Testimony of

Robert M. White, Jr.

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Evolution of the Commercial Real Estate Capital Markets and its Cycles

By
Robert M. White Jr.
President and Founder: Real Capital Analytics, Inc.

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Key Points

- The proposed banking agency guidance on commercial real estate lending concentrations appears to be predicated on fundamental misconceptions of how the commercial real estate market functions today.
- Today's commercial real estate market is very different from the one that existed in the late 1980s and early 1990s. Today's commercial real estate market benefits from greater transparency, increased scrutiny and more timely information associated with the growth in public Real Estate Investment Trusts and the creation of the Commercial Mortgage Backed Securities Market.
- The information feedback loop that is now in place should help prevent large boom bust cycles in the future.
- The definition of commercial real estate in the proposed guidance appears to be based on the misconception that the residential real estate market and commercial real estate market are sufficiently correlated to justify including certain types of residential real estate loans within the definition of commercial real estate.
- The commercial "for rent" and residential 'home ownership" real estate markets are distinctly different and move in different cycles.
- The commercial real estate capital markets have become a sophisticated national and international marketplace while the space, or leasing markets remain local.
- Equity capital for commercial property comes from a great diversity of sources, many of which did not exist in the 1980s.
- The commercial mortgage industry has been transformed by access to the public sector securities which now originates more loans than commercial banks using the commercial mortgage backed securities (CMBS) vehicle.
- Public equity (Real Estate Investment Trusts) and public debt (Commercial Mortgage Backed Securities) have revolutionized transparency and standards throughout the industry.
- Commercial real estate has emerged as the fourth asset class along with stocks, bonds and cash for a national and international investor base.
- It is unlikely that equity or debt capital will stop flowing to commercial real estate as it did in 1990 when the commercial real estate market crashed. The regulatory and private industry monitoring systems have created a check and balance system that is working well.

Purpose of This Written Testimony

Earlier this year, the federal banking agencies issued proposed guidance entitled "Concentrations In Commercial Real Estate Lending, Sound Risk Management Practices" (the "Guidance"). The proposed Guidance sets forth certain thresholds for assessing whether an institution has commercial real estate loan concentrations that would trigger heightened risk management practices and potentially higher capital requirements. After analyzing the proposed Guidance, it appears that it is predicated on fundamental misconceptions of how the commercial real estate market functions today. These misconceptions seem to be based on the assumption that this market has not witnessed fundamental changes over the last two decades. Simply stated, today's commercial real estate market is very different from the one that existed in the late 1980s and early 1990s. For example, the commercial real estate markets and their cycles are much more transparent today than they were a decade ago. This increased transparency allows investors, developers and lenders to react much more quickly to market risks and substantially reduces the potential for overbuilding. This increased market transparency should make future real estate cycles longer and less volatile.

The definition of commercial real estate in the proposed Guidance appears to be based on the misconception that the residential real estate market and commercial real estate market are correlated to such an extent that certain types of residential loans should be included within the definition of commercial real estate for purposes of the proposed Guidance. This is a faulty premise because the commercial real estate market and the residential real estate market are fundamentally different and move in different cycles.

Commercial real estate is a necessary and important part of economic growth. In order to avoid any potential unintended consequences, the bank regulatory approach to commercial real estate lending must be predicated on an accurate understanding of today's commercial real estate market environment. The purpose of this written testimony is to set forth the changes that have occurred in the commercial real estate market over the last two decades in order to address the misconceptions upon which the proposed Guidance appears to be based.

Defining the Markets

Capital vs Space Markets

In order to understand the cyclical nature of the real estate industry, it is important to differentiate the capital markets from the space, or leasing markets. Capital market factors concern such things as asset prices, liquidity, and mortgage rates. The space markets refer to leases, rental rates, and occupancy levels. The capital and space markets move in different cycles although each also influences the other. For example, in the 1980s, capital market factors, too much capital, lead to overdevelopment which in turn overbuilt and thus undermined the space markets. More recently, in 2001, the space markets suffered a demand shock, as high tech tenants evaporated almost overnight leaving considerable vacant space. However, at the same time leasing fundamentals were deteriorating, the capital markets for commercial property rallied, causing prices to rise. Investors, many burnt by the dot-com frenzy in stocks, were attracted to real estate because it is a tangible "hard" asset and it offered relatively high yields and significant portfolio diversification benefits. A new capital cycle began as large institutional investors and private individuals re-allocated capital from the stock market and into real estate.

