



Daniel Rose, CRE

REAL ESTATE: EVOLUTION OF AN INDUSTRY

By Daniel Rose, CRE

Dramatic changes have taken place in the real estate world in the past decades, and they involve every aspect of the field—design and construction, a bewildering variety of financial vehicles, new or modified forms of ownership, and so on.

The Greek philosopher Heraclitus, who first recognized the "permanence of change," and Charles Darwin, who grasped the concept of evolution, would feel at home in the real estate world of today.

Architects of a generation ago wouldn't believe that the most expensive housing units today are designed with dazzling kitchens that, in actual practice, are used chiefly to warm up Chinese take-out food; that the library of the past is now a media room without a printed book in sight; that maids' rooms have gone the way of the buggy whip and the quill pen; that the luxurious baths and home spas today would please even a Roman emperor; and that residents of virtually all economic levels today demand exercise and health facilities that were undreamt of a few years ago. Most interestingly, they would not believe that some of our most lavish and expensive housing units are in old converted factory and warehouse structures in the heart of former industrial districts.

As for office building design, the whole story is told by the fact that IBM had to move out of its lavish headquarters building only 18 years after it moved in, because the structure was so technologically obsolete that it was easier to relocate than to renovate and upgrade.

The jargon in the office development field today includes vocabulary that can elude even seasoned real estate professionals, with terms like "broad-band on-ramps," "optical fiber maps and metropolitan loops," "local exchange carriers," and the like.

Even apartment buildings are now going "green" and high-tech, with buildings now on the drawing boards with solar energy collectors, water re-use programs, and dedicated air systems.

In real estate finance, J.P. Morgan himself would probably be bewildered by the more complex derivatives now available for ultra-sophisticated investors who seek high returns with proportionate risk.

It seems only yesterday that the real estate field was bowled over by William Zeckendorf, Sr.'s introduction of his "Hawaiian technique," in which he divided a property's values into a fee position, a ground leasehold, an operating leasehold, and a residual position. Today one hears of a "collateralized mortgage obligation" (CMO) with seven "planned amortization class" (PAC) tranches, one "retail" (RTL) tranche, two "support payer" (SUP) tranches, one "support Z" (SZ) and one "jump-Z" bond and a "PAC residual" (RPC).

The values of all of those fluctuate with the rate of prepayments of the many individual mortgages in the underlying portfolio. At each level, an investor selects his degree of risk in line with his hope of reward. Needless to say, these are not markets for amateurs.

If Morgan himself would be bewildered by the more complex financial derivatives, he would have understood clearly that a capital-intensive industry like real estate sooner or later would attract publicly-traded vehicles for both debt and equity; but even he would be impressed that the market for commercial mortgage-backed securities has now reached \$300 billion and is growing, and that the market for Real Estate Investment Trust shares stands today at \$150 billion.

Morgan might not have anticipated that control of the nation's capital would shift, as it now has, away from commercial banks and life insurance companies and to pension funds and mutual funds; but he would have understood the drive toward industry consolidation in a globalized economy under conditions where the development of regional malls, say, or of investment grade hotels is generally beyond the reach of local speculative developers, and where the economies of scale can be substantial.

Changes in technology, in building design and in financing have been accompanied by other changes no less striking.

Only a few years ago, New York structures were built, financed, owned, managed and occupied by New Yorkers, just as those in Chicago or London, San Francisco or Paris were controlled locally. In today's globalized world, capital, ideas, and people flow freely across state and national borders. American developers, financiers, brokers, architects and technicians are active anywhere in the world where the rewards justify the risks.

At annual meetings of the Urban Land Institute, our premier national real estate organization, it is not unusual to hear Jerry Speyer of Tishman Speyer tell of his real estate experiences in Germany or Latin America, or Mel Simon compare the results of his Mall of America in Minneapolis with those of his European projects, or to hear Jerry Hines discuss his projects in Russia or China or more than a dozen other countries in which he is active.

Many of the people in this very room have no idea that the net cash flow from the apartment or office rent they pay in New York finds its way to investors in Germany or in England.

