Introduction

As with every successful conference, participants each came home with a highly individual perception of how the knowledge gained could be applied. Real Estate Issues *invited a number of attendees to contribute their own thoughts on the applications of conference themes in their businesses. Not surprisingly, the range of reactions was wide. Here are four commentaries: two from the U.S., and two from abroad. Lorenz Reibling considers how best to partner in placing international investments. Jose Pellegrino turns a skeptic eye to the benefits brought by large banks and rating agencies in Latin America, as well as suggesting a "small is beautiful" approach to local planning. Roy Schneiderman takes a long historical perspective in suggesting that "globalization" is hardly a novelty. And Martha Peyton provides insights into the pricing of capital and its effects on property value in a mixed-asset world.*

Cross Border Capital Flows — Perspectives from a Mixed Asset Portfolio Investor

by Martha S. Peyton, CRE

One of the clearest points made during the Capital Flows session at the Global Cities conference was the abundance of capital pouring into real estate to escape unattractive return prospects in other asset classes such as stocks and fixed income instruments. The flow is having an unsurprising adverse impact on real estate prices. The rise in prices and decline in cap rates prompted some of the panelists to opine that prices have become too high in both U.S. and major European markets. The price increases were judged to be inconsistent with actual and expected deterioration in occupancy and rents associated with weak economic performance. One panel member diagnosed the price increases as the start of a bubble, implying that real estate buyers were nurturing unrealistic illusions regarding property market prospects.

There is another less alarming explanation for the rise in prices that draws from the increasing integration of real estate into global capital markets. Historically, real estate was in a world of its own. Cap rates responded slowly at best to interest rate changes; property values replied on appraisals; and real estate investment was most commonly done through separate account managers specializing in real estate. In this environment, real estate could be viewed as a separate world in which expected IRRs on cash flowing institutional quality property were always pegged at double-digit levels. If recent price movements are viewed through this historical lens, real estate is indeed priced dearly.

But the world has changed. Capital markets are much more closely integrated than ever before. Ready availability of market data and analysis lubricates the integration. As a result, real estate has lost a good bit of the mystery that historically reinforced its separateness. Unattractive returns in mainstream asset classes is a recent bit of stimulus accelerating the integration process. As a part of the global marketplace, real estate investment prospects are being examined alongside all other alternative investments. For good or ill, the comparison factors boil down to expected return, risk, liquidity and the unique ownership burdens associated with hard assets versus soft.

Capital is flowing to real estate because it is priced attractively when expected return, risk, liquidity and ownership concerns are weighed against similar measures for alternative asset classes. Stocks are coming up short because the market has no real sense of fair value exacerbated by erosion of confidence in corporate financial reporting. Bonds of untainted investment grade borrowers are more palatable but offer yields based on a Treasury rate that has not been this low since the early 1960s. High yield below-investment-grade bonds offer higher yields but suffer from volatile credit risk. Investment in cash flowing properties with investment grade tenants and long-term leases is nirvana compared with the travail of alternatives.

But, of course, the demand is driving up prices—as well it should. When are prices too high? When the

expected risk-adjusted return is in line with alternative investments. When assessing risk-adjusted return, real estate investors need to acknowledge that the underlying riskless rate (i.e. Fed funds) is 1.75% and inflation expectations incorporated into the term premium brings the 10-year Treasury to the 3.6-4.0% range, absent an oil shock. Expected IRR=s in this environment will probably find an equilibrium below 10% for institutional quality property. How much below? Perhaps quite a bit given that medium quality BBB-grade corporate bonds are trading around 6.50%. But can a real estate buyer really use that 6.5% as a credible opportunity cost when it clearly represents an historically rock bottom and therefore temporary condition? Answering the question again requires that real estate buyers think like bond buyers. When considering a purchase of that 6.50% bond, a bond investor will mull over the duration bet attached to the bond. That involves evaluating how much value will be lost if interest rates rise, what is the risk of an interest rate rise, and again, what are alternative opportunities for my capital.

With all this said, I believe that the danger for real estate investors in the current environment is the temptation to take ever-greater risk in return for double-digit IRRs. For the market as a whole, the danger is that rising real estate prices might be misread as justifying significant new construction. A construction response to higher prices would indeed be a real estate "bubble."

Martha S. Peyton, CRE, *is an economist at Teachers Insurance and Annuity Association College Retirement Equities Fund (TIAA-CREF) in New York. (E-mail: mpeyton@tiaa-cref.org)*

Counseling in an Era of Change

by Roy Schneiderman, CRE

In reflecting upon the theme Global Cities in an Era of Change, the first thought that struck me was that there is not really a lot new here. After all, there have been, (relatively speaking at least) "global cities" for thousands of years. And I suspect that there may never have been an era in the history of mankind that would not have been described by those living at the time as "an era of change."

