

REIT SHARE PRICES AND THE DECLINING RELATIVE IMPORTANCE OF COMMERCIAL REAL ESTATE

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Introduction

Since the sharp decline in all U.S. stock prices in the fall of 1998, the prices of shares in real estate investment trusts (REITs) have failed to recover nearly as much as prices of most other types of stocks. In fact, most REIT share prices are now significantly lower than the per-share net asset values of the real properties held by the REITs concerned. This is a marked contrast to the premiums to net asset value in the same shares in 1996 and 1997.

The lagging behavior of REIT share prices behind the general stock market can best be understood in the perspective of the changing situation of commercial real estate in the overall U.S. financial investment landscape. That situation has been altered in the 1990s in two vital ways. First, the shift of ownership of a lot of real property into public markets has notably changed the identity of the people and institutions who at least consider investing in commercial real estate. Their behavior is different from that of the traditional suppliers of capital to this industry. Second, commercial property itself has become relatively less important in the U.S. financial investment landscape. These two changes are discussed in detail below.

* The views in this article are solely those of the author, and not necessarily those of the Brookings Institution, its Trustees, or its other staff members.

The New Broader Investor Perspective

The new group of potential investors in commercial real estate includes many individuals and institutions that formerly avoided this type of investment because they had little real estate expertise, and no convenient vehicles for investing in it. These investors include individuals, mutual funds, small pension funds, small insurance companies, and larger insurance companies seeking more diversified and liquid approaches to owning real estate. Now REITs and CMBSs provide them with such vehicles, and many stock analysts have sprung up to provide them with information about this exotic field. This new group of investors normally considers a much broader set of alternative investments than did the traditional investors in commercial properties. Therefore, commercial real estate must compete with many more alternatives in the minds of these investors. Moreover, these investors typically make stock purchase and sale decisions with much shorter time horizons than did the traditional owners of commercial real estate.

When commercial real estate was financed mainly by institutions specializing in that function, and not directly linked to Wall Street, then the relative role of commercial property in the overall financial landscape was not as crucial as it has become. No matter what stock-market-oriented investors thought about the relative desirability of commercial property as an investment, financing was still available for such property from these specialized private market institutions. Examples of such institutions were banks, insurance companies, savings and loans, and mortgage bankers. Pension funds also became involved to some degree, but they were always more heavily focused on the stock and bond markets than on commercial real estate.

But the advent of REIT ownership of a lot of commercial property, and REIT dominance of capital flows into private property markets, brought the desirability of commercial real estate as

an investment into direct competition with the desirability of stocks and bonds in general. This was inescapable because the investment officers weighing whether to buy REIT shares were comparing those shares with all other publicly-traded stocks. This was – and is – true of mutual fund managers as well as pension fund managers and individual investors.

Moreover, the change in ownership of properties formerly held by private developers and now held by public REITs altered the outlook and incentives typical of investors in real property. Developers who borrowed heavily to build properties were motivated by using tax-sheltered cash flows to build up equity over the long run by paying off debts. Their cash flows were sheltered by high interest and depreciation deductions. This resulted in low taxable incomes – or reportable earnings – but rapid pay-offs of debt or equity build-ups – especially during inflationary periods when market values rose rapidly. Another trait of their holdings was irregularity of earnings over time because of long initial construction and rent-up periods, plus intermittent heavy capital expenditures for modernization and rehabilitation. A key factor in this strategy is a long-term perspective with little emphasis on reportable earnings. Developers usually held the properties they created for many years while their equity positions built up. They often refinanced them periodically at ever-higher values, thanks to inflation, rather than selling them at all.

Investors in public REIT shares have much shorter time horizons – especially institutional investors who are rated by quarterly performance. A recent table in *Business Week* showed the average length of time that investors typically hold a share in a number of firms.¹ The average

¹ *Business Week*, September 13, 1999, page 74.

holding period for stock in Amazon.com was 7 days; for Yahoo!, 8 days; for IBM, 13.8 months; and for General Electric, 33.1 months. These are hardly long-term investments!² Also, today's stock market investors want steady increases in reportable earnings – stated as funds from operations (FFO) in REITs. Even more important, investors in REIT shares are constantly surveying a huge variety of alternative stock and bond investments available to them, for which they can use money from the same allocation pool as REIT shares. This is not true of both traditional equity and debt investors in commercial properties, who specialize in that one type of asset.

