Common Sense: Alive in the New Millennium

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Real estate capital market "common sense" is alive as we start the new millennium. The foundation for common sense in the new millennium began in 1999, when many sensible things happened in the industry, including:

- Mortgage lenders tightened their belts in geographic markets and property types that were becoming more risky.
- Mortgage lender belt-tightening occurred despite greater competition due to reduced mortgage demand.
- Pension funds significantly reduced their investment in new "opportunity" funds, reflecting the reality of fewer high-yielding investment opportunities.
- Investors began to actively seek international real estate investments, but on a more cautious basis than might have been expected given declining "opportunistic" investments in the U.S.
- Developers and capital sources conducted better market analyses, showing a healthy respect for a potential economic downturn after nine years of economic expansion.
- Many service providers and lenders accepted the inevitability of technological change and moved forward with technology investments.

This breakout of common sense in the real estate industry may not seem that impressive, but given tremendous bad judgment and the resulting real estate market volatility during the last fifteen years, these signs are encouraging. The hope going forward is that the "common sense" being shown by the industry today will be sustainable as a result of structural changes, including better information and underwriting systems, improved research, and the improved historic perspective of decision-makers.

Common sense will be needed in the new millennium to address the paradox in the real estate industry. The paradox is that just as property markets have achieved their most stable equilibrium in recent history, real estate investors, lenders, and service providers must implement radical changes to their strategies and operations to stay on top.

Given the most stable property markets in twenty years, it would seem logical to heed age-old advice such as "sticking to the knitting" in order to maintain market position and returns as overall 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 ("The Real Estate Industry Paradox," Scott R. Muldavin, *Real Estate Issues*, Summer 1999).

Real estate firms must adapt to less volatile market conditions, the positive and the negative influences of real estate securities, and new information and communication technologies, or be left behind by those who do.

The rest of this article provides an overview of the kinds of changes and activity that are underway in the real estate capital markets as the new millennium begins.

INVESTMENT AND FINANCING

Institutional real estate investors were very active in the third quarter of 1999, acquiring $14.2 billion, up from $8.8 billion in the second quarter of 1999. The office sector accounted for 50% of the total dollars invested, with retail and apartment properties taking up most of the rest. Hotel and industrial investment remained slow, accounting for less than 5% each of the total investment in the third quarter (*Investment Property and Real Estate Capital Markets Report*, November 1999).

At the Fall 1999 Pension Real Estate Association meeting, there was strong concurrence that advisors now have to work harder to produce returns. While real estate can produce returns of 12% to 15%, it will be hard to sustain something higher.

Advisors are preparing for the future of the real estate cycle by focusing on opportunities within their existing portfolios. Downside risk planning, incorporating potential stock market corrections or higher interest rates, is also being evaluated. Other advisors pointed out the growing importance of strategy and creative investment vehicles moving forward.

One panel, which addressed the impact of technology on real estate, was not able to come to definitive conclusions. Opinions about whether buildings and certain geographic locations would become obsolete were mixed. Interestingly, the possibility of wireless technology was brought up, which would dash some of the fears about buildings becoming obsolete (*Real Estate Finance and Investment*, November 1, 1999).

Sales of medium and larger properties dropped during the first half of 1999, while investment activities in smaller properties expanded by 19% during the same time. This divergence in sales activities by size is partially a result of the decline in large REIT acquisitions, but it also reflects the pick-up in activity by smaller private investors who are capitalizing on the continuing strengths of the economy and the real estate capital markets (*National Investment Research Report*, 1999 Mid-Year Update, Marcus & Millichap).

Accessing equity through the Internet is becoming a reality. One new Internet source for commercial real estate equity is EquityCity.com. EquityCity.com currently lists on its site approximately thirty to forty deals seeking equity capital. The average deal size is approximately $15 million, with average equity sought ranging from $3 million to $4 million. They cover all types of properties including land, new construction, and small to large properties.

