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THE DEMISE OF THE REIT'S AND THE FUTURE OF SYNDICATIONS

BY

ROBERT WIBERG

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THE DEMISE OF THE REIT'S AND THE FUTURE OF SYNDICATIONS

by

Robert Wiberg *

October 1984

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Center for Real Estate and Urban Economics

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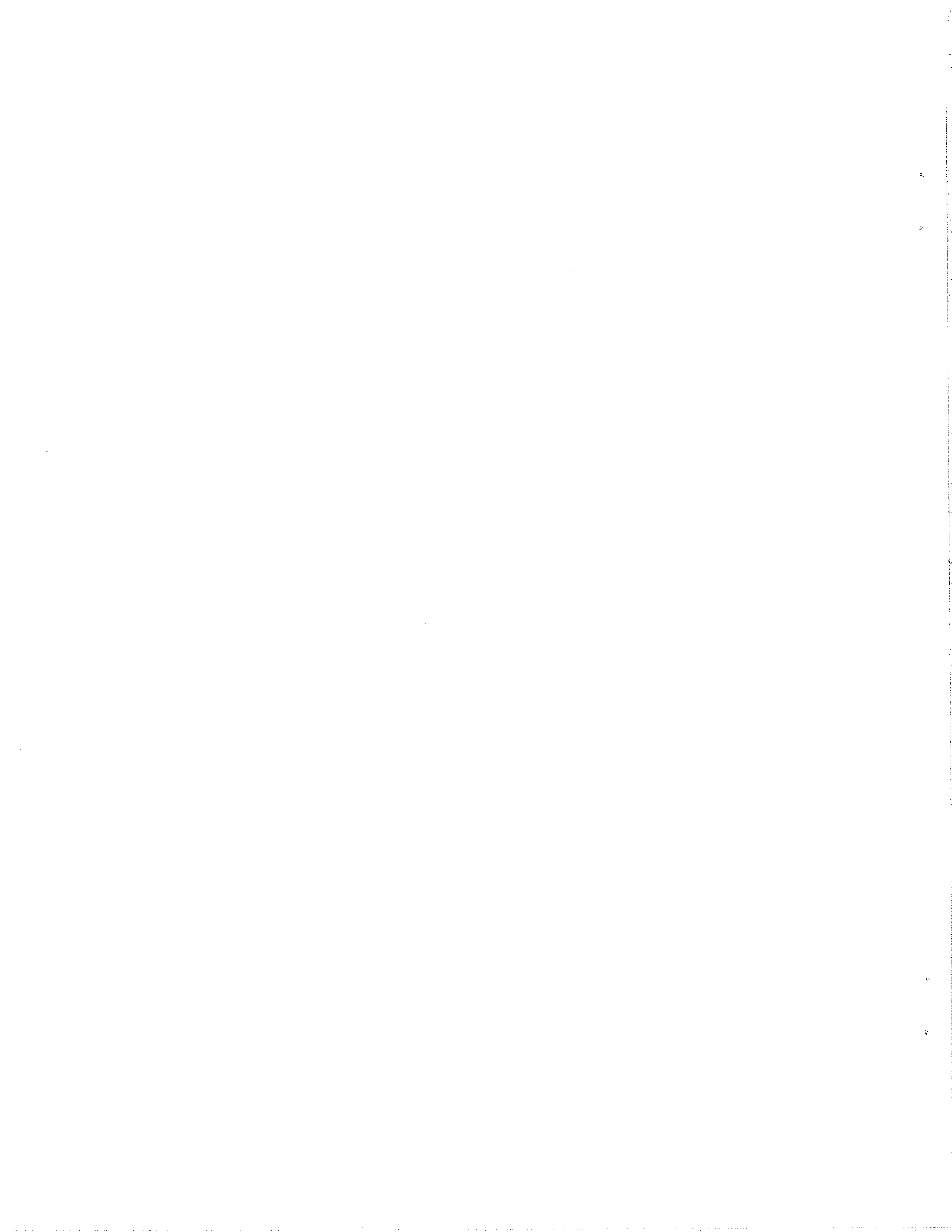

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EXECUTIVE SUMMARY

The dynamics of the Real Estate Investment Trusts (REIT) of the 1970's, and the real estate syndicators of today, offers an interesting comparison. Both investment vehicles represent the merger of a financial services organization with a real estate entity. Both have been very successful in attracting capital, by offering the benefits of real estate ownership to small investors. And both have met high expectations, offering a superior return on invested equity.

Only in the case of the REITs, the bottom eventually fell out. The dynamic was an overabundance of financing leading to an oversupply of new construction, high vacancy rates, low income, and eventually a negative cash flow. Covering the negative cash flow ate away at investor's equity, until the trust itself couldn't meet its obligations on borrowed funds, and fell into near bankruptcy.

While syndications offer an equity, rather than a debt position, the real estate aspects of the deal are largely the same. Broker/dealers raise funds on the promise of appreciation and tax writeoff, substantiated by the syndicator's early successes. A vast pool of funds overwhelms the real estate market (this time from

an ownership position), until the supply of product exceeds the underlying tenant's demand. The result is poor cash flow, especially damaging for a partnership established for large tax writeoffs. The tax oriented investor may then be required to cover the negative cash flow, while facing a stiff tax penalty if the project goes into default. The effect of such overbuilding is already being felt, particularly in the Sun Belt, the heartland of the real estate syndicator.

The future of syndication lies in the ability of sponsors to bring the supply of investor funds into equilibrium with the demand for rental units, rather than the demand for tax writeoffs. As long as tax factors continue to dominate the syndication business, all sponsors will be pushed to offer yields comparable to those of the tax oriented partnerships, which will have an adverse long run impact on the entire industry.

The prognosis for syndications given existing conditions, is for diminished returns to investors across the board. The hardest hit will be highly leveraged, tax oriented, non-diversified portfolios. The magnitude of any pending fallout, however, will not match that of the REITs, as both the projects and the sponsors are better capitalized. The implications for the real estate industry will be a reduction in the allocation of capital toward real estate ventures, more in

keeping with the risk/return relationship offered by other investment alternatives.

I - INTRODUCTION

The real estate industry is rapidly evolving to allow both small and large investors access to the benefits of real estate ownership. Management of these new investment vehicles requires not only real estate expertise, but financial sophistication as well. As for investors, they demand superior returns in an evolving and uncertain environment. The response has been the institutionalization of many financial aspects of the real estate business.

Two of the major investment vehicles available today are the Real Estate Investment Trusts (REITs) and limited partnerships (or syndications). Each offers a sophisticated, packaged option to investors who generally lack real estate expertise. Sponsored by well respected financial services organizations, these vehicles have gained investor respect. But the apparent security provided by the sponsoring institution, obscures the fact that unlike stocks or bonds, their products are subject to the inherent volatility of the real estate industry.

History has all too dramatically demonstrated the need for prudent investing in real estate ventures. The REIT shakeout of the 1970's made clear the fact

that REITs were secured by real estate, and not more stable industrial or service organizations. That lesson may be lost on many of todays investors in syndication, who seek the attractive returns, but pay all too little attention to the accompanying risk.

This paper attempts to isolate the major factors which led to the downfall of the REITs, and examines whether the same conditions may exist for investors in limited partnerships. In particular, this paper addresses the success of limited partnerships to date, and provides an analysis of their future prospects.

Due to the highly technical nature of these investments, this paper takes more or less a broad brush approach, identifying major elements of both investment vehicles, rather than the multitude of relevant but less significant issues.

