Capital Markets Adapt to Equilibrium

SCOTT MULDAVIN

SCOTT MULDAVIN is president of The Muldavin Company in San Rafael, CA. He may be contacted at smuldavin@ muldavin.com.

Real estate capital market participants are in a "wait and see" holding pattern, looking for signs of the next major change that will guide their market response. A collapse of the stock market, a major interest rate change, flagrant overbuilding, or even a Russian debt crisis would provide much needed guidance for real estate decision-makers. Unfortunately, the existing "boring" equilibrium of the capital and property markets is expected to continue, frustrating battle-tested decision-makers accustomed to frequent major market upheavals during the last 10 to 15 years.

Without a major sign to point to the way, real estate capital market participants have adopted a cautious outlook. Sufficient capital is available to provide ample liquidity for most segments of the market, but deal terms and investment structures reflect the growing caution.

The cautious atmosphere has contributed to a slowing of transaction and lending volumes. Investors and lenders are concerned that recent strong rent growth and moderate new construction supply cannot continue, and are demonstrating reluctance to buy or lend on properties using standard capitalization rates and underwriting criteria. Many property sellers are reluctant to sell at prices that don't reflect the current leases and profit potential of their properties. Many sellers are making the difficult decision to refinance and hold their properties, betting market strength is sustainable.

Mortgage supply remains strong with interest rates declining in recent months as clear signs of an economic slowdown are emerging (suggesting Alan Greenspan may hold steady or reduce interest rates in the future). However, lender underwriting has grown more conservative. Originations are down significally due to the slow-down in transactions and refinancing. Mortgage capital for specialty property types is available, but is more costly as the CMBS market continues to be hard on "non-vanilla" property types and insurance companies focus on the four "core" property types.

REITs have also approached the market cautiously despite year-to-date returns through the end of August of 18.5% versus 4.1% for the S&P 500. REIT caution can be shown in their reluctance to raise additional capital. According to the National Association of Real Estate Investment Trusts, through the end of July, total REIT capital raising was only $4.2 billion, compared to an annual average of near $30 billion for each of the last four years. So far, in the year 2000, there have been no initial public offerings and a very limited number of secondary equity offerings. Clearly, REITs are being cautious to avoid potential negative investor response to additional equity offerings.

As with the rest of the economy, the biggest real estate investment risks are being taken with technology and Internet companies. Substantial venture capital, industry cap-

ital, and even institutional capital is pursuing investment in new real estate related Internet, data, telecommunications, and services firms. Equity capital is also being raised to invest specifically in properties or locations that are tied to the "new economy." How these investments will influence the broader real estate capital markets will be an ongoing story that will unfold in the coming years.

The rest of this article provides a summary of prominent information and activities influencing the real estate capital markets during the previous quarter.

RE-EXAMINING REITS

The surprisingly robust turnaround of the REIT market so far in 2000, and the significant changes incorporated in the REIT Modernization Act that goes into effect on January 1, 2001, raise a number of critical questions about the future of REITs. Is there still room for REIT share price growth? Does the REIT structure still make sense?

First, the rebound in the REIT marketplace appears to be real, with year-to-date returns of 18.5% through the end of August 2000. The surge in performance was particularly welcome given returns of negative 4.6% in 1999 and negative 16.9% in 1998. The turnaround was led by a 37.5% increase in hotel returns, a 25.8% return for office and industrial REITs, and a 22.9% return for apartment REITs. Retail REITs have achieved year-to-date returns of 10.7%, while manufactured housing and self storage REITs grew the slowest at 4.3% and 6.9% respectively (*Comparative Valuation REIT Weekly*, Merrill Lynch [Thursday, August 31, 2000]).

