TOWERING
INVESTMENTS

The '90s Revolution in Real Estate Finance

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Fusion CMBSs, UPREITs, paper-clip and paired share REITs, conduits and opportunity funds - all these phrases, words or phrases are common in today's real estate lexicon but were not around a decade ago. This evolution in real estate industry vernacular reflects deep and fundamental change in the industry itself.

The Setting

During the early part of this decade, the real estate industry throughout the United States and, in particular, Southern California, went through wrenching changes. Optimism arising from the prolonged upswing in the late '80s, aggressive lending by S&Ls, foreign investment in US real estate and buoyant housing markets came rapidly to an end. The tax law changes of 1986, the peace dividend and a national recession caused market-wide reductions in the demand for housing and commercial space, dramatic declines in real estate asset values and rapidly growing portfolios of troubled real estate loans. The depth and duration of the decline was greater than most foresaw. Fro example, 32 of 35 separate annual forecasts of multi-family and single-family housing starts in California over the five years from 1989 to 1994 overestimated what actually happened in the subsequent year.

The result of this downturn was a virtual drying up of traditional sources of equity and debt capital. Most investors in real estate, including homeowners, found themselves struggling to maintain control of their homes and investments as asset values fell below the face amount of the debt on homes and investment property. Most lenders, particularly regulated lenders, sought to reduce their existing performing real estate loan portfolios and sell off troubled loans to maintain sufficient regulatory capital. Institutional investors, for the most part, reduced portfolio allocations as they wrestled with poorly performing directly owned investment real estate or illiquid, poorly performing real estate funds.

What happened to real estate firms in the early '90s largely depended on the extent of their leverage as liquidity dried up. Most entities with high leverage retrenched and focused on restructuring the balance sheet to survive as property incomes declined. Those that survived did so only because lenders and other creditors were persuaded to share the pain through drastic restructuring or a visit to bankruptcy court. Entities with low leverage often had to seek alternative sources of capital as bullet loans came due and lenders employed every opportunity to persuade borrowers to pay off outstanding debt. For financial intermediaries, survival depended on their ability to manage and limit the growth of portfolios of troubled assets. In this environment, most regulated lenders did not wish to roll over matured debt with even their best customers, let alone originate new loans. Between 1989 and 1994, lenders tightened credit standards. Ironically, almost anyone who could qualify for financing didn't need the money.

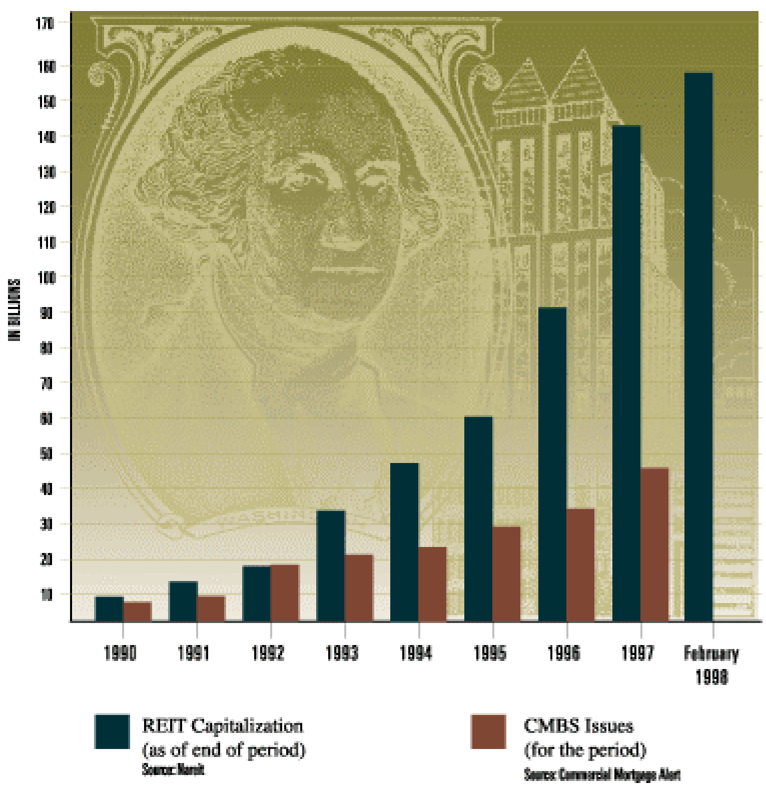
The substantial downward adjustment in real estate values allowed opportunistic investors with access to capital to earn impressive returns by servicing and working out distressed loans. Such funds were bought in bulk, repackaged and securitized or sold piecemeal. Subsequent acquirers added value through repositioning, marketing and/or portfolio assembly. Simultaneously, the lack of liquidity in real estate equity and debt markets created a vacuum that allowed public markets to invade one of the last sectors in the U.S. economy dominated by private capital. Even healthy real estate companies were starved for capital during the early 1990s.