The structure of the paper is as follows: Chapter 1 provides an introduction to the paper; Chapter 2 examines the growth of the real estate investment market; Chapter 3 addresses the REIT experience; Chapter 4 the role of limited partnerships; and Chapter 5 draws an analogy between the REITs and syndications, focusing on the future of the syndication business.

II - THE INSTITUTIONALIZATION OF REAL ESTATE

The institutionalization of real estate is a recent phenomenon. Investor interest in real estate prior to World War II was limited, with few accepted investment vehicles or managers. Individual investors were relegated to outright ownership positions, which lack the scale economies and diversification characteristic of pooled funds. Since that time an increasing number of real estate investment vehicles have been created, but until recently these packaged investments ere held in low regard by the general investment community. Real estate was viewed as a problematic investment because:

a) Professionalism in the industry was minimal, with few qualified advisors or investment options.

b) The organizational structure of the real estate market required a less technical approach to investment than with securities.

c) There was, and is, no central market for real estate investment.

d) The high leverage employed in real estate

transactions minimized equity requirements, thereby limiting investment opportunities to those not directly participating in the deal.

e) The geographic diversification of products, and their fixed nature, required a different market structure and expertise than typical of the securities industry.

f) Information on which to make qualified investment decisions was generally not available, lessening investor interest, and reducing marketing options available to brokers.

Since the mid 1960's there have been fundamental changes in the way real estate ventures are financed and owned. This institutionalization of the real estate investment management process was in response to a number of factors.

The traditional investment options, stocks and bonds, have offered disappointing yields, at times not even maintaining the real value of the initial investment. At the same time, concern over inflation and maintaining the real value of equity peaked in the mid 1970's when double digit inflation became a reality. Real estate is a preferred inflation hedge, as its

value is closely tied to, and in fact a major contributor to the index of inflation.

Investors saw the large returns available from real estate investment, in both the commercial and residential markets. The perception that real estate investment offers one of the few inefficient investment markets, where one could earn a superior return/risk relationship, became more prevalent.

Congress passed tax legislation designed to stimulate real estate investment, through tax reform. Real estate provided a level of tax sheltering generally not available to investors, while also generating significant capital appreciation.

The advent of investment advisors, both on and off Wall Street provided a new market for real estate investment vehicles. The new packages were seen as filling an investment void, while offering significant financial incentives to their sponsors.

In response to this new demand for investment options, the structure of the real estate investment industry evolved dramatically. Investment sponsors now include a multitude of industry groups, from small investment managers to large banks and insurance companies. Perhaps one of the most limiting constraints has been the availability of qualified investment

managers. These investment advisors must possess the skills of the security analyst in terms of financial and marketing skills, along with real estate sophistication required to operate on a national or regional level.

The parameters of the real estate investment marketplace are also bringing about fundamental strategic changes in the industry. With increased competition in the marketplace and slower economic growth, appreciation will no longer bail out bad investments. Fund managers must take a more sophisticated approach, developing a strategic investment philosophy to yield superior returns. The dynamic aspect of the marketplace will continue to force changes in the industry structure, and those who prosper must be astute enough to perceive and respond to the needs and constraints of the marketplace.

Today's Marketplace

Investor interest in real estate ventures has increased at unprecedented rates. Behind this recent wave of enthusiasm are several fundamental factors:

a) Individual investors generally lack the experience or resources to compete with professional investment managers, even if they decide to take an active

investment position. The highly trained real estate professional, on the other hand, can offer the specialized training in property analysis, finance, law , tax, etc., necessary to succeed in today's highly competitive market.

b) Contemporary real estate investment vehicles offer small investors a means of participating in ownership of a venture beyond their individual means. Packaged like securities, there is little expertise required of the investor to take an equity position.

c) Due to the legal structure of most investment options, the liability of the individual participant is generally limited to the amount of funds contributed.

d) The majority of investment vehicles offer a pool of real properties, representing a diversity of geographical locations and property types. This type of diversification is outside the scope of the individual investor, and provides some insulation from the strongly cyclical nature of the real estate business.

e) Along with diversification, pooled property funds allow economies of scale which could not be achieved by the individual investor. The skills required to maintain a competitive portfolio in terms of acquisitions,

management and disposition are beyond the capacities of most individuals, and require an even greater degree of expertise when operating on a national, rather than a local scale.

f) Pooled real estate funds provide a level of security not available to the individual investor. If one of the properties goes bad, substantial reserves are available to pull the partnership through. Credible fund sponsors also have increased accessibility to favorable lines of credit, and other non-bank sources of funds to meet short term capital requirements.

g) The illiquidity of real estate has been perceived as a major liability to potential investors. While few real estate investment vehicles provide true liquidity, most all sponsored pools do provide a means of equity recapture, through trading of shares or partnership repurchases. In either case, this provides significantly more financial flexibility than available in a typical ownership position.

The real estate financing and investment process has responded to investor interest. Rather than banks controlling the construction lending business, and life insurance companies the permanent financing market, new

opportunities are available to investors and developers alike. Since the mid 1960's there has been a burgeoning number of financing and ownership alternatives made available. Principal among these are the increasing role of non-banking, institutional sponsorship of REITs and syndications.

REITS emerged during the early 1960's as an opportunity for the individual investor to participate in a publicly traded real estate fund. The first of the significant vehicles open to small investors, REITs controlled as much as $21 billion in the early 1970's. Despite a subsequent and major shakeout of the industry, REITs still control over $3.5 billion in investor equity [Roulac,1983,p.7].

Today the dominant real estate investment vehicle is the limited partnership. Appealing to investors seeking both equity appreciation and tax shelter,the syndication business picked up where the REITs left off. Offering the ownership benefits of equity appreciation, interest writeoffs and depreciation, to date over $12.2 billion in funds have been placed in a combination of public partnerships alone.

III - REAL ESTATE INVESTMENT TRUSTS

Real Estate Investment Trusts (REITs) operate essentially as a conduit for investment funds, directed at the real estate industry. An REIT obtains its funds from individuals, banks, pension and mutual funds, and supplements this equity with borrowed money to leverage their assets. This capital is then invested in either an ownership position, or in construction or long term mortgages.

The REIT mechanism was facilitated by Congress in 1960 as a real estate investment vehicle with the tax advantages of mutual funds. REITs allow small shareholders to participate in a diversified portfolio of real estate holdings, while facilitating another source of capital for large scale development (and urban redevelopment). What makes a REIT particularly attractive is its exemption from corporate taxation, although dividends are still taxable to the recipient. To maintain this status Congress imposed stipulations requiring the trusts be unincorporated with at least 100 beneficial owners, of which no five control more than 50% of the shares; the trust must be a passive investor with active operations handled by an independent manager; 75% of their assets must be in real estate,

mortgages, cash or government securities at the end of each quarter; 75% of the gross income must be derived from real estate investments; and 90% of taxable income must be distributed to shareholders.

History

The first REITs were equity trusts which purchased properties outright and distributed the cash flow to investors. The leases were typically long term, but with inflated operating costs the trusts were only able to offer returns of 2-3% per year. More attractive, however, were the mortgage trusts which followed. These trusts placed their money in short term high yielding construction and development loans leveraged with borrowed funds, which enabled the early mortgage trusts to show impressive growth of 15% to 20% annually.