The REIT rebound has not lifted REIT prices so high as to limit future growth potential. One way to measure this is to look at REIT share prices compared to underlying net asset values. At the height of the REIT market in December of 1997, REITs on average traded at 126% of their underlying net asset values. Today, as of August 2000, REITs on average are trading at 95% of their underlying net asset values. While this is up significantly from lows of 79% as recently as March 2000, it is well below historic highs. Some industry analysts believe that "fair value" for the group is around 110% of net asset value, leaving significant room for growth.

Apartment REITs are the only sector trading at a premium to net asset value, averaging 103%. Office/industrial REITs are trading at 94% of net asset value while regional malls are still trading at 82% of net asset values ("New Data Series Reinforces Positive Stance on the Sector." *Real Estate Comment*, Merrill Lynch [August 30, 2000]).

Based on research by LaSalle Investment Management, REITs continue to provide diversification benefits to mixed asset portfolios. About a year ago, LaSalle published a report based on historical total return data that found that an optimal mixed asset portfolio would have included REITs at nearly every point along the risk return spectrum. This study documented high negative correlation between REITs and several sectors, including technology stocks (-0.51) and communications services (-0.48). Over the 12 months since that study, as technology stocks began to fall, REITs began to rise. REITs' counter cyclical relationship with technology stocks grew larger (-0.64). Based on these results, LaSalle concludes that REITs have played the diversifying role better than any other asset class during the last six years ("Opposites Still Attract," *Market Watch*, LaSalle Investment Management [Third Quarter, 2000]).

Despite recent positive performance and potential diversification benefits, the REIT structure has not proven itself ideal for all owners of real estate. REITs have not been able to take advantage of one of their most important benefits—improved access to capital—based on a review of the dramatic declines in secondary equity and unsecured debt capital raising so far in 2000.

Improved valuation is another typically cited benefit that has been challenged during the last year as share prices have languished significantly below net asset values for most REITs. With initial public offering costs of 6-7%, and low valuations in the marketplace today, conversion of private companies to REIT status is a particularly difficult proposition.

Despite some questions about the fit of the REIT structure for all owners of real estate, a strategic review of the REIT firm structure confirmed its benefits compared to a regular C-corporation. The strategic review included an analysis of the tax bill of the firm and all its shareholders, the cost of raising new capital publicly, and the costs (to C-corporations) of engaging in tax avoidance strategies. This study found that under all simulated conditions, there was a net positive benefit to the REIT structure over the C-corporation form, with the size of the benefit ranging from 0.3% to 10.6% of equity market capitalization ("The REIT Vehicle: Its Value Today and in the Future." *Journal of Real Estate Research*, 18 No.2 [1999]; PREA Research Review [2000]).

REIT structural benefits are expected to be enhanced when the REIT Modernization Act takes effect in January 2001. Despite numerous positive tax law

changes and IRS rulings, REITs have still been highly constrained by existing tax laws that require them to focus primarily on holding real property to earn rental income. The REIT Modernization Act of 1999 (RMA) offers relief in the form of expanded tenant service opportunities and reduced annual distribution requirements.

The RMA enables REITs to provide expanded tenant services through a new tax creation called a "Taxable REITs Subsidiary" (TRS). Like regular corporations, TRSs are subject to corporate level tax. However, the RMA reduces the annual distribution requirement from 95% of taxable income to 90% of taxable income.

Some examples of the kinds of services REITs will be able to provide include cleaning tenant space, providing maid service, assisting tenants in moving, and providing clerical and concierge services. Most importantly, the RMA gives REITs the "carte blanche" to explore new business opportunities, including Internet related businesses, which should stimulate growth in the REIT market ("REITs: Will the New Legislation Solve All Problems?"*Real Estate Finance Journal*, [Fall 2000]).

Lagging REIT share prices and the inability to raise capital, particularly in the retail REIT sector, have led to a number of mergers and liquidations. Burnham Pacific Properties has decided that the best way to maximize shareholder value is to liquidate assets rather than reorganize or sell the company. Bid prices and terms offered for the company were not deemed adequate to pursue those alternatives. Similarly, Phillips International Realty Corp. announced plans to liquidate and agreed to sell $204 million of its assets to Kimco Realty.

