MODERN SARDINE MANAGEMENT

Mr. A had a can of sardines. He sold them to Mr. B for $1. Mr. B sold them to Mr. C for $2. Mr. C sold them to Mr. D for $3. Mr. D opened them and found they were rotten. He complained to Mr. C that he wanted his money back. Mr. C said "No, you don't understand. There are eating sardines and trading sardines. Those were trading sardines."

by Samuel Zell

Premise: The current oversupply of real estate is different from past cyclical excesses. The present situation is a result of commoditization of real estate. Real estate investment rather than being the result of in-depth understanding of the dynamics of the industry, has become the in-depth focus on the numbers. This numerical orientation has replaced discipline and understanding. The results of this misdirection will be one of the biggest losses of capital in the country's history.

Real estate represents a unique investment in a non-fungible asset. The unique characteristics are induplicable. Modern valuation techniques applicable to industrial analysis are being applied to brick and mortar. Focused analytical approach emphasizes broad numerical assumptions that presume real estate to be a national market.

Real estate investment decisions do not lend themselves to macroeconomic issues. Real estate is a local market, by definition. It is not possible to focus on national trends; one must focus on local issues and characteristics. Internal rates of return and other mathematical formulas for real estate projections attempt to legitimize the presumption of predictable results.

Twenty years ago the real estate investor was taught that the three most important lessons of real estate were "location, location, location". Today this axiom is replaced by internal rates of return, price per unit or square foot and projections of future inflation rates. Although these new factors are relevant, they also indicate we have lost sight of the basic characteristics that drive and determine the value of real estate. The current love affair with projections has substituted modern analytical techniques for the basic understanding of the business.

Real estate, as an investment vehicle, historically has been driven by cash flow. Its role in an investment portfolio was stability, low risk, tax benefits and inflation protection. The high inflationary period from 1977 to 1981 distorted this perception. The proliferation of real estate syndicators, REITS, pension funds and financial institutions, viewing real estate as growth stock, unrealistically raised performance expectations. Without

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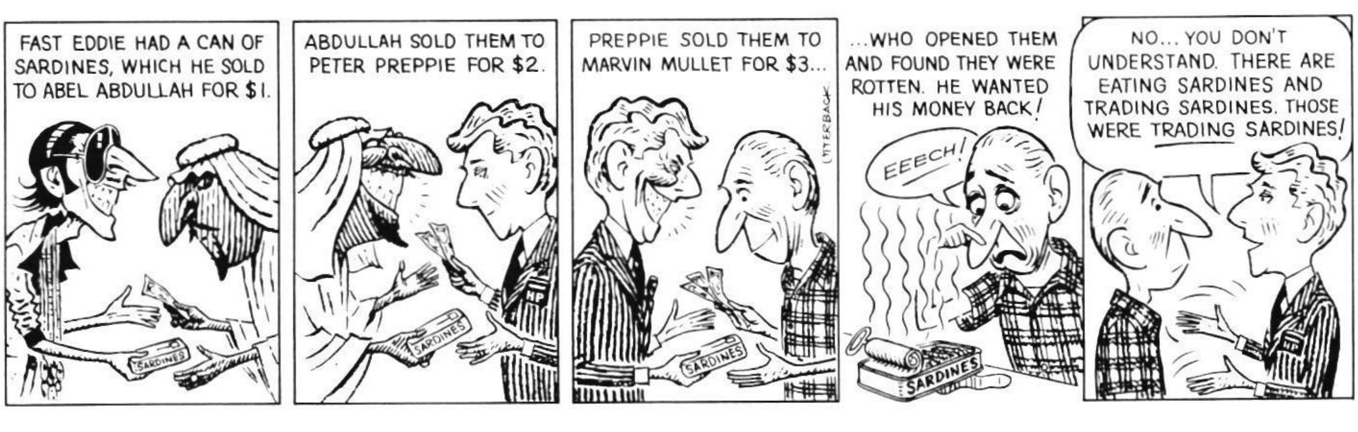

giving up the stability characteristics discussed above, the "numbers crunchers" have elevated real estate beyond realistic expectation. This elevation process has been achieved by superimposing numerical assumptions and attempting to make real estate conform to expectations applicable to other businesses. A typical real estate analysis today assumes stable growth with yearly increases in revenues generated by inflation. Future revisions and alterations in demand or competition are not incorporated or anticipated. If an analyst made the same assumptions of General Motors or other cyclical companies, the price of the earnings ratios would double. Such an analysis would receive very little credibility from the street, but is accepted in real estate as a matter of course.

