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The Money Truck Made a Pick Up and a Delivery in 1998

Real estate is an asset heavy business. There are more dollars per decision-making person than in most American industries. The decisions these people make are critically important as they control how our built environment will look for decades to come. This decision-making environment is inherently interdisciplinary and, thus, quite complex. Many diverse things must be considered, and then linked both legally and financially. This consideration runs from real environmental hazards to the more immediate hazards of no toilet paper in the bathroom. While a great deal happens requiring a tremendous amount of logistics, real estate fortunes tend to be made in acquisition/disposition of the dirt and in the financing. On the latter front, the money truck made two major stops this last year.

The money truck made a major pick up (concentrated in July) from REIT investors. A dollar placed in an S&P index fund at the beginning of 1998 would have painlessly become \$1.23 by the first of December. On the other hand, \$1 placed in a REIT mutual fund would have become \$0.84 over this same period. Losing 32% to the S&P index is clearly a very bad experience. How could this have happened?

Over the course of the year, the ten-year Treasury yield dropped from 5.7% to 4.8%. A decline of 16% in interest rates should have helped REIT pricing. Further, funds from operations in the REIT universe were up 15% and are currently forecast to be up another 10% in 1999.

The answer is quite simple. REITs are not growth stocks, dummy!¹ REITs had been sold to both retail investors and to mutual funds as growth vehicles. Because private yields in real estate assets were higher than the yields demanded in the public marketplace, "accretive" acquisitions facilitated rapid growth in REIT earnings over the 1995-1997 period. However, even the most simple-minded should have realized that this

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kind of growth is eventually self-defeating. Even if spreads between private and public yields never narrow,² increasing size makes continued growth ever more difficult. A \$100 million REIT can show attractive growth with acquisitions of \$50 million. On the other hand, a \$1 billion REIT needs \$500 million in acquisitions to show the same kind of per share earnings growth.

The self-defeating nature of the REITs as growth stocks became evident over the course of 1998. The REITs, for the most part, are value companies. Just as it's not good to fool Mother Nature, it's not good to fool Wall Street (and forget to sell before you are discovered). The difference between the FFO yield and the ten-year Treasury yield went from 180 basis points at the start of 1998 to over 500 basis points on December 1. Like all money truck pick ups, it was ugly for those who played the game.

At the other end of the spectrum, the money truck made a major unexpected (at the time) delivery in 1998. Those smart enough to realize that the explosion in CMBS conduit originations could not continue bought lots of property with Nomura's money during the second quarter. This was a period of time that (in retrospect) reminds one of the best days of savings and loan financing. The loan to value of 75% became a loan to cost of 95%, with aggressive cap rates and optimistic lease rollover assumptions. Even with effectively 90+% financing, after-debt service yields from property were positive on a current basis. With 100% of any future appreciation dropping to the 5% to 10% of the capital stack financed with equity, the second quarter buyer/borrower "locked in" 25%+ total returns for years to come. Not bad in a low-inflation environment.

Benefiting from the money truck stop didn't take any creative "value add" activity. It didn't take any development. All it took was buying an existing fully leased property and borrowing the maximum possible amount. Like many money truck deliveries, it didn't require a lot of higher level math: You just had to be standing on the right corner.

ENDNOTES

¹You will recall that a major money truck delivery was made to early 1990s investors who realized it was "fifty cents on the dollar, dummy!"

²This would be a highly unlikely event since both yields are dependent on the same cash flow stream, i.e., the operating income from property.

Mike Miles
Editor