

Economic Uncertainty Clouds Capital Market Outlook

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As the New Year gets started, real estate capital providers and owners are focused on interpreting the economic changes underway. Economic growth is slowing, but are we really headed for a recession? How deep will the recession be if we have it? How will a recession or slowdown influence different regions and property types? How will significant declines in technology companies and Nasdaq influence consumer spending? How broad will these effects be throughout the country? Are we really in an energy crisis that could influence employee and residential real estate decisions, or is this just a short-term problem?

These questions reflect the growing uncertainty in the markets, which affects real estate capital market providers much like it does other sectors of the investment market. Until a consensus view is reached on these issues, the uncertainty will continue to slow transactions, make real estate capital providers more skittish, and generally make it more difficult for buyers and sellers in the real estate market to conduct business.

In 2001, the changes in the economy are expected to have a direct influence on the real estate markets. This was not always the case, as huge oversupplies of real estate in the 1980s and early 1990s mitigated the influence of economic changes on the real estate markets. In fact, for many years, economic growth and real estate market conditions were

effectively delinked. For example, the real estate markets were in substantial disarray during long periods of time in the 1990s when the economy was growing.

Today, with real estate markets generally in equilibrium, and overbuilding generally in control, the influence of economic changes on the demand for real estate will have a more direct effect than it did in the last decade. Slower GDP will affect new construction, absorption, and rents. Declining personal income and consumer confidence will quickly impact retail sales. Energy costs, over the long run, will have significant effects, but in the short term the ability of many real estate owners to pass on energy expenses to tenants insulates the real estate sector from significant problems.

The rest of this article provides a summary of some of the key economic and capital market issues that are currently influencing the real estate markets, providing an assessment of what occurred in 2000, and some perspective on the outlook for 2001.

ECONOMIC AND MARKET OUTLOOK

Conner and Liang, in their article “The Four Forces” discuss their view of the four fundamental forces that have profound influence on real estate investments: population, employment, new technologies, and capital markets. Some of their key observations include:

- Population and labor growth rates will continue to slow during the next decade, but absolute increases in the U.S. population and labor force will still be substantial (14.2 million new workers expected in the next decade) providing numerous real estate opportunities;
- While wide variation still persists across U.S. markets, the inequality among the growth of economic locales has become much less pronounced in recent years. For example, the variation in growth rates among the top 100 MSAs is roughly half of what it was in 1971;
- More uniform employment growth and greater transparency in the capital markets, as well as diversification of capital sources, has produced a more stable environment that benefits both investors and operators;
- Technology employment is a key driver of real estate value, but the diversity of “technology” businesses is broadening, with each sector of the technology industry exerting different preferences relative to their business and employee real estate demands; and,
- Investment opportunities will continue to exist as pockets of intense demand, economic change, public-private capital market relationships, and the normal dynamic movement of the Four Forces rewards those who can best chart their course (Conner and Liang [2000]).

After a number of years of active trading in the U.S. office property markets, transaction activity has slowed. For central business district offices, the markets still remain hot, but many buyers have met their office allocation targets and are reluctant to pay today’s high prices given emerging uncertainty about the economy. Additionally, sellers are not compelled to sell today as rental and vacancy rates continue to be tight in most markets. Capital market conditions in the suburban office market are similar, with interest by investors moderating and some sellers unable to attract buyer interest.

Discount rates for CBD Office Properties in the 4th Quarter of 2000 were 11.04%, down from 11.18% in the 3rd Quarter of 2000. Overall cap rates have stabilized around 8.9% with residual cap rates closer to 9.5%. Suburban office property rates were not materially different from the CBD, except for overall cap rates, which were somewhat higher at 9.22%.¹

The ability of the real estate markets to positively respond to declining economic growth was underscored in the Real Estate Market Cycle Monitor Report published by Legg Mason in November 2000. While they acknowledge that the extreme peak caused by dot-com mania may be over, demand is still strong and supply remains constrained in most markets and property types. The economy has slowed to near 3% GDP, down from over 5% in the first half of 2000, but new supply also slowed in all property sectors, creating a reasonable balance.²

Increasing energy costs are not expected to have a significant impact on REIT earnings. In the apartment sector, over 95% of energy costs at apartment communities are directly borne by residents. Given the structure of most office leases, with an expense stop for the amount of operating expenses landlords pay, most significant energy cost increases should be able to be passed on to tenants. However, the base expense stop is reset to market as leases turn over, but in the office REIT sector, only approximately 12% to 13% of occupied square footage in leases expires annually mitigating the initial effect of energy price increases.

