The Equitization of Real Estate

What return does real estate deserve?

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AT THE BEGINNING of 1990, federal bank regulators fanned out across the country in search of excessive real estate loans. Shocked by the poor underwriting and excessive loan-to-value ratios (LTV) that had been discovered in Texas, they had orders to impose sanity on the capitalization structure of real estate. Up to that point, real estate was basically a 100 percent debt business, with small amounts of equity required to get a project under way, and a history of abusive tax syndicates in the early 1980s. But equity underwriting of future cash streams was a rare

commodity in the real estate industry as these regulators began to scrutinize banks and savings and loans across the country.

The regulators, armed with new federal lender regulations, were surprised at what they found at nearly every federally insured depository. Many lenders had provided real estate loans, particularly for development projects, at 100 percent of loan-to-cost, often with minimal underwriting and documentation. This meant that real estate owners had no equity invested, yet had 100 percent of the upside. This capital structure made no sense, and could be found in no other sector of the economy. Yet it was the common practice in commercial real estate, which represented one of the world's largest asset pools. Under intense regulatory pressure, banks announced that they were no longer making new loans, and many outstanding loans were in breach of covenants and must be repaid. Finding a 50 percent LTV loan was hard, even for properties with strong cash flow, and there was little hope of rolling over maturating debt. With the withdrawal of the industry's major capital source, property sales became almost nonexistent, and property values plummeted, although it was difficult to assess what "value" was, as so few properties were trading. This problem was exacerbated by the fact that the only properties on the market were being sold under duress by foreclosing lenders and government agencies, rather than by traditional property owners. As the 1990s dawned, the era of debt ended, and the era of real estate equitization began.

For a $2 trillion industry, this meant that as much as $500 billion of equity was necessary to replace debt and put the real estate industry's capital structure on par with other asset-rich, cash-flow businesses in terms of capital structure. The immediate reaction of most real estate owners was to view the problem as temporary and hope that lenders would soon revert to their old ways. But the more prescient realized that the world had changed, and that access to substantial equity would be required in this new era.

The obvious source of fresh equity should have been cash-rich pension funds. But those that had invested in real estate (remarkably, with little or no debt in an era when debt was massively underpriced) stood on the sidelines, as the value of their real estate portfolios plunged. Most had lost faith in their core real estate managers, who had repeatedly assured them that their properties could not fall in value. The open-end funds in which they invested were frozen as investors ran for the exits, and many managers were rocked by scandals involving properties being assigned artificially high valuations. Pension fund investors seeking to sell properties could do so only at substantial capital losses. In this environment, it was

practically impossible for pension fund investors to commit additional funds for real estate. Quite simply, real estate lacked the transparency and track record to attract new money from these funds. Thus, at a time when these funds should have been aggressively purchasing real estate, most were looking to exit.

The equitization of real estate was seriously hampered by real estate having become a four-letter word—deservedly so, as it had almost brought down the U.S. financial system. This, combined with serious global equity investors having never followed real estate, meant that it was going to take time to develop a solid equity following. In addition, for most people real estate was synonymous with development. Hence, most global equity investors did not realize that real estate ownership involved relatively predictable operating cash streams for mature properties.

As the search for equity began in earnest, an obvious source was leveraged buy-out (LBO) funds. But these funds lacked real estate underwriting expertise and were hesitant to enter the industry at a time when a recession was under way. Further, LBO funds faced issues with their existing investments due to the recession. Another potential source for equity was high-net-wealth individuals. But most knew little about real estate and lacked the real estate underwriting expertise required to evaluate real estate opportunities in a meltdown environment. Their entry was further handicapped by the absence of an appropriate investment vehicle, and realistically there was not sufficient capital available through high-wealth individuals to replace the half trillion dollars of debt trying to exit real estate.

A logical source of equity for any capital-intensive industry is public markets. Over the years, public markets have invested in nearly every industry that provides a sufficient risk-return trade-off. But public market investors lacked an understanding of real estate, as they had never underwritten real estate in the era of 100 percent debt and tax gimmicks.

During the 1990s, real estate investment opportunities improved, since prices plummeted as distressed owners teetered on the brink of financial disaster. Not only were these owners going to lose their properties through foreclosures, they would also lose the management fee streams associated with their properties, and faced enormous tax liabilities. Many owners went bankrupt, while even more faced the prospect of bankruptcy.

EQUITIZATION

A modest equitization effort was under way through real estate private equity funds modeled after LBO funds. The first two funds were Zell-Merrill Fund I and

Goldman Sachs' Whitehall Fund I. But these funds were small and difficult to raise, and absorbed much of the available high wealth and institutional equity seeking to enter at that point. Several visionary real estate players, led by Kimco, understood that the stabilized cash streams associated with their stabilized properties were quite safe when delivered, and that safe cash streams could be relatively easily valued by the stock market. Thus arose the alternative of an initial public offering (IPO), which allowed sponsors to avoid bankruptcy. The execution of an IPO was daunting, time-consuming, and expensive, and the outcome uncertain. But if successful, the sponsor could use the offering proceeds (net of expenses) to reduce debt to 40 percent to 50 percent LTV (loan-to-value) and avoid personal recourse.

A successful IPO also salvaged the fee stream from properties that would otherwise have been lost to sale or foreclosure. These fee streams were converted into a value equivalent via shares in the newly public company. In addition, if properly structured as an UPREIT, the sponsor avoided punitive tax liabilities. Finally, with their low LTVs, the newly public company could obtain a corporate line of credit, which could be used to purchase properties from foreclosing financial institutions and distressed owners.

