financing became linked to the prime rate, LIBOR or some other floating index.

This new level of volatility made it difficult to plan and execute real estate projects that might take two to five years to complete. The maturity of permanent financing dropped from 25–30 years to 7–10 years and became affectionately known as a "bullet loan," which had no clear indication as to the intended victim. In periods of rapidly escalating inflation, reserves for construction interest often proved inadequate, with the developer in default before construction was complete.

In essence, the financial institutions attempted to and, in some measure, succeeded in shifting the impact of inflation from themselves to developers and equity investors.

Tax Legislation

In the 1960s and 1970s, real estate, along with other assets and industries, received a moderate tax subsidy through the deduction of interest and depreciation. To meet public policy objectives, certain elements were singled out for favorable treatment (e.g., housing, downtown development, etc.), but real estate generally, was not treated any different than other investment assets.

In 1981, however, real estate received an unprecedented windfall from Congress. In order to spur business investment, the recovery period for the depreciation of investment assets was reduced substantially. This was further compounded by the successful efforts of the real estate lobby to have real estate exempted from new, "at risk" rules which limited deductions to the amount of funds invested. The combination of large capital investments, financed largely through nonrecourse debt, made real estate very attractive to taxable investors.

Although the recovery standards were modified somewhat by the tax bill of 1984, the subsidy still was significant, particularly when compared with other types of investments. Congress reversed itself in 1986 and took away virtually all of the subsidy from real estate, but not before the industry received a major infusion of new equity capital.

Deregulation

Tax legislation was not the only area in which government policy influenced the real estate capital market. In the late 1970s, Congress began deregulating America's financial institutions. As a result of deregulation, commercial banks were allowed to operate in geographical areas other than their traditional markets, and construction lending rapidly took on a national and, ultimately, international flavor. Thrift institutions, previously restricted to residential lending, were allowed to invest up to 10% of their assets in commercial properties.

Securitization

Wall Street periodically has been preoccupied with the desire to provide liquidity (and tradability) for non-liquid assets such as real estate. Thus, we have had the mortgage bonds of the 1920s and the Real Estate Investment Trust (REIT) of the 1960s and 1970s.

In the early 1980s, Wall Street discovered there was an opportunity to "securitize" existing mortgages for single family dwellings and sell them in pools to institutional investors. In 1986, two-thirds of all new mortgages for single family homes were securitized.[3]

Success with residential mortgages led to a drive to securitize equities in commercial properties. A series of new offerings hit the Street in 1985 and 1986, the most notable being Rockefeller Center. Efforts are currently underway to develop a credit rating system for commercial properties which undoubtedly will enhance future securitization efforts.

Internationalization

Real estate, along with other major capital markets, became thoroughly internationalized during the early 1980s. This process involved not only equity investment by foreign nationals but debt financing as well. Several securitized issues involving debt instruments, such as zero coupon bonds, were marketed to foreign investors. More recently, several Japanese banks have entered the United States mortgage market, providing formidable competition for domestic institutions.

Absentee Ownership

As a result of the institutionalization and internationalization of the real estate capital market, the ownership of real estate has become increasingly absentee in nature. Seldom does the local builder/investor go a few miles to

EXHIBIT II

TOTAL PRIVATE CAPITAL MARKET
Annual Investment
(Real $)