Using numerical analysis on real estate and conversion of the investment vehicle to a performance vehicle, reflects a naivete that only can lead to disaster. The proliferation of non-real estate thinking individuals in the business has created performance indexes that border on the ludicrous. The idea that a localized market participant, namely real estate, can be realistically valued and incorporated into a meaningful nationwide measuring system does not make sense. The concept of quarter to quarter valuation of brick and mortar generates numbers only relevant to institutional investors who demand tables comparable to those used in stock market investment.

How meaningful are these numbers? Are comparables really a true measure of value? Does the sale of the Bank of America Tower in San Francisco reflect the market, or is it a unique property sale? Because real estate is a singular and nonfungible asset, its price structure mirrors not only its income, but also the buyer's perception of its future competitive role in a specific community. The biggest losses in the past high inflationary period will be recognized on acquisitions whose price justification will be comparable sales. This misconception further distorts evaluation when investors use sales and performance in other cities as part of purchase justification.

Historically, the premier purchase of real estate occurred by opportunistic purchasing. Conventional wisdom made the acquisition of the Uris properties by Olympia & York in 1976 the single best acquisition of the last decade. Would the indexes of real estate valuation in 1976 suggest this was the appropriate time to commit funds to New York office space? Would an assessment of comparables in New York have supported the purchase? Clearly none of these tests would have endorsed this move. Yet the results of that acquisition have been spectacular.

Real Estate Performance

Real estate performance is a reflection of past and not a precursor of future levels of activity. The most significant factor influencing real estate's future value is competition. One could argue that the higher the occupancy and the rates, the more likely this level of performance will not continue. Real estate performance is what encourages new development. When evaluating a market, the true test of its strength and the likelihood of future performance is the relationship between the economics of development and market performance. For example, if office rents in a given market are strong at $20 net a square foot, and cost of construction is $150 a square foot, then development and new competition follows. Thus, a new development that earns a 13.33% yield encourages new buildings. Construction continues until the yield factor declines to discourage new market additions. The yield factor declines as a result of both increasing vacancy factors and reduction in rates or concessions. Trying to equate real estate economics with corporate strategies indicates the greatest weakness in analytical comparison. For example, a consumer product company develops a new product. Assuming it is successful, the company is able to materially improve its profitability by increasing market share. Market share expansion leads to large production runs which lower cost and increase margins. Real estate works in reverse. Whereas a consumer product has an almost unlimited audience for expansion, the market for real estate is confined to the size of the building. The more successful the developer at renting his building and increasing rates, the more likely to attract competition. Therefore the economies of scale which increase margins and profitability in consumer products are not available to real estate because of its finite size.

Bar To Access

Rather than focus on numerical indexes in investment decisions, the investor should focus on unique characteristics that protect the investment from competition. Thus bar to access is a critical element in the evaluation. A regional shopping center illustrates this principle. A center is anchored by major department stores which represent the magnets that attract shoppers to the mall. When the developer negotiates his lease with major tenants, an integral portion consists of operating agreements and radius clauses. Operating agreements require the retailer to operate the store at that location under its name for periods as long as 30 years. Radius clauses provide the retailer will not operate another store within a defined surrounding geographical area. These two factors enable this type of investment to be more secure and with a greater promise of success because the likelihood of competition is less probable.

The recent legislation in San Francisco limiting the height and density of the downtown area is another example of a bar to access. This legislation precludes the ability of competitors to enter the market. It also changes the economics of development since limiting the height reduces the economies of scale therefore requiring more land per square foot of building. These factors, combined with the limited geography of the city, make this a protected high cost (to the user) market.

