

JAMES A. GRAASKAMP COLLECTION OF TEACHING MATERIALS

II. CLASSES AT THE UNIVERSITY OF WISCONSIN--MADISON

- B. Business 522: Real Estate Finance (Also Known as Business 551, as of Semester II, 1974-75)
 - 2. Assorted Lecture Notes (Undated)

BUSINESS 522--SUMMER LECTURE

- I. From the standpoint of a developer and borrower - ownership of real estate is measured by the degree to which you can control and divert the cash flows of the real estate enterprise to your own benefit legally. It can be shown that there are more profits to be had with certainty above the net income line than below the net income line. Moreover the active real estate investor prefers hard dollars now while the passive investor may think he prefers soft dollars now and hard dollars later.
 - A. The developer is looking for debt which does not add to his default point or unbalance his balance sheet if he borrows more than 100%, particularly when each project has its own balance sheet.
 - B. The investor may be looking for tax benefits now and inflation hedges for later.
 - C. The result is something called a syndication, an instrument which is a second mortgage revenue bond with the tax status of an owner.
 - D. It is an excellent way to illustrate that real estate finance is the ability to creatively balance very sophisticated mixtures of financial attributes which affect risk, priority of yield, degree of management involvement, preferred credit position, equity, etc.
- II. A real estate syndication is a limited partnership under the uniform partnership act involving one or more general partners who are not judgement proof and one or more limited partners who disclaim any managerial responsibility in exchange for limitation of their investment to a specific amount. This amount may be their initial investment only or may include assessments up to a stated maximum.
 - A. It is essentially an awkward creature designed to take advantage of the tax laws.
 - B. However, it a useful risk sharing device for capitalizing high risk ventures because it can reduce the cash break-even point to the degree that it reduces debt obligation and spreads risk among more investors.
 - C. The key to success is both the economics of the venture and the management agreement with the general partner in order to avoid conflicts of interest and counter-productive incentives.
- III. Pursuing the tax questions, one might take the following questions in this order:
 - A. What is the purpose of the investment?
 1. For use (users have more liberal ordinary income - ordinary loss elections)
 2. For investment income and long term appreciation (for which capital gain treatment is available with some elections to expense of capitalize holding costs)

3. For trade or inventory (dealers status) (for which capital gain is almost never available)
- B. Is it a single tax or double tax entity?
1. Single tax entities would include:
 - a. Single proprietorship
 - b. General partnership
 - c. Sub-Chapter S Corporation
 - d. Limited partnerships
 - e. Other non-corporate associations
 2. Double tax entities would include:
 - a. Corporations not exempt above
 - b. Associations for profit with three or more of the following characteristics:
 - Limited liability or investors
 - Centralized management
 - Unlimited continuity
 - Marketable interests
- C.. What type of real estate is it by tax classification?
1. The personal residence
 2. Farm or extraction properties
 3. Investment residential
 - a. First user, or second user
 - b. Residential rehab
 - c. Conventional financing or federally funded and subsidized
 - d. Date acquired
 4. All other properties (limited depreciation and full recapture)
- D. What is the basic tax strategy to be pursued?
1. Deferral of income tax
 - a. Accelerated depreciation
 - b. Election to expense rather than capitalize
 2. Conversion income to capital gain
 - a. Accelerated depreciation on residential property
 - b. Upgrading personal residence
 3. Deferral of capital gains tax
 - a. Trade or exchange
 - b. Involuntary conversion

