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The Greater Baltimore Board of Realtors, Inc.

# Wisconsin wise men

*C. Gordon Gilbert, Jr.*
*C. Gordon Gilbert Associates*

A WEEK'S STAY in Madison at the University of Wisconsin can be a rather mind-bending experience when the real estate faculty is on the rampage. What is most startling is not the leap in technological advancement but the freshness of perspective. Three faculty members, one including James Graaskamp (two Jim Graaskamps would probably produce a nuclear reaction) in particular, might be considered dangerous heretics.

Jim Graaskamp, for example, could not care a jot for the entire concept of *ownership* of real estate. Ownership, after all, reasons Graaskamp, is purely a lawyer's concern; for all practical matters, who *owns* this or that interest in real property is immaterial to the fundamental understanding of how the game is played. The key concept is not ownership but control — control of the various profit centers generated by real estate. Once again, *ownership* is immaterial. As Graaskamp points out, the highest rates of return in real estate are enjoyed by people creating and developing the real estate project and not by buyers or owners with a relatively passive management role. Think of all the income streams generated by real estate that the equity investor seldom touches -- the mortgage banker (and/or mortgage broker), the management firm, the lawyer, the accountant, the real estate broker, the consultant, the general contractor, . . . Even the municipality or political subdivision may be a direct beneficiary of income streams that shoot by the investor, unpocketed. Also consider indirect benefits which accrue to third parties: a residential subdivision project may ignite demand for shopping facilities; a satellite office or industrial park may spur the growth of smaller service industries. Having expanded our horizons this far, it is not a great step to conclude that ownership of real property is of trivial importance when compared to *control* over multitudinous profit centers. Who has the power to divert these income streams to one's own benefit, or to the benefit of another? Therein lies the action; not in ownership. Next time a luncheon acquaintance starts rhapsodizing about the various properties he or she *owns*, be not too impressed; an ironic, mildly mocking smile is recommended.

## Traditional Notions

Having butchered the sacred cow of ownership, Graaskamp next may be heard to rake traditional notions of "highest and best use" over the coals. Appraisal texts define highest and best use in a number of ways, but the words always boil down to the bottom line: whatever use yields the highest value to the land and "ain't" illegal. Sounds reasonable; but in the context of understanding all these wonderful income streams going this way and that, whatever use yields highest value to the land becomes less significant. The crux of the issue is to understand the net benefits to be received by the producer of the commodity involved (the developer-investor-entrepreneur), by the consumer of the commodity (the tenant or user), and by the public at large. Indeed, a national-chain fast food restaurant use might qualify as the "highest and best use" of an Inner Harbor site (next to the Constellation, perhaps?), in the sense that such a use may actually produce the highest land value. But the net benefits to all concerned — the producer, consumer and the public — may be drastically reduced as a whole. Graaskamp insists on analyzing each project of real estate on the basis of benefits to all three . . . . he opts for the more descriptive phrase, "highest and most fitting use."

At the heart of this virtual disdain for "ownership" and "highest and best use" lies a peculiar grasping of the concept of real estate. To Graaskamp and others, real estate does not mean bricks and mortar sitting on land. Real estate means expertise. And expertise involves the creation and control over who is to benefit from what, and when.

### Space-Time Product

The traditional definition for real estate talks about a legal bundle of rights, and so forth. Graaskamp defines real estate as a space-time product. Space refers to that artificial environ fashioned by man or woman; time is the relentless dictator governing the value of money (or other benefits) and investment. These concepts are not entirely new, to be sure, but combine them with Graaskamp's fundamental theme of control over profit centers, and you have a valuable perspective. The smart participant in real estate perceives those profit centers over which he or she may benefit most from, with least exposure to harm; other profit centers which call for someone else's expertise, or which involve unacceptable potential for harm are to be avoided.

Use of the computer is much touted at the University, which is not surprising. Among the most vehement critics of computers, however, are Messrs. Robbins & Knitter, the first to holler that computers provide the fastest road to a wrong answer; or cry, "rubbish-in, rubbish-out," a favorite rallying call of those who refuse to be intimidated by queer looking printouts which appear to carry certainty out to the last 39½ cents. Of tantamount importance is the understanding of the model used in any analysis, be it computer-assisted or not. Because the analyst or consultant of real estate is unable to hoist the entire property upon the office desk and attack it with a Hewlett-Packard, he or she must devise a "model" which encaptures the significant variables of the venture. A rule of thumb such as a gross rent multiplier constitutes a model. Unfortunately, rules of thumb belong in the garden when it comes to more and more sophisticated projects or investments which often encompass a bewildering array of vicious variables, any one of which is capable of eating humans alive. There is no danger that slick computer programmers are going to put knowledgeable real estate heads out of business; the programmer can't know if his 72 page printout model fits the deal involved. The real estate analyst or consultant who uses computer assisted models is not worth his or her salt unless he or she can identify the critical variables at work in real life, and then understand how these variables are treated by the particular model chosen. With any model used, the user must form an educated idea of the confidence level the model merits. The real expert knows how to fashion and use models which are most predictive of probable outcomes. Computer assistance is merely incidental to a task which may be done without it.

### Ellwood Approach

Because few if any models are perfectly representative of a real life situation, there will always be some weakness somewhere. Take the Ellwood Approach for analyzing income properties. One of its basic premises is that the investor is demanding a certain yield or internal rate of return from his or her investment, and that money emanating from that investment is quickly reinvested in other projects yielding the same (high) rate of return. For many — indeed most — investors, this is not the case. Not every investor has either the resources or the opportunities to reinvest so profitably year-in and year-out. Unless your investor is Prudential or Equitable Life, beware of the Ellwood presumption; a high internal rate of return could significantly distort your analysis. Other models, using the so-called Fat Man's Internal Rate of Return allow analysis to proceed with a more modest reinvestment presumption, in fact any reinvestment rate you care to assume.

Other traditional real estate industry balloons received their share of disrespectful pin pricks. False notions concerning the benefits of leverage were deflated, for instance. The advantages of accelerated depreciation were shown to be greatly diminished as a result of the politicians' and lawyers' last efforts to tax reform. The role of sensitivity analysis was thoroughly discussed, with Graaskamp's assessment on the most critical variables that impacting on yield: of greatest impact is the initial cost to construct or acquire; then the loan ratio to cash costs; the mortgage interest rate and term; real estate taxes; operating expenses; finally the cost of land.

*Because of politics, expert warns*

# SIB should be wary of real estate

By MATT POMMER
Capital Times Staff Writer

Real state investments aren't for "political innocents," the State Investment Board has been warned.

Professor James Grasskamp, chairman of the University of Wisconsin's Real Estate and Urban Land Economics Department, urged the SIB Tuesday to consider its "political silhouette" if it actively renews real estate investing.

"Real estate (investing) requires at some point a single minded s.o.b.," said Grasskamp, a nationally recognized expert in real estate.

The State Investment Board handles an estimated $5.2 billion in state funds, most of it from public employee pension funds. Virtually all of the money in recent years has been put in Wall Street-type investments.

Opening the door to real estate investment invites political input, Grasskamp suggested. He said unions, veterans' groups and farm groups would seek to have input into the real estate investment issue.

Grasskamp warned that veterans' organizations might seek SIB funds to "help Mr. Moses off the hook," a reference to Veterans Secretary John Moses who has been seeking additional funds for the veterans' home mortgage program.

**Last week the largest state employee union asked the state to invest up to $135 million in pension funds in mortgages and small businesses in Wisconsin.**

Grasskamp warned the SIB it is difficult for a public group to say "no" to some investment proposals once it was fully in real estate investing. Public investment groups also lack the flexibility because of their "political silhouette," he suggested.

He cited the problems which the Wisconsin Foundation met when it moved to buy farmland on the edge of Madison to build a golf course for the University of Wisconsin. Controversy killed the project.

Grasskamp questioned whether the State Investment Board wanted to become involved in just holding mortgages.

"Direct mortgage lending is suspect," he said from an investment situation. "Bonds can do as well," he added, noting they are can be converted to cash. "I'm not sure you want to be in the direct mortgage business."

Money in the real estate business is made in obtaining government entitlements or in managing large projects, according to Grasskamp.

**"The Carleys (James and David) whole stock in trade is finesse in getting entitlements," said Grasskamp.** Government entitlements can mean things like rezoning to higher use, he explained.

