You Say You Want a (REIT) Revolution

Reflections on REITs at the millennium, and where we go from here

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The REIT revolution has stalled. At the end of 1999, prices for REIT shares were trading at discounts to net asset values not seen since the beginning of the decade, a time when REITs held less than five per cent of the assets now held by the industry. As 1999 ended, REIT FFO multiples shrank for more than two years in a row, and privately held real estate, as measured by the--admittedly flawed--NCREIF index, had outperformed the NAREIT index for two years running, by very wide margins (Table 1).

Table 1

Annual Returns

Year	NAREIT*	NCREIF
1992	14.6%	-4.3%
1993	19.7%	1.4%
1994	3.2%	6.4%
1995	15.3%	7.5%
1996	35.3%	10.3%
1997	20.3%	13.9%
1998	-17.5%	16.2%
1999	-4.6%	11.4%

* Equity REITs

REITs could follow one of several plausible scenarios. They could bounce back from their current cyclical low point and again trade at significant premiums to net asset value. If this happens, they would almost certainly resume their growth in U.S. real estate market share, growing faster than the industry as a whole. They could muddle along, much like the British property companies, that typically trade at a discount to net asset value, with occasional upward bounces. In this case, REITs would be a factor in the industry, but the share of U.S. real estate held by them would be unlikely to grow significantly. Alternatively, they could decline further in values and in multiples, and the industry could witness large scale privatizations or balance sheet recapitalizations that would cause the share of U.S. real estate controlled by REITs and other public companies to shrink considerably.

One can make a case for all of these scenarios. Only a few years ago, Peter Linneman, among others, argued that REITs were an unstoppable transforming force, one that would change the industry forever (see *WRER* Spring 1997). The uncertainty about what comes next cannot obscure the powerful impacts that the REIT industry's growth in the 1990s has already had on the capital markets for real estate. This winter of REIT discontent may be a good time to reflect on the impact that REITs have had on real estate capital markets to date, and to consider what their likely future impact will be, depending on which scenario comes to most closely resemble the future.

BEFORE THE REITS

Let's begin by remembering what the real estate industry was like before the modern REIT era began in 1992. We need to think about not just the industry itself, but also its capital market, as each had shaped the other. This industry and its capital markets had evolved together, with changes in the industry and changes in financing structures affecting each other, often unpredictably. Often, changes in one set in motion changes in the other, which reinforced the changes in both. Cause and effect in such a process are hard to distinguish. But it is easy to describe the industry before 1992, and to see how the real estate industry and its capital markets were reflections of each other.

Debt and the entrepreneurs

The real estate industry was financed predominantly by non-recourse debt. Although no figures are available on the consolidated balance sheet of the U.S. real estate industry, the importance of debt was overwhelming. Except for some institutional owners, the preferred method of financing was the use of as much non-recourse debt as could be obtained. There is nostalgia among many developers for debt financing in excess of cost. Listening to these reminiscences is akin to what it must it must have been like to hear the last explorers of the American West talk about the vanished buffalo herds.

The principal providers of these generous debt levels were financial intermediaries--banks and life insurance companies--not public capital markets. Of course, by the end of the 1980s and the beginning of the 1990s these institutions were all in full retreat from the business of real estate lending. Any public financial institution with an exposure to real estate on its balance sheet was punished by its shareholders, without regard to the riskiness of that exposure. So, even sound projects and borrowers found themselves completely frustrated in their search for capital. It was this capital drought that sowed the seeds of the growth in public markets as sources of capital for real estate, both equity and debt.

