THE INSTITUTIONALIZATION OF THE U.S. COMMERCIAL REAL ESTATE MARKET

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Thank you very much. Good morning. It is a great pleasure and honor for me to be here today. I truly mean that. I want to commend Portland State University for recognizing Real Estate as a needed field of study and then finding the resources to both provide education as well as engage in real estate.

The real estate industry around the world uses more capital than any other sector of any other economy, and it is one of the most under researched industry in the world. The more than we know, the more that we can learn, the more that we can understand the more the efficiency of the markets will evolve. And, we will be able to use less capital in a more efficient way, making capital more available for other economic activities. So, this is a wonderful cause that Portland State University has undertaken, and I take my hat off to every one of you in this room that is a sponsor of the program because it is critically important that the real estate industry sup-

■ Blake Eagle founded the National Council of Real Estate Investment Fiduciaries (NCREIF), a Chicago-based nonprofit commercial real estate industry association. The association collects, processes, validates and publishes investment performance return information on commercial real estate assets owned in the private market by pension funds, endowment funds and other institutional investors. This article was prepared by Angela Guo from his comments at the Portland State University Center for Real Estate's 8th annual conference; comments have been edited for clarity. Any opinions expressed are those of the author solely and do not represent the opinions of any other person or entity.

port and promulgate real estate education and research. So I take my hat off to all of you this morning.

My role here today is to address what has been the impact of institutional capital on the real estate market. I will start out by defining for us:

- What is an institutional investor?
- Who are the institutional investors that have participated in the U.S. markets?
- How many dollars have been invested?
- What has been the impact on the marketplace?
- What is the total institutional capital invested in Portland real estate?

"What is an institutional investor? It is an entity that pools up capital for investment. The sources of the institutional investor's capital can come from savers, depositors, policyholders, shareholders, investors, contributors, and donors. It depends on the type of institutional investor and where it gets its capital. It highly specializes in investment. They don't make products or offer services. They invest capital. Most institutional investors spread their capital across the entire spectrum of investment opportunities that exists in both of the debt and equity markets, the primary and secondary markets, public and private markets, and today as we know it, domestic and international markets.

There are, for the purpose of this discussion, three categories of institutional investors that play heavily in the real estate market: (1) financial intermediaries, (2) real estate investment trusts (REITs), and (3) private investment funds.

With respect to financial intermediaries, they are the banks, insurance companies, the thrift institutions, the credit unions. For a couple hundred years now, they have been providing most of the real estate credit to the industry. From everyone from construction and development loans, to bridge loans, gap loans, down to residential and commercial first mortgages. They are spread lenders; they are not equity investors. They borrow capital at one rate and lend the capital at a higher rate. The spread between the two rates is enough to cover operating expenses, provide them with a profit and compensate them for the risk undertaken given the type of loan that they might make. I don't need to tell you the impact they have had on the real estate market because they have been here for a couple hundred years. Basically, their impact is the quality and standards of underwriting depending on where we are in a particular cycle.

The next category is the REITs, this is a corporation or trust or association that does nothing but specializes in real estate. They don't do anything else. REITs were created by Congress in the 1960s and the purpose of the enabling legislation was to encourage both and small and large investors to invest in real estate. The real estate capital markets had historically been capital deficient particularly when it came to equity. REITs were to fill that void. Most of the REITs you know of today, the names of which you are familiar, are public companies. But, there are a lot of REITs that operate in the private market that invest in real estate just as well. I sit on the board of one of the big ones.

REIT invest primarily in equities and most of them favor operating properties as their investment. There is a small category of REITs that specialize in mortgages. There is a third category or REITs that do both mortgages and equities. They are called hybrid REITs. Ninety + percent of REITs are in the equity business. They are tax exempt, as you know, provided they pay out ninety percent earning to their shareholders. Even though they have been around for a lot of years, it took 30 years and 2 volatile real estate cycles before the market recognized the validity of the REIT and its ability to provide capital to the marketplace. During the early years, no one had ever even heard of them. It wasn't until 1990 that they really took off and grew.

