EQUITY OWNERSHIP IN DEVELOPMENT COMPANIES: A VEHICLE FOR INSTITUTIONAL INVESTMENT IN REAL ESTATE.

by

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Paul Anthony Heiss

Submitted to the Center for Real Estate Development on September 1, 1990 in partial fulfillment of the requirements for the degree of

Master of Science in Real Estate Development

ABSTRACT

This thesis explores and supports the increasing institutional financing of, and equity investment in, the operating businesses of real estate developers.

Increased illiquidity and regulation of traditional real estate capital markets have forced developers to seek interim operating and construction funds for new business. This thesis examines the opportunities, risks and returns on the portfolios of institutions who fund or acquire established development companies in relation to traditional, property specific, acquisitions.

The investment in an established developer requires the valuation of assets beyond the existing portfolio to include: operating futures, management skills, and corporate reputation. Finally, the thesis creates a valuation model for developer oriented, relationship based investments in localized entrepreneurial real estate organizations.

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This paper is dedicated:

To my parents, Bob and Noreen. Their support and confidence has never wavered. They encouraged my goals and showed me the way through their own success.

To Cordell, for the inspiration, the insight, and the healthy competition. Who’s better in powder anyway?

And especially to Angelina, who’s love and strength and patience continues to amaze.
CHAPTER 1

INTRODUCTION

This thesis explores and supports the argument for institutional investors to augment their real estate portfolio allocation needs through equity investments in development companies. Corporate equity ownership and financing structures may allow increased long term portfolio returns with lower risk than traditional, property specific investments. Ownership and control of the production of real estate may offer additional access to premium assets and market knowledge.

Public and private pension funds, insurance companies and private trusts concerned with reasonable portfolio returns or fiduciary management of their investments gravitated toward real estate as an acceptable asset class. Early research into returns and volatility showed that real estate could be an attractive addition to the institution’s stock and bond holdings. Consequently, institutional money managers added real estate to their investment portfolios during the late 1960’s and early 1970’s. Each real estate capital investment was actually a business investment dependent on successful leasing to commercial and residential tenants. In the aggregate, the real estate industry is composed of (a) real assets; (b) public and private firms that offer investment, asset, property, and development management services; (c) and the
providers of investment capital. ¹ The real estate service firms have not as yet been a critical part of the investment. Institutional real estate investors focused on real assets and property specific investments to fulfill their real estate portfolio allocation demands.

Preliminary forays into the world of real estate investment consisted primarily of debt financing on real assets with a guaranteed return on simple mortgage loans. High quality, well located trophy properties were the investments of choice. As the knowledge and skill level of institutional real estate managers increased, complicated financial structures with qualities of both debt and equity emerged. These investments were often backed by second tier, suburban, commercial and industrial properties. During this period of investment evolution and growth, institutional investors experienced substantial success with the real estate allocation of their overall portfolios.

That success, however, may be increasingly difficult to duplicate on a long term, risk adjusted basis during the real estate environment of the 1990’s. The explosive growth of both real estate values and floor space inventory in the United States ended in 1989. Record numbers of real estate company bankruptcies followed a plunge in the capital market’s willingness to finance the operation and construction of real estate.
Nevertheless, strong investment potential may still be available, to institutional investors willing to extend real estate investment into the means of production. Ownership, funding, and control of high caliber development companies may satisfy institutional demands for sustained high returns with low risk. Difficulties in the real estate industry may necessitate the long term financing of development companies to sustain the production of quality investments. The demarcation between investor and seller may continue to dissolve. To further this trend, institutional investors should explore equity ownership in development companies as a vehicle for continued investment in real estate.
CHAPTER 2
THE REAL ESTATE MARKETPLACE

THE INSTITUTIONAL ENVIRONMENT

The fiduciary acceptability of real estate investment as an asset class has evolved tremendously from its inception. Real estate investment by institutions (pension funds and fiduciary institutions) began in the early 1970's. Previous pension fund sponsors worried about the legality and acceptability of investing in real estate during until the early 1980's. As fiduciary investor's knowledge has increased, the acceptability of real estate has grown accordingly. In comparison, responsible bond and equity investment strategies has evolved to allow investments with, and in, experienced mutual fund managers. The augmentation of real estate portfolios with direct ownership of eminent developers may follow this same evolution.

Portfolio managers first explored simple debt and equity investment structures. Investors then financed trusts, commingled funds, joint ventures, and finally direct investments. Yet institutions have not been thoroughly satisfied with their investment structures. During the evolution, investors have continuously searched for better method of placing their money in real estate.
By 1990, contributions to pension funds grew over 100% from 1985 levels. During this time, the average of investment funds for real estate also increased to a 10% allocation percentage. The implicit demand for real estate grew from this 10% to over $268 billion by 1988.²

Implicit Demand for Real Estate
From Growth in Portfolios @ 10%

The fund's growth spurred investments at increasingly lower returns as "large amounts of money chased fewer quality projects."³ The respected Russell-NCREIF index tract the decline in total real estate returns over the past decade.⁴

REAL ESTATE TRENDS
RETURNS 1978-1988
The index also showed declines in 1990 returns divided by property type.\textsuperscript{5}

**RETURNS BY PROPERTY TYPE**

**1989**

![Bar chart showing returns by property type for 1989 with holding periods of 1, 3, and 5 years.]

Russell-NCREIF INDEX 1990

For the first time in its inception in 1978, real estate returns of the Russell-NCREIF Index (6\%) were lower than the benchmark U.S. T-Bill (8.2\%).\textsuperscript{6} The decline in real estate returns came through many different financial structures of institutional real estate investment. They included:

**INSTITUTIONAL REAL ESTATE INVESTMENT EVOLUTION**

- DEBT
- EQUITY
- REITS
- COMMINGLED FUNDS
- JOINT VENTURES
- DIRECT INVESTMENT
Traditional debt financing has been an acceptable financial structure from the inception of fiduciary real estate investing. Institutions invested in existing, successful, property and avoided development, leasing, and future valuation risk. The portfolio returns were quantifiable for the life of the investment. Development and construction loans were secured by the property and personal guarantees from the principals. During periods of strong growth in the late 1970’s and early 1980’s, many developers followed the "Wild cat approach to real estate development." The preferred "spec, spec" development projects financed at high risk with minimal equity from the company. The buildings were often started without any sales or leases in place.

Institutional lenders found, however, their debt margins and returns to be too low for their risk levels. An experienced developer commented, "Today the real estate entrepreneur finds that substantial equity is required to get a loan. Most simply, the traditional mortgage lenders are no longer willing to make money available on the favorable terms that they have in the past; the rates are higher and the ratios of loans are lower. Straight debt has fallen out of favor with lenders. They want more, often participation in the equity return."
EQUITY

Lenders realized that their real estate debt returns were often lackluster when compared to the developer’s leveraged equity returns. A substantial rise in real estate values during the early 1980’s accentuated the discrepancy between debt and equity. Institutional lenders developed hybrid structures including convertible mortgages and equity participations to capture appreciation increases in their real estate. Investors not willing to lend searched, often without success, for quality equity.

