

## **YOU'RE THE TOP**

### **A FEW THOUGHTS ABOUT TOPS, CHARLES B. WARREN**

There is little question that after a very long winter, real estate is springing back to life. There is some question, however as to whether what we are seeing today is spring, or maybe late summer. First I am going to mention a few indicators that lead me to believe that we are, perhaps, in July. Then I'll talk a bit about the role and structure of real estate that lead to its cyclic nature. Hotel development. Hotel development is a top of the cycle phenomenon. It takes time to develop a hotel, and until it is clear that such a hotel will be profitable, nobody wants to get involved. Unfortunately, by the time that profitability is provable it is usually late in the greater business cycle. And, of course, as is usual with real estate, ten developers are likely to build to satisfy the demand for six hotels. Speculative office development is another similar case. At least with offices the development curve is a little less steep and the evaluation time is a little less lengthy so that the early buildings may actually make money for a while. The arrival of office condominium development, though, is an almost infallible indication that the dance is nearly over. All of this is supply side. On the demand side, at least at this stage, there must also be a buyer. Fairly shortly that buyer will be thought of as the "greater fool", as in, "I was a fool to build/buy this thing, and only a greater fool would take it off my hands at a higher price."

### **THOUGHTS ABOUT CYCLES**

It has become fashionable to assert that the business cycle is dead. That assertion itself, in common with the booming art market, is a cyclical phenomenon. There are definitely some management advances that serve to moderate the business cycle. Superior inventory control through just in time manufacturing and production responsive to sales come to mind. An argument can be made that Moore's Law is an answer to the Marxian dilemma of capitalism. According to Marx, war was a necessity of the capitalist system to rid it of gluts and to produce profits. A corollary of Moore's Law, however, is that information systems join the ash heap of history in a matter of months. So war is no longer necessary to siphon off excess production. This effect, however, might just be a function of Dilbert style management which has no understanding of the function of information systems. A friend of mine adds that Marx really just underestimated the power of advertising. Perhaps information systems replacement will ultimately be seen as cyclical, like autos in the consumer sector. Would any of this matter to real estate, though? Real estate is a Marxian sort of good, utilitarian and long-lived. And the real estate industry, at least today, bears more resemblance to the capitalism of Henry Ford than that of Bill Gates.

### **FOR THAT MATTER HOW CAN WE TALK ABOUT REAL ESTATE AS ONE THING...**

Rather, let's think about a few divisions of real estate. The vast bulk of real estate investment is in user-occupied structures. The obvious example is single family residences. Another example is corporate owned industrial, factories and warehouses. One statistic claims that about 75% of non-residential real estate is in that category. So investment property, office buildings, shopping centers and large apartment

houses are a small fraction of the total stock of real estate. But it is the tip of the iceberg that is visible. A sneaky part, just below the surface, is the hybrid sort of property. Hotels are an example. They have large elements of a business, and their assets may include a large proportion of personal property and intangibles. Senior citizen housing is another hybrid. Yet another possible hybrid is the build-to-suit leased corporate facility. By using a lease instead of a bond the corporation creates a real property investment rather than a Wall Street Instrument. The corporation may pay some premium over its bond rate, but clears the asset off the balance sheet, gets out of the real estate business, and incidentally hopes to price the reversionary value advantageously in the sale. At the very least, unlike a bond, the company finishes its lease term with little or no final payment. It is not clear that companies have been very astute about facility development and management when measured by the bottom line. But the problem is not trivial, and it is not clear that the real estate community has a much better track record in these hybrids. Think of hotels again, or mental hospitals. Wall Street may be having an even more difficult time. Starwood Lodging comes to mind.

## REAL ESTATE CYCLES

The different segments march to different drummers, of course. Can anyone doubt that US exporters have benefited over the last decade from a dollar priced below purchasing power parity in relation to their European competitors. Do you not think that Boeing loves it and Airbus hates it? Conversely, is it not clear that to the extent that the US exports to Asia, or competes with Asian industries, the collapse of Asian currencies will put a big dent in profits? Now, do you not think that might have something to do with the construction of manufacturing and warehouse facilities in a year or so? That's the easy one. The more difficult is the rate of technological obsolescence. While I had some fun with the obsolescence of information systems above, there is no doubt that obsolescence affects most manufacturing processes, and, in the real estate sense of things, rapidly. How many processes and process oriented facilities can you think of that retain full functionality after twenty years. Would you like to e-mail me some suggestions (cbw@apo.com)? So, if the Rust Belt went through a replacement cycle in the 1980's, it will probably be due for another, absent any other cause, early in the next century. If that cycle can be funded out of profits, everybody will be happy. If not, then we will hear a tale of cyclic woe.

