



Real Estate

- Moderator: **Howard H. Stevenson**, Sarofim-Rock Baker Foundation Professor
- Panelists: **Michael D. Fascitelli**, President and Trustee of the Board, Vornado Realty Trust
Nori Gerardo, Partner, Chief Strategist for Private Real Estate, Chairman of Private Real Estate Investment Committee, Partners Group
Scott D. Malkin, Founder and Chairman, Value Retail PLC
William Poorvu, Adjunct Professor in Entrepreneurship, Emeritus
Arthur I. Segel, Professor of Management Practice, Finance Unit

Overview

After years of abundant capital and rising asset prices, the current financial crisis has hit the real estate sector very hard. The crisis may have started with residential real estate but it is also affecting commercial real estate. Asset prices have fallen and are expected to decline further; there are likely to be massive defaults; and debt is virtually nonexistent. And the situation is likely to get worse before it gets better.

The good news is that because of sharply falling asset prices, for those with cash, the next 12-24 months are likely to present very attractive buying opportunities.

Context

This panel discussed the global real estate crisis, the future of securitization, and predictions for the future of the U.S. real estate market.

Key Takeaways

- **The financing of real estate is central to the global financial crisis.**

Real estate has played a key role in many of the country's past recessions. However unlike previous recessions, this one deals heavily with the over-extension of debt in the residential market. (The issues on the commercial side are similar, just slightly delayed.)

Ms. Gerardo pinned the causes of the current crisis on the compensation structure for those on Wall Street, which doesn't have any type of long-term accountability, and on a lack of institutional memory, as those on Wall Street today have no knowledge of previous real estate-related crises.

- **In the United States, the real estate market faces reduced cash flows and significant re-pricing.**

The panelists were in agreement that the next 12 to 24 months are likely to be a very painful period for the U.S. real estate industry. Cash flow from commercial real estate—retail, offices, and hotels—will all be off. Debt is and will be extremely tight, and asset values, which have already declined significantly, will continue to fall. Mr. Fascitelli estimates that in New York City, asset values for commercial real estate are down 15%-20%, and he wouldn't be surprised if they fall by another 15%-20% in the next year or so. This has already led to a big drop in the share prices of REITs.

"Real estate values will have to fall."

— Michael D. Fascitelli

- **The housing market must bottom out before a recovery in the real estate sector can begin.**

The housing market is the key to everything—that market has to bottom out first, because everything else is derivative. Once people have visibility about where the housing market floor is, they can transact more confidently with that knowledge. Predictions are unclear about what will happen with the U.S. housing market. It is possible that the floor will be reached by the beginning of 2009. But some experts predict that bottoming out may not occur until 2011.

"The problem now is anything that begins with an M—mortgage—is a dirty word."

— Nori Gerardo

- **Expiring loans will have to be dealt with.**

As loans come due, they have to be dealt with. What will happen isn't clear. In some instances, banks will be flexible in restructuring debt and working out solutions. But in other instances there may be servicing agents or lawyers involved who have little incentive to be flexible. This will result in massive defaults and a tremendous amount of assets dumped onto the market, further depressing prices.

"The deleveraging of America is hard to do without causing tremendous pain."

— William Poorvu

It seems likely that there will be legislation that gives homeowners a window of time to attempt to work out a restructuring with their lender.

- **The real estate crisis is a global problem.**

The real estate crisis is not isolated to the United States. At one time, experts believed that real estate markets in different regions were decoupled from one another. However, recent events have proven this to be false as real estate markets in many parts of the world are off 30% to 50%. Real estate crises have spread around the globe.

— *Europe.* Throughout Europe, the real estate market is a cause for concern. Spain is in a very difficult situation. France, Germany, and Italy have been in a quasi-recession for the past five years. In the United Kingdom, housing prices have been on the increase but are now expected to decline, similar to the United States.



- *Middle East.* Dubai is experiencing a massive real estate bubble. In its quest to become a regional hub, the Dubai economy has been driven by real estate and infrastructure development. Buildings have been constructed on the fly without expertise, leading to significant environmental problems. In addition, there has been a huge stock market bubble. Although sustainable value exists in Dubai's real estate market, a major repricing is expected. Abu Dhabi is also in a risky situation as it is sitting on large quantities of subprime loans.

