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The "Bubble Effect" on Real Estate Values: A Commentary

Gil Sandler

***Gil Sandler** is a frequent contributor and member of the Board of Editors of* Real Estate Finance.
He is Managing Director of Realvest Capital Corporation and affiliates, which specialize in capital markets financing for real estate, governmental, and private clients. Mr. Sandler may be reached at gsandler@realvestcapital.com.

Alan Greenspan frets over "froth" in the real estate markets, just as he railed over "irrational exuberance" in the tech-laden stock market a few short years ago. Every new 25 basis point increase in the Fed Funds rate is accompanied by tough talk about the yield-curve "conundrum," which scares bond investors and ratchets mortgage rates up to the point where they derail a slowly awakening economy. Real estate prices continue to climb to unprecedented multiples of comparable rental costs.

Over most of the past two years, ordinary small investors—some pushed into early retirement by a shifting, and probably declining, economy—have begun to extol the virtues of real estate in the same way that they used to talk about IPOs and tech stocks in 1998–2000, just before their bubble burst. Pre-construction condos in expanding second-home markets have become "can't lose" siphons for home equity[1]—a foolproof "quick-flip," with easy leverage. Of course, we know what happened to our neighbors' and friends' flirtation with supposedly liquid investments in high-flying Internet, telecom, and global technology companies. These heavily promoted, and oft-mismanaged, engines of froth rode on the tech bubble, until finding Chapter 11 or being merged into other virtual shells with equally dismal prospects, while savings portfolios and even retirement accounts lost most of their value. Our friends who used to brag over cocktails about IPO profits fell strangely silent—that is, until they discovered real estate.

Now, we hear these small non-professional investors talking about a new inside track to financial paradise, but they do not quite make the connection between a market inflated by low rates and 10 years of limited development and forcibly elevated interest rates. Until recently, real estate investments were dominated by a few types of investors. First, there were the large financial institutions—pension funds, insurance companies, and REITs—investing primarily managed funds. While most institutions favored commercial properties, REITs and institutional joint ventures with residential developers expanded aggressively into "for sale" and multi-family residential projects. REITs, in particular, offered returns to individual investors that far exceeded both dividends on stocks and returns over the past five years since the tech/telecom bubble burst. Public ownership of REITs, both directly and through mutual funds and managed brokerage accounts, increased substantially.

Individual investors could also invest in large public homebuilding companies which were aggressively buying up farmland and older commercial and industrial properties, and moving further out on the newly extended interstate highways to build planned unit developments, often with pools, clubhouses, and other amenities. Cheap gas, low-rate car

financing, and even lower mortgage rates on as much as 90 percent financing facilitated the move from rental units, older houses, and condos to bigger houses with dramatic two-story entry foyers, volume ceilings, and bigger backyards (but, often, with no trees) or new townhouses with higher ceilings and more amenities in less crowded areas. The older houses, condos, and apartments became affordable for young families leaving more crowded, urban areas. Sounds pretty good all around.

THE NEW SPECULATOR

The real bubble, however, gets blown up by the New Speculator. This investor appears in two versions, with a similar effect on real estate values. The "do-it-yourself" investor had an instant epiphany on reading "Dummies" books on building a real estate empire, and set out to buy foreclosed or undervalued residential units. Often teaming with local realtors or Home Depot contractors to renovate them one-at-a-time, the plan was to "renovate 'n' rent" or "fix 'n' flip" undervalued or distressed[2] properties one at a time.[3] Of course, their investment return depends on value added at each step, their ability to buy low and sell high, and the availability of discounted transactional and renovation costs, but so long as mortgage rates remain low, and prices not too high, this strategy seems to work. Down payments can be drawn from low-rate tax-free mortgage refinancing and low-rate home equity loans but, inevitably, returns and the occasional, but now more visible, loss make it clear that this is just another form of musical chairs.[4]

The second form of our New Speculator reads all the promotional offerings of Baby-Boomer-oriented luxury communities and sees the instant opportunity. Seemingly impervious to margin calls on inflated stocks, our former stock market wizards discover pre-construction flipping of planned unit development (PUD) homes. Again, low mortgage and home equity rates, small five percent to 10 percent staged down-payments, early retirements with buy-out packages, and pent-up demand for second homes have conspired to double or even triple prices in the Sunbelt, waterfront, and mountain resorts, and both East and West coasts over the past three years. This gold rush mentality has also sucked renters into stretching their resources to get into coops and condos at historically inflated prices,[5] and enticed the New Speculator to believe he or she could flip at a huge leveraged profit before taking title or within a few months after closing.

