



NEW ENGLAND REAL ESTATE JOURNAL

Friday, July 27, 2001

THE LARGEST BUSINESS PUBLICATION OF ITS KIND IN THE NATION

By Dan Mee, Tremont Realty Capital

The maturing of the real estate industry produces rapid responses to market changes

In the not to distant past, the real estate industry was considered by most as one of the last inefficient frontiers: an investment class where with a little luck and perhaps a lot of "inside scoop" one could do quite well. Unfortunately, the converse of this axiom was also true, and the massive losses this sector suffered in the late 1980's and early 1990s proved that imperfect market information could lead to disaster.



The well-documented facts are that real estate markets entered the late 1980s recession burdened with significant over supply. This supply problem was caused mainly by inappropriate tax laws and undisciplined borrowers and lenders.

The tax laws pre 1986 encouraged real estate development solely for tax shelter vs. economic rational. This drove unprecedented levels of equity into development. Meanwhile lenders, primarily banks and S&Ls with little effective regulation, and flush with money

to lend from recent IPOs, essentially "threw money" at developers. The overbuilding and declining demand of the recession caused many projects to fail. This led the lenders to foreclose; catching caught the eye of the bank regulators, which in turn forced the banking industry to tighten credit standards. With tight credit, the real estate deals not initially in trouble, soon experienced defaults as the absence of liquidity in the credit markets precluded their ability to refinance. This reality had the insidious effect of spiraling the industry into still further recession.

Dramatic structural changes have occurred over the last ten years that have had a maturing effect on this asset class:

- Technological advances.
- Public equity ownership expansion.
- Public debt investment expansion.
- Segmentation of real estate capital markets.

The technological advances have served to disseminate industry data that heretofore was often closely held or simply cumbersome to assemble and evaluate. The automation of county registries of deeds,

as well as market intelligence on construction, leasing, and lending is now tracked, and made available for most markets and across property types.

A decade ago much of the country's real estate was owned by private families or life companies with no disclosure requirements. The result was a lot of "guess work" on what was going on in the market. Often these owners would not want to reveal "problems" for either competitive or denial reasons. The effect however was for the industry to continue to overdevelop six to eighteen months into a recession. This made the recession more severe and gave the real estate industry a boom / bust reputation. Public ownership of real estate in the form of REITs has grown from \$10 billion in 1990 to over \$130 billion today. This fact alone has caused dramatic improvement in information flow as REITs fulfill their quarterly reporting requirements.

Public investment in real estate debt primarily through the CMBS market has overlaid a disciplined, uniform underwriting that is so pervasive, most non CMBS lenders follow the guidelines if for no other reason than to broaden their level. These lenders now are

more realistic about their risk-reward tolerance, which has resulted in their leverage levels being capped at 65%-75% of cost. This has created an opportunity in the market to provide the gap financing, be it in the form of mezzanine debt or preferred equity at a more accurately priced yield for the level of risk underwritten. This appears to be very healthy for the capital markets, because investors and lenders can target their level of risk and be compensated appropriately. This also has the effect of lower capital costs for real estate sponsors.

The result of all of this change has made the real estate industry behave more rationally and perform similar to other industry cycles. The positive effect of this maturing is reduced overbuilding and more rapid responses to market changes. All of this should work to soften and shorten future real estate recessions. To that point, most informed observers of the current market conditions do not see over supply. Rather, the present real estate slowdown is more of a demand shock, which should be relatively short in duration.

Dan Mee is executive director, Tremont Realty Capital, Boston.