

Market Contradictions Confuse Capital Forecasts

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No one going through the process of forecasting his or her real estate or business operations for 2003 should feel alone if confused about how to interpret economic and real estate market conditions today. The mathematics of forecasting requires the future to behave similarly to the past in order for accuracy to be achieved. Today, with so many confusing indicators in the marketplace, everyone is looking at the forecasts of the major economic and real estate market gurus and wondering how much they should bet on the accuracy of the forecasts. Even deciding to reduce the number of big bets taken, and wait until more clarity arrives, involves a significant bet.

FORECASTING DIFFICULTY

The difficulty of forecasting the economy was the thesis of Todd Buhholz's keynote presentation at the Pension Real Estate Association Meeting in Chicago in late October 2002. He argued that the economy has changed so much that forecasts need to reflect many new realities. He made many points with a focus on how the speed of change has effected the way one has to look at industries and companies. For example, IBM now generates 75 percent of its revenue from products that are fewer than two years old. Salsa outsells ketchup in the United States. Who wins and who loses in the coming years, or even in the coming months, is much more difficult to predict today than in times past.

Mr. Buhholz also focused on the areas of international competition and the global segmentation of the labor markets. The differential in labor costs, and the tremendous availability of labor will keep costs down, and change competitive formulas for success for countries and companies.

He was relatively positive on the future, predicting that the economy would hobble along, with business inventories correcting and the continuing benefits of interest rate cuts propping up the economy. His biggest concerns were the potential for an increase in the price of oil, higher interest rates in the future, and continuing worldwide recession.

MARKET DISCONNECTS

The Real Estate Research Corporation, in its just published RERC Industry Outlook: 2003, picks up on this theme of market disconnects and the difficulty of forecasting. It makes the observation that the past offers no roadmap as to how the economy and real estate markets will respond to these contradictions over the coming years. Some of the market disconnects, or contradictions, that the Real Estate Research Corporation identifies include:

1. Increases in unemployment while the number of home sales and home prices reach historical highs;
2. High physical market vacancies while commercial debt default rates remain low;

3. Rising retail store defaults while capital flows to retail real estate escalate;
4. Eroding consumer confidence while consumers keep spending;
5. Real estate prices remaining steady as vacancies rise; and,
6. Gross Domestic Product remaining steady or increasing while businesses continue to contract or go bankrupt.

Real estate investors today must take a stand on where they think real estate prices and markets are going. Importantly, real estate now competes with other asset classes, including stocks, bonds, and alternative investments for capital. Accordingly, although one does not need a crystal ball to forecast that the real estate markets are not in great shape today, real estate's relative attractiveness, and relative pricing compared to other asset classes, and even compared to historical real rates of return, remain favorable.

Although trying to unravel the contradictions and understand today's markets is difficult, many market observers point to the 40 year low interest rates as the driver that is propping up household consumption, reducing the cost of operating businesses, enabling positive leverage, and generally has been the key source of the continuing strength of the real estate and economic markets during the last few years. Accordingly, given the historic lows at which interest rates are today, it is a simple thing to imagine that they will go up, but how long they stay low, and how far they rise, will be very important in setting a proper strategic direction today.

EQUITY MARKETS STRONG

The volume of real estate capital in the marketplace has been described as a Tsunami of real estate capital flooding the markets by Glen Whitmore, National Managing Director of Investment Sales for Holliday Fenoglio. Cash on cash deals for core and core plus buyers have declined a minimum of 75 to 100 basis points. Average leveraged IRRs have moved to the 11 percent to 14 percent range for core property, down from 15 percent to 18 percent a year ago. The most significant equity on the margin is high net worth syndicated equity, reallocated institutional pension capital to both commingled and separate accounts, and new institutional capital from mid-size pension funds, foundations, and endowments.

Opportunity funds no longer drive the market as they once did. A good example of this is that Blackstone has shifted to a core plus strategy, reducing yields and extending invest-

ment horizons to eight to ten years versus three to five years previously. This shift by some value-added and opportunity funds to core strategies is part of the reason the competition for higher quality stabilized properties has increased.¹

Another sign of the substantial availability of real estate capital is the large number of German investors planning additional investment in US real estate assets. German investors already made strong in-roads into the major US office markets in the late 1990s, but their current plans could result in even more substantial capital inflows to US real estate. Today, over 30 specific German investors have been identified as targeting US properties.

The substantial increase in interest by German investors is tied to Germany's recent enactment of a law, The Fourth Financial Market Promotion Act, which reduces the limitations on German open-end fund investment in non-European investments. This law passed in the Summer of 2002. Prior to the law's passage, only five of Germany's 19 open-end funds were able to freely invest in US real estate.

