FINDING DEVELOPMENT CAPITAL THROUGH PRIVATE INVESTORS

An Examination of Real Estate Investment Trusts, Pension Funds, and Syndications

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AN OVERVIEW

Problem Statement and Hypothesis
Research Methodologies
Research Delineations
Research Outcomes

"Buying real estate is not only the best way, the quickest way, and the safest way, but it is the only way to become wealthy."

-- Marshall Field
Project financing is one stage of the development process that often gets overlooked or bypassed by planners and designers. Attention is often focused on other stages of development, including market analysis, site analysis, and site design. Too many times, the assumption with project financing is that the developer would simply go to the bank to solve the problem. While this approach worked well in the previous decades, developers are quickly realizing that banks and other lending institutions will not always be the solution for project financing.

Since 1990, obtaining financing has become one of the greatest challenges facing a developer. Without the necessary financing, a developer cannot transfer his or her ideas into bricks and mortar. The strategy for obtaining financing is simple enough: one has to put together a package that not only will meet the project's financial needs, but will also be attractive enough to lenders and/or investors. These lenders and investors need good investment opportunities, much like the developer needs a source of financing.

Lending institutions such as banks have tightened their practices, leaving developers scratching their heads in search of capital. However, the opportunity still remains available to use private investors as a source of capital. Rather than having one lending institution carry the full burden of a loan, many investors share the burden. This thesis examines three methods of obtaining development capital through private investors: real estate investment trusts (REITs), pension funds, and syndications. While these methods primarily pertain to private development, some of the techniques can be applied to public sector development. This thesis project discusses each method, and explains why developers may need to consider other sources of capital. The ultimate goal of this project is to determine how these techniques compare with traditional financing methods, and to see if these techniques can provide greater benefits to the developer than using a bank for a source of capital.

PROBLEM STATEMENT AND HYPOTHESIS

Problem Statement

This research proposes to examine three alternative methods that developers can utilize for successful land development: REITs, Pension Funds, and Syndications. This examination will include whether these financing
techniques are being used to their fullest capability today, and will investigate the various advantages, disadvantages, and benefits these new techniques can offer to developers in comparison to traditional lending sources.

Hypothesis

REITs, pension funds, and syndications are valuable financing sources that offer many advantages to developers and are currently under-utilized as a financing source. All three techniques can provide greater economic and social benefits to a developer than traditional lending institutions.

RESEARCH DELINEATIONS

The research for this project accomplishes several things. First of all, the use of traditional financing sources (banks and savings and loans) is examined to show why they no longer dominate the real estate financing industry. From there, the background of all three “unconventional” financing sources are examined to determine why these methods became options for developers today. This project is structured to determine if these sources can fill the void left by traditional sources, and if these financing techniques are in fact good substitutes for traditional sources. The dynamics of each financing source is investigated to determine how they apply to different development projects. This study also investigates the various advantages and disadvantages to using these financing sources for development. Furthermore, the future of these financing alternatives is explored and predictions are made about what one can expect in the future regarding these three financing techniques. This study examines why these three financing techniques are not used to their fullest capability today, and offers suggestions on how each can be better utilized. Finally, the paper compares each new financing technique to traditional lending to see if REITs, pension funds, and syndications can offer more benefits to a developer than a lending institution.

What this study has not done is describe in any detail other financing sources developers can utilize (such as insurance companies, credit unions, and mortgage companies). This study focuses strictly on REITs, pension funds, and syndications in comparison with traditional lending sources such as banks and S & Ls. These three financing instruments were selected for a reason. First, these
methods have increased the most in use over the last decade. While no technique has completely filled the void left by conventional financing, these three have come the closest. Second, many believe that these three techniques offer the most potential to developers as a source of capital. For these reasons, the research has been restricted only to those three methods. This study compares the three financing methods to traditional lending sources, but does not compare them to each other. The paper also does not distinguish between different types of development projects. The focus is on the financing method, rather than the project itself, and no distinctions are made between residential, commercial, office, or industrial development projects, as the financing methods can apply to all of them. Finally, the research does not examine the distinction between development financing (obtaining and improving the land) and construction financing (building the project). The techniques apply to both, and the difference between the two is not investigated.

**RESEARCH METHODOLOGIES**

The methodologies used for this research include a four-step process. These steps include: literature review, obtaining published statistics, interviews with professional developers, and performing an economic analysis.

**Literature Review**

One of the primary methods for obtaining information has been through literature review. A variety of articles from books, journals, magazines, and newspapers has supplied background information on each financing technique. Furthermore, information has been obtained regarding traditional financing sources and the problems they face today. The literature review provided a good historical analysis regarding various financing sources, and supplied qualitative data by illustrating professional viewpoints regarding the successes and failures of each financing mechanism.

**Published statistical data**

Statistics from the Federal Reserve Bulletin and from other published documents were used to show that traditional financing sources are becoming
less dominant in providing capital for development, and that REITs, pension funds, and syndications are all improving. Statistics supplied quantitative data that illustrate trends throughout time (for example, the percentage of projects financed through syndications each year between 1985 and 1993). Quantitative data from the Federal Reserve Bulletin has shown to what degree developers utilized each financing technique for that particular year.

Interviews with professional developers

Professional developers from the Indianapolis region were studied to support the hypothesis about the three financing sources (see Appendix for a complete listing of developers used). A telephone interview was performed with ten developers to obtain the information shown in Figure 1.1. The researcher used these questions to discover if in fact professionals are using these three techniques. The phone interviews demonstrated whether or not local professionals use these methods, and determined why they are or are not using them. Furthermore, the phone survey illustrated whether or not the developer’s methods of obtaining

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**FIGURE 1.1**

**Information Gathered From Developers Through Phone Interviews**

1 - In financing existing projects today through your firm, what percentage of total capital is derived from REITs? From pension funds? From syndications? What percentage of total capital is obtained through traditional lending sources, such as banks?

2 - Have these percentages changed over time? Are you relying more heavily on banks today, or are you resorting to more “creative” financing methods?

3 - If in fact there has been a change, why did this happen? Was capital harder to attain through banks? Were syndications, REITs, or pension funds easier to put together?

4 - In your opinion, are there more advantages to these new financing techniques over traditional financing sources? Do you think developers will be using them more in the future?
capital changed over time, as well as explored why this change occurred. In some cases these professionals also discussed the advantages these financing methods offer, if they were in fact using them.

The questions were asked in an open-ended conversation. The researcher made efforts to be certain that the developers answered the questions as thoroughly as possible. Usually by telling them about the project, I was able simply to bring up certain subjects and let them do the talking. The developers answered all questions, and if they veered off track, I directed them back towards the topic. Since these techniques are “hot” today, many developers had much to say about them and in several instances talked for some time.

While the headquarters of these developers are in Indianapolis, the projects they were referring to in their answers are regional in nature. Most of these developers operate large firms that have projects in multiple states outside of Indiana. While information was only obtained from Indianapolis developers, it is believed that their responses are representative throughout the region and most of the country.

In addition to the phone interviews, the research also included personal interviews with several developers to discuss in more detail the advantages of each of the techniques. Over the phone I determined if the professional experts were interested in helping me, and if they possessed additional information that could be beneficial. A minimum of three personal interviews was expected to be performed to obtain more detailed information. However, most of the information needed was obtained over the phone. In one instance, an individual truly possessed additional knowledge where a personal interview was beneficial. Dean Donnelly, an attorney specializing in real estate with the firm Gene B. Glick Inc. met with me and spoke for over an hour. He was the only expert who provided me with more detailed examples of advantages and disadvantages to each financing technique.

The information received over the phone is more quantitative and statistical in nature. The personal face-to-face meeting provided more qualitative data.

**Economic analysis**

Ultimately, a rough economic analysis was constructed that compares each technique to traditional lending sources. A benefit/cost analysis was intended to be completed, yet the nature of the different financing sources provides many variables and a complete benefit/cost analysis that compares each source could
not be properly completed and supported. However, the economic analysis does provide some insight to different costs associated with each capital source, and does provide a basis for preliminary comparative analysis. The analysis provides only a “rough picture” as some of the financing complexities have been simplified for clarity.

To summarize, I utilized two techniques in obtaining data: surveying and field research. A combination of approaches was used in processing the data. The methodological approaches used include a historical method (studying past performances to help determine the trends); a descriptive method (describing the actual numbers, what percentage of capital comes from what source, what advantages each financing method has, etc...); and finally an analytical method (using the quantitative data from the Federal Reserve Bulletin and from the interviews to analyze the trends in financing).

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**RESEARCH OUTCOMES**

This thesis document represents eight months of research and analysis into alternative methods of financing development. This project is intended to illustrate to planners and developers different sources of capital available for development, and to show professionals that these sources offer some benefits that traditional lending institutions cannot provide. Furthermore, this project demonstrates that planners and developers may not need to be so reliant on lending institutions as they were in the past, as these new vehicles for capital may help developers achieve their goals.

The intended readers of this document are those individuals who are interested in learning more about the process of financing development and by those who wish to explore sources of capital beyond traditional financing through lending institutions. This document will also assist individuals who may be interested in investing in real estate, as the research focuses on using private investors as a source of development capital. This thesis examines development from both points of view: the developer who is in need of capital, and the investor, who may be able to help the developer while earning a profit for himself/herself.

Chapters 2 and 3 of this thesis examine the background of financing development leading up to today. Chapter 2 focuses on development in the
CHAPTER 1

1980s and how and why banks became so popular with developers. Chapter 3 discusses financing today, and why lending institutions that were once so popular with developers are no longer offering "sweet" deals. Chapter 3 also illustrates the current problem developers are facing in obtaining financing for their projects.

Chapters 4, 5, and 6 explain three alternative methods of receiving capital for development. Chapter 4 discusses the history and background of real estate investment trusts (REITs) and shows how developers can use REITs to finance development. Chapter 5 outlines the use of pension funds as a financing tool for real estate development and gives examples about how existing pension funds can offer deals for developers. Chapter 6 discusses the use of syndications or partnerships as a source of capital. This chapter also provides syndication examples to show the syndicate process.

Chapter 7 shows comparisons among each of the above mentioned financing tools with traditional sources such as banks. Chapter 7 illustrates the advantages and disadvantages of each technique and shows why developers may choose these methods over banks. Case studies from the Indianapolis region demonstrate how these techniques apply to local developers and show what impact these financing methods have had on professional development companies. This chapter also provides a rough economic analysis that compares some of the costs associated with each of the sources of capital.

Chapter 8 provides conclusions based on the previous chapters. This chapter also offers suggestions about how these financing techniques can be better utilized today and explores some of the new possibilities in the future regarding these financing sources. Due to the unfamiliar terminology used in this study, a technical glossary is included at the end of this document for the reader's reference. This document essentially examines the use of three alternatives that developers can utilize as a source of capital. Comparisons are made with traditional lending institutions to examine the similarities, differences, and possible benefits each source of capital can offer.
FINANCING DEVELOPMENT IN THE PAST

The Changes During the 1980s
Dominance of Lending Institutions
Savings and Loan Crisis

"So how does a developer find the money to finance a project he envisions? It is not easy, and for the last few years obtaining financing for a real estate project has become the most difficult job a developer must be able to solve."

-- Dean Donnelson
Vice-President of Real Estate Asset Management
Gene B. Glick Company
December 1994
Developers must deal with two primary financial requirements: debt capital and equity capital. Debt capital is money that a developer borrows at a fixed rate of return for a set number of years. The suppliers of debt capital have first claim on any income from operations, or from any proceeds in the case of bankruptcy. Equity capital is then the difference between the borrowed debt and the total project cost, and is the investment needed for a development to occur.

A number of different sources supply debt capital, including REITs, pension funds, and syndications, all of which will be discussed in greater detail in later chapters. The chief suppliers of debt capital traditionally are lending institutions such as savings and loan institutions, commercial banks, and savings banks. Savings and loan associations, or S & Ls, are typically thought of as a primary source of residential real estate loans. Federal regulation requires S & Ls to hold at least 80 percent of their assets in residential loans (Harwood and Jacobus 266). Savings banks originated for the same purpose of S & Ls, but have a more conservative attitude about real estate lending. As a result, savings banks invest slightly less of their assets in real estate than S & Ls. Commercial banks started lending money for real estate in 1913. The proportion of real estate loans in a bank’s portfolio varies greatly based on economic conditions and bank policy. Commercial banks will not only supply long-term financing, but are the greatest suppliers of interim financing, commonly referred to as construction loans, during development. These loans will usually require a take-out commitment by a reputable long-term lending institution to assume the loan after completion of construction.

Equity capital sources are more complex and diverse. Generally equity capital depends on investors, which may include earnings from a developer’s other projects or corporations. REITs, pension funds, and syndications are all forms which utilize investors in supplying equity capital. However, these sources are also suppliers of debt capital (the largest bulk of money developers need).

This chapter will detail how developers financed projects in the past, with emphasis on the development peak that occurred in the mid-1980s. Developers typically financed projects with the various lending institutions mentioned beforehand. However, many unique changes began occurring that would alter the world of real estate financing forever.
THE CHANGES DURING THE 1980s

Developers traditionally never had an easy time obtaining project financing, but the transformation in the market that has occurred in the last ten years has added to the complexity. James Noteware, principal of Laventhol & Horwath Real Estate Advisory, notes that three key changes occurred in the mid-1980s that affected real estate financing. These changes are as follows: 1) high inflation in the early 1980s that led to disinflation; 2) de-institutionalization of real estate; and 3) changes in tax the tax laws and benefits (Noteware 78).

