August 1994

Volume 19
Number Two

REAL ESTATE ISSUES

Capital Formation in Real E$tate

FOCUS EDITION

THE COUNSELORS OF REAL ESTATE™ ®
(American Society of Real Estate Counselors)

THE PRESIDENT SPEAKS

BIBLIOGRAPHY

As I pondered reaching that age
When sensible men disengage
I thought about golf and other such stuff
And asked myself—would that be enough

To occupy a retired me
If the arms and legs should atrophy?
Then I thought of "Issues" from the past
How reading them would be a blast

I found fine works by Jim Gibbons
Deserving of royal blue ribbons
There are papers on law as well as blight
And page after page by John Robert White

Both Frank Parker and Buzz McCoy
Have written things that I'd enjoy
And I'm sure it would not be hard
To sink my teeth into Bill Kinnard

I can read the words of Ronald Sturtz
Over and over until it hurts
And if there's a time that I get bored
I'll turn to Drachman as my reward

Peter Bowes and Samuel Zell
Have dealt with subjects very well
As have both Selden and Jerrold Stern
On what investors want to earn

For good reports on foreign plans
The best by far are John McMahan's
The specialty issues by and large
Should also give me quite a charge

As young folks move into my place
I think of all the joys I'll face
While others struggle with the torch
I'll read old "Issues" on my porch.

Franklin Hannoch, Jr., CRE
President
The Counselors of Real Estate

Published three times annually by The Counselors of Real Estate (American Society of Real Estate Counselors) of the NATIONAL ASSOCIATION OF REALTORS®, 430 North Michigan Avenue, Chicago, Illinois 60611.

Third class postage paid at Chicago. Subscription rates: $27 per year ($38 for two years, $47 for three years); $21 per year to students and faculty; $29 foreign rate, submit in U.S. currency; single copy $10. Remittances may be made by personal checks or by charge payable to The Counselors of Real Estate. Remittances, change of address notices, undeliverable copies, orders for subscriptions and editorial material should be sent to Real Estate Issues, The Counselors of Real Estate, 430 North Michigan Avenue, Chicago, Illinois 60611. 312/329-8257 FAX: 312/329-8881.

Library of Congress card number LC 76-55075

Printed in U.S.A.

INTRODUCING THE *FOCUS EDITION*

This *Focus Edition* is the first in a new annual series of *Real Estate Issues* that will present, each August, high quality articles devoted to a particular topic, as selected by the Editorial Board. In the April edition of the journal, I indicated that the August issue would represent an expansion of *REI* from two to three editions annually. I believe increasing the publishing frequency of *REI* provides an important outlet for authors (the majority of whom are CREs—Counselors of Real Estate) along with serving as a resource of important information for members of The Counselors of Real Estate and the general readership.

The first *Focus Edition* features "Capital Formation in Real Estate," a topic that is most relevant in the current real estate environment. It also serves as a follow-up to The Counselors' High Level Conference held in July on the same subject. "Capital Formation..." apparently is of great interest to authors, since the large number of high-quality submissions we received enabled us to publish an entire edition on the subject.

Such interest in the capital markets for real estate should not be surprising when we consider the tremendous changes that have occurred in this area during the past few years. The virtual demise of thrift institutions as an important source of capital for both residential and nonresidential real estate, the greatly increased role of the secondary market organizations (FNMA and FHLMC), the securitization of residential mortgages, the participation of Wall Street, the hugh growth of REITs and the increasing interest of pension funds in real estate are but a few of these current trends.

We strive to make each issue of *REI* relevant to the needs of our readers. I think you will agree that this first *Focus Edition* zeroes in on a topic of vital interest. Knowledgeable authors, who are leaders in their fields, have provided us with the latest and most incisive insights on market efficiency, REITs, pension fund investment in real estate, portfolio disposition, commercial mortgage securitization and the role of the Federal Reserve.

We welcome your comments on *Real Estate Issues*, along with your suggestions for future topics.

Hal Smith

Halbert C. Smith, CRE
Editor in chief

CONTRIBUTOR INFORMATION FOR REAL ESTATE ISSUES

The journal is published three times annually (April, August and December), and reaches a lucrative segment of the real estate industry as well as a representative cross section of professionals in related industries.

Subscribers to *Real Estate Issues* are primarily the owners, chairmen, presidents and vice presidents of real estate companies, financial corporations, property companies, banks, management companies, libraries and Realtor© boards throughout the country; professors and university personnel; and professionals in S&Ls, insurance companies and law firms.

Real Estate Issues is published for the benefit of the CRE (Counselor of Real Estate) and other real estate professionals, planners, architects, developers, economists, government personnel, lawyers and accountants. It focuses on providing up-to-date information on problems and topics in the field of real estate. Manuscripts are invited and should be addressed to:

Halbert C. Smith, CRE, Editor in chief
Real Estate Issues
The Counselors of Real Estate
430 North Michigan Avenue
Chicago, IL 60611

Review Process

All manuscripts are reviewed by three members of the editorial board with the author's name(s) kept anonymous. When accepted, the manuscript and any recommended changes is returned to the author for revision. If the manuscript is not accepted, the author is notified by letter.

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Deadlines

All manuscripts to be considered for the April edition must be submitted by January 15; for the August edition by May 15; for the December edition by September 15.

Manuscript/Illustrations Preparation

1. Manuscripts **must be submitted on disk** (along with hard copy): ASCII file format, Word Perfect or Word for Windows preferred. All submitted materials, including abstract, text and notes, are to be **double-spaced** on one side only per sheet, with wide margins. Recommended number of manuscript pages is not to exceed 25–30. **Submit five copies of the manuscript accompanied by a 50- to 100-word abstract and a brief biographical statement.**

2. All notes, both citations and explanatory, are to be numbered consecutively in the text and placed at the end of the manuscript.

3. Illustrations are to be considered as figures, numbered consecutively and submitted in a form suitable for reproduction.

4. Number all tables consecutively. All tables are to have titles.

5. Whenever possible, include glossy photographs which enhance the manuscript.

6. Title of article should contain no more than six words including an active verb.

7. For uniformity and accuracy consistent with our editorial policy, refer to the style rules in *The Chicago Manual of Style*.

THE BALLARD AWARD MANUSCRIPT SUBMISSION INFORMATION

The editorial board of *Real Estate Issues (REI)* is accepting manuscripts in competition for the 1994 Ballard Award. The competition is open to members of The Counselors of Real Estate and other real estate professionals. The $500 cash award and plaque is presented in November during The Counselor's annual convention to the author(s) whose manuscript best exemplifies the high standards of content maintained in the journal. The recipient is selected by a three person subcommittee comprised of members of The Counselors of Real Estate. Any articles published in *REI* during the 1994 calendar year are eligible for consideration and must be submitted by September 15, 1994.

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The Counselors of Real Estate, now in its 40th year, is an international group of high profile professionals including members of prominent real estate, financial, legal and accounting firms as well as leaders of government and academia who provide expert, objective advice on real property and land-related matters.

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Those designated as Counselors of Real Estate (CRE) have been recognized and esteemed by their peers as persons meeting the above definition in an exemplary fashion. They have demonstrated knowledge, experience, integrity and judgment in their real estate expertise. The CRE subscribes to and is bound by The Counselors' Code of Ethics and Standards of Professional Practice and endeavors to generously assist fellow CREs who are performing client services in a spirit of collegiality. Thus, the commitment to the individual client is complemented by a commitment to raise the standard of counseling practice for the industry as a whole.

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The CRE is compensated by pre-agreed fee or salary for services, rather than by commission or contingent fee. The counseling fee itself is assured and rendered for advice rather than achievement or outcome of the transaction. Overall compensation can be determined by the complexity of the service performed, its value to the client, the time and expense involved, the breadth of the Counselor's knowledge and experience, and the responsibilities assumed. **Anyone involved in real estate should consider consulting with a CRE.**

For more information on The Counselors of Real Estate, contact The Counselors' office, 430 North Michigan Avenue, Chicago, Illinois 60611; 312.329.8427; fax 312.329.8881. ■

THE LONG VIEW—A PERSPECTIVE ON THE REIT MARKET

by John McMahan, CRE

In 1993, the public securities markets raised over $11 billion in new capital for Real Estate Investment Trusts (REITs). This represented more real estate capital than was raised by any other source in 1993 and three times more than was raised by REITs during the prior five years combined. Was 1993 an aberration or is this a major first step on the much heralded road to securitized real estate? What are the implications for institutional investors regarding asset allocation, manager selection and governance, and internal staffing? For investment managers and consultants, does it require a fundamental shift in organizational strategy?

This article attempts to address these and other questions about the rapidly changing world of REITs and their role in real estate securitization. The history of REITs is briefly reviewed, followed by a discussion on the characteristics of modern REITs and why some pension fund investors find them attractive. Finally, we indulge in some crystal ball gazing to anticipate what all this means for institutional investing in the future.[1]

Historical Perspective

REITs didn't start out to be go-go operating companies with high expectations for future growth in earnings. The REIT Act of 1960 envisaged a conservative investment vehicle with "pass through" features which would encourage long term investment in real estate by individual, taxable investors. Less than half of the REITs operating in the sixties were self-advised (internally managed; no external advisor) and, even in these cases, management did not participate extensively in stock ownership. There was little market activity and not much coverage from the financial community.

In the late 1960s, Wall Street began shifting the emphasis of REIT Initial Public Offerings (IPOs) from long term equity investment to short term mortgage investment, largely in the form of construction loans. Mortgage REITs were the largest single source of capital funding for the 1971-1975 real estate boom, largely borrowing short and lending long in order to arbitrage the yield curve. This bubble collapsed in the mid-seventies and REITs became tarred with a negative image they have only recently begun to overcome. Not all of this

John McMahan, CRE, is a real estate consultant and investor. He was the founder and CEO of Mellon/McMahan Real Estate Advisors, a $2.2 billion real estate investment manager, and he served as chairman of the National Association of Real Estate Investment Advisors (NAREIM). McMahan was president of Mellon Participating Mortgage Trust (MPMT) and currently serves as a director of MPMT as well as BRE Properties, a REIT listed on the NYSE. He is a member of the faculty of the Haas Graduate School of Business Administration at the University of California, Berkeley. McMahan is a member of The Counselors of Real Estate.

was investor perception—REIT market values had declined almost 75% from their 1972 highs.

Largely as a result of the 1970s debacle, REITs fortunately missed the real estate boom of the 1980s. In the succeeding collapse of the real estate markets at the end of the decade, all forms of capital for real estate had evaporated. Developers and other owners of real estate found themselves with highly leveraged properties, often built with short term financing and no source of refinancing. With interest rates falling and real estate yields rising, Wall Street saw an opportunity to arbitrage between private and public markets.

The Kimco offering in 1991 was the first sign that REITs could play a major role in financing real estate and, more importantly, real estate operating companies. During 1991, eight IPOs involving REITs raised $808 million. A similar number was completed in 1992, raising $919 million. While this was a meaningful capital raising activity, particularly in a capital-starved real estate market, 1993 would prove to be a real turning point. Seventy-five equity IPOs raised $11.1 billion, compared with 62 issues raising $3.7 billion over the prior five years. Excluding placements of less than $50 million, 39 IPOs were completed raising $8.2 billion, approximately 14% of total IPO activity for the year in the entire securities market.

Perhaps more significant, the character of the 1993 IPOs was dramatically different. Virtually all the IPOs represented real estate operating companies, specializing by property type. The new REITs also were significantly larger—ten equity REITs had market capitalization of over $500 million (vs. two at the end of 1991) and 40 had capitalization exceeding $200 million (vs. ten in 1991). Almost two-thirds of new and proposed REITs were structured as UPREITs. Here the REIT owns an interest in one or more existing partnerships, an approach utilized to reduce the tax impact on selling partners.

Most of the 1993 IPOs were self-administered and, in many cases, management had significant equity positions, minimizing conflicts and enhancing congruency with investors. Most of the management groups had spent their careers specializing in the particular property type and had effectively worked together as a team for many years, including at least one full real estate cycle.

At year end 1993, the REIT market reflected many of the changes occurring at the individual firm level. Total market capitalization of all REITs increased to $31.6 billion (equity REITs to $25.6 billion). The 30 largest REITs measured $15.1 billion vs. $8.6 billion at the beginning of the year. REITs, however, still made up less than 2% of all privately held real estate assets.

In 1993, REIT shares continued to outperform the S&P 500 (18.7% vs. 10.1%), and dividend yields were 6.8% at year end, 83 basis points over ten-year treasuries and more than 400 basis points over the dividend yield of the S&P. REITs outperformed the private real estate market by over 2,000 basis points.

Institutional investors, primarily real estate mutual funds, provided almost one-half of the capital raised. As a result of this market activity, liquidity increased dramatically. Salomon Brothers estimated that a $1 million transaction involving 54 out of the 69 REITs they tracked could be consummated in two days or less. One percent of the outstanding shares of half the companies could be traded in the same period.[2]

The Modern REIT

Although regulations have loosened considerably over the years, REITs still must meet several fairly stringent rules if they are to maintain their REIT status.

- Have at least 100 shareholders. Five individuals cannot own more than 50% of the stock (5/50 rule)[3].
- Seventy-five percent of assets must be in real estate equity, mortgages, REIT shares or cash.
- Seventy-five percent of income must come from rents or mortgage interest.
- No more than 30% of operating income can come from properties held less than 4 years.
- Ninety-five percent of taxable income must be paid out annually.

As noted, most successful REITs are fully integrated operating companies rather than passive conduits for investor capital. Most are focused by property type and by geographical area, although the latter is changing as larger national firms come onto the scene. Retail and apartments are the dominant property type, which could account for some of the performance premium over private pension fund portfolios where office properties often dominate.

In terms of organization, all REITs must be a corporation or a trust and be managed by a board of directors or trustees. The majority of trustees must be independent of the REIT management. In fact, any major conflict of interest is usually penalized through share pricing.

As a pass-through vehicle, REITs should be expected to trade on the yield of underlying real estate assets, less a liquidity discount. Today, however, successful REIT operating companies often sell at premiums over the underlying yield, largely in anticipation of growth in earnings through development, refinancing or restructuring investments, and a shift in the yield expectations of real estate investors. The demand for REIT shares also is influenced significantly by dividend spreads over treasuries (institutional investors) and money market funds (retail investors).

Earnings usually are measured in terms of funds from operations (FOF) which is net income (GAAP), excluding capital costs, plus depreciation and amortization. Stock prices are increasingly compared to FOF flows, much the same as price/earnings ratios for non-real estate stocks.

Other factors that analysts and investors track are pay-out ratios (percent of distributable income that will be paid out as dividends), total debt to total capitalization (the market doesn't like leverage exceeding 45%), and the proportion of floating debt in the capital structure (60% of REIT IPOs in 1993 involved floating rate financing which averaged 16.3% of total capitalization).

Attraction Of REITs To Pension Investors

Pension funds are increasingly attracted to REITs as an investment vehicle. Much of this interest is no doubt related to continuing frustration with the lack of control and exit options associated with the illiquid private real estate market. For smaller plans, REITs unquestionably provide an opportunity, not otherwise available, to invest in real estate on a diversified basis with reasonable levels of liquidity.

There also is a certain attraction to the greater level of governance provided by the scrutiny of the public marketplace and the role played by outside directors. Side-by-side investment by management establishes a level of goal congruency not found in the typical investor-manager relationship utilized in the private marketplace. Some observers maintain that REITs provide more information to shareholders. While this may be true in the case of commingled funds, it is generally not true with separate accounts where the level of information is not only greater but customized to investor needs as well.

One thing is clear—REITs provide a welcome relief to the never-ending debate over the use of appraisals to establish investment value and as a way to measure investment and manager performance. In fact, there is some evidence that the performance of REIT shares can forecast changes in appraised values.[4]

In allocating assets to a portfolio, a crucial question is whether REITs behave like real estate or securities. (This is an integral part of the bigger issue—is real estate an asset class or merely an industrial sector? This debate is too lengthy to pursue here.) Most academic studies, to date, conclude that REIT returns correlate better with securities, specifically small cap stocks.[5] Since most of the REITs in these studies were small cap stocks, these conclusions are not surprising.

This is not just an academic concern. If REITs behave more like stocks than real estate, then the diversification advantage of having real estate in a multi-asset portfolio is lost or seriously diluted. In fact, the addition of REIT shares to a multi-asset portfolio may skew the performance of the portfolio by overweighing it with small cap stocks.

Where is the truth? I believe that we're simply going to have to wait to find out. Common sense would indicate that, since the income flows from REIT operations are exclusively from real estate, yields over time should perform more like real estate than securities. Perhaps with the increasing capitalization of the REIT market, future studies will confirm these intuitive observations.

Future Outlook

Over the next few months we can expect some turmoil in the REIT markets as interest rates increase and investment bankers (and investors) become more concerned with earnings quality and realistic growth scenarios. REITs utilizing floating rate financing will be particularly affected. UPREITs also can be expected to experience difficulties as they struggle to develop and implement a growth strategy. There will no doubt be several mergers and consolidations as REITs seek ways to achieve or maintain a growth pricing premium.

Generally, I expect REIT performance in 1994 to be good, but nothing like 1993. Fortunately, real estate values are still low enough to continue the REIT public-private market arbitrage strategy for at least another year, but these opportunities will become increasingly rare. On the positive side, more modest performance levels should provide a badly needed respite. The REIT market certainly does not need another major letdown like it experienced in the mid 1970s.

Over the longer term (5-7 years), I expect REITs to lead the way into a securitized future for real estate investing. There are simply too many positive features (e.g. liquidity, governance, etc.) for investors to avoid allocating at least a portion of their portfolios to real estate securities. Hopefully, this will, in time, lead to the same level of investor confidence enjoyed by the security markets.

The securitization of real estate has many far-reaching implications for current players. For plan sponsors, it means greater flexibility in establishing real estate portfolios, both in terms of portfolio management and in internal staffing to handle the process. Smaller plans and defined contribution plans will be able to effectively invest in real estate for the first time.

There has been considerable speculation regarding pension funds converting their private market real estate assets into securitized vehicles to gain liquidity. While this approach has been enhanced by the recent liberalization of the 5/50 rule, how many plan sponsors are going to want to convert at a time of improving real estate markets, particularly since, unlike developers with operating companies, pension plans cannot expect a pricing premium. Since most pension plans don't need liquidity to meet their investment goals, I doubt if many will be willing to take the additional discount in value. A similar set of circumstances may prove distasteful for private REITs trying to go public without a growth strategy premium. It may turn out to be more advantageous to sell/trade assets to an existing REIT or an IPO with a growth story to tell.

For real estate managers, securitization is a fundamental threat to business as usual. If managers do not position themselves in some manner to deal with securitization, they will witness the disintermediation of their role in the investment process and, if not corrected, possibly organizational extinction. Consultants must also transform their operations and, to some extent, their personnel to handle more complicated (and interesting) roles in the future.

Transaction players such as investment bankers, rating agencies, and accounting and law firms will no doubt continue to play strong roles. There also should be considerable growth in the role of both active and indexed real estate security managers who manage REITs and other securitized real estate. To date, these managers have been largely from security firms, but watch for new firms to emerge with a strong combination of security and real estate skills. In the retail area, a large proportion of real estate security advisors will be (or include) real estate mutual funds.

Securitization also enhances the move to international real estate investment. Public real estate companies are well established in many countries and often dominate real estate activity. Diversifying a global real estate portfolio at the share level is infinitely easier to implement than direct investment in fixed assets located in different legal and cultural environments. This will be particularly true of rapidly growing real estate markets in emerging economies.

As important a force as securitization will be, I believe it will supplement and not replace the private real estate market. Some investors will continue to prefer investing where they have greater control and believe they can achieve excessive returns from an inefficient marketplace. This will be particularly true for large players who have the market power and internal staff to successfully implement such programs. For all, REITs and securitization will bring a new dimension to real estate investing. Like an omelet, it ultimately should be very tasty, but a lot of eggs may be broken in the process.

NOTES

1. This article was originally presented to the *Institute for Fiduciary Education* in the Spring of 1994.

2. Kostin, David J., *Real Estate Investment Trusts—The 1993 REIT Explosion in Perspective*. Salomon Brothers, January 1994.

3. Recent legislation clarified that, for purposes of the 5/50 rule, REIT shareholders are the plan beneficiaries, rather than the plan itself.