"Dubai is the home of the biggest real estate bubble that we'll ever know."

— Scott D. Malkin

- *Asia.* Japan's economy is not strong—it is experiencing 0% GDP growth, and the country didn't really recover from the last recession. However, the real estate fundamentals aren't bad. There hasn't been overbuilding in the main cities and banks don't own toxic paper. From a debt perspective, the situation is not as bright. Huge numbers of mezzanine loans exist that are due in the next 18 months, and there is no one to take them out.
- *Emerging markets.* There are opportunities in emerging markets, but caution is necessary. When considering real estate investments in emerging markets, look for distress. Overseas markets with considerable distress include China, India, Colombia, and Brazil. One challenge with real estate in emerging markets is that it is difficult to identify good properties and to predict changes that will occur in different neighborhoods.

- **Securitization isn't evil and it isn't dead.**

The concept of securitization is a good one. The problems are that it was overused, securitized assets were not priced appropriate with the risk, and there was a misalignment of incentives. Securitization is likely to continue, but securitized assets need to be priced accordingly. A question without a clear answer is how the loans that have been securitized will be worked out.

- **Despite the current challenges in the real estate sector, there will be tremendous buying opportunities.**

As asset prices fall, there will be tremendous buying opportunities for those with capital. Property will be available

for pennies on the dollar. However, at the moment, most savvy real estate investors are sitting on the sidelines, too scared to invest. Mr. Fascitelli's firm has \$2.5 billion in cash and a line of credit for another \$1.5 billion. Even though this cash is earning less than 0.5%, he is afraid to invest right now. The panel believes that fear will diminish over the next 12-24 months and there will be the most opportunities available since the early 1990s.

- **The economy will experience deflation first, followed by inflation.**

In the short term, the U.S. economy will experience deflationary pressures. This is evidenced by the falling housing and commercial real estate prices. But as the government prints more money to try to stabilize the economy, inflationary pressures may mount—a process which could take two to three years. The economy may move from a deflationary bust to an inflationary bust, characterized by high inflation but economic contraction.

Modest levels of inflation (less than 6%) tend to be good for real estate markets. In an environment of modest inflation, individuals who have maintained high levels of cash will be able to buy better properties. Properties with income that can rise with inflation, such as hotels or retail rents, may be a reasonable inflation hedge.

"Inflation rates of more than 6% are bad for all asset classes; not just real estate."

— Arthur I. Segel

Other Important Points

- **Wall Street and political credibility.** Ms. Gerardo is of the view that not only has Wall Street's credibility been severely diminished, but the failure of Congress to quickly grasp the severity of the crisis and pass a bailout package shows that the government also lacks leadership and credibility.
- **Unemployment lag.** Following the stock market crash of 1929, unemployment didn't peak until 1933. This lag should be kept in mind when considering how long this difficult economy might last.



Speaker Biographies

Howard H. Stevenson, MBA 1965, DBA 1969 (Moderator) *Sarofim-Rock Baker Foundation Professor*

Howard Stevenson is Sarofim-Rock Baker Foundation Professor; senior associate dean, director of Publishing; and chairman of the board of Harvard Business Publishing. He served as the vice provost for Harvard University Resources and Planning, after service as senior associate provost from 2005 to 2007. As senior associate dean, director of External Relations at HBS from 2001 to 2005, he led the School's successful capital campaign. From 1999 to 2001, he served as chair of the Latin American Faculty Advisory Group. He also served as HBS's senior associate dean, director of Financial and Information Systems from 1991 to 1994. He has been faculty chair of the executive Owner/President Management Program and of the Publications Review Board for Harvard Business Press.

Stevenson was a founder and first president of the Baupost Group Inc., which manages partnerships investing in liquid securities for wealthy families. From 1978 to 1982, he was vice president of finance and administration and a director of Preco Corporation, a large, privately held manufacturing company. Before 1978, Stevenson held various academic appointments at Harvard University, specializing in real property asset management and general management. He received his BS in mathematics with distinction from Stanford University and his MBA, with high distinction, and DBA degrees from HBS.

