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THE CONSEQUENCE OF REAL ESTATE BUBBLES

Bears, bulls, and the merely complacent are all commenting on the condition of the housing market.

The following articles cover real estate booms and busts back to Roman times. Including the latter is not too farfetched. Secular contractions inspired the New Deal in Old Rome, which suggests that policymakers respond to the same stimuli in the same way – no matter what millennium or condition they find themselves in.

Some of the articles are lengthy, but it is important to place the latest mania in housing in perspective.

This could be consolidated into one lengthy article, but we have found that financial history becomes more vivid when contemporary sources are frequently quoted.

The first article covers the post-1929 secular contraction in real estate and credit. Published with permission here, it's from the April 24, 1992 edition of Grant's Interest Rate Advisor. An interesting line was "***last glacial, deflationary bear market in New York City real estate***" (begins with "***The Slowest Asset***").

The next article reviews today's precarious condition of Florida real estate. Mike Morgan (mike@morganflorida.com) is the author and it is titled "***Ghost Housing Market***".

This is followed by Frederick Lewis Allen's riveting description of the 1920s land bubble in Florida. This is extracted from ***Only Yesterday***. Published in 1931, it is a classic account of the "Roaring Twenties" bubble.

This is followed by a ***Wrap***, which briefly reviews the bubble collapse of 1343 to 1346, as well as other examples.

(Continued from page 5)
ture of the business is conveyed in one cloudy sentence on page six: "The partners of LP I are two limited partnerships affiliated with KKR, MA Associates, L.P. ("MA Associates") and KKR Partners II, L.P. ("KKR Partners II") and the Individual Original Investors." Concurrent with the sale of $250 million in notes and four million shares of senior exchangeable preferred, numerous partnerships, funds and subsidiaries (at which the foregoing only hints) will be rolled into one. Shares will be exchanged by various parties and debt reduced. At the end of the day, KKR will retain voting and investment power with respect to 96% of the outstanding stock.

A locust cloud of organization effectively obscures the financial record. Instead of the usual Summary Historical Financial Data, the prospectus offers a series of organization tables. Then it's right into the summary, unaudited, pro forma, consolidated financial data.

Of $1.3 billion in pro forma assets, intangibles constitute $984 million, or 76%. Except for this mountain of goodwill, book common equity would have been $262 million. As it is, however, tangible net worth amounts to minus $722 million. Debt to tangible capitalization is a number out of 1989 (or 1931): minus 824.5%. K-III will show net losses as far as the eye can see.

Meaning what, exactly? "The company believes that its liquidity, capital resources and cash flows are sufficient to fund planned capital expenditures, working capital requirements, interest and principal payments and the payment of preferred stock dividends for the foreseeable future," the prospectus states reassuringly. Then, again, K-III is in the acquisitions business, and the company's credit agreement establishes a $150 million "acquisition facility." There is no telling what the balance sheet might look like next year. Nor the income statement: K-III Holdings II (comprising the encyclopedia business and *Weekly Reader*) showed pro forma consolidated sales declines in 1991 over 1990. K-III Holdings III (*Seventeen, Daily Racing Form* and other magazines and newspapers) showed net sales declines for the six months ended Dec. 31, 1991, vs. the prior year's comparable period.

Grant's is holding its rhetorical fire. The market isn't crazy yet. Perhaps it is only preparing to lose its mind.

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The slowest asset

In Houston, office rents are falling again, fully a decade after the Texas energy business stopped inflating and began deflating. Rents continue to fall in New York, too, and Citibank is reportedly trying to sell the mortgage it holds on 40 Wall St. at a distress price. The amount that Citi is owed on the 70-story building, once a holding of the late, great Ferdinand Marcos, is $80 million. The amount that it is willing to accept in payment, according to *Crain's New York Business*, is $20 million, or $20 a square foot. A source of ours relates that the offered side of the market is, in fact, lower; a spokeswoman for Citicorp declines to provide a number. If the cost of refurbishing the building to attract an institutional clientele is anything like $100 million (as *Crain's* reports), the building's true, economic value might well be less than zero. It would certainly be low enough to rattle the downtown real estate community.

Real estate is an admittedly slow and illiquid asset, but it isn't in every postwar cycle that tall buildings collapse on the heads of the billionaires who own them. Recently, David Shulman of Salomon Brothers predicted that the slump in commercial real estate may last, in some regions, until the end of the decade and that it will be 12 years before the national office vacancy rate returns to 5% from about 20% today. To equity investors who have become accustomed to measuring bear markets in terms of days, weeks or months, such a thing is almost beyond imagining.

