Internet Influences on the Real Estate Capital Markets

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Given the substantial attention the Internet has attracted from the media and the man on the street, it is appropriate to examine how, and how significantly, the Internet is influencing the real estate capital markets today.

The perspective from 30,000 feet suggests the influences may not be that great. The Internet has not been a key factor in the current stabilization of the real estate capital markets. The Internet isn't lowering interest rates, and in fact, is probably increasing interest rates due to Alan Greenspan's public announcements to put the brakes on the "new economy" through continuing interest rate increases. The Internet hasn't saved the REIT market or significantly influenced the CMBS market for that matter. All in all, from a high level perspective, the Internet hasn't yet had a significant influence on the workings of the real estate capital markets.

The key word in the analysis above is "yet." No doubt, going forward, the Internet will continue to increase its influence on the real estate capital markets. Two key ways the Internet will influence the real estate capital markets will be in the reduction of transaction costs and the increase in market efficiency.

Transaction costs will be reduced directly through a reduction in underwriting costs as appraisals, environmental reviews, title insurance, and other vendors are efficiently contracted and managed through the Internet. Faster and higher-quality information flow between brokers, owners, lawyers, vendors, lenders, and other participants in the transaction process will reduce costs.

Perhaps most significant will be the Internet's ability to increase the efficiency of the real estate markets. While market inefficiency attracts many of today's real estate investors, market inefficiencies have a much more significant negative effect on the bulk of worldwide capital sources who are used to the flow and quality of information available in the stock and bond markets.

The Internet's communication capabilities will be particularly powerful for the real estate industry because of recent advances in real estate data and property management systems. In combination, the industry will reach a new level of transparency. While this could happen without the Internet, as it has in the stock and bond markets, the Internet provides a much more efficient way to get timely information directly to existing and potential investors.

The Internet will also significantly increase the efficiency of the real estate capital markets, providing a national market for real estate properties and capital. As an example of this, I recently assisted a firm in Thailand to identify capital sources worldwide through a series of two dozen e-mails, without ever having to wake up during the middle of the night to conduct a live phone call. Scores of commercial property listing and mortgage sourcing web sites are also now available at little or no cost to borrowers and buyers.

Finally, the Internet has substantial untapped power to help in the relationship and trust building that will continue to be the critical component of most real estate and capital market transactions. Relationships and trust are built through communication, and the Internet improves everyone's ability to maintain these relationships, complimenting the more traditional techniques of personal meetings and phone calls.

The rest of this article provides a summary of some of the key events and activities underway in the real estate capital markets during recent months.

INTERNET IMPACTS

The difficulty of effectively and profitably using the Internet for the real estate capital market is highlighted by the experience of E-Loan, the market leader in the online single-family mortgage business. At a recent conference on Internet companies in the real estate industry, analysts from Morgan Stanley, Dean Witter and Forrester Research discussed the significant problems E-Loan and other Internet mortgage companies have had during the last year.

E-Loan's stock has dropped dramatically, along with other online mortgage lenders, as the difficulties of their revenue models became more apparent and refinancing volumes plummeted. There was an agreement among the analysts that current online mortgage lenders are primarily sources for customer acquisition, and have not met the promise of providing efficiencies in business operations or costs.

Analysts also pointed out that mortgages, even single-family mortgages, are not particularly well-suited to the Internet. This sentiment seems to have been born out to date. E-Loan's marketing costs per loan (total marketing cost divided by the number of loans) went from $1,000 per loan when they initially began to over $4,000 today. At the same time, their "pre-marketing" profits per loan went from a $500 loss per loan in March 1999 to a loss of over $1,500 per loan as of February 2000. Together, this equates to a loss of over $5,000 per loan for each loan E-Loan originates. The economics for other companies were not thought to be much better.

The future of the industry is to move to a completely online mortgage to reduce the costs of origination, which are now two to three times higher at online companies versus the leading offline mortgage underwriter. While the expectation was not for a short-term transformation of the industry, it was expected that, over the mid- to longer term, significant changes would occur that would help move the industry to direct profitability in its basic business operations. Additionally, as a market leader, companies can exploit other linked business opportunities (Panel on Mortgage Lending and Internet, Real Estate Connect Conference, February 2000).

Online activity in the commercial real estate capital markets has picked up strongly during the last year. Borrowers seeking a commercial real estate mortgage can submit their projects and get loan quotes from a variety of sources including LoopLender, C-Lender, Redbricks, MortgageSelector, CoStar Capital, C-Loans, CapitalEngine, CapitalThinking, and others. Some of the major lenders such as GMAC, Heller Financial, Wells Fargo Mortgage, and Finova Realty Capital can be found on most major sites, but the sites do vary as to the lenders covered, the availability of due diligence and underwriting support services, fees, and other issues. Some companies, such as Redbricks, focus on a more select list of approximately twenty-five lenders, while C-Loans claims to have rates and offerings from over 750 mortgage lenders.

