

In your mimeograph packet there will be (ultimately) proposals about the 87 law; tax Matters in Real Estate have become a moving target. Lecture notes from one semester to another are relatively classic. First of all, relative to the text book, we do have Cooper and Pyhrr at the bookstore. If you are relatively new to the program I advise you to get the book as it will help you to pull things together. For those of you who have been with us for a while, you'll probably find it redundant. Four or five of the chapters are on the 1982 tax law which, unless you're into history, the thing is useless. Initially they were going to have their new addition out but knowing Cooper and Pyhrr, they aren't going to have it done until next Sept., at the earliest. So I have completely rebuilt the syllabus and plagiarized a great many additional readings which we'll adjust to the changing industry here, and the change in the tax laws, and the change in the institutional investment, and for that matter changes in structuring and so forth which is going on presently and try to make it as current as possible with readings up through Oct. and Dec. of 87; and including some excerpts from several new books that are out. Three chapters from the new book Riches into Ruin in Real Estate with Jim Powell who is a New York Times finance reporter that has so far one of the big players in real estate, a make a deal maker, and I think it's a pretty

interesting book. It's organized in such a way that it will give you some different ideas about areas of expertise such as construction management and looking at the skills involved in that. Looking at liability, there's a whole chapter on the Kansas City disaster at the Hyatt and implications of that and so forth, which has had some pretty peculiar implications on structuring pension funds and global liability move through and so forth and so on. Some of the players some of the disasters, the near disaster of Trammell Crow, and the resulting restructuring of Trammell, Crow to take control away from Trammell and put it in the partners that are coming along and might cause internal friction. And also I think you'll find some new names as well as some familiar ones involved as to who the big players are and what kind of folks they are. And so anyway, it's an interesting book if you have some time for a little extra reading. We also have Natalie McKelties book on Pension Fund Investment, we've taken several chapters out of that relative to pension funds strategies, mistakes, opportunities and so forth. I think you'll find a fairly wide selection of alternative sources of material which is one of the purposes of the reading list to sensitize you to the great variety of literature that's available one way or another and then organize that by subject matter. We'll probably expand on that as appropriate.

The second thing we need to have is Mark Eply as a TA in the course, specifically for bending your case studies onto the computer. He'll be a computer resource as well as a computer instructor for you. Mark's spent a lot of time and he's been poking around with Mike Robbins, trying to find a somewhat different format for computer use and here one of your problems is going to be choosing probably the appropriate software package that allows you to get the job done and address the real issues both particularly, and at the same time, we want to you take a look at a program called "PRO-JECT". Some of you are already familiar with it and the PRO-JECT people are very nice and allowed us a series of copies which will be locked into the hard disc machines upstairs; ten of them set up for you upstairs with manuals and so forth. It's a lease-by-lease program, as well as a fairly sophisticated current tax program. It also has a program called Dynamis, which then allows you to move through the base cash flow and start constructing matrixes of whatever ratios it is you think are relevant, rather than just simply getting what the program provides or doesn't provide. It also gives you an opportunity to structure and decide whether a partnership or a corporate shell or whatever, you know, might be more desirable, at least from a financial stand-point, not necessarily on other factors. And it is probably a program that's taking over out there in

the industry. "Finsim II" has had its day, Mr. Grant has died, it has not been updated adequately - the age of the changing tax laws certainly changing pace with changing attitudes as real estate investors change what's important in terms of financial analysis, and " PRO-JECT" is. I think once you get out there you'll find a significant percentage of the institutional investors are using " PRO-JECT" in-house if they don't have their own system, and their own system is probably quite similar. Mr. Sterns has been very nice in cooperating with us and providing the program. It is a program which sells for about \$6,000 and we have, therefore, taken precautions to protect it and the manuals, so please respect that. They have given us about \$60,000 worth of software. We'll protect our tail feathers by not abusing that. There will be talks based on its use a little later.

We also have another program called DNA which has a much more elaborate state tax model, looking at what different states would tax real estate for, which is now often considered in the investment courses with regard the federal law as the end all and be all. And in this course while we will down play a little bit the income tax game as its not as much of a game to play anymore, the real game is the estate tax law, the inheritance tax process, and therefore we will spend more time on that aspect of real

estate and in structuring to minimize the friction, through the process and minimize the tax burden on the process, and looking at real estate as a wealth transfer device from generation-to-generation as well as a wealth generation developer for the initial older investor. And the course will be split approximately six weeks on the individual investor side, about six weeks on the institutional investor's side and then about six weeks looking at the new media in terms of what REITs are doing and commingled funds and NLBs and REMICS and whatever. What are the pros and cons.

As many of you know, my favorite questions on the final are typically matrixes which say okay guys, here's five different structural frameworks for the real estate and here's twelve attributes relative to liquidity, and control, and risk, and so on, and you know, now compare and contrast on my little grid and matrix and so forth. So I'm going to give you a way to kind of organize you thoughts and boiling them down to the critical element. Okay. The two guides that we have are on the syllabus, one is courtesy of the Equitable and the other is not the courtesy of the Equitable, we had to pay for those. The reading packet is relatively enormous. It should be available by late Friday or early Saturday at Bob's at the corner of Randall and Johnson. I threw out about four and half inches. And I

added about ten. So even if 40% remain from last year there's only 20% of the new pile. In the process I had very interesting conversations with technical authors, Gary Cooper and Mike Farrow and Dale Ingrea, who have a new book out on real estate investment and so forth. And the problem is what they call real estate investment we teach in 550 and 551. And have gone well beyond their textbooks for that. For us there's just nothing out there. We got talking about Kenneth Leventhal and Stan Ross out there and Stan Ross says gee, we're kinda thinking about doing something jointly with Kenneth Leventhol and coming out with a real estate investment text or at least an anthology or something that would cover the need, because there's just nothing out there. There really isn't so I apologize for three pounds of mimeograph and so forth but them's the conditions what prevail, in what is a very rapidly moving area. In fact if any of you are thinking about coming professors I recommend that you consider serious ancient history where material does not change substantially from the time you're a graduate student until you're on social security. As long as your notes remain legible you're in business, but I have about four pamphlet files of notes for this course which are no longer relevant and I think I will hold ancient history in my next life cycle and if anybody finds an old scroll I

will deny it as a fraud and continue forward. Now, let's talk a little bit about real estate investment.

There is a tremendous deep dividing irony about teaching real estate investment in terms of the detail and complexity and presumption of rational systems that we have here because ultimately investment in real estate is simply a statement of hope. Think about that. It's really ironical that we spend that much time rationalizing something which essentially and ultimately is an irrational move. It is based on hope. You have absolutely no empirical reason for doing what you're doing, other than whatever system comes to mind at the moment. Think about that--its really ironic, we're making comments about a 15 or 20 or 30 year investment, which presumes essentially, that the social, and cultural, and technical elements will move forward at an orderly pace and to the degree that there's change there will be plenty of time for you to improvise and adjust accordingly, and of course, you have the eternal piece of garbage that says change always provides opportunity for creative advantage. Phewy. Find a creative advantage in a ranch for a real estate investor. You really need to look for the implicit assumptions which are statements of hope, and hope is what you're building the whole damn thing on. And therefore, you really begin as a real estate investor the statement of faith about people,

and politics, and about systems, and technology, and that's the context in which you're operating, and that's pretty mushy. To do financial ratios two decimal places when the whole damn thing rests on, you know, on whether somebody is going to shoot at somebody in the Persian Gulf - its insanity, fundamentally and blatantly. What you're really doing is you're making a commitment on faith, and then, rationalizing it so you feel good. It's a strange statement to make in a finance course in which we're going to worry about punching numbers and decimals, 1% rate of return and so forth and so on - it just isn't there. Deep down underneath you are building on shifting sands in which you're made a statement about faith. Real estate ultimately is a religious experience that I support. Real estate investment is all futuristic and it's all extrapolating on what we think we know. We move from irrational hope towards some sort rationalized attitude, and then ultimately we come up with an intellectual strategy that says hey, all things considered, this isn't bad, this is--if Reagan uses the Neutron bomb, well at least the real estate will survive. So in any event we have this basic dichotomy that at some point, real estate investment is a leaping assumption about the future and our ability to adjust and survive in a changing world.