IS RAISING RATES REALLY ABOUT INFLATION?

Enter Alan Greenspan, our inflation-fighting superhero. Despite consistently inconsistent economic statistics leaving more than a reasonable doubt about the true level of inflation,[6] the soon-to-retire Fed Chair seems committed to future .25 percent increases in the Fed Funds rate[7] "at a measured pace." This automatically increases short-term LIBOR rates on commercial loans to business customers and causes the major banks to increase their prime rate on floating-rate consumer loans. That, in itself, takes huge amounts of consumer buying power out of the system, limits the purchase of big-ticket capital items, and, eventually, tends to increase manufacturing inventory and reduce future production. Even more important, however, is that the Fed is intending these rate increases to ripple through the 5, 10, and 30-year Treasury rates that control mortgage rates. It is not provable, but it seems the Fed's mission is more to deflate real estate than to slow an anemic economy, perhaps because real estate represents such a large portion of personal net worth, and recently, spendable net income.

Over a few weeks in early Spring 2005, reports of mixed growth brought the benchmark 10-year Treasury note yield up nearly 100 bps from a previous low to 4.65 percent before backing down to the 4.40 percent range. This raised market predictions to 5 percent and 6 percent year-end rates for the 10 and 30-year Treasuries, and higher mortgage rates. After more than three years of cheap money, large real estate investors and developers rushed to lock in rates on inventory and projects in process and began to consider hedges in the futures markets. Then, in early June, bond and real estate markets were both buoyed by reports of lower consumer and producer prices, minimal GDP growth, and a somewhat stronger US dollar. One governor had the temerity to suggest that the Fed could cease its pattern of future rate increase after its late June meeting, pushing the 10-year Treasury yield down to 3.85 percent, only to be re-shocked back to 4.10 percent in early July.

Undaunted, Greenspan testified before Congress in late June about the conundrum of low long term rates which, significantly, impact mortgage rates. The benchmark 10-year Treasury remained inexplicably and unjustifiably low, he insisted, and signaling his unwavering intent to continue short-term rate increases until unduly accommodative rates reach a more neutral stopping point. That elusive time could

not be presently defined, he explained, but would be recognized when it surfaced. So much for all the "Green-speak."

THE MARKETS' REACTION

Now that we know that, barring unforeseen events, bond and mortgage rates are going up, what can we expect from the real estate markets? For starters, new residential development and construction should slow dramatically after the normal time lag, as fewer move-up and first-time buyers qualify for mortgages. Our New Speculator may or may not find a musical chair, but some will be forced to sell with smaller or no gains, and others may lose. Resident and non-resident owners with the recently popular option ARMs,[8] as well as short-term ARM borrowers, could find themselves in considerable distress when rates reset, and some will be forced to downsize or move to less-expensive markets.

These events will increase supply while demand is reduced by the cost of capital and shrinking pool of qualified buyers, depressing prices in all but the toniest areas.[9] Conventional loan-to-value ratios of up to 90 percent for good-income borrowers seem comfortable in a rising market, but both lenders and appraisers were inclined to press values upward. In a higher rate environment, with bank regulators tightening appraisal guidelines,[10] a two bedroom Manhattan condo offered at $1.3 million may soon be appraised, but not offered, at 10 percent to 20 percent less, which will take more new buyers, and most New Speculators, out of the market. Surely, at some point, potential residential buyers will resist ever-higher prices and save their down-payments and elect high rents rather than even higher carrying costs on the assumption that they will be well-compensated by appreciation. If, instead of looking forward to perpetually increasing bonuses and stepping up to a new McMansion funded by a huge McMortgage, buyers tone down their expectations, residential prices will stabilize or trickle down to lower levels, if not to reality. In fact, new condo development and conversions in some markets are already beginning to show signs of stress.[11]

COMMERCIAL PROPERTIES

Commercial properties have also benefited, albeit to a lesser degree, from the speculative boom and low rates. New residential development has created a need for new retail centers and the expansion and modernization of older centers. Low rates on both construction and permanent loans have supported new industrial and office development as well, without the need for higher commercial rent levels. After nearly a decade of inactivity, this freshening of real estate supply without substantially inflating rents was a positive effect of lower rates.