In response to high inflation during the early 1980s, lending institutions increased their real rate of interest to receive higher returns. As a result of this shift, the real cost of capital to developers increased, along with a "corresponding increase in the uncertainty of financing" (NAHB 100). However, by 1985 inflation decreased substantially and interest rates finally started to decline. Developers jumped at the lower interest rates, and a period of intense development began. A lower inflationary rate brought back debt financing, something that had disappeared during times of higher inflation.

Commercial banks and S & Ls traditionally provided financing for real estate. During the 1980s, the country's financial institution structure became deregulated, which led to a rise in syndications and Wall Street investments. Therefore, one might say that intermediaries of all types replaced institutions as the makers of real estate financing decisions, since decision makers began to invest other people's money. This "de-institutionalized" trend meant that the door was now open for investment vehicles to provide capital for development.

The Tax Reform Act of 1986 removed many of the special tax advantages associated with investing in real estate. Real estate became simply another form of investment, similar to other popular investment vehicles. As a result, investors in real estate began seeking higher returns on their investment rather than looking for tax breaks (NAHB 102).

Noteware further explains that the combined effect of these three factors was two-fold: they opened up sources of financing by creating new vehicles to channel capital into real estate, and they widened the search for the most efficient structures going into those deals (Noteware 79).

It is interesting to notice that Noteware's article was published in 1985. Experts realized in the mid-1980s that new possibilities were emerging for capital sources. However, Noteware's predictions do not actually come into play for
another five years. Noteware predicted the increased use of REITs, pension funds, and syndications as a source of capital for developers. While each of these techniques gradually increased the amounts of capital raised, as shown in Figure 2.1, none had a substantial impact on the real estate market. By 1989, REITs, pension funds, and syndications still accounted for less than five percent of the total capital for development projects. The primary reason for this was the dominance of lending institutions holding capital, which is discussed in the next section.

**FIGURE 2.1**

Annual Real Estate Equity Capital Flows: 1971-1990

*Note: 1989 and 1990 figures are projections

Source: McMahon, Property Development, 1989

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**THE DOMINANCE OF LENDING INSTITUTIONS**

Based on the changes that occurred within the marketplace, land development and construction reached an all-time peak during the 1980s. Construction starts reached a new high by 1985, and lending institutions such as
banks and savings and loans were bending over backwards to make deals with developers. Once inflation decreased by the mid-1980s and the cost of borrowing money became cheaper, builders and developers flocked to lending institutions in an effort to build. Real estate began to make a strong comeback and banks and savings and loan institutions were anxious to make land deals, as they realized the potential for profit. A period of intense development was beginning.

One of the key catalysts that produced the incentive to build was the Economic Recovery Act of 1981. This act, which helped the real estate industry out of its early recession, created generous depreciation allowances for commercial real estate and provided incentive to turn real estate into a tax shelter. These tax benefits persisted until 1986, when the Tax Reform Act of that year eliminated most of the tax benefits of real estate, but by that point, most of the construction boom had begun.

Many experts point to two key "L" words when describing the real estate boom of the 1980s: liquidity (massive amounts of money in the financial system) and leverage (high levels of debt) (Dentzer 64). Once the economy recovered from its poor economic state during the early 1980s, the nation's money supply grew dramatically, creating billions of new dollars searching for the best returns. Most of this money flowed into real estate. And debt became "fashionable" again in a lower inflationary and lower interest rate environment for both the borrower and the lender. By using leverage, a small amount of cash can control a large asset.

Lending institutions needed the real estate boom nearly as much as the developers did. Prior to the construction boom, banks had been losing business from poor loans made to developing countries, the oil bust, a farm recession, and overleveraged corporate buyouts (Sheets 38). Furthermore, many depositors were turning elsewhere to raise their own funds. Thus, with the boom in the real estate business, lending institutions jumped at the chance for new deals. Kenneth Sheets in US News & World Report states, "Real estate became a major outlet for lendable funds, because banks could charge developers relatively higher rates than they could other borrowers. It also looked like a quick way to shore up sagging earnings" (Sheets 39).

Real estate became one of the fastest growing loan categories for banks and other lending institutions. Real estate lending increased 27 percent in 1987 alone, and then another 18 percent in 1988. These increases were twice the rate of increase of total bank loans (Meehan 64). Real estate lending by commercial
banks tripled during the decade of the 1980s, from $268 billion to over $750 billion. Real estate loans accounted for nearly 37 percent of total bank assets by the end of the 1980s (Dentzer 64).

Lending practices began to change dramatically as well. Construction loans in the past had been typically only made to stable developers and were never more than 75 percent of the project's value. Lenders did not want to risk waiting 20 or 30 years to be repaid and often required take-out commitments to be considered for a construction loan. Banks would lend money for construction to be repaid in a short time period (typically within three years), then would look for another lending institution to "take out" the loan to obtain permanent financing. Prior to the mid-1980s, it was extremely rare for lending institutions to be involved with long-term project financing. As the 1980s progressed, lending institutions required less equity from developers, typically lending 85 to 90 percent of the project's value, and in some cases even 100 percent of the value, meaning the developer would not need any equity for a residential or construction loan. Lending institutions also began investing in long-term projects, providing both the construction loan and the permanent loan. With the deals lending institutions were offering, conventional financing sources such as banks and savings and loan industries accounted for 94 percent of all land loans by 1986, and 86 percent of all construction loans during that same time period (NAHB 101).

THE SAVINGS AND LOAN CRISIS

While most experts continually discuss commercial banks and savings banks as the source of capital for developers, savings and loan institutions were also extremely big lenders of capital. The government regulated S & Ls to invest more of their money in residential real estate than banks, and consequently they became extremely popular with developers. However, as previously mentioned, the country experienced a time of general deregulation in financial institutions. In 1980, the Depository Institutions Deregulation and Monetary Control Act became law, which eliminated most of the S & L's incentives to make development loans, and made other lending institutions more competitive.

Another important event that affected savings and loan institutions was the removal of Regulation Q in 1975. Regulation Q had placed a cap, or a
ceiling, on the interest rates that S & Ls could pay depositors. Once Congress removed Regulation Q, they opened the floodgates, as S & Ls now had to pay investors much higher interest rates to keep their business.

When interest rates were high, S & Ls found they needed to raise the interest rates they paid to depositors, or these depositors would take their money elsewhere. However, at the same time, S & Ls were holding long-term fixed rate loans with lower interest rates. So the rates they were paying depositors became much higher than the rates they had charged lenders. Disintermediation is the process by which depositors take money out of their savings accounts and invest in other means such as government securities, corporate bonds, or money markets.

The Depository Institutions Deregulation and Monetary Control Act loosened restrictions on investments that savings institutions can make. S & Ls began to lose large amounts of money, and thus began to make higher risk loans on undeveloped land in an attempt to recapture their share in the market. The new law meant that S & Ls could use depositor's money to enter business ventures with greater risk, rather than sticking with low-risk residential loans that they had typically been involved with in the past. Bad lending practices coupled with deregulation and disintermediation resulted in the much publicized "savings and loan crisis" during the late 1980s (Harwood and Jacobus 270).

Savings and loan institutions became saddled with at least $130 billion of problem real estate loans and foreclosures (Dentzer 62). This only marked the beginning of what would become a long downward spiral for lending institutions and real estate. The next chapter discusses the trouble that occurred in the 1990s and still plague many lending institutions and developers today.
FINANCING DEVELOPMENT IN THE 1990s AND TODAY

The Capital Crunch
Government Regulations
Banks as Lenders Today
The Search for New Capital

"Theodore Roosevelt argued that real estate is the surest route to wealth, but he was only half right. It may indeed be the surest route to wealth -- except when the nation is in a real estate depression."

-- Susan Dentzer
U.S. News and World Report
November 12, 1990
The real estate industry faced a major crisis as it entered the 1990s. The free spending 1980s came to a sharp close, and when the dust settled banks and other lending institutions were saddled with huge losses. Developers who had always relied on lending institutions were now faced with a major crisis. Consider that in 1988, S & Ls accounted for 40 percent of the capital for development, with banks covering most of the remainder. With S & Ls losing creditability due to heavy government regulations, California alone felt a $10 billion capital shortfall (Stephens, 1992, 4). Unfortunately for builders and developers, no one stepped in to replace those sources of capital.

The real estate boom of the 1980s led to overdevelopment. The decade of the 1980s began with only a five percent vacancy rate in office space. By 1990, the national vacancy rate for office space reached 20 percent (Dentzer 64). The key problem is that unlike real estate recessions in the past that were caused by reduced demand, this one stemmed almost entirely from an excess in supply. Some cities predicted that builders needed to construct no additional office space for another twenty years.

It became painfully obvious that developers could no longer rely on the lending institutions that were so good to them during the 1980s. With conventional financing sources no longer as readily available, a desperate need for new sources of capital existed. Gerry Donohue, consultant for Builder magazine, concluded, "Builders and developers have had to turn to new sources of financing because conventional sources have all but dried up" (Donohue, 1990, 325). This chapter outlines the troubles both lending institutions and developers are facing.

THE CAPITAL CRUNCH

Lending institutions found that they needed to tighten their lending practices -- unfortunately at the expense of the developer. Figure 3.1 shows how badly banks hurt developers. At one time, development and construction loans accounted for nearly 20 percent of banks' total loans. This percentage gradually decreased, to a point where less than one percent of a banks' total loans went towards development or construction. Fifteen percent of commercial bank's total capital or net worth was invested in problem real estate loans by 1990 totalling nearly $130 billion worth of nonperforming real estate loans (Dentzer 62). A
devastating chain reaction began taking place: lending windows were literally slammed shut and banks were calling in loans, thus dragging down developers. Experts realized that the real estate crunch was "destined to join the S & L crisis as one of the grimmest legacies of the debt-crazed 1980s" (Dentzer 62). The excess of capital in the 1980s undoubtedly led to a shortage of capital in the 1990s.

People could definitely see a domino effect: The real estate boom in the 1980s led to overdevelopment, which led to higher vacancy rates, which led to falling rents, which precipitated problem loans, which resulted in bank losses, which triggered tighter banking standards.

In 1991, the Federal Reserve Board conducted a survey of 60 U.S. banks and found that over three-quarters of them were using tougher underwriting standards on applications for construction and development financing. The majority of banks also stated that they were reluctant to lend money for any new commercial development (McKelvy 28). In another survey, over two-thirds of banks stated that finding financing would be their toughest task in the next few years (Cleland 12).
CHAPTER 3

As for other sources of capital for developers, savings and loans practically disappeared, particularly for commercial real estate. One real estate advisor noted, "I can safely predict that you will never see S & Ls have funds for commercial real estate again" (McKelvy 28). William Crombie, vice-president of finance for Pulte Homes Corporation, says, "There is a huge reaction to the S & L problems and the real estate problems associated with that. A lot of banks, even though there may be some good business in real estate, are not doing loans. Financial institutions have got so many nonperforming real estate loans in real estate that nobody wants to take real estate transactions to a loan committee" (Stephens, 1992, 6).

Despite any need for new development, lending institutions sent a message that they would not distinguish between a good real estate investment and a bad real estate investment. Banks considered all real estate to be a bad investment. Bruce Bulloch, a partner with Ernst and Young in Baltimore, said, "Banks have had a bad taste in their mouth about real estate loans . . . In the next three to five years we will not see financial institutions distinguishing between risky development projects and safer land development deals" (Stephens, 1992, 6).

GOVERNMENT REGULATIONS

Most of a commercial property's value comes from the income earned from leasing space. A typical rule of thumb is that when a new building is less than 85 percent leased, it probably is not earning enough to cover the developer's loans (Dentzer 65).

When bank regulators intervened in 1990, they forced banks to write down the value of loans. However, they created new capital ratios and requirements for the next year. The government sets capital ratios as a percentage of a bank's total assets that must be held as required reserves. These ratios were typically at six percent during the 1980s, but when the crisis struck, regulators increased the ratios to a two-tiered system that equalled about ten to twelve percent of the bank's total assets. By 1990, banks with substandard capital ratios managed one-third of the assets in the nation's banking system (Brumbaugh and Litan 4). This statistic is important because capital ratios protect the insurer by requiring bank shareholders to be the first to suffer losses. High capital ratios will deter risk-taking.
Many major banks began cutting dividends and setting aside huge reserves to cover massive loan losses. As real estate loan losses consumed capital, banks made fewer loans to meet the new capital ratios. At a time when borrowers were starting to feel the "crunch," banks called in loans from some of their best customers, including developers.

Those banks that were lending money tightened up their standards. Higher interest rates, additional fees, larger credit information, more equity, and longer processing times became commonplace. The days of lending 90 to 100 percent of the project's value were over. Some banks fund only 70 percent of the property's cost, assuming they make the loan in the first place (McKelvy 30). Banks also started requiring developers to show lease agreements before they would make any loan, something unheard of during the 1980s.

The changes in regulation forced banks to tighten their lending practices. Large banks virtually stopped making real estate loans, especially for speculative projects that lacked leasing commitments. The increase in bad real estate loans made bankers wary not only about construction and development loans, but about all lending.

The federal government formed the Resolution Trust Corporation in 1989 to help with the financial crisis, particularly with the savings and loan industry, and to seize foreclosed properties totaling about $150 billion in value. However the stricter capital requirements and the overall problems of lending institutions prompted many investors to balk at the RTC properties, which forced government to loosen financing standards for RTC properties. Today, many consider the RTC to be in a difficult situation, one that will take years to fully evolve.