One element of the course that helps that in the past was that how long is the time line of hope? We can have hopes that are three years long or hopes that are 25 years long and what's the time line of the hope? In some ways that's a very forgiving kind of thing. Pension funds tend to be more patient with their capital than you, who will starve if you don't flip the property within a few moments of the time of closing, but nevertheless we need to know what is the time line of hope. What's the time line of the pension fund versus the home buyer? How much does he have to rationalize, and what's his downside in terms of his hopes? And one thing we need to be aware of is that in our approach, to trying to get a handle on our hope, and structure that into some sort of rationalized attitude, how often are we being infected by topical attitudes, short term kinds of things? Investing against the tide is one premise, that everybody's wrong therefore, if they're buying, I'm selling, if they're selling, I'm buying, sort of thing that's certainly a statement about a topical attitude, certainly the contrarian position and his saying that essentially if you bet against the crowd you're probably going to be right at least more often than not.

I read an interesting article on the British attitude to investment in America. Certainly contradicts all the crap you read about why it is that people invest in this

country. The British pension funds said we're going to invest in America because America is being socialized and the time to invest in real estate is just before a country flips into socialism because at that point you have a monopoly. Because there will no longer an entrepreneurial incentive to create additional supply. He said it worked beautifully in England, it worked well in Germany, it worked well in Italy, why wouldn't it work in the U.S.? America is in that era in which it's moving into Socialism and that gives us our best advantage on big buildings. There's an attitude which certainly isn't topical. But articulated as an investment strategy. On the other hand, what about oil? We ARE going to run out of oil. The use of the car, ultimately is going to cost you at least \$2.50 a gallon by the year 2,000. Her attitude is saying they're pretty much as before, not bad \$.95 a gallon, why worry? If we have a responsible energy management program and you believe the democratic process is coming around to responsible legislative decisions ultimately, then why wouldn't you have an investment strategy that says hey, the numbers and major regional shopping centers are not a great idea, we really need to bring our shopping back into the neighborhood. Maybe I want to invest in a neighborhood centers where people can walk to and bicycle to and go on their motor bikes. They're not going to buy the damn thing for 20 years

from a pension fund. Investors forgot all about the energy crisis. What is there? Well your first reading is essentially when we run out of oil. When? What are we going to do about electric power? As much as 60% of the power in Chicago is atomically generated. And yet we know atomic power plants are losers, that the life cycle from atomic power plants is negative. It costs more to build it and run it than the power is worth. And there's also some suspicion, obviously, that we're going to have to either replace them or shut them down or find other ways to handle energy conservation. The Sears Roebuck Building (Sears Tower) uses more electricity in eight hours, to take care of 12,000 employees, than the City of Rockford uses in 24 hours. What does that tell you about the rate of obsolescence on a high rise office building. Water has to get pumped up vertically or down, and you have to pump it down because if you let it free fall you'll blow the bottom out of the system because of the vacuum you're going to create from the free fall. A couple of years ago there was an old dormitory at West Point. The cadets wanted to make sure it got renovated and it didn't look like the government was going to do much to bring it back into the 20th Century so they all got together - got their stop watches out, and flushed all the toilets in the building at the same time and absolutely destroyed the plumbing system from the vacuum

created. So whatever goes up likely with pumps and so forth has gotta come down the same line.

Ever think about what, if building futuristic, what's your premises about the future? And how far out are you taking the premise? Think that before? It starts to get you thinking about hey what happened when the baby boom moves through, who's coming behind to buy that house of the same size cohort. Ain't nobody coming through to buy that house of a cohort of the same size. Elderly housing, build a great project up in the Alma Center someplace. What do we have eight units up there or 15? I can't remember. That's great right now, because there are some folks that really need that up in Alma. But Alma is dying, the young people don't stay there. Who's going to be the old folks there at the end of that 40 year mortgage? Or for that matter, what's their housing quality going to be? How many thousand units do we have in the State currently under Section 8 housing? (Refers to the student) You're the expert on that. 15-16,000? Yes. Section 8er's? ...OK most of those are elderly following 10-11,000 of our elderly housing in which folks, are permitted to live at whatever 30% of their income may be, and the federal government pays the difference. Most of those guys are under contracts which begin to expire in what six to eight years, probably phase out in 12 - haven't the foggiest idea in government what they're going

to do to house those elderly. Who can not afford to be in homes alone. The investor's objective is to come out from under the hat plan of the Section 8 and have a well built, well-located apartment of about 550 sq. ft. that he can now rent in the market place at \$600-\$700 a month depending on where you are--does it exceed the income of any of the renters. Who's wrong? What's the investor's expectation down stream? Are you simply going to hold the government up on eminent domain and say fine baby if you want it back for those folks, you can buy it back. That's strategy. Real estate is based on futures. Some of those are mushy, some of those are known, we know how many folks there are going to be at certain age at a certain point in the future, because they're here now. We know about the folks that are elderly and can't afford housing. How many saw 60 minutes the other day? One of their features was the fact that the middle age class are homeless. Middle class can't afford an apartment in New York. A guy with a \$20-30,000 job as a computer operator whose wife died from a terminal illness wiped out their savings of \$30,000. Cost him his job at the same time. Can't afford to rent a place. Living in a public shelter and happy to have it. We've got some premises about the future hope and we spend so much time extrapolating cash flows that we tend to do that in a vacuum. We don't look at the context, that we anticipate

five years down stream, ten years down stream, fifteen years down stream. Appraisal idiots are taking the current cap rate at what the shopping center is 9% and saying gee, you know that's going to be such a desirable investment ten years from now we'll cap the terminal factor at 8 1/2%. Most all of the projects syndicated in 85 and 86 in Madison, by a couple of our local apartment developers, have negative net worths today--they are not worth the price of the mortgage. Price determines conventional cap rate. They've survived because they've got a 30 or 40 year commitments from 221D loans which are artificial mortgages and hopefully their cash flow will cover the mortgage payment. But at some point people will pay 25 or 30% of the value of that mortgage. It was a \$3.0 million mortgage, there was \$900,000 of equity that went into that project, theoretically--most of it went into the pocket of the syndicator and that project probably has a negative net worth of (\$600,000). A year and a half, change the tax law, change some premises about rent control and the overall supply of housing, some folks who don't want to live in apartments and you have a \$1.5 write down on the nominal value going in on that project in a year and a half. Things are getting tough. What was the hope of the guys going in? The hope was relatively short term, they don't look at the balance sheet at all, they simply said wow, look at the tax

shelter. I don't have to pay taxes this year, next year or the year after that--terrific. Now he would have to pay a capital gains tax on their loss because if Uncle Sam says, if you're released from the liability that's tantamount to constructive receipt or sale of the balance that you owe. They can't let go of that project now. They took all of their accelerated depreciation and all investment tax credits up front, and if they don't feed that little piggy even if it's bleeding, Uncle Sam is going to charge you more than the cost of carrying the project. One of the results, you have to have some sense of hope. Its true King said life is a series of short runs, but then that says something about the professional real estate operator. The professional real estate operator, unless he deals with large amounts of equity tends to make life a series of short runs 'cus he goes for the fee, not the investment. What's the fee to building the project, what's the fee of managing the project, what's the fee of syndicating it and securitizing the project, and what's the fee of brokering the project, what's the fee of leasing the project, what's the fee getting insurance, and they say, my God I don't want to own it. The real pro doesn't own anything today but tries to structure his deal so that if for some reason (I'm foreseeing to him) that equity goes up in value he can share on the upside. But otherwise he can take a walk.

Typical investor in real estate--equity investment particularly in real estate--as an individual, really doesn't have a sense about what he's really doing. Real estate is eventually tied obviously to market. Future money markets, and therefore, in many ways is in a macro context rather than a micro context. We spend a lot of time in feasibility being concerned with the micro context as it relates to the building next door, how does it relate to the folks within a mile and a half that might want to live there, etc., etc., but it ultimately the value is in a macro context.

