THE WORLDWIDE REAPPRAISAL OF REAL ESTATE VALUES

Although the slump in the global economy—and the value of commercial property—will continue for at least another year, real estate markets in the United States and France will rebound, and equity capital for real estate will be available from Pacific nations.

by R. Thomas Powers, CRE

The 1980s produced the most profound collision of economic, political and financial forces ever experienced in the real estate industry. Many of those market forces have changed forever the way we think about real estate assets, especially the value of those assets.

Perhaps the most complex events affecting real estate markets are the degree and speed of globalization of the marketplace. Compounding these occurrences is the liquidity of the real estate capital markets. Because real estate markets have been so flush with "everyman's capital," industry professionals have taken little time to ferret out exactly what has been happening, why it has been happening and what the consequences will be. Indeed, only now have we begun thinking about the global aspects of our industry.

The 1990s are illuminating the sobering realities of the investment excesses of the '80s. Today we understand that real estate *finance* depends more than ever on access to global capital markets, but access to these markets is clouded by international factors that influence real estate demand, investment criteria and, hence, the values of real estate assets.

The 1990s also are demonstrating that the cash flow performance of a real estate asset, its value, remains basically local in nature. The reconciliation of these two diverging realities—global finance and local economic performance—sets the stage for our industry's most significant research opportunities.

This article seeks to advance one small step in the clarification of international factors that affect real estate values. It presents near-term economic forecasts for key industrialized countries, scrutinizes differences in property valuation procedures among those countries and hypothesizes about the geographic areas of the global marketplace that likely will provide the equity basis for real estate's next growth cycle.

Factors Impacting Property Values Internationally

Income capitalization, replacement costs and comparable sales were approximately equally weighted as methodologies applied to the determination of commercial property values in the 1980s. Today income capitalization is by far the preferred measure of value. This shift in focus returns our industry to its most fundamental basis and indicates that the creation or the loss of a local-area job will be the most decisive component of global property values in the

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1990s. The more local jobs are created, the faster excess space will fill up and the faster net operating income will grow. The antithesis of that scenario, i.e., that slow or nonexistent job growth will suppress the net income from a property, is most evident in today's market.

Our industry therefore must keep an eye on the local environment, trying to understand as much as possible about the forces that will attract growth to one market and cause another to lie dormant. Fortunately, there are a number of proven theories and research methodologies to assist us. Development excesses during the 80s were brought about by a lack of respect for the market, not a lack of knowledge about how to monitor and measure supply and demand.

However, our industry also must keep an investment eye on distant environments, researching, quantifying and applying an emerging set of global "laws" that affect investment criteria and value. Here, we are starting from a small base of knowledge with no real theory to rely upon. For example, we now must include diverse currency exchange policies in our interest rate forecasts. We must recognize that inflation has international components, many of which can be "exported" or "imported" across political borders. We must understand that one country's valuation criteria cannot necessarily be applied to another's property markets. We now must agree that asset price and value are not one-in-the-same.

The International Outlook

The world economy is mired in the most pronounced recession in a decade, and there is no clear idea how it will turn around. In the United States unemployment remains at high levels. In Japan and Germany a significant slowdown in growth in 1992 is a complete reversal of the countries' economic position in 1991 and their ability to help avert a global economic downturn. The bursting of the real estate bubble in Tokyo has sent the Nikkei Index into a tailspin. Unexpectedly high unification costs have caused Germany's budget deficit to balloon, raised inflation and forced the Bundesbank to raise interest rates. Because of Germany's dominant economic position in Europe, its high interest rates have precipitated an international currency crisis.

The continuing worldwide economic slump has a negative impact on real estate values and, hence, prices. Further, the gap between asset value and price is widening, if the investment returns from Canary Wharf and Rockefeller Plaza are any indication. Even low interest rates in some countries have been no panacea for the real estate industry. Relaxed monetary policy in the United States and Japan has had no more than a marginal effect on consumer spending and business investment. And neither the United States nor Japan can expect any further fiscal boost; the United States because of the trillion-dollar budget deficit, and Japan because of the actions of its Ministry of Finance.

All the factors that have depressed global consumer confidence and spending over the past two years remain in place. Real estate prices are still falling, and consumers and banks are still burdened with excessive debt. Relative interest rates apparently will remain stagnant for at least six more months, possibly longer.

