by Dana Enfinger

A Conversation with Claude Gruen

Claude Gruen, *Ph.D., is principal economist with Gruen Gruen + Associates, a firm of urban economists and market strategists he co-founded in 1970. He is a founding director of RREEF America REIT I and RREEF America REIT III and sits on the Urban Land Institute's Community Development Council. Since 1990, Gruen has contributed the "Trends" column to* The Institutional Real Estate Letter. *Editor* ***Dana Enfinger*** *recently spoke with Gruen about how the entitlement process has affected the real estate industry during the past 35 years.*

How has the arena of commercial real estate changed since you got into the business?

All of real estate, not just commercial real estate, was very different in two respects. The first is the change in the capital markets. Before 1970, real estate was almost exclusively non–Wall Street. When developers, builders and property owners went dialing for dollars, the people they called were insurance companies and banks. They might have gone to private investors, but even that was not typical because, by and large, real estate was highly leveraged. But it was not unusual for real estate people to actually be on the paper themselves. In other words, the nonrecourse financing was what everybody sought, but they couldn't always get it. The heavy hitters in the capital markets were the banks, the saving and loans, and the pension funds.

The first time I talked to anybody from Wall Street would have been in the late '60s, when some of the Wall Street firms began to acquire real estate advising and consulting firms; they stuck their toes in it primarily as advisers. The concept of raising money was probably initiated when the Prudential Insurance Company started the first commingled fund.

After I left a large consulting firm and teaching in February 1970,

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we formed Gruen Gruen and Associates. At that time, almost all of our business was doing marketing research for builders, developers, and public policy makers and planners. Occasionally we had a few investors who would come in and ask questions like, "What should I build on this piece of land?" But basically, it was all market research. In those days, the consumer market was king. The real estate market was highly competitive in a boom-and-bust cycle. When things were good, money flowed from the sources I mentioned before, and that meant builders built until they overbuilt. The public generally thought development was good and the provision of public services — roads and utilities — was a desirable governmental function.

All that began to change on both the public and private side in the '70s, with the emergence of the commingled fund. The beginning of modern portfolio theory started taking shape; it held that the pension fund investors should not rely exclusively on stocks and bonds because they were missing a diversity opportunity by not putting their toes into the real estate waters.

Even more important than how the change in capital markets affected real estate is the issue of entitlement. A series of new ordinances passed by local governments in the early '70s worked to make entitlement much more critical. The whole concept of what the Constitution means by property rights changed dramatically. In order to be allowed to develop, you must get the approval of the neighbors and those that represent them on councils and planning commissions. We now take this as a matter of course. By the mid- to late '80s, we found that our clients — builders, developers and even cities — were much less interested in the market, but they wanted to know, "Can we get the property entitled? Can we get the development through the environmental process?" Entitlement, and to a lesser degree financing, was what people were concerned about.

How has entitlement affected the real estate market?

When you look at the profitability of real estate, particularly residential, the profit margins are now up dramatically. In the '60s, the percentage of residential development that was land cost was somewhere between 15 percent and 25 percent. Today, we're talking about between 35 percent and 45 percent for a single-family home. So there's been a whole shift. Entitlement has worked to increase the value of land to such a degree that getting the approval has become more important to many projects than hitting the sweet spot in the market. Now, we're not ignoring the market, but … the big jump in value comes with the approval. The danger is that the project will wind up being designed by a committee, as you have to get the approval of so many groups, that the consumer is certainly necessary, but he's no longer the king. That's true of all uses, with the possible exception of suburban office and industrial in some areas. If I go into a city manager's office in the suburbs representing a shopping center developer or an industrial developer, the manager may take me to lunch and might even pay for it. If I go into the housing office, I'm likely to be sitting cooling my heels a long time before the director will even let his or her assistant come out and talk to me. In this era of entitlement, tax-generating uses, particularly retailing, have been much preferred by cities and counties.

How has entitlement affected commercial real estate investing?

Many investors recognize that their returns are going to come from the increment of value including entitlement costs. Will Rogers told investors in the 1920s, "Everybody buy land. They're not making any more." If an investor does that today, he or she will likely find that the costs of obtaining entitlement — including the environmental process and the trade-offs that will have to be made like zoning, affordable housing and all the rest of it — are not worth it because the total costs flood the obtainable rents and returns.

It is increasingly important for investors to analyze the obtainable market and find out if those markets generate the rents and prices that will amortize construction costs and all of the delays and trade-offs that will be required to obtain approval for the project in the first place.

Because of this challenge, many core investors will not touch undeveloped property. They leave that to opportunity funds and hedge funds. They will only buy constructed and well-leased properties. Over time, even a core property runs risks associated with the obsolescence and the continuing change [around its] location. Except for a few world-class downtowns, there continues to be a shift of many functions to suburban subcenters. Jobs can now follow people in our service-driven economy. It used to be driven by manufacturing. Thirty years ago, you wanted the offices and retailing downtown; then the people would want to be there. Now you have to bring in retailing and cultural attractions in order to make people want to live there, and then the people who live there will want their offices there. The whole sequence of revitalization has changed since Gruen Gruen and Associates first started working for cities and developers. ❖