This new era of real estate equitization has four critical events: in 1989, the Zell-Merrill Fund I raised $409 million; in 1991, Goldman Sachs' Whitehall Fund I raised $166 million; Kimco's IPO in November 1991 raised $135 million; and Taubman's IPO in December 1992 raised $295 million. These four transac-

Figure 1: U.S. REIT equity offering proceeds

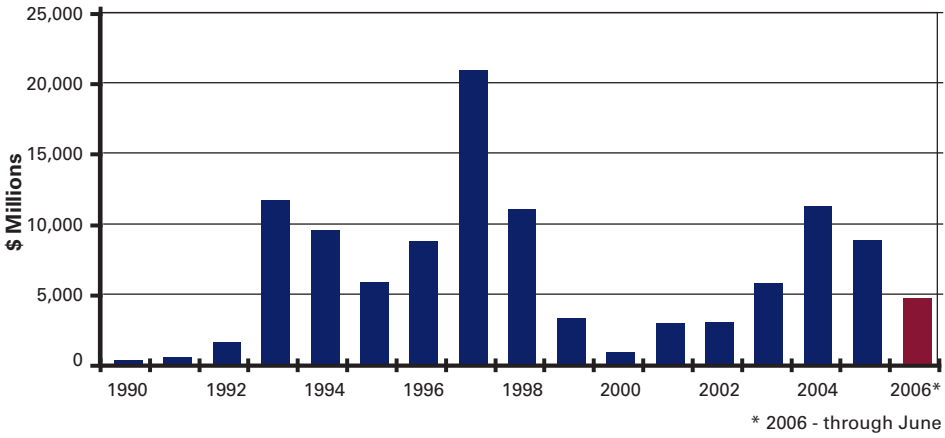
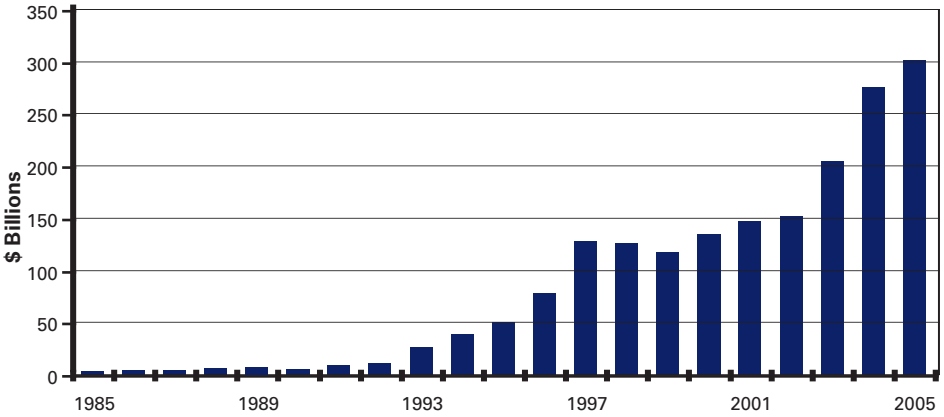


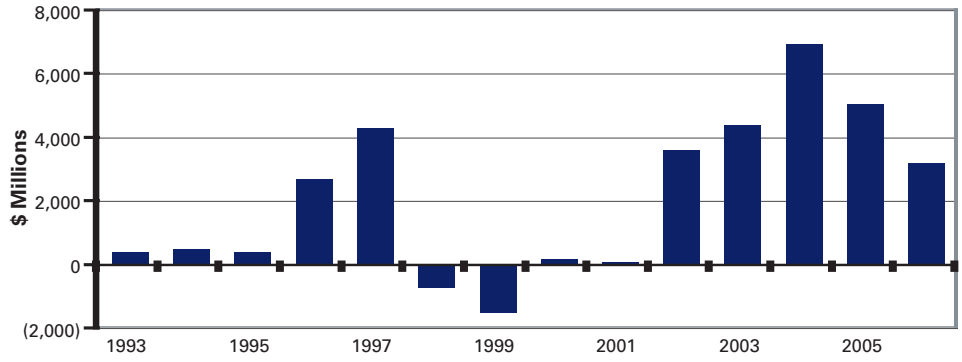
Figure 2: U.S. equity REIT market capitalization



tions set the tone for the modern real estate private equity fund and the modern REIT, respectively.

At the beginning of the 1990s, REITs were an obscure, capital market backwater. Out of roughly $2 trillion in industry value, equity REITs accounted for a mere $5.5 billion. In the early days of equitization, real estate pricing was tenuous at best. Burdened with a bad reputation, a poor track record, unproven sponsors, and complex investment vehicles, it is not surprising that public execution occurred at high cap rates relative to the risk. This pricing was consistent with the private pricing of real estate, which was dominated by distressed sales. For example, the typical REIT dividend yield at the end of 1993 was 6.2 percent. This implied an expected total return of roughly 10 percent for

Figure 3: Net inflows to real estate mutual funds

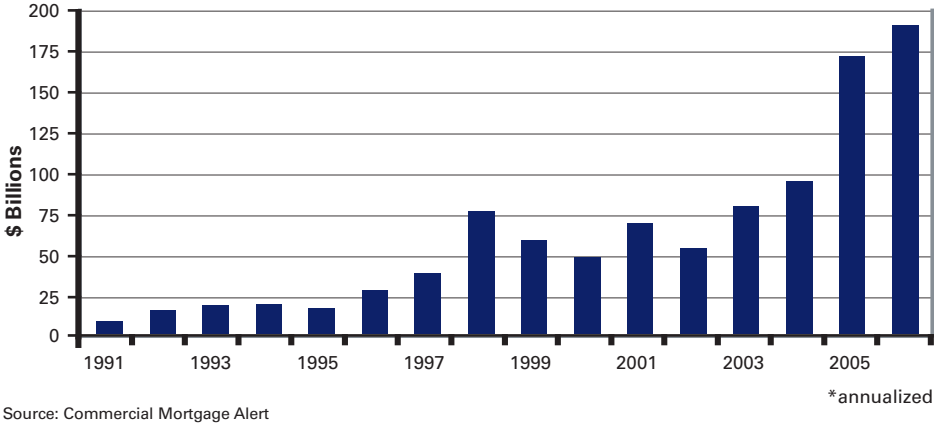


Source: AMG, Merrill Lynch. Note: 2006 data annualized

REITs, compared with a 5.8 percent ten-year Treasury rate, a 7.4 percent yield on BBB long-term bonds, and a roughly 9 percent total return expectation for diversified stock holdings. Thus, as 1993 ended, the expected total return for real estate investments was well in excess of those available for either stocks or bonds. This return premium was necessary to attract uninformed equity into real estate. As the initial REITs succeeded in avoiding bankruptcy while maintaining tax protection and management fee stream value, more IPOs occurred. At the same time, the success of the initial real estate private equity funds also attracted entrants.