4. Gyourko, Joseph, and Donald B. Keim. "What Does the Stock Market Tell Us About Real Estate Returns?", *Journal of the American Real Estate and Urban Economics Association*. Vol. 20, No. 3. (1992).
5. Giliberto, S. Michael, "Equity Real Estate Investment Trusts and Real Estate Returns," *The Journal of Real Estate Research*. 5. (1990).

THE BIG SWITCH: PUBLIC CAPITAL REPLACES PRIVATE DEBT

by Michael L. Evans, CRE

After being starved of investment for three years, almost everyone with a financial stake in real estate was eager for the capital spigot to be turned back on in January 1993. Top-tier developers and properties needed money for improvements. Lenders of all sizes knew most of their real estate loans coming due during the year would be difficult to collect. Pension funds, which had been expected to be *the* source of debt and equity capital in the 90s, mostly sat on the sidelines tending to their own portfolios. If cash-rich pension funds would not step forward at bargain prices, who would? The surprising answer was the public market.

In 1993, debt securitization came of age. Last year's red-hot equity REIT market demonstrated that the public market could supply property owners with capital, if the package was priced correctly and structured with appropriate concern for the investor. Due to a sustained low interest rate environment, higher-yield securitized pools of commercial real estate debt are proving to be popular with the fixed-yield investor. Debt pools have the added benefit of being able to segregate instruments into various risk categories. The highest tranches, or pieces, come with a high credit rating and maybe even a credit enhancement. A "B" tranche, often called the first-loss piece, carries a lower credit rating and higher interest rate. The B tranche typically absorbs all the pool's losses from foreclosure in the pool, allowing the higher AAA-rated tranche or tranches to sell and trade like a corporate bond or utility stock. Such bond-like status enables commercial real estate to tap the conservative investor as a capital source.

The flexible bundling of risk also permits a variety of structures making debt pools viable for a single building owner, a portfolio of properties, or a bank or insurance company that owns large mortgage portfolios. In the future, significant borrowers will be financing their portfolios through investment banks. The investment bank will structure a loan, throw it into a pool with similar risk-weighted loans and sell it to the public marketplace as a real estate-backed debt instrument.

According to Goldman Sachs & Co., $150 billion in commercial mortgages come due in 1994 and the number increases by $10 billion in each of the following years.[1] Most of the loans can now be securitized. Goldman Sachs estimates that 20% of the $1 trillion of outstanding commercial mortgages held by life insurance companies may be securitized by the end of the decade.

Michael L. Evans, CRE, is the national director of Ernst & Young's Real Estate Services, San Francisco, CA. Evans is a member of The Counselors of Real Estate.

The industry is creating a more uniform set of mortgage instruments with comprehensive, uniform terminology supported by information systems. For large commercial borrowers, securitized debt will be facilitated by large mortgage banking firms, investment banks and a select few insurance companies. For the small borrower, regional investment banking firms, smaller commercial banks and, perhaps, full-serve real estate companies will underwrite new loans.

Either way, the debt securitization phenomenon that began as a quasi-cooperative venture between investment banks and the RTC to resolve the S&L crisis has evolved to become a dynamic vehicle that will facilitate an orderly recapitalization of the industry. Capital is abundant in the U.S. now, and most investors—conservative or speculative, debt or equity—crave yields after a few years of essentially hoarding cash instruments. Rated real estate debt securities offer investors the high yield and the security of a credit rating.

With low interest rates, debt holders not only can refinance their debt, but also can sell off much of their liability to the public. With interest rates so low and the demand to securitize real estate so high, 1994 is sure to be a record year for securitizing private real estate debt, eclipsing the $15 billion total of 1993. The activity will spring from four areas: banks and insurance companies securitizing mortgage portfolios; corporations and institutions placing real estate into shared appreciation entities; private owners placing one property or several properties into CMOs (Collateralized Mortgage Obligations), REMICs (Real Estate Mortgage Investment Conduits), or private placement entities; and the most exciting scenario, the simultaneous securitization of equity and debt ownership.

REMICs

REMICs, initiated by Congress as part of the Tax Reform Act of 1986, were devised to provide a tax structure for the treatment of multi-class, mortgage-backed securities and were instituted to facilitate transactions in the secondary mortgage market, predominantly for single-family residential mortgage loans. At issue was the pass-through status of the issuer and the tax treatment of the securities. The REMIC formation ensures that a transaction will be taxed at the investor level only.

The REMIC is an effective vehicle for converting pools of illiquid real estate mortgages (primarily residential, to date) into capital market instruments. REMICs provide the opportunity to move assets off the balance sheet in an efficient manner by placing mortgage pools into tranches and selling them as mortgage-backed securities. Current industry conditions, combined with Wall Street's increased knowledge and expertise with real estate, place REMICs in a position to accommodate asset classes other than single-family residential mortgages and to service the need for cash to satisfy current debt obligations. REMICs provide major lending institutions the ability to diversify risk in the capital markets while benefitting from the spread between short- and long-term interest rates. Developers and property owners holding mortgage assets have used REMICs as a way to finance the buyout of bank and RTC debt at a discount.

REMIC Structure

The REMIC must be collateralized by a static pool of loans. These loans are ultimately tiered based upon mortgage portfolio requirements and pooled by property type, loan size and common underwriting standards. Once the portfolio reaches a particular size, the mortgage pool is securitized through a REMIC. The primary focus is on the actual mortgage and the underlying collateral cash flow, rather than the product itself. Pricing and structure is based on the evaluation of specific mortgages, cash flow from collateral and projected performance of mortgages and collateral.

The mortgage pools are placed into tranches reflecting the risk of the prevailing mortgages. The investment bank evaluates individual loans and the overall quality of the portfolio. A mortgage must be assignable and should be in a first-lien position. Any participations are likely to make it difficult to offer for sale a REMIC vehicle, and may be perceived negatively by the rating agencies. The basic question due diligence seeks to answer is whether the quality of the underlying real estate collateral and its reserves are capable of generating sufficient cash flows to service the debt.

The REMIC transaction involves detailed levels of due diligence, standardized accounting practices and institutional gradings and disclosures, which provide a means to evaluate competitive investments and ease investor concerns. The REMIC is easier and less expensive to initiate than other recapitalization transactions such as REITs.

Agency Ratings

REMICs are independently rated. Each rating agency imposes its individual standards to evaluate the quality of a mortgage portfolio. A particular REMIC can be structured with multiple tranches, each tranche receiving a different rating. Ratings are determined by debt/equity ratios, cash flow/debt service ratios and product type. For example, the risk associated with a portfolio of commercial or multi-family mortgages is greater than that of residential real property mortgages.

Future

The need for liquidity has pushed the use of REMICs to new asset types. Mortgage conduits will be utilized as a means to originate and refinance a diverse range of real estate loans, including shopping malls, apartment projects and commercial office properties. Over the past two years investment banks primarily have pooled multifamily residential mortgages. Retail, followed by commercial, is considered the next most attractive form of real estate debt in terms of risk. REMICs also are being used as an instrument for securitizing the mortgage debt portion of REITs. Mortgage conduits allow institutions to underwrite loans as part of the overall portfolio strategy.

The future of the REMIC vehicle appears robust as the real estate industry strives for liquidity and looks to this instrument for securitizing commercial and multifamily debt, and investors continue their intense interest in mortgage-backed securities.

Simultaneous Securitization

To make equity REITs attractive to investors, underwriters structure the offerings so they are not overburdened with excessive debt. Underwriters learned in 1993 that they could reduce the REIT's debt obligations even further by securitizing the debt through a public or private placement. Town and Country Trust, an equity REIT that Goldman took public in August 1993, effectively pioneered the simultaneous debt securitization offering. Low interest rates were a driving factor. The portfolio owned 32 apartment complexes in Washington, D.C., Baltimore, and southeastern Pennsylvania, boasting 92% occupancy and carrying $375 million in existing debt. About $113 million from the IPO (Initial Public Offering) proceeds were used with an outside line of credit to reduce the existing indebtedness to $232 million.

Rather than turn to a conventional lender for the reduced debt pool, which would have been fairly easy given the IPO proceeds and the portfolio's health, Town and Country created a subsidiary which initiated a $232 million loan to purchase all the individual property mortgages. The subsidiary then put together two tranches of the $232 million and sold them to the public. The first $185.6 million rated tranche carried a 5.85% fixed interest rate for five years; the less secure $46.4 million piece carried a floating rate of LIBOR plus 0.6%. Buyers of the second tranche assume the most significant part of the risk. Instead of having to borrow the entire debt obligation at an index rate, plus 2 points from a conventional lender, the owners reduced interest on 20% of the obligation, freeing up more capital for operations. Public investors, instead of a single institutional lender, assume the risk at an interest rate more favorable than that of a government security.

This type of structure applies to senior rated debt—not CMOs where you can have 15 or 20 tranches and different classes of properties. Surprisingly, buyers of the riskier tranches have been private investors, family trusts and some pension funds that want to diversify their investment portfolios. The floating debt notes have been priced 75 to 150 basis points over LIBOR, pushing the investor's return to about 6.5%, well above what the same investor can receive from Treasury bills. As interest rates rise, however, some investors may be more comfortable with a 6%-7% return from a government security.

Mortgage Portfolio Securitization

Once the largest lenders in real estate, life insurance companies now face a changed environment. Due to the imposition of the risked-based capital rules, insurers are likely to maintain higher reserves on their investments as of January 1994. The new requirements call for a 15% risk-based capital reserve on foreclosed real estate equities, a 10% reserve on investment equities and a 3% reserve on unrated mortgages. If those assets are securitized, the reserve requirements may drop. A life insurance company, a client of Ernst & Young's, sold $800 million of its performing loans to avoid maintaining millions in reserves for its real estate portfolio.

The tranched system of putting the risk into the lower level plays right into life insurers' hands. Regulators do not permit financial institutions to treat real estate loans as sold unless the first-loss piece (equity) is off their books. For example, in the offering mentioned above, the lower tranche would absorb all the risk and the insurance company would own nearly all the remaining rated debt. The yield may be lower than the interest rate on the existing mortgages, but the insurer no longer has to worry about potential workout situations or additional loss revenues.

Private Owner Conversion

For many owners, debt securitization offers the potential to refinance one property, several properties, or an entire portfolio at very attractive rates. Whatever the choice, underwriters still expect to underwrite only performing mortgages. Underwriters are not looking at the old interest rate in accepting properties. If cash flow from the property wasn't adequate to cover the old rate, it's probably not going to be capable to do so at the new rate. These are not ways to squeeze the last dollar out of a property.

In all debt securitization offerings, owners need to present historical cash flows from each property, identify and cure property deficiencies prior to securitization, and be prepared to project future market conditions that could impact the quality of collateral. Projecting cash flows for five to 10 years is expected.

Conclusion

Between 1990 and 1992, some of the biggest debt securitizations came from purchasers of RTC property portfolios and mortgages. Buyers like GE Capital purchased the RTC's assets with the intention to work out each loan and reposition each property as needed. Once the restructuring was completed, the purchasers fully expected to securitize the debt. With the RTC assets, the government and taxpayers absorbed the property's plunge in value. The difference in 1994 is that the low interest rate environment allows performing assets to be recapitalized and priced according to true market value, attracting much needed capital to real estate. Ironically, rising interest rates historically have accelerated real estate appreciation and subsequent investment. Though low interest rates have not done much for appreciation, they have ignited investment by the public.

NOTE

1. Brueggeman, William B., "Impending Correction in the Commercial Real Estate Mortgage Market: Its Magnitude and Timing." *Real Estate Research*, Goldman Sachs & Co., March 1993.

THE WASHINGTON REIT STRATEGY: FINANCING, INVESTMENT AND MANAGEMENT*

A Case Study

by John L. Glascock and Susan M. Wachter

We thank participants of the Homer Hoyt Advanced Studies Institute seminar on REITs, January 1994, for their helpful comments. We especially thank Bob Franks, Maury Seldin, CRE, Hal Smith, CRE, and Ron Racster for their assistance. Special thanks also to Tony Edwards of NAREIT for his editorial input, and to Frank Kahn of the Washington REIT for meeting with the authors and providing information on WRIT.

*We caution the reader that this research is the authors' interpretation of WRIT's strategy and does not necessarily reflect the opinions of WRIT executives or staff.

Of the 245 REITs identified by the National Association of Real Estate Investment Trusts (NAREIT) for the 20-year period 1972 to 1991, only 16 existed for the entire time.[1] The average exchange listed real estate investment trust (REIT) existed for less than ten years and the portfolio of REITs had a 20-year annual compound return of 8.59%; equity REITs had an annual compound return of 9.55%. By contrast, the Washington REIT (WRIT) had an annual compound rate of return of 16.04%. Why the difference? Why has the WRIT consistently outperformed other REITs? Frank Kahn, WRIT's chief executive officer, says it is because of WRIT's unique and steadfast strategy of low debt, concentration on growth, attention to management, diversification across property types, commitment to quality properties and the firm's commitment to its investors[2].

The research described in this article attempts to outline the WRIT strategy: financing, investment and management. It concentrates on the financing and investment aspects of strategy, but management and governance issues are identified. The source data is from annual reports and financial statements from the WRIT and personal conversations with Frank Kahn, other WRIT officials, and industry analysts. The purpose of the research is threefold: to identify the key ingredients in WRIT's strategy, to elaborate these ingredients in terms of principles and to develop testable implications.

WRIT's Corporate Strategy

Financing

WRIT takes a unique approach to financing real estate. It prefers to finance with equity capital and to issue that capital to noninstitutional investors. Thus, its conservative management and growth oriented investment policies afford a low cost of equity capital[3]. That debt reduces its flexibility to undertake, maintain and control the investment mix.[4]

John L. Glascock *is the Louisiana Real Estate Commission Chair of Real Estate at Louisiana State University, where he is professor of finance and real estate. Professor Glascock is currently serving as interim dean of the College of Business Administration at Louisiana State University. He serves on the editorial board of the* Journal of Real Estate Finance and Economics *and the* Journal of Real Estate Research. *Professor Glascock is secretary-treasurer of the American Real Estate and Urban Economics Association.*

Susan M. Wachter *is associate professor of finance and real estate at The Wharton School of the University of Pennsylvania and associate director of the Wharton Real Estate Center. A former president of the American Real Estate and Urban Economics Association, Dr. Wachter serves on the Board of Editors of* Journal of Housing Economics, Journal of the American Real Estate and Urban Economics Association *and the* Journal of Real Estate Finance and Economics. *A Fellow of the Homer Hoyt Institute, Dr. Wachter also serves on the Board of Directors of MIG Residential REIT and Beneficial Corporation, and on the Housing Policy Research Advisory Board of Fannie Mae.*

Low Debt Policy
Kahn says that a key part of WRIT's strategy is the maintenance of a low- to-no-debt policy. This seems contrary to conventional wisdom in real estate investing. First, real estate is considered to be low risk and thus appropriate for leverage potential, and second, leverage offers tax shields. However, WRIT offers answers to these traditional notions. Real estate is not a sure thing and thus always has inherent risk not only from the business cycle fluctuations in realty use, but from potential structural shifts in demand from sources such as office hoteling and space reductions from technological innovations, etc. More importantly, risk comes from the operating company. The REIT can be, and often is, organized in a way that affords significant management fees and adverse incentive problems. Also, there is interest rate and refinancing risk over the business cycle.

Next, the tax benefits of debt to REITs are unclear. In a REIT, 95% of the net income is passed through to the stockholders and not taxed at the corporate level. Thus, the normal tax benefit at the corporate level is not available for the REIT organizational form. Howe and Shilling (1988) make a similar argument in their research on REIT capital structure and security offerings.[5] Capozza and Lee (1994) provide an empirical investigation of the debt benefits to REITs and find no positive association between debt and REIT value.

Lastly, debt offers a firm the opportunity to grow too fast. In an expansive market, debt will allow the firm to concentrate on expansion instead of operations; a pay as you grow policy will constrain management to expand slower and accept the better opportunities. Thus, the lack of debt may reduce the hubris investment problem. For example, Roll (1986) indicates that management may be too optimistic in terms of valuing potential takeover targets. In the same context, Kahn argues that firms may be too optimistic about both their internal and external growth potential and that debt allows them to grow too rapidly—both in terms of selecting projects that have insufficient return and in terms of ability to manage the acquired assets and their debt.

In addition to the arguments made by WRIT's management, the finance literature also offers reasons for low-to-no-debt policy. Smith and Watts (1993) find that industries with high growth potential are characterized by low debt, low dividend payout and low dividend yields.[6] The general thesis is that higher growth firms do not want to give extra value to the bondholders and also do not want restrictions on their ability to achieve the potential higher returns from growth.[7] Thus, to the extent that REITs, such as WRIT, have significant growth opportunities, there is reason to pursue a low-debt policy.

Non-Institutional Equity
WRIT consistently attempts to avoid institutional investors. Road shows are seldom undertaken to educate institutions about WRIT; rather individual investors or institutions rely on the record. Even with this lack of institutional investors, WRIT has succeeded in getting the message out to the public through investment houses and brokers. WRIT consistently receives buy recommendations from industry advisory groups.[8]

While WRIT consistently has achieved a market for its shares and continues to receive good reviews from industry analysts, why does WRIT not favor institutional shareholders? Kahn indicates that institutions have a stronger preference for immediate high yields that would tend to push a REIT into more speculative investments. This is contrary to a more conservative steady long-term growth oriented approach that is favored by WRIT.

This is potentially in contrast to finance theories which suggest that large insider holdings and institutional holdings may help monitor management behavior. For example, Demsetz (1986) argues that large shareholders who are non-management insiders, help to effectively monitor firm activity. The implication is that ownership concentration may lead to increased firm value. This is consistent with Stulz's (1988) work which suggests that high levels of insider holdings tend to make effective management changes difficult.

Investment
WRIT pursues an investment strategy that has two components: long-term growth potential and niche selection. The key to a sustained growth policy in dividend payout and acquisition is to create an increasing cash flow from growth in operating income. WRIT rarely sells a property[9] and never for cash to meet dividends or operating considerations.

Long-term Growth Potential
WRIT attempts to select properties with growth in earnings potential. Typically, a new acquisition will be where WRIT management already has expertise and some expectation on the improved uses of the property. Thus, growth appears to be more from understanding the market niche than from general market growth already priced by analysts in existing property values. A good example is the acquisition of the office complex at 7700 Leesburg Pike. This complex had a poor market profile, a lack of adequate design for movement of office workers and client traffic (for example, one elevator serving two wings of a semi-circular building), and an undefined market niche. WRIT viewed 7700 Leesburg as a destabilized property (having an occupancy rate of just over 60%), and thus expected to buy the property at a price that would allow reasonable

rents even after renovation of key property components. The location's plan was for a primary office complex of small business tenants. It was expected that a reasonable price for the property would allow the WRIT officials to compete with good rents in the small office space market. Additionally, they put money into the property to remedy the existing functional obsolescence. Walls were moved and a second elevator was installed to allow for more convenient client access. The office complex was stabilized as of mid-1993 with 100% occupancy of existing space achieved by late 1993. There are plans to expand the rentable area of the building. Thus, growth has been achieved in three ways: more tenants for current space, higher rents due to better services and functional building improvement and more tenants expected after the expansion.

Niche Concentration

WRIT officials believe in staying with what they know. Deals have been offered from Baltimore to New York, and all have been consistently declined. Their philosophy is to buy what they understand, buy with a purpose in mind, buy with expected growth in revenues from rent increases and square foot expansions and manage within the focus. WRIT's niche involves two aspects. First, to remain primarily in the DC metroplex, a market essentially within a one hour drive from the home office. Second, to own and manage what are known in the industry as B-grade properties. These properties are mid-sized and mid-priced, serving primarily higher scale local and national tenants in non-prime but select locations and generally in need of quality management for success.

Concentration on known areas of expertise is supported by research in the management literature. Prahalad and Hamel (1990) argue that successful corporations concentrate on core competencies. Ehrhardt (1994) also argues that firms should reject apparent net present value projects that are not aligned with their strategic goals. He argues that cash estimates and potential outcomes have higher risk because the firm does not have experience with such projects. Thus, there may be a tendency to overestimate revenues and underestimate costs. Both Prahalad and Hamel's and Ehrhardt's arguments are consistent with WRIT's philosophy and Roll's thesis (called the hubris hypothesis) that firms tend to pay too much for acquisitions.

