

## Capital Markets Stabilize Real Estate Economy

In a twist of fate from the early 1990s, the real estate capital markets are now a reason to invest in real estate rather than a volatile factor increasing real estate investment risk.

The real estate capital markets have been a stabilizing force in the real estate property markets during the last 12 months. The growing size of the public real estate debt and equity securities markets, more intelligent underwriting, improved pricing of risk, and other factors have enabled the capital markets to remain liquid and reasonably priced during a significant economic downturn. Additionally, borrowers are in a better position to withstand short-term downturns without catastrophic losses.

Equally important to market health is the sustainability of real estate capital flows in the future. With continuing strong real returns in relation to uncertain bond and equity markets, real estate is well positioned to continue to attract substantial volumes of capital in the future. This sustained level of capital will provide a solid foundation for future market liquidity and reduce long-term return volatility.

This article describes the current availability of real estate capital, assesses the ability of the market to sustain capital flows in the future, examines how capital flows have influenced transaction activity, and evaluates the implications of changes in the capital and transaction markets for institutional real estate investors.

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## Current Availability of Real Estate Capital

Capital is readily available to the real estate markets, but capital activity is down, as shown in Exhibit 1. The strong current availability of capital is confirmed by a recent Urban Land Institute (ULI) survey of its council members as part of its regular mid-year forecast. More than 70 percent of the members thought that the real estate capital markets were either in balance or oversupplied. The

survey showed a modest shift toward expectations of greater availability of capital over the coming year as compared with last year's forecast.<sup>1</sup> Lenders and equity investors have capital, but lender activity is down as a result of declines in new construction, a slowing of refinancing, and a tightening of underwriting standards. Substantial amounts of equity seek acquisitions, but buyers and sellers remain separated over property values.

### Exhibit 1: Real Estate Capital Availability

Source	Capital Activity	Capital Availability
<b>Private Debt</b>	<ul style="list-style-type: none"> <li>• Originations in first quarter of 2002 were down 15.6 percent from first quarter 2001.<sup>a</sup></li> </ul>	<ul style="list-style-type: none"> <li>• Availability from insurance companies is expected to increase, but availability from banks and S&amp;Ls is expected to decrease.<sup>b</sup></li> <li>• Mortgage pricing, at sub-7 percent levels, remains near historic lows.</li> </ul>
<b>Public Debt</b>	<ul style="list-style-type: none"> <li>• CMBS issuance in early summer was down approximately 30 percent year-to-date from 2001 based on statistics from Commercial Mortgage Alert.</li> </ul>	<ul style="list-style-type: none"> <li>• With total U.S. issuance of \$74.3 billion in 2001 and projections of \$50–\$60 billion for 2002, substantial infrastructure and capital are available to meet demand.</li> <li>• Pricing tightened during the last year, from 145 basis points over ten-year Treasuries for AAA CMBS to approximately 100 basis points in early summer.</li> </ul>
<b>Private Equity</b>	<ul style="list-style-type: none"> <li>• Institutional real estate transaction activity declined 13.8 percent in the year ending March 2002 compared with the prior year.<sup>c</sup></li> <li>• Private local investors were still investing the most capital of any source, but their net new investment through May 2002 was down 50 percent from the same period in 2001.<sup>d</sup></li> </ul>	<ul style="list-style-type: none"> <li>• The availability of private equity capital is expected to increase moderately through 2003.<sup>e</sup></li> <li>• Private partnerships are expected to lead the increase in private equity funding, with pension funds, opportunity funds, and foreign investors also increasing their capital availability.</li> </ul>
<b>Public Equity</b>	<ul style="list-style-type: none"> <li>• REITs changed from net sellers to net buyers of retail properties in the fourth quarter of 2001.</li> <li>• In apartment properties, REITs have continued, although at a slower rate, to be net sellers of garden apartments, but in recent months have increased their acquisitions of mid- to high-rise apartments.</li> <li>• REITs have continued to be net sellers of industrial and suburban office properties but have recently increased their acquisitions of CBD office properties.<sup>f</sup></li> </ul>	<ul style="list-style-type: none"> <li>• REITs are expected to continue to provide capital to the real estate markets, but their net new capital will be limited by their relatively limited new issuance of initial public offerings and other capital.</li> </ul>

<sup>a</sup> Commercial Mortgage Originations Survey, Mortgage Bankers Association, 1st Quarter 2002

<sup>b</sup> Urban Land Institute Forecast; survey of ULI council members; May 2002

<sup>c</sup> Institutional Real Estate, Inc.