Shareholders of Bradley Real Estate, Inc., the nation's oldest real estate investment trust, approved a $1.2 billion merger between Bradley and privately held Heritage Property Investment Trust, taking it off the public market. Pan Pacific Retail Properties has also agreed to acquire Western Properties in a stock for stock transaction worth $440 million. Finally, several companies including JDN Realty, Federal Realty and Malan Realty have announced in the past year that they are pursuing strategic alternatives to their existing corporate structures.

While these liquidations and consolidations have been particularly prevalent in the retail sector, most REIT analysts and investors agree that the market does not need 200 REITs, and that consolidation to a number of around 50 would make sense over the next few years (*Weekly REIT Strategy*, Salomon Smith Barney [August 28, 2000]; *Institutional of Real Estate Newsline* [August 21, 2000]; GlobeStreet.com [September 1, 2000]).

REAL ESTATE DEBT MARKET TRENDS

The real estate mortgage markets are healthy, driven fundamentally by the strong real estate property markets and conservative underwriting. Accordingly, capital is available, but mortgage interest rates, loan to cost or loan to value ratios, and other terms remain conservative despite the strength of the market.

The longer term outlook for the real estate property markets continues to be strongly favorably, despite concerns about market cycles and downturns. According to *ULI's Market Forecast*, 48 of the 49 market areas they survey in the United States are projected to remain active and healthy through at least mid-2001. However, in most markets, rent and value increases are expected to be smaller than in recent years. Legg Mason's *Real Estate Markets Cycle Monitor Report* states that real estate demand is the strongest it has been in three decades and vacancies in all property types have come down. Construction starts continue to be constrained by tight labor and material supplies. A majority of markets have improved and the outlook is bright for the 60 MSAs they analyze on a quarterly basis (*ULI Forecast* [May 2000]; *Real Estate Markets Cycle Monitor*, Legg Mason Equity Research, 2nd Quarter 2000 Analysis [August 2000]).

Despite the strong real estate markets and substantial supply of real estate mortgage capital, pricing and underwriting have remained remarkably tight, particularly given past experience. Part of this stickiness with pricing and terms is due to lender reluctance to accept the strength of future market projections, but has also been a conscious strategy of addressing interest rate risk in an environment in which the Fed has raised interest rates six times since the summer of 1999. With signs of the economy slowing, and upward interest rate risk reduced, underwriting and pricing terms should soften somewhat in the coming months ("Capturing Capital." *Commercial Real Estate Investment* [July/August 2000]).

Mortgage origination volume during 2000 has declined in the range of 15-20% based on a review of CMBS issuance and lender surveys. CMBS issuance is down 22% in 2000 versus 1999 through the end of July with projections of a 25% decline through the end of the year.

With a combination of high interest rates and spreads, reduced volume of property sales, and a cyclical decline in refinancing activity, the CMBS sector was not the only one affected. The American Council of Life Insurance reported first quarter originations were down over 40% from the first quarter of 1999, and a survey by the Commercial Mortgage Alert of the 30 largest insur-

ance company originators indicates origination volume declining throughout 2000. Banks have also reported declines similar to the CMBS industry. (*Commercial Mortgage Alert* [July 3, 2000]; *Commercial Mortgage Commitments*, American Council of Life Insurance [1st Quarter, 2000]; *ULI Capital Markets Update* [August 2000].)

The CMBS market is projected to raise approximately $50 billion in 2000, an approximate 25% decline from the $68 billion issued in 1999. This decline is reflective of the overall decline in mortgage originations and reflects significantly widening spreads over treasuries for AAA securities, market aversion to specialized property types, and a scarcity of B piece buyers.