Several characteristics of the industry were created by this reliance on debt from financial institutions. Some were so pervasive and of such long standing that they were generally considered the way things *ought* to be in real estate. First, leaders tended to be very rich individuals who believed strongly in the virtues of non-recourse debt financing as the appropriate way to finance real estate. In an environment in which capital structures could be built with

unbelievably small equity positions and large helpings of relatively inexpensive debt financing, it was possible for a successful real estate developer to become enormously wealthy during the course of a career, sometimes in less than a decade. Those who had the talent or good fortune to see their development projects do well were richly rewarded. In a market economy, that kind of wealth was seen as evidence of business acumen. This was not true in all cases, however, and some of these success stories proved to be temporary, undone by the first significant experience of adversity. The fictional developer, Charlie Croker, of Tom Wolfe's *A Man in Full* is the archetype of this kind of developer.

The industry leaders of this era had a talent useful to the entrepreneur--they were persuasive. Access to cheap debt capital was a key ingredient to their success, so they learned how to package ideas and projects for lenders to emphasize their likelihood of success and minimize their risks. As a result, the industry acquired a slightly unsavory reputation among the financial institutions that provided it with capital. The salesmanship, high life style, and lack of business substance that were all too characteristic of the real estate industry bred resentment and distrust among the salaried employees of the institutional sources of capital. The infamous "saddlebags" scene of *A Man in Full* captures this resentment to perfection.

Admittedly, there were factors besides the dependence on debt capital that made the U.S. real estate industry so entrepreneurial in character. Consider the instructive, contrasting case of Europe. The greater restrictions on land use endemic to Europe are critical factors in the dominance of institutions in those real estate markets. Unlike the U.S., where local government control of land use effectively allows a developer to play one jurisdiction off against another until a suitable site is found, European land use policy is generally a national government prerogative. Development there requires the mobilization of large amounts of equity alongside debt. As a result, banks themselves are among the largest developers, and would rarely consider making debt financing available to an individual for a large scale real estate development. As surprised U.S. attendees at The Urban Land Institute's European meetings discover, European real estate industry leaders are more likely to be executives of the real estate arms of financial institutions than entrepreneurial developers.

Projects, not companies

While debt financing has not been the sole cause of the entrepreneurial quality of the U.S. industry's leaders, it has been a uniquely important contributor. A parallel phenomenon has been the industry almost exclusive use of project financing rather than corporate financing. After all, what U.S. developer had the balance sheet required to do corporate financing? Project financing was not unique to the real estate industry. Capital investments in the energy industry, the airline industry, and other capital-intensive projects have often been moved "off balance sheet." Sometimes it is the sheer scale of the projects that makes this approach attractive. Sometimes it is the existence of unique partnerships or other ownership characteristics that produces non-recourse project financing.

Yet no other industry approaches the real estate industry in the ubiquity and frequency of the project financing approach, particularly for small projects. Until the rise of true real estate companies, it was so clearly the default answer that it was hard to find exceptions. In 1993, I

was on a panel with executives of two other REITs, and the three companies we represented had issued *all* the unsecured corporate real estate debt that existed in the United States at that time, which was less than $1 billion dollars.

This dependence on project financing makes real estate financing a very labor-intensive activity. Further, the complexities of project financing dictate that its skilled practitioners are expensive. The origination costs that result are very high compared to the American industrial norm. But because project financing is so well understood and so common in the real estate industry, it is the most comfortable alternative to most industry participants. In addition, financial institutions still have many loan officers trained for real estate project lending. This has inhibited the exploitation of economies of scale in financing, even in the 1990s. The CMBS (commercial mortgage backed securities) market, which offers financing for projects in the public capital markets, has grown much more dramatically than the market for unsecured corporate real estate debt.

Cash flow and return on equity

Another major consequence of being a debt-financed industry has been a focus on cash flow rather than on income. Except for a few institutional investors, three groups dominated the industry in the pre-REIT era: if you were a lender, the calculation of depreciation was an esoteric exercise of little interest; if you were a borrower with close to 100 percent leverage, you were chiefly concerned with cash flow; if you were an individual borrower who was interested in how much cash you could expect to put in your pocket as a return on a transaction, you were likewise focused on cash flow.