He has written, cowritten, or edited 11 books and over 40 articles, including *New Business Ventures and the Entrepreneur*; *Policy Formulation and Administration*; *The Entrepreneurial Venture*; *Do Lunch or Be Lunch: The Power of Predictability in Creating Your Future*; *Winning Angels: The 7 Fundamentals of Early Stage Investing*; *Just Enough: Tools for Creating Success in Your Work and Life*; and *Make Your Own Luck*. He has also written, cowritten, or supervised over 150 HBS cases.

Stevenson is a director of Camp Dresser & McKee Inc. and Landmark Communications Inc., and a trustee for several private trusts and foundations. He is a life trustee of the Boston Ballet and has been a director of Sudbury Valley Trustees, where he was president from 1996 to 2000. He is chairman of the National Public Radio board of directors, a trustee of Mount Auburn Hospital, and a member of the advisory board of J.J. Strossmayer University of Osijek, Croatia.

Michael D. Fascitelli, MBA 1982 *President and Trustee of the Board, Vornado Realty Trust*

Michael Fascitelli is president and a trustee of the board of Vornado Realty Trust. He is also president and a trustee of Alexander's Inc. and a director of Toys "R" Us.

After graduating in 1978 from the University of Rhode Island with a BS summa cum laude in industrial engineering,

Fascitelli joined the Bristol-Myers Company. In 1982, he received an MBA with highest distinction from HBS and then worked for McKinsey & Company.

In 1985, Fascitelli joined Goldman Sachs & Co. in the real estate department. He became partner in 1992 and was head of the real estate investment banking business. He served on the Whitehall Investment Committee. In December 1996 he became president of Vornado Realty Trust.

Fascitelli is a trustee of the Urban Land Institute and chairman of Wharton's Zell/Lurie Real Estate Center. He serves on the boards of the New York University Child Study Center, Rockefeller University, and St. Bernard's School. The Greater New York Councils of Boy Scouts of America gave him the Good Scout Award, the James E. West Fellowship Award in 1997, and the Silver Beaver Award in 2003. In May 2008, he received an honorary doctor of laws degree from the University of Rhode Island.

Nori Gerardo *Partner, Chief Strategist for Private Real Estate, Chairman of Private Real Estate Investment Committee, Partners Group*

Nori Gerardo is a partner, chief strategist for private real estate, and chairman of the private real estate investment committee of Partners Group, one of the world's largest global alternative investment managers. Before joining the San Francisco office of Partners Group, she was managing partner and CEO of Pension Consulting Alliance, a global leader in real estate investment consulting, which she cofounded in 1988 and sold to Partners Group in 2007. Among the firm's clients for which Gerardo has primary client responsibility were the California Public Employees' Retirement Fund and the State of Oregon. She has also represented the sovereign wealth funds of Ireland, Norway, and the United Nations in developing their strategic initiatives for investing globally in real estate.

Earlier she cofounded Public Storage Management Inc., an institutional money management firm deploying pension capital to acquire real estate assets. She has also worked as an attorney specializing in SEC and ERISA matters on behalf of pension funds, real estate managers, and real estate pension consultants.

Gerardo graduated with honors from Stanford University and holds a JD from the UCLA School of Law, where she was the chief comment editor of the *UCLA Law Review*. She is a former member of the boards of the Pension Real Estate Association and the Real Estate Research Institute. In 2007 she was a lecturer at HBS and has guest lectured at the Wharton Business School and MIT Center for Real Estate, where she was the 2005 Commencement speaker. In 2006, *Private Equity Real Estate* magazine named her one of the 30 most influential individuals in private real estate worldwide. In 2007, the same publication named her the second most influential individual in private real estate globally, behind Sam Zell.

