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Real Estate Investment And The Business Cycle

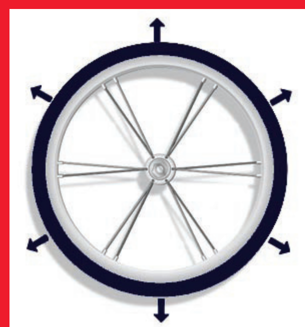
In the study of civilizations, the word "age" signifies the time between great empires—moving in a cycle that tracks the rise to power of an empire and its subsequent fall and disintegration.

The world's financial markets and business cycles also follow patterns. Markets are faced with cyclical patterns occurring over relatively short periods of time, producing champions as well as rogues.

Contrary to Darwin's speculations, we evolve in these cycles of time rather than evolving in linear time.

Albert Einstein in his theory of relativity points out that the space-time continuum, which defines the physics of the perceivable universe, is curved. Anything that is curved is part of a circle; it is not a plane, and nothing in our universe, including time, is linear.

The specialist, who cracks the codes that connect these rhythmic routines of the business cycle, would be in great demand.



It has been shown through various cycles that prolonged prosperity cannot be sustained indefinitely. Simply put, what goes up must come down.

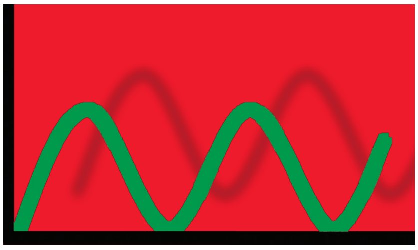
Business cycles by their very nature have high points and low points, resulting from periods of optimism followed by periods of pessimism, often leading to recessions. Panic, fear, and pessimism make the natural dips more hair-raising than need be.

A strong economy attracts investors who bid up the value of a product in an atmosphere of great optimism for its future value. As real estate values increase, the value of the securities related to real estate also rise, helping to rationalize any subsequent expectations of rising values.

Investors and the public tend to lose sight of the fundamentals in an up market and conspire to overheat the economy, followed by the sudden disappearance of secure returns. Optimism evaporates, and inevitably a downturn follows. The depth of this downturn and the resulting pessimism are directly proportional to the level of unrealized (expected) returns.

Whether we like it or not, Central Banks have limited power over capital markets. Even if a severe downturn is predicted with accuracy, it will still be very difficult to convince the public to refrain from investing in any particular sector, and the Central Bank would have a difficult time unilaterally legislating against it. In any event, if investor confidence is sufficiently high (as it is in most growing sectors), higher interest rates will not deter subsequent investments. The bigger issue lies in the overall economy: if a Central Bank raised interest rates to address the rise in real estate values, to use one example, the overall economy would be strongly impacted as well.

Many people view the rise in property values as a means of wealth creation, a task appointed to fund managers. The role of a Central Bank is to keep inflation in check but not to gauge industry valuations, and the application of individual policy in one particular sector would not be well received. Should the Central Bank take matters into its own hands, the public would lash out against the government. And because the government had not permitted the boom and bust to play itself out, the public would never know what had been averted.



Predicting a recession?

Ongoing efforts to find the best method for predicting recessions have introduced a variety of indicators and modelling techniques. Yet overall forecast accuracy has been mixed.

A recession is a significant decline in economic activity spread across the economy, lasting more than a few months, normally visible in real GDP, real income, employment, industrial production, and wholesale–retail sales. A recession begins just after the economy reaches a peak of activity and ends as the economy reaches its trough. Between trough and peak, the economy is in an expansion. (1)

In an ideal world, a boom economy ought to be followed by cautious optimism. The crashes experienced in the 1980s and 1990s are a strong argument against this "ideal world" conjecture.

1980s

During the 1980s Milton Friedman introduced the concept of a close and stable link between inflation and the money supply, proposing that inflation could be regulated by controlling the money supply. He preferred this to the use of fiscal policy because he believed that the government's role in steering an economy should be severely restricted. The concept has come to be known as laissez-faire.

