The Making of an Asset Class

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With the advent of Modern Portfolio Theory in the 1950s and its subsequent adoption by institutional investors in the 1960s to 1980s, commercial real estate went from cottage industry to bona fide asset class. But the obstacles to its ownership (including capital intensity, lack of transparency, operational requirements, geographic specificity and illiquidity) made real estate largely inaccessible to all but the largest investors. Twenty years ago, a remarkable transformation occurred: liquidity in real estate brought on by the rise of public REITs, CMBS, real estate private equity funds and the abundance of capital sources. Today, real estate competes directly with stocks, bonds, currencies, commodities and other financial assets. The evolution of the sector occurred much as evolution does in nature: life-threatening conditions forced inhabitants to adapt or perish and introduced new entrants to the ecosystem. As Charles Darwin famously observed, "It is not the strongest of the species that survives, nor the most intelligent... it is the one that is most adaptable to change." The creative destruction of the late 1980s and early 1990s forged a new species of real estate industry—more resilient than its ancestors but, as recent years attest, still vulnerable to threats old and new. Understanding the factors that catalyzed the industry’s transformation, and the lessons learned along the way, is the key to preparing for the many exciting challenges and opportunities that lie ahead.

Enter The Money

Prior to the 1990s, any significant equity investment in real estate was limited to pension funds and lending was limited to life companies, banks and thrifts. Despite being nearly 30 years old, the U.S. REIT market had a capitalization of less than $10 billion. Non-traditional investors such as private equity, hedge funds and Wall Street looked to real estate for office space rather than for investment. This stands in stark contrast to 2012, when the U.S. REIT sector has a market capitalization of over $400 billion (and controls nearly $1 trillion of assets) and the outstanding balance of Wall Street-originated CMBS is over $600 billion. What factors led to this dramatic sea change?

New capital sources migrated to real estate for many reasons. But the single biggest catalyst was probably the formation of the Resolution Trust Corporation (RTC) in 1989 (see Robert C. Larson’s article, "The RTC: Dispelling the Myths,” in the Spring 1997 WRER, Vol. 1, No. 1). The RTC was a U.S. government-owned asset management company authorized by Congress in response to the S&L crisis and tasked with overseeing the liquidation of assets, primarily real estate, seized from failed thrifts. This was an enormous undertaking given the volume of assets. Between 1989 and 1995, the RTC took over $394 billion in assets from 747 insolvent thrifts. Sensing the opportunity to provide liquidity to an industry that had none, a handful of entrepreneurs, private equity firms, and Wall Street merchant banks formed the first so-called opportunity funds. These funds often invested alongside the RTC in private-public partnerships acquiring billions of dollars of real estate assets at highly discounted prices. The investments were made more attractive by investment banks and credit companies offering to provide debt to the new partnerships through issuance of CMBS, a fairly new and unproven product at the time. The RTC single-handedly jump-started the real estate private equity and the CMBS industries, both of which irrevocably changed the real estate sector.

A second factor that indirectly gave rise to the enhanced liquidity of real estate was the adoption of new federal regulatory policies in response to the S&L crisis that created major disruptions in the real estate credit markets. Banks
were strongly encouraged to reduce exposure to real estate, write down loans, and foreclose on underlying assets. With commercial banks and thrifts no longer providing debt capital, owners and operators of even high-quality cash flowing assets began running the risk of losing their properties when their debt expired since no source of refinancing was available. With a Chapter 11 in one hand and an S-11 in the other, many real estate owners faced the choice of either going through bankruptcy or selling themselves to the public. Many succeed by following the latter route. From 1992 to 1997, the equity REIT market in the United States grew by a factor of 13, from a market capitalization of less than $10 billion to nearly $128 billion. The meteoric growth of the industry during this time is commonly referred to as the dawn of the "modern REIT era". Today more than a quarter of the equity invested in U.S. real estate is owned by publicly traded REITs.

**Figure 1:** U.S. real estate equity capital flows (1998-2011)

A third factor that expanded the supply of capital to real estate is what's commonly known as the "CIO's Dilemma." Since the 1980s, interest rates have undergone a secular decline. At around 2 percent today, 10-year treasury yields are the lowest they've been in the post-war era. Yet, while rates and yields on related investments have undergone a drastic reduction, the investment community remains deeply ingrained in the 7 percent to 8 percent annualized target return paradigm. This has led CIOs of pension funds, endowments and other institutions to look to an ever-expanding universe of alternative investments in order to add incremental risk and return to portfolios. These efforts spurred the demand for higher-yielding real estate products. While the original institutional real estate equity investors were focused purely on core income-oriented real estate, the general tendency over the past two decades, led by the university endowments, has been to move up the risk-spectrum to include more value-add and opportunistic strategies in portfolios. According to recent surveys conducted by the Urban Land Institute, allocation preferences in
the institutional investor community for core, value-add and opportunistic strategies are evenly split at around 25 percent of the total real estate allocation each (Figure 1).