Behind this growth was the insatiable financing needs of developers in periods of tight money. The REIT loans were often more liberal in their terms than conventional financing, albeit at somewhat higher rates. Funds were typically lent for land acquisition, infrastructure and improvements, limited to 65% to 75% of the project's appraised value, for an average of 18 months.

The trusts were also able to offer unique one-stop mortgage financing on a national basis. Touted as a money machine, the trusts would attract cheap funds on the basis of high earnings growth. With new shares selling at more than book value, the mortgage income they generated would serve to increase the firms overall earnings per share, in a process known as contradilution. Coupled with rising borrowing rates on newly invested funds, REIT stock prices skyrocketed.

Wall Street became captivated by the REITs, which were described as the Number One glamour stock of 1969 by a leading business periodical. With the opportunity for quick profit came an onslaught of new trusts, often started by groups with virtually no background in the field. Over the period July 1969 to November 1971, the number of registered trusts grew from 40 to 114, with combined assets of over $5 billion [Kenseth,1971,p.5].

Real estate itself is a volatile industry, and this trend is mirrored in its investment vehicles. The REITs first signs of weakness became apparent in the 1969 bear market. One of the industry leaders, Continental Mortgage, typified the experience, as its P/E ratio plummeted from 36-1 to 12-1, without any decline in earnings per share. The popular reasoning behind this precipitous decline, were questions as to the validity of the previous high price multiples. The

criticism centered on several issues, including:

a) The rapid proliferation of REITs might result in a glutted market.

b) Management would not be able to keep pace with the industry's rapid growth.

c) Declining interest rates would result in lowered earnings, and increased competition from conventional lenders.

d) Use of leverage might overextend the REITs and subject them to regulatory pressures.

As early as 1969 Barron's suggested "the trust business hardly looks like everybody's sure thing, and a thoroughgoing shakeout is probably inevitable". Investors were not disheartened however, and the decline was short lived. The criticisms were never really addressed, as growth in the real estate and stock market fueled the investment fire. Even declining interest rates and increased competition from banks was not perceived as problematic because as long as rates kept declining the REITs could cover their long term lending with cheaper short term money.

By 1973 total assets of the REIT industry approached $20 billion. While the REIT promoters were very successful in raising capital, those placing the money were encountering more difficult times. With the best projects financed by banks, the more unique or speculative deals went to the REITs. By late 1973, even the bread and butter REIT loans were saturated, and new money was placed in increasingly risky projects. More often than not there was no long term financing commitment to the deal, although the hope was appreciation would bail out even a dubious property.

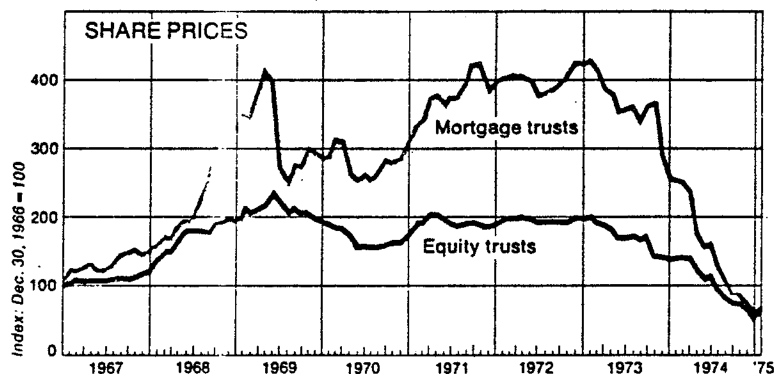
The structure of the industry propagated such activity, with the fund management separate from the trust itself by regulation. The advisors profited by earning a fee based on the assets controlled, typically 1% to 1.5% plus bonuses. The manager's profit only grew if more properties were acquired, regardless of their long run impact on the trust. As long as property values continued to increase, these abuses did not surface.

By 1974 the sun began to set on the REITs. High inflation and interest rates played havoc with the borrower's pro-formas, necessitating additional funds to avoid foreclosure. Too often the REITs continued to extend credit to minimize their problem loan portfolio, and concealed information from shareholders in the

process.

The extent of the REITs difficulties became apparent when in early 1974, the Walter J. Kasuba Realty Corporation filed for protection under Chapter XI of the Federal Bankruptcy Act. Kassuba was one of the nation's largest developers with a $550 million portfolio, of which $110 million was financed by 12 REITs. The first six months of 1974 spelled disaster for the REITs, who only a year earlier were still highly touted on Wall Street. Earnings of all the REITs were off sharply, with share prices plummeting. By July the average REIT was selling for 40% below book value. Losses in the REIT fallout were staggering, ith REIT prices dropping by 85% over the period of the 1973-1975 recession, as shown in Exhibit 1 below. Commented one trust manager "there are presently throughout the real estate industry more foreclosed properties for sale then at any other time since the Depression"(1).

EXHIBIT 1



Source: Wyndham,1975,p 115

While the peculiar structure of the REIT industry contributed to the shakeout, many aspects are endemic to other real estate investment vehicles. A number of the major factors contributing to the demise of the REITs, which may similarly affect other investment opportunities, are cataloged below.

Growth Pressures

The REITs were particularly susceptible to pressure from Wall Street for growth in assets and income. Incentives to management reinforced this philosophy, and often led to imprudent asset selection. While the REITs employed checks and balances to insure assets measured up to acceptable risk and return standards, this process was frustrated in two ways.

Appraisals - REITs often found themselves in the position of lending on land as well as improvements. While a nationally chartered bank will not make land loans, the REITs did not share this criteria, and exploited the often legitimate and substantial profits to be made on land loans. The practice of holding land was popular with developers as speculative pressure was forcing up land prices at rates up to 15% to 20% per year. By

1) W.J. Smith Jr., Managing Trustee of Cameron-Brown Investment Group

acquiring land in the path of development the developer could capitalize on this appreciation, while controlling a valuable site. To justify the land loans and maintain their 'conservative' philosophy, the as-developed appraisal became accepted. "For example, land purchased for as little as $300 per acre in the west could be appraised on an as-developed basis for $6,000. This represented the value of the land after improvements and amenities were put in. The cost of improvements, amenities, and holding costs was estimated to be $2,000 per acre. The net value of the land as developed was then $4,000. This valuation allowed the REITs to loan the full purchase price plus as much as three- to five-years of interest expenses, loan fees, real estate taxes, and administrative overhead allocation and still show a 'conservative appraisal'. In this case the land would have been purchased for $300 an acre, the carrying costs added another $300 an acre, and the trust still could have an appraisal show that showed a 25-50% loan/value ratio"[Stevenson,1977,p.251]. Of course in foreclosure it was often difficult to sell the land for even the $300 acquisition price. As a result the security of the loan rested entirely on the developers ability to carry out and successfully market the project.

Market Premiums

The product available to satisfy the REITs growing appetite was often overpriced and poorly located. To sell the deal the developer would market it as a superior product commanding market premiums, although often non-compatible with the target tenant market. To justify the pro-formas, market analysis continued to show above market rents growing at straight lined, high growth rates.

By investing in the project the REITs became the developer's partner in risk, but not return. On the downside the REITs had complete exposure, but generally did not have much participation in upside potential. Nor did the REITs have the personnel to properly inspect and appraise the properties, or to monitor it once financed.

Growth Incentives

The REIT underwriters were interested only in dealing with growth issues. Mortgage trusts were particularly appealing because they could be highly leveraged, with the funds quickly placed into an earings generating role. Moreover, the sponsors were often major institutions whose reputation added security to the offering. This quest for growth gave way to further issues, for which the underwriters took a

substantial fee.

