A Reprint from *Tierra Grande*

Old School

Lessons from the '80s and '90s

By Harold D. Hunt

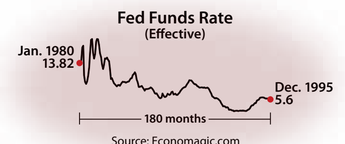
Real estate cycles are a bit like the fashion industry. Some old theme is resurrected again and again, but always with a new twist that sets it apart from previous versions.

The next several years will not be a repeat of the 1980s or the 1990s for commercial real estate. But a few lessons from that period may help frame how the commercial markets will evolve during the next few years.

Government Intervention

Timeline

- The 1980 Depository Institutions Deregulation and Monetary Control Act and Economic Recovery Tax Act of 1981 were primarily driven by politicians' desires to stimulate the economy during recession. The Garn-St. Germain Depository Institutions Act, passed in 1982, expanded the scope of savings and loan (S&L) lending. The result was a significant increase in risky lending.
- Commercial real estate markets were temporarily paralyzed as the 1981 Tax Act worked its way through Congress. In the months that Congress debated the legislation, commercial property values dropped as much as 30 percent. Some investors chose to sell quickly during that period of uncertainty to avoid possible increases in capital gains tax.



- The Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA) forced healthy S&Ls to sell real estate assets to raise capital. But high-quality real estate assets that had been performing well were already worth less because of the tighter lending standards imposed by federal regulators.
- The Resolution Trust Corporation (RTC), created in 1989, was hamstrung from the beginning. The pressure from Congress to liquidate properties quickly was at odds with

- an antidumping provision that was a part of RTC's original legislative mandate.
- The RTC attempted to remain independent of political and economic pressure. By 1992 Congress was calling the RTC irresponsible and inefficient.
- The RTC was acutely aware that if it sold distressed properties too cheap, the new owners would offer rents so low that healthy properties would be affected. As the inventory of distressed assets grew, estimating the value of all commercial properties became more difficult.

- $400 billion in failed S&L assets were eventually sold through the RTC. The rapid sale of real estate demanded by Congress significantly weakened the value of other nondistressed properties in many markets as predicted.
- Policy overreactions occurred in the early 1990s in an environment of "blame avoidance" by Congress. Politicians had no desire to appear soft on the S&Ls. Regulators restricted banks from originating even viable commercial real estate deals.
- The 1988 Basel Accord and FIRREA increased commercial real estate capital reserve requirements. The Office of the Comptroller of the Currency, the regulator for federally chartered banks, issued stricter underwriting guidelines in 1990. Higher risk was assigned to commercial real estate loans, forcing even higher capital retention. Meanwhile, creditworthy borrowers were being penalized for the deadbeat borrowers of the 1980s.
- Government regulators were running a significant number of banks by 1992, producing suboptimal results with their risk-averse behavior. This risk aversion prolonged illiquidity in the credit markets. Regulators dictated harsh loan-to-value and debt service coverage ratios, fearing Congressional investigations into their decisions. By avoiding all risk, lending was severely curtailed. A borrower's past payment history was often totally ignored.

Lessons Learned

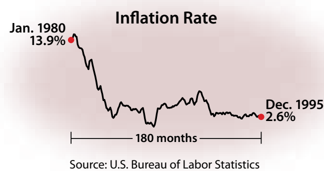
Decisions by regulators were often more politically driven than market driven. Government regulation, ownership and management of private assets did lead to long-term market stability in commercial real estate markets. However, government intervention proved too slow and cumbersome to orchestrate any viable short-term relief in crisis situations.

At the height of the commercial real estate boom, Congress had refused to pass any reforms that would have lessened the impending downturn. As a result, it was forced to offer economic incentives at the bottom of the bust to attempt a recovery.

Sources of Capital

Timeline

- S&Ls flooded the market with capital between 1981 and 1985, escalating overbuilding. Commercial banks, foreign investors, life insurance companies and pension funds continued the flow of capital from 1986 to 1989. Little or no equity was required in many commercial real estate deals. As a result, lenders controlled the level of new construction. Their financial participation in commercial real estate deals had transformed them into de facto equity investors.
- The 1986 Tax Reform Act had been passed to curb commercial real estate overbuilding. Investment began to shift to well-occupied existing properties. Capital still remained readily available. Declining interest rates led to increased use of leverage by investors to prop up property returns.



