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Real Estate and the Economy in 1984:

What Goes Down Must Come Up

by Anthony Downs, Ph.D., James Graaskamp, Ph.D.,
and Lloyd D. Hanford, Jr., CPM®

Even more than in most years, managing property in 1984 will be a juggling act. Overbuilding in the commercial sector will force rents down at the same time that influxes of institutional money are pushing up prices. Although high interest rates will keep housing starts low, apartment demand will cause rents to soar in many areas. Add to these ups and downs the circus atmosphere of the upcoming election, and making economic projections for 1984 becomes even more difficult. Yet, despite the seeming contradictions, three real estate leaders have consented to share some of their projections for the economy and the real estate industry over the next year.

Anthony Downs

The general economic outlook

In 1984, the economy will enter the second year of its general recovery from the recession of 1981-82. This has been quite a strong recovery and will continue to be so in 1984. The key economic question facing the nation is whether this expansion will be halted short of the normal three-to-four year duration by a conflict between the Federal Reserve's monetary policy and large federal deficits. The federal government seems likely to continue high-level spending and to finance it through deficits. In that case, its borrowing will conflict with rising private credit demands generated by the economic expansion. That will cause a rise in interest rates, probably toward the end of 1984 or 1985, assuming the Federal Reserve continues its policy of relatively tight money despite inflation.

The Federal Reserve has conflicting

objectives. It wants the recovery to continue, partly to prevent any major defaults on international loans. To sustain the recovery it cannot permit interest rates to rise very sharply. That means it must allow the money supply to expand so as to accommodate rising credit needs. On the other hand, it wants to keep inflation low. That requires restricting the growth of the money supply. The Fed will try to walk a very narrow line between those two goals.

I think inflation itself will not be very strong in 1984. Food prices will probably experience the largest rise among major elements of the Consumer Price Index. Taxes may also go up rapidly, depending on how the federal government finances its spending. I do not think material or energy prices will go up much. Wages have not been going up rapidly, and money costs will stay about the same.

Real estate market

In analyzing real estate market prospects for 1984, it is essential to differentiate between single-family residential markets and all other real estate markets, including commercial, industrial, and multifamily residential. These two markets are in entirely different phases of their cycles.

Single-family housing had three depressed years in 1980, 1981, and 1982. Its recovery just started in 1983 and will probably last at least another year. The strength of this recovery depends entirely upon the level of interest rates. If they stay about where they are now (12 to 14 percent), the housing market recovery will continue. It will probably be slightly weaker than it has been in 1983 in

terms of new construction, but still much better than 1982.

Nonresidential property generally is in a different phase of its cycle. There are three phases in the typical nonresidential cycle: the overbuilt phase, the gradual absorption phase, and the development boom phase. It does not matter which is considered "the first phase," since they always follow each other in the same order. Therefore, I will arbitrarily begin my description of this cycle with the overbuilt phase.

This usually starts at the beginning of a recession. At that time, all the property constructed during the preceding boom phase comes on the market—just as the demand for space is slowing down. Hence rents stop rising and either remain flat or decline slightly. Vacancy is high, and few new projects are begun.

Commercial and industrial markets had their big boom in construction from 1978 to 1981, when record numbers of new projects were started. Many of these projects continued through 1982 and 1983, coming onto the market in the midst of the recession or the early part of the recovery. This created a heavily overbuilt situation in 1982 and 1983 in nearly all areas, concerning nearly all types of nonresidential property.

In the typical general business cycle since the end of World War II, there has normally been a three-to-four year recovery and expansion period. During the first two years of recovery, the surplus new space that existed in the overbuilt phase is slowly occupied as business expands. This is the gradual absorption phase. During the last two years of the general recovery, a shortage of space arises. Rents rise

rapidly and vacancy plummets. This leads to a new nonresidential development boom.

The most recent overbuilt phase occurred mainly in 1982 and 1983. But so much new nonresidential construction took place from 1978 to 1981, the overbuilding was more severe than usual. As a result, commercial, industrial, retail, office, and hotel markets in 1984 will not be as strong as the single-family housing market. Operating rates of return in the former markets will remain depressed in 1984 because of overbuilding. However, the absorption of space generated by economic expansion will gradually allow rents to stabilize.