As somebody pointed out in Tokyo and Bonn (Germany), don't like Reagan. They don't have to support the next Treasury rate, and interest rates will move before the 88 elections, and the recession will start before the 88 elections, in other words fall into their debt. Think about that. It came from Soloman Brothers at a swaree for their economist Kaufman. Kaufman is saying that interest rates will be 11% to 11.5% by the third quarter of 88. What does that tell you about the retail prices in real estate? Do you, as a political agency operating simply within the corners of the U.S., have much to think about the interest rate any more? You've got a trade deficit in which people own your butt, and you got a federal deficit in which those that will buy your bonds own your butt, and the real estate

interest rate is going to be a function of whatever that is with a considerable loading. And what you pay for money, is going to determine what it is you can pay for the property. Because suddenly in the industry say hey, it's not loan-to-value ratios its debt-cover-ratio. And therefore, you need more equity and less debt. Indeed in uncertain times as Mr. Drucker will point out in one of the articles that you are reading, you're going to think, "Gee where does Graskamp get off with it, there's nothing in that real estate of value at all." Mr. Drucker points out that any enterprise in a period of uncertainty the objective is not profitability, its liquidity. Liquidity gives you the flexibility to survive, and the liquidity need of any enterprise, particularly in a point of inflation and also at a point of uncertain sales increases each year, because most of the cash for business earned cannot be paid out in dividends, but it is in fact needed to continue the enterprise. It's the working capital of the enterprise. And you need to read the real estate magazines and they're saying to builders hey, where are all builders that created last time? Well, the builders crashed because they were carrying inventory in land. They were carrying inventory in unfinished tenant estates. Dump it, now pay options on land at lower prices two years from now. The recession is going to begin in 88 or 89 depending on who you listen to, and

when that happens, nobody is going to be buying houses, therefore, that land inventory is going to be a millstone around your neck, so get rid of it. We tend to use ratios and goals that may not in fact be relevant to our hopes or to future realities for that matter. Real estate investment is relatively passive and long term. Real estate development is exploitation of a short term opportunity and spread - - - arbitrage if you will.

The essential strategy for the real estate investor is to increase his spread and he has only essentially two ways to do that says Sam Zell. He can enhance the monopoly character of his property and therefore, enhance his revenue. Or he can reduce his costs, including the costs of funds. Active investors--developers--they create their spread through opportunism at the micro level--buy low, sell high, etc. Exploiting inside information if you will. Pretty radical - in the stock market exploiting inside information is illegal. But it's the heart of development. It's knowing who's about to move from where and being there first. It's useful to know from a secretary that her president is thinking about moving their corporate offices. Nobody goes to jail for finding that out. The guys who lease, they know everybody in the front office. And, of course, it's useful to know that you're going to enjoy the income from what you're going to do. Half of investors on

the other hand enhance their spreads because of timing and because of their ability at arbitrage, typically between the money markets but sometimes between the skill markets. You'll see it in some of your readings, for example, Olympian and York, moved into New York and took Uras Corp. off the hook. Uras has built some major office buildings just when the market swooned in New York. They were in cash flow problems and they had a number of other crises in terms of the tenant or two that went bankrupt and moved out, and they bought Uras at a ridiculously low price per sq. ft. So they bought portfolios of it, 2, 3 million sq. ft. at prices considerably below \$100 a sq. ft. Five years later, the market sails and they're speculating in a commodity called square fee of Class B office space. By the time the market had stabilized again, what they were buying at \$35 to \$40 a sq. ft. in New York City was worth \$400 and \$500 a sq. ft. That's a quick way to make money, particularly if you do several million sq. ft. at a time. They estimated that one transaction made them \$5 billion and a couple of other businesses put together in the pact. Passive investor though, now the passive investor obviously needs to manage the property, but he's enhancing it because he can operate on a timely basis--buy low, sell high and because he can arbitrage perhaps reaching money markets that others can't reach. Classic example being the person, current CMO's, in

which, the poor bastard that's buying his house retail is paying 10.5% interest rate on the whole mortgage, but the guy who buys the portfolio goes into the money market investing in the Treasury curve and is able to come up with an average interest rate of maybe 6.5% and credit enhancement that adds another one point, now he's got a cost of funds at 7.5% versus the guy who's at retail at 10.5% and it's an unequal spread, the present value of that works out real well. So he's arbitraging, but he is still a passive investor, he hasn't seen a single one of those houses, never sold a thing in the house, never paid a single mortgage, but his timing is good and his arbitrage is good. So the essence of strategy and taxes for real estate fall back to passive investments, it's really exploiting institutional and technical details of the appropriate time in order to achieve a spread. Shidler, when he's here, will talk about that. He's a consummate artist at operating within the technical details of the FASB (Financial Accounting Standards Board) rules. Creating fictional profits for corporations while he steals their millions.

One of the problems of course with, going back to passive investors, is that the relationship to real estate creates an emotional vector, a creative-urge if you will, and it means that it's not always as rationally efficient as the folks in the theoretical finance courses would like to

believe. Psychic income is a significant source of return in real estate. You can try to buy it, you can put your thumb in your suspenders and say it's fine. And that's good for at least 1% on the cap rate. That's probably true - more true of real estate than any other kind of capital intensive kind of investment strategy. It's very hard to fill your pride in a stock that you bought or a bond or commercial paper note, you generally don't leave it out on the coffee table and talk smartly about it at the cocktail party.

Oh while we're talking about guest speakers, by the way, 785, I've got three out of four set down on the date if you want to write those down, if you're in the feasibility course you may want to write the dates down. All three of these will be at the Edgewater in the upper auditorium. Forgive me if I work backwards, but it's the way I remember them the best at the moment. April 29, will be Steve Jarchow, talking about real estate investment fund formation and specifically a Lincoln Properties thing which should be fun simply because it has so many twists and turns applied to it, it might as well be a novel and then April 8 will be Jay Shidler talking about how he does it. He should be a role model for all of you in that his first project was an assignment in the principles of real estate class with Don Allen, and a few of us had a good idea and said why don't

you go see so and so, a Japanese appraiser and investor in Honolulu and he did that, and he said gee that's a great idea Jay, let's go 50/50 which they did, and he had made his first killing before he finished his junior year at the University of Hawaii and came up with a very ritzy leverage formula. As a result the Shidler Company has seven partners around the country, by the way, but it's all for the greater glory of Fritz Shidler, had outside partners investing and so forth, it's all for the house account and they do not ever put their own money into a deal. And he might provide a little noted endorsement of what they perceive as a non-risk. But otherwise they do extremely well and have hundreds of millions of dollars in real estate now with no money down. And they aren't dealing in shacks down in the student quarter, we're talking about major industrial parks, office buildings and so forth. But at any rate he'll be here on the 8th. Very different corporate culture, very different view of real estate investment. The one before him will be on March 25, will be Todd Mansfield, and probably his boss, Bill Renal, of Disney Development Corporation and they do all of the so called non-gate real estate. And the first one and the one I still haven't got them nailed down to as to the date, it will either be the last Friday in February or the first Friday in March, will be Jerry Clay of JMB with a couple of his associates doing

the Cadillac Fairview deal for about six hours, it's about all that you can stand although he will probably just scratch the surface and which has been the largest real estate transaction to date in the history of world, other than the possibly the first seven days, so that program is pretty high powered. So they're all looking forward to it and at this point all of the three that are scheduled will be at the Edgewater, I can't say for sure about the last one.

Given our basic introduction to the mush of real estate investment the first eight readings are really some comments on the futurism of energy, the futurism of political and social trends, interesting comments out of the Economist Magazine on entrepreneurship, hope and strategy, and the possibilities of the future, demographically and otherwise. You'll find an article by George Sternlieb (or Steinlieb) that's interesting about the fate of the state. The major cities, he says today, are the home of the transfer payment. All citizens are virtually moved out, and that employers are likely to follow. The second section is essentially starting to say, gee, what is the strategy, what are some of the elements of strategy that the readings (end of side one) and the readings will begin to look at that. Japan will be telling you about core portfolios and the British will be talking about the socialism of America and the opportunity

for monopoly, and other investors like Coldwell Banker and so forth and so on will have other concepts of what they think the play is so far as they want to tell you. Obviously, none of them have an exclusive on any of it, but it certainly begins to suggest to you the infinite variety of investment attitudes, replaces the subject really of your hopes and expectations of the future that may be there. The other element of that will be looking at economic scenarios about the future. Begin to read whatever you see in the papers and perhaps some of the other books on futuristic looks at the coming depression in 1990 and other messages of hope from other authors and you have a number of scenarios which you're really going to have to in your own mind, kind of establish the premise on which you are operating. The popular choice, of course, is that most industrialism in the U.S. is going to go into a smooth transition into its new economic role of somewhat less significance world wide than before and that we will be able to resolve some of our social and political problems. That we'll have a steady economic growth with a few brief recessionary slow downs, but that they will be survivable, at least by the middle class. Those at the bottom of the economic structure will have a tough time of it. They will have gradually declining unemployment and that there will be some shift away from manufacturing toward other kinds of service enterprises and

so forth. This is socialism of one form or another. That growth always solves the deficit or the debt problems and you notice the Republicans are always talking the only thing we need to do is have lower interest rates and prosperity will then correct all social ills, and so forth, and the Democrats are of course taking the other view the only thing that will work is subsidy and taxes to the rich to subsidize the poor. And finally it worked that real interest rates will be relatively low and moderate during this decade of transition into the millennium.

