Real Estate Capital Markets: A New Paradigm?

by Bowen H. "Buzz" McCoy, CRE

If we can maintain the self-discipline we were forced to acquire in the early 1990s, together with improving the flow of data about real estate investment, the millennium could prove to be a golden age for all of us associated with commercial real estate investment.

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Introduction

The purpose of this article is to examine commercial real estate finance trends over the remainder of the current real estate cycle—or over a medium term of five years or so. Such an approach differs from the usual focus on the immediate pricing and availability of the capital markets. Instead, it is the purpose to focus more on the longer range significance of current trends than on the immediate situation.

Let us begin with the general economic framework. There are those who maintain that we have entered a new economic paradigm driven by globalization and technology, which will have the effect of dampening (or even eliminating) the business cycle as we have known it. Just-in-time inventory controls should eliminate the inventory swings which caused several of our post-World War II inflations. Globalization provides lower manufacturing costs throughout the world. The old basic heavy industries moved to Asia, and they will probably move next to Africa, as techno-service economies replace them.

Others postulate that the long sustained growth in U. S. corporate earnings has been caused by much more traditional factors, such as lower interest rates and lower depreciation charges from the large corporate restructurings of the past decade. This view would predict more normalized economic growth of around 2.5 percent a year, calculated on an average annual population growth of 1 percent and an average 1.5 percent annual growth in productivity. Inflation should not be a major factor over this period, as a result of globalization, the transfer of manufacturing to lower cost producers, and corporate downsizing.

No five-year projection ever includes a recession, yet one is likely over this

time frame. In any event, such a slowdown in the economy should have far less impact on real estate than usual, as we will have about worked out all the excesses of the late 1980s, and significant overbuilding should not as yet have occurred.

Service businesses will no doubt remain sluggish in terms of ultimate productivity. Skilled labor bottlenecks should be occurring in such sectors as airframe production, software engineering, chip manufacturers, and the like. The government deficit, especially entitlements, should remain a major issue throughout the period. Interest rates should remain historically high as a result of the global demand for capital. Speculative real estate building will be underway once again in such products as industrial, hotels, suburban office, and apartments.

LONGER CYCLE IMPACTS

Even a five-year time frame fails to take account of true long-term trends. It may be useful to briefly review certain trends which may ultimately play a major role in the pricing and availability of real estate capital.

Economic historians have studied the longer term implications of technology. It is interesting that the initial use of the electric dynamo on the manufacturing process was to shed light on water and steam-driven shaft and pulley manufacturing processes. It took over 50 years for the electric dynamo to be utilized efficiently in the manufacturing sector. The same may be true of the computer in the service industry. It could well be 2010 before the endless cycle of changing hardware, changing software, and continual human resistance reverts from anti-productive to productive. When it does, there will be immense productivity gains throughout the service sector.

"Unconventional" retail sales today have replaced about 110 regional malls. The average fully occupied office floor is 25 percent vacant at all times. Hoteling and personal data and communication packages will cause office use to become far more efficient. A 6-10 percent adaptive re-use and efficiency gain on the $3.3 trillion of commercial real estate in place could produce a dividend of several hundred million dollars. Despite such opportunities, significant quantities of retail and Class B and Class C office buildings must be completely reconfigured.

The securitization of commercial real estate is being held back chiefly by lack of better and more available data. When such data becomes available, as it will, there will be easier valuation, greater trust in the secondary market pricing of securities, and even greater recycling of assets among financial institutions. We will have synthetic securities to allow us to go both short and long on various property types and geographic markets, as well as the real estate market as a whole.

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The continued globalization of the worldwide money and capital markets as three billion new members are added to the market economies of the world will provide immense opportunities for investment capital.

The computer will drive further de-institutionalization of investment capital. Insurance companies must totally reposition their balance sheets, as defined contribution and 401(k) self-administered pension plans gain continued momentum. There will be public market access to real estate debt and equity through real estate mutual funds and worldwide trading over the Internet.

Demographics will drive the transfer of hundreds of billions of dollars of post-World War II wealth. Retirees will hold a greater percentage of the nations' invested wealth and will change patterns of retailing, entertainment, and the like.

At some point it would seem that inflation must raise its ugly head once again in the face of potential shortages of commodities, agricultural products, oil and gas, and highly skilled human capital.

This article does not attempt to address public policy issues which may also impact real estate over the medium-term. Clearly, such issues as capital gains tax reduction, indexing of capital gains, or reinvestment roll-over provisions (free of capital gains taxation) could have a major impact on the liquidity of the real estate capital markets.