Grasskamp also had warnings about what is happening in real estate in Madison. He said syndicates were being formed to buy older apartment buildings at $28,000 to $40,000 per unit. Members of the syndicates are showing great 'naivete' in the price they are paying, he said.

Grasskamp shook his head at a person who would "invest $1.25 to save a dollar in taxes." He noted Madison is assessing the apartments at the price paid by the investment syndicates.

# Real estate prof predicts evolution of the mortgage

By KIT SMITH
*Advertiser Financial Editor*

The Honolulu Advertiser
$ money matters

The days of the fixed-interest, 30-year mortgage as the standard for the home lending business are numbered, says nationally known real estate professor James A. Graaskamp.

Today's chaotic money markets point up the pitfalls that home lenders face in "borrowing short" (relying on short-term deposits) to "lend long" (for up to 30 years), he notes.

Thus, the creature known as the "variable rate mortgage" is likely to gain wider use in residential lending, said Graaskamp, chairman of the the department of real estate and urban land economics at the University of Wisconsin.

Graaskamp is in the Islands for a month as a visiting professor at the University of Hawaii's College of Business Administration. His visit is sponsored by the state Real Estate Commission through the University of Hawaii Foundation.

Although a post-polio quadriplegic, the burly, crew-cut Graaskamp, 46, is scheduled to present a series of workshops, seminars and classes on the Big Island, Maui and Kauai as well as Oahu. Among his specialties are appraising and project feasibility analysis.

Under variable rate mortgages as used widely in recent years in California, interest rates may rise during the life of the loan by up to 2½ percent over the the original rate. Increases are triggered by rises in the Federal Home Loan Bank of San Francisco's six-month cost-of-money index. (Rates must be adjusted downward if the index should decline sufficiently.)

(In Hawaii, while some savings and loans have used "escalator clauses" in some loans for many years, nothing like the California type variable mortgage has been tried here. Escalator clauses allow the lender to change rates at its option.)

Renegotiable rate mortgages, under which interest charges are renegotiated at set intervals (five years perhaps), also should see important use, particularly in commercial real estate, Graaskamp said in an interview.

He cited these arguments for lenders moving away from fixed-rate long-term mortgages:

- The average length of home loans nationally ranges between eight and 14 years depending on region.
- Home lenders are having to pay dearly to attract new deposits — 14.729 percent on six-month "money market certificates," for example. This is lifting institutions' average money costs sharply.

Meanwhile, fixed rates on years-old mortgages make it difficult to boost average yields on lenders' portfolios. Thus lenders are hard pressed to achieve the 1½ to 2 point "spread" over money costs that they need to cover operating expenses and allow for a profit, the visiting educator explained.

What does Graaskamp think of Honolulu's real estate market, which last year recorded the largest average increase in values nationally, according to Money magazine?

A market value of $300,000-plus for the 25th floor Discovery Bay condominium where he is staying "is mind-boggling," he said. (The original cost several years ago was under $100,000.)

In Madison, Wis. (home of the University of Wisconsin), "really good corn land goes for $3,000 an acre," he said. Subdivision acreage, with water and sewer mains installed, "goes for $5,000 an acre."

Real estate values, he said, "reflect a set of assumptions about the future, and that's the softest commodity in the world."

Still, he detects "nothing on the local scene to cause it (the real estate market) to go down."

On the other hand, he said, long-term demand is a function not only of the local scene but of the world and U.S. political and economic scenes. "And when you begin to look at that, it's quite fragile."

Graaskamp had this advice for families in the market for homes: Too often the tail wags the dog in a home purchase, with the family motivated primarily by hope of great increase in the property's future value.

Rather, he said, a family should be more concerned with how the purchase will affect lifestyle — convenience to work and to shopping, for example — and whether the monthly payments will curtail ability to travel.

Thus a family "ought to use the same criteria they would if they were analyzing a small business," he said.

If a home purchase does bring a big profit, "that's fine," said Graaskamp, "but that should not be the premise."

**James A. Graaskamp**
*Prices here 'mind-boggling'*

# He's teacher, master of real estate's bottom line

Charley Blaine 5/31/83
A TODAY

A few years ago, Donald vde, then a Madison, Wis., d developer, took a real es- investing course at the iversity of Wisconsin Busi-s School from James A. aaskamp.

Says Hovde on the rigor aaskamp demanded: "He rked my butt off."

Hovde, now awaiting confir-tion as a member of the deral Home Loan Bank ard after two years as depu-secretary of Housing and Ur-n Development, calls Graas-np "one of the most brilliant ademics I've ever been ex-sed to."

He also adds, because it's impossible not to, "It is truly miraculous how he has overcome all his disabilities."

From his wheelchair, Graaskamp, a quadriplegic who turns 50 June 17, has run the university's real estate program since 1964. He has built it into one of the best — possibly the best — in the USA, says Lewis Bolan, vice president of Real Estate Research Corp.

Graaskamp also has been a pioneer in developing computer programs for real estate professionals and has run home building, farm investment and real estate consulting firms.

He has been tireless in exhorting the 650 students that have gone through his program since 1964 to look at an investment critically, using all the tools of risk analysis possible.

At times, Graaskamp's conversation will soar off into the theoretical, but the bottom line is never far away.

He and a group of students once appraised a property in Washington state's Cascade Mountains for a company fighting a $12 million offer from the government to buy the land for the national wilderness system.

No one had ever worked out a way to put a price tag on the value of scenic vistas, he says.

The project took two years and generated one doctoral dissertation and four master's theses — and a $28 million settlement for the client after the appraisal came in at $36 million.

Former Graaskamp students abound in many of the USA's largest real estate companies. They form a huge network in constant communication with each other and with Graaskamp, whom they affectionately call "Chief."

Graaskamp, seven of his students and no fewer than 30 Wisconsin grads attended a recent conference of the Urban Land Institute in Seattle.

Graaskamp has been confined to a wheelchair since he was stricken by polio at age 17. But he never let that stop him.

He majored in creative writing, specializing in humor pieces, at Florida's Rollins College, where one professor was sure Graaskamp was headed for literary stardom, "because I was getting such elaborate rejection letters from *The New Yorker* magazine."

But Graaskamp returned to his native Wisconsin to earn master's and doctorate degrees and go into private business.

Graaskamp doesn't regard himself as handicapped, though he has worked hard at the university and other institutions for access to buildings for the handicapped.

When the governor named him Wisconsin's Handicapped Person of the Year in 1970, Graaskamp laughed when a former student wrote him, "I understand you've been named handicapped person of the year. When did you become handicapped?"

AP

**JAMES A. GRAASKAMP:** Chief of a real estate network

# Sell advantages, professor urges

Milwaukee Sentinel Oct 2nd, 1985

By Alvin L. Curtis

Brookfield — A successful real estate project creates a monopoly of its own and uses marketing tools to ensure success, a University of Wisconsin — Madison professor told a group of real estate executives Tuesday.

"Real estate was established when someone rolled the rock in front of the cave," said James A. Graaskamp, chairman of the UW — Madison department of real estate and urban land economics.

Graaskamp spoke to about 150 members of the Building Owners & Managers Association of Milwaukee at the Marriott Hotel in Brookfield.

Graaskamp was referring to one of four elements needed to create a monopoly for a project — something that separates it from the competition.

The first is to house an activity more efficiently, such as when early man enclosed the first cave, he quipped.

The others, he said, are to reduce anxiety, enhance self-esteem and reduce irritation. Early man provided the rest when he added fire and wall paintings.

"Those are the only four things you're marketing," he said.

Without some sort of monopoly advantage, the project must compete on price and "there is always someone to undercut you."

The monopoly can be created by giving the project some element that its competitors do not have, such as a special site or the timing of its entry into the marketplace.

To find that, "it requires sensitivity on your part which can be generated through marketing research."

Graaskamp pointed out that real estate is the only business where "people are walking through the product themselves."

He cited the example of one office building owner who sprayed his walks with a scent to make the area smell freshly mowed, used rich wood accents on the entry doors and double padding in the hallways.

"The entire real estate product was communicating," he said.

In some projects "the No. 1 enemy is claustrophobia." That is why in shopping centers ceiling heights are varied and waterfall sounds are introduced.

Graaskamp also said political research is important to the real estate developer. "Everything you do is a public entitlement."

Understanding the politics of a community is "critical to not creating problems before they start" and solving them if they do arise.

Market studies can help property managers understand why problems exist.

For example, the golf course at a major Wisconsin resort was designed by a professional, but was having trouble attracting golfers.

