The Outlook for Real Estate Funds

What lessons can be learned from the 18-year real estate cycle, and where are the opportunities now?

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Real estate funds have gone through one of their worst years in history, and the near-term outlook appears bleak. What are the lessons from this crisis for real estate funds? What are the key considerations for investors? This article aims to propose some fundamental and technical explanations and analyses both from a macro and micro perspective.

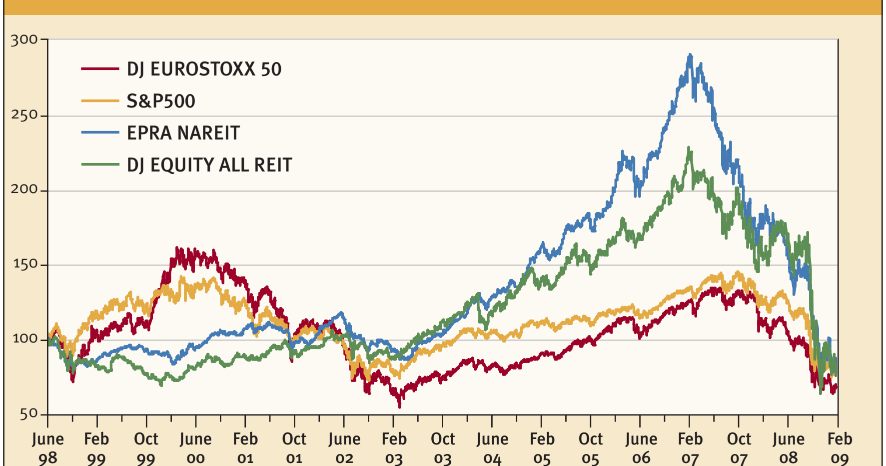
Diversification Benefits

Over the past few years, asset allocators, financial advisors, and banks contended that adding alternative asset classes—and real estate in particular—to a well-diversified portfolio would increase portfolio return and reduce risk as a result of the low correlation of alternative investments with stocks and bonds.

After the collapse of the 2000 stock market, real estate funds showed remarkable resilience until the start of the stock market recovery at the beginning of 2003. Since 2007, however, real estate funds have been performing poorly. The FTSE EPRA index of European real estate stocks tumbled by 50 percent in 2008, while the Dow Jones EURO STOXX 50 declined by 44 percent. The Dow Jones Equity All REIT index of U.S. real estate stocks tumbled 40 percent in 2008, a period when the S&P 500 experienced a drop of 37 percent. As shown in **Figure 1**, those who increased their allocation late in the real estate cycle were considerably worse off relative to those who were invested early in the cycle.

Real estate and housing are generally sensitive to the direction of long-term interest rates. Housing is typically counter-cyclical relative to stock markets because falling interest rates tend to favor homebuilders in a weaker economy and rising interest rates undermine homebuilders in a growing economy. In the most recent cycle, for example, U.S. homebuilders peaked in January 2006, 14 months before the REIT market's peak in May 2007. Homebuilders thus tend to be a leading indicator of the overall REIT market. What is fundamentally different between the strong resilience of REITs after the stock market collapse of 2000 and the dramatic decline of REITs since 2007, which preceded the 2008 stock market crash, is the existence of long-term cycles in real estate.

FIGURE 1



Source: Bloomberg

Lessons from the Cycle

Location is everything in real estate, of course, but developing a view of the broad real estate market cycle also provides an insight into the medium- to longer-term trends.

The existence of long cycles in real estate has been the subject of extensive research. Among the various cycles analyzed, the 18-year cycle in real estate has received a lot of attention. This cycle, first discovered by Homer Hoyt in his 1933 study *One Hundred Years of Land Values in Chicago*, seemed to disappear in the 1950s and 1960s, probably as a consequence of the Great Depression and of World War II, which mobilized significant rebuilding activity. The cycle emerged again in the 1970s.

In 1987, Kenneth Fisher, knowing that approximately three 18-year cycles fit within the 55-year Kondratiev wave,* also found that the business cycle appears to be the strongest when both the 18-year cycle and the Kondratiev wave are in an upswing, whereas it is the weakest when both are in a downswing.

