FROM CASSANDRA, WITH LOVE . . .

The fallout from tax reform and an overbuilt real estate market does not bode well for future real estate development and investment.

by Samuel Zell

Much has been written about the mid-1980s' massive oversupply of real estate in the United States. Estimates of the total losses from overbuilding, deregulation gone wild, fraud and concentrated area economic downturns range from $40 to $80 billion, with much of it yet to be recognized.

The major focus of analysts has been on how soon we will recover and how quickly we will regain normality. This is similar to the postoperative period when the patient believes that soon all will be normal again. Unfortunately, the prognosis between a broken leg and the one following an amputation are radically different and often the patient in the recovery room does not know the difference until the drugs wear off. This time, the drug is an overbuilt real estate scenario which is disguising the massive fundamental changes that have occurred within the industry.

The development of income-producing real estate has been a massive engine of growth for the past 20 years. During much of this period, real estate development activity has been on the forefront of growth rather than in response to it. Real estate's role has changed from an auxiliary function of the major growth factors—manufacturing, service, government—to a fourth factor that is creating unjustified activity and employment.

Income-producing construction, particularly office buildings, hotels, rental housing and strip centers, has produced, in one year, what was previously accepted as a ten-year supply. Today, the United States' real estate market is much like other countries that maintain employment by massive programs of underemployment. Farmers in China, employees of distribution systems in Japan, workers in government bureaucracies in the United States, India and the USSR are prime examples. Underutilization of real assets has masked the extent to which supply and demand have skewed. Most markets have obfuscated these realities by extending massive concessions on the assumption that current conditions represent temporary aberrations which will be cured as soon as the overbuilt period wears off. This is not too dissimilar from the budgetary process where politicians create current deficits for which the cure will come after the current unique circumstance passes. The economic events of 1987 have signaled a major change in our ability to embrace these unrealistic assumptions. The post-stock market crash reality has told us that major underlying changes have occurred and these changes will have a dramatic impact on this country for the foreseeable future. Our borrowing from the future debt has come due. The real estate industry will be one of the major victims of this change.

This industry has been buffeted by major structural changes in a very short period of time. These societal changes, from the extreme of tax reform to the reduction

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in our standard of living, signal the sunset of the real estate industry as an engine of employment and growth. The dislocation that the changes create will be significant and will dramatically reduce the ways in which we use and invest in real estate.

Although the prognostications are dire, they will prove to be necessary in order to reorient the industry to function on a true economic basis. The downsizing of the industry ultimately will reward those with staying power. Existing, well-located and tenanted real estate will become very dear.

On January 1, 1987, the Tax Reform Act of 1986 went into effect. This legislation represented the final uncoupling of a public policy of growth from the tax system. Although the law materially diminished many benefits that inured to the investor, the effective elimination of the ability to offset real estate losses against other income dramatically altered investment incentives in real estate. Noncash real estate investment losses that previously allowed an investor to defer tax payments, acted as a subsidy to the industry and the user/consumer. Tax reform converted the real estate business from one that builds for future demand to one that builds for pent-up demand.

This subsidy to development reduced the risk of construction and provided a yield to the investor while waiting for the income to catch up with the cost. Conventional wisdom anticipated that the loss of subsidy would increase the cost of occupancy to the tenant. The user market always has been elastic, and increase in price has lead to reduction in demand. Reduced demand has lead to an increase in the risk of creation.

Past tax policy encouraged risk by providing tax deductions and credits. In the past, the subsidies previously described lowered the cost of the delivered product. Encouraging competition and oversupply was the system's way of passing on the subsidy to the user.

Post-reform will make owning empty buildings very expensive. Post-reform, all invested dollars are hard, and the investor no longer benefits from converting deductions taken early at higher ordinary rates and recaptured at the point of sale with lower capital rates. This increased tax cost will lower after-tax net proceeds and discourage development.

Between 1965 and 1985, Chicago built an average of 2,022,300 square feet per annum of urban office space. That average represented about three times the average per annum for the previous 15 years. This tremendous creation of space and the absorption thereof reflected a combination of growth, consumption and the conversion of the economy from a manufacturing base to a service base. The recognition of this conversion became the justification for continued development and financing. Just as some trends in the past tended to lead to excessive assumptions ($90-a-barrel oil by 1986), the theoretical demand for new office space was limited only by the amount of money lenders were willing to commit to new structures.