Potential German investors include corporate pension funds, advisory firms, and closed-end funds, as well as open-end funds. Even banks, such as HypoVereinsbank of Munich and Landesbank Sachsenfonds, of Leipzig, have recently invested in office properties in New York, New Jersey, and Tampa.²

Evidence of the availability of capital for multi-family properties is demonstrated by the number of bids that are being taken by sellers. In a recent 97 unit 22-story apartment deal in Manhattan, there were over 50 players initially interested in the property. According to brokers on the deal, a typical listing a year ago generated between five to eight qualified offers from bidders, but the same bid today would generate 15 to 20 qualified bidders. This increase in capital interest goes across size categories, from \$10 million single asset deals to \$100 million portfolios.

Pension funds and private investors, composed of individuals, families and trusts, have been the most active sources of equity capital for apartments. Private investors, with the ability to place debt at 6 percent on a fixed basis, or under 5 percent on an adjustable basis, have been particularly active.³

Transaction volume, which has been lagging since the overall economic downturn started in early 2000, has picked up. According to figures in the *Investment Property Report* published by Institutional Real Estate Inc., commercial real estate transactions increased 20 percent in third quarter 2002 over activity in the second quarter. REITs also became more active, purchasing over one-third of all assets recorded

by Institutional Real Estate. Although this database is not comprehensive, it does provide some empirical evidence for the increase in transaction volume occurring in the market as many large core real estate investors in the pension community shed assets they have accumulated in recent years. Pension funds were net sellers in the third quarter, and expectations are they will be net sellers for all of 2002.⁴

The good news for public and private real estate debt investors is that delinquencies and foreclosures have remained quite low.

An area of multi-family investment that may make more sense for some investors is the low-income housing tax credit (LIHC) sector. Based on a study of 7,800 tax credit properties by Ernst & Young, foreclosure rates for tax credit housing have been significantly below that for all types of real estate. Since the LIHC program's inception in 1986, annual foreclosure rates have been approximately 0.01 percent compared to one percent to 3 percent for market rate apartments. Operating performance also has been strong, with average occupancies of 94.2 percent and debt service coverage ratios of 1.35. The housing tax credit sector also is very significant, accounting for production of more than 1 million-apartment units in the last 10 years, approximately 40 percent of all apartment production.⁵

In response to both the strong performance of multi-family tax investments, and the availability of capital from local banks that must meet their Community Reinvestment Act (CRA) requirements, the number of multi-family tax credit funds is increasing. Some of the key sponsors for these tax credit funds include Apollo Housing Capital, Boston Capital, First Sterling Financial Capital, Franklin Capital, Lend Lease, MuniMae Midland, Raymond James, The Richmond Group, and Simpson Housing Solutions.⁶

DEBT MARKETS STABLE

The real estate debt markets during the last quarter continued their trend of substantial liquidity and excellent pricing for the highest quality deals, and more difficult pricing and less availability for more risky properties with large lease

exposure or strategies that require strategic repositioning in order to achieve financial success. Fortunately, the growth and maturity of the mezzanine financing marketplace has continued, filling the capital gap faced by many lower quality or unstabilized properties.

Unlike the 1980s and early 1990s, when commercial banks and life insurance companies expanded their conventional lending activities, often taking uncompensated equity-like risks, the bifurcation of the debt market today between conventional mortgages and mezzanine financing has produced a more rational distribution of risks and rewards. Although the cost of capital for real estate entrepreneurs is higher with a combination of conventional and mezzanine financing than with conventional financing alone, the distribution of returns to the mezzanine lender and borrower are reasonable for the risks they take. This trend towards risk and reward segmentation will continue and become even more sophisticated moving forward.

Traditional commercial lending activity during the first six months of 2002 was essentially flat according to a recent survey by the Mortgage Bankers Association. Loan originations totaled \$32.8 billion, compared to \$32.6 billion for the same period in 2001. Despite hopes for origination increases due to declining interest rates, survey participants indicated deterioration in real estate fundamentals, a slowdown in property sales, and a lack of terrorism insurance as reasons activity remained low.⁷

The issuance of commercial mortgage-backed securities (CMBS) paralleled the moderate level of activity in the private debt market. Total CMBS issuance through the Third Quarter of 2002 was \$57.6 billion, a 6 percent decline from the same period in 2001. Issuance of US CMBS was only \$42.6 billion, down 15 percent compared to last year.

