CRE PERSPECTIVE

THE REAL ESTATE INDUSTRY PARADOX

by Scott R. Muldavin, CRE

The real estate industry is a paradox. Just as property markets achieve their most stable equilibrium in recent history, real estate investors, lenders, and service providers must scramble to meet today's unprecedented challenges.

With real estate property markets in their most stable condition in 20 years, it would seemingly be logical to heed age old advice such as "sticking to the knitting" or focus on "blocking and tackling" in order to maintain market position and returns as overall market growth moderates. However, given structural changes in market cycles, the growth of the public real estate securities markets, and the surge of successful "applications" of technology to real estate, such strategies are unlikely to succeed.

Real estate companies of all types and sizes need to carefully reflect on their investment choices; take a more sophisticated look at their customers, products, and alliance partners; and adopt strategic decision-making frameworks similar to those that have driven the success of many corporations in America that have adapted themselves to the new global economy.

WHY IS CHANGE REQUIRED WHEN MARKETS ARE SO STABLE?

Stable Markets

Stable markets themselves are at the root of much of the change necessary in the real estate industry. Most important, the more stable equilibrium in the real estate property markets today is not just a passing phase, but the beginning of a much less volatile market than has been experienced during the last 15 years.

As shown in *Exhibit 1*, the last 15 years have seen a dramatic period of excess capital and overbuilding in the mid-to-late 1980s, followed by an equally dramatic decline in capital and property values during the early 1990s. Capital flows since 1996 have been strong, but fairly close to the average of the last 18 years on an inflation-adjusted basis. Furthermore, construction levels for all property types on a national basis remain well within long-term norms; early signs of overbuilding in 1998 led to a strong corrective reaction by the industry.

Given structural changes in the finance system, the tax system, information availability, and the ownership of real estate, the likelihood of highly volatile market cycles on a national basis over the next 10 years is remote. This does not mean that there will not be overbuilding and/or capital shortages in certain property types or geographic regions, but overall, the volatility of market cycles should be much reduced over recent history.

Since most of the major real estate businesses today either started or grew dramatically during the last 15 years, and their cultures and businesses reflect an entrepreneurial orientation built around market volatility, reduced market volatility will require investors and lenders to change risk management systems and return goals and force service providers to focus on their customers, products, and potential merger and acquisition candidates to improve their productivity, pricing, and service.

Public Securities Market Growth

A second key change forcing greater sophistication by real estate companies is the development of the public securities industry during the last 10 years. The REIT and CMBS markets have grown from $27 billion in 1990 to nearly $360 billion today. For certain properties and mortgages, REITs and mortgage conduits have become the dominant providers of new capital.

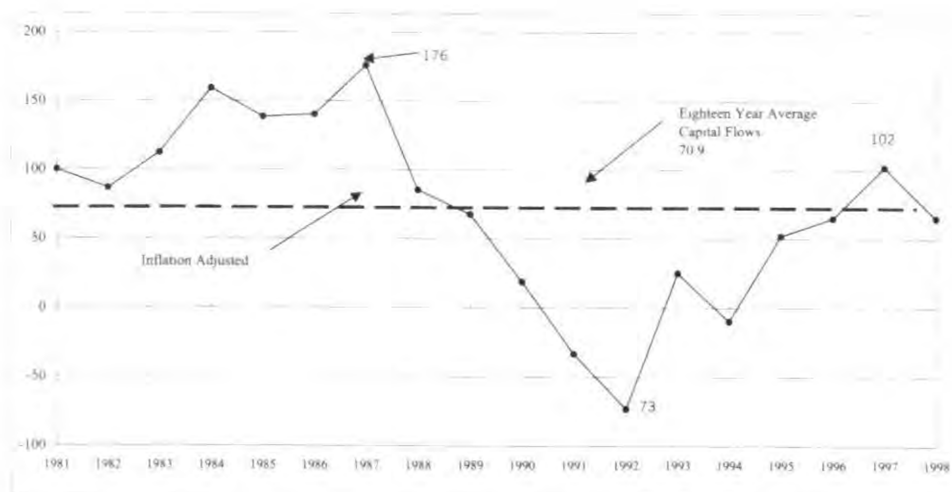
The real estate securities markets are particularly important to monitor because they react so strongly to non-real estate related investment issues. For example, due to concerns over Russian credit, the Brazilian economy, and a few other non-real estate related issues, the CMBS market collapsed in late summer of 1998, pushing mortgage spreads up over 100 basis points, and closing down the mortgage market for many lenders and borrowers.

Similarly, the REIT industry began a steep decline in the summer of 1998 finishing the year with a negative 18 percent return and experiencing market value declines of 20 percent to 50 percent from their peak in October of 1997. Again this all occurred during a period of relatively strong and stable real estate property markets.

Given the dramatic growth of public real estate securities, and their integration with the private real estate capital markets, the most successful companies will watch the dislocations and volatility in the

Figure 1

Overall Capital Flows Near Historic Norms[1]



[1] Index with 1981 set as the base year at 100.

Source: The Muldavin Company

real estate securities market in order to identify risk issues and capitalize on arbitrage opportunities between public and private real estate capital.