4. Avoidance of capital gains tax
 - a. Trading personal residence for condominium
 - b. Holding for estate transfer and estate tax
 - c. Gifting of appreciating assets
 5. Seeking lowest marginal rate on a progressive tax
 - a. Installment sale
 - b. Short term trust
 - c. Corporate conduits
- IV. The Limited Partnership may be a small local operation or, more recently, may be a national underwriting sold through securities dealers. Only in the past five years has it been recognized as a security--a partial interest in an asset made in expectation of future returns. Not only do the Blue Sky laws apply, but in Wisconsin once you have had a role in one syndication of any size, one is a syndicator and must register all future offerings regardless of size.
- A. The investment is made in units which may be subscribed with staggered payments so that tax savings in the first year account for much of the second year subscription. For an FHA project the price runs 11-15% of the mortgage amount.
 - B. The developer receives 5-10% ownership as a promotion fee, but these shares may have a second priority in the event of liquidation.
 - C. The typical deal gives the limited partner;
 1. 95-100% of aftertax cash flow
 2. 95-100% of tax shelter
 3. 80% of a refinancing
 4. His original investment plus 50-95% of any surplus in the event of liquidation
 - D. The developer-syndicator receives:
 1. A cashout of his project (captive market for land & construction services)
 2. A promoter's fee
 3. Management contract
 4. An interest in future cash from equity build-up for inflation at no risk to himself
 - E. The marketing problem of selling partnership shares:
 1. Sale by a single broker within the community
 2. Marketing via the seminar approach
 3. Marketing by the builder-developer
 4. Marketing through a securities underwriting firm
- V. Some problems and pitfalls of the limited partnership form of investment:
- A. Front end loading of sale price or dilution of construction costs

- B. Lack of incentives for developer to realize assumptions which he sold to investors
 - 1. Burnout of builder's profit
 - 2. Penalties for inadequate control of expenses
 - 3. Bonus incentives in management contract for high occupancy

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and low turnover
- C. Definitions of cash flows in which various partners are participating, etc.
- D. Conflict of interest of developer-manager with similar or neighboring properties, and refinancing decisions and sale decisions. Limited partners are now permitted to discharge property manager, general partner, and to approve refinancing or sale .
- E. SEC is now establishing standards of accounting, forecasting, projections, and minimum definitions and safety provisions for the limited partner.

SYSTEMATIC ESTIMATION OF FORECAST ANNUAL INCOME FOR AN INCOME-
PRODUCING PROPERTY

PART I. ANNUAL RETURNS TO INVESTOR

BASIC
APPRAISAL
A LA
SRA 201

- A. ESTIMATE POTENTIAL GROSS CASH INCOME: CASH INCOME FROM SPACE SALES
- B. DEDUCTIONS FROM POTENTIAL GROSS
 - 1. NORMAL VACANCY
 - 2. SEASONAL INCOME LOSS
 - 3. COLLECTION LOSSES
 - 4. FRANCHISE FEES, DEPOSITS RETURNED, ETC.
- C. ADD "OTHER" INCOME FROM SERVICE SALES
- D. DERIVE EFFECTIVE GROSS INCOME
- E. DEDUCT OPERATING EXPENSES (ON EXPECTED CASH OUTLAY WITHOUT ACCRUAL RESERVES)
 - 1. FIXED EXPENSES
 - 2. VARIABLE EXPENSES
 - 3. REPAIRS AND MAINTENANCE
 - 4. REPLACEMENTS
- F. DERIVE NET OPERATING INCOME

MORTGAGE
EQUITY
APPROACH

- G. DEDUCT ANNUAL DEBT SERVICE
 - 1. CONTRACT INTEREST
 - 2. SUPPLEMENTARY VARIABLE INTEREST
 - 3. PRINCIPAL AMORTIZATION
- H. DERIVE CASH THROW--OFF