Houston, with no zoning, presents the reverse case. The boom in energy was the engine that encouraged the massive oversupply in every form of real estate. But this oversupply was further exacerbated by the lack of impediments to expansion. Thus, residential properties of recent vintage were razed for new office space. Every piece of land represented another opportunity with unfortunately predictable results. The ease with which supply was increased reflects a market with no bars to access.

Demographics is another statistical benchmark currently influencing real estate investments. Although demographics provide a window in a geographical area to future expectations, they do not provide leading indicators for the potential success of a given investment. In many instances, just the reverse occurs. Investors often have had difficulty distinguishing between what portends well for those in the real estate activity business versus those in the investment real estate business. Therefore, growth statistics may be very bullish for builders, architects and construction lenders, but this activity only attracts competition. The most intelligent investment may perform poorly if it is surrounded by too much supply. Quality, as a bar to access, only works if the quantity element of the equation is under control.

The ultimate bar to access is replacement cost. If in the above-mentioned example, the rents were $12 net and new construction was still $150 a foot, there would be no incentive for competition until rates rose to a level that allowed for profitable development.

Replacement Cost

Replacement cost is a component which requires careful analysis. It is not limited to cost of construction, and it requires an understanding of all the development elements. During construction land cost and interest are major elements subject to wide swings. The land prices and construction loan costs fluctuate widely depending on local conditions. In boom periods, land values have doubled and tripled in response to a development frenzy. Cost of funds also has wide fluctuations. These two factors materially influence an investor's perception of his vulnerability to new competition and the comfort he can draw from the cost of acquisition.

Securitization

Securitization is another magic word that has been added to real estate lexicon. It represents the pooling of real estate mortgages into commercially tradeable instruments. Just as the current massive oversupply of real estate is a function of buyer rather than user demand, so too is securitization growth the result of demand by traders and institutions, not from a shortage of funds. Consequently scandals continue to surface as, lenders find their security pools impaired, and default rates are above historical levels. When an underwriter is processing a loan he knows will sell immediately, his care and concern is directly related to the length of time he owns the loan. This phenomenon is strikingly similar to the developer who builds a project for sale rather than a development he anticipates owning long-term.

The current attempt to develop securitized commercial mortgages only extends the separation of the investor from the risk he is taking. Securitization converts mortgages into a commodity that blurs the risk to the investor. Whereas government bonds and government agency bonds trade at a risk differential, the risk is clearly deliniated an an efficient market follows. In real estate mortgages, the amount and quality of information either precludes investigation or requires effort that is unlikely to be undertaken. The proliferation of securitized transactions represent a further move toward the replacement of real estate expertise with the common denominator, a Masters of Business Administration (M.B.A.).

Segmentation

Segmentation and market timing are new additions to the real estate vocabulary. Segmentation represents an attempt to subdivide the demand side of the equation so as to justify creation of a new product. The current boom in the construction of new lodging facilities is a clear example.

A hotel is a hotel unless it's a budget facility, a highway facility, a convention facility, a suite facility, a luxury facility or a super luxury facility. The most recent phenomenon is the suite hotel. Many markets in the country have no suite facilities or very few, and thus we are seeing them being constructed in a rapid proliferation. When an investor is considering this type of investment, what is the relevant market analysis? The developer presents the case that the all-suite hotel is not impacted by other similar facilities. Reality says that all lodging, in any given market, competes with one another. Although its nature may differ, there is almost always a price point that will change behavior. Certainly airline deregulation has proven that price is a very strong factor in behavior modification. The creation of low prices has dramatically increased the number of seats available, thereby affecting the full price carriers. Is the lodging industry any different? Can we justify the proliferation of new segmented facilities based on demand for lodging, or does it reflect application of unused increased capacity? Does the hotel chain with a development department make future investment decisions because of need in the marketplace, or need in the department? Once again we see a recurring theme in lodging that has been perceived in all real estate, separation of risk from responsibility. Historically, hotel chains or franchise operations owned the facilities they built. Thus overbuilding had direct and often times catastrophic impact on the owner. The market became the ultimate disciplinarian.

Today the hotel chains operate on management fees that put the entire responsibility for financial failure on the investor. A new hotel that does poorly creates massive losses for the owner and a diminution of income for the manager. Thus when a feasibility study on a new facility is undertaken, the investor, not manager, faces the responsibility for a poor decision.