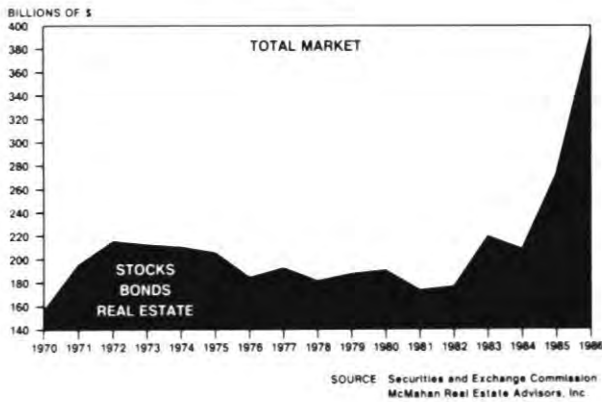


EXHIBIT III

TOTAL PRIVATE CAPITAL MARKET
Annual Investment
(Real $)
PERCENTAGE OF TOTAL

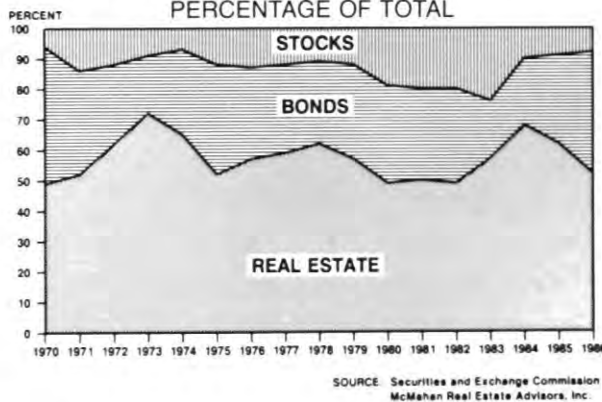
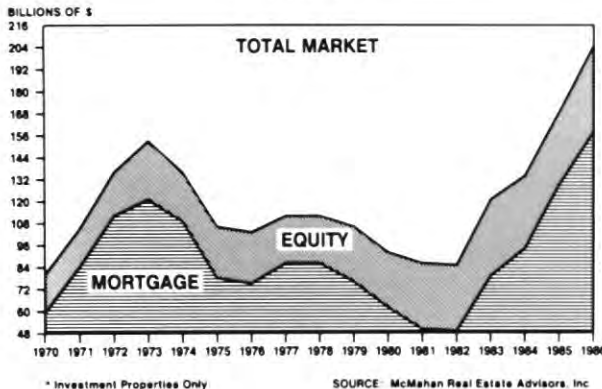


EXHIBIT IV

REAL ESTATE CAPITAL MARKET
Annual Investment
(Real $)



supervise the operation of a property. A more likely scenario is the remote investor relying on professional portfolio and property management to protect his investment and generate desired results. In many cases, the investor never sees the property; his only contact with it is through the quarterly financial report.

Annual Capital Flows

In order to understand the quantitative impact of these changes, it is necessary to analyze the annual real marginal flows of capital. Inflation must be removed to effectively compare different periods. Annual flows provide a more dynamic picture of the impact of external events and player positioning. It should be noted that these figures are for investment properties only and do not include single-family residential or user-owned properties. They also represent investment in completed properties; construction financing is excluded.

Exhibit II illustrates the total capital market, including stocks, bonds and real estate.[4] From this exhibit, it is clear that America has been awash with capital since 1984. The annual real investment flow in 1986 was almost double the 1972-73 period.

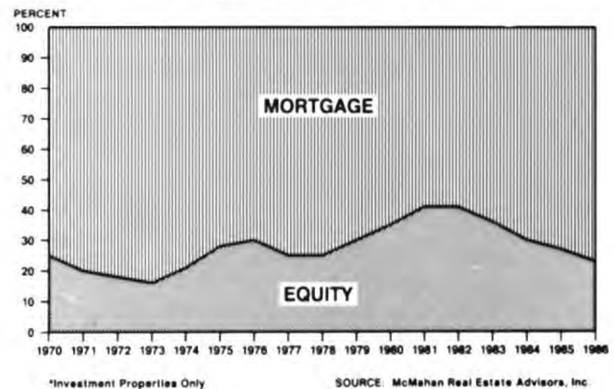
Exhibit III indicates that real estate has done a decent job of getting its share of the total capital flow, staying at or above 50% for most of the last 17 years.[5]

Exhibit IV shows the increase in capital that flowed into the real estate capital market between 1982 and 1986. This capital influx was largely due to the combined impact of the 1981 tax bill and deregulation of America's financial institutions.

The shift from mortgage to equity financing is readily apparent in Exhibit V. As inflation increased in the 1970s, a higher percentage of new capital was directed to equity investment. As inflation subsided, mortgages once again became attractive.

EXHIBIT V

REAL ESTATE CAPITAL MARKET
Annual Investment
(Real $)
PERCENTAGE OF TOTAL



Player Positioning

For a better view of the market dynamics during this period, it is instructive to review the activities of each of the major players. Not only were there substantive shifts in player position during the period, but several important new players emerged.

Mortgage Investors

Several players tended to prefer (or were restricted to) mortgage investments:[6]

Commercial Banks

Commercial banks were active permanent mortgage lenders during the 1970-86 period. As indicated in Exhibit VI, commercial banks were lending $20–$30 billion annually on real estate up until 1984.

Total mortgages increased to $50.4 billion in 1985 and $64.2 billion in 1986, in real dollar terms. (Again, it should be noted that these figures do not include construction lending.)