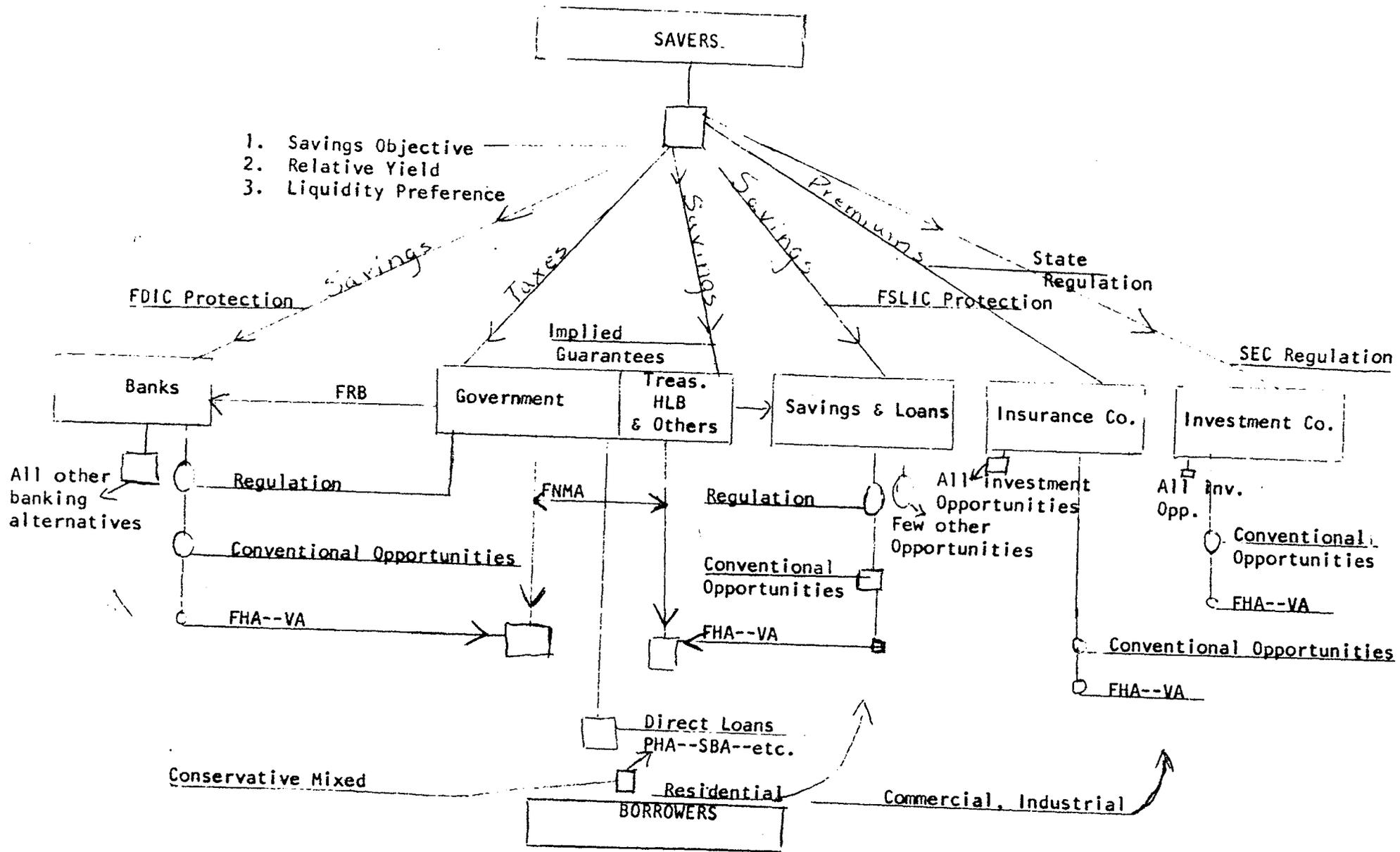
PART I
OF IMV
INVESTMENT
VALUE
APPROACH

- I. ADD BACK PRINCIPAL PAYMENTS AND REPLACEMENTS
- J. DEDUCT TAX DEPRECIATION ALLOWANCE
- K. DERIVE TAXABLE INCOME
- L. DETERMINE MARGINAL INCOME TAX ON REAL ESTATE INCOME
- M. DEDUCT INCOME TAX FROM CASH-THROW OFF (H)
- N. DERIVE AFTER-TAX CASH FLOW
- O. ADD TAX SAVINGS ON OTHER INCOME (IF K IS NEGATIVE)
- P. ADD SURPLUS FROM REFINANCING
- Q. DERIVE SPENDABLE AFTER-TAX CASH

PART II. RESALE RETURNS TO INVESTOR

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- A. ESTIMATED RESALE PRICE (EOY)
- B. DEDUCT BROKER'S COMMISSION AND OTHER TRANSACTION COSTS
- C. DERIVE EFFECTIVE GROSS PROCEEDS FROM SALE
- D. DEDUCT ALL CREDIT CLAIMS (EOY) OUTSTANDING
 - 1. SHORT AND LONG TERM NOTE BALANCES DUE
 - 2. PREPAYMENT PENALTIES
 - 3. DEDUCT EQUITY SHARES TO NON-OWNER INTEREST
- E. DERIVE PRE-TAX REVERSION TO EQUITY
- F. DEDUCT TAX CLAIMS ON OWNERSHIP INTEREST
 - 1. DEDUCT CAPITAL GAINS TAX
 - 2. DEDUCT INCOME TAX ON DISALLOWED ACCELERATED DEPRECIATION
 - 3. DEDUCT SURTAX ON TAXABLE PREFERENTIAL INCOME
- G. DERIVE AFTER TAX RESALE PROCEEDS TO INVESTOR