Understandably, developers did not like to sell successful projects with unrealized appreciation. An institutional investor lamented the problem, “A year ago, a developer would hardly deign to talk to you about selling a building at a price that was less than projected future rents capitalized at 8 %.”¹⁰ But quality equity may eventually become less expensive. The investor continued, “That same developer is now hustling around trying to sell at a price that is getting close to what he could get for a foreclosure auction. This should allow for easier and more profitable equity investment because “the developer’s conversion from euphoria to gloom is probably unwarranted.”¹¹ Clearly, asset based equity should be attractive over the near term.
REAL ESTATE INVESTMENT TRUSTS

As one form of investment in equity real estate, Real Estate Investment Trusts (REITS) became popular during the mid 1970's. REIT returns were negatively correlated with unleveraged equity real estate returns, highly correlated with common stock and, to a lesser degree, correlated with bonds. A broad index of equity real estate returns does little statistically to explain REIT share performance. REITs underperformed the Frank Russell Company Index (FRC) and the S & P 500 Index over their 15 year lifespan.

REIT returns improved somewhat during the late 1980's. The repeal of tax incentives in 1986 has renewed interest in REITs because of their interest in maximizing their cash flow income. However, real estate investment managers felt detached from the substance of the underlying asset pools. REIT's lackluster returns and movement with publicly traded equities have discouraged further institutional investment.

COMMINGLED FUNDS

A further extension of real estate investment structures was developed through commingled investment funds. The funds were sponsored by a fiduciary advisor who provided real estate expertise. Institutions invested with small amounts of money or with small staffs. An industry critic commented in 1982 that "The introduction of the pooled fund arrangement in 1970
enabled pension funds to diversify into real estate without having to become real estate "experts." The commingled fund arrangement have enabled both industries to meet without either parties having to become an "expert" in the other’s affairs. More importantly, however, these now pooled fund arrangements offer pension funds a way of entering real estate investments with a greater feeling of security. There has not been a real appreciation of the financial responsibilities and investment criteria of investors and advisors. The names of these substantial financial institutions stand as a sort of protection from the vicissitudes of a relatively "new" investment arena for many pension funds.

As the performance of fund managers and the skills of investment managers improved, communication and understanding has dramatically improved. However, some knowledgeable institutions desired greater contact with the properties. Most wanted to optimize their portfolio diversification through property types. Eventually, many real estate fund investors gravitated toward discretionary accounts with commingled advisors to increase control over their investments.

JOINT VENTURES

To further increase investment control, institutions also entered joint ventures. Aggressive pension fund advisory companies such as Copley Real Estate Advisors advocated joint ventures with strong regional
developers. Progressive advisors and sophisticated fund managers joined forces with reputable developers on promising projects. Relationships were established and repeated when successful. The institutions thereby gained access to the developer's strategic position and high returns. The financial structure promoted cooperation between developer and investor. Copley believed these relationship-based investments were promising and increased returns over commingled funds with similar or lessened risk.

**DIRECT INVESTMENT**

The next step in the evolution of real estate investment was direct investment, without developers or advisors as partners. Throughout the evolution, investors have been conceptually and legally distinct from developers. As late as 1978, one pension fund advisor commented, "To the best of my knowledge, there are no U.S. pension funds with in-house staffs doing development work for their own accounts." But the transformation of investor types was swift. "A trend developed for funds to become involved early on in the development process. The decade of the 1980's brought more sophisticated people into pension fund management." By 1990, many institutions had separate real estate departments locating and investing in projects. These departments often surpassed local developers in their own markets.

Progressive fund sponsors realized that, "A pension
plan that wants a better return than commingled funds offer should set up its own in-house real estate program. If done right, the plan will make more money on its holdings than a similar portfolio run by an investment advisor or a commingled fund.19 Others concurred, "A pension fund that proceeded on its own would be able to obtain higher returns than pooled equity funds after administrative expenses are paid."20

Some pension funds invested directly because it was "more economical to hire their own internal people. But staffs were kept lean in a pension fund to show good returns. The funds then ended up hiring external expertise anyway."22 The outside advisory firm's management and acquisition fees were quite high.

As pension funds began to invest directly, the market became very competitive for good projects. One industry observer noted, "private and commingled funds bid against one another for the best investments to the point that the highest quality projects returns were below the risks associated with real estate."21

There was no consensus among pension fund managers. Some felt the cost of maintaining a highly skilled investment management staff was significant and ought to be included in evaluating the expected returns of these real estate investment opportunities.23 Furthermore, it is uncertain that in-house development personnel have access to the strategic advantages of community based entrepreneurs and building type experts.
ADVISORS

Real estate service firms sprang up as fiduciary advisors to satisfy the increase in institutional real estate investment. They were retained for a variety of transactions. Advisory personnel had real estate or finance experience and sold their services and investments to individual or combined real estate funds. One real estate fund manager commented, "The trustees' desire to shield themselves from the possibly perverse consequences of real estate investing is one of the main reasons these advisory firms exist. They promise protection. Developers and other real estate people who have talked with pension funds about possible joint ventures and financing know that the one thing that inevitably kills any deal is that the pension officer refuses to accept the responsibility for making the deal. They want a fiduciary to approve it."^24

Advisory firms provided services beyond a fiduciary double check. These firms acted as brokers, managers, strategists, as well as councilors - for a fee. Advisors ran the daily investment and property management tasks and provided important access to sophisticated real estate developers. But the advisors often recommended the same project to different investors, or screened projects from certain buyers. They had strong leverage because "there was a lot of money chasing a few high quality properties."^25

Simultaneously, the advisors taught their clients
the fine points of real estate deal making on each successive investment. Eventually, the pension fund manager's increased skill level prompted them to question their advisor's recommendations.

Each of the investment vehicles was selected for different risk and return targets by managers with varying aversions to risk. No single structure met the pension fund's portfolio allocation needs. As such, the evolution of investment vehicles has been driven by the shortcomings of previous designs. In general, the institutional real estate investor has developed valuable skill and knowledge. As knowledge increases, investors pursue ever more complicated structures, thereby encroaching into the developer's arena. As the growth of the 1980's subsides, institutions will be hard pressed to find high quality, successful, real estate. The competition for real estate will increase.
THE REAL ESTATE ENVIRONMENT

The business of real estate development and finance grew at a moderate pace during the 1980's. Absorption of newly created space was strong in most markets. Effective rents and sale prices increased and real estate investment capital was plentiful. Real estate developers were also plentiful and offered diverse products with homogeneous returns. Institutional real estate funds generally pursued conservative investment structures. A few aggressive investors had an increasing appetite for equity participation and development deals. However, the end of the decade foreshadowed a different real estate environment.

The development business had radically deteriorated. 26

"Nothing is more humbling to a developer of the 1980's than to be a developer in the 1990's.

1990 began with most regional United States markets of all property categories in over supply. Vacancy rates increased to record levels in all major office, commercial, industrial, and residential sectors. 27 real estate developers were not optimistic about their future business.