What were the reasons behind this almost doubling of loan activity? While there is no single answer, there are some consistent patterns. For one thing, banks had run out of interesting lending opportunities. With the evolution of the commercial paper market, banking's traditional customer—the large corporation— was no longer a dependable source of loan demand. Alternatives, such as foreign loans, oil and gas and agriculture, had developed significant problems. This left consumer loans and real estate. While consumer loans generated higher yields, they also had higher costs of administration, and the competition for them was exceedingly fierce.

In the early 1980s, investment property lending looked very attractive to bank managers. Not only was its interest rate higher than for corporate lending, but investment property loans provided the opportunity for obtaining up-front points to further enhance yields. The banks also were staffed to originate and service real estate loans as a result of their construction loan departments. In fact, many of the permanent loans were generated originally as construction/permanent loan packages.

Savings and Loans

Until 1981, savings and loans were highly restricted in terms of the type of investment they could make. Congress deregulated financial institutions in 1981, allowing savings and loans to invest up to 10% of their portfolio in commercial property mortgages. Exhibit VII indicates the almost immediate result of this change in policy. Mortgages for investment properties totaled $6.8 billion in 1981; these mortgages were largely for multifamily residential. In 1986, almost $39 billion was invested, largely in commercial property mortgages.

Mutual Savings Banks

Exhibit VIII indicates that savings banks did not participate heavily in the mid-1970s real estate boom and were

EXHIBIT VI

REAL ESTATE CAPITAL MARKET
Annual Investment
(Real $)

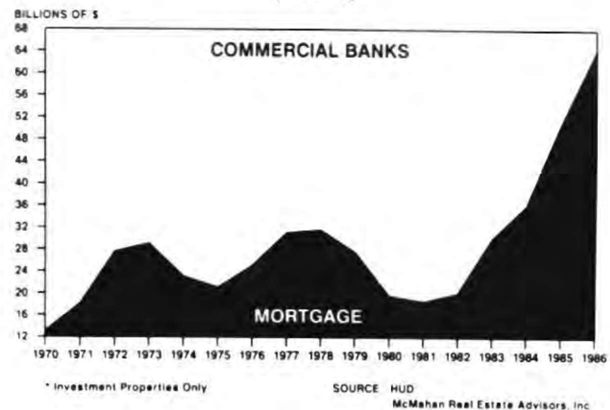


EXHIBIT VII

REAL ESTATE CAPITAL MARKET
Annual Investment
(Real $)

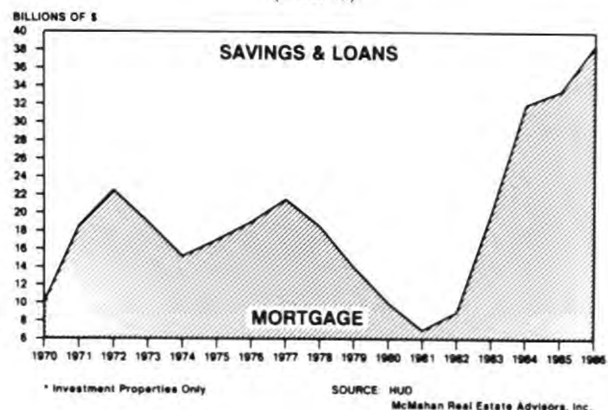
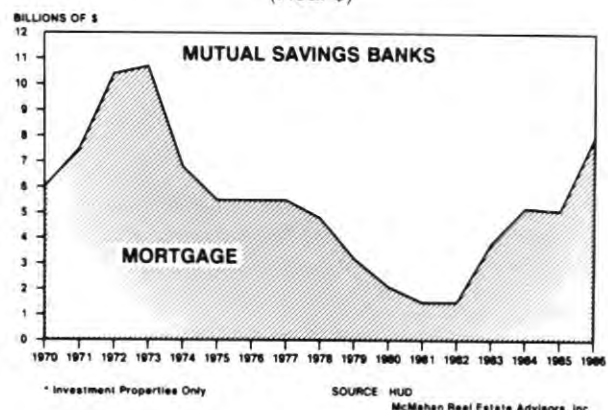


EXHIBIT VIII

REAL ESTATE CAPITAL MARKET
Annual Investment
(Real $)



at a very low level of involvement in 1981 as deregulation became effective. Between 1982 and 1986, however, savings banks added $23.6 billion in real assets to their mortgage portfolio. While savings banks participation in real terms was not as great as in the 1973-74 period, it was quite a change from 1981.

