# FOREIGN INVESTMENT, VERTICAL INTEGRATION AND THE STRUCTURE OF THE U.S. REAL ESTATE INDUSTRY

*Does foreign investment in U.S. real estate merely change the nationality of passive owners? Or does it signal the restructuring of the real estate industry in this country?*

by Lawrence S. Bacow

*In 1987, the Massachusetts Institute of Technology (MIT) Center for Real Estate Development in partnership with the National Association of Realtors began to explore the impact of foreign investment on U.S. real estate markets. The first phase of this project studied patterns of foreign investment in three cities: Los Angeles, Chicago and Washington, D.C. The objective was to gauge the magnitude of foreign investment and to understand the investment objectives of foreign purchasers. The results of phase one were published as MIT Center for Real Estate Development Working Paper Number 12, "Understanding Foreign Investment in U.S. Real Estate," by Lawrence S. Bacow. The next phase of the project revisited the same three cities 12 months later to determine if investment patterns had changed, and it examined investment patterns in three smaller cities: Phoenix, Atlanta and Honolulu. This phase also looked for evidence that foreign investors were branching out beyond the passive acquisition of existing properties into other real estate-related businesses. The results of the second phase of the project were reported in MIT Center for Real Estate Development Working Paper Number 16, "The Internationalization of the U.S. Real Estate Industry," also by Lawrence S. Bacow. This paper describes what was learned about vertical integration during the second phase of the research, and it explores the structural implications of the trends in foreign investment that were reported in the earlier phases of the project.*

Foreign investment in U.S. real estate is not a new phenomenon. Offshore investors have had a healthy appetite for our land and buildings since the Dutch purchased Manhattan Island from the indians in 1626. In recent years, foreign investment has been fueled by a cheap dollar, a strong U.S. economy, a stable political environment and tremendous liquidity on the part of foreign buyers. U.S. real estate has been particularly attractive to foreign buyers because it offers a higher cash yield than is available in most other countries (8-10% in the United States versus 2% in Japan and 5-6% in much of Europe) and because it is plentiful. Our markets are large; we place few, if any, restrictions on foreign ownership; and in contrast with building transactions in other countries, our buildings change hands relatively frequently. Thus, a foreign investor can more easily assemble a substantial portfolio of investment-grade properties in the United States than in other countries.

Since 1982, foreign holdings of U.S. real estate have more than doubled.[1] Initially, foreign investors focused on entry port cities such as New York, Los

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Angeles, Washington, D.C., and Chicago. However, as foreign investors have become more familiar and experienced with U.S. markets, they have expanded the locus of their acquisitions to smaller cities in the nation's interior. Perhaps no city has felt the impact of foreign investment more than Los Angeles where offshore investors now own interests in more than half the office space in the central business district. Substantial foreign holdings also exist in Atlanta, Phoenix and Honolulu. In fact, it is difficult to identify a single city of any size in the United States that does not have foreign real estate holdings.

Foreign investors' increasing interest in U.S. real estate has raised questions about the long-term consequences that these acquisitions will have for U.S. real estate markets. In a previous paper, I argued that passive acquisition of U.S. buildings by foreigners is essentially benign.[2] U.S. markets are too large to be controlled by foreign investors from any one nation. Far from being speculators, most foreign owners are long-term investors who maintain high standards for building maintenance and management. As a result, foreign ownership tends to introduce stability, not volatility, to U.S. markets. Tenants tend to be either ignorant or indifferent to the identity of their landlord. And contrary to popular belief, foreign purchasers do not possess any competitive advantage in acquiring U.S. properties because of supposed access to lower cost capital.

In this paper, I will analyze whether passive ownership of investment-grade properties by foreign institutions foreshadows vertical integration by foreign firms into related real estate businesses.

## The Current Degree Of Integration

Real estate companies in other parts of the world are far more integrated than they are in the United States. Perhaps the most striking example of such integration is the Japanese homebuilder, Misawa Homes. Misawa not only designs, builds and sells its homes, it also manufactures many of the homes' component parts, provides financing through a subsidiary to the ultimate purchaser, offers interior design services to its customers and even sells home furnishings through one of its divisions. Similarly, the Mitsui and Mitsubishi companies develop, finance, own, lease and manage their commercial properties throughout Japan. European real estate firms also have a tradition of vertical integration.