Finally, are consolidation and securitization cyclic trends or fundamental changes in real estate economics?. . . The combination of larger real estate firms having access to public capital markets and driving down their cost of capital is presumed to be a secular trend. This begins to follow the models in England, Holland, Hong Kong, and elsewhere. Capital cost is a large element in real estate development. If larger companies are better managed (not always a proper assumption) and have a significant cost advantage in the marketplace, this trend should continue. To assure this as a long-term trend, however, much work is still required to provide the reliable data on real estate which the public markets require.

Irrespective of the longer term nature of these trends, local knowledge and impact on land entitlement issues will continue to drive many aspects of the real estate markets. As larger consolidations of real estate companies become more bureaucratized, they will leave in their wake increasing opportunities for local players. Moreover, real estate will continue to function as part of the stock market and interest rate cycles, and there will be times when it is out of favor in the public markets. At such times the traditional arbitrage between public and private market prices of real estate assets will create opportunities and cause some of the consolidated public companies to take advantage of pricing anomalies to deconsolidate and return to private status.

STATE OF THE CAPITAL MARKETS

Financial Institutions

When analyzing the probable reaction of individual players in the capital markets, it is useful to attempt to look at the flow of funds through each of the major types of financial institutions. What is the nature of its liabilities? . . . How is it funded?. . . To what regulatory pressures is it subject? . . . What do security analysts and bond rating agencies take into consideration when evaluating its own debt or equity securities? . . . How does it make money?. . . For what behavior are its senior executives likely to be rewarded? . . . How can I design my financial offering in a manner which helps them solve their own internal problems and meet their objectives?

Commercial Banks

As we know, in recent years commercial banks have moved into spread pricing of funds at a premium over their cost of capital. Such a spread should account for the cost of underwriting the loan as well as the inherent risk that the loan may be delayed in repayment or go into default. Risk-based capital rules force banks to allocate more higher cost equity capital to real estate than they do, for example, to government bonds. Mark to market accounting (which may spread over the five-year period to "off balance sheet" derivatives and hedges) further increases the amount of higher cost capital a bank must carry. Third party market arbiters such as bond rating agencies and Wall Street security analysts put further pressure on banks to sustain a fairly high rate of return on equity capital. As a result of all these pressures, many banks have become intermediaries themselves, packaging portfolios of real estate investments to sell at a spread or for a fee to smaller banks or other financial institutions. Other banks have substantively withdrawn from the real estate business, as a result of their losses in the 1990s.

Banks will continue to be a major factor in the real estate finance business. The major issue is whether they can resist competitive pressures to lower underwriting standards. At present, loan to value ratios are deteriorating, with less equity and pre-leasing being required. Other types of underwriting standards are beginning to slip also, such as tenant improvement allowances, the number of months required to re-rent space, rent "spikes," and the like. As the real estate cycle stabilizes and new construction gains in volume, it is likely that lending spreads will continue to deteriorate and that underwriting standards will weaken. The commercial banks will no doubt, once again be the engine that drives new real estate construction. A new generation of construction loan technicians will have to be trained. On-the-job training in this field tends to be costly. Fewer banks than ever will probably engage in this process. Several large money center banks will be in real estate only to package and resell securitized product to others.

Insurance Companies

Insurance companies were the perfect long-term lender to real estate when their liabilities consisted of 20- and 30-year pay whole life insurance policies. Now that their liabilities are term insurance and a range of other short-term products, they can no longer survive as long-term investors. In addition, insurance companies have been subject in recent years to rigorous risk-based capital rules which harshly penalize their traditional real estate investments. The joint-venture financing of a larger single asset in a partnership with a major developer would now be subject to a 30 percent capital hit on the new rules, whereas a high-grade bond would have a

capital hit of 0.3 percent Thus we see many traditional real estate investors including Aetna, Prudential, and Travelers drastically shrinking their real estate portfolios.

Separate account investments for pension funds remain a long-term source of capital for insurance companies, although one may question the willingness of pension funds to commit such capital to an insurance company which has retreated from that business for its own account. Securitization also remains a major commitment of insurance companies. They are recycling their old portfolios through Wall Street and buying back the investment grade rated "top" pieces where they have augmented liquidity and a nominal capital requirement. Several insurance companies, such as Northwestern Mutual and Teachers' Insurance have remained strong participants in the real estate investment process, so it is difficult to characterize the entire industry. It is safe to predict, however, a greatly diminished capacity to service the real estate industry with the traditional forms of capital. Real estate investment will become less a principle business and more an agency business, as insurance companies attempt to intermediate the investment funds of others.