REAL ESTATE 1990
COMPAARED WITH 1989

BEAR MARKET FOR FIRM
85

BULL MARKET FOR FIR
13

BEAR MARKET/INDUSTRY
22
The overbuilt markets put pressure on rents and capitalized sale values of real estate equity. Additional recessionary pressure on the critical Standard Industry Category (S.I.C.) of Fire, Insurance, and Real Estate lessened those industry's office space needs. The consolidation of the service sector increased leasing concessions and lowered releasing face rents, further decreasing existing asset values.28

CAPITAL MARKETS

The demand for space was not helped by tightened capital markets. Increased regulatory control in the savings and loan and commercial banking industries over the deregulated environment of the 1980's precipitated a national credit squeeze. In July of 1990, the Galbreath Company, a prominent national developer, reflected, "The banks and savings and loans are basically out of the market" for construction loans. We are looking to pension funds, overseas investors and other sources of financing. As a result, there isn't a lot of new building."29

The tightened lending environment heightened the need for developer equity. Galbreath continued, "We have one suburban project that's a build to suit situation. The tenants are already lined up. But the lenders still want equity from us. That and other demands have prevented an agreement on financing, and the company hasn't started building yet. Our primary thrust has been to build where we have equity in the
project. But with situations more difficult to finance, the company will do more contract building.\textsuperscript{30}

The demand for additional equity and operating capital came during an environment of difficult tax policy. The Tax Reform Act of 1986 removed the tax shelter impetus to help raise real estate equity through syndications. This eroded the equity capital base available for real estate investment because of lowered yields. Equity capital raised through syndications dropped to one tenth of the level raised prior to tax reform.\textsuperscript{31} In summary, "Two of the major sources of capital dried up, the banks and the syndicators. The capital markets were moving in unsettling directions."\textsuperscript{32}

LIQUIDITY

The turbulent capital markets caused severe operating problems for developers. Development firms traditionally owned property and operated the company with high leverage. Most aggressive developers had only 10-15\% of their own equity in each project, providing large returns through positive leverage. Cash flow from completed projects covered corporate overhead, feasibility, architectural and legal expenses for new projects. Consequently, small cash flow shortfalls caused severe liquidity problems for thinly capitalized organizations. A developer commented, "We used to say, 'The more debt the better.', But those days are over in the development business. Now 'Equity will rule.' You need equity to ride out the tough times."\textsuperscript{33}
During down periods, a herd mentality developed in the entrepreneurial real estate community. To avoid looking bad, the image conscious developers waited until the onset of problems to sell their property. They feared signaling financial trouble to creditors and competitors. This mentality often impeded sales of assets during growth periods to generate cash flow. When sales could no longer be delayed, a wave of sellers often swamped the market. Few buyers were interested when the development community reacted to a cash flow crisis. By 1990, "The pendulum was hurtling beyond depression and into panic."34 "There were at least two reasons for their flight to panic. First, the real estate market has, or at least appears to have, stagnated. Second, very few deals are being made."35

There was little the real estate community could do to change the disconcerting aura. Developers and investors alike realized the credit crunch of 1990 may have been a short lived moment in terms of a pension's portfolio life.36 Ironically, "Those who understood potential long term values were either unable to finance acquisitions or waited for prices to bottom."37

Long time industry analysts commented, "Despite the sense of doom, the truth is that the real estate business is never as good or as bad as people say. Living in the real estate community is like spending your summer vacation in a ward for manic depressives, Yesterday, nothing could go wrong; and, today, nothing
can go right. There's no middle ground.™ 38

Surprisingly, some developers did not have liquidity problems. Large developers like JMB Institutional Realty of Chicago continued to thrive in the marketplace. One institutional investment partner said, "JMB is very well capitalized and remains in a very solid position." 39 The company's continued health in a turbulent real estate environment is due in large part to its access to institutional funds, which reduces its dependence on short term borrowed funds. 40

The real estate marketplace of 1990 is difficult for institutions and developers alike. Both parties have crisis they urgently want to solve.

Institutions have money to invest in real estate and they have grown familiar with developers, yet quality investments are scarce. They desire premium assets and recognize they need talented management to find and run them.

Developers want to survive. Severe overbuilding and liquidity problems have forced many to reconsider their place in the industry. They need to sell their property and their expertise. They need to sell to institutions.
CHAPTER 3
THE DEVELOPER INVESTMENT SCENARIOS

THE SOLUTION

Institutional equity investment in real estate development companies provides a practical solution for the needs of both portfolio managers and developers. Developers get operating capital to see them through the difficult development climate and to plan for future projects. Portfolios secure real estate class investments of the highest caliber. Yet, institutions may be reluctant to acquire these means of production in the real estate industry. The benefits to owner and investor alike should outweigh the difficulties of creating the relationship. Strong institutional leverage during the depressed market era may allow the structuring of investments to dampen investor's historical concerns.

Three distinct vehicles for equity and equity-like investments are available to pension funds. Investments include publicly traded stock, privately held equity and hybrid equity or corporate financing. Each financial structure has a number of related substructures. The various structures have characteristics suitable for strategic, investment and development needs.

- PUBLIC EQUITY
  Real Estate Companies
  Substantial Holdings
  REITS

- PRIVATE EQUITY
  Real Estate Companies
  Income Property
  Direct Investment

- HYBRID EQUITY
  Loan on Portfolio
  Loan on Cash Flow
  Preferred Stock
(A) PUBLICLY TRADED EQUITY

A major category of equity contains publicly traded stock. Publicly held stock includes development companies and companies with substantial real estate holdings that trade on a major stock exchange. Stock analysis and acquisition through traditional equity markets is similar to any public equity acquisition. The control of the real estate only comes through control of the majority of shares outstanding or through enough stock to obtain influential seats on the board of directors. These acquisitions may be realized by solicited or unsolicited stock offers at or above market price. Purchase of public stock may be directly from the company or through brokerage houses.

DEVELOPMENT COMPANIES

The first type of publicly traded equity contains development companies. There are only a few pure real estate companies with publicly traded stock of substantial size. Of these, many firms specialize in residential construction or building materials and may be unfamiliar to the institutional real estate investor. A number of hotel operating companies have in-house development divisions to supply product for their own account. Perini Investment Properties is one of the few examples with commercial, hotel, and residential expertise.41
SUBSTANTIAL REAL ESTATE

The second type of publicly traded equity includes corporations with substantial real estate holdings. Companies with real estate holdings may be attractive for equity investment for either their development divisions or in their miscellaneous holdings. Large utilities such as railroads, power utilities, mining, transportation and agriculture may have promising holdings. Large office users have vast supplies of owner occupied space. Other corporations may recognize value in their office buildings or industrial factories as redevelopment opportunities.

In fact, corporate real estate holdings dwarf institutional holdings in comparison. An example of a company with substantial real estate is the Sante Fe Pacific Railroad. A large pension fund commented, "The California Public Employees Retirement Systems' purchase of a 20 percent stake in Sante Fe Pacific Realty Corp. on Dec. 29, (1989) closed a year that saw pension funds taking larger and more unusual deals to meet their real estate allocation targets. It is the first time that the pension fund has asked for, and received, seats on the board of directors."42

The investment was well received by the real estate community. "It's one of the most creative investment deals a pension fund has ever been involved with," noted William Ramseyer, executive vice president with JMB Institutional Realty Corp. CalPERS has purchased common
stock, at a discount, and is now considering taking the developer private.\textsuperscript{43} Clearly, there was significant opportunity to explore investments in corporate real estate holdings.