As our competitive position worldwide deteriorated, more and more of our resources were moved from manufacturing to service. Both federal and state governments increased employment and the need for additional space. The proliferation of financial instruments, often representing a multitude of ways to skin the same cat, generated more demand for space to house the people who traded them, audited them, settled them, sued over them and wrote about them.

But trees do not grow to the sky, and demand for space from conversion does not endlessly compound. Not only does it not compound, but if underlying fundamentals change, demand can contract. Whether or not current conditions represent contraction, the period of heady growth is over. The demographics tell us that the rate of population growth has diminished, and the fall of the dollar has started the pendulum swinging the other way, back toward manufacturing.

The internationalization of monetary markets has permanently altered the United States' real estate market. Floating exchange rates and steep deficits inexorably have moved control over the cost and availability of funds offshore. It also has created an instantaneous ability to approve or disapprove changes in policy by putting pressure on our currency. This sensitivity has created a new, unwanted form of discipline. No longer can we, at will, monetize our past excessive debts and allow inflation to bail us out.

When real estate financing was primarily long-term, fixed-rate debt, real estate became a vehicle for the transfer of wealth from the saver to the user. The saver found his rate fixed at the same time that inflation reduced the purchasing power of his yield. In the real estate community, this was translated into getting bailed out by inflation.

The prospects from this kind of monetization are not possible in the current environment. Expansionary, undisciplined spending is immediately reflected in the value of our currency and stock markets. As a net debtor nation, our interest rates are governed by our creditors, and such inflation-creating policies are immediately translated into a higher cost of funds. Therefore, another subsidy has been removed from real estate, with floating rates and the monetization of previous excesses no longer being an option for extraction from oversupply. Thus, the cost of excess activity will increase exponentially as absorption will be governed by real growth requirements, not inflationary delusions.

Inflation also is less likely to govern future real estate decisions as much as it has in the past. As global competition controls prices in the United States, downsizing and adjustment in the standard of living will become the norm. Reduction in consumption, unfortunately, will remain the dominant theme for the foreseeable future. Real estate in the United States has reflected another form of consumption. Glaring examples of this consumption can be seen in the average number of square feet per person in residential and office buildings. These usage figures are at least double those in the Far East. Although accusations of underconsumption, particularly by the Japanese, are

valid, the contrast with our usage makes the alteration in our relative currencies believable.

Another example of underutilization of assets occurs when office buildings are built for $200 a square foot, then leased for ten years at two-thirds the rate needed to service the investment. The owner justifies the loss of his stream of income by capitalizing his losses and adding them to his basis. The theory behind this view is that growth in future value will ovecome initially higher subsidies to achieve occupancy. This is acceptable within reason, but at what point have tenant concessions amounted to a transfer of value that never will be recouped? How much current replacement cost can be capitalized and still produce returns that make real estate investment attractive? It stretches the imagination to believe that free rent and tenant allowances equal to 50 percent of the anticipated income from the lease ultimately will produce a viable investment.

The transfer of value or overinvestment in real estate represents a loss to the owner. The failure of the owner to recognize that a percentage of this capital has been consumed is the reason lenders and investors are slow to recognize change. By rolling current deficits into the future, postponement is achieved, and the inflation hope certificate is purchased. As the process continues, existing inventory is consumed, thereby diverting assets from productive uses. The fall of the dollar and the new international realities are forcing change that requires more productivity from asset employment.

Deflation, a fear not in the forefront of economic concern until the early 1980s, is a very real concern today. The Keynesian inflation bias got out of hand in the 1970s, and we are still in the process of trying to readjust without going too far the other way. Although significant decrease in demand is unlikely, one must realistically assess the real estate inventory from the perspective of need versus use. There currently is much more space used than is needed. The number of square feet per employee in office space is significantly greater than needed if austerity gains the upper hand.

Similarly, the resources absorbed by the continued expansion of our infrastructure to perpetuate the dream of a single family detached home no longer can be justified under current economic circumstances.

Retail development that creates multiple clones within a relatively close distance reflects the triumph of the art of development over the challenge of merchandizing. As long as capital is indiscriminately available for real estate, redundant creation will follow. In many cases, retailers will be forced to create more outlets than needed to preclude competition. If, however, the real estate had not been developed, no shortage of available supply would have surfaced.