For industrial properties, utility costs are relatively low, ranging from 2.5% to 3% of revenues. Additionally, industrial landlords often sign triple net leases which pass on all expenses to tenants. An exception to this is the refrigerated warehouse sector of the industrial markets, where energy costs constitute a large proportion of operating expense. With these types of properties, contracts generally do not have clauses that allow landlords to fully pass on operating expenses.

For retail properties, energy cost increase impacts should also be minimal. Mall landlords generally structure leases to pass on both inline stores and common area energy charges to their tenants. For neighborhood shopping centers, leases are often triple net. However, for both malls and neighborhood shopping centers, as well as office buildings and other properties, if energy costs rise too high it could limit the ability to raise rents to tenants.³

FUTURE PERSPECTIVES ON CITIES

The top five cities for conducting business in 2001, according to *Sales and Marketing Management* magazine, included Charlotte, North Carolina; Austin, Texas; Portland, Oregon; Salt Lake City, Utah; and Des Moines, Iowa. Looking even further down their list of the top 20 cities for business are cities such as Boise, Idaho; Cincin-

nati, Ohio; Omaha, Nebraska; and Sioux Falls, South Dakota. Clearly, affordable housing and good quality of life were a critical component in their assessment given growing housing and living costs as well as congestion in some of the most successful cities during the last two decades.⁴

A longer-term outlook of the issues facing cities in the 21st century was provided in the Urban Land Institute's "Cities in the 21st Century" publication. Six thoughtful articles by leading urban visionaries outline a number of possible future scenarios for cities.

The optimistic view of the cities is that they are experiencing a revival and that this trend will only grow stronger as cities enhance their traditional role of attracting the most talented, ambitious, and creative in society. New businesses today—technology, telecommunications, new media, and biomedical firms—rely on alliances, coalitions, entrepreneurs, changes in technologies, short-term collaborations, and a vibrant lifestyle to attract and keep their employees.

Those cities that meet the demands for environments that are conducive to communication are also expected to flourish in the future. This would include cities with strong technology and energy infrastructures, enhancing electronic communications, but also those cities that cater to face-to-face communications, and have excellent air transportation or airport hubs, such as Dulles near Washington, D.C. or Dallas, Fort Worth in Texas. Cities with large concentrations of hotel rooms and convention facilities are also expected to flourish. Face-to-face communication will continue to play a critical role in business in the future.

A more pessimistic scenario, that in fact could occur on a somewhat parallel track with an optimistic scenario, is one in which an infinitely expanding metropolitan region continues to draw people and resources to an ever expanding periphery, leading to increasing sprawl and the continuing decline of the inner urban core. Continuing concentration of poverty and economic segregation could bring collapse to many central cities and older suburbs, leading even prosperous regions to resemble "Garrison States" within whose gated communities the haves will seek to wall themselves off from the conflicts of the have-nots.

One of the authors indicates that a grassroots desire to limit sprawl, regional smart growth initiatives, increasing racial and ethnic diversity in cities and suburbs, and baby boomer demographics are all pro-urban trends that indicate that this more pessimistic vision of the 21st century American city can be moderated.

Interestingly, none of the articles provides a thorough review of the influence of housing affordability and qual-

ity of life as a driving force for employment growth, focusing instead on employment growth driving location decisions. As outlined in the Sales and Marketing Survey discussed above, there are many people, from a common sense perspective, that believe that low cost housing and a more rural, less intense, quality of life will be one of the key driving forces going forward.⁵

DEBT MARKET PERSPECTIVES

The commercial mortgage business in 2000 saw numerous mergers and acquisitions. Most of the merger and acquisition activity was undertaken by large deep pocket companies looking to broaden their lines of business and fill in product niches. Growth in the ability to serve borrowers across all product niches, as opposed to dramatic growth in a single sector of the mortgage market, was the path to growth pursued by the strongest companies.

