THE CREATIVE DESTRUCTION OF REAL ESTATE CAPITAL MARKETS*

by Bowen H. McCoy, CRE

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When I first went to Wall Street in the early 1960s, many senior corporate executives still carried with them an aversion to debt, an aversion they had developed during the economic depression of more than 30 years previous. Indeed, it took the publication of a book by Harvard Business School professor Gordon Donaldson, *Corporate Debt Capacity* (Harvard Business School Press, Boston 1967), to reawaken corporate America to the positive characteristics of financial leverage. By the end of the 1980s, Donaldson's message had been broadly received.

This tendency to remember long-term lessons is part of what makes "long-wave" societal and economic behavioral patterns. Such patterns have been identified by economists and social scientists from Serge Kondratieff and Friedrich Hegel and Karl Marx to, in our day, historian Arthur Schlesinger, Jr., and M.I.T. economist Jay Forrester who traces fundamental economic forces through history over 50- to 60-year cycles. In the 1930s, economist Joseph Schumpeter theorized about the "creative destruction" of capitalism, an idea that Michael Jensen, currently a Harvard Business School professor, applies to his analysis of the positive regenerative effects of leveraged buyouts and corporate restructuring.

My point in mentioning long-wave theories is to introduce the view that the period from 1990 to 1994 has ushered in a long-wave structural change in real estate financial markets. As a result of the destructive forces prevailing in this period, individuals involved with real estate financial institutions in the United States and Japan, in particular, have made radical changes in their business behavior that will last for the balance of their careers, far beyond the millennium. Their attitudes toward financial leverage, aggressive financial projections, megaprojects, developer profits, and related issues are resulting in the creative destruction and restructuring of real estate financial markets.

This will happen despite much peripheral noise in the marketplace from the financial press and others anxious to restart the real estate bandwagon. Articles encouraging real estate investment have appeared in the *Wall Street Journal*, *Barron's*, and *Fortune*. Many new real estate offerings for pension funds are in the market. Barton Biggs, Morgan Stanley's investment guru, has suggested institutions might allocate up to 15% of their assets to real estate. Thus, even though banks and insurance companies hold billions of dollars of unresolved real estate assets, new and evolving investment

Bowen H. McCoy, CRE, *is a real estate and business counselor with his firm Buzz McCoy Associates, Inc., Los Angeles. He is a member of The Counselors of Real Estate.*

funds are again beginning to push returns on newly acquired property to levels that current cash flows cannot support. This "noise" misreads the current conditions of real estate finance in commercial banks and insurance companies and on Wall Street. Commercial banks or insurance companies account for about half of all commercial real estate loans and investments. Until their real estate holdings conform to the demands of market arbiters and until new forms of real estate financing have been created, they will be essentially out of the market.

Commercial Banks

For banks, the key constraint on funding is not government regulation but access to the capital markets. Banks need to obtain funding at a cost that provides a competitive spread on their transactions. The more profitable the spread, the better the compensation, the better the ability to recruit high-powered managers, and the lower the cost of equity capital.

For debt capital, the higher the credit rating a bank gets from traditional bond rating agencies such as Moody's and Standard and Poors, the lower the cost of debt. And the rating agencies do not like real estate. Thus, the less real estate (and the less bad real estate), the cheaper the enterprise's funding cost.

Wall Street security analysts likewise have an aversion to real estate, which serves to augment its negative impact on stock prices and cost of capital. Stock and bond analysts have been as instrumental as government agencies in imposing mark-to-market accounting on commercial banks.

Risk-based capital rules requiring banks to carry an 8% reserve against commercial and industrial loans, while requiring no reserve for U.S. Government bonds, have moved banks out of real estate and small business loans into government bonds in the past four years. It costs them virtually nothing to invest in Treasuries with low short-term interest rates, while it costs them 125 to 150 basis points to underwrite and reserve against real estate loans. Their loading up on Treasuries has produced the second highest bank earnings in history. These earnings have been crucial in rebuilding bank reserves after real estate writeoffs.

The U.S. Treasury has a keen interest in keeping banks as holders of government debt. Over 20 years, the marginal buyer of Treasuries has moved from the Middle East to Japan to U.S. banks. Should banks start selling Treasuries, the bonds would have to offer higher interest rates to attract a new class of marginal buyer. It has even been suggested that if banks start dumping Treasuries, federal regulators may raise the required capital cushion against commercial and industrial loans from 8% to 10% or 12%.

The possibility of further bank regulatory actions—applying risk-based capital rules to off-balance sheet derivative securities transactions, requiring banks to meet certain social investment goals, and acting on several pending large bank consolidations—helps persuade bankers to favor treasury securities over commercial and industrial loans.

