Keynote Conversation with Sam Zell

BY ED FRIEDRICHS

Speaker:
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Changing demographics and global economy is creating opportunities and pitfalls for commercial real estate and consumerism

EF: How do you see demographics changing society, real estate, consumerism and investment opportunities?

SZ: We're in the middle of one of the greatest demographic transformations in history. I graduated from the University of Michigan on June 10, 1963. By June 18, I was married. One year later, 95 percent of everybody we interfaced with was married and some had children. Think about what that means. By the time that engineer graduated in the '60s, he'd probably be married and living in a single-family home in ticky tackyville in the suburbs, and he'd go to work at the suburban campus of a big corporation. As an example, in 1965, Motorola built a huge campus 35 miles northwest of Chicago. By 1995, that campus was only 40 percent occupied and Motorola was renting 200,000 square feet of office space in downtown Chicago so the company could attract workers.

This demographic shift has enormous implications for cities, real estate and the economy. A 21 to 30 year-old who was once buying diapers is now buying lattes for about the same per-person cost. For 25 years, we built 1 million single-family houses a year. Since 2008, we've only built 500,000 houses a year. We've eliminated half a million new homes, and along with them the expenditures of new furniture, new lawns, new everything, and that money is being redirected to places like Gold's Gym and Starbucks.

About the Author

Ed Friedrichs *completed his undergraduate degree in pre-architecture at Stanford University in 1965 and received his Master of Architecture degree from the University of Pennsylvania in 1968. He joined Gensler (now the largest and most respected architecture, design and planning firm in the world) in San Francisco in 1969, opening the firm's Los Angeles office in 1976. In 1995, he was appointed President and, in 2000, Chief Executive Officer of the firm, leading its development as one of the most successful and influential design firms in the world.*

Since moving to Reno in late 2014, he is working as a development partner on the West 2nd District, led by the Don J Clark Group.

He is a co-chair of the Reno Streetcar Coalition, which is providing leadership to construct a streetcar line connecting the University of Nevada Reno with downtown, mid-town and the convention center along Virginia Street.

My company, Equity Residential, is the largest owner of multi-family housing in CBDs (central business districts) in America. When we went public in 1993, our primary product was suburban garden apartments. At the time, the definition of a successful garden apartment project was one with expressway visibility. Today, the measure of success of an apartment building is its walk score. How many steps to Starbucks? How many steps to the gym? How many steps to the subway?

This is a changed environment. Young people are getting married later, and the fertility rate is lower. So they have enormous disposable incomes that the generations before them never had. Capital is being spent differently. Car ownership among younger people is going down, while the impact of technology is going up. Take Uber as an example. All these things are radically and rapidly changing the environment and how we as real estate people need to respond.

EF: Are we seeing the same trends in developed and emerging markets?

SZ: We're seeing these trends everywhere in the world. Fifteen years ago, Mexico had a fertility rate of 5.5. Today it's 2.5. India had a fertility rate of 7 or 8, and today it's closer to 2. Each year, many countries in the developed world will have fewer people in December than they had in the previous January. This is a worldwide phenomenon that, to some extent, is related to the delivery of information which is educating people to what may be defined as a better life.

The rise of the middle class in emerging markets, which occurred from roughly 1995 to 2008, was part of a cycle that pumped enormous amounts of capital and foreign investment and liquidity into those markets. There was a significant movement from poverty to the middle class. Unfortunately, that's starting to erode. A country like Brazil, which had the highest percentage of conversion to the middle class of any country, is sliding back into unemployment and poverty.

EF: Other than demographics, what core elements impact resilience in U.S. cities?

SZ: It starts and ends with the word leadership. To the extent that there is leadership in a community, there is progress. You look around the country and you can see the strong leader who is having an impact on his or her city and the weak leader who is kicking the can down the road. We certainly have more than one example of both in the United States today.

Geography is very important. Until a year ago, Houston was an exciting place to be. That's changed. On the other hand, Boston has become a giant magnet, just like Silicon Valley.