For similar reasons, a debt-financed industry has been more focused on return on equity than on return on total capital. American corporations analyze their investment decisions by looking at expected total return on total capital invested. Assuming that the risks of realizing those returns has been properly reflected in discount rates or otherwise, those investments that promise the best returns are pursued. Financing is generally regarded as a separate decision, one to be made in light of the risk/reward tradeoff involved in having different mixes of debt and equity, and the current capital market pricing anomalies. The insight that total enterprise value is unaffected by financing strategy won Nobel prizes for its authors, Francis Modigliani and Merton Miller.

In the real estate industry, Modigliani and Merton's theory is ignored and the two issues of return on investment and return on equity are routinely confused. The availability of attractive leverage is often cited as the primary reason for making an investment. The less equity is required, the greater the opportunity for a return on that amount. The point is true enough, if the debt is non-recourse. But this way of thinking leads to a very different set of choices about where to invest equity, pulling the industry away from investment opportunities with potentially high returns if they cannot be readily financed in the debt markets. As a result, debt pricing and allocation anomalies frequently drive real estate investment decisions more than supply/demand and return on invested capital.

Economic theory suggests that the result can be very poor outcomes indeed. Japan’s record of poor returns on its extremely high rate of savings may be the most dramatic example.

The Japanese economy under-invested in risk activities and over-invested in projects that were susceptible to financing with mispriced debt. This in turn led to a very low overall return on a huge pool of savings that has not been allowed to flow naturally to its best use. In an analogous way, excessive dependence on debt financing in American real estate has not always led to an optimal allocation of capital, encouraging capital to flow to credit quality real estate investment vehicles rather than those promising equity returns.

A real estate lender will always tend to avoid risky but potentially high return investment opportunities in favor of projects with a safe flow of income embodied in a physical structure with little required reinvestment. Perhaps it is no accident that regional malls were the gold standard of real estate assets in the period leading up to the modern REIT era. A dominant regional mall has an unusually predictable set of cash flows, with no single tenant accounting for a meaningful fraction of the property's income. While it may need periodic refurbishing, its physical structure is unlikely to wear out. Demographic changes in its trade area, which are unlikely to occur overnight, are typically the biggest risk such a property faces.

These characteristics made regional malls attract very high levels of non-recourse debt financing. Perversely, but predictably in a debt-dominated market, this also had the effect of making them especially attractive investments, and their price multiples were generally among the highest of any property type. Yet, once ownership of regional malls came to be dominated by public companies in the mid-1990s, their returns looked unappealing compared to the rising rent and value stories of other property types. To date, the sector has not been as dramatic an attraction in the public market as it was in the private market, where "safety first" remains the motto of the principal source of capital, lenders.

A pattern of boom and bust

Perhaps the most significant consequence of the real estate industry's dependence on debt has been a boom-and-bust pattern. Debt markets have no effective brakes other than the ringing of a collective alarm bell caused by the onset of defaults. This outcome is especially likely in a private debt market, where there is little widely available information for lenders to gauge short term trends. The result is a pattern all too familiar to real estate investors: excessive liquidity leading to overbuilding, leading to defaults, leading to illiquidity, leading to inventory absorption, leading back to excessive liquidity.

It is as if real estate debt markets historically have had only two speed settings, full power or full stop. The collective result is foreseeable but unavoidable even to those who are aware what is happening. Because lending markets have no mechanism for coordinated easing or tightening, lending is driven by a classic tragedy-of-the-commons logic, in which each institution's incentives to lend lead to excessive lending in the aggregate that can only be arrested by substantial collective disincentives to lend. The real estate industry lacks a monitor of its own, dedicated to assuring that the supply of money moderates the oversupply/contraction cycle that it will otherwise create in property markets. The heavy dependence on debt capital is the root cause of this boom/bust phenomenon.