Research showed the course was too difficult for the average golfer, who didn't want to go there and on the first day of his vacation and shoot a 129, he pointed out.

"The guy came there to have his ego boosted, not crushed."

Plans to put housing for the elderly in a peaceful countryside setting fail because of a lack of research.

"The elderly don't want to be in the peaceful countryside," he said. "They know they'll be there soon enough."

Instead, they prefer to overlook the street, "where they can see what's going on," he said.

You have to be prepared to attack the premises of your marketing and make sure the product is created in the eyes of the community and not the developer, Graaskamp said.

The developer needs to recognize that what is being sold is not square footage, but a space / time unit.

"Motels don't go by the square foot, but by the night," he said.

5/10/85

MILWAUKEE SENTINEL Business

# Professor argues UW off target on economy

By Alvin L. Curtis

**Brookfield** — The University of Wisconsin System is a refinery whose product mix does not meet today's market needs, the chairman of the University of Wisconsin Department of Real Estate and Land Economics said Thursday.

James A. Graaskamp told members of the Wisconsin Economic Development Association, meeting at the Marriott Hotel, that the university's role in economic development could be best served in the same way that most successful businesses are operated.

Graaskamp likened a university successfully involved in economic development to the companies in the book, "In Search of Excellence," strongly customer-oriented.

Economic development is often confused with land and buildings, Graaskamp said. There should also be a "software, a value system" at the university that promotes economic development. "Networking becomes a significant piece of software," he said.

However, at a time when more students than ever want to enroll in the School of Business, the university has been unable to provide the staff to meet the need, Graaskamp said. Instead, UW raised the standards for enrollment.

"I always thought that in a customer-oriented business, you put the resources where the business is," he said.

Why aren't students entitled to find out if they have the skills to become business executives, engineers or physicists, he asked.

"The ability to shift resources from one school to another is the real test of the commitment to economic development," Graaskamp said. Yet the university faculty has been faced with a two-year salary freeze and now a divisive debate about salaries, he said.

Graaskamp rapped a UW plan to raise funds for an indoor athletic and graduation facility. "Three janitors and a guy to drive the ice machine for the hockey team is not economic development," he said.

He argued that deans should be the ones to set and deal with how budgets are spent. "Tell me the dollars and my mission, and then get out of my way," he said.

Members of the association should set up small committees to study tenure, salaries and other issues in the university, and to try and influence the selection of regents.

The university is "not a monastic order, some keeper of the flame," Graaskamp noted, saying that education needs to be linked to fields where individuals are employable. At the same time, "we have to respect the arts" and ensure art and other professorships do not lose out in the struggle for funds, he said.

Graaskamp said that more students needed to be aware of economic issues. Of 41,000 students at the university, less than 5,000 are required to take economics courses, he said. "We spend an awful lot of money on sex education and driver education — neither of which you can afford without economics," he said.

At the same meeting, a representative of the Federal Reserve Bank of Chicago told the group that economic stimulants from the federal government were not likely to help local or regional economic development.

Karl A. Scheld, senior vice president and director of research, warned that industries, once viewed as responding to cyclical economic changes, were no longer the same.

"I don't think the rising tide (of economic recovery) will raise all the ships" as long as international and outside factors affected the economy.

"The forces for correcting those difficulties and those problems may very well be placed on your shoulders," Scheld warned.

With a changed world market, no prospects of federal bailouts and slower growth, "it really comes down to what you can do in your local markets," he said.

Edited by Geoffrey Smith

*How do you get rid of inflated real estate values in savings and loan portfolios? Why not call in the accountants?*

# Don't blame the appraiser

By Catherine Yang

SOMETHING ROTTEN seems to be going on in the world of real estate appraisers. Name a savings and loan oufit that has failed lately—Empire Savings & Loan Association in Texas, Glen Ellyn Savings & Loan Association in Illinois, San Marino Savings & Loan Association in California—and the problem underlying the failure is the same: poor asset quality, which often involves inflated real estate values.

The question is: Where were the appraisers? After all, the idea of an appraisal is to protect the lender in the event of a default. With at least one-fifth of the nation's 3,200 federally insured thrift institutions declared "problem" thrifts by the Federal Home Loan Bank Board (FHLBB), is there something wrong with the real estate appraisal system?

Very possibly. The average real estate appraiser is just a pawn in the process, however. Normally he is in business for himself and earns around $175 for figuring out the value of a typical single-family home, using several methods of valuation. If the loan officer likes his work, he'll get another job. If not, he's out scrambling for work.

Why would a thrift loan officer be unhappy with an appraisal? Because the appraised value of the property is insufficient to justify the loan he wants to make. "I have been told by banks that they couldn't hire me because my numbers were too low," says Donald Dorchester, senior vice president at the Chicago-based Real Estate Research Corp.

In fairness, some of the inflated property values on thrift books simply result from sharp falls in real estate markets. But a much larger amount results from greed. "The thrifts were competing to make loans, especially after their deregulation in 1982," says Robert Johnson, executive director of the National Association of Review Appraisers & Mortgage Underwriters (NARA/MU). The pressure to lend put the appraisers in a compromising position.

In theory, the thrifts' top management can be held accountable for accepting inflated appraisals. But the problem may be too widespread for that. Tempting as it might be to fire several hundred bank presidents all at once, one does risk causing a panic.

So what's to be done? "The connection between appraisers and salespeople must be broken," says Fayette Arnold, NARA/MU president. What's more, it's comparatively easy to get rid of an inflated mortgage loan—just sell it to Fannie Mae, Freddie Mac or Ginnie Mae. Some 65% of the single-family home mortgage loans are sold to these so-called secondary markets. "The private mortgage insurers and Fannie Mae are used as garbage disposals," says Arnold.

Belatedly, the secondary market has become aware of the problem. Judith Dedmon, vice president of quality standards at Fannie Mae, says that Fannie Mae's foreclosed properties include a significant number of overvalued appraisals. When Fannie Mae appraisers make their own evaluation, values differ as much as 15% to 30% from the original appraisal. Now, Fannie Mae is doubling its appraisal reviews, while continuing to enforce a rule that requires a lender to repurchase any loan with a faulty appraisal. It plans to issue tighter appraisal procedures early next year.

The Federal Home Loan Bank Board, which oversees the Federal Savings & Loan Insurance Corp. (FSLIC), is now bestirring itself as well. The FHLBB is concerned that currently appraised values often include financing concessions offered by the home seller, like interest rate buydowns and cash rebates. These financing measures are the cause of many inflated appraisals because their value vanishes in the event of default.

Regulation of appraisal work is made more difficult by the proliferation of weak professional appraiser societies. While most CPAs belong to one professional organization and follow a uniform code of practice, appraisers have their choice of at least a dozen professional groups, each with its own standards. But James Klopfenstein, president-elect of the Society of Real Estate Appraisers, estimates that fewer than 25% of the appraisers belong to them.

The driving force for reform ought to come from the people at greatest risk: the FSLIC. Professor James Graaskamp, chairman of the real estate department at the University of Wisconsin, thinks that the FHLBB should hire appraisers and require federally insured thrifts to use them.

But there may be a less drastic, free market solution: Require that a thrift's auditor review its appraisal work, with the implicit threat of qualifying his year-end annual report letter if no action is taken. ■

COVER STORY

1986

# Developers dread loss of loopholes


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By Jim Henderson
USA TODAY

For Robert Black, this is the darkest hour of a 25-year career as a commercial real estate developer. If the Senate's tax proposal for real estate and tax shelters passes as currently written, he stands to be wiped out.

"Like most builders, I've lost money before during down real estate cycles," says Black, 56, president of Hallmark Realty Homes Inc. in Fairfax, Va. "But this would be a catastrophe."

The plan would make several changes in the way real estate and real estate investments are taxed — but none as damaging as those affecting commercial developers.

By the time the law is in effect for one year, we'd see the loss of 350,000 multifamily housing starts — more than half the total starts projected for 1986, says the National Association of Home Builders. That would result in the loss of 377,000 construction and related jobs totaling $6.9 billion in lost wages, the association says. One result: Higher rents for tenants of office buildings and apartments.

Here's why. The plan takes a swipe at some of the key benefits investors get for putting money into real estate development: depreciation of the property, and capital gains from its sale. But the most damaging part of the plan, from the industry's standpoint, takes an ax to the limited partnership: the chief vehicle individual investors use to invest in commercial real estate and commercial developers use to finance a project.

