REAL RATES OF RETURN: DOES REAL ESTATE MAKE SENSE?

Yields from Treasury bonds and real estate investment trusts currently are the best indicators of appropriate real estate returns.

by James P. Ryan, CRE

During the early to mid-1980s real estate values increased dramatically due to the influx of capital from individual investors, syndicators, pension fund managers and foreign investors. The plethora of transactions during this period provided sufficient data for market analysts and appraisers to abstract capitalization and yield rates. As markets changed over the last several years, the number of transactions has decreased markedly. The oversupply of space, particularly in office buildings, coupled with the overall decline in the economy caused many investors to withdraw from the equity market.

Declines in value also have reduced the underlying security of many loans, restricting banks and other institutional lenders from making new mortgages. In fact over the last two years the value of office buildings in some pension fund portfolios has declined 50% or more. Negative appreciation, as shown in the FRC/NCREIF index since the fourth quarter of 1989, and concern about the economy also have kept buyers on the sidelines.

As values have eroded and returns declined, many investors have withdrawn totally from the real estate market. Low returns and business reasons, such as retiree benefits payouts, have prompted some plan sponsors to redeem their shares in funds, placing additional burdens on liquidity. Although investment managers recognize that it is not prudent to sell in a down market, some must sell to meet withdrawal requests from clients. Investor uncertainty and tight credit policies by lenders have created a void of meaningful data in the market to demonstrate market pricing. The limited data that is available is subject to various influences and pressures and requires significant adjustments by analysts. This article focuses on alternative sources of comparable yield data to support the valuation of real estate.

Returns

A structural shift has taken place in the real estate industry. The days of independent entrepreneurs or developers buying or building a project, and their institutional partners supplying most (if not all) of the capital, with little or no control, are gone. Today, pension funds, real estate investment trusts (REITs), foreign investors and other institutional players seek real estate investments with defined objectives and meaningful participation in mind. They are conscious of the risk/reward relationship and expect more direct involvement in the

James P. Ryan, CRE, is senior president, Equitable Real Estate Investment Management, Inc., Atlanta, Georgia. Responsible for the coordination and reporting of asset values for approximately 20 separate accounts, Ryan reviews new acquisitions, conducts ongoing periodic evaluations and asset dispositions and directly participates in evaluating six foreign markets for investment by domestic pension clients. He also serves as portfolio manager of the Value Enhancement Fund, a $200 million closed-end fund designed to acquire selective institutional-grade investments at depressed prices and generate unique opportunities for appreciation, development or expansion.

decision-making process. Many institutions have increased their real estate portfolios (in some cases by default of partnerships, foreclosure or other involuntary processes) and can draw upon property level experience to enhance future returns and make informed decisions. The expanded exposure to real estate, particularly within financial institutions and/or publicly traded companies, has heightened the relevance of performance to an organization.

Today's more powerful computer technology and networked databases also have made data more readily available. Investors no longer simply compare one real estate deal against another or look at the most recent sales in a market to make an acquisition decision; they consider alternative (non-real estate) investments and weigh the risks of a property against them. Far more scrutiny is applied to tenant underwriting and the timing of lease expirations than in the past. Property analysts must examine the industries of major tenants and judge their potential.

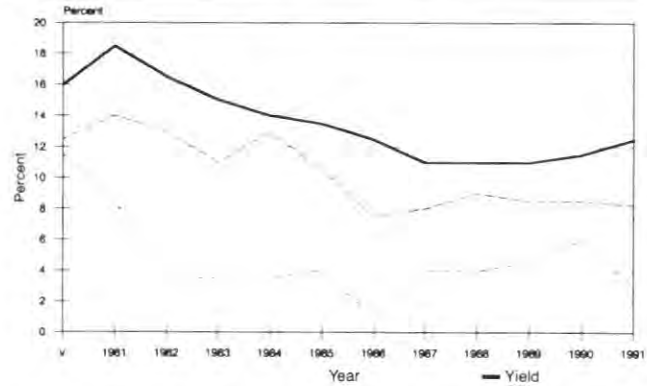
The dramatic changes in the world over the last two years and their impact on the U.S. economy have forced investors to delve deeper into the strength of tenant income streams. A few years ago tenants like Wang Computers, Eastern Airlines, Security Pacific, Drexel Burnham, Integrated Resources, etc., were considered to be desirable lessees. Within a relatively short period of time these and other similar companies filed bankruptcy or merged with other companies, potentially reducing their worth to a property. Now the heavy focus on the quality of cash flows requires discounts for weak tenants and more tenant/business analysis during the underwriting process.