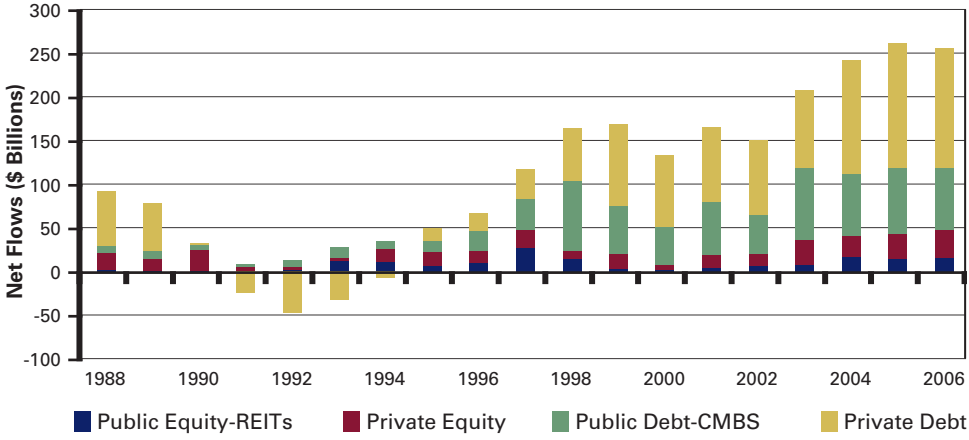
In a massive debt-for-equity swap, some $58.2 billion was raised by public companies from 1992 through 1997, with an additional $30 billion entering via real estate private equity funds. By the end of 1997, debt was returning to real estate markets, though in a very different form, and with lower LTVs. Specifically, commercial mortgage-backed securities (CMBS) were the primary debt vehicle, pooling individual mortgages that were cut into risk tranches and sold as securities into global debt markets. These debt securities were also initially mispriced as global bond investors and rating agencies lacked an understanding of real estate underwriting. As a result, the spreads on CMBS debt were much higher than their corporate counterparts, despite the fact that relatively transparent hard assets backed these instruments. CMBS issues also had high subordination levels, causing real estate debt to remain expensive relative to the underlying risk. This was the price that was paid for the misconduct of real estate lenders in the previous decade. Typical CMBS LTVs were 50 percent to 70 percent, and equity was required in every project.

Figure 4: Historical U.S. CMBS issuance



Source: Commercial Mortgage Alert

Figure 5: Capital flows in real estate



By the end of 1998, the first phase of the equitization of real estate was a success. Equity had tentatively entered real estate via real estate private funds and REITs, while CMBS brought debt back to real estate with disciplined underwriting. And these vehicles had withstood the capital market dislocation of the Russian ruble crisis.

WHAT RETURN DOES REAL ESTATE DESERVE?

Real estate cash flow cap rates for both public and private real estate fluctuated between 8 percent and 10 percent from 1993 to the end of 2001. Since the end of 2001, they have steadily fallen, to approximately 4.7 percent today. In addition to this initial cash flow return, one anticipates receiving an appreciation return roughly equal to the expected rate of inflation. Over the past decade, this inflation has generally been 2 percent to 3 percent. Some observers have argued that real estate cap rates will revert to their historic norms of the past ten to fifteen years. But to answer whether cap rates will rise, one must address the risk-adjusted return for real estate.

Investors have three alternatives in terms of deploying their capital. First, they can invest in the equity claims on the corporations of the world. If we focus our analysis on the equity claims of U.S. corporations, the expected return for this claim is proxied by the expected returns for the broad U.S. stock market. Second, investors can invest in the debt claims of the same corporations, as well as various levels of government (state/local/federal). These debts claims are best proxied by the long-term BBB bond yield. Third, they

can invest in the lease claims on the corporations and governments of the United States. These lease claims are primarily the lease claims held by the owners of real estate leased to government and corporate tenants. These lease claims, including the residual value, can be proxied by the ownership of a broad pool of cash flowing real estate such as the REIT index.

From a risk perspective, the debt and lease claims are far less risky than the equity claim, as corporations will pay their lease and debt claims prior to paying equity claims. As a result, the ownership of the debt and lease claims should command a substantially lower expected return than the ownership of the equity claim. Research by Jeremy Siegel of the Wharton School indicates that the expected return on the equity claim of U.S. corporations over the long-term is approximately 6 percent plus expected inflation. Thus, in a world of expected inflation of 2.5 percent, the total expected return for the ownership of the equity claim on U.S. corporations is today approximately 8.5 percent. Since no anticipated appreciation exists in the pricing of most debt claims, their total expected return is proxied by the BBB bond yield. In contrast, the ownership of the lease claim has both a cash flow component and an appreciation component reflective of expected appreciation.

Which is riskier, the debt claim or the real estate claim? Approximately 95 percent of the time, tenants will pay both their lease and debt claims in full. However, the remaining 5 percent of the time they will not fully honor these claims due to bankruptcy. Our analysis suggests that in bankruptcy the loss factor for real estate is slightly less than the loss suffered on the debt claim. To be conservative, we assume that bankruptcy losses are equal for the debt and the lease claim. This means that the total expected returns for the debt and the lease claims must be approximately equal. For example, if BBB bond yields are 7 percent, then the total return for real estate must also be 7 percent, comprised of 2.5 percent expected annual appreciation from inflation and 4.5 percent in current cash flow yield. Stated differently, the risk appropriate total expected return requires that the real estate cash flow return must be below the BBB yield by expected inflation.

Since BBB bond yields are 180 to 225 basis points over the ten-year Treasury yield, for today's 2.5 percent rate of expected inflation, the cash flow cap rate for real estate should be below the ten-year Treasury yield by 25 to 70 basis points. That is, if real estate cash flow cap rates exceed the ten-year Treasury yield, real estate is underpriced!