The period from 2001 and into 2004 has often been referred to as "the disconnect" of the commercial real estate markets. The capital environment (price) was very positive and improving yet the space markets (occupancy) were weak and faltering. Currently, the leasing conditions for almost all property types and most markets nationally are improving and the capital environment remains favorable. The capital and space markets are once again moving in the same direction.

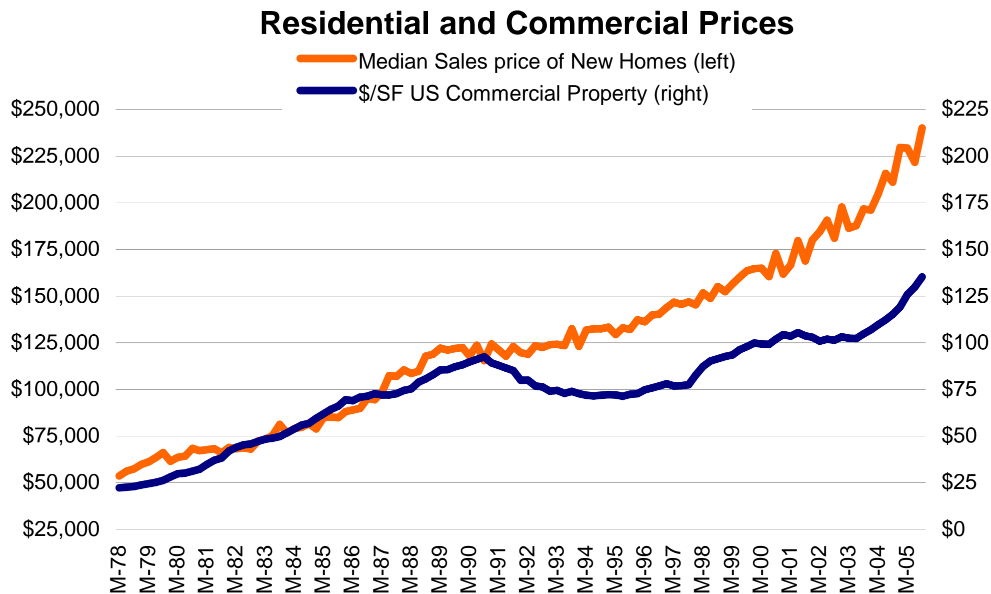
Local vs. National

The supply and demand factors that influence the space markets are specific to each local market where a property is located. The demand for space by tenants is determined largely by the strength of the local economy and the availability of space within that local market. By contrast, the capital markets have evolved into a national marketplace that is moving quickly toward globalization. Investors and bankers are no longer limited just to nearby markets, but are diversifying their portfolios by investing in opportunities in other markets, across regions and even offshore.

This free flow of real estate capital makes the capital markets more efficient and helps mitigate risks. For example, commercial property in California commands among the highest prices in the nation so some owners have recently decided to sell those assets at premium prices and buy property in markets that they perceive as cheap, such as Phoenix or Dallas or Atlanta. Over the past two years, the amount of real estate capital from California-based buyers has quadrupled. Only recently have the information and tools necessary to underwrite investments and operate in multiple markets become readily available. This information and tools were not available during the 1980s. Moreover, it is only since the Riegle-Neal Act in 1994 allowing interstate branch banking that banks have been permitted to diversify their mortgage portfolios geographically.

Residential vs Commercial Markets

A house and an office building are both considered real estate assets, yet both operate in entirely different capital environments and their economics are driven by entirely different supply and demand factors. A clear distinction between commercial and residential properties is made throughout the construction, lending, brokerage and investment industries as market participants have had to specialize to address the dichotomy of these two disparate classes of real estate. No longer can housing and commercial property be grouped simply as “real estate”.

