FOCUS ON REITs

From Evolution to Revolution

by Samuel Zell

The near-demise of the commercial real estate industry in 1990 was a watershed in the evolution of the business. The excesses of the 80s not only resulted in the greatest losses ever suffered by the lending community, but they also eliminated the primary role played by banks, insurance companies, and savings & loans in the financing of real estate.

With traditional sources of capital effectively out of the business, the industry was forced to approach the public capital markets for both debt and equity financing. The capital markets allocated funds to publicly traded companies, but on terms no longer exclusive to the attributes of a single asset class. The criteria for debt and equity execution shifted from evaluation of a specific asset to the assessment of a company and its ability to execute its strategies.

The vehicles created were variations on the REIT template created in 1960 but not fully accepted until the early 90s. As these entities were launched, easily accessible capital created public real estate companies with size and sophistication not previously seen. Far from being merely an evolution in financing, the shift to public ownership has set in motion a process of consolidation that represents a revolution on the landscape of commercial real estate.

Capital intensive industries have traditionally been dominated by a few, very large, very efficient players. Auto, steel, aluminum, and semiconductor manufacturing, as examples, all have evolved from highly fragmented groups to oligopolies as capital requirements make greater demands on ownership. The real estate industry, although capital intensive by nature, has historically been highly fragmented and local in practice. This fragmentation contributed to wide, cyclical swings and the excessive nature of development cycles as neither developers nor lenders had any ability to understand the "big picture." With the emergence of public reporting, the vastly improved flow of information acts swiftly to correct market imbalance, real or perceived, as capital market activities in fall 1998 vividly demonstrated.

This long overdue consolidation of the commercial real estate industry represents a recognition that it — just as other capital intensive industries — is oligopolistic in nature. Bringing scale and operating efficiencies to the real estate community represented new challenges, however, to building ownership and operation. As the definition of competition changed from the building across the street to a network of commonly owned buildings, economies of scale and scope have become more and more relevant in the competitive environment. Tenants recognize and benefit from operating efficiencies as professional management has taken on extraordinary significance.

The effects of public disclosure and transparency have reduced real estate's purely transactional opportunities. Competitive advantages stemming from sophisticated positioning of products and services to users of real estate now fuel differentiation and drive consolidation. Predictors of success include customer satisfaction, ability to build a value-added brand, and other performance measures associated with operating company models.

The real estate marketplace is also far less likely to sin again. The consolidation of the banking industry, well on its way to completion, has continued to diminish the sources of funding for new projects. The reduction in the number of banks competing in any given market should preclude the kinds of competition that in previous cycles resulted in capital consumption, not capital investment. As an industry tends toward fewer and more cautious players, supply and demand imbalance decreases and volatility diminishes.

This oligopolization will have very positive long-term benefits for the commercial real estate market. The revolution in progress will reduce the number of participants, and create a transparent market where both lenders and developers have a much more realistic perception of the risks and rewards of the commercial real estate market. REI

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Samuel Zell, *Chicago, is chairman of the board of Equity Office Properties Trust, Equity Residential Properties Trust, Manufactured Home Communities Inc., and Capital Trust. He manages the two largest REITs in existence and is a much sought-after contributor and speaker for various real estate-related publications and programs.*