In this environment, real estate investment trusts (REITs, pronounced "reetz") and CMBSs (commercial mortgage backed securities) have been seen by observers of the real estate industry as the wave of the future. Despite years of boosterism, neither had really taken hold prior to 1990. The real estate recession proved to be the catalyst that created critical mass and thus viable public markets for real estate equity and commercial real estate debt.

During this decade, the REIT market has grown from a capitalization of $8.7 billion at the end of 1990 to $155 billion at the end of February 1998. Annual CMBS volume has grown from $5.6 billion in 1990 to $44 billion in 1997, and the volume for 1998 is anticipated to reach $65 billion. In the first quarter of 1998, CMBS volume has reached $19.6 billion-suggesting that late 1997 estimates of 1998 activity may be low. The first quarter ended with the largest CMBS deal ever-a $3.3 billion dollar 'fusion' issue by Nomura Securities. Also, part of the public securities mix that evolved over the few years has been the use of unsecured public debt by REITs. Unsecured debt, preferred stock issues and medium-term notes issues by REITs in 1997 totaled $13.7 billion, compared to $6.3 billion in 1996. Clearly, the recession of the early 1990s has proven to be the catalyst for rapid growth in the role of public markets as a capital source for the real estate industry.

Real Estate Investment Trusts

Real estate investment trusts or REITs will be the predominant vehicle for real estate ownership for the foreseeable future. With the aging of the baby boomers and the consequent continued growth in private and



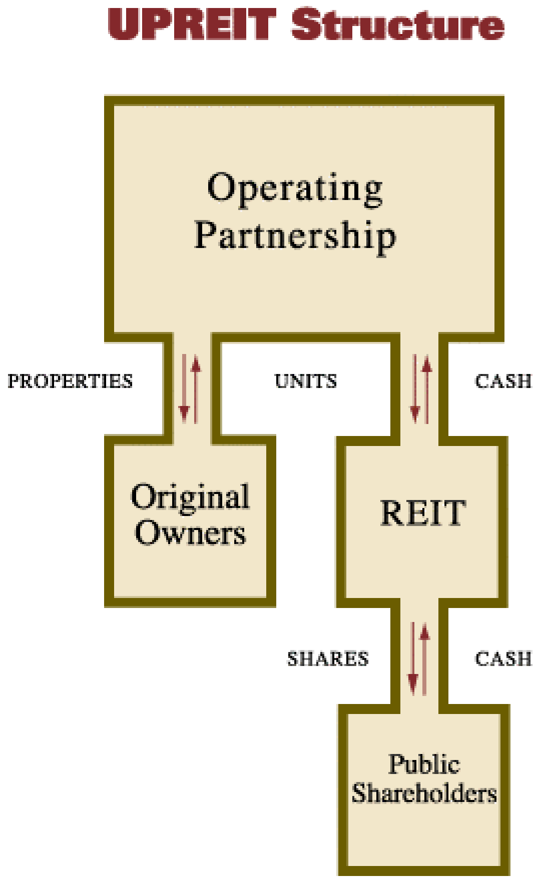
corporate pension plans, there will be continued demand for real estate investment vehicles that are liquid and that can be easily monitored.

