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SECTION B

### Big Investment Bubbles: Tulips, Tech Stocks and Now Real Estate?

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History is replete with stories of investment bubbles going back at least as far as the infamous Tulip Bulb Mania in 16th century Holland, the earliest reported "bubble." These days, we consider ourselves too sophisticated, educated and informed to possibly be duped into the herd mentality that produces investment bubbles.

Or could we? Notwithstanding our collective prowess, in the late 1990s non-income producing technology companies traded at extraordinary multiples to phantom earnings. It was widely believed that a fundamental change in the valuation of companies was occurring in this new information age. Supposedly, future earnings potential would be more important than the ability to service current expenses, generate earnings and pay dividends to stockholders.

We all know how that story ended. In the final analysis, there was no fundamental change, cash does count, earnings are important and investors really do want current dividends.

Now many people are asking if real estate is in for a similar bubble effect and when might it burst? To answer these questions, we need to understand what drives investment values and how those conditions are evidenced in today's real estate investments.

#### Asset Economics vs. Capital Flows

Two factors drive all investments: the inherent characteristics of the investment product and the macroeconomic capital markets. Asset characteristics are influenced by individual operating aspects of the asset and the associated asset class. A company's earnings potential and dividend payment record are valued by the capital market through a price earnings ratio, or a dividend discount model or both. Based upon this information, efficient market makers buy and sell the company's stock.

During the technology bubble, the individual operating aspects of the tech companies did not vary from the typical start-up model in most industries. The management team implemented business plans, the industry segments operated within normal bounds of efficiency and productivity, and the increased economies of scale helped to produce better products at increasingly higher margins. But, in many instances, companies did not produce net earnings and therefore did not generate net dividends.

The breakdown was not in the individual operating model; it was in the capital markets' perception of that operating model. The capital markets flocked to the technology sector and suggested that the old measures were antiquated. They poured in capital on an unparalleled basis and inflated the value as a result.

Then, disappointed by the individual operations, the markets became disillusioned with the industry and the herd instinct resulted in capital being redeployed to other asset classes.

The bubble burst because capital changed direction, not because of an inherent change in the business operations.

## Equity: Earnings vs. Capital

Recent analysis by the American Institute of Individual Investors attempted to segment the last 50 years of equity performance between business operations and capital market fluctuations. The results show relatively constant earnings and dividend characteristics. The wide swings in the stock market, then, can be attributed to the flight of capital to or from the equity asset class.

From 1950 to the end of the century, dividend and earnings growth rates were consistently in the range of 9.9 percent to 11.1 percent and volatility in overall returns over this period was a direct function of the capital available to the asset class.

For example, capital flooded into the equity markets in the post war period (1950 to 1965) and price earnings ratios increased to accommodate the capital. In the next period, 1966 to 1981, capital fled the market, price earnings dropped and total returns fell from 16.1 percent to 5.9 percent.

The market then reversed course from 1982 to 1999 as a new influx of capital drove the price earnings ratio up to an all time high of 26.4. Once again capital drove returns, this time to a compounded annual return of 16.8 percent, without any change in the underlying operational economics of the companies in the index. Finally, since 2000, the post-tech bubble decline has been driven by the absence of capital and characterized by a declining PE ratio as well as a decline in underlying earnings power as measured by dividend and earnings growth.

## Investment Real Estate vs. Capital

Like the equity market, real estate is driven by the underlying economics of properties, including rents, operating expense and capital costs. These tend to operate in a very narrow band and to grow consistently as the underlying economy expands over long periods. In this sector, market volatility is also driven by the presence of capital or, more specifically, the above or below normal allocations of capital to the asset class.

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Currently, an extremely high amount of capital is allocated to real estate, which has driven prices to high levels, prompting concerns about whether these levels are out of line with historic trends or beyond the range of competing yields from the equity market.

So does the real estate market exhibit any signs of the overheating that existed during the tech bubble? One clear similarity

is that the expanded capital inflow has caused the "PE ratio for real estate" (REPE) to increase. But that is where the similarities end. The direction is the same, but the volatility is much less. The spread between the expected REPE of 11 and the current high REPE of 14.1 is only 28 percent, compared to a stratospheric variable of 330 percent in the equity market's PE ratio during the tech bubble.

Another important comparison is the absolute level of the PE ratios. Lower PE ratios are safer and place more reliance on solid operating characteristics. High ratios are more speculative and present greater return but substantially higher risk. The equity PE is currently 21.5 while the REPE even under the most aggressive current measures is possibly as high as 16.6.

Real estate operating economics are subject to the same pressures as the stock market. The inherent growth in earnings and dividends for both asset classes are a function of the underlying economy and the ability of managers to produce valuable goods and services. Real estate is currently producing substantially higher cash returns and trades at a comparatively low PE ratio even under the most aggressive of current valuations. In the end, this asset class is not over valued and is not in a bubble condition and, in fact, is in better shape than the overall equity market. ■

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