Diversity Across Property Types

WRIT attempts to diversify across property types, but does not diversify across economic regions. Property type diversification has been shown to have significant risk-return benefits. For example, Miles and McCue (1982) found the correlation coefficient between REITs that held office property versus REITs that held retail property was 0.48. Firstenberg, et al, (1987) also found that property type was crucial in determining the best trade-off in constructing an efficient investment frontier. However, none of these studies demonstrates why investors could not create their own diversified portfolio of REITs which individually concentrated on single property types. There is also evidence that economic geographical diversification is useful (see the works of Hartzell, Heckman and Miles [1986] and Hartzell, Shulman and Wurtzebach [1987], and Pollakowski, Wachter and Lynford [1992] for details).

Thus, in general, we believe there is no reason to expect that such benefits will accrue to firms that pursue strategies where investors can choose portfolios from the market of undiversified REITs. An exception is those instances where the market is too thin to allow efficiency in operating individual real estate firms for each property type.[10] For example, in a small town, sales agents tend to sell all types of property, whereas in larger metropolitan areas, there is specialization in property types sold or managed. A second possibility is that the workers, including management, of the firm believe the diversification protects their human capital since there is less likelihood of a layoff during downturns. In this case, the market is indifferent, but it would be expected to reflect such insurance coverage in the firm's compensation structure.

Operational Management

WRIT seems to concentrate on three principles: low overhead, trim staff and direct executive involvement in day-to-day and long-range operations. Kahn is directly involved in weekly operation decisions and is critically involved in all acquisition, renovation and disposition decisions. Thus, WRIT resembles a closely held family business with a strong key manager structure.

Organization Form And Corporate Governance

WRIT asserts that it has a better equity cost of capital because it reduces agency costs between stockholders and management by having clear ethical standards and a straight-forward compensation program for management. For example, management cannot benefit from sales or property acquisitions or management fees other than salary and bonuses from normal operations. While this is an important issue for strategy and governance, all the important variables in this area are not identified, and this area needs further research.

Testable Implications

While many aspects of WRIT's strategy seem to involve clearly acceptable concepts, most are not testable within a finance frame. Questions as to management concentration on niche markets and key manager structures are difficult to identify and empirically test. Additionally, while finance cannot verify the concept of niche specialization, there seems to be evidence from the management literature that suggests successful firms concentrate on their areas of core competencies. However, some aspects of the strategy offer clear implications for finance.

Financing: Low-Debt Policies And Institutional Investors

Does debt have any benefits for REITs? In a normal corporation, debt traditionally is thought to provide tax and monitoring benefits. Stewart Myers (1986) provides a good overview of the potential benefits and costs of debt financing for traditional corporations. Tests for the benefit of debt can be structured to analyze REIT returns across firms with different debt structures while holding other differences constant. One problem in studying REIT returns and debt over the past few decades is that, ex post, government policy favored a low debt ratio.[11]

Second, does debt policy depend on investment opportunity? Are REITs like other firms that exhibit lower debt, lower payout ratios, etc. when higher growth opportunities exist? An interesting question is whether debt capacity encourages bad investment decisions for firms with high growth potential? The benefits of debt can be tested by controlling for expected growth using a market value to book value ratio. If firms with high market-to-book ratios have a low or negative coefficient on the debt variable, the implication is that debt potentially dilutes the firm's efforts under growth circumstances.

Investment: Property Type Diversification

The question of diversification and firm value has been well studied in economics and finance, but is real estate different? According to theory, real estate is like other assets and that firms which specialize in real estate likely will respond in a traditional manner. Thus, it is expected that diversification can be achieved by individual investors without assistance from firms or REITs. However, there may be circumstances which allow for a second best solution[12] where REITs and other firms benefit from property type diversity.

In large metropolitan areas, real estate firms have specialized staffs. Sales associates typically specialize in residential or commercial sales and even specialize in particular types of housing or property and geographical areas. However, in small towns, sales agents handle all. The Washington metropolitan area seems to be large enough to afford specialization of investment while allowing specialization and scale of management. Thus WRIT's property type diversity provides no unique advantage from a finance theory perspective. However, WRIT argues that the benefits of property diversification over the business allows for better management of their assets and for more stabilized growth.

Corporate Governance: Reduction In Agency Costs

One of the recent developments in economics and finance research is the notion of agency relationships and their costs in a corporate framework. Jensen and Meckling (1976) demonstrate that organizational form and agency relations influence the value of the firm, and Glascock and Turnbull (1994) demonstrate that the structure of the firm will be influenced by incentive compatibility conditions.[13] REITs and their various management forms, including the UPREITS, offer a rich data set for examining valuation effects of governance forms. Three key questions occur.

First, do REITs with widely held, but individually shallow stockholding and a strong manager with significant shares create, in essence, a closely held firm with potential key executive management problems? What management transition policy does WRIT have? What are the implications for REITs in general?

Second, do UPREITs create additional agency costs that are reflected in stock values? An UPREIT results from the combination of several partnerships into a single limited partnership, called the operating partnership, and the formation of a REIT which is the general and managing entity of the operating partnership. The operating partnership generally owns the property and the REIT owns shares in the operating partnership along with the limited partners. It is usual, but not required, for the REIT to be the majority shareholder of the operating partnership. The limited partners of the operating partnership have the right to sell their shares in the operating partnership to the REIT either for REIT shares or cash at the option of the REIT. However, the REIT does not have a forced conversion right. This arrangement allows the REIT to operate as a tax qualified REIT and also allows the partners, in general, to time their recognition of gain or loss on their partnership shares. As long as the limited partners leave their shares in the operating partnership and do not exchange their operating partnership shares for REIT shares or cash, they recognize no tax loss or gain on their shares, unless they are deemed to have been discharged of any of their share of debt of the previous partnership(s) that were folded into the operating partnership.[14] Thus, the value of the REIT may depend on the timing of the conversion of the limited partnership shares and the form of payment for those shares. Do offerings of the REIT shares in an UPREIT organization behave similarly to traditional REIT shares? If UPREITs are more risky, is the bid-ask spread larger to reflect more risk to the market-maker?

Third, are REITs that allow acquisition and disposition-based compensation different in stock pricing or return behavior? How do compensation of REITs differ from traditional firms?

Summary

The research in this article provides a description of WRIT's financing, investment and management strategy and indicates areas for analytically testing of the key components of WRIT's strategy. The effort concentrates on the financing and investment questions, but indicates that research also is needed in the areas of management and corporate governance. Kahn indicates that WRIT's success is due to its policies of low debt, growth investment, quality management, diversification across property types, quality property selection and commitment to its investors.

Many of these contentions are not directly testable, but some of WRIT's tenants of operation find support in the management as well as finance literature. Concentration on niche markets is supported by the work of Prahalad and Hamel (1990) who suggest that successful firms pursue areas of core compentencies and Ehrhardt who (1994) suggests that firms should concentrate on projects that support their strategic goals. Research by Howe and Shilling (1988) and Capozza and Lee (1994) supports Kahn's argument that debt may not provide REITs with increased value. Thus, many of Kahn's arguments are supported by academic theories and empirical studies.

REITs, with their various forms of operating companies and compensation schemes, offer a rich data set for studying valuation effects and governance forms. If WRIT is correct, straight-forward compensation schemes for management will be associated with higher equity values for investors. Additionally, is WRIT right in its approach to raising equity capital?

Overall, this research has provided an overview of the strategy and operational philosophy of a successful REIT and indicates there is a strong relationship between successful REIT policies and policies suggested by traditional academic research.

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NOTES

1. For detailed analysis of NAREIT identified REITs, see Glascock and Hughes (1994). Also see Gyourko and Siegal (1994) for a description of REIT returns from 1962 to 1993.
2. While we review the literature for support and contradiction of the various aspects of WRIT's strategy, we do not explicitly consider direct alternatives. This is particularly important in the issue of low-to-no-debt policy. What, for example, is the alternative strategy? Should firms pursue a maximum debt policy? While we believe that these are important questions, this research is limited primarily to a description of WRIT's strategy and general research that exists in the literature as well as future implied research that would help determine the goodness of that strategy.
3. For example, WRIT issued equity at $17 a share in 1992 which was 22 times earnings, and Kahn suggests that he has equity to invest at a cost of 4.55%. Of course this view of the cost of capital ignores the implicit expected growth component of the total cost of capital. However, Kahn tells us that the low cost of equity funds in terms of dividends helps the firm to achieve the needed growth in earning and therefore stock price. He believes that the successful firm observes an interaction between the cost of funds from the equity market demanded in terms of dividends and the ability of the firm to achieve the needed growth. The interaction is important in that lower dividend requirements afford the firm necessary flexibility to achieve growth. A firm that cannot demonstrate growth will be further limited by higher dividend requirements from the market.
4. One of Frank Kahn's favorite examples is that of other REITs that leveraged significantly during the last business real estate cycle only to find themselves forced to refinance during high interest periods. Kahn argues that such inopportune refinancing reduces flexibility in both management and investment actions.

5. There is some controversy in that Jaffe (1991) provides a theoretic argument which suggests that the capital structure of the REIT should be independent of its value. However, his case is based on reasonably strong assumptions about arbitrage opportunities and other aspects of the process.
6. Smith and Watts also argue that such firms will have more reliance on stock based compensation plans and higher levels of executive compensation than low growth potential firms.
7. This is also consistent with Myers' (1977) argument that firms with risky debt outstanding have less incentive to invest in positive net present value projects because these projects provide a redistribution of wealth from stockholders to bondholders.
8. Ferris Baker Watts and Wheat First Securities recommended buying in October 1993; A. G. Edwards & Sons issued a buy recommendation in June 1993; Dean Witter Reynolds recommended buying in September 1993; and Alex. Brown & Sons suggested buying in November 1993.
9. A recent sale of the firms original corporate offices was facilitated by a change in highest and best use. The property had higher market value as a restaurant and WRIT does not operate restaurants. Thus, the firm sold the property and recognized the appreciation. If the gain had been in WRIT's normal operating properties (e.g. a shopping center or office building), WRIT would have recognized the gain in increased rents, not from the sale.
10. We thank Jeff Fisher for providing this insight at a recent Homer Hoyt Seminar presentation of an earlier draft of this research.
11. This occurred primarily because of the volatility in government tax policies that first extended, then reduced, and then further reduced the depreciation benefits of real estate. Additionally, lending policies by banks that were encouraged by government policy led to a volatile market for real estate assets. Low debt individuals, as well as firms, tended to survive this period.
12. Potentially, there are not enough REITs in the Washington, DC area to allow diversification across property types, and thus the Washington REIT can provide some diversification to the investor by owning and operating various types of real estate.
13. Glascock and Turnbull (1994) show that differences in incentive compatibility conditions offer an explanation for the prevalence of owner-operated small real estate rental units.
14. Consult the IRS Code or a tax attorney for complete details of when gains or losses may be required to be recognized by the IRS.

CREATING A MORE EFFICIENT REAL ESTATE CAPITAL MARKET

Ivan Faggen, CRE and
Craig J. Faggen

The United States economy is the most powerful in the world. Its success can be attributed to a number of important factors, however, none are more important than the ability for U.S. corporations to access capital when needed. In the U.S., debt and equity issues can be registered with the Securities and Exchange Commission to create public ownership. Along with a number of well respected stock exchanges, corporations can be listed which enable the shareholders to have absolute liquidity regarding their investments. In addition, corporations have access to private market capital through the issuance of commercial paper and other similar financial instruments. All of this capital market activity is based upon full disclosure of historical financial data.

It is widely believed that the value of a stock share, or some other security, is equal to the present value of future streams of cash flow discounted at a rate commensurate with the risk inherent in the projection. In reality, corporations do not publicly project cash flows, and investors are ill prepared to make such estimates based upon obtainable data. What really happens is projections of cash flow are made based upon extrapolations of present levels of earnings determined by anticipating how the market will react in the future to the products of the corporation.

Let's contrast the way real estate and corporations obtain capital. At the present time, only a very small proportion of the capital needs of the real estate industry are provided by an efficient marketplace where there is sufficient data provided to all participants to make rational investment decisions. Real Estate Investment Trusts (REITs) and debt securitizations are exceptions to this statement, but they only represent a small percentage of the total capital in the real estate marketplace. Similar to corporations, the value of a property is the present value of its future cash flow. This valuation technique has become the most widely used method in the United States for providing valuations of income producing property. Real estate's hard asset designation enhances analysts' ability to value the property by examining a finite number of

Ivan Faggen, CRE, is a partner in the Los Angeles office of Arthur Andersen & Co., and he is the worldwide director of the firm's Real Estate Services Group. Faggen is a recognized authority in the real estate industry. He is a frequent speaker at leading national and regional conferences, and he has written numerous articles for industry publications. Faggen is a member of The Counselors of Real Estate.

Craig J. Faggen is completing a master of science degree in real estate at Massachusetts Institute of Technology. Previously, he was a senior associate in the Real Estate Capital Markets Group at Arthur Andersen & Co., Los Angeles, responsible for REIT offerings, securitized debt offerings, portfolio restructuring and corporate real estate services.

leases (which account substantially for all the revenues) and by reviewing general market conditions. Therefore, a strong argument could be made that it is much less difficult to analyze and project future cash flows from a real estate asset than it is from a corporation.

If future cash flows can be accurately estimated for a single real estate asset, then it is also true that such cash flows can be projected with increased accuracy for a pool of real estate assets. This pooling of properties reduces the variance of return on the assets due to the coefficient correlations between the individual assets, and it allows for more reliable projections by applying the outcome probabilities on a pool of properties. While real estate is subject to better analysis of future cash flows than most corporations, the capital markets for real estate would have to be judged as inefficient, whereas the capital markets for corporations could be judged as efficient.

If the real estate industry can develop techniques which create a more efficient marketplace for accessing real estate capital, the results would be dramatic. Significant amounts of capital, previously unavailable to real estate, would be allocated to real estate securities. The result would be a decrease in the cost of capital to the industry, with the long term effect of increasing the value of the present stock of buildings and reducing the cost of occupancy.

Why Is The Market Inefficient?

Traditionally, real estate debt came from banks and insurance companies on a single asset basis. Loans were made based upon data provided by the borrower relative to the asset or the project including projected future cash flows, debt coverage and an appraised value. Equity was provided by risk oriented investors, often in the form of partnerships or joint ventures, or by institutions such as pension funds. Debt and equity were essentially project related. The providers of capital often were motivated by their availability to put funds into the marketplace as opposed to strenuous and expert underwriting of the financial performance for the asset being financed.

Largely due to the availability of excess amounts of capital and a lack of underwriting skills on the part of the capital providers, the industry was able to obtain excessive debt and equity financing, which resulted in an overabundant supply of properties. Over the past 15 years, this inefficient way of allocating capital to the industry has resulted in exacerbated cycles which, in turn, caused enormous economic capital losses. Although we are not aware of any statistics to support the previous statement, we are firmly convinced that the insurance and banking industries have suffered net losses from real estate investment activities over the past 15 years. These losses resulted primarily from their inability to quantify the risk inherent in property investment, be it debt or equity. In our view, institutions will be reluctant to provide capital for real estate markets unless they are offered more comprehensive dependable financial data, less risk and higher yields.

Can Real Estate Capital Markets Become Efficient?

There is evidence that real estate capital markets can attain a high degree of efficiency. For many years the residential housing market has enjoyed access to an abundance of low cost funds through the securitization of residential home mortgages. A very sophisticated secondary market has been developed for such securities. The efficiency in this residential mortgage marketplace has resulted in many benefits to borrowers, lenders and the consuming public. Today, it is considered very desirable for banks and mortgage lending entities to originate mortgage loans in a volume that exceeds their portfolio requirements. The process of origination and servicing has become a profit center creating significant competition in the marketplace which is beneficial to developers and consumers of homes. In order to improve the credit rating of these mortgage-backed securities, government and quasi-governmental agencies have been established to offer credit enhancement. These entities have made large profits from credit enhancement fees. An enormous marketplace was established for the securities due to the overall low risk profile of that marketplace derived from capital sources which did not traditionally invest in residential real estate loans. The residential mortgage securitization marketplace has proved itself to be efficient and beneficial to the parties involved.

What About Securitization Of Commercial And Multifamily Residential Projects?

Until recently, this was impossible for the following reasons:

- It was believed there was substantial risk in relying on the projected cash flows.
- Because of this perception, there were no credit enhancers in the marketplace.
- Without credit enhancement, only a portion of the cash flow from the underlying collateral would qualify as investment grade financial instruments. This led to the concept of tranching commercial real estate securitizations into segments with different ratings and returns.
- There was no available and ready market for non-investment grade tranches.
- There were relatively few pools of cohesive real estate assets available to securitize.

Has The Situation Changed?

The answer is clearly yes, but not to where we have an efficient market for real estate capital. The barriers previously described were overcome effectively when, in 1992, the Resolution Trust Corporation (RTC) developed its commercial securitization techniques. The RTC was charged with disposing of real estate assets to the private sector, rather than maximizing values for such assets. Therefore, it had the opportunity to create a securitization marketplace where the noninvestment grade tranches could be sold to investors who were expecting to realize an extraordinarily high return from their investment. This was an extremely efficient way for the RTC to dispose of huge portfolios of real estate assets into the private sector.

The success of entrepreneurial buyers of portfolios, where the portfolio cash flows were securitized, caused significant interest by many to be involved in these types of transactions. Competition for the portfolios was quickly established, and within a short period of time, the pricing to the RTC had improved dramatically. Financial institutions with large portfolios of real estate debt and foreclosed assets watched with interest as the market for pools of assets was established. Several of the largest commercial banks and insurance companies, with significant exposure to real estate assets, began to contemplate the portfolio disposition strategy, the buyers being the same as those interested in the RTC portfolios. Such buyers would either securitize the portfolios, with the investment grade or near investment grade tranches sold in the marketplace, or would securitize the portfolios selling all of the tranches.

At present, the RTC and the financial institutions essentially have dealt with most of their portfolios of real estate assets appropriate for the securities marketplace. The buyers of these portfolios, though, have not even come close to satisfying their appetite. Financial institutions now are originating mortgages to create pools for securitization. We are beginning to see the same elements in place for commercial real estate securitizations as previously were present for single family, residential mortgage securitizations.

To give this credence, there is a substantial increase in the amount of securitized debt emanating from the commercial real estate market. In 1991, there was less than $5 billion in commercial mortgage-backed securities (CMBS) issued. This increased to approximately $12.5 billion in 1992 and reached an estimated $17 billion by year-end 1993. Although this trend clearly indicates an increase in the amount of commercial debt securitization, CMBS still only represent approximately 3% of the more than $1 trillion of commercial mortgages outstanding. The potential for short term increases in the issuance of CMBS is enhanced by the estimated 30% of existing commercial mortgages that are expected to refinance over the next two years.

Although the market for equity securitizations appears to be much smaller than for debt securitizations, it has taken on an important role for raising equity capital with attractive pricing in recent times. This has occurred primarily in the form of Real Estate Investment Trusts. These financial vehicles for raising equity have been well received due to their professional management, high quality real estate portfolios and enhanced liquidity.

Why Does Securitization Work?

An efficient real estate capital market provides enormous benefits to the industry. There is clear evidence that looking to pools of assets for raising capital significantly reduces cost of financing and increases the amount of capital available to the asset class.

Securitization of debt, which appears to be the most efficient way to raise capital for real estate, works for a number of complex reasons.

- There is an understanding by the market that the risk profile is reduced significantly when a number of comparable assets are pooled. Studies of recent transactions would indicate there is a large reduction in the cost of financing a pool of real estate assets, as opposed to single assets.
- The market recognizes a further reduction of risk when the entity that controls the collateral for the securitized debt is governed in the same manner that a corporation is governed. Typically, such entities have policies and procedures to ensure that all aspects of its business are dealt with by highly experienced and qualified personnel, and that a default by the borrower would be professionally handled. In addition, there also would be assurances that the debt is serviced in an appropriate manner and that distributions are made to the various tranches in accordance with their terms.
- The quality of the cash flows that support the securitization generally is reviewed by a number of highly competent parties prior to issuance. The investment banking firm that is underwriting the securities takes on a significant amount of responsibility for the reliability of the current cash flow data and for the future expectations. Generally, a rating agency is involved to assess the recovery assurance of both principal and interest of the various tranches. The ongoing monitoring by the rating agencies will enable the holders of the debt securities to accurately value their interest in the debt securitization. Finally, all commercial real estate securitizations require a significant amount of due diligence oriented services from highly qualified third parties.

