CRE PERSPECTIVE

Where Do We Go From Here?

by Michael L. Evans, CRE

Recently, many in our industry have asked the question: Is this the beginning of the end for the latest real estate up-market — or the end of the beginning?

Finding an answer, or more likely a "guesstimate," to that question, requires nothing less than a systematic approach to gathering information – followed by a dispassionate evaluation of the possibilities.

The following is a fairly straightforward evaluation to help you cut through the confusion and understand the basic dynamics of forces now at work in the marketplace.

First, a quick look at some basic macro economic factors should produce a logical prognostication. These include: the state of the economy; geo-demographics, the local regional and national dynamics of real estate markets and property sectors; the comparative health of overall capital markets; issues affecting the market for publicly-traded real estate securities; and outside influences such as the socio-economic-political status in Asia.

The general feeling right now is that we will continue to have an exceptionally low rate of inflation– and there is certainly no reason to believe that the U.S. economy is headed in a direction other than a soft landing. Currently, inflation is at a 1.3 percent annual rate, U.S. commodity prices have fallen because Asian demand for raw materials has fallen. Despite the changes in the world economy, the U.S. is still chugging along, albeit at a lower GDP rate than originally projected.

Given our current economic environment (a slower growth rate than projected), interest rates (although recently lowered twice), in my belief, are still about 100 basis points higher than they should be. As a result, we can probably expect to see additional rate decreases – which will again spur economic expansion as capital and carrying costs are reduced and corporate margins are increased. If you look at real interest rates (interest rate minus inflation), they are still high in relative terms, thus accounting for the premature expectation of future interest rate reductions.

No doubt the onus of a recession, and the precedent for a turn in fortunes, is out there as well. Remember when, just 10 years ago, the U.S. had a robust economy one year – and the beginning of a recession a year later? Commentators believe that although our economy is moving in the right direction, there is a chance of a recession as we enter the latter part of 1999 and the year 2000. Some on the other hand, see us gaining altitude in the year 2000 without even touching ground.

With its recent volatility, the stock market is not a good indicator of whether we will see a recession. The beginning of the Bear market in the U.S. – followed quickly by a recovery to almost all time highs– was a result of a hint of global bad news, (first from Asia then to Mexico and Russia, and now even in Brazil), offset by positive U.S. economic news.

To their credit, however, stock prices have certainly been responsive to interest rate changes. The Fed's last ½ percent drop in interest rates, spurred a 500-point, four-day rally by the Dow Jones. Are we better off today than we were a year ago? One only needs to look at the Dow Jones just one year ago to see that we are still higher than that record breaking benchmark. Sustainability of recent gains is the key question.

Which brings us to the question of public real estate ownership, specifically real estate investment trusts. The REIT market -- and its health -- is a major factor going forward in how the real estate market operates. Predicting annual 20 percent increases in REIT stock prices year after year for the foreseeable future was, and is, overly optimistic. We cannot realistically expect to have a repeat of the 36 percent increase in REIT prices in 1996 and the 20 percent rise we saw in 1997. REITs follow the stock market and there is some correlation between stock market advances and declines and the value of REIT stocks.

The consecutive increases in REIT prices in 1996 and 1997 were in part due to the differences between the construction costs of real estate and the acquisition costs of existing real estate. REITs merely took advantage of the arbitrage between the cost of building versus the cost of buying and the market gave their stock prices credit for the difference. Adding to their attractiveness was the fact that real estate is now regarded as an institutional grade investment.

In our current stock market environment, REITs are behaving like small cap stocks. The FFO (Funds from Operations) yield is 11 percent – with dividend yield today averaging eight percent. Only a year ago,

a number of the large REITs were yielding less than Treasury Bills and, as previously noted, appropriately so. The appreciation potential of REITs made up for this difference in yield. When coupled with dividend yield, REITs were able to deliver double digit returns to their investors.

Today, without the appreciation increment as large as it was previously, partially due to the absence of available capital, the cash-on-cash yield has to both increase and be more reflective of the historical difference in real estate yields (cash and appreciation) over bond yields, which historically has been about 400 basis points. The market adjusted the price of REIT stocks to bring this yield equilibrium back into sync.

