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Perspectives on the REIT Industry

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I HAVE BEEN LOOKING FORWARDto this opportunity today because I thought this would be a unique opportunity to share with you some of my perspectives on the REIT industry, and to share some of my perspectives that the REIT industry is no different from any other industry that needs to raise capital and be recognized in the capital markets, and to some extent, to be a little evangelical today and encourage you accordingly. I might add that my evangelical enthusiasm came from my most recent meeting with the Pope. But in trying to prepare for today's speech, really I had a dilemma. I look out there and see all of these faces. Obviously, I can't help but think that here grows my future competitors, and as such I really felt that I had to deal with the issue of competition, and although I might have very high goals of imparting information for you today, clearly there was a judgment question on my part as to how much I should tell you.

When I was preparing for this speech there was one thing that kept coming back to the forefront of my thought process and that was a bumper sticker I saw in Houston, Texas in 1984. It said, PLEASE GOD, GIVE US ONE MORE OIL BOOM AND WE PROMISE WE WON'T SCREW IT UP. Now I don't know how you may think that could be applicable to this industry, but I really hope you will give it some thought.

I believe that in order to understand this industry, you have to look at its history. Because, in fact, I don't think this is just one industry. I think it has been a series of iterations of an attempt to call a series of different kinds of businesses, one industry. In 1960, when the government passed the original REIT Act, the purpose was to create an opportunity for Joe lunch bucket and his friends to own real estate, and to own it in the form of a tradable security. Thus, we had the creation of the first REIT. They were basically dull, put together by real estate guys who knew nothing about the stock market and thought it was not relevant to them. They were built on acquiring assets, and hoping and expecting that inflation would make them more valuable. They sold as yield instruments, the word growth or anything else was really irrelevant, and in many cases, people sat around and waited for them to sink so that they could then be candidates for liquidation.

Then in 1969, another iteration was created, and that was the mortgage REIT. Probably nothing, nothing better exemplifies the difference between oranges and apples than trying to compare the REITs of 1960 to the REITs of 1969-74. When the REITs of 1960 were designed, they focused on very low risk, very low growth, dividend income, and inflation protection. They were sold as the perfect vehicles for the little old lady from Pasadena to invest her savings. Unfortunately, the REITs of 1969 were basically characterized somewhat similarly, although they were so far from the first REITs that there was no comparison. The REITs of 1969 represented a confluence of a number of things. First of all, taking advantage of the perception that REITs were income vehicles on the very low end of the risk scale. With that perception in place, the investment bankers—those are the moralists on Wall Street—could then package and put together mortgage REITs that took the greatest end of the risk spectrum in real estate, borrowed against it, over-leveraged themselves, populated themselves with that portion of the real estate industry that couldn't get a job in the private sector and went out and lost $11 billion out of $21 billion in four years. Truly an extraordinary achievement, losing that much money in that short a time.

Then in 1985, the REIT industry had somewhat of a revival. To a large extent the rebirth occurred because some very smart players used the REIT vehicle as a recapitalization of what was otherwise their business. Their business was a good business, and, consequently, they did well and the stockholders who bought their REITs did well. Unfortunately, discipline, restraint, and morality don't necessarily get very far west of the Hudson River and at the same time they were also creating REITs made up of finite life objectives, objectives about as stupid a concept as you can imagine—that is, you buy a very long-term asset and then artificially create its death.

Various other REITs were put together that assembled the dregs of private assemblers of real estate assets—and those that they didn't want to own themselves, they foisted upon the public, and the investment bankers were more than willing to do so for a fee of only 7 percent. Needless to say, except for a few outstanding candidates in the 1985 class, most of the rest have disappeared from the screen and the last I looked there weren't many mourners standing around hoping for them to reappear. Then 1989 came. That year represented the greatest single watershed change in the history of real estate in America. What it boiled down to was that they figured out that the game was over. Not only did they figure out that the game was over, but, worse than that, they figured out they hadn't made any money playing the game. Somehow or other even the bankers figured out that if you get 9 percent interest for five years and you loose 60 percent of your principal when it's due that wasn't necessarily a business with high margins or a great future.

The Savings and Loans that were providers of capital for the industry basically were taken over by the guys who ran the short-term REITs in the 1970s with a similar result. The pension funds that poured billions and billions of dollars into real estate in the 1980s did so with those same wonderful people from Wall Street who were very glib at selling the benefits of real estate, but never put up any of their own money and basically buried the pension funds in probably the greatest collection of rusty trophies in American history. With all of these things happening, the net effect was that our industry and the real estate industry, which is what NAREIT is and will rapidly become, faced a very different and dramatically changing environment—an environment where no capital was available for real estate investment.