The political reconfiguration of Eastern Europe has contributed greatly to the reduced need for a large defense budget. Therefore, defense-related businesses require closer scrutiny as lessees. Investigation into the specific use of space and viability of tenants is becoming increasingly important. Currently many property owners seek merely to fill vacant space, but analysts valuing a lease or property must focus not only on occupancy but on the worth of each tenant.

Appraisers and others therefore need to expand their due diligence to evaluate properly the risks of a new age. There is no substitute for good judgment and sound reasoning. However, consultants, analysts, appraisers and others need to adjust to new forms of tenancy and evaluate real estate from an occupancy cost perspective. This change in perspective may be viewed from two vantage points: the tenant's and the buyer's. Tenants want economical space and seek opportunities to realize the greatest net return. These goals may be accomplished by leasing high-quality space if the tenant's client base expects superior furnishings, or they may be accomplished by leasing a low-cost alternative if the tenant is driven by cost-cutting pressures. Office tenants in the 1990s will be sensitive to occupancy costs, as most businesses will be pressured to increase efficiency and profit margins. Buyers will seek to minimize risk and maximize return even more now than they have in the past. In contrast with the market of three or five years ago when buyers were much more aggressive and had the perceived benefit of strong appreciation to compensate for mistakes, the market of today has a dearth of transactions, reflecting investors' demands for higher returns.

FIGURE 1

Historical Real Estate Yields vs. Ten-Year Treasuries and the CPI



Source: Real Estate Research Corporation, Quarterly Real Estate Investment Surveys.

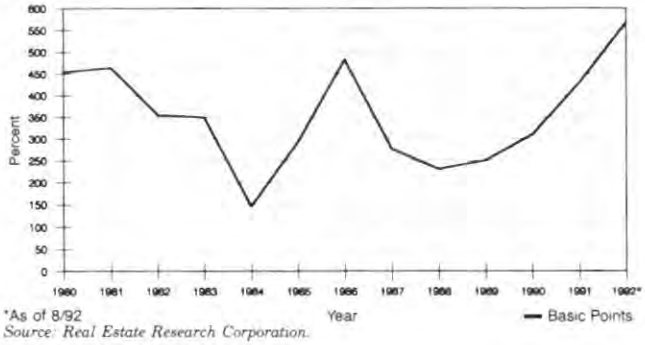
Most investors evaluate stocks, bonds and other vehicles, domestic and foreign, against real estate returns. Ten-year Treasury bonds historically have provided a starting point for valuing real estate returns. As shown in Figure 1, the yields for real estate, Treasuries and the Consumer Price Index (CPI) have followed similar trend lines. Anticipated real estate yields over the last 11 years consistently have exceeded yields for ten-year Treasuries to reflect the risk premium. Beginning in the late 1980s investors' confidence in achieving projected yields fell, creating a confidence premium.

Figure 2 shows that the spreads between real estate yields and ten-year Treasuries have ranged from a low of 146 basis points in 1984 to a high of 482 in 1986; their average spread or real estate risk premium was 327 basis points during the 1980s. Obviously the higher spreads reflect greater perceived risk for real estate as measured against Treasuries at various points in time.