Precedent is on Shulman's side, however, and the documentary evidence is available at the New York Public Library. One instructive story is that of the Equitable Building, 120 Broadway, a still-magnificent Wall Street skyscraper built in 1914-15. We've been reading up on the Equitable's past to try to reach a clearer understanding of the future. What we want to know is whether the real-estate-related credit cycle is over or ending, or, as Shulman and others suggest, still unfolding. The answer to that question is easy: It is still unfolding. H. Dale Hemmerdinger, a reader and New York City property owner, contends that years of misery lie ahead as long-term leases are replaced by new, lower-cost leases. "Costs are front-end loaded," Hemmerdinger says. "Even if the market turns tomorrow (which it won't), it will take me a long time to get rid of my free rent, of my $30 to $50 work letters, and I've got to get my rents up. In the meantime, my costs are still going up.... What Olympia & York is looking for is a short-term solution. I don't know how that works."

The period selected for this investigation was the last glacial, deflationary bear market in New York City real estate, that of the 1930s. We skipped the 1970s bear market because it was an inflationary downturn, one that featured rising commodity prices and expanding bank credit. In the Depression era, occupancy rates and interest rates fell, and chastened lenders

hung back from committing new funds. It has been a little like that in the 1990s, too. What is most interesting about the Equitable story, however, is what happened in the long succession of disinflationary years between the alleged return of prosperity in 1933 and the U.S. entry into World War II in 1941. The company stumped through the Depression only to seek bankruptcy protection at a time of relative prosperity. For those who like to use the stock market as a leading indicator of business activity, the failure occurred some nine years after the Dow Jones Industrial Average made its all-time low.

We are relating this story because it helps to convey a sense of the rhythm of a deflationary liquidation. It is slow motion, like a family reunion. If past is prologue, lessons from the 1930s may also apply to the 1990s (with certain modifications, of course, allowing for the mature welfare state, the full paper monetary standard and the possibility that the federal government may yet engineer a new inflation). For instance, construction activity will not make the hoped-for contribution to the next business expansion, real-estate losses will continue to weigh on banks and life insurance companies, and the patience of newspaper readers will be sorely tested. Like the man who came to dinner, Paul Reichmann might move onto the pages of *The Wall Street Journal* indefinitely. He and his lenders and their lawyers may carp and cavil and negotiate into the next millennium (but — to strike a bullish note — not into the one after that).

The best reason to study the Equitable Building is that the Equitable Office Building Corp. was once an investor-owned company, and its financial history is available in *Moody's Banks & Finance*. The original Equitable Building burned to the ground in 1912 on the same Broadway site, and Coleman DuPont came up from Delaware to organize a corporation to put up a bigger and better successor building. No visitor to 120 Broadway is likely to quibble with management's appraisal (c. 1915) that the building, originally housing 1.2 million square feet, is "among the great business structures of this hemisphere." It was so great, in fact — 40 stories rising straight up from the building line without a single setback — that the

The lobby of the Equitable Building. If only beauty could be capitalized.

shadows it cast on lower Manhattan galvanized a political movement to restrict the construction of anything so overpowering in the future. The Equitable Life Assurance Society of the United States gave DuPont a long-term, $20.5 million mortgage, one of the largest ever written up until that time. The interest rate was 4½%.

It is impossible to appreciate the Equitable story without a proper respect for the building's gleaming place in the Wall Street skyline. "Emphatically, and unequivocably," said the original sales brochure, perhaps reflecting market conditions as well as management's sense of decency, "we will not make to one tenant, regardless of his size or his importance or his desirability, any concession which is denied to others." The capitalization of the Equitable Office Building Corp. was conservative, and the tenants were grade A. The fact that 4½% eventually became an unmanageable rate of interest is a useful lesson in the relativity of nominal yields and the changeableness of rents. What seems low may later appear high, even oppressive; and, of course, vice versa.

The moral of the Equitable story is that a decline and fall takes time. In the roiled credit markets of 1930 and 1931, the Equitable Office Building Corp. 5s of 1952 were still quoted in the low 90s and mid 80s. In the nightmare year of 1931 — marked not only by a global liquidity crisis but also by a rash of real-estate foreclosures by New York savings banks and life insurance companies — the company showed a profit and comfortably covered its fixed charges; rental income was almost $6 million, or $5 a rentable square foot. After expenses, depreciation and taxes, net earnings totaled $2.4 million. Cash on hand totaled $1.5 million. Altogether, it must have seemed to the Equitable's creditors as if the Depression were happening to somebody else.

