

Capital Market Volatility Creates Profit Opportunities

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As we move into full swing in 2001, the real estate capital markets continue to prove themselves as an efficient allocator of capital. Unlike the 1980s, when thousands of bad real estate projects were funded, and the early 1990s when many great real estate projects went begging for capital, the capital markets are doing a much better job of allocating capital to the most deserving projects. Markets or property types that begin to show supply excesses are shut down by the capital markets. New undersupplied niches, such as telecom hotels and many multifamily markets, are able to attract needed capital to meet demands.

Interestingly, this newfound market efficiency has led to greater capital volatility, with capital moving quickly to where the perceived need is the greatest. Additionally, there is often an overreaction to perceived negatives or positives, with capital quickly moving to—or out of—a sector. It is this volatility that makes it tough for investors planning exit strategies, but also provides opportunities for capital sources with the ability to move quickly and conduct the complex and sophisticated due diligence required to take advantage of these opportunities.

Increasingly in the future, the firms able to take advantage of capital and property market volatility will be those who master technology. However, technology adoption in the real estate industry is already behind most major industry segments in the economy, and

continues to face challenges. Senior real estate executives responsible for decision-making about technology adoption have appeared to reach the overload point. At a recent Pension Real Estate Association conference, when it was announced that there would be no sessions on technology, people applauded. A technology conference sponsored by the Urban Land Institute and The Mortgage Bankers Association was also recently cancelled.

However, rather than blame slow technology adoption on leadership apathy or overload, the answer is a bit more complicated. The dramatic decline and disappearance of many Internet firms has created concern with executives about adopting a technology solution or information resource that may not be around tomorrow. This reluctance has grown as the surviving Internet companies develop sophisticated solutions that go beyond extending existing systems to changing the way companies do business. Accordingly, these new and powerful real estate technologies and systems cannot be adopted easily, or in many cases, incrementally. Substantial changes in organizational structures, systems and people are required to implement the changes.

It is this fundamental change of an organization, and the people running it, that is creating the block to technology adoption. Given such difficult cultural and organizational issues to overcome, the many different options available to companies to change their operations, and a concern about making major

changes when new technologies and systems may be around the corner, it is no wonder change has been slow. Thus, a firm must ask what is the true strategic benefit of increasing its use of technology, after it understands what it truly needs to achieve to sustain a competitive advantage.

The rest of this article summarizes some of the key equity, debt, technology, and employment trends influencing the real estate business today.

EQUITY TRENDS

Pension funds and life insurance companies are in the process of rethinking their real estate investment portfolios. Interestingly, over the past decade, life insurance companies have reduced real estate as a percentage of investment assets from more than 20% to less than 10%. Pension funds, which often target their allocation for real estate around 10%, on average invest only 5% of their pension portfolios in real estate. For many smaller funds, real estate is often omitted.

Life insurance companies have changed their real estate investing due to risk-based capital requirements imposed by regulators. Direct equity investments, mortgages, and real estate securities each have different reserves required for losses. Direct investments and mortgages have become less attractive than securitized investments, such as commercial mortgage-backed securities and stock, leading to a decline in real estate investment. The result of these changes is that life insurance companies have shifted toward debt and securities, moving away from private real estate equity investment. However, they still invest significant real estate equity in their investment management operations that manage money for pension fund investors.

Pension funds have pulled back somewhat from REIT investments, which had gained popularity in the mid-1990s, and are now refocused on private real estate equity investment. Perhaps their biggest challenge will be finding capital to allocate to real estate given substantial declines in overall portfolio values due to stock market declines.¹

Fewer real estate transactions are expected in 2001, based on a survey of major investors by the Investment Property Report published by Institutional Real Estate, Inc. The consensus of the people surveyed at the end of the first quarter of 2001 is that buyers are reluctant to buy assets priced assuming fully leased rents, when rents are falling and the economy appears to be weakening. This reluctance by buyers, and the limited number of sellers

who are willing to sell at a reduced rate, has led to a wide "bid-ask" spread.