Wall Street: Real Estate Investment Trusts (REITs)
REITs have served a powerful role in the recapitalization of and re-equitizing of many important real estate businesses. The result is that the current generation of REITs benefit from much higher grade property holdings than was the case in the 1970's model. In addition, for the most part, current REITs are less leveraged. Indeed, about 20 percent of the current REITs enjoy investment grade bond ratings on their debt. Taking these real estate assets into the public market has created a cheaper cost of capital and a much better public flow of information than was the case for these properties when held privately.

As one who had considerable experience with REITs in the 1970s, however, certain generic questions remain concerning the REIT structure. Is there such a thing as passive real estate?. . . Is not something lost when one removes the ultimate investor such a great distance from the properties themselves?. . . How do REITs provide the growth story which Wall Street calls for as acquisition properties revert back to replacement or greater than replacement cost?. . . REITs cannot retain significant capital due to the tax laws and investor preferences for a high dividend payout. Can the properties support a continually growing dividend payout throughout the real estate cycle?. . . Where do funds come from to provide necessary property replacements and renewals?. . . After the third or fourth year, there is mounting pressure on REIT trustees to trade-off between required capital expenditures and dividend payouts.

In my opinion, the new paradigm in real estate finance is not a dampening of the cyclical nature of the business, but the potential for a much broader and deeper marketplace for real estate capital driven by increased disclosure of information.

Over the next five years we will see growing consolidations among REITs. One requirement for an investment grade bond rating is a significant capital base. We would also see questions raised about the trade-off between low leverage and an investment grade rating and higher leverage more traditional for real estate assets. Mounting pressures to pay dividends and investor dissatisfaction with slow growth and relatively lower investment yields will cause REIT values to trail the market in general. This in turn will produce situations where the real estate shares are trading at significant discounts to the inherent underlying real estate values, thus causing firms to de-REIT, liquidate, go private, and the like.

In summary, one may predict a triage of REITs, with many being acquired; many limping along with depressed share prices and a higher cost of capital; and a few giants with good credit ratings and an industrial "General Electric-type" mentality of reducing operating costs, developing new properties, and a market orientation toward their tenants.

Wall Street: Commercial Mortgage-Backed Securities (CMBS)
This market has grown rapidly in part as a result of the requirement for commercial banks and insurance companies to hold investment grade rated real estate securities in order to benefit from the lowest requirement for risk-based capital. The process is to re-allocate cash flows from large single assets or portfolios of properties so that the investment grade rated "top" piece enjoys healthier cash flow support and the more speculative "bottom piece" becomes more risky and volatile. The market for the "top" pieces is virtually unlimited. A major limiting factor is the investment community appetite for the

"bottom" pieces, where mis-pricing is not uncommon and both buyer and seller can anticipate unpredictable windfalls and losses.

CMBS pricing is displaying the same phenomena as applied to highly leveraged "junk" corporate debt in the 1980s. CMBS spreads began quite high and then narrowed considerably, to below spreads charged on comparable debt by banks and insurance companies, as investors became more comfortable with the characteristics of the security and the investment market broadened.

There is at present perhaps an "illusion" of liquidity, as market makers in depth in the secondary market are few, and limited principally, to the original issuing house. Another inhibiting factor to the growth of this market is the lack of ongoing reliable data to support secondary trading and the issue of who pays the cost of such data. Once these problems are resolved, as in the case of REITs, there will be much more data available for CMBS assets in the public market than was the case when they were privately held. This itself should add validity to this market.

It is likely over the next five years that there will be unanticipated gains and losses from these securities, especially during the next down cycle. The major requirements for the sustainable growth of the market are a broadened investor base for the "bottom" piece and a major improvement in the secondary data dissemination required for price discovery. Despite these problems, unlike REITs, this market should continue to grow dramatically over the period.

Wall Street: Mutual Funds

Mutual funds, despite the huge increase in investible funds coming out of 401(k) plans, have not been a significant factor in the real estate capital markets. As these funds continue to grow, and as individuals become less sanguine about the equity markets, it is quite possible that a family of real estate mutual funds, or tradeable closed-end funds, will come into being. Such funds could hold unleveraged commercial properties, especially if investors do become dissatisfied with the REIT format. They could also provide debt funds for various types of participating or short- or medium-term mortgage instruments, much as the mortgage REITs attempted to do in the 1970s. Finally, higher yield and more risky mutual funds might become a home for the "bottom" pieces of the CMBS originations.

Opportunity Funds

Such funds have served to replace the equity funding of real estate which traditionally came from the life insurance companies. They were viewed as short-term vehicles, initially benefiting from the real estate fire sales of the early 1990s. They are probably here to stay, however, as they provide an opportunistic approach to the real estate markets which many investors prefer as a portion of a diversified portfolio. The relatively short-term payback of these funds allows a new look at rapidly changing investment conditions.