In 1932, rental income dropped by less than 5%, earnings per share by a little more than 10%. The common dividend was cut to $2.50 a share from the old $3 rate, but at least there was a dividend. So far, so good.

If the phrase "world coming to an end" has ever pertained to the resilient American economy, it was descriptive in 1933. Rental incomes plummeted, and 25% of the mortgage investments of the major U.S. life insurance companies wound up in default. In that harrowing year, the Equitable Office Building Corp. was able to earn $1.4 million, or $1.54 a share, a testament to the quality of the tenancy and the long terms of the leases.

Inevitably, of course, leases came up for renewal. Some tenants did renew (others moved out and still others went bankrupt) and the new leases were signed at low, Depression-era rates. In 1933, rentals fell to an average of $4.16 a square foot. In 1934, they averaged $3.66 a square foot. Operating expenses and real-estate taxes happened to drop in 1934, but the capital expenditure program went on. Hoping to save on energy costs — the price of oil had vaulted by 71% in the first year of the Roosevelt recovery — management converted the building's oil-fired steam generating plant to anthracite coal power. Earn-

ings in 1934 just topped the $1 million mark, or $1.25 a share, representing less than half of the 1931 rate. In the summer of 1934, the common dividend was omitted. It was reinstated at a lower rate in 1936: a false harbinger of recovery, it turned out.

The worst of the Depression was over, but rental income continued to fall as high-cost, 1920s leases were annually converted into low-cost, 1930s leases. (For 1920s and 1930s, of course, read 1980s and 1990s, respectively.) By 1936, the building's rental income amounted to just $2.68 a square foot, down by 46% from the levels prevailing in 1930. The Equitable Building's vacancy rate in the mid 1930s hovered around 15%. For perspective, the 1992 vacancy rate stands at 15.8%. Counting space available for sublease, it would amount to 20.5%. (We leave it to the real-estate scholars to determine the underlying cause of the decline of rents in lower Manhattan in the 1930s. Was it the still-weak national economy or overbuilding in the boom? Our bet is on the first hypothesis. In the 1920s, no self-respecting New York bank made real-estate loans.)

Periodically, but without great success, management petitioned the city for tax relief. The corporation paid $807,533 in real-estate taxes in 1935. It paid $788,800 in 1937 but $846,800 in 1939. War broke out in Europe in September 1939, and America became a haven for frightened money. It might have seemed to the average Wall Street investment strategist that a rally in rental income was imminent. But the building realized only $2.41 a square foot, on average, in 1939, and reported a net loss of $14,685, or two cents a share, its first annual deficit of the decade. It just barely covered fixed charges.

The company fell short in 1940, and again in 1941; management gave up the ghost eight months before Pearl Harbor. "The [bankruptcy] petition said that, although the company would not be able to meet its current obligations as they fall due, it has an income and assets sufficient to make possible an equitable reorganization," Moody's reported.

The same slow, dream-like pace of activity continued during the reorganization proceedings — another cautionary precedent for today's lenders. Committees were formed, plans submitted and meetings held. Paul J. Isaac, the reader who inspired this piece, tells a story about one such proceeding. He says that he got the anecdote from his father. An arbitrageur named Lou Green, of the firm of Stryker & Brown, was questioned by an SEC examiner, Isaac relates. Asked what class of security holder he represented, Green did not reply "the debenture holders," "the senior mortgage holder" or "the preferred." What he said was, "the short interest in the common." Wartime prosperity notwithstanding, the vacancy rate in early 1942 was almost 14%. On July 10, 1942, Federal Judge J.C. Knox approved the purchase of a $16 million war and bombardment insurance policy for $16,000 a year. Rents and margins were down: The net loss grew.

As for the Equitable reorganization proceeding, it was conducted without undue haste. Competing plans of reorganization were submitted, and at least once the U.S. Circuit Court of Appeals reversed Judge Knox. By the time the final plan was confirmed, in October 1948, fees and allowances to the trustees and attorneys had piled up to $792,521. In November 1947, the building got a new, 25-year mortgage from the John Hancock Mutual Life Insurance Co. In place of the overbearing 4½% interest rate was a reasonable 3.7% interest rate (which would later increase to 3¾%). The downward adjustment was just in time for the start of the long postwar rise in interest rates and also, of course, in rental rates. Still, the rent roll in December 1948 had returned only to an average of $3.47 a square foot, lower than the average for 1934.