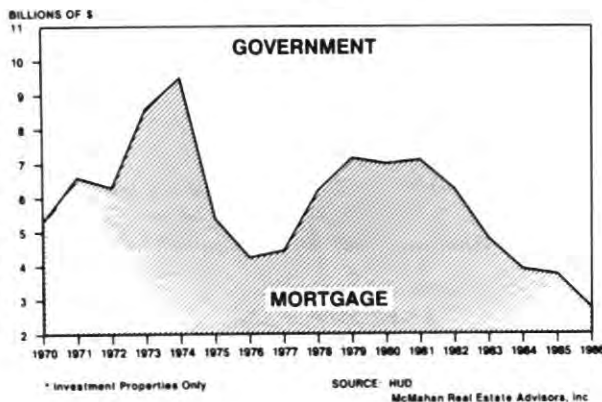
Federal Government

The federal government has financed real estate both through direct loans and as guarantor and/or issuer of mortgages held by private institutions. As indicated in Exhibit IX, the federal government has not particpated extensively in the permanent mortgage market for investment properties. Shifts in investment flows have been more closely associated with changing government policy than with any other factor. Note the decline during the Ford and Reagan administrations.

EXHIBIT IX

REAL ESTATE CAPITAL MARKET

Annual Investment
(Real $)



Mortgage/Equity Investors

Several institutions invested in real estate on both a mortgage and equity basis.

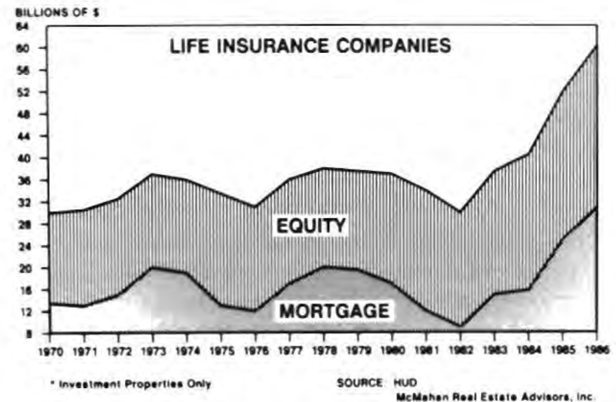
Life Insurance Companies

In the 1970s, life insurance companies were becoming increasingly concerned with a serious set of problems affecting the basic structure of their industry. Individual policyholders had finally become aware that whole life insurance policies were not a good investment during periods of inflation, and they were increasingly favoring term policies. Term insurance, however, did not create the buildup in reserves necessary to support large, long-term general account investment programs. The shorter life of term policies also made it increasingly difficult for the life insurance companies to match asset and liability maturities. Finally, and perhaps most crucially, higher levels of inflation were seriously eroding the earnings of mortgages and other fixed income securities.

EXHIBIT X

REAL ESTATE CAPITAL MARKET

Annual Investment
(Real $)



Insurance companies, anxious to realign their asset/liability mix, began shifting more and more of their assets to equity investments. They also began marketing commingled funds for pension fund investment in real estate.

Exhibit X indicates the real annual investments by life insurance company general accounts over the last 16 years. Generally, annual mortgage flows were in the $12 billion–$20 billion range until 1985 when they hit $26.8 billion and 1986 when they reached $29.5 billion. Equity investments were generally in the $17 billion – $20 billion range until the last few years when they increased to the $20 billion–$30 billion range.

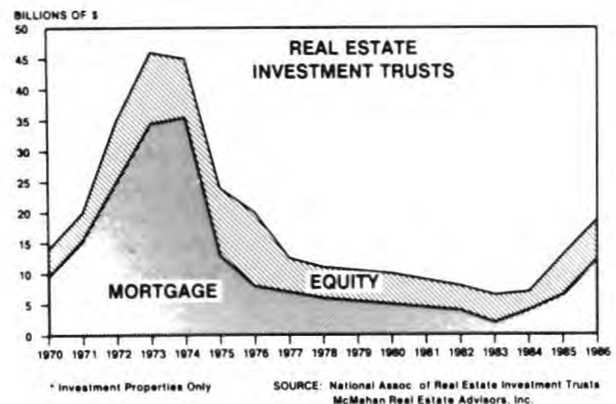
Real Estate Investment Trusts

As indicated in Exhibit XI, the glory years of the REITs were clearly the early 1970s. As interest rates tightened

EXHIBIT XI

REAL ESTATE CAPITAL MARKET

Annual Investment
(Real $)



in 1973, their ability to maintain a profitable spread diminished, and many loans went sour. The stock of most REITs plummeted below book value, and many REITs declared bankruptcy for many years. This period seemed to cast a spell over the whole industry, with most of the stocks trading below book value.