While returns are clearly coming down from the windfalls of a few years ago, such funds should be able to continue to generate returns at a significant premium over normalized equity returns in the stock market.

Opportunities will continue to include insurance company portfolios as they adjust their balance sheets, banks taken over by others, incubator REITs, REITs going private, raw land, incubator land for homebuilders, real estate operating companies requiring a capital partner, and distressed portfolios overseas.

Foreign Investors

From time to time over the years various parts of the world have found themselves afloat in dollars for particular reasons, and their financial institutions seek ways to invest such surplus flows. This was a part of the "Italian miracle" in the early 1960s, and it occurred in the Middle East in the early 1970s and in Japan throughout the 1980s. Typically such capital flows were invested first in U. S. government securities, then in high-grade corporate bonds and, late in the cycle, in equities, joint-ventures, and real estate. Financial intermediaries who tracked such flows and got there first ended up with a lion's share of the business. Instant communications render such windfalls less likely in the future.

It is difficult to predict where or when such surplus flows will be created in the future. Western Europe and Japan are dealing with internal deficits and capital problems, with the exception of the Dutch , who continue to invest in U. S. real estate--particularly REITs. At the moment, mainland China is the largest beneficiary of surplus cash flows, about a third of which are coming in from overseas Chinese. Large amounts of investment capital will be required in Eastern Europe and the former Soviet Empire, as well as developing market economies in Southeast Asia, Indonesia, and India, for example.

It thus seems less likely that the U.S. will benefit from foreign capital flows in real estate over the next five years to the same extent as we did in the 1970s and 1980s. As mentioned above, real estate seems to come late in the investment cycle, because of the technical nature, lack of available data, lack of trusted third party advisers, lack of liquidity and possible lack of an investment return which compensates for all the above factors as well as currency risk. The one area which is more likely to attract foreign investment is REITs and CMBS because of the relatively better data disclosure and relatively better perceived liquidity.

Pension Funds

Pension funds have not yet lived up to the expectation that 10 percent or more of their assets might be invested in real estate. Currently investment in real estate is less than a third of that amount. Returns on real estate are the lowest of any major asset class over the past decade, although recent returns have compared favorably with historical results (though nowhere nearly as favorable as the stock market up to the end of 1997). Probably no class of financial institution is coming out of the past 10 years more disoriented about real estate nor more capable of being the major capital provider to the industry. Pension funds remain the only major long-term investor left. The duration of their liabilities is perfectly suited to longer term real estate investment. As stock market returns revert back down to their mean (as well as real estate returns reverting back up to their mean), it would seem appropriate to expend major effort to rebuild pension fund's confidence in the real estate investment process.

The loss of confidence goes deeper than disappointment over stated investment returns. The intellectual underpinning of real estate has been lost. It is clearly not an inflation hedge when markets are overbuilt and there is no significant inflation. It may (or may not be) a separate asset class. While the advisory industry to pension funds was uniform in its rationale for real estate investment in the 1970s and 1980s, the advisors themselves now appear disoriented and lack a consistent rationale for the industry as to why pension funds should invest in real estate. There is debate even on what constitutes "core" real estate (for example, single asset transactions or securitized offerings).

Confidence in valuations and price discovery were eroded both on the way up in the late 1980s and on the way down in the early 1990s. Many pension fund portfolios appear to lack a basic strategic orientation, resembling rather more a series of brokered deals, with no sell-side strategy. In some cases there appears to be no basic alignment of interests among pension plan sponsors and their advisors. Pension funds feel they have been subjected to high risk, high fees, and low returns. Certain of the significant pension fund advisors are reluctant to have their performance benchmarked on a basis comparable to that employed in the fixed income and equity asset classes. Software support for real estate is lagging that available for other asset classes. There is a multiplicity of systems, inconsistent reporting of results, and massive amounts of data with little analysis for management decision-making.

Particularly in the pension fund area, we will see continuing fee pressure on advisors along with a demand for increasingly more and sophisticated services. The public markets will become ever more important, more liquid, more heavily traded, and the source of ever-improving information about the underlying real estate.

Many of these service provider issues are being addressed. New fee structures are being proposed, along with co-investment. Benchmarking systems are being adopted by certain plan sponsors. National property management companies are being formed on the premise of delivering lower cost service with superior management information systems.)

Along with securitized product from Wall Street, pension funds should be a major supplier of capital to real estate over the next five years, especially as they reallocate assets out of the U. S. equity market into alternate asset classes. In order to free up this capital to the real estate sector, however, more work needs to be accomplished on the intellectual underpinnings of real estate investment, as discussed in the following section.