Scrolling ahead a half century, to 1992, the Equitable Building is owned and managed by Silverstein Properties. A fund managed by J.P. Morgan Investment Management holds a participating mortgage on the property (entitling the creditors to a share of the cash flow). The lobby is still splendid, and the rentable area of the building is now put at 1.9 million square feet, an increase of 58% since the 1930s. According to a broker, the reasons for this miraculous growth relate, first, to the expandable definition of a square foot under New York law and, second, to the general tendency of potato chip bags to hold fewer chips every year. He implied that space inflation was in the air. As noted, the vacancy rate, not counting available sublease space, is 15%. One big tenant nowadays is the office of the New York State Attorney General; another is the law firm of Lester Schwab, Katz & Dwyer. The defunct Crossland Savings Bank occupies ground-floor space. Brokers say that deals can be struck at an effective rent of less than $22 a square foot over a 10-year lease for a 10,000-square-foot space. The number includes a work letter to finance construction and a certain amount of free rent. Neither Morgan nor Silverstein would comment on the economics of the building, but the numbers can only be bleak and — in view of the weakness of rents and the long-term nature of big-city leases — getting bleaker.

At a meeting of the New York Real Estate Board the other day, Larry A. Silverstein, head of Silverstein Properties, explained the real-estate profit-and-loss dilemma, and the April 15 *Real Estate Weekly* gave this account:

> Silverstein said the real problem is that commercial rents are so low — the deals are not economically viable for the owners. He said operating expenses amount to $7 and $8 per square foot, real estate taxes are running from $7 to $11 per square foot, tenant work letters are at $5 per square foot and $1 is going for leasing expenses. This adds up to $21 per square foot before debt service, he said.
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> Postwar building debt service averages $25 per square foot so Silverstein said owners need to see $46 per square foot just to break even. "In a $30 market," he said, "it's hard to see a profit and impossible not to incur a loss." In fact, he added, "There is no profit and the question is the magnitude of the loss."

In other words, losses loom indefinitely. If $21 per square foot is the average operating cost of a building before interest expense, it's a cinch that the owner of the Equitable Building is showing no profit after paying its lenders. "Quality projects in the end will become profitable," a vice president of Olympia & York Properties (Oregon) assured the Portland *Business Journal* recently. "It's just a matter of time." Based on the history of the Equitable Building, we would amend that claim. In a deflation, even quality projects will become unprofitable. It's inevitable.

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A similar path of a series of insolvencies by both equity and mortgage holders occurred with Chicago's Showmart Building from 1929 until the early 1950s. An index of U.S. farmland prices set a secular high of 50 in 1920 and plunged to 20 in the mid-1930s.

Ghost Housing Market (Florida, 2006) – Mike Morgan

We recently had two more of Wall Street's finest out on a tour of Florida real estate markets. After the first day, these guys needed diapers. They've been listening to the garbage from home building company management teams and what dribble they hear on the conference calls. I showed them reality, and it hit them like a ton of bricks.

Here's a review of reality.

Inventory -- Our current levels are all time highs. We've never seen anything like this. If you want to believe the NAR numbers, so be it. In the previously hot markets, inventory levels are well beyond a year, and in some markets 2-4 years. You have hundreds of thousands of homes in the hands of flippers, not to mention all of the unsold inventory the builders are sitting on, and you still have the normal market of people selling for reasons like death, new job, etc..

Ghost Market -- Why so much inventory? The Ghost Market of so called "investors." These people were not investors. Maybe speculators, but even that is too kind. They were uninformed gamblers. For the last two years, you had better odds at the Big Six Wheel in Vegas. And the builders knew it. The builders saw buyers flipping contracts before closing a few years back. There response was to include a contract provision that you could not assign the contract, and you must close with the builder. They told the Street they were doing this to control investors. Well, that's pure nonsense. If they wanted to keep investors out, they could have demanded sworn affidavits. They could have put deed restrictions in regarding sale and rental of the home.

But there logic was not to eliminate investors from the market, but rather to capitalize on them. So with assignments prohibited, the new wave of lemmings had to buy from the builders. And away we go! So now we have a market flooded with people that had no intention of living in the home. When, in the history of the world, have you seen millions of people

buying multiple homes like a box of donuts? Like donuts, the value of these homes is dropping as they sit on the market.