In many ways, the continuing mortgage mergers and growth by the largest companies are results of the turmoil in the markets in late 1998 when the collapse of the CMBS market left many borrowers out in the cold, reemphasizing the importance of long-term relationships. This re-emphasis by borrowers on long-term relationships has not been lost on the deep pocket companies leading the mortgage mergers as they position themselves to solidify their borrower relationships through improved service and breadth of product.

Some of the largest mergers in 2000 included Prudential Mortgage Capital's \$138 million acquisition of the WMF Group; Lend Lease Real Estate Investment's acquisition of AMRESCO, Inc.'s commercial mortgage business; Berkshire Mortgage Finance's \$40 million acquisition of Bankers Mutual; BB & T Corporation's acquisition of Laureate Capital Corporation; and KeyCorp's acquisition of Newport Mortgage Company.⁶

The CMBS market generated over \$50 billion in capital during 2000, still down nearly 30% from its peak of \$78 billion in 1998. Industry observers expect annual volume during the next few years to be in the \$45 to \$55 billion range, indicating that many of the firms that downsized or left the industry after the rapid growth period in 1998 are as unlikely to return.

According to George Smith Partners, the current tally of CMBS originators is 26, with 13 commercial banks, 3 finance companies, 7 Wall Street investment bankers, and 3 insurance companies. Mergers in 2000 have reduced the number of players including combinations between J. P. Morgan/Chase, Paine Webber/UBS, and DLJ/CS First Boston.

CMBS spreads leveled off during the 4th quarter of 2000, ranging around 155 basis points over 10 year treasuries for the AAA tranche and 230 basis points over treasuries for BBB rated securities. This compares favorably to the higher spreads experienced during April and May 2000 (170 basis points for AAA), but is significantly higher than the low of 86 basis points in July of 1998 for AAA rated securities.

While originators tend to feel profit spreads are thin and margins are tight, big changes in profits are not expected. The competition from traditional mortgage companies is strong and CMBS is largely seen as a “commodity” business today. Perhaps more difficult for underwriters than profit spreads, are the risks associated with holding loans prior to securitization, B buyers kicking out loans, and the subordination levels required from rating agencies. In particular, B piece buyers, who purchase the unrated portion of the bond pools (i.e., BB and below), have been asserting their right to kick out loans arbitrarily and it is not unusual for 5% to 10% of the pool to be heavily negotiated. While the BBB and below tranche only represent 8% of the typical securitization, this can still be a costly and frustrating process.

On the positive side, there was over \$50 billion of product originated last year and the U.S. Department of Labor has finally amended its prohibitive transaction rules issued under the Employee Retirement Income Security Act (ERISA) to allow pension funds to invest in a wide array of commercial backed securities not previously allowed. Effective August 23, 2000, pension funds have been able to purchase CMBS, credit ratings as low as BBB-. This compares positively to previous regulations, which limited pension fund investment to securities of A- or higher. This move should increase potential liquidity through an increase in demand, causing spreads in lower rated tranches of CMBS to narrow. However, it may take a few years for pension funds and pension advisors to develop the systems, comfort, and procedures to manage this new investment alternative.⁷

Life insurance companies are experiencing significant changes that influence their mortgage business. As they continue their conversion from mutual companies to stock companies, they are experiencing increased pressure from their shareholders to increase the return on equity. These factors put pressure on life insurance companies to behave more like banks, who found that their stockholders' requirements for return on equity forced them to hold very few long term, fixed rate investments on their balance sheets. This raises the question of who would

replace life insurance companies as providers of long-term capital to real estate if they follow in the banking industries' footsteps.

Life insurance companies are also reacting to these changes by chasing yield through nonstandard lending products and increasing their ability to compete across a broad array of short and longer-term real estate debt vehicles.

Pension funds, a logical source to make long-term commitments to the debt markets, have not adopted this role. Many pension funds are still confused about exactly where real estate debt fits in their overall asset allocation, and the decline in the stock market has inadvertently increased the percentage of pension fund portfolios in the real estate markets, potentially limiting pension fund short term interest in the debt markets.

