INSTITUTIONS RE-EXAMINE REAL ESTATE

by James P. Ryan, CRE

As we near the end of 1995, real estate is re-emerging as a viable investment product for institutional investors. Many were so badly burnt over the last five years that real estate is still a dirty word. But others have recognized that real estate, like most investments, is cyclical and that pricing probably went past its peak on the high side and now has probably dropped below a normal ebb on the low side. Many opportunistic funds have been structured to take advantage of this market opportunity, and institutions are participating in various areas, from direct equity to debt. This article will look at three major institutional players: pension plans, life insurance companies and banks. All have been affected by real estate and are responding to the changing market in different ways.

The total value of United States real estate, estimated at about $3.08 trillion, is divided approximately $1.86 trillion or 60% to non-institutional owners comprised mostly of government and private concerns. The balance, or $1.22 trillion, is considered institutional real estate and represents about 40% of the total. The institutional segment is further divided between debt and equity. The debt component is about $992.53 billion and the equity is $231.55 billion.

As indicated in Figure 1, the two largest players in the equity area are pension funds (43.4%) and life companies (21.6%). Combined, they represent 65% of the market. And the largest investors in the debt market are commercial banks with 39.4% market share. It wasn't until the late 1970s that pension funds started investing in real estate in a meaningful way. One of the strong arguments to invest in real estate was that it provided a good diversification to stocks and bonds which accounts for the bulk of invested pension dollars. Life companies have invested in both equity and debt for a number of years; recent regulatory changes have affected their investment strategy and many are becoming net sellers. Commercial banks were stung by many bad loans and, consequently, had growing REO (Real Estate Owned) portfolios which hurt earnings. Many banks have been restructured and others have merged or acquired other banks to expand market presence and create greater efficiencies.

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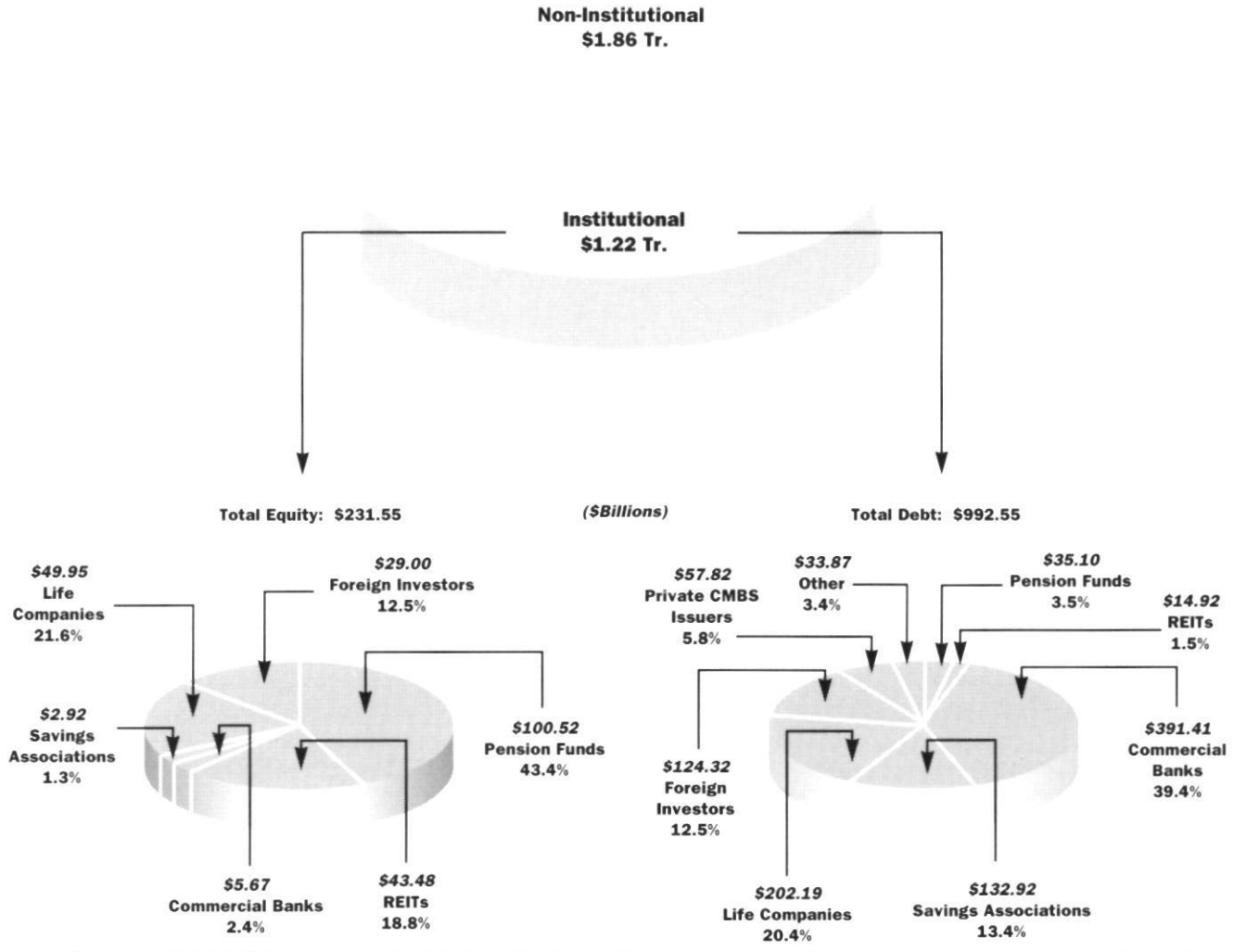
FIGURE 1

