Commercial Real Estate Capital Markets

Four decades of cycles in the commercial real estate market.

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I HAVE BEEN involved in capital market activities for almost fifty years and in commercial real estate finance for forty years. It thus seems appropriate on the occasion of the twenty-fifth anniversary of the Wharton Real Estate Center Advisory Board to provide an overview of real estate capital markets and their integration into the overall capital market system.

In recent years linkages among financial markets and financial and non-financial assets have increased. I can recall a young partner from Salomon Brothers in the early 1980s proudly bragging that they had invented securitized finance. Of course, the concept of securitization of assets has been around for a long time. At Morgan

Stanley we began securitizing automobile loans for General Motors Acceptance Corporation as early as the 1950s. In 1962, when the J. I. Case Company went bankrupt, money was raised to pay off the company's senior creditors by setting up a sales finance captive subsidiary and securitizing Case's accounts receivable. We used statistical analysis of the average remaining life, the default patterns, the delinquent payment frequency, and the average transaction size for each receivable. The process involved many of the same functions that are performed today on the assets underlying a collateralized mortgage obligation (CMO) or a commercial mortgage backed security (CMBS).

In the mid- to late 1960s, bauxite and iron ore facilities in Australia were financed by pledging twenty-five-year commercial contracts, primarily with Japanese companies, in support of private placements and public offerings of debt in both the domestic U.S. and the Eurodollar markets. The real estate investment trusts (REITs) of the 1970s were a means of introducing real estate mortgages and assets into the securities markets, while CMOs and master-limited partnerships did the same in the 1980s.

In 1970, I was one of the few senior investment bankers on Wall Street participating in real estate capital markets. At the time, real estate financing rates were administered by institutions such as insurance companies and savings banks, and they were essentially delinked from capital market activity. Morgan Stanley's activity in the real estate debt and equity markets at that time, in fact, did much to bring real estate finance into the capital markets system.

EQUITY LINKAGES

Three of the major equity transactions Morgan Stanley executed in the 1970s are examples of the lack of linkages between public and private markets. At times in the market cycle, privately held assets are valued much higher than assets held in public companies while at other times the reverse is the case. During the 1970s, public markets were demoralized and private owners were prepared to pay much higher values for real estate assets. We were able to sell the individual assets of Tishman Realty and Construction, for example, a company that didn't pay dividends and whose stock price was around $8 a share, for an equivalent of $27 a share. The real estate and insurance company assets of Monumental Properties traded at around $20 a share, and, when separated, the real estate assets alone sold for the equivalent of $70 a share. Ernie Hahn was almost bankrupt from overspending on new projects, but when we took his shopping centers out from under the public structure they sold for three times their trading value. The private market premiums were immense. We had caught Wall Street napping, although from then on they began to appreciate real estate as a separate asset class for investment.

There are many reasons for such anomalies. Private owners might tolerate a higher degree of leverage, may be willing to assume greater risk, may desire to control the property and thereby control certain sub-markets, and the like. The canniest and most nimble operators move back and forth between public and private markets throughout the cycle.

We had a private equity real estate investment trust, with institutional shareholders such as General Electric Pension Fund. There was no public market, but the pension funds insisted on a quarterly valuation as though they were publicly traded. The stock market tanked, and we took the public market valuation down to $8 a share; the original offering had been at $20 a share. We insisted the real estate was worth much more in the private market. The pension funds called our bluff and told us to liquidate. We achieved $28 a share, thus leaving the pension funds with a major reinvestment problem.

DEBT LINKAGES

In the 1970s, large institutions—primarily insurance companies—performed their overall investment asset allocations as part of their annual budgeting cycle. Real estate mortgages and real estate equities were assigned a budget to invest at the beginning of the year. Capital markets were so stable that quite often these allocations remained unchanged. Senior investment officers would price their mortgages not based on market conditions, but on how close they were to meeting their quotas, as performance reviews rewarded officers who invested their budgeted amounts for the year. As a result, private debt markets were delinked from public markets. Morgan Stanley discovered it could do a sale-leaseback of a corporate headquarters building for a Baa-rated regional bank or public utility for as much as 250 to 300 basis points below where the company's corporate debt would be trading. Most mortgage investment officers at insurance companies were delighted with the credit quality we could offer them compared with a typical real estate deal, and they ignored the public markets.

When one major life insurance company wished to avoid this anomaly, its chief economist sent a memo to all the field offices stating: "Do not make a mortgage loan on any corporate real estate at a rate less than the Aa utility rate posted in your daily newspaper." The memo described a very crude but effective method of creating a proxy rate for real estate. From this and other instances, capital market linkages to real estate were born. At the end of the decade, innovations such as the "spread" trading of debt instruments off of Treasuries and the increasing transparency of the real estate capital markets caused such pricing anomalies to disappear. But it was fun while it lasted.

