THE FUTURE ROLE OF REITS IN REAL ESTATE FINANCE

by Anthony Downs
Senior Fellow
The Brookings Institution*
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I. *Introduction.*

Major and somewhat conflicting changes in the roles of real estate investment trusts (REITs) in commercial real estate finance have occurred in the past few years. Before 1990, REITs played a relatively insignificant role in financing commercial real estate. But in the early and mid-1990s, REITs rose dramatically in prominence. By 1997, although REITs still owned only a small percentage of all existing commercial properties, they actually dominated current transactions in many commercial property markets. Yet REIT share prices began lagging the still-rising general stock market early in 1998. Then, in the fall of 1998, when the overall stock market dropped sharply, REIT shares also plunged. However, they have not recovered along with most of the rest of the market, even though most real estate properties themselves are still doing well.

These changes raise questions about the future roles of REITs in financing and operating commercial properties in the U.S. This article contends that the recent shift of much of on-going real estate equity and debt financing from traditional, purely private markets to securitized, public markets has changed the attitudes of investors towards commercial real estate in general. Their change in attitudes is unfavorable to the real estate industry under many economic conditions, including those prevailing in early 1999. This article explores these changes and discusses their implications for the future of commercial real estate in general and REITs in particular.

II. *The Dramatic Rise of REITs in the Early and Mid-1990s*.

REITs came into recent prominence when a regulatory clampdown on bank and insurance company and S and L lending in 1990 caused a credit crunch in commercial real estate markets. This regulatory

* The views in this article are solely those of the author, and not necessarily those of the Brookings Institution, its Trustees, or its other staff members.

action resulted from enormous overbuilding in the 1980s that precipitated a huge decline in private-market property values. Massive defaults, foreclosures, and bankruptcies resulted among developers and property owners. So regulators prohibited traditional real estate lenders from advancing any more credit to property owners and developers.

At the same time, the stock market was entering a period of unprecedented share price increases. This created a large property valuation difference between the public markets and the private markets. Owners of real estate portfolios could transform themselves into REITs and tap public markets for capital at low prices in terms of dividend yields. This created "positive spread investing" in which REITs could raise capital at a cost lower than the return they could get from investing that capital in buying properties at then-depressed private market prices. Thus, REITs used capital raised on Wall Street to acquire properties yielding high cap rates because of their low prices in private markets.

These conditions created a virtual "explosion" of REIT stock offerings after 1992. From 1982 through 1992, total initial and secondary stock offerings by REITs equaled $16.7 billion, or an average of $1.5 billion per year. From 1993 through 1998, such offerings equaled $98.9 billion, or an average of $16.5 billion per year – eleven times that in the earlier period.[1] The total market capitalization of all REITs (year-end stock prices times numbers of shares outstanding) skyrocketed from $8.7 billion in 119 REITs in 1990 to $140.5 billion in 210 REITs in 1997 – a rise of 1,514 percent! Thus, there can be no doubt that REITs as a group have enjoyed remarkable growth during the mid-to-late 1990s.

Moreover, there were multiple pressures on REITs to grow larger. The most important was the desire of each REIT to generate enough average daily turnover of its stock so that large institutional investors could buy or sell big blocks of its stock without affecting the market price. Such "transactional liquidity" would make it more efficient for big institutions to invest in a REIT. Big institutions like to buy and sell large lots to reduce their commission and administration costs. And the more big institutions that at least considered investing in a REIT, the larger the market for its shares -- and presumably the higher its share price. This stimulated many REITs to expand rapidly through

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1 Data from the National Association of Real Estate Investment Trusts (NAREIT) web site, March 1, 1999.

acquisitions. Their rapid growth created a short-run perception among many market investors that REITs were growth stocks.

The result was valuation of many REITs well above their net asset values. In the third quarter of 1996, according to Paine-Webber's analysis, its composite of REITs had a market capitalization 37 percent higher than the net asset value of all their properties considered separately. This premium remained at 27 percent in the fourth quarter of 1997.[2]

This situation coincided with the last part of the overbuilt cycle and the beginnings of the gradual absorption cycle in private real estate markets. Thus REIT capital came into play just as private markets were entering a rising portion of their cycle. REITs therefore became highly aggressive buyers of commercial properties and the dominant force in many private markets. The transfer of capital from public markets to private markets via REITs speeded up the gradual absorption phase of the traditional three-phase cycle and drove property prices upward faster than in the past.

However, because REITs had to distribute most of their internal earnings to their stockholders, they could grow rapidly only by issuing new stock offerings and using the proceeds to buy more properties. As long as the profitability of the properties they had bought, and continued to buy, kept rising because real estate markets were in the upward moving gradual absorption phase, buying properties raised their per-share earnings in spite of their issuing more shares. This reinforced the view that REITs were growth stocks.

III. ***The Effects of Changing Stock Market Conditions***.

However, this situation was dependent on continuation of favorable stock market conditions. When the stock market dropped sharply in value in the fall of 1998, REIT share prices fell too. In fact, REIT share prices actually began significantly lagging behind the general market in the spring of 1998. The NAREIT equity REIT price index (December 1971 = 100) peaked in December 1997 at 336.7, up 13.6 percent above one year earlier. It started sliding notably in April 1998. Yet the S and P 500 index kept rising through the first half of 1998.

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[2] Paine-Webber Equity Research, ***REIT 1998 Review and 1999 Outlook*** (New York: January 1999), p. 11.

But the general plunge in stock prices in August and September 1998 -- including REIT prices -- really shut down REIT access to low-cost capital. That forced REITs to sharply curtail their aggressive property buying. Moreover, although the S and P 500 index had recovered its earlier 1998 high levels by the end of 1998, the NAREIT equity REIT price index kept falling. In the second quarter of 1998, Paine-Webber's measure of the total market value of REIT shares (plus REIT debt) was 19 percent below the net asset value of those REITs; in the third quarter, it was 11 percent below that net asset value. True, different types of REITs showed different price patterns. But by January 1999, the NAREIT equity REIT index was at 255.0, 24 percent below its December 1997 level.

This withdrawal of REIT capital from private markets took the upward pressure off of prices, causing them to stabilize or decline. That outcome was furthered by the simultaneous withdrawal of Commercial Mortgage Backed Security (CMBS) financing on the mortgage side, caused by the same sudden crunch in public markets in the fall of 1998.