This disconnect between buyers and sellers has happened many times in the past, and typically last three to six months, with sellers becoming more realistic about the true value of their assets. However, bid-ask spreads vary widely by property type and geographic market, with property types with longer leases or accelerated rent increases in prior years maintaining the largest bid-ask spreads.

According to the CB Richard Ellis, high net worth individuals and syndicates led the buying scene in 2000, accounting for 44% of transactions last year. Life insurance companies and pension funds closed 25% of the deals; equity and opportunity funds closed 14% of the transactions; and REITs accounted for 11% of transactions.

Some sales activity should be generated from opportunity funds in 2001, which have raised substantial money in the past 3-4 years and invested in assets for short holding periods. With high IRR requirements, opportunity funds are caught in the bind of potentially selling properties at lower prices than they would like, or holding off on sales which can dramatically reduce IRRs.²

Tax-exempt investors maintained their allocations to REIT shares in 2000, despite some concerns about pension funds getting out of the market given the volatility of the REIT marketplace. REIT investment allocation appears now to be steady at about 15% of pension fund real estate portfolios.

The continued flow of institutional capital to the REIT marketplace will be an important boost to REIT shares. Another positive for the marketplace is the growth in the number of vehicles that are targeting REIT securities. A number of mutual funds were reportedly brought to market in 2000 that were planning to invest in a variety of REIT shares, as well as an Index Fund and a Hedge Fund. These vehicles are new but expected to be an important part of the future of the REIT marketplace.

Another key trend with REITs is their growing development focus. In an attempt to achieve greater returns and growth, REITs and real estate operating companies are reported to have a pipeline of approximately \$18 billion, according to Green Street Advisors. This represents approximately 20% of REIT market equity. How the strategy of increased development focus plays out in the marketplace is yet to be seen.³

The challenge real estate portfolio managers face in selecting an index to benchmark their REIT performance was the highlighted topic in a recent article in the PREA Quarterly. There is a proliferation of REIT indices includ-

ing the S&P Composite REIT Index, The Dow Jones REIT Index, The Cohen and Steers Realty Index, the NAREIT Index, the Morgan Stanley REIT Index, the Wilshire Real Estate Securities Index, and the Wilshire REIT Index.

Each of these indices is constructed slightly differently, with different property type weightings, company specific differences, and resulting differences in the returns they produce. The authors of the PREA Quarterly article choose to focus on four indices, the NAREIT Index, the Morgan Stanley Index, The Wilshire Real Estate Securities Index, and the Wilshire REIT Index. Of these four, three were designed to measure the same thing: the performance of equity REITs. The fourth, the Wilshire Real Estate Securities Index, includes a handful of major non-REIT real estate companies.

The authors conclude that the Wilshire indices were designed best to capture the performance of the traditional institutional definition of "real estate." Accordingly, for an index dominated by the performance of companies operating in the primary property types, the Wilshire Index was recommended by the authors. Both the NAREIT and Morgan Stanley indices include many emerging and specialty property types and the "finance company like" net lease companies. Clearly, depending on the specific objectives of the fund, managers need to carefully review the different strengths and weaknesses of each index for their specific purpose.⁴

Pension capital, after a brief rest from mid-summer 2000 to the start of 2001, has again refocused on real estate. Office buildings, particularly suburban office buildings, are not attracting much interest currently, with many funds having over-allocated this sector in recent years. However, expansion of pension funds into apartments, industrial properties even retail seems likely during the rest of 2001.

While suburban office buildings are not currently in high demand, some market observers suggest that there are attractive deals with cap rates at or above 10% that could provide strong opportunities going forward. From a slightly contrarian perspective, there are funds and firms focusing on land investment and technology-related real estate, trying to arbitrage on the substantial negative perception of those property types in the market today. Given the tremendous dominant role of technology, some investors are developing products to evaluate and invest in attractive opportunities in those markets.