Quality - Builders have been selling the vast majority of their homes to flippers. Flippers don't care about quality. Rarely does a flipper order a competent home inspection. Rarely does a flipper even do a walk through. They are only concerned with flipping the contract as soon as they close. The builders did not let this opportunity go unnoticed. They built lower and lower quality homes, often ignoring building codes. How? In many markets the pace of construction has outpaced the ability of the local authorities to inspect homes, so these markets allow the builder to hire their very own private inspectors. Now if you hired an inspector that flagged your homes, how long do you think you would keep that inspector? So the builders find inspectors that are willing to look the other way. Many of the homes on the market today do not meet building codes. We are seeing an escalation of defective roofs, defective trusses, defective stucco and the list goes on. We actually set up a website to help home buyers with information. I'd like to report on all of the home builders, but for now our site is focused on just one builder www.Lennar-Homes.info. We'll be adding new sites over the next few months.

Location - Once again, builders realized they could sell anything as long as they pegged it as "pre-construction." Building next to dumps, rail lines and depressed areas became the norm. Flippers never bothered to visit the sites. Let's look at Miami. Out of area flippers just hear two things. "Miami" and "pre-construction." Our trips through Miami reveal that many of the construction zones are in depressed areas full of crack houses, empty warehouses and worse.

The flippers didn't care, and neither did the builders. But the "real" buyers that might live in these condos and homes care. And they are not going to buy these projects.

Cancellations - If you think the cancellation rate is less than 50%, I've got a bridge for sale. Flippers are dumb, but they are not going to wipe themselves out. If they bought a property

for $500,000 and it is now selling for $400,000, why would they close? They will simply walk away from their contract, leaving the builder with more unsold inventory. Here's one example to drive this point home. An investor client of ours was recently released from his contract price of $490,000. The builder just resold it for $315,000. That's a "real life" example. That's a 36% haircut for the builder. Margins? There are none at these prices. P/E ratio low? How about no P/E ratios?

One final note: The flippers have about 3% in closing costs with the builder. Then they have about 10% with the new buyer. So they need a 13% increase in price to break even. What would you do if prices have already fallen by 20%? Lose another 7% or walk away from the contract?

Affordability - Prices skyrocketed artificially because flippers did not care about price. They only cared about one thing . . . Were they getting pre-construction pricing? Now we have a flood of inventory on the market that buyers cannot afford. First time buyers generally need homes under $300,000. Even in previously hot markets like Port St. Lucie, we saw average home prices rise above $300,000 for pre-construction homes. And the high end market is not immune to this problem either. Buyers that purchase million dollar plus homes are far more astute then the first time buyer. The high end buyers read the Wall Street Journal and follow the numbers. They see the massive build up of inventory, and they all tell me the same thing. "We're looking, but we're going to wait till prices come down." And with that kind of logic, prices will continue to drop.

Interest Rates - Compounding the affordability problem are interest rates. A little over a year ago a buyer could secure a $300,000 mortgage for $1,250 a month (less if they used an ARM). Now the same buyer is looking at a $1,750, or $6,000 a year more in mortgage payments.

Florida Bust – 1926 – Frederick Lewis Allen

"It [Florida real estate] *began obviously to collapse in the spring and summer of 1926. People who held binders and had*

failed to get rid of them were defaulting right and left on their payments. One man who had sold acreage early in 1925 for twelve dollars an acre, and had cursed himself for his stupidity when it was resold later in the year for seventeen dollars, and then thirty dollars, and finally sixty dollars an acre, was surprised a year or two afterward to find that the entire series of subsequent purchases was in default, that he could not recover the money still due him, and that his only redress was to take his land back again. There were cases in which the land not only came back to the original owner, but came back burdened with taxes and assessment which amount to more than the cash he had received for it; and furthermore he found his land blighted with a half-completed development."

"The final phase of the real-estate boom on the nineteen-twenties centered in the cities themselves. The tower-building mania reached its climax in New York – since towers in the metropolis are a potent advertisement – and particularly in the Grand Central district of New York. Here the building boom attained immense proportions, coming to its peak of intensity in 1928. New pinnacles shot into the air forty stories, fifty stories, and more; between 1918 and 1930 the amount of space available for office use in large modern buildings in that district was multiplied approximately by ten."

"The confidence had been excessive. Skyscrapers had been over-produced. In the spring of 1931 it was reliably stated that some 17 per cent of the space in the big office buildings of the Grand Central district, and some 40 per cent of that in the big office buildings of the Plaza district farther uptown, was not bringing in a return; owners of new skyscrapers were inveigling business concerns into occupying vacant floors by offering other buildings; and financiers were shaking their heads over the precarious condition of many realty investments in New York."