THE REIT CHALLENGE

The modern REIT era began with the explosion of capital raising that followed 1992. Few involved had any intention of upsetting the traditional patterns of real estate capital markets, or of remaking the industry. For many, a REIT offering was just another capital-raising event. It was common for industry leaders to talk about the importance of having multiple capital sources, a lesson learned from the capital drought of the early 1990s. A very few of the successful pioneers believed that the coming of the REITs marked the beginning of a fundamental transformation of the industry, and acted accordingly. But virtually no one was able to foresee the changes to the industry that the REITs--and their public debt market twin sister, CMBS--would create, or that the decade would end with the current state of uncertainty about the future of the public role in real estate capital markets.

REITs threatened to change everything about the real estate industry in the United States, from the superficial to the profound. Consider the style of leadership in the traditional industry and in REITs. The Charlie Croker image is not an acceptable face to present to the public capital markets, who prefer their corporate leaders to be thoughtful, deliberate, and above all focused on the creation of value first for investors and secondly for themselves. For this reason, style makeovers abounded among those who aspired to change from mobilizers of debt to mobilizers of public equity capital. Overnight it became important for REIT leaders to under-promise and then outperform, rather than to embellish opportunities and downplay risks.

Some REITs experimented with financing using unsecured corporate debt rather than project financing. This experiment had a mixed record, and the industry’s collective comfort level with project financing remains quite high. Rating agencies maintained very high standards for the awarding of investment grade status to real estate companies. They were nervous about the reduced security of unsecured financing, which also did not have a good historical track record, and about the industry's reputation for getting lenders in trouble. Some companies who chose to be investment grade credits chafed under what they regarded as the excessively conservative balance sheets that resulted. By the end of the decade, markets for unsecured corporate real estate debt, which had been slow to develop, were not deep enough to make the cost of unsecured debt less than traditional secured financing.

The CMBS markets took off in parallel with the equity REIT markets. There was less resistance to this form of project-based financing, which could be used by REITs and non-REITs alike. To many borrowers, it seemed little more than a new, more flexible source of project financing, one that was sometimes also less expensive. Their main concern was not knowing the identity of the lender they were going to repay. In the third quarter of 1998, this pattern came to a halt, as illiquidity in the CMBS market caused many borrowers to have second thoughts about the reliability of CMBS lenders. As the decade ended, the dominant form of real estate debt financing was as unresolved as the future role of REITs in the equity market. However, CMBS markets had come to dwarf traditional lenders in the amount of financing made available each year, even after the setback of 1998, and unsecured corporate financing failed to be a significant factor. But the future market share of each of these forms of real estate debt finance remains an open question as the millennium begins.

REITs have conspicuously avoided debt financing markets. Debt finance for real estate was available during the 1990s at very attractive rates compared to the 1970s and 1980s, yet REITs generally used less substantial leverage than private market participants. Investment grade REITs usually were financed less than 50 percent with debt, and few exceeded 60 percent. In contrast, real estate opportunity funds created great wealth for many of their investors in the same decade by being very aggressive in using debt financing, routinely using leverage levels in excess of 70 percent.

The difference in these approaches illustrates the choice between corporate financing and project financing. With each deal compartmentalized, the high risk/high return objectives of the opportunity funds were best achieved by maximizing their use of leverage to increase upside and limit downside. Public equity markets are skeptical of this approach. Public market analysts want to fully understand the consolidated debt picture of any company, and to separate whether earnings are attributable to real estate skills or to good financing--the former being regarded as a valuable, repeatable achievement, the latter not.

A stock market investor searches for management that knows how to achieve success on the left hand side of a balance sheet, not the right. On the right hand side of the balance sheet, investors hope management will make it a priority to avoid mistakes that can kill the company, not search for ways to "create value." Corporate management is expected to control financing cost and to make prudent use of leverage to enhance returns on equity. But debt financing is discouraged if it entails risks to earnings--as it most assuredly does when leverage, particularly floating rate or short term leverage, is pushed as far as it can be in real estate.