A fourth factor in the expansion of the real estate capital markets has been the deluge of cross-border capital in the United States due in large part to the emergence of sovereign wealth funds. Despite its fiscal issues, the United States remains regarded by the world as the safe haven for investment and has experienced a steady flood of capital from overseas. Until recently the vast majority of this capital was invested in U.S. real estate indirectly via private equity funds, REITs and other investment vehicles. But as these capital sources grow in magnitude and sophistication, many sovereign wealth funds and foreign pension funds have demonstrated a desire to take on a more active and direct role in sourcing and executing their U.S. real estate investments. This trend began with the foreign pension funds located closest to the United States, but investors from Asia, the Middle East and Europe are becoming increasingly direct players as well. As this trend continues, it should have sweeping consequences on the shape of the industry.

Finally, one of the most significant factors in the evolution of the real estate capital markets has been technological innovation, which has helped the industry overcome one of its biggest obstacles to newcomers: a lack of transparency. Not long ago, third-party data providers were nonexistent and brokers and investors had to compile and maintain their own market statistics. This lack of data made it difficult to make informed investment decisions, particularly for industry outsiders. The emergence of online services such as CoStar and Real Capital Analytics, as well as the Internet, dramatically changed the industry by providing more accurate and timely data and more democratic access to it. Industry adoption of tools such as ARGUS led to greater consistency in underwriting. Finally, the rise of public REITs and CMBS placed greater scrutiny on the industry by forcing public companies and borrowers to be transparent and meet strict reporting requirements. Research analysts that cover the REIT market have helped further shine an objective light on the industry. All these factors lowered the sector's barriers-to-entry, opening it up to a broader spectrum of investors and capital.

Lessons Learned

Real estate’s evolution during the last two decades has been a great success. The industry today is significantly more dynamic, transparent and adaptable. However, many valuable lessons can be drawn from the trials and tribulations of the last two decades.

A key lesson learned is that access to more diverse capital sources is a double-edged sword. On the positive side, the availability of both a public and private capital market has proven to be a lifeline for the industry, since from time to time the traditional liquidity sources may be closed for one but open for the other. In 2009, following the severe financial market dislocation of the prior year, the private real estate markets were frozen. Real estate owners were in dire need of liquidity. But while the private markets offered no respite, the public equity and debt markets enabled REITs to raise more than $30 billion in funds. Not only did access to both public and private markets provide essential liquidity, it also shed light on valuation at a time when the transactions market was shut down. With REIT shares and CMBS priced daily, the price movements of these securities helped provide a sense of direction when there was no private price discovery. This provided a marker to gauge the extent of the financial crisis’ impact on the industry and provided a lighted path for the industry to work its way out.

However, there is a dark-side to having access to all this capital. With real estate more closely tied to the global financial markets, its correlation with other financial asset classes has increased, diminishing what was previously one of its major benefits. Additionally, while real estate has been extremely successful at competing with other asset classes for capital, there have been and will be times when other asset classes will prevail, even when real estate looks
strong to insiders. This lack of "stickiness" with respect to the underlying capital can cause heightened volatility, as capital that is here today could be gone tomorrow.

Another important lesson learned from the last twenty years is the importance of using leverage in a disciplined manner. While this issue is not unique to real estate, it is of particular importance to this industry given the higher leverage that is generally available in real estate versus other sectors. While leverage has been more modest in the years following the financial crisis, the mezzanine and subordinate debt markets are strengthening and borrowers are increasingly able to access higher proceeds. This is good news overall since the availability of appropriately priced capital higher in the stack can be very useful and appropriate in certain circumstances. But remaining vigilant and keeping reckless overleveraging at bay is good for the financial health of both the industry and its constituents.

One other development that reminds us what real estate is has been the attempt to profile it as "just another financial product." The over-reliance on financial models by some participants in the industry is a result of this mentality. Prior to the financial crisis of 2008, the financial models used by rating agencies supposedly assessed the riskiness of loans primarily through quantifiable metrics such as debt service coverage ratios, loan-to-value, and so on. But more difficult to measure (and to model) factors like location, tenant industries, supply/demand, competing properties and market volatility also have significant impacts on real estate. When the economic downturn and financial crisis hit, many of the properties in marginal locations or with exposure to especially hard-hit industries performed worse regardless of how strong their initial loan metrics looked. Another by-product of the attempt to view real estate as purely a financial product was the emergence of collateralized debt obligations (CDOs), which pooled subordinate tranches of CMBS loans and repackaged them to create new AAA-rated securities. The new securities turned out to be anything but AAA. Just like the tax credit-fueled development boom of the early 1980s, the CDO debacle illustrated that when investments in real estate become too decoupled from underlying property fundamentals, it generally ends badly. In a digital world, there is a tendency to view real estate with a digital lens by abstracting it into 0s and 1s. Recent years have reminded us that the "bricks and sticks" still matter.

