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**REAL ESTATE TODAY, or**  
**DARWIN'S SECOND THOUGHTS**

by Daniel Rose

We meet at a difficult and challenging moment for our industry.

The Biblical story of Joseph's dream, with its alternating fat and lean years, is being enacted once again; and Washingtonians take little solace in the knowledge that conditions are worse elsewhere.

Nationwide, our industry is geared up to produce more product than the economy requires; and office buildings, convention centers, hotels, retail outlets and recreational facilities in virtually every regional market are at or near a state of over-supply.

Only in housing is there currently an unfilled absolute need, and in that sector rising prices have increasingly put our product beyond the ability of the consumer to pay for what he would like and for what our society feels he should have.

To make matters worse, the office of the Controller of the Currency is pressing the banking industry to slam on the brakes with an unparalleled speed and severity on real estate loans of all types; and the impact on an industry whose life's blood is credit is devastating.

Market forces should now tend to dampen supply; and rising demand will at some point not only absorb the existing inventory

but will call forth new product as well.

The picture comes to mind of the group caught in a thunderstorm, when a little old lady asked Mark Twain if he thought the rain would stop, and Twain replied, "Madam, it always has."

It is important for all of us -- real estate practitioners, lenders and federal regulators -- to keep in mind that we are faced with a cyclical and temporary problem; and that it is in all our best interests to get through this rough patch with minimal damage to our respective organizations, our industry and the general economy as well.

In the early 1970's, real estate investment trusts for various reasons stimulated new construction beyond what markets could absorb. Bankers who had prudently not lent on individual projects suddenly awakened to the fact that they had lent massively to trusts who had.

The real estate industry was threatened; the banking industry was threatened, and the national economy was in danger of another serious blow at a moment of stress from other reasons, in the aftermath of the Arab oil shock.

Fortunately, wise heads prevailed. The government gave the banks time, the banks gave our industry time, and conditions righted themselves gradually.

In the case of U.S. banks lending to foreign nations in the early 1980's, precipitous and severe action by the government would have been destructive. Once again, wise heads prevailed, and

time permitted the banks to build reserves and to adjust accordingly.

Today, too, an orderly and prudent allocation of credit is clearly called for, but common sense and past experience argue strongly for thoughtful and reasonable tightening rather than the severe and indiscriminate measures now being applied.

The dangerous new concept called "non-performing performing loans" and the failure by government banking regulators to distinguish between fresh land loans or new construction loans, on the one hand, and newly completed jobs or "mid-course" construction loans, on the other, seem destined to cause unnecessary turmoil in our field precisely at a moment when it is in the worst position to sustain it.

To permit the return to orderly market conditions, however, not only will common sense be indicated on the part of commercial bankers.

Developers themselves and their mortgagees will have to exercise restraint in bringing to market more space than can possibly be absorbed.

If total net absorption of office space in the Washington market was just over 2 million feet in 1989 and apparently will be about the same in 1990, the 8.5 MM feet now under construction will represent a four year supply.

And the total amount of new space proposed, approaching 20 MM feet, will obviously have to be held off the market for several

years to come.

Given prudent restraint and common sense on the part of all the players in the development game, the industry as a whole should be able to muddle through, with pain but hopefully without devastation.

Our goal, in military terms, should be to keep an orderly retreat from turning into a disastrous rout.

The day of "money driven" development is past; supply-and-demand factors must once again control activity, as in the long run they always will.

Those organizations and individuals that can adjust accordingly will be able to continue in business in one way or another and be on hand for the next wave of development.

At the end of his life, Charles Darwin regretted the phrase "survival of the fittest", which came to be identified with his name and with his theories of evolution.

He much preferred the concept "survival of the most adaptable", and that will be the dominant theme of Washington real estate for the period we have entered.

### **I - The Unknowns We Face**

In the years ahead, our industry must be able to adjust to major "unknowns", such as the state of the U.S. economy and the availability and cost of investment capital.

It must take in stride such "unforeseens" as the opening up of Eastern Europe and the end of the cold war, upheavals in foreign financial markets, the impact of our military and defense budget re-adjustment and the appearance on the scene of an important new entity like the Resolution Trust Corporation.

And a whole host of other formidably important questions must be taken in stride.

To begin with, the state of the U.S. economy has been a continuing agreeable surprise, as the long-anticipated economic downturn has not yet materialized and perhaps never will.

And perhaps the Federal Reserve will be able to stay on that fine line between inflation and recession which will permit both gentle growth and low interest rates.

Although the commercial banking industry is gasping for air, life insurance companies, pension funds and foreign investors all have long term funds available, and all are prepared to deal with the appropriate real estate product in the appropriate market with appropriate colleagues.

Many of the major pension funds are prepared to allocate up to 10% or 15% of their assets to real estate but have not yet been able to find sufficiently desirable vehicles; but they are there and they are still looking.