In 1983-84, the fortune of the REITs turned more favorable as they were increasingly used as core investment vehicles for securitized issues introduced by Wall Street. The last two years have been relatively good ones for the REITs, although these years are nothing compared with the 1970s.

Pension Funds

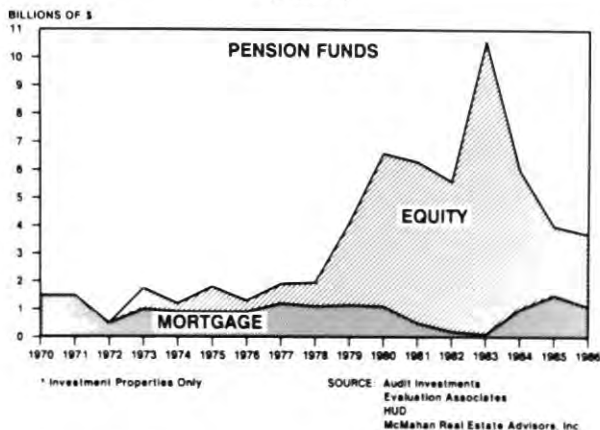
In the mid-1970s, rapidly spiraling inflation began eroding the value of financial assets, and pension funds sponsors became concerned about their ability to fund retirement liabilities. Although fixed income securities were particularly affected, equities did not prove to offer the inflation protection that had been widely assumed.

Beginning with Prudential's open-end fund, PRISA, in 1970, corporate retirement plans began moving into real estate equities. The growth was relatively slow, however, until government regulations were modified to suggest that investment exclusively in securities was not prudent and that plan sponsors should consider other types of assets, such as real estate.

EXHIBIT XII

REAL ESTATE CAPITAL MARKET

Annual Investment
(Real $)

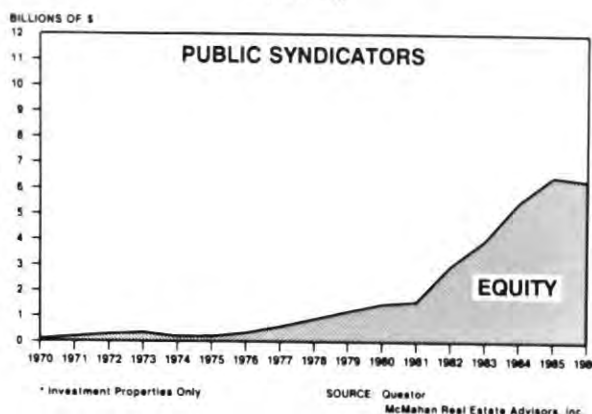


As Exhibit XII illustrates, pension fund equity investment took off in 1978 and peaked in 1983 at $10.9 billion annually. The flow of investment dropped in subsequent years, as inflationary fears abated and the stock market provided a more attractive opportunity. Mortgage investing by pension funds increased slightly during this period, although pension funds never have been the force in direct mortgages that they are in the secondary mortgage market.

EXHIBIT XIII

REAL ESTATE CAPITAL MARKET

Annual Investment
(Real $)



Equity Investors

There also were some investors who preferred equity investments:

Public Syndicators

As indicated in Exhibit XIII, public syndicators did not really gain momentum until the tax bill of 1981 created a major windfall for real estate investors.[7] During the subsequent five years, public syndicators invested approximately $54.5 billion in real estate. The Tax Reform Act of 1986 threw the syndication industry into quite a turmoil, and it is not clear at this point exactly what the final results will be.

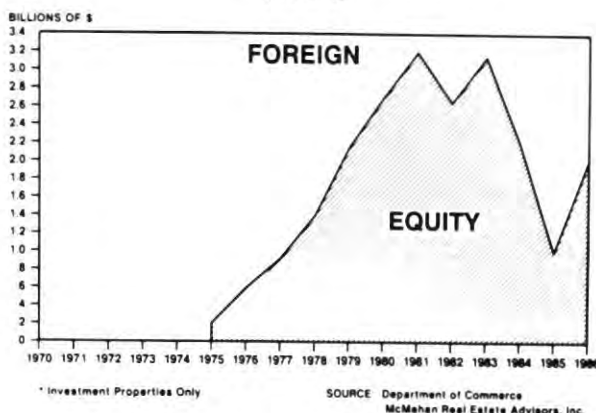
Foreign Investors

In the late 1970s, a relatively cheap dollar, coupled with a large, stable real estate market, made United States real estate highly attractive to foreign investors. Most

EXHIBIT XIV

REAL ESTATE CAPITAL MARKET

Annual Investment
(Real $)



were passive, although some, such as the Canadians, became active in the production process.