The growth incentive also had a direct impact on the trust's active management. The fee structure was based on the total assets controlled, without respect to the leverage utilized. By demonstrating growth the trust could attract new investors, increase leverage and boost the advisor's fees. Whether or not the project generated income, the broader asset base generated additional management fees and profits.

Management Control

The availability of REIT funds outpaced the availability of managers competent to place and service loans. Inexperienced personnel became loan officers after 12 month training periods. Staffs as small as eight were reportedly running a loan portfolio in excess of three billion dollars. Stretched to the limit, some lending officers were handling 40 to 100 loans per person[Stevenson,1977,p.256].

This pressure as well as a lack of experience helped lead the REITs astray. Low quality projects were financed, because the loan officer did not have the experience or market knowledge to properly assess the loan package. Operating on a national basis, new markets were entered without adequate information. Time pressures forced officers to loan on projects with

incomplete or inadequate market and engineering studies.

Control over funds, once appropriated, was also lacking. Funds were directed to pay the developer's overhead or other non-related expenses. Often the REITs were aware of this and built surpluses into the loan to cover such costs. As long as the market was good, rising sales prices and rents covered these dubious costs, but in lean times it only aggravated and disguised the extent of the problem loan portfolio.

Accounting Practices

Accounting practices for the REITs were complicated and non-standardized. This often meant the information available to investors was inadequate and misleading. The books of the REITs in many cases misrepresented the true financial position of the trust, which only became apparent in the fallout of 1974. One particular area of accounting misinformation was in the accrual of interest on the trust's books, before it was actually received. Many loans were made with the interest and principal due on maturity, but the borrower's interest payments were recorded on the books currently, as if they were actually being received, which led to an overstatement of the REITs earnings. This practice was widespread, with $4.2

billion, or 31% of the outstanding REIT loans in 1974, actually nonaccruing [Robertson,1975,p.115].

Problem Loan Coverups

The REITs were extremely reluctant to show a bad loan on their books because of its impact on their balance sheet. The problem loan stigma could be avoided in a legalistic sense by re-writing the loan, based on new value created through a reappraisal. Vacancy and sales problems were viewed as temporary, with the REITs lending additional funds to cover the developer's cash flow problems. When loans became seriously in default, they were sold at lage discounts. Only the discount didn't appear on the books, but only in the terms.

For instance, "an REIT which has sunk $14 million into some soured project wants to get back at least that sum - on paper - so it won't be forced to book a loss on its investment. For the privilege of keeping up accounting appearances, it may offer a 30 year mortgage at, say 6.5% interest - which, as even a casual visitor from the moon knows, is slightly below the going rate"[Thomas,1974,p.3].

Loan Loss Provisions

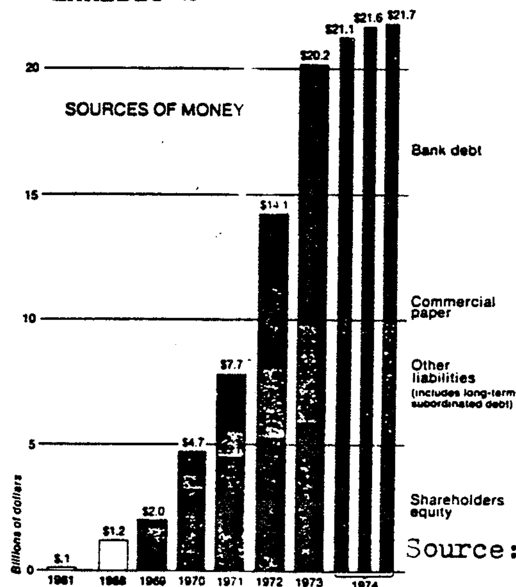
The REITs uniformly had under capitalized their accounts for loan losses. The industry's history of low loan losses, accounting to only $12 million for the $30 billion lent between 1960 and 1975, contributed to the perception that controls were not needed, and resources adequate in this area [Elebash,1980,p.272]. Even those REITs who acknowledged the inherent risk in their loans were dissuaded from making loss provisions because of the adverse impacts it would have on their dividend yields.

As the evidence of a pending shakeout of the REITs mounted, auditors wary of law suits began a close examination of the REITs portfolio. The effect on the REITs was staggering, for instance the case of Chase Manhattan's trust. The trusts $800 million in assets had been backed by only $2.3 million in loss provisions. On the basis of an in depth bank exam, the reserves were raised to a total of $5.3 million. But the outside auditors, after an extensive survey came up with a somewhat higher reserve figure of $16.3 million.This downpayment on loss reserves resulted in a 55% decline in earnings for the year [Robertson,1975,p.115].

Liability Management

REITs originally financed their assets by borrowing long term, or through private placements with insurance companies. By 1971 the REITs discovered the short term commercial paper market. The heavy use of this cheap money was backed up by unused bank credit lines. The leverage utilized by the REITs also increased to an average of 2.5 to 1 for all trusts, although several were leveraged as high as 7 to 1. The fall out hit when the commercial paper market dried up, and the trust fell back on the bank lines to pay off the debt. As lending losses began to accrue, shareholder equity declined and bank debt soared, as shown in Exhibit 2. Only a consortium of 100 banks under pressure form the Federal Reserve kept the majority of the REITs from falling into bankruptcy, the only alternative available to the trusts in order to suspend interest payments and shield their stockholders.

EXHIBIT 2



Source: Wyndham,1975,p 114

Update

Few REITS have been formed since 1974, following the major industry shakeout. Investor confidence has aned, in light of the very substantial capital losses incurred through REIT investments. Today there is approximately $3.5 billion invested in REITs, with a much higher representation of equity, rather than highly leveraged mortgage trusts.

IV - REAL STATE SYNDICATIONS

Real estate syndications offer an alternative real estate investment vehicle to the small and large investor. Rather than operate as a publicly traded pool of equity or mortgage funds, the syndicates acquire property through a limited partnership arrangement, and distribute the proceeds to the investors. The popularity of this mechanism has been expressed by investors, who placed an estimated $6 billion into public partnerships, and up to another $20 billion in private deals last year [Stephens,1983,p.387].

History

Real estate syndications have been around since the Second World War, generally appealing to well healed investors seeking tax shelter. In these arrangements, a sponsor serving as general partner, raises funds from a group of limited partners and invests the proceeds in a new development. The tax losses incurred during construction and the initial lease up period are credited to the limited partner, and generally are sufficient, given the investor's tax bracket, to recover much of their investment. Cash flow and capital appreciation from the project are

simply a bonus.

The other form of partnership, the public deals, were originally not structured for tax advantage, but as an equity investment with a predictable cashflow return. These early partnerships purchased existing properties, and allowed small investors to become involved in projects they could not otherwise take an ownership position in.

In contrast to the private placements which generally involve a specific project, the public partnerships are closed end pools of investor's funds offered through a prospectus, which covers several typical but unspecified properties. Public syndications, while similar to one another in financial structure, are differentiated by their acquisition criterion, geographic preference, property type, and risk profile. Most deals are set up for capital appreciation rather than large tax advantages.

