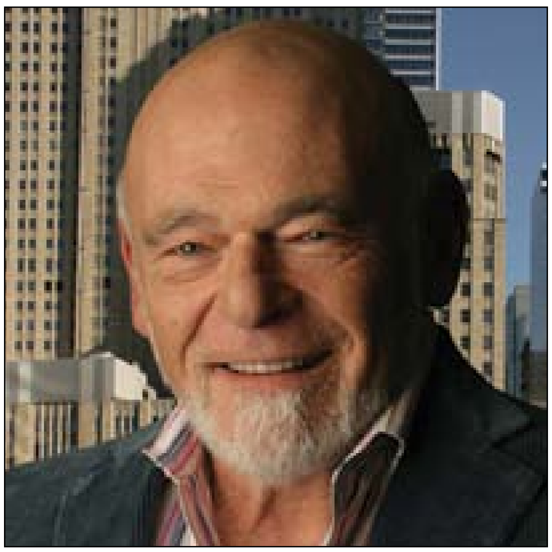
The Business of Taking Risks

An Interview with Sam Zell,
Chairman, Equity Group Investments, LLC



Sam Zell

EDITORS' NOTE *Sam Zell is Chairman of Equity Group Investments, LLC (EGI), the private investment firm he founded 41 years ago. He is also Chairman of Equity International, which he co-founded in 1999. Zell's investments span industries and continents, and include interests in finance, energy, transportation, communications, and real estate. He maintains substantial interests in, and is the Chairman of, five public companies listed on the New York Stock Exchange. Zell is also Chairman of Tribune Company. Previously, he served as Chairman for Equity Office Properties Trust, the largest office REIT in the U.S. He serves on the JPMorgan National Advisory Board; the President's Advisory Board at the University of Michigan; the Visitor's Committee at the University of Michigan Law School; and with the combined efforts of the University of Michigan Business School, he established the Zell/Lurie Institute for Entrepreneurial Studies. He is a long-standing supporter of the University of Pennsylvania Wharton Real Estate Center, and has endowed the Samuel Zell/Robert Lurie Real Estate Center at Wharton. Zell is a graduate of the University of Michigan and the University of Michigan Law School. He began his career in real estate while an undergraduate.*

COMPANY BRIEF *Sam Zell founded Equity Group Investments (www.equityinternational.com), a private investment company, in 1968 and, over the past 40 years, established an outstanding reputation as an opportunistic investor, financier, builder, and operator of industry-leading companies. Zell pioneered the public equitization of the commercial real estate industry through the creation and leadership of Equity Office Properties Trust, Equity Residential Properties Trust, Equity LifeStyle Properties, and Capital Trust. EGI's portfolio encompasses a broad range of corporate and real estate interests including Tribune Company, Starwood Hotels & Resorts, Covanta, Anixter, American Commercial Lines, Kuwait Energy, and WRScompass, among others.*

Were you surprised by the depth and severity of the economic crisis?

I don't think anyone could have envisioned how severe the recession would become. What we had was a panic. No one ever foresees a panic, as opposed to a slowing or completion of a cycle. Prior to 2008, I envisioned that we would have a recession in 2009 because of the change in Presidents; history shows that each new President in his first year generally "fixes" things, and the result is a recession that can be blamed on the last guy.

What I didn't envision was that the government would be as inconsistent in dealing with the economy as it has been. It created fear by letting Lehman Brothers go under, and then clearly statied that it had no way to "solve" the looming crisis. In the case of Lehman, unfortunately, the government didn't clarify it would not provide a bailout, which would have signaled to the market that Lehman Brothers would have to solve its own problems. By doing nothing, the government gave the impression that Lehman Brothers could potentially be bailed out like Bear Stearns, and under that assumption, everyone just stood by and watched as Lehman went down. This event so shook confidence – both domestically and internationally – that it led to a panic. Obviously, the severity of that panic was much worse than anybody could have envisioned.

Do you see signs of stabilization within the real estate market, and what response do you have for those who say it will never come back to where it was?

There's a distinction between the residential and commercial markets. There is little doubt that the residential market was a disaster. By the time all the proctoscopics on the single-family market are done, you're going to find that fraud played as big a role as anything else, whether it was fraud on the part of the borrower, the broker, or on Wall Street.