EquityCity.com currently has about 2,000 real estate investor members. These members have a capacity to invest of over $28 billion on a per transaction basis. (Based on adding up their maximum investment limits per transaction.) To apply for membership in EquityCity.com you need to be an accredited investor, as defined by the Securities and Exchange Commission (SEC) in Rule 501 of Regulation D.

Fees for firms seeking equity capital through the web site have moved from an initial flat rate fee of $200 to $2,000, to a success-based fee of three quarters of a point, to three or four points depending on the specifics of a particular deal. Split fee arrangements for an individual or company bringing a deal to them can be negotiated. With the new success-based fees due to be implemented in the next few weeks, the flat fees from $200 to $2,000 will be discontinued, replaced by a $100 upfront processing fee.

While Internet equity competition is limited to date, it can be expected that competitor firms will emerge to compete directly with EquityCity.com on a broad basis as well as by identifying specific niches on which to focus (interview conducted December 1999).

In another sign of the demand for mezzanine loans in the marketplace, Massachusetts Mutual has teamed up with Boston Capital to set up a mezzanine loan fund that is expected to be funded with $250 million of equity. Massachusetts Mutual is contributing some capital, with the rest coming from a handful of other institutional investors, including other insurance companies.

The fund will focus on participation loans, which require property owners to pay back more than the amount borrowed. Loans will range from $5 million to $15 million on properties valued at $50 million to $100 million. The fund can also buy subordinate classes of commercial MBS, but that is likely to be a secondary focus. The fund believes its key advantage is that relatively few mezzanine lenders are focused on loans over $10 million, thus limiting their competition (*Commercial Mortgage Alert*, October 18, 1999).

MERGERS, ACQUISITIONS, AND ALLIANCES

In today's fast-moving marketplace, companies that need new capabilities have been turning more frequently to strategic alliances, as opposed to mergers or outright acquisitions. In fact, the average large company, which may have had no alliances a decade ago, now has in excess of thirty.

Despite the growing popularity of strategic alliances, recent research shows that 323 senior executives who were surveyed felt that 61% of their alliances were essentially disappointments or failures, while only 39% met or exceeded expectations.

In a detailed analysis of alliances, it was found that five myths — misunderstandings about the true nature of alliances — were at the heart of most alliance problems. These five myths are:

- Alliances are like a marriage.
- The integration task for an alliance is the same as for a merger.
- One government's model fits all alliances.
- It is adequate for alliance expertise to reside within an elite corps of decision-makers.
- Alliance performance is impossible to measure.

(*Dispelling the Myths of Alliances*, Andersen Consulting, September 1999).

REIT mergers and acquisitions declined substantially in 1999 due to significantly depressed share prices. REITs typically like to use their stock as currency in an acquisition. Accordingly, when stock prices are low, their currency is less valuable, making it more expensive to acquire. Furthermore, if a company is selling, it wants to sell at the highest price. With market prices averaging an approximate 20% discount to net asset values, few companies want to sell at prices buyers want to pay.

Perhaps most compelling, consolidation is no longer seen as a good way to maximize shareholder value. Leveraged buyouts or outright liquidations are currently better strategies. Many companies have also taken to heart the difficulties that arise in many mergers and alliances (*Commercial Property News*, Real Estate Securities, October 16, 1999).

Sunstone Hotel Investors, owner of fifty-nine hotels in eight states, was purchased by SHP Acquisition, LLC, an affiliate of Westbrook Partners, and certain members of Sunstone Hotel Investors' senior management team (*PRNewswire*, 11/17/99).

Further evidence of the consolidation underway in the hotel industry is the recent signing of a definitive merger agreement between the Hilton Hotel Corporation and Promus Hotel Corporation. This $4 billion cash and stock transaction will create a joint company with a total of nearly 1,700 hotels, 290,000 rooms, and 85,000 employees (*Commercial Property News*, October 16, 1999).

Wells Fargo & Company recently purchased Eastdil Realty LLC, adding real estate advisory expertise to Wells Fargo's service lineup. This purchase also gives them a stronger foothold on the East Coast (*Commercial Property News*, November 1, 1999).