Market forces reflect the difference between corporate and project finance. To most individual developers, the question of the "right" amount of debt never arises-- instead, the issue is merely how much debt is available. To a corporate CFO, the mix of debt and equity is an important issue of corporate strategy. The Modigliani and Miller theory argues that investors will not reward a more leveraged balance sheet. Instead, they will raise a company's equity cost of capital in reaction to the increased risk to equity returns that more debt creates, thus exactly offsetting the benefit that might otherwise arise. Convincing traditional real estate borrowers (or lenders) of the merits of this theory is an uphill struggle, as any REIT analyst will attest who has tried to convince current REIT CEOs. Hence, the debate over the right financing strategy for REITs remains unsettled, as corporate finance ideas that are commonplace in other industries collide with traditional thinking among real estate practitioners. The result is a combination of confusion, heated arguments, and experimentation that will take years of market experience to sort out.

While that debate rages, public market financing is experimenting with economies of scale. In fact, proponents of REITs suggest that economies of scale in financing are a key advantage. They argue that given how important the cost of financing is in a capital-intensive industry like real estate, even small advantages in capital raising costs will have an important cumulative effect over time, making it inevitable that well-managed, large scale REITs will become more dominant players in the industry. Although experience suggests that large scale public companies in other industries benefit from economies of scale, so far the record is too

short to demonstrate whether REITs will in fact enjoy a long term lower cost of raising capital than other industry participants.

Economies of scale can be an advantage for REITs in more than financing. The advent of public companies with ambitions to become dominant industry participants has led to experiments in how real estate companies can use size to create value for shareholders. There have been efforts to create value by using economies of scale to lower costs through better purchasing of goods and services. There have been experiments in using traffic, such as in regional malls, to generate licensing revenue from advertisers looking for mass audiences. There are continuing experiments in trying to collect ancillary revenue from apartment tenants for services that size makes it economic to offer. Office owners are trying to generate revenue from providing telecommunications infrastructure, including internet connections. Several companies have tried to understand whether branding their properties can increase their pricing power as landlords.

All these efforts, while still in their infancy, are the result of REITs' increased scale. Scale was not impossible for successful private real estate operators to achieve before the advent of public markets, but the incentive that the public market provide to large companies is a powerful spur to innovation. Public markets push them to look for new ways to demonstrate that they are capable of generating above average returns on their asset base. In contrast, the typical private real estate mogul generally does not even have a consolidated financial statement for his business interests. The reliance of such owners on project financing, and the fact that ownership of each of their assets often differs, makes it unlikely that the effort of preparing such a statement would be made. In the absence of this data, it is difficult for the advantages of scale to be analyzed or considered relative to the status quo. It is not a coincidence that the explosion of experiments in value creation through scale has occurred only as some of the public companies have become large.

The depreciation debate

It is also not a coincidence that the rise of public companies has been accompanied by an increasingly noisy debate about the right measure of depreciation in real estate. Because public markets are used to measuring income, not cash flow, getting the right number for depreciation has been an issue that has consumed considerable energy on the part of REITs and their analysts. The traditional measure of real estate depreciation called for by U.S. GAAP is almost universally acknowledged to be too high, because it assumes that real estate has no residual value, depreciating property to zero. In response, in 1991 NAREIT took the extraordinary step for a trade association of trying to create an alternative measure of income for its members to use in reporting financial results. It initiated the concept of Funds from Operations (FFO), which was to be a public company analogue to the “cash flow” term used in private real estate, calculated as the operating income of a real estate company with depreciation added back. The constraints of S.E.C. and U.S. GAAP accountants prevented this measure from being audited, or treated as anything other than a supplemental measure of performance. Nonetheless, REIT management quickly embraced this concept, and, predictably, some abused it.