These are all manifestations of a consumptive and very rich society. The events of the last 15 years are coming home to roost. We have overproduced, overallocated and overemployed in real estate. This overconsumption means there is vast opportunity to reduce demand and still meet requirements. A slow transition from use to need will avoid the pitfalls of deflation. A faster change could deflate our economy and lead to a repeat of the 1930s. Whether fast or slow, the result will be a reduction in overall demand as our society adjusts to a lower standard of living.

The economic environment now will dictate major changes in real estate. The situation is analogous to the energy business. For a period of ten years, huge amounts of human and financial capital were committed until incremental investment was no longer justified. The hangover in the oil field has been very severe. Local economies dependent upon the industry as the engine of growth require lengthy periods of adjustment.

Real estate in many communities has been the engine that fueled growth. As the reality of oversupply reduces new development, the support staff begins to contract. This contraction further reduces demand in a saturated market. This recovery and absorption both are extended by the fall of real estate activity.

An additional influence on the future of the industry is in regulatory control. The United States has by far the least regulated market in the world. Even *laissez faire* bastions such as Hong Kong maintain very strong influence and control over all use or reuse of land. The philosophy of the United States historically has been very growth oriented. Civic pride often has been measured by the number of new residences per month, trumpeted through the national media. No one person has foreseen the impact on the community of unstructured development.

The downzoning of downtown Los Angeles and the height restrictions in San Francisco are but two examples of communities that are attempting to reduce new development. The pendulum of change is likely to continue moving toward more regulation and a lengthening of the development process. This will increase costs and open development to much closer scrutiny than in the past.

Belatedly, communities are beginning to understand better the cost of growth and undisciplined development and its effect on the tax burden of the whole community. Greater awareness of cost, both direct and indirect, is bringing home the reality that communities must have a greater stake in the planning process. The logical, although not necessarily better, result of this trend is realigning the development process in the United States toward more worldwide norms. Booms and busts are municipal financial disasters, and greater scrutiny and involvement represent actions of self-interest by municipalities. Further regulation will slow development, increase costs and subject development proposals to the challenge of need.

As new development slows, the existing inventory of first-class structures will fill gradually. A chastened real estate lending and investment community will find that most new office construction, commissioned after 1982, will prove to be economically unjustified. Real estate investors will obfuscate their losses by redoing their pro formas to reduce yield expectations.

During the inflation yo-yo years of the 1970s, lease terms

were shortened to theoretically increase the owner's yield by making the releasing period arrive sooner. This strategy not only did not work, but it contributed to the destabilization of the office market by encouraging lease takeovers and by aiding the mobility of tenants. Shorter leases which reflected projected increases also made internal rates of return higher and thus made real estate seem more attractive.

Valuation techniques will revert back to a multiple of cash flow versus an analysis based on value per square foot. A new appreciation for the benefit of a lease will emerge. The real estate industry will become more conservative, and emphasis on long-term leases will become the norm. Security of income stream will become paramount in investment criteria.

The purchases of office buildings in the United States by the Japanese reflect this philosophy. Although they have been accused of overpaying, the test of time is likely to prove them right and prudent.

The supply and demand equation in real estate will improve slowly, with real income remaining essentially flat until the oversupply is absorbed. Many communities will suffer the double whammy of oversupply and unemployment, which will be exaggerated by the severe reduction in the construction industry. The absorption process will be much slower than the previous recoveries. Whereas in the past, oversupply was followed by rapid recovery creating a V of activity, this period more likely will be a slow, upward angle creating an L with bias.

The degree of pain and suffering (loss) that the real estate lending and investment community absorbs will materially intimidate future commitments of funds. Real estate investment without inflation and the leverage of fixed-rate debt will compare poorly with other active investments. Real estate, as part of a core institutional holding, will provide security and predictability in an increasingly volatile environment. As the cyclical nature of real estate development wanes, the market will pay a premium in capitalization rates for the safety and security of tenanted bricks and mortar. By contrast, the spread in value between the occupied and non-occupied will become much greater. The United States' market will look much more like the foreign ones. Yields will decrease as the risks involved in potential vacancy recede, and they will remain very low as the amount of funds available for secure, tenanted real estate investment opportunities remain much larger than supply. There will be an oversupply of development opportunities, and the only shortage will be one of leases.

The challenge for the rest of the century will be to recognize and acknowledge basic and underlying changes. The prognostication herein represents a bitter pill to a consumptive and macho industry. Failure to recognize and differentiate between past overbuilding and structural change in demand, use and affordability will be viewed with the same historical reverence held by those who opened the gates to Troy.