Capital Sources: The Flow of Funds
Total U.S. Real Estate: $3.08 Trillion
As of 6/30/95



Source: Equitable Real Estate Investment Management, Inc.

Pension Funds

Pension Funds represent one of the fastest growing pools of capital in the United States. As shown, pension funds assets are projected to double from 1987 to 1997, or grow from $1.5 trillion to $3.2 trillion. Over this period, the mix of assets has changed and is expected to continue changing.

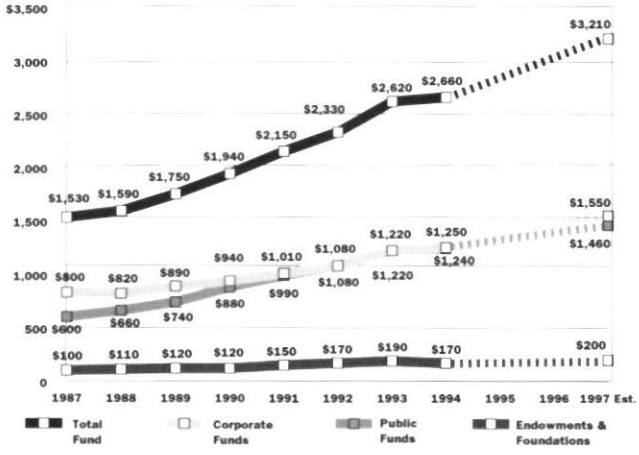
The major change has been a reduction in domestic bonds from 35.3% in 1984 to 24.9% estimated in 1997. International stocks/bonds, or those emerging markets, picked up most of the excess growing from 3.7% in 1989 to 13.8% estimated in 1997. Equity real estate, as we all know, has not fared well in recent years. Due primarily to value declines, equity real estate has dropped from 5.2% of pension assets to about 3.2% in 1994. The good news is that by 1997 this asset class is expected to grow by about 1% or $32 billion.

The Russell-NCREIF Property Index reported positive returns for all four quarters of 1994, and it ended the year with a healthy 6.73% annual return. The first quarter of 1995 has continued the trend with a positive 2.0% return.