REITs have their roots in enabling legislation dating from 1960, which authorized a form of ownership of real estate that would not be taxable at the entity level provided specific requirements were met. REITs must invest primarily in real estate equity or debt. They must pass through 95 percent of their net income to the shareholders; and they must behave more like investment entities than developers, builders or asset managers. For legislators, REITs were to be the real estate industry's answer to the mutual fund. For investors, REITs offer diversification and liquidity not available through direct investment.
Since REITs could not pass through paper losses, for a long time they were at a competitive disadvantage to limited partnerships as the entity of choice for investment in real estate. Real estate investment was tax-advantaged in the United States, due to investors' ability to shelter other income with real estate losses resulting from short accelerated depreciation schedules and high leverage. Until tax reform in 1986, REITs also were required to farm out property management activities to third parties-thus removing from the investors' direct control the day-to-day operations of properties in their portfolio. Finally, even though in theory REITs provided the liquidity and diversification sought by institutional investors, the low capitalization of the sector and the low average capitalization of individual REITs precluded involvement by most institutional investors.

It was not until the exit of traditional capital sources from the real estate industry in the early '90s, coincident with a hot public equities market and a low interest rate environment, that the components came together to facilitate the growth of the REIT industry. With high stock prices came relatively low dividend yields. On the other hand, relatively low property prices allowed REITs to offer relatively high yields. Yield-driven investors, including income-oriented mutual funds, migrated to REITs in the early '90s, and this liquidity allowed cash-strapped real estate investors to tap this new market.

An early success story from Southern California was Irvine Apartment Communities, which raised $206.5 million in December of 1993 by employing an UPREIT structure. Don Bren used this vehicle to generate capital to pay down existing debt and further build their portfolio of multi-family properties. The term UPREIT is an acronym for "umbrella partnership REIT," a 1990s structure that permits property investors to contribute properties to a REIT in return for partnership units directly convertible to REIT shares at the investors' option. The advantage of this structure is that an investor can transfer ownership from an existing entity to a REIT without incurring an immediate tax liability and at the same time gain the liquidity and growth potential associated with the REIT structure.

In addition, during most of the '90s, public markets attached a greater multiple to property income than did private markets. Thus, for example, one might buy properties at a 10 percent cap rate and sell to a REIT at an 8 percent cap rate. Part of the recovery of property values during the latter part of the '90s has been associated with the reduction of the potential arbitrage profits associated with this process, a profit often labeled the public markets "pop."



