Commercial Real Estate Finance - Global or Local?

by Bowen H. "Buzz" McCoy, CRE

Introduction

Commercial real estate has traditionally been considered a local business, based upon locational characteristics and intimate knowledge of tenant needs. Trans-national real estate investment in the decade of the 1980s coupled with globalization of money and capital markets in the 1990s has caused some to believe that commercial real estate is a fungible commodity, which may be traded broadly irrespective of local needs or characteristics. This manuscript attempts to describe some of the linkages between global and local real estate. We shall begin with a brief survey of U.S. real estate capital markets, move on to the international capital markets, and conclude with a statement of how a local business — real estate — can react to global capital markets.

U.S. Capital Markets for Commercial Real Estate Finance

Perhaps the leading query is: how much longer can our longest sustained growth boom continue without running into inflationary pressures? There does appear to be a whiff of inflation in the air. Labor cost increases are disguised in part by signing bonuses, trips to Hawaii, annual bonus awards, stock options, and the like. Yet many localities are operating at under three percent unemployment, a statistic below traditional reckoning of frictional employment levels. Shortages are appearing in items such as dry wall and copper. The Federal Reserve Bank is practicing a balancing act between keeping interest rates low until the Asian crisis is resolved and moving to higher rates to avoid longer term inflation. Most economists seem to be predicting good growth through the year-2000 Presidential election and a possible shallow slow-down in 2001, caused in part by higher interest rates.

About the Author

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Certain economists posit that the Federal Reserve may have to raise interest rates even if there is low inflation, in order to cut off excessive consumer demand. Such excessive consumer demand has been fueled by the stock market bubble as well as the large disparity of imports over exports. Should the Fed take corrective action to stem excessive consumption and asset value inflation, a recession could easily be the result.

Meanwhile, the competition between public and private sources of capital continues. Insurance companies and commercial banks continue to benefit from Wall Street's liquidity squeeze in the last half of 1998. Spreads on real estate lending remain quite high, compared to the first half of 1998, although availability of funding has improved. Commercial banks remain aggressive on underwriting standards in selective cases. Insurance companies are aggressively marketing whole loans, syndicating such investments among two or three entities, seeking ways to justify higher loans to value and seeking to standardize mortgage documents.

In the public markets, real estate investment trusts (REITs) still represent a relatively small percentage of the commercial finance market. Prices of REIT stock remain depressed as large capital flows continue into Internet, media, and finance companies. The public markets think something bad is going to happen to real estate. REITs have become recognized as slow growth vehicles, somewhat underleveraged from a real estate point of view. They have moved from trading at 15 percent to 20 percent premiums to net asset value to trading at 15 percent to 20 percent discounts to net asset value. Those REITs that are able to reduce expenses, build ancillary businesses, and provide accretional external growth will do the best. Stock repurchases also can improve value. In the long run, the number of REITs will decrease sharply.

Commercial Mortgage Backed Securities (CMBS) have not recovered to the values they represented in 1998. CMBS pricing spreads to 10-year Treasuries remain relatively high for each rating category, and especially high for the lower rated tranches. The "bottom" pieces are priced at spreads to Treasuries roughly double those of early last year. CMBS portfolios have not gone through a down-cycle as yet. There is uncertainty as to how these portfolios will perform. What is a normalized ratio of past due loans and delinquencies during a real estate recession? Who will collate and disseminate the data for these large portfolios? Who pays for such information? Will market makers for such securities stay around during a down cycle? Answers to these types of investor queries are not clear at the present time.

Private equity in real estate continues to be aggressive. Private equity is priced differently than public equity, because of the higher leverage tolerated and the perceived greater investment risk which is sought. One interesting transaction during the initial six months of 1999 was the privatization of a large, California-based apartment REIT. The principal paid a 24 percent premium over the market price of the common stock. As a private market buyer, he was able to roughly double the financial leverage on the properties. He could also integrate the bulk of the properties into his master plan for the entire holdings. The difference between public and private market equity pricing in this case was entirely rational. The transaction is a good case study for the logical difference in public and private market equity valuation.

