A SPECIAL PUBLICATION OF NATIONAL REAL ESTATE INVESTOR

Wall Street Wrap™

APRIL 1998

An INTERTEC®/PRIMEDIA Publication

Mirando & Howard jumpstart TransAtlantic's conduit biz

National Real Estate INVESTOR

The Fusion Scenario: Real Estate and Wall Street

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The Capital Markets Roundtable was sponsored by National Real Estate Investor Magazine for the second year---and panelists' views agreed with the session's title---as Public Capital and Public Real Estate Companies are now clearly fused together.

As witnessed by the phenomenal growth in Securitization and in REIT formation, these events presage a fundamental shift in the ownership, financing, and management of the entire commercial real estate sector.

The panelists also agreed that both private and institutional performance expectations, and the traditional long view of real estate cycles, has never been tested in the trading crucible of Wall Street. Now it is possible that real estate credit availability may soon be a function of public market confidence---and that while real estate market and property fundamentals may remain strong, outsized market forces can easily influence Public Company values.

Managed Assets—A Prescription for Healthcare Real Estate?

Douglas King
Partner
Perkins Eastman
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Harris Schwartzberg
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The fast-evolving Healthcare real estate industry mandates flexibility and financial creativity---as developer products and services must change with delivery systems. Hospitals and Healthcare providers are all seeking new ways to distribute services further into suburban residential clusters---while Assisted Living projects may be moving back to the city. All panelists concurred that most real estate product formats and designs would continue to evolve with the Healthcare industry---and that the consolidations now underway still afford great opportunities for innovative private developers who can listen carefully to users, and will act swiftly to fill both locational and facility needs.

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Citicorp
Global Real Estate

Business Mobility and Organizational Change—Impacts on Corporate Real Estat

Corporate facilities are increasingly "Foot Loose" and are able to shift the traditional workforce to match incentives and lifestyle objectives. Current organizational initiati for "Right-Sizing" the workplace and "Out Sourcing" core support staff, also include new "Flexible Facility" concepts to address higher human resources costs. Many comp nies now use "Labor Stress Analysis" to evaluate Site and Location decisions. The challenge is to rapidly accommodate Busin Unit real estate needs.

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Dr. John Konarski III
Director of Research,
Vice President
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Joyce Steves Storm
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JSS Advisors

Dougal Casey
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Veronica Hackett
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Development Corp.

Stuart Silberberg
Managing Director
Nomura Capital
America

Peter Gurney
Principal
Gurney Retail
Advisors

COLUMBIA

ʾhe Globalization of Real Estate

:orporations now routinely request service ›roviders to supply seamless real estate ●es world wide—and as just-in-time, ıanufacturing, and work processes follow ·lobal time-zone clocks for perpetual ›roduction---can a Globalized Real Estate ndustry be far behind? Lack of common ·erformance measures and market data now ıhibit standardized debt/equity finance--- ut Public Company formats are globalizing s well. For USA firms wishing to expand verseas, cultural differences, and the need ɔr local contacts, will require flexible and daptable organizations.

Louise Matthews
Vice President,
Corporate Facilities
Colgate Palmolive

Daryl Williams
Director
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Merrill Lynch

Kevin Hyland
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Vice President
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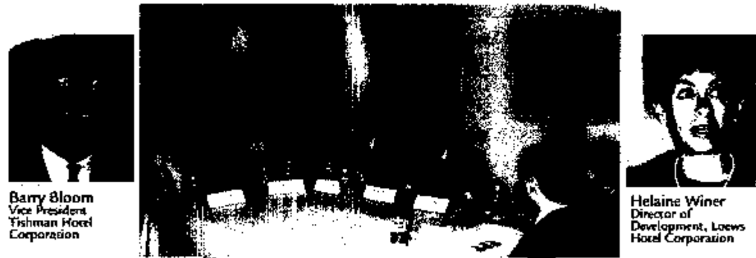
Charles Shorter
Senior Manager, Ernst
& Young/Kenneth
Leventhal

ːetail Trends to the Millenium--- ɭerging Entertainment and Retail

his panel focused on the future of retailing- the inevitable surge of Electronic ommerce, the continued over-building in ıe "Big Box" and Power Center categories--- ıd the continual saga of Department Store onsolidation. Agreement revolved about ıe importance of new market support ıalytics---with the growing power of GIS atabases matched to merchandising strate- ●he panel saw potential growth in Value-Retailing" as well as neo-traditional Village-Style" Specialty Retail---and the ıticipated synergy between Themed ntertainment and with Lifestyle retailing.

Hotel & Lodging Industry Outlook 98—Will Performance Peak?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Kenneth Leventhal

Recognizing large barriers-to-entry for the Full Service Convention and Luxury Hotel segments, panelists also noted the rapid expansion of the Limited Service types, brands and locations.

After a very hot and fast expansion of Hotel Rates and Occupancies with price wars, acquisition frenzies, office or residential-to-hotel conversion manias, and major Hotel brand consolidations---the challenge now for the "Acquisition Machines" is to manage people and budgets. Well managed and promoted Resorts and niche market specialty hotels/inns will enjoy good fundamental market support---as long as the current economic expansion prevails.