Already, foreign firms are competing to provide construction, development, leasing, property management and financial services to the U.S. real estate community. Our survey of foreign investment practices in a number of U.S. cities revealed a substantial amount of foreign real estate activity that extended beyond the passive acquisition of existing buildings (see Table 1). For example, Shimizu, Ohbayashi and Kumagai Gumi, three of Japan's largest construction companies, have significant operations in the United States, and they are competing for large-scale contracts. These companies also have used their development subsidiaries to gain entry into the U.S. contracting business. Some of Korea's largest contractors have established subsidiaries in the United States, and several Japanese and European firms function as their own developers in southern California, Washington, D.C., Honolulu, Phoenix and Atlanta.

L.J. Hooker, an Australian company, is perhaps the best example of a foreign firm that has integrated into a range of related real estate businesses. In Australia, Hooker is active as a major developer, property manager, contractor and commercial and residential broker. In addition, the firm has mining interests and produces some building products. The company entered the U.S. real estate market 14 years ago as a developer of shopping malls; it subsequently expanded into residential development. In the past two years, Hooker further integrated its U.S. operations by acquiring two major retailers, B. Altman and Bonwit Teller, as well as Merrill Lynch's commercial brokerage house.

Mitsui Fudosan has followed a pattern of expansion and acquisition in this country that parallels its activities in its principal market. It has purchased existing properties in the United States, entered into joint ventures with U.S. developers, acquired a property management company on the West Coast to manage its portfolio (Aspen Woods), started a residential brokerage operation in Honolulu (Mitsui ReHouse) and established a syndication to provide services to Japanese individuals who wish to invest in the United States. It also is developing a major office tower in Los Angeles and has retained the Gerald D. Hines company on a fee basis for development services.

Some foreign companies are pursuing other strategies. For example, foreign banks are aggressively competing for the construction lending business and are seeking to place permanent financing for properties located in the United States.[3] And in the past few years, several foreign firms have purchased interests in U.S. real estate companies. For example, Orient Leasing, a Japanese brokerage and financial investment firm, acquired a share of Rubloff & Co.; Nomura Securities purchased 50% of Eastdil Realty; and Dai-Ichi purchased a 40% interest in LaSalle Partners.

I would like to argue that, notwithstanding the flurry of foreign activity noted here, the size and structure of the U.S. real estate industry precludes large-scale vertical integration by foreign firms or their domestic counterparts. The future restructuring of the U.S. real estate industry will be driven not by offshore investors seeking to integrate but by the continuing institutionalization of a previously highly entrepreneurial and atomistic industry. U.S. providers of services to the real estate industry will face foreign competition, but this competition will be no greater than the competition experienced by service providers in other industries.

To make the above argument in a coherent fashion first requires an analysis of the rationale for vertical integration.

**TABLE 1**

Foreign Firms Active in Real Estate Related Businesses in the United States

| Firm | Location | Activity | Nationality |
|---|---|---|---|
| Campeau | Cincinnati<br>New York<br>Boston | Development<br>Retailing<br>Property management | Canada |
| City/State | Washington, D.C. | Development | Australia |
| Hasegawa Komuten | Honolulu<br>New York<br>San Francisco<br>Los Angeles | Investment<br>Development<br>Construction<br>Brokerage<br>Property management | Japan |
| L.J. Hooker | Atlanta<br>Phoenix<br>Stamford, CT | Development<br>Construction<br>Brokerage<br>Retailing | Australia |
| Julien Josephs | Washington, D.C. | Development | Australia |
| Kumagai Gumi | New York | Development<br>Construction<br>Finance | Japan |
| London & Leeds | New York<br>Boston<br>Washington, D.C. | Investment<br>Development | Britain |
| Manhattan Equities | New York | Investment<br>Development | Brazil |
| Mitsui Real Estate | New York<br>Los Angeles<br>Honolulu | Investment<br>Syndication<br>Development<br>Property management | Japan |
| Ohbayashi | Los Angeles | Development<br>Construction | Japan |
| Okada | New York | Brokerage | Japan |
| Olympia & York | New York | Investment<br>Development<br>Property management | Canada |
| Ronald HSU | Maryland | Construction | Korea |
| Shuwa | Los Angeles | Investment<br>Development | Japan |
| Shimizu | New York<br>Phoenix<br>Los Angeles | Development<br>Construction | Japan |
| Tobashima | New York<br>Los Angeles | Investment<br>Development<br>Construction | Japan |