Tax Effect

The tax shelter advantages of syndication come from two sources, depreciation and interest writeoffs. If the 50% tax bracket investor can achieve $1.50 in tax writeoffs from these sources, for every $1.00 he invests, his ownership position costs on net $.25 on the dollar. If the project is successful and generates

a positive cash flow of say 6% (cash on cash) for each dollar invested, the return to the limited partner is \$.06 on his \$.25 investment, for an after tax return of 24%. While most tax advantaged deals cannot exhibit such a positive cash flow, even a break even cash flow ill yield an attractive return if there is substantial appreciation in the market.

Risks

While simple on the surface, syndications may run into more trouble operationally. A primary requirement of a successful syndication is selecting the right property. For if the project does not generate sufficient income to cover its costs, the limited partner will either have to put up more money, or sell the property. More often than not the property is turned back to the bank in a case like this for a release from the mortgage obligation. But the investors are still liable for the tax consequences of the sale, in terms of capital gains rates on the difference between book value and straight line depreciation, and for ordinary tax rates on the accelerated portion of the depreciation (in the case of an apartment complex). So while the upside of a syndication is attractive, the downside includes the potential loss of the limited partners initial investment, as well as severe tax consequences.

Track Record

The allure of syndications is their admirable track record. The more tax advantaged partnerships formed in the early 1970's have offered an average return of 17% after tax, while less aggressive equity deals have shown after tax returns of 12%. An analysis of six public partnerships put together during 1970-1971 provides the details. In a standard public offering, the sponsor will receive 20% to 35% of the benefits of the project. The sponsor's fees and performance bonus amount to 10% of the proceeds for organization and underwriting, 10% of the cash flow and 15% of the appreciation. Beyond this, acquisition costs amount to roughly 13% of gross proceeds with a liquidation fee on the back end of the deal [Friedman,1981,p.12].

The properties are typically held 6 to 14 years with an operating life of seven years, a two year sale period, and a five year mortgage offering to the buyer. Thus the original investment is recouped by the end of the operating period, with the appreciation benefits realized in terms of repayment of the note.

The return breaks down as follows (to the 50% tax bracket investor): the benefits accruing to the partner yield 11% after tax annually with 7.5% of this amount coming from tax writeoffs, and 3.5% from cash flow.

Average yearly appreciation amounted to 24% annually. The notes given on sale of the property generate an additional 14% annually after tax for five years. The total after tax return over the 14 years was 240%, yielding a 17% after tax average return per year. Without the sponsors cut, the return would have been in the range of 21% to 26%.

The less leveraged equity deals offer smaller returns. With a 10 year operating life, these partnerships will have a total life cycle of approximately 17 years. The partner, averaging in the 35-40% tax bracket, receives an annual 7-9% after tax return. This breaks down to a 8% cash distribution with either a 1% tax writeoff or a 1% tax liability. Combined with appreciation, the return averaged 12% after taxes.

But the underlying market conditions which generated these returns may be changing. Those entering partnerships today face higher interest rates and lower appreciation potential than most of the deals these returns are based on. Moreover, the bulk of the current acquisitions have been made in Texas, Florida and other states which likely will not match the performance of the California based portfolios of the 1970's. In addition, the leverage available to syndicators today has declined, with sellers requiring larger downpayments in the range of 25-40%. Public

partnerships founded in 1982 offered on average leverage of only 2.25 times the gross proceeds, versus 3.3 times the proceeds for partnerships formed in the early 1970's [Roulac,1983].

Summary of Public
Syndication Offerings

Year	Purchase Price as Multiple of Proceeds
1971-72	3.30 times
1973-77	2.85
1978-79	2.50
1980-82	2.25

The success of syndications to date should not obscure potential pitfalls from investors. With the syndication market becoming more competitive and the margins stretched thinner, the probability of deals beginning to stumble is ever present. A catalog of possible pitfalls is presented below:

Experience

The attractive track record of syndicators has simplified the task of fund raising to the point where

available investment dollars overwhelm the number of quality properties available in the market. Syndicators who lack the expertise to correctly judge market opportunities and risks are likely to overpay for properties and diminish long term returns to investors. With the prevalence of pooled offerings, investor knowledge of what assets they have an equity stake in, is limited. The sponsor indicates simply that the properties acquired will be similar to those purchased in the past, however the market is much more competitive now then it was when the early portfolios were formed. The simple need to place funds may undermine a syndication which is driven by its marketing department's need for growth.

Working against this danger is the increasing professionalism of the industry. In 1983 the seven largest syndicators accounted for 75% of the total annual dollar offerings of partnerships filed with the Securities and Exchange Commission. Challenging the dominance of the large syndicators is the emergence of Wall Street brokerage houses. After years of marketing syndicator's products, these firms are beginning to sponsor deals, operating as general partners. Together the Wall Street firms raised $850 million in the first nine months of 1983, representing 30% of the total for all fund sponsors. Raising money for public syndicators has been relatively easy for many of the larger

brokerage houses. Merrill Lynch Hubbard, for example, raised $250 million for its Income Realty Partnership III offering in 22 business days. Moreover, a company official stated that the firm could have placed another $100 million if product were available [Stephens,1983,p.38].

Wall Street's sophistication in securities does not insure its competence in real estate matters, however. It is too early to tell whether these large institutions have the experience necessary to manage real estate portfolios, but many within the industry see a dearth of real estate knowledge. Moreover, it is difficult for the investor to differentiate between sponsors, particularly new ones without an established real estate presence.

On the other end of the spectrum are small investment managers, sponsoring private partnerships. Not only may these individuals lack real estate or syndication expertise, they also may lack the net worth to carry the property through the life of the partnership. If the deal goes bad, the investors are exposed to both loss of equity and adverse tax impacts on disposition of the property.

Prices

The conventional wisdom today is that there is too much syndication money chasing too few quality real estate developments. The result, of course, is real estate prices are being driven up across the board. For example, Investment Trendwatch, a publication of the Equitable Life Assurance Society of the United States cites the following example: "A real-estate syndicator recently paid a seller $58 million for a downtown office building in a major western city. The building asking price had been $50 million".

A principal culprit in the rapid price hikes is the availability of substantial tax advantages to investors. Most tax syndicators are willing to settle for a break-even, or slightly negative cash flow from the project, because of the tax writeoffs available from interest payments and depreciation. While the consensus is that the very aggressive tax syndicators are the ones really pushing prices up, the fact of the matter is, to acquire property any syndicator is going to have to pay the going price, whether or not they structure for tax advantages. And paying the going price likely will mean all syndicators will have an increased reliance on tax advantages, to offer any reasonable return.

The newest entrant in the price wars are the large institutional investors, principally the life insurance companies. Historically they have been protected from the syndicators by the latter's preference for garden apartment complexes. But with product becoming scarce, and with capital inflow at record levels, the syndicators are going head to head with the institutional buyers. Prices of large commercial developments are climbing, and despite the grumbling of the institutions, they continue to buy. And with the deep pockets life insurance companies bring to the table, the price escalation is likely to continue. As a result, institutional buyers are looking forward to a shakeout of the syndication industry. This would bring prices back in line with the supply and demand for space rather than tax shelter, and allow the institutions to pick up syndicator's properties which are foreclosed upon.