Yet commercial properties themselves were doing very well, because the economy kept on expanding. Moreover, the shut-down of REIT and CMBS financing, plus lack of bank construction financing, in the fall 1998 credit panic slowed the development boom. This reduced the probability of large-scale overbuilding in 1999, thereby at least diminishing a threat to the continuing prosperity of existing real properties.

These developments raise three issues: (1) What impacts did the shift to public market financing have upon the timing of the traditional real estate cycle? (2) Why did REIT share prices not recover along with the rest of the market? and (3) Will REIT prices move upward sharply in the near future to become more in line with other stock prices, given REITs' superior dividend and earnings prospects?

IV. *The Impacts of REIT Financing Upon the Timing of the Real Estate Cycle*

The shift of a major portion of new capital flows into commercial real estate markets from traditional private-market sources to public market sources has clearly affected the timing of the "classic" real estate cycle. That "classic" cycle, as I define it, has three major phases: the development boom phase, the overbuilt phase, and the gradual absorption phase.

The ***development boom phase*** starts when the general economy is at the peak of its expansion, as it has been for two years. Overall space demands have cut vacancies very low and raised rents, so developers start building new space. We had the greatest development boom ever in the late 1980s, which led to huge overbuilding of all types.

But just when all that new space comes onto the market, as in the early 1990s, the overall economy goes into a recession and space demand stops rising. That causes the ***overbuilt phase.*** It lasted unusually long -- until 1993 – because the surpluses built up in the 1980s boom were so huge because of widespread over-financing. New building stops, rents fall, values fall, and vacancy rates soar. Office values collapsed by 40-50 percent in the early 1990s.

Then the economy goes into a new expansion and space demands start rising again. This gradually reduces vacancies, but rents remain low and little new building starts. This is the ***gradual absorption phase,*** which we were in from 1994 until 1997. Eventually, if the general economic expansion continues long enough, this phase creates the conditions for a new development boom. After vacancies fall low enough, competition for space forces rents upward, and property values follow. In fact, values often lead in anticipation of future rent increases. Eventually, rents rise above the levels required to support new construction, and another development boom begins. Such a boom started in U.S. commercial property markets in late 1997, and was fully underway across almost the entire nation throughout 1998.

The developments of the 1990s described above have surely made public markets much more important influences on commercial property markets than in the past. True, public markets have not become the totally dominant force that many proponents of REITs forecast. But they have become powerful enough to change the timing of the three phases in the “classic” real estate cycle.

If the stock market is in an ascending phase at the same time that real property markets are emerging from an overbuilt phase, or even are still overbuilt, then public markets shift capital into private markets through REITs and CMBSs. They use that capital to buy existing properties. This accelerates the end of the overbuilt phase, and speeds up the gradual absorption phase, by creating upward pressure on private property prices. The result is that the next development boom starts earlier than it would have without this influence. If the development boom starts while the stock market is still ascending, then it too is speeded up by the flows of capital into new development. Both these things happened in 1997 and early 1998.

Conversely, if the stock market suffers a sharp drop for any reason during the gradual absorption or development boom phases, then capital flows from public markets into private markets are suddenly curtailed. That slows the speed at which the gradual absorption phase is transformed into a new development boom, or slows down the development boom if it has already started. The latter occurred in the fall of 1998, and its effects are still present.

Normally, the stock market peaks and begins to decline somewhat before the overall economy peaks, thus anticipating a general recession. (However, some stock market declines – like the spectacular fall in October 1987 – have not been closely followed by a general recession.) But each real estate development boom normally begins very close to when the general economy's expansion is peaking -- like the current boom that started in late 1997. Consequently, there should usually be a period of continuing general prosperity after stock prices -- at least for REITs -- have fallen somewhat but before real estate markets have become overbuilt through new development, and before a general recession has arrived. During this period, private property markets will place higher values on commercial properties than public markets, partly because public REITs cannot then float more stock issues at low capital costs. This was true in the late 1970s, and is true now. Such periods create arbitrage opportunities for firms shifting properties from public to private markets, as in taking public REITs private or liquidating them. Thus, in the late 1970s, several publicly-listed corporations with large real estate holdings liquidated those holdings for per-share proceeds higher than their total stock prices! Such "windows of opportunity" may not last long, however.

Thus the greater volatility of stock markets than real estate markets (discussed further below) will in the future affect the speed at which various phases of the real estate cycle take place. However, I do not think the greater role of public markets has changed the basic nature of the three phases or their usual order of succession.

V. *The Changing Relative Importance of Commercial Real Estate in the Investment Universe*

The lagging behavior of REIT share prices behind the general stock market can best be explored in the perspective of the changing situation of commercial real estate in the overall U.S. financial investment landscape. That situation has been altered in the 1990s in two vital ways. First, the shift of ownership of a lot of real property into public markets has notably changed the identity of the people and institutions who at least consider investing in commercial real estate. Their behavior is different from that of the traditional suppliers of capital to this industry. Second, commercial property itself has become relatively less important in the U.S. financial investment landscape. These two changes are discussed in detail below.

—The new broader investor perspective. The new group of potential investors in commercial real estate includes many individuals and institutions that formerly avoided this type of investment because they had little real estate expertise, and no convenient vehicles for investing in it. These investors include individuals, mutual funds, small pension funds, small insurance companies, and larger insurance companies seeking more diversified and liquid approaches to owning real estate. Now REITs and CMBSs provide them with such vehicles, and many stock analysts have sprung up to provide them with information about this exotic field. This new group of investors normally considers a much broader set of alternative investments than did the traditional investors in commercial properties. Therefore, commercial real estate must compete with many more alternatives in the minds of these investors.

When commercial real estate was financed mainly by institutions specializing in that function, and not directly linked to Wall Street, then the relative role of commercial property in the overall financial landscape was not as crucial as it has become. No matter what stock- market-oriented investors thought about the relative desirability of commercial property as an investment, financing was still available for such property from these specialized private market institutions. Examples of such institutions were banks, insurance companies, savings and loans, and mortgage bankers. Pension funds also became involved to some degree, but they were always more heavily focused on the stock and bond markets than on commercial real estate.

But the advent of REIT ownership of a lot of commercial property, and REIT dominance of capital flows into private property markets, brought the desirability of commercial real estate as an investment into direct competition with the desirability of stocks and bonds in general. This was inescapable because the investment officers weighing whether to buy REIT shares were comparing those shares with all other publicly-traded stocks. This was – and is – true of mutual fund managers as well as pension fund managers and individual investors.