As of 1994, about 43% of all pension funds invested in equity real estate. This was down slightly (about 2%) from 1993. During 1995, corporate and public funds are expected to increase their equity

FIGURE 2

Pension Fund Capitalization

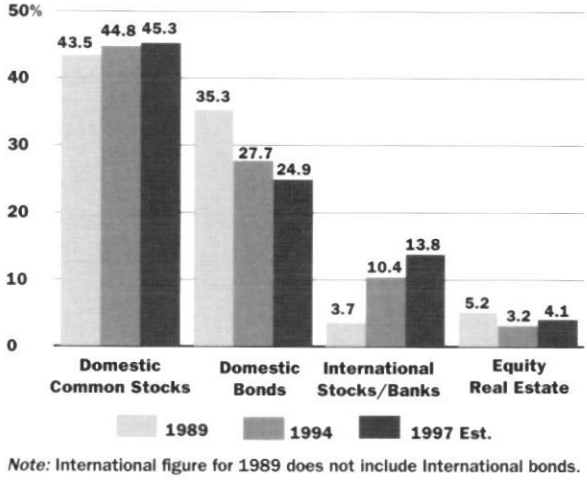


Source: Greenwich Associates

real estate slightly, but endowments and foundations should grow by about 7%. Pension funds are moving back into the market, but they are using their experiences of the 1980s to ask the right questions and understand the risks prior to committing. Many funds are deciding whether an average fund's real estate allocation of 3.2% is worth the time and effort, since an allocation of approximately 10% is necessary to achieve any diversification benefits. Some funds wonder whether real estate is worth the effort; it commands higher advisory fees than stocks and bonds and demands more attention.

FIGURE 3

Pension Fund Asset Mix

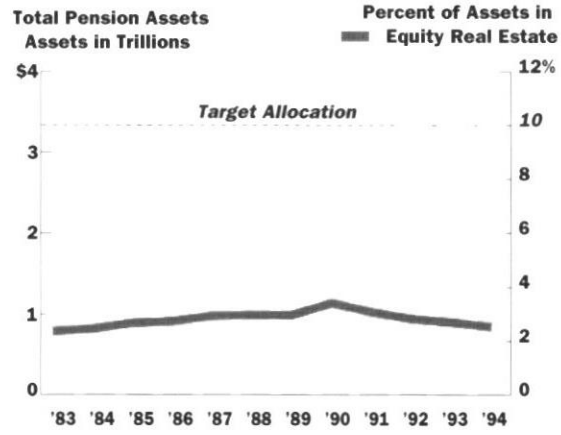


Note: International figure for 1989 does not include International bonds.

Source: Greenwich Associates

FIGURE 4

Pension Fund Assets in Equity Real Estate

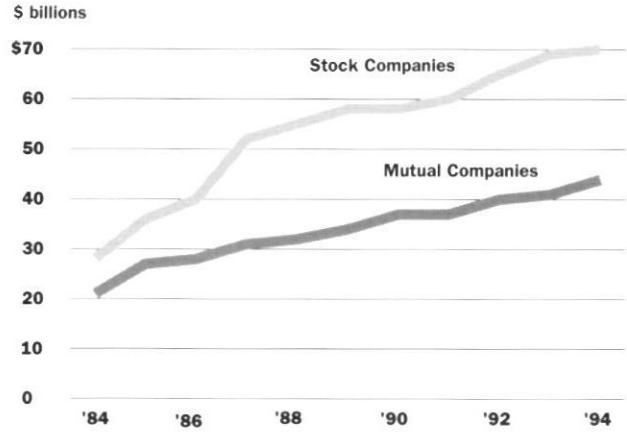


Source: Federal Reserve; *Money Market Directory*; Equitable Real Estate Investment Management, Inc.

Those that do stay with the asset class will probably look for greater diversification within the real estate sector and grow into REITs and mortgages. Currently pension funds are the largest investors in the private equity real estate market. As their real estate appetite grows, they are expected to expand into the public equity market which provides more liquidity and debt investments—private or public. Private debt investments would be traditional whole loans, whereas public debt would be CMBS (Commercial Mortgage Backed Securities). Mortgages, whether private or public, tend to address fixed income needs rather than pure real estate mortgages.