The flood of money into real estate and its consequences

This entire situation has been rendered somewhat unusual by the tremendous recent flood of money into residential, commercial, and industrial real estate from syndicators and savings and loans. Thrift institutions and syndicators can raise money more cheaply than most other financial intermediaries due to their special relationship with the federal government. Federally insured deposit accounts at savings and loans attract investors willing to accept a lower rate of return on their assets than they otherwise would. Paying lower interest allows savings and loans to raise money more cheaply than money market funds. Syndicators can raise money at low cost to themselves because tax-shelter benefits to investors supplement returns from the properties in which they invest. Both these low-cost sources of funds are slanted at real estate.

Savings and loans are used to investing in real estate and will continue to focus on it despite their recently broadened asset powers. Real estate syndicators must do so to ob-

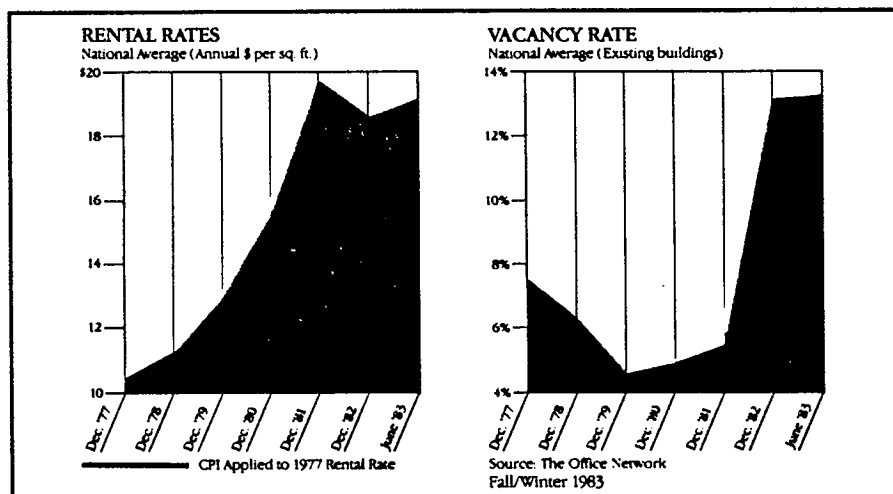
tain the tax benefits that sustain their activities.

As a result a lot of money is looking for property, especially existing ones already almost fully occupied. However, 1984 will not see a big increase in the inflows of money into thrifts and banks as 1983 did. The new accounts introduced in 1983 are now in place and their big growth has already occurred.

• With all this money available, quite a few new properties will be built in the near future, even though many markets for them are still weak. Intense bidding for existing

properties by savings and loans and syndicators will drive prices up and yields down during 1984. Many investors will be attracted to building property because the yields on existing properties are depressed. Developers will begin to construct more new properties in order to get what they believe are the high yields they offer. However, in most cases, these to-be-built properties will not really





have higher yields, only higher risks.

Part of this investment picture will depend on what happens to interest rates. If they rise sharply, syndication will slow down because some people now investing in syndicates will shift to the bond market. However, I do not think interest rates will go up much before the 1984 election. But if we do not have a change in the deficit situation, we will get a surge in interest rates in 1985 that will slow down the recovery generally. It will be especially harmful to real estate activity.

Changes in apartment rental rates will vary tremendously from place to place in 1984. Some parts of the country are terrifically overbuilt with rental units. In Houston, for example, rents have dropped sharply because of high vacancies due to overbuilding. In other areas where much less new construction of apartments has taken place, rents have been going up faster than the general cost of living. Thus, in late 1983, the Consumer Price Index for rent for the nation as a whole was rising twice as fast as the CPI for all items. I anticipate that this will continue for the entire country but not in every market.

Conclusion

Nineteen eighty-four will be a year in

which demand for all types of nonresidential property gradually expands. But big oversupplies still exist in many areas. Consequently, cost control and marketing will both be very important. Concerning residential rental properties, conditions will be quite different in two types of markets. In heavily overbuilt areas, economic survival is the key management problem. It also requires concentration on marketing and cost control. In stronger rental apartment markets, careful political relations with the community to avoid tenant unrest and demands for rent control will be a key management problem.

For all these types of properties, 1984 will be a slightly better year than 1983, and immensely better than 1982. That is why my motto for the coming year is, "You'll smile more in '84."

Summarized from an interview with Anthony Downs conducted by the Journal of Property Management on November 15, 1983.