Alternatively one can analyze the appropriate pricing of real estate using the Capital Asset Pricing Model (CAPM). CAPM states that the total expected return for an asset is equal to the risk-free rate

(ten-year Treasury yield), plus beta times the market return net of the risk-free rate. Due to the longevity of real estate leases, and the differential supply and demand dynamics of real estate relative to other sectors of the economy, long-term real estate betas are 0.4 to 0.5. Since real estate reduces portfolio return volatility by not being perfectly correlated with market returns, the total expected real estate return should be less than for stocks, and above the ten-year Treasury, to the extent that beta exceeds zero. For example, for today's ten-year Treasury yield of 5 percent, and an expected stock market return of 8.5 percent, the total expected return for a real estate beta of 0.5 is 6.75 percent. Note that for a 2.5 percent expected rate of inflation, the cash flow cap rate for real estate must be approximately 4.25 percent; that is, the total expected return minus expected appreciation (in this example, 6.75 percent minus 2.5 percent). Note that this yields a cash flow cap rate that is 75 basis points below the ten-year Treasury rate.

These alternative approaches to analyzing the total expected return one deserves for real estate generate almost identical results. Namely, the total expected return on real estate should be roughly equal to the yield on BBB bonds, and the typical real estate cash flow cap rate should be 25 to 100 basis points below the ten-year Treasury yield. Higher expected returns mean that real estate is underpriced, while expected returns below this level indicate that real estate is overpriced.

Some argue that this analysis is correct for a diversified pool of real estate, but does not hold for any single property. But this is also the case for every individual stock or bond. Since diversification can be achieved at the investor portfolio level, the total expected returns are reduced to the point where the analyses above applies for each asset class. This is particularly relevant for real estate, which prior to the equitization of real estate did not offer large diversified investment opportunities. But investors today can diversify their ownership across a broad pool of REITs, real estate equity funds, and direct investments, and in doing so, push down expected real estate returns. This outcome is perhaps one of the greatest benefits of the equitization of real estate.

REAL ESTATE PRICING IN THE ERA OF EQUITIZATION

Throughout the era of equitization, the ownership of real estate has been substantially underpriced. In fact, from 1990 through 2002, the cash flow cap rate for real estate (that is, ignoring any expected appreciation) exceeded the total expected return for stocks. This was the case even though the equity claim is notably riskier

than the lease claim. Underpricing continued through mid-2004, as the total expected return on real estate (cash flow cap rate plus inflationary appreciation) exceeded that of stocks. Only in the past two years, as cap rates have plunged, has this not been the case.

Figure 6 displays the estimated cash flow cap rate spreads relative to the ten-year Treasury yield for differing types of real estate. Due to the appraisal lag in NCREIF data, these cap rates are lagged 18 months to provide a more accurate presentation of the timing (Figure 7). Note that cash flow cap rate spreads were significantly negative in the early 1980s, when owning real estate was about purchasing not only cash flow but also access to mispriced debt and substantial tax write-offs. As the tax breaks were eliminated at the end of 1986, real estate cash flow cap rate spreads rose. However, the access to mispriced debt meant that real estate investors were willing to pay well in excess of the risk-adjusted price associated with the cash streams alone. As the 1990s dawned, cash flow cap rate spreads exploded, as not only were the cash streams more questionable in the recessionary economic environment, but also the ownership of real estate meant the lack of access to fairly priced debt.

Throughout the 1990s, real estate remained substantially underpriced as debt attempted to exit the market. During this period, anyone with access to equity and courage in their convictions realized a once-in-a-lifetime purchasing opportunity. As the equitization of real estate evolved into the mid-1990s, cash flow cap rates spreads narrowed, but remained positive. However, by the end of the 1990s, real estate cash flow cap rate spreads moved upwards, as cash

