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Rethinking real estate:

Contrarian strategies for profiting from down markets

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Back in the day, John Jacob Astor sold a parcel of land on Wall Street for \$8,000. The buyer, confident that he had gotten the better of the legendary Astor, couldn't resist gloating after the papers were signed. "That parcel will be worth \$12,000 in a few years."

"True," said Astor. "But with your \$8,000, I will buy ten parcels of land above Canal Street that will be worth \$80,000 by that time."

Investment opportunities are often created when there is an extreme imbalance between supply and demand, or between information and outlook. Throughout a typical real estate cycle, extreme market fluctuations will periodically support irrationally high valuations for underperforming properties, and will occasionally produce low prices for solid assets. Market prices tend to reflect prevailing bias rather than the correct valuation, particularly during the periods of prolonged optimism or pessimism that bracket a real estate cycle.

Contrarian investors benefit from market cycles because they understand that present conditions would not continue indefinitely. Further, contrarian investors who recognize the leading indicators of a market boom or downturn can sell when market inefficiencies are in their favor and can proactively hoard capital in advance of adverse conditions and buying opportunities.

However, making strategic business decisions is extremely difficult during turbulent markets. In a gradually rising market, investors can generally safely take cues from what their peers are doing. However, in a volatile or overheated market, these cues no longer reflect strong underlying fundamentals.

"We suffer from knowing the numbers when we ought to be questioning the assumptions," said contrarian investor Sam Zell. "Unchallenged assumptions are my ultimate enemy."

Financial models are only as good as the assumptions behind them. We tend to extrapolate future conditions based on the recent past, expecting that circumstances will continue in a similar vein. This is a fundamentally flawed assumption. In uncertain times the range of possible outcomes is much broader. Future conditions do not necessarily resemble historical conditions, and it is difficult to make accurate assumptions about revenue or prices, or even to know which assumptions need to be adjusted.

Generally-accepted forecasts and assumptions break down when markets move into what economists refer to as 'far-from-equilibrium' conditions. In extreme cases, the effects of one shock become the causes of another.

For example, difficult-to-predict acyclical events such as earthquakes, hurricanes, or terrorist attacks tend to give rise to other statistically improbable events such as widespread looting, destruction, and epidemics of disease. While conventional wisdom indicates that the likelihood of two such improbable events occurring in sequence should be lower than if they occurred separately, empirical evidence suggests the opposite. Real estate markets follow similar patterns.

Nassim Nicholas Taleb coined the term 'Black Swan' to describe situations that are defined by low predictability and high impact, but which were foreseeable in hindsight. Because of their low predictability, most pro formas or risk management models tend to exclude these Black Swans by understating the 'worst-case' scenarios or by anchoring worst-case assumptions on recent historical numbers. Black Swans tend to happen with some regularity, exposing firms to risky investments and forcing management to be reactive instead of proactive. This past cycle was defined by such Black Swan events.

For example, the 'worst-case' forecast for Fannie Mae/Freddie Mac was a 12-15% drop in house prices — the actual numbers turned out to be closer to 40-50% in some areas. Roger Lowenstein of the *New York Times* observed that Moody's gave AAA ratings to some CDOs and assigned potential losses of 2%. As actual numbers emerged, Moody's subsequently revised their models to reflect credit ratings of B or lower and potential losses of 27% or higher.

The boom years of any real estate cycle are defined by a suspension of disbelief: a conviction that high prices *actually* reflected the underlying value, that the fundamentals *really* had shifted, and a conviction that prices would keep rising. In a self-reinforcing cycle, pro-forma prices and assumptions are typically tied to the recent past — rather than taking a view which is both longer-term and more granular, to reflect the possible volatility during transitional markets.

‘Irrational exuberance’ is the phrase often used to describe this market mentality, but it is not the most accurate phrase. The bubble mentality is driven by denial, fear, and greed as much as by the euphoria of rapid and disproportionate profits.

Internal incentives and the need to meet benchmarked returns enticed even conservative players into this frenzy. For example, bonuses were paid to loan originators on volume, rather than on the long-term performance of the mortgages. Management and directors of banks that did not offer subprime mortgages were, for a period, criticized for ‘missing out on’ a marvelous market opportunity from which many of their competitors were profiting.

