COMMENTARY

The End of Real Estate

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Successfully managing solid assets will be essential.

It started with moderately priced restaurants, then hotels, and, more recently, retirement housing. Once these former sectors of the real estate industry began providing predictable, sustainable cash flow, they were spun off to become separate businesses.

A similar change is happening or will happen to most real estate income property types. Once independent industries are spun off, only a remnant of the real estate industry will remain. In fact, what is occurring is a natural evolution that will make the former pieces of the industry conform to the generally accepted standards of American business.

For decades, the real estate industry has been an opportunistic free-for-all. It has been largely project oriented: if the market wanted industrial one year, it built industrial; if apartments were the rage, it built apartments. Whether the finished project was held or flipped, management was done on a "catch-as-catch-can" basis, and viewed as a necessary evil.

Over the past few cycles, however, the real estate industry has begun to spin off new entities that look and behave entirely differently from their chaotic birthplace. There is more order, reasonably predictable cash flow, and better business practices. Of course, certain companies implement these changes more effectively than others. These companies will probably be more successful, allowing them to absorb less successful companies, and the new industry will begin to coalesce.

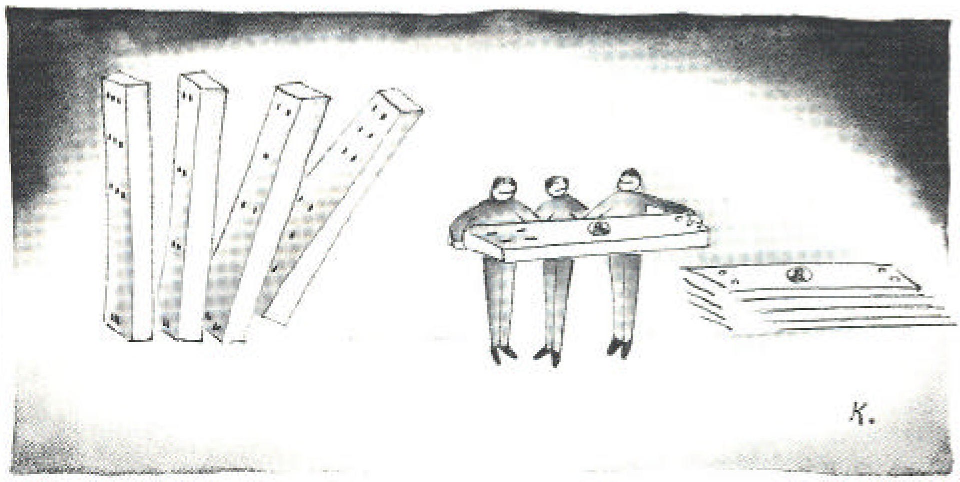
While the rest of corporate America has created the most productive process-oriented economy in the world, the real estate industry with its one-shot deals has been made up of individuals and companies that to a third party have no intrinsic investment value.

One benefit of a process orientation has been the ability to publicly trade the ownership interest of companies. Currently, the stock market values average publicly traded companies at about 20 times their earnings—the equivalent of a 5 percent cap rate, unheard of by real estate standards (except for the inflated prices paid by certain Japanese investors in the late 1980s).

One of the many complaints from former independent developers is that process-oriented businesses such as property management, pension advisory services, or mortgage brokering are not profitable. What they really mean is that there are few "home runs," which is certainly true. However, few developers have calculated the payoff from a well-run, process-oriented business, either from the ultimate sale of the company or by taking it public. With every dollar of after-tax revenue valued at upwards of $20, the potential payoff can be quite lucrative.

The structure of real estate is evolving as formulas and critical success factors are developed, thus allowing a process orientation. For example, the policies and procedures of the Philadelphia office of Manpower, Inc., or Xerox are the same as at their offices in Seattle. A business hotel in Los Angeles is now exactly like one in Atlanta. A power center in Sacramento is the same as one in Boston. And more and more, power center competitors in Sacramento and Boston will be the same as well. Significantly, the financial intermediary for many of these competing companies will be one of a handful of large Wall Street firms.

Real estate has seen this shift to a process orientation accelerated by the massive depression in the early 1990s. Most real estate professionals now are convinced that there has to be a better way to run the business. (The irony is that the economic recession that brought the industry to its knees was very mild, a drop of only 1.8 percent in the GDP.)



But it was the industry's financiers who ensured that there would be more discipline. Relatively high equity requirements are now the industry norm. The creation of publicly traded equity and securitized debt markets, controlled by investment bankers and the Security and Exchange Commission, is imposing a level of discipline the industry has never seen. This will be beneficial, especially during the next depression, but it also is breaking up the industry as we know it.