Figure 6: Cap rate spreads over 10-year Treasury

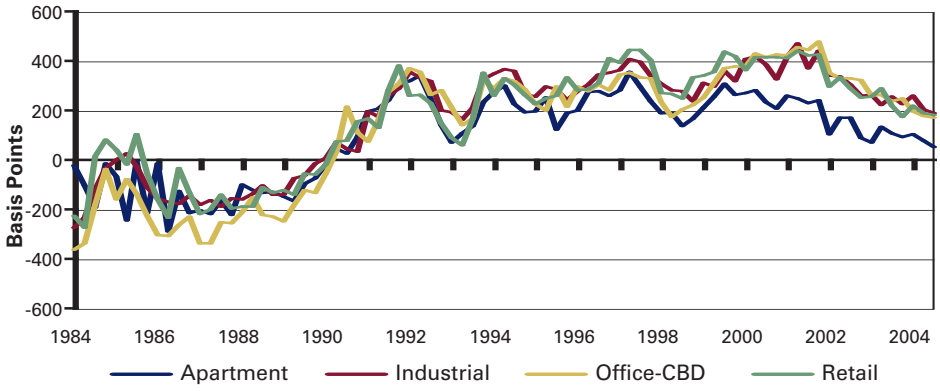


Figure 7: NCREIF cap rates lagged 18 months

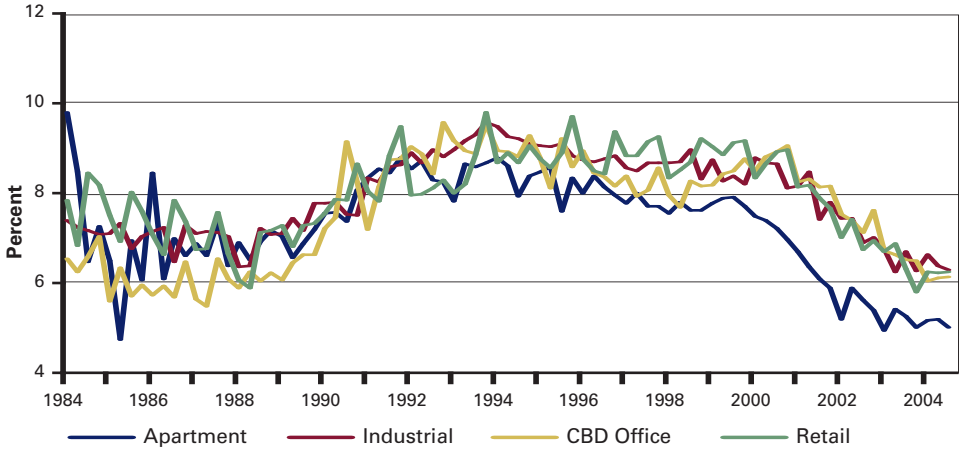
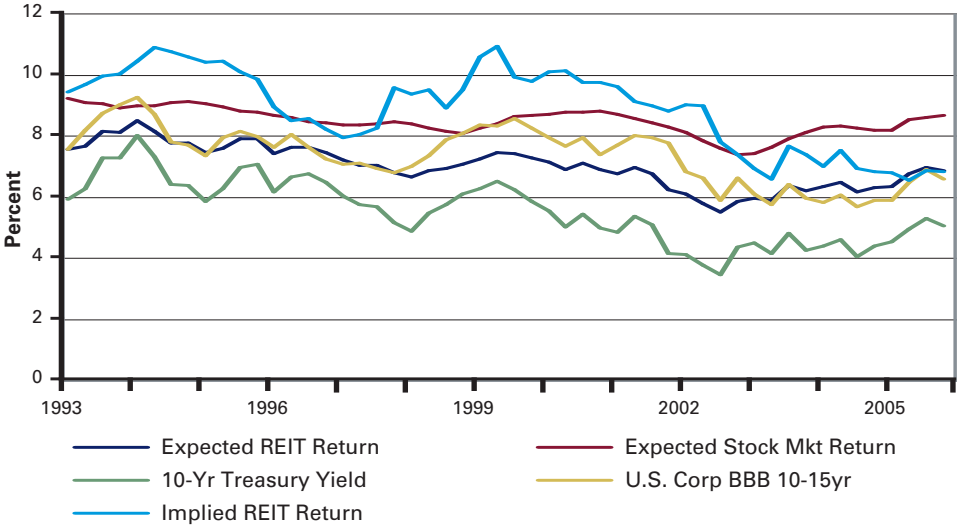


Figure 8: Yield comparison



streams fell out of favor during the Tech Bubble. Only when the bubble burst five years ago did cash flow cap rate spreads begin to fall. Yet as recently as a year ago (the most recently available data given the appraisal lag), cash flow cap rates spreads were generally positive. This stands in stark contrast to theoretically justified negative spreads.

Figure 8 displays estimates of average REIT total expected returns, calculated as the dividend yield plus expected

Figure 9: Difference between REIT dividend yield and average U.S. corporate BBB yield

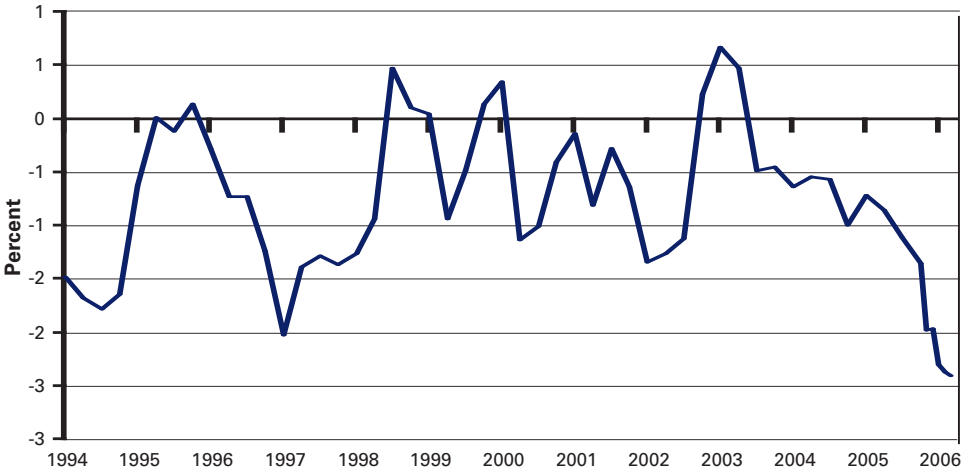
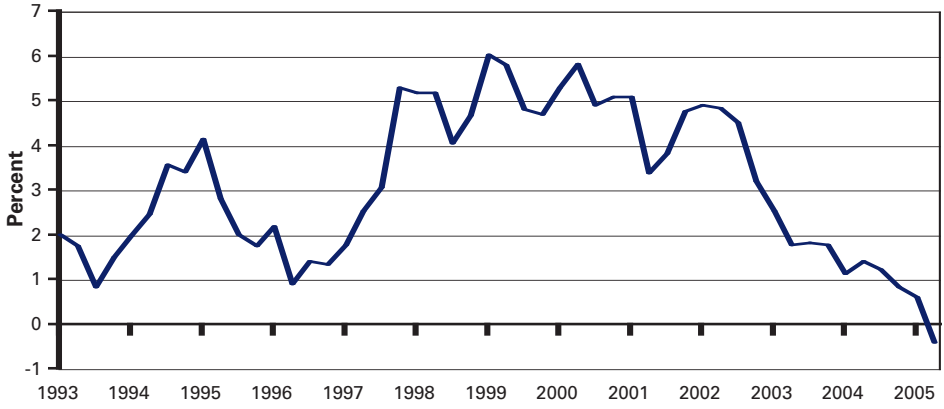


Figure 10: Difference between REIT AFFO yield and 10-year Treasury yield



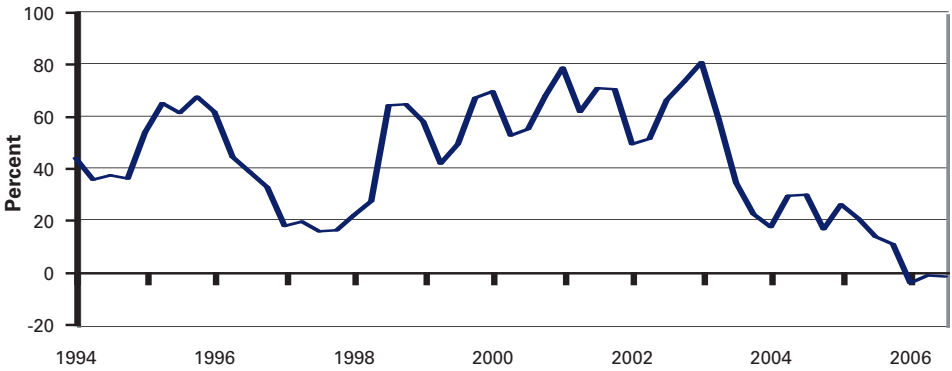
appreciation (measured by the three-quarter moving average inflation rate.) Also displayed are the BBB bond yield, the ten-year Treasury yield, and the expected stock market return (measured by 6 percent plus expected inflation). Figure 9 displays the spread between the average REIT dividend yield and the U.S. corporate BBB bond yield, while Figure 10 shows the REIT AFFO yield over the ten-year Treasury. In the early days of the equitization of real estate, expected returns were 35 percent to 40 percent higher than deserved. By the