BANKS AS LENDERS TODAY

By 1992, three out of four executives believed that it would take the real estate industry three to five years to recover (Cleland 12). Even today, banks are facing many challenges: tighter capital ratios, relaxing bankruptcy laws, costly new regulations, growing liability for bank officers, and congressional delays over banking reform.

Despite the growing doom in the banking industry, lending institutions still account for a large amount of capital in the development process. Well
known developers who have had good reputations in the past are able to manage deals with local banks. Of ten professional developers studied for this project, six rely on lending institutions for their chief source of capital. In a survey of the nation's top 100 home builders of 1992, three quarters stated they rely chiefly on lending institutions as a source of capital (Donohue 171).

In 1986, when development reached its peak, lending institutions accounted for about 90 percent of the capital in development projects. Today, banks and savings and loans account for over two-thirds of the capital for development. While lending institutions certainly do not dominate as they did during the boom of the 1980s, they still account for a large amount of capital. The change is better understood through the lending practices of the banks discussed earlier. Banks began lending much less, and were no longer lending 100 percent of the project's cost. Therefore, one would expect the total funds going towards development to be lower. Essentially one can realize that banks provide much less debt capital than they used to, forcing the developer to come up with more equity.

Banks have on some occasions worked with developers and devised structures that allow for the borrowing of more money. Examples of new banking tools include mezzanine financing and off-balance sheet financing. Some experts have predicted that banks need to restructure themselves if they want to remain competitive, or their depositors and investors will not give them a second chance. Since real estate lending has provided a source of growth and future earnings to banks, bankers should look at the decision making and information managing processes more clearly (Brady 35).

Shaun Brady, the vice-president for the Marine Midland Realty Credit Corporation believes that there is enough competition from other sources of capital to make the banking system collapse. He states, "To remain competitive with other sources of capital, banks need to reduce their bureaucracies and become more flexible, offer competitive rates and terms, and become a more stable source of funds" (Brady 36). Brady firmly believes that the banking system needs major restructring for survival, and the future of banks in real estate lending lies in looking closely and learning from mistakes of the past. He states that banks desperately need to focus on information management technologies to improve their underwriting and administrative systems (Brady 38).

Many experts agree that the banking industry took a hard hit during the capital crunch of the early 1990s. Despite new loan structures and the increased
flexibility and stability banks are offering, it is questionable whether lending institutions will ever dominate the capital market like they did one decade ago.

THE SEARCH FOR NEW CAPITAL

Despite the negative outlook towards real estate these days, some experts offer positive advice about the future. Arthur Fefferman, the president of AFC Realty, authored several articles in which he listed his "rules" to achieving successful financing in real estate projects. One of the most important rules he emphasizes is to look beyond the traditional sources of financing. He notes, "Some of the old players have dropped out -- most obviously, the commercial banks, [and] S & Ls . . . But now there are new players providing money, whether debt or equity capital" (Fefferman 118).

Fefferman goes on to note several sources of financing, including syndications, pension funds, and real estate investment trusts (or REITs), that developers can use for debt and/or equity capital. Gerry Donohue, consultant for Builder magazine, published a list entitled "13 Ways To Finance Land Acquisition" in 1989. Among the list of thirteen ways are REITs, pension funds, and land partnerships or syndications (Donohue 212).

While traditional financing sources still remain the chief suppliers of capital for real estate, their lending practices have become much stricter, causing developers to look elsewhere for sources of capital. Developers found that turning to private investors for capital has been extremely rewarding. REITs, pension funds, and syndications all gained recent popularity as a new source of capital. Figure 3.2 on the following page illustrates the increased use of these techniques as a source of capital for developers. It should be realized that all three financing strategies rely on private investors, thus the burden of the loan falls on many people rather than one lending institution.

The next three chapters discuss these three new financing instruments in greater detail. Each chapter highlights how these techniques work and why developers use them today. Furthermore, the risks for each method are described, and several examples of REITs, pension funds, and syndications are offered to show a greater understanding about these new sources of capital.
Breakdown of Developers' Source of Capital

**1986**

- Other sources (7%)
- REITs, Pension Funds, and Syndications (3%)
- Banks and Savings and Loans (90%*)

*Actual numbers: 86% for construction loans
94% for land loans

**1994**

- Other sources (14%)
- REITs, Pension Funds, and Syndications (17%)
- Banks and Savings and Loans (69%)

Sources: National Association of Home Builders, 1987
Federal Reserve Bulletin, 1994
Margin of Error = +/- 3.5%
REAL ESTATE INVESTMENT TRUSTS (REITs)

History of REITs
How REITs Work
Why Use REITs
REIT Examples

"The REIT is probably the only segment that I know of where new capital is being raised for real estate."

-- Arthur Von Thaden
President, BRE Properties Inc.
National Real Estate Investor
October 1992
Banks and other lending institutions are the traditional way to acquire money for financing real estate. However, the new trend is to sell stock to the public through a real estate investment trust. REITs simply put are publicly traded real estate companies, or corporations and trusts that combine the capital of investors to acquire, provide financing for, or in some cases build new real estate for income producing properties. The REIT emphasizes the biggest change occurring in real estate today. Once thought of as a local industry, real estate quickly has become a national industry that involves Wall Street and the public securities market.

The previous chapter illustrated the primary reason for the increased popularity of REITs. Conventional financing sources declined in availability. Developers burned banks when they could not repay them, causing many lending institutions to shy away from real estate.

Jack Rodman, director of one of the nation’s top real estate consulting firms Kenneth Leventhol & Co., states that REITs are "among the handful of new financing vehicles poised to pump money into homebuilding [as well as to] help finance other property types as demand increases" (Kleege, 1991, 13). Furthermore, William Hauser, research associate for the Urban Land Institute and consultant for real estate finance issues, states, "The real estate investment trust (REIT) has been the most talked about rescue vehicle for cash-starved property owners and developers" (Hauser 27).

At a time when traditional financing sources have dried up, the capital raising potential of REITs is very compelling. But the costs of organizing a REIT prohibit most small and midsize companies. A cost-effective REIT needs to be in the $100 million range. And cost is not the only hurdle to overcome. A developer must have "good real estate," meaning their properties must be able to generate the cash flow to provide REIT shareholders with the yields they want (Sumichrast 2). Forming a REIT presents challenges and opportunities that will allow greater access to capital for developers. "There is potential for the REIT market to double, or even triple, by the end of the decade," notes Chris Lucas, research director for the National Association of Real Estate Investment Trusts (Sumichrast 1).

This chapter examines one of the most talked about phenomenons in the real estate finance industry -- REITs. This chapter explains the history of the REIT, examines the process by which REITs can raise money for developers, and shows how a REIT can benefit both a developer and investor. Finally, this chapter presents and analyzes several REIT examples.
HISTORY OF REITS

Congress created REITs in 1960 as a way to encourage small investors to invest in real estate, but they remained a minor player in the field for about ten years. REITs did not become extremely popular with investors and developers until the early 1970s. REITs skyrocketed in use, but soon collapsed from the market because developers did not utilize sound lending practices. Experts claim the problem was that they were simply "abused" by developers. REITs may take the form of two structures: a blind pool, or a specified pool. In a specified pool, developers target and advertise certain properties so that a potential investor would know exactly what his or her money is going towards. A blind pool, on the other hand, does not have specified properties, and an investor allows the company to invest his or her money towards the best projects. Developers used blind pools for more speculative development, and in the 1970s most of the REITs fell into this category.

Other experts believe REITs collapsed in the 1970s due to professionals sponsoring them for their tax advantages rather than for their potential to generate appropriate cash flow. Robert Hester, partner of Arthur Anderson & Company (one of the "big six" accounting firms in the nation), states, "REITs today are much more sophisticated. You have players who are true real estate people managing the properties" (Hansen 29). He further notes that REITs are becoming larger and more specialized.

Several factors attribute to the recent upsurge of REITs. First, investors realize that a real estate recovery is underway. Second, REITs offer opportunities to participate in the ownership of income-producing properties without the drawbacks of partnerships. Third, REITs today are quite different from the highly unleveraged, risky blind pool trusts of the 1970s (Berquist et al 29).

Generally, well managed properties with stable cash flows and growth potential are the best candidates for REITs. The prefered property types for REITs are those with specific market niches, such as commercial properties and multi-family projects. Office complexes and industrial properties currently have the least interest.

The year 1993 was the biggest year for REITs. REITs generated over six billion dollars of capital in 1993, and companies formed 93 new REITs in that year. Figure 4.1 illustrates the pattern of REIT growth over the last ten years. The bar graph shows the value of initial public offerings in billions of dollars.
Notice in 1993 alone, companies offered nearly nine billion dollars in new REITs, more than the total amount of new REITs for the previous seven years.

**HOW REITS WORK**

Several regulations exist for REITs that companies must enforce for tax benefits. A board of directors must direct the corporation or trust. REITs must have fully transferable shares, and must have at least 100 shareholders. A minimum of 75 percent of a REITs assets must be in real estate, including land and improvements, mortgages, shares in other REITs, or property leaseholds. A REIT must derive at least 75 percent of its income from real property rentals or loans. Five or fewer people may hold no more than half of a REITs shares (known as the 5/50 rule). Most importantly, a REIT must distribute 95 percent of its taxable income to its shareholders, excluding capital gains (Winter 249).

Forming a REIT is a lengthy process usually requiring eight months to one year. It involves obtaining an underwriter, lawyers, accountants, and other
professionals. The corporation must file a registration statement with the Securities and Exchange Commission (SEC) that identifies the organization, properties, financial structure, and other important details. Finally, the corporation makes an initial public offering (IPO), establishes a price, and can then sell REIT units.

Experts argue that REITs become very popular when alternative investments have low yields, which may explain their popularity throughout the early 1990s. With low interest rates, investors usually are attracted to anything that gives a higher yield than stocks and bonds. While investors may not consider REITs a good investment now due to rising interest rates, they are still important players in the real estate market.

The structure of a REIT allows only the shareholder to assure income taxes on dividends, rather than the company and the shareholder, thus avoiding double-taxation. REITs are therefore exempt from income taxes, provided they are distributing 95 percent of their income to their shareholders. Therefore, one might say that the only player who does not win with a REIT scenario is the former lender, who typically is not at the top of a developer’s concern list anyway.

Not all companies can establish REITs, as history indicates that the size of the package is in the $250 million range. The costs of initial public offerings typically are about six to ten percent of the capital raised, meaning REITs of less than $100 million are typically not effective. Realize also that with a REIT structure, the entire company is converted into a public investment vehicle. Some developers believe they are "letting go" of their company by creating a REIT, and thus this psychological barrier has prevented many REIT formations.

### WHY USE REITS

In short, REITs are extremely popular with investors for three reasons. First, they provide liquidity or exitability, meaning an investor can sell shares easily and back out of a deal if he or she sees something unappealing or is in need of cash. Investors can thus invest in real estate without being locked in. Second, REITs provide tax benefits for the investor because they are "pass-through" entities, meaning the tax consequences flow through the entity and reside with the partners. Third, REITs have traditionally shown that they can provide a stable return on investment, typically about six to nine percent annually (Winter 248).
Returns to shareholders gradually increased during the late 1980s into the 1990s. The gap between yields from ten-year treasury bonds and REITs decreased as interest rates fell. In 1994, REITs were still a popular choice with investors, as utility stocks and bonds were both down. Syndicated investment columnist Steve Halpern noted in April 1994 that REITs are an option investors might consider. "REITs offer strong yields -- many above six percent -- as well as the chance for appreciation. Indeed, many analysts believe real estate itself is poised to do quite well in the years ahead" (Halpern E7).

REITs have been on an upswing since 1985. The major impetus came with the Tax Reform Act of 1986, which removed the tax shelter aspects for investing in real estate and made syndications less attractive. The REIT countered the negative aspects of the Tax Reform Act, and investors who still sought tax benefits turned to the REIT.

Investors have many choices when they invest in REITs as well. They can be as conservative or as risky as they want. Some REITs are stable income producers, yielding about five or six percent. These are the companies that typically develop suburban shopping centers. Other REITs are growth candidates, offering medium risk with office buildings, industrial parks, and even vacant land. Since nearly all REITs on the market today are specialized, a potential investor knows exactly what type of projects his or her money is going towards, and can take whatever degree of risk they desire.

The high price of debt and equity capital are the primary reasons developers create REITs. REITs have the ability to perform debt financing. Recall that in the 1980s, banks would lend up to 100 percent of the project. Once the capital crunch occurred, banks became only interested in short-term financing, requiring developers to provide more equity. With REITs, debt financing is possible once again. In fact, many companies used proceeds from their REITs to pay off previous debts, usually with double-digit interest rates.

The transformation of a private company into a publicly traded REIT involves many fundamental changes, things that a corporation must consider in the decision-making process. A new REIT faces organizational challenges, as it will undergo closer public scrutiny and it will have to provide formal financial reports. It must also have strong public relations to deal with questions from investors and the media. The newly formed REIT must also prepare to upgrade computer systems and accounting departments to deal with additional information
gathering and management. As a publicly traded company, information also becomes public record (Berquist et al 32).

The big challenge facing REITs is their ability to grow. They are required to distribute nearly all of their income to their shareholders and pay taxes on their capital gains. It becomes very difficult to accumulate enough capital to acquire new properties or develop existing ones (Berquist et al 32). But, REITs can grow many different ways. A REIT can make a secondary offering to raise additional capital for more properties. A REIT may also sell existing properties, or merge with existing REITs. REITs may enhance the value of existing properties by refinancing at lower rates. A REIT also may issue umbrella partnership interests in an UPREIT structure to acquire additional properties. Chapter 8 discusses this UPREIT structure in greater detail.