Now I might add that in only a limited case could anybody really make a case for any capital required in real estate, so we've moved into a period where a construction crane is an endangered species and bullet loans are what the world is all about today. With this came the emergence of what I'll call the 1991 and 1992 REIT version. I might add that the 1991 and 1992 REIT version is probably the first REIT version that is really designed and created to actually work. Where there really is a justification for their existence, and where, in fact, the structure and the pricing for the first time really represented a scenario where it was a "fair deal to both sides," both the buyer and the issuer. Now, I must admit that the concept of a real estate guy giving anybody a fair deal is totally out of character, but every now and then, every squirrel finds an acorn, and even the real estate industry, as cynical and as willing as it has been to basically misinform anyone who would listen (whether it meant preparing proformas to sell to the banks for construction or preparing pro formas to sell to the Japanese, or variations on that theme), for the first time recognized that it has only one source of capital and in order for it to continue to exist, both sides must get a fair deal.

What is a fair deal? First it begins with low debt to equity ratio. Now, I operate a $6 billion real estate portfolio at 85 percent leverage. I'm a pro with deep pockets and I can make that judgment every day as to whether or not I want to play in that arena. When you sell securities to the public, the public is not buying your level of risk, because it is also not getting the highly leveraged benefit going the other way. Consequently, if we are going to see this industry double and triple in size (as it should) and if we are going to see the continued equitization of real estate across the board, we are going to have to accept the fact that it must have a lower beta and a lower risk quotient than that which we, as private owners, are both very comfortable and happy to own and deal with on an on-going basis.

Secondly, there isn't any doubt that the real estate industry is made up of some of the smartest guys around, and ten or fifteen years of experience in this industry only hones those intelligence capabilities. But we need to do deals that are straight. We need to sell income in place. We need to sell reality—we don't need, nor should we sell futures. If we sell futures we will end up fouling our own nest.

Third, ours is an industry that has historically been fraught with conflict. Consequently, we should have self-managed REITs where the people running the REITs are incentivized, REITs where the people running the REITs have only one responsibility and that is to grow the value of the REITs for its shareholders.

Fourth, quality properties. The real estate industry is full of all kinds of different levels of quality in terms of its product, from the "trophy AAA to slum properties" (whose cash flow is very interesting). You'd be surprised if you ever looked at the operating statements of serious slum properties because their cash flow is staggeringly high. The problem is that there is no capital value—it is literally cash flow only. Consequently, we have to be disciplined. We as the creators of REITs, we the investment bankers, we the self-styled critics of the industry all have to not lose sight of the fact that we have a very significant real interest in making this work. Quality sponsors, sponsors who are true real estate people who understand the elements of real estate, as opposed to those who only understand how to put a prospectus together. Sponsors who are at risk. Sponsors who have their own money on the table. Sponsors who feel and have a real obligation to what they are doing.

Interestingly enough, and amazingly so, Wall Street seems to get it so far, but the frenzy of the REIT creation is beginning to push the Street to the outside edges of the envelope. That activity will ultimately dramatically impair the growth of this industry. Wall Street has to learn not to over-compete against each other. Wall Street must learn that the amount of gold at the end of the rainbow in the equitization of the real estate industry in this country is relatively large, and to do something short-term today pushes the envelope that recreates the ghosts of 1973 and is a form of self-flagellation that ultimately will be very expensive.

We have today real estate funds, funds that have been created specifically to buy real estate investment trusts. The creation of this separate pool of capital devoted to our industry is an extraordinary asset. We have to protect them, if nothing else, from themselves. We have to make sure that they produce good track records. We have to make sure that they do terrific because if they do terrific, the amount of capital available to us will only grow. If we continue to think that we can put it over on them and we do, this will be a very short-lived phenomena and my guess is that the real estate industry will not have access to the capital markets again, at least not during my career.