**REITs**

A third, and familiar structure for public real estate holdings are Real Estate Investment Trusts (REITs). REITs that trade on major exchanges may be acquired for long term hold or taken private and reorganized. Most REIT portfolio holdings and development intentions have been well defined in the trust offering. REITs have specialized in many property types and development scenarios.\textsuperscript{44}

Though somewhat out of favor, REITs may be a credible alternative for the smaller investor. Many REITs such as Federal Realty employ high quality management to oversee high quality assets. Direct control, however, may not be obtainable due to frequent takeover defenses written into the trust offerings.

**(B) PRIVATE EQUITY**

Private company equity owners are the second major category of developer investment. This type of equity involves development companies that are closely held, other thinly traded corporations and limited partnerships. Analysis and acquisition of each company may be peculiar to each firm. The holder of private equity must either be ready to sell their interest or be
convinced to sell with the lure of a high price. The majority of entrepreneurial real estate developers will fit into this category.

**DEVELOPMENT COMPANIES**

The first and most important subcategory of private equity include development companies. Traditional development companies that specialize in specific markets or product types may part with their equity holdings.

One exemplary sale to JMB Institutional Realty was the Cadillac Fairview portfolio, which was the largest developer in Canada. "JMB paid about $2 billion for Toronto developer Cadillac Fairview in 1987. JMB also purchased another developer when they paid $920 million in 1988 for Amfac Inc. of Hawaii. Ownership of the developers also fit well with their ownership of public companies. JMB was general partner in the limited partnership under which the California Public Employees Retirement System last year paid $398 million for a 20% stake in Santa Fe Pacific Corp’s real estate holdings." Conclusively, some of the largest and most respected investors are beginning to look toward development companies to satisfy their real estate demands.

**INCOME PROPERTY HOLDINGS**

Income property holdings are a second subcategory of private equity. Small corporations and families hold equity and manage substantial quantities of private
income property. Institutions may approach income property holders who want to sell their holdings after life changes or to raise capital.\textsuperscript{46}

Examples include the syndication of Rockefeller Center by the Rockefeller family. Numerous other families may hold strategically valuable real estate suitable for institutional acquisition.

**DIRECT INVESTMENT**

The third subcategory of private equity investment includes direct institutional investment. Investment managers may decide to create a development company to fill a demand that is not being met. In this strategy the institution will not, however, be able to obtain the strategic benefit and cost savings associated with the purchase of an existing company.

An analyst commented, "From the pension fund viewpoint, the only real reason to develop is that at times it is cheaper to build a building than to buy an existing one. Some development people will have no choice but to work for pension funds. Several large foreign pension funds have already done this successfully."\textsuperscript{47}

**(C) HYBRID CORPORATE FINANCING**

The third major category of developer investments includes hybrid corporate financing. Hybrids include many combinations of convertible mortgages, preferred stock and controlling loan agreements. Control of a
developer may be gained through hybrid debt at favorable terms if the developer has cash flow difficulties. Hybrid structures may arise from the unsuitability or unwillingness of a developer to part with their equity portfolio. Corporate financing may also allow for investment in the developer’s current and future real estate projects.

Developers with famous names got most of the debt financing. The European funds were interested in relationship based financing and equity sharing for individual projects in individual markets. The Japanese wanted to secure companies in broad markets and product types. When the Japanese become a stock holder in company, the developer had to enter into a long term non-compete clause. The hybrid financed developer then had little flexibility to deal with anyone else for financing or new projects.48

\textit{LOAN TO DEVELOPER SECURED BY PORTFOLIO EQUITY}

An investor can gain access to a developer by capitalizing the company with an operating loan. The security may be equity on existing or future projects. The ability to access portfolio equity may be negotiable. The extent of negotiability would depend upon the financial health of the developer.

Congress Group ventures was an example of medium tier entrepreneurial developer that secured corporate financing. Organized as a Subchapter S corporation, they developed 5 million square feet of commercial space
in New England and were financially sound. The owner wanted to protect the asset base that he had built up but still raise cash. He gave collateral only on his future projects. He said, "If you have an earnings drop they come and take your buildings, just like that. I've worked too hard to give away everything I have built up. When they convert your property you have a phantom tax gain and no cash flow or project tax shelter to cover the bill. They are only secured by the development projects."\footnote{49}

**LOAN TO DEVELOPER SECURED BY FUTURE CASH FLOWS**

Loans secured by future cash flows could also be used to control a developer. The secured amount of investment funds is significantly smaller than loans secured by assets but could have higher returns.

A lender commented, "The only problem is that the pension fund has lost control of the property. The developer is legally the owner. When disputes arise over how the property should be managed or when it should be sold, the pension fund has no real say. The developer's decisions rule. Trading off control of the property for a few extra points of return is a poor strategy in a development deal unless the fund totally trusts its partner, an unlikely occurrence."\footnote{50}

Yet, these loans could be successfully combined with other financing vehicles. For example, "JMB loaned the developer $75 million in addition to the $400 million paid for the 20% equity stake. That loan could be paid
back in the form of an even greater equity interest.”51

**PREFERRED STOCK AND ADDITIONAL FINANCIAL STRUCTURES**

A corporate type of financing vehicle may be more prevalent in real estate debt and equity areas in the future. Hybrid debt options were being offered by pension advisors like Aldrich Eastman & Waltch.52 These structures could be almost anything. For example, “a preferred stock or subordinated debenture combined with equity warrants. The investor would put up money and, unlike a project financing, the capital would not be taken out to go into the developer’s pocket. The money would stay in the company. It would be used as working capital, to expand the developer’s business and to take advantage of other opportunities. This obviously increases liquidity, and from the developer’s point of view, institutionalizes the borrowing capacity.”52

The company can remain private and avoid registration/disclosure requirements associated with a public offering. Further, it may not be a taxable event for the developer, hence there is no tax on sale, which may be very important. Finally, a well respected developer, such as the Macomber Company53, may be able to retain substantial control over the operation of its business.54

In a participating mortgage the fund passes some significant tax benefits to the developer. The developer owns the property and can claim all the construction write offs. The developer can also deduct
the "mortgage payments" to the pension fund "lender." Instead of paying shares of income to a part owner, the project may make deductible interest payments.

The flexible framework of equity investments in real estate development companies may meet the needs of both investor and seller. The array of structuring vehicles may tailor the investment to particular investment characteristics. Advantages should be realized by the equity investments. Institutions will find quality, long-term real estate and developers will find short term liquidity with long term profitability.
Numerous economic and strategic benefits will be gained by institutional investments in corporate real estate, equity-like vehicles. Enhanced portfolio diversification, risk evaluation, and fiduciary management will provide increased real returns with lowered systematic risk.

