When Markets Clash

by Bowen H. "Buzz" McCoy, CRE

A BIT OF HISTORY

Recent events in the real estate capital markets may be seen as part of the evolving clash between public and private markets for real estate. Back in the 1970s the two markets were almost completely de-linked. Public real estate companies traded at times as much as 80 percent below the net asset value of the real estate carried on their books. This was borne out by the liquidation of Tishman Realty for approximately three and one-half times the price of its common stock; the Ernie Hahn company for three times the value of its common stock; and Monumental Properties, for almost four times the value of its common stock.

In the 1970's debt markets, investment bankers could place mortgage securities secured by headquarters properties of regional banks or public utilities at as much as 250 basis points below the rate at which the public debt of the parent company was trading. This lead to the chief economist of Equitable Life publishing an edict to all the field offices stating that no corporate mortgage could be issued at a rate less than that quoted in the daily *Wall Street Journal* for publicly traded Aa public utilities. Thus were capital market linkages born.

The 1970s also saw the initial round of REITs. They were mostly mortgage oriented. Those equity trusts which were formed, for the most part, lacked the quality of property which we see in today's REITs. A number of factors, including disintermediation, poor management, and small lot size caused the preponderance of these trusts to disappear by the early 1980s. Several real estate companies went public during the early part of the 1970s, but most of them returned to private status later in the decade, when private real estate assets were valued much more highly than public companies. Securitized debt also made an

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appearance in the 1970s, although it was limited primarily to tranched debt of high quality issuers, secured by a lease to their headquarters building. The debt tranches were structured to take advantage of a positive sloping yield curve, and bore little resemblance to the slicing and dicing of today. Thus the public markets for real estate debt and equity securities emerged in the 1970s, but the preponderance of commercial real estate finance was private, dominated by the insurance companies.

In the 1980s, private financing sources continued to dominate the real estate capital markets, with insurance companies prevailing in the debt and equity markets, including large joint-ventures. Pension funds began to allocate capital to real estate, and the pension fund advisory business grew rapidly. Commercial banks became increasingly aggressive throughout the decade, lowering spreads and underwriting standards to create market share. Even savings and loans, which had been traditional housing lenders, participated as syndicates of commercial real estate ventures. Private foreign investors came into the market in a big way as well. The real estate capital markets were flooded by private financing sources, and the quality of investment portfolios deteriorated as a result of the concomitant overbuilding.

Regulators placed stringent pressures on private financing sources in the early 1990s, including the imposition of risk-based capital rules on commercial banks and insurance companies. Many savings and loans were beyond salvaging. Pension funds lagged several years in marking their holdings to market. Credit and common stock analysts made it clear that real estate was "toxic." In the early 1990s the funding of financial institutions with large real estate holdings became problematic. The private market for commercial real estate finance had dried up.

REITs, especially after the tax efficient up-REIT ruling first given to Taubman, became an excellent vehicle to raise equity capital to pay down the banks. Developers who had never considered a REIT were encouraged by their lenders to do so, and the quality of real estate placed into REITs far exceeded that of the previous round. REITs benefited from the repricing of real estate, coming out of the depression in the mid-1990s, and investors were lured by annual returns of 30 percent for two years back-to-back. As a result, REITs were viewed as a growth stocks, not the income security they had been designed to be.

Commercial Mortgage Backed Securities, formerly purchased chiefly by savings and loans, came into the fore as other lending sources dried up. A series of problematic investments could somehow achieve alchemy by being pooled, and the disparate cash flow characteristics of a hundred loans proved a more stable financing vehicle than individual whole loans. Disproportionate cash flow was dedicated to the "top" piece, and the rating agencies provided investment grade ratings to such tranches. A market developed for the "bottom" piece among opportunity funds and those willing to take higher risk. Issuances ballooned and the public debt markets drove many commercial banks out of the business. Underwriters of CMBS evolved from being intermediaries to becoming principals, extending their own capital when necessary and holding unsold, often riskier pieces in inventory. By acting as principal they could issue a competitive quote to a borrower and make as much as a 150-200 basis point "inside spread" by slicing and dicing the pooled securities. This worked fine as long as the market was receptive. Otherwise, inventory backed up, and the investment banks began to have the same problem the commercial banks had experienced early in the decade.

WHAT HAPPENED IN 1998?

By the first half of 1998, the public debt markets had pretty much taken the commercial banks out of the business. Because of their "inside spread," the investment banks could undercut the commercial banks in pricing their loans. The commercial banks could not compete with Wall Street on spread and sustain an adequate return on their capital. Underwriting standards began to deteriorate in the banking system, as they attempted to remain competitive. By mid-summer, 1998, Alan Greenspan cautioned the commercial banks on their lending practices to real estate. It looked like the public markets were here to stay, and the private markets were losing significant market share.

Some analysts raised queries about the possible fragility of the CMBS market as well. The rising tide of the repricing of real estate in the mid-1990s was lifting all boats and possibly masking the performance of many of these loans over time. An investment grade rating could obscure the nature of the assets in the investment pools. Large CMBS pools had not been fully tested in a real estate recession. A good statistical record of loans past due and delinquent during adverse times had not been compiled. Ongoing due diligence on individual loans in pools in the secondary market was problematic. It is not

clear how such diligence is to be funded, or who is to perform it. Liquidity in the secondary markets could become a fiction. An investment grade rating did not mean there was a depth of market makers. Often the only market maker was the original issuer, and the trades were "by appointment." This was especially true when investment banks were bulked up on inventory. Thus, it was realized, in many ways, that large CMBS commercial mortgage pools were unseasoned, untested, immature securities. We would need to go through at least one full economic cycle to fully understand how they would perform over time.

