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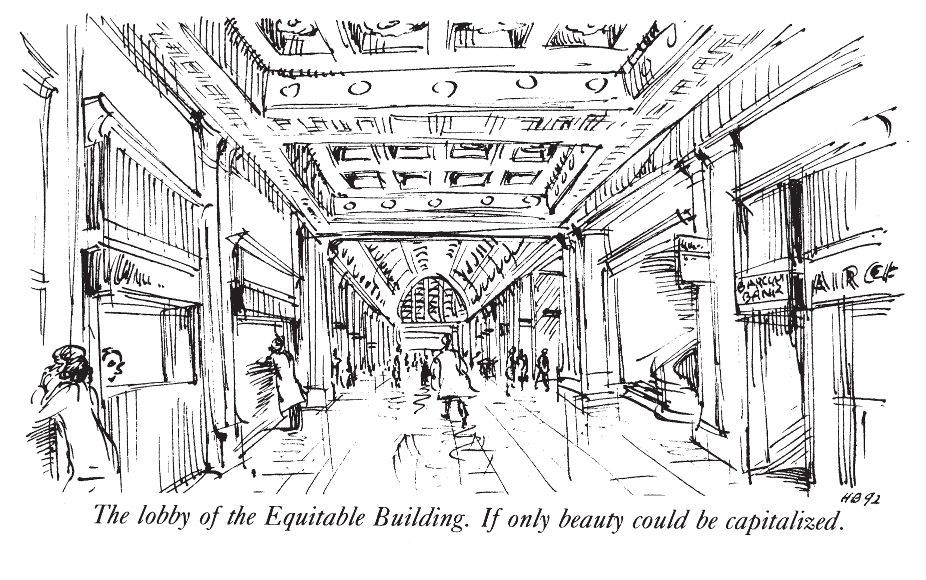
The slowest asset

In Houston, office rents are falling again, fully a decade after the Texas energy business stopped inflating and began deflating. Rents continue to fall in New York, too, and Citibank is reportedly trying to sell the mortgage it holds on 40 Wall St. at a distress price. The amount that Citi is owed on the 70-story building, once a holding of the late, great Ferdinand Marcos, is $80 million. The amount that it is willing to accept in payment, according to *Crain's New York Business*, is $20 million, or $20 a square foot. A source of ours relates that the offered side of the market is, in fact, lower; a spokeswoman for Citicorp declines to provide a number. If the cost of refurbishing the building to attract an institutional clientele is anything like $100 million (as Crain's reports), the building's true, economic value might well be less than zero. It would certainly be low enough to rattle the downtown real estate community.

Real estate is an admittedly slow and illiquid asset, but it isn't in every postwar cycle that tall buildings collapse on the heads of the billionaires who own them. Recently, David Shulman of Salomon Brothers predicted that the slump in commercial real estate may last, in some regions, until the end of the decade and that it will be 12 years before the national office vacancy rate returns to 5% from about 20% today. To equity investors who have become accustomed to measuring bear markets in terms of days, weeks or months, such a thing is almost beyond imagining.

Precedent is on Shulman's side, however, and the documentary evidence is available at the New York Public Library. One instructive story is that of the Equitable Building, 120 Broadway, a still-magnificent Wall Street skyscraper built in 1914-15. We've been reading up on the Equitable's past to try to reach a clearer understanding of the future. What we want to know is whether the realestate-related credit cycle is over or ending, or, as Shulman and others suggest, still unfolding. The answer to that question is easy: It is still unfolding. H. Dale Hemmerdinger, a reader and New York City property owner, contends that years of misery lie ahead as long-term leases are replaced by new, lower-cost leases. "Costs are front-end loaded," Hemmerdinger says. "Even if the market turns tomorrow (which it won't), it will take me a long time to get rid of my free rent, of my $30 to $50 work letters, and I've got to get my rents up. In the meantime, my costs are still going up.. . . What Olympia & York is looking for is a short-term solution. I don't know how that works."

The period selected for this investigation was the last glacial, deflationary bear market in New York City real estate, that of the 1930s. We skipped the 1970s bear market because it was an inflationary downturn, one that featured rising commodity prices and expanding bank credit. In the Depression era, occupancy rates and interest rates fell, and chastened lenders hung back from committing new funds. It has been a little like that in the 1990s, too. What is most interesting about the Equitable story, however, is what happened in the long succession of disinflationary years between the alleged return of prosperity in 1933 and the U.S. entry into World War II in 1941. The company stumped through the



The lobby of the Equitable Building. If only beauty could be capitalized.

Depression only to seek bankruptcy protection at a time of relative prosperity. For those who like to use the stock market as a leading indicator of business activity, the failure occurred some nine years after the Dow Jones Industrial Average made its all-time low.

