



REAL ESTATE REPORT

WHARTON REAL ESTATE CLUB NEWSLETTER

SPRING 2007

ISSUE 1

New York Development and Finance Treks



The Wharton Real Estate Club took New York by storm on Friday, January 12. We had 20 attendees on each of two treks – one focused on Development, and the other on Finance and Private Equity. The Development Trek visited with Related Companies, Vornado Realty Trust, and Forest City Ratner. Forest City even took us on a tour of the unfinished New York Times Building, where we took in the views from the 52-story roof in midtown. The Finance and PE Trek visited Apollo Real Estate, Lehman Brothers Real Estate Private Equity Group, Morgan Stanley Real Estate, and New Plan Excel. At the end of the day we met for a joint happy hour with New York area Real Estate alumni. If you would like more detailed information on the firm visits or the New York market, please feel free to contact David Orowitz, Andreas Hadjitheoris, or Laura Kirschbaum for Development, or Sally Mahloudji or Lee-Shian Hsieh for Finance.

Chicago Real Estate Career Trek

On Friday, December 8, Rachna, Aaron, Patricia, Laura, Kelly and Melissa braved 8°F weather and hit the streets of Chicago to visit four firms and learn about the real estate market in the Windy City. The day started off with a visit to AMLI Residential's headquarters, where we heard about the apartment market in Chicago. Next was a visit with the John Buck Company, who gave us a tremendous overview of the Chicago market and took us for a brief tour of their new development at 111 S. Wacker Drive. From there we headed to Hines, where we ran into Nate McOmber who was there for his interview. We were even able to see their leasing center for their new development, directly overlooking the construction site. We finished the day with Walton Street Capital, where we learned about how they finance developments in other countries. If you would like more detailed information on the firms or Chicago market, please feel free to contact Kelly Meissner or Melissa Bryan.

March

1 The Next 100 Million: Where Will They Go?

Hosted by the Penn Institute for Urban Research and Regional Plan Association 6:00 pm, JMHH F85 reception to follow

14 Co-Presidency Slate Speeches

6:30pm, JMHH 345
Voting begins afterward

16 Spring Argus Training

9am-3pm, JMHH 240

20 VP Slate Speeches

6:30pm, JMHH 240
Voting begins afterward

23 New Club Officers Announced

23 Property Tour of the Rittenhouse Hotel

April

11 Real Estate Club Social

Welcome the new Board!

Wharton Real Estate Alumni:

Be sure to register for the **Real Estate Alumni Directory** to gain access to hundreds of Wharton real estate alumni, news, alumni events, and job opportunities!

<http://realestate.wharton.upenn.edu/alumni/>

Philadelphia Career Trek

On Friday, December 1, Wharton sent a full crowd of 25 people to visit the five firms on the Philadelphia Trek. Although we had some limitations for afternoon space, the whole group was able to tour Toll Brothers Development at Naval Square and Liberty Property Trust's development at Navy Yards. Both of our early visits included a discussion of the history of the area being developed, followed by a site tour. We had lunch and candid conversation with AMC Delancy, where Ken Baylin shared his advice for us as new people to the world of real estate. Next we headed to Cira Center to visit with Brandywine's Urban Division, where we learned that the LED lights are to emphasize the architectural significance of the building even at night. We finished the day with coffee and cookies at the Center City District offices, where Paul Levy showed us slides depicting the state of Philadelphia in 1990, and everything that the District has done to make Center City a better place to live since then. If you would like more detailed information on the firms or Philadelphia market, please feel free to contact Laura Grable or Charlie Rose.

(Note: The following analysis and commentary is the sole opinion of the authors, and does not reflect the views or opinions of Wharton or the views or opinions of The Wharton Real Estate Club Newsletter and its editors. The statistics referenced in this commentary were provided solely by the author and have not been independently verified by the Wharton Real Estate Club Newsletter or its editors).

Apartment Rentals Sarah DeSantis-Sullivan

2007 appears poised to be a strong year for multi-family residential, trending on declines in vacancy, favorable demographic trends, challenges faced by over-extended homeowners, and rental growth.

On the demand side, the run-up in housing prices over the past several years has turned potential buyers off in fear that home prices will fall; in fact, over half of Marcus and Millichap^[1] survey respondents from August and September of 2006 expect a modest, but notable, correction of 10%-20% in housing prices this year. Furthermore, many past buyers have been left in jeopardy of default, with nearly a quarter of recent-year mortgages adjustable-rate. An ever-increasing number of owners are faced with large, unaffordable, mortgage payments when loans reset. In some of the highest-priced markets, homeowners already spend almost half of their income on housing, far above the recommended 30-35%. The combination of deteriorating credit with reduced affordability hastens the growth of the renter pool over the next few years.