These would include valuations of the underlying collateral and a highly structured review of the potential for gain or loss of revenues from the collateral as a result of future events. Examples of the issues that are reviewed by third parties would include lease rollover risk, tenant quality assessments, general market conditions and the competitive environment.

- The market appreciates the increased liquidity that results from securitizing debt. The investment grade pieces trade at small variables from competing securities. These tranches are highly liquid. The noninvestment grade tranches appear to have more liquidity than the instrument as a whole loan. An additional advantage of the securitization is the ability to sell various denominations of the loan as opposed to selling the whole loan or a group of whole loans to a single entity.
- The concept of securitization opens up or expands markets. Institutional investors are able to design portfolios that mix and match tranches to accommodate a desired risk profile. This opens up a strong new market in the pension industry which can now obtain an appropriate percentage of the portfolio in noninvestment grade tranches to accommodate their portfolio needs. Life insurance companies will benefit from the previously mentioned reasons along with a reduction in the risk based capital requirements for many of these securities as opposed to whole loans.

Securitization of equity offers many of the same benefits as securitization of debt. These include:

- Reduced risk profile
- Corporate governance & professional management
- Underwriting of cash flows, but generally without the involvement of rating agencies
- Liquidity, to even a greater degree than debt
- Expanded market segments to obtain capital.

Conclusion

The creation of greater efficiency in the capital markets for real estate is essential to the success of the industry. We have just weathered a severe recession and have lost significant credibility in the marketplace. The use of debt and equity securitization, backed by highly professional financial analyses and valuations, cannot only regain the credibility needed for success, but it also can expand the way we approach capital markets, reduce the cost of capital to the industry and provide an environment where the various industry players can realize successful and rewarding careers.

THE DISPOSITION MARKET FOR LARGE PORTFOLIOS

by Brian Furlong

Since 1991 a market in portfolio dispositions has been established. To understand the current market for disposing of large portfolios and to anticipate future changes, it is important to understand how and why today's market evolved. This article discusses the development of the current marketplace, and when and when not to use various disposition strategies.

Today's market developed from the boom market of the 1980s, which gave way to the bust of the late 1980s and early 1990s. During the worst period of the national real estate market bust (around 1991), investment capital fled the market en masse. This created a demand vacuum which, in turn, created great investment opportunity. Many of today's most prominent methods to dispose of large portfolios (bulk sales, securitization, auction sales) developed to induce new forms of capital for investment in a real estate market with more sellers than buyers.

The Boom Period

At the beginning of the 1990s, many major financial institutions in the United States found themselves holding an excessive number of commercial real estate mortgages and equities. These assets were dropping in value, yet their demand was so thin, it was all but impossible to sell them.

Most of these assets were acquired during the heady 1980s. That decade began with sky-high interest rates and a shortage of real estate in most markets. By 1982, interest rates began a long pronounced decline, and a major development boom was on from coast-to-coast. By mid-decade property values had appreciated greatly mostly because of the drop in interest rates along with a flood of investment capital, both debt and equity, which entered the markets to pursue the high returns previously experienced.

By mid-decade, new development was outpacing the capacity of the growing economy to fill the space, and vacancy rates in many markets reached post-war highs. However, so many capital sources were plying the real estate markets in search of opportunities to place debt and equity that property values continued to rise even in the face of too much vacant space. Investment demand had become uncoupled from the underlying property market conditions. Lenders from coast-to-coast scrambled to meet high origination targets by lending on projects which they hoped would outperform the dismal general market conditions.

***Brian Furlong** is a senior vice president of Landauer Associates in New York. Landauer is a full service real estate consulting firm which advises and assists clients in disposing of and acquiring commercial real estate and mortgage assets, individually and in portfolios.*

In most markets (and even longer in California), the late 1980s found construction lenders continuing to originate loans in large volume. Outstanding construction loan balances continued to swell for a few years after originations began to decline, since construction lenders had made multi-year funding commitments to cover both hard and soft construction costs inclusive of interest during the construction period. Because the construction lenders had made these multi-year commitments extending into the early 1990s, they could not scale back their construction loan receivables for some time even after they realized that many of their projects were not feasible.

Many of the banks had been relationship lenders. These relationships turned out to be for naught when times got bad, since the loans were non-recourse. Many borrowers decided they did not want to support construction loan relationships which would not be needed until new financing was feasible.

The Bust

During 1989 and 1990, the extent to which real estate was oversupplied began to be understood by most domestic lending institutions. The Resolution Trust Corporation (RTC) had been formed, and congressional estimates of the cost to bail out the thrift industry were reaching hundreds of billions of dollars. The Bank of New England had to be bailed out by taxpayers, and this triggered an audit by the Office of the Controller of the Currency (OCC) and others of real estate loans from other major regional and money center banks. As a result of the OCC audits, the new lending window slammed shut in early 1989 at all major New England banks. The audits resulted in stiff penalties in the form of high reserve requirements tied to bank construction loan holdings. When the OCC expanded its audits to banks in the Mid-Atlantic region and elsewhere, new lending also ceased abruptly in these locations.

The chill was on. In conformance with the new regulatory pressure, banks which previously had extended loans for underleased properties without a permanent loan takeout, began to declare the loans under default because it was clear that the market would not support the debt service requirements. Insurance companies noted the deteriorating market conditions and the new conservatism at banks, and they too drastically reduced their allocations for commercial real estate lending. Credit corporations, which made participating or second-lien loans, were near the first lines of loss when debt service coverage and values eroded. They, too, stopped lending. Foreign banks, which stepped up their lending at the peak of the market in the late 1980s, realized their big mistake and closed up shop. All major sources of funds stopped lending in rapid succession, and a liquidity vacuum resulted.

The loss of liquidity in the debt markets was matched by a loss from real estate equity sources. Those who had relied on leverage to support their acquisitions were out of the game due to the lack of available loans. Unleveraged investors had no clear motive for investing, since assets were clearly declining in value and most tax benefits to losses had been eliminated in late 1986. Pension funds tried to reverse their previous trend of increasing investments in real estate, but this proved impossible since the fund managers could not find a market for their properties at the par carrying value of the funds.

Many owners tried unsuccessfully to market their properties in the early 1990s. The drop in achievable market value, below carrying value, often was seen as too great. Many owners who had explored the markets decided they would prefer waiting out the real estate bust rather than sell. But some owners had to sell, including the RTC which had committed to Congress and the public it would maintain a certain pace of asset dispositions. The RTC started out by selling individual mortgages and real estate equity assets. However, they could not achieve the desired pace of dispositions using individual sales. The people who previously had bought individual S&L-quality investment properties often were severely weakened by their prior real estate investments. They could not raise the equity or debt monies necessary to buy RTC properties. Furthermore, the price the RTC could legally accept for individual assets was tied to appraised value, and these often were too high for a sale. Appraisers were overestimating the values, because they relied on property sales from prior times. They had not fully adjusted their values to reflect the decline in investor liquidity.

Creating Demand In A Time Of General Illiquidity

With virtually all the traditional providers of real estate capital on the sidelines, the RTC had to try new methods to dispose of their assets. They started to get rid of their assets in bulk, offering them in blocks large enough to entice major opportunistic investors with ready access to funds from sources other than traditional real estate capital providers. The money to be invested would be raised by consortiums of wealthy individuals, the capital base of major investment banks and capital market sources such as the commercial paper sales of the General Electric Credit Corporation. Many of the people who would invest in the RTC pools of real estate and mortgage assets did not have extensive experience in commercial real estate from prior investments. However, they were experienced opportunistic investors who knew that the best time to buy was when most investors had fled a market. Excess returns were available to those who bought low when existing owners were desperate to sell.

At the start of the 1990s, the RTC sold assets in bulk by selling entire thrift institutions. Their assets were mostly real estate and mortgages, so the buyers of these thrifts were able to make an opportunistic asset play while also gaining control of a financial institution which might someday have a going-concern value. These thrift institutions were sold with RTC supports against the downside risk to the investors, yet the investors could achieve huge gains if the thrift's real estate and mortgage holdings went up in value. Major financial players, such as William Simon, the Bass Brothers and Lew Ranieri, knew a good deal when they saw one, and they reaped hefty profits from their early, privately negotiated purchases of RTC-controlled thrifts.

The Rise Of The Commercial Mortgage-Backed Securities Market

Prior to 1991, most commercial mortgage-backed securities (CMBS) were backed by single assets or small pools of assets. Credit ratings for pooled transactions often were dependent on the use of credit support from highly credit-worthy third parties, such as AAA-rated monoline insurers. Those who provided the outside credit support, including first loss letter of credit, performed their own analysis on the likely incidence of loan default and the severity of related losses. The risk of loss for those who bought rated debt was greatly diminished by the fact that the providers of the credit support had pledged they would absorb much of the expected loss on the underlying mortgage loans, even in scenarios where the underlying loans performed quite poorly. As a result of the risk mitigation from credit support, CMBS offered for sale received strong investment grade ratings, such as single-A or better. Bond buyers did not have an appetite at this time for much default risk, so bonds rated below single-A generally were not offered.

During 1991, the RTC decided it would tap the CMBS market to sell large blocks of mortgage assets. However, as of early 1991 the CMBS market, backed by large pools of mortgages, was immature and thinly traded. The RTC had a huge inventory of assets for disposal without a ready market. The RTC had to create a market.

When the first RTC CMBS issues were sold, buyers insisted on much higher spreads for CMBS bonds with a given credit rating relative to more established types of securities with the same rating (such as a corporate or a government bond). The high spreads were necessary to sell the bonds because:

- Bond buyers were uncertain of the accuracy of the rating opinion for CMBS, since the agencies had little experience with large commercial pools.
- The real estate markets seemed to be in a downward spiral of uncertain duration created by very weak property market fundamentals and a dearth of investor demand and funds available by lenders.
- So much money previously had been lost in commercial real estate, even by market experts such as the Reichmanns of Olympia & York, there was a general aversion to any investment backed by real estate.
- Many of the potential bond buyers knew little about real estate and had little experience in buying CMBS. They were largely dependent on the underwriting and structuring expertise of the investment bank structuring the CMBS deals, the rating agencies and other intermediaries and service providers in the securitization process. The bond buyers had to be brought up the learning curve on the process of underwriting and structuring CMBS transactions if they were to increase the effective level of demand for the CMBS assets and reduce the spreads demanded for uncertainty.

The RTC jumped-started the CMBS market by:

- Selling cheap where they sold CMBS tranches at high spreads relative to their ratings, while at the same time providing large cash reserves and other credit support mechanisms. This allowed the rating agencies to establish suitably conservative ratings for the various tranches of the CMBS issues.
- Rating agencies, due diligence contractors, investment bankers, loan serving firms and others were able to go to school on the first RTC pooled deals. They refined their underwriting methods with these deals and, in turn, started to educate bond buyers on the asset class and how it is underwritten and structured. The RTC provided a steady stream of large-pool CMBS transactions, which allowed the key firms in the CMBS field to staff up with good people. New companies were attracted into the field.
- The RTC started with the simplest property type to underwrite, multi-family, the property type with which many bond buyers were most comfortable. The RTC started with performing loans rather than non-performing loans, again because the performing loans are easier to underwrite and are an easier sell to bond buyers who were cautiously entering the market.

Market Demand Expands
Based on the first performing multi-family CMBS transactions, the market began to gain some depth of demand, and the rating agencies, investment bankers and others involved with formulating the transactions gained valuable experience which could be used to expand the market. Transactions, including loans on property types other than multi-family, began to appear. Rating criteria were developed for non-performing loans, and the first non-performing pools of loans were rated and sold. Gradually, but steadily, spreads tightened between CMBS bonds and corporate bonds with the same rating. Market acceptance of CMBS was increasing, and buyers were beginning to emerge who would purchase CMBS tranches with higher ratings of risk in pursuit of higher returns. Bonds with a BBB rating began to be issued routinely and sometimes the tranching occurred even down to the BB and B level. The development of a market for higher risk bonds meant that the amount of equity, cash reserve or other credit support in a transaction could be greatly reduced and that the issuer of a CMBS did not need to retain as much risk as before. As the market developed for non-investment grade bonds, CMBS could be used to finance a higher loan-to-value.[1]

The CMBS market has become an increasingly efficient, less costly source of financing as the impediments fell away. Rating agencies have become more adept at rating risk, and investment grade bond buyers have become more comfortable with rating agency opinions. Bond buyers for all grades of real estate securities have grown in number, and competition has driven down spreads.

During 1991 and 1992, the RTC accounted for the great majority of the CMBS issues and most of the innovation in developing this product type. During 1992, the private sector institutions began slowly increasing their volume of activity in this market. By 1993, the RTC was scaling down its pace of new issuance, since most of its inventory had been worked through. Private institutions, including solvent banks and insurance companies, and entities which had purchased assets in bulk, picked up the slack left by the receding RTC. Pricing in the CMBS market had become attractive to the private sector issuers, because of the reduced spreads needed to sell CMBS and a large decline in the general level of long-term interest rates in the bond markets. The CMBS market had a record year for origination volume in 1993, and a strong pace of issuance has continued into 1994.

Securitization works best for assets which have a strong current cash flow. Generally, rating agencies look for a diversified asset pool with diversification by property type, location, management and other factors which affect mortgage performance. When securitizing a pool of assets, it is generally best not to have more than 10% of the pool comprised of one asset. Multi-family, industrial and retail properties tend to be treated best in a securitization, while office and hotel properties are, on average, underwritten more harshly. For some properties, a rating agency gives less credit for a possible upswing in cyclical market conditions than would the buyer of the property. For example, buyers of Midtown New York office buildings recently have been placing high bids relative to current cash flow under the assumption that rents will spike in Manhattan during the next few years. Rating agencies would be disinclined to reflect a rent spike in their underwriting. Therefore, an owner of a New York office building looking to cash out of its investment is better advised to sell the property on a retail basis than include the asset in a pool destined to be securitized using a CMBS.

Rating agencies base their analysis primarily on the ability of the underlying properties to support debt service. They analyze cash flow, and they give little credit to any premium which may exist in the value of a property not directly connected to the property's capacity to generate cash flow. For example, a rating agency will not give credit to a premium in value due to the special appeal of a property to an owner/user. Nor will a value premium be recognized due to a buyer pricing the asset using a percentage of replacement cost or a floor value per square foot of the asset. Many major office buildings can be sold with the pricing based on some method other than discounted cash flow analysis, but the rating agency underwriting models will not recognize these premiums to value, because they do not help the property generate additional debt service coverage.

In sum, mortgage securitization has become a great way to raise low-cost debt on many asset types. However, it may be best to leave certain large properties and other properties with strong upside potential out of a debt securitization if the maximum available cash is sought on the disposition. It is also necessary to have a large enough transaction so that front-end costs connected to the securitization do not represent too high a proportion of the funds raised by the bond sales. Typically, pooled-asset CMBS transactions tend to be $50 million or more.

Bulk Sales
The second vehicle used by the RTC to dispose of large pools of mortgages and owned real estate assets have been bulk sales. As with CMBS, bulk sales by the RTC became a major phenomenon in 1991. Again, the first product type to be disposed of was multi-family. The first RTC assets were sold

very cheaply in bulk for many of the same reasons the first pooled-asset CMBS transactions carried high returns to the investors. The real estate markets were in disarray in 1991, and there was so little capital in search of major real estate transactions, that the assets had to be sold cheap to induce demand.

The market for assets sold in bulk strengthened during the same time period as did the CMBS, in large part as a result of the CMBS tightening. As cheaper CMBS financing became available, for an ever-higher loan-to-value, bulk buyers raised their bids for the bulk assets.

Many of the early buyers of assets in bulk were able to realize large returns. These returns were received by various methods including financing out, sales of individual properties which had been bought cheaply in bulk, and through receipt of new capital into their investment ventures. When it became clear that large returns could be made in bulk acquisitions, the established buyers were flooded with new investment capital and many new entities entered the market in search of acquisitions. Sellers started to achieve much better prices on the assets they sold, because so much more money became available for acquisition and the underlying real estate property market conditions had reached bottom and were beginning to improve. As with the CMBS market, the RTC at first was the dominant seller. In 1993, the private sector overtook the RTC, and now most deals originate from banks, life insurance companies and thrift institutions.

Since many buyers will look to the securities markets to finance their acquisitions from a bulk sale, buyers may pay less for assets which do not fit well in a CMBS. Buyers of large pools of assets in bulk often do not have much time to spend underwriting each individual asset. With strict time constraints, there is a tendency to use global assumptions in the pricing analysis whenever possible. Unusual upside potential is often overlooked by buyers when their analyses is global. For example, a global assumption that rents will grow at a flat rate may be too conservative in some markets where a detailed analysis of local economic and rental market trends would indicate a rent spike is likely. The quick analysis forced on bulk buyers by limits of time and due diligence budget also may inhibit them from uncovering methods to work out troubled properties. Therefore, the best way to realize the full upside potential of particularly promising properties may be to sell the properties individually to buyers who will not treat the properties in a global fashion.

Auctions

Real estate auctions have been around for a long time. Historically, auctions have been used by sellers looking to sell quick, such as in tax or debt foreclosure sales or for particularly hard-to-sell properties. For example, auctions were used to sell vacant headquarters-type office buildings in remote locations and highly specialized vacant factories.

During the recent real estate downturn, auctions gained a new legitimacy as a quick way to sell commercial property.[2] Early on during the recent real estate bust, the RTC and many private lenders found it so hard to sell assets through traditional brokerage sources that they turned to auctions. The assets sold at auctions generally were troubled by the weak real estate markets, but in many cases they were otherwise good, functional and attractive. These sellers decided that, with a proper marketing program, it was possible to get the best prices for properties using an auction sale.

Various types of auctions are utilized, including the outcry auction, which is a live or telecast event similar in format to an art auction; the electronic auction where bidding takes place via a computer network or by telephone with the bidding process tracked on a computer network; and the sealed bid sale where bids must be mailed to a central point by a set day.

Bidding in any auction format takes place on a certain date, so the bidders know they have to mobilize their efforts to develop a bid that is ready by the specified day This is a good way to induce bids from people who might otherwise delay or procrastinate if the asset was being sold by a traditional negotiated sale process without a clearly understood and enforced termination date.

Where many assets are for sale, the preparation of the selling materials to buyers tend to be standardized in order to take advantage of economies of scale. All bidders for a given asset receive or are given access to a common set of due diligence files and selling materials. This makes it more practical to deal with many more potential bidders. It is in contrast to the sale of an asset through traditional brokerage channels where information often is developed and distributed to each bidder on an as needed, customized basis.

Typically auctions make heavy use of mass media to advertise the sale. This may include advertisements in local real estate publications and the Wall Street Journal, electronic notices about the sale over Telerate or other electronic medium, or other methods such as mass mailings. It is now common to group large numbers of properties for simultaneous sale in a single auction event where bids are placed individually on a property-by-property basis. These assets may include mortgages or real estate equities contributed by one seller or multiple sellers. In grouping many assets together, a critical mass is created which attracts attention to the sale.

Marketing resources also are pooled, so the sale event can be broadly advertised to the buying public.

Auctions have become an accepted, mainstream disposition method. It has become clear to many sellers that, when properly managed, an auction can maximize the competition among potential buyers for a property. More competition among bidders raises the transaction price. Auctions are a particularly good method for assets left out of a bulk disposition, because an individual sale will result in better pricing. This may include very large assets which because of their large size would cause the pool to have less than an acceptable level of diversification. Some office and hotel properties also do well in an auction sale versus a pool sale. This is particularly true if they have strong upside potential or if they would trade with a value higher than the results of a cash flow analysis. Assets with value related to their prestige, rather than their cash flow, also could receive a better price if sold by auction rather than in a pool disposition. Examples are prestigious resorts or golf courses.

Equity REITS

In contrast to the paralysis that hit the marketplace for commercial real estate sales during the recent real estate bust, an active and liquid market was retained for equity REITs. REIT prices declined as early as 1987, and they experienced a large aggregate decline by 1991. Because REIT values were marked down so far so early, they had great appreciation potential from the low base of values they had reached. Equity REIT buyers concluded that the decline in share prices which took place during 1987-1990 was sufficient to make REITs a good opportunistic investment choice with strong current returns. REIT prices boomed during 1991, 1992 and early 1993. Appreciation slowed by mid-1993, because current returns had declined substantially due to the run-up in price and because the market began to reach saturation due to a flood of new issues.