While the perception of price escalation is widespread, there has been little research to quantify the magnitude of this effect. One recent study, by Cain and Scott, a real estate firm in the Seattle area, has concluded prices paid by syndicators are no higher than those paid by private investors. Moreover, the study indicates the terms negotiated by the syndicators were more favorable then for private investors, making the entire deal more attractive. Specifically the study looked at apartment transactions, focusing on

those typified by a 145 unit, garden style complex. The study concluded that syndicators put less cash up front, averaging $600,000 vs. $850,000 for private investors, and carried purchase money loans at an average of 11% for eight years, vs. 12% for seven years for non-syndicators. Cain & Scott attribute these better deals to the syndicators experience and scrutiny, while pointing out that net of the sponsors fees, private investors may still be realizing a preferred return. Although this study addresses the comparative position of syndicators and private investors, it does not show a market trend. So while syndicators pay less than private investors on average, the entire market may well be driven up by the syndicator's own need for product.

Conflicts of Interest

With the price of existing properties driven up, and the quantity of available properties decreasing, there is a growing interest among syndicators in development. Besides providing their own product, development allows for heightened tax writeoffs. By forming the partnership before construction commences, the pay-in period is extended over several years, enhancing the value of the tax shelter. Of course with return comes risk, and by entering the development realm, investors are exposing themselves to the

riskiest portion of the real estate business.

The development arrangement is also beneficial to the syndication's sponsor, who can tack a 10-20% development fee on to the fees already charged. But with development comes the potential for a conflict of interest between the sponsor and investors, over the development fees and transfer price of the property.

Perhaps more common, and more susceptible to conflict of interest charges, is the practice of resyndicating properties. Quoting David A. Smith in a recent article in Real Estate Review, "In resyndication you do not have to terminate the selling partnership. You do not have to change controlling general partners. ... Resyndication is likely to be the best solution for the problems of owners of virtually all troubled or marginal properties. For healthy properties, resyndication represents an opportunity to restructure the transaction, cash out a favorable residual, and if necessary inject more cash to the property.".

Another apparent benefit, in resyndicating marginal properties is too cover up losses which would otherwise accrue to the partnership, by reselling the property at market rates to another partnership controlled by the same sponsor. This ability of the sponsor to determine the sales and purchase price between two separate partnerships opens the door for significant

conflict of interest charges.

Fees

The large fees charged by syndication sponsors has drawn criticism from many investors and observers. It is difficult to make a definitive statement on the fee structure of public sponsors, because the allocation of fees is generally complex and particular to each sponsor. There are common elements, however, with fees generally charged for the origination, operation and termination phases of the partnership. The major up-front fees are for partnership organization and acquisition. During the operational phase the sponsor gets revenue from property management, partnership management and a participation in the projects cash flow. On termination, the sponsor collects a sale commission and a portion of the equity appreciation.

Competitive pressures have put downward pressure on management fees, which have generally declined over the past decade. Nonetheless critics are quick to point out that after fees, less than 75% of the gross syndication proceeds are actually invested in property. The syndicators counter that for these fees the investor is buying real estate, legal and marketing expertise, as well as a diversified portfolio of investments, which he would not be able to assemble himself.

While this is true the question of where management incentives lie, whether with volume of production or long run partnership return, must be addressed.

Of the proceeds raised by public partnerships between 1970 and 1982, the Questor Real Estate Syndication Yearbook breaks down the allocation of equity funds as:

A) Formation Costs		
Underwriting Commissions	8.1%	
Organizational Expenses	2.3%	10.4%
B) Acquisition Costs		
Total Acquisition Fees	9.0%	
Fees, Expenses and Prepaid	10.1%	
Net Cash Payments to Sellers	60.9%	80.0%
C) Reserves		9.6%
Total Equity Investment		100.0%

The sponsor's compensation after partnership formation costs, breaks down between the acquisition, operating, and disposition phases as follows:

A) Acquisition Fees 66.3%

B) Operating Fees

Property Management	13.3%	
Partnership Management	5.6%	
Partnership Interests	5.8%	24.8%
C) Termination Fees		
Resale Commissions	5.9%	
Disposition	3.0%	8.9%
Total		100.0%

Diversification

While syndication is rapidly evolving, its presence has historically been felt in only a restricted portion of the real estate market. Real estate partnerships have favored apartment acquisition in the past, for several reasons. First, with home prices out of reach of much of the American public, there will be a continuing demand for apartment units. Second, with the rate of household formation increasing faster than the supply of new construction, rental rates will be forced up. Third, apartment rents are significantly below those required to make new construction profitable. Closing this gap will yield higher rents, and higher property values for existing property.

As a result, across-the-board of public

syndications, 49.9% of properties held are apartments, with office buildings comprising 18.4%, and shopping centers 17.5%. The portfolio distribution over 1982-1983 actually reflected a 6% increase in the apartment concentration of the aggregate portfolio [Roulac,1983,p.57].

Similarly, partnerships are highly skewed in their geographic distribution. Syndicators have consistently favored Sun Belt properties, particularly for their large apartment holdings. Together properties in the South and Southwest make up 51% of the public syndicators aggregate portfolio, with the Pacific region the next largest at 17.4%, followed by the Midwest with 15.9%. Changes between 1981 and 1982 reflect the industry's fascination with the Sun Belt, with properties in the South and Southwest actually increasing in portfolio representation, while Pacific properties have declined, no doubt because of the syndicators perceived fear of rent control ordinances in California.

This high concentration of investments in Sun Belt apartments is due to the historical high returns in this market. Overbuilding has clearly lessened this sector's desirability, and most likely its potential return. An investor in a poorly diversified portfolio may show a superior expected return, but is also subject to additional risk. Here the risk is of vacancies

bringing down project incomes below pro-forma levels, which if sustained, could lead to substantial loss of equity, and the potential demise of the syndication industry.

Tax Aspects

Tax shelter aspects of real estate syndications have largely been the driving force behind the industry's rapid ascension in the investment community. Syndications offer substantial tax writeoffs, as high as three to four times the initial equity put up, even a conservatively structured deal offers 1 to 1 tax writeoffs. These writeoffs come from two principal sources, interest deductions and depreciation.

Many tax oriented syndicators have been able to create large tax benefits by financial gimmickry, rather than through the true economic value of the project. By marking up the purchase price of the project through fees and commissions, the taxable basis of the property is increased, along with the annual depreciation writeoffs. Moreover, to cover the large mortgage payments required by the inflated purchase price, the partnership's sponsor offers deferred interest payments to the partnership. By accounting standards this interest can be deducted currently, although only paid in the future. The result, an artificially increased

tax writeoff. Of course at the back end the investor will have little left in the deal after the accrued interest and other charges are deducted from the sales price. Nevertheless, the tax writeoffs in the early years alone can offer an attractive return to the investor.

Congress, in a move to reduce the Federal deficit has proposed tax law changes that will effect real estate partnerships on both counts. By lengthening the depreciation schedule from 15 to 20 years, and closing the deferred interest loophole, Congress figures to save $3.5 billion between now and 1987 [Lipman,1984,p.24]. To compensate for this loss, syndicators claim they will pay less for properties, and restructure their tax positions. Without these substantial tax benefits, however, returns are bound to tumble, to levels typical of equity oriented offerings.

Liquidity

Investors in limited partnerships have little liquidity in the event they need to raise cash quickly. Many sponsors will aid the investor in finding new partners to assume the sellers position in the syndicate, but they will not guarantee it.

The reason why an effective secondary market for real estate securities has not evolved is several fold.

Legally, the status of the limited partnership is in jeopardy with excessive trading of shares, leading to a change in tax status to that of a corporate entity. Valuation of partnership shares is also difficult, and may not be cost effective in any case given the low volume of potential real estate share trades. Even if a market were established, there would be relatively few buyers willing to meet the minimum investment requirements of partnerships.