A limited partnership allows tax deductions generated by business to be passed directly to investors, who can claim them on their personal income tax returns. The Senate plan would limit those write-offs severely by:

- Limiting loss deductions to the amount of income received from limited partnerships. (Excess losses, however, could be carried forward.) There would be no grandfathering of existing partnerships, but the change would not be

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COVER STORY

USA TODAY 1986

# Senate plan rocks developers

Continued from 1B

fully phased in until 1991.

■ Lengthening the time you could depreciate property — thus cutting the yearly write-off. Depreciation would take 27½ years for residential property and 31½ years for all other property, up from the current 19 years. Depreciation also would be calculated on a straight-line basis; the current accelerated method gives you a greater portion of depreciation write-off in the early years. For example: Under current law, a $1 million apartment building would generate $88,000 in depreciation write-offs the first year; under the proposal it would generate $36,364 in write-offs the first year.

■ Ending favorable tax treatment of long-term gains that lets you exclude from taxation 60% of profit from the sale of an asset held six months. So under the new plan, the pot of gold at the end of the real estate rainbow would be taxed as ordinary income. Granted, the plan would drop the top individual tax rate to 27% from 50%, but under current law someone in the 50% bracket pays a maximum tax rate of 20% on long-term gains.

Despite the phase-in, the changes would scare away most individual investors, developers say.

Developers such as Black could be devastated, because long before the money comes rolling in from limited partnership investors, his company has had to borrow big to get the project started.

"You name it and we put it up (for collateral): my house, office buildings we own, company stock, the works," Black said.

Some projects now on the drawing board could go unfinished, and someone will have to pay for the work done so far.

"If you think banks have a lot of bad real estate loans on their books now, it's nothing compared to what they're going to have if this tax plan goes through," said Michael Amenta, real estate specialist for the accounting firm Laventhol & Horwath. "They're changing the rules in the middle of the game, by not grandfathering projects already begun."

But the plan would have more far-reaching effects than hurting some commercial developers. If the tax incentives of real estate investing are reduced, some other incentives would have to be increased to attract investors. What's left? Rents.

"There's no doubt about it. This thing is going to drive up rents," said Black, who said he would have to raise rents on his office-complex project 35% to make it worthwhile for investors under new tax rules.

But finding commercial — or residential — tenants who would pay higher rents may be tough. "There has been a lot of overbuilding in many areas because the current tax system rewards for developing real estate, regardless of whether there was a demand for the properties," said James Graaskamp, professor of real estate at the University of Wisconsin and president of Landmark Research Inc., a real estate investment consulting firm.

The USA average downtown office vacancy rate was 16.5% at the end of the first quarter of 1986, up from 3.4% for first quarter of 1980, according to Coldwell Banker Real Estate Services. The vacancy rate for suburban office space was 22.5%. The apartment vacancy rate for the same period was 6.9%, highest since 1967, according to the Bureau of the Census.

Where there is adequate supply of both apartments and offices, rents would not increase much at first, Graaskamp said. "But ultimately, if a tax law causes people not to build any more, rents would begin to rise," he said.

The NAHB predicts that after five years under the new plan, rents on existing offices and apartments would be 20% higher than without it, and that values of commercial properties would fall 20%.

If that is true, investors would have to change their attitudes toward real estate as an investment. "Real estate would become a 'keeper' investment rather than one that you get into for short-term tax benefits and a quick profit," Graaskamp said.

For a small investor, owning an individual rental property would make a lot of sense as a long-term investment. Selling wouldn't be as profitable because all gains would be taxed as ordinary income, and the prospect for higher rents would mean greater income. And that income would be taxed at the plan's lower rates (a top of 27% vs. 50% now.) So real estate would be attractive because of its ability to generate income — rather than tax losses.

Because limited partnerships no longer would be attractive to smaller investors, large-scale development and real estate ownership would be financed by a few very wealthy investors and institutional investors such as insurance companies and banks and pension funds, said McDonald Williams, managing partner of the Dallas-based construction company, Trammell Crow Co. Individual investors would be left with single-family units and small apartment buildings.

"But direct ownership has always been the best route for the individual," Graaskamp said. Although the limited partnerships may be the easier way to invest, they are not efficient or economic. "Up-front fees for these partnership can easily run 20% of your investment or more," says tax adviser William Brennan, publisher of *Brennan Reports*, Valley Forge, Pa. On top of that are annual fees for property management and administrative costs.

Meanwhile, the threat of the tax plan has had an immediate effect on the industry. "In one week, everything has ground to a halt," Amenta said. "My clients who are selling tell me all the buyers have run for the sidelines, and those that have ongoing projects are afraid to invest more money in case they have to dump the property."

# Salomon Bros. launches new real estate group

SALOMON BROTHERS INC. has selected an academic advisory board of real estate experts to assist its real estate research group in analyzing and reporting on the commercial real estate market.

Comprised of six outside consultants and seven Salomon Brothers real estate professionals, the real estate research group is headed by Kenneth T. Rosen, consultant/manager of Real Estate Research at Salomon Brothers. Professor Rosen, a well-known real estate economist, is on leave from the University of California, Berkeley, where he is chairman of the Center for Real Estate and Urban Economics and Professor of Business.

The members of the academic advisory board include: Anthony Downs, Brookings Institution; James Graaskamp, University of Wisconsin; Sherman Maisel, University of California, Berkeley; Mike Miles, University of North Carolina; Lawrence Smith, University of Toronto; and Dwight Jaffee, Princeton University, Professor in Economics Department, and Public Interest Director of Federal Home Loan Bank of New York.

The Salomon Brothers real estate research group includes Kenneth T. Rosen, consultant/manager of real estate research; David Shulman, vice president; Anne Mengden, vice president/REIT analyst; Robert Hopkins, senior research analyst; David Hartzell, vice president; Andrea Lepcio and Mari Canton, research analysts; and Julia Fernald and Karen Samols, research assistants.

The real estate research group will look at market fundamentals on a national and metropolitan area basis; rates of return on commercial debt and equity real estate research assets; and flows of capital to the real estate market.

# UNCOMMON SENSE

## Real estate expert James Graaskamp thinks the tax bill may be much ado about nothing. Other issues are not so easily dismissed.

BY MARGARET OPSATA

We all know what the new tax bill contains, but what does it really mean for real estate? Will it halt new construction and drive rents through the roof? Or is it a breath of fresh air in a stagnant marketplace? More to the point, can an investor win under the new rules, or has the game been rigged against him?

For answers, we turn to James A. Graaskamp, chairman of the Real Estate and Urban Land Economics Department at the University of Wisconsin's School of Business in Madison. Not only is he regarded by many as among the most knowledgeable and objective industry observers in the country, but his real estate curriculum has trained some of the leaders of today's real estate industry.

In Graaskamp's view, the legislation's impact on real estate itself will generally be positive. The big losers are the syndicators and limited partners who have confused real estate with the proverbial goose that lays golden eggs. "Those who have profited unfairly, taking fees relative to tax shelter, have been hit pretty hard," he admits. "So have the players who depended on the excesses of syndications for their profits." Syndication of "elegantly crafted partnerships" that "created space to have an investment product to sell rather than to serve any real economic function," he says, will become a memory, and sooner rather than later. "In a lot of cases," he says with bemusement, "investors would spend a dollar and a quarter to get into a deal where

Brent Nicastro

**James A. Graaskamp: Planners should rely on logic and demographic realities.**

they could avoid paying a dollar in taxes."

With that kind of dubiously structured program eliminated from the market, the frenzied national building boom in commercial space should subside. This, of course, would allow overbuilt markets to absorb their existing excess. "In the long run, it will stabilize the upside value of existing real estate," says Graaskamp. But what then? When the oversupply is reduced, will there be a shortfall of space? Graaskamp isn't sure, but he is positive that the amount of new product that gets built will not be decided by the tax bill. The balance of rental supply and demand "is a function of financing more than of tax law," he points out. If a developer can build something the market needs at a price that makes sense, he'll do it. If interest rates are too high, he'll wait.

As planners know, some observers are predicting a catastrophe in rental housing. They point to the loss of incentives for new construction and stringent new restrictions imposed on legitimate deductions incurred for operating rental properties. As a result, by their reasoning at least, owners of existing buildings will have no alternative but to pass their higher costs through to tenants, driving up rents some 20% to 40%. In the most dramatic versions of this scenario, single parents, the elderly and the working poor will be driven into the streets.