Due to the cyclical nature of real estate, high spreads indicate buying opportunities if the investor is confident that the projected income can be achieved; a low variance reflects selling opportunities. In late August, 1992, ten-year Treasuries were yielding 6.47% as measured against average real estate yields of 12.1% for a spread of 563 basis points. When compared with the average, this spread reflected a premium of 241 basis points. As yields for alternative investments dropped, the confidence premium for real estate increased. Lower

FIGURE 2

Spreads between Real Estate Yields and Ten-Year Treasuries



Source: Real Estate Research Corporation.

growth rates for projected cash flow and conservative releasing assumptions greatly increased the probability of realizing projected returns. Most valuation assumptions today are deemed to be reasonable; they do not follow market examples of the greater fool theory, which influenced values over the past few years. The historically high spread between real estate and Treasury yields means that investors are waiting for experience to demonstrate that current projections are fair. And the gap continues to widen due to the increased pressure on sellers. The question is: At what point will the trend line change? If today's projected cash flows are correct and returns are realized, capital will return to real estate. As capital returns, the credibility risk premium will drop to a more normal level, and we should see real growth in value and a decline in anticipated real rates of return. But until this happens the wide return margin and conservative cash flow projections will produce excellent returns for investors who recognize the imbalance of today's market.

Analysts should be sensitive to the relative position of real estate returns to comparable investments and evaluate the specific strengths and weaknesses of each property against the market. Currently there is a perception that projections do not represent future performance and that therefore yields are uncharacteristically high. Large amounts of capital are waiting to invest in real estate once the market hits bottom. This realization will not become evident until the market has already begun to rebound.

Table 1 assesses anticipated real estate yields in relation to the CPI. When the projected 12.1% real estate return for 1992 is compared with the expected 4% inflation rate, an 8.1% real rate of return is indicated. If a 4% inflation rate is assumed for the next 10 years, a real rate of return of 2.47% is reflected for ten-year Treasuries vs. an 8.1% real rate of return for real estate. It is interesting to note that the confidence premium (real estate real return—ten-year Treasury real return) for achieving the 8.1% return has grown from about 150 basis points in 1984 to 563 today.

TABLE 1

Real Estate Yields vs. the CPI

Year	Real Estate Yield	CPI	Real Rate of Return
1980	16.00%	12.5	3.5
1981	18.55%	8.9	9.65
1982	16.55%	3.8	12.75
1983	14.60%	3.8	10.8
1984	13.90%	3.9	10
1985	13.55%	3.8	9.75
1986	12.50%	1.1	11.4
1987	11.15%	4.4	6.75
1988	11.15%	4.4	6.75
1989	11.00%	4.6	6.4
1990	11.65%	6.1	5.55
1991	12.15%	3.1	9.05
1992	12.10%	4	8.1

Source: RERC; Kiplinger Washington Letter.

Real estate's recent poor performance has been due primarily to overly optimistic cash flow projections used in the acquisition and subsequent valuation analysis (since valuation simulates buyers). Because demand has outpaced supply, aggressive projections have produced apparently achievable cash flows and acceptable yields. Today's market assumptions for the most part are much more conservative and in many cases pessimistic; so the realization of projected yields is much more feasible. The increased likelihood of realizing projected yields should reduce the confidence premium. The real estate market is in a transitional stage. Structural changes are being made in ownership groups and methods of evaluation. The motivation to acquire/sell real estate also is changing based on portfolio needs and yield opportunities. Real estate valuation requires a broad understanding of investment markets and motivations.

Focus On Investment Priorities

It is interesting to note how investors' perceptions of the future as well as current economics create different premiums in real estate. In certain periods, like 1988 and 1989, a premium was placed on appreciation, particularly in regional shopping centers. Properties were bought at very low initial yields in anticipation of higher future earnings. Now the premium is placed on high initial returns and liquidity; limited weight is given to appreciation. Real estate investments compete for capital with other alternative investments and must comply with the more stringent capital market standards. As a result, they generally seek high initial yields that compare favorably with yields on medium- to long-term government bonds and place less weight on appreciation. The illiquidity of real estate funds has cast doubt on the appraisal process and made it difficult to support values. The only real support for values will be renewed transaction activity. Until an active transaction market returns alternative markets will provide the best support for appropriate yield rates.

As mentioned, the spreads over Treasury bonds provide valuable insight into the market.