The phrase “things will be different this time” has surfaced in every recent bubble as a justification for the disconnect between price and value, whether that is home prices soaring beyond the ability of households to afford them without exotic mortgages, or to justify the valuation of dotcoms without earnings. Sir James Goldsmith dubbed those words the most expensive phrase in any language.

In the face of such systemic optimism and greed, when almost everyone is making more money at a faster pace, it is difficult to heed the few dissenting voices. But it is critical to remember that present conditions will not persist indefinitely, and that these valuations will not be sustainable over the long term. While procyclical players are launching projects with long lead times hoping to take advantage of the increased demand and higher prices, contrarians take advantage of these market inefficiencies to sell their properties at a premium and to hoard capital for better investment opportunities.

Conversely, during the bear segment of any market cycle there are periods where consumer confidence tumbles and investor pessimism reaches an extreme. The constant stream of negative news makes it seem as if the bottom has fallen out of the market, and that present conditions will continue indefinitely. This is when procyclical investors are reluctant to enter the market and when contrarians may find more attractive deals.

Contrarian investors benefit from an asymmetry of perception. Excessive optimism compromises judgment, leading to reckless investments that increase exposure to risk. Excessive pessimism prevents investors from identifying or seizing potential opportunities. While the market swings provide great opportunities, contrarian investors find extremes swings of perception counterproductive.

By questioning assumptions and moving counter to the herd, contrarian investors find value where — or when — others overlooked it. There is often a lag between when conditions actually shift and when these shifts are recognized by the market and the media. Investors who are able to identify the warning signs of a market shift well in advance are positioned to take proactive measures.

Leading indicators of a market downturn

The quality of our investment decisions depends largely on the accuracy and timeliness of the information with which we are working — as well as the judgment to parse that data and assumptions into productive insights.

This bubble has been marked by a systematic distortion of information. Ratings agencies such as Moody’s and Standard & Poor’s established questionable credit standards that determined which loans Wall Street could repackage and which borrowers would qualify for mortgages. Lax appraisal standards further contributed to this obfuscation. Relying on this sort of biased information erodes investors’ ability to make informed decisions about how much risk they are willing to take relative to the expected returns.

Real estate investors can infer a pending market correction from the extensive quantitative metrics available¹, as well as the empirical and qualitative measurements which are not recorded on major indices, but which are just as informative.

Part 1: The rise

The first sign of a pending downturn is paradoxically a dramatic rise in the markets. The same indicators that the general public regards as signs of a very healthy market are the signals for contrarian investors to move to the sidelines.

“How do I know that a market correction is coming?” said Zell. “Irrational exuberance. Free money from lenders. Everyone who can swing a hammer fancies himself a developer.”

“When everyone with a pulse is becoming a real estate agent because it seems like easy money, it’s a fairly accurate sign that a correction won’t be too far off,” said Ary Freilich, the managing partner of Blumberg & Freilich Equities, an investment partnership which he co-founded in 1991 to capitalize on the unusual market opportunities that were created following the real estate crash of the late 1980s.

According to Zell, one of the primary indicators of a market imbalance is when the national percentage of homeownership moves significantly beyond its historic levels of 62-64%.

“Every ten years or so there is some well-intentioned government program to raise the rates of homeownership. These policies ask lenders to ignore the reality of peoples’ ability to pay back a mortgage. So ownership rates go artificially higher for a while until many properties get foreclosed, and then revert to their natural level.”

Another indicator of an overheating market is when traditional metrics — the ratio of housing prices to personal income, or the comparable costs of owning vs. renting a similar property — shift

significantly from their historical levels. (Although it can be amusing to watch the pundits and public relations people try to justify why “things are different this time.”)

When housing market fundamentals are strong, there are typically increases in both rental and ownership prices. In hindsight: since the real estate bubble began in mid-1990s, rents (averaged nationally) have increased only slightly more than the rate of inflation. Even in many of the cities with the largest run-ups in home sales prices — such as New York, San Francisco and Seattle — rental prices have been largely weak.