The boom had been fueled by investors attracted to current returns from the REITs which exceeded returns from alternative investments in a low and dropping interest rate environment, and by the rates of appreciation realized. Some institutional investors have been attracted to REITs as a securitized method of investing in assets backed by real estate which has more liquidity than most non-securitized channels for real estate investment. Equity REITs are one of the principal methods for partially disposing of an owner's investment in a large portfolio. Many owners have raised substantial sums of equity capital through a REIT origination and used some of this equity to retire debt carried at an interest rate which was above market.

Most entities which form REITs retain the management responsibility and often a sizable equity stake. Buyers will look carefully at the strength of the proposed management and the protections in place against management/shareholder conflicts of interest. Assets generally will be priced based on income in place, so the assets should have high current cash returns. The portfolio also should be large enough so fixed-cost origination fees are not prohibitive. Curently, most REIT originations are well above $50 million.

Conclusion

The real estate investment market bust of 1989 created a demand vacuum by 1991. Vacuums are unnatural, and they tend to be short-lived. In response to particularly enticing investment opportunities, buyers eventualiy came forth to fill the void. By the onset of 1994 many buyers were actively sourcing deals, both for pool and individual acquisitions. Pricing has tightened for dispositions using mortgage-backed bonds, bulk sales, auctions and REITs. Noting the renewed vigor in the investment markets and improvements in the supply/demand balance of the underlying rental markets, many traditional lenders once again are making loans. Increased liquidity across the board has resulted in higher prices irrespective of the selling technique, including individual negotiated property sales. If the economy continues to grow, we can look forward to good times in the real estate business for the next few years.

REFERENCES

1. When the market for CMBS was limited to bonds with a strong investment grade rating, loan-to-value ratios in a CMBS financing were lower than the loan-to-value rating achievable on loans from institutional lenders. The rating agencies estimate that a typical insurance company loan, newly originated, has a level of default risk roughly equivalent to the default risk on a BBB mortgage-backed bond. Once the CMBS market developed for bonds rated below BBB, CMBS became a financing option which allowed for higher loan-to-value ratios than has been the historic norm for insurance company loans.
2. Although auctions typically involve sales of individual properties, many individual assets or small pools of assets can be sold to separate buyers at one auction event taking place in one day. An auction event, therefore, can be seen as a portfolio disposition channel.

THE CREATIVE DESTRUCTION OF REAL ESTATE CAPITAL MARKETS*

by Bowen H. McCoy, CRE

*Reprinted from Urban Land, June 1994, published by Urban Land Institute, Washington, D.C., pp. 19-22.

When I first went to Wall Street in the early 1960s, many senior corporate executives still carried with them an aversion to debt, an aversion they had developed during the economic depression of more than 30 years previous. Indeed, it took the publication of a book by Harvard Business School professor Gordon Donaldson, *Corporate Debt Capacity* (Harvard Business School Press, Boston 1967), to reawaken corporate America to the positive characteristics of financial leverage. By the end of the 1980s, Donaldson's message had been broadly received.

This tendency to remember long-term lessons is part of what makes "long-wave" societal and economic behavioral patterns. Such patterns have been identified by economists and social scientists from Serge Kondratieff and Friedrich Hegel and Karl Marx to, in our day, historian Arthur Schlesinger, Jr., and M.I.T. economist Jay Forrester who traces fundamental economic forces through history over 50- to 60-year cycles. In the 1930s, economist Joseph Schumpeter theorized about the "creative destruction" of capitalism, an idea that Michael Jensen, currently a Harvard Business School professor, applies to his analysis of the positive regenerative effects of leveraged buyouts and corporate restructuring.

My point in mentioning long-wave theories is to introduce the view that the period from 1990 to 1994 has ushered in a long-wave structural change in real estate financial markets. As a result of the destructive forces prevailing in this period, individuals involved with real estate financial institutions in the United States and Japan, in particular, have made radical changes in their business behavior that will last for the balance of their careers, far beyond the millennium. Their attitudes toward financial leverage, aggressive financial projections, megaprojects, developer profits, and related issues are resulting in the creative destruction and restructuring of real estate financial markets.

This will happen despite much peripheral noise in the marketplace from the financial press and others anxious to restart the real estate bandwagon. Articles encouraging real estate investment have appeared in the *Wall Street Journal*, *Barron's*, and *Fortune*. Many new real estate offerings for pension funds are in the market. Barton Biggs, Morgan Stanley's investment guru, has suggested institutions might allocate up to 15% of their assets to real estate. Thus, even though banks and insurance companies hold billions of dollars of unresolved real estate assets, new and evolving investment

Bowen H. McCoy, CRE, *is a real estate and business counselor with his firm Buzz McCoy Associates, Inc., Los Angeles. He is a member of The Counselors of Real Estate.*

funds are again beginning to push returns on newly acquired property to levels that current cash flows cannot support. This "noise" misreads the current conditions of real estate finance in commercial banks and insurance companies and on Wall Street. Commercial banks or insurance companies account for about half of all commercial real estate loans and investments. Until their real estate holdings conform to the demands of market arbiters and until new forms of real estate financing have been created, they will be essentially out of the market.

Commercial Banks

For banks, the key constraint on funding is not government regulation but access to the capital markets. Banks need to obtain funding at a cost that provides a competitive spread on their transactions. The more profitable the spread, the better the compensation, the better the ability to recruit high-powered managers, and the lower the cost of equity capital.

For debt capital, the higher the credit rating a bank gets from traditional bond rating agencies such as Moody's and Standard and Poors, the lower the cost of debt. And the rating agencies do not like real estate. Thus, the less real estate (and the less bad real estate), the cheaper the enterprise's funding cost.

Wall Street security analysts likewise have an aversion to real estate, which serves to augment its negative impact on stock prices and cost of capital. Stock and bond analysts have been as instrumental as government agencies in imposing mark-to-market accounting on commercial banks.

Risk-based capital rules requiring banks to carry an 8% reserve against commercial and industrial loans, while requiring no reserve for U.S. Government bonds, have moved banks out of real estate and small business loans into government bonds in the past four years. It costs them virtually nothing to invest in Treasuries with low short-term interest rates, while it costs them 125 to 150 basis points to underwrite and reserve against real estate loans. Their loading up on Treasuries has produced the second highest bank earnings in history. These earnings have been crucial in rebuilding bank reserves after real estate writeoffs.

The U.S. Treasury has a keen interest in keeping banks as holders of government debt. Over 20 years, the marginal buyer of Treasuries has moved from the Middle East to Japan to U.S. banks. Should banks start selling Treasuries, the bonds would have to offer higher interest rates to attract a new class of marginal buyer. It has even been suggested that if banks start dumping Treasuries, federal regulators may raise the required capital cushion against commercial and industrial loans from 8% to 10% or 12%.

The possibility of further bank regulatory actions—applying risk-based capital rules to off-balance sheet derivative securities transactions, requiring banks to meet certain social investment goals, and acting on several pending large bank consolidations—helps persuade bankers to favor treasury securities over commercial and industrial loans.

At the same time, more far-sighted bankers are beginning to imagine what new forms of instruments might be needed to bring them back into real estate financial markets. A few banks are cautiously reentering the real estate debt market—with 75% loan to value (value figured conservatively) on recourse loans and with corporate-style security covenants, and 50% or less loan to value on nonrecourse loans.

Japanese banks have all the same problems of capital access, funding, and rating agencies. Only recently has the Japanese banking system appeared prepared to face up to its real estate financial problems.

Insurance Companies

Insurance companies, generally speaking, are confronting the same array of problems as commercial banks, although two to three years later in the cycle. They are less likely to use the capital markets to fund their loans and investments, but when they do they encounter the same rating agency and mark-to-market constraints. If they happen to be publicly traded, their common stock is subject to the same scrutiny.

Insurance companies finance most of their transactions through the sale of financial products to consumers. Today's products produce funding with fairly short maturities, and the pressure for investment performance is high. Insurance companies are hurting from the movement away from group retirement plans to individually managed 401(k) IRAs, which tend to invest directly in mutual funds.

Fitchs, Bests, and other companies rate the investment quality of insurance companies for the consumers of insurance products. Higher ratings will, in theory, attract more customers. To obtain higher ratings, the insurance companies must lighten up on their real estate holdings.

And like banks, insurance companies face risk-based capital requirements, which are imposed by the National Association of Insurance Commissioners, a professional association of state insurance regulators (see "Real Estate Investment by Insurance Companies" in the March 1994 issue of *Urban Land*). U.S. government bonds require no capital reserve; bonds rated A and higher require 0.3%; foreclosed property and delinquent commercial mortgages require 15%; and commercial mortgages in foreclosure, joint ventures, and limited partnerships require 20%. Reserves for the ten largest assets must be doubled. These requirements ring the death knell for insurance company joint ventures on single large projects.

A recent ruling by the U.S. Supreme Court that Employee Retirement Income Security Act (ERISA) rules apply to assets held in insurance company general accounts also adds to the woes of insurance companies. Among other things, this means that a tenant leasing more than 10% of a building owned by an insurance company becomes "a party of interest" in that investment.

The most obvious way out for insurance companies is the intermediation of their real estate assets through securitization. They can sell off concentrated holdings and buy back through syndicates only securities that hold an A or better rating. This will create unprecedented demand for commercial real estate syndication and necessitate finding whole new markets for those tranches of real estate assets no longer deemed suitable for investment by insurance companies.

Outside of special purpose separate account funds, insurance companies are unlikely to seek nonconforming real estate loans or investments while the intermediation process takes form.

Wall Street

The nonconforming commercial real estate assets of banks and insurance companies thus offer Wall Street an unprecedented opportunity. The market for commercial real estate securitization is relatively undeveloped to date, with the bulk of the transactions having come from the Resolution Trust Corporation. Wall Street brings a trading mentality to real estate and is, generally, unwilling to commit the time or resources needed for adequate due diligence and testing procedures. This factor in turn opens up an opportunity for a new class of real estate practitioners, most likely public accounting firms.

Wall Street can participate in the commercial real estate finance process in a number of areas:

REITs. The $550 billion of commercial real estate assets held by banks and insurance companies dwarfs the $14 billion that REITs raised in 1993. REITs are yield-driven instruments. Investors look for roughly 8% current return and 12% overall return. The attractiveness of the current return that REITs offer is vulnerable in the long term to a rise in interest rates and the growth of more liquid money market funds. Their appreciation and growth component is also threatened by competition from other REITs and investors bidding up prices of existing properties.

Although the quality of property held by today's REITs is far more attractive than that held in the last REIT cycle, REITs remain an awkward vehicle for owning real estate. The tax laws impose a degree of passivity on REITs that is not appropriate to real estate ownership and operation. Over their investment cycle, REITs favor dividend maintenance and growth over capital replacements and renewals. They are forced to pay out such a large percentage of cash flow as dividends that they cannot accumulate reserves for property enhancement. It is not likely that REITs will be the panacea of the real estate capital market.

Opportunity Funds. Opportunity funds have amassed several billion dollars of buying power from pension funds and wealthy individuals to take advantage of anomalies in market valuation in the wake of the sudden departure of traditional financial sources from the real estate market. In the last four years, returns of 30% a year were not uncommon. But the wholesale dumping of property by the federal government and financial institutions is about over, though Japanese banks may continue to engage in it. Owners are pricing portfolios much tighter and bidders are becoming more numerous. There is less spread among the bids. A prospective bidder can spend hundreds of hours and several hundred thousand dollars in due diligence, only to come up with a dry hole.

Many opportunity funds add significant value to properties by applying sound operating techniques and remedying previous neglect. Their spreads and returns are bound to narrow, but the funds will continue to be a good vehicle for owning and managing securitized property and investing in the riskier, nonrated tranches of real estate securities.

Mutual Funds. Mutual funds have burgeoned as they chase markets and yields around the world. Lower-quality, high-yield money market mutual funds have been attracting individually managed IRA pools, and these funds are an obvious market for the riskiest layer, the so-called Z tranche, of securitized commercial real estate product.

Securitization. It appears that Wall Street will enjoy a unique opportunity to recycle bank and insurance company restructured securities, requiring as high as 20% to 30% risk-based reserves, into assets needing only 0.3% reserves. The recycling apparatus will be a massive securitization process. As much cash flow as required will be dedicated to a top investment tranche, which will be rated A or better and sold back in pieces to syndicates of banks and insurance companies. The bottom tranche will be sold to opportunity funds, higher risk mutual funds, and other risk-oriented investors, including some pension funds.

The only limit to the size of this market is the appetite of the investment community for the Z tranche. Both packager and purchaser likely will misunderstand the investment characteristics of the Z tranche, which will at times be mispriced and thus produce both windfalls and large losses for the investors. Not to worry, however. The creative destruction of the current cycle will not have to be dealt with until the next cycle.

An act pending in Congress would stimulate commercial securitization. The Commercial Mortgage Capital Availability Act would expand residential secondary mortgage market provisions to commercial real estate conduits. It would:

- extend SEC shelf registration provisions to commercial mortgage conduits;
- exempt such conduits from ERISA; and
- allow banks to base their 8%, risk-based reserves on the participations they retain in commercial loans instead of on the entire principal of the loans.

The prediction of one prominent syndicator of real estate that commercial real estate syndication will grow to $1 trillion by 2000 appears exaggerated. Such an outcome would solve the real estate problems of financial institutions around the world. In any case, this market should grow rapidly in the next five years.

A major drawback in securitization is that the further investment in real estate is removed from the potential for active and aggressive management, the more problematic the investment outcomes. Wall Street tends to avoid initial due diligence and, even more so, ongoing operating responsibility by relying on conservative debt rations, corporate-style covenants, and diversity in packaging. Growth in securitization will provide opportunities for purveyors of due diligence services and individuals able to manage large pools of assets.

The Creative Part Of Destruction

As the destructive slope of the current real estate cycle begins to flatten out, it is time to address some ongoing issues in order to define the future of real estate capital markets.

Valuation. It is extraordinarily difficult to value real estate under present market conditions. In some CBDs, the calculation of true net effective rents is close to impossible to perform because data are not disclosed on free rent, tenant improvement contributions, give-backs, and other payments or concessions; and we lack data on the overhang of sublet space. Thus, to predict the time required to retenant a project becomes extremely difficult. Original cost and replacement cost are meaningless benchmarks.

As securitization progresses, properties will trade on statistical assumptions regarding rent that will produce windfalls and losses—further demoralizing the market. Appraisals can be as delinked from values in the present demoralized market as they were in the speculative boon of the 1980s. To attract broader and deeper market participants to the real estate capital markets, we must be able to provide more reliable appraisals of commercial real estate. Pension funds, for example, remain relatively underinvested in real estate. As returns on financial assets regress toward their long term average over the next few years, real estate may become even more appealing to such funds. Pension fund managers remain dubious about real estate because of the unrealistic reporting and valuations they witnessed at the beginning of the real estate collapse in 1990/1991.

Reliable Databases. Standarized, nonproprietary information on rents, sales prices, supply, and changes in occupancy is needed to underpin the growth in securitization. A disinterested party should collect and disseminate data.

Several industry associations, including the Urban land Institute, are looking into the feasibility of producing a statistically reliable rental index for key markets throughout the United States and for the country as a whole. For the first time, some major financial institutions—banks, insurance companies, and pension funds—have indicated their interest in sharing their real estate data.

Reliable data can help bring large financial institutions back into the real estate capital markets. Securitization in a statistically reliable market offers these institutions the liquidity they need for trading their positions.

Looking ahead, one might even contemplate the arrival of derivative real estate securities that would allow investors to buy a basket of options on particular geographic markets or property types, going long or short at any particular time.

We need reliable data to better forecast real estate cycles. Better data will bring more players into the market and lower the premium for real estate capital. Then, all real estate practitioners will share in the challenge of creating the real estate capital markets of the future.

PORTFOLIO DISPOSITION STRATEGIES: THE INSTITUTIONAL DECISION OF THE DECADE

by Michael P. Buckley, CRE

The rush to real estate in the 1970s and early 1980s produced obvious investment excesses which registered in institutional portfolios during the late 1980s and early 1990s. Many institutions now face the Decision of the Decade — how to reduce their real estate exposure in the most cost effective and rational manner.

Although financial experts generally believe real estate markets have started to stabilize, large numbers of troubled and foreclosed assets still remain. Management can no longer wait for the expected cyclical return of real estate values and a return to healthy portfolio performance. Global dynamics of the 90s—downsizing, continued absorption of overbuilt space, corporate hotelling and value declines triggered by governmental dispositions—have created a new institutional imperative for thinking through real estate portfolio strategies.

The new institutional imperative for disposition strategies of real estate portfolios is generated by pressures on management in the following areas:

- Re-emphasis on *core businesses and re-engineering initiatives* surfacing the question of whether or not real estate lending or ownership makes sense compared to the core business enterprise.
- For public companies, the *reaction of the stock price* to poor real estate portfolio performance has been recognized, and presumably a stock lift would be garnered if real estate inventory levels could be reduced.
- New *risk-based capital standards,* derivatives of the banking excesses of the 70s to be applied against life insurance companies, will produce increasing concern by regulatory agencies; analysts will monitor real estate portfolio concentrations.
- *Reducing exposure to expected slow growth* in the real estate sector would presumably be matched by investment opportunities for faster growth in telecommunications, information processing and biotechnology.
- *Recognition that real estate portfolios require large capital infusions,* particularly due to unexpected events such as tenant erosion, is coupled with the desire to redeploy capital to mainline, core businesses.
- *Declining appraisal values* have diluted overall returns and have unduly influenced company perceptions. Pension fund reactions to dilutions of portfolio values have been severe and well vocalized.

Michael P. Buckley, CRE, is Ernst & Young's National Director for Real Estate Consulting. Ernst & Young has substantial experience in large scale real estate portfolio disposition reviews on behalf of major banks and insurance companies. Buckley is a member of The Counselors of Real Estate.

- Many institutions believe that due to *specialized, intensive management requirements,* the *level-of-effort* for real estate is totally out of scale with other asset classes, such as stocks, bonds and agricultural investments.

This article will try to identify key strategies currently used in today's evolutionary and dynamic environment and discuss both benefits and roadblocks management may encounter as it strives to identify the right disposition strategy. Disposition approaches for sellers of major portfolios, including real estate collateralized loans and other Real Estate Owned (REO), can provide opportunities for management to achieve their exposure reduction goals, while at the same time provide opportunities for the buyers to achieve significant returns.

The Yield Issue

Irrespective of disposition alternatives considered by an institutional owner, the question of portfolio yield remains. Many have observed that while real estate may have experienced its first major period of volatility in many decades, yields remain at a significant spread above treasuries, and as a semi-passive investment, perhaps real estate ought not to be given short shrift. Unfortunately, financial institutions are increasingly judged by mainline core businesses, such as enterprise lending and corporate finance for banking, rather than real estate investment, much of which was procured accidentally through foreclosure.

For life companies, whose principal concern is with interest spread over treasuries to afford opportunities to fund policy growth, real estate investing has become an overly concentrated activity and is beset by regulatory concerns. Nonetheless, the yield on disposition is important as portfolio valuations have been pledged specifically against redemptions for policy holders or other guaranteed annuity style accounts.

Portfolio Sample/Credit Risk Profile

By performing an initial analysis and sampling of the portfolio's individual loans, an internal *rating system* can be established to identify and stratify the sample's risk profile. An initial risk profile assessment of the individual mortgages will be determined by analyzing the critical elements including:

- Payment history
- Current loan status
  Performing, subperforming, non-performing
- Product type
  Office, retail, apartment, etc.
- Geographic location
- Loan maturity dates
- Appraised value
  Original (at time of loan origination)
  Latest (updated appraisals)
- Current loan-to-value ratios (LTV)
- Deferred maintenance
- Anticipated capital expenditures and tenant improvements
- Environmental constraints
- Guarantees
- Cross-defaults and cross-collateralization issues

Segregating and identifying the risk profile of each mortgage loan also includes assessing if the loan will be paid in full at the current maturity date. If the potential for full payment at maturity is uncertain, additional analysis should consider: the loan may need to be refinanced by the fund or the likelihood that bankruptcy protection may be sought by the borrower, especially in single asset ownership structures.