Many consider REITs synonymous with partnerships or syndications (discussed in greater detail in Chapter 6), but without the high fees and tax forms. Furthermore, they offer the one thing that syndications cannot offer the investor: liquidity. If investors need to, they can sell their shares and be out, something that a partnership does not allow. Figure 4.2 below shows some comparisons of REITs to syndications from the developer's viewpoint.

**FIGURE 4.2**

**Comparison of REITs to Syndications**

**Advantages:**
- Liquidity or exitability for investors
- Simplified reporting
- Avoids negative perception of partnerships by investors
- Attracts new investors
- Congress and the IRS view REITs favorably
- Reduces administrative burden associated with partnerships

**Disadvantages:**
- Organizational, income, and asset tests need to be met to qualify for REIT status
- Failure to qualify as REIT results in large tax liability
- REITs cannot pass losses through to investors

*Source: Sanichrist, Real Estate Perspectives: The Quarterly Report, 1993*
CHAPTER 4

REIT EXAMPLES

The Kimco Corporation, a shopping center development company headquartered in Rosalyn, NY, achieved immediate success when it filed its IPO in 1990 and raised more than $100 million in one year. Milton Cooper, chairman of Kimco, stated, "Our feeling was that a REIT properly structured, was going to be the real estate investment vehicle for the 1990s" (Bergsman 62).

Perhaps the greatest REIT success story is found with the Weingarten Realty Corporation. "Investors feel the real estate market in many parts of the United States has hit bottom and is looking to make a play," says Steve Richter, vice-president of Weingarten Realty. "The REIT vehicle has been enhanced because it is publicly traded; its price is listed every day on a stock exchange. It also means the investment is liquid when most real estate investments are not" (Bergsman 64) Fortune magazine cited Weingarten Realty as a company to watch in 1988, when the company first formed its REIT. Fortune labeled Weingarten as "the best-managed publicly traded land development company in the United States" (Fromson 61). The company managed to increase profits by 31 percent in a one-year time frame, and was able to build and develop when other developers were searching for cash. Weingarten currently has a market value of over $600 million and sells at about $30 per share. It has yielded investors about seven percent.

But experts are quick to point that companies like Weingarten and Kimco are the exception, not the rule, for REIT formations. Both companies had excellent track records with many years of producing dividends. William Newman, chairman of New Plan Realty Trust (the largest publicly traded REIT), is critical of companies looking to form a REIT simply as a way to solve financial problems. He concludes that REITs are successful as an entrance vehicle for developers not "an exit vehicle for a troubled developer" (Bergsman 64).

Two Detroit manufactured housing companies filed initial public offerings for REITs in October of 1993. Both the Chateau Land Development Company and Sundance Enterprises established REITs and were each able to raise over $100 million dollars to acquire properties. Both companies chose to form a REIT because it is a quick way to get cash and escape income taxes on capital gains (Halliday 2).

Edward DeBartolo made national news in late 1993 when he announced that his company was "going public." DeBartolo, owner of both the San Francisco 49ers and the largest shopping center empire in the nation, filed an initial public
offering in September of 1993 for $600 million, the biggest REIT offering ever. The Ohio-based company sought relief from its bank debt accrued from the capital crunch. In 1988, a $480 million loan to Federated Department Stores would later seek bankruptcy. The company immediately used the newly formed REIT to repay previous debts and refinance projects at lower rates (Pinder D1).

The Indianapolis region has two REITs and a third publicly traded company. Duke Realty Investments Inc. and Simon Properties L.P. both have established REITs and appear on the New York Stock Exchange. The Forum Retirement Group Inc. is a publicly traded real estate company on NASDAQ, but does not distribute 95 percent of earnings to shareholders, and does not qualify as a REIT. All three of these companies turned to Wall Street as a source of capital once the credit crunch occurred. All three companies were in the position to form a REIT, as all had the economies of scale needed for publicly traded companies to be successful. Initially, going public worked very well for these firms. Simon Properties L.P. completed the Mall of America in Minneapolis, and has been heavily involved with the Circle Centre Mall in downtown Indianapolis. Both Duke Realty and Forum Retirement Group were doing very well with investors.

Recently, a fourth Indianapolis development company turned to the public as a source of capital. In February 1995, Davis Homes LLC filed an initial public offering to establish a REIT. Davis Homes is a builder of single family homes in Indianapolis that has been operating for ten years. They have established themselves as one of the largest home builders in the region, and are now looking for new capital sources to continue their building tradition. All four of these companies showed that a REIT would help acquire capital when the banks were not lending.

However, in the last six months a new phenomenon began. For the first time in several years, REITs began to take a downswing. Stock prices for both Duke and Forum began to fall, and are still declining today. As interest rates began to rise (after a long period of remaining historically low), investors began to pull their money from REITs and invest elsewhere. Chapter 9 of this study describes this trend in greater detail.
CHAPTER 4
CHAPTER 5

PENSION FUNDS AS A SOURCE OF CAPITAL

History of Pension Funds
How Pension Funds Work
Why Use Pension Funds
Pension Fund Examples

"Planners involved in economic development planning should be aware of the capital available from pension funds for innovative projects . . . like affordable housing"

-- Wim Wiewel
Director of Great Cities Program
University of Illinois at Chicago
Planning magazine
February 1995
CHAPTER 5

Some professionals have argued that pension funds may possibly be the last hope for obtaining new money for development. They represent an enormous pool of assets, over $2.5 trillion. Unfortunately, very little of that money is put into real estate. The amount of pension fund money put into real estate doubled between 1987 and 1990, but that total was still only $94 billion, about four percent of pension funds' total assets (Retkwa 68).

The troubled banking industry has caused many developers to turn to pension funds as alternative for capital. Rosalyn Retkwa in National Real Estate Investor states, "With the savings and loan industry in severe straits and the commercial banks beset with problems, there's an increasing interest in tapping into pension funds as the next great source of capital for real estate" (Retkwa 68).

Many experts agree that pension funds may be the best answer to developers' problems. Paul Saylor, principal for International Property Consultants, states, "Pension funds are the source of capital, and will be more so in the future. The pension funds will really dictate what this real estate marketplace does" (Retkwa 68). Furthermore, Jean Dimeo, consultant for Pension World, notes, "Developers and brokers believe pension funds can be dominant players in the marketplace. Of all investors, pension funds are considered the most reliable source of capital" (Dimeo 6).

Chapter 5 describes the use of pension funds as a source of capital for real estate development. Furthermore, this chapter presents the historical use of pension funds in real estate and the process of using pension funds for capital. The chapter also mentions some advantages to using pension funds and concludes with several pension fund examples.

HISTORY OF PENSION FUNDS

The pension fund world has endured many changes over the last ten years. Throughout the 1970s and most of the 1980s, pension fund investments in real estate have been only through "core properties." That refers to well-located, well-leased office towers in big cities (Retkwa 70). But returns on that segment of the market lowered dramatically by the early 1990s, causing pension fund investors to rethink their strategies.
Many pension funds began to liquidate their real estate investments in the 1990s. The primary reason was due to unanticipated higher volatility and lower return rates. The slumping real estate market of the early 1990s caused many pension funds to seek other forms of investment. The pension fund at Xerox Corporation, for example, reduced their investment in real estate from ten percent to seven percent in 1991.

The poor outlook for real estate combined with high vacancy rates are the chief reasons for the switch in allocation. Pension fund investors believed better opportunities existed in other sectors. The "risk estimate" for real estate that was once only thought of at five to six percent jumped to 12-16 percent (Hemmerick 35). By increasing the risk element for real estate, investors would then need to search for lower risk investments, or investments that produced higher yields.

Therefore, many pension fund investors turned away from real estate during the late 1980s, investing their money towards more profitable stocks and bonds. But stock prices had reached a high point by 1992 and started a slow decline, while property values hit rock bottom. Pension fund advisors saw their investments in stocks decrease, and realized that they could make money in real estate.

Pension fund advisors realized that in order to seek higher returns, they had to take greater risks. Indeed, they began moving away from the typical "trophy properties" and started to invest in other sectors, including apartments and nursing homes. James Noteware of Laventhal and Horwath states, "They [pension funds] are more willing to move forward and invest in the development process itself, so they are taking construction risk" (Retkwa 71).

William Chadwick is the chairman of the Pension Real Estate Association in Hartford Connecticut and also is the president of Public Storage Institutional Realty. His business completed over $1 billion in development deals during the late 1980s and early 1990s. Chadwick notes that pension funds were undergoing a major transition period, one that would dramatically alter the development world. "The more sophisticated developers will be driven to the pension funds because of the funds willingness to negotiate complex structures," he states (Kleege, 1990, 8).

The overall shift in pension fund allocation is characterized by the trend to diversify pension fund investments. Pension funds showed they had a willingness to broaden their interests to include almost anything that made sense, and no type of real estate deal existed that funds would not consider. Experts
believe that real estate can give pension funds good diversification, but high volatility (Hemmerick 35).

All this means that pension fund advisors became more specialized in an effort to gain greater access to funds. Even today, developers have found that a specialty niche in the pension fund market helps to gain greater control of the market, and therefore, provides more capital needed for the developer's specific needs.

During the early 1990s, pension funds made an ambitious goal to double their $100 billion investment in real estate over the next five years. Discussion arose as to whether this increase in capital would interfere with the already sagging domain of banks and other lending institutions. The overall consensus was that the new pension fund activity would bring up real estate prices, and that the role of pension funds in real estate would not threaten the banking industry. Recall from chapter two that banks lent approximately $750 billion for real estate by 1990, thus the $100 billion from pension funds does not significantly interfere.

By 1993, pension fund investment in real estate totalled $185 billion. Typically, funds with over $500 million in assets invested five percent of their portfolios in real estate, while those with under $500 million invested about two percent (Dimeo 6). Despite dramatically increasing the amount of capital put towards real estate, professionals still argue that as much as 12-15 percent of a pension fund's assets could be put towards real estate.

Today, pension fund advisors typically are not investing in blind pool ventures, but are moving towards more direct investments. Direct investing allows the fund to gain greater control over costs, and reduces management fees. However, some of the larger pension funds have starting co-investing programs in which they invest in larger properties along with other pension funds.

**HOW PENSION FUNDS WORK**

A report compiled by the Real Estate Research Corporation in 1990 showed that pension funds could be the primary source for debt and equity financing for real estate during the 1990s (Williams 47). As mentioned beforehand, many pension fund advisors are now looking for diversification, rather than relying on
returns from stocks and bonds, which offers an excellent opportunity for the real estate industry.

In order for a developer to become active with pension funds, he or she must become a pension fund advisor. The appeal of being an advisor is that huge amounts of money come in on a regular basis from plan contributions, and the advisor needs to invest that money. People interested in the advisory business can typically expect to spend at least three years soliciting pension funds before they see their first sign of steady returns on their investments. However, once an advisor establishes the relationship, it usually is long-term.

Currently, over 250 pension funds have assets greater than $1 billion and invest in real estate. In the past, these funds invested in open-ended funds that usually meant large pools of money sponsored by a bank. Today, many funds have shifted towards closed-end funds and more direct investments.

Pension fund income from debt-financed real estate traditionally was never tax exempt with seller financing, which restricted many investments. However, in 1992 a new tax reform package called the Unrelated Business Investment Tax (UBIT) relaxed these restrictions. The UBIT reform effectively broadened the type of real estate investments a pension fund can make.

Another big change that may occur is the change in the 5/50 rule with REITs (see Chapter 4). This rule states that no more than five individuals can own over half of a REIT’s value. One of the primary ways that pension funds have helped the real estate market is by investing in REITs. A pension fund counts as one individual, and the 5/50 rule severely restricts the amount of capital that pension funds can invest in real estate ventures.

Despite increased real estate allocations and possible changes in both REIT and tax laws, many pension funds still remain leery about investing in real estate. Advisors note that it is not easy to invest large amounts of money in good, high-quality real estate, simply because not much is out there.

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**WHY USE PENSION FUNDS**

Perhaps the feature that attracts developers to pension funds the most is the large amount of capital that they generate. Much like REITs, pension funds
control a large amount of assets, and can offer a developer a large amount of money for one project. As mentioned at the beginning of this chapter, pension funds have assets in excess of $2.5 trillion. If developers can find ways to get pension funds to allocate more money towards real estate, there exists a potential to generate large pools of capital.

Now may also be the best time for developers to take advantage of pension funds. In the past two years, stock and utility bond values, typical investments for pension funds, have dropped in value. Pension funds are looking to diversify and real estate appears to be a very attractive investment for pension funds. Once interest rates increase again, stock prices most likely will also increase. The story is one similar to REITs: investors will pull investments away from real estate and return to investing in the stock market, where their returns will be greater with less risk.

In comparison with lending institutions, pension funds are more flexible for developers. Pension funds are long-term investors, whereas banks do not usually make long-term development loans and are in only for the short term. Pension funds are also willing to make deals with developers, such as covering the take-out commitment, or supplying the equity needed for a loan. Chapter 7 provides a greater comparison of pension funds to traditional lending sources.

Unlike banks, pension funds do not have to match deposits or maintain a spread of interest rates which means that pension funds can take their time choosing projects, and can be more satisfied with lower yields. Most pension fund groups have set a minimal annual return rate of five percent, but typically are receiving returns in the ten percent range (Kleege, 1990, 8).

