# The Forces Not Changing Real Estate Forever

*What if building apartment houses is not the same as making widgets?*

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**WHEN PETER LINNEMAN'S** "The Forces Changing Real Estate Forever" appeared in the *Wharton Real Estate Review* five years ago, I questioned his assumptions. Five years later, I am more than ever convinced that the comparison of the real estate industry with industries such as petroleum, automobile, aerospace, steel, railroads, and tire manufacturing is not valid. In these industries one is able to consolidate production—that is, the making of things—which cannot happen in real estate. In the real estate industry there are simply too many product types and too many producers to allow meaningful consolidation.

Real estate involves two very different activities: the development of new real estate and the ownership of existing real estate. It is only in the development of new real estate, or in the expansion of existing real estate, that economic value is actually created. While it is possible, to some extent, to accumulate developed property, actual production takes place only through the development process. And it is impossible to imagine the development process controlled and centralized in a few hands.

It is possible to consolidate in selected sectors, such as regional malls. This is a mature industry with fewer than nine new regional malls being opened each year, a total of approximately 10 million square feet of space. However, there are more than 60 million square feet of big-box space being developed each year. These 60 million square feet will have very little ownership concentration, except that the large big-box retailers will own their own real estate.

The so-called major real estate companies are not, in fact, key players in either development or ownership in the office, apartment, and industrial sectors. If one looks at the number of apartments, office buildings, or industrial buildings that are built each year, the top twenty developers in these areas do not own a meaningful percentage of development. In ownership, the same is true. As a matter of fact, most of the larger accumulators of real estate—the REITs—were started by people who were developers. When an economic crisis appeared, they formed REITs and began to accumulate real estate. Yet, even with all this accumulation, these companies are a very small part of the real estate market, and there has been no indication—based on their stock prices and their company values compared to private owner property values—that there have been any major benefits from the consolidation of properties.

Peter Linneman refers to the decline of the importance of location. He mentions Rockefeller Center as an example of the shift from the importance of location. I would argue that Rockefeller Center is today the best example precisely of the importance of location. The most desirable properties are those in the best locations.

Let's examine the characteristics of the argument that changes are being made in the real estate industry forever. Linneman's paper raises five points dealing with leadership, capital, overhead, enhanced revenues, and successful risk management.

### LEADERSHIP

The leadership we have had in the real estate business over the last ten years is much less visionary than in previous years, because when it became necessary for real estate companies to go public, operators were forced into specific areas of real estate—regional malls, apartments, offices, and so on. This has had a major effect on the ability to do mixed-use projects. It has also led to much less development. It is important not to forget that all real estate now owned was conceived and built by a developer. Historically, the developers have been the great visionaries of our business: Rouse, DeBartolo, Hines, Carr, Bucksbaum, and others. Leadership played a greater role in development than in consolidation. After all, most businesses become consolidated during or after periods of distress. Great leadership will return to real estate when a group of young people begins to develop new ideas and new programs. That is not happening.

### LONG-TERM CAPITAL

"The Forces Changing Real Estate Forever" claims that consolidation will lead to less expensive access to capital. Compare a REIT that finances a property at 30 percent of cost and puts in 70 percent in equity, with a corporation or individual that finances real estate at 70 percent of cost while putting in 30 percent in equity. While the REIT may pay 6 percent for the borrowed money, and the developer may pay 8 percent, the more highly leveraged owner will have a higher rate of return. In addition, because the REIT has to pay out 5 percent or 6 percent of its capital in dividends, its capital cost is much greater than an individual or corporation that uses more leverage and pays no dividend.

### LOW OVERHEAD

One of the great things about real estate is low overhead. In many instances, the operating costs are passed on to the tenants. The only money that accrues to the management company may be management fees which can be anywhere from 2 percent to 5 percent. I do not believe there is much money to be made by trying to reduce overheads even further.

### ENHANCED REVENUES

Enhanced revenue opportunities have not materialized in the real estate industry, and I do not believe they will materialize in the immediate future. In almost every area where owners are attempting to enhance revenues, in cable television and telecommunications, for example, there are companies for whom that revenue is a sole source. I do not believe the real estate industry will be able to compete successfully with these providers.

## SUCCESSFUL RISK MANAGEMENT

I have no reason to believe that large public companies or consolidators (including my own company) have done a better job in risk management in real estate than others. As a matter of fact, one could argue that borrowing recourse as opposed to having property debt with less recourse, contains more risk than the non-recourse borrower.

## CONCLUSION

While I understand the thesis of "The Forces Changing Real Estate Forever," I do not believe it holds true for our industry. The real estate industry is too vast, has too many players, is much too dynamic, and needs constant creativity, which is not often found in large organizations. Larger is not better. Because the industries to which Linneman alludes are producing defined products, the five attributes of consolidation he lists can accrue to their benefit. However, each real estate deal is a separate deal—the equivalent of a separate product. What the real estate industry really needs is the kind of visionary leadership that is not often found in large bureaucracies. There are so many different sources of capital that it is possible to build projects without needing direct low-cost capital because of leverage. Developers can use partners, tax credits, and other vehicles. Low overhead and enhanced revenues are not meaningful in our business. Finally, successful risk management is in the hands of each entrepreneur; size does not matter.

My late mother told me, "If you go into the real estate business, remember it is not a business, but a group of deals, each one different. Your success will depend upon your ability to navigate the opportunities of each deal." This is the crux of my main objection to "The Forces Changing Real Estate Forever." The real estate development business is different from those businesses that mass-produce products; the advantages of consolidation simply do not apply.