EF: What are the characteristics of leadership that are going to help cities become more resilient and thrive?

SZ: When I think about the United States, I think about where I want to invest. I would probably identify Seattle as the #1 market. It has all the elements for success, including barriers to entry. There's more water, and there are more bridges and more opportunities to fail in Seattle than almost any other city in the country. That creates scarcity, and scarcity creates a very healthy environment for real estate owners. Seattle has done a fabulous job of attracting and accommodating industry. The ability for Amazon and other companies to develop these huge campuses couldn't have happened without leadership and significant local support.

Another city I think is in great shape is Dallas. Dallas has massively diversified over the last 25 years. The city's very libertarian environment makes it an attractive place to move. In a market like Dallas, there are few barriers to entry. Before I got into the public company business, I was a buyer and seller in Dallas and rode the cycles. But if you own a public company, the name of the game is consistency, transparency and predictability, and you don't get credit for one-time gains. Today, I own no real estate in Dallas.

New York is one of everybody's favorite markets. But it's a very, very difficult market. As in Dallas, there is no shortage of developers, and a single event can trigger a reaction in the market that can negatively affect the developers and the city. Somebody, for example, sold an apartment in New York for $100 million; that's $10,000 to $12,000 a square foot. So developers started building $12,000-a-square-foot apartments, and they're not selling. It comes down to affordability. Somebody will pay $100 million for an apartment, but how do you translate that into a herd? We're seeing significant changes in New York, including weakness in office construction.

EF: What's your position in the office market?

SZ: In 2007 we sold Equity Office Properties, the largest transaction that anybody had ever done. It was my baby and I created it, but I'm a hard-nosed realist. I accepted a godfather offer because as chairman of a public company, my responsibility is always to the shareholders. Since that time, we have bought and sold office buildings privately and took over a REIT with $7 billion worth of office space. We've sold about $3 billion of it in the last couple of years. I think the U.S. real estate market is benign, which means it's softening and it's hard to see it going up.

EF: In desirable markets such as San Francisco and New York City, residential costs are astronomical and the disparity with other cities is dramatic. How do you create affordable housing in these areas?

SZ: There is no way, other than in a command/control society, that you can create affordable housing. You can only create affordable housing by increasing supply and, therefore, by creating more opportunity and more options.

What you have in California and a number of other places are political decisions that increase zoning restrictions and sustainability requirements, which will soon eliminate all the people because nobody will be able to afford to live there. Compliance costs in the United States, locally and at the federal level, have probably doubled since 2008, while productivity has gone down. The more you create compliance costs, the less productive everybody is. This is a conundrum for the U.S.

We're a very unique country. As far as I know, there is no country in the world that has prospered as this one has. And I think it's very much correlated to freedom. Freedom is the ability to do things. It's not the ability to prevent other people from doing things.

EF: What are the characteristics of successful leaders?

SZ: They're realists. They demonstrate the shortest distance between two points is a straight line. They know where they want to go. They have to eliminate all the squiggles that special interest groups are pushing for and stick to the straight line. They've got to be able to say: Here's what we need, and here's how we're going to get it done.

The founding fathers created a republic, not a democracy. We are on the edge now of going from a republic to a democracy. I think we've over-played everybody's opinion on everything, and the result is you can't get anything done.

EF: What are biggest influences in emerging markets in creating resilience? Who's doing it right or wrong?

SZ: My organization has invested in real estate companies all over in emerging markets — China, India, Brazil, Argentina, Mexico, Chile, Columbia, among others. We discovered that those countries that were close to investment grade were the most disciplined. No government is more disciplined than when it's on the verge of investment grade because if it gets to investment grade, there's an absolute reward that you can measure the next day. Discipline and predictability are extraordinarily important. It takes bravery, guts and a lot of political capital to make things happen.