At the same time, more far-sighted bankers are beginning to imagine what new forms of instruments might be needed to bring them back into real estate financial markets. A few banks are cautiously reentering the real estate debt market—with 75% loan to value (value figured conservatively) on recourse loans and with corporate-style security covenants, and 50% or less loan to value on nonrecourse loans.

Japanese banks have all the same problems of capital access, funding, and rating agencies. Only recently has the Japanese banking system appeared prepared to face up to its real estate financial problems.

Insurance Companies

Insurance companies, generally speaking, are confronting the same array of problems as commercial banks, although two to three years later in the cycle. They are less likely to use the capital markets to fund their loans and investments, but when they do they encounter the same rating agency and mark-to-market constraints. If they happen to be publicly traded, their common stock is subject to the same scrutiny.

Insurance companies finance most of their transactions through the sale of financial products to consumers. Today's products produce funding with fairly short maturities, and the pressure for investment performance is high. Insurance companies are hurting from the movement away from group retirement plans to individually managed 401(k) IRAs, which tend to invest directly in mutual funds.

Fitchs, Bests, and other companies rate the investment quality of insurance companies for the consumers of insurance products. Higher ratings will, in theory, attract more customers. To obtain higher ratings, the insurance companies must lighten up on their real estate holdings.

And like banks, insurance companies face risk-based capital requirements, which are imposed by the National Association of Insurance Commissioners, a professional association of state insurance regulators (see "Real Estate Investment by Insurance Companies" in the March 1994 issue of *Urban Land*). U.S. government bonds require no capital

reserve; bonds rated A and higher require 0.3%; foreclosed property and delinquent commercial mortgages require 15%; and commercial mortgages in foreclosure, joint ventures, and limited partnerships require 20%. Reserves for the ten largest assets must be doubled. These requirements ring the death knell for insurance company joint ventures on single large projects.

A recent ruling by the U.S. Supreme Court that Employee Retirement Income Security Act (ERISA) rules apply to assets held in insurance company general accounts also adds to the woes of insurance companies. Among other things, this means that a tenant leasing more than 10% of a building owned by an insurance company becomes "a party of interest" in that investment.

The most obvious way out for insurance companies is the intermediation of their real estate assets through securitization. They can sell off concentrated holdings and buy back through syndicates only securities that hold an A or better rating. This will create unprecedented demand for commercial real estate syndication and necessitate finding whole new markets for those tranches of real estate assets no longer deemed suitable for investment by insurance companies.

Outside of special purpose separate account funds, insurance companies are unlikely to seek nonconforming real estate loans or investments while the intermediation process takes form.

Wall Street

The nonconforming commercial real estate assets of banks and insurance companies thus offer Wall Street an unprecedented opportunity. The market for commercial real estate securitization is relatively undeveloped to date, with the bulk of the transactions having come from the Resolution Trust Corporation. Wall Street brings a trading mentality to real estate and is, generally, unwilling to commit the time or resources needed for adequate due diligence and testing procedures. This factor in turn opens up an opportunity for a new class of real estate practitioners, most likely public accounting firms.

Wall Street can participate in the commercial real estate finance process in a number of areas:

REITs. The $550 billion of commercial real estate assets held by banks and insurance companies dwarfs the $14 billion that REITs raised in 1993. REITs are yield-driven instruments. Investors look for roughly 8% current return and 12% overall return. The attractiveness of the current return that REITs offer is vulnerable in the long term to a rise in interest rates and the growth of more liquid money market funds. Their appreciation and growth component is also threatened by competition from other REITs and investors bidding up prices of existing properties.

Although the quality of property held by today's REITs is far more attractive than that held in the last REIT cycle, REITs remain an awkward vehicle for owning real estate. The tax laws impose a degree of passivity on REITs that is not appropriate to real estate ownership and operation. Over their investment cycle, REITs favor dividend maintenance and growth over capital replacements and renewals. They are forced to pay out such a large percentage of cash flow as dividends that they cannot accumulate reserves for property enhancement. It is not likely that REITs will be the panacea of the real estate capital market.

Opportunity Funds. Opportunity funds have amassed several billion dollars of buying power from pension funds and wealthy individuals to take advantage of anomalies in market valuation in the wake of the sudden departure of traditional financial sources from the real estate market. In the last four years, returns of 30% a year were not uncommon. But the wholesale dumping of property by the federal government and financial institutions is about over, though Japanese banks may continue to engage in it. Owners are pricing portfolios much tighter and bidders are becoming more numerous. There is less spread among the bids. A prospective bidder can spend hundreds of hours and several hundred thousand dollars in due diligence, only to come up with a dry hole.