Table 1 offers a snapshot economic outlook for key industrialized nations through 1993. It shows clearly that there is little on the horizon to suggest that the global economy will return to an '80s-type boom any time soon. Therefore, it is realistic to expect that commercial property *values* will continue to languish while property *prices* will experience ever-greater downward pressures. Continued uncertainty over the likelihood of an impending economic upturn will result in deflation of select property types and with it will come absorption and ultimately reduced asset prices.

Compounding sluggish and uncertain economic growth is the recognition that inflation will not be a savior, particularly within the real estate sector, this time around. And while the lack of inflation is good medicine in the long run, for now it merely

TABLE 1

The Economic Outlook for Select Industrialized Nations, 1991-1993

	Economic Growth (in percent)			Consumer Inflation (in percent)			Jobless Rate (in percent)		
Country	1991	1992	1993	1991	1992	1993	1991	1992	1993
UnitedStates	–0.7	1.6	2.4	4.2	3.1	3.0	6.8	7.3	6.9
Japan	4.5	2.2	3.0	3.3	2.2	2.5	2.1	2.1	2.3
Germany	1.2	2.0	2.4	3.5	3.8	4.0	3.8	6.5	6.3
France	1.2	1.8	2.1	1.8	3.1	3.0	9.6	10.0	9.7
Italy	1.0	1.6	1.9	1.6	6.4	7.0	10.9	10.8	10.9
Britain	–2.2	0.8	1.4	0.8	5.9	5.9	8.1	9.7	10.2
Canada	–1.5	2.3	2.5	5.6	1.7	3.0	10.3	10.0	10.1
Spain	2.8	2.9	3.3	6.0	6.0	6.5	5.1	6.1	5.5

Source: International Monetary Fund, 1991-1992; Takenaka & Company, 1993.

intensifies the pain by raising the level of real interest rates investors face. This is not to say that property prices will not rise without inflation; it does recognize, however, that some inflationary boost would do wonders to raise investors' expectations of yield trends.

Also contributing to continued economic stagnation are the poor prospects for employment growth within major countries. Between 1991 and 1992 unemployment increased in every country except Italy and Canada, and it remained level in Japan. World employment growth is forecast to remain sluggish over the next 18 months. And within that context neither real estate prices nor values can be expected to rebound.

A closer examination of Table 1 offers some insights, albeit subjective ones, into the likelihood of recovery for certain real estate markets. The failure to dampen inflation will hurt Italy and Britain, forcing up interest rates and depressing net equity capital formation. Unemployment will rise in Japan, Britain and Canada—net excess commercial space rarely is absorbed under such a scenario. However, the United States and France are positioned favorably on the inflationary front, and their job markets should improve; hence, it is fair to expect some uptick in the demand for commercial space in these two countries. Investor confidence in real estate, per se, also should begin to rebound. Right now real estate cannot compete with equities on either a risk or yield basis. This situation will change but only in conjunction with increased economic growth, price enhancement and improved consumer confidence.

Price Vs. Value In Real Estate

During the 1980s real property prices in most developed nations were well beyond their economic value. This circumstance was fueled by too much money, from throughout the world, chasing too few properties and causing more properties to come on line.

Other factors were at work as well. Among the more prominent was the application of the "theory of relative value." This "theory," empirically expressed, was one reason why the Japanese have significantly overpaid for many assets. The comparison of high office rents in Tokyo with relatively low rents in New York City led to the notion that rents were undervalued in New York. But as we now know, the theory of relative value holds only if an asset is portable and can be delivered into the higher-priced market at the lower basis. Clearly the purchase of a U.S. office building on the basis that it will be worth twice as much in Japan is ludicrous because one cannot move the building to Japan to take advantage of the lower relative basis.

A dramatic difference, or shift, in currency values between two countries is another component in the theory of relative value. As the value between currencies shift, there is an approximately equal and inverse shift in real asset values within the two countries. The fallacy of investing based on this logic should be evident by now.

The world's real estate market will find price-value equilibrium only when all investors accept the view that both price and value are computed off the cash (net operating income) a property generates, capitalized by an interest rate reflecting:

- risk;
- inflation; and
- the global economy.

Securitization: Leading The Way For Global Market Unificiation

If asset price and value are to merge again in the 1990s, and they certainly will, the mechanism that will best assist the process appears to be securitization. At the very least securitization will be an important piece of the value-unification process.

The term securitization is applied routinely to the formation of any security that has fragmented ownership and can be freely traded. In commercial real estate securities include everything from commercial paper backed by a letter of credit to real estate investment trusts and public master limited partnerships. While not a new concept, securitization is now reaching prominence. And it is doing so because it fulfills the growing needs of both borrowers and lenders/investors, regardless of nationality. From the standpoint of the borrower securitization provides the following advantages:

- broader access to capital;
- faster access to funds;
- greater flexibility, especially compared with a mortgage; and
- lower interest costs.