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James Graaskamp

There is a growing sense that Congress will not hold the defense budget or social security in check over the long term. Therefore, following the '84 election, we will return to a rising rate of inflation. In response to this anticipated rise, management investment portfolios are beginning to return to real estate both for pensions and for general investment. The result will be, I think, that much more money will be chasing products than there are good products to be had. Consequently, real estate prices for large residential and commercial investment properties will continue to rise in 1984.

The same strength will not carry over to the single-family residential market. When interest rates reach somewhere over 13 percent, demand to purchase homes drops off quickly. We seem to be approaching that range now. The houses which are likely to sell in 1984 will be those where owners are willing to sell for significantly less than listing price or to take back some type of financing.

Part of the relative strength of investment property is that the monetary policies of the Federal Reserve are keeping short-term rates lower than long-term ones. During 1984, however, people are going to begin to perceive that serious inflation is bound to follow the current economic policy and is only being postponed by Volcker's manipulation of the money rate. Portfolio managers will be more perceptive of that and will start to see some real estate now.

Income real estate, particularly good income-producing commercial properties, will be the first to become inflationary. Essentially we have overbuilt in virtually every market, especially office and retail, but, in spite of low rates of return on some properties, investors will go into real estate first as a hedge against inflation.

Even now money is coming back to buy. The last year has been relatively a side-wise one in transactions, but there has not been a great deal of pressure to build. In the last quarter, you began to see overall capitalization rates starting to fall. Money is returning in a rush to real estate. There is not that much good product available, and therefore, to the degree there are transactions, there will be a preference for buildings with existing tenants.

I do not think that investors will particularly favor one type of investment property over another. The quality of the property itself will determine how attractive it is to investors. To the degree that investment banks buy commercial property, existing older buildings will be preferred. In spite of a growing number of transactions, only a limited amount of new construction will be initiated.

During 1984, you can probably expect good commercial markets in second and third tier cities in which you have, say, a state capital, high-tech industry, and so on. Such cities are likely to be stable and tend not to be overbuilt.

The current 15-year straight-line recovery period is intended to encourage new development rather than simply benefit existing buildings that have already depreciated. One cannot expect that the recovery period under the current rules will be extended for existing buildings, especially since the government is already moving to plug some of those structuring loopholes.

Once inflation begins to be stronger, the demand for space will decrease simply because costs will become prohibitive. While there will not be a dramatic difference in 1984, there are a whole variety of subtle influences going on that we have already seen. In shopping centers, you see the size of stores is already dropping. Store

owners do not want to tie up capital in fixtures. And with computerized inventory controls, it is possible to service that store from a central warehouse.

In office buildings you are eliminating partitions, which uses less space and improves air flow. Elevated computerized floors will allow cables for word processors, computers, and so forth to be located in different areas. And with station-mounted versus wall-mounted lighting, offices will acquire tremendous flexibility.

Businesses are moving away from partition offices to more prefabricated-office-furniture offices, which save space as well as offering certain tax advantages. Firms do not want to borrow money to furnish a store or borrow money to furnish an office building unless they can recover it quickly. The whole area of tenant improvements, I think, is going to extend to the residential area as well.

There are different options that may take place. One is the very small 400-500 square foot unit, very carefully laid out, which includes furniture so tenants do not have to borrow money to furnish it. Or tenants may lease the furniture package separately from the apartment.

I think the rent is going to stay relatively flat in 1984, due primarily to overbuilding. Landlords anticipating inflation will push hard for escalator clauses and pass-throughs in office buildings and investment property as a hedge against what we call unanticipated inflation, rather than trying to raise rents significantly.

In 1984, tenants will be upgrading existing leases to lock in 1984 rents rather than being forced to move in a few years. In this way business managers will try to maintain their future profit margins by exploiting current vacancies.

While I do not anticipate that utility costs, with the possible exception of telephone charges, will rise signifi-

cantly during the next year, money will be spent on upgrading mechanical controls to increase efficiency. Managers will also attempt to eliminate or curtail Saturday or Sunday occupancy or occupancy past a certain hour in the evenings.

In 1984, I believe that property managers will face different problems depending on the types of property they manage. In managing new property, managers will have to find ways of consolidating their leasing and controlling maintenance costs to hold on for the longer term. Last time rental rates dropped, people dumped their properties. This time people are searching for ways to break even by minimizing debt and by locking in new tenants now with free rents until rental rates start to rise.