AAA spreads, which had compressed to about 124 basis points over 10-year treasuries at the end of 1999, were up to 165 basis points by the end of August, 2000, forcing lenders who wish to securitize their product to increase their rates to levels that cause borrower resistance. The small number of buyers for B pieces has also induced caution in the decision to underwrite new CMBS issues. At least one issuance was cancelled as a result of the reduced number of interested B piece buyers.

One bright spot for the CMBS industry is the passage of new amendments to the Employee Retirement Income Security Act that will enable pension funds to buy securitizes with ratings as low as BBB-, compared to existing regulations which limit their investment to AAA rated securities.

Another bright spot is the continued growth of CMBS secured by properties located outside the U.S. In the first 6 months of 2000, $7.1 billion or 25.5% was secured by properties located outside the U.S., compared to $5.6 billion or 16.1% which was secured by non-U.S. properties in a similar period in 1999. Canada, the United Kingdom, and Asia all have established CMBS markets. Further, Italy and Spain just recently have passed legislation enabling CMBS transactions. This activity and the continued strength of the market in the core property types provides a vision of an adaptable public debt market that will be around for a long time. (*Barrons/John D. Levy and Company National Mortgage Survey* [August 28, 2000]; "Maturing CMBS Market Adjusts to External/Internal Factors." *Commercial Investment Real Estate* [September/October 2000]; *Commercial Mortgage Alert*; *ULI's Capital Markets Update*, [August 2000]).

One of the biggest changes in financing strategy today is that borrowers have shifted their focus to short and intermediate term loans, which run for three to five years, rather than 10 years. Borrowers are reluctant to lock in today's higher rates, but they also do not want to be forced to refinance before, at the earliest, three years.

Some lenders are also offering participating first mortgages, keeping interest rates artificially low and taking part of the interest payment out of the cash flow. Mezzanine real estate financing, of which a participation mortgage is just one type, is filling the gap between high cost equity and lower loan-to-value first mortgages. As a result of the many complex financing choices available to developers and investors, sophisticated mortgage brokers are finding strong demand for their services, despite the proliferation of Internet financing sources ("Tilting Towards Slowdown." Mortgage Banking [July 2000]).

While sophisticated mortgage brokers and financial advisors can make the difference structuring the best financing solution for a developer or an investor, there is no question that the Internet is influencing the way real estate financing is being conduced. Today, owners and investors can quickly and directly identify and access equity and debt capital sources through numerous Internet companies that have emerged. Some of the leading companies in this sector include LoopLender, CapitalThinking.com, CapitalEngine.com, C-lender, Redbricks.com, MortgageSelector.com, and Cyberloan.com. Additionally, real estate Internet information companies like Pikenet provide direct links to over 180 separate investment companies and financial institutions. The trick today is not just to identify companies with capital, but to identify which of the Internet organizations and/or mortgage brokers offer the kind of services, focus, and fee arrangements that you are comfortable with ("Technology Stimulates Capital Market Changes." *The Journal of Property Management*, [November/December]).

Hotel financing has undergone many ups and downs during the last few years. With significant declines in hotel REITs, a movement by lenders towards more conservative and traditional office and apartment loans, and overbuilding in the hotel market, hotel financing has been difficult. As an example of this, hotel financing in Boston, even in anticipation of a new convention center opening in 2003, has not been easy.

However, there is some good news. Hotel REITs have rebounded dramatically in 2000. A number of CMBS lenders have opted to tighten their spreads in full service hotel loans by some 25 basis points. Rating agencies such as Fitch are taking a more tolerant view towards hotels. Fitch, for example, has announced that its new ratings policy will allow for hotels to be underwritten based on the last 12 months of actual income while previous policy capped income at the level achieved in 1998.

These advances will only be sustainable if hotel development activity slows. While activity has slowed recently, hotel development activity remains at historically high levels, and signs of a major near term slowdown are not evident. ("Hotel Projects Stall as Private Capital Stays on the Sidelines." *Globestreet.com* [August 15, 2000]; *Weekly REIT Strategy*, Salomon Smith Barney [August 21, 2000]; *Barrons/John B. Levy and Company National Mortgage Survey* [August 28, 2000]).