DELINQUENCIES LOW

The good news for public and private real estate debt investors is that delinquencies and foreclosures have remained quite low despite substantial problems in US real estate markets overall. CMBS delinquencies, based on data for seasoned transactions, were 2.09 percent of outstanding mortgages, a 79 basis point increase from a year ago.⁸

Private real estate mortgage delinquency rates also remained low relative to historic standards. The American Council of Life Insurance delinquency rates for commercial mortgages went up 5 basis points in the Second Quarter of 2002 but still totaled only .27 percent of the industry's approximately \$204 billion of mortgages outstanding. The

insurance industry's non-performing loan rate (the total of delinquencies plus foreclosures) was reported to be .28 percent at the end of the Second Quarter of 2002. Importantly, this compares to a non-performing loan rate of approximately 7.5 percent of mortgages outstanding in December 1992, the low point of the prior real estate cycle.⁹

Commercial mortgage foreclosure and delinquencies statistics, and the level of distress they imply, are becoming more important today. Literally scores of investment managers (there are over 350 real estate investment managers in the market today) are raising capital from pension funds, endowments, high net worth individuals, and others to take advantage of expected opportunities in the distressed real estate markets. However, while delinquency and foreclosure rates are increasing, and most observers expect them to increase further in the coming years, the level of distress, and related acquisition opportunities, are going to fall well below most people's expectations.

The low levels of distress are due to a number of easily understood factors. First, the owners of most distressed property owned their property during substantial rent and value increases in the late 1990s, thus cushioning recent dramatic value declines.

Second, tighter loan underwriting in recent years provides an equity cushion that mitigates potential distress.

Third, dramatically declining interest rates during the last two years make it possible for many marginally performing buildings to continue to meet debt service payments.

Finally, with stock and bond markets struggling, and the high price of many real estate properties, investors seeking to extricate themselves from distressed situations have fewer alternative places to put their money, and are willing to take their chances on a demand driven recovery of the real estate markets.

This being said, the next few years will provide substantial opportunities to buy poor or under performing properties with significant upside. With office market rents dropping over 20 percent, and in some cases over 50 percent in many markets, problems in the hotel industry, and the likelihood of a moderate recovery, or perhaps even a double dip recession, many property owners are feeling the pain. Office and hotel properties will provide the best opportunities for distressed property or loan acquisitions during the next two years.

Another issue influencing the level of distressed property acquisition opportunities is the willingness of lenders to work with borrowers that are in trouble. Lenders historically have extended maturities, discounted loan principal payoffs,

or reduced rates in their effort to help borrowers work out their problems. In an interesting article by John Harding and C.F. Sirmans in *Real Estate Economics*, they take an academic look at how lender policies relative to borrowers affect property collateral. Borrowers have an incentive to extract as much cash as possible from the underlying collateral and to take on additional risk. Lenders try to limit these actions through covenants and costly monitoring. Harding and Sirmans found that borrowers who expect their lenders will renegotiate maturity in the event of default have less incentive to under invest or divert cash flow and value from the collateral during the term of the loan than do borrowers who expect lenders to renegotiate the loan principal by accepting a discounted payoff. As another period of distress in the real estate markets begins, both lenders and borrowers can learn from the last cycle to positively enhance their respective positions.¹⁰

Another interesting phenomenon that has been occurring in the debt markets is the preponderance of adjustable-rate versus fixed-rate deals that are being done. Estimates by participants in the market suggest up to 50 percent or more of current debt deals being underwritten are adjustable rate. This is particularly surprising in that current fixed rates of 6 percent or lower for the highest quality properties are at historic lows, and most people expect rates to go up. However, with adjustable rate mortgages even lower, and flexibility of adjustable rate deals, the adjustable rate market should continue despite expected increases in interest rates over the next few years. Part of borrower reluctance for fixed-rate deals, particularly from mortgage conduits, is the punitive prepayment and yield maintenance clauses that essentially lock in borrowers to long-term financing for many years, reducing borrower flexibility and liquidity.¹¹

The expectation of interest rate increases in the future was underscored on November 6, 2002, when the Federal Reserve Board cut the Federal Funds Rate by another 50 basis points to 1.25 percent. This marked the Fed's 11th rate cut since 2001 and left rates approximately 5 percent below rates of over 6.5 percent in November 2000. This dramatic decline in short-term interest rates has also affected longer-term rates. Five-year treasuries dropped from around 6 percent in the Fall of 2000 to under 3 percent today. Similarly, 10-year treasuries dropped from around 5.8 percent in the Fall of 2000 to around 4 percent today. The Federal Reserve Board's recent 50 basis point drop in the Federal Funds Rate had little initial impact on longer-term rates, with down-

ward movements of only 10 or 20 basis points after the rate cut was announced.

INSURANCE STAYS AT TOP THE AGENDA

Property and liability insurance continues to be a key and growing concern in the investment and the operation of real estate assets. Insurance costs of all types have risen dramatically during 2002, with terrorism and mold issues getting the most attention. The Congressional Conference Committee that has been charged with reconciling House and Senate terrorism bills, and advancing a joint recommendation, has finally presented its bill. In short, the bill requires insurers to offer terrorism insurance, but makes the government 90 percent responsible for any terrorism losses above a deductible set for each insurance company. For very large losses (\$10 billion initially increasing to \$15 billion by 2005), the government can recoup its losses by charging up to a 3 percent surcharge on premiums.