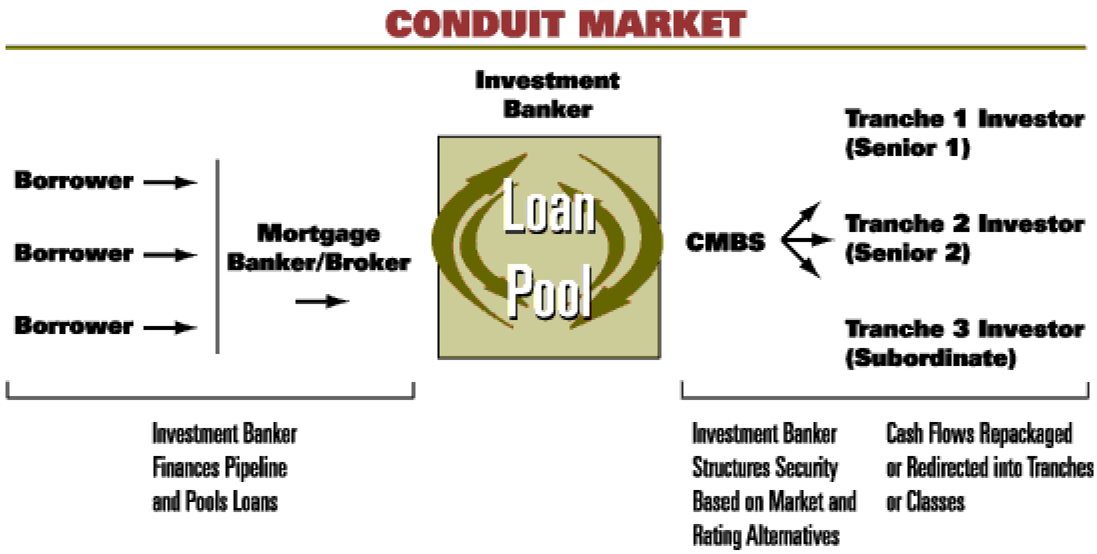
This "pop" is the result of investors' belief that REITs can continue to grow earnings by expanding their portfolios through acquisitions and/or mergers as well as operate properties more efficiently through economies of scale in local markets. These benefits are associated with the gradual shift of U.S. commercial real estate from private and institutional ownership to public ownership through the REIT vehicle. As this ownership shift continues, REITs are finding it more difficult to identify existing investment properties or portfolios for acquisition. But as market fundamentals have improved along with prices, new development and foreign markets have emerged to sustain the rates of growth investors are seeking.
The icing on the cake for the REIT industry (and part of its success) has been the shift of pension fund investors from direct investment in real estate to REIT investment.

Starwood Lodging Trust is probably the most well-known example of a 'paired share' REIT. Starwood has been an aggressive buyer of hotel properties, having purchased the Westin chain and ITT (including the Sheraton Hotel chain) during the last several months. Most REITs must farm out property management to related entities, but paired share REITs actually consist of side-by-side investment and operating companies. The investment company is a REIT which simply owns the real estate and is not taxable, while the operating company operates the real estate and is taxable. However, since the companies are not at arms length, there is usually not much taxable income that finds its way to the operating company. Shareholders automatically own a piece of both symbiotic entities. Legislation prevents new paired share REITs from being formed (although those that remain are grandfathered), and the U.S. Congress is considering limiting the range of future activities of the existing paired share REITs.

Selected California REITs as of March 31, 1998

Company Name	Ticker Symbol	Market Cap (mil)	Property Type
Arden Realty, Inc. *Beverly Hills*	ARI	$1,700	Office
Bay Apartment Communities *San Jose*	BYA	$968	Apartment
BRE Properties, Inc. *San Francisco*	BRE	$1,200	Apartment
Burnham Pacific Properties, Inc. *San Diego*	BPP	$466	Retail
Essex Property Trust, Inc. *Palo Alto*	ESS	$571	Apartment
Alexander Haagan Properties, Inc. *Manhattan Beach*	ACH	$317	Retail
Irvine Apartment Communities, Inc. *Newport Beach*	IAC	$629	Apartment
Kilroy Realty Corporation *El Segundo*	KRC	$764	Diverse
The Macerich Company, Inc. *Santa Monica*	MAC	$859	Retail
Pacific Gulf Properties, Inc. *Newport Beach*	PAG	$458	Diverse
Spieker Properties, Inc. *Menlo Park*	SPK	$1,766	Diverse

Since no new paired share entities can be formed, the "paper-clip" REIT has evolved. Here, contractual arrangements "clip" a REIT to a related operating company. Of course, in this situation, there is no guarantee that the shareholder's will be the same for both entities or that contracts can keep the "clipped" company's incentives aligned with the REIT. Paired share REITs can shift costs to the operating company to reduce tax liability, and shareholders will be indifferent since the shifting of the cost burden is internalized. With a paper-clip structure there seems to be little incentive to own the shares of the "clipped" operating company. It is too early to tell how these structures will perform.