In the residential market, I've seen a series of examples of where single-family housing has been overbooked, and unfortunately, the genesis of the problem leads us right back to the government. Historically, the U.S. seems to function well when it has 62 to 64 percent single-family homeownership. Periodically, the political system encourages a much higher level, without regard to affordability. This time, we took home ownership to 69 percent, which means that people who simply cannot afford houses were able to buy them. Every time we go above that 62 to 64 percent range, there are economic consequences, and this time was no different.

There was also another political element to the residential market collapse. In 2000, Fannie and Freddie carried no subprime loans, and they carried very few subprime loans until the financial steamboat in 2004, whereupon Barney Frank told us to encourage affordable housing and he would protect us from defaults. So, Fannie May went from 0 in subprime loans to 40 percent. These political drivers of the financial crisis are overlooked.

Today, the single-family market has probably reached equilibrium. Household formations are at 1 million a year, and the inventory of existing single-family homes totals roughly a seven-month supply. New construction is about one quarter from the peak. So over the next 12 months, the market should absorb existing supply. In the end, it's all about supply and demand. We're seeing that gradual return to equilibrium in supply and demand create stability on the price front; home prices have stopped falling, and will begin to adjust to new normal levels.

On the commercial side, I tend to have a somewhat different view than most people. The current mantra is that commercial real estate is the next shoe to drop, and "if you thought the single family decline was bad, wait until you see what happens in the commercial sector." I challenge that thesis. There is little doubt that the commercial real estate market today is very soft. However, everything again comes down to supply and demand. No new commercial construction has been committed since July 2007. Today, you cannot get a construction loan, and rents do not even begin to justify the costs necessary to develop, so we are in for another couple of years of nearly no new development. During that period of time, the current weakness will end, and we'll see that which is currently being vacated fill up again. That is the good news.

The bad news is that the absorption is going to be, give or take, 30 percent less in rate than was previously projected. Consequently, with "pretend and extend" being the mantra, maturities are not the issue as long as the asset owners can afford to keep paying the debt service. At the other end, you will see many fully occupied buildings producing inadequate rates of return, at which point we will have a repeat of what happened in the early '90s when there was no capital available to real estate. The only option was the public markets, which effectively provided capital to real estate, but at an enormous dilution to the owners. At the time, I owned 100 percent of Equity Residential, and needed to create liquidity, so I had to dilute my ownership position by going public. The net effect was that I started out at 100 percent ownership and I ended up with a viable public company of which I owned 20 percent. If you carry this analogy forward to today, you might end up with a fully occupied building on Park Avenue that earns 4 percent returns and has rates at 7 percent. Effectively, the owner is going to have to bring in new capital and dilute his position. All he has now is a hope certificate.

I don't think there will be massive grave-dancing opportunities. The reality is, there is no distressed property. And that's key, because everyone thinks, any day now, owners are going to be forced to sell, and that is not the case. The government has taken a big role in the financial sector, effectively cushioning the entire system. This eliminates the sense of urgency that banks and other lenders feel in terms of taking action – unlike in 1990/91, when any one of the major banks had 20 projects that were coming back to them, and all they wanted to do was get those assets off their books. That led to opportunities to buy all kinds of distressed assets. This time around, lenders have a lot more patience because their liquidity is being provided by the federal government. So I don't think the likelihood of the bargain-sale pricing or the commercial foreclosure crisis, which people are wringing their hands about, is in the cards.

You have a strong business in Brazil. How optimistic are you long term for that emerging market, and has that market been affected as severely by the economic crisis?

I would rate Brazil as the number one market in the world in terms of characteristics and opportunity for a few reasons: Brazil has 180 million people so there is scale. It's growing; the country is adding, give or take, 14 million people per year. It is fuel self-sufficient. It is food self-sufficient. And, as opposed to Mexico, Brazil has a large professional management class that is available and recruitable to create new companies.

In terms of other prominent global markets, does China also offer that type of long-term option and opportunities?

When you invest in emerging markets, you trade growth for the rule of law. I would not like to rely upon the local judicial system to protect my interests in any emerging market. So it all starts with one question: who's your partner?