ADVANTAGES OF OWNERSHIP

- DIVERSIFICATION
- PREMIUM PROPERTIES
- SECURED STREAM OF PROJECTS
- RISK EVALUATION
- CONTROL
- ACCESS TO INFORMATION
- ACCESS TO MANAGEMENT
- QUALITY
- EFFICIENCY

DIVERSIFICATION

Investment managers may be concerned with the impact of real estate’s on their entire portfolio. Real estate funds gain enhanced portfolio diversification through access to premium properties, to future projects and to corporate profits. The California Public Employees Retirement System purchase of Sante Fe Realty stock is an example of this portfolio diversification. The investment fund stated, "Calpers was eager for the Sante
Fe deal because its portfolio melded perfectly into the Calpers portfolio, which was under weighted in California."\(^5^8\) Consequently, fund managers can efficiently search for companies that specialize in market niches and regions where their portfolios are weak.

In comparing real estate risk to the stock market, a portfolio manager said, "it is easier to diversify away unsystematic risk in real estate than in almost any of the S&P industry groupings. This creates the potential for risk reduction through diversification within the real estate portfolio."\(^5^9\) Investment in a real estate developer should also behave contracyclicly to the common stock market to provide further diversification benefits.\(^6^0\)

**PREMIUM PROPERTY ACCESS**

Large real estate development companies who build for their account traditionally own substantial leveraged equity in their portfolios. In fact, many corporate mission statements describe their intent to keep the very best property as part of their "long term commitment to quality."\(^6^1\) Many developers intended to hold their best performing assets for as long as they are in business and sell off their marginal performers. This makes sense for developers. Traditional refinancing arrangements permits owners to realize appreciation of their buildings in a nontaxable transaction.
On the other hand, as capital and real estate markets become tight and builders search for liquidity, these sacrosanct assets may become available. A pension fund advisor echoed this point, "Pension funds are finding it increasingly difficult to fulfill their real estate allocations. And with developers holding on to their best performing properties, buying a piece of a developer may be the only way to get the quality assets.

At most, the astute real investors will be able to purchase the developer's quality holdings. At least, the investor will be able to collateralize hybrid investments with assets of the highest order.

SECURED STREAM OF PROJECTS

The institutional investor may also be able to secure future access to these quality assets. The Calpers fund stated, "One reason the fund invested in a developer is it needs a steady stream of prime real estate projects." 62

The pricing of the developer equity investment will, in effect, contain a call option on the products created during the next building cycle. Fund managers can purchase projects ahead of time at wholesale prices for the fund's portfolio. 63 Advisors concurred that ownership of a developer may be seen as "A call option on the future product offerings." 64 "Institutions may secure projects by buying at wholesale instead of retail." 65 Another advisor concurred, "One of the most interesting aspects of this type of transaction is the
ability to be more on the developer’s side of the deal. If the investor capitalizes the developer they are in effect, participating on a wholesale basis. This should realize the investor substantial economic benefits.\textsuperscript{66}

If the fund buys the property, the investment managers would have exercised their option. Otherwise, the development corporation could profit from the sale of the project to outside interests, presumably at retail prices. The call option would not have been exercised by the investment managers but the development profits could be captured through the fund’s equity participation. In either scenario the real estate fund captures the development profit of successful projects.

An interesting sidelight to the securing of future projects will be the ability to hold product from the market. An institution with substantial existing portfolio presence in a certain product type or market may wish to protect against the deteriorated value of those assets. Indeed, a well recognized strategy for sustaining advantage in a fragmented industry supports the acquisition and closure of important competitors.\textsuperscript{67}

Both the promotion and prevention of specific product types could be controlled at the direction of the investment manager. Portfolio diversification deficiencies could be mitigated through the active control of developments in process. Institutions will have satisfied their need for a steady stream of real estate assets.
Government regulation has become so strong in New England and many parts of California that builders will not be able to start a company on the strength of a promising project. The up front carrying costs are too high. Equity funding will give them the ability to complete difficult projects for the fund.

**CALL OPTION CASH FLOWS**

Investments in a healthy developer should also be partially valued as a call option on the yearly operating earnings of the company. An established builder's cash flows may be discounted at an appropriate growth rate and valued separately from the existing assets. Calpers recognized this value in their purchase of Sante Fe Pacific. "Through the deal, the pension fund has gained access to earnings from some of the most significant real estate development deals in California."68

**RISK EVALUATION**

An institutional purchase of a real estate developer will not increase individual, property specific risks. Moreover, retaining the management structure responsible for, and most knowledgeable of, the portfolio should lower systematic risks. The developer will have no control over the systematic risk associated with the general real estate economy. However, the developer will be in the most advantageous position to maintain established relationships with local officials, property managers and tenants."69
Advisors cautioned that risks are not technically lower. The returns are "Preferred returns, not guaranteed returns. Stock with seats on the board of directors is not the same as mortgages secured by assets." But an advisor discounted the value of a guaranteed return, "This guarantee is only worth something if the developer has the money to back it up. The moneyed partner will essentially be left with all the risk since he is the only one with any real money in the deal. The venture can end up as jaunt by the moneyed partner into the development business."

Portfolios of diversely sponsored 'equity participations' can suffer from a high degree of illiquidity. In the long run, the control may provide better real security.

CONTROL OF PORTFOLIO

One of the greatest values to the institutional investor may be the ability to exercise substantial control over management of the real estate portfolio. Investment managers should look beyond simple market timing questions of hold and sell periods. Investment funds may be able to design project size, architectural and locational characteristics to their exact specifications. Suboptimal portfolio "fits" of buildings with undesirable characteristics may be eliminated.

Again, Calpers recognized this opportunity. "The California Public Employees Retirement System plans to
be an active player in the strategic decisions made by the real estate company. It's a unique investment. We do really feel that as a minority partner, along with the other minority partners, we have a great deal of influence that can be made on strategy and business policy of the company. Because of this control, "Officials expect the investment returns from the fund's stake in Sante Fe Pacific Realty Corp to be significantly more than the 5% real return they expect from the system's average real estate holdings."  

ACCESS TO INFORMATION  

A further advantage of equity ownership will be access to information. Real estate funds will gain access to information directly from the source. By eliminating the communication barrier between buyer and seller, the buyer may lower their uncertainty risk premium. Managers will also gain access to proprietary market knowledge from local insiders. The local information also should be more valuable than traditional advisors sporadic and second hand data. In addition, localized information sources may be timely and exhaustive.  

MARKET POWER OF DEVELOPERS  

The best developers may be able to exhibit market power and realize better returns for their product. An analyst commented, "The long term trend toward consolidation of the development industry will give additional market power to the surviving large
developers. The semi efficient real estate market with many builders and lessors of space will become more inefficient. Competition will decrease due to increased barriers and costs of development. Some developers may corner the market in specialized niches.  

**MANAGEMENT**

Institutional investors will gain the advantage of the most experienced and talented entrepreneurial real estate professionals in the industry. The equity purchase will buy "access to top management for the fund’s real estate portfolio." Quality real estate management that understands asset management, tenant relations, lease negotiation, and market timing will have a strong positive effect on terminal real estate values.

Many private real estate developers who would not consider salaried employment or consulting positions with an investment fund will become available. The first investment funds to acquire or fund the few major developers in each region will secure the scarce high quality human capital. Overlapping development company portfolio acquisitions can be consolidated or merged under the best management talent of each.