*This listing represents only those foreign firms that responded to a survey conducted in July, 1988.*
*Source: K. Carignan McNeil and L. Bacow.*

## Why Integrate Vertically?

Vertical integration is the act of incorporating into a firm a technologically distinct service or product or a process that was previously purchased by the firm or sold by others in the marketplace. For example, a company that is principally in the oil refining business would be integrating vertically if it were to enter into oil exploration or production and

the crude oil transportation business. It would also be integrating vertically if it distributed its finished products on a wholesale or retail basis.

A variety of reasons are commonly cited in the industrial organization literature to explain why firms integrate vertically. Unfortunately, the traditional rationales are of limited usefulness in trying to understand why real estate firms might integrate.

The most common explanation for vertical integration is to capture various types of economies of production or distribution. Often, firms view these choices as buy/make decisions. However, as long as a market is relatively efficient, a firm should not be able to make a product more cheaply than it can buy the product in the marketplace unless the process of integration itself generates efficiencies. Porter identifies a number of integration economies.[4]

*Combined Operations*
Sometimes combining operations yields savings by reducing the number of steps in the production process. In the classic example of hot rolling steel, if steelmaking and rolling are combined, the steel does not need to be reheated prior to rolling. In the real estate business, efficiencies that result from combined operations are few and far between. Although combining road work with site preparation may bring about some savings if a residential developer can avoid bringing heavy equipment to the site more than once, the same economies can be realized simply through efficient scheduling of subcontractors.

*Scheduling And Coordination*
An integrated firm may realize scheduling and coordination economies by sequencing activities carefully. For example, inventory can be controlled better if a firm coordinates the production of both factor inputs and final products. Once again, however, scheduling and coordination economies are rarely issues in the real estate business. Producers and suppliers of intermediate goods and services are highly disassociated. As a result, multiple sources of supply exist, and except for strikes, rarely is development interrupted or delayed by an activity that could be controlled through vertical integration. Instead, delays usually result either from weakness in demand for the product or from regulatory problems.

*Information Economies*
Vertical integration may produce information economies by generating data on changes in the preferences of customers or on the cost of producing particular products. This is the principal explanation why developers (and building owners) often market and manage their own space. For example, the housing developer who markets his own product gains firsthand knowledge of the consumer's willingness to pay for certain amenities. Similarly, the owner who manages his own buildings learns much about the preferences and future space requirements of his tenants as well as the costs of operating his buildings. The developer with a captive construction company has substantial cost estimation information in-house and may be able to exercise more control over quality. For the foreign investor seeking to build a large portfolio, acquiring a brokerage company may represent a reasonable strategy for acquiring market information.

*Efficient Production*
Integration may yield savings by allowing a firm to substitute a series of internal transactions for those that otherwise would be conducted in the marketplace. If contracting is cumbersome and time-consuming, the integrated firm may have an advantage in bringing products to the marketplace through a more efficient production process. For example, the developer with a captive construction company in theory does not have to go through a lengthy bidding process in the development of a construction budget. In reality, however, dealing with captive providers is often as difficult as dealing with market providers. Captive subsidiaries are not subject to the same competitive pressures as independent providers, nor are they motivated by the fear of losing the job. As a result, they are often less efficient and less responsive than independent competitors.