The current bust in real estate markets is happening precisely 18 years after the last major real estate bust of 1990. This coincidence may be a chance event, but what is most important to understand is the nature of the real estate cycle. The fundamental pattern at work in the real estate cycle is that, following an initial surge in inflation, rents tend to rise faster than expenses (because the latter are generally fixed contractually). The outcome is that net operating income, the rental income of a property after operating expenses, tends to rise at a faster rate than inflation. This acceleration of net operating income eventually is noticed

* A concept developed by Russian economist Nikolai Kondratiev in 1925, K-waves are long-term cycles in the global economy (as opposed to short-term business cycles).

by an increasingly broad range of investors, who pour more capital into this asset class. The lag involved in the planning, design, development, and financing of real estate projects is typically measured in years. Thus, the outcome is a further increase in net operating income before excess capacities start to appear and rents go sky high. At this stage, any slowdown of the economy may provide the tipping point for a contraction.

The current cycle was fueled by an unprecedented flow of capital into real estate. This capital flow resulted from a combination of three things: the steep decline in rates in 2000 (dictated by the U.S. Federal Reserve), the relaxing of lending standards by many financial institutions, and financial innovation on the investment side. The necessary deleveraging of real estate investments may thus exert a durable downward pressure on prices until it reverts to a long-term average.

Inflation, Deflation, or Stagflation?

Analysis of the real estate cycle can provide invaluable insight, but inflation or deflation can have profound implications for real estate values and thus must be considered carefully in valuation and allocation decisions.

John Murphy, who studied the price action of related markets sectors in *Intermarket Analysis: Profitting from Global Market Relationships*, has shown that although real estate is generally closely related to the cycle of inflation (it is often said to be an inflation hedge), it can also be sensitive to deflation.

Historically, the major boom and bust phases in real estate have been preceded by a spike in inflation. The boom and bust of the 1920s followed a spike in inflation from 1918 to 1920. The boom and bust of the 1980s followed a prolonged period of inflation from 1973 to 1981, which corresponded to commodity-fueled inflation during the boom phase.

During the Great Depression, home and land prices plummeted for 10 years and only started to recover with inflation at the end of the 1940s. The Japanese real estate market provided a more recent example of real estate price trends in a deflationary environment, declining for 13 consecutive years. (Note that this decline followed the stock market peak of December 1989 with a two-year lag.)

Finding the dominant long-term trend in inflation or deflation, while filtering out seasonal counter-cyclical patterns, provides hints as to one of the fundamental drivers of real estate prices. Identifying the long-term trend in inflation or deflation is also one of the most important questions in terms of strategic asset allocation for all asset classes. Currently, a debate rages between those who believe that the recent monetary expansion will result in a deflationary scenario and those who believe it will lead to an inflationary scenario. (Robert Prechter, an expert on wave analysis [a form of technical analysis that combines principles of fractal geometry with the Elliott wave principle—the premise that crowd psychology moves from optimism to pessimism and vice versa], offers an unconventional argument on the rare phenomenon of deflationary depression in his book *Conquer the Crash*. Although wave analysis is subjective in nature and you may not agree with Prechter's conclusions, his arguments are worth considering.) The uncertainties regarding the bailout plans implemented in a large number of jurisdictions also fuel fears of an inflation scenario in which paper assets would quickly erode their value as a result of an outpouring of liquidity. The Federal Reserve is even considering buying long-term U.S. Treasuries, which would result in the same effect. Another possible scenario is the one of stagflation, a term coined in the 1970s to describe a situation in which an overflow of liquidity cannot be absorbed by a depressed economy. Note that real estate performed poorly during the stagflation of 1970s.

Impacts and Opportunities

After these macro considerations, the question remains: What impact will the current crisis on real estate funds have? In short, cash-strapped and highly leveraged property funds with refinancing on the horizon are likely to fight for survival in 2009.

Whereas rental income of European commercial real estate showed some resilience in 2007, this relative overall stability probably had more to do with long-term leases, as opposed to an indication of current market rents. With prime office rents expected to fall in major European cities, including London, Dublin, Madrid, and Barcelona (to name some of the hardest hit in 2008), the worsening of the rental market is likely to have an adverse impact on the cash flows of some European property funds. In turn, the new leases that will be made at lower rates will be locked in for years and will have a lasting effect on cash flows for property funds.

The evolution of the rental market is only one part of the equation, and both the extent and the depth of the economic recession are difficult to forecast at this stage. Any significant worsening of the economy will add more woes to existing property portfolios, leading to higher vacancies as a result of businesses contracting or going out of business. Financial stability and high concentration of tenants in highly cyclical industries, such as automotive, construction, heavy equipments, will thus be key risks to monitor for property funds' cash flows.

