Real estate industry undergoing massive changes

Samuel Zell

Samuel Zell is founder and Chairman of the Board of Chicago-based Equity Group Investments, Inc., an entrepreneurial real estate investment firm. His co-investments with institutional investors have raised over $2.5 billion in funds currently invested in diversified portfolios. He also serves as Chairman of the Board of Trustees for Equity Residential Properties, the largest apartment real estate investment trust in the United States; and Equity Office Properties Trust, the largest office portfolio of any publicly traded full-service office company in the U.S.

Speaking on U.S. and global real estate markets, Samuel Zell said that "liquidity and liquid real estate" are the buzzwords heard all over the world.

Direct investment -- a pension fund buys a building, owns and manages the building, then sells the building - is taking a back seat to indirect investment - stock in a Real Estate Investment Trust (REIT). Said Zell: "The number one issue on everyone's lips is conversion liquidity; how do we go from direct to indirect?"

The real estate industry, which represents 10 to 12 percent of the U.S. GNP, is undergoing "massive changes that will alter many things, including values. In order to understand the extraordinary forces behind these changes, "we must go back to 1960."

Good news, bad news

In 1960 Congress passed a law called the Real Estate Investment Trust, commonly known as REITs, which are public vehicles for real estate that allow people to buy and sell stock and thereby own pieces of property all over the country.

A REIT exempts dividend income from double taxation. Generally, investment profit is taxed at both the corporate and individual levels. In effect, this entity could pass through its cash flow to its owners, provided it paid out 95 percent of its income.

The creation of this vehicle was good news, said Zell. "The bad news was that Congress really didn't understand the U.S. commercial real estate market." The new REITs failed to attract the talent that existed in the real estate industry. Instead, they were run by people from other industries, such as insurance or banking.

The six to ten REITs that were created due to Congress' actions were economic failures "in terms that they never did anything," said Zell.

"Ultimately, these entities traded very similarly to the way closed-end funds trade today -- at a discount to net asset value."

Meanwhile, in the rest of the real estate industry it was business as usual. Private developers could finance anywhere from 105 percent to 110 percent of cost. "The first thing you figured out was you don't need a partner," said Zell "And the second thing you figured out was the last thing you need is to deal with the public."

On this basis, there were no incentives for the people who would normally be players in REITs to participate, and, in fact, they did not.
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From riches to rags

In 1969, a banker at Union Bank in California came up with the idea of using the REIT vehicle to create an entity that makes short-term real estate loans. He went public, then sold to Continental Bank, and it became the Continental Illinois National Bank Real Estate Investment Trust, a scenario followed by the hordes on Wall Street. This idea became a $21 billion industry in 36 months.

As the amount of money that Wall Street could raise increased, and the number of REIT vehicles increased, competition increased. And the risks taken skyrocketed. It took just another 36 months for the $21 billion industry to be reduced to $10 billion. The problem: a massive amount of liquidity that led to an oversupply and devaluation of properties.

"Those who invested in REITs got badly screwed, particularly when the REITs went broke," said Zell, adding that real estate got a bad name on Wall Street.

Counting on inflation

In 1980, having come out of a real estate depression or recession, everybody in the world simultaneously decided that real estate was the place to be. Pension funds raised their real estate allocations from 1 percent to 5 percent. Wall Street was selling assets rather than stocks.

"We leveled two mountains in Italy to have enough marble for the floors and walls across the country. And everybody accepted that inflation would work."

From 1945 until 1980, people invested in real estate, counting on inflation to bail them out. "In the 1980s we had $100 billion per year going into the commercial real estate market," said Zell.

"First you made the smart decision to buy the real estate, then you restructured the deal to create a massive amount of fixed rate, long-term, below market debt. By investing in a 6 percent interest environment, then having the environment move to 9 percent, unit values increased by one third. Our $4 billion investment increased in value to $5.5 billion."

Today, there is a bigger risk of deflation than inflation. "Part of the difficulty around the world is that people have to learn how to make money without inflation," said Zell.

Industry busted

Zell noted that in the first years of 1980 buildings were built because there were tenants; in the second five years of the '80s, buildings were built because there were buyers for those buildings. "We ended up with a massive oversupply of commercial real estate. It basically busted the industry and busted the private market and destroyed the definition of value."

Zell added, "If you don't know what something is worth, you won't buy it."