**Scott D. Malkin, MBA 1983***Founder and Chairman, Value Retail PLC*

Scott Malkin is the founder and chairman of Value Retail PLC, a company that develops and operates high-end outlet shopping villages serving the capital cities of western Europe. These nine properties generate average sales as high as approximately \$2,000 per square foot and have total sales of about \$1.5 billion. Shareholders in Value Retail include Chelsea Property Group (the wholly owned subsidiary of Simon Property Group), Hammerson PLC, Deutsche Bank, and the Dutch Pension Fund ABP.

Malkin is also the founder and chairman of S.D. Malkin Properties, a specialist property investment and development company concentrating on innovative retail and boutique hotel projects in the United States. S.D. Malkin Properties is the majority shareholder in Value Retail PLC. Its projects include the award-winning, full-price luxury retail development 2 Rodeo Drive in Beverly Hills, California, where S.D. Malkin Properties was a partner and served as project manager.

Malkin is a graduate of Harvard College, Harvard Law School, and HBS. Among other Harvard commitments, he serves as a member of the Overseers' Committee to Visit Harvard Business School and as fundraising chair for the MBA Class of 1983's 25th Reunion. He is also a trustee of the Urban Land Institute and of Community Service Volunteers and a member of the New York Public Library Council of Conservators. Malkin and his family have lived in London since 1991.

William Poorvu, MBA*Adjunct Professor in Entrepreneurship, Emeritus*

William Poorvu is the Class of 1961 Adjunct Professor in Entrepreneurship, Emeritus at Harvard Business School. He taught and was responsible for the real estate courses there for 35 years. He was the School's first adjunct professor, its first adjunct professor with a named chair, and the first non-tenured professor at Harvard University to be given Emeritus status. He also was on the faculty of the Graduate School of Design for many years. He is the author of several books on real estate, the two most recent being *Creating and Growing Real Estate Wealth: The 4 Stages to a Lifetime of Success*, 2008 and *The Real Estate Game – The Intelligent Guide to Decision-Making and Investment*, 1999.

As a practitioner he has been the managing partner in a number of private real estate companies. From 1963–1982 he was the cofounder, vice chair and treasurer of Boston Broadcasters, Inc., and in 1982 a cofounder and chair of The Baupost Group LLC, an investment firm where he currently is cochair of its Board of Advisors. For 22 years he was also an independent trustee of the MFS Group of Mutual Funds. He has also served on the board of a number of public Real Estate Investment Trusts over the years.

Among his community activities, he is a life trustee and former vice chair and treasurer of the Boston Symphony

Orchestra, a trustee and treasurer of the Gardner Museum and vice chair of the National Public Radio Foundation. He has chaired or cochaired all three of their investment committees. He is a member of the Carnegie Corporation Investment Committee and a former member of the Yale University Investment Committee and of the Yale University Council. He has served on various government commissions including the State Department's Overseas Presence Advisory Panel.

He received his BA from Yale University in 1956 and his MBA in 1958 from Harvard Business School.

Arthur I. Segel*Professor of Management Practice, Finance Unit*

Arthur Segel is Professor of Management Practice in the Finance unit at HBS. He teaches the second-year MBA elective Real Property. He also teaches in Executive Education programs. Previously, he was the cofounder (1982) and co-owner of TA Associates Realty, and before that he was vice president at Boston Properties and deputy for finance and administration at Massport under Governor Michael Dukakis.

Segel is chair of the advisory committee of Xander Funds, a real estate private equity investment company in India that he cofounded in 2005. He serves on the advisory committees of HighVista, a firm based in Boston that specializes in the management of broadly diversified portfolios of marketable securities and alternative asset classes, and of London-based Portland Capital, an international real estate hedge fund with a bias toward European public real estate securities. Segel cofounded the Tobin Project, a nonprofit academic progressive think tank based in Cambridge, Massachusetts, in 2004 and the 21st Century Fund, a nonprofit for public education, in 1998.

Segel is a member of the Urban Land Institute, NAIOP, and the Boston Symphony Orchestra's executive committee. He was named one of the 30 most influential players in real estate in 2006 after a poll conducted in the *Private Equity Real Estate Journal*. He received an MBA from Stanford University and a BA from Harvard College.