Mixed-Use Development— Lessons Learned from Three Decades

Jack Beyer
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Beyer Blinder Belle

Ellen Sinreich
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Did we learn from the mixed-Use prototypes of the 70's and 80's? Probably not enough---as a veritable litany of operational problems, caused by combining high-density multiple uses and common architectural features on tight urban sites, was solemnly chanted by this panel. A consensus evolved for strong design concepts to create clear architectural "addresses" for each major use, permitting merchandising and operational flexibility. The panel urged that a project's components be legally and functionally separated for financing. But whether fad or trend—history has proven mixed-use projects are complicated and risky---and that each component should <u>not</u> count on the implied synergy between uses---but rather each should have its own discrete market support and merchandising appeal.

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On the Cover:
Louis Mirando and James Howard are the dynamic duo running TransAtlantic, the conduit arm of Deutsche Bank in New York.
Photo by William Neumann

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How well does Wall Street 'fuse' with real estate?

Photos by William Neumann, New York

Michael Buckley (center) leads the recent roundtable discussion at Columbia University.

Leading players discuss the evolving capital markets at Columbia University.

By Ben Johnson
Publisher, *National Real Estate Investor*

Fusion is one of those words that speaks both positive and negative connotations at the same time. But it is precisely the right word when describing Wall Street's increased prominence in nearly all aspects relating to the United States commercial real estate market.

Recently the subject of fusion was coined by Michael Buckley, partner in E&Y Kenneth Leventhal's Real Estate Practice in New York and faculty member of Columbia University's Real Estate Program. The occasion was our second annual look into Columbia University's Spring Roundtable Series for the Graduate School of Architecture, Planning and Preservation in early March. In fact, I found the complete title for the roundtable – The Fusion Scenario: Real Estate and Wall Street – to fit nicely with the theme of *Wall Street Wrap*. The following are excerpts from that discussion.

Michael Buckley: Tonight we entitled this in an imaginative way with the idea of fusion, whether or not capital markets are fusing with Wall Street so that they are inseparable or is this just a momentary realignment of the stars and we'll go back to business as usual. Certainly the providence of the life companies and the banks has changed. Whether or not they are changed forever of course we will discuss here tonight.

What are some of the issues you see as we change from a private-developer dominant to an institutional format?

Mike Miles: The institutions have been around forever. Pru used to be at $43 billion and the biggest owner of real estate in the country. It's just a new set of institutions from the ones we used to have. The thing that is most interesting about it is if you look at the securitized product and who drives pricing there, it's not the people you think of as real estate people. If you look at Fidelity which is a big consumer of securitized product, of the REITs we own, only half are owned by real estate people. The other half are owned by diversified mutual funds who invest in real estate not because they like office buildings or think office buildings have more of a rent pop left than malls. But simply because it fits for them that particular day over anything that is available anywhere in the world.

So you can have dramatic shifts. It is a much more excit-

(Clockwise from upper left) Spencer Young of Morgan Stanley Realty, Mike Miles from Fidelity Investment, F. Jonathan Dracos of Investcorp, Robert Falzon with Prudential Securities, Phoebe Moreo of E&Y Kenneth Leventhal and Ben McGrath of Chase Securities.

loan was maybe 20% of the pool. Now we're looking at conduits that are 200-400 loans. Clearly, these are multi-billion-dollar transactions, so the process has really come to the fact that everyone has figured out what works and what doesn't on two levels.

One is in terms of just mechanics. How do you process information back and forth. The industry has done a very good job in streamlining that. We're not quite at the point where somebody runs around with a camera on their head and photographs all of the buildings. But we are getting the point where information is essentially at your fingertips at a moment's notice. You can cull through it. It doesn't take you hours to comb through the file to find the environmental report. From a process point of view, we've done better. We now have information out on the Internet on the performance of these securities.

The other side of it is the competitive environment that we're in. It is such that so much capital is chasing borrowers that there are a lot of people who are being smoked out of the woodwork, borrowers who may have been convicted of embezzlement 20 years ago, but the prospectus says for the past 10 years he hasn't done anything wrong. Well, perhaps he just got out. (laughter) So many people are in this game that we're clearly at the point where we may have gone overboard in some cases. On the good side the conduit market has reached up and brought some traditional insurance company borrowers into the fold. On the down side, we've sucked some people up out of the woodwork and I think that's bad. And it's really going to be left to the next cycle to distinguish who did a better job originating and that will determine the cost of capital.

Buckley: From your position, how do you see the capital markets evolving?

Ben McGrath: There's no doubt that past sins are in part a result of the long-standing relationship focus of the business. Perhaps one of the biggest complaints about the rating agency process will prove to be its saving grace which is that it is a rather dispassionate process, and the rating agency personnel are for the most part shielded from the relationship pressure that is intrinsicto the production business.