All of this came to a head, of course, in the liquidity crisis in the debt markets in late summer of 1998. Problems with Russia, Latin America, and Asia caused liquidity to dry up in the emerging markets debt market. This liquidity crisis created a flight to quality—primarily to U.S. Government and high-grade corporate bonds. The market became binary. A debt security was either high-grade or it was not; there were no shades of gray. CMBS was swept up along with high yield and other lower quality debt issues. The real estate financial community was puzzled that real estate debt was being regarded as too risky, especially when the supply and demand characteristics of commercial real estate were probably as well in balance as at any time in recent years. It became obvious quickly, however, that investors regarded CMBS paper as unseasoned and immature, for the reasons cited above, and they quickly dumped it into the illiquidity hopper.

The real estate public equity markets, in the form of REITs, also took a battering in 1998. As commercial real estate re-pricing was completed, it became apparent that REITs would no longer be growth stocks. The process of moving equity securities from one class of investor to another can be quite expensive. The stock market continued throughout 1998, despite a few bumps and grinds, to place a higher value on growth stocks than on income stocks. The result was a decline in value for virtually all REIT shares, with some classes of real estate suffering far more than others.

As a result of the reversal in fortunes of public debt and equity real estate securities, the private market came roaring back in, to a much greater degree than earlier in the decade. Some insurance companies made 80 percent of their annual mortgage commitments during the last third of the year. Commercial banks, while cautious in their lending standards, found the widened spreads far more to their liking.

The future of REITs will be driven by the state of the real estate economy. For the next two to three years leases will continue to roll over out of below-market rents, allowing some REITs to experience double digit store-to-store growth. This is typical for this stage in a recovery from such a severe depression, but it will create expectations which will not be sustainable in flat or declining rental markets.

It was interesting to observe the speed with which the private markets attempted to regain market share to take advantage of the public market difficulties.

WHERE DO WE GO FROM HERE?

The liquidity crisis of 1998 reminded us once again that life in the real estate capital markets is not linear. Just because the public markets dominate finance for a few years does not necessarily mean that the private markets are dead. Far from it. In the heady days of CMBS growth, analysts were predicting that the public debt market would become the primary source for real estate finance. The wake up call of 1998 was that public securities markets can dry up quickly for periods of time for reasons which have absolutely nothing to do with the quality of the underlying real estate assets. This potential periodic de-linkage of the capital markets from the underlying assets should cause all major users of real estate capital to desire to have multiple sources available, in both the public and private markets. In fact, despite the progress made in the public markets throughout this decade, a case can still be made that real estate is essentially private market business.

The future of REITs will be driven by the state of the real estate economy. For the next two to three years leases will continue to roll over out of below-market rents, allowing some REITs to experience double digit store-to-store growth. This is typical for this stage in a recovery from such a severe depression, but it will create expectations which will not be sustainable in flat or declining rental markets. As this cycle of REITs grows more mature, there will be increasing pressure to rob properties of desirable or even critical capital expenditures in order to maintain investor expectations regarding dividend levels. Over time, this will degrade the portfolios of

many REITs. When we experience the next real estate recession, dividend growth will cease to meet investor desires, and stock prices will fall. When stock prices fall to a certain level, say around 65 percent of net asset value, opportunity funds and real estate operators will begin to take REITs private, (much as they did with public real estate operating companies in the 1970s). For those attuned to arbitraging anomalies between the public and private markets, there will be money to be made.

It will be difficult to differentiate among CMBS issuers until we have a downturn and we can study how individual portfolios fare. As these securities mature, there will undoubtedly be "branding" distinctions made in the marketplace among issuers, based upon the support of secondary market trading activities; ongoing due diligence on individual loans over the cycle; the quality of follow-up information provided to the marketplace; and the diligence and tenacity applied to past due or delinquent loans. If true secondary markets develop in terms of information flow and trading activity, there should be substantial continued growth in this market.

If, over time, public markets dominate real estate finance, the real estate markets will become far more transparent, with copious amounts of public data available on individual properties. In this event, it is likely that the long dreamed of national rental index may become a reality. With enough public data on hand, various indices of property types and locations could be traded long or short, and hedge markets could develop for major users of space. This has long been a vision of many who deplore the still mysterious and arcane nature of real estate information, the difficulty of obtaining pure net rental data, or even consistently measuring space in various locations.

Despite the transparency of the public markets, and the better information flow, there is the irony that such markets could still become highly volatile and de-linked from the underlying real estate assets. Recently Alan Greenspan warned of the risks of the new international financial architecture. The increased volatility of the markets can, in effect, cause lower growth because of the anxiety created. This, of course, is exactly what occurred in the debt markets in late summer of 1998.

On the other hand, there may be many who do not really want a fully public, transparent real estate capital market. Real estate remains primarily a local and an insider's game. Detailed real time market knowledge is not broadly shared. The industry wants the world to be predictable, while it remains unpredictable. In a thoroughly predictable, transparent world, profits are limited. Obviously, the entrepreneurial talent which makes this business so entertaining and adventuresome would not be drawn to such an environment. So, as much as some may yearn for perfect markets and a broad public market for real estate, we had better keep the private markets alive and well. We had better hope that the public and private markets continue clashing. Without both of these marketplaces, we would lose much of our unique character, as well as opportunities to trade them off for our own profit. REI

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