BECOMING EVERGREEN

The Full-Service Real Estate Company of the 1990s

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Real estate development companies have always been deal driven and project oriented. Development, particularly in the 1980s, was a swashbuckling enterprise. And it was where the real fun was to be had while adding the most value. Real estate's other aspects, such as acquisitions, property management, leasing, consulting, and appraisal, were considered secondary and often left to nondevelopment firms to carry out.

This view of development is changing. *Development* firms are evolving into *real estate* companies that will

- invest in and improve existing assets,
- manage assets on a large scale,
- provide fee services that do not involve capital risk,
- dispose of assets when appropriate, and
- develop new assets only when market conditions are right.

This broadening of the development business recalls Theodore Levitt's "Marketing Myopia" in the September 1975 *Harvard Business Review,* one of the most widely reprinted *HBR* articles. Its premise was that many companies too narrowly define the business they are in.

As an example, Levitt discussed railroad executives who thought they were in the railroad business, when in fact they were in the transportation (not to mention real estate) business, competing with barges, pipelines, trucks, and airlines. These executives (or their successors) realized the error in their thinking only after they had run their companies into the ground.

As development company executives survey the wreckage of the current downturn, many are revising their strategies. Some of the most prominent developers in the United States no longer view their companies as being strictly in the development business. They are, more broadly, in the real estate business.

Goodbye, Easy Street

When times were good in development (such as the mid- to late 1980s and the late 1970s), there was a great deal of money to be made. Barriers to entry into the business were low—developers had little need to provide significant equity in deals, their partners did not emphasize strong track records over a long period of time, and government approvals were relatively easy to come by.

Development companies raised money from an array of institutions—insurance companies, banks, S&Ls, pension funds, foreign investors, credit corporations, and others—that came into and went out of the picture at various times.

The constantly changing lending and joint venture officers of these institutions were many times inexperienced and naive. They failed to require of developers a track record that extended over a full real estate cycle. Superficialities sufficed—a glossy brochure, a wood-paneled office, a (leased) luxury car. (Thus, the reputation for being flashy but flaky that developers acquired, often deservedly.)

However, the days when developers could obtain money easily for a superficial proposal package are probably over, even when development opportunities and credit reemerge. Why? First, the real estate downturn already has created severe distress in the financial community. As the most cyclical of industries, real estate has been through many downturns, each producing some pain for equity and debt investors. But in the past when development opportunities resurfaced, investors new and old rushed back in with lending policies not much changed from those that had gotten them into trouble.

This time, however, poorly performing real estate has made a major contribution to the collapse of much of the S&L industry, currently threatens commercial banking, has provided foreign investors with a long string of losses, and is attracting financial storm clouds over the huge insurance industry and industrial credit corporations.

The substantial property loan writedowns that led many institutions to the brink of extinction will improve institutional memory. Loan policies, once the credit crunch is over, will be tightened significantly for the foreseeable future. Also, new federal regulations already in place and probable future federal

legislation will mitigate the "Have Money, Must Lend" approach of the delirious recent past.

When credit is available again, equity requirements will be in the 20 to 40 percent range. The day of the 110 percent loan is over, probably forever. The increased equity requirement will significantly raise this barrier of entry into development and property acquisition. Players will be limited to companies with institutional or other deep-pocket equity connections.

Second, real estate companies will need more than cash to operate in tomorrow's changed environment. Specifically, they will need a reputation for delivering on their commitments, a name that carries an implied promise of quality and commitments fulfilled at nearly any cost to the company. In other words, real estate companies will need both consumer/regulator and financial/investor "franchises." Consumer product companies, such as Proctor & Gamble and Kellogg's, have recognized the importance of their "franchise" with the public, and have gone so far as to put the dollar value of their product names on the balance sheet. The financial/investor "franchise" of most successful companies gives them ready access to low-cost commercial paper for debt and the public market for equity.

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A consumer "franchise" has become critical to winning public approval for a project in an increasingly growth-controlled world. More and more, only "white hat" firms will obtain the right to develop new projects, reaping the rewards of developing and owning in a supply-managed environment. A financial "franchise" among sources of project financing will become crucial once the credit crunch is over. And an investor "franchise" may be critical to attracting equity to the real estate company as a whole.

Becoming Evergreen

Trammell Crow Company is in the vanguard of the transition from a primarily development-oriented to a full-service real estate company. Its goal is to become "evergreen"—to make money in bad development times as well as good ones. This will mean reasonably predictable future earnings. (Note: Trammell Crow Company is connected with Trammell Crow Residential in name only; the two companies have no marketing or management affiliation.)