The House Price Index produced by the Office of Federal Housing Enterprise Oversight tracks resales of the same houses, giving the best analysis for precise price changes of the same property, rather than reflecting a shift to more or less expensive homes coming on the market — although it does not account for renovations to the properties. The HPI gives some of the clearest evidence of the bubble: from roughly 1945 until the mid-1990s, housing prices increased on average at the same rate as other goods and services. Since the mid-1990s, the nationwide HPI has increased by over 50-100% at the market’s peak, after adjusting for inflation.

Many leading indicators of a pending downturn initially reflect the increased demand of an imbalanced market: faster absorption rates, packed open houses, bidding wars, and units selling above their asking price. Another sign is when prices are rising so rapidly that individuals become speculators in housing, flipping preconstruction contracts on new condos for significant profits.

This mentality also affects real estate professionals. During these periods, many investors bought buildings with yields below the cost of capital, assuming that rents would continue to rise and the property value would appreciate. Many commercial developers put up buildings with little or no preleasing, assuming that the near future would resemble the recent past.

1 In the United States, significant market metrics are provided through the Case-Schiller Index, Commerce Department or Census Bureau (housing starts), House Price Index (HPI), Mortgage Bankers Association (weekly data on mortgage applications), National Association of Home Builders (monthly sales and price figures, housing starts), and the National Association of Realtors (existing home sales).

Part II: The market peak, and the beginning of the decline

These are signs for contrarian investors to begin questioning assumptions: will this growth continue? Are these valuations sustainable?

In every cycle, there are typically a handful of anecdotal events that signify a market peak. Each cycle has its version of the apocryphal story that J. P. Morgan withdrew from the stock market when his shoe shine boy was giving him investment tips. This past cycle, it was the Wall Street Journal's coverage of the Irish carpenter (who was himself benefitting from his own country's real estate boom and the currency imbalance) buying a million dollar condo on Wall Street as an investment property. A flurry of record-breaking deals or per-square-foot prices — such as the \$5.4B acquisition of Stuyvesant Town, or the condos at 15 Central Park West selling for up to \$17,000 a square foot — is also a sign that the market is overheated.

As the market cycles, the shift from exuberance to downturn is first marked by denial. Many developers, brokers and lenders express a variation of “it might be happening elsewhere, but not here” or “it won't affect my buyers because of their income levels.”

Part III: The decline

The leading indicators of the downturn itself are more easily tracked through conventional metrics.

According to Freilich, in a dense urban market such as New York City, the price of air rights is very sensitive to changes in anticipated demand and typically fall in advance of land or building prices. The health of the real estate market can also be inferred from a number of countercyclical indicators. Economist Randall Pozdena has observed an inverse relationship between interest rates and housing starts since the 1970s. In addition, energy, gas, and oil prices move countercyclically to housing.

In a weakening market, the rate of price increases declines and eventually reverses. The number of transactions falls and there is an increase in broken contracts as buyer confidence diminishes, jobs are lost, or as credit is tightened. This slower absorption

rate combined with the projects under construction leads to an overhang of inventory.

There is typically a “wait and see” period where buyers expect prices to drop and sellers expect prices to recover. As inventory builds, ‘commodity’ developments are forced to compete on price, and the advantage goes to the either low-cost producer or to the developers of distinct or highly-desirable products, or those in prime locations — although this may only reduce rather than avoid the effects of price declines.

The use of sales incentives by residential developers can also give a good empirical sense of how far into a bear market the real estate cycle has moved. Because cutting prices weakens comparable sales figures for other units in a development, developers reduce listing prices as a last resort. In order to maintain the appearance of stable prices, developers may initially offer noncash incentives such as upgrades or prepaid condo fees or amenities such as parking. These concessions maintain the appearance of stable prices because the indices for average and median home prices only reflect contracted prices, not concessions.

Cash incentives typically arrive further in the bear segment of the real estate cycle. Developers may offer buyer agents bonuses, cover closing costs, subsidize financing, offer buyers guarantees against price declines, or even hold mortgages outright to ensure that buyers can get into their properties. These may even be done in conjunction with price cuts.