Partly because it did not have the sanction of any organization other than a small trade association, the merits of FFO have been a punching bag for REIT analysts since the idea was introduced. This debate has done nothing for the credibility of the industry in the investor market place, with critics asserting that FFO is overly generous in its representation of REIT earnings. The industry has twice commissioned task forces to examine the issue in an effort to put it to rest, but both have ended only by "clarifying" the term, neither recommending that it be discontinued nor substituting a different measure. Hence the agony of a public debate has been prolonged, despite a common frustration with the process by FFO fans and critics alike. As a result, the real estate industry, unlike any other, continues to use a non-auditable measure of earnings.

The reason for the self-inflicted wound is that the industry is not finding it easy to collectively agree on the appropriate measure of depreciation in real estate. In the past, the real estate industry's reliance on debt financing made the right measure of depreciation appear unimportant, because lenders and borrowers focused on measures of current cash flow rather than on sustainable income. It is unimportant no longer. The public equity market will continue to find it hard to do what it does best--comparing the investment opportunity in REIT stocks with those of other industries--until it believes that it is possible to meaningfully compare the earnings of REITs with the earnings of other companies. The debate about the right measure of real estate depreciation will not end until a consensus arises that is enforced by the accounting profession--or, much less likely, until the real estate industry completely renounces the public equity market and its curious measure of income.

Volatility, risk, transparency

Public capital market problems unrelated to real estate fundamentals have sometimes affected real estate values in unprecedented ways. In 1998, the third quarter saw a massive withdrawal of capital from real estate during a period of improving real estate fundamentals. The cause was a flight to liquidity in the broader capital markets, having nothing to do with real estate. But the result was a dramatic adjustment in the value of real estate assets, which may have fallen 15 percent or more in one quarter, an unprecedented degree of measured volatility.

Many institutions invest in real estate in order to provide diversification to portfolios dominated by stocks and bonds. The events of the third quarter of 1998 raise a number of questions about the increasing linkage of real estate to these markets. The question of most interest to many institutional investors is what the increased linkage will do to the historical lack of correlation between real estate and stocks and bonds. Following the events of late 1998, the correlation between REITs and small cap stocks jumped, after three years of decline. This pattern continued in 1999. In the future, will REITs behave like real estate, or like stocks? The answer will bear heavily on whether institutional investors come to regard REITs as a substitute for real estate. The early enthusiasts for using REITs in this way took heavy casualties in the markets of 1998 and 1999. They were embarrassed by the underperformance of REITs relative to measured results for private real estate, and by the failure of the REITs to provide a diversification benefits during market volatility. If the correlation between stocks and REITs

remains high, institutional investors will continue to play both sides of the fence and invest in both REITs and property, but they will resist treating them as interchangeable.

Another question that also affects institutional investor behavior is whether the volatility of private real estate returns rise in response to the linkages to public capital markets. Certainly the third quarter of 1998 indicated that there are new kinds of volatility in private real estate investing, and that the magnitude of this new volatility is considerably greater than before. It may be that the nature of risk in real estate investing has been changed by public markets. In the old, debt-dominated world of real estate, one only cared about values when it was time to refinance.

Transparency was seen from the start as one of the virtues of public markets. There were high hopes among REIT enthusiasts that the transparency created by REITs and CMBS would moderate the debt-financed market dynamic of alternating excess liquidity and constraint. There are hopeful signs that the boom and bust cycle may be moderating. Real estate markets were in the unusual position of equilibrium for virtually all of 1999. New building was occurring, but not at a pace great enough to create excess supply. Capitalization rates changed little.

Ironically, while it appears that the greater transparency created by the disclosures of public real estate companies may be at the root of this equilibrium, the mechanism by which discipline is being enforced is via the debt markets. In general, REITs still own too small a percentage of the commercial real estate market to drive equilibrium by themselves. But their information effects have much greater potency. As 1999 progressed, there were important limitations on the availability of capital despite the fact that mortgage delinquencies were at or near record lows. What was unusual was that the limitations were not across the board, but instead focused on those specific situations where there was fear of overbuilding. Bank lenders appeared to be reading and reacting to REIT analyst coverage. The best example may be Dallas in 1999, where a fear of overbuilding in the office sector, widely publicized by REIT market reports, led to a sharp drop in new permits, a drop most likely created by a withdrawal of construction lending.