Year	**# REITs**	**Market Cap**	**# Equity REITs**	**Market Cap**	**# Other REITs**	**Market Cap**
1971	34	$1.5 B	12	$0.3 B	22	$1.2 B
1975	46	$0.9 B	12	$0.3 B	34	$0.6 B
1980	75	$2.3 B	35	$0.9 B	40	$1.4 B
1990	119	$8.7 B	58	$5.6 B	61	$3.2 B
2000	189	$138.7 B	158	$134.4 B	31	$4.2 B
2010	153	$389.3 B	126	$358.9 B	27	$ 30.4 B
2012	172	$603.4 B	139	$544.4 B	33	$59.0 B

In 1971, there were 34 REITs with a market cap of $1.5 billion, which is not even measurable in real estate terms. In 1998, there were only 75 REITs, with only $2.3 billion. In the late 1980s, we went through a horrible real estate crash with excess capital, overbuilding, markets came down. There was a need to recapitalize a considerable amount of real estate, particularly real estate in the hands of large developers. The only place they could go for capital for recapitalization was in the public market. The private market and the intermediaries didn't have any money or didn't want to invest. This is when the REIT industry took off. In 2000, you have 189 REITs with $138.7 billion of assets and in 2012, we have an industry with a market cap of $603.4 billion and the equity REITs are about $550 billion. That is $550 billion in equity that wasn't there 23 years ago. And it has had a significant impact on the marketplace as you will see.

Private investment funds, as they have been defined, are single purpose investment trusts. They are sponsored and set up to fund a particular purpose, mostly for the public good: retirement, education, scientific research, and philanthropy. They are generically known as pension funds, endowment funds, and charitable foundations. Like the REITs, they are tax exempt and they are true portfolio investors. They invest in accordance with a strategic plan that is put together to achieve the objectives for what the institution was set up for, in the first place. I work for the Frank Russell Company and we advise pension funds for many years. We help them to develop their asset allocation models. Then, help them set up an investment objective for each one of the asset classes in which they have allocated capital. Then, we would help them find and hire their investment managers to monitor their performance. That's what an institutional investor in this category is all about. They diversify across asset classes and diversify across investment managers. Totally this group holds about $13 trillion of assets; pretty huge pool of money. They could buy off the government debt. Pension funds make up of $11 trillion of that total. And the pension fund capital is the largest single pool of investable capital in the world.

With respect to real estate, private investment funds spread their capital across three different categories of strategies: Core, Value Added, and Opportunistic. Core investing is buying and investing in operating properties. Value-added is looking at properties that need some kind of refurbishing and redevelopment or repositioning. It's a higher risk and therefore higher expected return. And finally, last but not least, it the opportunistic strategy which takes on the development risks at the beginning of a cycle or looks to buy distressed real estate at the end of a cycle.

Pension funds are the biggest pool of investable capital in the world. In 1970, zero dollars were invested in real estate. So, stop and think about that. Real estate is the oldest form of investment known to mankind. There was a time a human being's wealth was measured by how many acres they owned or how many animals they owned. Here was the biggest pool of capital and they were not participating in the largest capital market in the world. Today, they have $500 billion, maybe $550 billion, invested in real estate equity.

So between the REITs and the pension funds and their partners of endowment funds and charitable foundations, they have put in about a trillion dollars' worth of equity in the real estate markets in the past 40 years. That is an incredible amount. It has had a significant amount of impact on the marketplace.

For one, institutional investors have legitimized real state as an investment asset class. Number two, it requires professional management, and thereby enhancing real estate industry related professionalism to which Portland State University and its education and research programs are making a big contribution. Thirdly, it forced and promulgated transparency; something that the real estate industry abhorred in the early days. Operators preferred to keep their data to themselves. However, if institutional capital was to come into the market, and the industry wanted capital, then, the operators would have to make the information more available. Fourthly, it requires measurement. Institutional investors, pension funds, endowments, and charitable foundations must report the returns on their assets on a quarterly basis to their underlying constituents and/or their trustees and beneficiaries, a the case may be.

