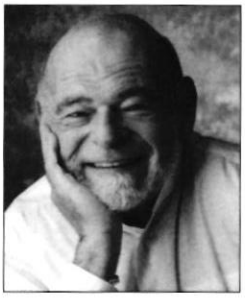
FOCUS ON THE ECONOMY

THIS TIME IT'S DIFFERENT

by Samuel Zell



There's a bumper sticker that was seen in Houston at the end of the last real estate cycle—*Please, God, just give me one more boom and this time I promise not to screw it up.*

The real estate industry may have been granted its wish. This time it really may be different.

The current economic downturn is unprecedented in the slope of its decline. But the new discipline brought about through the sea of change in real estate lending over the last decade is resulting in a properly positioned real estate market, with sufficient supply to absorb economic growth but without the excess that has characteristically been a drag on recovery as lenders struggled to cover the lack of cash flow.

It is impossible to overestimate the significance of the loss of dedicated real estate lenders to the demise of the boom and bust cycles of the real estate industry. The massive shifts in both the structure and philosophy of traditional real estate lenders will, for perhaps the first time in modern real estate history, break the correlation of a looming real estate oversupply with the early stages of economic recovery.

Historically, real estate has been segmented as an asset class with institutional allocations separate and distinct from cash, debt, or equity. Lending institutions—S&Ls, insurance companies, banks—thus began their budget year with an allocation for real estate that once committed, rarely went anywhere else, regardless of changing conditions in the marketplace. In theory, uncommitted funds in any given segment were returned to the general pot if unexpended. Needless to say, examples of return of capital were rare.

Such practices led to significant excesses. Supply and demand forces related to the supply and demand for capital for the asset class, rather than for customers and space inventory. Thus, the existing pool of capital for a cyclical industry was dangerously insensitive to changing conditions. The result was a lag of years rather than months between the time when indicators should have put the brake on new supply to the actual cessation of construction. This massive misallocation of capital produced not only an oversupply of real estate unsupported by cash flow, but resulted in a drag on emerging economic recovery that lasted well past the resumption of job growth and other positive indicators.

The evolution of the real estate capital markets in the last decade, particularly towards publicly-traded REITs, has been propelled by the increasing demand of the capital markets for liquidity. Job growth through the 1990s finally completed absorption of the oversupply of the 80s. The re-emergence of the construction crane on the skyline in 1998, however, almost immediately resulted in the stock price deterioration of REITs, reflecting the perception of "here we go again" oversupply. This snapping-shut of the capital markets,

particularly for equity, acted as a governor of the industry, resulting in the deferral or cancellation of much of the anticipated oversupply. And where in years past, funds might readily have been available from the debt side, this source was no longer available, nor did it re-materialize. The ancillary effect of the increased information flow of public markets has been to act as a benchmark for pricing capital for all other sources. The discipline predicted in a newly accountable marketplace proved indeed to produce the necessary braking effect.

But this was not a one-time phenomenon. The most far-reaching effect of this realignment of the capital markets has been the virtual elimination of dedicated real estate lending, allowing capital to most appropriately seek opportunity, in any sector. In efficient markets, capital flows to the perceived best opportunities instead of following pre-ordained conclusions. While it may have seemed to be a growth engine, in reality, dedication of capital to real estate as a separate segment impaired the natural flow of capital to the best opportunities, and ultimately led to the destructive consequences of oversupply.

The REIT market in 1998 marked the first instance where capital freely fled the real estate markets to perceived better—non real estate—opportunities. While harsh in its swiftness, the market discipline so imposed headed off nascent overbuilding, and ultimately greatly enhanced the stability of the real estate sector. The current recessionary cycle is proving an even greater test of the new capital reality. Given the volatility of the equity markets as the market has finally come to terms with the concept of valuation based on earnings and assets, this is historically where the real estate lending cycle would have begun to create oversupply. However, the reality is much different.

We are already seeing a significant reduction in the delta between absorption and completion in commercial real estate as the economy recovers, compared to 1989-91, with vastly more alignment between the forces of supply and demand. Today, we increasingly see capital available to flow to the highest opportunities available to institutional lenders. And for the first time, as we emerge from recession and the market begins to improve, we will find real estate is not in a state of vast oversupply.

This time, it really *is* different. REI

ABOUT OUR FEATURED COLUMNIST

Samuel Zell, *Chicago, is chairman of the board of Equity Group Investments, 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.*