There has been a move to improve share liquidity, for example the National Association of Security Dealers is considering a centralized posting of bid and call prices for shares in limited partnerships. Firms now exist to buy back investor's shares, but at a substantially discounted price.

V - REIT'S AND SYNDICATIONS: COMMON GROUND

There is widespread speculation of a pending fallout among syndicators. A common analogy is to the collapse of the REIT's in the mid 1970's. This chapter examines the circumstances which led to the demise of the REIT's, and highlights similar conditions which may portend the future of the syndication business.

REIT Fallout

The fallout of the REITs highlights an important dichotomy between the role of REITs as a financial services organization, and their position as a real estate entity. When both parts of the organization are growing there is harmony. However, when growth in the two sectors is not synchronous, the venture can become self destructive, as the stakes and motivations of the financier and the real estate managers may be incongruous.

The driving factor behind the success of the REITs was the ability of the REIT sponsors to raise money. Attracted by high historical returns, investors purchased REIT shares much like they would any other security. Only in this case the security was backed by real estate, rather than a manufacturing or service

organization. This distinction was not appreciated by most investors, who's concerns were focused on growth in earnings and stock price.

The fund's sponsors accommodated this perception, by reorganizing their REIT portfolios to emphasize highly leveraged construction lending trusts. Given the sponsor's fee structure based on a percentage of the assets managed, short term actions which would spur increased current returns and hence investment, dominated the decision making. The fact that the funds would have to be placed in secure mortgages, became a secondary issue.

While many of the REIT's loan officers were experienced, the industry's normal precautions were coopted by the trust's need to place capital. In order to expedite the loan production process, market research and control of funds was sacrificed. What the trust's managers forgot in their haste to place capital, was the boom or bust nature of the real estate industry.

As Kenneth Leventhal pointed out "There is not an industry quite like this one, where four guys can look at a 500 unit housing demand and all four build 500 units to fill the demand, creating 2,000 units. We operate on inadequate information". What is missing in the real estate market, versus the security market, is

a lack of market information. Exacerbating this problem is the long lead time involved in development, which makes projects once begun, difficult to stop.

The real estate cycle is a well acknowledged, but poorly documented phenomenon. Its roots lie in a developers propensity to build when money is available, often without respect to the underlying demand or nature of the competition. A principal limiting constraint on development has been lender's scrutiny of a proposed project. During the heyday of the REITs this scrutiny was lost, either through time pressure or inexperience. In either case, sustained, liberal allocation of money to developers set the stage for the coming fallout.

The magnitude of the down swing in the real estate cycle was traditionally mitigated by the supply of mortgage money within a particular region. With the REITs national mortgage lending capacity, a given 'hot' city had more funds available than projects. Even once lenders realized a particular market was overheated there was little which could be done to salvage projects already underconstruction. To get any return the project had to be completed, and face an extended lease up period. Unless loss provisions were substantial, and in most cases they weren't, the investor's equity began to erode to cover the projects negative cash

flow.

At every step along the way the REITs stymied the real estate industry's internal checks, due to growth pressures. Even the bottom line return wasn't a good indicator, because short run yields were a poor indicator of long term returns.

A fundamental issue, then, is whether the security markets are themselves compatible with the real estate industry. Security markets function on the basis of accurate and complete market information. Investors are well aware of the quality of the stocks they hold, and of a firm's underlying value. Security analysts are sufficient in number, that even if one misjudges a stock, the consensus will usually offer an accurate analysis of the firms and industry's position.

Real estate, on the other hand, is characterized by it's coveted desire for secrecy. Most developers are privately held, and information concerning their finances and philosophy is generally not available. Moreover, the industry is starved for information, but the participants are not willing to contribute. There is no centralized analysis operation, with most documented information of a proprietary nature. Making matters worse, by the time a developer realizes that the market has turned flat, the project is too far along to quit. Despite the fact that costs are sunk,

and good money should not be thrown after bad, a developer's reputation is better served by completing the building and sitting it out, than having a memorial hole in the ground with the developers name on it.

Wall Street and real estate developers will never offer a good, long run partnership until those who raise the funds also have a significant stake in the outcome of the investment. With conflicting incentives the two parties never really work together, although the strength of a good market can obscure this weakness.

Syndications

Syndicating real estate is not a new idea, it has been around since the 1940's. The syndication concept came through the REIT fallout largely unscathed, because the total assets controlled by the syndications in the early 1970's was minimal and thus were their relative losses. Since that time the growth of syndications has outpaced even that of the REITs in their heyday. Only in this case investors are not being sold a high current yield, but in most cases tax shelter and capital appreciation. They are also being sold real estate expertise, in the form of the partnership's sponsor, and access to capital and leverage beyond their own means.

Investors are well aware of the inflation hedge qualities that real estate affords, and they are also aware that appreciation is not likely to match that of previous years. What brokers can sell though, is highly leveraged tax shelter. Real estate investments can be structured into one of the highest yielding, but proven, tax shelters available. Offering 2 to 4-1 tax writeoffs, the tax-oriented syndicators have been raising capital at unprecedented rates.

This is where the parallel between the REITs and the syndications begins, with the fund's capital growth being driven by highly competitive, fee oriented sponsors. The natural incentive is for developers to overbuild with the prospect of facing a sellers market on project completion. While the syndicators have generally not provided construction financing, the savings and loan industry, awash in I.R.A. money has been all to happy to accommodate their interim financing needs.

Investors unsavvy in the workings of the real estate business are investing in deals which provide more tax form than substance. Willing to settle for a break even cashflow and high tax writeoffs, these highly leveraged syndicators have profited handsomely during an upswing in the real estate market. But stretched to the margin, the inevitable overbuilding will reduce vacancy rates and turn leverage negative.

The result, unchecked, will be poor returns, and loss of investor equity. Even those syndicators which are not highly tax motivated are swept along with the crowd; if they are to acquire property they have to pay the going (tax syndicator's) price, and if they are going to get investors they have to offer competitive (tax syndicator's) returns.

Overbuilding in certain sectors of the real estate market is more due to an overdemand for syndication product, than from a heated demand among tenants. Few syndicators will turn money back to investors, and few marketing departments are willing to stop soliciting funds (given their incentive structure), because the acquisition department cannot place the money. The result is sellers have numerous potential buyers to playoff against one another, driving up prices.

At the same time developers capitalize on the syndicator's demand for product by building and selling. For the apartment market to be in equilibrium, there must be a balance between the tenant's demand for rentable units, and the supply of these units. The syndicators are ignoring this fundamental balance and are creating a secondary equilibrium, between the syndicator's demand for apartment complexes, and their supply.

Thus, while there is a sellers market for complexes, there is a buyers market among renters. Obviously this disparity cannot exist in a well functioning market, meaning there must be a net inflow of capital to the system to feed the positive returns accruing to both buyers (renters) and sellers (developers). This net inflow comes from the limited partners and from the government, through tax writeoffs. This type of imbalance cannot be sustained, eventually the investors will shift to higher yielding assets, and the government will close the drain on their budget. There can be no long term free lunch.

An Example

Perhaps the most dramatic example of the syndicator's effect on the real estate market, is the present position of apartments in the Sun Belt states. Developers and syndicators alike entered this market, attracted by the regions growing economy and strong demographic characteristics. Their basic philosophy can be summed up by one syndicators view of the area: "There has been a growing awareness on the part of the public that a well built, well-managed apartment project enables them to get multiple returns with a limited downside risk. The brokerage community is beginning to understand apartments, and that has helped increase the amount of cash that can be placed....At a

15% mortgage rate only 6.7% of all Americans can qualify for a single family home. This indicates that demand for apartments, and consequently rents, will continue to rise. To hedge your bets, look for projects that have the potential to be converted to condominiums"(1).