Apartment properties appear to be the favorite assets for pension funds currently. The big issue for apartment deals is their availability. The availability of invest-

ment-grade apartments, particularly in older cities is very limited. According to the National Multi-Housing Council, for example, just 1.6 million of the estimated 15.8 million apartment units nationwide have been built since 1990. Apartments have also improved their performance in recent years. According to the National Council of Real Estate Investment Fiduciaries, returns for apartments have increased from 5.8% in 1990 to 11.4% today. These positive indicators were borne out in a year-end 2000 Investor Survey conducted by the Real Estate Research Corporation, where investors ranked apartments as the top investment choice for 2001, giving them a 7.3 on a scale of 10.⁵

While each investor's portfolio needs to be customized based on their own goals, objectives and investing philosophies, LaSalle Investment Management recommended the following changes for an income-oriented investor in 2001 based on their "model portfolio" analysis. They recommend a 4% overweighing of apartments and Central Business District office buildings and a continued underweighting of regional malls by 6%. They also recommend a slight increase of 2% for industrial properties and an underweighting of suburban office by 2%, hotels by 1% and retail open-air facilities properties by 1%.

Their recommendations for the U.S. public real estate securities market are to increase office/industrial investing by 5%, apartment investing by 3%, with all other classes underweighted by small margins, with retail again being the property class most significantly underweighted, by 5%.⁶

DEBT TRENDS

Soft landing or not, no widespread credit problems are foreseen based on research by John Hancock Real Estate Finance. Their "cautious optimism" is due primarily to expected modest inflows of capital into the commercial real estate markets. Capital reductions are due primarily to subdued investor expectations and growing regulatory oversight of real estate lending.

They see the outlook for the real estate credit markets as being positive for 2001, with the major risks coming from excessive pricing volatility and a potential real estate liquidity crunch. Debt pricing volatility is largely tied to the fact that CMBS and mortgage spreads have become increasingly linked to swap spreads, which have been volatile. Additionally, with many capital sources pulling in and out of the market based on changing market conditions, volatility is likely to be with us for some time.

Perhaps, the biggest concern for the debt markets is the possibility of a real estate liquidity crunch. The prospects

for a severe liquidity crunch are based on the corporate bond market. According to Moody's Investors Service, July 14, 2000 Credit Research Rating Action, the default rate on speculative grade corporate bonds is expected to rise to 8.4% by late 2001, the highest rate since the 1991 recession. This negative experience could make lenders tighten underwriting further, which when combined with tighter regulatory oversight of lending practices could create a liquidity crunch. It will be important during the coming year to watch the Federal Reserve and FDIC to see how they respond to a potential liquidity crunch.

John Hancock expects the origination volume to remain stable in 2001 with a volume of around \$300 billion a year, down from the nearly \$400 billion a year during the late 1990s. Declining construction, low near-term rollover financing demand, and tighter underwriting standards, are expected to keep origination volume down, while low interest rates and the general strength of most lending institutions are positives moving forward.⁷

Based on concerns in the economy and the FDIC's October 2000 warning report about markets at risk of oversupply, it is more difficult to find debt capital, particularly for new construction loans. The decline of the availability of debt, particularly construction debt, will have a number of implications. First, speculative construction should fall, a good thing given the current state of the markets. Low leverage or all cash buyers will be able to compete more favorably with leveraged buyers. Finally, developers and other investors will be looking for more equity and mezzanine debt to replace more traditional debt. In fact, given declines in interest rates, it is not the cost of debt that will be a problem in 2001, but the amount of property that can be financed.⁸

The market for mezzanine financings continues to have legs in the current debt environment. Given the substantial number of loans that were underwritten by investment banks and others, and then securitized into commercial mortgage-backed securities, there are many developers and investors that own properties subject to loans in a CMBS pool. One of the biggest problems for these borrowers is the inability to record a second deed of trust against these properties.