FIGURE 5

Insurance Company Revenues



Source: A. M. Best Company

Life Insurance Companies

Life companies are the second largest source of capital in the equity market with about $50 billion dollars, but they are even a larger participant in the debt market with about $200 billion. The insurance industry, particularly mutual insurance companies, is in the midst of major restructuring. Many insurance companies are consolidating and others are downsizing; some are selling nonessential businesses to raise capital, while others are refocusing management on core business areas. For example:

- Prudential Insurance lost over $900 million last year and is embroiled in lawsuits over agents' sales practices. They are also selling their mortgage company.
- Metropolitan Life sold its health care, home mortgage and real estate brokerage businesses. It is currently in the process of merging with New England Mutual.
- New York Life is merging various business lines.

Many mutual insurance companies, which are owned by policyholders, are looking at converting to stock ownership to raise additional capital on Wall Street. The mutual structure limits their ability to attract investment capital and therefore inhibits growth.

The Equitable Companies converted from a mutual insurance company to a stock company in the nation's largest demutualization in 1992 and has raised its capital base significantly. It also has restructured other assets to increase capital. Alliance Capital, a subsidiary of Equitable, recently was taken public, and Equitable just restructured Donaldsen, Lufkin & Jenrette from a privately held firm to a public company. Equitable sold 20% of the company to the public and retained 80% ownership. This not only generated income but established a value for the remaining shares.

There are three reasons why equity real estate is being reduced in life insurance companies:

- risk-based capital
- rating agencies
- variable life policies.

Life insurance companies have been heavily impacted by regulatory restrictions. The massive real estate problems that brought down many banks and thrifts in the late 1980s prompted the federal government to place tighter controls on the insurance industry. Due to problems associated with junk bonds and real estate, the NAIC (National Association of Insurance Commissioners) developed new regulations for the insurance industry that negatively affected real estate.

FIGURE 6

Statutory Risk-Based Capital Requirements For Life-Insurance Companies
(Selected Assets)

Asset Category	Statutory Risk-Based Capital *(Percent of Assets)*
MORTGAGES	
1-to-4-Family Residential	0.6% to 1.0%
Commercial and Multifamily-Current	1.0% to 3.0%
Commercial and Multifamily-Delinquent	3.0% to 6.0%
Mortgages in Foreclosure	20.0%
REAL ESTATE	
Company Occupied	10.0%
Investment Property	10.0%
Foreclosed Property (REO)	15.0%
STOCKS	
Common	0.0% to 30.0%
Preferred	2.3% to 30.0%
BONDS	
Class 1 (A or higher)	0.3%
Class 2 to 3 (BBB to BB)	1.0% to 4.0%
Class 4 to 6 (B, CC, D)	9.0% to 30.0%

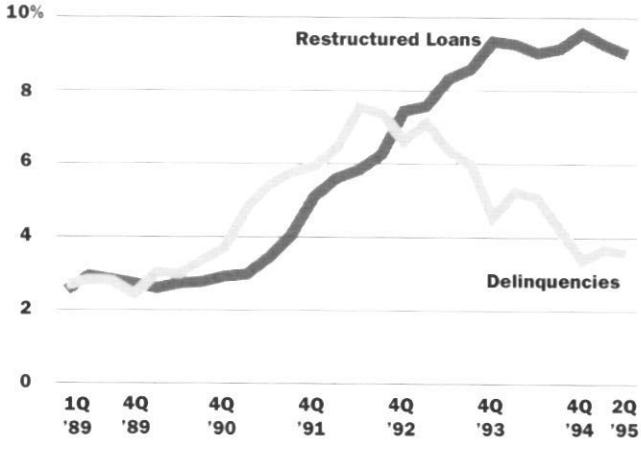
Source: National Association of Insurance Commissioners

In 1993, the NAIC introduced risk-based capital (RBC) rules requiring that minimum levels of capital be reserved on a sliding scale to reflect the riskiness of investments and operations. In addition to NAIC requirements, many rating agencies have taken a dim view of real estate assets on the balance sheet of insurance companies. Ratings by credit agencies have an impact on the cost of capital for insurance companies which can affect their ability to sell insurance. Therefore, equity real estate has become a drain on many insurance companies and has prompted sale programs among many large insurers. As shown in Figure 6, the reserve requirement for a Class A bond is .3% compared to 10% for investment real estate. It is interesting that a Class BBB bond only requires a 4% reserve while a Class A investment property requires a reserve of 10% against a company's asset base. The third reason equity real estate is becoming a difficult investment option is that the market is changing from whole life policies to variable life policies. With whole life policies, an insurer could match the duration of a policy closer to long-term investments. With variable life, the duration of a policy is less certain, and shorter term investments, like bullet loans, match better.