The apartment market is further bolstered by the prospect of significant rental growth. The Marcus and Millichap survey conducted revealed that 62% of real estate investors are confident that effective rents for apartments will rise. Furthermore, 35% of respondents expect an increase in the prices of apartments, more than for any other commercial asset class. Optimism appears based on job growth and the retraction of the single-family market. While during the 2001-2005 period apartment rental rates were flat or declined, the decrease in vacancy rates will once again allow owners to raise rents and reduce concessions. Finally, markets some markets may experience unpredicted rental supply constraints due to the condo-conversion boom over the past several years.

Houston Career Trek

On Friday, November 17, Andres, Cesareo, Chad, Megan and Patricia traveled to Houston to visit Trammel Crow, Hanover, Hines (headquarters) and Weingarten. The trek focused on development and included two site visits. It was a great day: all of the firms were very welcoming and talked liberally about the real estate industry and their respective firm's successes. As we learned, the Houston market is booming due to an influx of new residents, which, in turn drives the housing and office markets in the area. In addition, on a more practical note, we learned to closely read the parking signs in order to avoid visiting the Houston towing company at midnight. If you would like more detailed information on the firm visits or the Houston market, please feel free to contact Patricia Werhahn or Megan Thomas.

Though moderating the trend in apartment rental growth are for-rent condos, all-in-all 2007 looks to be a positive year for the sub-sector. The rate of rent growth looks to surpass that of appreciation. As a result, investors remain bullish, with nearly half expecting an increase in cap rates.

Other Notables:

As of late 2006, development trails demand, with the number of in-process units unchanged from a year before. Levels remain below those reported in 2004 and 2005.

The potential exists for a large number of condo projects to be brought in as rentals. Expectations for 2007 units currently rest at 92,000, but they could easily be surpassed.

Allocations to real estate by institutions are expected to rise in 2007 to twice the historical norm to between 10 and 15% in 2007. Institutions have been paying premiums for top-tier assets at the high end of the market.

Source: "2007 Real Estate Investor Outlook", Marcus and Millichap "Apartment Fundamentals Expected to Remain Strong in 2007", Multi-Housing News; www.multi-housingnews.com

Real Estate In India

Giuseppe Sette

When I was a kid, my grandfather – a developer in Rome – used to tell me stories of Italy after World War II. A poor country blasted by the war and still heavily agricultural, Italy was headed rapidly into that economic boom that would be called the “Italian miracle” in successive decades. Rome was blooming: residential property went for 100% presale, as did retail – with retailers eager to reap the fruits of the welfare surge. And office absorption by government and private business seemed insatiable. It was a developer’s dream that lasted for two decades, until the oil crisis.



When I landed in Bombay, I felt exactly the same atmosphere, I met with real estate professionals in Mumbai, Delhi and Bangalore. The key impression I got is that of an emerging market. Some developers have reached national scale, fundraise in London and produce western-quality property. And the major brokers are all there, including DTZ Rockwood, Cushman & Wakefield, and Jones Lang LaSalle. Yet the market as a whole appears to be pristine and underserved in a number of value chain segments. REITs are yet to be introduced, and capital markets on the Bombay and National Stock Exchanges are still in their adolescence. Debt operators are limited mainly to local banks, with the private debt and mezzanine industry still in its infancy due to the inadequacy of the legal system. International equity partners have recently appeared in the market – as foreign direct investments were liberalized in February 2005 – but still only 0.5% of the total national property is managed “professionally” [*Economic Times, Real Estate section*]. While current prices seem over-inflated, all in all the market is hot.

A Closer Look at the Market

The three *Tier I* cities are Delhi (20 million inhabitants in the metropolitan area called NCR), Mumbai (formerly Bombay, 25 million inhabitants in the wide metropolitan area) and Bangalore (6 million inhabitants only in the city). Then follow *Tier II*: Pune, Hyderabad, Chennai; and *Tier III*: Kolkata (Calcutta), Mangalore, Nagpur, and the other 15 hubs.

Delhi is the government capital and has been experiencing a horizontal expansion of real estate as land was easily available and building height was constrained. On the other side, Mumbai is the financial capital of the nation – hosting the National Stock Exchange – and is land-constrained as it stands on an island. Together with Bangalore, these cities should represent the key long term bet on the market, although prices nowadays are considered excessive, and investors are actively looking at Tier II/III cities.

Drivers for Growth

The key drivers in the evolution of the real estate market are:

Increase in urbanization Only 300 million people live in cities, which implies an urbanization rate of 28% (vs. China’s 40%). This means that 800 million people still conduct rural lives. As new jobs open, the migration from the countryside is expected to continue.

Emergence of the middle class The wave of money generated by the service industry is sustaining a strong growth in employment from local and multinational corporations, with consequent need for new class A and B office space. Conversely, new jobs are sustaining the emergence of a middle class, which desires better housing and high-quality retail.