Institutional investors changed the perception of real estate investment. When they first looked at real estate, they saw it as a deal driven, fee motivated, tax oriented, over-leveraged, over promoted sector of the economy that was too risky and too entrepreneurial that they couldn't get a quantitative handle on the market place.

Once institutional investors entered and recognized at what benefits that real estate might offer them, they began to realize that it was number one, a portfolio diversifier. It is required that they spread their capital across assets in such a way to spread risk. Also, real estate could be seen as a very good inflation hedge. At the time, when they just entered the market inflation was a big concern to portfolio investors. Thirdly, when you looked at an operating property without leverage, it produced a pretty good stream of income. It competed well with the dividend side of preferred stocks and competed well with the bond market. Real estate investment offered something the bond market didn't and that was the potential of capital growth because in many ways, a piece of commercial real estate is a portfolio of leases wrapped up in a bundle of commodities. The commodities, steel, brick and mortar, have prices that rise in periods of inflation. So, in a relatively short time, real estate became accepted as an asset class with the institutional investors, right alongside equities, fixed income and money market securities.

With capital flowing in from institutional investors, the industry was enhanced in professionalism. We saw a new industry evolve called real estate investment management or real estate portfolio management. This was an entity or business that offered to institutional investors:

- Research driven investment strategies
- Asset management and portfolio management
- Leasing, market value accounting, investment reporting
- Valuation, performance measurement
- Portfolio monitoring
- Periodic buy/sell/hold analysis.

They are really and truly investment operators versus deal makers, promoters or developers. Not making fun or degrading any of those professions. This just simply added another professional level to the industry that did not exist before. Today there are more than 300 real estate investment portfolio management organizations in the country; many are, I'm sure, familiar to some of you in the audience. The original sponsorship came out of the insurance industry, commercial banks, Wall Street, registered investment advisors, and developers are even in the business. As strange as it may sound sometimes, some of the biggest real estate developers offer real estate management services to the institutional investor. There are real estate brokerages that are engaged in the business and even some of the pubic REITs offer private real estate management to institutional investors. The total assets that are under professional managers are at $500 billion to $550 billion in equity that was mentioned before. What separates the professional management industry from other segments of the industry is that they are paid on the basis of the assets under management and they get extra compensation for beating benchmarks or indexes, whatever the case may be, as opposed to being compensated for transactions.

Institutional investors also require information on a timely basis and a reliable basis. They want their information to be able to be verified by third-party independent objective evaluators, such as the university systems with their real estate centers around the country. The reason they demand this information is that they are mandated to make intelligent and informed investment decisions. They must monitor and track their results and they like to, on a periodic basis, undertake a buy/sell/hold analysis to ensure they not holding onto the property for any other reasons other than making the optimal return out of the asset class. They want information at every level; property level, investment level, and market level. They want it in every form possible; operating expenses, transaction prices, rental rates, vacancy ratios, absorption rates, construction rates, amount of inventory and more. Otherwise, the capital wouldn't flow and the industry would be short the equity capital it has earned. But it has responded and resulted in more market transparency.

The transparent part of the industry evolved out of organizations forming to respond to the needs of the institutional investors. The first one was NCRIEF to respond to performance measurement. But today there are a number of well-known and recognized private companies that are in the real estate information business, such as CBRE Econometrics, REIS, Costar, Portfolio Property Research, and Moody's. These companies all engage in real estate economic forecasting, looking at markets and submarkets, as well as the national market on a macro basis on supply and demand and inventory, and where the economy's demands for real estate are going to be; a map, if you will, of the future prospects of the marketplace. Real Estate Capital Analytics came out about five years ago and now provides transaction data to the market across the spectrum so you get prices on what real estate is trading for; cap rates and discount rates. Appraisal firms, such as Atlus Real Estate Research Corporation, provide valuation data to the marketplace, which is very important. In private real estate, we must assess the market every quarter and we need information to make the process work. Wall Street engages in public analysis of public companies. They have research analysts that are devoted to the public real estate market.