When market conditions deteriorate to the point where condo sales seem unlikely, residential developers may auction off units in order to stem their losses, or they may convert their condos to rentals if there is sufficient market demand. Developers may unload unfinished projects or partially-improved land onto joint-venture partners or opportunity funds.

Housing starts are adversely affected when interest rates rise, prices fall, or when absorption slows. The irony is that lenders tend to fund projects when the present situation is good (making the conventional yet flawed assumption that the near future will look like the recent past), despite the fact that the long lead times of most projects means that they will generally mature into a very different economic situation. This practice contributes to the cyclical overbuilding of the industry.

Part IV: Static markets and uncertainty

Real estate is not an aggregated commodity. It does not rise, fall, or recover equally across geographic lines or asset classes. Some areas may be affected later, to a lesser degree, or not at all. Areas that are fundamentally desirable tend to hold their value better than emerging neighborhoods. The run-up in prices in emerging areas was driven by expectation of higher future yields, or by buyers who saw it as a less-expensive alternative to a more-desirable area. Market corrections may stall this momentum.

Credit expansion stimulated the real economy, so credit contraction should have an adverse effect. Housing prices were driven higher when loose lending requirements and low interest rates enabled more people to become buyers, creating an artificially high level of demand. Now, the reverse is happening. Marginally-qualified consumers may not qualify for loans under tighter regulations, and will continue renting.

It is difficult for both procyclical and contrarian investors to determine how far real estate prices can fall during a market decline, in order to know when a market appears to be in equilibrium.

For the most recent bubble, it is unclear whether home prices may fall to the income-rent ratios at the level before the credit standards were loosened, or even further.

Is 'equilibrium' when the price declines offset the price gains from the housing bubble, adjusted for population growth and household formation since then? The expansion of mortgage credit in the 1990s was achieved through traditional products, according to the Harvard University *State of the Nation's Housing 2008* report. From 2003 onwards, much of the mortgage market's growth was driven by riskier interest-only, payment-option, and subprime loans. Zell's take on the natural level of homeownership was correct: the national homeownership rate peaked in 2004 and has since retreated below its 2003 level, with over 2 million homes in foreclosure.

Or will prices decline below those levels to reflect the higher carrying costs of owning property given the higher costs of gas, oil, and utilities? Howard Kunstler believes that the desirability

of the postwar suburbs has been dependent upon inexpensive gas and oil to support the longer commutes and larger properties. Will banks adjust their debt-income ratios to reflect these higher carrying costs now that energy prices have risen significantly? Or will banks offer incentives for higher-performance 'green' properties that offer slightly higher initial costs but lower operating expenses?

Emotional factors such as consumer confidence play a role in determining real estate prices. Prices are indicators of the anticipated future income or upside from an asset. Prices fluctuate to reflect changes in perceived upside of a property: during a boom, buyers and investors are willing to overpay for property because they believe prices would continue to rise. After a bust, buyers tend to scale back their expectations and bid more conservatively, at least for a while.

Part V: Gradual recovery, moving into the next cycle

During the gradual recovery after any downturn, the markets tend to have a risk-averse period in which capital is still more difficult to obtain, developers and investors become less leveraged, and in which buyers scale back their expectations. Both price increases and the pace of transactions recover slowly and unevenly.

Behavior is fairly consistent, cycle after cycle. Each market cycle will be the first one for a new crop of investors, developers, lenders, and buyers — and their behavior will be largely procyclical. As capital becomes easier to obtain, prices increase at a faster pace, assumptions begin to change, and looser lending sparks the next development boom, which leads again to the inevitable imbalance of supply and demand.

Nassim Nicholas Taleb said that people are programmed to learn specifics, but not to infer general rules from their observations, which is why we tend to be caught unaware even by cyclical events.

Zell echoed this thought: "Real estate people are typically better at transactions than at strategy. They don't tend to be able to look around the corner. To them, the beanstalk is always growing to the sky."

