Real Estate: Past, Present, and Future

The reflections of a real estate pioneer.

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FROM THE LATE 1960s to early 1970s, the commercial real estate industry was primarily driven by developers and the entire focus was on building. Developers identified sites, negotiated zoning, acquired the financing, constructed the building, often ran up occupancy, and perhaps sold the property. They also got a significant return from their own edifice complexes: "Look how terrific it is that I got that building to go up."

From day one my company described itself as an operator rather than a developer. We focused on controlling the economics of the property, because taking development risks for limited returns

made no sense to me. At that time, U.S. markets were flooded with real estate money. Everybody was building more of everything, and the market became massively oversupplied. Everyone was talking about how great it was going to be, but I was talking about how the sky was going to fall. In the beginning of 1973, I stopped all new activity and focused on building a distressed-property management company.

Lending institutions of that era were not required to mark to market, which was critical to what my associates and I were doing. The idea was to recreate on their balance sheets something that wouldn't require them to take a write-down. We bought $4 billion worth of real estate at 1973 prices, sat down with the lender and said, "Here's what the cash flow is. Divide the cash flow by the amount owed and that's the interest rate necessary to carry the property." We thought we'd make maybe $50 million in five years. We didn't envision how many opportunities would be created by the bleak economy of the late 1970s — we made even more!

Everybody asked how we did it. The reality is we created a massive arbitrage. We took on $4 billion worth of debt at an average interest rate of 6 percent in an environment where the inflation rate was 9 percent. Sure, we picked some good properties, but overall it was the creation of an enormous amount of non-recourse, fixed-rate (in some cases 300 to 400 basis points below going rate) debt. Our fortune was made on the arbitrage.

THE BIRTH OF THE OPPORTUNITY FUND

People have always made money by taking advantage of inefficient markets. By 1980, we saw several significant problems with the way that the real estate business was going. Any owner of commercial real estate could hire an MBA to do an HP12 deal that never had recessions or rents going down, and then put it up for sale and get 16 people to come bid on it. That's not a description of a good, long-run investment real estate market.

Up until that point, the tax benefits of real estate were what you got in exchange for lack of liquidity. By 1980, the price of the property was X, and the price of tax benefits was X+1. Historically, the lenders to the real estate community provided long-term, fixed-rate, non-recourse, self-amortizing debt. That's a cloaked way of describing the passage of economic value from the lender to the owner. During the 1980s, the insurance companies finally realized that making 30-year fixed-rate loans didn't make sense.

Losing the benefit of cheap long-term money relative to sustainable property yields dramatically changed the value of real estate — so we shifted focus. Our goal

between 1980 and 1990 was to create a non–real-estate portfolio equal to our real estate portfolio. We were successful in doing that by exploiting another inefficiency. In 1981 Congress passed a law that dealt with the Real Estate Investment Trusts (REITs) that had been created in the early 1970s. These were very different kinds of companies than today's REITs. They were strictly short-term mortgage lenders, and they had all gone broke. They had come out of bankruptcy with huge tax loss carry-forwards that, until 1981, were usable three years forward and three years back. The new law allowed tax losses to be carried forward 15 years. It became clear that the market was giving no value at all to the extended benefit of the Net Operating Losses (NOLs) carry forward. We bought control of companies with a couple of billion dollars' worth of NOLs, essentially for free.

For example, ITEL Corporation, a big-equipment leasing company, was the largest bankruptcy in history up to that point. At that time, the stock was $3 per share and the company's NOL was $450 million, or about $75 per share. You had a $75 per share NOL and a company that could be liquidated for $3, so the $75 per share net operating loss carry forward was essentially free. We bought the business and converted the entire $2 billion of losses into sheltered income on other cash flowing businesses we acquired.

Meanwhile, in the uncontrolled real estate market of the 1980s, we were seeing excessive activity. Nowhere was the market "giddiness" more apparent than in the Rockefeller Center deal, in which the Japanese buyers essentially paid a price equivalent to $4.5 billion for the entire property. The property was foreclosed on a few years later for about $1.25 billion — more than a slight miss — and then sold again seven years later for $1.75 billion. It was as unreal as the dot-com bubble.

By the late 1980s lending institutions were being required to mark to market. The days of trying to figure out how to make things look good on a balance sheet were gone. Instead of being able to acquire troubled properties with relatively little equity capital, we believed that this time we would need massive amounts of equity, because you now had to buy everything for cash — at big discounts. Hence, the "opportunity fund" was born. By the end of 1987 we had raised $400 million, which became the basis of the first Zell-Merrill Fund. Subsequently, we raised another $2.5 billion and used it to buy high-quality assets at significant discounts to replacement cost.