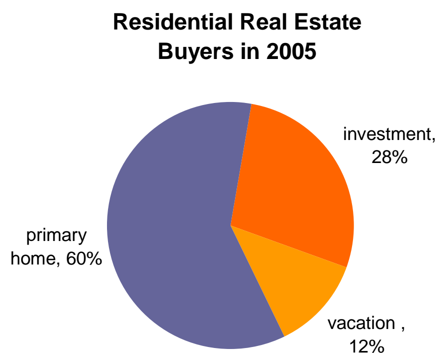


sources: NCREIF, NAHB

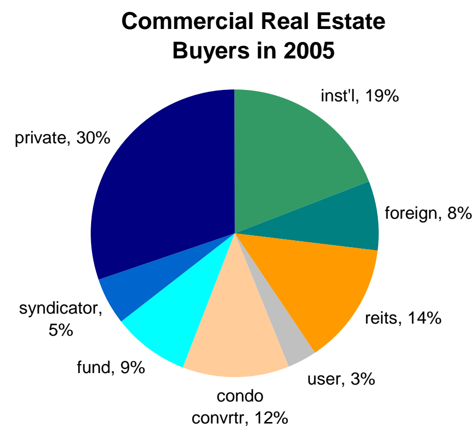
Over the past 25 years, prices for commercial and residential property have moved independently and have not shared the same “real estate” cycles. For example, between December 2000 and December 2003, the median price for a new home increased by 21%, yet the average price for commercial property increased by just 3% over the same period. Again, in a different economic period between 1989 and 1992, prices for commercial property fell 16% while housing prices

actually increased. Certainly, prices for all types of newly constructed real estate are affected by similar influences such as land and raw material costs, interest rates and the general economic climate, but ultimately prices for residential and commercial property are determined independently.

One reason the housing and commercial markets move in different cycles is that commercial property buyers encompass a diverse pool of capital sources (buyers/investors) beyond the private individuals that that own and live in housing. Institutional investors (pension funds and endowments), REITs, and foreign investors now represent almost half of all commercial acquisitions. Moreover, these investors tend to be low/no-leverage buyers making them less sensitive to rising interest rates than are other investors and most homebuyers. In addition, most commercial investors have a long-term perspective and buy and hold property for the income. In comparison, a speculator/flipper mentality has become pervasive in the residential market and their profits depend almost entirely on price appreciation. Residential buyers are generally also local in scope, but most commercial buyers are national if not international investors with greater freedom to invest without geographic limitations.



source: National Association of Realtors



source: Real Capital Analytics

Equity capital for commercial real estate has evolved significantly over the past 25 years to include a diversity of public and private, domestic and foreign, and institutional and entrepreneurial sources. Prior to 1980, commercial property investors were similar in composition to home buyers in that the capital was largely private and local. While private investors still play an important role in the capital markets, the commercial marketplace is no longer dependant on them. In 2005, more sophisticated and better capitalized groups of buyers were responsible for 70% of commercial property acquisitions. The influx of these other capital sources has fundamentally changed the nature of the commercial marketplace since the 1980s and the diversity of capital has made it far less volatile.

Overview of the Commercial Real Estate Capital Markets

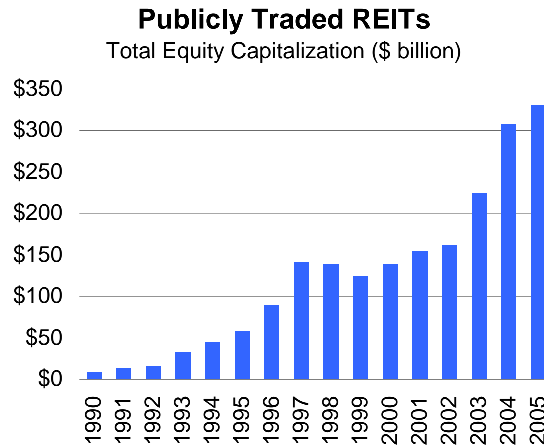
A Diversity of Equity Capital

A summary of the current buyers of commercial property highlights the diversity of investors and illustrates the secular changes that have occurred in the capital markets for commercial real estate since 1990. The growth of institutional and public equity capital in commercial real estate evidences its maturity as an accepted, primary asset class on par with stocks and bonds. Foreign capital is not new in commercial real estate, but the emergence of a global marketplace has been a significant recent development that continues to change the market. In addition, new investment vehicles have been formed to access capital from outside of Wall Street and institutional channels. A new breed of syndicators in the form of private REITs and tenancy-in-common interests, have