1. Type of Property
2. Required Loan Ratio
3. Money Cost

- High Degree of Discretion
- ▣ Low Degree of Discretion
- High Degree of Regulation
- ◌ Low Degree of Regulation

- D. Where a project will not be leased to a single tenant, the lender wants an accurate measure of market demand for the space to be rented. While the developer himself may fly blind or have a local appraiser do a market study, when it comes time to meet the lender, the borrower will turn to a marketing expert with a name in the field. For example, a department store may have a pretty fair study of the Madison market as to who will buy what where. Nevertheless the lender wants to see corroboration by Larry Smith and Company, research associates, or one of the others.
1. For example, these studies might delineate the primary and secondary market area for a shopping center. With the use of census data and household questionnaires the study may determine disposable income in area and portion of disposable income spent on various classes of household possessions or needs. Potential sales are divided up among existing stores in the area, out of area stores, and the proposed retail development. Sales forecasts can be converted both into a measure of space needs and potential rental income under a given set of lease assumptions.
 2. In the case of apartment projects there would be a study of the local supply and demand for rental space and the rents charged for comparable units.
- E. An economic or market study is required by most lenders to support an income estimate. The more expensive the project and hence the bigger the loan necessary, the more sophisticated and professional are the economic studies submitted.

- III. Risk and responsibility of project management was often slighted until recently. However, with the creation of temporary excess supply in many kinds of space, lenders look to management ability to justify a loan despite a discouraging market analysis. The lender looks to past management records as a measure of proficiency and pride in operating skill. Then the lender wants to introduce some risk for the developer to provide the incentive to use his management skill.
- A. Management can be in the hands of the borrower or shifted to a tenant or management intermediary. The lender will look at past records very carefully for an indication of these skills. Operating budgets of a proposed project will be compared to those of comparable projects. There are annual national studies of operating expense ratios for apartments, hotels-motels, and office buildings of different sizes and different locales.
 - B. To these expenses the insurance company analyst will add costs of absentee ownership on the assumption that if the insurance had to foreclose and operate the property, it would hire local professional managers until such time as they disposed of the property. Assuming you were going to buy an eight-family apartment building, live in it, and manage it yourself, you might not include a management fee in your expense budget and forecast of profit. The lender would adjust your income statement for the appropriate management fee of 5% to 10% of gross rents,

- C. Each lender will have various ratios by which he can judge operating efficiency. For example, a lender might decide it takes 100 units to support a full-time manager, that 98% occupancy or better indicated rents were too low and capacity to meet demands of bigger tenants left unavailable.
 - D. A key measure of managerial ability is found in the impression created in the analyst by a physical design of a building. An apartment building depends almost entirely on the right combination of site and structure to provide business momentum. An office building or motel require a particular kind of business management ability while a shopping center will not be financed unless its management is in the hands of an experienced retailer, not an experienced real estate man. The lender can judge this experience by analysis of the design.
- IV. Commercial building design must be judged both from the standpoint of sales appeal and operating efficiency. Lenders have hundreds of criteria to measure these factors.
- A. For example, a lender today may require a design for apartments that requires sound proofing, a vestibule entry, extra closet space, certain minimum room sizes, inside and outside parking space, a special freight elevator plus one passenger elevator for every sixty units, air conditioning, and a swimming pool.
 - B. The efficiency of the design may be judged on gross rentable area to gross building area, operating costs per square foot, capital costs per square foot, ground coverage ratios, ratios of building perimeter to area, and so on.
 - C. The specification of materials and finishes will indicate whether the builder is building for low cost or long term operating economy. Ideally, the lender would reject an application where a short term attitude prevailed. However, lenders today are too anxious to make every loan possible, and so merely attempt to negotiate loan terms that will permit speedier amortization or prohibit assignment of the mortgage. In the latter case when the builder sells the lender automatically gets his cash back, so that he needn't be exposed to rapid depreciation of the structure after the first few years of the loan.
 - D. After the 1930's the lenders were most leery of special use structures. Today loans on special structures have either low loan-to-value ratios, short terms, or high interest rates. For example lenders will advance only 60% on a bowling alley, for no more than 12 years, at an interest rate of 6½% or more. Moreover, they prefer buildings that are located and built so that they might serve as supermarkets or light industrial plants as the lending industry is not convinced that bowling is here to stay.
- V. With a market study, operating cost study, and capital cost estimate based on a particular design it is possible to put together a capital budget and an operating budget.