Pension funds do not offer the tax advantages that a REIT can offer. However, one of the new changes that may occur with the UBIT restructuring would allow for different tax credit programs. These programs would give developers extra incentives to turn to pension funds, and would also give pension fund advisors greater incentive to invest in real estate.

Along with the transition in the market that pension funds are undergoing, changes are also occurring that impact the greatest beneficiary: the employee who relies on his or her pension plan after retirement. In the past a company would have one pension plan that affects all employees. Today, it has become commonplace for companies to offer several pension plans to employees. The employee then has a choice as to which pension plan to select. He or she may wish to diversify their pension plan and select a plan that invests more in real
estate than others. This change indicates that the individual now has greater flexibility about how his or her pension money is invested. If investments in real estate provide good returns, an increased demand for real estate investments is possible, which means more capital for developers.

PENSION FUND EXAMPLES

The nation's largest pension fund has turned many heads in the last five years. The Teacher's Insurance and Annuity Association (TIAA) merged with the College Retirement Equities Fund (CREF) in the 1980s, to combine for a $125 billion trust. This public fund is nearly three times the size of the largest private pension fund, which is AT&T. The TIAA-CREF fund invested over $500 million towards the building of the Mall of America, the largest single investment in one project by any pension fund.

An Indianapolis example best illustrates the flexibility of pension funds as a real estate resource. While no major developers in Indianapolis consistently rely on pension funds as a source of capital, there have been a few examples of pension fund use in the region. In one instance, a local developer received 75 percent of the capital he needed from a bank, and turned to the AFL-CIO pension fund to provide the remaining 25 percent equity needed. The pension fund agreed to supply the capital, on the condition that developers use local union labor for construction. This example illustrates the deal making ability that pension funds can offer developers.

Planners and developers gave national attention to the California Public Employees Retirement System pension fund, known as CalPERS. In 1992, this company made a decision to allocate $375 million to five real estate investment firms to assist with single family housing construction. Developers targeted over 89 projects that could not receive financing through traditional sources. These developments produced nearly 10,000 new housing units, with the bulk of them being affordable starter homes. CalPERS announced in 1994 that they had already received a 20 percent return on their investment, with only seven of the 89 projects completed (Bennett 4).

CalPERS started a trend with their example, known as "economically targeted investments" (ETI). Currently 18 states have created laws that direct
public pension fund managers to invest anywhere from one to five percent of their assets in economic development programs. The ETI program first originated under the Carter administration during the late 1970s. In 1984, a New York City public pension fund became the first to invest in urban revitalization. The program received its major boost in 1993 when President Clinton supported the use of the nation's pension fund assets (totalling over $4 trillion by the end of 1994) to help the economy.

Other state pension funds used the ETI program to improve their local economies. Colorado's Public Employees' Retirement Association (PERA) for example, used capital funds to create over 6,000 new jobs. Seven other states immediately followed this initiative and "earmarked pension monies for job creation" (Bennett 5).

CalPERS set a national standard by becoming the only pension fund building single-family housing. Many other funds are carefully tracking CalPERS before deciding whether to jump into the single-family market. Other pension funds were involved in housing, but in a less direct way. The nation's top 50 public pension funds allocated over 60 percent of their ETI money towards construction loans and equity investments for residential and commercial properties (Bennett 5).

One of the greatest arguments about pension funds is their lack of interest in investing towards affordable housing. Many experts have calculated good returns for affordable housing ventures, but pension funds typically are not interested. One section of Chapter 8 discusses this phenomenon in greater detail. However, the city of Hartford, Connecticut recently broke the stereotype by investing over $1 million of pension fund money into low-income housing units. Investors expect the projects to yield a seven percent return on the fund's investment.

Experts are quick to warn that CalPERS may have been extremely lucky with its success. Richard Pieser, planning professor at the University of Southern California, states, "CalPERS made a killing on timing. The state had a huge pent-up demand for housing, and no one was financing or building it in the early 1990s. Land was relatively cheap, because so much of it belonged to banks, and mortgage rates were low" (Bennett 6).

Finding good properties also poses a problem for pension funds. Many public pension funds voted to commit large funds to real estate (especially affordable housing) but ended up reneging on their deal because of the lack of suitable
projects. Still other doubters believe that too much use of pension fund money in real estate will hurt workers receiving their retirement checks due to the risk involved.

Still, investors remain optimistic about the ETI program in general. David Bronner, director of the Retirement Systems of Alabama, has been making a name of himself in Alabama. He recently allocated about five percent of his $14 billion pension fund towards the ETI program. His reasoning is that "if we don't do something to improve the economy of this state, no one else will" (Bennett 7).

These three pension fund examples illustrate some of the capabilities pension funds can provide developers. While pension funds may never be the primary source of capital for developers, they still have the capability to be a major player in the development picture and developers should not forget about them.
CHAPTER 5
REAL ESTATE SYNDICATIONS

History of Syndications
How Syndications Work
Why Use Syndications
Syndication Examples

"Where can the real estate industry turn for capital? ... One source of real estate capital, probably the largest of all, will be syndications."

-- Wade Lamming
American Banker
August 24, 1993
A real estate syndication is an organization that pools together a group of investors who combine their financial resources to acquire, develop, and manage real estate investments. Syndications may include shopping centers, office buildings, apartments, or any other form of real estate. Syndicates may attract investors who are interested in real estate because of the various benefits. Generally, investors do not have the time, desire, or knowledge needed to conduct the business of a syndicate. A real estate professional, the sponsor or syndicator, is thus needed for expertise in establishing and organizing the syndication. The syndicator then is responsible for finding the property, negotiating the acquisition, and managing it until its sale.

Syndications can take several organizational forms such as a corporation, a joint ownership, or a partnership. Corporate syndications operate similar to REITs in that organizations sell shares to raise capital and invest in real estate projects. However, despite the limited liability of investors, the corporate syndication is not popular because of double taxation (both the organization and the investor pay taxes on income earned). The joint ownership form is also unpopular due to legal uncertainties. For example, when one of the joint owners dies or refuses to cooperate, a stalemate may occur in the operation and the investment may turn sour. The preferred form of a syndicate is the partnership, and that is the focus of this chapter.

The exact term that describes this preferred syndicate form is limited partnership. A limited partnership consists of at least one general partner and at least one limited partner. The general partners are the syndicators, the ones responsible for the debts and obligations of the partnership. The limited partners are the passive investors who supply the needed capital and are not responsible for debts and obligations. The real estate syndicator, therefore, combines the financial resources of the passive investor to successfully invest in real estate.

As the need for new sources of capital continues, syndications remain a popular tool for developers. Chapter 6 focuses on real estate syndications and why developers use them for a source of capital. Furthermore, this chapter presents an overview of the syndication process and explains how syndications work with limited partnerships, and concludes with several syndication examples to show how syndicates work.
HISTORY OF SYNDICATIONS

The Securities Act of 1933 regulates real estate syndications by insuring that sponsors or syndicators disclose material facts to investors to prevent fraud. A security is an investment contract in which a person invests money in a common enterprise and expects profits from the efforts of a third party (Sirmans 382). Therefore, by definition when a syndicator offers an investor an interest in the profits and losses of the investment, the promoters are offering a security. When a sponsor makes an offering of shares to an investor, he or she must register those securities with the Securities and Exchange Commission (SEC). Some states also have state regulations and requirements with which syndicators must comply.

Since registration proves to be time consuming, costly, and filled with legal ramifications, syndicators try to find ways to avoid registration with the SEC. Several exemptions do in fact exist for which sponsors do not need to register securities. One such exemption is an intrastate offering, which offers securities only to residents of a single state by a person or corporation doing business in the same state. Another example is a private offering exemption, which occurs when an investor offers shares to at least 35 purchasers who he or she considers sophisticated enough to not require the protection of the SEC. Furthermore, Regulation A exists which exempts registration if the capital amount raised is under $500,000 (Sirmans 383).

Several tax laws also regulate the use of real estate syndication. The tax regulations are rather complex, and one cannot possibly explain the impacts of every tax regulation on syndications. The focus is placed on the most recent change affecting syndications, the Tax Reform Act of 1986.

In the past, Congress never considered limited partnerships to be taxable entities, meaning profits and losses went directly to the investors. Investors found limited partnerships appealing due to the tax shelter aspects the investment offered. However, the Tax Reform Act of 1986 revoked many of the tax shelter aspects associated with real estate investments. This law affected syndications the most, as many investors had chosen syndications for the tax benefits.

Syndications peaked in use during the development boom of the 1980s, but took a nose-dive after the Tax Reform Act of 1986. However, they never left the financing marketplace. The Tax Reform Act established the need for real estate professionals to devise new types of syndications that would create "a new
basis for investment to convince the investing public to risk its money in real estate" (Mandel 15). Investors and syndicators both had success with past syndications used for tax shelter purposes. It took a long time for syndicators to convince investors that they should invest in real estate for current and long-term economic benefits rather than only for tax shelter purposes. However, syndicators needed to convince these investors, for they realized lending institutions were no longer reliable as a source of capital.

When lending institutions began to have their troubles in the early 1990s, developers knew the money had to come from somewhere, and frequently turned to syndications for the answer, despite the higher costs involved. By serving as a syndicator, a developer does not have to provide any of the capital himself and can focus on finding a project in which investors would be interested. Rather than worrying about where the money would come from, a developer could focus his or her attention on finding the right kinds of projects. A 1990 survey of the nation's top 100 homebuilders showed that nearly one out of four used syndications as a source of financing (Donohue, 1990, 171).

**HOW SYNDICATIONS WORK**

A syndication operates much the same way as a REIT does (described in Chapter 4). Syndications may occur with specified pools or blind pools. With a specified pool, a sponsor (syndicator) normally would locate a property that he or she believes is a good investment and secures an option to buy it. The syndicator would then find potential investors who might be interested. The investors would analyze the property and decide whether or not to invest. A sponsor also presents important financial and economic data to the potential investor at this point. A blind pool syndication occurs when a syndicator offers interests to investors in unspecified properties. In this scenario, the syndicator raises capital to purchase real estate before he selects any specific property. The investor receives no financial and economic data to analyze. These blind pool syndications are also known as *venture funds* (Sirmans 380).

Syndications present unique legal, financial, and tax problems that make it difficult to analyze the precise risk involved for both the investor and syndicator.
The general and limited partners must make a limited partnership agreement that spells out areas of potential conflict. This agreement should cover the following: what fees the syndicator pays, how the syndicator distributes cash flows, how the syndicator handles management, and how the syndicator divides equity and future assessments among the limited and general partners (Sirmans 381). The agreement should also state what happens when a general partner dies as well as mention the procedure for removing a partner.

Syndications were primarily set up for tax shelter purposes. With a tax shelter, investors generate artificial "losses" through accelerated depreciation techniques that therefore reduce the tax liability of the investor. The investor is not responsible for paying taxes on depreciation, and can therefore write off much of the earnings from a syndication through a tax shelter.

Syndications obviously present a much riskier investment than a REIT or even a pension fund. The "high fliers" of the real estate business usually favor syndications. Typically the investors or limited partners in a syndicate are individuals or corporations. However, with the struggles of lending institutions, in several cases savings institutions have taken the risk of a syndication or assume the role of the "high flier."

Other examples exist where pension funds have participated in the limited partnership, serving as the limited partner. As mentioned in the previous chapter, pension fund investors are looking to diversify (particularly in the real estate market) and a syndication offers the possibility of such an investment. Pension deals are best suited for long-term, large-scale development since most of the competitors such as banks want their money back in three years.

Syndications are typically thought of as inefficient vehicles because of the excess fees needed to make the project work. Banks that fund money for any needed capital within a limited partnership typically charge a rate higher than prime, meaning additional costs of borrowing money. It can be very difficult for a syndication to be successful. Furthermore, the high risks involved discourage many investors from investing in syndications. Syndications have fallen apart, as illustrated in one example later in this chapter, for many different reasons. Some of the causes of syndication failures are poor management, improper screening of investors, or poor property location (Kane 30).

The expected yields for syndications vary considerably, considering the various risks and fees that are involved. Syndications have the potential to crumble...
for both the investor and syndicator, something less likely to happen with a pension fund or REIT, because the inherent risk is much higher. Sources showed that typical syndications provide returns of approximately nine to 12 percent (Fruchbom 32).

WHY USE SYNDICATIONS

Syndications may be the last remaining source of capital available for developers today. REITs and pension funds both appeared to fill the void left by banks and other lending institutions. However, with interest rates rising rapidly, investors may no longer be attracted to these vehicles. Syndications showed an increase in use during the year of 1994, particularly for multi-family projects. While the Clinton administration has imposed tax increases on the wealthy, Congress is also discussing possible changes to the tax code. Two changes in particular are passive loss provisions and deferral of taxes on income from the cancellation of real estate (Lamming 15). Should these changes occur, syndicates would be the most benefited, as real estate might again become an investment for tax shelter purposes.

Regardless of any changes in the tax laws, real estate syndications still offer a number of benefits to the investor that a good developer should be able to market to potential investors. Since funds are pooled together, syndicate members are able to participate in larger investments. A potential investor is therefore able to buy more real estate through a syndicate than as an individual. Syndicates can therefore attract investors because of the diversification.

Syndications may also be attractive to investors because of the ease of access. Investors usually do not have the knowledge to assemble a venture that will yield the most benefits. By joining a syndicate, the investor now is associated with a real estate professional with the knowledge and experience to develop a successful real estate package.