The office and industrial rental markets have prospered in new or expanding markets but merely stabilized in most central business districts and major suburban markets.[12] The lower returns available to large institutional investors in the stock and bond markets has led to an increase in real estate allocation from the three percent to five percent range to as much as eight percent to 12 percent.[13] All of this means more money chasing the same properties, lower cap rates, and lower cash returns on non-leveraged investment. As in the individual residential investment sector, the assumption is that total returns will be greatly enhanced by capital appreciation. Increasing leverage with low-cost mortgage financing in the commercial mortgage backed securities (CMBS) market also helps returns on equity, but many of the major institutional investors invest equity or limit leverage to 60 percent to 65 percent LTV compared to the 80 percent to 85 percent common among entrepreneurial groups. The arrival of cash-rich hedge funds and non-traditional real estate investors[14] to provide mezzanine and supplemental equity has also increased available leverage.[15]

The unusually high multiple of net operating income paid in recent transactions and limited prospects of rental income growth suggests that certain properties in suitable locations can offer better appreciation by conversion to residential condominium use, where multiples of rental cost has not deterred condo sales.[16]

A DRAG ON DEVELOPMENT

Higher interest rates will not only discourage future development, but rate resets on commercial loans could also pressure rents before the economic expansion, which is uncertain at best, can absorb them. Corporate profits will be reduced by higher interest rates, and sales growth will be limited by tight consumer spending power. In this context, higher rent levels could have the unintended effect of moving corporate tenants into further consolidation of locations and employment reductions. Without too much effort, tight money and illiquidity in the real estate markets move the economy closer to recession.

If we look at the past few years, from moderately high interest rates and a booming stock market, to a shrinking economy with high unemployment, it seems as if the Fed dug out of the recession and engineered a return to modest growth primarily by reducing interest rates to historic lev-

els. The result has been a slowly rejuvenating stock market but a bubble in real estate. A real concern that needs to be addressed is that returning rates to earlier, theoretically neutral, levels could cause the real estate bubble to burst, and undo so much of the sustainable growth that was the Fed's only way to cure the last recession.

REMEMBER THE LAST REAL ESTATE RECESSION?

The similarities to the late 1980s real estate implosion are all too apparent:

- The arrival of individual, as well as professional, speculators, as well as more entrepreneurial foreign and small commercial investors. This is almost laughably the real estate equivalent of the proverbial odd-lotter or small stock-picker.
- The gold rush frenzy to avoid missing the market.
- The over-extension of credit premised on rising collateral values.
- The disregard by lenders and borrowers alike of refinancing or rate reset risk, based, again, on future appreciation of collateral values.
- The virtual disregard of borrowers' limited cash flow, especially pre-boomers and early retirees.
- The Greater Fool theory popularized by stock market booms that real estate prices have no intrinsic levels, and ultimately move only one way—up.
- The belief that real estate investment is fundamentally invulnerable and can resist cyclical fluctuations.

This is not to suggest that the present scenario could repeat the massive bank failures, RTC distress sales, and moratorium on new development experienced from 1987 through 1995. With a bit of foresight and restraint, the Fed will recognize that its primary goal of repressing inflation must include other actions besides jacking up rates to cause consumer pain. The last real estate depression was also aggravated by the Tax Reform Act of 1986, which simultaneously discouraged individual real estate investment[17] and flooded the market with foreclosure sales. Surely, removing speculation is a laudable objective, but the Fed must not push interest rate levels to the point where they create economic pain or illiquid real estate markets. Forced foreclosures and auctions, write-downs of real estate loans, and the sudden disappearance of real estate equity need not be casualties of the war on inflation.

IN SEARCH OF A NEUTRAL RATE

So, what is a neutral level for interest rates, which the Fed tells us we will know when it arrives? By definition, a neutral rate has to balance and avoid discouraging both speculation and consumption. Clearly, that rate depends on expectation levels. If consumers will borrow at high rates to buy real estate, cars, and LCD TVs because they know those prices will go up by the same amount, or that their incomes will grow, the economy could sustain a higher rate. This mentality prevailed during the early 1980s when the prime rate reached 21 percent in 1981 and 16 percent rates were tolerated for mortgages and car loans. The US economy, however, has changed radically since and incomes for most consumers cannot realistically go up 10 percent or more annually, if at all. Thus, rates should be much lower to be neutral, considering that a much greater part of our economy is supported by early retirees or un-retired consumers with limited incomes.