One key result of these changes in the debt markets, and the general risk posture of the debt markets today, is that there is an increased equity requirement in real estate transactions, imposing a higher weighted average cost of capital on buyers.⁸

EQUITY AND INVESTMENT TRENDS

The private real estate equity markets reemerged strongly in 2000. With the REIT (IPO) market drying up almost completely, and overall new REIT offerings down dramatically from the mid-to-late 1990s (2 IPOs in 1999, 0 in 2000); private real estate equity sources have reemerged as the leaders in the real estate equity markets.

Private real estate equity capital is available from endowments, pension funds, pension fund investment managers, and from smaller private investors and partnerships throughout the country. More so than in the past, particularly for the larger private capital sources, there is an interest in forming alliances with real estate companies that can create value in specialized niches.

While the interest in longer-term relationships is the good news for many real estate companies, the bad, or perhaps difficult, news is the typical co-investment requirements of 10% to 20% required by many private equity investors to insure alignment of interests.

The larger institutional private capital sources are more flexible than they were in the 1980s and 1990s, often willing to structure transactions through recapitalization of an entity, selling or buying portions of a portfolio, forming a fund through a strategic alliance, or engaging in a series of one-time joint ventures. Internal rates of return range today from the mid-teens to the mid-twenties, with leverage ratios from 60%-75%. Typi-

cally, the private capital source requires a preferred return of 10%-12%.

Other typical private equity demands include the right to force a sale, and control over major decisions such as acquisition of new properties, sales, refinancing, major leases, and annual budgets. However, experience shows that most private investors do not have the staff to, or interest in, micromanaging their partners.⁹

As concerns about the U.S. economy continue to brew, the European continent will continue to offer a growing number of investment opportunities for foreign and U.S. capital that for much of the 1990s had been focused in the United States.

With the creation of the European Union, cross-border trading and development is booming, partly because of the introduction of the euro. The euro, while somewhat shaky during parts of 2000, clearly has eliminated currency risk across much of Europe, particularly Western Europe. The disparity in capitalization rates among nations in Western Europe has declined and better transparency of information is evident. There are still problems with varying taxes and legal systems, but these barriers are also being worked on.

Mortgage debt is one of the hottest investment types in Europe today, particular among Americans and Germans. German banks have the lowest cost of capital due to their ability to sell bonds to support real estate debt and existence of "Landesbanks," banks underwritten by German states which can underwrite debt at a state level. Americans and other foreign investors have to compete with major banks in most European countries given the historic tradition of banks dominating real estate finance in Europe.¹⁰

Public companies, including REITS, are now under increased scrutiny to prohibit "selective" disclosure of material nonpublic information to securities analysts, institutional investors and existing stockholders. On August 15, 2000 the Securities Exchange Commission approved Regulation FD ("Fair Disclosure"), which will require that when an issuer makes an intentional disclosure of material nonpublic information to designated persons, it must do so in a manner that provides simultaneous disclosure to the general public.

While it is too early to fully tell, public companies could use Regulation FD as an excuse for reducing the current level of disclosure, or they could provide even more widespread disclosure of material information equally to all investors.

On a practical level, REIT executives need to be more careful in providing information about their company at conferences and in small meetings with investors and/or

other business associates. Regulation FD also makes it more difficult for REIT analysts that have typically communicated directly with REIT, to obtain guidance on earning estimates and other issues. Going forward, while one-on-one meetings will continue to be allowed, they will be less productive and major nonpublic information will have to be issued through press releases or other means.

