

THE IMPACT OF PUBLIC CAPITAL MARKETS ON URBAN REAL ESTATE

THE ROLE OF PUBLIC CAPITAL MARKETS ON URBAN REAL ESTATE

I. INTRODUCTION

A. Context for This Discussion

The premise of this paper is that understanding the dynamics of new forms of financial intermediation is necessary for understanding the dynamics of metropolitan area growth and urban economies in this country. Regional and local real estate markets are changing. Publicly-owned companies that control national or regional asset portfolios are becoming substantial buyers and sellers, and Wall Street -- rather than Main Street -- financial intermediaries are assuming a greater role in financing commercial real estate development. These market changes are likely to affect what is built, where it is built, and for whom it is built. We are at an early stage in both the evolution of real estate markets, from ones dominated by individuals and privately-held entities to ones largely affected by publicly-owned companies, and in the evolution of real estate finance markets, from ones dominated by local or regional commercial banks, thrifts, insurance companies, and pension funds to ones more substantially governed by national investment banks and credit underwriters. The strategies of these companies and underwriters are clear in some respects but not in others. So, much about the probable results for the built environment and urban economies remains left to conjecture.

Meanwhile, private and public constituents who are not primarily involved in real estate development or finance continue to seek and pursue strategies that improve the economic, social, and environmental welfare of their cities, inner suburbs, and metropolitan regions. Their prospects depend in part on their access to capital to implement their strategies for community revitalization or viability, creation of economic opportunity, preservation or restoration of environmental resources, assurance of public safety, improvement of public education, and provision of equitable access to social and health services. These strategies may or may not conflict with, complement, or otherwise connect with the strategies being pursued by the emerging property owners and credit intermediaries.

This paper intends to facilitate a public understanding and discussion that will increase the prospects for greater harmony among the various private and public sector strategies that will benefit our urban and metropolitan communities economically, socially, and environmentally.

B. The Emerging Dynamics in the Real Estate and Real Estate Finance Sectors

The public capital markets are playing an increasingly significant role in financing the ownership and development of commercial real estate. Since 1991 real estate investment trusts [“REITs”] have emerged as substantial acquirers of commercial real estate, and underwriters of commercial mortgage-backed securities have emerged as important sources of credit for the acquisition and development of commercial real estate. This paper notes the recent dynamics of the public capital markets in real estate finance and then discusses certain issues and opportunities that are likely to interest parties concerned with housing, community development, and urban growth policies.

REITs are corporate entities whose attributes are determined by the Federal Internal Revenue Code. Congress designed them to enable small investors to invest in real estate. Like a mutual fund, the REIT is not taxed on its corporate income, so long as it distributes 95 percent of its net taxable income to its stockholders each year. The REIT’s stockholders are taxed on their dividend income. REITs are also subject to the regulatory jurisdiction of the Securities and Exchange Commission.

REITs can be privately or publicly held. They can own properties or make real estate secured loans, or do both. The following discussion focuses primarily on publicly held, equity REITs. REITs normally specialize in a property sector. They invest, for example, in hotels, commercial office buildings, apartment buildings, regional retail malls, commercial retail strip shopping centers, industrial warehouses, storage facilities, or other types of income-producing property. However, REITs may diversify their property investments.

Commercial mortgage-backed securities [“CMBS”] are a form of debt security, the terms of which are largely determined by negotiation among private parties. But, their terms are also influenced by the Internal Revenue Code’s provisions regarding REMICs [“real estate mortgage investment conduits”] and more recently FASITs [“financial asset securitization investment trusts”]. Issuers of CMBS are subject to the regulatory

jurisdiction of the Securities and Exchange Commission. CMBS represent interests in a pool of loans secured by mortgages on commercial, income producing properties. The loan payments are distributed to the securities holders in accordance with their relative priority of claim to the payments. The pooled loans may be secured by the same property type, such as commercial office or apartment buildings, or more typically by different types of properties.

Commercial real estate in the United States is primarily held by privately held entities or individuals rather than publicly owned companies. But the equity capitalization of equity REITs has increased to more than \$160 billion, and substantial assets have moved into the control of publicly owned companies, primarily REITs. Last year alone, REITs acquired approximately \$35 billion of investment-grade real estate. The greatest ownership by publicly owned companies exists in the hotel/gaming resort and regional mall property sectors.¹ Publicly owned companies control a smaller share of apartment and non-mall retail properties.² They control only a marginal share of the commercial office and industrial warehouse property sectors.³

At the same time as the capitalization of equity REITs has burgeoned, the volume of outstanding CMBS has skyrocketed. The cumulative outstanding CMBS indebtedness now exceeds \$170 billion. Approximately one-half of the debt that supports the payments on outstanding CMBS is collateralized by multi-family properties.⁴ Notwithstanding the mushrooming of outstanding CMBS securities, the CMBS market remains a relatively small source of the total commercial mortgage debt. In 1997, the CMBS market originated 13 percent of commercial mortgage loans.⁵

To date, equity REITs have been primarily acquiring existing, income-producing properties. However, as the REITs have pursued aggressive acquisition strategies, they

¹ B. Ziering, B. Winograd, and W. McIntosh, "Tracking A Capital Market Transformation: Public Market Commercial Real Estate Penetration," Real Estate Finance [Fall 1997] [hereafter Ziering et al.] at 18, 20.

² Ziering et al. at 20.

³ Ziering et al. at 17, 19.

⁴ March 20, 1998, interview with Sally Gordon, KPMG Peat Marwick.

⁵ Federal Reserve Bulletin [December 1997].

have competed for properties and bid up their prices, so that in some markets the prices realized for existing buildings have triggered new construction. As the prices of existing properties have escalated, REITs have allocated increasing amounts of capital to the development of new properties. Depending upon their capital and management capacities, REITs have undertaken new development projects alone or with other developers and capital providers.

The equity ownership of the publicly owned REITs as of December 31, 1996, was split evenly between institutional and individual investors.⁶ The rapid emergence of the publicly- and privately-owned REIT is attributable in substantial part to the interest of pension funds, life insurance companies, and other institutional investors in holding investment grade, income-producing real estate indirectly rather than directly. Institutional investors lost substantial amounts on their real estate investments during the severe recession of the late 1980s and early 1990s. Their experience has persuaded them to search for a more easily liquidated form of investment.

The rapid emergence of the equity REIT and CMBS markets is also attributable to the credit crunch that occurred with the last recession. The credit crunch followed the overextension of commercial mortgage credit by commercial banks, thrifts, and life insurance companies. In response, regulators of these institutions increased their capital adequacy requirements. These, in turn, have motivated traditional portfolio lenders to hold the more highly rated interests in CMBS rather than simply in whole loans, as their credit risk is less and, therefore, their capital requirement is less.

The national credit rating agencies -- Standard & Poor's, Moody's, Fitch Investors Services/IBCA, and Duff & Phelps -- rate both CMBS and REIT securities. The ratings affect the marketability of the securities and the capital costs of their issuers. The Securities and Exchange Commission acknowledges the rating agencies' status, but does not actively oversee them.

⁶ Paine Webber, REIT 1997 Review and 1998 Outlook at 16.