The second alternative scenario would be something like this that we're going to have a somewhat erratic transition. The transition to the new economic United States is going to be interrupted by some recessions that are comparable to the 70's and we'll be a little Raggedy Andy. That economic growth is erratic with some spurts interrupted by stagnation or negative growth, staggering unemployment will move from 7% to 12%, it will be somewhat regional. There will be continued pockets of unemployment and indeed maybe some pockets of outright rebellion in areas that are not barring or getting their fair share of economic opportunity. Debt loads, for example, remain high with considerable default rates and there will have to be considerable rescheduling of repayments to protect the credibility of our financial institutions. That's already true. Twenty-five to fifty

billion dollars in losses in the savings and loans. The entire savings and loan industry have a surplus of barely 2% of the total deposit. And some 5-600 of them are already bankrupt and we can't afford to close them because FSLDIC is itself bankrupt. The problem is less severe in the banks because the banks don't have to report what their losses are since as long as there's a possibility of repayment, the accounting statement does not have to reflect the underlying value of the assets and it continues to reflect the amount of the note or their debt reserves being only as what they perceive to be the reduction in how much they will collect from the note. Again, it's an erratic scenario with its assumed pressure to control government deficit will continue increases in tax rates and increasingly severe spending adjustments. Certainly some talk of that presently--if that's not what the presidential election's about, I don't know what it is about. The board leader stood up and said we only got two ways to go baby and that's one, raise taxes and two, reduce deficits. Where are the hot areas right now? If you look in the book about attitudes, Boston, New England- - Wow, that is the place to invest. What's been responsible for doing with the come back? They get more defense dollars per capita than other part of the United States. Why do they do that? For every congressman and senator position aspiring chairmanships and sub-

chairmanships are concerned. But if, in fact, we do have a budget direction, what's going to get cut?--defense. Set the gold industry at the market. ? Maybe the miracle of the Northeast isn't quite such a miracle at all, it just may be that they get enough federal dollars out of Uncle. Will real estate interest rates moderate gradually as deflationary forces, because of excess capacity decline and debt loads keep pressure on borrowing? What about our trade deficit? If we allow interest rates to fall, what happens? Less foreign capital comes over here because at that point the spread between the opportunity cost here and someplace else is less--and they might as well take their money home. So the erratic transition scenario isn't necessarily a very good one for real estate. It may benefit some, it may benefit others. The dollar continues to fall, some jobs will come home. I think it was Tandy, it was reported that they were bringing all of their computer factory operations back from Korea to the U.S., particularly the Southwest, because the labor factor was now cheaper in America's Southwest than it was in Korea. The trade balance, the dollar and so forth and so on. But notice it comes back to none unionized, none structured labor pools which can continue to be exploited. Now what the data implied relative to the new immigration act which if it is enforced starting in '88, means there's isn't going to be enough hope

to pick your cabbages and your melons and so forth, or work in your electronics plant. Things work together? The institutional framework from which real estate operates is extremely ?? (don't understand) and extremely broad.

The third scenario, of course, if you're a pessimist is we actually have economic destruction, that we might have significant default on foreign and domestic loans. That we never will get our government deficit under control. And that we eventually will have to have drafted drastic control measures, a real austerity program. Period of rising unemployment concentrated particularly in the traditional areas of defense and manufacturing. Obviously spreading ultimately to other industries as well. Real interest rates will have to remain high for most of the 1980's, one to deflect against inflation and two to protect us against a run on the dollar by overseas money.

Four, we will have social disruptions in our cities where we have 25% of our population now in poverty. The number and percentage ratio and absolute number of poverty has risen under the Reagan administration rather than decline. And they're getting restless. Question is, can we keep them drugged long enough so they don't fight, it's a real question. Which of those social scenarios, economic scenarios do you want to take? We should begin to influence then your view of real estate--and real estate investment

versus development. Exploitation of the opportunity of the short term Keynesian active investor, or whether in fact as a portfolio investor you have to be fatalistic and say gee, I need diversification because I don't where lightning is going to hit next. But they can't all fall down at the same time. But to what degree is the systematic risk that the stock investor likes to talk about, beginning the task, perhaps carries much more significance than the nonsystematic risks which can be relatively easily stabilized in real estate.

And so we begin real estate investment by having to make a fairly mushy set of assumptions about the future context in which one operates. Keeping one eye to the leeward, as it were, and having a hope about the future, or otherwise you're going to the CD's and Treasuries and the mason jars in the back yard. Think about that. What is the hope, what's the framework within which we're now going to build a rationalized systematic method of selection and management and presumably increase of our net worth. If we look at the rationalized nonpsychic income benefits of real estate its only two things--one, increase our spendable income, or two, increase the net worth that we can benefit from in our life time and pass on to the next generation. The most significant thing Reagan has done is to allow the middle class to pass on their net worth, by raising the

exemptions significantly on the federal estate tax so that it can pay us more or less in tax with the minimum liquidity exposure for the next generation. We'll begin to look at that as the semester progresses. How do we improve our spendable cash, how do we improve the liquidating value of our net worth so we can transfer, in this life or the next, to whatever cause or purpose we wish. Okay, we'll come back to that. (end of tape)

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Week 1

In your mimeograph packet there will be ultimately proposals to the 87 law, Tax Matters in Real Estate. What you know from one semester to another are relatively classic. First of all relative to the text book we do have Stuper and Theater at the bookstore. I advise you to get the book as it will help you to pull things together. For those of you who haven't to this point, you'll probably find it redundant. Four or five of the chapters are on the 1982 tax law which unless you're into history the thing is useful. Initially they were going to have their new addition out but knowing Hoover and Here, they happen to have till next Sept. as the earliest. So I have completely rebuilt the syllabus and plagiarized a good many additional readings which we'll adjust to the changing industry here, and the change in the tax laws and the change in the institutional investment and changes in structuring and so forth which is going on presently and try to make it as current as possible with readings up through Oct. and Dec. of 87. Including some excerpts from several new books that are out. Three chapters from the new book Riches into Ruin in Real Estate with Jim Powell who is a New York Times finance reporter that has so far one of the big players in real estate, a make a deal maker and I think its a pretty interesting book. Its organized in such a way that it will give you some different ideas about areas of expertise such as construction management and the skills involved in that. Looking at liability, there's a whole chapter on the Kansas City disaster at the Hyatt and implications of that and so forth, which has had some pretty guilty implications on structuring pension funds and global liability move through and so forth and so on. Some of the players some of the disasters, the near disaster of Travell Crow and the resulting restructuring of Travell Crow to take control away from Travell and put it in the partners that are coming along and might cause internal friction. And also I think the new names involved as to who the big players are and what kind of folks they are. So anyway, its an interesting book that has been assigned for a little extra reading. We also have Natalie McKenties book on Pension Fund Investment, we've taken several chapters out of that relative to pension funds strategies, mistakes, opportunities and so forth. A wide selection of alternative sources of material which is one of the purposes of government to testify the use of direct variety of literature that's available and then organize that by subject matter. We'll probably expand on that as appropriate. The second thing we need to have is Mark Eply is a TA in