These combined factors then will be used to develop a top-down matrix of characteristics to increase, or mitigate, the risk profile of each individual mortgage. This analytical format approach has been applied to mortgage loan analyses currently or recently performed for insurance companies and commercial banks. The risk profile format must be consistently applied to the portfolio to be recognized as an industry standard and as an acceptable approach by capital markets.

Findings generated from the sample then will be statistically applied to the remaining loans in the mortgage portfolio. The sample portfolio will be extrapolated by the adequate credit evaluation coverage from the sample that may be generally applied to the remaining portfolio. Individual loan findings from the sample and comments will be summarized in the form of a term sheet identifying areas of concern, possible recommendations that might be used in dealing with borrowers, junior lenders and guarantors and other applicable loan participants.

Portfolio Level Evaluation

In conjunction with the individual loan analyses outlined in the portfolio sample, findings should be aggregated to determine the weighted average risk profile for an initial portfolio level evaluation. By utilizing the initial methodology, management will be in the best position to make additional stratifications of the portfolio based on specific parameters (year of maturity, product type, geographic location, performing history, LTVs) and stratifications preferred by buyers active in capital markets.

Buyer/Investor Characteristics

Investors have multiple financial goals. An institution would be wise to match portfolios against specific financial objectives for each investor group assembled around the following clusters:

Yield Junkies — Investor groups searching for derivative products with absolute spreads above treasuries or other fixed rate returns.

Asset/Liability Managers — trying to match anticipated yields and cash flow timing with other existing obligatory requirements such as Guaranteed Investment Contracts.

Asset Performance Incrementors — Groups betting on their own ability to out-manage current owners on a property or portfolio, thus affecting more positive yield.

Turnaround Negotiators — Those betting on their ability to take a portfolio of non-performing loans, restructure debt with note holders, and resale the resulting performing loans on an asset pool basis.

Six Major Disposition Alternatives

In searching for an appropriate decision strategy, a financial institution must consider all available alternatives, and choose amongst those that fit best with its investment yield objectives and its portfolio mix.

Six major alternatives cover the range of possible approaches, recognizing that for each strategy alternative, special decision criteria may exist such as portfolio mix, pressures on disposition timing and managing wider marketplace perceptions, including those of regulatory agencies and shareholders. The six major alternatives are as follows:

1. **Single Asset Managed Sale** — An asset by asset individualized marketing program, targeting single assets to prequalified buyers. This time and marketing-intensive activity obviously requires close attention for each asset, but also clearly yields the maximum price per asset of all the portfolio disposition alternatives.
2. **Outcry Auctions** — An auction provides a date certain outcome for a transaction. The yield price tends to cluster around preset floor prices or reserved prices. Auctions have had a negative connotation as they were used with RTC and with bank-foreclosed properties. The auction approach requires clear bidder prequalification and an effective marketing organization to produce a correctly intensive bid environment.
3. **Pooled Asset Sales** — Targeted groups of assets can be prepackaged and aligned with corresponding buyer pools, private sale or mini-auctions to small, prequalified buyer lists. Pooled asset sales can be conducted by sealed bid on a selective invitation basis or in direct individual negotiations. The obvious efficiency of pooling assets drives down per asset marketing costs.

   Pooled assets can include healthy loans and some troubled loans all collaterized by real estate. Note that cash flows on the healthy loans enhance the overall portfolio yield. Healthy performing loans are sometimes disposed of by management's desire to sell off exposure in a particular product mix or out-of-territory assets.
4. **Bulk Portfolio Sale** — Selling the entire portfolio, or very large segments in bulk, also provides a date certain outcome. This technique of asset bundling can provide a portfolio effect of including some very good with some bad assets to smooth out investor yield. Bulk portfolio sales have heavy costs to implement for due diligence legal and preparation of comprehensive marketing packages. Bulk sales can be conducted by sealed bid from a pre-invited list of bidders, or direct negotiation with large value-oriented credit companies or syndicators.

   Again, managing buyer perceptions, providing for an orderly bidding process, and prequalification of bidders to permit the expensive and intensive due diligence required of an effective sale, while maintaining a properly competitive environment, requires knowledge, contacts and deft sense of timing on behalf of the sponsor. Many institutions will rely on outside consulting judgment to implement.
5. **Securitized Asset Pool** — An asset pool can be contributed to a new entity which is securitized. This has the effect of monetizing assets or changing the asset risk profile while the institution usually retains a residual piece in marketable form. The securitized approach requires heavy investment of time and effort for due diligence, legal clearance, pre-planning of tax impact on the sponsor and the obvious involvement of investment banks in the process. The sales outcome is uncertain over longer periods of time because the issuance price, less substantial implementation costs incurred over a protracted period of time, establishes the portfolio yield to the sponsor.

   A variation is the Special Purpose Entity (SPE) Formation, especially by foreign institutions, which is created to acquire troubled assets from the depository institutions, including foreign banks with U.S. agencies. This format allows the wholly-owned subsidiary of the offshore parent corporation to acquire the assets and use the anticipated cash flow stream from the underlying assets as collateral to approach the bond market in a non participatory issuance.
6. **Real Estate Investment Trusts (REIT)** — A REIT is a real estate trust vehicle designed to hold operating real estate and pass-through the net operating income under certain controlled conditions. The vehicle changes the asset risk base for financial institutions as it creates a security, and

the resulting stock can be widely held. New changes in the tax code allow USA pension funds to directly invest in REITs, as they previously were prohibited from doing so. This may expand the buyer pool significantly beyond Wall Street and private investors who have recently renewed keen interest in REITs due to the performance spread over treasuries for good operating properties.

The conversion of real estate portfolio to a REIT has an advantage beyond liquefying a pool of assets. The REIT can preserve an existing management staff; the group is transferred to the REIT as the self-directing management entity.

REITs have significant costs for implementation including due diligence, reporting requirements and cost of the initial public offering.

Asset Pooling Criteria

If a bulk sale is to be pursued, pooling assets can enhance the offering's vitality by broadening appeal to potential buyers and by segregating assets into like-type or defined-use clusters to aid in investment assessments. For example, pools of Real Estate Owned (REO) and certain performing and non-performing loans could be grouped by geographic area or building type. Multi-family residential has sufficiently different characteristics from other building types to stand alone and could be concentrated as a separate asset type.

If a portfolio contains a solid concentration of loans to a single entity, a pool of those loans would allow focused negotiations with the borrower by the future investor. Sorting the portfolio by geographic area and building type, such as industrial, multi-family and office, would be the first step. This would be followed by rank ordering by stability of cash flow and tenancy and by estimates of capital investments required including upgrades, deferred maintenance and probable tenant improvement budgets. Certain high quality stabilized assets frequently are deliberately placed in pools to increase their appeal and smooth out the performance criteria.

Pricing Factors And Salability

Derived Investment Value (DIV) is the benchmark value of an asset. The DIV is based on standardized discount and valuation factors and originally was promulgated by the RTC to assist in an orderly disposition of large scale asset pools.

There are a series of intangible marketing components that impact the sale of pooled assets and are primarily related to the following factors:

Timing and marketing with regard to other large pooled asset sales, with the presumption that announcement, due diligence and sale dates do not unduly overlap for like-sized asset pools, same geographic area or building type.

Institutions ability to finance seller's purchase or to partially finance portions of asset pools, broaden significantly the base of investor groups and could produce higher gross sales.

Salability of the portfolio is really a function of due diligence performed on the portfolio, reasonableness of product mix, credit rating of the debtors, equity offerings to be sold against the real estate and the anticipated secondary market for specific pieces of the proposed capital structure.

Due to the current rates of return available on portfolios, it is likely that many money managers will seek to enhance the affective overall yield of their early investments that were purchased at the top end of the market. This is true whether the purchaser is acquiring paper secured by cash flow streams or an outright purchase of the entire portfolio real estate component.

Assessment Of Portfolio Discount

Pricing of the portfolio must first segregate assets into buckets depending on the initial business plan suggested by management. Once the assets have been categorized (product type, geographic location, participation, contractual maturity date) cash flows can be projected based on pre-established and usually acceptable underwriting parameters. The primary focus used in today's market is derived investment value as suggested under the RTC manual and a forecasted cash flow stream. A set of parameters will give comfort to the potential bidder as to what may be expected should bankruptcies, foreclosures, litigation, tenant rollovers and other negative impacts on financial status affect being able to pay the loan.

Whether using forecasted cash flows or DIV, the next step is to anticipate tranches in the overall capital structure to sell the identified portfolio. Assessing the impact of the portfolio discount is a function of establishing the asset criteria for each bucket including defined portfolio yield goals of management.

Asset Pool Sizing

Asset pools of $70-$100 million of book value are preferred by investors. Above $100 million, investors generally need to participate with other groups, and a longer marketing and organizational period is required. Below $70 million, the cost to prepare a bid often erodes the ability to generate a reasonable return. Splitting off smaller pools of specific asset types (such as multi-family and single-family) to specific buyers who have expertise in those areas (as well as certain other very defined asset types, such as industrial) are exceptions to that general principle. Realization of a higher overall portfolio sales price can be achieved through competitive bidding based on buyer confidence in the data provided in the smaller-sized pools. Combined with the seller's credibility, the comprehensive information package provided to buyers and segregation into prequalified, identified pools, are fundamental to success.

Due Diligence Issues

A primary issue that must be addressed during the due diligence process is environmental impact. Has it been adequately documented? What is the likelihood that an updated environmental assessment will suggest that issues facing the particular property are problematic in nature and need to be further explored? Special factors to consider are mortgage provisions including non-recourse/exculpation language and those related to low and moderate income housing (FHA) mortgages.

A reliable format and conformity of the information stream available in the asset files must include documentation of market support and cash flow analysis including forecasted cash flows or derived investment value sensitivity analysis. Of primary importance is file conformity, identifying and addressing hidden costs, environmental impacts, major tenant improvements, leasing commissions and capital expenditures.

Portfolio Marketing

After the intensive effort involved in making the right portfolio disposition decision and the commitment of extraordinary management effort and outside consulting, marketing of the portfolio should not receive last minute consideration. Institutions need to manage the bidder/buyer relationship with adequate prebidding conferences and ongoing due diligence cooperation.

It is not enough to provide access to a war room of file boxes for the buyer's visiting due diligence team, but rather to organize, clarify and describe the assets in as much detail as possible. Marketing requires internal marketing to management, external to rating agencies, underwriters, investment advisors or potential purchasers of debt instruments, such as money managers and pension plans. Premarketing the effort to rating and regulatory agencies also is important so that perceptions of the disposition process are maintained and enhanced as an orderly, efficient and responsible effort to yield maximum price.

An investment in collateral sales support materials, including illustrative brochures, is fundamental to establishing that the offering is organized and viable. Visual organization of data is crucially important since each institution is competing with another and investors have numerous opportunities. Only the opportunities that are clearly articulated and organized for investment review stand the best chances of positive action.

Portfolio marketing also includes an interactive relationship between the intent of the offering memorandum, if a public debt offering, a private placement tying back to warranties and purchase agreements. Representations and warranties outlined in the private sale contracts, as well as representations made in offering memorandum, will impact tax and accounting treatments should the seller provide guarantees or should the buyer have the potential to put back assets.

REIT Issues

There is so much current interest in real estate investment trusts that a strategic analysis of this institutional option is practically mandated. Many of the current offerings are privately held portfolios converting to REIT formats to pay down existing debt by private developers whose management organizations are being preserved into the REIT. The REIT option is attractive due to the premium pricing imputed by capital markets for well-defined and qualified portfolios. Other institutional owners may well pursue formation of REITs if the price multiple holds. This premium may well be worth the level of effort required to form the REIT, particularly for institutional holders, as discounts from carried book value may be significantly lessened.

The following issues are important to consider in evaluating a REIT strategy:

- *95% of taxable income must go to shareholders.* This REIT feature creates a funding problem with portfolios that require future deferred maintenance or large scale tenant improvements.
- *Complexion of ownership must be fairly broad,* although recent legislation has permitted pension funds to invest, which would mean that finding a strategic pension plan partner would be an important consideration.
- *Portfolio management is important.* This provides an opportunity to reallocate current institutional staff to the REIT. Implications of this severance of expertise, however, are difficult to assess on the remaining portfolio.
- *Repricing assets to an effective shareholder yield* may have an impact on current values.
- *Cost to achieve transaction closure* and cost to implement the initial public offering are high for due diligence and legal expenses.
- *Yield price is typically a combination* of the dividend based on 85% net cash flow distribution plus a stock appreciation factor.

Certain Realities

Regardless of the disposition strategy decided upon, an institutional sponsor must recognize that investors will price assets based on property level cash flows and assumed improvements in performance to be obtained under the investor's stewardship. There is no question that value resides in properties which benefit from more hands-on property and asset management. Investors will perceive this upside and price assets with that performance recovery in mind.

A portfolio-level asset disposition is a reasonable strategy if the following can be achieved:

- Certainty and swift resolution of the real estate portfolio disposition and delivery of cash or securities to the institution in lieu of the real estate obligation.
- Shorter length of time and lower overall cost rather than proceeding with individual loan foreclosures, remediation and REO sales.
- Swifter resolution of public perception of real estate problems.

While debt capital is not presently available in most real estate markets for individual asset purchases, surprisingly investors in portfolio pool purchases have experience in structuring debt transactions from a variety of financial sources, many with lower cost debt including the credit arms of major agricultural and manufacturing corporations.

While the press has become familiar with the portfolio asset sale process and the private investor base has been educated on potential upside yields, the market also has established a current range of values for such portfolio sales which unfortunately have tended to produce large discounts over book value. There is recent evidence that prices are migrating upwards. Certainly there is room for investors to expect a wide variety of institutional investors to offer portfolios of institutional quality over the next decade.

Conclusion

Financial institutions may have to seek alternative disposition for their portfolios of owned real estate, current commercial mortgage holdings or non-performing loans. This is due to pressures from regulatory agencies, public perceptions on corporate stock prices held down by underperforming real estate and lackluster real estate demand potentials over the next decade resulting from demographic shifts, global competition and corporate downsizing.

Many institutions have significantly staffed up to handle the management responsibilities of increased real estate ownership, including involuntary ownership through foreclosures. However, pressures may yet mount through new risk based capital requirements for the life industry to mandate portfolio dispositions at a broader scale.

While distressed real estate, such as that held by the RTC, has been the subject of large scale bulk sales, securitization and special purpose hybrid partnerships, the institutional portfolios have stood apart. Strategies available to financial institutions have a wide range of impact on eventual sale price and level-of-effort. The scale of most major institutional portfolios will require a blend of approaches to maximize both value and human resources available for an orderly disposition process.

Many strategies, particularly the formation of Real Estate Investment Trusts, are vehicles to convert the risk profile of the asset pool to a marketable security. Several institutions will combine portfolios and create special purpose management teams to operate the combined portfolios under a REIT or securitized pool format. As institutions work down the chain of safe investment, the capital markets may provide the best opportunity to qualify real estate investment yield parameters and serve to validate or challenge portfolio hold/sell decisions.

FEDERAL RESERVE'S INFLUENCE ON REAL ESTATE INVESTMENTS

by James E. Gibbons, CRE

The Federal Reserve continues as a *hot* news item. Everyday newspapers are filled with Fed's latest monetary moves, replete with speculations on what may happen next. TV and radio news broadcasts cover Federal Reserve Chairman Greenspan's reports to Congress and his grilling by supportive and not so supportive legislators, including the Banking Committee chair. President Clinton appears compelled to express mild support for Fed policies; financial markets reflect fear and trembling waiting for the next meeting of the Open Market Committee; developers and mortgage bankers offer public pronouncements about the effects of higher interest rates on the economy. In the center of all this excitement is the Fed.

Federal Reserve As Inflation-Fighter

In early February 1994 Federal Reserve lifted the Fed Funds rate target. Fed opined that while inflation was largely under control, it took the step as a preemptive strike to deter a future surge. A similar rate hike was made seven weeks later. Whatever the intent, the results saw an increase in the funds rate from 3.0% to 3.5%, and, to the surprise of many including Fed, during this interval the U.S. Treasury 30-year bond rate moved up from about 6% to over 7% and mortgage rates rose more than 1%. The two Fed moves, advertised as cutting inflation off at the pass to hold down long-term interest rates, produced an opposite effect; bond prices fell sharply and yields soared. Instead of stabilizing markets, a distinctly bearish atmosphere emerged. The results have shown investors as thorougly rattled. What does Fed know about inflation that they do not?

The negative attitude is so pronounced that it has spilled over to the equity markets. Real estate also is experiencing a similar sharp run-up of mortgage interest rates, which if they continue, will have to impact industry investment performances and values. Capitalization and discount rates, critical investor considerations, are composite money rates, and as such are market elements influenced by fluctuating capital availability and cost. New and existing residential sales as well as home building may slow down. Such adversity can produce widespread repercussion, since these items have been major props to the recent economic recovery. Thus,

James E. Gibbons, CRE, is director of Jamaica Savings Bank, New York and Eastern Realty Investment Corporation, Washington, D.C. He was director of the Manhattan Life Insurance Company and Bankers Trust Company, New York, and he is a past president of The Counselors of Real Estate.

The information in this article was recently presented as an introduction to the 1994 High Level Conference on "CAPITAL: Who Has It, Who Wants It, and How Do We Get It?," sponsored by The Counselors of Real Estate.

Federal Reserve policy and implementation clearly influence real estate and all other economic sectors.

The sensitivity of real estate to financial markets has been enormously heightened by the explosion in securitization of its debt and equity interests. Market makers in these securities often price them to provide expected yields quoted as various basis point spreads above U.S. Treasury yields for like maturities. Thus, changes in items such as mortgage rates which previously might have been slow to transpire, now occur almost immediately with capital market fluctuations. While many government officials, economists and financial analysts have questioned the wisdom of the Federal Reserve in raising interest rates, no one has questioned the authority and ability of the Fed to do so. What is the precedent for the Federal Reserve to handle its monetary policy missions? How did it attain its present prominence? How does it work?

Creation And Missions Of Federal Reserve

As a result of bad depression experiences and money crises over the nation's early years, Congress in 1913 created the Federal Reserve System to be our central bank with the following missions: to be a lender of last resort and to promote orderly growth of our economy. The intent was to prevent further financial crises resulting from unbalanced capital flows throughout the country. When created, the system was divided into 12 districts, each with a reserve bank and all governed by a seven member Board of Governors appointed by the President. Governors have 14-year terms and the chairman is appointed to a four-year term by the President. The Fed, as it is called, is a completely independent body with enormous economic clout. Congress frequently makes noises about restricting its powers, but so far that has not happened. Federal Reserve formulates and implements our nation's monetary policy, and in the process regulates capital availability and flows. Though much more could be said about composition and missions, we will plunge into the matter of money and Fed's influence on interest rates, the item of prime importance to real estate people.

Credit Regulation Tools

Money

As counselors we talk about and are involved in real estate investments. They relate to land, bricks and mortar, but are, in fact, only one commodity: money. In our markets an investment usually combines a substantial portion of debt capital, mortgage and a smaller amount of equity, venture funds. Like it or not, we are involved in monetary affairs, and we owe it to our clients to be reasonably informed.

Money has a cost and a value. The cost is expressed as an interest rate, the cost to hire funds for a venture. Value has a global quality; it is an exchange concept. What can money be exchanged for in terms of goods, services and other nations' currencies. Since capital cost and value are subject to continuing market variations, a real estate investment's value must fluctuate similarly. Cost, or interest rates, are the products of supply and demand laws. Demand for funds is created by the ongoing activities of the general economy. However, supply is a reasonably controlled factor, and in the United States the Federal Reserve is *the* regulating agency. Clearly, variations in supply will cause interest rate fluctuations with a myriad of impacts throughout the economy, particularly in the very interest-sensitive arena of real estate investment.