With energy costs more than twice normal levels, and not showing any signs of restraint, a seven percent prime rate[18] carries with it ARM mortgage rates at or close to six percent, and car loan and lease rates around seven percent. This will suck out discretionary income, a major source of speculation, but the Fed's pride will be short-lived when consumers have no buying power, and the layoffs begin anew. Given the widely suspected decline in real net spendable income that contradicts rosy new job growth reports, a 6.25 percent prime and 4.25 percent Treasury note may already be too high to avoid selective loan defaults and real estate price erosion. Perhaps neutral rates can be lower and the bubble can gently shrink without being burst.

A MESSAGE FROM DOWN-UNDER

Aside from the unnecessarily harsh lessons of the 1980s, real estate debacle, which do not seem to worry the Fed, some bubble lessons might be drawn from the recent stabilization and decline in various Australian real estate markets. The comparison is imperfect, yet instructive. After a recession that saw 10+ percent unemployment and 17 percent interest rates, housing prices began to rise in 1997 fueled primarily, as here, by the Reserve Bank of Australia's moves to reduce interest rates, along with reduced unemployment. Australian tax laws also favored real estate income investments[19] so the home equity

source of capital[20] also supported speculation in rental properties.[21]

Since 2003, the Australia Fed began jawboning rates up and began to require lenders to stress-test their loan assumptions, which tightened lending standards. In late 2004, they began raising rates, and have infused three 25 bps increases so far. The result has been softening of the bubble, but no burst as yet. Housing price increases have gone from an average of nearly 20 percent in the past few years to just 0.4 percent on a national basis, gaining only 0.2 percent in Sydney, and losing 5.2 percent in Melbourne. As can be expected in the United States, however, the greatest impact has been a 10 percent decline nationally in speculation-driven investment properties. Housing equity withdrawal stopped, which triggered a sharp slowdown in consumer spending and the beginning of concern over the impact of future rate increases or unemployment caused by reduced consumer spending.[22] So far, it looks like a soft landing for Australian real estate.

LET'S GO, FED

What might work out to be a neutral rate in Australia might be too high here, and the real economic cost of collapsing real estate values is just too great to be justified by an occasional report of higher consumer prices. The rate conundrum may have no more sinister an explanation than a more global economy than previously encountered, low worldwide rates, and inflation expectations that attract foreign investors to US Treasuries.[23] It hardly warrants crushing real estate values by inflicting rate pain across all non-30-year mortgage borrowers.

The Fed should focus not on driving real estate values down to catch those without a musical chair, or rates up to punish those who did not get their mixed message early on, but on curing speculative fever. For example, tightening lending standards based on stress test is a major step forward, but probably arrived later than it should. Another tool of the central banking system is apportioning credit based on use, just as the margin rules restrict speculative fever in the securities markets. Thus, the bank regulators could require more equity for investment purchases, and restrict second mortgage and home equity withdrawals beyond a comfortable level to curtail speculation that is not supported by rental income. This would produce a gentler bubble meltdown and limit the risks of rate-induced consumer poverty.