Moreover, the change in ownership of properties formerly held by private developers and now held by public REITs altered the outlook and incentives typical of investors in real property. Developers who borrowed heavily to build properties were motivated by using tax-sheltered cash flows to build up equity over the long run by paying off debts. Their cash flows were sheltered by high interest and depreciation deductions. This resulted in low taxable incomes – or reportable earnings – but rapid pay-offs of debt or equity build-ups – especially during inflationary periods when market values rose rapidly. Another trait of their holdings was irregularity of earnings over time because of long initial construction and rent-up periods, plus intermittent heavy capital expenditures for modernization and rehabilitation. A key factor in this strategy is a long-term perspective with little emphasis on reportable earnings.

Investors in public REIT shares have much shorter time horizons – especially institutional investors who are rated by quarterly performance. Also, they want steady increases in reportable earnings – stated as FFO in REITs. Even more important, investors in REIT shares are constantly surveying a huge variety of alternative stock and bond investments available to them, for which they can use money from the same allocation pool as REIT shares. This is not true of both traditional equity and debt investors in commercial properties, who specialize in that one type of asset.

Therefore, the ***relative attraction*** of REIT shares compared with that of high-tech stocks, internet stocks, large-cap stocks, and many other types of stocks has now become much more important in determining what happens to the valuation of real properties than it ever was in the past. This is the converse side of the advantage that REITs have of exposing real estate to large pools of investible capital that formerly ignored commercial properties. The expansion of the basic capital pool allocable to real property is supposed to reduce the cost of capital, and it did so under favorable stock-market conditions. But REIT shares must compete in this expanded capital pool with far more types of alternative investments than in the past. If something makes REIT shares seem less desirable than these alternatives, that negative something may outweigh the positive advantage of tapping into a larger basic capital pool.

—The declining relative importance of commercial real estate. Moreover, commercial real estate itself has become relatively much less important in the overall U.S. financial landscape than it was in the past. This has occurred because of the immense increase in value of both stocks and bonds during the 1990s, thanks to a soaring stock market. In 1980, the total value of all U.S. corporate equities was $1.569 trillion. By 1990, that value had risen to $3.544 trillion, or by 126 percent. But by the end of the first half of 1998, corporate equities had zoomed to $14.556 trillion – a rise of 311 percent over 1990. Corporate and foreign bonds rose 229 percent in the 1980s and another 122 percent from 1990 to 1998.[3]

In contrast, commercial property values have remained relatively stagnant since the late 1980s. The Federal Reserve’s Flow of Funds Accounts valued total real estate tangible assets held by households, non-profit organizations, and nonfinancial corporations (including housing) at $6.6 trillion in 1990 and $8.7 trillion in 1997. That is a gain of only 32 percent, compared to a rise of 232 percent in corporate equities in the same period. Commercial mortgages alone increased in value from $754 billion in 1990 to $890.5 billion at the end of the first half of 1998, a gain of 18.1 percent during the period when corporate equities were rising 311 percent.

CB-Richard Ellis publishes National Real Estate Indexes of the per-square-foot sales prices of four types of property in over 50 major U.S. metropolitan areas. These indexes use the average sales prices in the second quarter of 1987 as their base, setting that price equal to 100. Each index is an approximate indicator of commercial property price changes because the mix of properties sold shifts from one quarter to the next, and no corrections for variations in property quality are built into the index. Even so, these indexes provide rough measures of how much commercial property prices have moved over time. An accompanying chart sets forth the movement of four such indexes from 1987 through 1998, showing data for only the second and fourth quarters of each year. The average per-square-foot price of CBD office space (the lowest line) declined by over 25 percent from 1987 to 1993, then barely recovered its 1987 level by 1998. In contrast, the average per-square-foot price of rental apartments (the topmost line) remained relatively flat until 1994, then rose steadily to achieve a 51 percent gain over its 1987 level by 1998. The average prices of the other two types of properties showed overall gains from

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[3] Data from the Federal Reserve Flow of Funds Accounts, Fourth Quarter 1993 and Second Quarter 1998.

1987 to 1998 of 18.8 percent for industrial-warehouse space, and 9.7 percent for community and neighborhood shopping centers. In contrast, the Standard and Poor index of 500 stocks increased by 278 percent from 1987 to 1998. As shown on a second accompanying chart, that gain is more than five times as great as the gain experienced in the same period by apartments, and infinitely greater than the gain experienced by office space – which did not gain at all.

As a result of these comparatively small increases in commercial property prices, the relative significance of commercial real estate in the wealth of the nation has declined sharply since 1990. Paine-Webber estimated the total market value of all institutional quality commercial real property in the U.S. as $3.7 trillion at the end of 1998.[4] But the value of corporate equities in mid-1998 was $14.6 trillion – or almost four times as great as that of all commercial property combined. Yet in 1990, corporate equities were probably worth just slightly more than all commercial property combined. Corporate and foreign bonds also had a market value of $3.7 trillion in mid-1998 – more than double what it was in 1990.

The Federal Reserve Board's analysis of household balance sheets for 1990 and 1997 also shows a sharp change in the relative importance of real estate vs. corporate equities and other equity securities. In 1990, households held $3.968 trillion as corporate equities, mutual fund shares, and half of their pension fund reserves (presumably also in corporate equities). But they also held $6.609 trillion in real estate, including their own homes. Thus, about one-fifth of their assets consisted of stocks and one-third of real estate. By 1997, the value of households' corporate equities, mutual fund shares, and half of their pension reserves had zoomed by 181 percent to $11.145 trillion, but the value of their real estate had increased by only 31.6 percent to $8.694 trillion.[5] So their holdings of corporate equities (including

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4 Paine Webber Equity Research, ***REIT 1998 Review and 1999 Outlook*** (New York: January 1999), p. 19. The Urban Land Institute's estimate of the 1995 value of commercial real estate structures, including apartments, adjusted for land as 20 percent of total value, is also roughly $3.7 trillion. See the Urban Land Institute, ***America s Real Estate: Natural Resource, National Legacy*** (Washington D.C.: 1997), pp. 32, 40, and 41.