Securitization also has many benefits from the lenders/investors' point of view:

- increased liquidity;
- standardized rating process, which facilitates participation; and
- increased product creation, which enhances marketability.

There are large and growing numbers of real estate securities on today's market. The oldest is the mortgage-backed security; newer breeds include commercial mortgage securities, collateralized mortgage obligations (CMOs) and real estate investment mortgage conduits (REMICS). Even real estate investment trusts (REITs) are coming back into favor. The more rapidly global real estate securitization takes hold, the quicker the industry will close the gap between asset price and value.

A Worldwide Rethinking Of The Notion Of Value

Clearly a worldwide reappraisal regarding real estate values is underway. Vacant space, falling rents and even negative absorption are rampant. Once pro forma returns assumed a 5% vacancy rate; today a 15% assumption is closer to the norm. It is not unusual to find several well-known property valuers in disagreement about the value of an asset—several years ago this circumstance would have been

TABLE 2

Comparative Real Estate Valuation and Yield Criteria for Select Industrialized Countries, 1991

Criteria	United Kingdom	Japan	United States	Germany	Spain
Debt Coverage Ratio	1.1-1	— —	1.25-1	— —	1.25-1
L-T-V	<60%	70%	<75%	15-25% (of product cost)	65%
Yields					
Office	7.5%	2-4%	7-10%	4-5%	5.5-8%
Retail	9%	— —	7-9%	6.5-7.5%	— —
Industrial	7%	3-5%	5-6%	5%	9-11%
Value calculations	**capitalize income, adjust for quality of lease structure and term of rent reviews**	**"Normal Price" is nexus of market sales, income stream; 75% of that value**	**Compare income stream capital, market sales and replacement**	**Gross Rent Method—capital market rent income cap rate follows a risk free investment**	**Similar to the U.S.**

Sources: UK: Hillier Parker Research
Japan: Takenaka & Company
U.S.: Cushman Wakefield
Germany: Deutsche Centralbanken Kredit AG
Spain: Madrid Stock Exchange, Banco de Santandor

unheard of. And the underlying assumption that property values only rise has proven to be a myth.

Except for the land system in the United Kingdom, most of the world's major real estate markets (e.g., those of Japan, Germany and Spain) are not well understood by outside investors. And unfortunately, there is no one place to go to consult with a "how to" advisor.

This situation begs an answer to an intriguing question: Are properties being valued according to the same criteria among different countries and investor groups? The answer? A resounding no. Therein lies another fundamental problem that prevents global property markets from making a strong, united comeback. Further, without normalized rating techniques, securitization cannot happen, and the global investment community remains cold to our products.

Following is a brief status report on some of the key international property markets and a review of the asset valuation techniques used in different countries. Table 2 provides a snapshot of each country's valuation procedure and the comparative property yields among markets.

The United Kingdom

Bank lending to the property markets in the United Kingdom has all but dried up. British bankers place great emphasis on the quality of the lease structure, with most utilizing 25-year terms and requiring rent reviews every five years. The United Kingdom clearly needs to develop a meaningful market for securitized products which would allow financing to move outside the banking arena and into the international real estate capital markets.

The most negative feature facing developers and lenders in the United Kingdom is the "yield gap"—the difference between property yields and prevailing interest rates. Prime downtown commercial property yields between 5% and 6%; long-term yields on bonds approach 10%. Rents are so low that developers cannot finance the yield gap, making property sales and refinancing the only way to survive.

A commercial property in the United Kingdom is valued by capitalizing the income then adjusting for the quality of the leases and the term of rent reviews.

Japan

Real estate lending in Japan is done by financial institutions, but it is carried out in the form of corporate finance. This contrasts sharply with lending practices in North America and Europe, which focus heavily on the income generation of the property itself. Japanese lenders tend to rely on criteria involving the borrower's personal credibility, perceived understanding of real estate and corporate business strategy. Japanese lenders do not place significant merit on the asset or development opportunity in their investment decision; they assume the corporation will support the asset's performance.

The Japanese refer to the value of real estate as the "normal price." The normal price is the nexus of the borrower's credibility and comparable market sales multiplied by 75%. One may now begin to understand why the Japanese have made real estate investment mistakes.