Pension funds valued good management. A portfolio manager commented, "When the amount of money a fund can lose through stupid deals and mismanagement of its property is measured against the annual compensation of a good real estate man, it appears paltry. The plan
should measure the cost of the man against the amount of money he can make for them and not try to get by with cut-rate real estate people who will work for straight salaries.  

Furthermore, "Pension officers should compare the work they put into real estate to the work they did the last time they hired a new stock or bond manager. They had to decide on a stock or bond strategy and do asset allocation analyses. They researched dozens of managers and intensively interviewed half a dozen or more. After all, the pension officer is venturing into an investment frontier for his fund and will want to work as carefully as possible."  

QUALITY

The advantages of owning a developer will only be realized through quality purchases. Real estate investors should look to acquire healthy companies with intelligent management. Real estate fiduciaries should not follow the lead of "wall street buy outs that have occurred because of poor management, it is not applicable to the real estate industry per se." "Quality management may be able to effectively modify real estate to optimize long term returns and values. Astute asset managers should continuously modify specific portfolio properties to maintain market acceptance.

One aspect of real estate risk is the notion of product obsolescence and enhancement. Although many
financial models of real estate transactions make assumptions ignoring these risks, obsolescence and enhancement exist and ultimately affect the residual value of the asset. If the product maintains its attractiveness over time, then its value in equilibrium will be its replacement cost. However, if there is obsolescence or deterioration, then its value would be lower than its replacement cost, preventing the residual value from fully passing through the inflation increases. Conversely, if the product improves over time because its site value is enhanced, then its replacement cost would increase at a rate faster than that of inflation."\(^{83}\) The purchase of quality assets with high quality management should be the most profitable long term investment strategy.

**EFFICIENCY**

Another advantage of equity control may be increased efficiency. Internal regional and property type expertise in development companies should increase the efficiency of market research for investment fund managers. Furthermore, portfolios under weighted in one area can efficiently structure one large developer portfolio acquisition. Real estate advisors concurred, "A professional real estate management organization can help pension funds pursue varying investment strategies in the inefficient real estate market. Professional management should be able to weed out overvalued and inappropriate investments for the pension fund."\(^{84}\)
Establishing the price of an operating real estate development company involves consideration of items beyond traditional real estate analysis. Importantly, investment in an established developer requires discounted cash flow valuation of the assets. In addition the investment requires the further valuation of: the premium for corporate control, the access to management, and the rights to future projects and cash flow.

Corporate acquisition valuation does not determine one, indisputable value. Rather, the process creates a range of values within which successful negotiations can take place. Institutions considering an equity investment in a real estate developer should evaluate, and then aggregate the company's individual aspects to ascertain a maximum price.
PORTFOLIO EQUITY

The most important and definable aspect of a real estate developer's worth consists of its equity portfolio. Each project's cash flow may be capitalized to ascertain a discounted net present value. Institutional investors are familiar with this process. Analysis should be no different than that of a traditional building acquisition. Lease terms and quality, project location, and financial characteristics all contribute to the capitalization rate and ultimate asset value.

Some industry professionals believe portfolio acquisitions provide further value to equity assets. They believe asset values can be greater in a group if you can gain market power in a small enough city. Portfolios may also be more valuable in large markets. A 1990, 20% equity offering of the Reichman Family's U.S. holdings of class A office space was especially valuable because of its substantial market share of modern, large floor plate buildings in New York City. Most development companies may not, however, poses a large enough portfolio to provide additional value to their equity portfolio.

CONTROL PREMIUM

Beyond value of portfolio equity, significant value can be placed on control of a company's daily operations. Indeed, the holding period risk premium may be reduced once the 51% threshold of voting rights has
been achieved. The majority equity holder may influence the direction of operations toward developments that are most beneficial for the institutional real estate portfolio.

To value a control premium, one can look to the equities markets for insight. Public equity mergers and acquisitions activity accelerated to record levels during the late 1980’s. Although not specifically related to real estate, this effort developed financial models to help value a going concern and its many aspects for acquisition.

Milton Rock, in The Mergers and Acquisition Handbook, explained the difference between technical asset value and the eventual price paid to control the company’s stock. Rock explained, “Acquisition valuation is perhaps less theoretical and more concerned with the real world than discounted cash flow valuation. It is an attempt to estimate where a company will "trade" in the market for corporate control.”

Rock highlighted the value of controlling equity. He stated, “The value of a company in the market for corporate control is higher (and often very much higher) than its value in the secondary trading market. Why? Part of the answer is found in the word "control." If nothing else, control of assets and the ability to direct all of the free cash flow generated by the assets are worth more to a business manager than participation in a small percentage of a business, without control, is
worth to the individual stockholder. This control may provide different opportunities to different investors. Some investors may wish to break apart the assets of the firm. Some investors may desire the strategic alliance created by combining firms. Still others may reduce their losses by keeping the business out of risky endeavors.

Real estate firms did not demand a high premium for their control. Investors put little value in a firm's market presence and good will. The control premium for the few real estate firms acquired during the late 1980's were substantially below the All Industries Average. This is probably due to the fact that real estate development is a disaggregated industry with no dominant national firm.

PREMIUM OVER MARKET PRICE
U.S. MERGERS & ACQUISITIONS

[Bar chart showing premium over market price for different industries from 1986 to 1989]
Furthermore, no constant price/earnings ratio could be extrapolated from merger and acquisition activity. The price/earnings ratio declined dramatically during the late 1980's. Traditional investment strategy would conclude that investors devalued future real estate earnings by paying lower earnings multiples.

Another measure of value may be rule of thumb multiples of book value. Rock explained, "Book value multiples also are used widely in the financial services industry, where they function partially as surrogates for net liquidation value because the assets and liabilities are carried at values (theoretically at least) close to market. The multiple of cash flow, intuitively attractive because of the potential relationship to discounted cash flow valuation, also can be very useful." Again, the process does not produce one "correct" value but a range of defensible values.
The following average multiples for 1987 real estate company acquisitions may be used as rough guides of value: 91

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<th>Multiple of Earnings</th>
<th>Multi of Net Worth</th>
<th>Percent of Sales</th>
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<tr>
<td>1987</td>
<td>41.8</td>
<td>2.49</td>
<td>149.2</td>
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The choice of the proper price/earnings multiple may have a large effect on the terminal value, and care should be taken to choose a multiple consistent with the characteristics of both the company and the industry at that time. For example, one should use low P/E numbers for companies with stable margins and relatively low growth rates. 92

The control premium for real estate development companies ranged between a minimum 23% and the industry average of 40%. Investors discounted the earnings potential and acquisition multiples for real estate companies by two thirds over other equity investments. Institutional real estate investors therefor may be able to obtain real estate cash flows at relatively attractive control premiums.

**MANAGEMENT**

High quality management was valued in all industries and was especially so in the risky real estate development field. "It is axiomatic in the real estate business, on all property, that owners make the best managers. Anything that improves a property’s cash flow increases a property’s value." 93 Quantifying this value,
however, may be difficult.