Finally, highly leveraged property funds may be particularly at risk when either loan-to-value (LTV) covenants are tight or when any refinancing is expected in the near term. Clearly, the lenders hold the key to the fate of those deals. Before explaining why the respect of LTV covenants is so important in this environment, let's revisit the mechanism of financial leverage.

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The use of financial leverage by real estate investment funds acts as an amplifier for overall returns. In a rising property market, leverage effectively lifts the overall returns available to the equity holders as equity investors benefit from net capital gains made upon exit of property investments financed by both their own equity capital and also external financing. The debt providers' income, however, is capped at the agreed financing rate; therefore, they do not participate in the full upside upon exit of property investments by the fund.

In a falling property market, leverage magnifies losses for equity investors because the borrowed funds (plus interest) remain due regardless of the value of the property investments. In addition, banks or other providers of real estate lending impose minimum LTV covenants that must be complied with by the borrower on a periodic basis, typically at least once a year. Few statistics exist, but LTV covenants ranging from 50 percent to 90 percent are not uncommon and breaches generally trigger a process that may ultimately result in a seizure of the collateral by the lenders. Thus, a forced sale of the seized assets may result in significant capital losses for the borrower. In the current market characterized by a dramatic decline in value in the fourth quarter of 2008, any further deterioration may expose real estate investment funds to a dramatic loss of capital.

Another source of risk in relation to leverage is any need to refinance existing real estate debt that will become due in the near term. With credit nearly dried up, refinancing (especially for large property deals) may be almost impossible. Reactions by banks have ranged from extending the loan to foreclosing on the collateral. In some cases, governments have invited themselves to the table by means of nationalizing banks, providing insurance, or implementing troubled asset relief programs. The idea of establishing "bad banks" to absorb toxic assets has been hotly debated. One of the unknowns is how governments are likely to react when troubled loans are effectively under their control. For example, consider that the bulk of European commercial mortgage-backed securities (CMBS) will become due for balloon repayment in the upcoming two to four years.

In consideration of the above, the situation of real estate funds will largely depend on their vintage year, their degree of leverage, the portion of committed capital invested, as follows:

- Funds with low financial leverage, broad geographic diversification, and holding fewer cyclical assets invested long before the peak of the market are more likely to weather the storm, although values will go down.
- Funds with moderate levels of leverage and a limited number of investments experiencing either tight covenants or covenant breaches may survive if they can address those issues with lenders and have the ability to reduce their leverage (through shareholders' loans, for example), as any asset sale would more than likely result in a dramatic loss of capital in this market. Many funds in this category launched late in the cycle will likely be exposed to substantial capital losses.
- Funds with high leverage, many "top of the cycle" acquisitions, concentrated portfolios, tenants in highly cyclical segments (shopping malls, warehouses, offices) experiencing significant covenant breaches will be exposed to major capital losses and their sponsors may not survive this crisis.

Where are the opportunities in this challenging market? A large number of funds targeting distressed properties have been set up over the past year (87 according to Prequin's Private equity Intelligence service) and an even larger number of distressed funds are expected to be created this year. But is the timing right for such funds to invest in real estate?

The golden rule for value creation is the same old mantra, "buy low, sell high." Although the real estate markets have dropped substantially in value, very few investors are yet calling a bottom. But considering the imperfect and opaque nature of real estate markets, the current markets offer significant opportunities provided that the due diligence on the property and on the debt is done right and valuations have been thoroughly stress-tested. Distressed sellers may at present be the best opportunities. (Under a bankruptcy or liquidation process, however, administrators or liquidators may take a longer view on the disposal of the assets). Governments have also become a major player where troubled real estate assets are concerned. Will the price paid by these rescue packages set a floor value for these assets, or will it inflate their value?

The prospects of these opportunistic funds vary depending on the nature of the distressed assets in which they invest. Many U.S. funds specializing in distressed assets, for example, have been acquiring unsold inventories of residential real estate with the objective of positioning these assets for the rental market and eventually selling the portfolio when the housing market recovers. These funds are generally less concerned about timing a bottom. Distressed commercial real estate deals carry far more risks if the market continues to slide. The few sizable deals that have been explored in Europe have been for prime properties in prime locations at high yields. These deals may eventually become benchmarks, but the current reality is that most funds are testing the waters in an exploratory phase.

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