One piece of the information being made available on a constant basis is the difference between the public and private market placing; the premium or the discount, whatever the case may be. This is valuable information for the marketplace. Most recently, we've had a new entrance into the information business. The British firm Income Property Data provides portfolio information to the industry.

With all this information, academia took notice and began to really start look at real estate as a field of study. The information providers make the data available to the academic world, on a very reasonable, if not free, basis. This enriches the literature of the industry, if you will, and brings in the third party credibility as it tests the data within the laboratories of the academic community to see how valid it is. This has spawned and expanded the interest in academia for further research and educational resources such as Portland State University. Furthermore, we are also seeing real estate degree programs on the rise.

As mentioned before pension funds require performance measurement and they need to have their assets valued on a regular basis for two reasons. One, to keep their constituents and sponsors informed, and secondly, they want to know how they are doing against other asset classes; How is real estate doing against other asset classes? How is *my* real estate doing against other managers? How is *my* portfolio doing against other pension funds? So, it is the constant measuring of performance and comparative analysis to deal with where we stand in the mix and how we may be able to improve our performance is what performance measurement is all about.

National Council of Real Estate Investment Fiduciaries (NCREIF) was founded in 1981 to answer the question of performance in private real estate. This is an industry association made up of real estate investment managers (over 45 big institutional investors), plan sponsors (such as CalPERS, and the General Motors retirement plan), accountants, appraisers, academics and consultants. They all get in a room and decide on how to set the rules for performance measurement; the data that is required and how the calculations will be set.

The NCREIF's mission is to collect data, calculate it, and publish. No statements made. It simply is a data repository, data manager, and publisher of what the data tells us. In 1977, when the NCREIF Property Index (NPI) started, there were 256 properties worth $550 million worth of market value. Critics said that it was hardly a representative cross section of the real estate industry. Today, the number of properties is at 7,181 with a market value of $329.1 billion. During the life of the index, over 9,000 properties have been sold with a market value in excess of $150 billion. There is history in the database of over 17,000 properties with millions of data points that can be researched down to the nth degree. This never would have happened if institutional capital had not come into the marketplace. You may be interested to know the total return in the 35 years of NCREIF history of the income properties in the portfolio index. On an unlevered basis, the return is 8.8 percent, income 7.1 percent, and the capital growth at 1.55 percent. This stacks up, on a long term basis, very competitively with the stock and bond markets.

As a result of institutional investors and diversifying their real estate holdings, we now publish a Timberland Index, a Farmland Index, an Open-End Diversified Core Equity Index (ODCE), an all Open-End Fund Index, and a Transaction Based Index. Furthermore, in working with counterparts in Europe and Asia to link up our respective databases, we hope to create a Global Property Index within a year that can be sorted to determine the impact of return of different countries over different periods of time. This is all a result of the over trillion dollars of institutional capital that has come into the marketplace in the last 40 years.

So, in summary, real estate today is an established investment asset class. Investors can participate in the public market, private market, or both, as many of them do. Investors can look to professional real estate managers, who operate in an environment of highly accountable fiduciary responsibility. There are all kinds of information out there, on both the market level and the investment level, to provide you with what you need to make intelligent decisions. It isn't fully free yet, but it's no longer an arm and a leg and it's not held back, it's available for those that want to use the information.

Last but not least, I thought you'd be interested to know that there are 142 properties in NCREIF index that are located here in the Portland market. So, Portland is clearly on the radar scope of the institutional investment manager and the capital.

Property Type	Number of Properties	Market Value
Apartments	26	$1,437.0 million
Industrial	86	834.1 million
Office	19	810.1 million
Retail	11	1,008.1 million
Total	**142**	**$4,089.3 million**

This breaks down to 26 apartments, 86 industrial properties, 19 office buildings and 11 shopping centers.

That is my story and I am sticking with it. Thank you very much. ■