Institutional investors readily employ advisory consulting firms for strategic planning, acquisitions, legal, and accounting services. Some estimates may be extrapolated from the fees charged for these services by consultants. In addition, advisors provided asset management and property management services. These combined fees substantially impacted the overall return of real estate portfolios. The industry average fees for direct investment include:

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<tr>
<th>Service</th>
<th>Fee</th>
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<tr>
<td>Acquisition Fee</td>
<td>1.5% Appraised Value</td>
</tr>
<tr>
<td>Asset Management</td>
<td>1-2% Appraised Value/Year</td>
</tr>
<tr>
<td>Property Management</td>
<td>2-3% Gross Receipt per Year</td>
</tr>
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Commingled real estate funds included these costs in their returns and charged an additional management fee. One pension fund investment manager commented, "A commingled fund will generally take a fee off the top of the return which ranges from about 0.9% to 1.5% of the asset value in the fund. The average is somewhere around 1.2%, but this figure is so particular to the fund that it may not be all that meaningful. As more investment managers enter the commingled fund business this fee will certainly drop, but it will have to remain somewhat representative of true costs incurred."94

A rudimentary addition of the standard management fees provides a management valuation near 5% of appraised portfolio value. With leverage, this value may be much higher as a percentage of equity. Appropriate deductions should be taken for functions
performed outside of the real estate development company such as building maintenance.

Consolidation of the management functions within an acquired development company may save additional fees. A large fund believed, "The in house operation is approximately one third cheaper than an outside advisor. It is also better."\textsuperscript{95} After overhead allowances, the advisory firms were very expensive. On average, one employee at a large advisory company manages 15 properties valued near $500 million, generating fees of $2.5 million.\textsuperscript{96} Talented individuals should provide acquisition and asset management services at a fraction of customary advisory fees.

The value of superior management may be the most difficult to determine, and yet the most beneficial. Talented management may understand the business of real estate investment to the point that systematic risk is reduced. Poor investments may be avoided and profitable investments may be enhanced. Equity investment in an entrepreneurial real estate developer may be most beneficial when it allows this access to superior human capital.

\textit{CALL OPTION ON PROJECTS}

Another important aspect to value in acquisition concerns access to future development assets. Institutions may secure development rights, at an early stage, for specialized and promising projects. Many developments have been traditionally sold before
completion on a cost plus carry basis. However, institutions may want to consider control of a company as a call option on future developments projects. Investors have the opportunity, but not the obligation, to acquire and hold the property on a wholesale basis when complete.

A comparison may be drawn with the securities options market and a value may be estimated with the Black–Scholes Option Pricing Model. The model translates volatility, time, price, and interest rates into an estimated value for a stock option. Historic real estate values may be used in the model to predict an option value. Model inputs may be estimated as:

| Real Estate Company Stock Volatility | 21.7% |
| Development Period                  | 7 years |
| Risk Free Rate                      | 8.0% |
| Base and Exercise Price              | 100 |

The volatility figure is found in publicly traded real estate companies only. This figure has not been either proven or disproven to apply to private market real estate assets. The Black–Scholes Model values the call option on future projects with a base price of 100 as high as 45%. The model may or may not apply to the purchase of quality real estate projects. However, the sizable value placed on future development rights by the model should not be overlooked.

The real estate industry in general, and institutional investors in particular, may be underestimating the value of access to projects at
wholesale prices. At a minimum, the industry has begun to trade and place great emphasis on the value of development rights early in the building process.

CALL OPTION ON CASH FLOW

An extension of the call option notion may be to apply it to future corporate cash flow. Institutional investors may wish to capture operating cash flow or profits from development and other related business. Though discounted cash flow analysis could also value stable cash flow streams, the option format may be appropriate. Investors who wish to capitalize the operations of the company could leave cash flow in the company. Otherwise, investors could use the cash to pay dividends on their equity if desirable.

Using a time frame of one year and similar rates as the call option on future projects, the model values the option at 8% of asset equity value.

The amount of equity investment necessary to acquire and fund development companies will vary widely. Developer’s historically high leverage implies that a relatively small amount of equity will be necessary to acquire their portfolio and expertise. A fund that desired to invest additional money in a portfolio may retire the debt associated with each property that is paid out to other lenders.
The timing of the investment return will also vary. Call options of projects will expire 5 to 7 years from the initial investment. In contrast, management expertise should begin to increase portfolio values soon after the financing. The chart below depicts a typical investment payback scenario.

**DEVELOPER EQUITY RETURN ON INVESTMENT**

Overall, the science and art of valuation for an operating real estate developer will require thorough analysis and strong judgement. The valuation of 'soft' items such as control and management value may be anathema to real estate managers comfortable with simple discounted cash flow analysis. However, real value and risk reduction may be found beyond the assets. Equities market investors relied on this trend to increase non real estate stock values during the 1980’s. Institutional real estate managers may be able to capture this additional value through strong negotiation and shrewd analysis.
CHAPTER 6
THE CANDIDATES FOR EQUITY OWNERSHIP

Successfully capturing value in a developer’s equity will require the evaluation of real estate markets, the development industries and the developers in them. Real estate segments should be investigated in both regional markets and product types. Promising industry segments will contain an array of development companies with distinct reputation, quality, and financial traits. Differences in individual portfolio characteristics will further distinguish possible candidates by type, size, and location.
INSTITUTIONAL PORTFOLIO NEEDS

Institutions should first analyze their internal needs and goals to create a fully diversified portfolio. Strategies for regional diversification, investment vehicles and management criteria may influence acquisition selections. A pension fund manager believed the process should be handled directly. "Private portfolio investing is the ideal route for pension fund real estate investors who have enough capital to create an adequately diversified portfolio and to sustain the associated operating expenses. Since successful real estate investors frequently express their experienced based belief that control is the most critical investment element, the private portfolio investing route seems to be the most sensible strategy for large pension funds in particular."100

REGIONAL DIVERSIFICATION

Sophisticated real estate investors have divided the United States into numerous segments in order to best understand the nature of local markets. The eight nations of the North America was an attempt to tie real estate trends to the underlying nature of the regional economy.101 Other works divided North America into further economic segments. These or similar regional diversification strategies should already be in effect in most institutional portfolios.

Investors should not plan to move the developer’s management. A successful regional developer strategized
on this point. "The valuable relationship skills of a regional developer are not transferable to other regions and that the National developers strategy to operate in many markets will produce suboptimal returns."102

A further breakdown of regions from U.S. Census data into SMSA’s (Standard Metropolitan Statistical Areas) may be the most appropriate measure to look at development presence. Of the thousands of SMSA’s, 27 major markets are of appropriate size and health to support an active real estate development industry.103 These 27 markets may be balanced within an investment portfolio as a first step toward market diversification.

**NUMBER OF INVESTMENT OPPORTUNITIES**

Within each market, five to ten reputable, established, development companies will dominate the real estate business. When this notion is extrapolated to the 27 SMSA’s, a range of 150 to 300 companies becomes available. Of that array, many builders will overlap regions and product types. Although size is not a measure of portfolio management excellence, most of the "top 100" developers in any category should be considered possible acquisition targets.

A salient point lies in the fact that these top 100 developers represent only 14% of the sizable existing development companies. In 1990 there were 737 real estate development and related businesses in the United States with yearly revenues over $1 million.104 In addition, there were thousands of firms with lesser
earnings.