The initial notion was that, if you had the money, you could strike deals with disinterested owners. This was very different from the standard "trust me, I'll line up the money" real estate guy, who by the time he'd lined up the money had lost the

opportunity. That was one key advantage of the first opportunity fund. The other advantage came later, between 1988 — when we closed the fund — and the beginning of 1992. During that time we literally operated in a market without competitors. Financial institutions with distressed assets had a choice: they could either sell to us, or to nobody.

An example: In 1989 we were alerted to an office building in the South that was financed by a large bank. The building owners had a $28 million construction loan that had gone bad, so they came to us and asked us to buy the property. We looked at it, underwrote it, went back and offered $16 million cash. The bank said no. They wanted a minimum of $18 million, or else they would take it to the market. We told them to go ahead. They took it to the market, and a year later came back to us asking for $16 million. We hadn't seen the property for a year so we needed to re-inspect and re-underwrite it. It turned out the bank had made a couple of inadvisable leases in the interim period, which reduced the economic value of the property. We came back with an offer of $14 million. They refused and again took it to the market. One year later we bought the property from them for $9.1 million. We're selling the building today for $27 million or $28 million.

UNFORESEEN CIRCUMSTANCES

The first of the four Zell-Merrill funds, which should have done best, did the worst. Why? Nobody anticipated that the Gulf War would start in August 1990. For the next year nothing happened: nobody made decisions, nobody moved into new space, nobody expanded.

1990 also happened to be as negative a period as ever existed in the real estate industry. The federal government decided that the ills of the world were the result of real estate lending — which was partly true — and terrorized the banking system for lending to real estate. I recall one situation where a bank closed the loan on Tuesday. The Feds came in on Friday and wrote it down 30 percent (because they had a fire-sale analysis of value). When a bank makes a loan on Tuesday and has to put up reserves of 30 percent by Friday, you can bet that bank isn't going to make any more loans for a while — of any kind.

The result was a total loss of liquidity in real estate markets. At that time, the total market capitalization of all the public real estate companies was about $6 billion. We had remained private because, like everybody else, there was no reason to be public. The private market was so much more attractive because of cheap debt and tax breaks. To be blunt, the public companies were mainly second-tier players. What

were called the "public" real estate markets really were just companies that were mere collections of assets.

On the non-real estate side we had a couple of pubic companies that were teaching us the lesson that liquidity equals value. At the same time, in 1990 I was worth over a billion dollars but scared to death whether I could make my next payroll because of real estate market illiquidity. That defines liquidity. There were no new funds going to the industry and every bank was calling up asking to be paid. A great number of the major real estate families of that time got wiped out, or had their positions dramatically diminished. It became obvious that there had been a major change and the traditional sources of real estate lending had dried up. By the early 1990s all of those lenders, the S&Ls and insurance companies, were out of the business and the only option available was the public markets. So we took the bulk of our operations and properties public.

After I raised about $2 billion, I stopped raising funds via private equity vehicles, to a large extent because I thought the majority of real estate opportunities had disappeared. Goldman Sachs was the next major opportunity fund, which has never gone public and has just kept going. Why? It's all a question of risk. In order for opportunity funds to produce the kinds of returns that are appropriate, they now have to use very high leverage and to take on high-risk properties. If you invest only one dollar and you make 20 cents on your dollar (and you have $27 billion of debt behind it), you've just made a 20 percent return. I didn't see that as the kind of "taking advantage of the cycle" that I was looking for. I never viewed myself as being in the business of raising money. Rather, I viewed myself as a professional opportunist and real estate operator who identified a unique scenario and took advantage of it while the risks rewards were appropriate.

By 1993, we owned the largest portfolio of mobile home parks in the country. We also owned 25,000 apartments, 25 million square feet of retail space, and 25 million square feet of office space. That was on the private side. In addition, our four opportunity funds had their primary focus on office. We were looking for over-improvement opportunities, so we wanted to buy the fanciest office buildings at the highest discount to replacement cost. Eventually, I took the apartment company and the mobile home park group public. When I'd almost finished investing the fourth opportunity fund, we had gotten rid of everything but the office holdings.

We created Equity Office Properties, which at $5 billion was the largest public offering that anybody had ever done. Today it's worth roughly $30 billion. Equity Residential, which we started in 1993 and took public at $800 million, is

now about $15 billion total market capital. All we really did was apply the rules of the non–real-estate world to real estate: liquidity and a focus on operations equals value. I realized that in the public arena nonrecurring gains don't create value. The investor doesn't want to buy on the hope that it'll sell on a profit. Everything is about predictable, accountable, transparent streams of income.

I never got into hotels because hotels aren't real estate; they're operating businesses. Every night you have to promote and fill the rooms. Moreover, the hotel business suffers an immediate effect from changes in the economy. The office business is only minimally affected by the events of September 11. People will stand on the sidelines for 6 to 10 months making no decisions, but eventually things will move. The multifamily side, too, is going to be relatively stable. The hotel sector, however, is being hurt badly because it's a business whose survival is predicated upon a level of activity by consumers that, at least for the near future, is going to be limited.