<sup>d</sup> Real Capital Analytics, Apartment, Flex/Industrial, Retail, and Office Capital Trends Monthly, June 2002

<sup>e</sup> ULI 2002 Forecast Supplement, May 2002

<sup>f</sup> Real Capital Analytics, Apartment, Flex/Industrial, Retail, and Office Capital Trends Monthly, June 2002

Private mortgage originations are down approximately 16 percent from last year, and total CMBS issuance is projected to decline nearly 30 percent in 2002. New acquisitions by institutional real estate investors declined nearly 14 percent in the year ending March 2002 compared with the prior year.<sup>2</sup>

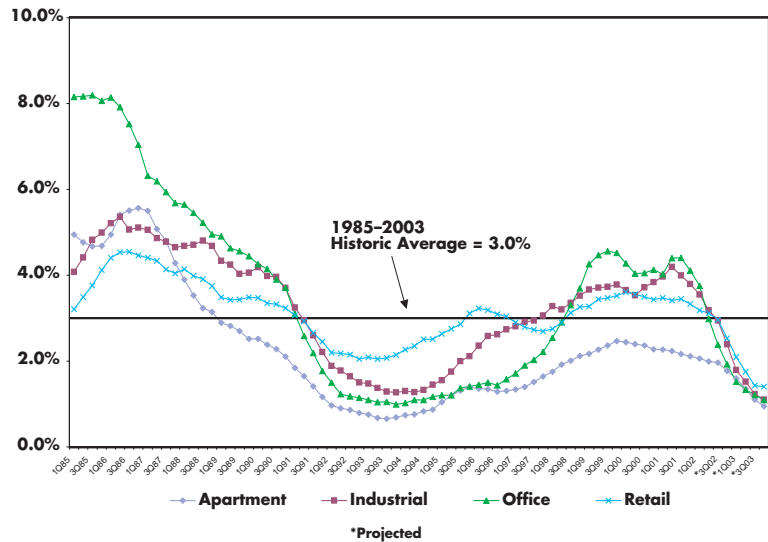
However, although total activity is down, REITs and private local investors have remained net buyers. Private investors are taking advantage of historically low interest rates while REITs are reinvesting capital from asset sales and secondary offerings. REIT joint ventures with pension capital are occurring but have been less desirable for REITs given other capital alternatives.

Though overall real estate capital availability remains high, there has been a significant shift toward more rigorous underwriting standards in the commercial mortgage markets. The shift is tough for real estate investors with limited equity resources and properties with greater leasing and market risk, but tougher underwriting and a rapid shutdown of construction lending activity are just the kinds of response a mature and efficient market takes to get itself back to equilibrium.

Mortgage underwriting is expected to remain conservative. More than 70 percent of respondents to the ULI's 2002 Mid-Year Forecast Survey expected underwriting standards to become more stringent over the coming year. Those opinions were confirmed by the May 2002 Federal Reserve Board opinion survey of senior loan officers, which indicated that lending standards for commercial real estate loans continue to be more restrictive, with 30 percent of banks tightening standards in recent months.

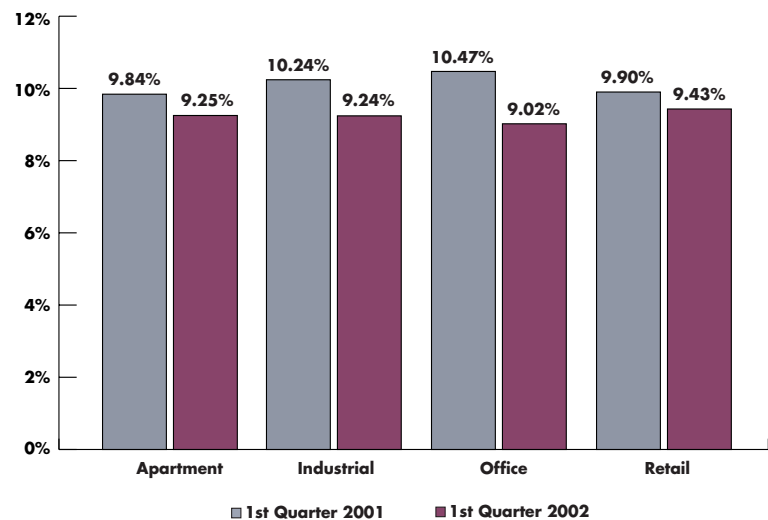
Tougher standards and the near shutdown of new construction lending are restraining the supply of real estate. This is a very positive sign, ensuring market improvement as the economy rebounds. Based on a review of the pipeline of construction activity as forecast by Property and Portfolio Research, new construction as a percent of total inventory is forecast to decline significantly from the 4 percent range for most property types between 1998 and 2001 to less than 2 percent per year in 2003, well below historic