Electronic telecommunication, easy air travel and the powerful geo-political changes of the past decade have caused the world to shrink to a degree almost inconceivable a short time ago. Only 64 years ago England's Prime Minister, Neville Chamberlain, could refer to Czechoslovakia as a "far off country of which we know little." The flying time from London to Prague is now under two hours.

Today, globalization and securitization mean that

the home mortgage of a worker in, say, Richmond, Virginia can be financed by the life savings of a worker in Brussels or Stockholm, at the lowest interest rates the world's free capital market permits.

In an overview like today's, where we have been and where we are can be seen with clarity; what remain to be considered are the problems of where we are headed.

All of us are aware of several powerful trends that are likely to continue, such as the population movement away from cold, dark and wet areas of this country to warm, sunny, and dry ones. The relentless shift in economic primacy away from blue-collar employment in heavy industry and manufacturing and toward a broad range of white-collar activities (in reality, they now wear sport shirts!) is an old story. We will continue to see the surge of population and jobs beyond the city limits of our largest cities, and certainly a group like this is aware of the increasing degree to which we are becoming a knowledge-based society where electronic handling of information is changing all our lives.

Demographics, too, present facts that must be faced. Thanks to immigration, the U.S. population is expected to grow some 20% in the next 20 years, adding 50 to 60 million people, overwhelmingly from Latin America and Asia. The ramifications of this immigration will be complex, especially in the West and South, where most are expected to settle. But the spillover will be felt everywhere, in center cities, in "edge cities," in older suburbs and in fringe areas that are being called "edge-burbs."

The true costs of old-fashioned sprawl are increasingly obvious, with everyone aware of its impact on clean air and declining underground water tables, of vanishing farmland or open space near cities and painfully lengthening commutation time. This is spurring denser, mixed-use development in "edge-burbs" and in older, revitalizing suburbs with access to mass transit.

How we deal with older, deteriorating suburbs and with dysfunctional older industrial centers is one of the great challenges of the decades ahead. Camden, New Jersey, across the river from Philadelphia, is a case in point. With its industrial jobs having fled, some 20% of its housing units are vacant or abandoned, tax revenues have shrunk

and the state of public education is such that an estimated half of its residents are functionally illiterate. The only flourishing enterprise in town is the open-air narcotics business, which employs over 2,000 people and brings in over \$200 million annually—a sum greater than the city budget. More than aspirin and band-aids are needed to turn around this sick city.

In the decade of the 1990s, Las Vegas had a population growth rate of 85%, and Scottsdale, Arizona grew by 56%, and Austin, Texas grew by 41%. In the same period, other cities shrank. Hartford, Connecticut, for example, lost 13% of its population, St. Louis, Missouri lost 12% and Baltimore lost 11%. And that was at the height of a boom.

A common joke in Detroit a few years ago was of a sign that said, "Will the last company to leave town please turn out the lights," and perhaps that sign will appear elsewhere. Helping older cities to renew themselves must be high on the nation's agenda.

As investment capital does flow into deteriorated areas and vitality returns, the complex process called "gentrification" takes place. At present, most of the costs of gentrification now seem to fall on the poorest who are displaced, and in time we must learn how to spread those costs appropriately.

But looking ahead, there are two major unanswered questions our society must deal with: first, how our largest cities will reconstitute themselves to adjust to emerging economic, social, and technological conditions; and, second, how will we all adjust to the challenge of terrorism.

About the first, many signs are already clear.

When we add the next 20% to our population, we will not expand our road networks or our parking by 20%, and worsening congestion will force new approaches to density, telecommunications, public transportation, and the needs of pedestrians.

As long as gasoline remains cheaper than bottled water, America will continue its love affair with the automobile; but perhaps in time, cars will be used more for recreation and less for transportation to and from work.

We all know that the industrial city of a century ago is ancient history; its dense business district,

its upper-class housing separate but nearby, and its manufacturing and workers housing in the next ring, are gone with the wind.

The post-World War II city, with its new suburbs encroaching on farmland, has evolved into endless sprawl with neither charm nor convenience.

Today's emerging model is a multi-centered, dispersed city/region whose nodes are connected by effective transportation, and whose workspaces, housing, retail, recreational, hospitality, and cultural facilities are intertwined.