As indicated in Exhibit XIV, the foreign appetite for United States real estate began drying up in 1983 as the dollar strengthened and surpluses in the Middle East dried up, but it came back strong in 1986 as the dollar fell to new historical lows.[8] The Japanese, in particular, became agressive buyers of United States real estate in order to arbitrage the currency and yield spread between the countries.

Exhibits XV and XVI combine the mortgage and equity flows from all the players discussed above.

EXHIBIT XV

REAL ESTATE CAPITAL MARKET

Annual Investment
(Real $)

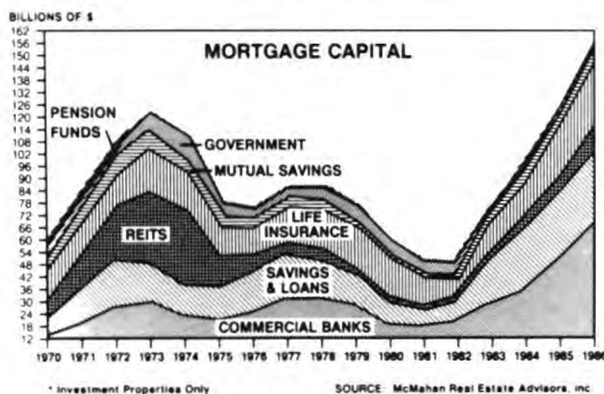
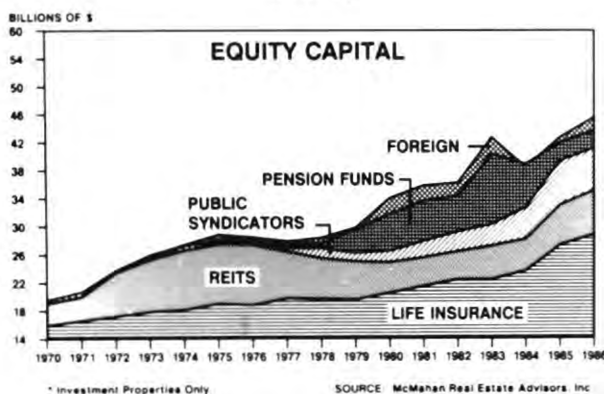


EXHIBIT XVI

REAL ESTATE CAPITAL MARKET

Annual Investment
(Real $)



Comparing Two Boom Periods

Clearly, the capital market had pumped a lot of money into real estate over the last five years. In order to put these flows into perspective, it is instructive to compare the most recent boom period with the last such period, 1971-75. Exhibit XVII summarizes the total real dollar flows for each of the five-year periods by the source of capital.

Our most recent boom period had approximately 17.7% more real capital available than the 1971-75 period. With mortgage capital virtually the same in each period, equity capital has provided the major difference, up 90.5%. In 1971-75, one in five dollars in new real estate capital was an equity dollar; in 1982-86, one out of three dollars was an equity dollar.

REITs were the major source of mortgage capital in the 1971-75 period, but they were not major players during the latest boom. The major increases in mortgage capital came from commercial banks (+67.0%) and savings and loans (+49.9%). Mortgage capital from life insurance companies was down slightly (−2.1%), and capital from savings banks (−43.4%), government (−41.2%) and pension funds (−28.3%) was down substantially.

In terms of equity capital, life insurance companies increased their level of investment (+41.0%) and still constituted the major equity investor, but not to the same degree of dominance that they held in the 1971-75 period. Major increases came from the new players—syndicators, pension funds and foreign investors—with REITs playing a smaller role. Of the $115.2 billion in additional equity capital fueling the recent boom period, $88.8 billion (77.1%) came from new players.

The Emerging Real Estate Capital Market

Exhibit XVIII illustrates the emerging real estate market. A first impression is how much more complicated the