the course, specifically for 17 year case studies onto the computer. He'll be a computer resource as well as a computer instructor for you. Mark's spent a lot of time and he's been poking around with Mike Robbins and trying to find somewhat different format for computer use and here one of your problems is your problems is going to be choosing probably the appropriate software package that allows you to get the job done and address the real issues both particularly and at the same time we want to you take a look at a program called project, some of you are already familiar with it and the project people are very nice and allow this series of copies which will be locked into the hard disc machines upstairs, left ten of them set up for you upstairs with manuals and so forth. Its a lease by lease program as well as a fairly sophisticated current tax program, but it also has a program called Dynamis, which then allows you to move through the base cash flow and start constructing matrixes of whatever ratios it is you think are relevant whether just simply getting what the program provides or doesn't provide, its also gives you an opportunity to structure and decide whether a partnership or a corporate shell or whatever might be more desirable at least from a financial standpoint, not necessarily on other factors. It is probably a program that's taking over out there in the industry. Finsim II has had its day, which has died, it has not been adequately changing tax laws, not necessarily changing pace with changing attitudes as real estate investors change whats important in terms of financial analysis and project is, and I think once you get out there, a significant percentage of investors are using project in-house if they don't have their own system relative to the property quite similar. It is a program which sells for about \$6,000 and we have, therefore, taken precautions to protect it and the manual, so please respect that. They have given us about \$60,000 worth of software. We'll protect our tail feathers by 71. We also have another program call DNA which has a much more elaborate state tax model, looking at what different states would tax real estate for, which is now often considered in the investment courses which the federal laws and all of the 73 and so on. And in this course while we will down play a little bit the income tax advantages, its not as much of a game to play anymore, the real game is the estate tax law, the inheritance tax process, and therefore we will spend more time on that aspect of real restate and structuring to minimize the friction through the process and minimize the tax burden on the process and looking at real estate as a wealth transfer device from generation to generation as well as a wealth generation developer for the initial older investor. And the course will be split approximately six weeks on the individual investor side, about six weeks on the institutional investor's side and then about six weeks looking at the new media in terms of what REITs are doing and NLBs and whatever. What are the pros and cons. As many of you know, my favorite questions on the final are typically matrixes which say okay guys, here's five different structural frameworks for the real estate and here's twelve attributes relative to liquidity and control and risk and so on, and you know now compare and contrast on my little grid and matrix and so forth. So I'm going to give you a way to kind of organize you thoughts and boiling them down to the critical element. Okay. The two statutories that we have are on the syllabus, one is courtesy of the equitable and the other is not the courtesy of the 93. The reading packet is relatively enormous. It should be available by late Friday or early Saturday at Bob's at the corner of Randall and Johnson. I threw out about four and half inches. And I added about ten. So even if 40% remain from last year there's only 20% of the new pile. In the process I had very interesting conversations with 105 authors, Gary Cooper and Mike Farrow and Dale Ingrea, who have a new book out on real estate investment and so forth. And the problem is what they call real estate

investment we teach in 550 and 551. And have gone well beyond their textbooks for that. We got talking about Kenneth Rutherford and Dan Ross out there and Stan Ross says gee, that would be Monday night and we're kinda thinking about doing something slightly Kenneth Leventhol and coming out with a real estate investment text or at least Don Hollick or somebody that would cover the need, because there's just nothing out there, there really isn't so I apologize for three pounds of mimeograph and so forth. Them's the conditions what prevail. And what is a very rapidly moving area. In fact if any of you are thinking about coming professors I recommend that you consider serious ancient history where materials so not change substantially from the time you're a graduate student until your on select. As long as you don't remain legible you're in business, but I have about four pamphlet files of notes for this course which are no longer relevant and I think I will hold ancient history in my next life cycle and if anybody finds an old scroll I will deny it as a fraud and continue forward. Now, let's talk a little bit about real estate investment. There is a tremendous gap to meet supplies in hiring about teaching real estate investment in terms of the detail and complexity and presumption of rational systems that we have here because ultimately investment in real estate is simply a statement of hope. Think about that. Its really ironical that we spent that much time rationalizing something which essentially and ultimately is an irrational move. It is based on hope. You have absolutely no empirical reason for doing what you're doing other than whatever system comes to mind at the moment. Think about that--its really ironic, we're making comments about a 15 or 20 or 30 year investment which presumes essentially that the social and cultural and technical elements will move forward at an orderly pace and to the degree that there's change there will be plenty of time for you to improvise and adjust accordingly and of course, you have internal piece of garbage that says change always provides opportunity for creative advantage. Phewy. Find a creative advantage in a ranch for a real estate investor. You really need to look for the implicate assumptions which are statements of hope and hope is what you're building the whole damn thing on. And therefore, you really begin as a real estate investor the statement of age about people and politics and about systems and technology and that's the context in which you're operating, and that's pretty mushy. To do financial ratios two decimal places when the whole damn thing rests on whether somebody is going to shoot at somebody in the Persian Gulf, its insanity fundamentally and blatantly. What you're really doing is you're making a commitment on faith and then rationalizing it so you feel good. Its a strange statement to make in a finance course in which we're going to worry about punching numbers and decimals 1% rate of return and so forth and so on, it just isn't there. Deep down underneath there are building and shifting sands in which you're made a statement about faith. Real estate ultimately is a religious experience. What may happen is all futuristic and its all extrapolating what we think we know. We move from irrational hope to towards some sort rationalized attitude, then ultimately we come up with a intellectual strategy that says hey, all things considered this isn't bad, this is--if Reagan uses the Neutron bomb well at least the real estate will survive. So in any event we have the basic dichotomy that at some point real estate investment is a leaping assumption about the future and our ability to adjust and survive in a changing world. One that helps that in the past was that how long is the time line of hope? We can have hopes that are three years long or hopes that are 25 years long and what's the time line of the hope? In some ways that's a very forgiving kind of thing. Pension funds 170 with their capital than you who will starve if you don't flip the property within a few moments of the time of closing, but nevertheless we need to know what is the time

line of hope. What's the time line of the pension fund versus the home buyer? How much does he have to rationalize, and what's his downside in terms of his hopes? And one thing we need to be aware of is that in our approach to trying to get a handle on our hope and structure that into some sort of rationalized attitude, how often are we being infected by tropical attitudes, short term kinds of things? Investing against the tide is one premise, everybody's wrong therefore, if they're buying, I'm selling, if they're selling, I'm buying, sort of thing that's certainly a statement about a topical attitude certainly the contrarian position and his saying that essentially that you go against the crowd you're probably going to be right at least more often than not. I read an interesting article on the British attitude on the Americas. Certainly counterfactual in fact you read about why it is that people invest in this country. The British pension funds said there, we're going to invest in America because America is being socialized and the time to invest in real estate is just before a country flips into socialism because at that point you have a monopoly because they there will no longer an entrepreneurial incentive to create additional supply. He said it worked beautifully in England, it worked well in Germany, it worked well in Italy, why wouldn't it work in the U.S.? America is in that era in which its moving into Socialism and that gives us our best advantage on big buildings. There's an attitude which certainly isn't topical. But articulated as an investment strategy. On the other hand, what about oil? We are going to run out of oil. The use of the car, ultimately is going to cost you at least \$2.50 a gallon by the year 2,000. 201 her attitude? Her attitude is saying they're pretty much as before, not bad .95 a gallon why worry. If we have a responsible energy management program and you believe the democratic process coming around to responsible legislative decisions ultimately, then why wouldn't you have an investment strategy that says hey, the numbers and major regional shopping centers are not a great idea, we really need to bring our shoppers back into the neighborhood. Maybe I want to invest in a neighborhood centers where people can walk to and bicycle to and go on a motor bike. They're not going to buy the damn thing for 20 years from a pension fund. Forgot all about the 212. What is there? Well you're first thinking is essentially when we run out of oil. How do you when? How do you plan? Who do you know that went to college? As much as 60% of the power in Chicago is atomically generated. And yet we know atomic power plants are losers, that the life cycle from atomic power plants is measured. It costs more to build it and run it than the power is worth. And there's also some suspicion obviously that we're going to have either 220 or shut them down or find other ways to handle energy masterly. The Sears Roebuck Building uses electricity in eight hours to take care of 12,000 employees that the City of Rockford uses in 24 hours. What does that tell you about the 223 on the high rise office building. We either are going to have to get pumped up vertically or down and you have to pump it down because if you let it free fall you'll blow a 225 out of the system because of the vacuum you're going to create from the free fall. A couple of years ago there was a old dormitory at West Point. 227 make sure it got renovated and it didn't look like the government was going to do much to bring it back into the 20th Century but what does all of that get after 229 at the same time and absolutely destroyed the plumbing system from the vacuum created 231. So whatever goes up likely comes down the same line. Ever think about what, if building futuristic, what's your premises of the future? And how far out are you taking the premise? Think that before. Now starting get you thinking about hey what happened to the baby boom moves through, whose coming behind to buy that house of the same size cohort. Ain't nobody coming through to buy that house of a cohort of the same size. Elderly housing it would make project up in the Alma Center