So although the specific characteristics ("the details") that we see in our world today appear extraordinary in their complexity, sophistication, and richness, it is much less clear whether or not there is anything fundamentally different about our current world, society, culture, etc.

This is not to say that fundamental changes do not occur. They do. But those fundamental changes generally can only be seen in retrospect, and usually with a fair amount of distance and perspective. Or put another way, those who think that there is necessarily an inexorable march towards the globalization of the world's economy should note that the Euro does not mark the first time (or even the second time) that Europe has tried a unified currency. And only time will tell if the current effort is 1) the successful culmination of a long-term trend, 2) an unsuccessful experiment during a brief period of pan-Europeanism, or 3) something in between.

So against that backdrop, I offer up the following four thoughts with respect to how the current trend towards globalization and urbanization/suburbanization will impact the practice of real estate counseling:

- Successfully cultivating and nurturing relationships will continue to be the single most important element of a counseling practice. This has been true for a long time, and is likely to be true no matter how far technology, or globalization, or any other trend changes the "details" of our world and society.

- Integrity and reputation will become increasingly important. Of course, integrity and reputation have always been important in a counseling practice. However, accessing information about people has heretofore been a rather haphazard affair. But in a world where people can easily send out an e-mail to hundreds of people that they know personally asking "I am thinking of doing a deal with Mr. or Mrs. X, do you know them?" counselors are likely to find that their history, as embodied in the corpus of their work and their reputation, becomes increasingly important.

- There will continue to be a squeeze on mid-sized firms. Large firms will be able to achieve some scale in order to accommodate large projects. And small firms will remain nimble and flexible as conditions change. But mid-sized firms will find themselves in the worst of both worlds.

- Continued improvements in technology will allow for small firms to partner on a project basis or a product-line basis. The market acceptance of this type of ad hoc counseling partnership will continue to increase, with the key factor being the ability to successfully convey the message to the client that the people involved can (and have) successfully work(ed) together.

Roy Schneiderman, CRE, *is principal and founder of Bard Consulting in San Francisco.*

EVEN IN GLOBAL CITIES, THINK LOCALLY

by Jose Carlos Pellegrino, CRE

Returning from the Global Cities in an Era of Change conference at Harvard University, I considered some consequences for the city and county of Saõ Paulo. Imagine, for instance, would be the organization of District Councils or Zone Councils, with representatives of main schools and colleges, professional associations, small commercial businesses and establishments, and ordinary men and women who would meet once a week or every other week to discuss priorities for the regions they belong to.

Of course, these Councils will not have political strength, but would have the ability to assert to mayors, planners, and politicians grassroots needs in the fields of development, health, and educational facilities, transportation changes, and things of that sort.

Within a short time these Councils would convert themselves into important political cells. This would be a natural consequence, if it is considered that the family is the cradle of everything and the Councils would the best representative of families in a given district or sector. Obviously, city and county governments would not want to see the creation of such Councils, specially the professional politicians, because in the long run the present system would be replaced by a better one. Here in Saõ Paulo this idea will not be accepted, especially at this moment when we have a radical leftist government. But that is no reason to dismiss such a democratic idea as a practical goal.

The second consideration concerns relates to the risk factors in my country, as it has been set or determined by some rating agencies all over the world. In fact, if you start to think just a little bit, you might suspect these agencies are self-perpetuating and not especially helpful to the very countries they purport to assist. Why? Because, in a way, they are all linked to financial complexes; that is, they all have direct interests in their own funds and other types of investments. Certainly the record of success in South America is not a strong one.

Large banks invest in some areas and then, all of sudden, right after selling their position with big profits, they proclaim that same investment "too risky." What a shame! Corporate and financial gamesmanship is becoming a plague, with companies acting with little or no ethics at all, resulting in significant losses all over the world. I see the rating criteria as applied here lacking good technical support and largely based on guesses and assumptions.

The common threat is this: As "macro" policy is made at the governmental or corporate level, there is a tendency to miss what is actually occurring at the level where most people live and work. Let's keep our eyes on the richness and complexity that are visible locally.

Jose Carlos Pellegrino, CRE, CIPS, *is senior and major partner of Pellegrino and Associates of São Paulo, Brazil. (E-mail: pellegrino@terra.com.br)*

PARNTERSHIPS IN GLOBAL REAL ESTATE

by Lorenz Reibling

At the "Global Cities in an Era of Change," International Real Estate Symposium, September 4-6, 2002 held at Harvard University, how to manage risk over diversified real estate pools was a much discussed topic. The main division was over single or multiple bets on real estate entrepreneurs operating in diverse markets. This discussion is not new, but in today's world of uncertainty surely has new value and deserves a fresh look. The guiding questions for assessing this topic should be:

1. How do you reduce the intrinsic risk of a real estate asset?

2. How does a global investor, such as an insurance company, a pension fund, or the truly wealthy family office most efficiently distribute capital over markets and risks?