Therefore, the *relative attraction* of REIT shares compared with that of high-tech stocks, internet stocks, large-cap stocks, and many other types of stocks has now become much more important in determining what happens to the valuation of real properties than it ever was in the past. This is the converse side of the advantage that REITs have of exposing real estate to large pools of investible capital that formerly ignored commercial properties. The expansion of the basic capital pool allocable to real property is supposed to reduce the cost of capital, and it did so under favorable stock-market conditions. But REIT shares must compete in this expanded capital pool with far more types of alternative investments than in the past. If something makes REIT shares seem less desirable than these alternatives, that negative something may outweigh

² True, except for stocks with the very shortest holding periods, these averages probably result from many people who trade stocks hourly, plus many others who hold stocks for long periods, with few people in the middle of such a bi-modal distribution.

the positive advantage of tapping into a larger basic capital pool.

The Declining Relative Importance of Commercial Real Estate

Moreover, commercial real estate itself has become relatively much less important in the overall U.S. financial landscape than it was in the past. This has occurred because of the immense increase in value of both stocks and bonds during the 1990s, thanks to a soaring stock market. In 1980, the total value of all U.S. corporate equities was \$1.569 trillion. By 1990, that value had risen to \$3.544 trillion, or by 126 percent. But by the end of the first half of 1998, corporate equities had zoomed to \$14.556 trillion – a rise of 311 percent over 1990. Corporate and foreign bonds rose 229 percent in the 1980s and another 122 percent from 1990 to 1998.³

In contrast, commercial property values have remained relatively stagnant since the late 1980s. The Federal Reserve's Flow of Funds Accounts valued total real estate tangible assets held by households, non-profit organizations, and nonfinancial corporations (including housing) at \$6.6 trillion in 1990 and \$8.7 trillion in 1997. That is a gain of only 32 percent, compared to a rise of 232 percent in the overall value of corporate equities in the same period. Commercial mortgages alone increased in value from \$754 billion in 1990 to \$890.5 billion at the end of the first half of 1998, a gain of 18.1 percent during the period when corporate equities were rising 311 percent.

³ Data from the Federal Reserve Flow of Funds Accounts, Fourth Quarter 1993 and Second Quarter 1998.

CB-Richard Ellis publishes National Real Estate Indexes of the per-square-foot sales prices of four types of property in over 50 major U.S. metropolitan areas. These indexes use the average sales prices in the second quarter of 1987 as their base, setting that price equal to 100. Each index is only an approximate indicator of commercial property price changes because the mix of properties sold shifts from one quarter to the next, and no corrections for variations in property quality are built into the index. Even so, these indexes provide rough measures of how much commercial property prices have moved over time. The average per-square-foot price of CBD office space declined by over 25 percent from 1987 to 1993, then barely recovered its 1987 level by 1998. In contrast, the average per-square-foot price of rental apartments remained relatively flat until 1994, then rose steadily to achieve a 51 percent gain over its 1987 level by 1998. The average prices of the other two types of properties showed overall gains from 1987 to 1998 of 18.8 percent for industrial-warehouse space, and 9.7 percent for community and neighborhood shopping centers. In contrast, the Standard and Poor index of 500 stocks increased by 278 percent from 1987 to 1998. *That gain by stocks is more than five times as great as the gain experienced in the same period by apartments, and infinitely greater than the gain experienced by office space – which did not gain at all.*

As a result of these comparatively small increases in commercial property prices, the relative significance of commercial real estate in the wealth of the nation has declined sharply since 1990. Paine-Webber estimated the total market value of all institutional quality

commercial real property in the U.S. as \$3.7 trillion at the end of 1998.⁴ But the value of corporate equities in mid-1998 was \$14.6 trillion – or almost four times as great as that of all commercial property combined. Yet in 1990, corporate equities were probably worth just slightly more than all commercial property combined. Corporate and foreign bonds also had a market value of \$3.7 trillion in mid-1998 – more than double what it was in 1990.

⁴ Paine Webber Equity Research, *REIT 1998 Review and 1999 Outlook* (New York: January 1999), p. 19. The Urban Land Institute's estimate of the 1995 value of commercial real estate structures, including apartments, adjusted for land as 20 percent of total value, is also roughly \$3.7 trillion. See the Urban Land Institute, *America's Real Estate: Natural Resource, National Legacy* (Washington D.C.: 1997), pp. 32, 40, and 41.