My view on the market is we are moving ever more quickly toward a heavily equity and debt public-market securitized business. REIT market is up almost 60% from the end of 1996. At the same time, one of our biggest client bases at Chase is the private equity players, the Investcorps, the AEWs, the Apollos. This client group is out marching through the markets with say, $50 billion of buying power right now, and they're playing primarily in the private markets. At the same time, they are counting on a future, more vibrant capital market for their exit in a lot of cases. In addition, you have the third client

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ing time for pricing because the biggest acquirers are the REITs this last year. The REITs are driven by people who aren't real estate people. So there's all kinds of action around the margins to make it more fun.

Buckley: On the conversion side, where is the product coming from and is there an end to the product side?

Spencer Young: Currently there is $1.3 trillion in commercial mortgages outstanding. Roughly 10% of that rolls over in each year, and so you find that Wall Street is effectively clamoring for that product. In total, about 14% is securitized, the rest is being placed through traditional lenders. The balance has been shifting and it's really been done through this vehicle that has been emerging in a big way, known as the conduit. The conduit comes in many different forms. It comes in the form of direct lending such as Nomura. They have a direct program, which means they built up a significant infrastructure and a vast amount of people placed in certain key cities throughout the United States and have done a good job of that. Then you have a situation working with principally mortgage banks and that I think has been utilized in large part by most every Wall Street firm in some form or other. Then you have that one traditional conduit channel of working with a financial institution where you get pretty strong reps. and warranties.

(Clockwise from upper left) Michael Buckley of E&Y Kenneth Leventhal, Joe Franzetti of Duff & Phelps and Michael Reid of Lehman Brothers.

In terms of the source of product, it's coming from refinancing, it's coming from, to a certain extent, new construction. The FASIT vehicle is a way to deal with new construction and also deal with some moving parts. Under the traditional REMIC structure which is generally the way CMBS goes out, you have to have a very static pool, so that's a new innovation.

Spencer: The one interesting aspect about the conduit phenomenon is that last year, $44 billion was securitized, a 48% increase [over 1996] and it pretty much beat every expert's expectation by a long shot. The consensus seems to be that it will do $50 billion plus, and more than half of that is being done in the conduit format. The view generally is that is the form of financing for real estate for the foreseeable future.

Buckley: Mr. Franzetti, 10 years ago, your company wasn't in this business, and now you definitely are. Do you think this is down to a science side or what part is still art?

Joseph Franzetti: I think we're getting down to some part, but I'm not sure if it's science, art or some other part of the anatomy that we seem to be getting to in terms of where the process is going. When you look at it, what was probably the idea of good conduit just a few years ago was 35 loans where one

Columbia University
Spring Roundtable Series
The Fusion Scenario: Real Estate and Wall Street

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Dir. Capital Markets
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Spencer Young
Vice President
Morgan Stanley Realty

sitions that have been done. They are setting the cap rate. So when you're setting your loan-to-values, guess who's setting your values? It's the REITs. They're out there buying. And they will continue to buy as long as they can do that accretively. If they cease to do that, they are going to have a tougher time justifying those values that you established and the loans that you put against it, banks like ours and Lehman and others that are in the business of doing some bridge lending in order to facilitate our investment banking and our conduit businesses. We're looking at those loans where you could see a real ripple effect in the marketplace driven by this securitization that's happened. It's one of the pluses and one of the negatives that's happened. If you're not looking at real estate from a capital markets standpoint and looking at both the debt and the equity side at the same time, it's in for a lot of trouble.

Buckley: What about issues on the management side? Do you guys worry a lot about when you look at an offering who's running the store and whether they are capable of managing the transition?

Miles: The fascinating thing about a REIT is think how few people really run a REIT. In terms of decision-makers and drivers and the key people, there aren't many. When you think about Crescent how many people come to mind? Two? What's fascinating is what's going to happen to the guys who are below them who are actually doing the work when the REIT market sits flat for a while and they have all of those stock options.

Buckley: Let's bring in FASITs again. What is it?

Moreo: Financial Assets Securitization Investment Trust. It's basically like a real estate mortgage investment conduit, a REMIC. It is a tax vehicle for pooling debt instruments of any kind. Real estate, credit cards, etc.

Buckley: Which brings up all kinds of interesting issues on values and information.

Franzetti: That is the issue about FASITs. It is the kitchen sink. In theory, my gosh, we have finally found the Golden Goose here because we're going to squeeze this baby until all the eggs are out because we're going to put construction loans in there and hide some other things. The sponsor can substitute anything they want or substitute the bad loans so the buyer can never really understand the performance of the originator.

Young: In a sense it (a recent Nomura/Morgan Stanley FASIT) is trailblazing and Nomura has shown time and time again they can set the stage for what the future will bring. What they did is took interim loans and put it into a transaction. They can actually earn out additional monies on the transaction and it provides an exit strategy for Wall Street to be able to provide interim financing, which in the past was really a non-starter. Given the amount of competition that has arisen, everyone is looking for a way to have a competitive advantage, and if you have the gumption and the capital by which to take that bet, the read is that it has been a success and others are clamoring to replicate that success.

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