One of the keys to the mezzanine programs offered today is that they allow borrowers to use their partnership as collateral for new loans, thus getting around the issue of recording a second deed of trust on a piece of property. These mezzanine lenders offer programs with specific terms and conditions for payment that include upfront and outback points with an inter-

est only rate of return during the term.⁹

Real estate capital has become more scarce for the hotel industry, reducing construction levels. According to a study by Paine Webber, and statistics from F.W. Dodge and Lodging Econometrics, hotel construction starts are down up to 30%. However, while new construction is slowing, the country's largest 25 markets are still expected to see their inventory of new lodgings increase in the near term due to properties scheduled to come on line.

Longer term, the slowing of construction will be good for an industry that has rebounded substantially in recent years. While the industry's occupancy rates are expected to decline in the next few years, even with slowed construction, occupancy declines are expected to be minimal.

Tightening lending standards, as reported by the Federal Reserve's Fourth Quarter Survey of senior loan officers, and higher equity requirements are making debt capital more difficult to access. Perhaps more important than cost, is the amount of equity that is required to get a new construction deal started. According to some, equity requirements of 45% of cost are necessary to obtain a hotel construction loan today. As to the equity markets, private equity is most prevalent, as institutional money remains primarily on the sidelines.¹⁰

Financing over the Internet has grown over the last year, but even those with the biggest stake in the business indicate that companies that rely on online origination are unlikely to be successful. The biggest benefit that financing sources have seen is the use of the Internet to communicate information and parts of the origination process to those with whom they work.

None of the companies that are currently doing business on the net, including Express Financial Corp., which is expected to do \$400 million in loans in 2001, or MortgageRamp.com, is basing their success on online origination. Face to face meetings, newspaper and radio advertising, and traditional marketing techniques are combined with online systems to be successful.

Firms like MortgageRamp.com rely on more than their online services, with real estate appraisal resources nationwide as well as a contract underwriting platform. Firms like Capital Thinking, Inc. have phased out their direct online loan origination completely, focusing on a backend application server provider business called Blue Wire, servicing major clients such as J. P. Morgan Mortgage Capital and PNC Real Estate Finance.

Tools like Blue Wire are integrated into a company's own technology infrastructure to streamline and automate

the entire loan process, from the origination and quotation stage to packaging, data formatting, due diligence, closing, and securitization. Similarly, Seagull Technology's Real Estate Information Management Service offers a complete system for automating bids and management of all vendors including appraisers, engineers, environmental firms and others that can be adapted to a bank or insurance company's existing systems. They also offer a complete loan management system that is being used by Wells Fargo Bank and other companies.¹¹

The reorganization of major real estate finance companies continues. Banks, insurance companies, and mortgage companies have continued to reorganize their operations to incorporate higher risk, higher return products such as mezzanine financing, incorporate Internet financing and/or backend technology solutions into their business, and adjust their geographic or product type focus as markets change. An example of this is Prudential Mortgage Capital Company, which announced at a recent Mortgage Bankers Association meeting their plan to provide mortgage brokers and borrowers with a single source of service despite multiple loan needs.

Prudential is creating teams to carry out the full range of services from its major regional offices, creating product specialists and regional underwriting and closing teams. One managing director at Prudential articulated the change in this way "the old business model was like bringing borrowers to a food court where they would have to select what they think they need. The new approach is more like sitting down at a table and being provided with the right product." Prudential is also moving to incorporate mortgage servicing more closely into its overall new business plan.¹²

TECHNOLOGY TRENDS

According to a survey of leaders in real estate companies and corporate real estate departments, most real estate companies are still struggling to determine and manage the affect of the Internet on their business. Interestingly, only 21% felt that their employees understood the Internet's role in their business strategy. Most respondents, approximately 60%, felt that the Internet has not generated new competition to their business. Perhaps most interesting, a significant majority of respondents reported that less than 25% of their customers and suppliers were asking for electronic communications. Despite these findings, 75% indicated that they were willing to reengineer their business processes to take advantage of e-

business opportunities. Only 15% said they were not open to reengineering the way that they do business.