5 Most of the real estate held by households consists of owner-occupied housing. Median prices of single-family homes sold increased by 30 percent from 1990 to 1997, according to the National Association of Realtors ***Real Estate Outlook*** (January 1999) and the ***Statistical Abstract of the United States: 1997,*** p. 720. This implies that the values of all other real estate held by households -- including commercial properties -- went up slightly faster than the values of homes. So the 31.6 percent increase for all real estate held by households is a reasonable estimate for the increase in value of their commercial properties too.

mutual fund shares and half of their pension fund reserves) had gone from 40 percent less valuable than their real estate holdings to 28 percent more valuable. About 56 percent of their total increase in assets from 1990 to 1997 consisted of greater values of equity securities, whereas only 16 percent consisted of more valuable real estate. Clearly, securitized wealth has replaced real estate as the number one type of household asset, at least for all households considered together. (This is probably less true of households in the lower half of the income distribution, since securitized wealth is more narrowly distributed than home ownership).

These data dramatically illustrate that commercial real estate both has a much smaller total value than its main investment rivals, and also has increased in value since 1990 much less than their spectacular gains. ***Moreover, commercial property has proven a much riskier investment than stocks or bonds during the recent past***. This is true because of the collapse of most commercial property values in the real estate debacle of 1990, and the low returns to REIT shares in 1998. Consequently, investors who normally compare buying interests in commercial property with interests in a broad variety of stocks and bonds are much less likely to be attracted by REITs than by the latter. Hence the shift from investors institutionally tied to real estate to investors facing a much greater breadth of choices has reduced the appeal of commercial real properties as a place to put investible funds. Why should they invest in something that is not very important in total size, has recently exhibited very low increases in value, and is prone to severe declines in value – in contrast to something that appears to rise in value indefinitely, and recovers rapidly from its occasional falls in value? No wonder REITs have lost their glamor!

VI. ***Other Factors Reducing the Attractiveness of Investing in Commercial Real Estate***.

Several other characteristics of REIT shares have recently reduced their relative desirability to investors as compared to other alternatives, such as technology stocks.

---***During the 1980s, the commercial property industry aggravated its reputation for overbuilding when capital is available by creating massive space surpluses. This resulted in an enormous loss of value among existing commercial properties in 1990. Investors therefore still regard commercial real estate as very risky.*** Office space fell about 50 percent in value on the average and other types of properties similarly sustained immense losses. This burned many institutions and made them wary about the stability of commercial property values over time. It also generated a great desire on their part for "liquidity" – the ability to withdraw quickly from real estate investments without sustaining big capital losses.

The main reason for the tendency of commercial property markets to become overbuilt is that when financial capital flows into those markets and thereby drives up the prices of existing properties beyond reproduction costs, further capital flows stimulate a lot of new property development. This added property undermines the prosperity – and therefore the market value – of all existing properties. So rising property prices tend to establish limits on their own further increases by evoking more competition. In contrast, when large amounts of financial capital have recently flown into the stock market, that has not expanded the supply of stocks commensurately – in spite of many initial public offerings (IPOs). Consequently, the prices of existing stocks have been driven upward. This is "inflation" in stock prices – an increased amount of money chasing a relatively slow-growing amount of shares.

However, increases in corporate equity prices have not stimulated corresponding increases in the productive capacity of the industries concerned, and therefore have not undermined the profitability of existing firms in the same way that increased capital flows into real estate have done. Most industrial firms can increase their outputs greatly from "normal" levels without adding much productive capacity by intensifying the use of their existing capacity, such as by running round-the-clock shifts. Therefore, increases in demand do not necessarily call forth additional capacity that undermines the profitability of existing capacity. That is not true of commercial real estate. A building cannot expand its "output" of space once it has reached 100 percent occupancy. So increases in demand beyond that point call forth new buildings that tend to be larger than the immediately-needed extra space, thereby causing competition for previously-existing space. Moreover, the newer space is technically more up-to-date and therefore strongly competitive with all older space.

True, many industrial firms have taken advantage of favorable stock market conditions to expand and modernize their productive capacity. But they have usually not done so to the extent that commercial real estate has done so. This restraint occurs partly because many industrial firms enjoy quasi-monopolistic market power because of the high costs new firms must face in order to enter those markets. In contrast, it is relatively easy for additional producers to enter most commercial property markets.

—Real estate markets have moved out of the rising-value gradual absorption phase of their basic cycle into the less buoyant development boom phase; so investors expect smaller improvements in property prosperity in the near future. The current real estate cycle hit bottom in the overbuilt phase, which started in 1990 and stayed low until about 1993. But then it went into the gradual absorption phase. This rising-value phase, which lasted from 1994 through mid-1997, involved steady increases in occupancy, rents, and property values. It coincided with the rise of REITs, which were able to take advantage of these increases to obtain rapidly- growing earnings. But this phase generated a development boom in late 1997 and especially in 1998 that raised the specter of more overbuilding and a "topping out" of the real estate cycle. Hence sophisticated investors started worrying about potential overbuilding well before it actually appeared.

---***The rapid growth of REIT share values in the period from 1994 through 1997 led many investors to mistakenly regard REITs as growth stocks capable of sustaining annual earnings increases in the 15 percent or higher range.*** When REIT share values fell in the fall of 1998, REITs pulled back from their aggressive buying that had generated and sustained much of the rising value of properties in 1996 and 1997. This demonstrated that their ability to expand through acquisitions was not constant, but could be undermined by changes in stock market conditions. This demonstration killed the idea that REITs were true "growth stocks," since they were then forced to grow only through the use of internally-generated capital, which does not arise at anything like a 15 percent per year rate. Many investors -- particularly mutual funds -- who had regarded REITs as growth stocks pulled out of the market. That enormously weakened the demand for REIT shares and prevented their prices from rising along with those in the rest of the market.

In reality, most REITs should be regarded as income stocks with relatively slow average growth prospects, for three reasons. First, they are income stocks because they pay much higher dividends, in relation to their total earnings, than most corporate equities. They are required to do so by the statutes establishing REITs. Second, they can grow their cash flows only through (1) greater internal profitability from their existing properties, which is limited by the slow-growing nature of most commercial property markets, (2) reinvestment of internally- generated capital, which is severely limited because they must distribute most of their taxable earnings to their shareholders, and (3) acquisitions financed by raising more outside capital, which is difficult under present market conditions. These limitations reduce their price-earnings ratios compared to true growth stocks. That is why many growth-oriented investors withdrew from REITs. At the same time, based upon current price-earnings ratios, many investors were regarding most other stocks as growth stocks, although their doing so is not necessarily rational.