Incidentally, reports of how the pension funds have done with their real estate investments may be misleading.

Recently, for example, the \$31 billion California State Teachers Retirement System announced that in 1989 its real estate portfolio returned 8.8%, and for the three year period it received a compound annual return of 9.1%.

This group expects to invest \$1-1/2 to \$2 billion in real estate in the next 3 to 5 years.

AT & T's pension fund, with \$32 billion in assets, of which \$3.8 billion or about 12% is in real estate, is another that is hoping to raise its real estate % to 15% of assets in the new few years.

And AT & T's real estate returns have roughly equaled their returns on their bond portfolio.

RJR Nabisco, another interesting example, is typical of business pension funds with about 6% of its assets in real estate now but hoping to acquire more, for diversification and risk reduction.

Similarly, life insurance companies and foreign investors are still looking for worthwhile holdings; and the world is not really coming to its end.

## **II - Unforeseens**

About the major unforeseens relating to our industry, one can only say that so far, at least, they have not been as difficult as many expected.

The Tokyo stock market crash has been taken in stride; the capital sums suddenly planned for investment in eastern Europe have not

caused major financial dislocations; the impact of the defense slow-down looks as if it will be gradual; the demise of major retail chains such as Bonwit Teller and B. Altman's have not caused the anticipated problems, and so on.

Only the worsening of the Savings and Loan situation and the eventual impact of the Resolution Trust Corporation wait ominously, with no one certain about how orderly their massive property dispositions will be or how powerful will be their effect on other properties that are currently able to keep their heads above water.

But it will be years before the problem is brought down to comfortably manageable proportions.

### **III - Problems**

About the other questions we face – local, regional, national and international; financial, economic and political – one can only say that if they all conspire to give our industry time to work out its excesses gradually, all can be well.

If they conspire to force us to move precipitously, fierce pain can result.

### **IV - Changing Players in the Game**

Another interesting factor we face today is the changing nature

of the players in the real estate game.

- Former bankers are now liquidators;
- Former lenders are now developers and owners
- Former owners are now asset managers
- Former brokers are now consultants

A firm like my own, Rose Associates, Inc., which over its 60 year life has always balanced its building, owning and managing activities with asset management and "work-out" activities for institutions, today finds itself much more interested in a call from an institution with a troubled property to be turned around or re-cycled than we are in a call from a broker with no matter what piece of new land for sale.

Our whole industry will be in this posture for several years, and practitioners of all sorts – whether bankers, builders, brokers or whatever – would do well to start applying today's skills to today's problems.

### **V - Time Horizons**

It is clear that our time horizons must adjust to the conditions we face, and we must act accordingly.

New York City is an interesting case in point:

In 1965, New York seemed like the vibrant center of the universe, and although no one predicted it ---

In 1975, it was flat on its back, facing the threat of municipal bankruptcy. Once again, no one expected it but ---

In 1985, New York was the dynamic center of a bubbling, ever-growing world market for financial services. Today, what has happened to the values of its trophy office towers? And who dares to predict the character of New York five years hence?

The oil patch in general, of course, but Houston in particular, is another example of dramatic cyclical change that has repeatedly stumped the forecasters.

And now that Washington has become a world class city in virtually all respects, who can recall that only 30 years ago, John F. Kennedy referred to it contemptuously as a backwater with "southern efficiency and northern charm"?

Although we Americans may be short-sighted in our time frame and parochial in our local outlook, it is interesting to see that major foreign real estate investors are decidedly neither.

With traditionally longer time horizons, deeper pockets and greater patience, it is entirely possible that prudent foreign real estate investors will figuratively look across the valleys to the next mountain peak.

Just as our current national madness of excessive consumption

and inadequate saving contrasts with their inadequate consumption and excessive saving, so the distressed market conditions caused by our money-driven construction binge are likely to result in their picking up real estate gems at bargain basement prices.

And if the Controller of the Currency continues his current practices, he will cause the involuntary dumping of properties that will make U.S. real estate available at a fire sale.

#### **VI - Areas of Opportunity**

In the climate we face, the areas of opportunity for the real estate field in the early 1990's will clearly be:

- A - "Work-outs"
- B - "Fill-ins" or special situations
- C - Foreign markets

#### **VII - Advantages of U.S. Developers Abroad**

- A) Access to U.S. corporate tenants
- B) Willingness to take risks that European "merchant builders do not.
- C) Familiarity with large-scale development
- D) Access to world capital and finance markets
- E) Conception of Europe as a whole rather than this or that particular country.

**VIII - Lessons and Conclusions**

A - Professionalism no longer a luxury but a necessity

B - "Narrow-gauged" companies or individuals at a disadvantage

C - Reputation and character an ever-increasingly important stock-in-trade

**IX - Questions and Answers**