The implications for the industry are many. Obviously, real estate companies will become more process oriented. Lessons learned will be retained over time rather than lost during periodic depressions, which in the past meant bankruptcies and layoffs. The drive to offer services better, faster, and cheaper will dominate industry thinking. Asset and property managers will prosper while developers will find their freedom and personal finances curtailed. Real estate professionals will have to retool not only their skills but also their work methods. Developers who once could rationalize inefficiencies by claiming a huge payoff upon sale or refinancng (which sometimes happened but more often did not) today will be held accountable for producing projects with sustainable cash flow.

A second implication will be the continued growth of publicly traded real estate firms, either capital risk companies such as REITs, operating risk service firms, or a combination of the two. At the base of their business, capital risk firms will have relatively unleveraged real estate assets, allowing the better managed ones to sail through depressions without fear of bankruptcy. Successfully managing solid assets will be essential since public markets will reward those who can deliver the highest increases in annual "same store sales."

Today, most REITs, like their predecessor development firms, value most their acquisition and development talent. Wall Street, however, will teach the industry during the next downturn that management is what counts. The current lull in new offerings, compared with 1993 and 1994, is mainly a pause as investors wait to see how the industry performs during the next downturn. The major question is whether REITs are real estate stocks or REIT stocks, a crucial difference. Wall Street will reward those that perform as REITs and severely discipline those that perform like highly cyclical real estate. The anticipated consolidation of REITs (which will happen because institutional investors want to see larger companies with more efficient overhead structure and larger daily trading volume) will result from companies with the highest price/earning ratios picking up those with low ratios. High ratios result from a conservative balance sheet, superior management, and predictable earnings—not characteristic of the real estate industry.

Operating risk companies, such as the new and improved Trammell Crow Company and LaSalle Partners, will probably be the next wave of firms to go public. They will do it for the same reason companies in general have gone to Wall Street: to increase their equity base to grow and create liquidity for their founders. But, there will also be a third reason: to obtain legitimacy, especially for firms who serve the day-to-day real estate needs of corporations and financial institutions. Since real estate firms have not enjoyed stellar reputations, going public like their clients will make them part of the club. Nothing sells to a corporate bureaucrat like an SEC-approved 10-K annual report.

The spin-off of the corporate real estate management business from the real estate industry is inevitable. Today, nonresidential real estate assets total approximately $3 trillion. More than 70 percent of those assets are owned or leased by corporate America.

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The vast majority of this $2.1 trillion portfolio is managed in house by corporate staff. The trend toward outsourcing will surely drive a majority of this management function to specialized outside vendors. This has been the case with corporate food service management—not a particularly strategic function—by firms such as Marriott, ARAMARK, and Ogden. It is presently taking place with corporate information processing—a very strategic function—by IBM, Anderson Consulting, and EDS.

The potential size of this new corporate real estate management industry is enormous. It requires an annual expenditure of between 5 and 7 percent of the real estate asset base for assets, property, construction, tenant improvements, management, and leasing commissions. This means that annual revenues will run from between $105 billion and $150 billion, more than the revenues of the aerospace/defense industry and about equivalent to the revenue base of the chemical industry. With average after-tax profit margins of, say, 8 percent and a price/earnings ratio of 20, the industry would have a capitalized value of between $168 billion and $240 billion—making it one of the country's largest industries.

Also, hybrid firms may emerge, such as AMRESCO, which combines capital risk and operating risk businesses. A Dallas-based real estate financial services firm, AMRESCO specializes in a variety of interrelated businesses, including portfolio workout, mortgage banking, portfolio and asset management, pension advisory services, and others. The firm is a relative newcomer to the ranks of publicly traded firms, but Wall Street seems to like what it sees, with trading at a price/earnings ratio in the 20s.

Firms that will not be acceptable to public markets will be those that have erratic, unpredictable cash flow and low margins. The short experience of Koll Property Management as a publicly traded company illustrates the type of firm that will not find a market. Koll has 30-day cancelable property management contracts in a high-price competitive business. During its three years as a public company, the stock rarely traded above its initial offering, in spite of extremely high revenue growth, and eventually went private again. Traditional real estate development companies will not be candidates to go public either, given the project-oriented nature of their business and the erratic nature of their earnings.

Of course, there will still be room for the well-capitalized and well-managed private real estate company, such as Faison Associates, that specializes in specific geographic markets and product types. However, characteristics like that of a public firm will be required: conservative balance sheet, superior management, and predictable earnings. Like their publicly traded competition, they will have a foundation of owned, cash-flowing assets; process-oriented service businesses; or a combination of the two. These firms have the freedom of developing new assets when the market is favorable and of turning down new projects when the market is unfavorable, without jeopardizing revenues.

The end of real estate does not mean that the swashbuckling past is completely over. There will always be those who will develop new products and pioneer new markets. But after the product or market is proven, it will probably be either the well-capitalized private real estate firm or the publicly traded company that will take over.

In time, the bosses will be the professional managers who know how to run operating businesses and the developers will build only when they are told to. ◆

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