Bank examiners, in their efforts to recoup some of the money on bad loans, "literally changed the definition of collateral from something sold in an orderly fashion to fire sale proceeds." So in 1990 and 1991, the commercial real estate industry "was on its knees, in gridlock; liquidity equals value and without liquidity, there is no value."
In 1991, Milton Cooper of Chemco, in conjunction with Merrill Lynch, took his strip shopping center company public as a Real Estate Investment Trust -- the first "new REIT." It had 25 percent debt, an unheard of low level of debt for the real estate industry, and paid something like 8 1/2 percent dividend. At the time, the federal fund rates were 3 percent. Federal fund rates are the interest rates charged for funds borrowed among the commercial banks.

The success of Cooper's Chemco helped attract more money from the capital markets to commercial real estate and increased the growth of real estate investment trusts.

From that beginning in 1991 real estate equity has increased from about $3 billion or $4 billion dollars to $120 billion. "The majority of the $120 billion went to banks to reduce debt levels to a point where a company could function," said Zell.

REITs begat REITS: strip shopping center REITs, apartment REITs, mall REITs, storage company REITs, hotel REITs, office REITs.

The proliferation of these vehicles was not due to the creation of new companies, said Zell, "but to the conversion of privately owned companies to publicly owned companies." There are now close to 150 to 200 REITs, 75 percent of which were created in the last four or five years. "We're certainly going to see a dramatic reduction in the number of these vehicles out there."

"Liquid real estate"

"When you look at the market, what you see for the first time in history is 'liquid real estate,'" said Zell. "But in order to have liquidity, you have to get to scale of operation quickly. An apartment complex that is part of an efficiently operated, integrated network can operate for materially less than a stand-alone unit. Economy of scale results in huge cost savings.

"We went from 16,000 apartment units in September of 1993 to about 140,000 apartments today; from 800 million total market capitalization to 7 billion total market cap today. The total market cap equals the number of shares outstanding times the price. Public markets provide transparency, said Zell. "The more money involved, the more interest there is."

Billions of dollars of securities are traded based on information. With the growth of the commercial real estate industry has come sophistication. It has evolved from an industry that rarely shared information to one where information is readily available on the Internet.

"Today nobody is asking us how many new buildings we are going to build. They want to know about margins, why margins are better or worse, and what is the plan. We've taken a rogue business and disciplined it, not of its choice. And like any industry or any scenario, there's an enormous amount of resistance to change, sometimes due to emotion, mostly due to economics and destabilization."

Endangered species

Zell predicted that the construction crane will continue to be an endangered species, "even though between now and the year 2000, the $120 billion of market equity will more than double."
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The cost of construction is not justified by the rents, he said. "It will take a long time, well beyond the point at which the numerical indices would suggest, before the supply-demand equilibrium will be restored."

Most real estate markets in the world did not escape the pain and suffering the United States' real estate market endured; many are experiencing it now. As the world markets recover, "they will be looking for a new paradigm, a new understanding of how this business will function in the future."

Zell believes there are investment opportunities, both domestically and internationally. On Nov. 1, 1997, Mexico will introduce a REIT law. Argentina and Turkey have REIT laws, and other countries are studying U.S. REIT laws.

"I think commercial real estate in the United States is in a sweet spot. I think in the next 10 years we're going to have relatively little dislocation, relatively little loss of discipline, and I think real estate will, as a business, outperform most of its asset classes."

Global strategies

In the global markets, "our goal is to create a multiple of New York Stock Exchange companies that represents liquid real estate in different parts of the world," said Samuel Zell. The focus is on income production as opposed to brick and mortar production. Zell expects that the capital side of the business will have extraordinary growth.

Japan

In Japan Zell's company has been buying apartments that are leased to ex-patriots and guaranteed by their parent corporations, thus sidestepping Japan's landlord/tenant law. This is an attractive place to invest for the purpose of generating yen income.

Eastern Europe former Soviet Union

Partnerships with key players are the object in this area. "We're just about to open the first McDonald's in Tblisi, to be followed by three or four more. McDonald's will build them and lease them to us on no minimum, 100 percent gross, 7 percent revenue." Baku, the capital of Azerbaijan, is the site of office buildings and a hotel and casino, which Zell is building with his joint venture partners. "We think that the city of Baku has enormous prospects, and we intend to play there."

Central Europe

"We're making investments in net leased assets in Central Europe, Poland, Czechoslovakia," said Zell. "We believe that 20 years from now, Central Europe will be economically more powerful than Western Europe." Germany has the lowest percentage of home ownership anywhere in Europe. "There's an apartment market in Germany that, pro rata to its size, is even bigger than the apartment market in the U.S."

Argentina, Brazil

"We're laying bricks and mortar for future investments, but the goal in each case is to focus on the generation of income, not the generation of events."