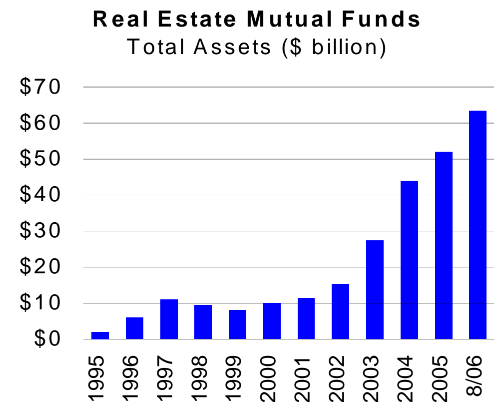
acquired almost $40 billion of commercial property since 2002. Private equity funds pool capital from a variety of sources and have acquired almost $80 billion since 2002. Originally called "Vulture Funds", these funds were born out of the Resolution Trust Company liquidations of bank real estate owned REO portfolios in the early 1990s. In addition, joint ventures between these large investors and local, private firms have proliferated. Consequently, the private sector has far greater access to capital and is less limited by geography. Few commercial real estate investors are local anymore as the mobility of capital nationally and globally has never been greater.

Public Real Estate Investment Trusts ("REITs")

The U.S. Congress created REITs in 1960 but the equity REITs in particular, only became a material part of the commercial real estate capital markets in the mid 1990s. Since then, REITs have flourished and have helped to transform the entire commercial real estate capital markets. Not only did REITs raise billions of capital dollars by allowing small investors to invest in large commercial properties, it helped bring in a new wave of transparency and scrutiny to the sector. Over the past decade, approximately 500 new analyst positions have been created solely to analyze the commercial real estate sector and the activity of the REITs. At the end of 2005, there were nearly 200 public REITs with a market equity capitalization of $330 billion and ownership over $750 billion of real estate properties. In 2005, public REITs accounted for approximately 14% of all commercial property acquisitions in the US.



source: NAREIT



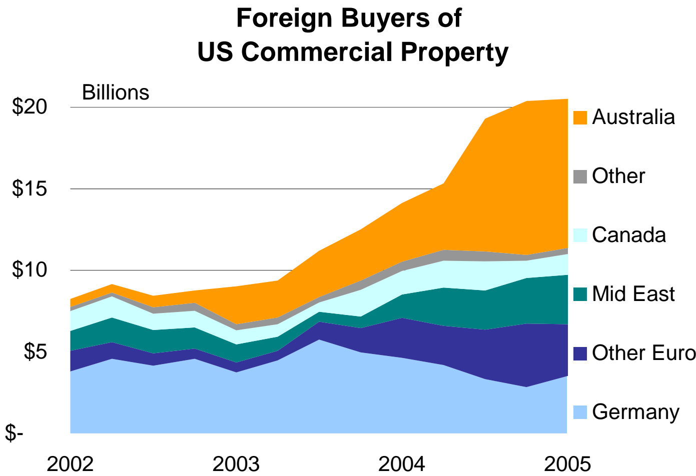
source: Merrill Lynch, AMG Data

Public REITs have gone through two major growth periods over the past decade. The first occurred in 1996-97 and the second occurred in 2003-04 as REITs became main-stream stock market investments. The role of REITs continues to grow as pension capital migrates from defined benefit plans to defined contribution (401K type) plans. As more 401(k) plans are providing the option, assets in real estate mutual funds, which invest primarily in REITS, have soared. Total assets of real estate mutual funds totaled $52 billion at the end of 2005, up from $10 billion just five years ago.

Foreign Investors

US commercial real estate has always held appeal among foreign investors. In the 1980s it was the Dutch and the Japanese. German investors accounted for the majority of foreign capital in the 1990s. However, until recently, most foreign investment was directed to trophy properties in a relatively select group of markets like Washington, New York and San Francisco. Thus, foreign buyers impacted prices in only a few markets and then for only the best real estate.

This is no longer the case as the globalization of the real estate industry has taken off and is clearly accelerating. In 2005, Australians purchased one of every ten community shopping centers that were sold in the U.S. as a diversity of buyers from around the globe are now active commercial real estate buyers. Moreover, the U.S. is now exporting real estate capital and U.S.-based private equity funds, among others, are significant investors throughout Europe, South America and increasingly, the Pacific Rim.