Commercial Mortgage-backed Securities

On the debt side, changes have been equally dramatic, though perhaps not quite as high-profile. REITs rather than conduits have garnered most of the attention of the press. The term "conduit" initially referred to a relationship established between an investment bank with access to the bond market and regional mortgage bankers or brokers with ability to market and underwrite loans to pre-determined specifications. The investment bank would specify underwriting criteria and finance a pipeline of qualified loans from their representative mortgage broker/banker until a pool of loans was assembled with sufficient critical mass to be securitized. Securitization means that the loans become collateral for a commercial mortgage-backed security (CMBS) issue.

CMBS issues are usually multi-class with senior and subordinate pieces. In a simple senior/subordinate structure, the senior piece is relatively low-risk because it is protected by the first loss position of the subordinate piece as well as the underlying loans and their collateral. Usually the senior pieces are structured in such a way that rating agencies will give an investment-grade rating, enhancing marketability and reducing the face rate on the security.

While this was the original definition of a conduit, the term has evolved into more general usage and now refers to virtually any process by which multiple loans are assembled by investment banks to be used as collateral for a CMBS issue. Many commercial banks now act as conduits for their own lending activities. Since banks have traditionally been active construction lenders, it is now possible for them to roll construction loans over into permanent loans which can be securitized immediately.

The growth of the conduit market has made commercial real estate lending increasingly competitive, particularly with commercial banks and savings banks now actively pursuing business. In fact, reflecting how rapidly the market has turned, the FDIC recently expressed concern about evidence of more liberal underwriting standards evolving as commercial banks and conduits compete for available transactions. To-date 1998 volume provides some insight into the level of comfort investors now have with this type of fixed income investment. Indeed, first-quarter CMBS volume of $19.6 billion is already almost half of 1997's annual volume of $44 billion. Recently, Nomura Asset Capital assembled a record number of conduit mortgages and large dollar value loans to issue a $3.3-billion CMBS. The collateral pool was comprised of 326 loans on 436 properties of virtually every type in 43 of the 50 states. The principle balance of the loans in the pool ranged in size from under $1 million to over $175 million with the average loan balance at just under $11.5 million. Included in the pool were a $175-million loan secured by Fox Plaza in Century City and a $140- million loan secured by Park LaBrea Towers, an apartment complex in the mid-Wilshire area.

The securitization of this record amount of conduit loans and high value loans, dubbed a "fusion" deal, provides economies of scale but also has inherent risk that spreads may deteriorate while the loans are being warehoused.

REITs can access the CMBS market if they choose to encumber properties in their portfolio to generate capital to grow. However, the number of REITs with investment-grade credit ratings has continued to increase, and these REITs have chosen to tap medium- and long-term unsecured bonds markets. Another vehicle that permits both residential and commercial mortgage originators or investors to tap public markets is the mortgage REIT or the hybrid mortgage/equity REIT. Hybrid or mortgage REITs invest in mortgages. In some cases, entities that originate loans may choose to manage a related REIT that will have a right of first refusal to purchase loans originated by the related entity. For example, Imperial Credit Industries manages both a residential and a commercial mortgage REIT. Thus any residential or commercial mortgage originated by an Imperial entity can be held in portfolio, securitized (as a CMBS or MBS) or sold to either REIT. Essentially, Imperial has access to different sources of capital which it can employ at any given time. The choice of how to finance a particular loan will be a function of liquidity and cost of capital at each source along with the anticipated exit strategy for the asset.

What does all of this mean to the industry?

Enhanced information about commercial property markets. REIT and CMBS investors and underwriters will require more, better and consistent data and analysis about commercial property markets nationally and locally. More information and analysis is already available, and there will be still further improvements.

Efforts to increase the cost efficiency of individual properties. Cost containment and economies are important to REITs as they seek to enhance earnings.

"Portfolio" marketing strategies. Many REITs own significant numbers of properties in individual markets. This may enhance their ability to work with corporate tenants or to market space effectively and efficiently on those markets.