On a positive note, for those individuals that have REITs in their personal portfolios, there is a greater likelihood that information obtained through the media will be "fresh" than would have been the case earlier, somewhat leveling the playing field. The key downside will be if REIT, concerned about Regulation FD, actually reduce the flow of information to everyone as a result of the higher scrutiny of their disclosure.¹¹

MISCELLANEOUS INSIGHTS

The difficult decision today for corporate real estate facilities managers is not whether or not they should outsource some of their responsibilities, but how they should go about doing it. Outsourcing today is a reality:

- The market for outsource facility management services is expected to surge from \$9 billion in 1996 to \$23 billion by 2001, according to the Outsourcing Institute;
- 89% of executives surveyed by the International Association of Corporate Real Estate Executives (NACORE) outsource development and construction;
- 79% of real estate executives said they expect the use of alliances and outsourcing by the corporate real estate industry to increase during the next two years, according to a study conducted by the International Development Research Council (IDRC); and
- In 1999, a survey by the Houston-based International Facility Management Association found that 97% of its 539 respondents outsourced or out-tasked their projects; each facility manager having, on average, 20 separate contract vendors.

With outsourcing a reality, and on average, facility managers having 20 contract vendors including landscaping, plumbing, heating and air conditioning, janitorial, maintenance, hazardous waste removal and recycling, occupational health and safety services, it is a growing challenge to effectively manage the volume of outsource services.

With the portfolios of many investors and corporations growing larger and more globally diversified, the management tasks have gotten even tougher. With investors and corporate management demanding ever increasing operating efficiencies, the pressure to implement technological innovations that streamline business processes is fierce.

“Smart Buildings,” where the mechanical systems are entirely computerized can improve energy management and are capable of tracking many kinds of data, including utility meters; utility bills; vendor activity inside of buildings like arrivals, performance, and departures; and other internal systems. The challenge is to conduct good cost-benefit analysis and select vendors and systems that will survive any possible shakeouts in the technology community. Convincing short-term focused senior management to “invest” in new building technologies is also a challenging task for many facility managers.

Newer and better systems and solutions are continuing to be refined and developed by web-based service companies. The future, as early as 2001, will provide opportunities for forward thinking facilities managers, and their senior management, to invest corporate capital resources to continue to improve the efficiency of their operations.¹²

Riggs and Harms, in their article “Realized versus Required Rates of Return and What It Means to the Real Estate Industry,” provide an interesting assessment of how closely realized returns have matched required returns over the last 20 years. Based on a review of RERC’s Quarterly Investment Survey and the NCREIF property returns index, they have found that the approximate 20-year average total realized and required returns were 9.5% and 12.9%, respectively, for a negative spread of 3.4%. If you look only at properties actually sold in the NCREIF Property Index, the gap widens to nearly 5%.

This negative spread suggests that the industry has performed poorly in predicting performance. The inability to predict, or generate, required returns increases the risk of the investment class, thus somewhat explaining why pension plan allocations have remained at less than 3% of their total portfolios, and for those pension funds that have a real estate allocation, approximately 7%.

The authors explain that the evolution of the real estate asset class is no different than that experienced by the stock market. Prior to the 1960’s, institutional investors focused primarily on the bond market. Not until the 1960’s when Wall Street recognized the need for creditable historical data, did the stock become a mainstream institutional investment.

Real estate is entering into the earlier phases of

what the stock market experienced some 40 years ago. With NCREIF, RERC, and other data sources nearly 20 years old, the industry is reaching a point where it can more confidently predict risk and return characteristics for commercial real estate. This improved data availability, in combination with the structural changes in the real estate capital markets that suggest less dramatic cycles, should make real estate an even more attractive institutional investment in the future (Riggs and Harms [2000]).

CONCLUSION

The economy will sort itself out like it always does. Fortunately, real estate should perform positively on a relative basis to most financial assets, providing a protection against severe downtimes. Capital market providers will remain cautious making deals tougher and slower to implement. However, the money is there, so patience and diligence will be rewarded.

ENDNOTES

¹Korpacz Real Estate Investor Survey, PricewaterhouseCoopers, 4th quarter, 2000.

²Analysis, Real Estate Market Cycle Monitor, Equity Research, Legg Mason, 3rd quarter 2000.

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⁸Financing Notes, Cohen Financial, December 2000.

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¹¹“Regulation Fair Disclosure—The Chill Is in the Air,” *Pension Real Estate Quarterly*, Fall 2000.

¹²“Pulling Some Strings, A Case for Outsourcing Facilities Management,” *Journal of Property Management*, November/December 2000; “The Facilities Executives Guide to Outsourcing,” *The Outsourcing Report*, December 2000.

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