The Five Overlooked Features of the Real Estate Capital Markets

Did the real estate industry really change forever? Five years later, an answer.

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THE THESIS of Peter Linneman's paper, "The Forces Changing the Real Estate Industry Forever" (*WRER* Spring 1997) is that real estate is a capital-intensive industry, and, as has occurred in other capital-intensive industries in the past, the competitive advantages of large firms will force the consolidation of ownership into a few hands. Linneman's paper argued that over the following twenty to thirty years, visionary leadership, the low cost of long-term capital, low overheads, enhanced revenue and purchasing opportunities, and better risk management would lead to a reordering of the industry. Now, five years later, it is interesting to take stock of how well Linneman's argument is holding up.

On balance, so far it appears that Linneman's prediction of dramatic change is holding up somewhat better than his prediction of the shape of that change. With the benefit of hindsight, it now appears that he overlooked—or under-stated—the peculiar nature of the capital market for real estate, and the obstacles that would prevent capital from flowing to dominant firms. His prediction might have taken place if the industry was financed primarily by equity capital raised in public markets, as is the case for other capital-intensive industries such as steel, autos, and chemicals. But the real estate market's peculiar history has created a number of unusual structural features that have inhibited capital and talent from accreting to those who have only moderate advantages over others—at least, so far. In fact, the industry's capital markets, while dramatically changed, still contain five features that limit the power of the advantages of public ownership.

FIVE FEATURES

First, real estate investment trusts (REITs) have not yet gained important advantages in raising capital, either debt or equity. There are four sources of debt capital for REITs—commercial mortgage backed securities (CMBS), unsecured bonds, bank lines, and property mortgages—but other borrowers have access to three of these four, and sometimes have the ability to raise additional proceeds by virtue of a higher tolerance for leverage. In the five years since Linneman argued that corporate debt issuance would become an important source of competitive advantage for REITs, CMBS financing has instead become a much more important source of debt than unsecured REIT debt. The CMBS market had $293 billion outstanding at the end of 2001, while all REIT unsecured debt totaled only $67 billion.

While there's room for a lively debate over why this happened, the success of the CMBS market has meant not only that public companies have been unable to monopolize cheap debt in the industry, but that private debt users have often been able to raise money on their assets at least as cheaply as the largest REITs. Some REITs that issued unsecured debt have continued to finance using other means as well in recognition of this reality. It's worth remembering that debt is still the real estate industry's largest source of capital, and that many REITs have suffered from a competitive disadvantage relative to private market players because they have been generally forced to be among the more conservative borrowers in the industry. Other sources of equity capital have proven more tolerant of higher leverage levels.

Equity capital has not been cheaply or easily available to REITs. Since real estate

needs capital more frequently than other industries, the policy of the investment banking community to enforce its standard underwriting discounts—that is, costs—has pushed the cost of raising equity capital for REITs beyond tolerable limits. The result has been the development of sporadic discounting in the form of the so-called spot follow-on market, and a bias against raising equity on the part of REIT managements. The latter was exacerbated by the fall in stock prices that occurred in the late 1990s. The high cost of raising equity has led to the dramatic reduction in payout ratios that Linneman predicted, from a high of 80 percent to 100 percent, cited as standard in 1997, toward the 55 percent minimum that he estimated to be required by REIT tax rules. Retained equity has been an attractive source of financing, but, given the comparative size and depth of the CMBS market, it has not been as abundant as would be necessary to constitute a meaningful competitive advantage. Total cash flow retained by REITs in 2001 was an at all-time high of almost $6 billion, which was dwarfed by the $97 billion raised though CMBS during the same year.