To be in the real estate business, as contrasted with the development business, is to incorporate a core of service businesses that will provide positive cash flow and earnings during all phases of the roller-coaster real estate cycle. The development company that makes the strategic change to thinking and acting like a real estate company will need to modify its structure and focus. Some of the shifts that probably will be required are described in the following sections.

Fee Orientation

A development company has two options for weathering the inevitable downside of real estate cycles: sufficient equity to hold the organization and portfolio together or strong operating service businesses that provide fee income in bad times as well as good. Few companies have sufficient equity, and those that do may not wish to invest it in excess development capacity. Therefore, for most companies, the only option is to become providers of property management, for-fee development, asset management, and other fee services.

The existing real estate asset base in speculative building in the United States takes constant management, maintenance, and repair. This reality offers the opportunity to generate huge revenues. Unfortunately, most real estate development companies make no serious attempt to capture these revenues.

For example, the Dallas speculative industrial market contains 300 million square feet of space, 11.4 percent of which was vacant in 1990. This inventory is worth, at $50 a square foot, $15 billion. Conservatively calculating that every year an equivalent of 10 percent of the asset base must be spent for such services as leasing, management, roof repair, and tenant improvements, there are $1.5 billion in annual revenues available to service providers in this market.

In contrast, during boom development years the inventory will grow by about 10 percent, or 30 million square feet, with a value of $1.5 billion, the same as the annual services revenues. Admittedly, development revenues are more profitable than services revenues, but that has not meant much in Dallas over the past few years, when next to nothing has been built.

Many developers consider fee businesses merely a port in the storm. These businesses are, in fact, highly competitive and price sensitive; few providers have established names and specialties that allow them to demand price premiums. Therefore, the key to profitability in fee services lies in efficiency and low-cost operations, which are not the hallmark of the development industry.

Fee-service businesses can achieve higher profit margins only through streamlining systems, standardiz-

ing procedures, and greatly increasing volumes to spread fixed overhead costs. The servicing of home loans represents the best example of a real estate fee business that has learned how to make money. Its cost/revenue ratios drop dramatically at certain volume levels. And the volume levels necessary to achieve these savings are well known. In fact, mortgage servicing contracts are actually bought and sold because of their reliable cash flow and the possibility of lower operating costs for the acquiring firm resulting from economies of scale.

Among the former developers turned real estate companies that have made or are making the transition to profitable fee businesses are many companies that survived the prolonged Texas downturn.

Transwestern Property Company went from being a nearly bankrupt, overextended office and industrial developer in the mid-1980s to one of the largest managers of income property in Texas and one of the top 30 asset management companies in the United States today. The company has learned how to manage, efficiently and profitably, over 30 million square feet of space.

Trammell Crow Company, with over 230 million square feet in its portfolio of owned and managed property, is the largest U.S. asset management firm. It has recently reorganized to reflect the importance of this aspect of its business. The operating efficiency of this fee business is a major reason for the company's return to profitability after a couple of years of losses in the late 1980s.

Achieving increased efficiency and cost control in real estate fee businesses has only recently received the attention it needs. And the ability of firms to achieve a critical mass of business depends on consolidation of the asset management industry, which will take a number of years to achieve. But the result will be a complete restructuring of the industry in the 1990s.

National/Local Capabilities

The geographically dispersed organization of most major development firms is based on a fact of life, namely that real estate is a local business. This will not change. However, a real estate firm's ability to deliver locally in a competitive and cost-effective manner will come to depend more and more on its national (and international) abilities in finance, marketing, and asset management.

National/international financial capability is needed for raising debt and equity. One person or department in a real estate firm must act as the single point of contact in the company's dealings with the large financial institutions—like Prudential, Teachers, and Citicorp—that will probably increase their dominance of the industry in the 1990s. That person or department will have to have a single corporate story to tell, a story based on predictable corporate earnings and commitment on the part of all the local operations to overall company goals.

To lease office, industrial, or retail space, real estate companies must develop better working relationships with corporate real estate managers and familiarity with their corporate culture and procedures. National/international marketing capabilities will provide a real estate company a decided competitive advantage in the corporate user market.

Marketing to large corporate users goes beyond leasing. Large public companies are centralizing controls and standardizing procedures for their real estate operations. The big trend in corporations is "outsourcing"—contracting to outsiders—some or all of these real estate functions. Outsourcing will become a large new fee and development revenue source for real estate companies.