Provident Bank has acquired Capstone Realty Advisors. Capstone originates permanent, long-term fixed-rate commercial real estate loans primarily for life insurance companies. With the acquisition of Capstone, Provident rounds out its commercial mortgage offerings, which already include construction loans, mini-perm loans, and permanent loans financed through securitization (*PRNewswire*, 9/21/99).

Bank One, which recently sold its commercial mortgage and servicing operations, will now provide long-term mortgages to its customers through an alliance with GMAC Commercial Mortgage. GMAC will have representatives in thirteen Bank One offices for customers looking for conduit-style mortgages. Bank One, which continues to write $3 billion of short-term mortgages annually, will retain the ability to provide full service to its clients (*Commercial Mortgage Alert*, October 4, 1999).

Transwestern Commercial Services, a full-service real estate firm, and property manager Voit Management Company have signed a merger agreement. Their merger will create a firm with a total of 27 offices, 1,450 professionals, and a management portfolio of more than 90 million square feet valued in excess of $8.5 billion (Institutional Real Estate Newsline, October 4, 1999).

Grubb & Ellis continues its acquisition mode with the purchase of Landauer Realty Group, adding a well-regarded real estate valuation, consulting, and capital markets group to its company (*Commercial Property News*, October 16, 1999).

PROPERTY TRENDS

In a sign of the increased difficulty and cost of financing for the senior housing industry, Sunrise Assisted Living, Inc. canceled plans to acquire $88.2 million of senior living assets from Consolation Health Services. The declining performance of the properties prevented Sunrise

from getting cost-effective financing. The deal was to have included twelve existing senior living communities in the mid-Atlantic, three senior living communities under construction, and several sites for future communities (*Institutional Real Estate Newsline*, November 22, 1999).

Investors in industrial warehouse space should rethink their exposure to warehouses based on a recent study of the impact of e-commerce on the warehouse markets. While there does not appear to be a short-term reason to be seriously concerned, the report argues that reduced demand for warehouse space coming from the rapidly expanding business-to-business e-commerce sales will outweigh the increased demands from Internet retailers and direct sales operations of manufacturers.

The report also notes that the nation's warehouse markets have proved resilient in the face of past competitor shocks — i.e., just-in-time manufacturing during the 1980s, the Wal-Mart juggernaut, and the rapid growth in third-party logistics. Warehouse markets across the nation took those shocks in stride, with no visible ill effects on rents or prices.

However, the report does conclude that for Internet retailers and manufacturers with direct sales operations, close proximity to airports and major shipping hubs will be more important than ever. Investors should consider redirecting whatever exposure they have toward those geographic markets that service major shipping hubs such as Northern New Jersey; Atlanta; Memphis; Chicago; Columbus, Ohio; Dallas; and Los Angeles ("Warehousing.com, e-Commerce's Impact on the Warehouse Market," *Merrill Lynch In Depth Report*, November 9, 1999).

In a growing trend, neighborhood shopping center developers are adding entertainment components to open-air strip and power centers. Some developers have begun to experiment with entertainment components in their suburban properties, creating a sense of place with architectural themes, fountains, outdoor dining, stadium seating theaters, bookstores, and retailers that bring fun and excitement to their offerings.

While these types of entertainment-oriented projects won't work in all locations or in every situation, they do represent a window to a future where retail establishments must offer a more attractive environment to attract shoppers to their doors ("Strip Centers Get in the Act," *Shopping Center World*, June 1999).

Continuing evidence of the pervasiveness of the Internet and its importance to real estate services firms is included in a new report entitled "Real Estate Technology," which was released at the National Association of Realtors Convention in the Fall. Based on their study, online member access has risen from 25.7% in 1997 to 71.3% today. Most importantly, on average, those who use the net on a regular basis have an income $22,500 greater than those who do not (*Inman News*, November 12, 1999).