Reserve Requirement

For Federal Reserve to carry out its missions, Congress gave it the necessary tools to regulate money and credit. There are three separate but interrelated devices. First, there is the *reserve requirement*. With fairly recent legislation, most banks are compelled to be members of the reserve system, especially those controlling the bulk of the nation's deposits. One requirement of membership is to maintain with Fed a reserve account calculated as a percentage of the institution's deposits. There are varying percentages for different deposit types; we have a fractional reserve system. Funds in the account are regarded as sterilized. They cannot be used in the member bank's business, and they earn no interest. Fed can vary reserve requirements from time to time, and by so doing, either makes more loanable money available to banks or withdraws and sterilizes additional funds. In recent years, this credit regulation tool has not been extensively used for changing capital availability

Discount Rate

The second tool is the *discount rate*. A privilege of Fed membership is the right to borrow from the central bank. If business is booming and loan demand is intense, banks might be interested in acquiring funds to accommodate its customers. The interest rate Fed charges its borrowing members is called the discount rate. Obviously, a low rate has an expansive effect in that it facilitates lending activity, while a high rate has the opposite effect. Fed does not give members free and unlimited access to borrowing. It watches the banking system carefully for signs that institutions might be overexpanding their lending and thereby promoting inflation. Fed considers the latter our economy's most dangerous malady. At present, the discount rate is not the primary tool for credit regulation, but it is an effective device used by the reserve system to signal financial markets about its economic and monetary views, particularly on inflation.

Open Market Committee
The third tool is *open market operations*. Fed has a policy making body called the Federal Open Market Committee which consists of the seven members of the Reserve Board, the president of the New York Reserve Bank, and, on a rotating basis, the presidents of four other reserve banks. This group holds regular meetings where it studies the latest domestic and global economic and capital market data and then sets monetary policy for an ensuing time period. To implement policy, directions are given to the New York Reserve Bank to execute a series of open market purchases and sales of U.S. Treasury securities. The transactions appropriately influence capital availability and cost to bring them into conformity with the objectives of the Open Market Committee. When Fed buys securities from dealers, it pays with its check which dealers deposit in the banking system. Thus purchases expand money supply. If Fed executes sales and purchasing dealers pay with their checks, this removes funds from the banking system.

There are many interesting facets to open market activities. For example, a great deal of leverage is involved because of a relationship to the reserve requirement. To illustrate, assume a reserve requirement of 20% and an Open Market Committee purchase of $1,000,000 in securities. The selling dealer deposits the check in his bank, which sends it to Fed for payment. Fed pays by crediting the bank's reserve account. If, at that time, the account is in full compliance with reserve requirements, the transaction creates $1,000,000 in free or excess reserves. With a 20% reserve requirement, the $1,000,000 can serve as reserve for $5,000,000 of additional deposits. The bank could then lend $5,000,000 to customers and thus credit their checking accounts to create that volume of deposits. In a sense this is bank's manufacturing money. If instead, the Fed sells $1,000,000 of Treasury securities and there is a 20% reserve requirement, the process is reversed and the effect is a possible $5,000,000 decrease in available credit.

Fed Funds
The next topic for consideration is *fed funds*, and this leads to an examination of the Central Bank's control or influence on interest rates. Member banks regularly must display balance sheets demonstrating their full compliance with reserve requirements. Just prior to the settlement, or prove up date, some banks may be short of reserves and others may have excess. To meet requirements, banks short of reserves borrow from those with surplus. The loans are very short term, e.g., overnight, and since they are from bank to bank, quality is considered high. The rate of interest paid on these borrowings is called the fed funds rate, because the money involved is in reserve accounts.

As in any free market, when banking system reserves are plentiful the fed funds rate is modest, and when there is scarcity the rate is high. This is simply supply and demand in action. However, Federal Reserve through its Open Market Committee operations can significantly expand or contract available free reserves, thereby raising or lowering the fed funds rate. Thus, Fed exercises direct control on this important funds rate from which all other short term interest rates are keyed.

At regular meetings of the Open Market Committee, monetary policy is formulated which includes setting the Fed Funds target rate for an ensuing period of time. Instruction is then given to the New York Federal Reserve Bank to conduct daily open market purchases and sales in order to maintain the rate on selected target. If the rate moves above the desired level, purchases can be executed which bring additional reserves into the banking system and lower the funds rate. Conversely, if the rate drops below target, sales can be made to withdraw reserves and raise the rate. The New York Federal Reserve Bank enters the capital market daily implementing Open Market Committee policy and keeping the Fed Funds rate on target.

Fed Watchers
The financial markets closely follow Fed's activities in funds, since these activities are regarded as the best evidences of the Central Bank's views and thinking about the economy and monetary conditions, particularly the inflation situation. A group of economists and financial experts known as *fed watchers* track its open market operations daily and infer the Fed's current state of mind. Investors rely heavily on their judgment and pay well for the advisory services.

Why fed watchers? The meeting minutes of the Open Market Committee are kept secret until the next meeting. During the blackout period, only the record of their open market transactions can provide clues on the policy decisions made at the recent meeting. Early in February 1994, Fed increased the funds target rate by 0.25%. While not a big move, it was very significant because it was the first upward adjustment in five years. Sensing it would have great psychological impact, the Central Bank took the unprecedented step of immediate public disclosure. Seven weeks later a second 0.25% rate hike received somewhat similar publicity. It is expected, however, that going forward Fed will maintain much of its traditional secrecy to guard against improper trading in the financial market.

Fed Funds Rate And Real Estate
Many observers regard the fed funds rate as the most important short term interest rate, since it is

controlled by the Central Bank and reflects its extensive knowledge of economic and monetary conditions. Indeed, other short term rates seem to key off the funds rate. While real estate investments mainly involve intermediate to longer term capital, there are many facets of industry operations that employ short term financing where the interest cost is directly manipulated by Federal Reserve.

To what extent can Fed manipulate the interest costs of longer term funds, such as mortgage interest rates, which are so material in real estate investments? Widely held opinion is that the Central Bank does not directly control those rates but, at most, has an indirect influence. Rather, the principal moving force is the financial market perceptions of inflation's probable future course. A nominal interest rate is regarded as a combination of real return on capital plus compensation for inflation's expected erosion of monetary values. As inflation fears increase, investors react by discounting bond values which consequently lifts interest rate levels. With intermediate and longer term paper, the discounts usually run steeper than they do in shorter maturities. Hence, a normal yield curve shows interest rates increasing as maturities lengthen. Fed jealously guards its reputation as the economy's preeminent inflation fighter.

Looking Ahead

The May 17, 1994 meeting of the Open Market Committee produced a 50-basis point hike in the fed funds rate. Momentarily this seemed to quiet bearish bond market attitudes. Again, Fed went public by announcing the move and its magnitude, even indicating that immediate further actions did not appear necessary. The theory advanced is that the step taken is sufficiently strong to quiet inflation fears and thereby prevent long-term interest rates from rising. This climate is expected to enable the economy to continue its expansion at an acceptable pace without any inflation problems.

Not everyone signs on to this forecast. There are a number of economists who predict the Fed will have to tighten again before the end of the summer. Such divided opinion may prevent or delay any improvement in long-term interest rates. Certainly, residential mortgage rates do not show any sign of receding to the favorable levels experienced earlier this year. This, of course, is not a boost for new and existing home sales, and mortgage refinances have slowed markedly.

There is a disquieting fear that more adjustment is ahead. Many think the interest moves might feed on themselves. All businesses operate with capital. If capital becomes more expensive, the costs have to be factored into the prices of goods and services. Such price inflation could bring additional credit tightening which would be a damaging negative for economic growth. In light of what has happened and what could occur, all parties, especially real estate counselors, must become keen "Fed Watchers."

RECAPITALIZING A REAL ESTATE COMPANY WHEN REAL ESTATE IS OUT OF FAVOR

A Case Study

by Christopher J. Whyman, CRE

The company, a wholly owned U.S. real estate subsidiary of a United Kingdom pension fund, was created in the mid 1970s and financed mainly by loans from its parent. Subsequently, further loans, all at prevailing U.S. market rates, were made to enable the company to purchase U.S. real estate investments. In April 1987, this debt was refinanced by a private placement at the then excellent rate of 8-3/8%. The private placement was secured by a portfolio of U.K. government issued gilt edged securities held by the pension fund in the U.K. The private placement was for a period of seven years and had to be refinanced in March 1994.

Market Background In 1993

- The real estate market crash was in its fourth year and lending on commercial property was very scarce and very difficult.
- Interest rates were dropping to record lows as efforts continued to restart the U.S. economy.
- The U.K. pension fund parent wished to be relieved of the loan security provided by the charge it had given over its gilt portfolio so it could trade more actively and reduce its exposure in gilts.

REIT Consideration

The company actively considered forming a Real Estate Investment Trust (REIT) and visited a number of Wall Street houses. It became apparent that a public REIT would be difficult to form as the principle real estate asset was large (valued on its own in excess of the market value of many of the existing REITs), and the portfolio was diversified both geographically and by product type. The market was looking for single asset class companies with properties located close to one another. In addition, the presence of a hotel in the large mixed-use asset was a problem since REITs cannot recognize direct hotel income. As discussions proceeded, the company management also became aware of a significant problem in running a REIT composed largely of office space—the need to distribute 95% of the income against the market need to fund occasional large sums of money for tenant improvements as leases expire. The REIT route was eventually dropped.

The Company's Search

The company then started early to prepare for its refinancing task. Work commenced 12 months

Christopher J. Whyman, CRE, is president and chief executive officer of Eastern Realty Investment Corporation, Washington, D.C., investors and owners of institutional quality U.S. real estate on behalf of The Electricity Supply Pension Scheme of England and Wales. Eastern Realty's principle asset is ownership and management of L'Enfant Plaza, a two million square foot mixed-use development in Washington, D.C. Whyman is a member of The Counselors of Real Estate and also a fellow of The Royal Institution of Chartered Surveyors.

before the due date. The company visited and interviewed 24 investment advisor companies, pension funds, institutions and other advisers and moved toward a short list of four investment houses. These included the adviser who had placed the original private placement loan.

The Company's Requirements

- $105 million
- lowest possible interest rates
- five year term or less
- maximum flexibility to prepay early if needed or desired.

The following forms of refinancing were considered.

- Traditional mortgage. It became apparent quickly that this route would not work because the portfolio valued at about $300 million was likely to be of insufficient size to provide backing for a large enough loan without additional security. A hotel was a significant part of the major asset in this portfolio, and hotels were strongly out of favor with lenders. The portfolio would need to be considered without the hotel. Debt coverage would be on the order of 65%, possibly up to 70%, but without the hotel the portfolio on its own was not large enough to support the loan required. Some form of guarantee would be needed in addition to the security of the real estate. Further reasons for discounting were likely higher relative interest rate levels and lack of prepayment flexibility without penalty.

Primary Debt Market Alternatives

	PROS	CONS
Underwritten Public Offering	—Deepest market —Best pricing —Most liquidity —Longest term —Investors view offerings on *take it or leave it basis*	—Level of initial and ongoing disclosure required —SEC review likely to be time consuming
144A	—Most of the same characteristics as public in terms of term and pricing with less stringent disclosure requirements —Investors view offerings on *take it or leave it basis*	—Market not as deep or liquid as public market —Pricing not quite as favorable
Eurobond Market	—Pricing generally competitive with U.S. market —Receptive to the pension fund's name and story —Extremely competitive pricing	—$105 million is considered small
Traditional Private Placement	—Avoid rating and SEC registration —Receptive to the pension fund's name and story	—Pricing generally wider —Expect some convenant negotiations
Commercial Bank	—Receptive to noncorporate credits	—Expect some convenant negotiations
Commercial Paper	—Deep market —Aggressive pricing —Shortest term —Prepayment flexibility —No SEC registration required	—Ratings required —Interest rate risk (can be mitigated through swaps) Refinancing risk

Description Of Primary U.S. Debt Market Alternatives

	Underwritten Public Offering	144A Underwritten Offering	Traditional Private Placement/ Bank Market
General Description	Would require substantial disclosure with respect to the U.K. pension fund. SEC review likely to take 6-8 weeks. Might require restatement of financials for a 5-year period. Broadest market available.	A hybrid market between the private and public arenas; ratings and liquidity make many traditional "public" investors (insurance companies, state funds) indifferent between underwritten 144A and public transactions.	Historically, the preferred market for selling complex structure, or unusual credits.
Pricing	For stronger, well-known credits the liquidity of the market allows for more attractive pricing than private market. Can create same benefits as funding floating rate by swapping out early maturities.	While sensitive to credit ratings and name recognition, pricing can be achieved at a substantial savings over the private market. Can create same benefits as funding floating rate by swapping out early maturities.	Least attractive pricing, but higher initial spread cost can be mitigated through delayed funding strategy if available. Does offer potential of funding on floating rate basis.
Documentation	1. Prospectus 2. Underwriting Agreement 3. Indenture	1. Offering Memorandum 2. Purchase Agreement 3. Indenture	1. Agent's Letter 2. Detailed Loan Agreement
Maximum Term	30 years	15-30 years	Bank "corporate market" 7-10 years Institutional market 15-20 years
Accountant's Comfort Letter Required	Yes	Yes	No
Ratings Required	Yes	Yes	No
Transfer/Settlement	DTC Preferred (Depository Trust Company)	DTC Preferred	Issuer and Investor Direct
Type of Investor	Very large investor base consisting of insurance companies, pension funds, money managers, and mutual funds.	Incrementally larger investor base than the private market. Increasing cross-section of public market buyers.	The market for private project debt consists primarily of sophisticated insurance companies and banks familiar with credits.
Investor Investment Decision	Public Bond Department	Private Placement or Public Bond Department	Private Placement Department or Bank Credit Committee
Degree of Investor Negotiation	None	None	High
Regulatory/Registration Requirements	SEC registration of securities under the Securities Act of 1933 is required.	Rule 144A provides an exemption for resale of restricted (unregistered) securities between qualified institutional buyers (QIBs).	SEC Regulation D exempts registration for private placements when certain conditions regarding the sophistication level of investors and the timing of resale are met.
Timing	As SEC filing and ratings are required, accessing the market can take somewhat longer particularly if the SEC decides to review the filing.	As SEC registration is not required, the market can be accessed very quickly. The credit rating process drives the timing of a 144A or public offering.	As ratings and SEC registration are not required, the market can be accessed quickly. However, negotiating loan agreement can be very time consuming.
Trading Implication	Enhanced initial distribution and secondary trading	Enhanced initial distribution and secondary trading	Illiquid

- Once the company, particularly it's parent U.K. pension fund, had accepted the need for a guarantee and indicated a willingness to provide one, a number of new alternatives opened up. In examining the alternatives with the parent guarantee, it soon became obvious that if the parent sought and obtained a rating from the relevant agencies more choices were available and the interest rate also would be lower due to the size and security offered by the parent. The advice given, and taken, was to pursue the rating diligently and choose the market at the last moment depending on how each was performing at the time.

  The markets considered were:
  Eurobond
  U.S. Public
  144A
  Private Market
  Commercial Banks
  Commercial Paper

Commercial Paper
In light of its flexibility, the generally held view of the economy, the likelihood of interest rates remaining relatively low and the ability to cap interest rate rises, the company chose commercial paper as its refinancing vehicle.

Rating The Pension Fund
This turned out to be a complicated and time consuming affair made more difficult by the different national and state laws (in the U.S.), and, in particular, the nature and status of pension funds and trustees in U.K. laws. After many weeks of late nights, the U.K. pension fund was given an indicative long term debt rating by Standard & Poors of AAA. Commercial paper issued by the company and guaranteed by the pension fund has been rated A-1+ by S&P and P-1 by Moody's. The pension fund became the first ever fund outside the U.S. and only about the third (including the U.S.) to be rated. These were the highest ratings possible, and

Indicative Cost Comparison Across Markets
(January 20, 1994)

Assumption: 5 Year Maturity and AAA/Aaa Guarantee

	Commercial Paper	U.S. Public	144A	Private	Bank	Eurobond Market
Treasury Yield	5.05	5.05	5.05	5.05	5.05	5.05
Spread over 5 yr T						
AAA	.20	.30	.40-.45	.65-.75	.65-.70	.20-.30
AA	.22	.37	.47-.52	.65-.75	.65-.70	.30-.40
Reoffer Yield						
AAA	5.25	5.30	5.48	5.75	5.73	5.30
AA	5.27	5.37	5.55	5.75	5.73	5.40
Expenses	.04-.05	.13-.20	.11-.18	.05-.09	.02-.03	.03-.04
Fee (Execution & Structuring)	.22	.21	.21	.18	.15	.15
All in Cost						
AAA	5.52	5.73	5.84	6.00	5.91	5.49
AA	5.54	5.80	5.91	6.00	5.91	5.59
Floating Rate Conversion						
AAA	LIBOR + .22	LIBOR + .43	LIBOR + .54	LIBOR + .70	LIBOR + .61	LIBOR + .19
AA	LIBOR + .24	LIBOR + .50	LIBOR + .61	LIBOR + .70	LIBOR + .61	LIBOR + .29

Note: Commercial paper and bank floating rate cost converted to fixed rate via swap market. All fixed rates converted to floating rate via swap market.

they were achieved at a time when others were not able to sustain their existing AAA rating.

Benefits Of A Rating

The rating achieved had the following benefits:

- lower interest rates
- greater access to the market especially when money is tight
- greater access to the derivative market if desired
- a significantly improved market view of the company and of the pension fund as very secure businesses.

Successful Issue

Over half of the paper was taken up at a rate on top of the U.S. Government repurchase agreement (repo) rate and the remainder was taken up at the rate commanded by the very best U.S. corporations. Effectively, therefore, the first issue was at about 3.68%, resulting in an annualized savings of $5 million in interest payments.

Swaps, Caps And Collars

Various techniques have been developed to allow an issuer to hedge exposure, including sharp increases in interest rates.

Swaps allow companies to convert several years of a floating rate obligation to a fixed rate by executing an interest rate swap. During the past five years, the swap market has grown dramatically providing substantial liquidity which is enhanced by a number of mechanisms allowing swap underwriting, swap reversal and swap sale.

Caps are like life insurance policies. A premium is paid to insure against an event that it is hoped will not happen. Caps allow the company to enjoy the low cost of floating rate financing and also to protect itself against sharp rises in short-term rates. A cap is a series of calls—the right to buy the underlyer at the strike price. For example, in early April 1994, the issuer of one month commercial paper at 3.62% for an up front premium of 31 basis points per year for three years could have purchased a cap at a strike rate of 7% for that period. Other techniques available include collars (whereby a company, by giving away some of the upside of low floating rates, can cheapen its protection against rising rates), average rate caps, step-up caps and rebate caps (where a company purchases a cap for a higher upfront premium, but if the one month cap is below the rebate rate on the rebate date, the company receives the premium of a conventional cap back as a rebate).

The Players

The Company	Eastern Realty Investment Corporation, Washington D.C.
The Parent	Electricity Supply Pension Scheme (the second largest pension fund in Britain)
The Advisor	Goldman Sachs and Company

EMERGING TRENDS IN COMMERCIAL MORTGAGE SECURITIZATION

by John J. Healy, Jr., CRE,
Patricia R. Healy and
Eric R. Lindner

The purpose of this article is to acquaint the reader with the commercial mortgage securitization market and its role in capital formation, areas to consider in the transaction process and the importance of institutional loan servicing.

In *Capital Sources for Real Estate*, March 1994, authors Michael Zuckerman and Thomas D. Kearns report that debt securitization began in the early 1980s at Salomon Brothers, a major New York investment banking firm.[1] At that time, Salomon realized that investors were interested in buying securities backed by a large diversified group of mortgages on single family homes, as opposed to directly investing in individual mortgages. This progressed to a point where, in the early to middle 1980s, collateralized mortgage obligations (CMOs) on residential properties became one of the leading investment vehicles and profit centers for the investment banking community.

In the 1980s, commercial securitization began in earnest and involved the aggregation of debt secured by a few large institutional-type office buildings in major U.S. cities. Typically, a bank would pool the loans and an investment bank would sell senior participations with the bank holding the junior, or subordinate, participation piece. Single-purpose insurance companies were created to provide credit enhancement for debt securities by insuring the repayment of debt in the event of performance difficulties with the borrower(s). This avoided reliance on the collateral and focused emphasis on the credit quality of the insurer. Zuckerman also reported that in March 1990, Donaldson Lufkin Jenrette Inc. considered securitizing the financing of a series of properties for one borrower without any credit enhancement. This significant financing for MLG Properties closed in August 1991.

