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INVESTMENT PROSPECTS IN THE UNITED STATES PROPERTY MARKET

by Daniel Rose

I. OVERVIEW

Real estate has always been a perplexing field for non-professionals. The advantages of real estate investment in these difficult times, however, seem to justify the time and effort required to understand the underlying concepts and to become familiar with current developments in the field.

Our goal today is to review the events of the recent past and the current scene, discuss varied forms of investment possible, and finally review current foreign investment in the U. S. property market.

II WHERE HAVE WE BEEN?

When colleagues at Rose Associates suggested that I begin this discussion with a statement of investment philosophy, my first thought was of Bertrand Russell's comment, "Science is what we know, and philosophy is what we don't know".

It is in that philosophic vein that one must consider 1975 - a quixotic year in which a supposedly "conservative" first mortgage was foreclosed on New York's world-famous Chrysler Building, but a year in which a supposedly "hare-brained" $12,000,000 investment in transporting the dismantled "London Bridge" to Lake Havasu, Arizona has turned out a roaring success.

Has the world gone mad? one might ask. Haven't the most disastrous Real Estate Investment Trusts been sponsored by the biggest and best banks? Haven't the best-known names in the American real estate world been involved in the biggest croppers? Can one truly apply logic to real estate; and do the old, commonsense rules and guidelines still apply?

Yes, they do.

They have just been forgotten or ignored.

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In an atmosphere recalling that of the Dutch Tulip Craze, the South Sea Bubble or the Florida Land Boom of the 1920's, men and institutions were carried away by the heady real estate market that prevailed from 1971 to 1973, and classic errors were committed by those who should have known better.

Borrowing short and lending long is dangerous - whether by a financial novice or a massive R. E. I. T. Hoping inflation will bail out excessively large loans on marginal properties without regard to underlying current values is foolish, period. Saturating a sound market without regard to future absorption possibilities is unsafe, regardless of one's need to "get the money out working".

When all of the foregoing takes place just prior to the worst recession and severest inflation in a generation, it is easy to understand how an orderly retreat can become a rout, and a thought-provoking misfortune turn into an utter disaster.

This review is not to pour salt in open wounds or point fingers; it is rather in the spirit of Santayana's thoughtful observation that "Those who cannot remember the past are condemned to repeat it."

Real estate <u>is</u> an investment field which periodically has witnessed immense growth in capital values; an investment field that does compare favorably with other inflation hedges; it is an investment field that <u>can</u> absorb any scale of investment capital at one's disposal.

Real estate clearly does merit consideration and investigation as an investment vehicle; but the same commonsense rules that apply to <u>all</u> investments are applicable here, and the same care and attention must be paid.

Pitfalls as well as opportunities must be considered, returns compared with risks; and prospective investments must be measured against investment goals. The character and competence of one's advisors are of paramount importance; and careful attention should be paid to an investment portfolio on a continuing basis.

The unfolding debacles of the past year have cleared the air considerably. Prospective purchasers, lenders and professionals at all levels are considerably more cautious and circumspect than in the recent past. Players entering the game today find the atmosphere more sober and reliable, much to everyone's benefit.

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III THE CURRENT SCENE

The frenetic real estate boom of 1971-72-73 left most areas of the United States with surplus development completed or underway when war broke out in the Middle East in October of 1973. An Arab oil embargo was soon followed by a surge in energy costs; and severe recession coupled with a drastic credit squeeze and the highest interest rates since the American Civil War, all struck with stunning rapidity.

Production momentum rolled on as economic demand shriveled. When the dust settled, many millions of square feet of office space stood vacant across the nation; hundreds of thousands of resort or "second home" condominium units remained unsold, and tens of thousands of new hotel or motel rooms remained dark. The markets for new industrial space and retail shopping facilities were in marginally better condition, but they too suffered badly as construction costs soared and interest rates reached unheard of levels.

The massive correction that took place in 1974 and 1975 has absorbed some of the oversupply, but much "over-hang" remains.

By late 1975, apartment starts hit their lowest level in 15 years and total housing starts (which, including mobile homes, reached 2.6 million, 3 million and 2.6 million in 1971, 1972 and 1973) bottomed out well below 1.5 million before starting a modest upturn. The inventory of unsold condominium apartments has reached a peak of approximately 200,000 units, with production just starting to fall below the level of sales; in the over-built southern Florida market, for example, best estimates are that it will take nearly two years to return to "normal" market conditions.

Millions of square feet of prime office space sit vacant in older cities such as New York, Chicago and Los Angeles, and even the burgeoning "newer" cities of the South such as Atlanta and Houston report massive vacancies.

If new development prospects appear grim, however, a totally different picture emerges for existing properties. As the national economy picks up steam and as demand strengthens, the high leverage characteristics of real estate are destined to come into sharp focus.

Well-planned, well-built, and well-located existing projects are likely to benefit substantially by improved economic conditions when new competing development activity resumes at much higher costs and therefore much higher rents. Ever-increasing construction costs, increasingly severe governmental

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land use and environmental controls, and the prospects for less favorable federal tax treatment for new construction, combined with more conservative mortgage financing patterns, are all handicaps that new projects will face.