The final lesson of the last two decades is about what it takes to be successful in today's real estate market. Prior to the 1990s, success in real estate was more closely linked to one's knowledge, connections (especially with lenders and local zoning officials), relationships and operational skills. Today having a firm mastery of the capital markets, knowing who the investors are and being able to price and source each component of the capital stack is equally important. Today more than ever, real estate and capital have a symbiotic relationship. One cannot exist without the other.

**Back To The Future**

Having discussed the catalysts of the industry's evolution, and some of the lessons that resulted, what inferences can be made about where the industry may be headed? Here are five predictions about the real estate industry of the future.

*Prediction 1: Real estate ownership will continue to globalize.* The world is full of geopolitical uncertainty and the United States remains one of the few places investors come to for stability. Major regions of the world (Asia and the Middle East in particular) have only begun investing in U.S. real estate. Additionally, the globalization of real estate is not just about foreign investment in the United States. American real estate companies will become more global over time. Many real estate funds and operators have already raised capital to invest overseas. Additionally, public REITs, led by the retail, industrial and hospitality sectors, will continue to globalize as a means to achieve greater scale and to better serve their tenants and customers who are becoming increasingly global themselves.
Prediction 2: The line between debt and equity will continue to blur. Twenty years ago debt and equity were as distinct as oil and water. Today, debt and equity forms a continuum. The branching of risk and packaging of the capital stack that the securitization model popularized has expanded well beyond the CMBS market. Structured equity and mezzanine debt transactions have become increasingly common, particularly in markets where greater volatility has led to a wider bid-ask spread. For instance, preferred equity transactions have proven to be a useful way to minimize differing views on value by giving greater certainty of cash flow to the buyer while allowing the seller to participate in the lion's share of the upside. We are likely to see many more innovative structures emerge over time that combine characteristics of both debt and equity.

Prediction 3: Public ownership of real estate will increase. For most of the past twenty years, capital flows into the U.S. public REIT market grew steadily. The exception was the period from 2006 to 2008 when the private market's considerably cheaper cost of capital prevailed and prompted significant privatization. Since that time, capital flows into REITs have increased once again. REITs are an exceptionally easy way for many investors to gain their exposure to real estate. They offer investors daily pricing and liquidity, current income, favorable taxation, audited financials and analyst coverage. Particularly for those investors looking to enter the U.S. real estate market for the first time, REITs would seem to be the most logical choice. There is also another major dynamic in the background that could have far-reaching consequences for capital flows into REITs over the long-term. The nation's—and the world's—retirement system is undergoing a switch from the defined benefit plans that once ruled to the defined contribution plans that have replaced them. Less than 50 percent of the 200 largest U.S. companies had ongoing defined benefit plans in 2009, compared to 61 percent only three years earlier. The shift from pension funds to individually controlled retirement accounts such as 401(k)s will place greater emphasis on ownership of assets in a liquid securities format since such accounts allow participants to change their allocations, unlike infinite life pension funds. REITs are well positioned to benefit as a result. As the public equity market grows in importance and public ownership of real estate increases, how will the demand be met? The likelihood is not that there will be a greater number of REITs, but that the existing REITs will need to grow larger and more scalable. To accommodate this we may see more passive REITs that utilize greater third-party management than the more active REITs that exist today.

Prediction 4: Real estate cycles will be more frequent and less pronounced. The acceptance of real estate in investor portfolios alongside traditional asset classes means that capital focused on real estate must compete with other investments for a share of investors' wallets. Viewing real estate as an alternative to an investment in high-yield bonds, for example, means that such investors will allocate in and out of real estate in favor of other investments from time to time as near-term opportunities in one sector eclipse that of another. With less sticky capital we are likely to see greater pricing volatility, resulting in more frequent cycles. That said, the cycles themselves should be less pronounced since access to better information and more transparency will enable smarter decision-making.

Prediction 5: Demand for professionally trained real estate managers will rise. The idea that MBAs would be hired into the real estate industry in droves would have seemed far-fetched to most twenty-five years ago, when Wharton’s real estate program began. The industry then was highly fragmented and controlled predominantly by wealthy families rather than by institutions. Unless one’s father or uncle was in the business, real estate was not a likely career from the standpoint of an undergraduate or MBA looking for a job on Wall Street. Yet today, solid training in traditional business disciplines such as finance and accounting have become prerequisites for a career in real estate. Universities and industry collaborations like the Wharton School and the Zell-Lurie Real Estate Center have become extremely important to the industry, as both a source for knowledge-sharing and a breeding ground for talent. As the institutionalization of real estate continues turning what was once a family business into a modernized industry, professionally trained real estate managers and the schools that educate them will be in higher demand.

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