FUTURE SCENARIOS

The pattern of market activity has been changed by equity transparency, and the effects have been at least as important in the debt markets as in the REIT markets. Yet the third quarter of 1998 is a reminder that this linkage to public markets is not always for the better. Has the nature of risk in real estate investing shifted, with long term equilibrium replacing the historical boom and bust cycle, but with a new threat emerging of periodic capital withdrawal caused by public market disturbances exogenous to the real estate industry itself? And, if that is the case, is real estate likely to be as good a portfolio diversifier as it has been in the past? If not, will institutional investors lower their target allocations to real estate? And what role will REITs play in the portfolios of such investors?

These are questions that only time and experience can answer. Yet it is possible to imagine two alternative scenarios that represent the extremes of what might happen when public capital continues to increase in importance, or when it recedes. What we know about the way things were before the advent of the modern REIT era, and what we have seen happen so far,

make it plausible to sketch out what we might logically expect to happen on a number of fronts in each of these scenarios.

If the public markets resume their rise in importance, we are likely to see a real estate industry in which equity financing likewise rises in importance. Debt financing will remain secured financing for the foreseeable future, but the industry would tilt toward equity financing under pressure from public investors who will reward real estate value creation and devalue pure financing success. There will be larger real estate companies, as those who successfully find ways to use their size to create value will continue to grow. The leadership of the industry will increasingly pass from entrepreneurial hands into the hands of those capable of leading such large scale enterprises. The industry will continue to search for increasing respectability in public capital markets, and debates about the right measure of depreciation and income will continue until--as in other industries--a consensus emerges that can be enforced by the accounting profession. The search for increased respect in the capital markets will also place a premium on putting shareholder interests ahead of personal gain. Transparency will continue to increase, and the way in which real estate behaves in varying economic conditions will consequently become better understood by investors, leading to a lower cost of capital for the industry as a whole as risk premiums for real estate investing fall. Liquidity will always be an issue in an industry as capital-intensive as real estate, but liquidity crises will be shorter in duration, as market-clearing prices will be easier for capital market participants to recognize and establish.

On the other hand, if the public equity market experiences a widespread recapitalization of the industry away from the public and back into private markets, the industry still will not revert completely back to its old ways. Public information and the transparency it creates will continue to be available, and will have an effect on lending behavior disproportionate to its importance in dollar terms. Credit officers will have new tools to evaluate the plausibility of borrowing proposals, and will surely take advantage of them. It is less clear what direction the CMBS market will take. Its fate is not tied to the REIT market, as its participants span the industry, encompassing both private and public market borrowers. But if the CMBS market continues to determine the marginal cost of real estate debt, then the volatility of real estate cycles in the future will depend greatly on whether the CMBS market becomes a source of credit discipline, or instability. The record so far suggests either outcome is possible. Given the inherent tendency of debt markets and public markets to overshoot, greater rather than lesser volatility for real estate lending, in supply and in pricing terms, is probable.

In all likelihood, the future will be more complex than either of these two scenarios. For example, it is possible that the public and private markets will pass market leadership back and forth between them, with first one and then the other being the dominant influence. This would in many ways be the most exciting and interesting outcome, because it would create so much change that it would multiply the opportunities, for investors and practitioners alike. It is also possible that the market share of the public and private sectors could fall into a long term equilibrium, as appears to be the case in the United Kingdom.

In any event, it is clear that U.S. real estate capital markets, and the real estate industry itself, have been profoundly affected by the arrival of significant public companies. It is no understatement to call it a revolution, given the scope of the changes that it has set in motion. Things will never be the same, no matter how the industry evolves from here.

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