The impact on existing real estate is likely to be dramatic. Desirable American properties purchased in 1976 on the basis of actual cash flow returns may prove historic opportunities.

Thoughtful purchases can be made today that represent realistic current values and reasonable growth prospects. Careful analysis should make it possible to distinguish those areas and those specific projects best suited to benefit from the anticipated economic rebound, as opposed to those likely to languish for years to come.

IV INVESTMENT FORMS

Though it is immovable, relatively illiquid, taxed differently and lends itself to high leverage due to the relative ease with which it can be financed, investment real estate bears many similarities to all other investment fields.

In fact, one may find a real estate equivalent of almost any stock exchange vehicle. Net leases with the safety (and approximate return) of corporate bonds are at one end of the spectrum, with highly speculative equivalents of "blue sky" common stock at the other. Prudence and good advice are therefore as necessary in the real estate field as in any other.

American real estate can be owned in many different legal forms. On examination it can be seen that each form was designed to suit a particular purpose or to fill a specific need.

Holdings may be in sole proprietorship, partnership, joint venture, corporate or trust form. One may own one or more entities directly, have a partial ownership of several parcels in conjunction with other owners, or have indirect ownership in a broad portfolio. This latter position is achieved by buying shares of stock in a publicly-held real estate corporation or in a real estate investment trust, or by participating in a real estate "common fund" or in a syndication.

Although the bulk of investors today seem determined to buy individual parcels, other alternatives may yield higher returns with fewer headaches and less risk.

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For most large scale foreign investors who seek diversification with reasonable prospects for safety and growth, the wisest vehicles are probably the better institution-sponsored common funds (such as Prudential Life Insurance Co.'s "PRISA", First National Bank of Chicago's Fund F, or the Wells Fargo Equity Fund, to name a few) or the better-managed equity R. E. I. T.'s such as Corporate Property Investors of New York, General Growth Properties or Connecticut General Insurance Co.'s equity trust. In such cases, an investor is buying into a property portfolio at fair market value or perhaps at a discount, and is getting supervisory expertise as a bonus.

One set of factors to be considered in choosing between a "closed end" equity trust and an "open-end" commingled fund is that of the trade-off between relative lack of liquidity in one case versus problems of accurate evaluation in the other. Although these questions should be noted for the record, neither has proved too great a handicap in actual practice.

In the final analysis, however, one's appraisal of the integrity, the competence and the past track record of the advisors should prove the best guide in the long run.

V. RECENT FOREIGN INVESTMENT ACTIVITY IN U.S. PROPERTY

The world-wide economic downturn in 1974 has focused new international attention on the relative resilience of the American economy, and widespread political ferment throughout the world has served to underscore the comparative stability of the U.S. political scene. As a result, international capital has looked more searchingly at American havens than in the past.

The capacity of our economy for steady growth, the relative stability of the dollar, the national de termination to control inflation within reasonable bounds, and the lack of political controls on foreign ownership have also been important factors.

The recent $23 million purchase by the United Realty Co. of Kuwait of twenty-three Boston properties from the Maurice Gordon Estate, the $15 million contribution by the Kuwait Investment Company to the Atlanta Hilton center, and the Kuwait Investment Company's $70 million purchase of Kiawah Island off Colston Harbour in South Carolina, are all likely harbingers of greater Arab involvement to come.

French developer Jacques Teze, President of Paris-based Sefrius Corporation is starting work on a major retail center in the heart of Boston, which he finds a congenial atmosphere in which to work. And it was Boston, too, of course, in which Central and District Properties, Ltd. of London and Town and City Properties Ltd., also of London created a major stake in the State Street Bank Building, the Keystone Building and the 33 acre Boston Wharf properties by South Station.

Our firm, Rose Associates, is proud to have been the co-developer of the Keystone Building, Managing Agent of SSB and joint venturer in the Boston Wharf project.

British funds have long been involved in U. S. real estate, with New York's Pan Am Building one of the better-known projects developed partially with English capital. More recently, the English Electric Industry Superannuation Fund's appointment of New York's James Landauer Associates to seek investment opportunities for them is indicative of greater activity to come.

German groups active in U. S. real estate include such well-known names as Volkswagon (through a wholly-owned subsidiary), Neue Heimat and the Deutschebank in various ways. Phillips Lamp of Holland, and various wealthy French, German and Italian families are known to be making real estate purchases, as are various Mexi can and South American interests that had not previously done so.

A number of major foreign groups (including the United Nations Pension Fund itself) are well-pleased with their stake in Corporate Property Investors, a New York-based equity Real Estate Investment Trust originally sponsored by Lazard Freres. C. P. I. (whose investment portfolio of first class American regional shopping centers is considered outstanding) has been perhaps the major success story among the American equity trusts.

Other investment vehicles known to be attracting foreign interest are the commingled funds recently launched by the Bank of America, the Travelers Insurance Company and the Texas Commerce Bank, among many others.

VI CONCLUSIONS

There seems to be wide-spread agreement that the U. S. property market offers excellent investment prospects at present.

There is also general agreement that such investments should be made in the same manner that porcupines make love, i. e. very, very carefully.