While most of the sites are free for potential borrowers (typically paid for on the back end by lenders), some new sites such as CapitalEngine.com and CapitalThinking.com charge brokerage fees, although at rates lower than a traditional mortgage broker.

The commercial mortgage brokerage business will continue to be relationship-driven in the future, but all commercial lenders will be influenced by the increased flow of competitive information on rates and programs to borrowers as well as the increasing operating efficiencies as more underwriting moves online.

Additionally, companies like RealWebFunds, which provides a platform for submitting and exchanging loan packages between lenders and mortgage brokers, America's Note Network, which provides a secondary market for real estate notes, and other cash flows, and Commercial Finance — National Financial Services Network, which provides a database for financial products and services all provide other services to the mortgage markets that should increase the overall efficiency of the marketplace (Pikenet.com, individual company websites [March 2000]).

Financing real estate start-up companies in the Internet world is not easy today. You need to contemplate going through four or more rounds of financing including the seed round, where "angels" or "incubator" capital is sought. The second round would be capital from a top-tier early-stage venture capitalist or perhaps a key strategic industry player or alliance partner. Next, numer-

ous subsequent rounds of mezzanine financing are possible, which may involve an investment banker, as well as the sources from the first two rounds. Finally, if all goes well, an initial public offering provides access to a large source of capital. Multiple rounds of financing enable a new company to limit the dilution of its equity and let the value and creditability of its business increase its valuation at the IPO level.

Early-round venture capitalists look for companies to demonstrate a deep understanding of their business, both opportunities and risks. One of the most important factors to many venture capitalists is for the leaders of the company seeking financing to demonstrate their commitment in as compelling a way as possible, showing that they have foreclosed other business opportunities and are focused on a "do or die" push to make their business work.

For later-stage financing, from venture capitalists or investment banks, the key things to demonstrate are a huge market opportunity, a compelling technology solution, an enormous value proposition to customers, "first-mover" advantage, a compelling business and revenue model, and a great management team. It is not hard to see why only a small percentage of businesses seeking capital get funded (Panel on Seeking Venture Capital, the Real Estate Connect Conference, February 2000).

In a show of the financial strength of public Internet companies, FrontLine Capital Group, a public Internet company focused on business-to-business commerce companies, is merging with CarrAmerica Realty Corp.'s executive office suite affiliate, HQ Global Workplaces, Inc. The $380 million transaction will create a company worth over $1 billion. CarrAmerica will retain a 19% ownership stake in the merged company, which will retain the HQ Global name (*Commercial Property News* [March 1, 2000]).

MORTGAGE MARKET TRENDS

While capital for commercial real estate mortgages remains plentiful, costs have increased substantially over the last year. Ten-year Treasuries have increased from a low of 4.4% in October 1998 to near 6.4% in the first quarter of 2000. Treasury bill rates are up over 150 basis points from early 1999. These T-bill increases have significantly increased mortgage rates despite some tightening of mortgage rate spreads over-treasuries in the last nine months.

While mortgage rate increases have had negative effects — increasing debt costs on REITs given their large volumes of adjustable-rate debt, for example — a historical perspective on interest rates tempers current concerns. While it is true that rates have risen since 1998, the average ten-year T-bill rate of 5.26% in 1998 was the lowest in over thirty years. Even today's T-bill rate (approximately 6.4% at the end of the first quarter) is nearly identical to the rates available between 1995 and 1997, and lower than any year, except 1993, since 1972.

Accordingly, while Alan Greenspan seems determined to raise rates until he can put the brakes on the "new economy," rate increases are unlikely to have significant long-term negative effects on the real estate industry (Commercial Mortgage Commitments, The American Council of Life Insurance, Third Quarter 1999; Selected Interest Rates; Federal Reserve Bank, *The San Francisco Chronicle,* "Greenspan says Rates will Rise until Economy Slows and the Stocks Stumble," March 7, 2000).

The demand for mortgage financing is projected to decline from around $300 billion a year during the late 1990s to around $200 billion a year for the next few years. This decline is due in large part to the wave of refinancing activity during the past few years that has removed many properties from the refinancing market. Future "rollover" demand is expected to fall below $100 billion a year, down from around $200 billion during the mid to late 1990s. Slower value appreciation will also reduce the debt-bearing capacity of existing commercial real estate. We expect a decline in new construction from $140 billion in 1998 to approximately $100 billion per year, which will also decrease mortgage demand.

Despite decreases in the demand by borrowers, the capacity for commercial real estate lending is expected to grow. With the continuation of the CMBS market, and growing interest by life companies and money center banks in growing mortgage volumes, mortgage interest rates are expected to be under downward pressure over the next few years (Han, Jun and Anthony Wood, "The New Millennium Party isn't Over Yet," *Mortgage Banking,* February 2000).