**Exhibit 2: Construction Pipeline**  
Annualized Starts as a Percent of Existing Stock



Source: Property Portfolio Research; The Muldavin Company, Inc.

**Exhibit 3: Overall Cap Rates**



Source: RealtyRates.com; Investor Survey 2Q02; The Muldavin Company, Inc.

norms of near 3 percent, as shown in Exhibit 2.

Another intriguing sign of the strong availability of capital is the recent decline in capitalization rates, despite uncertain economic trends. According to RealtyRates.com's investor survey, cap rates for all four major property types dropped sharply between the first quarter of 2001 and the first quarter of 2002, as shown in Exhibit 3. Announcements in June that REIT analysts were lowering cap rates and raising net asset values further confirm these trends. Perhaps buyers outsmarted the economists,

<sup>2</sup> Institutional Real Estate, Inc.

none of whom anticipated the 5 percent GDP growth in the first quarter of 2002. Despite some positive economic news, stock market declines and concerns over job growth remain a nagging concern for future growth prospects.

On the debt side, continued low interest rates and spreads of only 100 basis points over ten-year Treasuries for AAA CMBS securities provide clear evidence of the availability of reasonably priced capital for assets with required equity contributions and lower risk profiles.

In short, the real estate capital markets have passed their first tough test since the early 1990s. The positive news is that capital has remained available throughout the current real estate market decline, indicating a more mature and efficient market than existed in the early 1990s. Unlike the early 1990s, there is no liquidity crisis today—liquidity can be found at a reasonable price. Those seeking capital must increase their proportion of equity given tighter debt markets, but that is a normal and reasonable response to current market conditions.

### **Sustainability of Real Estate Capital Flows**

Equally important to the current availability of capital is the long-term sustainability of capital flows. Without belief in the long-term sustainability of capital flows, people could negatively view today's declining cap rates as a result of "too much capital chasing too few deals."

If capital flows are sustainable, and investors believe it, investors will gain confidence in the long-term liquidity of real estate, thereby reducing risk and concerns about future exits from current investments. We expect this confidence to give buyers the impetus they need to bet on the future, thereby helping to jumpstart transaction activity from a sluggish past year.

The good news is a growing consensus on the importance of real estate in portfolios for all investors. In our discussions with generalist consultants and economists in recent months, even prior to recent stock market problems, there seems to be a strong consensus for a relatively flat S&P 500 equi-

ties market over the next five to ten years. With concern over high price-earnings multiples and resulting high market valuations plaguing the equities markets for many years, we see more investors taking a somewhat pessimistic long-term view of the stock market. Concerns about company credit and anticipated interest rate increases during at least the next 12 months have also raised concerns about the direction of the bond market, highlighting real estate's relative attractiveness to investor portfolios.

There is a precedent for a relatively flat equities market on a real return basis during the last 30 years. Between 1971 and 1984, the total average annual real return for the S&P 500 was only 1.6 percent, compared with bond returns at 2.4 percent and real estate returns of 4.4 percent.<sup>3</sup> This 14-year period of relatively flat real returns in the stock market occurred prior to the significant increases in PE multiples, suggesting that the possibility of a period of flat S&P returns should be seriously considered.