Evolving compensation arrangements for commercial leasing brokers. REITs may gain significant leverage with the brokerage community to the extent that they have a dominant ownership position in particular submarkets.

Greater linkages between equity markets, real estate capital markets and the market for commercial real estate. Public equity and debt markets will play a greater role in the cost and availability of equity and debt for commercial real estate investment.

Sustained institutional interest. Because of institutional investors' desire for liquidity, public information and established monitoring procedures provided by public markets, REITs and CMBS will continue to replace direct investment as the medium of choice for many pension funds, foundations and other institutional investors.

Slowing pace of asset acquisition and growing merger, development and international activity. As REITs find it more difficult to acquire existing properties at reasonable prices, acquisition of underperforming REITs, new development and international markets will offer avenues for sustained growth.

Traditional lenders will have a smaller role in real estate debt markets. Virtually all lenders will be seeking to manage risk associated with real estate lending through the effective use of secondary markets. New instruments do not eliminate risk but make it easier to share.

What does all this mean to you and me?

If you are a borrower, (an investor in a small strip center or apartment building, for example), the existence of conduits means that there is a more competitive market for your business as a borrower and, thus, better pricing. Further, the next time banks exit from the scene there will be another source of capital that will not go away (though they might get more expensive). To be on top of this, you need to know what kinds of product (loan and collateral characteristics such as property type and value) fit the criteria of the conduits and what kind of underwriting criteria they apply.

If you are a tenant, chances are you may be renting your space from a REIT. In general, this means that there will be more standardization in property management, as REITs seek to benefit from economies of scale in asset management.

If you are an investor, you want to ask yourself if you should invest directly in real estate or whether you should own real estate indirectly by purchasing a portfolio of REIT shares. The former provides you with independence and freedom to time purchases and sales of individual properties along with values for your assets that may not be subject to the expectations of investors in public markets. The latter provides you with better diversification, professional management, operational economies of scale but less direct control over real estate portfolio decisions.

If you are seeking a career in the real estate industry, you will need to be more sophisticated in the area of real estate finance as Wall Street demands financial sophistication in addition to fundamental knowledge of the market and institutions. As well, even if you do not end up working directly for a REIT or a conduit, you will be doing business with them and competing against them. Niches of opportunity will remain as always, but the competition will be intense and the demands rigorous.

Marshall School's Program in Real Estate

Real estate has been taught at the undergraduate and MBA level at USC's Marshall School of Business since the 1950s and '60s. USC was where many of Southern California's industry professionals had their first exposure to the industry. The Program has always prided itself in mixing theory and practice in the classroom so as to expose students to the fundamentals while at the same time providing insight into day-to-day industry practice.

The last decade, however, has seen a dramatic change in the industry, and USC's Program in Real Estate continues to evolve to reflect academia's perspective on the industry as well as the industry's need for managers with knowledge of the industry and critical underlying principles. For example, during the early part of decade, a course was created that focused totally on distressed real estate and mortgages. This material had, to our knowledge, never been the subject of any real estate finance course in any business school in the United States. The work-out process involves expertise in real estate law (often both transactional and entitlement law), real estate market analysis, construction and real estate finance as well as bankruptcy law and contracts. A series of cases reflecting different types of distressed situations were developed to facilitate the teaching of this material. Virtually no existing cases (Harvard, Darden or Stanford) included the richness that was ultimately part of these cases. For many of our students, learning about real estate development had provided the capstone experience in the program. During the early '90s, exploring how to resolve problems with distressed real estate provided the capstone experience and propelled many of our graduates into careers in the area.

As the market evolved, cases dealing with equity REITs, mortgage REITs, real estate securities investment advisement and commercial mortgage-backed securities have been included in the class, which has now evolved into an advanced real estate finance class. To reflect the increasing role of public markets in the real estate industry, it is likely that that course will begin to focus more on investment in real estate equity (specifically, equity REITs), and another course will be developed that focuses on public investment in real estate debt, specifically, mortgage-backed securities, commercial mortgage-backed securities and conduits. However, since studying distressed real estate provides great insight into the kinds of problems that can arise during the business cycle, cases dealing with distressed real estate will not be dropped from the curriculum. In our degree program offerings, the goal is to build on the core material in finance, accounting, marketing, strategy, economics and operations.