The third reason is that the commercial property industry is a relatively mature industry; so its future growth is limited by the overall growth rate of the nation's real estate markets. True, the U.S. population is likely to rise by about 12 million persons every five years from 1995 to 2020, and serving them will require a lot more real properties of all types. But that is a population growth rate of less than one percent per year. Some faster-growing regions will grow much more rapidly than that low average. But the larger a REIT is, and the more diversified its holdings are across many regions, the more the growth rate of its markets is likely to resemble the slow average growth rate of the entire nation. Therefore, the growth of most REITs' underlying markets is not suitable to producing high growth rates in REITs' income or funds from operations.

In contrast to REIT share prices, the prices of many other groups of stocks had soared before the credit panic of fall 1998, and soared again once that panic had ended. These groups of stocks seemed far more attractive to investors because they grew rapidly in value, had no long-term reputation for disaster, and had no recent history of disaster – as did commercial property markets.

--- ***REIT shares form a very small part of overall stock market capitalized value, and real estate holdings of all financial institutions constitute a very small part of their total assets.*** At the end of 1997, the market value of all equity REIT shares combined was $127.8 billion, according to NAREIT. If the overall debt-to-total-value ratio of REITs was 40 percent, then the total value of equity REITs including debt was $213 billion. Without allowing for any premium or discount of REIT market value to net asset value, that constituted only 5.8 percent of the total 1998 value of all commercial property of $3.7 trillion as estimated by Paine-Webber. (This is only a rough estimate because the data come from disparate sources. But it illustrates that REITs now own only a very small share of commercial properties.)

Moreover, the $127.8 billion of equity REIT shares outstanding formed less than one percent of the $14.556 trillion of total corporate equities as of mid-1998. It is natural that many investors scanning all available horizons for profit opportunities do not devote much attention to this tiny segment of the investment universe, especially in view of its recent short-comings. They are much more strongly attracted to bigger, more glamorous, better-publicized, and much higher-growth sectors like technology and the internet.

VII. ***Relationships Between REIT Share Prices and REIT Net Asset Values***

Because most REIT share prices are now valued below the net asset values of their own properties, some stock analysts believe those share prices will surely rise to eliminate this discount. Such an increase would put the relationship between REIT share prices and REIT net asset values more in line with that relationship as exhibited by other types of corporate equities. This issue is related to the fundamental question of whether public markets allocate capital to real estate more efficiently than private markets. Many defenders of Wall Street claim such superior allocational efficiency for public markets. For example, they attribute the sudden decline in capital flows from public markets into private markets in the fall of 1998 to the superior insight of public market investors into the increased possibility of overbuilding in property markets. This is part of their claim that public markets allocate financial capital to real estate more efficiently than private markets.

Supposedly, public markets are more efficient because (1) they provide much more information to investors about property performance and the future plans of developers, (2) they provide daily pricing of REIT portfolios, (3) their liquidity allows rapid movements in and out of stock positions, (4) they demand less leveraged property financing less susceptible to default,
(5) their incentive structures more closely align the interests of capital providers, property managers, and shareholders, and (6) they tap into a broader set of capital sources than those focused mainly on real estate, and therefore should achieve a lower average cost of capital over the long run. These advantages should result in lower susceptibility of public markets to over- supplying capital to real estate, thereby

creating overbuilding, or under-supplying capital, thereby creating credit crunches that unduly depress property prices.

The evidence concerning whether public markets achieve these results is mixed. The Japanese stock market horribly allocated capital in its price run-up from 1986-1989. That “bubble” burst with a two-thirds fall in stock prices in 1990 that immensely affected Japanese real estate markets, in which land prices have fallen over 60 percent with little subsequent recovery. True, the U.S. economy is in much better condition than the Japanese economy, and U.S. stock markets are not close to being identical to the Japanese stock market. Nevertheless, that experience shows that public markets do not always allocate capital efficiently.

Also, U.S. real estate stock prices plunged in both October 1987 and fall 1998 when no corresponding sudden decline was occurring in the prosperity of property markets. And current stratospheric price-earnings ratios on many technology and internet stocks do not seem consistent with efficient allocation of capital. In addition, the sudden cut-off of funding in CMBS markets in fall 1998 was part of a general global financial panic caused by Russia’s default, the Asian crisis, and the possible devaluation by Brazil, not by superior public-market- investor insights. And public market investors had not stopped REITs from paying excessively- high prices for many properties acquired in late 1997 and early 1998. All these facts imply that public markets are not more efficient allocators of capital to real estate than private markets.

Furthermore, it is clear that public markets cannot ***always*** raise real estate equity capital at a lower cost than private markets. There are times – like the present – when properties are evaluated as worth more by private markets than by public ones, and when both equity and debt capital can be raised in private markets at lower cost than in public markets. One reason is that the fees paid to investment bankers for stock offerings can be as high as 10 percent of the proceeds. So which markets are more efficient depends on current conditions in both types.

On the other hand, REIT stock prices did start falling behind the general market early in 1998, showing some investor disaffection with real estate. And the subsequent slowdown in flows of funds into real property markets certainly did reduce the pace of new development. That had the effect of reducing the rate of possible future overbuilding that will occur in 1999. Once REIT shares fell along with other stocks, public market investors reappraised the desirability of investing further in those stocks because of the less favorable position of private markets in their overall cycle. That may help explain why REIT shares have not come back in value like the rest of the market. These data seem to demonstrate some superior efficiency of public markets in capital allocation. Thus, the overall evidence is rather ambiguous.

Yet the evidence does not strongly support the view that REIT share prices are almost sure to rise to equal or surpass REIT net asset values. When REIT share prices were well above net asset values, proponents of REITs claimed that premium was a reward for the superiority of managing whole portfolios of properties rather than one-property-at-a-time, and for the high quality of management in particular REITs. But those conditions have not changed, and yet REIT share prices are now being substantially discounted below net asset value.

Why is that? The market might be concluding that the volatility of REIT stock prices is so much greater than the volatility of private market prices that there should be a discount for greater risk. Or it might conclude that the limitations on leverage of REITs make them less attractive than straight ownership of properties. In Europe, where public companies have owned real estate for decades, their share prices trade a discounts to net asset value.

After all, stock prices generally are more volatile than private real estate prices, even though the latter can fall dramatically, as in 1990. Market conditions normally change much faster and with less predictability in the stock market than in real property markets. Stock prices in 1987 and 1998 took sharp declines when private property prices were relatively stable. REIT share prices fell along with all other stocks, causing a devaluation of the real estate in the public ownership form. In property markets, no commensurate sudden worsening of conditions occurred. This greater volatility of stock prices -- ironically caused by their greater liquidity -- can be a drawback that may outweigh the superior liquidity of REIT shares.