- A. The capital budget may not determine the loan ratio, which is often based on capitalized income value, but it will tell the lender how the developer expects to raise the money necessary for the project. It will suggest the equity at risk to the developer, and thus the strength of his incentive to succeed.
- B. The operating budget is vital. Cash flow is all important. The project must generate enough cash to pay operating expenses, real estate taxes, and debt service, and still leave a margin after taxes for contingencies.
 - 1. Generally these budgets must be planned to parallel periodic payment on the mortgage. If the mortgage is paid monthly, a 120 month forecast period might be used; if mortgage is payable quarterly, a 30 period forecast might be used.
 - 2. The ratio of cash disbursements to total possible cash receipts will vary from about 70% for office buildings to 80% for apartments. This is the default ratio we have mentioned earlier. Often a special budget is created for the first period required to fill the building with tenants and complete start-up expenses.
 - 3. To protect himself lenders today often require that a building have leased a certain minimum percentage of its rentable area before the lender need honor his committment for permanent financing.
 - 4. In addition, the lender reserves the right to reappraise the property just before the loan is closed. If the developer has had to reduce rents to secure the necessary number of tenants, the capitalized income value would fall and the loan would be reduced proportionately. This is why developers seldom reduce rents but instead give away a few months' free rent or special bonuses like a trip to Europe. In this way the rent roll remains undisturbed for appraisal purposes.
 - 5. Where cash flow is tight, and may be skimpiers after depreciation offsets on income taxes are used, the lender will want to create cash reserves by preventing cash distribution to stockholder-investors. The mortgage may require maintenance of a minimum cash balance, quick ratio, or prohibit dividends that would be a reduction in capital for the property involved.

VI. Appraised value for determining the loan amount maximum is not so clear cut as in the residential field. First, the appraisal will stress capitalized income value, rather than cost of construction or something called market value. Admittedly the capitalization factor will be set by data from the market place but there are still an infinite variety of adjustments and limitations which may be made.

- A. For example, FHA loans on apartments may be limited to so many dollars per room. Say \$2,900 in most areas or \$3,700 in high cost areas.

- B. The problem is in counting the number of rooms. A balcony may be one-half a room, a living room with a folding wall to make a den may count as two rooms though either room for itself would not be of useful size. The dining area may count as half a room if it is one dimension and a full room if it is another, and so to secure the maximum loan, developers tend to design the building to secure the maximum room count according to who's keeping score, FHA, MAI, or MBA.
 - C. In determining capital budget, the developer may include certain non-cash items such as his builder's profit and overhead where he is both the developer and the contractor. He may include the residual value of the land with the apartment house on it, rather than his purchase price. This gimmick makes it possible to balance capitalized income value and cost approaches in the appraisal.
 - D. Many lenders are bamboozled when borrowers do not distinguish between income attributable to real estate and income attributable to business operations. For example, a building for a restaurant should not be valued on the profits of the restaurant, profits which may be due to an excellent chef, a smart steward, or good promotion. Instead, the building should be valued at its rental value to a restaurant operator.
 - E. The desire of the developer to build with somebody else's money is exceeded only by the desire of the bankers to find a rationale on which to loan the money. At the same time the lender likes an anchor to leeward.
- VI. The lender will try to protect himself from various contingencies with some of the following provisions:
- A. Partial endorsement
 - B. Subordination of leases or leaseholds
 - C. Prepayment closed or with heavy penalties
 - D. Non-assignment of mortgage
 - E. Incentive financing with stock, warrants, etc.
 - F. FHA or MGIC guaranties
 - G. Right of entry, possession, and assignment of rental incomes
 - H. Trustee operation in event of default