Though I was the fifth-largest owner of retail space in the early 1990s, I chose not to go forward in the retail arena, primarily because I viewed it as confused, not only in the matter of retailing itself, but also because it lacked the stability and predictability I was comfortable with. Another critical factor was that I did not believe we could be the best retail real estate company in the market. So I liquidated my retail portfolio, as I was building the other three.

REAL ESTATE COMPANY AS SERVICE PROVIDER

People used to say that real estate was "different" from other industries, but we argued that it's no different from making jet engines. The real estate business today has to compete for capital and customers with everybody else in the global economy. The days of its being an unrelated, separate asset class are clearly over.

We've led the entire consolidation of the industry and have always emphasized scale. Very little of our expansion was development. Overall, more than 95 percent was achieved by acquisition. People have tagged us for saying "bigger is better," but what we were really saying is "bigger has the opportunity to be better." On the other hand, while it helps to have extraordinary size to be an NBA player, there are a lot of big lugs who aren't any good and can't make it in the NBA despite their size. It's also how skillfully you play.

What we're trying to do is to brand real estate, which nobody has ever done because they've never had the scale to do it. The Prudential may have had a comparable-sized real estate portfolio in the past, but they didn't run it as one network.

We, on the other hand, are the largest owner of office space in the country, with 150 million square feet. Over the last three years, we've been developing a program with the idea of creating a direct relationship with our major tenants. The goal is to put them in a position where, given a choice, they're always going to pick an Equity office building. We meet with them twice a year. We talk about their problems. We're trying to convert the real estate business into a true service provider.

When the September 11 crisis hit New York City and 29 million square feet of office space were destroyed, every square foot of existing space became golden. We called our major tenants and told them what we had, asked what they needed, and asked what we could do to help — before we leased a single vacant square foot of space to anybody else, anywhere in the country. We got a lot of positive reactions to this strategy, but more important, we got our major tenants to understand that we're truly a partnership. It's no longer the adversarial relationship between landlord and tenant. It's 1+1=3.

We just did a deal whereby we consolidated a company in one space. We took them out of space in six of our other buildings, simply let them out of the leases, and put them in a new one. Previously, even a big asset managers such as Prudential or Equitable would have had to buy out each one of those leases separately, since each building had a separate investor, or pool of investors.

We've always addressed real estate opportunities with the very different focus of creating a massive, efficiently operating network. For example, we now have a relationship with a carpet mill in Dalton, Georgia that manufactures carpeting for our apartments. It cuts them to order in the factory and then drop-ships them to the apartments, all at a lower price than we were paying before. In Seattle, we're the largest owner of multifamily housing, with 12,000 apartments. Four years ago, we owned 4,000 apartments and it cost us $150 to paint an apartment when somebody left. Today it costs $100 to paint the same apartment with the same paint. Why? The painter now works for us full-time. He doesn't have to worry about layoffs or drumming up business. He only has to worry about doing a good job. We get a 33 percent benefit and he gets the equivalent of a predictable stream of business.

The real test of our model is how well it works in hard economic times. For example, there are roughly 30,000 layoffs in Seattle. Because of our scale, we have at least a 10 percent cost of operations advantage. In a fully occupied market, that cost advantage makes us slightly more profitable. In a weak market, however, our competitors will be losing money while we'll still be making money.

When we took Equity Office public in

1997, our margins were 57 percent, meaning for every dollar of rent we collected, 57 cents went to the bottom line. At that time we were a $5 billion company. Today we're a $30 billion company and our margins are 68 percent. We've increased how much of every rent dollar flows to the bottom line. We've done it by being more efficient.

THE FUTURE

Real estate is an industry that was historically sheltered, very elitist, and limited to relatively small players who could borrow money and had great connections with local banks. But the local banks are gone. Times have changed. An industry that represents some 15 percent of the U.S. GNP has been taken out of the backwater and brought to the forefront. Today, if you want capital to play, you're going to have to compete.

There's an enormous opportunity in real estate for marketing. Traditionally, we've only marketed real estate when we're renting a building to tenants, or marketing to the bank. That will change. For example, 600,000 people with an extraordinarily high demographic profile go in and out of Equity Office buildings every day. Equity Residential interfaces with more than one million people a year who are 25 to 40, have high disposable income, and buy 80,000 houses a year. As part of our service in the future, we can do a lot more by building on the intimate relationship that we have with these people with whom we interact from the initial renting stage.

Those who run real estate companies are going to be very different in the future. The future CEOs of the industry leaders will be much more sophisticated, much more financial, much more operating-oriented, and getting younger. They may not even necessarily have any real estate experience.

This article is based on a lecture given to Wharton students in September 2001.