Real estate assets also have some inherent investment advantages in chaotic markets. Long-term leases in office, industrial, and retail properties enable asset managers to maintain stable incomes even in a down market. For example, a typical office property may have 15 percent of its tenants turning over each year. Accordingly, if a down market lasts a few years, the substantial majority of tenants are in place at pre-downturn rental rates. Astute managers carefully manage lease durations and plan—through lease structures and tenant improvements—for potential unexpected lease terminations. However, for property owners with substantial over-market rent-lease exposure, roll-overs can cause significant economic hardship.

In multi-tenant properties, a real estate owner can diversify across scores of companies or individuals (apartments) with a single asset. Diversifying across the country with multiple properties provides further diversification benefits. Certainly, stock market diversification can be achieved with the thousands of public companies, but real estate's "hard asset" foundation provides comfort not found

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<sup>3</sup> Composite real estate return is the average of the commercial real estate capitalization rate, the Prudential Real Estate separate accounts return and Evaluation Associates return; "Nine Reasons to Invest in Real Estate," Stephen Roulac & Company.

elsewhere in the investment market.

The short- and long-term attractiveness of real estate is best evaluated by considering real returns. Although forecasts of the NCREIF Property Index through 2002 range from 5 percent to 9 percent—significantly lower than the 12.2 percent generated over the five years ending in 2001—real estate is still fairly valued and should generate real returns at or above historic averages.

Although real estate returns may moderate from the levels investors have enjoyed in recent years, returns should still be quite attractive on a relative basis. In his Second Quarter 2002 Market Watch report, Bill Maher of LaSalle Investment Management cites a recent Greenwich Associates study that found that institutional investors believe real estate will produce an average return of 9 percent in 2002, well above the prognosis for stocks (5 percent to 7 percent) and for bonds (4 percent to 6 percent).<sup>4</sup>

Clearly, the case for the long-term sustainability of real estate capital flows is bolstered by real estate's strong current relative attractiveness to other asset classes. Additionally, though 401k investors, small pension funds, endowments, and small life insurance companies have been unable to easily access real estate investments historically, new investment management products have been developed to tap this vast new source of real estate capital and more are likely to follow, providing a continuing source of new real estate capital.

### Why Has Transaction Activity Slowed?

Despite substantial capital availability throughout the recent 12 months, the level of transaction activity has slowed significantly. According to the *CoStar COMPS Trend Report*, total transaction volume in the four main property types fell from a peak of \$24.6 billion in the second quarter of 2001 to \$15.2 billion in the first quarter of 2002, a drop of 38 percent (Exhibit 4). The slowing of transaction activity began first with office properties in the

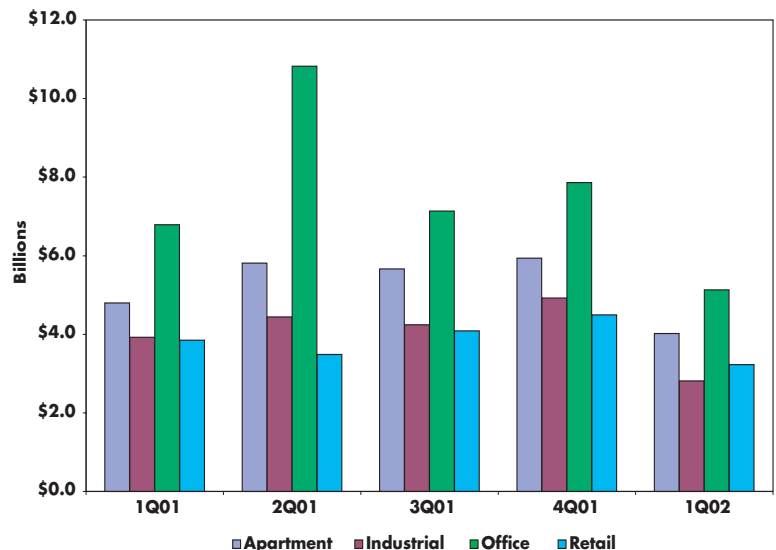
third quarter of 2001, but the most significant declines for apartment, retail, and industrial properties occurred in the first quarter of 2002.