REAL ESTATE CYCLES

I see the real estate world as a series of discontinuous cycles—the public market pricing cycle, the private market pricing cycle, the interest rate cycle, and the local real estate supply and demand cycle. In addition, general economic cycles—five or six of which I have lived through in my professional life—overlay real estate cycles. A way to "understand" real estate—and to make a fair amount of money from it—is to keep an eye on all these cycles as they play out in relationship to one another, creating pricing and value anomalies and opportunities for profit.

When I started in real estate finance in the 1970s, it was the greatest commercial real estate downturn since the 1930s. (Little did I know that two worse downturns were yet to come!) REITs had only recently come on the scene, primarily as mortgage investors, and most failed to survive the downturn, giving these investment vehicles a bad name. Pension funds began cautiously to put their feet in the real estate waters.

In the mid-1970s, the federal government initiated some significant financial deregulation policies, loosening restraints on financial institutions. This led to a slackening of investment discipline, which carried forward into the 1980s. Capital flows into real estate were augmented by foreign investors from the Middle East, Japan, and Canada. By the early 1980s, inflation was rampant and interest rates were sky-high. By the end of the decade, these conditions had stabilized, and an excess of investment funds became available to commercial real estate, which fostered an overbuilding binge that took many years to work off.

The early 1990s saw (guess what?) "the worst real estate depression since the 1930s." The fundamental cause was the market's over-reaction to financial deregulation in the mid-1970s. Before deregulation, government-insured deposits were invested in safe investments. After deregulation, financial institutions were allowed to access capital and make investments relatively unconstrained by regulations. The growing practice of spread banking increased the cost of funds and pushed institutions to make riskier and riskier investments, including investments in commercial real estate.

Institutions without sophisticated real estate experience began offering openended construction loans, loans with high loan-to-value ratios, and joint venture equity investments in real estate. Financial pro formas showed ever-escalating rent continuing unabated for the next ten years, along with much lower inflation rates for expenses. Market studies for new urban high-rise office buildings were based on assertions by their developers that the building's superior location and design, or even the personality of its owner, would make it out perform the already-constructed empty building next door.

Many major financial institutions saddled with poor real estate loans and investments would have been bankrupt if they had marked their real estate to market. Federal regulators stepped in, and the flow of capital to the commercial real estate markets essentially disappeared. By the mid-1990s, new risk-based capital rules, a new tax-enhanced version of real estate investment trusts, the mobilization of opportunity funds and the proliferation of CMBS had helped restore the demoralized capital markets.

Just when we began to think that the real estate market had returned to normal (what is "normal" in a cyclical market?), the events of 9/11 created new turmoil. Two market conditions helped the industry avert another nose dive: the capital constraints that operated in the 1990s and relatively low interest rates. The constraints on capital flows in the 1990s precluded overbuilding and gave commercial real estate markets plenty of time to work off the excess of the 1980s. In some markets, including the downtown Los Angeles office market, it took almost fifteen years to reach equilibrium. The interest rates that prevailed over a sustained period of time in the early years of the new century seemed to many observers to be abnormally low. In fact, they were about the same as they were when I started at Morgan Stanley in 1962, but it had taken forty years to get back there.

By 2005, I was predicting the end of such low interest rates and cautioning against over-borrowing at cheap rates, as rates rose and loan to value ratios declined. Accordingly, there was the danger of getting caught in a liquidity squeeze. Capitalization rates of as little as 5.5 percent seemed ridiculously low, but justified in the eyes of some investors on the basis of the lower relative return to cash or bonds or stocks. Obviously a rising stock market would wipe out real estate's relative advantage. Lower capitalization rates for completed projects reflected rising replacement costs and lengthening land entitlement processes. I reminded investors that CMBS securities had never been tested in a stressful market and that REITs could become stressed at the later stages in their life cycle. By mid-decade, opportunity funds were providing excess liquidity to the markets. Furthermore, I worried about the experience factor of many developers. The marketplace had never experienced a down market like that of the early 1990s, and to be truly seasoned, real estate practitioners must have survived both ends of a cycle.

THE CURRENT CYCLE

Starting in 1994 I have written annual commentaries on the real estate capital markets for *Urban Land* magazine. In February 2006 I wrote: "It appears we are in for another cycle—it is time to manage debt structures prudently… Debt underwriting standards have deteriorated. In structured debt deals, loan to value percentages have moved up into the 90s. It would be ironic if the financial instruments that alleviated the credit crisis of the early 1990s became contributors to a real estate credit squeeze in the next few years. The market may be forgetting the financial discipline it learned so hard in the 1990s. Proceed with caution!"