Graaskamp, for one, doesn't swallow this story. "Nothing is going to happen to rents now that wasn't going to happen to them anyway," he says flatly. "Rents are controlled by market supply and demand. If you accept the basic premise that we are overbuilt, there is not a lot of ability to push rents forward and keep your units filled." The wave of refinancings that have been completed for successful properties also should help to hold rents on a steady course. "Investors have already taken big chunks of cash out recently or are getting tremendous increases in cash flow," he says. "They are under no pressure to roll rents forward and perhaps raise their vacancy rates." This is good news for apartment dwellers but not for people currently invested in disappointing apartment syndications. Those who expected rapid rent escalations to bail them out should not hold their breath. "If somebody is in a rental program and it's not doing too well," Graaskamp says, "he isn't going to be saved by higher rents as long as there are too many apartments and not enough tenants."

The problem with this view is that it requires an abundance of common sense —more than can be expected from tax-oriented investors and more than a few syndication companies. Graaskamp urges planners to rely on logic and demographic realities when sorting through the piles of new real estate partnership offerings—virtually all of which are being touted as *the* answer to tax law changes. Raw land deals provide a good example. Starting with that horrific picture of displaced families fleeing from rent hikes, some sponsors suggest that the most exciting investment opportunity of the decade is undeveloped land on urban perimeters. The sales pitch goes like this: We'll buy it, hold it and sell it for a tidy profit to a developer who needs it to create a new suburb for people who are forced out of overpriced cities. Investors who are adventuresome enough to forgo cash

**Higher rents won't help as long as there are too many apartments and not enough tenants.**

flow for a few years will strike it rich when the land speculation pays off down the road.

On the surface, this argument sounds persuasive. It even may seem to make sense—until Graaskamp rebuts it. "You just have to look at the age groups in the demographic structure to know that those sponsors are whistling in the dark," he says. "First-time home buyers —the 24- to 35-year-olds—are becoming an increasingly smaller group. By the same token, the biggest age group, the baby boomers, is now into second homes and planning to move into third homes. They'll have more homes they want to sell than there are second-home buyers, and there will be even fewer first-home buyers to take what the second-home owners want to sell. If interest rates go up and keep some of the younger ones out of the housing market," he warns, "the problem will become obvious more quickly. A lot of people think that as early as the 1990s, the home markets are going to be really out of sync."

Obviously, the severity of the situation will vary by the part of the country buyers are in. "If there's a lot of migration in," says Graaskamp, "the balance may be better. But, in general, there is going to be a continuing tendency toward increasing density and more infilling of our urban areas. The sprawl to the outer perimeters won't be as great. All this suggests that raw land won't be as good an investment as it once was."

Nowhere in this analysis did Graaskamp once mention the words "tax bill." That's because he believes that demographics and interest rates, not income baskets or passive-loss rules, will control the housing markets in 1987 just as they did in 1887, when people paid no federal income taxes at all.

Despite his harsh words, Graaskamp is not critical of syndication as an activity. If the limited partnership structure can create a product that the marketplace needs, he's all for it, even if the product creates significant write-offs for investors. What he dislikes are programs that dump commercial space where it is not needed, solely so that the sponsor can line his pockets and the limited partners can dodge taxes. Unfortunately, much of the syndication activity in the early 1980s fell into the latter category. Syndicators who succeed in the future, Graaskamp insists, "will have to look for some other rationale, one which is rational and has economic justification." And those willing to play by the new rules can find plenty of opportunities left.

One syndication area that Graaskamp likes is historic renovation. "We have a very significant stock of real estate that goes back to 1936," he points out, "and there's an incentive to refurbish and restore it because the historic tax credit has been saved." But planners should choose sponsors with great care. "The complexities of dealing with older buildings require a technical expertise that syndicators, by and large, don't have," he says.

He is also bullish on rolling up several separate limited partnerships into a single, larger partnership. "I think there probably is a great deal of money to be made by taking buildings in syndications which have gotten past their puberty and are producing good cash flow and blending them with some of the more recent partnership efforts, which have not had time to become economically viable," he says. On the day after the House/Senate conference committee reached agreement on the tax bill—the time of this interview—it appeared that income and losses from real estate investment trusts would be placed in the portfolio basket, not the more limiting passive basket. If that's true, Graaskamp also expects to see "many of the limited partnerships being rolled up into investment trusts so they can change their status from passive to portfolio. Perhaps in the process, they can create some capital losses that would be applied against the income." He also is intrigued by the suggestion that syndicators buy corporations that have large tax carry-forwards. "By rolling up their limited partnerships into the corporate structure," he says, "they can shelter the income and build up a significant book value per share."

For planners with clients who earn taxable income under $75,000 and want to invest in real estate, Graaskamp advises incorporation. "The small investor who falls into the 28% personal tax bracket would be better off," he notes, because corporate income up to $50,000 is taxed at 15%, and between $50,000 and $75,000, the rate climbs to only 25%. (The much-discussed new corporate rate of 34% takes effect only at levels over $75,000.) Incorporation also delivers other advantages, including the chance to establish a corporate pension plan to replace the individual retirement account—to which investors with income over $50,000 ($35,000 for singles) can no longer deduct contributions.

It's too early to tell, Graaskamp believes, exactly what impact the restructured corporate rate schedule will have on major corporate ownership of real estate. "It is clear that the long-term trend, in which government tried to encourage more corporate ownership of real estate in an effort to suppress syndication, has been reversed," he says. "Real estate owned by big corporations will now be more heavily taxed. My guess is that the larger entities will find that being in a real estate investment trust will be more advantageous."

**"Without the preferential treatment of capital gains, those who milk their properties will do as well as those who enhance their value. I would prefer to see the ones who enhance the value reap the rewards."**

Only one provision in the new bill seriously troubles Graaskamp. "By eliminating the preferential treatment of capital gains," he points out, "those who milk their properties will do as well as those who enhance their value. I would prefer to see the ones who enhance the value reap the rewards. It's more expensive to create wealth than to simply enjoy spending it." If he could rewrite the code, he would reinstate favored treatment for capital gains, but only for those that were truly long-term —perhaps a 10-year holding period.

Even though the capital gains preference will be gone in 1987, Graaskamp advises planners to use the theory behind it—creation of capital by enhancement of value—as a fine screen to sort out the syndications now available that have the best chance to deliver attractive real-cash returns. "Look for organizations that buy undermanaged properties and enhance the assets through better management," he advises. "Several are out there that have always done business on this basis and done it very well. For them and their investors, I don't think the tax law change will make any real difference."□

From Midwest Real Estate News

# Graaskamp urges greater research in marketing for rental real estate field

By Al Curtis

**Milwaukee** — Market research and market strategy need to go hand in hand for the real estate professional, according to the head of the University of Wisconsin's Madison School of Real Estate and Urban Land Economics.

Sound marketing data can give the rental real estate owner and manager an edge over the competition in what is today an extremely competitive market, said James A. Graaskamp.

Graaskamp recently spoke to members of the Building Owners and Managers Association of Milwaukee.

"Marketing research can be a very sophisticated part of a project," he said.

The real value of the investment is a revenue stream that has some element of stability, Graaskamp said. Assuring that stream means the owner or manager must create a monopoly of sorts, something that distinguishes his project from another. Marketing can help make that distinction.

Market research—no matter what type—permits the focusing of a real estate project on selected segments of consumers with an unusual product requirement, at a particular point in time and location when the alternatives of supply are limited.

Good research can help the developer create a monopoly of product and of service.

Real estate is a combination of product and service, Graaskamp said; and as a result, it offers the greatest number of options to explore.

Real estate today contains—and the developer needs—a high level of service in order to help distinguish his project from someone else's, he said.

"The future of real estate is in management," Graaskamp said. Graaskamp divided marketing research into five general functions:

- Market studies of the total variables in the long term in which the project must operate. He cited an aging population that will require apartment builders to design units with convenience in mind.
- Merchandising studies of the controlled variable in the short term. These are the variables the developer can control to capture market opportunities.
- Market communication studies to find ways to persuade the customer prior to and at the point of sale. Graaskamp cited the example of an office building owner who had the walkways up to his building sprayed with the scent of freshly mowed grass and added rich wood accents to the interior of the building.

"The entire real estate product is a communicator," he said. Graaskamp added that real estate is unique among products in that "people are walking in the product themselves."

- The market research must interact with the project's feasibility analysis from the start in a synergistic way, rather than a linear fashion. Projects that have implicit premises need to be tested right away to avoid false starts and wasted research.