- Foreign investors originally focused quite narrowly on prime properties in a few downtown commercial markets. As they broadened their scope by geography and property type, U.S. capital markets became more dependent on their funds for liquidity.
- Globalization of capital markets had disconnected the money source from a property's location in the 1980s. Financial deregulation and globalization sustained overbuilding through 1989 in many markets as capital continued to flow from tax-exempt pension funds and foreign investors. New construction was occurring in markets with less than 10 percent vacancy regardless of other economic fundamentals.
- Most foreign investment was gone by 1991. When financing sources began disappearing, distressed sales increased. Borrowers were being forced to repay loans or increase equity. Lenders often sold properties too quickly, depressing prices further.
- By end of 1993, financial capital was again returning to commercial real estate. More liquidity resulted in increasing property values. During the recovery, high-quality properties generally increased in value first.
- A turnaround in commercial real estate by the mid-1990s was fueled by:
  - a desperate search for decent yields,
  - RTC having sold off almost all of its distressed properties,
  - REIT purchases boosting commercial space demand, and
  - genuine economic growth in some areas, which further increased demand for space.
- Rents were increasing by 1994, although they were not yet high enough to justify new construction in many

- markets. Property owners noticed the market improvement and sellers began holding out for higher sales prices.
- Property values in some markets were outpacing rents in 1994 because of increased capital availability from REITs and commercial mortgage-backed securities (CMBS) and declining capitalization rates based on increased expectations for higher future rents.
- By 1996, public policy scholar Anthony Downs had recognized two looming problems with CMBS. He feared that:
  - underwriters would not be sufficiently cautious in firms that were not holding the loans in their portfolios, and
  - borrowers would have more trouble renegotiating terms in the event of default or foreclosure.

Lessons Learned

After capital and commercial real estate markets had integrated in the 1990s, the speed at which money could move in and out of investments around the globe became a major concern. Capital market disruptions now had a sudden and dramatic effect on the flow of funds to commercial real estate, increasing market volatility. Separating loan originators from those actually holding the notes increased the risk of financing bad projects.

Source: Economagic.com

Lending Environment

Timeline

- Through 1986, the 1981 Tax Act allowed developers and owners of newly constructed Class-A office space to decrease rents. Before-tax property losses were often negated after steep, front-loaded depreciation benefits were factored in. Many Class-B tenants relocated to new, more affordable Class-A space. Landlords in existing B-buildings were often unwilling to drop rents for vacating tenants for fear of having to renegotiate all tenant rents.
- Local lenders were often compelled to continue making loans on new space as vacancy rates increased because if they refused deals, lenders outside their market would lend in their place. Local lenders minimized their losses on local B-space buildings by capturing some profit from financing new Class-A buildings.
- Even well-run S&Ls began reporting losses in 1988 as property values dropped and tougher accounting standards were put in place.
- Banks increased their commercial real estate loans from 25 percent to 37 percent of their loan portfolio between 1984 and 1989, stepping in for the troubled S&Ls.
- In the late 1980s, many banks were hit hard twice. First, a bigger loan-loss capital reserve was required for their commercial real estate assets. Then came an actual write-down of nonperforming real estate assets.
- By the early 1990s, banks were unable to raise new capital, leading them to call in many existing loans and refuse to extend new credit.
- Many five-year balloon mortgages originated in 1986 began defaulting in 1991 because borrowers could not obtain funds for refinancing.
- By 1992, lenders knew that $0.5 trillion in commercial mortgages would come due in the next five years. At the time, they believed that borrowers would have no alternate source of capital to refinance and lenders would be forced to retain and roll over the unwanted debt, restructure the mortgages or foreclose.
- By the mid-1990s, REITs and the CMBS industry had become a major source of funding, bringing commercial real estate lending back to the markets.

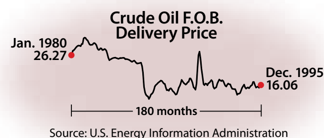
Lessons Learned

Credit standards in a local market were being set by the most aggressive lender, which was often one from outside the community. Construction loan take-outs and permanent loan refinancing became a game of musical chairs for lenders when liquidity dried up. Financial innovation can create new sources of capital to supplement traditional commercial real estate lending.

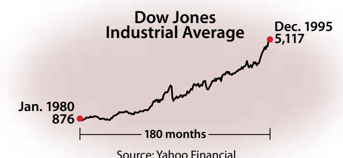
Investment

Timeline

- During the 1980s, large institutions began to replace the traditional developers and investors who had owned commercial property in the past.
- Developments started in the mid-80s eventually began to influence older, well-performing properties as their leases rolled over during the period of oversupply. Owners of healthy existing properties had originally assumed tenants would remain loyal and not relocate.
- By 1990, developers were unable to refinance properties or sell them for cash. Distressed asset sales from S&Ls had a negative impact on property values nearby.
- U.S. commercial real estate values dropped by $1 trillion between 1989 and 1992. Credit grew more slowly in 1991 than any year since World War II. Buildings without tenants secured by long-term leases faced limitless downside valuation risk in 1992.
- In 1992, public infrastructure construction made up the bulk of new development activity. New private development was typically limited to single-tenant, build-to-suit properties constructed for a specific user.