Residential property responds to the business cycle as it affects family income. If family income in gross rises then prices will also rise because they are, in gross, set by the criteria of the lenders who advance 80% of the purchase prices. Certainly there may be lags, and the correspondence over the short term or small geographic area may not be perfect, but over the long term family income and lending criteria drive house prices. If unemployment is down and wages up, rising house prices are

not news. By the same token, restrictive lending practices which often are contemporary with falling incomes and rising unemployment exacerbate the decline of house prices. Decline, you ask? When have house prices declined? Answer, look to Southern California 1991 to 1996. And the decline seen there was probably numerically less severe than the actual distress, when you consider that it was concurrent with a phenomenal increase in foreclosures. Foreclosures are one sign of an inability of a market to clear, at least at the price level of the underlying indebtedness.

Investment properties respond to criteria that are pretty well discussed and understood: vacancy, rents, and net income. For office properties vacancy has something to do with the supply side. In the last several years very little new product has been put on the ground as we worked through the excesses of the Savings and Loan debacle, and the impact of the 1986 Tax Act. Supply could be regarded as fixed. Only build-to-suit, like Federal Reserve or General Services Administration Buildings were constructed. That can no longer be assumed. From now on in the cycle a supply analysis that omits the pipeline will lead to grief. The demand side is similar to corporate facilities. When times are lean, people talk about how little space people need, hotelling office space, and telecommuting. As profitability improves, keep your eye on the office space per worker number, want to bet it won't rise? Apartment properties are also an income and expense analysis, but the income in this case is constrained by wages, similar to houses. Absent doubling or tripling up, a good topic for TV sitcoms, there is no way to increase rents above the trend line for wages. Do you really think that you can change the proportion of income allocated to rent simply because you want to increase the reported quarterly income? At the moment some rent increases have been possible, but that is similar to the office buildings which have also seen an increase of income as vacancy falls. With the arrival of new construction the equilibrium will be restored in both cases.

Hybrid property, hotels, senior housing, and the like, are yet another cycle. That, in general, can be called a cycle of capital availability, or the availability of greater fools. Senior housing is always sold on the theme of the population curve, how many people will be so old, if not now, then in the near future. With the exception of a few developers, however, who are particularly well attuned to their market, most such projects are sold better to planning authorities and prospective investors than they are to prospective residents. Face it, most older people like where they are and will either be dragged out kicking and screaming or feet first.

## **THE REAL ESTATE CYCLE AS AN INVENTORY CYCLE**

The real estate cycle, to the extent that it can be generalized, most often resembles a classic inventory cycle. That is to say that the feedback mechanism is a glut, failure of the weaker manufacturers, retrenchment of the rest, and an eventual clearance of the market. It is not surprising that this should be so. Virtually none of the mechanisms which have tended to mitigate inventory cycles in manufacturing exist in real estate. Information is much less comprehensive and timely. Reaction times are necessarily slower as the units are large, costly, and time consuming to produce. Ship building might be a possible analogy, and tends also to have cycles of glut and scarcity. At the

moment the world is awash with ships, built to respond to the need of a few years ago. It is possible that in a generation information will be more readily available, but this time around we aren't that much better off than last. Of course the length of real estate cycles, on the order of a decade, makes for a low learning curve. An argument can be made that cycles will persist simply because of the ignorance of the actors, a sort of western capitalistic enactment of the Hindu Wheel of Life.

Another cyclical factor is the availability of debt. This cycle, why should a bank have loaned money on real estate five years ago when they could milk the short - long spread on virtually risk free investments?

Now that is less possible. Last time around it was the attempt to pump up the bottom line with points to stave off the consequences of an inverted yield curve that led to the most disastrous decisions. Keating defended himself by saying he was just doing what Congress had asked the S&L's to do in 1980, and to some extent he spoke truth. So, in any case, we are at a point in the cycle where lenders may be tempted by yield while underestimating the risk which they are buying. There is no doubt that the banks are back in the market. And while sloppy underwriting probably formed only part of the problem, there was a disaster in small residential loans in Southern California in the first half of the decade the likes of which have not been seen since the mid-1960's. The decline of home values played a large part, but if loans of up to 125% of equity are now readily available, can underwriting not be said to have a part? I won't moan about the termination of appraisal as a risk management tool. Appraisal was a casualty of a short term perspective to long term assets. And its demise was a cooperative effort of some appraisers struggling to stay dry as the ship was sinking as much as the lender-clients pulling its plug. In its present debased form appraisal would be of small service in averting the greater losses to come.

