



# REAL ESTATE LAW & INDUSTRY



## REPORT

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### INVESTMENT IN REITS

## The Bull Market in Commercial Real Estate Has Begun . . . With a Vengeance

By BRAD CASE

**M**arkets move fast. It seemed as though nothing could have been more awful for real estate investors than the fourth quarter of 2008. Property returns declined by 8.3 percent on an appraised-value basis. Core funds lost 11 percent. Value-added funds lost 17 percent. Opportunistic funds lost 28 percent. National Council of Real Estate Investment Fiduciaries (NCREIF) members recorded just 39 property transactions. Publicly traded REITs raised just \$1 billion dollars in new capital—the lowest total ever, relative to market cap—signalling that neither REIT managers nor potential investors thought much of investment opportunities in the commercial real estate industry.

Even that torpor was nothing compared to the first months of 2009. While property returns continued to fall, transaction volume shriveled even more, with NCREIF members recording just 19 transactions nationwide. Through mid-March, publicly traded equity REITs raised just \$500 million in new capital. David Geltner, the Massachusetts Institute of Technology professor behind the Transaction-Based Index and the Moody's/REAL Commercial Property Price Index, exclaimed that “we have reached levels of illiquidity in the commercial

property market that I would never have imagined possible in the 21<sup>st</sup> century.”

By mid-March, though, attentive investors had noticed that conditions were already starting to change—and things happen quickly when conditions change. REIT stock prices hit bottom on March 6, and by March 18 had already risen 25 percent. The next day, Alexandria Real Estate Equities raised \$308 million. One day later, Simon Property Group raised \$1.2 billion—more than the entire industry had raised during the fourth quarter of 2008. Since then, as of May 15, other REITs have raised an additional \$12.1 billion and REIT stocks have moved up 46 percent from their low.

The signal sent by that pace of capital raising is hard to ignore: investors believe that conditions are in place for extraordinary returns in real estate—just not on the private side, where swaps trading continues to indicate that sophisticated investors believe property values still have a decline of more than 35 percent coming.

I've said before that the current real estate market bears striking similarities to the market in the early 1990s, when property values had just started a decline that lasted two-and-a-half years—and from which direct property investors didn't recover for more than five years. Meanwhile, publicly traded REITs had already completed their downturn and had started a bull market that lasted more than seven years with returns averaging nearly 21 percent per year.

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**REITs Recapitalizing.** The current pace of recapitalization adds to the resemblance. REIT security issuance during 2009Q2 has been about 6.5 percent of REIT market capitalization. During the last market cycle, REIT recapitalization first hit such a pace at the beginning of 1992. In that year REIT investments returned 14.6 percent; at the same time, privately held core properties returned -4.3 percent, core funds -5.5 percent, value-added funds -11.2 percent, and opportunistic funds -11.8 percent. Longer-term returns were equally one-sided: over the five years 1991-1995 publicly traded REITs returned an average of 17.1 percent per year while private real estate averaged 4.1 percent, core funds 3.8 percent, value-added funds 3.9 percent, and opportunistic funds 6.5 percent.

The parallel is reinforced by the fact that most of this year's capital has been on the equity side. Equity raised during the first half of 2009Q2 has equalled about 5.5 percent of REIT market capitalization. During the last market cycle the REIT industry hit that milestone in 1992Q4, and again the ensuing years were strong for real estate investors in the public markets. One-year returns starting in 1992Q4 were 34.1 percent for publicly traded REITs compared to -1.2 percent for private core properties, -1.5 percent for core funds, -7.2 percent for value-added funds, and -15.3 percent for opportunistic funds. Even on a five-year basis, as the private markets recovered, publicly traded REITs still outcompeted private investment managers: over the five years 1992Q4-1996Q4 returns averaged 18.8 percent per year on the public side compared to just 6.2 percent for private core properties, 6.8 percent for core funds, 7.6 percent for value-added funds, and 10.2 percent for opportunistic funds.

That kind of vision for the future explains why the REIT security offerings were greeted so enthusiastically: investors believe that there are, indeed, extraordinary returns to be made.

**The Other Side of Paradise.** Not all investors, though, are positioned to take advantage of the opportunity. On May 15 the *Wall Street Journal* reported that Goldman Sachs's Whitehall 2007 fund—which has already written off more than half of its \$3.7 billion in invested capital—has issued a call for another \$1 billion in committed capital. This capital infusion, though, isn't intended to take advantage of extraordinary investment opportunities, nor are investors misreading it that way: Goldman's hope is simply that the new infusion will enable it eventually to recover perhaps 71 percent of investors' invested capital. That means the best-case scenario is for investors to endure losses of "only" about 4 percent per year for the life of the fund.

At least one Goldman employee didn't seem to share the fund's optimism: according to the article, the employee chose an immediate 64 percent loss over his or her estimate of the fund's eventual payout. And fund investors are "upset," according to the *Journal*, that they weren't given a chance to achieve the same 64 percent loss.

So, what separates the winners—those investors positioned to take advantage of the opportunities in real estate—from the losers? Liquidity. For investment managers (public or private) that means, first and most simply, having the ability to tap capital markets quickly and efficiently in response to investment opportunities. And, with favorable capital costs having swung dramatically from the debt to the equity side of the market in the last year, it means having efficient access to *both* kinds of capital.

But in a market where investors continue to be worried about their own liquidity, it won't be enough to raise capital under the promise that investors will see their returns eventually. Successful investment managers will have to be able to ensure their prospective investors' liquidity, too: they have to offer an exit strategy.

**REITs Offer Exit Strategy.** In a nutshell, the need for an exit strategy is what separated publicly traded REITs from the private side of the market—direct property, core funds, value-added funds, and opportunistic funds—during the early 1990s, and what's likely to separate them again in the current market. That's because of the idea that I started with: markets move fast. Conditions change. And when conditions are changing, the successful investors are the ones who are able to respond by redeploying capital.

Fundamentally, what separates the publicly traded REIT industry in a time of rapidly changing markets is the fact that it's a publicly traded REIT industry. There exists no capital market mechanism in the world as efficient as the New York Stock Exchange for raising capital when market conditions are right, while ensuring that investors can redeploy their capital as conditions change. That means investors won't be contractually obligated to respond to a capital call designed optimistically to recover 71 cents on the dollar a decade later, when conditions just aren't right for highly leveraged, illiquid real estate investment through non-transparent investment managers whose interests are poorly aligned with those of their clients. Instead, public-market investors can redeploy that billion dollars into a publicly traded REIT market that has risen 46 percent in 10 weeks.

For real estate investors on the public side, the flood of capital suggests that the bull market has, indeed, begun.