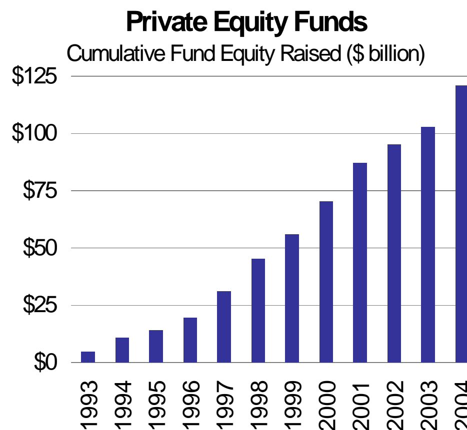


source: Real Capital Analytics

Globalization of REITs and CMBS is also taking off. In 2001 Japan entered the REIT arena and in 2003 France followed. The Netherlands, Singapore, Canada and Belgium and the UK recently changed their laws to create REITS. Hong Kong amended legislation last year to allow its REITs to invest in overseas real estate. North American companies still account for 50% of the world's REITs, but international REITs are growing quickly.

Private Equity Funds

Also known as hedge, equity or opportunity funds, Private Equity Funds pool capital in multi-million dollar increments from wealthy sophisticated "qualified" investors. They have currently amassed a huge amount of capital and are responsible for a wave of corporate takeovers throughout all industries, not just real estate. Real estate funds started in the 1990s and there are over 250 real estate specific hedge funds that have raised over $125 billion of equity. This equates to a buying power up to $500 billion since fund investments are often highly leveraged. However, not all of this capital will be invested in the US. Higher risk/higher return allocations by institutions and foreign investors are often placed with hedge funds, blurring the distinction between capital sectors. Fund sponsors are considered private since they invest their own equity and have discretion over the fund's investments.



source: Ernst & Young

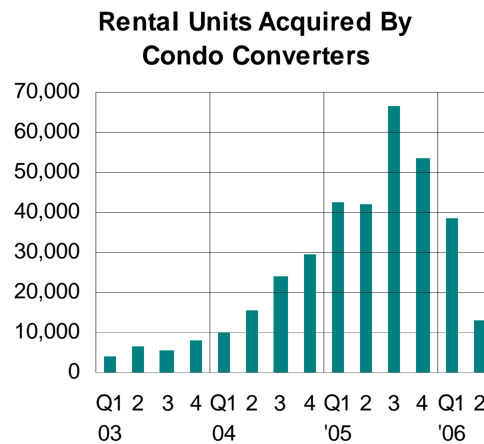
Syndicators

Private REITs and Tenancy-in-Common ("TIC") groups are part of the private sector that represent a relatively new group of buyers very different from the tax syndicators in the 1980s. These groups raise capital by syndicating equity through financial advisors to wealthy private individuals and families, primarily baby boomers nearing retirement. Most investors in the current syndications are seeking yield and a stabile cash flow. Consequently, TICs and private REITs acquisitions have generally been of higher quality, well occupied properties. TICs have an

additional benefit in that they qualify for 1031 like-kind exchanges that defer capital gains taxes to a later time. Combined, TICs and private REITs acquired $14 billion of core property in 2005, up ten fold since 2001. Private REITs accounted for $8.7 billion of acquisitions last year but their growth is slowing and total TIC acquisitions may exceed that of the private REITs. Despite all the press generated by this new class of investors, syndicators accounted for only 5% of all commercial property acquisitions in 2005.

Condo Converters

While the capital markets for residential and commercial real estate are unique, the home ownership and rental apartment housing markets are directly linked by the recent wave of condominium conversions. Converters were the most active buyers of apartment property in 2005 with over $31 billion of acquisitions. They differ from all the other classes of real estate investors in that they are cyclical buyers that can come and go quickly. Condo Converters arbitrage temporary pricing differences between the commercial income producing apartments and residential home ownership markets. Between 2004 and 2005, they acquired over 280,000 rental apartment properties in the commercial marketplace and sold them individually at higher prices in the residential home ownership market. Furthermore, this number excludes a significant number of properties converted by existing owners, new condo developments, and developments planned to be rentals but changed to condos prior to completion.