In the laissez-faire view, the state has no responsibility to engage in intervention to maintain a desired wealth distribution or to create a welfare state to protect people from poverty, instead relying on charity and the market system. Laissez-faire also embodies the view that a government should not be in the business of granting privileges. As such, advocates of laissez-faire support the idea that the government should not create legal monopolies or use force to damage de facto monopolies. Supporters of laissez-faire also support free trade on the grounds that the state should not use protectionist measures such as tariffs and subsidies in order to curtail trade through national frontiers. (http://en.wikipedia.org/wiki/Laissez-faire)

The US Federal Reserve abandoned this policy in the early 1980s, and one recalls Paul Volcker's decision to deliberately raise interest rates to whatever level was necessary to bring down the rate of inflation. The federal rate was about 11% in 1979 and rose to 20% by June 1981.The prime interest rate, an important economic measure, reached 21.5% by June 1982. This hurled the US and Canada into the deep recession of the early 1980s, the result of a deliberate attempt to curb inflation and to stabilize the economy.

The solid stance taken by Paul Volcker has since then been a matter of much debate about what constitutes effective monetary policy and demand management.

Real estate developers were caught in the middle of this upheaval in interest rates and inflation. Commercial property owners could not meet their financial obligations.

Standard Due Diligence

During the early 1980s the standard analytical tools for real estate underwriting (currently referred to as due diligence) by financial institutions involved the application of the internal rate of return (IRR) over a ten-year projection period, followed by an exit strategy at the beginning of the eleventh year. The eleventh year income was capped and the re-sale value was determined, commonly referred as the reversion value of the asset.

This analytical process estimated the present value (potential initial price) for the investment. No institution would pay more for an asset than the present value of that income projection, based

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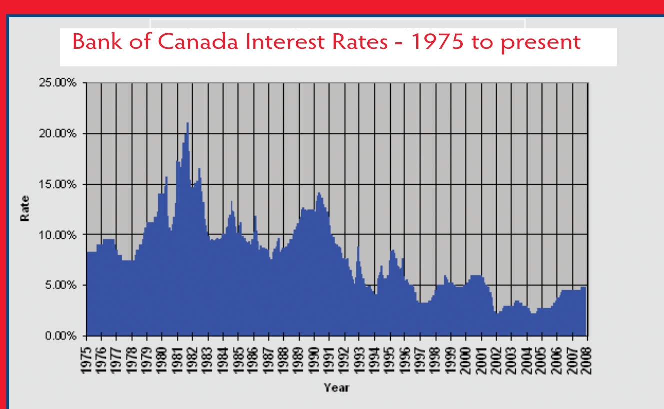

Source : http://www.bcrealtor.com/d_bkcan.htm on a threshold value for the IRR, which was set by the financial institution's investment criteria. If, for example, a life insurance company required an internal rate of return of, say 15%, then the current value of the income stream would be evaluated with that rate, and the investment would therefore be approved (endorsed, sanctioned) by the organization.

The discussion above is a much-simplified description of the underwriting process. (see table below)

In the early 1980s, with inflation rates at 11% and as interest rates continued to rise, there would be a similar rise in the required IRR. The institutions needed to underwrite their future acquisitions based on a new set of parameters to justify the opportunity cost of the capital invested.

To add to the confusion, the inflation scare led to volatility and uncertainty in private beliefs. While actual inflation is very important, inflationary expectations are a very strong factor in decision making.

It was standard practice in the IRR analysis to assume inflation constant throughout the projection, encouraging the unfortunate further assumption that the inflation rate of the day, the highest in history, would be sustained throughout the future 10-year projection period. This caused the annual cash flow, on paper, to increase dramatically, thereby creating unsustainable value increases.