Wrap: It is true that "***they are not making real estate any more***", but prices are subject to intense speculation whereby leverage is over-employed.

This is inevitably followed by forced liquidation and such financial crises related to real estate are noted in the literature. The 1343 – 1346 crash in mortgages and property in northern Italy is well researched.

The Monetary Policy of Fourteenth Century Florence by Carlo M. Cipolla is worth reading.

Some notable points would include the heading to Chapter 1 "***The Great Crash of 1343-1346***". Cipolla records that the crises ended "***a period of secular growth and the beginning of a long and arduous search for new equilibriums***".

Florence was the principal financial market, so the effect of the crises was comparable to a collapse in the senior stock exchange in our times.

During the euphoria of the preceding decades, merchant and banking houses had loaned out substantial amounts of money in what was regarded as perfectly secure investment yielding a good return.

The damage was widespread geographically and, according to Cipolla, "***The collapse of the banks brought losses to all who held deposits in them; in the more fortunate instances depositors were able to retrieve only a half, or a third, or a fifth of their funds. The list of the Antellesis' creditors*** [includes] ***… magnates, as well as artisans, widows, and orphans."***.

The contemporary chronicler, Giovanni Villani, used the phrase "***manacamento della credenza***", which translates simply as a "***want of credit***".

Cipolla also writes that the crises were attended by "***wild fluctuations in the relative values of gold and silver***".

This could be important as, recently, the gold/silver ratio has been increasing in volatility.

The financial history of the Roman Empire is not thoroughly detailed, but includes mention of a number of crises in mortgage and property markets. These are significant in implementing virtually all of the schemes dreamt up by Roosevelt's deluded "***New Dealers***".

More recently, more than a decade of speculation in financial and tangible assets climaxed in the summer of 1873. The consequent

contraction endured from 1873 until 1896 and was named "***The Great Depression***" by leading economists and analyzed as such until as late as 1940.

Fortunately, there is an index of U.K. farmland values in pounds per acre. After soaring from 37 to 55 in the 1870s, the index declined to a little less than 20 in 1896.

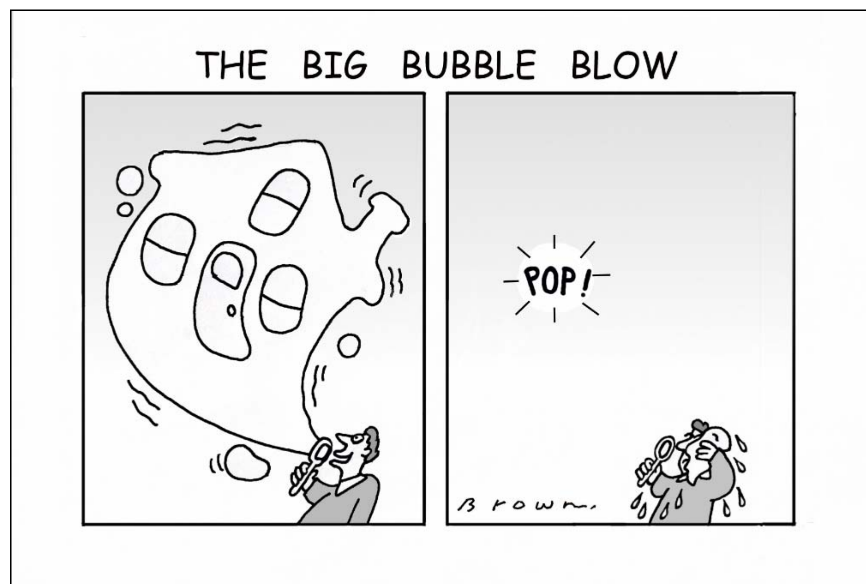
The decline in rents for the same period ranged from 32% to 43%. One researcher mentioned that the problem of collecting rents needed to be recognized and was estimated at times as only 90% successful.

It is important to understand that this was a depression within which there was an outstanding improvement in agricultural productivity.

In drawing some conclusions, typically big booms in real estate have been followed by long consolidations in both price and credit conditions.

Shorter-term examples include regrettable U.S. experiments in "***wildcat banking***", when land bubbles erupted in 1837 and 1857. These were followed by brief but severe contractions. The 15-year bear market in Japan's real estate is the most recent big example and is well reported.

Of course, there is no certainty that recent manias in real estate will lead to a contraction, but then there is no certainty that they won't.



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