Varying declines in transaction activity by specific property type are confirmed by Real Capital Analytics, which reports the following year-to-date (through May 2002) changes in property sales: garden apartments, down 12.5 percent; mid- and high-rise apartments, flat; strip centers, flat; industrial, down 35 percent; flex, down 50 percent; office, down 20 percent.<sup>5</sup>

The decline in transaction activity is natural at this stage in the real estate cycle. Overall, though there are some differences by property types, the real estate markets are in what Glenn Mueller of Legg Mason would describe as a “recession,” in which low or negative growth combined with continuing but slowing construction starts push vacancy rates higher. Mueller's ongoing real estate cycles research has shown that, historically, market conditions such as we have today cause transaction activity to stall, as the bid-ask spread in property prices widens.<sup>6</sup>

Interestingly, based on surveys conducted annually by Real Estate Research Corporation (RERC),

**Exhibit 4: Transaction Volume**



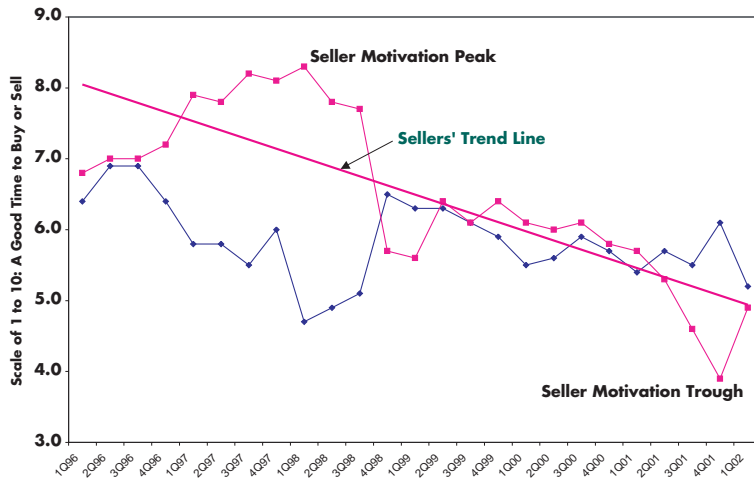
Source: *CoStar COMPS Trend Report*; The Muldavin Company, Inc.

<sup>4</sup> “Lower Nominal Returns from U.S. Real Estate Still Produce Attractive Real Estate Returns,” William Maher, LaSalle Investment Management, second quarter of 2002

<sup>5</sup> “Capital Trends Monthly,” June 2002, Real Capital Analytics. Regional mall transaction volume was up dramatically in the first five months of 2002 as a result of two large acquisitions of the Rodamco and Jacobs portfolios.

<sup>6</sup> “Real Estate Markets Cycle,” Glen Mueller, Legg Mason, First Quarter 2002 Analysis, May 2002

**Exhibit 5: Seller Motivation: 1996–2002**



Source: Real Estate Research Corporation; The Muldavin Company, Inc.

**Exhibit 6: Office Market Forecasters' Agreement Index<sup>a</sup>**

Agreement Rank	Market	Forecast Performance Rank <sup>b</sup>
<b>Highest Level of Agreement</b>		
1	Miami	4
2	Denver	37
3	Detroit	20
4	Washington, D.C.	3
5	West Palm Beach	7
6	Jacksonville	5
7	Charlotte	25
8	Fort Worth	23
9	Minneapolis	30
10	Kansas City, Mo.	17
<b>Lowest Level of Agreement</b>		
30	Chicago	22
31	Boston	38
32	Seattle	37
33	San Jose	39
34	Orange County	27
35	Oakland	19
36	Austin	31
37	Riverside/ San Bernardino	8
38	New York	11
39	San Francisco	32

<sup>a</sup> Derived from research by Guggenheim Real Estate. Index measures the level of agreement in the two-year performance forecasts of Property and Portfolio Research, REIS Reports, Torto Wheaton Research, and Guggenheim Real Estate.  
<sup>b</sup> Average performance rank of the two-year forecasts of Property and Portfolio Research, REIS Reports, Torto Wheaton Research, and Guggenheim Real Estate.

bid-ask spreads of 66 basis points at year-end 2001 were near or below averages for the last nine years and are tightening more in 2002.<sup>7</sup> With spreads declining in 2002 from historic norms, we expect transaction activity to increase.