We are relating this story because it helps to convey a sense of the rhythm of a deflationary liquidation. It is slow motion, like a family reunion. If past is prologue, lessons from the 1930s may also apply to the 1990s (with certain modifications, of course, allowing for the mature welfare state, the full paper monetary standard and the possibility that the federal government may yet engineer a new inflation). For instance, construction activity will not make the hoped-for contribution to the next business expansion, real- estate losses will continue to weigh on banks and life insurance companies, and the patience of newspaper readers will be sorely tested. Like the man who came to dinner, Paul Reichmann might move onto the pages of *The Wall Street Journal* indefinitely. He and his lenders and their lawyers may carp and cavil and negotiate into the next millennium (but — to strike a bullish note — not into the one after that).

The best reason to study the Equitable Building is that the Equitable Office Building Corp. was once an investor-owned company, and its financial history is available in *Moody's Banks & Finance*. The original Equitable Building burned to the ground in 1912 on the same Broadway site, and Coleman DuPont came up from Delaware to organize a corporation to put up a bigger and better successor building. No visitor to 120 Broadway is likely to quibble with management's appraisal (c. 1915) that the building, originally housing 1.2 million square feet, is "among the great business structures of this hemisphere." It was so great, in fact — 40 stories rising straight up from the building line without a single setback — that the shadows it cast on lower Manhattan galvanized a political movement to restrict the construction of anything so overpowering in the future. The Equitable Life Assurance Society of the United States gave DuPont a longterm, $20.5 million mortgage, one of the largest ever written up until that time. The interest rate was 4 1/2%.

It is impossible to appreciate the Equitable story without a proper respect for the building's gleaming place in the Wall Street skyline. "Emphatically, and unequivocably," said the original sales brochure, perhaps reflecting market conditions as well as management's sense of decency, "we will not make to one tenant, regardless of his size or his importance or his desirability, any concession which is denied to others." The capitalization of the Equitable Office Building Corp. was conservative, and the tenants were grade A. The fact that 4 1/2% eventually became an unmanageable rate of interest is a useful lesson in the relativity of nominal yields and the changeableness of rents. What seems low may later appear high, even oppressive; and, of course, vice versa.

The moral of the Equitable story is that a decline and fall takes time. In the roiled credit markets of 1930 and 1931; the Equitable Office Building Corp. 5s of 1952 were still quoted in the low 90s and mid 80s. In the nightmare year of 1931 — marked not only by a global liquidity crisis but also by a rash of real-estate foreclosures by New York savings banks and life insurance companies — the company showed a profit and comfortably covered its fixed charges; rental income was almost $6 million, or $5 a rentable square foot. After expenses, depreciation and taxes, net earnings totaled $2.4 million. Cash on hand totaled $1.5 million. Altogether, it must have seemed to the Equitable's creditors as if the Depression were happening to somebody else.

In 1932, rental income dropped by less than 5%, earnings per share by a little more than 10%. The common dividend was cut to $2.50 a share from the old $3 rate, but at least there was a dividend. So far, so good.

If the phrase "world coming to an end" has ever pertained to the resilient American economy, it was descriptive in 1933. Rental incomes plummeted, and 25% of the mortgage investments of the major U.S. life insurance companies wound up in default. In that harrowing year, the Equitable Office Building Corp. was able to earn $1.4 million, or $1.54 a share, a testament to the quality of the tenancy and the long terms of the leases.

Inevitably, of course, leases came up for renewal. Some tenants did renew (others moved out and still others went bankrupt) and the new leases were signed at low, Depression-era rates. In 1933, rentals fell to an average of $4.16 a square foot. In 1934, they averaged $3.66 a square foot. Operating expenses and real-estate taxes happened to drop in 1934, but the capital expenditure program went on. Hoping to save on energy costs — the price of oil had vaulted by 71% in the first year of the Roosevelt recovery — management converted the building's oil-fired steam generating plant to anthracite coal power. Earnings in 1934 just topped the $1 million mark, or $1.25 a share, representing less than half of the 1931 rate. In the summer of 1934, the common dividend was omitted. It was reinstated at a lower rate in 1936: a false harbinger of recovery, it turned out.

The worst of the Depression was over, but rental income continued to fall as high-cost, 1920s leases were annually converted into low-cost, 1930s leases. (For 1920s and 1930s, of course, read 1980s and 1990s, respectively.) By 1936, the building's rental income amounted to just $2.68 a square foot, down by 46% from the levels prevailing in 1930. The Equitable Building's vacancy rate in the mid 1930s hovered around 15%. For perspective, the 1992 vacancy rate stands at 15.8%. Counting space available for sublease, it would amount to 20.5%. (We leave it to the real-estate scholars to determine the underlying cause of the decline of rents in lower Manhattan in the 1930s. Was it the still-weak national economy or overbuilding in the boom? Our bet is on the first hypothesis. In the 1920s, no self- respecting New York bank made real-estate loans.)