*Input And Demand*
Perhaps the strongest reason to integrate vertically is to ensure a continuing supply of needed factor inputs or a demand for the firm's end products. Until the Federal Home Loan Bank Board put a stop to this practice, developers in the Sunbelt were acquiring thrifts largely to ensure a ready source of capital (arguably their most important factor input) to finance their development activities. Developers also have acquired construction companies to ensure that their projects would receive adequate attention during times of peak construction activity. Similarly, the evolution from construction to development is a natural one. The owner of a construction company already possesses the technical knowledge of how to build a building. As a general contractor, he already bears much of the construction risk for a project, and he does so for a relatively modest fee. By entering the development business, he can simultaneously generate additional business for his construction company and earn substantially higher returns. This strategy has been aggressively pursued by a number of Japanese construction companies, including Ohbayashi and Kumagai which have elected to enter the highly competitive U.S. contracting business by financing joint venture developments in which they also serve as the general contractor.

Institutional purchasers of real estate, both foreign and domestic, have integrated into the development business to ensure a steady stream of future products. In the past few years, domestic institutions, especially pension funds, have increased the portion of their assets that they wish to hold in real estate from about 3% to 10%. As a result, pension funds, in concert with foreign investors, have bid up prices for investment-grade buildings and bid down yields. To reach their target asset allocations, these investors have been forced into the development

business. Both foreign and domestic institutions now participate in equity joint ventures on development projects; they establish captive development companies; and they make equity-like investments in independent real estate companies.

The retail business is another example of integration in which developers and retailers work to ensure access to supply and demand. Some of the nation's largest shopping center developers (Taubman, DeBartolo, Campeau and Hooker) have invested in the retail business as a way of gaining control of major anchor tenants for their new developments. Sears has become a major developer of shopping centers through its Homart subsidiary. Retailers and shopping center developers integrate vertically because of the symbiotic relationship that exists between anchor tenants, smaller satellite tenants and shopping center developers.

Typically, shopping centers are anchored by a few very large national stores that act as magnets to draw customers to the site. These stores lease their space on extremely favorable terms, often generating little or no cash flow in excess of operating expenses for the developer/owner. With a strong anchor, a shopping center developer can obtain favorable financing as well as a good mix of smaller tenants on terms that typically provide for base rent plus a percentage of sales. Without an anchor, a developer cannot build a conventional shopping center. By controlling the anchor, the developer assures demand for his space, and he can prevent the anchor store from locating in a competing center.

*Bargaining Power And Value*

The previous discussion illustrates two rationales for vertical integration: to offset the bargaining power of suppliers or customers and to capture the value created through contractual relationships. Because of the important role they play in the development of a shopping center, anchor tenants wield enormous power in lease negotiations. The developer with a captive anchor offsets this bargaining advantage, at least with respect to his captive tenants. Similarly, the retailer that integrates into shopping center development captures for itself some of the value that is created through the signing of its own lease. In a weak office market, a major tenant may also succeed in capturing the value created through its lease by obtaining an equity interest in the building. Among national office users, International Business Machines, Inc., has pursued a strategy of joint venturing with office developers on projects in which IBM is a major tenant. This type of vertical integration occurs infrequently in office building development because, unlike a national retail anchor, an office tenant rarely attracts additional tenants to a building. Many small stores may wish to locate near a Sears store because they know that the legions of people who flock to Sears also will buy goods at other stores. By owning the shopping center, Sears can capture some of this value. In contrast, there is little, if any, benefit for most businesses to locate in the same building as IBM.

*Fee Business*

For developers, there is an additional reason to integrate vertically: to diversify into fee businesses that operate independently of the development cycle. The fundamental strategic problem faced by most developers is how to sustain their organizations through downturns in the development cycle. By its nature, real estate development is the most cyclical of all businesses. The conventional wisdom is that the development cycle results from sensitivity to macroeconomic conditions. But the real sources of the cycle are the durable nature of the product and the stochastic nature of the demand. Unfortunately for developers, buildings last for years. Unlike food or toothpaste, there is relatively little continuous replacement demand for new buildings. Instead, demand results from structural shifts in the economy, marginal changes in demographics or improvements in local economic conditions that give rise to new development opportunities. Developers must figure out how to cover their overhead during periods of scarce development opportunities when they are not earning development fees (if they are investment builders) or development profits (if they are merchant builders).