A year later I wrote: "Real estate capital markets are not well positioned to sustain a general shock to the system. The capital markets are not pricing risk in general… There is a great deal of stress built into the system. There is enormous refinancing risk. There is a misalignment of interests. Risk is not priced into the system… If one managed one's business to protect oneself against the crisis, one would not do any business… There is moral hazard in the presumption that the distribution of risk mitigates responsibility… Now is an excellent time to apply systematic risk analysis to the development and financing of projects. Do not over borrow on projects or on an operating company basis. Keep some powder dry. Keep financing flexible to add equity to projects and to take advantage of the distressed prices that will surely follow."

In a February 2008 article, I wrote: "It appears to be a systemic breakdown. There were fraudulent mortgage brokers, uninformed homebuyers, speculative buyers who owned as many as a dozen homes with no equity and an expectation of continually rising prices, overly aggressive Wall Street firms, overwhelmed rating agencies, and buyers of securitized mortgage debt who did not perform adequate due diligence. Cynicism appears to have run rampant… It is likely we are in the midst of one of the most severe credit crises ever. It is anticipated to last for two to three years, and the ramifications are expected to last even longer. Federal policy alone will not restore confidence to financial institutions. The recapitalization of these institutions, already under way, will continue. The lack of liquidity will affect everyone to some degree."

My February 2009 article stated: "If you did not play the game, you would lose all your 'good' people… The irony is that, if we had fully priced random fat-tailed risk into our financial models, we would have priced ourselves out of the market… As we recover, aversion will develop to the size and power of the remaining key financial institutions… Trust has been destroyed, and it will take a long time to rebuild it… The current crisis will become a searing experience that will resonate in the national consciousness for years to come… Some will take comfort from the increased regulatory climate; yet, rules in themselves do not create the trust that is required for the financial system to work smoothly… Financial institutions must become less linked to one another by the compounding risks of derivative instruments… The key to a smoothly operating global financial market is trust in the system. When trust evaporates, often overnight, significant, if not major, financial firms find it impossible to fund themselves: they are exposed to insolvency… What we have seen is an extraordinarily large number of free riders, who take no ultimate responsibility for their actions beyond their pay checks, and a dearth of true leadership willing to take responsible action to maintain trust in the system… We will recover; as we have the deepest and most resilient economy in the world. It will just last longer than any of us has witnessed before."

In early winter 2010 I wrote: "Conditions in the U.S. commercial real estate capital markets are as severe as ever—and likely to remain that way… The massive deleveraging of commercial real estate leaves a huge equity hole to be filled… Some predict no meaningful new development until 2013-2014… We are at the end of the beginning of the financial duress, not at the beginning of the end… Mark-to-market accounting remains controversial. Forcing banks to mark assets down at the bottom of the cycle is unduly burdensome and could bankrupt otherwise solvent institutions… Workouts of CMBS portfolios remain cumbersome… We are entering an era of conservatism with lower loan values, conservative underwriting, reserves, restrictive covenants, forms of recourse, individual buyer due diligence and the like… We should all learn to live a cycle ahead and benefit from the opportunities that are sure to come."

THE FUTURE

As of late 2010, it appears the economy remains quite fragile. Unemployment is 9.6 percent and "under-employment" is far higher. We need more than a million new jobs a year just to keep up with population growth. Thus it could take anywhere from five to a dozen years to catch up, assuming no double-dip recession in the meantime. Jobs growth drives the economy, including housing. Between six million and ten million families are facing foreclosure, assuming the documentation gets straightened out. The FDIC predicts 700 smaller banks will fail. Over-valued securities that have not marked to market continue to be held in great volume by commercial and investment banks, the Federal Reserve System, the FDIC, and the GSEs. We have not as yet affected market clearing prices for these assets. The major banks have indicated they will not begin to think about increasing their dividend payments until 2012. CMBS issuances are about 5 percent of their highs, and the terms are vastly different.

When will conditions return to normal? Not for at least another three years, and perhaps much longer. How will we know what is normal? Narrowing spreads on all forms of debt will be a strong signal, but the characteristics of the debt in terms of loan amount, covenants and the like will be much different. Banking will become more highly regulated and more capital-intensive and the returns on capital will decrease, gradually driving down compensation. Once we accomplish this massive readjustment, we can look forward to rising interest rates and inflation, caused by the huge federal deficit. At least we do not have over-building to contend with. Astute real estate players will know where they are in the cycle and try to think a half-cycle ahead in terms of opportunities.

A long-term career in real estate is sustained by people and trust, not by money and power. If you can compete in a rough-and-tumble business and sustain long-term trust relationships with people, you will prosper. If you view your clients as people you can take advantage of, you will not succeed. Instead, regard your business not as an unending series of deals, but as a series of long-term trust relationships that you carefully nurture.

Real estate has become a profession. To this day, I can travel to almost any major city in the United States and see projects that Morgan Stanley helped finance. It gives me great satisfaction to know that, in our way, we helped shape the built environment of so many cities, provided jobs and promoted community. I see the potential in the real estate business for adventure, success, and a noble calling.