Counterintuitive strategies for profiting from downturns

Opportunities are worthless without the resources to act on them. When contrarian investors sense an overheating market and a pending downturn, they stop building or buying and prepare for both the coming opportunities and the adversity of a bear market. In order to take advantage of buying opportunities, they raise capital by selling marginal properties for valuations that would not otherwise be sustainable, taking advantage of the market inefficiencies that are in their favor during the bull segment of a cycle.

“Of course, if you’re going right when everyone else is going left, you can be certain they’ll be telling you, ‘look, you just don’t understand...’” said Zell.

In the early 1970s, Zell felt that the real estate industry was ignoring the rules of supply and demand, and he felt that the capacity exceeded the demand for space. He stopped doing new deals and structured a company to focus on distressed real estate.

These capital reserves also help investors weather rough periods in order to realize long-term gains. During the bear segment of a market cycle, it is often possible to purchase buildings at below their replacement cost. However, turning around an underperforming building typically requires the financial reserves to make significant capital improvements and sustain a longer-than-expected lease-up period.²

“It comes down to the quality of your assumptions and due diligence,” said Freilich. “Investors need to have enough liquidity for a cushion in the event that their assumptions about rental growth projections, vacancy rates, or creditworthiness of anchor tenants turn out to be too robust. It returns to the basic question of a building’s ability to generate cash. Does the property have favorable and durable economic characteristics?”

In some cases, an analysis could be completely logical but reality doesn’t comply with the forecasts. “We refer to this approach as ‘HP12C’ logic. It’s mathematically consistent, but it doesn’t take human bias or chance into account,” said Freilich.

For example, the 9/11 attack on the World Trade Center eliminated the equivalent of 13M square feet of commercial space. This also happened to be roughly the amount of available commercial space in New York City at the time. “It should have brought the market into equilibrium,” said Freilich. “Instead, many of these firms relocated to Connecticut or New Jersey. And the commercial market in NYC remained oversupplied.”

“That’s another example of the right thinking, but the wrong assumptions,” said Zell. “People assumed that the market was just Manhattan. They didn’t question whether Connecticut and New Jersey would be substitutes for Manhattan.”

However, it is difficult to question assumptions.

For example, the conventional wisdom after the stock market crash in April 2000 was that real estate markets would lag the equity market by 6 months. As a result, many people were expecting real estate prices to fall by October 2000. Although clear in hindsight, it would have been difficult to foresee that the real estate industry instead benefited from investors’ desire for hard assets after the collapse of the stock market bubble in 2000.

Many of the macroeconomic forecasts have been significantly off, prematurely correct, or right for the wrong reasons. The major drivers for economic shocks and shifts — the Black Swans with their high impact but low predictability — were largely unrecognized in advance. Each of these developments came from outside the lot lines of conventional thinking. Similarly, economist John Kay surveyed the forecasts of British economists and found that they tended to make similar forecasts that were often wrong in the same way.

² The same economic conditions that allows buildings to be bought below replacement cost also creates adverse business conditions for potential commercial tenants, leading to higher risk of bankruptcies. There are direct correlations between unemployment rates and retail vacancies, and even the conventional wisdom that law firms benefit during down markets isn’t entirely true — billings may be up, but collections may not be.

“There are obvious incentives to moving with the pack,” said Douglass T. Lind, an advisor to senior management of Fortune 100 companies. “The outlier either sees what everyone is missing, or has completely used the wrong assumptions.”

“When you make a bet that goes against the prevailing wisdom, the stakes are higher,” said Lind. “You either get a promotion and a large bonus if it works, or fired if it doesn’t.”

Zell finds making investment decisions contrary to the prevailing direction of the market less risky than undertaking development: “I don’t suffer from an edifice complex. In that business, half the rate of return comes from the satisfaction from seeing the building go up.”

Even the language used to describe the same strategy differs from ‘value investing’ in the equity markets to ‘bottom feeding’ in the real estate sector. The terminology reflects the difference in mentality between those who build and those who invest.

“The ones who are complaining are either the ones who are forced to sell or who are facing foreclosure,” said Freilich. “I’d rather be a bottom-feeder than a bottom-feedee, any day.”

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