Despite decreasing demand for commercial mortgages, life insurance companies project a slight increase in 2000 mortgage originations over 1999. Commitments of $22.3 billion were strong in 1999, but approximately 10% off the record high volume in 1998. Allocations to office buildings are forecasted to fall to 35% from the 40% seen during 1999, with industrial properties capturing most of that decrease, moving from a 13% to a 17% allocation (Mortgage Outlook 2000, American Council of Life Insurance, January 2000).

Based on a survey of forty lenders, insurance companies, securitized lenders and banks have all increased

their allocation of funds for real estate loans in 2000. Lenders were very positive about the condition of their current loan portfolios, the quality of current loan submissions, and the belief that the current favorable lending environment will continue for existing cash-flowing properties. There was less enthusiasm about development loans (National Association of Corporate Real Estate Executives Information Center; Survey by Fantini & George, February 2000).

The forecast for CMBS issuance in 2000 ranges between $40 and $50 billion, compared to the $64 billion issued in 1999. However, the international CMBS market is beginning to pick up. CMBS offerings are being issued in Hong Kong, Australia, and Japan, with activity in Japan expected to accelerate most rapidly. CMBS offerings from Europe are continuing and securitization in Latin America is just beginning ("Real Estate Capital Markets," Korpacz Real Estate Investor Survey, First Quarter 2000).

One continuing consequence of the collapse of the CMBS market in late 1998 is the dramatic reduction in conduit lending. Prior to late 1998, conduit lenders — firms originating loans specifically for placement in the commercial mortgage-backed securities market — were broadening their reach to fund large, small, and higher-risk real estate projects. Today, many conduit lenders require greater equity and shy away from difficult or larger projects. Commercial banks and insurance companies have picked up the slack for traditional, less risky lending, but there remains a gap in the marketplace for higher-risk real estate products.

To fill this gap, regional lenders who were priced out of the market previously by conduit financing are beginning to remerge for loans with greater risk. Additionally, multiproduct lenders providing a broad array of debt products are becoming more common. Finally, mezzanine capital sources have evolved to take on the higher-risk, higher return debt and equity positions in real estate products. These sources are expected to have a growing role going forward ("Out of the Ashes," Adam Weissburg, Forward, Cox, Castle & Nicholson, Winter 2000).

Commercial mortgage banking mergers and acquisitions continue strong today, although for somewhat different reasons than those that drove consolidations during 1997 and 1998. While the earlier push for mergers and acquisitions resulted from companies who wanted to go into the business due to the strong economy, positive real estate fundamentals, and increasing public equity in the real estate markets, today's activity is driven by factors such as strategic diversification to maintain product diversity and fuel growth, economic considerations, succession planning, and significant new technology requirements ("Who Said Consolidation was Dead?" Gregory Longoria, *Mortgage Banking,* February 2000).

In another sign of the continuing merger activity in the lending industry, KeyCorp is acquiring National Realty Funding, combining KeyCorp's $5 billion in annual mortgage lending with National Realty's strengths as a national conduit originator and major CMBS loan servicer (*Commercial Property News,* March 1, 2000).

The third-party commercial mortgage servicing business continued to grow in 1999. According to the Mortgage Bankers Association, servicing volume overall by third-party services increased by almost 20% over 1998, indicating growing interest by financial institutions in outsourcing their commercial mortgage servicing.

GMAC Commercial Mortgage led all services by a significant margin, with a portfolio of $78.2 billion, up more than 50% from year-end 1998. The top six mortgage servicers, GMAC, Ameresco, Midland Loan Services, First Union Securities, ORIX Real Estate Capital Markets, and GE Capital Loan Services, all service portfolios of over $25 billion, and were significantly larger than the companies ranked below them.

Despite the dominance of large companies, the commercial mortgage servicing marketplace is still quite fragmented, with sixty-two companies servicing at least $1 billion in third-party commercial loans. So while consolidation is certainly occurring, there is an equal offsetting and entrepreneurial force in which individuals have split off from established companies to set up their own shops (*Mortgage Servicing News*, March 2000).

OWNERSHIP ISSUES

Real estate companies are more aggressively managing operational risks today. The legal and regulatory climate for the real estate industry is far more complex today than it was only five or ten years ago. Fortunately, new and better risk management tools are being developed. New insurance products for environmental, construction, and employment exposures are complex, but available and beneficial for many companies. While many of these operational risk management activities require substantial upfront cost, they represent a reasonable alternative to ignoring potential problems ("Take My Risk Please," Forward, Jeffrey Masters, Cox, Castle & Nicholson, Winter 2000).

The REIT Modernization Act (RMA) was signed into law by President Clinton late in 1999, and will take effect on January 1, 2001. The passage of this Act is seen as a significant positive for the REIT industry, with both Moody's and Standard & Poor's Corporation issuing reports that support the positive effect of the RMA on REIT creditworthiness.