REIT INSIGHTS

The REIT sector continued its poor performance during the Fall of 1999, with returns of –7.0% for the ninety days prior to November 29, 1999. This compared to S&P 500 returns of 4.3% and S&P Small Cap 600 returns of 3.3%.

Year-to-date returns through November 1999 averaged –7.5%, with healthcare the biggest loser at –27.7%, and apartments the only sector with a positive return at 5.2%. Year-to-date returns on the S&P 500 were a positive 16.6%, while the S&P Small Cap 600 returns were only 4.8% (*REIT Valuation Weekly*, Merrill Lynch, November 19, 1999).

The question of whether public equity REITs can be substituted for private real estate equity for the purposes of rebalancing institutional investor portfolios is important to portfolio managers. In a recently released study comparing public and private real estate between January 1986 and December 1996, researchers concluded that all measures used to examine the relationship between public and private real estate clearly indicate significant differences between the two real estate asset classifications. Moreover, these differences hold across all four property types examined. Because public and private real estate returns behave so differently, they should be treated as two separate or distinct asset classes.

Importantly, these conclusions are based on information prior to the collapse of the REIT market in 1997, and provide additional evidence in the debate about the proper role of equity REITs in an investment portfolio. Treating REITs as a direct substitute for private real estate does not appear supportable today, although this doesn't answer the question of whether REIT prices are sufficiently low to begin an aggressive buying program ("Are E-REITs Real Estate?" *Journal of Real Estate Portfolio Management*, Volume 5, No. 2, 1999).

In a sign that REITs may not have reached their bottom, Moody's Investor Service has issued a negative outlook on the entire real estate investment trust industry. Moody's is warning investors that the industry's appetite for risk and leverage has increased due to difficulty in

obtaining financing through the capital markets and a peak in the real estate cycle. REITs most likely to experience downgrades are those that take the risk of increasing leverage to propel growth, or divest core assets, which may alter the quality of their portfolio and damage their long-term profitability and financial flexibility (*Real Estate Finance and Investment*, October 18, 1999).

Apartment REITs have optimal debt levels that are about 10% higher than other non-apartment REITs, according to a new research study entitled "Leverage and Value in Apartment REITs." This study finds that apartment REITs, on average, use significantly more debt — 7% to 9% — in their capital structure than non-apartment REITs, and that this increase is mostly in the form of long-term debt.

This higher leverage is seen as appropriate for apartment REITs, because 1) apartments are more liquid than other properties, 2) their cash flow characteristics are attractive to lenders, and 3) Fannie Mae and Freddie Mac provide a broad base of mortgage financing for the apartment industry. These conclusions are important because shareholder values can be increased significantly by increasing leverage on a sensible basis ("Leverage and Value in Apartment REITs," September 1999, Dennis Capoza and Paul Sequin, National Multi-Housing Council).

Corporate loans to real estate investment trusts totaled only $5.9 billion during the third quarter of 1999, bringing the total for the first nine months of the year to $15.5 billion. This is in stark contrast to the $43 billion that was raised during the first three quarters of 1998, according to the Loan Pricing Corporation, a New York-based firm that tracks corporate loans and high-yield bonds.

Total REIT lending reached a record $51.5 billion in 1998, preceded by a then-record $41.4 billion in 1997. 1999 lending is projected to be approximately $20 billion, more than a 60% drop.

With approximately $16 billion of loans undertaken by REITs during the boom years of 1997 and 1998 due to be refinanced in 2000, there is substantial opportunity in this sector for those interested in lending to the REIT community. Leading the lenders for the corporate real estate finance sector are Chase Manhattan, Bank of America, Credit Lyonnais, First Union, Deutsche Alex.Brown, PaineWebber, and J.P. Morgan, all of whom have originated over $2 billion so far in 1999 (*PRNewswire*, November 18, 1999).

CONCLUSION

The new millennium will begin during a time of great prosperity for the real estate industry. Firms that apply "common sense" to the complex changes underway will continue to achieve strong results and avoid obsolescence.