Reflections on US Real Estate

[US Real Estate Market]

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Influence of Technology Sector

Bifurcated Real Estate Market

The real estate market can reasonably be divided into two segments: the first includes those areas that cater to the technology industry (San Francisco area, Boston, New York City, west Los Angeles), and the second segment is everything else. In the technology-driven areas, the leasing market is incredibly hot and price insensitive. Most VC-backed companies are not sensitive to pricing; the businesses just need to get office space and they are willing to pay almost any price to get it. Rents of $80 to $100 per square foot are not uncommon. These prices are roughly double what they were two to three years ago and are adjusted upwards weekly. Many sellers have taken their properties off the market because the rents are rising so quickly that the owners do not want to leave anything on the table by selling "too soon." Savvy landlords are demanding warrants, co-investment rights, and letters of credit to cover six to 18 months of rent in the event the dot.com company runs out of capital. In the non-tech areas, rents have been somewhat flat.

Lifestyle Demands Dictating Rents

Within these technology-driven markets (and to a lesser extent the general market), there has been a shift in the type of property that generates top rents. All types of tenants (not just start-ups) are beginning to look for office space in attractive brick buildings with courtyards and easy walk-in access. The old standard of driving into a huge parking garage, winding around looking for a space, and taking an elevator into a high rise building has lost its appeal for many prospective tenants. The southern California markets of Pasadena and Glendale provide an excellent example of this phenomenon. A few years ago, rent in Glendale's traditional high rise office building exceeded rent in a Pasadena office. Now business owners want to be located in charming brick buildings in Old Town Pasadena, and rents are 40% higher there than in Glendale.

Shared Tenant Services Companies

During the past six to 12 months, over a dozen new companies have been created to offer the "last mile" of service for voice and data to office building tenants. Real estate managers (especially REITs) are being offered equity in exchange for access to building tenants. The companies (Allied Riser, Broadband Office, Cypress Communications, Eureka Broadband, Intermedia, NextLink, Urban Media, and OnSite, to name a few) agree to wire the landlord's properties with broadband, cable, and fiber and to provide services to the tenant. They then give the property owner ownership in the company, typically in the form of warrants, in return for this access to an installed base of tenants. TIFF's managers have commented that they have been taken aback by this whole process — the companies are offering needed services that landlords would have gladly purchased. Getting the services (and the warrants) for free has been a pleasant surprise. All of TIFF's managers have contributed these warrants to the funds that own the properties, and it is possible that they will enhance TIFF's real estate returns. (An investor just can't get away from technology market exposure!) It is well known in the market that many if not most REITs and opportunity funds are not contributing these warrants to the underlying funds.

Supply and Demand

Major Sellers

The two primary sources for investment opportunities for our managers are REITs and maturing opportunity funds seeking to sell assets.

* Continued consolidation activity in the REIT sector is expected to generate asset sales providing our managers with attractive acquisitions opportunities. An example is Equity Office's recent purchase of Cornerstone. The transaction was followed by a drop in Equity Office's share price, a sign that Wall Street views the move as too aggressive (increased debt on Equity Office's part). Our managers are in discussions with several REITs regarding potential acquisition of properties. Most REITs are seeking ways to raise their stock price and will probably sell property assets to raise capital to buy back stock and pay down debt.
* Maturing opportunity funds offer another situation for asset sales to our manager base. Maturing funds have a pent-up need to sell assets because they cannot continue to hold them without decreasing their IRRs. Several of our managers are in discussions with such opportunity funds.

Overall, forced sales by REITs present the best purchase opportunity for our funds at this writing. Deals that fell through in 1998 and 1999 may also provide attractive buying opportunities.

Buy Side

On the buy side, there are two main classes of buyers: full price buyers and opportunity funds.

* Pension funds represent the majority of full price buyers. Unfortunately, pension funds' capacity to close on deals is suspect. There are generally lots of conditions and hurdles to overcome. Certain foreign investors are also willing to pay full price, but they tend to be attracted to Class A properties with little capital and leasing risk. These properties are becoming harder to find.
* Opportunity buyers are willing to be a bit more aggressive and take a bit more risk. Unfortunately, these buyers tend to need larger amounts of leverage. Creditors are

less willing to offer 70% to 80% leverage as they did in the past, and rising interest rates will make it increasingly difficult for these buyers to get the kind of leverage they need.

With the exception of activity in hot technology-driven markets, the overall real estate market is extremely slow with very few properties changing hands. Now that REIT buyers have ceased acquisition activity, there are far fewer potential purchasers. The market used to place value on embedded rent gains through turnover, lease up, or increasing rents, but the industry has shifted to pricing real rents instead of valuing incremental rent or growth projections. Today, current income is valued more than potential capital appreciation.

Financing

Lenders, like everyone else, are wondering where interest rates are going. Additionally, outstanding debt remains high because so many REITs have not kept up with their payment schedules. This will ripple through the entire real estate market.

REITs

Public REITs have proven to be a flawed vehicle for real estate assets. The REIT market is coming off two consecutive negative years. The NAREIT Equity Index returned -17.5% in 1998 and -4.6% in 1999. Similarly, the Morgan Stanley REIT Index returned -16.9% and -4.6% over the same periods, respectively. When compared to positive double-digit returns on the NCREIF Indices (which do not include REIT stocks) over the same two years, the performance of the REIT sector looks dismal. Some observers attribute this poor performance to the REIT Index's sharp rise in the years leading up to its 1998 downturn (i.e., a simple case of valuations reverting to the mean) while others attribute it to "the Street's" dawning recognition that REITs are suboptimally structured from outside investors' perspective. At TIFF, we think there is some merit to both perspectives but ascribe more significance to the latter (i.e., perceived suboptimality of REITs, which attempt to transmute an inherently illiquid asset class into a seemingly liquid one). It must also be noted that NCREIF return data tend to lag actual market conditions by many months. Consequently, the REIT sector has perhaps underperformed the NCREIF Index by a narrower margin than current data indicate. Currently, few REITs trade above their net asset value (NAV). REITs worked for a brief time in the mid-1990s when vacancy rates were decreasing from 20% to negligible levels and rents were rising. These factors enabled REITs to generate the earnings growth equity investors expected. When their capacity for organic growth slowed, REITs went on buying binges to provide top line growth and they wound up being over-leveraged. Then the REIT market collapsed, and we are now seeing consolidation in the market. The realistic long-term growth rate of REITs is 5% or less (based on funds from operations), which is not going to be attractive to the public markets. Investing in a REIT is similar to investing in a closed-end vehicle that you know is going to trade below NAV. Another flaw is the annual distribution requirements (95% of income). This requirement limits reinvestment in properties, which is a key driver in creating long-term value.

Opportunity Funds

Billions of dollars have poured into so-called opportunity funds over the past 10 years. TIFF has stayed clear of all of them. The high levels of leverage that such funds employ generate UBTI, making them even less attractive for foundations in particular. Our belief is that people have made money over time in real estate by backing strong local operators who are investing in well-defined local or regional markets. Small local groups who know the properties in the market enjoy proprietary deal flow, use modest amounts of leverage, maintain extensive contacts in each market, and make real operating improvements instead of depending on leverage to generate returns are the ones who make money over the long term. We also prefer the alignment of interest between our managers and their outside investors that tends to accompany small fund sizes and meaningful co-investments by each general partner team.