Market Timing

Market timing is another concept borrowed from the managerial world and incorporated into real estate. The developer who begins a building in the midst of oversupply justifies his investment on the scientific premise that between 4:00am and 2:00pm on March 27, 1989, there will be a shortage of space. Coincidentally, that specific moment in time is when his building will be completed. This kind of thought process once again replaces the fundamental of the real estate market with statistical analysis operating in a vacuum. Can the developer predict new competition? Can he predict recessions that slow absorption? Can he predict a tenant's willingness to remain in less desirable space until a better or cheaper situation is available? The array of variables is so unpredictable that the risk of failure becomes unquantifiable. The at-risk owner-developer would never endorse this endeavor, but by separating the risk from the creator of the project, we have perpetuated development without focus on demand and economic exposure.

Today the greed for product creation is unchecked. As long as lenders or buyers are willing to support investments without the developer taking any risk, the oversupply scenario will continue. When developers work for a fee off the top, somewhat like an investment banker in a merger, the fear of loss will not discipline the process. If the creator of the product is not dependent on the success of his creation for financial reward, then his orientation will shift from what works to what sells. The real estate world has altered the definition of success from cash flow of occupied real estate to groundbreaking ceremonies.

Allocation Of Resources

Allocation of resources represents another element distorting the real estate market. When major pension funds with billions of dollars decide that their involvement in real estate should be increased from 2 to 10%, tremendous funds become diverted to real estate. These new sources of capital are allocated to the industry because a group of non-real estate people have reached a conclusion, usually on the advice of advisors who profit handsomely by the investment of funds.

Once an allocation decision has been made, it also becomes a benchmark for the in-house fund managers. The next trustees meeting will undoubtedly include the question, "How have we done at increasing our percentage in real estate?" Compensation for these people tends to be oriented toward asset allocation of objectives, rather than incentives based upon fund performance.

This kind of allocation once again disregards the opportunistic nature of the business. Real estate success has gone to those with deep pockets and the ability to take advantage of the cyclical nature of the business. The great fortunes made in real estate have come from buying property during market troughs and holding them through cycles. Because of the fiduciary nature of these funds, the increase in allocation usually is made after the cycle has peaked, thus the process is reverse of what had been successful. Abstract fund allocation continues the thesis of distancing the real estate participant from the property.

The real estate business is entrepreneurial, fraught with risk and the commensurate reward. It is a business that does not lend itself to empirical analysis distanced from the realities of the marketplace. It is a highly leveraged business that requires an attention to detail that does not lend itself to delegation. The conversion of real estate from a localized to a national business has not improved the performance and has led to the greatest oversupply of brick and mortar in the country's history.

Loss Of Discipline

The loss of discipline has been the major contributor to this sorry state. Discipline comes from the marketplace, from fear of loss and the consequences that come from overindulgence. When the developer is long gone with profit in the bank, his appetite for future activity is not diminished by vacancy in the market. The fact that he has developed and sold a product that resulted in major losses for the buyer is not his concern.

Discipline also has evaporated from the lending community. The lender must be fearful with a focus on his ability to get repaid rather than on up-front points. Demanding and getting significant equity from the developer means that the creation process is a shared risk where both parties have similar concern for the project's success. Realistic evaluation of the risk elements by the lending community requires a reversion to past techniques. True equity requirements imposed on the developer not only insures caution and discipline, but also reduces the debt service load in the initial years. Office development with rental achievement clauses were a standard fixture of the pre-inflationary period. The commitment of funds not only required impelling market consideration, but also required a tenant commitment for a significant percentage of the space. The lending community now finds itself with losses from lack of focus and confusion about their role. Greed has caused reaching for a "piece of the action" at the cost of safety and preservation of principal.