3. The common denominator in these discussions is the recognition that real estate by definition is immobile. Most European languages use terms such as *immobilier, Immoblien, immobili* etc. that reflect this attribute better than the English term "real estate." How to deal with the local nature of real estate, particularly in regard to people and financing, is much disputed.

Put in a nutshell, the two camps are divided along the following fault line:

1. Group A trusts the "best" local partner or operator in each individual market and desires to maximize the return by actively searching for those partners or operators.

2. Group B trusts one diversified real estate partner, who in turn has operations in numerous markets under one set of controls and typically uses the same brand name as a business asset in all markets.

Conventional wisdom would suggest that, in theory, Group A should indeed harvest higher returns over a constant risk, assuming that Group and Group B would invest in the same type of real estate, at the same time, using identical leverage, operating costs, etc. Obviously, such conditions rarely if ever occur, but the distinction is useful in thinking clearly about the problem. It is indeed one indicator of the difficulties in executing a coherent investment strategy over a large number of operating entities.

The evident advantage of Group A is the higher degree of diversification. Group A is operating not only over different markets, but also different companies. If it is desirable to spread risk in the portfolio, it seems to be a fruitful approach to real estate investing.

But, offering a not far-fetched analogy, the likelihood of collecting a gallery of Van Goghs, Boticellis, Rembrandts, and Singers by simply visiting distant and exotic places while meeting interesting people is borderline absurd. Artists—and real estate operators—of this exquisite caliber are equally rare. Hence any investor should recognize the limited supply of such talent. Given this shortage of excellent and—today maybe most important—trustworthy partners, the strategy used by Group A is extremely time consuming. It also comes with a great intrinsic risk to this approach, one that is often overlooked: the more people you have to trust with your investments, the more likely you are to pick a bad apple out of the bunch. U.S. institutions are still nursing the wounds suffered by confusing superb, but unfortunately falsified replicas with the real thing. Remarks one major U.S. hedge fund investor about a transaction in Western Europe: "We could have never imagined how a bunch of pin-striped, serious-looking bankers pulled us over the table as if we were naive beginners."

Group B investors may avoid the worst mistakes predictably more often than Group A investors. Making a series of "good picks" in multiple markets is much harder, than building one good relationship with an operator active in the same markets.

The "people factor" is a risk widely underestimated in an industry driven by "deals," as if these individual transactions were virtually devoid of a significant management risk. But it should be apparent that the higher the expected returns, the higher also the "people risk." Managing real estate risks in repositioning, refinancing, or even devel-

oping and redeveloping is, by any measure, comparable with risks inherent in manufacturing procedures such as re-tooling, introduction of new products, or major capital events such as the issuance of debt or an IPO. Nobody in his right mind would leave the management of such risks to unknown characters with a merely parochial understanding of the world.

This by no means minimizes the value of the local operator. In fact, even an entity chosen by Group B might in certain well defined cases enter into joint-ventures with local operators. This would typically be in the first few years of breaking into a new market, or for specialty projects with complex technical, financing or political risks.

Group B investors rely upon the integrity, corporate governance, and standardized reporting systems of their relationship partner to make exact comparisons between various risk/return events across multiple markets.

The most prominent feature of a single entity is the ability to gather, format, and preserve input from numerous markets over various real estate cycles. Experience generates an important "gut feeling," a sense that "we have seen that before" or "they do this differently there." Such judgments can then be verified with independent market data.

The ability to compare notes and transfer know-how in assessing and managing risks requires a central brain or processing entity, distant enough from the micro-management issues of the local theater, yet still close enough and capable enough to interact decisively and authoritatively with local risks and opportunities. This indispensable know-how cannot be imbedded adequately within mammoth investment houses. The psychology of the top real estate minds runs counter to the notion of institutional domesticity. Rather than working with a toothless tiger, sophisticated investors need to interact with market opportunity.

Prudent investors have learned their lessons and adjusted their investment programs accordingly. Rather than investing in the best deals or the best people in a specific market, they invest in a competent real estate organization, a brain, with eyes, ears, and a nose that sees, hears, and smells beyond the local weather report. This relationship partner is defined by documented high integrity under duress, deep real estate know-how condensed into a relatively small number of top executives and the impeccable ability to not only perceive but report changes in risk. These type of organizations are few and far in between. Such a proven relationship partner can be invaluable in sorting out the true opportunities from the mountain of "irresistible" real estate deals presented to any large investor.

ABOUT THE AUTHOR

Lorenz Reibling is president and CEO of Taurus Investment Group, Inc., in Deerfield Beach, Fla.