time of the Russian ruble crisis, the mispricing had narrowed to about 20 percent, but as the bubble set in, underpricing soared to as much as 70 percent. In fact, between September 1997 and December 2000, expected real estate returns rose by 217 basis points, even as real estate operating fundamentals were improving. At the same time, Treasury yields fell by 48 basis points. This created a staggering period of mispricing. REIT implied total returns reached a high of 10.2 percent just before the bubble burst, at a time when ten-year Treasury yield stood at roughly 4.9 percent, BBB bond yields were at 7.5 percent, and expected stock returns were at 8.6 percent.

After the bubble burst, expected real estate returns steadily fell. But as expected real estate returns fell, BBB bond and ten-year Treasury yields also fell rapidly. As a result, between December 2000 and June 2003, real estate expected return rates fell by 232 basis points, while ten-year Treasury yields fell by 211 basis points, leaving real estate pricing still substantially out of alignment with the risk. Not until September 2003 did the expected real estate cash return equal the total expected return on stocks, and not until March 2006 did it approach the BBB bond yield. That is, until March 2006, real estate was underpriced in spite of four years of large and continuous declines in cap rates.

Over the past two years, real estate cash flow cap rates have continued to drift downward. At the same time, stock return expectations have risen modestly as inflation rose, while Treasury yields have risen

Figure 11: REIT under- (over-)pricing based on CAPM



Assumptions: REIT beta = 0.5; Exp. REIT dividend appreciation = 3%; Exp. market rate of return = 6% + 3-qtr moving avg Core CPI; Risk-free rate = 10-Yr Treasury

by 90 basis points and BBB bond yields rose by 60 basis points. And only recently have cash flow cap rate spreads turned modestly negative. We believe that this modest negative cash flow cap rate spread will fall by another 25 to 50 basis points over the coming year. But for the first time in 16 years, real estate is not massively underpriced.

Figure 11 displays the extent of real estate underpricing based upon CAPM, using a beta of 0.5 and an expected long-term dividend growth rate equal to the three-quarter moving average inflation rate. This more structured methodology yields the same story of considerable underpricing in the early-1990s, as equity began to flow into real estate. Underpricing lessened until the bubble. But CAPM reveals that during the bubble, there was enormous underpricing, disappearing only with the recent run-up in ten-year Treasury yields and the ongoing decline of cash flow cap rates. Figure 12 illustrates an under-(over-)pricing matrix, assuming a beta range of 0.3 to 0.6 and long-term annual dividend growth of 2 to 3.5 percent.

Theoretically, capital market adjustments occur instantaneously, as there is always enough "smart money" to arbitrage any mispricing caused by capital outflows. But the experience of the real estate industry reveals that the answer to the question, "How long will it take real estate equity to efficiently price real estate cash streams?" is "About 15 years." This capital market adjustment took so long because knowledge was a rare commodity, and courage of investment convictions even more rarely met knowledge.

WHAT ABOUT MORTGAGE PRICING?

An interesting corollary is that if real estate expected total return should approximately equal BBB bond yields, then real estate debt (which holds the second loss position on real estate cash streams) should price substantially better

Figure 12: REIT under- (over-)pricing through July 28, 2006

		Long-Term Annual Dividend Growth			
		2.0%	2.5%	3.0%	3.5%
Beta	0.3	1.7%	15.9%	34.6%	60.6%
	0.4	-6.3%	5.6%	20.9%	41.4%
	0.5	3.2%	-3.1%	9.7%	26.4%
	0.6	-19.1%	-10.4%	0.4%	14.2%

than BBB bonds. Yet, until very recently, real estate debt was priced at a premium—not the expected discount—to BBB debt. Only recently has this reversed, as global debt markets have slowly come to better understand real estate. Not surprisingly, if real estate debt was substantially overpriced, real estate was underpriced.

Another way to see the mispricing of real estate debt over the last fifteen years is to note that the spreads on comparably rated CMBS tranches have generally been wider than comparable corporates. This reflects the lack of comfort with these instruments among both ratings agencies and investors, particularly in the early days when real estate was a four-letter word. But, as real estate demonstrated that the high default rates of the late 1980s and early 1990s were not reflective of the risks of underlying cash streams, but rather excessive leverage, real estate debt pricing improved. This is also seen in declining subordination levels for CMBS.

A further demonstration of the mispricing of real estate debt is that REIT corporate debt has generally been rated around BBB. But this cannot be correct pricing if the underlying cash streams of real estate held by these companies is basically BBB in quality, and these REITs have only 40 percent to 50 percent LTVs. Instead, REIT debt was substantially overpriced due to systematic underrating by the rating agencies. This underrating is seen in the fact that there have been no defaults on REIT debt, while equivalently rated corporate debt has seen both defaults and transitions to lower ratings.

Given current leverage, it is likely that most REIT corporate debt should be rated A+ to AA. These ratings, and attendant pricing, will come in time. As it does, the advantages to being a public company will increase, as companies will be able to access fairly priced corporate debt.

WHY ARE REITS GOING PRIVATE?