Periodically, but without great success, management petitioned the city for tax relief. The corporation paid $807,533 in real-estate taxes in 1935. It paid $788,800 in 1937 but $846,800 in 1939. War broke out in Europe in September 1939, and America became a haven for frightened money. It might have seemed to the average Wall Street investment strategist that a rally in rental income was imminent. But the building realized only $2.41 a square foot, on average, in 1939, and reported a net loss of $14,685, or two cents a share, its first annual deficit of the decade. It just barely covered fixed charges.

The company fell short in 1940, and again in 1941; management gave up the ghost eight months before Pearl Harbor.

"The [bankruptcy] petition said that, although the company would not be able to meet its current obligations as they fall due, it has an income and assets sufficient to make possible an equitable reorganization," Moody's reported.

The same slow, dream-like pace of activity continued during the reorganization proceedings — another cautionary precedent for today's lenders. Committees were formed, plans submitted and meetings held. Paul J. Isaac, the reader who inspired this piece, tells a story about one such proceeding. He says that he got the anecdote from his father. An arbitrageur named Lou Green, of the firm of Stryker & Brown, was questioned by an SEC examiner, Isaac relates. Asked what class of security holder he represented, Green did not reply "the debenture holders," "the senior mortgage holder" or "the preferred." What he said was, "the short interest in the common." Wartime prosperity notwithstanding, the vacancy rate in early 1942 was almost 14%. On July 10, 1942, Federal Judge J.C. Knox approved the purchase of a $16 million war and bombardment insurance policy for $16,000 a year. Rents and margins were down: The net loss grew.

As for the Equitable reorganization proceeding, it was conducted without undue haste. Competing plans of reorganization were submitted, and at least once the U.S. Circuit Court of Appeals reversed Judge Knox. By the time the final plan was confirmed, in October 1948, fees and allowances to the trustees and attorneys had piled up to $792,521. In November 1947, the building got a new, 25-year mortgage from the John Hancock Mutual Life Insurance Co. In place of the overbearing 4 1/2% interest rate was a reasonable 3.7% interest rate (which would later increase to 3 3/4%). The downward adjustment was just in time for the start of the long postwar rise in interest rates and also, of course, in rental rates. Still, the rent roll in December 1948 had returned only to an average of $3.47 a square foot, lower than the average for 1934.

Scrolling ahead a half century, to 1992, the Equitable Building is owned and managed by Silverstein Properties. A fund managed by J.P. Morgan Investment Management holds a participating mortgage on the property (entitling the creditors to a share of the cash flow). The lobby is still splendid, and the rentable area of the building is now put at 1.9 million square feet, an increase of 58% since the 1930s. According to a broker, the reasons for this miraculous growth relate, first, to the expandable definition of a square foot under New York law and, second, to the general tendency of potato chip bags to hold fewer chips every year. He implied that space inflation was in the air. As noted, the vacancy rate, not counting available sublease space, is 15%. One big tenant nowadays is the office of the New York State Attorney General; another is the law firm of Lester Schwab, Katz & Dwyer. The defunct Crossland Savings Bank occupies ground-floor space. Brokers say that deals can be struck at an effective rent of less than $22 a square foot over a 10-year lease for a 10,000-square-foot space. The number includes a work letter to finance construction and a certain amount of free rent. Neither Morgan nor Silverstein would comment on the economics of the building, but the numbers can only be bleak and — in view of the weakness of rents and the long-term nature of big-city leases — getting bleaker.

At a meeting of the New York Real Estate Board the other day, Larry A. Silverstein, head of Silverstein Properties, explained the real-estate profitand-loss dilemma, and the April 15 Real Estate Weekly gave this account:

> Silverstein said the real problem is that commercial rents are so low — the deals are not economically viable for the owners. He said operating expenses amount to $7 and $8 per square foot, real estate taxes are running from $7 to $11 per square foot, tenant work letters are at $5 per square foot and $1 is going for leasing expenses. This adds up to $21 per square foot before debt service, he said.
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> Postwar building debt service averages $25 per square foot so Silverstein said owners need to see $46 per square foot just to break even. "In a $30 market," he said. "it's hard to see a profit and impossible not to incur a loss." In fact, he added, "There is no profit and the question is the magnitude of the loss."

In other words, losses loom indefinitely. If $21 per square foot is the average operating cost of a building before interest expense, it's a cinch that the owner of the Equitable Building is showing no profit after paying its lenders. "Quality projects in the end will become profitable," a vice president of Olympia & York Properties (Oregon) assured the Portland *Business Journal* recently. "It's just a matter of time." Based on the history of the Equitable Building, we would amend that claim. In a deflation, even quality projects will become unprofitable. It's inevitable.

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