REITs

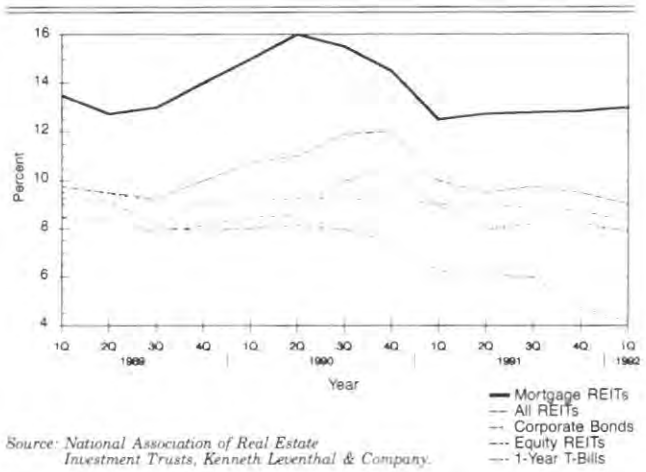
Another benchmark is the REIT. A REIT is a corporation or business trust or an unincorporated association whose income is not taxable at the entity level if it meets certain tests of the Internal Revenue Service. It raises capital by issuing shares of stock or other forms of securities and by borrowing. It must make cash distributions of at least 95% of its annual taxable income.

A REIT must have at least 100 shareholders, but it may be publicly traded or private. It can invest in real estate assets and/or mortgages, but it must be a passive investor; it cannot be deemed an active trade or business. REITs focus on high current yields and provide excellent liquidity because they trade on the national stock exchanges and in the over-the-counter market.

While real estate in general has attracted little new capital, the REIT market has sparked interest. According to the National Association of Investment Trusts, eight initial equity offerings totaling $808 million were completed in 1991. Although no initial REIT offering was completed in the first quarter of 1992, market analysts expect REIT offerings to be strong this year. The Taubman Company, Inc., a national shopping center developer and manager has filed a prospectus with the Securities and Exchange Commission for the Taubman Centers, Inc. This REIT will include 19 centers, 16 of which will be super-regional malls. General Growth also is considering a regional mall REIT, and the Oliver Carr Company in Washington, D.C. is considering a REIT composed of office building investments in the Washington, D.C., area.

FIGURE 3

REITs vs. Other Investments: Comparative Yield Analysis



Source: National Association of Real Estate Investment Trusts, Kenneth Leventhal & Company.

Response to new REIT offerings will provide excellent insights into the appetite of investors. The strong performance of REITs in 1991, as shown in Figure 3, and the anticipated strength of new IPOs, indicate that investors have not abandoned real estate but seek higher initial returns and place a premium on liquidity. The recent growth in REITs indicates that investors still like real estate and that liquidity reduces the confidence premium. While REIT market pricing must be adjusted for individual properties, the level of activity and the features of individual offerings provide insight into investor thinking.

Analysts need to adjust REIT yields for equity real estate. The pricing of REIT shares must consider restrictions that will preserve the trust's nontaxable status as a passive investment conduit. Because REITs typically are groups of properties that investors cannot differentiate by property, investors buy shares in a package and have little control. The yields likewise must reflect package pricing rather than the merits of individual properties.

Legal and underwriting fees generally are higher, in the range of 6% to 8% of publicly issued proceeds, vs. around 2% for a private sale. REITs focus on cash flow and limit the investor's ability to create or enhance value. Since REITs must distribute 95% of taxable income, they retain little of their earnings for growth or expanded developments. Therefore, sources of cash flow are limited to new issues, leverage and depreciation allowances. REITs also are considered passive investments; therefore, they cannot "flip" properties for profit or engage in active construction and development on an ongoing basis.

Conclusion

Changes in earnings are not influenced by changes in property values; rather changes in values are dependent on realized and anticipated changes in earnings. Unfortunately there is no shortcut to estimating appropriate yields in a market with very little transaction activity. The analyst must maximize use of available tools and base at least part of the valuation on whether the risk is fairly priced against the risk associated with other investment opportunities and fairly evaluated in terms of risk/reward relationships.