Graaskamp cited the example of a housing project for the elderly set in the peaceful countryside.

"The elderly don't want to be in the peaceful countryside," Graaskamp said. "They know they'll be in the green soon enough. The elderly prefer a view of the street so they can see what's going on."

Graaskamp said developers "have to be prepared to attach the premise of marketing and make sure the product is created in the eyes of the customer and not the developer."

- The inital marketing premises of the project defines its "strategic positioning" as it relates to the uncontrolled external variables that can be exploited or neutralized.

"The ability to set up the data tells when to get into the market," he said, "and when and why an oversupply is likely to occur."

In studying for a project, it's important to recognize that what's being sold is the space/time unit, not the sq. ft., Graaskamp said.

"Motels don't go by sq. ft., but by the room for the night," he pointed out.

# Mayor, business nurtured project

Getting the Grand Avenue shopping mall from an idea to a fact was a matter of a strong mayor and a group of business investors with clout, according to University of Wisconsin-Madison real estate expert James Graaskamp.

Graaskamp said many downtown rebirth projects never leave the planner's sketch book because no leader takes control to assemble money and public support. Other projects lose their way in a political and bureaucratic maze and emerge as only shells, he said.

In Milwaukee, he said, the Milwaukee Redevelopment Corp. played an important role. Composed of business executives, the redevelopment corporation was able to assemble the support in the business community for the Grand Avenue.

The support was necessary, he said, because business money was needed for the construction. Business owners were willing to participate, he said, because through the redevelopment corporation they became insiders on the project, able to exert some control over the result.

The structure of Milwaukee politics also played a role, he said. Mayor Henry Maier is a powerful mayor, he said, able to gain support for projects he approves. Consequently, he said, political bickering that can destroy projects was avoided.

Wisc. State Journal Tues. June 1, 1982

# UW-Madison's 'Chief' is a real power in the land

By Steve Kerch 11/15/87
Chicago Tribune

MADISON—A newspaper article once asked "Why is Prof. Graaskamp so irascible?"

"And that was a friendly reporter," quipped James Graaskamp, the often outspoken yet remarkably revered leader of one of the few programs in higher education that is dedicated to teaching real estate development.

"If you're the mayor of Madison, you might call him a rabble-rouser. He's not afraid to speak out on issues like a new civic center or reuse of an abandoned rail corridor," said Norman Flynn, president of Flynn Baker Inc. Real Estate in Madison and a national director of the National Association of Realtors.

"There are a lot of other things you might call him—a friend, an ally—but he is best known as 'Chief,' as he is fondly called by his 900-plus graduates," Flynn said. "He has developed one of the really renowned programs in real estate and as a consequence is having a significant impact on the real estate industry in this country."

Graaskamp, 54, is chairman of the department of real estate and urban land economics in the University of Wisconsin's school of business here. His program is regarded as the first in the country to specialize in development analysis.

Some in the real estate industry question whether development—which has traditionally drawn its recruits from pursuits as various as architecture, law, banking and brokerage—can be taught in a classroom. But to hear Graaskamp's graduates tell it, the professor's program has been invaluable.

At a recent reunion here, more than 350 alumni of the real estate program gathered to exchange stories and establish contacts. From the roster of attendees, it was clear the Chief's Indians have infiltrated almost every aspect of the real estate industry.

"There were only 8 or 10 of us back in the Dark Ages when the program started," said Michael Feiner, chief executive officer of MDC Holdings Inc. in Denver, one of the nation's largest home builders.

"I can remember that Prof. Graaskamp had this really radical idea back in 1966—an after-tax cash flow analysis. But he has always been on the cutting edge and it's why we've been fortunate to have been a part of the program. The success of all of us in this room speaks to that," he told the gathering.

For those developers who didn't master Graaskamp's after-tax flow cash analysis, the tax reform act of 1986—which took away many of the tax advantages to real estate investing—was a tough blow. For Graaskamp's graduates, the change in the tax code merely gave them one more reason to praise his program.

"There is no greater factor in my life than Prof. Graaskamp," Feiner said. "Without him, I would not have been able to get into the unusual areas [like securitization and collateralized mortgage obligations] I have. Heck, I was here at the university for nine years. I must have liked something other than the Corvettes and the girls."

It wasn't always easy being a business student in the '60s on the Madison campus, a time when the town was a flashpoint for protest against the Vietnam War and only finance majors wore sport coats.

Graaskamp recalled a "panic stricken" woman from the west side of the city who complained about some "sinister folks" stalking through the back yards of her neighborhood. It turned out to be only a bearded Feiner and another real estate student, who were taking their advanced appraisal course rather seriously.

Today the real estate program is the fourth largest in the school of business with 103 master's students and 68 undergraduates enrolled this academic year. Seven doctoral students are in the program, although the department could only fund four positions—"the rest came anyway," Graaskamp said.

Classes offered range from real estate law to market research to equity investment. There is a heavy emphasis on the practical side of the development business that attempts to bring the real world into the classroom.

To that end, the program also provides a variety of guest speakers throughout the year who are flown in from around the country to lecture on topics of concern in the real estate industry. Those programs are funded by alumni.

The graduates may be young, but they are influential. Sixty-eight of the 350 alumni at the reunion work in Chicago. Their names pop up at dozens of area real estate, financial, development, accounting and appraisal firms.

Five graduates, who made up a panel on property acquisitions, together have a hand in real estate investment portfolios that total more than $25 billion. The firms they work for—JMB Realty in Atlanta, Heitman Financial in Los Angeles, Equitable Life in San Francisco, Aldrich, Eastman & Waltch in Boston and Bennett & Kahnweiler in Chicago—show how much of a cross-section of the country

See Milwaukee, pg. 2H

Tribune photo by Steve Kerch

University of Wisconsin real estate and urban land economics graduates refer to their outspoken department chairman, James Graaskamp, as "Chief."

# Chief

Continued from the first page

Graaskamp's graduates span.

Graduates have even spread across the globe to Norway and the Netherlands.

Graaskamp was asked to moderate a recent Urban Land Institute seminar in Milwaukee that focused on several of the city's downtown development projects. Organizers did not know how appropriate the selection of the professor was—every one of the projects discussed that day involved one of his graduates in a leading role.

"One thing I did learn from Prof. Graaskamp's program was if you don't have the answer, just keep asking the question, because sooner or later you will get the answer," said Thomas Klein, a developer with Madison-based Oakbrook Corp.

Klein helped put the financing together for Yankee Hill, a $33 million apartment development in Milwaukee. His description of the package—which included tax increment bonds, writedowns on the urban renewal land and first and second mortgages from a city general bond issue—confounded a panel of experts at the seminar. But it left Graaskamp grinning.

The unconventional delights the Chief. He is not enamored of the university system, in which the faculty and administration control the purse strings and the ideology. The real estate tradition, he said, is "ignoring the university's rules." And Graaskamp's alumni have rallied to his call.

They have set up their own foundation, connected to the university, which provides endowments to fund teaching assistant positions, among other things. This year the alumni have started a second fund, not connected to the university, which they hope will be able to boost the salaries of worthy professors. The faculty prevent any such enhancements through university foundations.

"We hope to dip into the endowment fund to make up the difference between what the UW pays and what the rest of the world pays. The university pay scale assumes living in Madison is worth $20,000 a year," Graaskamp said. "We've already lost two professors to the business world. It appears those who can are doing, and that is a terrible precedent for teachers."

Graaskamp pulls no punches outside academia either. At a recent National Association of Realtors roundtable at the Ritz-Carlton in Chicago, he took issue with the NAR's position that no federal law is needed to establish standards in the appraisal industry.

"Virtually all the culprits in appraisal scandals have been able to resign or are still sanctioned to perform appraisals," he said. "I just don't see an industry willing to fund the tremendous cost of a standards board without a federal law."

He chided the Realtors for their insistence on maintaining their own appraisal arm, the American Institute of Real Estate Appraisers.

"I'm a lone voice, but I just don't see how—if appraisers are to be independent—they can stay under the umbrella of a group that is essentially a marketing organization," he said.

Commenting on the lunch laid out at the Ritz, he reminded participants that "the price would have subsidized two more Section 8 [low-income housing] units."

Graaskamp's outside work comes through Landmark Research Inc., a consulting firm of which he is president that specializes in courtroom appraisals, feasibility studies and institutional investment.