Vertical integration represents one approach to the cyclical problem. Brokerage and property management are two fee businesses that are closely linked to the development business yet operate independently of the development cycle. Demand for these services is proportional to the magnitude of the *stock* of existing buildings as distinct from the *flow* of new buildings created through development. Similarly, mortgage brokerage and tenant construction offer similar opportunities to diversify into related businesses that are less cyclical than development. Another approach to the cyclical problem is for a developer to strictly avoid any form of integration. If a developer contracts for virtually all services with third parties, he can keep overhead to a minimum and hunker down during lulls in the development cycle. So while vertical integration may be one strategy for dealing with cycles, it is by no means the only strategy.

*Integration In Real Estate*

In sum, there are a variety of reasons why real estate firms integrate at the fringes of their businesses. Investors integrate into development to gain access to product. Developers integrate into brokerage to gain knowledge of customers and their preferences. Owners integrate into property management to ensure management from an owner's perspective. Contractors integrate into development to earn a larger reward for the risks they are taking and to ensure a steady stream of work. Large retail developers integrate into retailing to improve their bargaining position relative to anchor tenants. Retailers integrate into development to capture the full value created through their leases. And everyone considers integration as a means of diversification.

While the above discussion explains why vertical integration occurs at the margins of different

segments of the real estate industry, it does not help us understand why fully integrated real estate companies have not proliferated in the United States as they have in other countries. The next section of this paper examines structural characteristics of the U.S. real estate industry that are likely to thwart large-scale vertical integration.

**FIGURE 1:**

The Real Estate Value Chain

| Activity | Services |
|---|---|
| Land Assemblage | Brokerage, Financing |
| ↓ | |
| Horizontal Development | Legal, Planning, Construction |
| ↓ | |
| Vertical Development | Design, Construction, Financing |
| ↓ | |
| Leasing/Sales | Brokerage, Marketing |
| ↓ | |
| Asset Management | Property Management, Permanent Financing |
| ↓ | |
| Investment Asset | Investment Brokerage |

## Vertical Integration And Industry Structure

Value can be created in real estate in a variety of ways: through land assemblage, horizontal or vertical development, leasing or sales, asset management and investment. (see Figure 1) Land assemblage is the process of assembling adjacent sites to permit the development of a larger project; those who engage exclusively in this process are land speculators. Once a site has been assembled, the process of horizontal development occurs. This process includes obtaining permits and approvals and developing roads and the necessary infrastructure to support the development of buildings on the site. Those who engage only in this process are land developers who may sell their sites to end users or wholesale their sites as large parcels to developers. Vertical development is the process of actually developing buildings for occupancy. Once vertical development has been completed, leasing or sale of the buildings takes place and asset management begins.

The ways in which value can be added to real estate are supported by many services, including brokerage and financing; planning and construction; design, construction and financing; marketing; property management and permanent financing; and investment brokerage (Figure 1). A completely vertically integrated firm would be involved in all of the methods of adding value to real estate, and it would perform all of the necessary supporting services in-house. In contrast to Japan and some European countries, the United States has few such firms. There are a variety of reasons for this.

*The Local Nature Of Services*

Many of the services needed to operate a fully integrated development company in the United States can only be provided locally. Prior to the start of vertical development, it is local expertise that creates value in real estate; it is the knowledge of local buying opportunities, local planning laws, local politics, and local building trades and contractors. While an architect can design a building from a remote location and financing sources can be located virtually anywhere, lawyers (at least those responsible for the approval process), brokers and property managers typically must be located in close proximity to their projects. To be competitive, contractors also need to establish relationships with local subcontractors. Thus, if a real estate company operates in more than one U.S. market, it must recreate much of its organization in each part of the country where it is active. Every one of its regional offices must have its own construction company, its own brokerage operation, its own legal group and its own property management company.

The difficulty with this arrangement is that few U.S. companies operate on a large enough scale to sustain an integrated operation in every market. Rather, U.S. companies find it far more efficient to contract for services with third party providers in various locales. This explains why the only fully integrated (i.e, construction, development, brokerage and property management) real estate companies in the United States are regional companies such as Spaulding & Slye which operates only in New England and in Washington, D.C. The large national developers in the United States (Trammell Crow, Gerald Hines, Lincoln Properties, etc.) generally restrict their activities to development, marketing and, in some cases, property management. By way of contrast, Japanese real estate markets are smaller geographically and more homogeneous; therefore, it is easier for integrated real estate companies to operate throughout the country. Moreover, Japanese industry traditionally has operated in an integrated fashion or through interlocking ownerships and directorates.