We first invested in Brazil right after President Lula da Silva was elected. He had been a labor leader and was very, very popular. When he got elected, he was very disciplined. He was a social liberal and an economic conservative. He applied it exactly in that fashion and Brazil took off. By the end of first term, his economic strength wasn't quite what it was when he started, and his social orientation was warped. By the end of the second term, Brazil looked a lot like other countries in Latin America that were undisciplined.

Unfortunately, he was followed by Dilma Rousseff. She decided they were going to build everything in Brazil. An example was drill ships for the off-shore oil industry. Korea spent 80 years learning how to build those ships and, overnight, the contracts went to local companies. It was a disaster. This was repeated over and over again. The net effect was the country's growth rate was negative 4 percent last year.

There is no substitute for discipline. When we invest in these countries around the world, we keep looking for discipline. The key question is "Do they have leadership?"

EF: Where is the world going? Are there any good places to invest?

SZ: My answer is: Tell me where the demand is. There is nothing more critical. Can you identify a country of scale in the world that's growing at more than 3 percent? Aside from China, which reports numbers that aren't real, every other country is down. Mexico used to grow at 6 percent; it's now growing at 2.5 percent. The challenge and the question, as a worldwide investor, is: Where is the demand?

We have a world in which there is a dearth of demand. In the last year, with the dollar at close to an all-time high in strength, we see the Japanese yen devalued by 30 percent, the Euro devalued by 30 percent, the Russian ruble devalued by 50 percent, the Brazilian real devalued by 65 percent. We've gone from a world in which there was significant demand to one where there's a shortage of demand, and a lot of countries are playing the currency game in an attempt to overcome the tension. The 1930s told us that wasn't the policy that would lead to growth.

In the last 12 months, world trade is down in value 14 percent. Short of serious recessions, that's the first time since WWII that there's been a diminishment of world trade. We're a world of fiat currencies while the volatility of currencies and how they interface is critically important to how the world survives. The thesis that the U.S. can do well while the rest of the world suffers is unrealistic. We have an interconnected world and we can't lose sight of that.

EF: To summarize, what do you see happening in U.S. real estate over the next number of years?

SZ: The political environment in our country is divisive. We have an enormous lack of leadership. This impacts real estate. It's hard to be ebullient.

Growth, demographics and liquidity drive the real estate business. We've had pretty weak growth, our fertility rate is going down, and we've had enormous liquidity that has driven down cap rates.

Other than using other people's money — which is a factor today more than it ever was — what's the motivation to take the risk in a real estate market that is not strong? I think we're likely to see lower occupancy rates as supply increases. We had a two- to three-year period where we had virtually no increase in the supply of multi-family homes. Recently, we've had a significant increase. It's likely those extraordinary rents and increases in multi-family space are likely to be diminished.

On the office space side, I don't think there's a significant demand factor except in isolated cases such as a place like Silicon Valley but, overall, it's hard to identify where the demand is.

On the retail side, we're still dealing with the impact of on-line shopping and how much more it's going to take out of retail brick-and-mortar sales. The big super malls are doing great, and the little neighborhood strip centers are doing fine, but everything else is getting hammered and is more likely to do worse tomorrow than it did yesterday.

There are other areas such as warehousing that are doing okay, but supply and demand tells us it's hard to make a case that we're going to see real estate values increase. With the cap rates at the lowest I've ever seen in my career, it seems to be there's more on the downside than the upside.

Ten years from now, I think we will see a significantly lower percentage of home ownership. Without exception since WWII, any time home ownership went above 64 percent, we've had significant over-supply and excessive encouragement to buy often, frankly, by people who couldn't afford it. That was before the demographic changes of the 21st century. If I were to predict where we'll be in 2025, I'd be comfortable suggesting home ownership would be in the 50s or below. You might ask: How do you have a society that doesn't have skin the game? But few people realize the homeownership rate in Germany is only 40 percent. We are moving as a society from suburbanization to more urbanization. I see nothing on the horizon that is likely to change that. I think Gen Y will do almost anything they can to avoid leaving the urban core, including having fewer children. ■