The other issue is the culture. In Brazil, entrepreneurs tend to be third or fourth generation. They are easy to work with and readily accept input; they have had enough exposure to the U.S. market to understand how it functions. In China, entrepreneurs are still first-generation, and tend to be extremely strong-willed and stubborn, so it's a tougher environment in which to do business. But the growth, size, and scale of the population in China are the trade-offs.

You are known as the quintessential entrepreneur. Is that part of your make up, and have you always had the desire to create and build?

In junior high school, we had a dance and instead of going to the dance, I set up a photo lab and took pictures of people and then sold them their pictures.

When I was 12, my parents moved to the suburbs, and I'd take the train into the city for school. One of the things that fascinated me was the magazine stands underneath the L stations, because they had girly magazines, which didn't exist in the suburbs. In 1953, Hugh Hefner came out with *Playboy*, and I bought it for 50 cents. I soon realized there was a market because it was not sold outside city limits, so I started exporting *Playboy*. I'd buy it for 50 cents and sell it to my friends for $3. I was doing big business.

There are various characteristics that define an entrepreneur. Probably the most significant is that an entrepreneur sees problems, but as opposed to most, he also sees solutions. I look at and see things differently, and with a different kind of motivation, than most people.

Based on that, is your belief that those are characteristics and traits you're born with, or can they be taught?

I created an entrepreneurial center at the University of Michigan, the purpose of which is to address those classic questions: Are you born with it or can you learn it? Is it an art or is it a science? The answer lies somewhere in between. I don't think that someone without a risk perspective can ever be a successful entrepreneur. First and foremost, you have to both thrive on risk and have the self confidence to know you can address it and deal with it. When it's all said and done, part of entrepreneurialism is genetic; part of it comes from the culture in which you grew up; and part of it is education.

But in the end, someone has to have an aptitude; he has to get a real satisfaction in figuring out how to make 1+1=3, and most importantly, he has to see the opportunity to make 1+1=3 in the first place.

Entrepreneurs are great at taking risks and finding solutions, but as the company grows, it's very hard to find those who are also good managers. You've been able to be both.

I'm not sure I agree with that. I'm Chairman of everything and CEO of nothing. What I've done in my business career is identify and focus on what I'm good at. Although I'm capable of running a company – and I have – my competitive advantage is not in managing a company on a daily basis. I don't think I'm a better-than-average operator. Where I excel is as a strategist and as an owner, and there is a big difference between an owner and an operator. One of the strongest criticisms I have of the public system is that every company needs an owner. Consequently, I've been a big advocate of the separation of CEO and Chairman simply because in the optimum scenario, the Chairman should be worried about big risks, big directions, and big changes, and the CEO should be worried about how to run the business every day.

You're very involved in the community with many philanthropic efforts. Was the desire to contribute instilled in you early on, and do you see that as a responsibility for business leaders today?

From the first day of my life, awareness, sensitivity, and support for others have always been part of the mantra and the culture of Judaism in which I grew up. So the idea of sharing my success by virtue of trying to make a difference is very ingrained in everything I am and do.

Is it sometimes hard, with all the need out there, to know where to contribute and when to say no?

I support a lot of things, but it is more important for me to figure out how to make a difference. The entrepreneurial center at Michigan is one example. We also support the M.F.A. in Creative Writing program at the University of Michigan, and with relatively modest contributions, we've been able to dramatically change the program. The measure of our success is the books these students produce. So when Oprah Winfrey picked as her "Book of the Year" an author who was part of the Zell program at the University of Michigan, that was an awesome achievement.

I created the Zell/Lurie Real Estate Center at Wharton because Wharton was far ahead of everyone else in the country in terms of understanding how the real estate world was changing, and I wanted to create the opportunity to both encourage that and take it to the next level.

You've accomplished so much, and you don't need the day-to-day headaches and stress. Why are you still so engaged in the business?

In the past 10 years, I worked less than the previous 10 years. The previous 10 years, I worked less than the 10 years before that. In the beginning, we worked six days a week; then somewhere along the line, we went to five days a week. I'm intrigued by what I do. I love the challenge. I'm not particularly monetarily driven. I wake up every day and ask, how can I make 1+1=6? I can't imagine any scenario that didn't have that kind of intellectual and emotional challenge, and the satisfaction that comes with making the right decision. I don't view what I do as work, and in the end, I'm doing what makes me happy. I do what works for Sam. ●