Why are so many REITs going private (Figure 13)? If today's REIT pricing is roughly correct, it is not that these private buyers are exploiting enormous underpricing. In fact, that opportunity was largely passed over by private equity players until recently, as their funds were too small to take on these opportunities. It is noteworthy that pricing today offers little in the way of positive leverage opportunities. In fact, negative leverage is often the case. In addition, the debt that private borrowers use costs approximately the same as public company debt. If anything, public companies can access debt more cheaply than private entities. In addition, the equity return required by most private buyers is generally the same

Figure 13: Recent REIT privatizations

Acquired Entity	Buyer	Price ($Mil)
CarrAmerica (pending)	Blackstone Group	$5,600.0
Arden Realty (pending)	GE Real Estate	$4,800.0
Centerpoint Properties	Calpers, LaSalle	$3,400.0
Capital Automotive REIT	DRA Advisors	$2,960.8
Gables Residential	ING Clarion	$2,313.7
Storage USA	Extra Space, Prudential	$2,300.0
CRT Properties	DRA Advisors	$1,501.4
Town & Country Trust	Morgan Stanley, Onex	$1,500.0
Kramont Realty	Centro Properties	$1,103.9
Bedford Property (pending)	LBA Realty	$796.7
Prime Group Realty	Lightstone Group	$662.0

Source: Linneman Associates

or higher than that required by public equity. So if there is no major return capital market arbitrage achievable by going private, why have so many companies gone private in the past eighteen months? (Figure 13)

The answer is threefold. First, many of these going-private REITs are sponsors who never wanted to go public, and did so only to avoid bankruptcy. A decade later, these sponsors have aged, and most found that the public arena (particularly with Sarbanes-Oxley [SOX] headaches) is difficult. These entrepreneurial sprits were never comfortable operating a public company, with their requirements for reporting, strategy, and governance. Absent the bizarre world of the early 1990s, these sponsors would never have gone public. But the complete absence of debt and the need for large pools of equity drove them to survive by going public in the 1990s. Having survived, many had little appetite for the public world.

Interestingly, most of the going-private REITs are exits for these original sponsors. Most will pursue entrepreneurial deals funded either from their own capital or via equity provided by private equity firms. These entrepreneurs always felt hamstrung by the low debt levels imposed on REITs. Their exit is proof that real estate pricing has finally improved to the point where it is roughly in line with its risk, as otherwise these savvy real estate players would not have cashed out. Having achieved full value for their properties, they can gracefully exit the public playing field having served their—and their shareholders'—interests. To have sold when real estate was

so obviously mispriced would have been a breach of their fiduciary and personal responsibility. Stated differently, these private transactions are evidence that real estate pricing is today in line with risk.

These going-private acquisitions also reflect that private real estate equity pools have finally grown to the point where they can make such purchases, as until recently private equity pools were insufficient to execute a meaningful going-private transaction. A further reason for going-private transactions is that as real estate pricing has come in line with the risk, private equity players have found it harder to achieve returns in excess of risk simply by acquiring real estate. As a result, some are now resorting to highly leveraged buyouts (LBOs), making a highly levered "bet" that cash flows will improve at 5 percent to 6 percent annually for the next three years, and cap rates will remain stable. These are classic LBOs of strong cash-flow streams. If they are right, and cap rates remain low while cash flows increase substantially, these going-private transactions will yield the 20 percent or greater equity IRRs they are seeking. If they are wrong, these transactions will underperform.

Going-private LBOs reflect the maturation of real estate capital markets, as LBOs have existed for years in other sectors. Just like traditional LBO funds, going-private REIT purchasers are willing to accept the risk of higher debt levels than the public market finds acceptable. If the behavior of LBO firms is an indicator, many of the acquired properties will enter public hands as the business plan is achieved.

Finally, some going-private transactions reflect that some of these REITs have missed opportunities to reposition their properties. This is because their entrepreneurial sponsors were so absorbed with the process of running a public company that they were sometimes unable to focus on the blocking and tackling of real estate. The private buyers hope to treat these assets with "loving care" or sell them to owners who will pay for the right to add value.

Nevertheless, there remains a major role for public real estate companies. In fact, new public REITs have entered the market even as others have gone private. The most creative public companies have demonstrated that, as we argued eight years ago, there is very little that a well managed public company cannot do in terms of its capital structure that a private company can do; but there are things that a public company can do that a private company cannot. Thus, the best REITs are pursuing joint ventures with private capital, managing third-party assets, and operating value-added funds. These REITs have become efficient operating companies and the public market has provided them with unparalleled access to both public and private capital with a speed that is hard to match.

Consider that a large REIT can raise a billion dollars in days, versus the months it takes even the best private equity funds to raise the same amount.

CHALLENGES REMAIN

Public real estate firms must resolve a number of issues. Foremost among these is to establish executive compensation structures that reward value creation, and assure that top-quality management can be attracted and retained. This problem arises because the REIT IPOs in the 1990s squeezed compensation in order to achieve every penny in valuation. However, this created executive compensation schemes that were unsustainably low. While REIT compensation has improved, it has not kept pace with the opportunities available in the private market. Thus, much of the best talent remains private, or at public companies in other sectors (such as financial services).

Another problem is that only a few REITs have successfully incorporated meaningful value-add platforms. This includes not only development, but leveraged subsidiaries, high-risk activities, and other value-creation activities. This reflects that most REIT management teams have been slow to demonstrate that they can create value. Similarly, they have been slow to move into alternative property types. As a result, unlike the best private equity players, most REITs are restricted to a single property strategy. While this is appropriate for some, others must convince public capital providers that they can successfully allocate capital and operate across property types. Further, while management fees may not be as stable as property cash flows, a successfully created management fee stream is extremely valuable. One need only look at the trading multiples associated with investment management companies. A major problem that arises in this context is the resolution of the inherent conflict of interest in fee management relationships. However, as REIT managers gain investor trust, they should be able to deal with these conflicts as effectively as fee managers in other industries.

Finally, while SOX is a major headache, the truth is that the financial costs associated with SOX are small compared to the diversion of scarce management time and energy. As SOX becomes more routine, we suspect that it will become less of a burden. While many cite SOX as a reason for going-private transactions, we believe it is more of a rationalization than a reason.

WHAT HAPPENS FROM HERE?