An analysis of RERC's historical data on investors' rating of time periods as a good time to buy or sell real estate (Exhibit 5) shows that seller motivation is key to transaction activity—more so than buyer demand. Seller motivation has been steadily declining since it peaked in the first quarter of 1998. Buyer interest in acquisitions has remained relatively stable since 1999, but when seller motivation declined in 2000 and then plummeted in the second half of 2001, transaction activity declined precipitously. Seller motivation rebounded dramatically in the first quarter of 2002, which may portend an increase in transaction activity.

The substantial slowing in transaction activity is also a result of historically low refinancing rates, which allow owners to pull capital out of their properties through refinancing, rather than selling at today's market prices. Significantly improved underwriting over the last five years has also resulted in stronger borrowers and capital structures on properties, enabling more sellers to avoid distress sales.

### Future Outlook for Transaction Activity

Although continued uncertainty about the pace of job growth in the current economic recovery may slow transactions in the near term, transaction activity is expected to accelerate. Transaction activity will pick up when bid-ask spreads get smaller as both buyers and sellers adjust their expectations and come to a meeting of the minds.

An indication of where and how this might happen in the office market is provided by research recently conducted by Guggenheim Real Estate, (Exhibit 6).<sup>8</sup> Markets are ranked by highest and lowest levels of agreement among four major forecasters, along with each market's average performance rank. Miami, Washington, D.C.,

<sup>7</sup> Bid-Ask Capitalization Rates, Real Estate Research Corporation, June 2002. The bid-ask spread is the difference between the cap rates at which buyers want to buy and sellers want to sell.

<sup>8</sup> Guggenheim Real Estate Plus National and Top 55 MSA June Forecast for Commercial Real Estate Returns, David Guilkey and Mike Miles, June 2002

West Palm Beach, and Jacksonville are markets that have both high performance expectations and agreement to that effect—a combination that is expected to spark transaction activity.

Another source of likely transaction activity is the substantial volume of property owned by opportunity and value-added funds due to their acquisition binge over the last three to four years. Given the significant positive value increases that many real estate funds experienced early in their holding periods and their need to achieve high promised rates of return, it is not prudent for them to hold their properties for too long. Though many funds have substantial resources and don't have to sell, we project significant transaction activity from opportunity and value-added funds in the coming years.

Both opportunity funds and other owners will also be encouraged to sell their properties as the markets firm up and new higher-return investment opportunities become available. Many entrepreneurial owners do not have the required equity to participate in new opportunities without selling currently performing assets, and, accordingly, we expect this type of activity to pick up during the next 12 months.

Although many borrowers are much stronger than in the early 1990s, when many distress sales occurred, distress is on the rise as a result of weakened cash flows for owners of properties in the markets and property types that have been most negatively affected by the current downturn, hotels and technology-based office markets, for example. In some cases, even properties that are meeting cash flow commitments to their lenders are in trouble, as lenders require equity infusions due to debt covenants that require maintenance of minimum loan-to-value ratios. In combination

with the growing number of leases coming due on unoccupied but rent-paying space, distress will create transaction activity in select markets and property types.

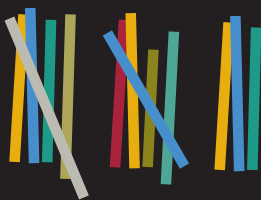
### Key Implications for Institutional Investors

The ebb and flow of real estate capital and transaction activity has significant implications for institutional investors. Most importantly, the real estate capital markets have passed the sanity check brought on by the recent economic downturn. Capital has been more intelligently allocated—unlike investment in the telecommunication and technology sectors—resulting in less pain than in the early 1990s downturn.

Other key implications include the following:

- Real estate returns are attractive in relation to alternatives, and exit risk is mitigated by sustainable capital flows to real estate.
- Reduced transaction activity does not represent a liquidity crisis, just a short-term period of market dislocation.
- Transaction activity is expected to accelerate, particularly in markets where there is agreement among forecasters that the outlook is positive.
- Tougher debt underwriting will increase the need for real estate equity and make it tougher to capitalize higher risk and/or specialized niche assets.

Finally, the current, but not uncommon, disconnect between capital availability and transaction activity provides opportunities not only for traditional, selective investing by property types and markets but also for creative outperformance via slicing of the capital stack as in CMBS, mezzanine financing, preferred or common stock, and REIT debt alternatives. ■



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