The days of segregated and isolated uses of housing, office, and retail are long gone, and good ride-dance.

Throughout the world, pedestrian-friendly, automobile-free zones are appearing more and more frequently; recycled industrial buildings no longer excite comment; and the impact on urban economy (not culture, mind you, but economy) of the success of Frank Gehry's Guggenheim Museum in Bilbao, Spain, is not lost on planners; and the belief that high-tech communication will lead to an immediate exodus to the exurbs is belied by New York's Silicon Alley and similar areas throughout the world.

Disgusted by the ugliness, cost, and inconvenience of sprawl, planners now discuss "urban containment," with concepts of "greenbelts" to permanently protect a band of open space around a city, or "urban growth boundaries," a line separating urban and rural use, or "urban service boundaries" denoting a line beyond which a city's infrastructure—such as sewer, water or even schools—should not extend.

In physics, the terms "centrifugal" and "centripetal" describe the "push" vs. the "pull" forces of nature; and the same forces are at work on our cities. Some activities will be attracted to urban cores, some to outlying areas, but cities themselves will flourish.

The regional city of the future can be a more livable, more desirable answer to our needs, especially if we can solve two important and perhaps related problems: dense concentrations of poverty and the heartbreaking failure of public education.

We have the knowledge and the means to deconcentrate poverty, and we should. And sooner or

later we will realize that the challenge of public education can be solved just as the challenge of public safety has been solved in the past decade.

The day can come again when our public schools are cheerful, non-violent places of learning and upward social mobility.

We had such public schools once and we can have them again, if we demand them.

We can learn again, as we have forgotten, to teach our children from the earliest grades to read with comprehension, to write and express themselves clearly, to count and to compute accurately. Our schools can give the basic knowledge needed to function in our society, and they can again reflect the self-discipline, high aspirations and self-confidence that schools taught in the past. When they do, good things must follow.

One of those good things will be that middle-class children can again flow back into inner-city public schools, which will benefit everyone concerned.

A new city form is beginning to evolve everywhere, and here in New York, the rebuilding of Lower Manhattan will represent the new paradigm.

First, of course, we must get past the nonsense of talking about either reconstructing exactly what was misbuilt there a generation ago, on the one hand, or of creating a 16-acre cemetery in the heart of our financial district, on the other.

The rebuilt area must have state-of-the-art transportation connections to the other parts of the city and the region, and have a 24-hour, seven-day-a-week character. Far from being another white collar ghetto, it must reflect a wide range of uses.

By 2012, when, God willing, the Olympics arrive with all of its additions to the city's infrastructure, New York could be the world's first truly 21st century city.

About the challenge of terrorism, the key thoughts are "vulnerability," "contingency planning," "redundancy," "deconcentration," and "common sense."

Yes, we are vulnerable, and much more so than we previously thought possible; and, yes, the larger

the company, the more necessary is appropriate contingency planning.

Back-up facilities and equipment, dispersed but integrated locations on different power grids and communications networks, unprepossessing premises rather than the imposing "trophy" office tower, rethought telecommunications—all are on everyone's mind. Subjects like water supplies and drainage systems are being reviewed, the location of key personnel and the duplication of important records are being studied, and all aspects of operation are up for discussion. We will adapt.

The general exodus from large cities that some have predicted has not and will not happen any more than it did in a London under IRA attack or a Moscow under Chechen threat.

Life will continue as before, with common-sense modifications, precautions, and redundancies seen as a collective form of necessary insurance.

At various times over the centuries, doomsayers were certain that the end of the world had come. One such period was in New England in the late

1600s, and one particular sect believed it could even predict the very day.

The congregation debated selling all its worldly goods, distributing the proceeds to the poor and gathering in the churchyard at noon to greet the Angel Gabriel with song and prayer. One wise old congregant rose to insist that the Lord loved work and workers. He proposed that they all greet the Lord hard at work as on every other day of the year. As far as we know, they and their descendants are still at work.

I believe that in these uncertain times of Osama bin Ladin and Saddam Hussein, the real estate field should greet the future in the same way.

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