In executive education, since 1993, USC's Marshall School of Business has been home to SPIRE, the Summer Program in Real Estate, a two-week in residence executive program for professionals having an undergraduate degree and significant real estate experience in the for-profit, non-profit or public sectors. During five years, the program has graduated over 120 professionals, many of whom have gone on to develop affordable housing, consult to community based organizations, pursue further graduate business education, assemble financing packages for community development projects and develop commercial projects. This program is unique in that it provides executive education, industry contacts, access and networking opportunities for professionals with a commitment to maintaining and building many neighborhoods including those in our inner city.

Terminology

REIT

Real estate investment trust-an entity designed for the purpose of investing in real estate assets including direct equity ownership of real estate and debt secured by real estate. If certain requirements are met, including pass-through to investors of 95 percent of the REIT's taxable income, the entity need pay no federal tax.

UPREIT

A REIT IPO where the entity is created through the contribution of property to an operating partnership which is jointly owned by the REIT and the contributing entity. The contributing entity receives partnership units which are convertible into REIT shares at the contributor's option. No capital gains tax liability is incurred when the property is contributed-only when the partnership units are converted.

Paired-shared REIT

A REIT and a companion taxable operating company which are owned simultaneously by all shareholders. This permits the operating company to carry on activities the REIT is precluded from undertaking. Usually, as many expenses as possible are shifted to the operating company so as to minimize overall tax liability.

Paper-clip REIT

A REIT and a companion taxable operating company which operates symbiotically. The related operating company may carry on activities that a REIT is precluded from doing. The shares of the REIT and the operating company trade separately.

CMBS

Commercial mortgage-backed securities-securities which are collateralized by mortgages on commercial properties defined to include any income-producing real estate (e.g., office, industrial, retail, hotel, multi-family and special use).

Conduit

The process by which mortgages underwritten to pre-determined specifications are originated in the primary market by mortgage brokers or bankers and then find their way to the secondary market facilitated by an investment bank. The investment bank funds the pipeline, pools the loans and underwrites a mortgage-backed security collateralized by the loan pool.

Senior/subordinated structure

Classes of a CMBS issue. Investors in the senior-rated classes are usually protected by the subordinated piece as well as the underlying mortgage collateral and property. The investors in the subordinated class will experience the first loss if there is a default. That class would have to be depleted before any loss is experienced by the investors in the senior classes.

Tranche or class

Mortgage-backed securities often are split into several classes based on the priority in which investors receive cash flows from the underlying mortgage collateral. These classes are often called tranches or 'slices,' derived from the French verb 'trancher' which means 'to slice.'

First loss

In the event of a default by a mortgage holder, the structure of a mortgage-backed security may require that investors in a particular class, the 'first loss' class, bear the burden of any loss associated with the default. This protects the more senior classes allowing them to be rated by a rating agency.

Asset/liability mismatch

If a financial institution owns interest-bearing assets and liabilities of different maturities or interest rate adjustment periods, an asset/liability mismatch exists. This usually results in the institution taking on interest rate risk as the interest rate on assets (e.g., loans) adjusts at a different speed than the interest rate on borrowing (e.g., deposits.

About the Author

David Dale-Johnson serves as Director of the Marshall School's Program in Real Estate and Associate Professor of Finance & Business Economics. He specializes in real estate economics and real estate finance. Most of his research has focused on the pricing of real estate assets, including housing, mortgages, mortgage-backed securities and indexes of real estate market performance. Dale-Johnson has served as a consultant to a number of local governments in the U.S. and Canada, to the U.S. Department of Housing and Urban Development and to numerous private-sector entities.