Second, transparency has created liquidity and a lower cost of capital for all. While addressed only implicitly in Linneman's paper, arguably the most powerful influence that REITs have had on real estate capital markets has been to foster much greater understanding of the economics and fundamentals (that is, discussions of supply and demand) of the industry among all capital providers. This has created greater sophistication in the financing process, lowering the cost of capital for worthwhile development projects even as it has weeded out many questionable projects that might have received financing in a less transparent market. Hence, the industry over the last five years has generally not suffered from the problem of excess supply that had so often plagued it in the past. (The recent increase in vacancy rates has been due to a sharp drop in demand rather than excessive building.) Whatever advantage REITs may have in the cost of capital has therefore been a secondary effect, overwhelmed by the impact of greater transparency on the broader capital market for real estate.

Third, portfolio vision has not been the only way to generate returns in the market, nor has it been solely confined to REITs, so rational pricing has not brought all capital to the REITs. While REITs have proven adept at articulating their business strategies, and those who were best at it have attracted capital, capital was also attracted to other forms of value creation. A lot of value in the real estate industry is still created the old-fashioned way, by development of land or redevelopment of

existing properties. Private markets have responded as well, blunting the competitive advantage. Opportunity funds and other private investment products have evolved, articulating other strategies as a way to raise capital, often in competition with REITs.

Fourth, the public market has valued only certain aspects of real estate, leaving development to the private market. Generally speaking, the amount of development undertaken by REITs has been relatively small. Only a few specialized REITs with particular expertise in a specific property type have been developers. This is no accident, as the risks and low initial current returns associated with most development make it unattractive to REIT investors. As the industry has evolved, its shareholder base has gravitated towards a natural constituency of yield-oriented, defensive investors who appreciate that real estate has those characteristics. Finding a home for development risk in REITs has been difficult. Hence, portfolio management and operating expertise have become the main categories for value creation for public companies. As Linneman correctly pointed out, these were likely to be the natural advantages of the REITs. But the public market constituency for that kind of investment has not been easily transferred to the traditional source of value creation in real estate—development—and a lively private market to finance development has continued.

Lastly, there has been a market for measurement effects that continues to bind certain capital sources to the private markets. This may be a cynical way to state the point, but there is clearly a part of the real estate capital market that values the opportunity to invest in real estate because it is not marked to market daily. Pension funds frequently fall into this category. Investors of this type are interested in the enhancing effects of adding real estate to a portfolio of stocks and bonds, and need to be persuaded that REITs are the functional equivalent of directly owning property. Obviously, not all are convinced, as pension funds continue to own more than $150 billion in U.S. property, some of it in joint ventures with REITs.

CONCLUSION

The jury may still be out, since some of Linneman's predictions may take longer than five years to manifest themselves. The paper itself suggests that twenty to thirty years may be necessary. In the last five years, connection to the broader markets has not always been a good thing. The third quarter of 1998, for example, saw a substantial withdrawal of capital from the real estate market at a

time when real estate fundamentals were still quite attractive, which reflected the linkage that had been established between public market capital flows and the real estate industry. And size has not yet obviously made it cheaper to raise capital, because liquidity has not been a powerful enough differentiator in the robust stock markets that characterized the early part of the five-year period. So it is too soon to say whether the five overlooked features of the real estate market will prove more significant in the long run than up to now.

But Linneman did get it absolutely right when he observed that REITs had created a revolution, and that the real estate capital markets would never be the same again. What the REIT market has not absorbed, it has dramatically affected. For example, lending practices have changed as a result of the increased transparency of the market. The nature of the real estate cycle has been transformed, with much less volatility and less risk of overbuilding. The nature of risk in real estate investing has been changed, as events in public capital markets unrelated to the industry can now affect capital flows and asset values. Finally, the required skill sets for industry leadership have evolved to include not only the ability to talk lenders into buying a projection, but also the ability to articulate a long-term strategy for creating value and building an organization.

And no one who has been part of the real estate industry in the last five years would disagree with Linneman's statement in the paper's last paragraph: "Changes greater than this industry has ever seen are under way … these changes will create enormous wealth for the successful, and destroy the wealth of those unable or unwilling to adapt."