Managers for new buyers of older properties are going to be unable to move their rents forward because they are going to be competing with new buildings. Instead managers will focus on enforcing pass-through provisions to generate revenue without creating a negative attitude among tenants. In the past some of the landlords backed off and did not pursue the pass-throughs, so when all the increases came through in a lump, tenants said, "If it is that bad now, what will it be like later?" Today you have to treat your existing tenants with a good deal of sensitivity in this overbuilt market, or they will just go someplace else for short-term free rent.

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Lloyd D. Hanford, Jr.

The major issues that will face the U.S. economy in 1984 are whether or not our productivity and gross national product will continue to rise and whether or not our trend of monetary restraint will continue, thereby keeping inflation in check. Most importantly, I think that in 1984 we should anticipate that some politicians will attempt to manipulate economic factors and indications in order to make an impression on the public when it comes time to go to the polls in November. As a consequence, much of what we see in 1984 will have to be analyzed as to whether it is real or artificially induced.

It appears that in some areas of the country there is a very apparent shortage of housing. But, although there are many people who need housing, I suspect that only a small percentage of this need group can qualify to purchase at current prices and current interest rates. Therefore, the production of new housing units should not be much in advance of real demand during 1984—real demand being the demand group ready, willing, and, most importantly, able to buy.

Whenever you have a situation where housing is unaffordable for large segments of the population, rental housing becomes the only housing alternative. If rental housing enjoys greater demand and there is an inadequate supply of rental housing being created, the obvious result is a trend to higher rents. It is important for managers and owners to recognize that once the level of rents has been pushed to where the typical housing consumers cannot afford rental housing, there is no alternative for those citizens but to turn their faces to Washington and scream "help." The property manager and the rental housing owner should recognize that if we become a nation where the majority are renters instead of a nation of owners (as we are quickly becoming),

there is an apparent danger than when the citizens ask the government for help, the government will respond with a national rent control law.

I do think that the recovery which began in 1983 looks like it is stronger than anyone expected. The recovery should carry through 1984.

I do not think that interest rates will rise significantly in 1984. The interesting thing is that everyone was predicting six months ago that by the third or fourth quarter of 1983 we would see a major upswing in interest rates through the massive governmental refinancing that was going to take place in the fourth quarter. And to the surprise of the forecasters, the major upswing in interest rates has not occurred as yet. It appears that there is adequate money accumulating in the financial institutions to at least temporarily forestall any major rise in interest rates as a result of the governmental financing. However, it is my belief that if the recovery continues, the corporate demand for money should increase. This pressure, coupled with governmental borrowing, should induce some upward move in money rates, particularly if the Fed's monetary policy remains the same. The government is certainly not going to be scaling back its monetary needs. But there is nothing at present that would suggest a return to the high rates of 1981 and 1982.

I think the most significant change in real estate markets resulting from economic factors is the shift in real estate investment strategies from dependence on inflation to improve value to dependence on good management as the means to enhance value. Ever since October 1979 we have not been able to use historic trends as an indication of possible future trends in the real estate market. Up to October 1979 much of the rapid rise in real estate prices and value was directly attributable to the

fear of inflation. Since 1979, the monetary policy followed by the Federal Reserve has been very successful in reducing the rate of inflation, with the result that the typical investor is not investing out of fear of inflation. And as of the moment, there is no basis for predicting any return to the double-digit inflation rates of past years.

The overall structure of the real estate transaction is becoming much more dependent on management for profitable results. To prosper in the changing market of 1984, the manager will have to continue to sharpen his or her skills, particularly in managing the expense side of building operations. This creates tremendous opportunities for the managers, but it also brings with it a tremendous pressure to perform. And because the market is changing so rapidly, we no longer deal with annual or semianual change, we deal with daily and monthly change. This means that the property manager is going to manage properties on an instant-reaction, 24-hour-a-day basis, not on a monthly basis.

I do not anticipate that, as a general rule, operating expenses are going to rise any faster than inflation. There is no basis for predicting, in 1984 at least, that there will be any major run up in energy costs, for example. The manager is not a magician and cannot wave a magic wand to bring the price of oil down to \$12 a barrel. But the manager can explore methods of operating more efficiently by reducing the consumption of goods and services without in any way lowering the level of service. Examination of the work schedules and deployment of the labor staff, reassignments of jobs, and reorganization of the method in which the labor is performing will often result in increased productivity per employee without reducing the level of service. This is one example of the ways the manager

will have to reduce expenses in 1984.