What has happened in the REIT sector is not reflective nor predictive of what has happened to real estate. Recent commentators have noted that there has been a 15 percent to 20 percent downward adjustment in real estate prices as a result of a number of factors. I believe that a slightly smaller drop has actually occurred. There clearly has been some disintegration in real estate prices, but not as a result of the decline in REITs. Currently REITs are selling at a 10 percent discount to net asset value and should trade at plus or minus 10 percent over the long term. IPOs have peaked out for now, but should be back in force as investment demand for REITs increases in early 1999. As capital re-enters the real estate market, realistic growth strategies will once again drive REIT prices upward. Add to this the apparent about-face in the Clinton Administration's attitude toward REITs — manifested most recently in the 2000 budget proposal — and the strong potential for real growth in the REIT market is evident.

Again, it is important to point out that the real estate market – and any price declines – are separate from the decline in REIT prices. While there clearly has been some reflection from the so-called tainting of REIT values over the last 10 months, the decline in actual real estate prices is largely a result of the end of the tremendous capital flow that was provided to the real estate sector through the CMBS market.

It was not long ago that the CMBS market contributed virtually nothing to real estate financing -- loans were made by traditional lenders such as banks and life insurance companies. In late August/September 1998; as a result of the massive amount of CMBS issues in the market, there was a "rush to quality" by investors that caused CMBS spreads to widen and attracted traditional lenders back into the market. Along with the increase in issues of CMBS, the buyers of CMBS borrowed money to buy new debt instruments. Thus, we had debt financing debt and a house of cards ready to fall. With this enormous supply of CMBS, there were not enough buyers to sustain the market and absorb the supply. The market became more nervous with the conceptual bankruptcy of Long Term Capital Management, one of the largest buyers of long-term Triple-A CMBS issues. Investors in CMBS and potential investors in new CMBS issues did not want to buy if Long Term Capital was going to liquidate its large CMBS position and further oversupply the market.

As of last September, there existed an "overhang" of approximately $25-$30 billion dollars of CMBS paper inventory. By January 1999, something like $10 or $15 billion of this had been sold, leaving up to $15 billion in paper still to be sold. It will take a number of months to absorb this supply in the marketplace.

Nevertheless, the CMBS market rolls on. Last year was a record year for CMBS issuance despite the September "slip" in the market. In 1997, issuance totaled $43.8 billion. Last year, $78.3 billion in loans were securitized and sold as CMBS, a figure some have estimated to be approximately 75 percent of the total financing market. Changes within the industry are apparent and we expect more conduits to exit the market as pressure builds on these lenders to back their programs with more equity (they borrow too!) and also tighten their underwriting of mortgage loans. This means that lenders will have to do far deeper property market analysis — drilling down to submarkets — and also giving greater scrutiny to the creditworthiness of borrowers, especially in a down-market scenario. In short, conduits that want to play in this market over the long-term, will have to think and act and operate more like banks or credit companies.

The so-called credit crunch that took hold late last year was not truly a credit crunch but actually the result of an over-supply of credit. Banks and lenders did become more liberal in their Loan To Value (LTV) ratios and too competitive in their rates. Thus, one could conclude that real estate is still an acceptable and viable investment – the problem is that the financing vehicles were not kept in check until the flight to quality instilled rapid discipline and forced major conduits such as Nomura to back out of the market in late August 1998.

In many respects, the CMBS crunch and the reduction of capital available to the real estate industry can be seen as a very

positive omen. Had it not occurred during the summer of 1998, overbuilding would be more likely in major cities as office projects moved forward and oversupplied an already fully employed economy. Additionally, the so-called credit crunch has already directed capital into higher quality projects with better and more stable projects being completed and less stable projects being avoided or delayed.

Today, many markets are at their stabilization point, estimated by E&Y Kenneth Leventhal (E&YKL) to be 7.5 percent vacancy rate in office; 3.5 percent vacancy rate in industrial; and about six percent in apartments. Rates below these vacancies will spur new construction, vacancy rates above will not – all being a function of the potential rents that can be achieved in the marketplace. Based on a recent study completed by E&YKL, many markets in the U.S. – especially those with exceptionally low current vacancy rates – will see significantly higher vacancy rates by the end of the year 2000, mainly as a result of slower absorption and increased construction.

Where do we go from here?

Real estate fundamentals are the key to the near future. Currently, there is virtually **no overbuilding** on a national basis. This presents tremendous investment opportunities to either buy REITs at significantly discounted values and/or purchase CMBS at high yields. Interestingly, there is a lot of talk about buying the "B" pieces of CMBS today at 30 percent yields.

Virtually overlooked in this market, are the huge portfolios of real estate owned by Corporate America, foreign banks, and institutions. Few today want to sell at bargain prices.

Real estate investors can do incredibly well during the coming months if they are on top of and sensitive to these industry trends. It will not be as easy as it was in 1994, but opportunities for real wealth creation through real estate are **everywhere.**REI

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