With a limited partnership, the individual investors are not liable for any obligations the syndicate incurs. The maximum loss that can occur is the initial equity investment from the investor. The limited partners are not liable for any debts or losses that may occur to the property.
C.F. Sirmans, professor of finance at Louisiana State University, concludes, "Real estate syndication is a practical alternative to all-or-nothing investments that the individual investor is likely to face. By being able to invest in several different ventures at the same time, the investor decreases the risk of losing the entire investment" (Sirmans 380).

SYNDICATION EXAMPLES

A new form of financing became available in the mid-1980s known as the investor pay-through note, which allowed savings institutions to participate in the syndication market. VMS Realty in Chicago tested the market for lending institutions serving as the limited partner in 1985. The four projects used by this limited partnership ended up with yields between 10 and 12 percent, which at the time was comparable to Treasury security investments (Kane 31).

While the VMS Realty limited partnership may be a successful syndicate, many unsuccessful partnerships exist as well. Investors of a San Jose apartment complex saw their investment turn sour when the syndication filed for bankruptcy. Over 80 individuals served as the limited partners with the San Francisco based company IMA properties acting as the general partner and syndicator. Investors put forward over $4 million toward Foothill Apartments in 1985 (Aragon and Barry 1). They expected returns of about 15 percent based on market studies and economic analysis. However, even if the investment did not pan out, they still had an excellent tax shelter. Then in 1986, practically overnight investors could no longer take the big tax write-offs, thanks to the Tax Reform Act.

The Tax Reform Act only marked the beginning of the problems for Foothill Apartments. The property did not generate the cash flows expected, as the apartment market became more competitive in San Jose. The project later needed a new roof and a new plumbing system. Unfortunately, tax benefits did not ease the investors' losses. The limited partners later dumped IMA as the general partner and replaced it with Park Place Group, a firm specializing in recoveries. In the end, the partners managed to put funds in an escrow account that paid off much of the property's debts. In a few years, the partnership hopes to sell the property to recover most of the losses, but it still remains uncertain as
to whether the limited partners will be able to retrieve their money (Aragon and Barry 35).

In the Indianapolis region, syndications were extremely popular during the 1980s. Several top development companies including Mansur Group and Gene B. Glick Inc. did much of their financing through syndications. However, once the market became unattractive for development, Gene B. Glick no longer performed new construction and instead focused on property management. Similarly, Mansur Group reduced the amount of limited partnerships because of additional risk involved and the negative attitudes of investors. Today, the firms most involved with syndications are the smaller firms with one or two employees and a small operating budget. Firms such as Tri-Star Realty and Marks Companies have both turned to syndications once the banks tightened their lending practices. Today these firms perform the majority of their deals with syndication type financing. Several other specialty firms in Indianapolis specialize in syndications, including the firm R. N. Thompson, which serves as the general partner for development deals and assembles syndication packages.

Hopefully, this chapter makes clear exactly how a syndication works and why developers use them as sources of capital. Syndications provide a riskier investment than REITs or pension funds, but may also provide higher returns. Syndications can easily be compared to REITs, as both have many things in common. The fundamental difference that distinguishes the two is that REITs have greater liquidity, meaning the investor can bail out more easily if something goes wrong. The next chapter focuses on the comparisons of REITs, pension funds, and syndications to traditional lending institutions.
A COMPARISON TO TRADITIONAL FINANCING SOURCES

Advantages and Disadvantages of Each Capital Source
Indianapolis Case Studies
Economic Analysis

"One of the major factors that separates the successful developer from the not-so-successful developer is his ability to obtain financing. The successful developer understands that there are many ingredients involved in obtaining financing."

-- Harry Goleman, AIA
Financing Real Estate Development
The previous three chapters explained the dynamics of REITs, pension funds, and syndications. However, one needs to compare how each of these methods measures against traditional lending institutions as a source of capital. Banks will be the comparative tool used throughout this chapter for lending institutions. Realize that a developer essentially has two options for obtaining capital for a development project. The developer can either acquire the money from a lending institution at a fixed interest rate for a set number of years (debt capital), or the developer can obtain the cash from investors who wish to invest in the real estate venture (equity capital). REITs, pension funds, and syndications are vehicles by which a developer utilizes private investors for capital while a bank represents the more traditional approach of acquiring capital through a lending institution.

Chapter 7 examines the various advantages and disadvantages to using REITs, pension funds, and syndications as a source of capital compared to banks. Furthermore, this chapter presents case studies of Indianapolis developers and how they utilize these financing techniques. Included is a look at how the credit crunch affected these Indianapolis developers and their financing methods. Finally, this chapter provides a simple economic analysis that compares costs using a bank, a REIT, a pension fund, and a syndication as the source of capital.

ADVANTAGES AND DISADVANTAGES OF EACH CAPITAL SOURCE

Each source of capital provides unique advantages and disadvantages for both the developer who needs the capital, and the investor who is looking for an opportunity to increase his or her yield. The major principle that applies to all three of these techniques is that all have the potential ability to provide the developer a cheaper form of money than a bank. If this fundamental rule did not exist, then none of these techniques would be of any use. However, other more specific advantages and disadvantages exist and are discussed for each of these capital sources. Figure 7.1 summarizes the information presented.
REITs

A REIT provides a major advantage over a bank in that a developer can acquire a large amount of capital at one time. REITs have the ability to raise massive amounts of capital in a short amount of time. In 1992, REITs raised over six billion dollars of capital for development (Berquist et al. 29). Developers are able to construct bigger projects and can generally plan on a grander scale with a REIT compared to bank financing. Obviously, some efficiencies exist when one can quickly raise bulk amounts of capital.

Corporations also receive tax benefits from a REIT. The shareholder assumes all of the income taxes, thus the company avoids double taxation. REITs are exempt from income taxes, providing they distribute at least 95 percent of their net income to the shareholders.

REITs also have the advantage of flexibility. Congress has placed strict regulations on banks and other lending institutions that limit the potential for developers. Banks essentially want their money back as soon as possible and are typically not interested in long-term development projects. The regulations for REITs are less stringent, and developers can use REITs for long-term, permanent financing.

Investors also see several advantages with REITs. The biggest advantage is liquidity, or exitability. By investing in a REIT, investors can easily sell their shares if the need arises. Investors also have the advantage of choice, similar to that of stocks. Investors can be as risky or adventurous as they want because different REITs specialize in different projects. For example, an investor may want to choose a REIT that only develops stable suburban shopping centers. Or perhaps an investor would like to invest in a company that takes more risks such as developing raw land or industrial sites. Investors typically know the projects their money is utilized for and can take as little or as great a risk as they desire.

Unfortunately, developers face several disadvantages with REITs. The single greatest disadvantage for a developer is time, as REITs usually require lengthy start-ups. According to Dean Donnelson of Gene B. Glick Inc. in Indianapolis, the overall time for forming a REIT can take up to two years. The amount of additional fees needed for start-ups also penalizes a developer. An initial public offering for a REIT requires fees for brokers, lawyers, accountants, and other professionals which add to the extra costs. A developer must also have large amounts of up-front capital. Many experts believe a REIT would only be effective...
for companies in excess of $100 million, thereby eliminating small and mid-size developers.

As mentioned earlier, REITs can raise large amounts of capital, which can provide for increased efficiency. However, if not careful, large amounts of capital may also cause problems and prove to be a disadvantage. While developers are able to construct larger, grander projects with more capital, they tend to think less about details such as traffic, congestion, pollution, and environmental protection. When a developer raises too much capital at once, social and environmental costs have the potential to be overlooked, as the emphasis becomes placed on large scale, new construction. Planners must be aware of these disadvantages that come with the capital raising potential of REITs.

**Pension funds**

While the large capital raising potential may be the greatest advantage of a REIT, flexibility is the greatest asset of pension funds as a source of development capital. All the professionals surveyed for this study cited the flexibility of pension funds as a major advantage to using them. Pension funds are very passive investors, and are nearly always looking for long-term investments. Banks, on the other hand, rarely look at long-term investing and want their money back as quickly as possible with a real estate loan. Pension funds also provide flexibility for developers by making deals such as covering take-out commitments or supplying equity capital needed, as illustrated in the example in Chapter 5.

Pension funds also attract developers because of the large amounts of capital they generate. Similar to REITs, pension funds command an enormous pool of assets and can provide a large bulk of money in a short time period, which proves to be both an advantage and disadvantage. As investment vehicles, pension funds look for diversity in their investments, and have shown willingness to invest more funds toward real estate.

The major disadvantage with pension funds is the relative small amounts of money they typically put towards real estate. On the average, pension funds allocate about four percent of their total assets towards real estate and housing (Ferlauto 249). Thus, it does a developer little good when pension funds raise billions of dollars if only a small percentage of it is invested towards real estate. The other disadvantage with pension funds is the need for a pension fund advisor. Developers need to become advisors in order to receive continual financing from pension funds.
It usually takes several years for a developer to become an advisor and establish a strong enough relationship to receive funds on a regular basis. Therefore, time becomes a major consideration for acquiring capital from pension funds.

**Syndications**

Syndications are popular instruments because developers can make deals without utilizing any of their own money. Well organized syndicates allow the developer to use the investors' money. Therefore, rather than worrying about where the money is coming from, the developer can focus on creating more projects. Syndications also provide the same advantages of REITs and pension funds in that they are more flexible than banks and consider long-term investments. Furthermore, syndications can raise large pools of money, similar to REITs and pension funds.

Syndications also provide the investor, or limited partner, many advantages. Potential investors need no expertise or knowledge as they become associated with a professional, the syndicator. By joining in a syndicate pool, investors can participate in larger investments than as individuals. Investors also have the benefit of not being responsible for any losses the project should incur. The maximum loss that could occur is the initial investment amount.

The popularity of syndications with investors is what makes them popular financing instruments for developers. Unfortunately, several disadvantages also confront the investor. The tax benefits that had once made syndications extremely popular no longer exist, as investors may no longer write off any benefits. Investors also may not be attracted to syndications because of the long-term investment. Unlike REITs, syndications offer no exitability and investors may not bail out during a project's lifetime. The only way to exit is when the project is sold.

Developers also face many of the same disadvantages in syndications as with REITs. Start-ups can be difficult with syndications, as developers need additional fees for lawyers and other professionals. Syndications require some "marketing expertise" by developers, as they must be successful in finding willing investors.

Figure 7.1 on the following page summarizes the various advantages and disadvantages for all three of these capital sources. For the most part, the advantages and disadvantages are the same for all three private investment vehicles.
Advantages and Disadvantages of Using Private Investors (REITs, Pension Funds, and Syndications) Compared to Banks

**Advantages**

- Cheaper cost of money
- Flexibility: less regulation
- Patience: more comfortable with long term investment
- Ability to raise large amounts of money at one time: bigger projects possible
- Potential tax benefits

**Disadvantages**

- Time: start ups are very difficult
- Additional fees: lawyers, brokers, accountants, etc.
- Large amounts of capital needed up front
- Large projects could lead to other unforeseen problems
- Reliance on individual's willingness and ability to invest

**INDIANAPOLIS CASE STUDIES**

Several Indianapolis developers experimented with using various capital raising techniques. A total of ten development companies from the Indianapolis region were examined to note the use and impacts of capital sources. A range of firms was studied, with varying sizes, operating budgets, and project types to receive as broad a perspective as possible. In each case, the researcher examined how the company financed current development projects, and what changes have occurred over the last ten years as a result of the credit crunch. For presentation purposes, the ten companies are divided into three groups based upon their size and financial characteristics. Figure 7.2 on the following page illustrates the ten firms studied and their basic characteristics. For a complete profile of these firms, see Appendix B.
Indianapolis Development Firms

Group I
Average size: 1100 employees
Average operating revenues: $190 million

Davis Homes LLC
Duke Realty Investments Inc.
Forum Retirement Group L.P.
Simon Properties L.P.

Group II
Average size: 270 employees
Average operating revenues: $45 million

C. P. Morgan Inc.
Gene B. Glick Inc.
Mansur Group Inc.

Group III
Average size: 2 employees
Average operating revenues: $0.3 million

Marks Companies Inc.
Tri-Star Realty Inc.
Wells-Zeigler Development Co.

The firms in Group I are high profile developers with projects completed in several states. All four of these companies are publicly traded companies. Both Simon Properties and Duke Realty established REITs within the past five years, and are available on the New York Stock Exchange. Forum Retirement Group is offered on NASDAQ, but is not a REIT because they do not distribute 95 percent of their earnings back to shareholders. Davis Homes recently filed an initial public offering and is currently in the midst of a REIT formation. All of these examples illustrate large companies that realized the potentials of REIT
formations. None of these companies needed a REIT to survive, as they all had performed quite well without a REIT status, yet all turned to REITs as a vehicle to enhance their company and as a means to acquire more capital when the standards became more difficult from lending institutions.

The companies in Group II are all mid-size developers with good reputations. The credit crunch did not hurt these developers badly, primarily because all have had a good credit history with banks. Both Gene B. Glick Inc. and Mansur Group have utilized limited partnership syndications as a primary source of development capital. Once the credit crunch occurred, they still were able to rely on these limited partnerships. However, both companies were in secure positions where they did not have to construct new projects to survive. Today, both companies are operating primarily as property managers and are not constructing new projects simply because the market does not make sense to do so. C. P. Morgan has always had an outstanding reputation as suburban home developers and have been able to maintain their credit rating with local banks. The company has seen no need to utilize other financing sources because they have suffered little in the past and can still rely on banks for their needed capital.