As the development community consolidates, various large development companies will dominate in each major metropolitan area. Investors should pursue these firms. If the region is small enough, the major developers will be able to increase their yields through decreased competition and market power. The most influential development firms may be powerful in more than one market in each product type. These firms should capture the majority of the region's development potential and investor's attention.

***THE INDUSTRY***

Institutional investors should also look for industries and development types with barriers to competition. Each developer's industry and product type may have different entry premiums and barriers to competition. The most promising companies will be in market segments with strategic advantages that are difficult to duplicate. High permitting costs, grandfathered government permits, and development rights for one-of-a-kind projects may be items that preclude competition.

***COMPETITION*** Analysis of corporate competitors is critical for successful equity investments. One fund manager theorized, "Competition from other developers should also be evaluated on a portfolio wide basis. Will a large equity funding allow them to enter the market with previously unbuildable product? Will the
A developer continued, "Real estate development is not a business of fairness. Small developers simply will not be able to compete with the larger, more politically connected players. Those relationships are invaluable in terms of getting a project through the permitting, construction and lease up phases. There is at least a 10-15% cost savings from strong relationships. Every time schedule in the process can be accelerated or at least managed effectively." 106

Investors will also have to control the competitive instincts of the top management in the firm they acquire. An investor managed this risk with the structure of their investment. "They "captivated" the developer with certain exclusionist provisions that ensure that the developer would not create another company to compete with this one now that the developer has recapitalized his existing activities." 107

For development company investors, competitive analysis should go far beyond traditional discounted cash flow analysis and may be the key to profitable developer acquisitions.

GOVERNMENT REGULATION

Investors should also look for developers who may be stifled by local government. The difficult regulatory environments and the cost of land has increased start up costs for projects. Permitting and development times
have increased, some projects now take seven to ten years to implement.\textsuperscript{108}

In one example, "Prudential Insurance Company complained that city regulations and special interest groups meant it could take hundreds of thousands of dollars and five years or more just to find out how you can develop your property. Consider an independent developer stuck in the midst of such municipal deliberations. The expense on his high priced construction money adds up. That extra two years of waiting for city approval is more than enough to drive him into lethal cost overruns that kill the deal before it has a chance at life."\textsuperscript{109}

Indeed, European funds have pursued regulated investment environments to the fullest. "In Great Britain, insurance companies and pension funds dominate the real estate business because years of tight government control of development have driven everyone else out of the business. Institutions, particularly pension funds, are the only ones with any money to lend, and they do not lend, they buy property and hold onto it forever."\textsuperscript{110} Investors who see this trend beginning in the U.S. should look to use it to their full advantage. Development companies that can withstand regulatory pressures should ultimately create substantial value.

\textbf{THE DEVELOPER}

Upon selection of desirable regions and markets segments, the investor must ascertain the best developer
in each to fill the portfolio's requirements. An advisor commented, "It seems inherently easier for a local company to evaluate real estate assets that it is for a national or non local pension fund since the value of these assets is so particular to the local market. I suspect that this would be true on any size project, but especially on smaller ones." Pension funds and Insurance companies pursuing this trend have gravitated toward the "splashier names in the development industry. These names were easier to sell to their investment committees." To date, the famous name has provided the investor a de facto screening mechanism and a comfort level about general professionalism.

To further screen a company, "Look closely at management's ability, reputation, and standing in its industry. Management's track record and its actual performance against business plans should be assessed, along with their historical ability to manage during adverse market conditions. Be assured that management has a clear sense of direction and is capable of achieving its goals." In addition, institutions should screen numerous other skills. The developer should have: knowledge of the city and it's regulatory systems; strong contractor and tenant relations; and cultural and political sensitivity.

The aggregation and institutionalization of the real estate development industry will continue. A respected developer commented, "I can't see how most of the
development companies will compete in the future.” Undercapitalized development companies will be forced to find an investment partner or go out of business. Pressure will be put on medium sized developers who do not dominate a specific market or product niche. This may spur movement toward three tiers of development organizations. The three tiers may include:

The National Developer – Financed by major pension funds, they will operate in all markets through national headquarters and act as a conduit for projects developed for the fund’s portfolio. These could be national advisory umbrellas that provide efficient market analysis and financial aid to regional offices.

The Regional Developer – Also financed by pension funds and insurance companies, Regional developers will surface with the power to impact local markets. The developers will provide product for investment to different funds who want to invest in that market on a project specific basis.

The Boutique Developer – Financed by personal or corporate equity, Boutique developers will emerge to provide specialized product types and infill commercial sites under 20,000 S.F. that the National and Regional developers bypass.

Of this group, the best equity purchases will be of companies that clearly define their role within the future development spectrum.
CHAPTER 7
CONCLUSIONS

From the previous discussion, one can draw a number of conclusions:

- The assets of pension funds continue to grow, and institutional investors desire profitable locations for their real estate portfolio allocations.
- The sources of real estate investment capital have declined, and developers are searching for liquidity to finance their ongoing operations.
- Equity ownership of real estate development companies is a workable solution for institutional investment and developer financing needs.
- To accomplish their goals, pension funds, and other large, patient investors should purchase the stock or hybrid debt of real estate development companies.
- The equity control of development firms will provide numerous strategic advantages, significant value enhancement, and risk reduction to investors.
- The value of acquiring and controlling an operating development company is significantly higher than the discounted cash flow valuation of its properties.
- The strongest real estate development companies in each market and in each product type are good candidates for portfolio diversification through equity investment.
- Institutions have substantial negotiation strength over illiquid development companies.
Consequently, institutions should guard against imposing undue restrictions on the development firms they acquire. Long time real estate managers feel the "need to keep the entrepreneurial spirit in real estate management is critical for the best results." Yet the environment is ripe for developer investment overtures. An experienced investment manager predicted strong negotiation leverage for institutional investors:

"Just about the only owners capable of holding out a good chunk of ownership from the predations of the institutional lender are those developers who have such expertise in developing a particular type of income property that they are indispensable. Unless they put the deal together, there will be no deal for an investor to buy. In the end, these developers have the best leverage of any developer or individual owner. Because some developers are more indispensable than others.

But as money becomes scarce, so do the clever deals. Income property financing is less a negotiation between equals than the granting of a favor by those with money - the institutions - to those without it - the property owners. Even indispensable developers can become dispensable if they need cash badly enough. Unless present owners have the resources to wait until institutions tire of this position, the owner must give them what they want. Where else can he go?

An advisor concurred, "We have seen a lot of opportunities to do this recently and there are substantial benefits for investors and developers." Clearly, development company equity provides strong institutional investment opportunity.
NOTES

CHAPTER 1


CHAPTER 2


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12. Zisler & Ross, note 5 supra.


14. Ibid.
15. Wong, note 9 supra.  
20. Wong, note 9 supra.  
22. Martin, note 3 supra.  
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24. McKelvy, note 19 supra.  
30. Ibid.  
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33. Interview with Mark Fowler, President, Americraft Builders, Inc., Phoenix, AZ (June 1990).  
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40. Ibid.

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CHAPTER 4

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61. Commercial Propert News ?
62. Franz, note 42 supra.
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77. Brouns & Lietz, note 18 supra.
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