NOTES

1. According to Economy.com, home equity withdrawals increased from $266 billion in 2003 to $705 billion in 2004, much of it being funneled into real estate investments. Research firm SRI Consulting Business Intelligence estimated that 2.2 million households used home equity to buy additional real estate—more than double the one million estimated for a decade earlier. *See* J.R. Hagerty and R. Simon, "As Prices Rise, Homeowners Go Deep in Debt to Buy Real Estate," *The Wall Street Journal*, May 23, 2005, pp. A1, A10.
2. One Washington, DC area investor has reportedly accumulated 40 properties now valued at $25 million with underlying mortgages of $15 to $16 million. His technique of buying from distressed owners on the brink of foreclosure and renting them back can work if the seller can pay enough rent to cover the investor's mortgage, and the lender approves a near-bargain price. *See* Hagerty and Simon, *supra* n.1. This strategy does not work, however, once the market is inflated to anything close to the 25 times rental income we are now seeing in New York or the 35 multiple in California.
3. Individuals will have to compete with professionals in major markets. Institutional distressed investors such as GE Commercial Finance Real Estate and Palisades Financial, LLC, seem to have re-discovered this sector after RTC popularized it in the 1990s. *See* R. Chittun and R. Smith, "After the Fall," *The Wall Street Journal*, June 29, 2005, p. B4.
4. Even well-conceived "flip" investments require staying power to avoid or delay losses. *See* Hagerty and Simon, *supra* n.1.
5. Even renters became speculators by dumping all of their savings and borrowed funds into homes, coops, and condos at prices 25 to 35 times their rental value—the real estate equivalent of the tech stock bubble.
6. A major point of contention between proponents of maintaining lower rates and Greenspan's advocates of continuing Fed Fund rate increases is that the various US economic reports do not adequately adjust for the impact of doubled fuel and energy prices on net spendable consumer income or for the true net under-employment rate. They maintain that millions of downsized or RIF'd middle and upper-middle managers beyond unemployment payouts who have given up the job search and living on fixed investment income and home equity loan proceeds are not included in the stats, nor are the displaced workers forced into new careers in lower-paying areas.
7. Fed Funds rates are impacted by the Federal Reserve entering the open market and executing "repo" transactions with major banks. Simultaneously, the Fed raises the Fed discount rate charged to smaller banks and thrifts on overnight loans.
8. Option ARMS start with below-market teaser rates such as 2 percent or even lower, which rise periodically, but due to caps on payment increases, the differential between the pay rate and floating market causes the principal amount to increase. The resulting negative amortization increases the risk to both borrowers and lenders that rate resets in three to five years, or sales, will require more owner equity than an inconsistent economy can generate.
9. Prices in Manhattan, San Francisco, Los Angles, the Hamptons, and other high-end markets are somewhat insulated from mortgage rates, so long as their major source of cash infusion—Wall Street bonuses, tech stock options or buyouts, or Hollywood—continue.
10. Bank regulators have issued guidelines requiring tighter analytic criteria for home equity loans under varying stress conditions such as higher interest rates, and are preparing similar guidelines for new mortgage loans. These are intended to address the risks to both lenders and borrowers of the increasingly popular option-ARMs and other high-leverage loans fueling real estate speculation. *See* Hagert and Simon, *supra* n.1.
11. Real estate analysts have seen signs of the bubble effect in restructured loans and slow sales due to condo oversupply in Chicago, with potential bubble problems due to investor speculation in Miami. *The Wall Street Journal*, June 22, 2005, p. B10.
12. For example, Manhattan midtown vacancy rates declined from 12.3 percent to 10.3 percent from May 2004 to May 2005, while asking rents increased from $50/sq. ft. to $53/ sq. ft. *The New York Times*, June 22, 2005, p. C8.
13. Sales of commercial property in 2005 are reportedly at historically high levels—$15.1 billion in 2004 and $12.67 billion in the first half of 2005 alone. The April 2005 sale of the 2.9 MM sq. ft. MetLife Building (formerly the PanAm Building) to institutional investors for $1.72 billion was a record for a single building. *The New York Times*, June 22, 2005, p. C8.
14. The Carlyle Group, long-known for its success in LBO and other corporate investments, is reportedly an investor with Equity Residential in the Trump Place purchase. *The Wall Street Journal*, June 22, 2005, p. B10.
15. Real estate has also become a major component of overall value in recent corporate transactions, particularly in the sale of retailers such as Toys 'R' Us, purchased by Bain Capital and Kohlberg Kravis Roberts with Vornado Realty Trust, and the Sears-K-Mart merger engineered by Kmart's real estate investor chairman.
16. Equity Residential, a major residential REIT with other foreign and institutional investors, reportedly purchased the 3-building Trump Place for $816 MM, at a 4.5 percent cap rate on residential rents. The prevailing rent of $730/ Sq. Ft. is considerably less than the $1,000-$1,300 available on new condo sales. *The Wall Street Journal*, June 22 2005, p. B 10.
17. This unprecedented change in the Internal Revenue Code was retroactively applied to punish real estate tax syndicates and flooded the market with leveraged properties developed or acquired at costs not supported by economics.
18. At this early July writing, the prime rate was 6.25 percent, and expected to be increased to 6.50 percent in late August 2005.
19. R. Bonner, "Hole in the Housing Bubble," *The New York Times*, July 5, 2005, p. C1, C7.
20. Reportedly, home equity loans were introduced by Citigroup and are now standard fare. *See* Bonner, *supra* n.19.
21. Although mortgage interest on occupied homes is not deductible, operating losses on rental properties can be deducted against taxable ordinary income, and capital gain rates are half the top tax bracket. *See* Bonner, *supra* n.19 at p. C7.
22. *See* Bonner, *supra* n.19 at p. C7.
23. *See* E. Andrews, "Low Rates Could be Around for Long Term," *The New York Times*, June 29, 2005, p. C1, C10.