Redevelopment opportunity In historical downtowns, the urban quality of even the most prime real estate locations is low by western standards. Bombay is the most evident case, where slums survive next to the “posh” parts of the city, and even in prime locations, life-long fixed rents are withholding landlords from redeveloping decaying properties.

Introduction of Foreign Direct Investments Liberalization in early 2005 allowed automatic authorization for real estate FDIs aimed at developing at least 50,000 square meters of “resorts, townships or commercial premises”. There are \$10 billion of FDIs in pipeline for the current year.

Cap rates vs. interest rates vs. inflation While spreads are not dramatic – with cap rates just over 10%, and debt on stabilized property around 9-10%. A 5% inflation rate allows for an inflation-hedge strategy on stabilized leveraged properties.

The Dark Side of the Moon – A Country Full of Risks

Of course, not all that glitters is gold. The country has some serious issues that a real estate operator has to face.

Speculation and a real estate bubble Bombay suffered a real estate bubble burst from 1995 to 2001, as the market anticipated the outsourcing boom too much in advance. Today, prices have reached historical peaks, yet speculation has been strong. In the residential market, one can find condos that have been sold out and are still half empty, Dubai-style. Expecting a correction in the short term might be unreasonable.

Legal system fallacies Title and deed identification are still far from western standards. Many times, *de facto* owners of property can claim no title to it, so they can’t legally sell it. This is hindering the development of debt instruments and the amount of leverage available in the market.

Social and religious turmoil Poverty is widespread across the region, with at least 400 million people living in poverty. Bombay alone is home to 50,000 street children below age 15 because they have “fled abuse and violence in their rural houses” [*TOI January 6th*]. Religious conflict between the Hindu majority and the Muslim minority is still ongoing. Border conflicts are still relevant. Pakistan and the Kashmir are a question in the Northwest. Marxist vs. Maoist conflicts are present in the Northeast. Sri Lankan turmoil in influences the Southeast. While peace-making processes are underway, the political risk cannot be underestimated.

Is This the Right Moment?

So, is this the right moment to do business in India? The answer is in your willingness to take risk. Yet, if you look at the potential for downturn in some western real estate markets in the next few years, India could be the El Dorado of Real Estate.

Source: Deutsche Bank Research "Building up India, Outlook for India's real estate market" May 8, 2006

Samuel Zell Lecture, November 14, 2006

Samuel Zell, the endowment donor of the Zell/Lurie Real Estate Center at Wharton, spoke to a full house in G06 on Tuesday afternoon. The format was a conversation with Peter Linneman, the Albert Sussman Professor of Real Estate here at Wharton. Their conversation often included personal anecdotes of their many years working together in the real estate industry.

Zell has been nicknamed the "Grave Dancer" because of his proclivity for buying distressed assets and reviving them. He has been well-rewarded for his efforts. Until the recent sale of Equity Office Properties, Sam Zell could have been considered the second largest property holder in the United States, behind only the federal government.

Linneman began the discussion asking about Robert Lurie, the "other name" in both Wharton's and the University of Michigan's Zell/Lurie research centers, concentrating on real estate and entrepreneurial studies, respectively. Although Zell funded both centers, he insisted that Lurie's name be included as well. Zell's reasoning was that he and Lurie were true partners, starting when they were undergraduate property management entrepreneurs at the University of Michigan, and continuing for over 20 years until Lurie's death. Zell attributed their close partnership to a combination of longstanding trust and shared risk, adding that although there are many great people, great business partners are extremely difficult to find.

Throughout the lecture, Zell returned to what appeared to be his main lesson to the group of MBAs and undergraduates assembled – that America is truly the land of opportunity. He was born only ninety days after his parents emigrated from Poland, and even though he started "from scratch", he is now on the Forbes list of America's wealthiest people. Zell attributed his success to understanding simple economics, constantly seeking efficiencies, and having self confidence.

In his entrepreneurial spirit, Zell made the point that "nobody ever made good margins by going along with everyone else." He believes that to be successful, one has to have the confidence to trust economic intuition and not buy into conventional wisdom. His great successes have been when he sees everyone following a trend, when he believes that the right decision is the opposite. Zell insisted that in those cases, it is best to "march the other way, and march the other way with conviction."

Zell maintains substantial interests in and serves as Chairman of the Board of various corporations, including Equity Lifestyle Properties, Inc. (ELS), a self-administered and self-managed equity real estate investment trust which owns and operates manufactured home communities in 26 states; Equity Residential (EQR), the largest apartment real estate investment trust in the United States; Capital Trust (CT), a specialized real estate finance company; and until recently, Equity Office Properties Trust (EOP) the largest office portfolio of any publicly traded, full-service office company in the United States. Zell is also Chairman of Equity International Properties which invests in real estate-related companies outside of the United States.

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