In another development, a new company, Commercial Defeasance, has been formed to specialize in helping real estate owners with defeasance. Defeasance became more prominent in the commercial real estate capital markets in the early 1990s as a way to make commercial mortgage backed securities more attractive. Borrowers continue to encounter defeasance as an option in new loan originations.

Defeasance is an alternative to prepayment penalties and is selected much like a borrower selects a fixed rate or floating rate loan. Defeasance allows a real estate borrower to replace real estate collateral with qualified government securities. This substitution of collateral benefits both the borrower and the CMBS buyers. From the borrower's standpoint, it can cost less than many traditional prepayment penalties, and from the bond buyers standpoint, the credit quality of the substitute government securities strengthens the entire pool. However, given its complexity, many borrowers have been hesitant to use this form of prepayment. With the start of this new company, and others that may follow, commercial defeasance is likely to become more prevalent in the coming years. ("Defeasance: A Practical Overview." *Mortgage Banking* [July 2000]; *Institutional Real Estate Newsline* [May 15, 2000]).

TRENDS IN THE EQUITY MARKETS

As discussed above, public equity markets have improved their performance significantly during the last year, but they have been unable to generate substantial additional equity for the real estate market through either initial or secondary offerings. Through joint venture relationships with pension funds, and select secondary offerings, they have been a positive source of capital, but their significance as a buyer and capital provider is significantly down from recent years. REITs can be expected to increase their equity contributions during the next 12 months, but their growth in new equity is unlikely to achieve the levels seen in the mid-to-late 1990s.

Institutional investment activity, as reported by Institutional Real Estate Inc., has declined significantly so far in 2000. On a trailing 12-month basis, the average number of completed transactions per period has decreased nearly 30% through the first half of 2000.

The investment focus of pension funds has also changed dramatically from recent years when opportunity funds dominated new investment. During the first half of 2000, pension funds allocated 31% of their new investment to core property investments, 20% to REITs, 18% to value-added properties, 18% to specialty properties, and 12% to opportunistic properties (Institutional Real Estate Inc.; *ULI Capital Markets Update* [August 2000]).

German investment in the U.S. property market, which has been robust in recent years, is expected to decline in 2000 given the strong dollar, rising interest rates, and the strong performance of the German stock market. This could have a significant effect on some of the high profile office properties in CBDs where German investors have been active. German capital has been particularly active recently in Dallas, Houston, Manhattan, Chicago, and San Francisco ("German Retreat." *IREIzine* [May 4, 2000]).

Private investors have continued to be very active in U.S. real estate markets, dominating small and midsize property sales throughout the country. One measure of the size of the private equity market is the $30 billion in equity represented by like-kind exchange transactions in 1999.

Like-kind exchanges utilize Section 1031 of the Internal Revenue Code and continue to be a favorite means of deferring, and sometimes eliminating, tax on profit from the sale of real estate. Unlike past years where the news on the exchange front was negative as legislative activity focused on the sector, during the last year most of the news has been good ("Reserve Exchange Provisions: New Flexibility for Property Owners." *Real Estate Strategies*, 1999 Tax Development Issue, Deloitte & Touche [Spring 2000]).

Like the debt markets, the equity markets are beginning to be more significantly influenced by the Internet. A number of sites have been set up specifically to address the matching of real estate equity to real estate equity opportunities. These sites, including PropertyCapital.com and EquityCity.com, serve both investors and those seeking equity capital, offering a variety of services to help link money to opportunities.

Many of the Internet companies that initially focused on the debt side have plans to pursue the equity side of the business, and many of the large brokerage and investment banking firms such as Cushman Wakefield and others have set up Internet sites to help put equity sources and

opportunities together. Other companies like Askingprice.com are focused on providing a "broker free" market place where major institutional buyers and sellers can buy and sell their real estate.