Group III firms are the most interesting to examine. These small developers operate on their own without much staff, and the credit crunch has affected these firms the most. These companies are far too small for a REIT to be a financing alternative, and they do not have the credit history to rely on banks for their capital. Furthermore, they do not develop enough properties to rely on property management to survive. Essentially, these small developers must continue new development to stay in business, yet they are extremely limited with the sources of capital they can obtain. Pension funds and syndications prove to be the most beneficial to these smaller companies. In fact, both Tri-Star Realty and Marks Companies utilize syndications as their financing source for most projects. All three companies have relied on unconventional, "creative" financing mechanisms for capital when the banks would not lend.

These case study examples illustrate the use and need for these three financing techniques in the real world. Some companies can clearly benefit from new sources of capital, as they provide advantages that banks cannot match. To further illustrate the benefits these techniques can offer, the following section provides an overview of the costs associated with these various financing methods.
ECONOMIC ANALYSIS

The overriding concept behind all three of the private investor vehicles studied is that they all have the potential to provide the developer with cheaper money than a bank. The question then becomes, how much cheaper? REITs, pension funds, and syndications all have additional start-up costs that banks do not have. Furthermore, the start-up time is typically longer than with traditional lending institutions. If REITs, pension funds, and syndications do actually provide cheaper money than banks, does this compensate for the additional time and start-up costs needed?

Unfortunately, no clear answer can be found to this question. Different projects will produce different results and developers do not have a magic formula that shows the precise costs for each financing source. One should also remember that developers very seldom will use REITs, pension funds, or syndications as the sole source of capital for a project. Most often, developers first turn to lending institutions and then look to these other sources for the equity needed. While REITs, pension funds, and syndications all have the ability to perform debt financing, traditionally developers use them as equity sources.

Despite the complexities in determining the costs of using these sources, figures from past projects show some of the costs developers can anticipate. As mentioned before, the largest factors impacting these sources are start-up costs and time. Bank financing is typically not a time consuming task for developers, as the processing time usually takes only a few months. However, the legal complexities of REITs, pension funds, and syndications make start-ups more difficult. REITs and syndications can each take several years to establish. Pension funds do not take as long, yet if a developer wishes to continually tap into this source of capital, he or she must become an advisor and can expect to wait up to three years before seeing any constant flow of funds. Obviously, the extra time associated with these sources adds additional costs for the developer, as time delays affect payment schedules.

External costs also become a concern for a developer. External costs are any costs not directly related to the cash flow of the project, and includes things such as attorney fees, closing costs, loan origination fees, and credit analysis. While these costs vary from project to project, banks generally have much cheaper external costs than other sources. For large projects (over $1 million), one can expect external costs between five and eight percent from a bank. Pension funds
also have low external costs that are comparable to banks. REITs and syndications, however, have very high external costs due to additional legal and broker fees. Past REIT and syndication projects show external costs between eight and twelve percent of the total project cost.

Despite these high additional costs for REITs, pension funds, and syndications, they have some economical benefits that banks do not offer. Banks typically charge very high interest rates for construction and development loans, usually two to eight percent over the prime rate. If a company uses a REIT as the chief financial tool, then it can use proceeds from past REIT projects to build new construction, and thus avoid higher bank rates.

Banks typically have a "spread" that calculates the interest rate they charge developers. Banks borrow money from Federal Reserve Banks at the discount rate, now between five and six percent. Furthermore, banks are also obligated to pay their depositors an established rate. Thus, when making loans to developers, they must charge a rate higher than what they are paying to borrow money or are paying their depositors, thus setting a spread between the rate they are lending money and the rate they are borrowing money. Pension funds do not have depositors like banks, and can be more flexible with rates, since they do not have a spread to cover like most lending institutions. This flexibility proves to be a big cost advantage for developers using pension funds.

One should realize that a bank, much like a private investor, is making an investment by giving a developer a loan. The bank believes that the project will succeed and will provide an annual return equal to the rate they have charged the developer. Banks will charge developers anywhere from prime rate to three percent over prime rate for permanent financing. With the prime rate currently at nine percent, yields for banks are between nine and twelve percent annually. The yields for REITs, pension funds, and syndications are not as high for investors. Research has shown that most REITs yield the investor an annual return between six and nine percent. Pension fund investments in real estate have yielded an average between seven and ten percent. Syndications will vary depending on the size and nature of the project. A syndication is a much riskier investment, with no guarantee of a set yield. Recent successful syndications have yielded between ten and twelve percent annually.

The yields for these sources will vary, depending on the nature and success of the project. However, one can see that the yields for each capital source are lower than banks, which shows how developers can receive a cheaper form of
money. Yet, these are only the expected yields. Actual returns will vary depending on the success or failure of the project. A bank knows they will receive a set interest rate throughout the project (providing they have established a fixed-rate loan and not an adjustable rate loan). The yields for REITs, pension funds, and syndications can easily change throughout the project, thus adding uncertainty to the calculations.

Hopefully, this analysis shows some of costs associated with each financing technique. Precise data is nearly impossible to obtain, as numerous unknown variables make calculations very difficult. Factors such as the developer's credit history and experience with these capital sources makes calculating time and costs very difficult. The uncertainty with using REITs, pension funds, and syndications makes them less attractive for developers, yet with banks and other lending institutions providing less capital today, these options become more attractive. Developers have learned that these capital sources have been able to provide benefits that banks cannot offer. Figure 7.3 below summarizes the various economic considerations with each source of capital.

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**FIGURE 7.3**

Cost Comparisons With Different Capital Sources

<table>
<thead>
<tr>
<th>Capital Source</th>
<th>Annual Yields for Investors</th>
<th>External Cost Estimates</th>
<th>Start-up time</th>
</tr>
</thead>
<tbody>
<tr>
<td>Banks</td>
<td>9 - 12%</td>
<td>5 - 8%</td>
<td>Under 1/2 year</td>
</tr>
<tr>
<td>REITs</td>
<td>6 - 9%</td>
<td>8 - 12%</td>
<td>1 - 2 years</td>
</tr>
<tr>
<td>Pension Funds</td>
<td>7 - 10%</td>
<td>5 - 8%</td>
<td>1/2 - 2 years</td>
</tr>
<tr>
<td>Syndications</td>
<td>10 - 12%</td>
<td>8 - 12%</td>
<td>1 - 2 years</td>
</tr>
</tbody>
</table>

* External cost estimates based on percentage of total project cost

** Information for this table obtained from personal interviews and from Aragon and Barry, 1991; Hauser, 1994; Retkwa, 1990; and Winter, 1994
CHAPTER 7
CHAPTER 8

CONCLUSIONS

Under-utilization of Capital Sources
The Future of Private Investors as Capital Sources
Final Thoughts

"Real estate is the only trillion dollar industry that requires no skills, machinery or personal capital to enter. You can hire the skills, rent the bulldozers, and borrow money and obtain equity from total strangers! Is it no wonder that there are no rules of economics?"

-- Sanford Goodkin
Pension World
January 1991
While the 1980s marked a new era in development, today the effects of the real estate craze have left many developers in trouble. Lending institutions can no longer provide the capital they once did, leaving many developers in need for new sources of equity capital. Paula Stephens, in *National Real Estate Investor*, claimed, "New pools of capital are being formed . . . but it's not enough to replace traditional forms of financing" (Stephens, 1992, 5). The excess of capital during the 1980s led to a shortage of capital during the 1990s, and developers have had to find new sources of capital.

REITs, pension funds, and syndications have all increased dramatically in use during the last ten years. The credit crunch during the late 1980s led to the need for new sources. When banks and other lending institutions tightened their standards, developers needed to find alternative sources of capital. The crunch during this time period directly led to an increased use of REITs, pension funds, and syndications.

UNDER-UTILIZATION OF CAPITAL SOURCES

Despite the numerous advantages and benefits REITs, pension funds, and syndications can offer, these financing methods still account for only a small portion of total development capital today. Less than 15 percent of the capital for development projects comes from REITs, pension funds, and syndications while nearly 70 percent of the capital comes from lending institutions. As the previous chapter illustrated, all three of these techniques can provide greater economic benefits to a developer, and a number of other advantages also exist that make these appealing for developers and investors. Yet the fact remains that developers use all three minimally.

With the numerous benefits and advantages these capital sources offer, many believe that developers are not utilizing them enough. Developers have many possibilities to use REITs, pension funds, and syndications to a greater extent. All three have potential to become prominent players in the real estate financing industry, and indeed over the last ten years all have grown dramatically. However, with the possibilities stated in this section, one might conclude that developers are under-utilizing these techniques today.
One instrument that illustrates the under-utilization of these capital sources is the existing REIT structure. REITs have proven to be major contributors to the financing industry, as they raised over six billion dollars in 1992 and again in 1993. Yet, the existing structure limits REIT use and offers little flexibility. While REITs are instrumental in creating new vehicles of capital, new formats can allow the REIT to be even more effective. Two such instruments, an umbrella partnership and a conduit, are presented below to demonstrate new techniques that can provide for stronger utilization of REITs today.

The upsurge of REITs during the 1990s has led to several new structures that provide the developer with increased flexibility and new possibilities. One such structure is an umbrella partnership, or an UPREIT. The umbrella structure partnership began when Congress enacted the Limited Partnership Rollup Reform Act in 1993. This act primarily helped syndication vehicles, as the purpose was to protect limited partners from mismanaged sponsors. However, the act also brought about the UPREIT, a structure that combines the benefits of limited partnerships with the benefits of REITs. With an UPREIT structure, property owners may convert their interests into the REIT format without recognizing capital gains. The UPREIT structure gained popularity among the top REITs. In fact, 15 of the top 20 REITs filed in 1993 were UPREITs (Hauser 30). The UPREIT structure brings property assets and income into a REIT without incurring immediate taxation. Unlike typical REITs that use capital to acquire property, the UPREIT uses capital to purchase an interest in a partnership where the REIT sponsor becomes the general partner (Sumichrast 4).

Another popular tool that allows for increased effectiveness with REITs is the conduit. Banks established real estate mortgage investment conduits (REMICs) in 1986 to increase activity in the secondary mortgage market. A conduit allows banks to earn money for service rather than taking the risks of a traditional lender. Banks assemble loans with brokers and offer these loans as securities. Lately, banks have shown a willingness to reenter the real estate business by backing up REITs with a REMIC. The banks essentially sponsor the REIT with a conduit, which allows mortgage securities to back the REIT format. The REIT can then structure different levels of participation in a project by investors. Many complicated rules and regulations have restricted the use of this REIT/REMIC relationship since its conception in 1991. The advantages of this structure include greater flexibility for investors wishing to participate in REIT formations, and the potential for using private capital with public cooperation. William Weirick,
assistant professor of economics at Northeast Louisiana University, claims, "The REIT/REMIC combination may become the development framework of choice for the 1990s" (Weirick 74).

Housing experts have forever criticized pension fund allocation. The nation's top 1000 pension funds invest less than four percent of their assets into housing and real estate, and most of these funds go into high-end commercial development (Ferlauto 249). A fraction of national pension fund money directed towards housing, particularly low-income affordable housing, would add billions of dollars to the housing market. Housing investments not only create housing opportunities, but also create jobs, revitalize neighborhoods, and stimulate the economies of local communities where pension contributors live and work (Ferlauto 250). Clearly the ETI programs brought about by CalPERS (see Chapter 5) have demonstrated the benefits of housing investments by pension funds.

Experts note that affordable housing sales remained strong during the economic recession of the early 1990s. Yields in commercial properties fell during the recession, or credit crunch, causing investors to review residential real estate. Deyo Breen, chief operating officer of Acquest Management Inc., notes, "Sponsors will feel more comfortable with residential real estate investments as they gain more knowledge about the development process [and] pension funds may most easily invest in residential real estate as passive role players" (Breen and Hochman 31). Pension fund advisors admit their lack of expertise with residential property holds them back. The potential for greater residential investing exists, and both investors and developers can certainly benefit.

Another major problem that has held back pension fund investments in real estate is the 5/50 rule in the REIT market. One of the easiest ways for pension fund investors to assist the real estate market is to invest in REITs. However, recall that the 5/50 rule prevents five or fewer individuals from owning more than 50 percent of a REIT's stock. The REIT industry is trying to liberalize this rule to encourage greater investments from pension funds. Pension funds are viewed as individual investors, regardless of their size. The 5/50 rule has put a barrier on expanded investment by larger pension funds. Thus far, relaxation of the 5/50 rule has not made it to Congress, yet many people are supporting it.

All of the ideas presented above illustrate the point that REITs, pension funds, and syndications have not achieved maximum utilization. Yet remember that developers are limited in their use of these sources by the investor. If investors are not willing to supply the capital, it is hard to state that developers are under-
utilizing these techniques. Certainly the potential exists for increased use of all three sources of capital. However, the single greatest barrier to use might be the performance of other investment vehicles, such as stocks and bonds. If these vehicles are available, why should an investor consider a risky investment like real estate? More specifically, interest rates have proven to be a strong indicator of investment performance, as illustrated in the next section.

THE FUTURE OF PRIVATE INVESTORS AS CAPITAL SOURCES

Generally speaking, people tend to invest more during periods of lower interest rates. People have more money to invest during these times, and history shows that investment increases with drops in the interest rate. However, usually during periods of low interest rates, typical investment vehicles such as stocks, have lower rates of return.