EXHIBIT XVII

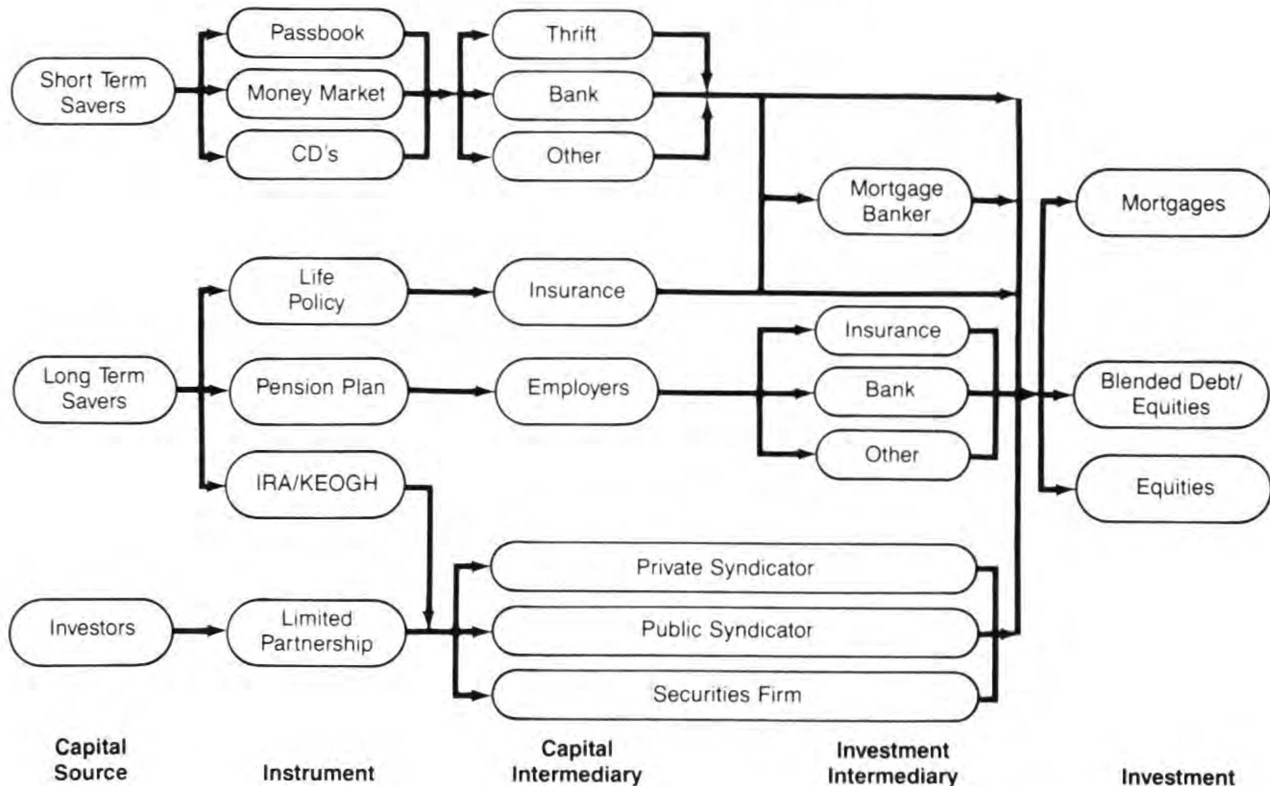
Sources Of Capital For
Two Real Estate Booms
(Billion)

Mortgages	**1971-1975**		**1982-1986**		**% Change**
REITs	$123.4	24.8%	$ 29.6	6.0%	(76.0%)
Banks	120.0	24.1	200.4	40.6	67.0
Savings & Loans	90.5	18.2	135.7	27.5	49.9
Life Insurance Co.	80.9	16.2	79.2	16.1	(2.1)
Savings Banks	41.7	8.4	23.6	4.8	(43.4)
Government	36.2	7.3	21.3	4.3	(41.2)
Pension Funds	5.3	1.1	3.8	.8	(28.3)
	498.0	100.0	493.6	100.0	(.9)
% Total		79.6%		67.1%	
Equity					
Life Insurance Co.	$ 89.3	70.2%	$125.9	51.9%	41.0%
REITs	35.0	27.5	24.8	10.2	(29.1)
Pension Funds	2.0	1.6	26.3	10.9	1,215.0
Syndicators	1.0	.8	54.5	22.5	5,350.0
Foreign	—	—	11.0	4.5	—
	127.3	100.0	242.5	100.0	90.5
% Total		20.4%		32.9%	
Totals	$625.3	100.0%	$736.1	100.0%	17.7%

Source: McMahan Real Estate Advisors, Inc.

EXHIBIT XVIII

EMERGING REAL ESTATE CAPITAL MARKET



SOURCE: John McMahan Associates, Inc.

new capital market is compared with the traditional market. Now, there are three streams instead of two, distinguishing between short- and long-term savers.

Note also that the function of each player is not as clear as the function of the players in the traditional market. As a result of both forward and backward integration, many players today are not only capital aggregators but capital deployers as well. Players may operate directly in some markets and through intermediaries in others.