One influence on this issue is that many investors in stocks have much shorter time horizons than those in real properties. This is particularly true of fund managers of all types, who are judged on their quarterly performances. This sets the stage for greater volatility of REIT share prices than property prices. The supposed liquidity advantage of REIT shares encourages this short-term thinking; in contrast to the illiquidity of direct ownership. Stock markets are also much more subject to fads among investors than property markets, although such fads can occur in the latter too.

In view of all these considerations, the fact that REIT share prices are currently discounted below net asset values does not necessarily imply that those prices will surely rise to eliminate that discount in the near future. Moreover, further new development may create more competition for existing REIT properties. As we look ahead in 1999, I do not believe the development boom phase of this cycle is yet over. Mortgage funding in particular, both from traditional sources and from CMBSs, is going to come back by this spring. That will enable a lot of further development to take place – both halted projects, and new ones not yet underway. This will occur because (1) the economy is still booming and demanding more space and (2) there is still a lot of institutional investment money looking for somewhere to go and worried about the stock market. Of course, if the stock market plunges, this scenario concerning further development would be changed.

VIII. ***The Long-Run Roles of REITs in Future U.S. Commercial Property Markets***

Many property owners adopted the REIT vehicle in desperation in the early-to-mid 1990s because no other sources of capital were available, and because "positive spread investing" then appeared very attractive. But the stock market conditions unusually favorable to REITs then extant could not be sustained indefinitely. Thus, the financing superiority claimed for REITs was a temporary phenomenon, though it could reappear under some conditions.

But current stock market conditions favor private real estate firms -- including non-REIT corporations -- over REITs. The former can borrow at very low interest rates and invest at higher cap rates, while using much higher leverage ratios than Wall Street allows for REITs. Also, non-REIT private corporations can pay no dividends and use all their internal earnings to expand. Their requirement to pay taxes is partly overcome by using depreciation to shelter cash flows. Another big advantage they have over REITs is the ability to engage in activities other than renting space, which are becoming more important over time to property operators. (However, this advantage of non-REITs would be removed if Congress passes the Taxable REIT Subsidiary law currently proposed by NAREIT.) These qualities make private corporations especially superior to REITs for new development. Consequently, at least a few present REITs are likely to convert to C-corporation status, as has Starwood.

In fact, the stock market has always undervalued the tax-sheltered cash-flows generated by highly-leveraged real estate sheltered by depreciation, because those cash flows are not equivalent to reportable net income. Developers who create and hang onto real estate benefit from the internal equity build-up resulting from these cash flows ***over the long run*** by minimizing dividend payouts. But many institutional investors in the stock market are not truly long-run oriented; they are more oriented towards current reportable earnings and dividends. This difference in perception has not been solved even by recent massive increase in analysis and data.

In order to grow much, REITs must constantly raise more outside equity, causing possible dilution and payment of high costs for capital when stock markets are unfavorable. This will limit REITs' capacity for rapid growth except when stock market conditions are very favorable, or through consolidation by stock trades.

In reality, ***REITs are now basically in the stock market business even more than in the real estate business***. So the adverse perception of the real estate industry by investors described earlier limits future increases in REIT share prices. Moreover, institutional holdings of REIT stocks are tiny compared to holdings of other stocks, and the poor performance of real estate investments in the early 1990s and in 1998 minimizes the interest of institutional investors in real estate vehicles.

One last disadvantage of the REIT industry has been emphasized by Sam Zell – there are probably too many REITs. The industry has overcapacity in its ownership vehicles, and this befuddles investors. Consolidation will cut this number down, but I do not foresee just one or two firms in each property type.

On the other hand, the REIT form has some key advantages, too. Its main benefits are non-payment of taxes at the firm level and convenience to investors as a means of investing in diversified portfolios of real estate without the hassles and greater risks of direct ownership**.** Thus, ***REITs have much greater advantages on the stock investors side than on the operators side***. This means there will be a sizable market among investors who want to treat REITs as mutual funds in equity real estate, although the amount of capital they want to put into real estate has so far been very small compared to their interest in other areas.

No doubt, REITs will continue to exist to serve that market, but they will not be REITs focused on rapid growth. Rather, they will be REITs focused on managing large and geographically diverse portfolios to provide sizable dividends to their investors at relatively low risk. This means REITs as a group will not have high price-earnings ratios but will pay above- average income to those who own them.

Another advantage claimed for REITs is their ability to achieve economies of scale in property operation, as well as property financing. I confess to considerable skepticism about operational economies of scale beyond the regional level. I also believe the currently-touted concepts of “property branding” and “providing non-real estate services to captive tenants” will prove much more profitable in theory than in practice.

Undoubtedly, consolidation of REITs will continue, especially because large ones can swallow up less-profitable small ones by trading stock rather than raising capital in the markets. So some very large REITs will emerge in some classes of property, but no class will be dominated by just one or two huge REITs.

To some degree, REITs can offset the disadvantage of having to distribute their earnings by using depreciation to minimize taxable earnings, keeping dividend payouts relatively low, and using their tax-sheltered residuals to expand. They should also borrow as much as possible under present low-interest conditions; there is no reason why their debt-to-total-capitalized-value ratios could not prudently reach 60 percent. And if the new Taxable REIT Subsidiary structure being considered in Washington passes, REITs may escape limits on their types of activities.