someplace. What do we have eight units up there or 15 I can't remember. That's great right now, because there are some folks that really need that up in Alma. But Alma is dying, the young people don't stay there. Whose going to be the old folks there at the end of that 40 year mortgage? Or for that matter, what's there housing quality going to be, when how many thousand units do we have in the State currently under Section 8 housing. You'll be the expert on that as well. 13-16,000 Section 8er's...most of those are elderly following 10-11,000 of our elderly housing in which folks are permitted to live at whatever 30% of their income may be, and the federal government pays the difference. Most low guys under contract which begin to expire in what six to eight years, isn't the foggiest idea in government what they're going to do with the house 259. The investor's objective is to come out from under the hat plan of the Section 8 and have a well built, well located apartments of about 550 sq. ft. that he can now rent in the market place at \$600-\$700 a month depending on where you are--does it exceed the income of 265. Whose wrong? What's the investor's expectation down stream. Are you simply going to hold the government up on eminent domain and say fine baby if you want it back for those folks you can buy it back. That's strategy. Real estate is based on futures. Some of those are mushy, some of those are known, we know how many folks there are going to be at certain age at a certain point in the future, because they're here now. We know about the folks that are elderly and can't afford housing. How many saw 60 minutes the other day, one of their features was the fact that the 274 are homeless. Middle class. Can't afford an apartment in New York. A guy with a \$20-30,000 job as a computer operator whose wife died from a terminal illness whipped out their savings of \$30,000. Cost him his job at the same time. Can't afford to rent a place. Living in a public shelter and happy to have it. We've got some premises about the future that we spent how much time extrapolating cash flows that we tend to do that in a vacuum. We don't know what is the context that we anticipate five years down stream, ten years down stream, fifteen years down stream. Appraisal idiots are taking the current cap rate at what the shopping center is 9% and saying gee, you know that's going to be such a desirable investment ten years from now we'll cap the terminal factor in half 287. So all the projects syndicated in 85 and 86 in Madison, by a couple of our local apartment developers are of negative net worth today--they are not worth the price of the mortgage. Price determines conventional cap rate. They've survived because they've got a 30 or 40 year commitment from 221D loans which are artificial mortgages and hopefully their cash flow will cover the mortgage payment. But at some point it will take 25 or 30% of that mortgage as quickly as our mortgage that was \$900,000 of equity that went into that project theoretically--most of it went into the pocket of the syndicator and that project probably has a negative net worth of \$600,000. A year and a half, change the tax law, change some premises about rent control and the overall supply of housing, because most don't want to live in apartments and you have a \$1.5 breakdown on the nominal value going in on that project in a year and a half. What was the hope of the guys going in? The hope was relatively short term, they don't look at the balance sheet at all they simply said wow, look at the tax shelter. I don't have to pay taxes this year, next year or the year after that--terrific. Now he would have to pay a capital gains tax on their loss because if Uncle Sam says if you're released from the liability that's 312 enough to construct your proceed or sale at the balance that you owe. They can't let go of that project now. They took all of their accelerated appreciation and investment tax credits up front and if they don't feed that little piggy even if its bleeding, Uncle Sam is going to charge you more that the cost of carrying the project. One of the results, you have to have some sense

of hope. Its true king said life is a series of short runs, but then that says something the professional real estate operator. The professional real estate operator, unless he deals with large amounts of equity tends to make life a series of short runs and he goes for the fee, not the investment. What's the fee to building the project, what's the fee of managing the project, what's the fee of syndicating it and 325, and what's the fee of 326, what's the fee of leasing the project, what's the fee getting insurance, they say, my God I don't want to own it. The real 328 doesn't own anything today. I'm trying to structure the deal so that if for some reason I'm foreseeing to him and equity goes up in value he can chair up the upside. But otherwise he can take a walk. Typical investor in real estate--equity investment particularly in real estate--as an individual, really doesn't have a sense about what he's really doing. Real estate is eventually tied to the fair market value. Future money markets and therefore, in many ways is in a macro context rather than a micro context. We spend a lot of time in feasibility being considered as the micro context as it relates to the building next door, how does it relate to the folks within a mile and a half that might want to live there, etc., etc., but it ultimately values as a macro context. As somebody pointed out in Tokyo and Salem, Germany, don't like Reagan. They don't have to support the next Treasury rate and interest rates will move before the 88 elections and the recession will start before the 88 elections, in other words fall into their debt. Think about that. It came from Salomon Brothers swaree 351 is saying that interest rates will be 11 to 11.5% by the third quarter of 88. What does that tell you about the retail prices in real estate. Do you as a political agencies operating simply within the corners of the U.S. have much to say about the interest rate any more. You're got a trade deficit in which people own your butt, and you got a federal deficit in which those that will buy your bonds own your butt and the real estate interest rate is going to be a function of whatever that is for a considerable loan. And what you pay for money, and they determine what it is you can pay for the property. Because several in the industry say hey, its not loan to value ratios its debt cover ratio. And therefore, you need more equity and less debt. Indeed in uncertain times as Mr. Drucker will point out in one of the articles that you are reading, you're going to say gee where does man get off with it, there's nothing in that real estate of value at all. Mr. Drucker points out that any enterprise in a period of uncertainty the objective is not profitability, its liquidity. Liquidity gives you the flexibility to survive and the liquidity need of any enterprise particularly in a point of inflation and also at a point of uncertain sales increases each year, because most of the cash for business earned cannot be paid out intuitive, but it is in fact needed to continue the enterprise. Its the working capital of the enterprise. And you need to read the real estate magazines and they're saying to builders hey, where are all builders drag last time. Well, the builders dragged because they were carrying inventory and land. They were carrying inventory in unfinished 379. 380 now paid options on land at lower prices two years from now. The recession is going to begin in 88 or 89 depending on who you listen to and when that happens nobody is going to be buying houses therefore, that land inventory is going to be a milestone around their neck, so get rid of it. We tend to use ratios and goals that may not in fact be relevant to our hopes or to future realities for that matter. Real estate investment is relatively passive and long term. Real estate development is exploitation of a short term opportunity and spread. Arbatragae if you will. The essential strategy for the real estate investor is to increase his spread and he has only essentially two ways to do that says Dansville. He can enhance the monopoly character of his property and therefore, enhance his revenue. Or he can reduce his costs including