Many opportunity funds add significant value to properties by applying sound operating techniques and remedying previous neglect. Their spreads and returns are bound to narrow, but the funds will continue to be a good vehicle for owning and managing securitized property and investing in the riskier, nonrated tranches of real estate securities.

Mutual Funds. Mutual funds have burgeoned as they chase markets and yields around the world. Lower-quality, high-yield money market mutual funds have been attracting individually managed IRA pools, and these funds are an obvious market for the riskiest layer, the so-called Z tranche, of securitized commercial real estate product.

Securitization. It appears that Wall Street will enjoy a unique opportunity to recycle bank and insurance company restructured securities, requiring as high as 20% to 30% risk-based reserves, into assets needing only 0.3% reserves. The recycling apparatus will be a massive securitization process. As much cash flow as required will be dedicated to a top investment tranche, which will be rated A or better and sold back in pieces to syndicates of banks and insurance companies. The bottom

tranche will be sold to opportunity funds, higher risk mutual funds, and other risk-oriented investors, including some pension funds.

The only limit to the size of this market is the appetite of the investment community for the Z tranche. Both packager and purchaser likely will misunderstand the investment characteristics of the Z tranche, which will at times be mispriced and thus produce both windfalls and large losses for the investors. Not to worry, however. The creative destruction of the current cycle will not have to be dealt with until the next cycle.

An act pending in Congress would stimulate commercial securitization. The Commercial Mortgage Capital Availability Act would expand residential secondary mortgage market provisions to commercial real estate conduits. It would:

- extend SEC shelf registration provisions to commercial mortgage conduits;
- exempt such conduits from ERISA; and
- allow banks to base their 8%, risk-based reserves on the participations they retain in commercial loans instead of on the entire principal of the loans.

The prediction of one prominent syndicator of real estate that commercial real estate syndication will grow to $1 trillion by 2000 appears exaggerated. Such an outcome would solve the real estate problems of financial institutions around the world. In any case, this market should grow rapidly in the next five years.

A major drawback in securitization is that the further investment in real estate is removed from the potential for active and aggressive management, the more problematic the investment outcomes. Wall Street tends to avoid initial due diligence and, even more so, ongoing operating responsibility by relying on conservative debt rations, corporate-style covenants, and diversity in packaging. Growth in securitization will provide opportunities for purveyors of due diligence services and individuals able to manage large pools of assets.

The Creative Part Of Destruction

As the destructive slope of the current real estate cycle begins to flatten out, it is time to address some ongoing issues in order to define the future of real estate capital markets.

Valuation. It is extraordinarily difficult to value real estate under present market conditions. In some CBDs, the calculation of true net effective rents is close to impossible to perform because data are not disclosed on free rent, tenant improvement contributions, give-backs, and other payments or concessions; and we lack data on the overhang of sublet space. Thus, to predict the time required to retenant a project becomes extremely difficult. Original cost and replacement cost are meaningless benchmarks.

As securitization progresses, properties will trade on statistical assumptions regarding rent that will produce windfalls and losses—further demoralizing the market. Appraisals can be as delinked from values in the present demoralized market as they were in the speculative boon of the 1980s. To attract broader and deeper market participants to the real estate capital markets, we must be able to provide more reliable appraisals of commercial real estate. Pension funds, for example, remain relatively underinvested in real estate. As returns on financial assets regress toward their long term average over the next few years, real estate may become even more appealing to such funds. Pension fund managers remain dubious about real estate because of the unrealistic reporting and valuations they witnessed at the beginning of the real estate collapse in 1990/1991.

Reliable Databases. Standarized, nonproprietary information on rents, sales prices, supply, and changes in occupancy is needed to underpin the growth in securitization. A disinterested party should collect and disseminate data.

Several industry associations, including the Urban land Institute, are looking into the feasibility of producing a statistically reliable rental index for key markets throughout the United States and for the country as a whole. For the first time, some major financial institutions—banks, insurance companies, and pension funds—have indicated their interest in sharing their real estate data.

Reliable data can help bring large financial institutions back into the real estate capital markets. Securitization in a statistically reliable market offers these institutions the liquidity they need for trading their positions.

Looking ahead, one might even contemplate the arrival of derivative real estate securities that would allow investors to buy a basket of options on particular geographic markets or property types, going long or short at any particular time.

We need reliable data to better forecast real estate cycles. Better data will bring more players into the market and lower the premium for real estate capital. Then, all real estate practitioners will share in the challenge of creating the real estate capital markets of the future.