As life companies have disposed of real estate assets, they have also tightened their underwriting standards. Delinquency rates have shown marked improvement, dropping from 5.25% in early 1994 to about 3.5% in the second quarter of 1995.

FIGURE 7

Life Insurance Companies' Underperforming Commercial Mortgages



Source: American Council of Life Insurance

Today, life insurance companies are moving back into the mortgage market for larger loans in the $15 to $50 million range. The spreads on mortgages over like term treasuries still are very good compared to the spreads on bonds of similar rating.

Banks

In today's banking industry, big certainly means better. Most banks are either in the process of acquiring or being acquired. The focus is on creating market efficiencies by cutting expenses. Recently, Chase and Chemical merged. Today Bank of America and Nationsbank are in discussion about a possible merger, as are First Interstate and Wells Fargo.

FIGURE 8

Commercial Bank Lending
($ Billions)

Period	Real Estate Loans Outstanding*	Loan Delinquencies**	REO	Loan Delinquency Rates
1991	$249.58	$14.50	$13.18***	5.81%
1992	257.78	13.43	13.20	5.21
1993	267.70	10.60	8.36	3.96
1994	283.18	7.39	5.19	2.61
Q1'95	288.80	8.17	4.25	2.83

**Excludes development, construction and multifamily loans.*
***Defined as "Loans Noncurrent," i.e., loans that are past due 90 days or more or that are in nonaccrual status.*
****Estimate*

Source: American Council of Life Insurance

Banks have been moving aggressively to fill gaps in the mortgage market. They are writing shorter term loans with floating rates and recourse construction loans. Many are extending lines of credit to REITs and other pools of investment capital with reasonable loan-to-value ratios.

During the first half of the 90s, the real estate loans portion of banks' assets has grown from about $250 billion to about $289 billion, while loan delinquencies and REOs have declined. The banks have worked hard to improve their balance sheets. As the industry becomes more competitive and margins continue to get squeezed, banks will have to grow their asset base to improve earnings. As the real estate market recovers and new construction becomes more plausible, the banks will function as a control lever on the supply of new real estate. Their renewed focus on conservative underwriting should help discipline the market which will benefit all.

Real estate, like any investment, is cyclical. The perception that real estate is a dirty word is changing. Opportunity funds and REITs have led the capital market back into real estate and posted some excellent returns by taking some risks. The early funds focused on acquiring large loan packages of performing and nonperforming loans from the RTC and savings and loans. These opportunities have diminished dramatically. However, other opportunities still are very strong. Many institutions, particularly banks and insurance companies, are in a sales mode and need to reduce their real estate exposure. Therefore, some excellent buying opportunities are available.

Ten year treasuries currently are about 6% and average projected real estate yields (as measured by Real Estate Research Corporation) are 11.4% (as of June 1995), indicating a 540 basis point spread. This compares favorably to the normal spread of 200-400 basis points which indicates the returns to real estate are above the normal range. In other words, on a relative basis compared to other capital assets, real estate is undervalued indicating now is a good time to buy. Finally, inflation is projected to remain in check for the balance of this decade. This is good news for all, particularly the debt market. Lenders are returning to the market which is good news for borrowers. The key is that real estate is again becoming attractive in many different forms, equity or debt, private or public ownership.

The institutional real estate market is definitely in better shape today than it was a year ago. Some are moving back in while others are moving out. I think it is fair to say we are all a lot wiser today than we were before the bottom fell out. Let's hope our memories last a long time so we all can enjoy a prosperous future.