In the early 1990s, the Resolution Trust Corporation began pursuing debt securitization as a way

John J. Healy, Jr., CRE, *is a founding principal of The Hanford/Healy Companies, a national firm specializing in real estate appraisal, consulting, research, asset management and advisory services. He is also managing principal of The Hanford/Healy/Appraisal, Consulting, and Research Companies. He holds professional designations awarded by the Appraisal Institute and The Counselors Real Estate.*

Patricia R. Healy *is managing pincipal of Hanford/Healy Asset Management Company, and she is a licensed real estate broker in the state of California. Her academic activities include guest lectures at the University of Virginia and the American Institute of Banking. Previous she served as a faculty member of St. Mary's College.*

Eric R. Lindner *is managing principal of Hanford/Healy Advisory Company, and is responsible for the Hanford/Healy/Asset Management Company's asset-related marketing activities. He has more than 25 years of experience in the areas of real estate finance and asset management.*

to liquidate its portfolios. A trust is established and the loans are assigned to a trustee. The trustee holds the mortgages as collateral for the securities to be issued to the investors. In addition to the underlying real estate, investors rely on ratings given by agencies such as Standard and Poor's Ratings Group, Moody's Investors Service, Duff & Phelps Credit Rating Co., and Fitch Investors Service, Inc.

Typically loans are underwritten on a property-by-property basis. When the loans are assembled (pooled) in a security or bond, the debt (by definition) has been securitized. The securities are stratified (tranched) into various levels of risk based on the loan-to-value ratio and the debt service coverage. The rating agencies then evaluate the risk and assign a rating to the various tranches; reserves, in the form of subordinations, also are required. As would be surmised, there are corresponding interest rate differentials that correspond with the established tranches. These various methods of rating risk provide the investor with some formalized assessment of exposure.

As might be imagined, the market for commercial and multifamily securitized products is growing rapidly. It was reported in *The Institutional Real Estate Letter* that during the period July 1, 1991 to June 30, 1992, members of the Mortgage Bankers Association originated about $10.6 billion of commercial mortgages.[2] As of June 1992, mortgage bankers administered or serviced approximately $160 billion of commercial and multifamily mortgages.[3] As there continues to be a desire/need for liquidity and flexibility on the balance sheet of financial institutions, it is forecast that commercial mortgage securitization will continue at an exponentially increasing rate.

There is a new trend to develop liquidity for a tranche of the security that has typically been held by the originator. This is the unrated portion of the security. As previously mentioned, there may be a number of tranches that could range from AAA rated security to BB rating (for example). There is usually an unrated piece of the security which would have the lowest priority on the cash flow and/or principal. This unrated component, or what is colloquially referred to as the "B" piece, historically has experienced limited liquidity. Previously, there has been investor interest in this portion of the security. To successfully purchase this "B" piece, the due diligence process and the loan management servicing process become increasingly critical to the success and efficient execution of the offering.

Transaction Components

The market for commercial mortgage securitization, while relatively embryonic compared to other asset classes, nevertheless has evolved to where fundamental transaction characteristics or components are recognized as critical to successful execution. Characteristic transaction components that are deemed essential include:

A. *A thoughfully organized collateral pool* wherein the property types, geographic characteristics and loan sizes combine to facilitate an investment which can be efficiently risk-rated and priced. Excessive collateral diversity, significant concentration (borrower, geographic or collateral) or a mortgage exposure relating to rate of maturity may defeat a meaningful analysis and unnecessarily complicate the investment process.

B. *A methodical and comprehensive due diligence process and resulting work product* will facilitate not only the investor analysis (particularly with respect to the unrated and below-investment-grade tranches) but also assist in rating agency analysis. The due diligence process requires focus on both the deal structure and attributes and the underlying collateral (real estate). Single family pools tend to be more homogenous (commodity-like), while commercial loans necessitate a more complicated underwriting process.

C. *The transaction must be rating agency friendly.* The deal must be structured and presented in a way that is consistent with criteria deemed appropriate by the agencies. This criteria would include collateral composition and presentation, master and special servicer qualifications and relationship and sensitivity to market(s) dynamics.

D. *Near-term and long-term transaction success* will be profoundly influenced by and dependent upon how the collateral pool is managed. It is essential that not only are the servicers qualified and experienced, but also that the servicing strategy and relationship (i.e. master and special servicer) are well defined and articulated.

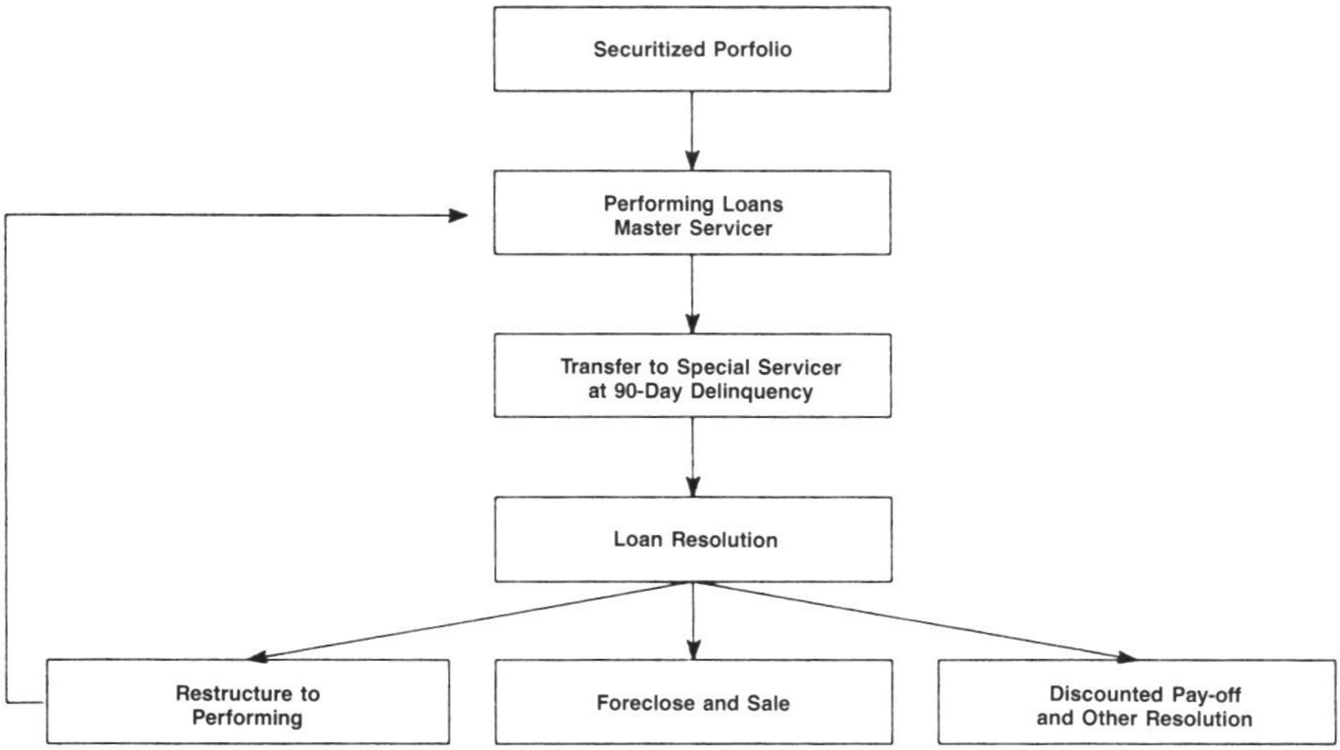
If the market for REMICs involving commercial mortgages grows at the rate many industry experts forecast, it will result from accurate market and transaction information available on a timely basis. Market growth and efficiency is dependent upon the investment community's receiving and being able to confidently evaluate market transaction-specific data. The ability to ensure the timely collection and distribution of transaction performance information will significantly enhance (and differentiate) the initial execution of a deal.

Integrated And Seamless Servicing

Critical to the efficient execution of a commercial mortgage security is the character and quality of the firms servicing the collateral pool. Given the fundamental nature of real estate debt secured by commercial properties, current as well as historic

Figure 1

Securitized Portfolio Management
Master/Special Interaction



market dynamics, and basic real estate supply and demand issues, portfolio mortgage management must be skilled and positioned to act on, rather than react to, changed or changing circumstances.

Current convention suggests that servicing is bifurcated between a traditional *master servicer* and a *special servicer*. The master servicer has been responsible for the day-to-day servicing of the performing pool, while the special servicer has been responsible for asset-specific management, on a stand-by basis. This occurs when a loan becomes nonperforming and/or when other asset-specific issues occur which could adversely impact the security's performance.

The role and responsibility of the special servicer historically have been viewed as being reactive to asset-specific events. Given the nature of the underlying collateral, a reactive role may put the special servicer and the security's performance at risk. As may be expected, there can be a long time between the event and the efficient transfer of responsibility (master to special). The dual structure does not provide an environment which promotes proactive management. The structural flaw inherent within this approach has been apparent in some of the early RTC securities. In theory it works; in practice it falls short.

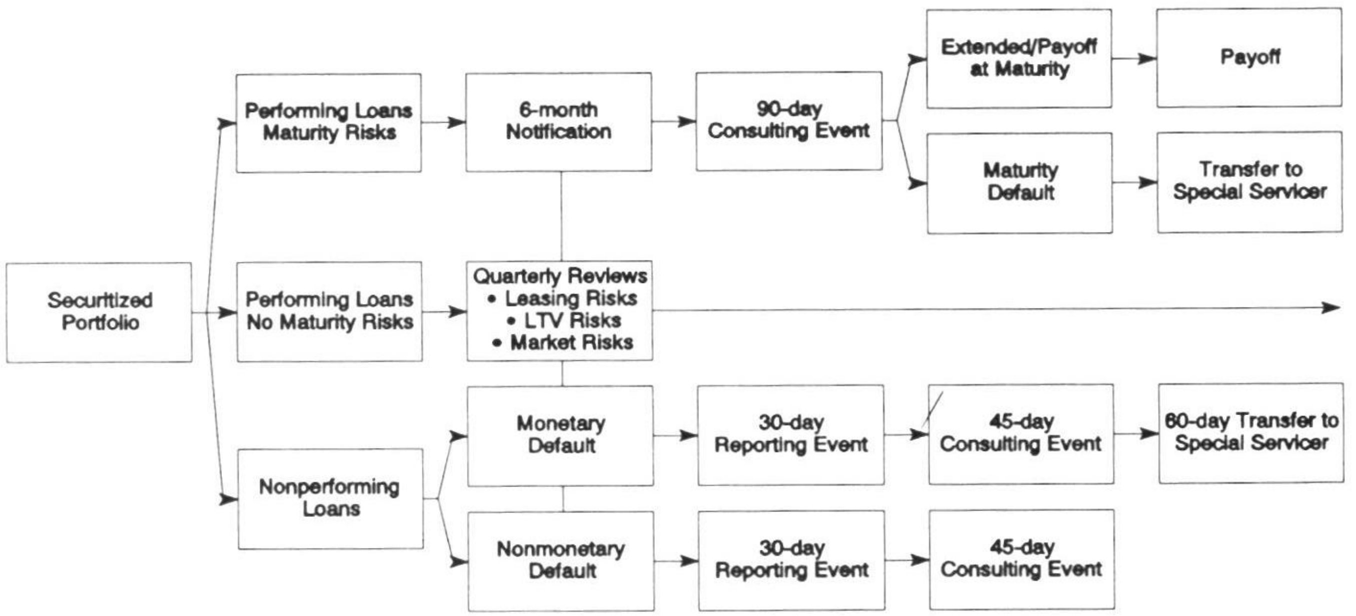
The security, its investors and the market are much better served by a structure which encourages proactive involvement by the servicers in anticipating and having in place strategies which address portfolio management requirements. To illustrate this point, the following figures detail two simplistic special servicer-master servicer relations. Figure 1 is an illustration of the classic relationship wherein the activities are clearly bifurcated and mechanical; Figure 2 is an example of a relationship which requires integrated and proactive involvement. In addition, the role of the special servicer is to be the guardian of the first loss or "B" piece position. These two roles are complementary and should reflect aligned economic interests for all investors.

Conclusion

The evaluation, presentation and acquisition of a securitized transaction involving commercial mortgages require a thoughtful and well-supported analysis of portfolio and underlying collateral risks.

Figure 2

Securitized Portfolio Management
Master/Special Interaction



As part of the evaluation process, the portfolio should be disected and reconstructed so the asset-specific risks or issues may be considered in the context of the portfolio.

The analysis should include an evaluation of portfolio attributes (e.g. Weighted Average Coupon [WAC], Weighted Average Maturity [WAM], Debt Service Coverage Ratio [DSCR], Loan-to-Value ratio [LTV], etc), the identification and analysis of assets with high risk profiles, the handicapping of individual assets. Also employed, if and when needed, is the development of a loan loss adjusted cash flow for the portfolio, property/size analysis, real estate market analysis and the examination of alternative risk management and mitigation strategies.

A focused and methodical analysis is an absolute requirement for three (3) primary reasons (and audiences):

A. To achieve most favorable consideration by the rating agencies which translate to optimal execution;

B. To facilitate the investment review by prospective first loss investors; and

C. To create a solid foundation for the development and implementation of portfolio management (servicing strategies).

By involving the entity(ies) that ultimately will perform the ongoing servicing in the portfolio underwriting, a significantly better understanding of the asset's composition will result which eventually will effect a more efficient trade.

NOTES

1. Zuckerman, Michael and Thomas D. Kearns, *Capital Sources for Real Estate*. Boston, MA:, Warren, Gorham and Lamont, 1984, p.1.
2. Excerpted from page 1 of *"The Role of the Mortgage Banker in the Origination, Underwriting and Servicing of Commercial Mortgage Loans for the Institutional Investment Community,"* a report issued jointly by the California Mortgage Bankers Association and Instititional Real Estate, Inc., 1994.
3. Ibid.

COUNSELOR'S PERSPECTIVE

Pension Fund Participation In Real Estate Capital Formation

by Barbara R. Cambon, CRE

For the last decade, pension funds were viewed as an important and growing source of real estate capital. However, over the last several years, when the traditional sources of capital were withdrawing from the market, pension funds did not fill the capital gap in a meaningful way. Now that it appears the real estate market has hit bottom, how will pension funds participate in the market recovery? This article provides a review of the investment marketplace from a pension investment perspective and explores three major strategic investment directions currently being considered by pension funds.

The Investment Marketplace

After a virtual withdrawal of capital from real estate markets for several years and the lack of transaction activity, real estate investment markets are selectively springing to life in 1994. The economic activity required to absorb excess space is rebounding in some areas of the country with the outlook continuing to be diverse depending upon the economic region and property type under consideration. In addition, the real estate investment marketplace continues to evolve characterized by new sources of capital and investment structures.

Investor activity indeed has begun to resurface, fueled by a variety of new capital sources. While the capital binge of the 1980s involved a number of parties, including commercial banks, S&Ls, insurance companies and foreign investors (along with pension funds), the newest sources of capital emanate from Wall Street. Following its significant repricing over the past four years, the recognition that real estate provides competitive current income returns compared to other financial assets (without the more speculative reliance on value growth to produce returns) is driving this trend.

Real estate investment trusts (REITs) have proliferated. The market capitalization of this public market sector grew by $9.1 billion in 1993 to a total of $34.6 billion for equity REITs, an increase of 36% in just one year. Significantly, many of these real estate IPOs (initial public offerings) represent premier real estate operating companies turning from private debt sources to the relatively cheap public equity markets to recapitalize their firms. Capital has flowed to this sector primarily from yield-driven, fixed-income investors, which may cause this sector to falter in the face of higher interest rates. The consensus view, however, seems to be that well-managed companies will endure and prosper if they have solid growth prospects in property segments where economies of scale may be exploited (e.g., apartments and regional malls). On a related note, capital-rich REITs recently have been accused of overheating some local property investment marketplaces, specifically for apartments and regional malls. For example, apartment capitalization rates fell 50 to 100 basis points or more in sought-after locations.

Wall Street also has entered into the vacuum for issuance of mortgage debt created by the withdrawal of financial institutions from their traditional real estate lending role. Mortgage brokers are finding new life through conduit arrangements with Wall Street capital sources to originate loans which are packaged and sold as commercial mortgage-backed securities. This trend was jump-started by the RTC's pioneering effort in pooling and packaging loans for sale as it worked out the problem portfolios of the nation's failed lending institutions. This activity, coupled with the re-emergence of insurance company lending for smaller-valued properties, has provided breathing room for property owners looking to refinance debt, albeit under more conservative underwriting terms.

Pension Fund Activity

Pension funds also are exhibiting increased interest in the real estate marketplace. Preferences for investment strategies and structures have been articulated and absorbed by the manager community with resulting changes in how investment activity will be conducted in the future. Large separate account investors have hammered down fee structures and re-entered the market selectively, enjoying the discretion that significant capital wields. For other investors, a next generation of pooled fund products is emerging

__Barbara R. Cambon, CRE,__ is owner, president of the corporation and a member of the Management Committee of Institutional Property Consultants, Inc., in San Diego, California. She is actively involved in real estate pension consulting and has performed extensive research on historical investment performance. Cambon is a member of The Counselors of Real Estate.

to meet the expressed needs of investors, including increased control (e.g., through corporate governance provisions and increased ability to terminate management), lower and more incentive-oriented fee structures and more clearly articulated strategies. In addition, the non-profit industry effort to effect a secondary market for existing pooled fund units (known as the Clearinghouse) is officially organized and poised to begin transactions.

New Strategic Investment Directions

The first strategy for pension fund participation in real estate is the traditional core portfolio, the strategy used by most pension funds to build their real estate portfolios. The core portfolio strategy is characterized by a focus on well-leased buildings generating stable operating income. Property types include office, retail, industrial and, more recently, apartments. National geographic diversification is sought to avoid property concentrations in markets subject to similar economic changes.

As the traditional core strategy began to lose appeal for both portfolio and market reasons, a second strategy emerged—"niche" investing. This strategy is characterized by very specialized real estate-related investments which are also very diverse. As pension funds added a non-core component to their strategy, the focus shifted to market niches where risk-adjusted returns appeared to be more attractive and there was not an overabundance of capital from a multiplicity of sources. Niche strategy property types include agricultural land, timberland, undeveloped land, fast food franchise restaurants and single-family residential development.

The third investment strategy is opportunistic investing. This strategy seeks to earn higher (in some instances, substantially higher) rates of return and encompasses a broad range of acquisition targets. Attributes of this strategy include bulk portfolio purchases of performing and non-performing loans and real-estate-owned (REO) from financial institutions; single-asset purchases from distressed sellers; acquisition of out-of-favor property types, i.e., office buildings; and acquisition of real estate companies. By pension fund standards, holding periods are expected to be relatively short and returns are projected to be in excess of 20%.

Which strategy is attracting the most capital today? Clearly the favorite is the opportunistic strategy. The appeal of high returns and realized profits is very strong. Traditional strategies were not designed to deliver above-market returns and too little profit was realized. This new wave of opportunistic investing brought forth a new group of pooled fund sponsors/advisors (or partners). Wall Street firms (Zell/Merrill Lynch, Goldman Sachs, Morgan Stanley) are active players who are investing meaningful amounts of their own capital. This has struck a positive chord for pension investors seeking better alignment of interest between themselves and pooled fund sponsors.

Conclusion

As we progress through 1994, the pall over the real estate marketplace appears to be lifting. Capital from pension investors and nontraditional capital sources, such as the public debt and equity markets, is beginning to revive the dormant real estate investment marketplace of the past four years. While, like the economy, the real estate market will continue to have an underlying cyclical nature, the increased diversification of capital sources and improved public and private investment structures for real estate should bring a degree of maturation to the investment marketplace which will benefit all investors going forward.

From a pension investment perspective, increased investor emphasis on current yield (as opposed to speculative value increases), accompanied by improved investment structures allowing for greater control and liquidity, make this an ideal time for investors to consider the deployment of their real estate allocations. Property types in selected areas, including apartments, industrial and certain retail formats, are generating attractive current cash yields with the prospect of value increases over the next several years. For the more opportunistic investor, office properties, primarily in suburban locations, also may be attractive.

As a note of caution, perhaps the only thing we can be certain about regarding the future is that it will not be an exact replica of the past. Therefore, it is important to remain vigilant regarding the impacts of new capital sources and investment structures on the performance of the real estate marketplace. This will be particularly important as new construction begins to mitigate the potential for another boom-bust cycle mirroring, in severity, that of the early 1990s.

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