In the United States, we can expect some foreign firms to be successful with a vertically integrated strategy in a few specific, homogeneous real estate markets. For example, Hasegawa Komuten is one of Japan's largest condominium developers. The company is very active in Honolulu where it caters largely to Japanese buyers. In Honolulu, the firm not only develops but constructs, markets and manages its properties. This strategy may be reasonable to follow in Honolulu or a few other well-defined markets, but it would be problematic if pursued simultaneously in many diverse markets throughout the United States. Unless a company developed a substantial number of buildings in each market, it

could not support a full construction company and brokerage operation in every city in which it was active.

*The Compensation Problem*

The second difficulty in organizing a fully integrated real estate company in the United States is managerial in nature. In contrast to other parts of the world, the United States has traditionally compensated people who perform management, brokerage and development services very differently. Managers, be they property managers or general managers, are usually paid a straight salary and a bonus or a share in profits based upon the performance of the company. Brokers are typically compensated through commissions. And development personnel often receive equity interests in the projects they develop in addition to a salary. The firm that attempts to bring brokerage, management and development under one roof runs the risk of creating friction over compensation issues.

For example, brokers, who often receive large commissions as they lease the space immediately after completion of a project, would be paid in excess of the salaries earned by the most senior managers. Inevitably, this difference in compensation would breed resentment among those who were responsible for developing a project and who typically would wait years until the project was sold before they could recognize the benefits of equity participation. And in the interim, it would be the managers of the company who would create the most value in the project through careful management of the investment asset.

While this compensation problem is not insurmountable, it may help to explain why few fully integrated real estate firms exist in the United States. Furthermore, the difficulty of providing competitive compensation for brokerage and development personnel without upsetting the salary structure also may explain why relatively few large U.S. institutions have managed to integrate directly into development. Instead, large U.S. companies find it easier to participate in development through joint ventures or passive investments in independent development companies.

The recent experiences of Hooker and Campeau illustrate the investment and managerial risks confronting foreign real estate firms that attempt to integrate beyond their core businesses in the United States. Both firms acquired major department store chains as part of a larger integration strategy. In doing so, they attempted to manage a highly specialized business—retailing—in which the firms lacked special expertise. Today, both companies are on the brink of bankruptcy. The experience of Hooker and Campeau suggests that the potential gains from integration are sometimes more easily identified in theory than they are realized in actual practice.

*Macroeconomic Risk*

The third obstacle to large-scale vertical integration in real estate is that it tends to expose a firm to more macroeconomic risk. Although the time it takes to bring products to the marketplace is shortening for other industries because of technical and managerial advances, the time necessary to complete the value chain for real estate is lengthening. It takes longer to develop a project today in the United States than it did 10 or 20 years ago. There are a variety of reasons for this: the approval process is longer, financing is more complicated, and buildings themselves are more sophisticated and often take longer to construct. Because of the protracted value chain, a large firm that takes a project from raw land all the way through to completion of a development as an investment asset is more exposed to macroeconomic downturns than a small firm that times its entry and exit into the market. As the value chain continues to lengthen, integrating may be a less attractive strategy for dealing with the cyclical nature of real estate than contracting out all possible services to third parties and hunkering down during downturns in the development cycle.

## The Consequences Of Foreign Investment

Notwithstanding their widely admired management skills, even the Japanese have not figured out how to overcome the structural obstacles that confront companies seeking to vertically integrate in the U.S. real estate industry. Foreign firms active in U.S. markets face exactly the same problems (and opportunities) as U.S. firms. Moreover, the longer foreign investors are present in the United States, the more they tend to behave like domestic investors. So, over time, we would expect to see a variety of strategies being pursued by foreign real estate interests that are likely to mirror the strategies that are being pursued by domestic real estate companies. Some of these strategies will include integration at the margins of core businesses. Integration on a scale comparable to what is experienced in other countries, however, is unlikely.