the costs of funds. Active investors--developers--they create their spread through opportunism at the micro level--buy low, sell high, etc. Exploiting inside information if you will. Pretty radical in the stock market exploiting inside information is illegal. Its the heart of development. Its knowing whose about to move from where and being there first. Its useful to know from a secretary that her president is thinking about moving their corporate offices. Nobody goes to jail for finding that out. The guy who leads, they everybody in the front office. And, of course, its useful to know that you're going to enjoy the income of what you're going to do. Half of investors on the other hand enhance their spread because of timing and because of their ability at arbitrage, typically between the money markets but sometimes between the 427 markets. You'll see it in some of your readings, for example, the wife is an Olympian 428, moved into New York and took Uras Corp. off the hook. Uras has built some major art facilities just when the market swooned in New York. They were in cash flow problems and they had a number of other crises in terms of the ten or two that went bankrupt and moved out, and they bought Uras at a meticulously low price per sq. ft. So they bought portfolios of it, 2, 3 million sq. ft. at prices considerably below \$100 a sq. ft. Five years later, the market sails and they're speculating it to come at a sq. ft. of class B office space. By the time the market had quickly widen again, what they were buying at \$35 to 40 a sq. ft. in New York City was worth \$400 and \$500 a sq. ft. That's a quick way to make money particularly if you do it several million sq. ft. at a time. They had to make that one transaction made them \$5 billion and a couple of other businesses put together the pact. Passive investor, now passive investor obviously means the 449 that manages the property, but he's enhancing it because he can operate on a timely basis--buy low sell high and because he can arbitrage perhaps thinking money markets that others can't reach. Classic example being the person current CMO's in which the poor bastard that's buying his house retail is paying 10.5% interest rate on the whole mortgage, that the guy who buys the portfolio goes into the money market investing in the Treasury Reserve and is able to come up with an average interest rate of maybe 6.5% better enhancement so he adds another one point, now he's got a cost of funds at 7.5 versus the guy whose at retail at 10.5 and its an unequal spread, it spreads value that what's up or low. So he's arbitraging, but he still has them and hasn't seen a single one of those houses, never sold a thing in the house, never paid a single mortgage. By the time he did good in his arbitrage. So the essence of strategy and taxes for real estate fall back to passive investments, its really exploiting institutional and technical details of the appropriate time in order to achieve a spread. Sifer when he's here will talk about that. He's a consummate artist at operating within the technical details of the fasby rules. Creating fictional profits for corporations while he steals their millions. One of the problems of course with go back to passive investors is the relationship to real estate creates an emotional vector, a creative berg if you will, and it means that its not always as rationally efficient as the folks in theoretical finance courses would like to believe. Psychic income is a significant source of return in real estate. You can try to buy it, you can put your thumb in your suspenders and say its fine. And that's good for a least 1% of the cap rate. That's probably more true of real estate than any other kind of capital intensive kind of investment strategy. Its very hard to fill your pride in a stock that you bought or a bond or commercial caper note, you generally don't leave it out on the coffee table and talk smartly about it at the cocktail party. While we're talking about guest speakers, by the way, 795, I've got three out of four set down on the date if you want to write those down, if you're in the feasibility course you may want to write the

dates down. All three of these will be at the Edgewater the upper auditorium. Forgive me as I work backwards, but it's the way I remember them the best at the moment. April 29, will be Steve Jarchow, talking about real estate investment plus formation and specifically a Lincoln Properties which should be fun simply because it has so many twists and turns applied to it it might as well be a model and then April 8 will be Jay Shiberg talking about how he does it he will be a role model for all of you in that his first project was an assignment in the principles of real estate class with Don Allen and a few of us had a good idea and why don't you go see so and so, a Japanese appraiser and investor in Honolulu and he did that and he said gee that's a great idea Dave, let's go 50/50 which they did and he had made his first killing before he finished his Junior year at the University of Hawaii and came up with a very ritzy leverage formula. As a result the Shidler Company has seven partners around the country by the way, but it's all for the greater glory of Fritz Shidler, had outside partners investing and so forth, it's all for the house account and they do not ever put their own money into it here. And he might provide a little noted endorsement of what they perceive as a none risk. But otherwise they do extremely well and have hundreds of millions of dollars in real estate now with no money down. And they aren't dealing in shacks down in the student quarter, we're talking about major industrial parks, office buildings and so forth. But at any rate he'll be here on the 8th. Very different corporate culture, very different view of real estate investment. The one before him will be on March 25, will be Bob Mansfield, and probably his boss, Bill Renal, of Disney Development Corporation and they do all of the so called none gate 558. And the first one and the one I still haven't got them nailed down to as to the date, the last Friday in February or the first Friday in March, will be Jerry Clay of Data 566 with a couple of his associates doing the Cadillac Fairview deal for about six hours is about all that you can stand although he will probably just scratch the surface and which has been the largest real estate transaction to date in the history of 572, other than the possibly the first seven days of 574, so that program is pretty high powered. So they're all looking forward to it and at this point all of the three that are scheduled will be at the Edgewater, I can't say for sure about the last one. Given our introduction to the mush of real estate investment the first 587 are really some comments on the futurism of energy, the futurism of political and social trends, interesting comments out of the Economist Magazine on 593, hope and strategy, and the possibilities of the future demographically and otherwise. You'll find an article by George Stringly that's interesting about the state of 599. The major cities, he says today, are the home of the transfer payment. All citizens are virtually 602 and moved out and that employers are likely to follow. The second sector is essentially starting to say, gee, what is the strategy, what are some of the elements of strategy that the readings (end of side one) and the readings will begin to look at that. Japan will be telling you about core portfolios and the British will be talking about the socialism of America and the opportunity for monopoly, and other investors like Caldwell Banker and so forth and so on will have other concepts of what they think the play is so far as they want to tell you. Obviously, none of them have an exclusive on any of it, but it certainly begins to suggest to you the infinite variety of investment attitudes, replaces the subject really of your hopes and expectations of the future that may. The other element of that will be looking at economic scenarios about the future. Begin to read whatever you see in the papers and perhaps some of the other books on futuristic looks at the coming depression in 1990 and other messages of hope from other authors and you have a number of scenarios which you're really going to have to in your own mind kind of establish the premise on which

you are operating. The 21 is that most industrial specific to the U.S. is going to go into a smooth transition into its new economic role of somewhat less significance world wide than before and that we will be able to resolve some of our social and political problems. That we'll have a steady economic growth with a few brief recessionary slow downs, but that will be survivable at least by the middle class. Those at the bottom of the economic structure will have a tough time of it. They will have gradually declining unemployment and that there will be some shift away from manufacturing for other kinds of service enterprises and so forth. This is how 30 of one form or another. That growth always solves the deficit or the debt problems and you notice the Republicans are always talking the only thing we need to do is have lower interest rates and prosperity will then correct all social ills and so forth and the Democrats are of course taking the other view the only thing that will work is subsidy and taxes to the rich to subsidize the poor. And finally it worked that real interest rates will be relatively low and moderate during this decade of transition into the millennium. The second alternative scenario would be something like this that we're going to have a somewhat erratic transition. The transition to the new economic United States is going to be interrupted by some recessions that are comparable to the 70's and we'll be a little Raggedy Andy. That economic growth is erratic with some spurts interrupted by stagnation or negative growth, stager economic employment will move from 7 to 12%, it will be somewhat regional. There will be continued pockets of unemployment and indeed maybe some pockets of outright rebellion in areas that are not barring or getting their fair share of economic opportunity. Debt loads, for example, remain high will considerable default rates and there will have to be considerable rescheduling of repayments to protect the credibility of our financial institutions. That's already true. Twenty-five to fifty billion dollars in losses in the savings and loans. The entire savings and loan industry has a surplus of barely 2% of the total deposit. And some 5-600 of them are already bankrupt and we can't afford to close them because FSLDIC is itself bankrupt. The problem is less severe in the banks because the banks don't have to report what their losses are since as long as there's a possibility of repayment, the accounting statement does not have to reflect the underlying value of the assets and it continues to reflect the amount of the note or their debt reserves being only as what they perceive to be the reduction in how much they will collect from the note. Again, its an erratic scenario with its assumed pressure to control government deficit will continue increases in tax rates and increasingly spending adjustments. Certainly some talk of that presently--if that's not what the presidential election's about, I don't know what it is about. 060 stood up and said we only got two ways to go baby and that's one, raise taxes and two, reduce deficits. What are the 061 rates right now? If you look in the book about attitudes, Boston, New England--Baah, that place is best. What's been responsible for doing with the come back? They could afford a set sense of dollars per capita than other part of the United States. Why do they use that? For every congressman and senator position aspiring chairmanships and sub-chairmanships are concerned. But if in fact we do have a budget direction what's going to get cut--defense. Set the gold industry at the market. 068 Maybe the miracle of the Northeast isn't quite such a miracle at all, it just may be that they get enough federal dollars as an uncle. Will real estate interest rates moderate gradually as deflationary forces, because of excess capacity decline and debt loads 071 on borrowing? What about our trade deficit? If we allow interest rates to fall, what happens? Less foreign capital comes over here because at that point the spread between the opportunity cost here and someplace else is less--and they might as well take their money home.