We have to bring REITs to the market, and doing it today is most appropriate. It is most appropriate because the market is at a bottom cycle, and by doing this at the bottom cycle the sponsor is really not getting any great bargain, not in his initial IPO. Those sponsors who are trying to make a home run on their initial IPO will pay an enormous price later on. The very important basic premise of what really is a fair deal is a deal where everybody makes money, both the sponsor and the stockholder. That is what it is all about. The 1992 REITs are not about off-loading problems onto somebody else. They are about equitization of an enormous industry, equitization of an industry that is less represented in our capital markets than in the capital markets of any other country in the world. If you wander around the world and compare the role of real estate in the GNP vs. the role of real estate in the capital markets, you will find that the United States is the least capital-represented real estate of any market in the world. On average, real estate represents about 15 percent of the market cap of world stock exchanges. That gives you an idea of the size, the scope, and the importance of the opportunity. This is a permanent activity. It is not a flash in the pan, if we don't screw it up, if we don't get greedy, if we understand both the importance of sharing what we have accomplished and the importance of being cleaner than Caesar's wife, this is an industry that can literally grow exponentially over the next five years. It will provide a primary access to capital, it will be the primary choice of banks and insurance companies that do not currently want to make loans but will make them in the real estate area.

Individuals and ultimately the REIT industry will solve one of the dilemmas of the investing public, and that is, How do I bet one way or the other? The number of people who have called me in 1988 and 1989 and asked how to short real estate confirms the interest and demand. There is no way to short real estate. In the same manner, people are coming to me today saying, How do I buy real estate and how come there isn't a bigger vehicle with serious liquidity that I could, in fact, buy or sell and know that I have locked-in liquidity on the other side of the transaction? That is something we are just starting to do.

We need to get a lot bigger, we need to create a lot bigger vehicle. We are creating too many small vehicles wherein overhead is a major fact, where the ability to grow is limited in terms of size, and yet the real future in this industry is going to emanate from the creation of the multiple of very large mega-REITs that give sophisticated investors the opportunity to make a real bet on real estate as an asset class, and have the liquidity to both enter and exit.

We're not going to have a business anymore where we are selling inflation. We have to have a business where we sell growth. If we do not have growth, REITs will be nothing more than bonds in drag. That is not going to be very attractive for the buyers, and not very attractive for the sponsors. We have to forget about inflation, we have to forget about refinancing, we have to forget about leverage. We have to forget about these being the three main vehicles on which we have justified our existence for the last twenty-five years, and we have to understand that REIT stock will respond to growth. REIT stocks are nothing more than a company encapsulated in a tax advantage vehicle.

You have to understand that you are going to be judged, and your stocks are going to go up or down, based on the quality of your company. The fact that it happens to be encapsulated in a REIT doesn't mean anything. In the same manner, your dividend rate is not your cost of capital. Your cost of capital is the return anticipated by an investor or which might be otherwise available in other companies, and how this particular asset responds to that particular standard. You have to be able to present an intelligent picture of the fact that you have an operating growing company. In the same manner I might add that whether your yield is 4 percent or 6 percent, those people who are buying your stock are buying your stock because they are anticipating a combined cash and price appreciation from 12 percent to 15 percent.

That is the boogie. That is what you have to earn on an on-going basis to have a real viable company. You're going to have to grow by acquisitions. You're going to have to grow by reworking your properties. You're going to have to focus on concepts like return on investment and return on equity because the buyers of these stocks are, in fact, going to be focusing on that arena. There is a great myth out there that REITs are very popular because every little old lady in America is taking her money out of CDs and buying REITs. And the answer is yes, there has been tremendous demand on the retail side for REITs, but REITs don't go up because the little old lady in Pasadena says buy me another 1,000 shares. REITs go up because institutions have decided that this is an arena to play in and they, in fact, go through the kinds of valuations and assessments I am describing to separate the various players within the industry, and to identify those players that have the opportunity to really grow, grow in cash flow, grow in value of their properties, and grow by acquisitions.

There are a number of REITs out there that are being sold and predicated on the construction of additional whatever it is they do. I would admonish you and suggest to you that if you sit down and do the calculations on how long it takes to build something, how much equity is invested, what the return on that equity really is, it makes it very hard to justify a growth story based on construction and development, let alone addressing the whole question of risk, time factors, etc. I think you are also going to see a different definition of velocity. The REITs that succeed, the REITs that produce superior performance to their stockholders, are not REITs that buy assets for a dollar and hope to sell them for two dollars. The REITs that will and are succeeding are REITs that you buy for a dollar and make them worth three dollars by virtue of creating more cash flow, thereby increasing dividends and creating more capital for growth so that the historical concept of buy low/sell high may, in fact, be a very intelligent strategy for an individual entrepreneur, but it is clearly not a consistent and predictable pattern upon which an investor, and particularly an institutional investor, can make decisions on an on-going basis.