He is also a former member of the board of directors of the Wisconsin Housing Finance Authority, an Urban Land Institute trustee and research fellow and a member of Salomon Brothers real estate research advisory committee.

Graaskamp contracted polio when he was a 17-year-old high school senior in Milwaukee. His disability ended his athletic career, but has never curbed his academic interests.

"Real estate cuts across every major issue of our time," he once told the Milwaukee Journal. "Man is the only animal that builds his terrarium around him as he goes and there are tremendous ethical conflicts inherent in that. Real estate is business and social ethics, public policy through private research and action."

Old Dominion University
Norfolk, Virginia

mid-1980s



## REAL ESTATE

# ODU may land a realty center

No more is real estate a "wide-open, laissez-faire" kind of business in which an entrepreneur risked only his own money. Gone are the days when "most of your deals were no-brainers because you were guaranteed a return on low-cost money with a product always in demand." And times have passed when "you just made four or five phone calls and either you had a deal or you didn't."

John Levin

Those observations are from James A. Graaskamp, chairman of the real estate and urban land economics department at the University of Wisconsin. Graaskamp was in town last week as a consultant to Old Dominion University, which in the next year will attempt to set up a real estate center specializing in property asset management.

"The game has changed dramatically, influenced by the environmental movement, consumers and financing that have moved real estate from a parochial business to one that's international," he said.

And they've made it a business that in many markets is chronically overbuilt and politically charged, Graaskamp said.

Indeed, because of those factors, real estate "is the best medium for teaching risk management," he said. A developer, who has to be concerned about capital markets, tax laws, money rates and politics, can find that any or maybe all of those factors can change dramatically midway through a project.

"The new entrepreneur has to be able to deal with a set of variables that can change every day. You need people who are able to assemble a lot of facts and turn them into a decision quickly," he said.

Demand is high right now for such people, those trained to deal with the risks that confront real estate companies and corporations that have sizable property holdings, Graaskamp said. Yet there are few colleges and universities turning them out.

Students, too, are changing, he said. "We have a whole group of students coming out of things like environmental studies going into real estate because they feel they can make more of a contribution to society by being in decision-making jobs than as regulators and naysayers."

Graaskamp's own program draws its roots from 1920, when the University of Wisconsin started courses on urban land economics. In 1932, it became the nation's first four-year college program in real estate, and under Graaskamp it has added a specialty in computer applications for land use and appraisal.

Other major universities, he said, offer academic concentrations in development, housing and finance. Old Dominion, he said, has an opportunity to produce graduates who are in demand by financial and insurance companies managing real estate, corporations concerned with housing their own operations and government agencies that need to buy and sell real estate.

As important, Graaskamp said, would be the research produced by a center focused on real estate asset management. "The largest element of risk in real estate is based on the quality of data on which decisions are based," he said.

A real estate focus at ODU would mean "turning out business managers for other fields that have a vocabulary for real estate and the proper concern for real estate management."

And the center would also provide continuing education, where those working in the field could take one- and two-week courses that capsulize new ideas being taught to students, he said.

Linda P. Fletcher, chairman of the finance department at ODU's school of business adminstration, said the real estate center would come together as quickly as money is raised to endow it. The university's board of visitors authorized the plan this spring and appropriated money to get it started. ODU now has two professors teaching undergraduate courses on real estate, but a graduate program will demand a larger faculty, she said.

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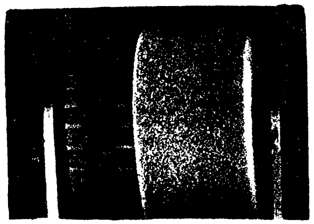
**Washington developer** Terry A. Busby said he's so confident of selling out the $8.5 million condominium he's building from an old cotton warehouse that he's begun serious planning for a second phase, a 13-story tower.

Busby is one of the pioneers converting Norfolk's Front Street warehouse and industrial area into what some are speculating will be the region's next gold coast for luxury apartments. Busby's project, the Pier, will contain 66 units in a six-story building due to open late this year. It sits atop a former cotton warehouse on a pier jutting into the Elizabeth River.

Busby's confidence was tested late last month when his Great Atlantic Capital Corp. asked the 150 people who had expressed interest since the project was announced a year ago to indicate how serious they were about buying. Each potential buyer was told to register at a local savings and loan office; 73 of them signed. "We believe most of them are serious buyers," he said.

Condos at the Pier are generally smaller and priced below other new downtown Norfolk waterfront buildings. For units with 1,000 to 2,500 square feet, Busby will charge $93,000 to $236,000. The price scale is intended to lure people who might not be convinced the building's neighborhood is indeed changing.

But Busby said the location offers such impressive views of the river and downtown skyline that architects have been told to install sunken balconies so visibility from the living room won't be obstructed. ■



# Changing appraisal system costly, painful

BY MAUDE SCOTT
Journal real estate editor

Calling appraising a "discipline of disinformation," real estate consultant and educator Dr. James Graaskamp said the system must be changed to make appraisers independent.

But it will be expensive and painful to some appraisers and lenders to "redress the embarrassment to the appraisal industry."

Standardization of the appraisal business at federal and state levels is moving with fits and starts but is inevitable, because the government agencies ultimately responsible for banks with bad real estate loans are in no shape to handle major defaults, Graaskamp said.

Graaskamp, in Seattle this week as a consultant to the Port of Seattle on its waterfront development, said the appraisal process is frequently fraudulent and responsible for the overvaluation of financial institutions across the country.

"It is small exaggeration to believe that the difference between solvency and insolvency of at least a thousand of our financial institutions is probably 100 basis points on the cap rate used to value their interest in distressed real estate," Graaskamp said.

"A little cooperation with their accountants allows them to evaluate their real estate on the loan value rather than asset value.

"Both the process and purpose of an appraisal for new development and related financing requires advocacy by the appraiser, disinformation for the files of the lender and fee structures based on contempt for the research process," he said.

Graaskamp said the thrift industry, banks and syndications stand to lose between $25 and $50 billion because of bad loans which were justified by faulty appraisals.

Congress is set to vote soon on HR-3675, the Real Estate Appraisal Reform Act of 1987, which would impose appraisal standards and certification on people dealing with federally-insured agencies or matters of "high public purpose," though just what that means is not defined.

Graaskamp said an earlier bill, R-41C, introduced needed discipline into the appraisal process, requiring, for example, an assessment of the value added by marketing, signature of the loan officer indicating that he concurs with the appraisal and separation of the value of the real estate from the service provided in it such as nursing homes.

That bill also would have had lenders selecting and paying for appraisals and charging the expense back to the borrower.

Graaskamp said establishing appraisal standards similiar to accounting standards will give appraisers more bargaining power with developers and lenders.

"Developers and their lenders will lose control of the appraisal process and the appraiser. The appraiser will become an advocate of the public interest as a check and balance on a lending system which is anti-appraisal, pro-transaction and biased toward credit enhancement."

But that will also give accountants a big advantage. Arthur Anderson & Co. is now the second largest appraisal firm in the country and Graaskamp expects more Big 8 firms to drive appraisers out of business.

"Soon developers will be dealing with accountants who understand appraisal rather than appraisers who are bad accountants," he said.

But the expense will increase dramatically, he said, with more thorough reports costing four and five times as much as appraisals cost today.

Graaskamp said the industry feels like it is being picked on unfairly but the system is seriously flawed and changes must be made. "Doctors have malpractice insurance but they usually can't do so much damage."

Graaskamp, a professor at the University of Wisconsin, made his comments at a meeting sponsored by the Seattle law firm of Ferguson & Burdell.

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James A. Graaskamp

# Graaskamp to offer '87 predictions

Noted real estate researcher James A. Graaskamp will make his predictions for commercial real estate in 1987 at a luncheon meeting of the Chicago Office Leasing Brokers Association [COLBA] in downtown Chicago.

The meeting, which is open to the public, will begin at 11:30 a.m. Feb. 12 at the Standard Club, 320 S. Plymouth Ct. Admission is free to COLBA members and $20 for non-members. Reservations are mandatory and may be made by calling Rita Overend at 641-0055.

Graaskamp is president and founder of Landmark Research Inc., and chairman of the real estate and urban land economics department in the School of Business at the University of Wisconsin.

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# The Real Estate Markets in 1988—Coming into Focus

## A Series of Interviews

### Overview: James A. Graaskamp

In talking about the performance of the real estate market in 1987 and in 1988, we first have to differentiate between the residential and investment properties. Residential has been slow in 1987, despite reasonable interest rates during the election year. The market seems to have met most of the backup in demand that may have occurred because of higher interest rates. In addition, demographics are starting to move against a high demand for single-family homes. As a result, the residential sales market for 1988 will be stable, but slow.