The Federal Reserve Board's analysis of household balance sheets for 1990 and 1997 also shows a sharp change in the relative importance of real estate vs. corporate equities and other equity securities. In 1990, households held \$3.968 trillion as corporate equities, mutual fund shares, and half of their pension fund reserves (presumably also in corporate equities). But they also held \$6.609 trillion in real estate, including their own homes. Thus, about one-fifth of their assets consisted of stocks and one-third of real estate. By 1997, the value of households' corporate equities, mutual fund shares, and half of their pension reserves had zoomed by 181 percent to \$11.145 trillion, but the value of their real estate had increased by only 31.6 percent to \$8.694 trillion.⁵ So their holdings of corporate equities (including mutual fund shares and half of their pension fund reserves) had gone from 40 percent less valuable than their real estate holdings to 28 percent more valuable. About 56 percent of their total increase in assets from 1990 to 1997 consisted of greater values of equity securities, whereas only 16 percent consisted

⁵ Most of the real estate held by households consists of owner-occupied housing. Median prices of single-family homes sold increased by 30 percent from 1990 to 1997, according to the National Association of Realtors *Real Estate Outlook* (January 1999) and the *Statistical Abstract of the United States: 1997*, p. 720. This implies that the values of all other real estate held by households -- including commercial properties -- went up slightly faster than the values of homes. So the 31.6 percent increase for all real estate held by households is a reasonable estimate for the increase in value of their commercial properties too.

of more valuable real estate. Clearly, securitized wealth has replaced real estate as the number one type of household asset, at least for all households considered together. (This is probably less true of households in the lower half of the income distribution, since securitized wealth is more narrowly distributed than home ownership).

These data dramatically illustrate that commercial real estate both has a much smaller total value than its main investment rivals, and also has increased in value since 1990 much less than their spectacular gains. Moreover, commercial property has proven a much riskier investment than stocks or bonds during the recent past. This is true because of the collapse of most commercial property values in the real estate debacle of 1990, and the low returns to REIT shares in 1998. Consequently, investors who normally compare buying interests in commercial property with interests in a broad variety of stocks and bonds are much less likely to be attracted by REITs than by the latter. Hence the shift from investors institutionally tied to real estate to investors facing a much greater breadth of choices has reduced the appeal of commercial real properties as a place to put investible funds. Why should they invest in something that is not very important in total size, has recently exhibited very low increases in value, and is prone to severe declines in value – in contrast to something that appears to rise in value indefinitely, and recovers rapidly from its occasional falls in value? No wonder REITs have lost their glamor!

Should Investors Forget About Commercial Real Estate?

The above analysis seemingly sets forth a bleak future for investing in commercial real estate – especially in the form of REIT shares. Why should anyone do so? Three reasons still remain valid.

First, investing in commercial real estate – especially directly, rather than through REIT shares – provides some portfolio diversification against investing solely in stocks and bonds. Property values have recently been notably higher in private markets than in public markets, because REIT share prices have fallen below their net asset values per share. As the experiences of the 1990s clearly show, asset values in private commercial property markets do not move in the same time pattern as those in stock and bond markets. Therefore, unless an investor wants to focus solely on high-risk, high-growth-potential assets, owning some commercial real estate improves the expected value of his or her portfolio.⁶

Second, the U.S. will continue to grow in total population, and therefore will need a lot more commercial properties of all types over the next 20 years. The nation's population is expected to rise by about 47 million persons from 2000 to 2020 – about the same increase as occurred from 1980 to 2000. A huge amount of commercial property was built in the past 20 years to accommodate that growth, and a lot more will be required in the next two decades. So there will be a lot of opportunities for profitable development of new properties, and profitable operation of existing ones, in the future. True, the nation's population as a whole is growing only about one percent per year. But growth is much faster than that in certain regions, especially in the South and West. So individual developers and operators concentrated in high-growth areas can experience faster-than-average increases in total profits over time. And some

⁶ For a detail discussion of this argument, see Property and Portfolio Research Strategist, *Why Real Estate?* Volume 3, Number 10 (August 1999).

specific property-type niches will also grow much faster than all commercial property on the average.

Third, as the baby-boom generation enters into retirement ages after 2000, the investment emphasis of many of its members may shift from growth-oriented assets to income-oriented assets. This may increase the relative attraction to investors of REIT shares because they pay relatively high dividends.

Conclusions

The relative lag of REIT share prices behind broader indices of stock values is not just a temporary fluke. Rather, it stems from some fundamental changes in the nature of the nation's capital markets – especially in those providing funds for commercial real properties. As a result, the future shows a mixed industry consisting of REITs, other forms of publicly-owned real estate companies, and private companies, all seeking to adjust to the basically mature, less significant, and slow-growth nature of the real estate industry. REITs will not expand to take over dominance in any forms of property – though regional malls are closest to that outcome.

Consolidation will continue to mark the REIT industry, but not to the point where a few monster firms have the power to set prices in property markets.

Yet because current general economic conditions are so favorable to real estate operations, plenty of money will be made in REITs. Moreover, as the population ages, more investors will place higher value on income stocks with strong dividends, such as REITs. That may push REIT share prices upward relative to the prices of other stocks. And the greater prominence of the REIT format may help reduce, if not prevent, the chronic overbuilding that has plagued private

property markets in the past. So REITs are not only here to stay, but will remain powerful forces influencing commercial property markets for the foreseeable future.