However, condominium conversion activity has fallen off sharply in 2006 as lenders started exercising greater discipline at the first sign of a slowing in the housing market. So far this year, just over $8 billion of condo conversion deals have been completed and the total for the year is likely to be half of the 2005 level.

The Ebb and Flow of Capital

Condo converters serve as an excellent example of the natural ebbs and flows of real estate capital and the discipline of checks and balances that are now part of the capital markets. Condo converters appeared, dominated the market for a period, and are now quickly retreating as housing prices are no longer rising. Due to the diversity of capital sources now active for commercial real estate, other buyers have stepped in as condo conversion activity declined and there has been no significant price correction for commercial property. It also illustrates the information feedback loop that is now in place that should help to prevent large boom bust cycles in the future. Better real-time data on the housing market provided an early indication that condo sales were softening and condo converters and their lenders were able to curtail activity very quickly. Furthermore, banks that continued to lend aggressively on condo projects have been penalized in the stock market. Corus Bankshares, the leading lender to condo developers and converters, saw its share price fall 31% between June and August as investors became more circumspect of its loan concentration for condo projects.

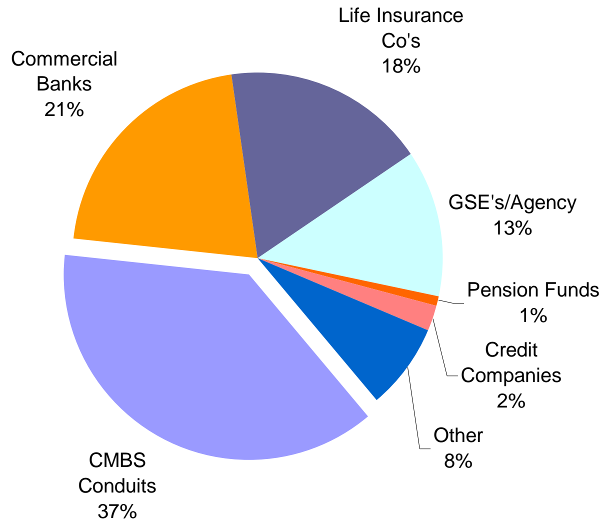
A Diversity of Debt Capital

Total commercial and multifamily mortgage debt outstanding recently surpassed $2.7 trillion according to the Mortgage Bankers Association analysis of the Federal Reserve Board Flow of Funds data. The debt capital markets for commercial real estate have undergone the greatest transformation over the past decade. What was a private marketplace involving many regional

lenders has now become a national marketplace with a large public component. The securitization of commercial mortgages introduced public capital into the commercial real estate debt markets. Commercial Mortgage Backed Securities ("CMBS") were pioneered by the government's Resolution Trust Company in the early 1990s and are now the largest originators of commercial mortgages. In addition to the advent of CMBS, the introduction of interstate banking in 1994 allowed mortgage capital from the commercial banks to flow across state lines more easily. In a short period, the debt capital markets became more public and more efficient.

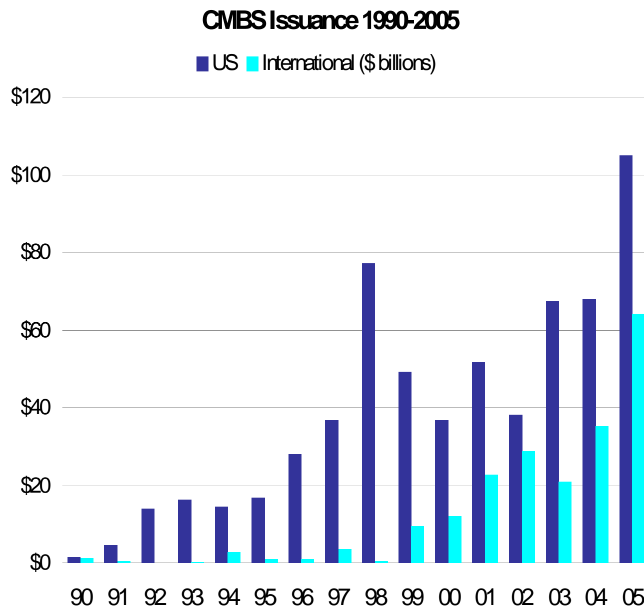
Commercial and Multifamily Mortgage Originations

2005 market share by volume



source: Mortgage Bankers Association

Domestically, CMBS originations reached $170 billion in 2005, up from less than $20 billion a decade earlier. CMBS conduits which source the loans accounted for 37% of all commercial and multifamily originations in the U.S. last year. Total outstanding volume of CMBS reached $683 billion at the end of 2005. Internationally, the CMBS market doubled in 2005 with nearly $70 billion in volume.