INTERNATIONAL CAPITAL MARKETS FOR REAL ESTATE

The phenomenon in U.S. capital markets which remains less fully understood is the linkage between domestic real estate capital pricing and the international capital markets. To illustrate the point, why should whatever happens to the Thai bhat affect my ability to finance local real estate? It is a complex issue. Capital markets do not like surprises. In 1998, we had several of them in a row, ranging from Russia, Brazil, and South East Asia to New York and Connecticut where Long Term Capital Management, a large hedge fund, became illiquid. At such times of uncertainty, there is a flight to quality in the capital markets. Capital came out of emerging markets debt, lower grade corporate debt ("junk bonds"), and real estate debt, causing spreads to Treasuries to double virtually overnight.

Why is commercial real estate debt lumped together with emerging third world countries and "junk bonds?" It is because of the lack of transparency of real estate investment data, lack of solid comparable information, and lack of full disclosure. Real estate is still seen to be a local and a private business. The concomitant lack of transparency is also a deterring factor in U.S. pension funds making larger allocations to this asset class.

The Asian real estate problem has not been cured. There is an estimated two trillion dollars of debt overhang in these markets. In the 1980s, the

Japanese applied local valuation to global markets. The local valuations they utilized were in effect rigged prices, artificially kept high to keep the ruling party in power. The Japanese also took currency risk. In the 1990s, both the currency and the markets went against them. As a result of strong cultural preferences for not admitting mistakes and not acting decisively, little has been accomplished during the past eight years. In the United States we resolved our real estate problems in about five years. We were willing to tolerate windfalls and excessive gains. Our resolved real estate assets were estimated to amount to the equivalent of about two percent to three percent of one year's GNP. A comparable figure for Japan is estimated at 18 percent to 20 percent. Moreover, the quality of unresolved Japanese real estate assets is not good. There has also been a criminal element identified with certain types of Japanese real estate assets. In 1998 Japan resolved $50 billion of real estate assets, or four percent of the estimated $1.2 trillion of bad paper outstanding.

In China, the potential is even worse. Many of the huge state owned enterprises are effectively bankrupt. There is an excessive supply of high rise office buildings in Shanghai and elsewhere, some owned by the Peoples' Liberation Army. The state owned banking system is filled with illiquid paper extended to state owned enterprises and real estate projects. The state owned banks are essentially financed by the savings of the country, including the huge peasant class. It is estimated it will take as long as 10 years to resolve the situation. If denied World Trade Organization membership and other international recognition, there is always the chance that China may become more insular. Along with this is the risk of devaluation of their currency, should the resolution of their economy become unsynchronized, resulting in yet another Asian crisis.

Finally, there is the imponderability of a resolution problem in the Russian economy. Thus one may easily predict further turmoil in the international capital markets from time to time. Real estate capital markets in the U.S. will suffer during such times of crisis, as real estate will continue to be viewed as immature and non-transparent. Private markets such as banks, insurance companies, pension funds, and private equity will benefit from such disruptions in the public markets.

CONCLUSION

Is real estate global or local? Essentially it is local and private, but financing costs are going to be driven by world events, among other factors. Thus real estate is a local business in a global marketplace. A real estate owner-operator must think locally and act globally. Here are some suggestions as to how a typical local owner-operator of commercial real estate may react to the increased complexities of the real estate capital markets.

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- Have a long-term capital strategy, not a short-term tactic of always getting the cheapest capital available.
- Think locally about location, tenant needs and satisfaction, competition, and the like.
- Act globally in the sense of being able to interpret the impact of global events on financing costs and access to capital.
- Line up your capital needs early.
- Have plenty of equity in your project.
- Try to finance a couple of years ahead in order to prevent being in the capital markets at a time of crisis.
- Maintain good capital sources in both the public and private markets.
- Be certain your private capital financing source is not itself dependent on the public markets to lay off its own loans and investments.
- Be prepared to pay a premium, if necessary, for availability of capital.
- On a longer term basis, do what you can, through The Counselors of Real Estate or other organizations, to increase the professionalism and transparency of real estate information.

No one anticipates, or even desires, a "perfect" market for real estate finance. That would take all

the fun out of the game. But no one enjoys the capital crunches either; and — from time to time — they will remain with us. So fasten your seat belts; and enjoy the ride.REI

NOTES

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