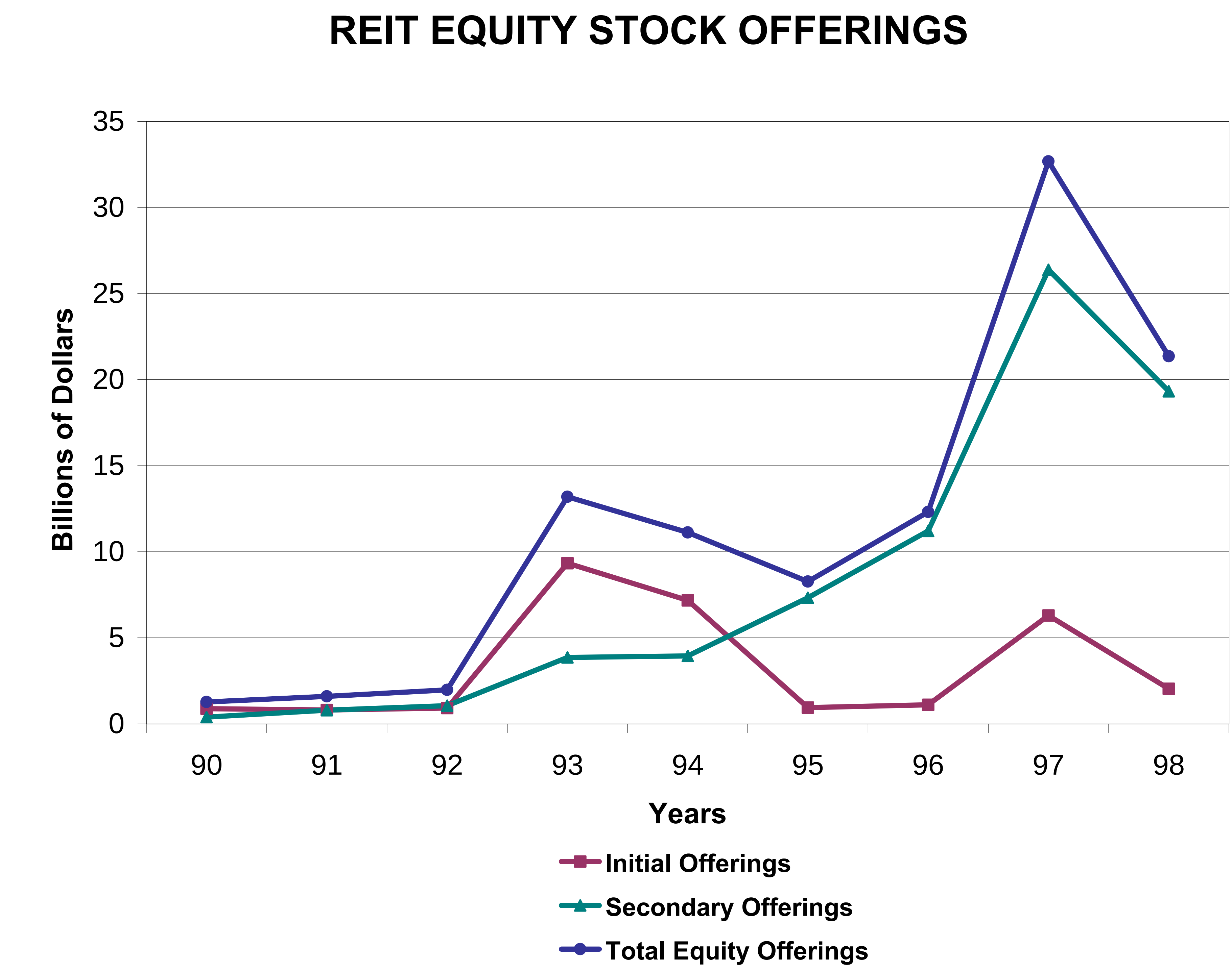
One final advantage of REITs is that they have been operated at relatively low leverages. That helps them remain rather immune to the massive bankruptcies that plagued traditional highly-leveraged developers in the early 1990s. Thus, low leverage will protect REITs from the most dire consequences of overbuilding by non-REIT developers, if it should occur. But low leverage also limits their return on equity, thereby preventing them from achieving growth stock status.

IX. *Conclusions.*

The long-run balance between REITs and other forms of owning real estate will thus depend heavily upon the relative time periods in which stock market conditions are strongly favorable to REITS, or not so favorable. If conditions favorable to REITs prevail much of the time, REITs will be able to expand their absolute and relative roles at the expense of other forms of ownership. But if neutral or unfavorable conditions prevail much of the time, REITs will not expand so much relative to other firms. It is hazardous for me, a real estate expert, to predict stock market conditions. Certainly future stock market conditions will from time to time become more favorable to REITs than they are in early 1999 when this is being written. But it seems unlikely that conditions as favorable to REITs as existed from 1993 through 1997 will prevail most of the time in the future. Therefore, I see REITs as remaining important forces in real estate markets for a long time, and expanding their relative shares of commercial ownership over the long run. But they will not come to dominate those markets as much as they appeared to have from 1996 through mid-1998.

So the future shows a mixed industry consisting of REITs, other forms of publicly-owned real estate companies, and private companies, all seeking to adjust to the basically mature, less significant, and slow-growth nature of the real estate industry. REITs will not expand to take over dominance in any forms of property – though regional malls are closest to that outcome. Consolidation will continue to mark the REIT industry, but not to the point where a few monster firms have the power to set prices in property markets.

Yet because current general economic conditions are so favorable to real estate operations, plenty of money will be made in REITs. Moreover, as the population ages, more investors will place higher value on income stocks with strong dividends, such as REITs. That may push REIT share prices upward relative to the prices of other stocks. And the greater prominence of the REIT format may help reduce, if not prevent, the chronic overbuilding that has plagued private property markets in the past. So REITs are not only here to stay, but will remain powerful forces influencing both public and private real estate markets – even if they are not named “Real Estate Dot Com.”