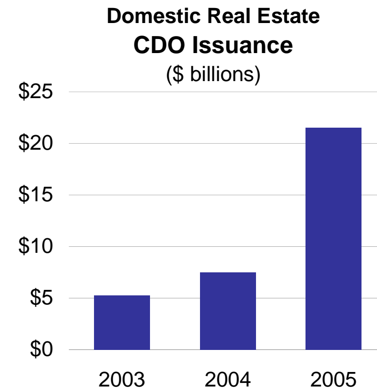
Source: Commercial Mortgage Alert

The CMBS market completed the fourth quadrant of capital for commercial real estate: private equity, private debt, public equity (REITs), public debt (CMBS). Four quadrants of capital define most mature financial markets but the CMBS market has helped to transform the industry in many other ways as well. It has brought an even greater level of transparency and much needed standards. CMBS has helped standardize underwriting, reporting and documentation throughout the entire industry. Standardization has facilitated the nationalization of the real estate debt capital markets and

has also lead to an active secondary market for commercial mortgages.

An option has developed for lenders to sell whole loans in an active secondary market for both performing and non-performing commercial mortgages. Commercial mortgages are now far more liquid assets than ever before. Thus banks that make loans in their local markets can sell those loans into the national capital markets and replace that investment with real estate securities that hold a nationally diversified mix of real estate debt. Thus local lending risk is substantially reduced.

The commercial real estate finance arena continues to evolve with new securitized products such as Collateralized Debt Obligations ("CDO"s) and new lenders, particularly for mezzanine debt or second mortgages. Origination volume of mezzanine loans tripled in 2005 to almost $13 billion according to the Mortgage Bankers Association which only started tracking mezzanine loans recently. Many of these mezzanine loans or whole loans purchased in the secondary market populate a new form of securitization called CDO's. Issuance of real estate CDO's tripled in 2005 to over $20 billion.



source: Commercial Real Estate Direct

Real Estate as an Asset Class

Perhaps the greatest change that has occurred in the commercial real estate capital markets since the 1980s is its perception within the greater investment universe. Many portfolio investors now consider commercial real estate as the fourth asset class along with stocks, bonds, and cash. The dot-com bust cemented this role when investors of all types and sizes realized they had previously been under allocated to this $24 trillion asset base (estimated by Prudential Real Estate Investors, January 2003).

In order for commercial real estate to become a true asset class, it had to become more transparent and win the trust of investors. Since the emergence of a public sector with the REITs and CMBS, the level of information and scrutiny throughout the industry has improved dramatically. The real estate discipline has gained stature relative to corporate America in recent years. Real estate ethics also trumped corporate America in a recent study by Roulac published in the Journal of Real Estate Literature. REITs were ranked as having the best corporate governance over all other publicly traded companies. Prior to the late 1980s, appraisal regulation was virtually nonexistent but since then the appraisal industry is characterized by well-trained and experienced professionals and solid appraisal policies and procedures. Real estate has also become a true profession and thus a popular academic discipline. The number of university real estate programs has doubled since the 1980s with over 600 dedicated faculty and 10,000 students currently involved in the study of the real estate industry.

Conclusion

The debt and equity capital markets for commercial real estate have evolved greatly since the late 1980s to become more diverse, sophisticated, efficient and transparent. The net result is a much greater level of liquidity and a lesser degree of risk for commercial property equity and debt investments. Regulation from within the industry and scrutiny of the public markets provides a layer of checks and balances that will help avoid boom and bust periods and ensure the liquidity of commercial property. Greater mobility of capital between the states and even internationally facilitates an even distribution of capital and decreases the likelihood of concentrations or a bubble occurring in individual markets. The real estate capital markets continue to evolve and grow to provide greater liquidity and mitigate risks throughout the commercial real estate industry.