As to some of the technical issues of implementation, for those implementing systems, 30% indicated that they did not have security systems in place and less than half of the respondents stated that their organization had a plan to handle e-business interruption. Half the respondents indicated that they had not taken measures to protect intellectual property.¹³

Some of the key changes that have occurred during the last year in the commercial real estate Internet sector are the growth in the number of companies trying to serve the sector, the introduction of major technology companies into the space, and the growth of the large consortiums that are trying to shape the industry. Additionally, whereas previously the majority of websites were simple extensions of traditional real estate business models, today most major dot-coms are creating totally new business models with holistic solutions that combine both information and service.

The consortiums in the real estate technology sector essentially are partnerships among some of the largest companies in the industry to sponsor and, in most cases, take a piece of specific Internet companies. Sponsorship can take the form of capital investment and/or commitment to use a particular company's service.

Some of the key consortiums include Broadband Office, Octane, Project Constellation, and Office Technology. Broadband Office's goal is to enable its customers to plug into a broadband office wall jack and access a full range of communication/Internet services and e-business solutions. Octane was created primarily to invest and support procurement companies, such as Sitestuff, in which it is heavily invested. Project Constellation was set up more broadly to identify, invest in, and promote the widespread acceptance of real estate related Internet, e-commerce, and broadband enterprises for the entire real estate industry. The Office Technology consortium's two key initiatives include an online landlord procurement exchange and an online leasing exchange. With the dramatic decline in Nasdaq, the substantial profit goals of the consortiums have moderated, with a retargeted focus on their ability to control market share and impose order and standardization on the industry.¹⁴

While many dot-coms are closing their doors and technology firms in general are struggling, technology companies continue to be a driving force of our economy. J.P. Morgan in their recent outlook report took a strong stand that the Internet and the Internet-related businesses will continue to be an increasingly important part of our economy.

Interestingly, they indicate that one could view the recent increase in layoffs not as a sign of a shrinking industry, but instead of one that is undergoing what economist, Joseph Schumpeter called “creative destruction.” As firms with poor business plans die, capital and talent become available for firms with better ideas. Accordingly, new Internet companies continue to form and many of the survivors are developing more successful platforms to transform the operations and business models of their firms.

Many traditional “legacy” companies are utilizing their resources to propel their Internet subsidiaries to serve the market. One such example is First Commercial Corporation’s Liquidity.com. Liquidity.com helps registered users search loan pools for sales using various search criteria, such as property types, loan balance, interest rate, and geographical location. An array of analytic tools and search engines are expected to increase the efficiency of those seeking to buy and sell portfolios of commercial mortgages.¹⁵

HIRING AND COMPENSATION

Despite concerns with the technology industry and the economy overall, hiring in the commercial real estate industry is expected to remain substantial in the near future, according to a survey conducted by Ferguson Partners. Nearly 70% of commercial real estate CEOs said their hiring would increase either slightly or dramatically in the near future. Private developers and finance companies were expected to be the most aggressive employers. Acquisitions, development, asset management, and property management were the types of jobs that were expected to be most active in the near future. The Northeast and the West Coast were the regions with the most demand expected for new employees.¹⁶

In other compensation news, the CEOs of development companies earned on average \$264,900 based on a survey of 161 development firms with asset portfolios ranging in value from under \$10 million to \$500 million and over by the National Association of Industrial and Office Properties. Total compensation included base salaries of \$200,000 and incentives and benefits worth \$64,900. Salaries were highest for CEOs working in the Southeast, followed by those in the West Central Region, the Western U.S., North Central, and Northeast states.¹⁷

CONCLUSION

The real estate capital markets continue to play a critical role in managing a real estate portfolio or business. More so than in the past, businesses and investors must critically evaluate capital markets to accurately gauge exit strategies and measure business opportunity. Market timing as a strategy is here to stay, and the capital markets are key to market timing. Firms that diligently work through the technology maze and make intelligent investments will prevail.

ENDNOTES

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