Like many investment vehicles, REITs have traditionally shown strong dependence on interest rates. When interest rates dropped during the 1990s, REITs increased in use. Consider Figure 8.1 below which shows the annual average prime rate over the last five years compared to the value of initial public offerings by REITs.

**FIGURE 8.1**

Comparison of Annual Prime Rates with REIT Formations

<table>
<thead>
<tr>
<th>Year</th>
<th>Average Prime Rate</th>
<th>Initial Public Offering Totals</th>
</tr>
</thead>
<tbody>
<tr>
<td>1990</td>
<td>10.01</td>
<td>$0.8 billion</td>
</tr>
<tr>
<td>1991</td>
<td>8.46</td>
<td>$1 billion</td>
</tr>
<tr>
<td>1992</td>
<td>6.25</td>
<td>$1.5 billion</td>
</tr>
<tr>
<td>1993</td>
<td>6.00</td>
<td>$8.9 billion</td>
</tr>
<tr>
<td>1994</td>
<td>7.11</td>
<td>$2.9 billion</td>
</tr>
</tbody>
</table>

*Sources: Hauser, *Urban Land*, 1994

*Federal Reserve Bulletin*
Furthermore, consider that between 1992 and 1993, the prime rate never reached a point higher than 6.5. In fact, in the time period between August of 1992 and March of 1994, the prime rate remained at exactly 6.0. The years of 1992 and 1993 proved to be the best years ever for REITs. REITs raised a total of $13 billion in real estate capital between 1992 and 1993 (Berquist et al 29). The last time REITs raised a significant amount was during 1986 and 1987 when they raised a total of about $4 billion each year. Incidentally the prime rate during those years hovered around eight percent, significantly lower than average.

The implication with REITs also holds true with the other investment vehicles. Both pension funds and syndications normally function better during periods of low interest rates, as investors will find these vehicles attractive. However, if interest rates increase, investors usually sell their REIT shares and invest into stocks. Likewise, pension fund investors will find real estate less attractive during higher interest rate periods and will invest less in real estate vehicles. Interest rates have been steadily climbing during the past year. The Federal Reserve Board has increased the discount rate five times over the past 18 months, causing banks to raise the prime rate. We have seen investments in REITs decline as a result of these rate increases. Furthermore, the stock market has been performing very well, as the market reached an all-time high of 4,200 in April 1995, again proving the point that investors tend to pull investments away from real estate vehicles and into stocks during periods of higher interest rates.

While interest rates may prove to be the most significant factor in examining the future of REITs, pension funds, and syndications, government regulation also influences future decisions. One has already witnessed the impact of stricter bank regulations on the real estate market. Changes in regulations with syndications (particularly tax reform packages) and REITs could enhance their popularity as an investment vehicle. As previously discussed, a change in the 5/50 rule would make REITs a more popular investment with pension funds. Increased government assistance may also help in bringing new pools of capital to the housing market through the use of pension funds or syndications.

Over the past five years, banks have seen their share of problems. Stricter regulation and capital requirements meant banks were lending less money to developers. Banks have seen other vehicles such as pension funds, REITs, and syndications take much of their business away. Banks and other lending institutions have realized they need to become more flexible to recapture some of the market they had lost. Recently, talks have focused around repealing the
Glass-Steagall Act in banking. This act, which has been in existence for over 60 years, restricts banking investment and sets limitations to the projects in which they can participate. Removal of this important act could open the gates for banks to once again become prominent players in the real estate financing industry.

**FINAL THOUGHTS**

Financing has become the most important, and most difficult, part of the development process. In the past, planners and developers needed to consider only a few financial options since banks and savings and loan institutions had provided excellent packages to developers. However, the S & L scandal and the credit crunch created serious problems for lending institutions. These institutions lost massive amounts of money and needed to tighten their standards at the expense of the developer. No longer could a developer easily get a loan to finance the project he or she envisioned. Developers quickly needed new sources of capital to fill the void.

Developers began to rely on private investors as a source of capital. Three vehicles, REITs, pension funds, and syndications, all increased in use over the last five years and provided developers an alternative to lending institutions. Despite their limitations, complications, and start-up costs, developers found that private investors could indeed be the source of capital they needed.

REITs, pension funds, and syndications all provide developers advantages that lending institutions could not offer. They offer flexibility, something the highly regulated banks traditionally could not do. Private investor vehicles present a more passive, long-term investment to the developer. All three vehicles also allow the developer to raise large sums of money in a short time period. Furthermore, despite the extra time and money needed for start-ups, both REITs and pension funds provide a cheaper form of money than banks, while syndications provide a comparable cost of money.

However, lending institutions still remain the chief suppliers of capital today, accounting for about 70 percent of total development capital. The ease and simplicity has made banks popular vehicles for high-profile developers with good credit ratings. Those developers with good credit ratings can still make deals with banks. The banking industry may have fallen upon hard times during
the 1980s and early 1990s, but it will never go away. On the contrary, banks will always remain key players in the financing marketplace, but many doubt they will ever capture the market as they did during the 1980s.

While large, well-known development companies may be able to receive loans from banks today, many of the small and mid-size companies are shut out. Banks have learned their lesson, and while they still lend money, they are extremely cautious about to whom they lend it. Small and mid-size companies need alternative financing sources to survive, and indeed syndications and pension funds may be the best source for these companies. The previous five years have given an indication that one can gain benefits by using REITs, pension funds, and syndications, and developers may realize that they no longer need to be as reliant on banks as in the past.

So what is the implication to the planning profession? Planners typically are not well-informed about financing vehicles, yet they must be apprised of these untapped pools of resources. While REITs may be restricted in use only to larger companies, both pension funds and syndications have been a valuable resource to small and mid-size developers. Syndications led to the development of many multi-family housing projects that otherwise might not have been completed. Furthermore, the pool of capital available from pension funds is definitely worth examination by planners. Certainly the ETI programs initiated by the CalPERS pension fund (see Chapter 5) prove that pension funds are a valuable resource for effective planning.

Clearly, the simple analysis performed in this study is enough to, at the very least, give these investment vehicles a second look. Not only do they provide the developer the needed funds to make a project work, but they also provide investment opportunities for individuals or corporations. A good planner should be aware of the potential for REITs, pension funds, and syndications, for innovation can come from these three sources. These vehicles may provide the financial answer for new housing, economic development, and community revitalization.


Vinocur, Barry. 1994. "With REIT market in a slump, pension funds show interest in buying; advisors branch into securities." *Barrons*, December 6, 46.


APPENDICES

Appendix A:
Glossary

Appendix B:
Indianapolis Development Firm Profiles
APPENDIX A:  
GLOSSARY

Capital
The money, or cash, a developer needs to complete a real estate project. Capital can take the form of debt capital or equity capital.

Commercial Bank
A lending institution that provides a wide range of services. Commercial banks store more of the nation's money than S & Ls, but lend less for real estate, and thus rank second behind S & Ls in importance in real estate lending. Most bank deposits come from short-term deposits, rather than savings and time deposits, meaning commercial banks tend to emphasize short term loans.

Construction Loan
A short-term loan which enables a developer to pay contractors' bills and other expenses incurred before and during the construction period. Also referred to as an interim loan.

Debt Capital
Money loaned at an agreed interest rate for a fixed number of years; distinguished from equity capital.

Developer
The person, or group of people, who acquire property with the intention of improving its value in an attempt to gain profit.

Development Loan
A short-term loan, advanced before a construction loan, used by developers to acquire land and install basic utilities such as roads, sewers, water supply systems, etc.

Development Process
The process through which development projects are conceived, initiated, analyzed, financed, designed, built, and managed.

Discount Rate
The rate of interest that Federal Reserve Banks charge on other loans to depository institutions, such as commercial banks.

Disinflation
A reduction in the rate of increase in the price level, or more simply a lowering of the rate of inflation.
Disintermediation
The widespread movement of money out of financial institutions and into corporate and government debt instruments. This process may occur when the limits on interest rates payable by these institutions are lower than the rates of return that can be obtained elsewhere.

Equity Capital
Money invested by owners or others who share in profits; distinguished from debt capital.

Financing
The process through which a developer obtains the capital he or she needs to purchase land, design, build, and even manage a development project, either through loans (construction, development, or permanent) or through equity sharing (REITs, pension funds, syndications).

General Partners
The group of people who organize and operate the limited partnership form of a syndication. They agree to accept the full financial liability of the partnership.

Investor
Any individual or organization, not a mortgage lender, who lays out resources in order to obtain income, profit, or other benefits from real estate ventures.

Lending Institution
Includes banks, credit unions, savings and loan associations, stock and bond brokers, and other institutions that accept deposits of income saved and offer to loan these funds, in return for interest payments, to those who wish to borrow.

Leverage
The technique of maximizing an investment's profit-equity ratio, usually achieved through borrowing.

Limited Partners
The group of people who provide the bulk of the investment capital in a limited partnership. They have little say in the day-to-day management of the partnership and share the profits with the general partners.

Limited Partnership
A form of co-ownership in a syndication where general partners organize and operate the partnership and limited partners provide the capital. The limited partner is not liable for the debts and obligations of the partnership.
Liquidity
Cash position based on assets that can readily be converted into cash.

Permanent Loan
A long-term mortgage loan, distinguished from a short-term interim loan or construction loan.

Real Estate Investment Trust (REIT)
A publicly traded real estate company that raises capital by pooling investor money using the trust form of ownership. The REIT distributes 95% of income earned to the shareholders, and features single taxation of profits.

Real Estate Mortgage Investment Conduit (REMIC)
A publicly traded debt security backed by a fixed pool of mortgages. A REIT can be backed with a REMIC status to allow different levels of participation.

Savings and Loan Association (S & L)
A lending institution that is a primary source of real estate loans for developers. S & Ls are regulated to hold at least 80% of their assets in residential loans.

Syndication
An organization that brings together a group of passive investors who combine their financial resources to acquire, develop, operate, and/or market real estate investments.

Take-Out Loan
A permanent loan or mortgage that is obtained to take over and repay the construction loan.

Tax Shelter
Any tax deductible expense generated by an investment property. Typically, tax shelter refers to depreciation that a taxpayer can report as a deduction against other income.

Umbrella REIT (UPREIT)
A REIT formation that combines the benefits of REIT's and partnerships. Rather than directly acquiring the property, the UPREIT uses capital to purchase an interest in a partnership. The UPREIT allows partnerships to become more liquid for investors.
APPENDIX B:
INDIANAPOLIS DEVELOPMENT FIRM PROFILES

C. P. Morgan Inc.
Contact person: Mark Boyce
Title: Chief Operating Officer
Address: 301 E. Carmel Drive
         Carmel, IN 46032
Telephone: (317) 848-4040
Staff size: 50 employees
Operating budget: $36 million
Development type: Residential real estate

Davis Homes, LLC
Contact person: William Blake
Title: Chief Operating Officer
Address: 3755 E. 82nd Street #120
         Indianapolis, IN 46240
Telephone: (317) 595-2800
Staff size: 200 employees
Operating budget: $84 million
Development type: Residential real estate

Duke Realty Investments Inc.
Contact person: Darrel Zink
Title: Chief Financial Officer
Address: 8888 Keystone Crossing
         Indianapolis, IN 46240
Telephone: (317) 846-4700
Staff size: 350 employees
Operating budget: $18 million
Development type: Commercial, office, and industrial real estate
**Forum Retirement Group L.P.**

- **Contact person:** Paul A. Shively
- **Title:** Chief Financial Officer
- **Address:** 8900 Keystone Crossing #200
  - Indianapolis, IN 46240
- **Telephone:** (317) 846-0700
- **Staff size:** 1000 employees
- **Operating budget:** $42 million
- **Development type:** Retirement homes

**Gene B. Glick Inc.**

- **Contact person:** Dean Donnelson,
- **Title:** Vice President Asset Management
- **Address:** 8330 Woodfield Crossing
  - Indianapolis, IN 46240
- **Telephone:** (317) 469-0400
- **Staff size:** 600 employees
- **Operating budget:** $68 million
- **Development type:** Commercial and residential real estate

**Mansur Group Inc.**

- **Contact person:** Andrew Banister
- **Title:** Chief Financial Officer
- **Address:** 10 W. Market Street #700
  - Indianapolis, IN 46204
- **Telephone:** (317) 464-8200
- **Staff size:** 150 employees
- **Operating budget:** $31 million
- **Development type:** Commercial real estate

**Marks Companies Inc.**

- **Contact person:** Benton Marks
- **Title:** President
- **Address:** 445 N. Pennsylvania Street
  - Indianapolis, IN 46204
- **Telephone:** (317) 267-1400
- **Staff size:** 2 employees
- **Operating budget:** $0.4 million
- **Development type:** Commercial and residential real estate
**Simon Properties L.P.**
Contact person: David Simon  
Title: Chief Financial Officer  
Address: PO Box 7033  
Indianapolis, IN 46207  
Telephone: (317) 636-1600  
Staff size: 2,900 employees  
Operating budget: $620 million  
Development type: Shopping centers

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**Tri-Star Realty Company**
Contact person: Jack Moran  
Title: President  
Address: 7168 Graham Road #150  
Indianapolis, IN 46250  
Telephone: (317) 576-0505  
Staff size: 2 employees  
Operating budget: $0.4 million  
Development type: Commercial and residential real estate

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**Wells-Ziegler Development Company**
Contact person: Dean Ziegler  
Title: President  
Address: 2250 W. 86th Street #200  
Indianapolis, IN 46260  
Telephone: (317) 328-9331  
Staff size: 1 employee  
Operating budget: $0.2 million  
Development type: Commercial and residential real estate