Cambridge-Maastricht Symposium 2005

Editors' Introduction

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This Special Issue of the Journal of Real Estate Finance and Economics presents papers presented at the 6th Cambridge-Maastricht Symposium, held at Madingley Hall, University of Cambridge, in June 2005. The papers covered a range of issues in real estate finance and economics. In all, 12 papers were presented, with six being selected for publication in this Special Issue of the Journal of Real Estate Finance and Economics. Of these six papers, three were written by research teams based in Europe and three are from the United States.

In their paper "A Quarterly Transaction-Based Index of Institutional Real Estate Investment Performance and Movements in Supply and Demand" Jeff Fisher, David Geltner and Henry Pollakowski develop a new index of commercial real estate performance. Their new index is especially constructed to be used for research in a way that traditional commercial real estate indices are not. It is a transaction based index, based on hedonic regression and using regional and property type dummies as hedonic variables. This means the index is not hampered by the smoothing and lagging of traditional appraisal-based indices, and therefore better suited for mixed-asset performance comparisons and portfolio analysis.

Carolina Fugazza, Massimo Guidolin and Giovanna Nicodano also look at mixed-asset portfolio issues and at real estate's role in these portfolios. Their paper "Investing for the Long Run in European Real Estate" investigates how a long-horizon investor would optimally allocate across European real estate, stocks, bonds and cash, taking account of predictability in risk premia. Due to the relatively strong predictability of real estate risk premia, they find that the optimal portfolio allocations to real estate increase with the investment horizon. Real estate's relative power as an inflation hedge also builds up with the investment horizon.

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Zhilan Feng, Chinmoy Ghosh and C.F. Sirmans investigate the capital structure of US REITs. Their paper "On the Capital Structure of Real Estate Investment Trusts" explores how the regulatory provisions of REITs influence their capital structure decisions. REITs pay no corporate tax and pay out ninety percent of their earnings as dividends, so one would assume low leverage. However, the authors find that REITs with strong growth and high market valuations raise capital through debt issuance, and use a governance argument as a possible explanation for this. The monitoring benefit of mandatory interest payments could substitute for—lacking—alternative monitoring mechanisms.

In their paper "Expected Default Probabilities in Structural Models: Empirical Evidence," Kanak Patel and Ricardo Pereira estimate the default probabilities of publicly listed failed and non-failed real estate companies in the UK and empirically analyze the performance of a set of six structural models. The authors find that the estimated default probabilities of the different models are clustered, and that the structural models do a better job at predicting default then traditional measures. In order to assess how well accounting and financial variables explains actual EDP variability, a stepwise procedure is employed to estimate a logistic regression with the score of the best structural model and the accounting and financial variables. The results of the logit regressions show that all accounting and financial variables are statistically significant and have the expected sign and reveal that the clustering of the structural models is not so pronounced in explaining the variation in probability of default.

The paper by Dean Paxson, "Sequential American Exchange Property Options," proposes a method for valuation and management of real estate development projects. The author decomposes a real estate project into three sequential options, each getting the owner of the project to acquire the developed property. The method explicitly takes into account brownfield redevelopment projects, where the first stage represents the clean-up or site-preparation phase, and the second stage represents the actual construction of the new building. This is an "exchange option," that is, an option to exchange one stochastically varying asset for another, the idea being that the second stage exercise price could represent stochastic construction costs to build. The model also employs the classical financial option valuation assumptions of Brownian motion dynamics for both of the state variables, and immediate exercise of both stages. It provides a new closed-form approximate solution, which is computationally efficient and accurate. Illustrations are provided of the sensitivity of the real sequential options and optimal timing to changes in several parameters, which provide a framework for property policy (tax, subsidy and regulatory) guidelines and for property development strategy evaluation.

The paper by Rose Neng Lai, Ko Wang and Jing Yang, "Stickiness of Rental Rates and Developers' Option Exercise Strategies," incorporates sticky rents into the dynamic options exercise model. The model assumes that developers will seek a revenue-maximizing occupancy level and will allow an optimal excess vacancy rate in the market. The authors obtain closed-form solutions for the timing of developments and the time lag between developers' construction decisions by using the expected mean time to estimate development intensity. They analyze how various factors might affect a developer's supply decision in terms of magnitude and direction. In a sticky rental rate setting, their model performs better than traditional

market clearance based real options models in terms of interpreting the essence of overbuilding and vacancies. It is shown that developers' exercise strategies differ among markets and under different conditions. Specifically, the size and the type of property markets can affect developers' exercise strategies.

Many people have generously contributed their time and energy to this Special Issue and to the 6th Maastricht-Cambridge Symposium. We owe special thanks to the authors, referees and discussants for a highly engaging and stimulating debate. We should like to express our gratitude to C F Sirmans and Dean Paxson who assisted us in selecting the papers for presentation at the Symposium. We are also grateful to the Department of Land Economy, University of Cambridge, for hosting the Symposium meeting.