There is such a thing in gap accounting called non-recurring gains. You buy a property, you sell it two years later, and you make a profit. The street is going to interpret that as a non-recurring gain, and although you may get the cash for it you're not going to get the credit for it in terms of multiple. The name of the game is building viable, strong, predictable, growth stories in terms of what your REIT does and how it functions. In the same manner there is a premium for simplicity. Make it simple. Some of the contortions that I have seen, attempts by the developer to sponsor REITs but keep control—I'm going to get twenty-five votes for every one share I own, I'm going to slip this in here, slip that in there, I'm going to require the CIA to interpret the structure so I can then explain it to the dumb idiots who buy my stuff. That kind of lack of intelligence and that kind of hubris is something that hurt REITs in past offerings, and frankly, I think the penalty for it is going to grow from here.

How not to screw it up. Don't push the envelope. Yes, we probably know more about our industry than the guys buying our stocks, no question about it. But you know what? You're going to need their capital so you better understand that in order to succeed it is really a partnership of both of us, the buyer and the seller, both focused on making money. Keep it clean—I know everybody has a mother-in-law, sister-in-law, and a brother-in-law, but that does not qualify them as directors of a publicly held company. It really doesn't. Some people have said if you put God on the board it will be okay. That is also a bunch of nonsense. The bottom line is you should be building a board made up of smart businessmen and real estate people who can contribute. Your officers are already on the payroll. They don't need to be directors. What you need are outside people who can give support, make intelligent contributions, and represent the people who really own your REIT—and that is the stockholders, not you. The market is unforgiving. Anybody who doesn't understand that should look at the 1993 fallen angels. In the middle of a stock market that has been going up for three years, there are stocks out there today that are down 50, 60, 70 percent, and they are down because they basically disappointed the Street by telling the Street something and then not performing. Make sure you can deliver what you promise. Make sure you promise what you can deliver.

Lastly, when we look at NAREIT itself we're looking at an industry that is changing, and NAREIT itself is going to have to change. We have a cultural clash that is just starting. You have Arthur Viner and the old guys who basically, in effect, preserved this organization. Then, you have a whole bunch of new guys who are rapidly becoming the major factor in this industry. How NAREIT is able to bring these two groups together successfully without a turf war will say a lot about NAREIT's future going forward. We have to establish standards. NAREIT has to go out into the forefront and establish standards on what is a REIT of the 1990s. And yes, that may in fact offend some people, but just as every other trade group tries to establish standards, this one too, particularly with its growing size, has to step out and say this is what we believe, this is what we believe the risk ratio should be, this is what we believe this industry should represent and we are willing to stick our neck out to say it like it is.

As an industry, we need to get together quickly and rapidly with the Urban Land Institute, the National Realty Committee, the National Apartment Association, all of which are intertwined with income-producing real estate, and create a significant lobby on Capitol Hill. I don't have to tell each of you that real estate, despite its staggering size, has been the least effective lobbyer in Washington of any major industry. To a large extent that has been a function of the fact that there has been no major institution such as NAREIT that has represented a large chunk of our industry. There is an industry of apartment owners and managers, The National Realty Council, which were the big guys, and variations on the theme. What we have to do is bring it all together and create a strong and consistent story and force to our industry. We have to encourage everybody involved in REITs to higher levels of disclosure, higher levels of purity, and, for sure, ongoing discipline. If we do all of this the future is very bright.

This industry, which is just crossing $20 billion, could easily be $150 billion three years from now. We're talking about a seven times growth in size. This is an industry that could be a major part of everyone's portfolio. This is an industry that can and should provide the pension funds with an opportunity to own real estate on an ongoing basis.

Whether we succeed or we fail, it is very much going to be a function of how well we executed this phase—how well we remember that everybody has to come out ahead, not just the sponsors, and so it is with great joy and some trepidation that I stand up here today and tell you that I believe this industry has a great future. Certainly the real estate industry is made up of a group of the smartest, most adept businessmen in this country. When it comes to being transactionists, nobody holds a candle to the real estate community. Unfortunately, when it comes to being conceptionalist, it is like the Mohave Desert in the real estate industry. If you want to see this industry grow and prosper, we not only have to be the best deal makers in the business, we have to understand where we are going and understand that we are trying to create a long-term growth business, a business that will provide all of us with access to capital and return for them that provides the capital getting rewarded.

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