While it is hard to know precisely which Internet companies or processes will become most successful, the Internet is providing improved information and efficiency to the process which will benefit owners and investors over time.

DATA REVOLUTION

The real estate property and capital markets are at the beginning of a data revolution. Like most revolutions, this one won't be bloodless, with many causalities along the way. The causalities will include data and software companies, new Internet service providers, and traditional real estate investors, lenders, and service providers who struggle to adapt to the revolutionary changes underway.

The revolution in the real estate data markets is caused fundamentally by the Internet, which enables companies to gather, integrate, and distribute information in a much more cost effective manner than in the past. Importantly, many Internet companies are generating new types of data based on their systems and procedures that will give users information previously not available.

For example, Internet finance and listing companies are generating expansive new databases with vast quantities of information previously not available. Web log information (information about the specific users of particular Internet sites and their behavior while using the sites) provide tremendously valuable information about how tenants, borrowers, and others think and make decisions. This information, and much more, will be cleaned and made available in future years, requiring development of new applications and decision-making models for real estate industry players.

One of the key areas of growth in the data markets will be through much more detailed segmentation of data. For example, I recently received a listing of different property types from which I could segment my search request while using E-Comp's comparable sales database. There were 56 separate listings for retail buildings, 19 different types of office properties, 34 different types of industrial buildings, and 24 specialty property types. Clearly, if I could match comparable sales information with market rents, vacancy rates, and operating expense information at such a level of detail, my dream of fingertip real estate investment analysis would be closer to reality.

As might be expected, there are significant bumps in the road to fingertip real estate investment analysis. One of the biggest current challenges is to understand the specific source and collection methodology for each of the types of data that one collects from the Internet. To quote Ross Perot, when one "gets under the hood" of many of the new data companies, or companies that have data as a result of other activities, there are significant methodological issues and problems which make direct application of the data challenging. Additionally, with all the strategic alliances and data sharing relationships among the Internet firms today, it is very likely that the source where you find data is not the original source of the data, making understanding of the methodology and data collecting process much more difficult.

Despite these limitations, real estate data is getting cheaper and better. Established data firms like REIS, Comps, and Torto Wheaton have been acquired or have accessed significant venture capital to improve both their data coverage and quality, as well as their development of new applications. These firms, as well as data integration firms such as eReal Estate Integration, are working hard to develop software and decision-making tools that incorporate a wide array of data to solve industry problems. Many other companies, such as The Realm and numerous companies in the building and construction industry, have received significant venture capital to push forward applications and systems to help real estate industry decision-makers. The key to these endeavors will be for these firms to tackle what high technology firms have had to tackle for the last 30 years—getting engineers and MBAs to work together to meet specific client needs.

The importance of applications and data management in the Internet world was put into perspective in a recent article in the *San Francisco Chronicle* that discussed a research paper that estimated that the World Wide Web is 500 times larger than the maps provided by popular search engines like Yahoo, Alta Vista, and Google.com. Based on the methodology and software developed in putting together the research paper cited in the *Chronicle*, Bright Planet, the firm that authored the report, estimated that there are now about 550 billion documents stored on the Web. Combined Internet search engines index about one billion of these pages. Dynamic new search engines are being developed to more effectively access and manage the information on the net, but the point of the overwhelming nature of the Internet's resources is clear. On a positive note, in a survey of

33,000 search engine users earlier this year, NPD New Media Services found that 81% of the respondents said they found what they were looking for all or most of the time ("Internet Much Bigger than Most People Think." *San Francisco Chronicle* [August 2000]).

CONCLUSION

Real estate capital is available, although somewhat more costly than in recent years as investors and lenders begin to show skepticism about the continuation of good times. For those investors or capital sources willing and able to evaluate and act on the new and better information available on money and property markets, substantial profits are available. For others, profit will be found in making the Internet revolution pay through improved systems and ways of doing business. Either way, it is a great time to be in the real estate industry!