Lending Community

The lending community further has been buffeted by a shortage of opportunities to loan large amounts of funds. With the disappearance of energy, agriculture and LDC, hard pressed lenders have over-committed to the real estate community to keep the asset side of their balance sheet from withering. Financial deregulation also has added to the lack of discipline in the marketplace. Savings and loan associations raised massive funds in the brokered market without subjecting themselves to testing their financial ability. The Federal Deposit Insurance Corporation (FDIC), by insuring deposits of all institutions up to $100,000, makes the flow of funds indiscriminate. Since the holder of a certificate of deposit is looking to the federal insurance and not the institutions for repayment, the funds flow to the institution willing to pay the most, without regard of their ability to invest or repay. The spate of failures here in the last few years have been marked by a large flow of funds emanated from brokered deposits of unnamed investors who were getting a superior yield without the commensurate risk.

The institutions themselves also have lost their internal discipline. Over the past few years, the majority of savings and loans have converted from mutual institutions to stock companies. With these conversions, the quarter-to-quarter results affected stock prices, which in turn affected executive compensation and the ability to raise capital. Thus, risky loans with large up-front fees energized the earnings statement and the stock prices, and left for the future the issue of fund repayment. The volatility of interest rates discouraged lenders from holding single-family, fixed-rate loans which now are routinely sold into the securitized market. Without the base of single family loans, these institutions have been forced to seek lending opportunities outside their areas of expertise. The results have been predictable; losses, fraud and the acceptance of risk levels inappropriate to the perceived reward.

This new flow of funds into real estate has pressured traditional lenders to relax their standards in order to remain competitive. Once again, we see a repetition of supply and demand skewing the marketplace with distorted results.

Syndication Growth

The astronomical growth of the syndication business in the past five years also has severly affected the real estate market. The billions of dollars diverted to real estate through limited partnerships have materially contributed to an oversupply in the marketplace. In a manner similar to the REIT experience 10 years earlier, exponential growth in the available funds was unrelated to the growth of opportunity. Thus, the business became one of raising money rather than investing. These companies have been predominantly market rather than real estate driven. As the flow of funds increased, the talent needed for investment decreased. This marketing orientation rewarded those who raised and invested the funds rather than focusing on the results of these investments. Since the measure of success is in the future, and those who invest are not penalized for poor performance, the process is undisciplined. The talent making these investment decisions generally has been inexperienced, without knowledge of the previous market cycles. The results, unfortunately, are predictable and add to the perpetuation of an industry that has lost touch with the basics.

Conclusion

The recovery of the market will be slow and painful. The monetization of the currency that previously bailed out real estate excesses will not appear this time. Oversupply and deflation will make internal rates of return, projected rental increases and numerical justification of investment irrelevant in the future. Success or failure will accrue to those who have focused their efforts on the basics that make the business work. The Hewlett-Packard jockeys of the scientific real estate community will be replaced by the traditional real estate *professional* who has learned his trade in operation and not in projection of real estate.

Unfortunately, the size of the losses will ultimately bring the real estate business back to reality. These losses will instill the discipline that the players have been unable to implement. Savants will look back on this period and equate it to the historic excesses of the past. The tulip craze in Holland in the 17th century, the railroad boom of the 19th century, and the Florida land boom of the 1920s all reflect the frenzies of those eras when the participants lost sight of the underlying fundamentals. The moral of the story is: when they stop eating the sardines and only focus on trading them, the stench will become overpowering.

The Ballard Award Manuscript Submission Information

The editorial board of *Real Estate Issues* is accepting manuscripts in competition for the 1986 Ballard Award. The competition is open to members of the American Society of Real Estate Counselors and other real estate professionals. The $500 cash award and plaque will be presented in November at the Society's 1986 Convention in New York City to the author whose manuscript best exemplifies the high standards of content maintained in the Journal. The selection is made by Editor in Chief Jared Shlaes and Associate Editors James Gibbons and Roger Foster. Any articles published in the Journal during the present calendar year (Spring/Summer and Fall/Winter editions) are eligible for consideration.

The annual Ballard Award was first presented in 1985 to James A. Graaskamp, CRE, for his article, "Identification and Delineation of Real Estate Market Research," which appeared in the Spring/Summer issue. Funding for the award is provided by the generous contribution of the William S. Ballard Scholarship Fund in memory of Mr. Ballard, a former CRE.

To be considered eligible for judging, all manuscripts must be submitted by August 1, 1986. See page 35, "Contributor Information for *Real Estate Issues*," for specific guidelines in manuscript preparation.