The consolidation of real estate ownership by financial institutions is propelling real estate companies to develop national/international capabilities in asset management services. Increasingly sophisticated management techniques for property portfolios and assets are putting the emphasis on uniform standards of management and reporting, wherever and whatever the property.

Firms with national/international financial, marketing, and asset management capabilities that are able to combine these capabilities with local market knowledge and talent will be the low-cost producers of services and projects. But they must never forget that real estate is fundamentally a local business.

From Partnership to Corporation

Trammell Crow introduced the partnership approach to real estate development 30 years ago for the compensation of employees. The idea caught on. Partnership has been the preferred way to compensate employees of development companies ever since. But earlier this year Trammell Crow Company switched to a corporate form of organization, a symbolically significant move. Other development companies making the strategic change to becoming real estate companies probably will follow suit.

The 1986 Tax Act did away with most of the tax reasons to offer project partnership interests to employees. In the wake of the souring of many deals, a growing number of employees have begun to shy away from partnership structures since their personal liability is not limited. Furthermore, partnerships are administratively burdensome. Even small development firms with relatively few deals find onerous the tremendous cost and complexity of tax account-

ing and investor reporting for separate projects. And the "exit strategy" when an employee leaves the company is always troublesome.

Additionally, real estate companies are now considering a shift to a corporate legal structure to hold company-owned project interests. In the future, equity will have to be retained at the corporate level to bolster the balance sheet, so that an arrangement whereby projects are owned by a series of unrelated partnerships may no longer be appropriate.

Finally, a corporation rather than a partnership is the best vehicle for providing the fee services that companies need to offer to sustain a positive and growing earnings record. Real estate companies will find that the corporate form provides a foundation on which they can build evergreen service businesses while it also creates an asset base and a strong balance sheet for financing purposes.

Company Investment Value

Development companies have traditionally had very little inherent corporate value. It is virtually impossible to value Lincoln Properties, The Galbreath Company, or Maguire Thomas Partners: most or all of their assets are held in partnerships outside the company, and they have very little "going concern" value.

However, it is probable that *real estate* companies will have ongoing corporate value, calculated as a multiple of earnings, assuming those earnings are reasonably predictable. A focus on corporate valuation, rather than on project valuations, is a significant departure from the approach of development companies in the 1980s.

Investment banking firms and entertainment companies were in the same boat 30 years ago. Like development companies today, investment banks (Salomon Brothers, Shearson, Kidder Peabody) and movie and television companies (MCA, Columbia Pictures, Warner Brothers) were project oriented. As they said in Hollywood, "You're only as good as your last movie."

But firms in these businesses in the 1970s and 1980s needed to raise large sums of equity capital to remain competitive. Rather than being deal makers using other people's money, they became major investors in their own corporate overhead and projects.

A few firms, like Disney and Merrill Lynch, developed their equity internally. Most others, like Shearson, Kidder Peabody, MCA, and Warner Brothers, were acquired by huge conglomerates that paid healthy multiples of earnings for the right to fund the future equity needs of the acquired companies. Matsushita paid $6.59 billion—$66 per share, 25 times earnings—for MCA, the equivalent of a 4 percent cap rate in real estate terms. While Matsushita did acquire some real assets—the Universal Pictures film library and theme park, for example—it was most interested in acquiring the reasonably predictable future dealmaking ability of MCA's movie business.

To create corporate, as contrasted with project, value, real estate firms need to establish a predictable earnings stream at the company level and justify the future growth potential of that earnings stream. Catellus Development (the former subsidiary of the Atchison Topeka & Santa Fe Railroad), for example, has raised capital at the corporate level from large investors, including the railroad itself, CalPERS (California State Employees Pension Fund), and Olympia & York, as well as the public market. Its investors look to the overall performance of the company rather than to individual projects for their returns.

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A real estate company with a reasonably predictable earnings stream could be valued at six to 20 times earnings. This would make selling shares, either publicly or privately, possible and would provide a source of equity that development-oriented companies have not been particularly successful at tapping up to now.

In the 1990s, players in the real estate business will fall into two camps: the big and successful and the small and limited. What will separate them is the ability to raise equity on the corporate level for both new development and acquisition and for the expansion of operating fee businesses. Projects of a certain size and significant fee contracts will be available only to well-capitalized companies. Those without steady, strong equity sources will have to get along by scrambling after joint venture partners deal by deal.

The shift from a development orientation to a full-service real estate orientation is not easy to make. Company executives need to change their conception of the business they are in and then change their business strategies and structures accordingly. But by making these changes, the real estate industry will win investor confidence and stabilize itself—actions that are needed now more than ever. ■

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