Most notably, the RMA will allow a REIT to own up to 100% of the stock of a taxable REIT subsidiary that can provide services to REIT tenants and other third parties. This change will deal with many technical issues that have prevented REITs from generating and diversifying their revenue through the provision of critical services to tenants and third parties. For example, as a result of the RMA, Equity Residential Properties Trust was reported to be moving forward with the acquisition of Globe Business, an apartment and office furniture rental company with an attractive reservation system. REITs have been particularly concerned about the quality of independent contractor services that they have had to provide to their own properties and are looking forward to the change.

Another key change of the RMA is the lowering of the required dividend payout for REITs from 95% to 90% of taxable income, leading to a greater level of much needed retained capital (NAREIT Press Release, February 8, 2000; *Commercial Property News*, February 16, 2000; "REITs Modernized," Tony Edwards, National Association of Real Estate Investment Trusts, December 1999).

A key impact of the Internet on property owners is the difficult choices they face in the telecommunications arena to keep their buildings competitive. Building owners serving both small and large tenants are increasingly under pressure to provide services such as high-speed Internet access and bundled voice, data, and cable/video services. Demand for these is estimated to be increasing by at least 40% per year.

Providing these services can help owners retain existing tenants, attract new tenants, and provide a new source of revenues. However, while the need for such services is easy to understand, it is less easy to decide which of the many firms providing such services are right for a particular building.

Part of the confusion in selecting telecom service providers is understanding what each firm provides. Some service providers, like Devnet, work exclusively with building owners, providing the "riser" infrastructure that tenants hook into. Other firms, like OnSite Access or Allied Riser, bring in telecom infrastructure to the tenant and sell a "bundle" of services directly to tenants. Firms like Brix Communication are well-known for replacing infrastructure with new fiber optics, while companies like Netlink or Siteline use existing infrastructure. Finally, companies like Winstar Communications offer wireless alternatives with rooftop dish antennas (Review of Internet sites and marketing materials, March 2000).

MARKET INSIGHTS

In an article mixing positive news with caution, Hugh Kelly of Grubb & Ellis reports that most property markets are in equilibrium with no immediate threat of a sudden volatile disturbance of conditions in the market. However, while waters are calm, he also suggests that successful real estate investors in the coming years will need to renew their attention to the study of the demand for real estate, rather than naively expecting the post–1993 expansion growth rates to continue indefinitely. Changing demographic patterns, a dearth of workers in the career-building ages of twenty-five through forty-four, more creative and appealing physical spaces, and careful, not gloom and doom, assessments of the impact of the Internet on retail properties are some of the areas he thinks are important going forward ("Good Times Roll On," *Commercial Investment in Real Estate,* January/February 2000).

Figures on foreign direct investment by U.S. manufacturers point to a preference for higher-wage countries, contrary to common belief. Total global foreign direct investment by U.S. manufacturers is expected to surpass $46 billion in 1999, a 72% increase over 1998. High-wage countries accounted for 80% of all capital outflows based on detailed data from 1998, the last year in which complete information is available. Global expansion strategies are driven by relative economic stability, well-developed infrastructure, lucrative market potential, and talented and skilled workers. Access to lower-cost labor and raw materials are important but are not the primary drivers.

This global phenomenon is also becoming true in the U.S., where there has been a substantial increase in relocations and business growth in many of the highest-cost regions, including the San Francisco Bay Area, Boston, New York, and other financial and technology centers ("The Review," Deloitte & Touche, February 28, 2000).

U.S. industrial markets continue to be "remarkably stable," with overall vacancy rates of 6.6% at the end of 1999, the same as they were at the end of 1998. This stability is partially a result of the ability of industrial property devel-

opers to adjust to changing demand and overbuilding quickly given the shorter development lead times of industrial property. It is also the result of the strength of industrial demand due to a growth in Internet-related business (The Society of Industrial and Office Realtors, Industrial Market 2000 Report, GSP FinFax, March 2000).

Hotel/motel construction is expected to slow after four years of double-digit growth. This is good news because in 1999 strong industry profitability growth began to stall. In the second quarter of 1999, occupancy rates fell by 1.2%. Room supply was up 4.3% while demand only increased 3.4%. Some slowdown in profitability was expected after the lodging industry enjoyed its most profitable year ever in 1998 when profits increased over 23% ("Building and Design in Construction," February 2000, *Land Use Digest,* March 2000).

CONCLUSION

Clearly, the Internet is poised to have a significant impact on the real estate capital markets, serving primarily as a new platform for the delivery of data and services. However, the E-Loan example demonstrates that the economics of even market-leading companies may be challenging for some time. Other non-technology factors will continue to be key indicators of change and should not be discounted as the world moves into the Internet generation.