Industrial and warehousing/distribution activity may shift somewhat to third- and fourth-tier cities and distribution points during 1988. The attraction of these cities is that labor costs are lower, congestion is less, and perhaps the labor pool is higher quality.

For other commercial properties, there will be a further drop off in construction in 1988 in response to oversupply of new buildings almost everywhere. There may be further building because interest rates are still fairly low and some investors may want to lock in these interest rates now for the next 10 years. As the budget deficit and the trade deficit catch up with us, interest rates will begin to inch upward in the third and fourth quarters of 1988.

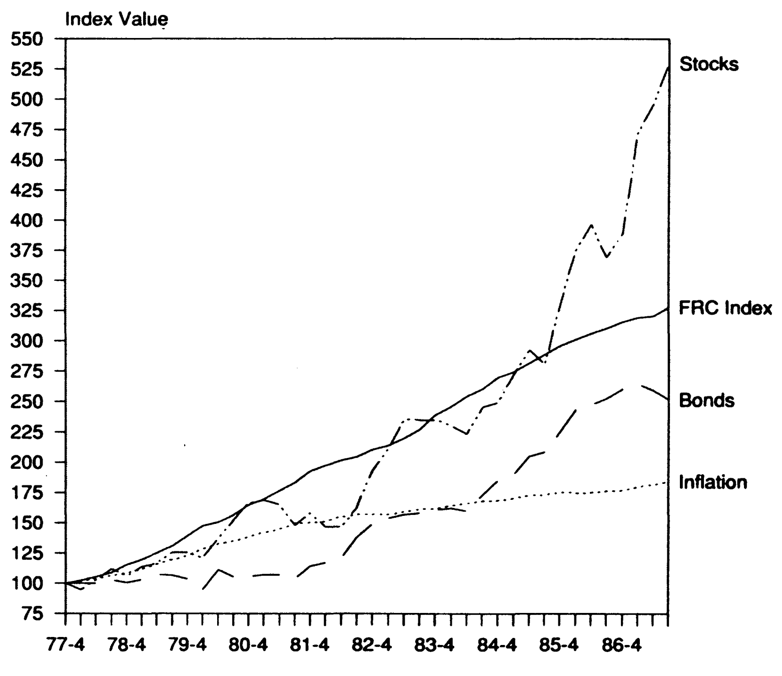
In the next few years, there will be a further shift of business out of the downtown areas, particularly in major cities. The problems of major metropolitan areas in terms of congestion, crime, and poor public education are causing some businesses to migrate out of the core into the suburbs and smaller metropolitan areas. Even with lower effective rents downtown, the cost of space per workstation is becoming prohibitive for back-office personnel.

And as cities begin to look for revenues to handle their social problems, the commuter employee pool will become a prime target for a payroll or similar tax. So the costs of occupancy will continue to rise for the downtown employer. The cost of space in the suburbs is less, plus there is a larger group of better educated, better trained employees to chose from. Many higher-level businesspeople interested in the quality of life no longer find it attractive to work downtown. In a few cities, such as Chicago or Boston, there is significant housing downtown to keep workers in the city. But this is not true in New York, Los Angeles, and many other cities.

Businesses migrating to the suburbs still represent a small part of the whole—5 to 10 percent—but this group can have a significant marginal impact on owners' ability to increase or even maintain rents. However, this suburban shift may present some build-to-suit office opportunities in the suburbs.

Demographics are also suggesting a move of population toward smaller rural counties, both collar counties and outlying areas. Here again, these areas offer a quality of life that is unavailable or extremely expensive in more urban areas. These areas will get more than their share of high-tech business in the next few years. Indeed there are two books out on this subject now—*The New Heartland*, by John Herbers, and *Regions*

**FRC Index and Alternatives**



*of Opportunity,* by Dr. Jack Lessinger—commenting on the political implications of the shift.

Given this fact, real estate investment opportunities are clearly more than the $100 million office buildings pension funds are buying. We need to find a vehicle for syphoning real estate capital from this investment pool to smaller third- and fourth-tier cities where the best opportunities will be.

Another prime investment for 1988 will be buying and upgrading older shopping centers and older office buildings. In these investments you can buy demographics in a good location. This asset enhancement will also involve buying out old leaseholds to improve the performance of existing properties. It is in these areas that new value will be created, not in new development.

During 1988, real estate is going to be relatively flat. To keep it from declining, the commercial market will need inexpensive money available on a 10-year term. This should be available for another 15 months or so. However, once the election is over, interest rates will start to climb.

The money markets themselves will become even more concerned about Congress's inability and unwillingness to correct the tax deficit or the trade deficit. A subsidiary of the trade problem is our oil energy program, which is virtually nonexistent. If we elected an honest president, which is unlikely, there would be a heavy tax on oil, which would raise gasoline prices to $1.25 to $1.50 a gallon. That, of course, would have a negative effect.

Secondly, after the election, I think you will see an increase in the tax rate—perhaps to 35 percent. The middle class will have to pay for our budget and trade deficits.

Further, as the dollar drops lower, the spending on imported products by the middle class will be greatly reduced. Businesses, especially automobiles, that have depended on imported sales are going to be very adversely affected.

It was Lester Thurow who pointed out that over 50 percent of the products on our shelves today and an even greater percentage of products in specialty shops are imported. The free fall dollar we have now is going to produce very rapid escalation in prices of imported goods. This will force the middle-class buyer back to American-made products, provided, of course, that American producers do not raise their prices correspondingly. This move back to American products could benefit light industrial manufacturers in non-union areas, but it is not very good for retail prices in general.

If gas prices rise, trade areas will compress around regional centers. However, neighborhood and community centers will do better as people move less and demographics stay in place. Less discretionary income will also force consumers to spend more on the basics and less on recreational shopping. This will also hurt regional centers more. Retailers in regional centers will find it difficult to obtain the sales they need to cover rents. Shopping center owners may have to forego some automatic bumps now written into many leases because of declining retail sales.

There will also be opportunities in high-service oriented real estate during the next few years—housing for the elderly, service delivery, and so forth. In the years ahead, real estate will become less and less a significant part of the total enterprise. Those that have a stronger understanding of the total enterprise, not just the business of selling space, will prosper.

For example, a shopping center developer who understands how to help a tenant secure a Small Business Administration loan will create a new tenant for a center. There are only a limited number of tenants—either you steal from other properties or you manufacture new enterprises to house in your own property.

Most of these trends are projected over the next five years. We now have one year of a lame duck president and at least another year before the new president can get any policies in place. However, businesspeople are quite capable of looking through the fog and seeing which direction the country is going.

James A. Graaskamp, SREA, CRE, CPCU, Ph.D., is the president and founder of Landmark Reseach, Inc., and chariman of the Department of Real Estate and Urban Land Economics in the School of Business at the University of Wisconsin, Madison.

Dr. Graaskamp is the designer and instructor of the Urban Land Institute School of Real Estate Development and the American Bankers Association National School of Real Estate Finance. Among his numerous awards are the Richard T. Ely Real Estate Educator Award from Lambda Alpha and the Alfred E. Reinman, Jr., Award from the Society of Real Estate Appraisers.

## Office Buildings: Kevin M. Mahony

Generally speaking, office markets around the country remain severely overbuilt as we enter 1988. Of course, because real estate is such a local business, national vacancy rates do not really tell the story. There are areas such as Back Bay in Boston that are extremely tight. Contrast that with Houston or Dallas, and you find a very different situation. But when you take the 20 percent vacancy in Dallas and combine it with the 2 percent vacancy in Back Bay Boston, statistics show that you have a national vacancy of 11 percent. That can be deceiving. You really have to focus on submarkets.

Submarkets that are prospering do share certain basic real estate fundamentals. Areas that are well-diversified economically, particularly those that are dependent on high-tech and service industries, should fare well in 1988. Markets that depend on heavy manufacturing, such as Detroit, may suffer over the next year or two.

The second consideration affecting a market's prosperity is the prohibitions placed on development. In Boston, for example, it probably takes from two to five years to get the approvals you need to construct a major building. The restraints on development are horrendous.

In other markets, approvals are much more generous. For example, Atlanta and Dallas are relatively easy to develop in. In some respects this factor has caused their overbuilding problems. Cities with a very high cost of entry will