REIT EQUITY STOCK OFFERINGS
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Billions of Dollars
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Years
Initial Offerings
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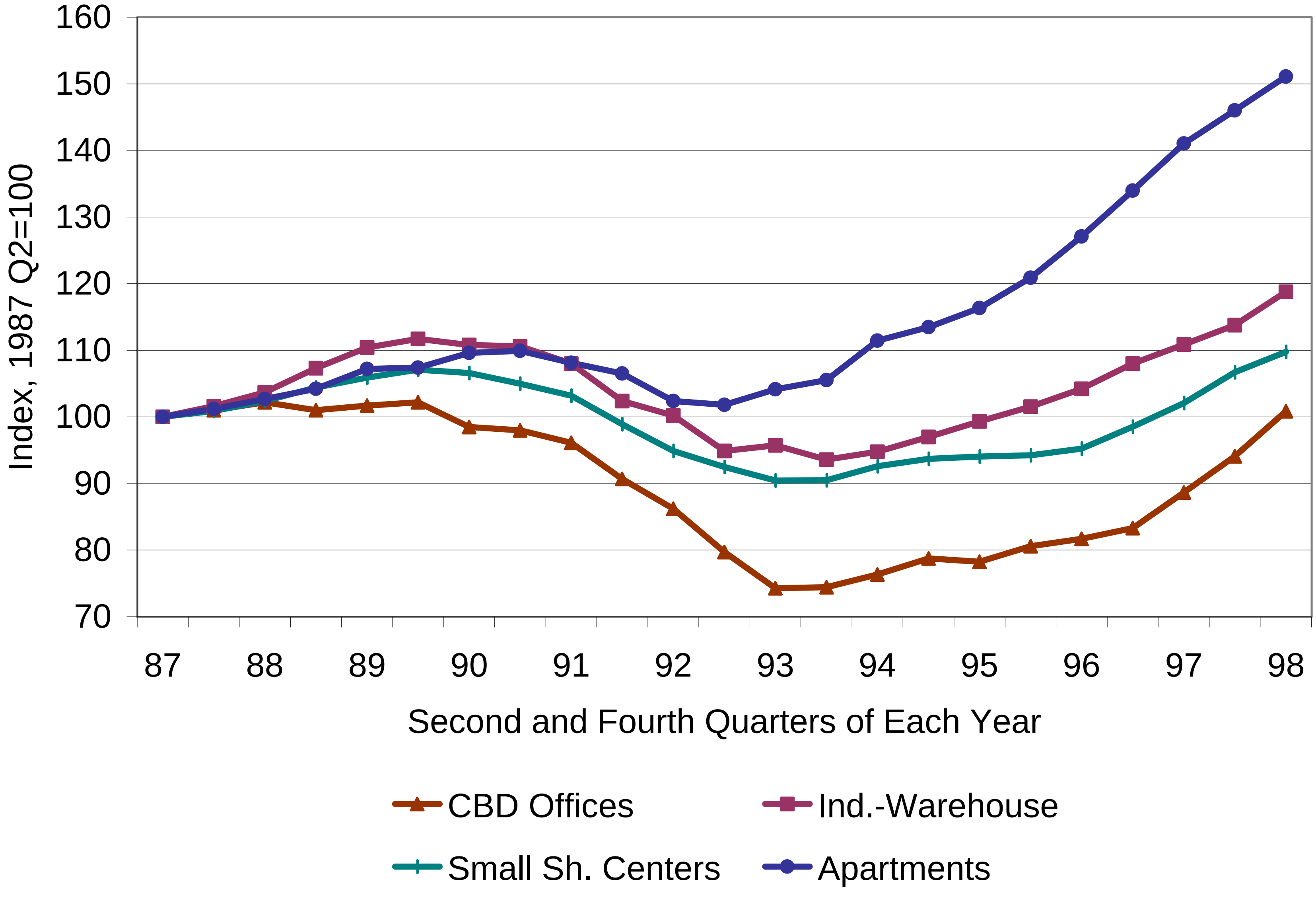
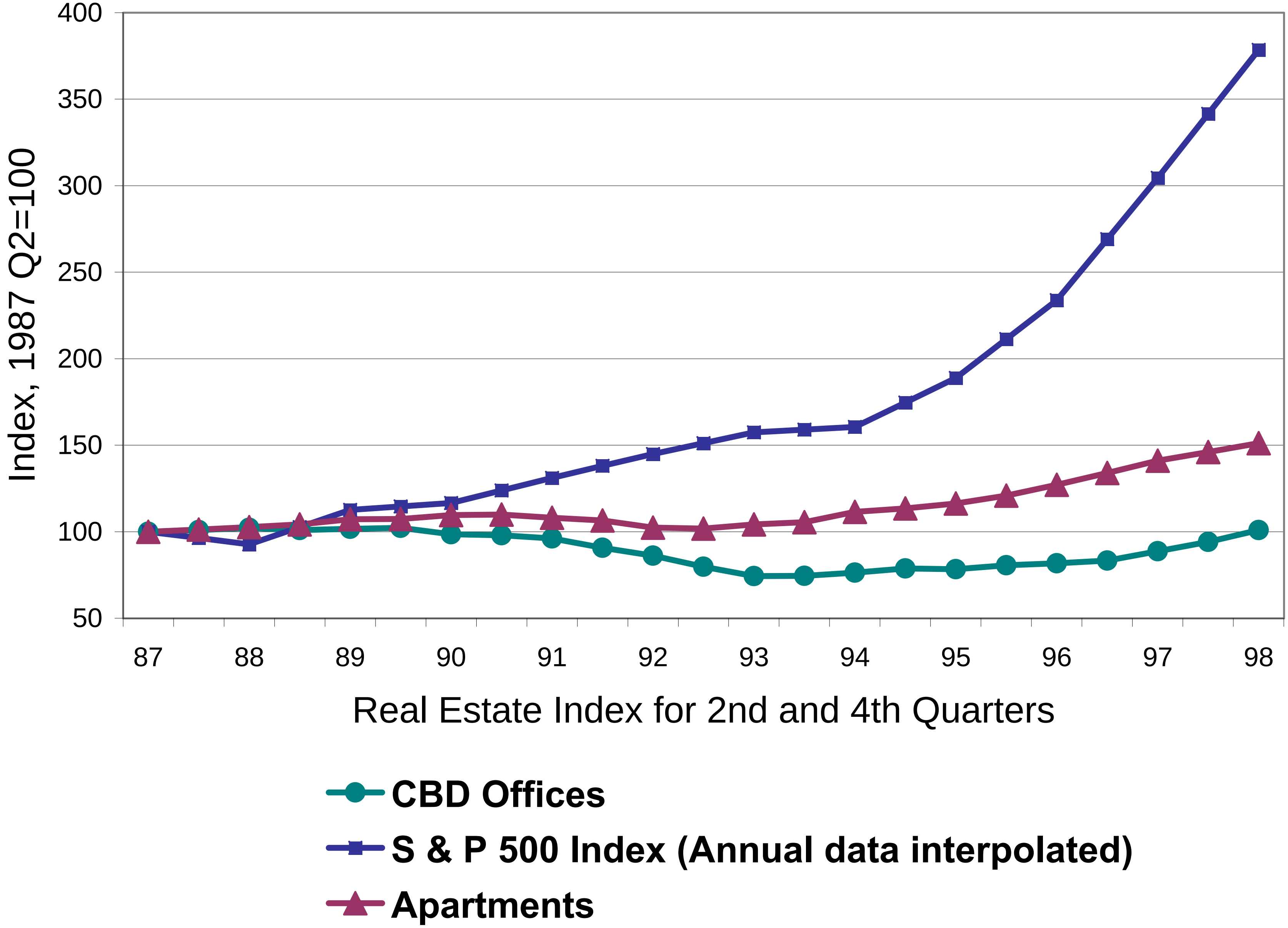
Price Indexes of Commercial Properties



Price Indexes of Commercial Properties



KEY ASSETS OF HOUSEHOLDS