Germany
Commercial property accounts for approximately 30% of all construction in Germany. Valuation of property relies most heavily on the gross rental method, which is based on the capitalization of net rental income. The capitalization rate follows the current "risk free" investment.

Large property funds finance new construction in Germany. One important fund is the open-end fund, which is initiated by banks to place shares through their branch network. A closed-end fund also exists. This fund offers substantial tax incentives; however, there is no regulated market for reselling the fund shares.

Insurance companies have a relatively large appetite for real estate, which consumes about 10% of their collective portfolio. And within Europe, Germany is by far the market of favor for other European investors. By the middle of 1991 foreign investment in German real estate was estimated to be DM13.6 billion. The Scandinavians had the largest share at DM4.9 billion; followed by the Dutch (DM3.8 billion) and the British with DM3.3 billion.

Spain
Real estate valuation in Spain is approached on a somewhat different basis than valuation conducted in European counterparts. For example, loan requests are treated on a case-by-case basis, and the most important determinants of future income are the quality of the future tenants and the lease conditions. As one "protection" for the lender, loan-to-value ratios fluctuate between 50% and 70%. Also, leasing is prominent in Spain, and if the tenant base is solid, a property may be purchased. Institutions often purchase property before it performs economically.

Outside of Germany, Spain has been the most significant beneficiary of the boom in European real estate investment. Spain has benefited by hosting the 1992 Olympics and by its expected role in the European Economic Community (EEC). Also, demand for new space has outstripped supply by a significant degree, keeping yields higher in Spain than in any other market in Europe.

Whither Real Estate's Equity Capital In The 1990s?

Many U.S. real estate professionals over the past two years have bemoaned the "credit crunch," the supposed lack of debt available to support product development. All the evidence I have refutes the existence of a credit crunch; however, evidence does point to an equity crisis within our industry. Most equity dollars invested in the 1980s have been written off; those dollars were the first to dissolve. Developers who expect to build a steady stream of products in the 1990s must find and latch onto a scare breed—the real estate equity investor. There will be relatively few equity investors from the United States; reducing our massive debt loads and rebuilding equity will be the name of the game here.

Europe will continue undergoing that extraordinarily expensive unification "game" in the '90s. Germany already is feeling the strain as interest rates rise significantly, along with unemployment. Equity-seekers should keep their eyes on the EEC's Second Banking Coordination Directive which takes effect on January 1, 1993 and provides a single European license to conduct banking business. The directive allows institutions that offer certain banking activities in its own country to undertake the same activities in every other European community without obtaining additional licensing. Still, real estate's capital markets hardly will be overrun with equity capital from Europe during the 1990s.

What is becoming increasingly clear is that the Pacific Rim will be the world's net provider of equity in the 1990s, whatever the investment type. True, Pacific countries are growing fast and have demands of their own, but also consider the following facts:

- In 1990 total Pacific Rim gross national product (GNP) was $1.63 trillion; by 2000 it will be be $5.01 trillion— rivaling that of the EEC and almost equaling that of the United States.
- Taiwan, Indonesia, Thailand and Hong Kong have earmarked over US$500 billion to spend for public works and capital improvements over the next *two* years. This is more than the United States and Europe plan to spend over the next *five* years.

For those with imagination and an eye for the future, better understanding of the world's economic engine in the 1990s will make a great deal of sense.

Global Real Estate Markets Are A Reality

The continued globalization of our real estate markets is a given. Although we know that many investment mistakes inevitably will be made, such is the price of education. We also know that many things must happen to have a truly global property investment market. For example, a thorough property-rating system must be developed. Fannie Mae led such an achievement in the U.S. housing markets, providing the basis for today's booming residential mortgage-backed security trading. While not simple, another system can be achieved for commercial property in the 1990s.

Investment in commercial property will be less speculative in the '90s. Lenders and investors will demand a higher level of due diligence, and they will invest only in those projects that can stand on demand, alone.

Equity capital for real estate will be in short supply, and those who supply equity will have the best investment opportunities to choose from. Expect a surge of both debt and equity funds to be forthcoming, with Southeast Asia leading the way.

Finally, if the market is to reach equilibrium and remain there, more owner-operators must find a way to participate in the investment opportunities of the '90s. It is doubtful that a group of passive investors purchasing ten hotel properties is what the market needs, unless the managing partner really understands that business.

Ready or not, globalization of the world's real estate financial market is here. When will it merge with the realities of the local marketplace? And when will the sum of such a merger receive the respect needed to properly value real estate products in the 1990s? These questions, and many more, merit our collective answers.