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Real estate continues to hedge its bets when it comes to derivatives

By Sarah Trefethen

It's right there in the name. Even when hundreds of millions of dollars are at stake, real estate is real.

The tangible world of square footage, ceiling heights and floor plates has so far proved resistant to the more abstract financial instruments of Wall Street. But eyes are moving once again to the idea that financial tools could be applied to the commercial rental market.

"It's an old structure that's rearing its head again," said David Eyzenberg, a principal in the real estate management firm Avison Young and an adjunct professor of real estate at New York University. Efforts to launch a property derivatives market last happened in 2008, he said, with Cushman and Wakefield and CBRE both expressing interest that petered out, perhaps due to the collapse of the credit market.

In markets other than commercial real estate — including interest-bearing loans and the price of oil — investors have the opportunity to hedge against changing prices by purchasing derivatives.

A borrower worried that interest could increase on his floating-rate loan could protect himself by betting that the increase will happen. If interest rates go up, he will have to pay more on the loan, but he'll make it up by being on the right side of the swap. On the other side of the swap are lenders and other investors betting that interest rates will go down.

DAVID EYZENBERG

Real estate derivatives would use the same principal to allow tenants and landlords to protect themselves from, respectively, increasing and decreasing rents.

The most prominent advocate of property derivatives is Howard Lutnick, chief executive of the investment-banking firm Cantor Fitzgerald and its financial brokerage arm, BGC Partners. BGC Partners purchased the real estate brokerage Newmark Knight Frank last year and is in the process of buying Grubb and Ellis to merge with Newmark.

In an interview with the *Wall Street Journal* following the Newmark purchase last year, Lutnick predicted property derivatives would become a common part of tenants' and landlords' transactions in commercial real estate.

Industry veterans have greeted the idea with both curiosity and a healthy dose of skepticism.

Leslie Himell, managing partner at Himmel + Meringoff Properties, heard Lutnick speak at a recent event and was intrigued by the prospect of property derivatives, she said.

But Himell wondered if the tools that work for uniform commodities would be as effective in the quirky world of commercial real estate. Himell + Meringoff owns and operates more than two million square feet of commercial space in New York City.

"Interest rates are very standardized. They don't have a personality, if you will, or a shape or a size. The wonderful thing about real estate is you can have two assets right next to each other with the same square footage and different rental rates," Himell said. "It's about the personal touch of the leasing agent, it's about the reliability of the landlord, it's about light, it's about layout, it's about management, it's about location, it's about operating expenses, it's about distance from the subway."

Past efforts to launch property derivatives have relied on a standard price index. But, perhaps in response to concerns like Himell's, the model BGC is said to be considering would set up the swaps for each property on an individual basis. So, a tenant could purchase a derivative that is specifically tied to the rent in that tenant's building, as opposed to an index that takes the average of rents across the city.

If each swap is individually tailored to a specific property and marketed to tenants as a way to protect against rent increases, the question then becomes who would buy into the other side of the swap, according to Eizenburg. If a tenant wants to hedge against rents going up, someone else must be willing to bet that the rent in that building will go down.

"It's not like playing paddleball against the wall. You can't do it by yourself; it's like tennis. Who's going to be your counter party?" he said, adding, "how often does it happen that the tenants think the rents are going to go up and the landlord thinks the rents are going to go down?"

Swaps might not be for everyone in the industry, said veteran real estate attorney Michael Lefkowitz, a partner with the firm Rosenberg & Estis, who is also a commercial landlord through his family's firm. Louis Lefkowitz Realty, based in long island, owns retail, office and industrial space.

"We're not in the Manhattan office market. I find that we have fairly stable rents and there is stable growth," Lefkowitz said, explaining that he saw little need for derivatives in his company's portfolio.

HOWARD LUTNICK

"I would think that it certainly would make sense for your class-A office owner, who might have financing coming due at a time at which a substantial portion of the property is becoming vacant and would want to hedge against a downturn in the market which might affect his ability to refinance," he said.

Eyzenberg predicts that derivatives will come to the brick-and-mortar world of commercial real estate, but on a small scale, he said.

Lefkowitz sounded a note of caution, recalling the collapse of the mortgage market in 2008.

"We are coming out of a period in which this type of financial engineering to control risks in markets certainly resulted in something that far exceeded people's expectations regarding the dangers of these types of products," he said. "If we were to instill this type of product without some level of regulation, I think we would all need to be a little wary."