Structurally, there are likely to be two major consequences of large-scale foreign ownership of U.S. buildings. First, there will be more foreign competition in related businesses. As long as there are foreign buyers, there will be companies catering to provide services to them. Some of these service providers will themselves be foreign companies that share a common language and culture with their customers. There will be foreign-owned brokerage companies, foreign-owned property management companies, foreign-owned construction companies, foreign-owned design firms, foreign-owned banks and foreign-owned development companies. But there also will be domestic firms seeking to serve the same clientele, and foreign-owned firms will be competing with domestic firms for both foreign and domestic business. Some real estate-related businesses such as construction lending may even come to be dominated by foreign institutions. But it is highly unlikely that massively integrated firms will emerge in the United States as they have in other countries.

Perhaps the more significant consequence of large-scale foreign ownership is that it will hasten the institutionalization of the real estate industry

in the United States. Foreign ownership is largely institutional ownership involving pension funds, insurance companies, sovereign governments and major corporations. The influx of foreign capital has coincided with an increase in the portion of assets allocated to real estate by domestic pension funds. As institutional money, both foreign and domestic, has flocked to real estate, yields on investment-grade assets have been bid down to levels below the long-term cost of debt. Furthermore, because of soft rental markets, the return on cost for new buildings in many markets is now below the long-term cost of capital. The result of this bidding up of prices and bidding down of yields is that developers can no longer afford to own the buildings they develop. As a result, they are developing buildings to sell to institutional buyers at capitalization rates below the return on cost.[5] This process reinforces the institutionalization of the real estate market, and at the same time, it forces developers to pursue a fee-based, merchant-build strategy.

In time, U.S. real estate markets may begin to look like European markets, with the bulk of the investment-grade building stock being in the hands of large institutions. These buildings will not sell as frequently as buildings sell in the United States today. Developers will be forced into alliances with institutional partners because it will be difficult to finance new projects without gaining access to large amounts of equity. The development industry will consolidate because smaller, under-capitalized developers will have a difficult time competing in this environment. But institutional ownership should introduce more stability to real estate markets, and it should bode well for individuals with asset management skills who are able to create value for long-term owners through astute management of real estate portfolios.

## NOTES

1. See Bacow, L. "Understanding Foreign Investment in U.S. Real Estate," MIT Center for Real Estate Development Working Paper Number 12, November, 1987.
2. See Bacow, L. "The Internationalization of the U.S. Real Estate Industry," MIT Center for Real Estate Development Working Paper Number 16, November, 1988.
3. See Louargand, M. "Foreign Bank Participation in United States Mortgage Markets," MIT Center for Real Estate Development Working Paper, December, 1989.
4. Porter, M. *Competitive Strategy* (New York: The Free Press, 1980) pp. 302–9.
5. An example may help to illustrate this point. Suppose a developer builds a project for $10 million, and the project upon completion generates $950,000 per year in net operating income (i.e., income after expenses excluding debt service). If the long-term cost of debt is 10% and lenders require a debt service coverage ratio of 1.2 (i.e., to ensure that enough cash flow is available to service the debt, lenders will lend only up to the point where the net operating income exceeds the debt service by 20%), then only about $792,000 will be available to service the debt ($950,000 ÷ 1.2). Even if the developer can borrow on an interest-only basis, this project will support only $7.92 million in debt. If he must amortize the principal, he can borrow less. Thus, if the developer wishes to own the project as an investment, he must come up with over $2 million in equity to bridge the gap. On the other hand, an institutional investor looking to earn an 8.5% return on its money should be willing to spend around $11.15 million to acquire the same property ($950,000 ÷ .85). Given this choice, most developers opt to sell to the institutional buyer and look for the next project to build. A number of factors have brought about this set of events: declining development margins (the return on cost has been falling steadily in most markets due to declining real rents and a lengthening development process); the bidding up of prices and bidding down of yields by institutional buyers even in the face of falling income streams from properties; and the cost of debt relative to the return on cost.

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