Technology Applications

The third key issue that will require real estate companies to stay on their toes is the dramatic increase in successful real estate technology "applications." Certainly, retail sales on the Internet and changes in the way people and businesses use real estate due to technology will be critical issues to follow going forward, but more specifically, real estate companies must stay on top of how technology changes will affect their customers, products, and delivery systems.

During the last six to 12 months, the ability to "apply" technology to real estate issues has increased significantly. Property transactions and financing have been significantly influenced. There are over a dozen major companies and scores of smaller companies offering properties through sophisticated Internet sites. There are a similar and growing number of sources for commercial mortgages and equity. These sources will not necessarily replace existing service providers, but they will change the way business is done, and the way their customers interact with them.

Finally, the magnitude of the changes that technology will bring must also be understood in analyzing real estate investment opportunities. According to International Data Corp, Internet commerce worldwide is expected to grow to more than $1 trillion by 2003. Equally amazing, the Department of Commerce recently released a forecast that almost half of the American workforce will be employed by information-technology-related companies by 2006. Clearly today is not the time to "stick to your knitting" or keep your head down and "block and tackle," but to take a more activist approach to understanding the world in which your business operates.

IMPLICATIONS OF MARKET CHANGES

Changes in the volatility of property markets, the growth of the public real estate securities markets and technology effect real estate companies and investors differently. Some of the responses by various industry sectors are discussed below.

Pension Funds and Investment Managers

Pension funds are still trying to find the best "script" to guide their real estate investment business for the new millennium. Strong real estate returns and the thriving REIT market provided the foundation for their "investment scripts" through mid-1998. Many pension funds were going to move their "core" real estate assets into REITs and invest their private real estate investment dollars into opportunity funds to attract the returns they had grown accustom to.

With the dramatic decline of the REIT industry since mid-1998 and the strong performance of private real estate equity, pension fund plans were turned upside down and many are still searching for the right path to move forward. Reluctant to give up on the liquidity and other advantages of the REIT vehicle, many pension funds have been involved with REITs in joint-ventures where they share both equity investment and returns.

With the massive delinking of REIT returns from the real estate property markets – for example hotel REITs had a negative 53 percent return for 1998 compared to a 16 percent positive return for private hotel investment – pension funds are still trying to determine where REITs fit in their portfolio. Like the international real estate markets, REITs can provide opportunistic investment, but for at least the next few years, substituting REIT stocks for "core" private equity investment will be slowed as the industry tries again to understand the proper role for REITs in their portfolios.

Pension investment managers have been equally buffeted by changes in the marketplace. Following the poor performance by many investment managers during the early 1990s, and equally poor performance for those managers that handled REITs for their pension clients during the last 12 months, pension investment managers are working closely with pension funds to sort these investment issues out. "Opportunity funds," international funds, co-investment, joint-ventures, and traditional private equity deals are the investments that seem to continue to attract attention in the pension market.

Mortgage Lenders

The demutualization of life insurance companies, the growing financial strength of commercial banks, and the unexpected CMBS collapse in August of 1998 have insurance companies, commercial banks, investment banks, and brokerage companies scrambling to determine the best approach for their businesses. Insurance companies, whose focus on growth has been enhanced as they become public stock companies, are initiating CMBS lending programs and contemplating brokerage, while commercial banks are actively diversifying to become both portfolio lenders and sponsors of their own CMBS issues. Successful mortgage brokers that can access product still have tremendous value in the industry, and these firms are trying to balance the best way to take advantage of their strengths while maintaining long-term relationships and origination volumes.

Mortgage lenders are confronted with these dynamic competitor market changes during a time when overall demand for mortgages is declining. The last two or three years has seen substantial mortgage demand as mortgages that were made during the early 1990s were refinanced at today's low rates. High transaction volume and owners leveraging up (due to the significant increases in the value of their properties), also increased the demand for mortgages. While there still is substantial mortgage demand, the decline in refinancing due to the many years of low interest rates and general slackening in the transaction market has made it critical for mortgage lenders to integrate both mortgage demand analysis and a clear understanding of their strengths in the competitive marketplace to map a successful strategy.

Technology also is beginning to play a key role for mortgage lenders. During the last six months alone, there have been numerous new commercial mortgage Internet sites that have developed and more are sure to follow. The Internet will not make relationship-oriented brokerage businesses obsolete, but it will dramatically alter the way borrowers interact with their brokers and provide distinction for those firms and individuals that use it to greatest advantage.

Service Providers

Service providers, including brokerage firms, property management firms, title companies, lawyers, consultants, and others must also adapt to the less volatile and more moderate growth market environment. Classic corporate strategies such as developing economies of scale, new management approaches, maximizing the application of technology, and improved product and competitor segmentation and analysis will be key to service provider success. The importance of these changes has been noted by many firms as mergers, acquisitions, and alliances amongst service firms continue at a strong pace.

Conclusion

Successful real estate firms must confront the paradox of a more stable and less volatile property market with an activist approach to their real estate businesses. There are still substantial inefficiencies in the marketplace, and the substantial magnitude of the real estate industry, (including the massive volume of corporate real estate), provides a significant pot of gold for those that can successfully navigate their firms through the changes underway in the market today. REI

ABOUT THE AUTHOR

Scott R. Muldavin, CRE, *is president of the Muldavin Company in San Rafael, CA, where he specializes in strategic management, business operations, product design, marketing, and due diligence. (E-mail: Smuldavin@muldavin.com)*