

## Evolution Revolution

*No longer developer-driven and focused on how-to-finance-it-and-build-it, the real estate industry has become a major asset class in a sophisticated investment environment.*

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**TWENTY-FIVE YEARS** ago, commercial real estate was a local business, considered on an asset-by-asset, rather than on a portfolio, basis. The industry lacked transparency; information was cobbled together by each owner, borrower, lender, or broker, and zealously guarded. It was the ultimate definition of an inefficient market. The ability to control information and to allocate capital created enormous opportunities for wealth creation and asset accumulation. Personal relationships between developers and tenants frequently led to oligopolistic local ownership. A very small group comprised what little national presence the industry had, and it was an elite boys

club, represented by a few players such as William Zeckendorf and Trammell Crow. There were a small number of institutional asset owners at the time, primarily insurance companies, and there were a handful of syndicators who sold interests in assets to individual investors. “Infernal” rates of return were yet to be born, and performance measurement was focused on cash flow. Growth was tangible and came in the form of new construction, as opposed to increased NOI. There was abundant non-recourse leverage, and buyers were compensated for their lack of liquidity with favorable tax laws.

In the 1980s, readily available financing, early development successes in the real estate cycle, and a growing thirst for tax benefits without regard to risk led to a massive construction boom. The simple economics of supply and demand were replaced with the flippant philosophy that “either a tax syndicate or the Japanese will buy it,” the latter sentiment reflecting the buying spree of U.S. assets by Japanese investors.

In October 1986, the federal government passed the Tax Reform Act, which dramatically reduced the tax benefits on which the industry had come to rely. Combined with massive oversupply across the country, this led to the near-death experience of the commercial real estate industry in 1990. Savings and loans and many highly respected real estate compa-

nies were forced into bankruptcy. Industry losses exceeded \$80 billion, commercial property values dropped as much as 50 percent, and dedicated real estate lenders disappeared seemingly overnight. In 1992, at a loss for capital and facing a cliff of foreclosures, the industry turned to the public markets for liquidity. The public markets were receptive, but dismissed performance measures related to one-off asset sales in favor of those focused on cash flow and NOI growth. So, the industry began to target scale. Bigger became better, and companies began to amass large national portfolios. Along with the Internet, the disclosure requirements of the public markets introduced accessibility to massive amounts of data for lenders and borrowers. Thousands of comparables and market data were made available, enabling the development of assumptions and projections with real-time data. The Real Estate Center at Wharton—more than any other academic group—acknowledged and accepted these seismic changes in the industry and refocused its curricula to reflect advanced real estate finance as well as public company conflicts, governance and ethics.

The results of this new era in the real estate industry were spectacular. The re-adoption of the 1960s’ REIT model provided liquidity, when no liquidity was otherwise available, and the inclusion of REITs in the S&P and other indices

forced the investment community to accept real estate as a relevant asset class. More recently, during the panic of 2008, the REIT sector was put to a severe test. The panic reinforced the most significant defense for the existence of REITs—access to capital. Public commercial real estate owners had an enviable source of liquidity, while most private owners had nowhere to turn.

#### LOOKING AHEAD

Today, U.S. REITs comprise a market of \$300 billion to \$400 billion with solid growth, predictable dividends, a studied investor base and seasoned management teams. Proliferation within the real estate industry will likely continue, and will be accelerated by the reintroduction of some companies that were taken out of the public markets during the wave of privatization between 2005 and 2007. The REIT sector will also likely grow as many massively leveraged, often underwater, private owners will need to dilute their positions to stay afloat. Some will form new REITs, while others will serve as acquisition candidates for existing companies.

REITs are now a solid fixture on Wall Street, and they are gaining momentum on foreign stock exchanges as well. There are 17 countries that include REITs in their public markets, three of which are in

undeveloped countries (Malaysia, South Africa and Turkey). To date, ownership and tax laws have often been significant hurdles in foreign REIT industry advancement, but governments are implementing changes to provide better incentives for new REIT issuance. For example, Mexico's REIT structure has been in place for more than five years, but only after recently easing the tax liabilities has the country been able to announce its first REIT listing on the BOLSA, Fibra Uno, on March 17, 2011.

The coming decade will bring exponential expansion of investment in today's emerging markets. Comparatively, growth in the developed world is significantly less compelling. The prospects for growth in U.S. commercial real estate are limited by low single-digit GDP expansion, single-digit population expansion and a surplus of existing inventory. Looking ahead, the U.S. will no longer be the global leader in generating economic growth numbers, nor will any other developed country. For the foreseeable future, growth—and subsequently opportunity—will be found in the emerging markets. In particular, Brazil, Turkey, Indonesia, India, Colombia, Vietnam, and China have compelling demographics and scale (Table I). They also carry significantly more risk, and investors will need to trade growth for the rule of law to participate.

**Table I: Emerging market demand characteristics. Common denominator: SCALE**

<b>Brazil</b>
Fifth-largest population in the world
Predominantly young population
Strong economic growth
Emerging middle class with increasing consumerism
Energy and food self-sufficient
Politically stable government
Strong professional management talent pool
<b>Indonesia</b>
Fourth-largest population in the world
66 percent are between 15 and 64 years old; mean age of 27
Sixteenth-largest country by area
Middle-income consumers growth from 23 million to 50 million by 2015
Risks: widespread poverty, poor infrastructure and systemic corruption
<b>China</b>
Largest population in the world: 1.3 billion people
Strong urbanization of younger populace
Strong demand for home ownership
Increasing consumerism
Risk: government command economy risk
<b>Colombia</b>
50 million people (third-largest population in Latin America)
Stock exchange integration with Chile and Peru by year end 2011
Increase of multinational companies
Improving security
<b>India</b>
Fifth-largest economy in the world by GDP: 1 billion people
Predominantly young population; only 5 percent are 65 and over; median age is 26
Largest democracy in the world
Average annual economic growth of 7 percent
Liberal economic policies, privatization of state-owned enterprises, free trade
Risks: widespread poverty, poor infrastructure and systemic corruption
<b>Turkey</b>
Second-largest population in Europe: 73 million people
Youngest population in Europe: more than 50 percent under 29
Seventeenth-largest economy globally
Growing REIT industry
<b>Vietnam</b>
86 million people, two-thirds under 35
Leading exporter (rice, seafood, coffee, footwear, furniture)
Low labor costs; highly educated workforce: 90 percent literacy rate
Foreign Direct Investment (FDI)-friendly market environment

REITs—and Wharton’s real estate program—are well-positioned for the next generation. But their ability to maximize their opportunities will depend, once again, on their adaptability. In the coming 25 years, the future of the industry—and the forefront of education—will need to re-focus outside of developed countries. Capital chases growth, and that will be found in emerging markets. Their opportunities, risks and dynamics are what future students need to understand to become leaders in the commercial real estate world.