But the buyer is really at the sharp end of demand. There is an interesting article in *The Journal Of Real Estate Portfolio Management*\* which outlined some of the problems institutional investors had in the last cycle discovering, let alone evaluating, that they had problems with their real estate. A portion of the problem appears that the math didn't give answers as quickly or unambiguously as in a portfolio of publicly traded debt securities, and the managers basically have taken a few years to figure that out. You only get a few chances to learn in the length of a career, and the institutional memory is non-existent. Greenspan spoke a year or so ago of irrational exuberance on Wall Street. The market hiccupped and moved higher. Now, although dividends are low P/E's are high, and profit prospects are even more dubious, nobody wants to yell fire in this theater. We aren't quite to the breath holding stage in real estate, we maybe haven't even started to party hearty.

There are some who like conspiracy theories. I dislike them because they assume super-intelligence and synoptic information. Greed and ignorance are usually sufficient to account for real estate mistakes. In fact there is an argument that there is no such thing as a mistake. It's merely a book keeping question as to who gets stuck with the tab at the end of the day. Perhaps some of the prosperity of the Reagan years was due to a few trillion dollars flowing through the S&L's to carpenters, masons, roofers, electricians, developers, architects, loan officers, tellers, even appraisers. And finally the taxpayer ponied up five or ten percent of it to settle the accounts. Who cares? The Social Security trust fund probably ended up with the tab. So let's survey some past patsies. First there were an awful lot of limited partners prior to 1986 who were bit on every cycle,

but again, Uncle Sam payed for a lot of that, and the general partners mostly weren't complaining. In the late '60's sloppy and fraudulent underwriting led to our last small loan S&L crisis. Most of the failures were merged out at little cost. In the 1970's REIT's bit the dust. They led the way to overbuilt markets and stumbled in the energy crisis recession of 1973-4. Through the gyrations of the late 1970's people fled from money to real estate as a response to inflation. It was episodically hard to sell property, but it was even more difficult to lose money. The stage was set for the 1980's. In 1979 a friend of mine was at a meeting where it was decided to build the Embarcadero Center in San Francisco. While maintaining that everybody present was too smart to repeat the mistakes of the mid-1970's he related the story of the meeting. It seems that a feasibility/marketing study had been commissioned. The experts appropriately reported that if anyone proposed adding that much office space to downtown San Francisco, the results were not predictable. The quantity was just too large in relation to historic absorption and the existing stock. The meeting chair concluded by looking around the table and saying that if the outcome couldn't

be predicted, then they ought to go ahead. After all, they were in the development business. A later and far less successful development decision was subsequently reported as a discussion between two of that developer's executives as to which bank they should steal \$100 million from. I suppose that might be another indication of a market top. We all know that the 1980's was a cycle fueled by S&L money that was wounded by the 1986 Tax Act and killed by the Gulf War. But, beside the taxpayer, who got stuck. Well, the institutional portfolio folks are still complaining how they never got to their theoretic optimum real estate ratio because of falling prices. The Japanese are generally pretty stoic. Their system does not encourage complaining. At this point, though, it seems less a question about their wise long term perspective than a question about holding their breath and hoping that they can hold it long enough to come out alright at the end. The recent crises in other Asian countries may have some influence on that.

So what about this time around? Is it the REIT's turn to buy dinner? I think it boils down to two questions. First, is there any more cheap property to buy? Well, if the Japanese bail out, maybe. Second, to what extent will they be able to tap Wall Street? If the stock market goes through a major correction, will an REIT with a dividend yield of 4% look good? Maybe not. And after a correction, there is a lesser likelihood of the Street buying the idea that REIT's are growth stocks. If at the end of this year the Dow is in the 9,000 to 10,000 range, however, that yield might look pretty good. And that story might sound sort of plausible, especially if there have been some earnings disappointments in other sectors. It isn't that hard to buy earnings. And it has been a long time since National Student Marketing demonstrated the limits of the technique. There is no reason to suppose that REIT's won't take the opportunity if the Street gives it to them, and no reason to believe that the Street will discern the problems in time to bail out\*.

So, fellow grasshoppers, the sun is on the leaf. Sing and be merry. It's a great time to build, write leases and sell. But if you want to hedge your bets, you might put in a lowball offer on a mega-building in Kuala Lumpur.

\*Agency Costs and Inefficiency in Commercial Real Estate, Graff and Webb, p.19-, The Journal Of Real Estate Portfolio Management, Vol.3 No.1 1997

[Recent topics of interest](#)

[Request for proposal](#)

[Home](#)