Sharing this outlook developers and syndicators have swamped the Sun Belt with apartment complexes, driving up vacancy rates to 10-30%. Many of the complexes were started one or two years ago when vacancies were low. But given real estate's boom or bust nature, many of the newly completed complexes are opening into an oversupplied market. Exacerbating this problem is, "the reversal of the condominium conversion craze that swept the country three years ago. In a period of low returns on investment in condominiums and a growing affordability of single family homes, the condo conversion market has lost its competitive edge, resulting in condo's being turned back into rental properties. This is adding to the Sun Belt apartment glut" [Meagher,1984,p.4].

The development fever is being fueled by builders and syndicators banking on the long run economics and demography of the Sun Belt. But while some go into the

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1) Donald Waldrop, President of U.S. Shelter, quoted in National Real Estate Investor: June, 1982.

market assuming they will face an extended lease up period, others plan on a quick killing by looking for tax writeoffs. Supporting this fragile structure are the S&L's who are currently financing over 50% of apartment construction throughout the country. As Jack Crozier, the president of Murray Financial Corporation in Dallas pointed out, "There's more money out there then ever before".

As in the case of the REITs, an overabundance of money is leading to excesses in the real estate market. And while many of the S&L's providing financing are only lending in local markets which they know well, there is a great number, who as the REITs, are providing long distance, ill informed financing.

Areas particularly hard hit include Atlanta, Phoenix, Dallas and Houston. Vacancies in Atlanta as of a year ago stood at 10-12%, while another 12,000 units were still under construction. In Phoenix, with a vacancy rate of approximately 11.6%, 9,000 multifamily permits were given out in the first six months of 1983, vs. 11,000 in all of 1982. Dallas, with a current vacancy rate of over 10%, similarly faces a growing over supply of apartments, with 44,300 units under construction in the first quarter of 1983, a 152% increase over the first quarter of 1982. Finally Houston faces the biggest overbuilding problems in the Sun Belt, and

despite reduced rents, apartment owners cannot lease their units. The plight of one apartment owner summed up their collective experience.

"Five other apartment complexs are opening up in the immediate area, all of which will offer some type of special. And a few miles east, down the main road that isn't on the map, another complex with more than a dozen buildings celebrates yet another week of its grand opening, silent as a ghost town, with only seven cars parked within its hundreds of spaces" [Zieman,193,p.18]. This in a city which was the fastest growing metropolitan area in the U.S. over the past five years.

Checks in the System

The principal checks on growth within the real estate industry, whether REITs or syndications, are the availability of product, availability of funds and return on investment. If minimum tolerance levels in any or all of these attributes cannot be met, investment will stop. For the REITs, although there was no shortage of funds, the dearth of quality projects led to a low return on investment. Only in this case, the bottom dropped out so quickly, everyone got burned.

For syndicators, the parameters are the same, although tax legislation is also a primary determinant

of value. To date, availability of funds or property has not stopped the syndicators, although marginal properties and high prices are common. The enviable track record of syndicators lures investors in, attracted by high historic returns. The higher vacancy and purchase prices have not worked through the system yet, which would reduce returns. Thus investor information may lag the market considerably, and while lower returns may reduce investor demand down the road, it is not apparent now. The major short term factor which may highly influence both syndication sponsors and investors, are changes in tax legislation.

While extending the depreciation schedule and removing accrued interes writeoff provisions may sound detrimental to investors, it may well be in their best interests. Changes in tax legislation would drive out tax-motivated development, reducing new construction and forcing apartment prices and rents to more accurately reflect the underlying demand and supply for rental units. With new construction limited, vacancies will fall and the investor who is in the syndication before tax changes will receive a better return.

Of course, syndication sponsors will suffer, with new partnerships deprived of tax benefits grandfathered in to existing partnerships. Potential investors will face lower returns, implying less capital will be

directed to syndication efforts, and sponsor's compensation will ultimately diminish.

Lessons From The Past

Both the REIT debacle, and the pending problems of syndication, bring out one important lesson. When financial service firms deal in real estate securities, fund raising decisions of the sponsor tend to overwhelm the real estate decisions fundamental to the investment's success. This has been clearly demonstrated in both cases, with investor's funds invested in what ultimately ends up in marginal properties or marginal markets.

To achieve success in real estate investing, an objective analysis of the projects market and financial feasibility is fundamental. Regardless of how well a deal is structured, it will fall apart in a weak market unless there is underlying value in the property. When the need to place funds becomes paramount to the quality of the assets it's invested in, the investment is destined for failure.

This tradeoff is made by the funds sponsor, for investors in the partnership the analysis of the fund is more difficult. Little information is available on the sponsor's day to day activities. Investors have to take the syndicator's prospectus at face value, and

rely on the sponsors integrity in investing capital, especially for commingled funds.

The Future of Syndication

The syndicator's ability to offer continued high returns is contingent on a number of factors, which include:

a) Market Conditions - Syndicators both influence and are influenced by the condition of the real estate markets. The performance of their existing and future acquisitions will depend on levels of future construction, availability of financing, demographic change, the state of the economy, etc.

b) Syndicator's Philosophy - Syndicators can offer varied returns depending on their partnership structure, tax orientation, degree of leverage and diversification of investment.

c) Return on Existing Portfolio - The return to current investors will depend on the syndicator's portfolio, and how it performs in the future. This will influence the syndicator's ability to raise funds in the future.

d) Competitive Response - The ability of syndicators to offer superior returns depends highly on the degree of competition and innovation exhibited in response to changes in both the underwriting and real estate environment.

e) Changes in Tax Legislation - Congressional pressure to close tax loopholes may have a profound effect on the industry, and particularly on the marketability of syndications vis-a-vis other investments.

Just how these factors will pan out is difficult to say. In general, syndicators will likely compete increasingly over the next few years for property and investor's funds. As competition builds, the economics of new projects will diminish on a relative scale, with fewer quality properties available. This growth will also hurt the performance of existing partnerships, with heightened price competition and increased vacancies. Changes in tax legislation will differentially hurt new, over existing partnerships, depending on how much of the existing partnership's tax practices are grandfathered in.

It appears clear that returns will fall from the high levels afforded to partnerships formed in the mid 1970's. The most vulnerable sector is highly leveraged, tax advantaged apartment investments in the Sun Belt.

Pooled syndications of diversified product type and location should fare relatively well. Also equity partnerships will be less volatile in their returns, than leveraged, tax oriented syndications. And over the long run, projects purchased for their underlying

economic value should perform well, relative to break-even deals structured for high initial tax writeoffs.

It is unlikely a crash of the magnitude of the REIT fallout will occur in syndications. REITs suffered from highly leveraged, non-equity positions, with few loss reserves. These problems are less severe in the case of syndications, although they exist to some degree. The larger impact, most likely, will be diminished returns to syndication investors across the board. This will be caused by increased competition among syndicators, and inevitable changes in tax legislation. The impact on syndicator's will be a diminished ability to raise funds, eventually bringing the real estate market more or less back toward equilibrium. As for investors, the artificial enhancement of syndication returns due to tax impacts will be diminished, and the capital allocated to the overall real estate industry will diminish.

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