It is also interesting to note that there are new types of instruments for investment that embody the features of both debt and equity financing. These instruments are exceedingly more complicated than the fixed rate mortgage and locally based limited partnership interests of the past.

In terms of the future, there appear to be several near-term trends:

- *Linkage to Other Capital Markets.* There can be no question that real estate will continue to be linked to other capital markets. The attitude of pension fund managers towards GICs will directly influence the availability and cost of mortgage financing. The international view of real estate equity investing will influence the yield and competition for investment properties.
- *Linkage to Other Real Estate Markets.* With the internationalization of the real estate capital market, there is a greater linkage between the United States and foreign real estate markets. The differential between capitalization rates in Japan and the United States ultimately may have a greater influence on Japanese investment patterns than the yen/dollar differential.
- *Greater Volatility.* As a result of these linkages, the real estate capital market will be much more volatile than it has been in the past. This may make it increasingly difficult to finance large projects that require several years of patient money.
- *Greater Difficulty in Reaching Equilibrium.* With greater volatility, real estate is finding it more difficult to reach market equilibrium. There is no better example of this than the spectacle of new buildings being started when existing vacancy rates are in the 20% – 30% range.

  This means that we may have continued periods of overbuilding and resultant soft real estate markets. Frictional vacancy soon may be redefined to be 10% rather than the traditional 5%.
- *Separation of Production and Investment.* As real estate ownership becomes more absentee in nature,

the production process is increasingly becoming separated from that of investment. The traditional investment builder is becoming a merchant builder, not unlike the single family residential developer. This will have considerable consequences for the long-term quality of real estate products but, at the same time, will introduce significant management opportunities for non-production players.

Over the longer term, the view is not as clear. One scenario would see a continuation of the current capital instability and soft market conditions as part of an unsettled global financial malaise. In this scenario, United States yields would remain relatively high, reflecting uncertainties in the marketplace.

The contrasting scenario, would see a firming of the United States real estate market, lower vacancies and a worldwide movement toward equilibrium. Capitalization rates in the United States would fall as vacancies drop and investors require greater levels of preleasing, credit enhancement and other devices to reduce risk. In essence, the United States would move from a speculative building mode to one based on established tenant demand. Equilibrium would be further enhanced as foreign capitalization rates would rise in order to prevent capital flight to the United States.

Summary

Regardless of the ultimate outcome, it is clear that the United States real estate capital market has changed markedly from the relatively sequestered market of the 1950s and 1960s. These changes have had a major impact on the real estate industry and its players. As with any dramatic change of this nature, opportunities have been created for those with the ability to understand the evolving situation and to act accordingly. No doubt there will be additional opportunities in the future.

NOTES

1. Unless otherwise indicated, all dollar references for the period 1970-86 are in real dollars, adjusted for inflation based on the Consumer Price Index (100 = 1983). Data sources appear in the exhibits.
2. Long-term real interest rates were below the historical 3.0% level for almost five years, from 1977 to 1981.
3. Includes Fannie Mae, Freddie Mac, Ginny Mae and conventional pass-throughs (98% guaranteed by a government agency). Source: Salomon Bros., U.S. League of Savings and Loans, U.S. Department of Housing and Urban Development.
4. New marginal capital for stocks and bonds is based on new issues, less company stock purchases and calls.
5. Corporations, of course, generate a large amount of capital through retained earnings, which is not included in these numbers.
6. Several mortgage lenders also made equity investments, and equity investors may have invested in mortgages. The categories are based on the predominant area of activity.
7. Figures are not available for private syndications which, according to industry estimates, may be one to two times as great as public syndications.
8. These numbers are based on government reports of foreign transactions. They do not include unreported transactions and, as a result, are probably conservative.

The Appraisal Journal

Subscription (1 year):
Members, $20
Nonmembers, $25
Single copy: $7.50

Published quarterly:
January, April, July, and October by
AMERICAN INSTITUTE OF REAL ESTATE APPRAISERS
430 North Michigan Avenue
Chicago, Illinois 60611-4088

OCTOBER 1987

Profile of the Modern Real Estate Appraiser
John R. White, MAI

Fee Simple and Partial Interests
AIREA

Valuing Young Timber Scheduled for Future Harvest
W. David Klemperer

Appraisal of a Class III Landfill
Henry C. Entreken, MAI

An Overview of the Real Estate Investment Marketplace
Joseph J. Del Casino

Office Space Demand Analysis
J.R. Kimball, MAI, and Barbara S. Bloomberg

Techniques of Area Analysis
Jerome Dasso

Basket Planning under the Tax Reform Act of 1986
Mark L. Levine, MAI