And cost saving will become increasingly important to tenants in 1984. The consumer of the real estate service is now saying, "Hey, manage the expense side of the ledger for me because I don't want to pay any more rent than I have to pay." Consequently, the manager is now really serving two masters—the owner on the gross-income side and on the net-income side and the tenant in the middle on the expense ledger. I think that even in a very strong market where occupancy rates are 98 percent and 99 percent, the tenant who is paying for any increase in operating expenses is now comparing the managerial abilities of one building against another.

In the commercial sector I do not believe that 1984 is going to experience any rapid rise in commercial rental rates. The office sector in most major markets is overbuilt, and the forces of competition will put rents under pressure. In many market sectors, office rents may come down.

Office building rents will probably remain flat at best, although there are many office building tenants now finishing leases that were made five, six, seven, and eight years ago at rents which were low by comparison to current rents. For these tenants rents will rise dramatically, but the market rates will not rise.

I think the same is true in shopping centers and retail space. Minimum rents in both shopping center and commercial should remain flat over 1984. If the recovery remains strong, some downward movement in minimum rent levels would be expected to occur in 1985.

I think that even though vacancy rates in office space are high, building is going to continue, just because of the nature of the real estate project. As the old saying goes, once the train is on the track, it is very hard to stop it. Many of these projects commenced

OVERVIEW — 20 METROPOLITAN AREAS

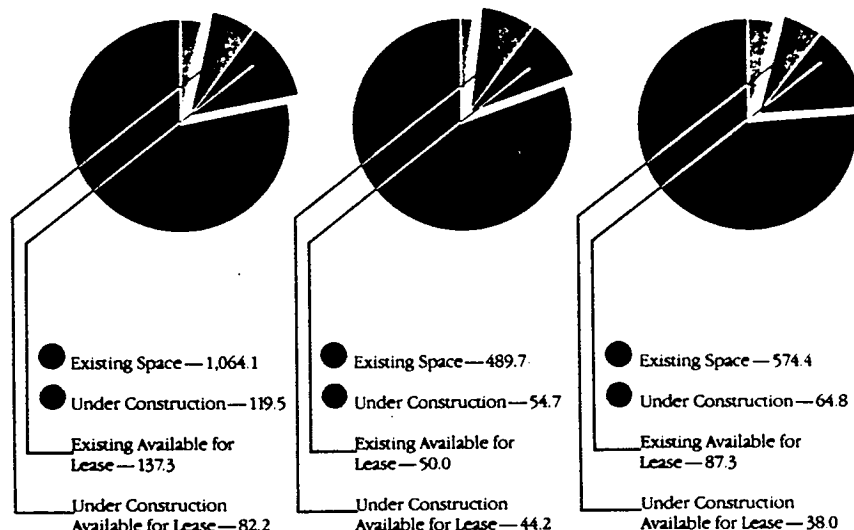
Sq. ft. measurements are Rentable Area

Source: The Office Network
Fall/Winter 1983

Total Office Space*
1,183.6 (million sq. ft.)

Total CBD Office Space
544.4 (million sq. ft.)

Total Outside CBD Office
Space 639.2 (million sq. ft.)



*The total office space has been divided into major classifications: CBD and Outside CBD
(All figures in million sq. ft.)

with the acquisition of land maybe a year or two years ago at a time when the rental market appeared much stronger than it is today. Following the acquisition of land, the developer has probably spent substantial money in the planning process. In this situation the building may go ahead even though the demand for the space is totally different than at the time the project was conceived.

I think that the other side of that point is that new land purchases for projects which are going to commence planning in 1984 will slow down dramatically in response to the apparent oversupply in many communities.

I think that institutional investors will continue to be active in the real market in 1984 whether the market is showing signs of vacancy or not. The question will be whether they will

stay at the same high level of prices that were paid in 1981 and 1982. I think the answer is that we have already seen evidence that these funds are very sophisticated and are driving very hard bargains. They are very carefully researching markets and measuring the value of property based on their real anticipation of operating results over time. They are probably not going to leave the market; they are just going to be tougher buyers.

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