Other Financial Institutions

There will also continue to be other types of powerful financial institutions engaged in commercial real estate finance. There will be finance companies with strong credit ratings and broad and sophisticated access to international capital markets which will find opportunistic ways to intermediate capital

into the real estate business. It is less likely that these will be conglomerates such as Sears and Westinghouse, who attempted to reach into real estate, and then pulled back. It is more likely that they will follow the G. E. Capital model of highly sophisticated and aggressive utilizers of the capital markets process.

INTELLECTUAL UNDERPINNINGS OF REAL ESTATE INVESTMENT

The somewhat simplistic intellectual rationale of real estate investment as an inflation hedge simply does not work anymore. Inflation is not as worrisome as it was a decade ago; and real estate has not performed. Securitization techniques such as REITs and CMBS have only made the debate more confusing. Do REITs trade like small capitalization stocks?. . . Is the value of physical real estate altered significantly when it is placed inside an REIT format?. . . Is there some alchemy that can make a 6 percent yielding asset become a 10 percent yielding asset?. . . How long can the financial levitation last?. . . These queries may become less significant as REIT relative payouts and growth begin to decline.

The further development of real estate derivatives and financial hedges will allow sophisticated investors to sector rotate in and out of real estate, or property types, or locations on a basis impossible when trading physical assets. The major impediment to their development is the lack of broad availability of data on a consistent basis.

The price anomalies which obtain between public and private real estate markets continue to confuse potential investors, many of whom believe the best deals trade to insiders in the game. As mentioned above, such anomalies will surely obtain once again when REITs decline in relative value (caused by lower than expected growth in cash flow and dividends), while the values of the underlying real estate increase along with rents and decreased vacancies.

What is the appropriate return for real estate held in an institutional investment portfolio? . . . How does one know that the return is good or bad compared to other financial assets, (especially in the case where real estate seems to command high fees, is essentially hand-crafted, illiquid, and based upon imperfect price and data discovery)?. . . Some have suggested that real estate, on this basis, should return around 500 basis points over the 10-year Treasury. Such a spread may be intellectually consoling, but can such returns be sustained on investment grade commercial real estate?

How does one obtain consistent reliable data upon which to base sound real estate investment decisions? It turns out that office buildings are measured on different bases in differing locales. The calculation of economic rent varies from purveyor to purveyor, and often important components are left out. How is vacancy to be calculated?. . . How about a downsized tenant paying above market rent on untenanted space?

Pension funds will not meet their potential as real estate investors until these types of queries are resolved. Growing exposure to the public markets should serve to support the development of consistent and reliable data. Those individuals who can deliver the data freely and openly, and not keep it sequestered in the hands of the privileged few owners and brokers, will end up controlling the real estate investment industry.

CONCLUSION

Over the next five years we will see many of the things we have seen in the past. On the margin, there will be too much capital flowing into real estate, primarily from commercial banks, Wall Street, and pension funds. This will carry with it the continual threat of overbuilding in certain markets and locations, although the economic downturn we can anticipate over the time frame will mitigate the severity of such overbuilding in this cycle.

We will experience an unusual degree of functional obsolescence in real estate over this period. Probably several hundred regional malls are already ripe for adaptive re-use. In certain cities, high-rise downtown office structures will continue to give way to suburban offices with cheaper transportation and other costs. Hoteling will further change office usage and the number of square feet utilized per capita. We have already seen high-rise office structures in formerly attractive locations, which may be filled with asbestos, becoming economically obsolescent.

Particularly in the pension fund area, we will see continuing fee pressure on advisors along with a demand for increasingly more and sophisticated services. The public markets will become ever more important, more liquid, more heavily traded, and the source of ever-improving information about the underlying real estate.

In my opinion, the new paradigm in real estate finance is not a dampening of the cyclical nature of the business, but the potential for a much broader

and deeper marketplace for real estate capital driven by increased disclosure of information.

Above, all, what will be required over this period is intelligence; out of the box thinking; creativity; the willingness to risk investment dollars on management information systems; the ability to see the problems of the financial institutions as readily as you can see your own; and the ability to develop longer term trust relationships based upon honesty and integrity.

If we can maintain the self-discipline we were forced to acquire in the early 1990s, together with improving the flow of data about real estate investment, the millennium could prove to be a golden age for all of us associated with commercial real estate investment. REI

ABOUT THE AUTHOR

Bowen H. "Buzz" McCoy, CRE, *is president of Buzz McCoy Associates, a real estate and business counseling firm in Los Angeles. He presently serves as the 1997 president of The Counselors of Real Estate, as a ULI trustee, and as president of the Urban Land Foundation.*