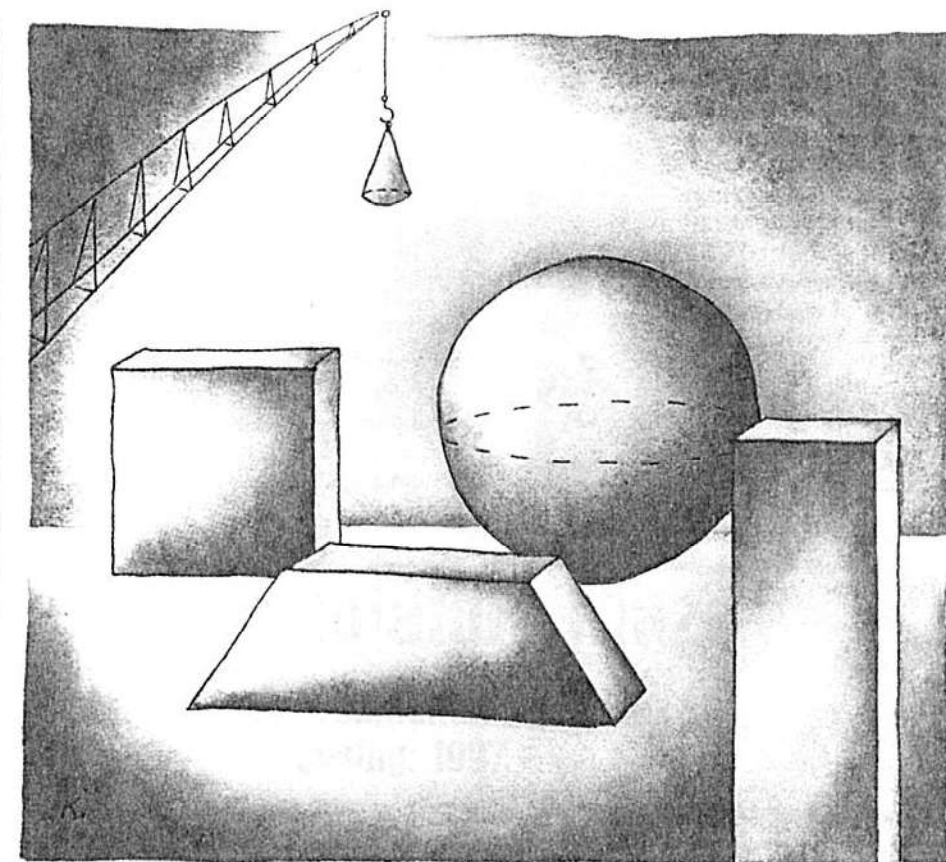
Commentary

Real Estate Is Not a Commodity

CLAUDE GRUEN

Properties must be defined and redefined to be market responsive.



The air around participants in the real estate industry is rife with information about securitizations, consolidations, and a plethora of newly important organizational formats. Today more than $40 billion in property is owned by publicly traded REITs, whose stock appears so far to behave much like small capitalization stocks. With the continued growth of commercial mortgage-backed securities (CMBS), Wall Street has supplanted the primary role of direct insurance company and bank lending. Mergers, acquisitions, and initial public offerings (IPOs) are creating ever larger REITs and more integrated real estate companies—just as other industries are unbundling the conglomerates that were only recently touted as possessing economies of scale and complementary skills. Innovative joint ventures between various entities, including public agencies and private firms, are now frequently formed to implement land development and adaptation of existing uses.

Americans tend to reorganize every few years—particularly after a crisis. However, the structural changes in the real estate industry arise from an urge deeper than the itch to reorganize. As anyone who has ever attended a ULI meeting knows, capitalization and financing fascinate the real estate cognoscenti. It is capitalization and financing changes that are reshaping real estate businesses. Yet, except for the decreased use of leverage and the requirement for more equity—the one fundamental effect of the recent organizational transformations—little of substance has changed.

Financing and the equity requirements of real estate affect only the timing of real estate activity in the United States and the value of property at any point in time. In the longer run these effects tend to wash out. The economic viability and investment returns of the built environment are determined by the effectiveness of real property in meeting the economic, social, and psychological demands of its users. The structural modifications that fill today's real estate press and conference proceedings have not significantly altered the mission of the real estate industry.

That mission is to profitably create, maintain, and adapt space and groupings of space. To be profitable over time and thereby further economic growth and enhance the quality of life for consumers, the real estate industry must produce and maintain agglomerations of space in response to marketplace demands. Real estate is durable, but the determinants of user demand are unique and constantly changing. So decision makers must forecast the future. Whether the decision is what to build, how to maintain it, what to adapt, or when to buy and sell, decision makers must focus on the demands and options of space users, that is, on tenants and buyers. Regardless of where they function in the real estate chain, industry workers must differentiate the properties they produce and that are under their stewardship so as to define and redefine them to be market responsive.

Just as a cook needs heat for the oven, real estate developers and managers need financing and capital to do their jobs. But how this financing or capital base is structured has no more to do with the quality of real estate than the source of heat for the oven determines the quality of the cook's meal. Lenders and investors and those who advise and act for them may find accepting this generalization injurious to their egos. However, they will find rejecting it injurious to their incomes. True, a real estate operation with deep pockets can survive losses and lower

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returns much longer than a highly leveraged entity. But sustaining losses and low returns are not among the performance expectations set by real estate investors or lenders.

The congruence of market demands and property characteristics determine investment returns. High returns will go to investors who support real estate developers and asset managers that differentiate space and locations in congruity with market demands. The right differentiation will earn high returns. The wrong differentiation will lose money. No differentiation can only, at best, break even.

Consider the state of satisfaction of an investor whose portfolio contains the following properties:

- One hundred fifty acres of vacant land entitled for industrial use at an FAR of between .3 and .5 in an area experiencing explosive high technical or industrial growth.
- A large "high cube" warehouse built to process rather than just store goods located within a major transportation hub.
- A regional shopping center that has undergone consumer friendly remodeling and whose tenant mix has been adjusted so that dominance in a major market has been maintained.
- An apartment community that has been managed and maintained so that it has kept its image as the "in" place for a growing market segment.
- An office center that caters to small- and medium-sized users in an affluent suburb.

The investor would be particularly pleased if he or she purchased these properties about five years ago, at the nadir of the real estate slump. Yet this portfolio would be likely to satisfy the investor even if the properties were purchased during the boom years of the 1980s. The owners of such properties will not agree with those who say that the structural changes in the industry have turned real estate into a commodity. Commodities have uniform characteristics, making them fungible and therefore easily traded. But in real estate, it is the *difference* that counts.

We have already seen what happens to a great American industry when it is taken over by financial managers tuned only to the music played by Wall Street. Before the American automobile industry went back to responding to consumers, it lost market share to foreign manufacturers who focused on mechanical and electrical—rather than financial—engineering. For an example closer to the real estate industry, look at the many department stores that turned over their retailing businesses to financial wizards rather than merchants. Only department stores like Nordstrom, which conti[n]ues to appropriately differentiate its good[s] and services, have avoided the devastatio[n] wrought by competition.

Recent characterizations of changes i[n] the real estate industry as "being so dram[at]ic that they have made real estate a commodity" are not only erroneous, but dangerous. Real estate profitability depends upon products and services that are *not* fungible. Like a computer virus that corrupts a good program, thinking of real estate as a commodity corrupts the mind s[et] needed to achieve the real estate mission.

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