The key question is whether insurance will be available. Based on a recent September 2002 Building Owners and Managers Association (BOMA) terrorism survey, 25 percent of survey participants reported they were unable to obtain terrorism insurance, regardless of cost. Reported increases in terrorism insurance premiums for those who could get it ranged from an average low of 20 percent to a high of 200 percent. Fortunately, the current draft of the Conference Committee bill addresses these concerns in a fairly comprehensive way. The bill requires property insurers to participate through the end of 2004 and potentially through the end of 2005. The bill also removes any policies in current clauses that exclude terrorism coverage so long as the property owner pays the adjusted premium.

As to cost, the current version of the bill gives insurers a backstop that protects them from the full financial impact of a major incident and removes this justification for higher rates. Unlike the House bill, the Conference Committee version does not contain provisions limiting punitive damages, leaving this to the states. Even though there are no punitive damage limits, the bill does not disallow federal money from being spent on punitive damages. However, states will have to develop reasonable laws relative to punitive damages in order to keep insurance premiums reasonable. With insurers forced to provide coverage, competition in the sector should also increase. Finally, with insurance typically only being about one percent of the operating cost of most buildings, even if met with massive rate hikes, only

the most problematic properties should run into severe operational problems.¹²

TOXIC MOLD

Liability exposure due to toxic mold claims continues to create uncertainty for both single-family and commercial property investors. California is one state that is taking this issue seriously. California was the first state, in October 2001, to pass a law regulating exposure to mold in the home and in the workplace. The California law requires the California Department of Health Services to develop standards for mold exposure, and imposes strict disclosure requirements on owners of commercial and residential properties, the violation of which can result in penalties.

Although the mandated disclosures will not be required until at least six months following the Department of Health Services Adoption of standards, which is not expected until at least the end of 2002, property owners and acquirers need to prepare for the new disclosure rules. Some of these disclosure rules include written notice of potential mold problems to prospective buyers and written disclosure from landlords to their prospective and current tenants if they know mold is present and exceeds exposure limits. Tenants of commercial and industrial real property will be required to provide written disclosure to landlords if they know of the presence of mold or conditions of chronic water intrusion into the building. As the standards are developed, the law requires an assessment of the economic feasibility of implementation, and this hopefully will provide the basis for the development of reasonable standards.¹³

INVESTMENT INSIGHTS

In one of the more thoughtful articles looking at the effects of the terrorist attacks on September 11, 2001, Maureen McAvey argues that one of the key impacts of 9/11 is on federal, state, and local budgets. Not only are government budgets severely stressed due to declines in the stock market and general economy (declining tax revenues), the tremendous demands at all levels of government to invest in our security apparatus is forcing governments to make stark choices about their priorities. Investment in new roads, transit, and other infrastructures is balanced against other critical needs such as improved public health, police and fire protection and overall better security for state and local facilities.

The implications of these growing budget demands, and tremendous government cash shortfalls, will most affect new real estate development. Most projects of any scale require

some degree of public investment, and in this era of tightened budgets, public funds will be harder to come by. Local developers will need to be able to fully articulate the public benefits of their projects, and should expect to amortize higher fees, costs, and taxes throughout their project's life span. On a positive note for existing real estate owners, when development is made more difficult and expensive, the value of existing assets increases.¹⁴

CONCLUSION

The confusion in the real estate markets and general economy provides opportunities for those with the vision, and risk tolerance, to place their bets. Fortunately, the relative advantages of real estate, and the substantial continued availability of capital, should provide a backstop for potential downside risks. Additionally, while office vacancies have increased to levels, in some cases, beyond those seen during the real estate collapse in the early 1990s, the primary cause has not been a dysfunctional inefficiently allocated capital market, but an unanticipated demand side collapse. Because all industries have been impacted by this economy-wide

demand collapse and real estate, in most cases, hasn't compounded its own problems with an oversupply problem, the real estate industry should be able to pick itself up more quickly once the economy rebounds than it did in the early 1990s.

NOTES

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7. Mortgage Bankers Association of America, *Survey of Mortgage Lending*, 2nd Quarter 2002.
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9. American Council of Life Insurance, *Quarterly Survey of Mortgage Loan Delinquencies and Foreclosures*, 2nd Quarter of 2002.
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13. "Remediating Mold," *Urban Land*, June 2002.
14. "The Price of Security and the Competition for Scarce Resources," *ULI On the Future*, Fall 2002.