- The boom and bust periods of the 1980s and 1990s were greatly affected by investor psychology, not just economic fundamentals. Investors did not always act rationally. In the 1980s, before the boom's peak:
  - a positive economic event justified higher prices,
  - investor confidence increased, leading to greater use of leverage, and
  - a "herd effect" increased demand for properties simply because prices were increasing. The boom collapsed when:
    - an external economic shock reduced speculative demand,
    - market prices decreased in the face of even deeper expected price reductions, and
    - additions to supply overwhelmed demand while driving down rents and occupancy rates.
- The peak in commercial property values occurred in 1988 and 1989. By 1992, values had dropped 25 to 50 percent in most markets. A "value crunch," not a credit crunch, had restrained refinancing by 1993. Some borrowers were expecting loan refinancing based on values that no longer existed. Alternatively, new owners who had purchased properties at low prices from RTC had much less trouble refinancing.



- By 1994, investors who had bought properties from the RTC were often able to make money flipping the properties. Many had paid 50 cents on the dollar or less. However, the next generation of owners were tied to true improvement in market fundamentals for an acceptable return on their investments.
- By 1995, a large number of opportunity funds were actively looking for high returns from commercial real estate, but the best deals had already been made.

Lessons Learned

After the peak, investors were convinced that commercial real estate markets had stabilized a number of times, only to see values drop again. Tenants generally weighed the cost of moving against the lure of lower rents in newer distressed properties, showing little loyalty to landlords. Commercial real estate markets rebounded fastest in areas with strong job growth, affordable housing and adequate public infrastructure.

Appraisal and Valuation

Timeline

- During the overbuilding of the 1980s, investors shifted to valuing buildings based on their current cash flows, not on pro forma estimates of future rent and appreciation.
- Buyers first purchased prime properties rarely put up for sale in the early periods of the commercial real estate downturn, causing the magnitude of the value decline to be delayed.
- Distressed sales were often used as comparables in the 1990s. These sales hurt lenders who were forced to mark properties down to the lower current market values, even if the properties were performing well and not for sale.

Lessons Learned

A lack of property sales made it extremely difficult to accurately value commercial real estate. In periods where the long-term future is uncertain, current income becomes more valuable than projections of future income. Mandatory mark-to-market accounting standards caused healthy, performing properties to inflict damage on lenders' balance sheets unexpectedly.

Is the Past Repeating Itself?

Currently, excessive liquidity and financial leverage have been replaced by a massive dry spell in the capital markets. Government has again started out with an awkward response to the real estate market crisis. A dearth of sales activity is also clouding the estimation of current market values, as was the case in the early 1990s.

On the positive side, the extent of overbuilding in this cycle will be nothing like the 1980s. When the economy does begin to improve, the time to absorb the available space should be much shorter.

The flow of credit is still critical to the long-term health of commercial real estate. The CMBS market may be revived but likely in a different form.

It remains to be seen whether financial innovation in credit markets will be stifled by too much government intervention. The fate of commercial real estate may be in the hands of equity investors sitting on a sea of cash in opportunity funds. When this money moves in, a bottom *may* be near. But that move will require much more economic stability and market clarity.

Dr. Hunt (hhunt@tamu.edu) is a research economist with the Real Estate Center at Texas A&M University.

THE TAKEAWAY

Based on the timeline of the 1980s and 1990s economic downturn and eventual recovery, the current commercial real estate situation may last longer than expected. Part of the problem may be attributed to recurrence of a wide bid-ask spread in the property markets.

MAYS BUSINESS SCHOOL

Texas A&M University
2115 TAMU
College Station, TX 77843-2115

http://recenter.tamu.edu
979-845-2031

Director, Gary W. Maler; **Chief Economist,** Dr. Mark G. Dotzour; **Communications Director,** David S. Jones; **Managing Editor,** Nancy McQuistion; **Associate Editor,** Bryan Pope; **Assistant Editor,** Kammy Baumann; **Art Director,** Robert P. Beals II; **Graphic Designer,** JP Beato III; **Circulation Manager,** Mark Baumann; **Typography,** Real Estate Center.

Advisory Committee

Ronald C. Wakefield, San Antonio, chairman; James Michael Boyd, Houston, vice chairman; Mona R. Bailey, North Richland Hills; Catarina Gonzales Cron, Houston; Jacquelyn K. Hawkins, Austin; Joe Bob McCartt, Amarillo; D. Marc McDougal, Lubbock; Kathleen McKenzie Owen, Pipe Creek; Barbara A. Russell, Denton; and John D. Eckstrum, Conroe, ex-officio representing the Texas Real Estate Commission.

Tierra Grande (ISSN 1070-0234) is published quarterly by the Real Estate Center at Texas A&M University, College Station, Texas 77843-2115. Subscriptions are free to Texas real estate licensees. Other subscribers, $20 per year. Views expressed are those of the authors and do not imply endorsement by the Real Estate Center, Mays Business School or Texas A&M University. The Texas A&M University System serves people of all ages, regardless of socioeconomic level, race, color, sex, religion, disability or national origin. Photography/Illustrations: Real Estate Center files, p. 1, 2, 3, 4, 5, 6.