As seen in several real estate cycles, when a particular investment has peaked, or the economy begins to show signs of leveling off, the players strive for efficiency. In many instances, the developer/owner finds himself unable to proceed with a development project already underway, or find that his financing costs had increased to a level where he would welcome a partner.

The early 1980s were a period of intense consolidation. Institutional and private investors formed joint ventures. And in response to the economic climate of the day, the joint venture underwent some structural changes.

Institutional investors fashioned a joint venture whereby they would propose a 50–50 joint venture structure to the developer/partner, but with a modification in the cash flow distribution. The already inflated cash flows would be distributed 80–20 in favour of the institution, illustrating how this idea increases the IRR to the benefit of the institution, from 16.07% to 20.03%, a level that would satisfy the institution's internal approval committees.

The developer/partner's returns are notably lower. On paper he owns a 50% stake in the property but receives only 20% of the benefits, for a return which barely brushes the inflation rate.

The higher interest rates and higher inflation did not deter these investments. This particular practice continued throughout the early eighties in spite of the fact that by 1983 bank failures were increasing in the United States.

From a legal standpoint, the institution was just as vulnerable, if not more vulnerable, than the developer, an interesting twist when it came time to exercise the buy–sell clause or the "shotgun" clause within the joint venture agreement. Wealth had eroded for everyone, and the participants were searching for a means by which to survive the current storm with the application of long-term investment decisions based on less than sustainable criteria.

Monetary policy should focus primarily on creating an environment where inflation remains low, stable, and predictable; where economic decisions can take place based on that expectation; where industry would be willing to enter into long-term contracts, and where consumers would make long-term investments and major decisions; and where banks would transact over longer terms. In such an environment, job creation and economic growth can occur, and the expected level of inflation rate for this to take place would be within a stabilized 2–3% range.

By the end of 1984, Paul Volcker's disinflation intervention successfully reduced the inflation rate from the industry-adopted 10% level to 4%—and to 3% by 1985. By that time, however, the institutions had become the majority holders of commercial real estate portfolios, a situation that continues to this day. •

(1) Source: National Bureau of Economic Research (NBER)

A			IRR - 10 YEARS		1	2	3	4	5	6	7	8	9	10
		100%			1982	1983	1984	1985	1986	1987	1988	1989	1990	1991
			16.07%	$ (55,920,000)	$ (23,830,600)	$ 6,740,800	$ 7,414,880	$ 8,156,368	$ 8,972,005	$ 9,869,205	$ 10,856,126	$ 11,941,738	$ 13,135,912	$ 191,054,546

B			IRR - 10 YEARS		1	2	3	4	5	6	7	8	9	10
		50%			1982	1983	1984	1985	1986	1987	1988	1989	1990	1991
			16.07%	$ (27,960,000)	$ (11,915,300)	$ 3,370,400	$ 3,707,440	$ 4,078,184	$ 4,486,002	$ 4,934,603	$ 5,428,063	$ 5,970,869	$ 6,567,956	$ 95,527,273

C			IRR - 10 YEARS		1	2	3	4	5	6	7	8	9	10
	Invest	50%			1982	1983	1984	1985	1986	1987	1988	1989	1990	1991
	C/F	80%	20.03%	$ (27,960,000)	$ (11,915,300)	$ 5,392,640	$ 5,931,904	$ 6,525,094	$ 7,177,604	$ 7,895,364	$ 8,684,901	$ 9,553,391	$ 10,508,730	$ 95,527,273

D			IRR - 10 YEARS		1	2	3	4	5	6	7	8	9	10
	Invest	50%			1982	1983	1984	1985	1986	1987	1988	1989	1990	1991
	C/F	20%	12.08%	$ (27,960,000)	$ (11,915,300)	$ 1,348,160	$ 1,482,976	$ 1,631,274	$ 1,794,401	$ 1,973,841	$ 2,171,225	$ 2,388,348	$ 2,627,182	$ 95,527,273