Many wonder what will happen to real estate cap rates if long-term interest rates

rise. Some observers are heartened by the lack of correlation over the past 15 years between REIT returns and interest rates. But this lack of correlation is primarily due to the history of prolonged mispricing of real estate. Once real estate is correctly priced, it will be more highly correlated with interest rates. In the end, real estate returns must rise if rates on competitive assets rise substantially. Hence, if rates rise because of higher real return requirements, cap rates will rise. But if interest rates rise substantially because of inflation, real estate cash flows will rise commensurately over the long-term. In this case, rising cap rates will not erode real estate values. In fact, the transferable long-term mortgages used by real estate investors serve as a partial hedge against such cap rate movements, as the mortgage liability declines in value as rates rise. This hedging effect of mortgages is true whether the interest rate increase is caused by inflation or increased real return requirements. Also, bond returns and corporate equity returns will erode in the face of rising rates.

In short, once real estate is correctly priced, future return expectations must correlate to some degree with notable interest rate movements. However, a statistical comment is in order. To the extent that most interest rate movements are minor, they will not closely correlate with real estate pricing. Since small, random movements in interest rates dominate the data, the correlation will remain low for "normal" interest rate changes.

In the near term, the question is, as pension funds and other institutional investors increase their real estate allocations, will real estate pricing overshoot? Theoretically there is no reason for overshooting to occur. But large amounts of capital are earmarked for real estate investment over the next two years by institutional investors driving through rear-view mirrors. Reacting to real estate's having been the best performing asset class over the last five years, they are acting as if it will be the best performing asset over the next five, and are committing substantial capital allocations. And once institutional money is committed, it will generally be invested irrespective of pricing.

The question is whether enough "smart money" will exit real estate as this wave of money enters to keep real estate pricing in balance. Our hunch (not theory) is that even though a lot of smart money will pull out in the face of these inflows, there will not be enough smart money to offset the inflows. As a result, we believe that over the next two years, real estate cash streams will become overpriced relative to risk. This means real estate cash flow cap rates in excess of 100 basis points under ten-year Treasury rates.

A mitigant to this overpricing will be the lack of positive leverage. While other sectors, such as tech and biotech, have

experienced overpricing in the face of negative leverage, they have not traditionally been leverage-driven sectors. That real estate has traditionally been highly leveraged means that most investors are uncomfortable with negative leverage. While this will dampen the degree of overpricing, we do not believe it will stop modest overpricing.

It is interesting to note that as real estate becomes correctly priced, the ability to add value to real estate becomes critical. This is because when real estate was massively underpriced, just having money and the conviction to purchase was enough to achieve superior returns. The use of debt with massive positive leverage only increased returns. In such a world, the ability to add value was nice, but not necessary. In fact, it may have even reduced the ability to make profits, as planning and executing value-add strategies takes time. Such efforts only slowed down the ability to buy real estate. While it is true that those who added value earned better returns, they also had higher expenses and risks. And who needed value-add-related headaches when there was so much money lying on the street?

Many opportunity funds have not performed much better than REITs over the last decade—this, in spite of their taking on greater financial and operating risks and providing less liquidity and transparency. Add to this the fact that REITs operated with far less debt, and you see that some real estate private equity funds' performance reflected nothing more than buying with large amounts of debt in a good buying environment. Given the compensation structure of private equity funds (versus REITs), the sponsors of these funds generated massively greater sponsor profits than if they had worked for REITs.

But once real estate is correctly priced relative to risk, and positive leverage exists only for higher risk properties, the only ways to earn outsized returns is to either exploit inefficiencies found in less transparent situations or add value by development, redevelopment, or repositioning. This is why many funds are now seeking assets in less efficient foreign markets. It is also why development- and redevelopment-focused funds and operators (including certain REITs) are ever-more attractive investment alternatives. Once the only way to get superior risk-adjusted returns is to dependably add value where others cannot, if you can add value, you have a rare skill.

Since real estate value-add strategies historically have a 15 percent to 20 percent gross profit margin, executing value-add strategies with approximately 70 percent debt generates 20 percent or greater IRRs over a three- to four-year period. The challenge is to find and dependably execute such opportunities.

A challenge facing institutional investors today is that many real estate private equity funds achieved their success in an era where value-add was secondary to simply "being there." It is now essential to carefully vet sponsors in order to assess if they can create value, or were "just there" successes. Value-add strategies, when successfully executed, not only enhance returns in good times but also offer a substantial risk mitigant in down markets. This is because the lower cost basis of value-add means that if values fall, even though value-add returns will fall short of expectations, they can be positive. In contrast, when a core strategy encounters falling values, they generate negative returns.

Some fund managers will simply use leverage to generate equity return. But most investors can leverage their positions far more cheaply. They do not need to pay a manager a 1.5 percent annual fee and a 20 percent promote just to leverage stabilized properties. Investors desiring high leverage on core position can create a diversified portfolio of quality REITs using balance sheet debt. We have designed such strategies for investors who realize that paying fund level fees and promotes for leverage on core real estate makes no sense.

We believe the final phase of the equitization of real estate will take another ten to twelve years. This is consistent with our earlier conjecture a decade ago that real estate equitization would take roughly twenty-five to thirty years. There will be many new public and private real estate vehicles, and public real estate vehicles will continue to grow in size and more efficiently access capital. Major players will not only grow domestically, but will also operate in major foreign markets. This process will be no easier for real estate firms than it was for Goldman Sachs, Morgan Stanley, E&Y, General Electric, or Microsoft. But the best will figure out how to do it. They will also become better at adding value and will design competitive compensation packages. Private players will primarily be funded by large pools of private equity, channeled through private-equity allocators. Many value-add players will be relatively small and will operate value-add platforms that are localized, yet capitalized by global equity sources.

All of this will occur in an environment of negative leverage, for although real estate has historically had positive leverage, it was reflective of mispricing. No other asset-rich industry, with relatively stable cash flows, operates with positive leverage, because it is not risk-justified. Think of GE as the proxy for such firms, and you realize that negative leverage will be the norm. There will be room for entrepreneurial operators, large-scale corporate operators, local developers, redevelopers, and efficient managers of

cash streams. Over the next ten to twelve years, there will be periods when real estate capital is too cheap, and times when it is too expensive. But the most creative and disciplined entrepreneurs and managers will find ways to make money. This will be the foundation of success going forward.