So the erratic transition scenario isn't necessarily a very good one for real estate. It may benefit some, it may benefit 077. The dollar continues to fall, some jobs will come home. I think it was Tandy, it was reported that they were bringing all of their computer factory operations back from Korea to the U.S., particularly the Southwest, because the labor factor was now cheaper in America's Southwest than it was in Korea. The breakdown of the dollar and so forth and so on. But noted it comes back to none unionized, none structured labor pools which can continue to be exploited. Now what the data implied relative to the new immigration act which is enforced in 88, means there's isn't going to be enough hope to pick your cabbages and your melons and so forth, but your 086 and your psychotic 086. Things work together. The institutional framework from which real estate operates is extremely 088 and extremely broad. The third scenario, of course, if your a pessimist is we actually have atomic destruction, that we might have significant default on foreign and domestic loans. That never will get our government deficit under control. And that we eventually will have to have drafted deficit control and a real austerity program. Period of rising unemployment concentrated particularly in the traditional areas of defense manufacturing. Obviously spreading ultimately to other industries as well. Real interest rates will have to remain high for most of the 1980's, but one deflects inflation and two protect us against a run on the dollar by overseas money. We will have social destruction in our cities where we have 25% of our population now in poverty. The number and percentage of ratio and absolute number of poverty has risen under the Reagan administration rather than decline. And they're getting less. Question is can we keep them drugged long enough so they don't fight, its a real question. Which of those social scenarios, economic scenarios do you want to take? We should begin to influence then your view of real estate--and real estate investment versus development. Exploitation of the opportunity of the short term Keysian active investor, or whether in fact as a portfolio investor you have to be fatalistic and say gee, I need the diversification because I don't where lightning is going to hit next. So they all can't fall down at the same time. But what with you read the systematic where the stock investor likes to talk about. Beginning the task 113 much more significance than the nonsystematic risks which can be relatively easily stabilized in real estate. And so we begin real estate investment by having to make a fairly mushy set of assumptions about the future context in which one operates. Keeping one eye to the leeward as it were and having a hope about the future, or otherwise you're going to the seas and drudgeries and the mason jars in the back yard. Think about that. What is the hope, what's the framework within which we're now going to build a rationalized systematic method of selection and management and presumably increase of our net worth. If we look at the rationalized nonpsychic income benefits of real estate its only two things--one, increase our spendable income or two, increase the net worth that we can benefit from in our life time and pass on to the next generation. The most significant thing Reagan has done is to allow the middle class to pass on their net worth by raising the exemptions significantly on the federal estate tax so that it can pay us more or less in tax with the minimum liquidity exposure for the next generation. We'll begin to look at that as the semester progresses. How do we improve/group 133 our spendable cash, how do we improve the liquidating value of our net worth so we can transfer in this life or the next to whatever cause or purpose we wish. Okay, we'll come back to that next time. (end of tape)

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Sorry for the delay, just as I was coming in I got a call from a Pension Age and I had to give them a report on higher education and 856 in 15 minutes. Can you imagine what that's going to look like? We started out with, which numbers do you think is the right number in appraisal? As a result it took 20 minutes. But he now knows which number is the right number in appraisal--my number is the right answer. Okay, I understand your readings are now ready at Bob's Copy Shop. You can take a pickup truck now and bring those home and that should keep you off the street until the better part of the week anyway.

We were talking at the close of the last session that there's a certain irony to the real estate investment process because, while we spend a great deal of time in systematic analysis and two point decimal measurement of returns and ratios of one form or another, it begins with a rather soft hope about the future context for that investment and those hopes really can be subdivided further into a hierarchy of concerns and I would like to begin to define those, recognizing as there is not absolutism unfortunately in real estate other than insolvency and Chapter 11, which is relatively absolute and final. I came back from Texas where that seems to be a chronic problem. Even the late great Vice President, Connelly is going

through bankruptcy as a result of his real estate holdings and was pictured prominently in the Dallas paper on Friday morning, selling off the family heirlooms to contribute to the liquidity of his enterprises or nonliquidity as the case may be. At any rate, Texas is a disaster zone, but a very great opportunity area for folks that would like to learn how to run real estate under difficult conditions. And I mean that quite seriously. While I was there, there was one bank I worked for, First Republic, and I think during the day we created at least six new positions in real estate appraisal and asset management in which you can really get some super intense responsibility with hands on management of assets not even mentioning of course what you could do with FSLDIC and so forth. So if you really want some big toys to play with as a postgraduate education, defunct real estate all over the country offers some wonderful opportunities.

The hierarchy of that we'll talk about is first political exposure. I'll expand on the details of it, I'll just give you the seven initially. The degree of market monopoly. Three, the degree of management enhanciveness. Four, the financial attributes of the enterprise, and I guess if you're being precise you can say economic/financial attributes of the enterprise. For example, a hotel is a fixed expense variable revenue type of enterprise. As

compared to a triple net lease back to a AAA credit which essentially is in the nature of a bond secured by real estate. Number five, the number of decision points which allow one to make an abrupt exit. An alternative way of looking at that is the length of the commitments. Number six, would be the federal and state income tax attributes. Even tax exempt nonprofits are sometimes taxable and not exempt. And the last one, number seven, is the fit of the real estate to the estate for distribution plan. We typically look at estate plans as something peculiar to an individual looking at who his heirs may be and so forth, but ultimately any corporate enterprise has a distribution plan. Sometimes it's explicit to finite real estate investment trust says whoever still owns a share of our stock in tenth year will participate in the liquidation proceeds of the trust. The closed end fund for the pension fund says probably between the tenth and twelfth year we're going to terminate and sell off our properties and distribute the profits presumably from the property. Well, that essentially is an estate plan only for a corporate body as opposed to a physical body and quite often that estate plan is a significant ploy in the total investment. Certainly even more so prior to the 1986 tax plan in which if you went into a 30 day liquidation there were no capital gains taxes paid by the corporation, the double tax attribute dropped

out and the proceeds moved right through to the tax payer and the tax payer sorted out what was open on the property and so forth. Well, that may be part of the ploy--how do I get out of this baby and how do I move through it? Or maybe I want to structure my real estate so my distribution plan really is ultimately a spin-off of assets created from the real estate side to shareholders or perhaps I want to roll it up in corporate merger into a larger corporation. Many times that's done of course, simply claiming it as it appears in the short term but many many times that's part of the long term plan of the investment. Well, it's not only as important to figure out how do I get into it and what do I do with it when I got it, its also important to figure out up front how do I plan to get out of it. Because there may be investments that you can't get out of and that you would like to get out of. For example, in structuring a deal with Dave Schuler, some of you've had it at deal on a land lease, in effect, what we did was, set it up so that at the termination of the land lease the owner of the land can reject accepting the property back. That if the building hasn't been removed from the site at the option of the owner of the land, he, in fact, gives the deed to the building owner. Why would he want to do something like that? Well, specifically because in the event of a seismic disturbance on the West Coast and the building half falls down and you

are now notified by public authorities to remove it because it's a hazard to society, that's a hell of an expense and you don't want to do that. You want a way to escape that and so you can say, "Fine, tender the building to me and I'll tender you the deed and you tear the building down, it was your building in the first place but I wanted a cleared site." And since you won't give a clear site, you got the deed baby it's yours. And so you really ought to know all of the practical ways in which you're going to get out as well as the way you're going to get in. Put the light in at the end of the tunnel so to speak. You never want to go into a tunnel in which it's all dark at the other end, because you never quite know when that locomotives going to be coming through from the other way. So build the light in at the end of the tunnel as part of the plan. So now let's look at those seven items in detail.

All of these are relatively soft issues obviously reflecting the component of hope, a direction in which you are hoping to move the enterprise realizing that as we refine the time period more and more will be on a program of improvisation--improvisation guided by these general longer terms' objectives. If we take a really long term view of life, maybe our hopes will be realized with a great deal of bumps along the way. On a day-to-day basis it a little more problematic and messy. I think most real estate investors

today, particularly institutional investors today, realize that their primary risk is a political exposure. And that political exposure takes three forms--one of course, is changing public land use control patterns. When I bought it, it was conforming, they changed the rules, now if I stumbled to nonconforming use they won't let me rebuild it or the next buyer won't be able to develop it as I thought he might or whatever. There's just an infinite variety of little surprises and upsets and therefore you notice developers spend a lot of time talking about when do I have a vested interest in the property, zoning, and so forth. I've come in, I've done my plan, I've got the plat filed, and so forth, when does it test, when does it say I can do that without having someone come in and say, "OOPS, wait a minute, we've changed our environmental rules--the traffic congestion is too high, or the population density is too high or, as in California at one point, golly gee, that's a beautiful development you've got there but unfortunately now its important that the public driving by on the highway be able to see the ocean from all points and therefore, you can't build a house that goes more than two feet above the grade. OOPS wait a minute, I'm on to something there, what happened there?" So public land use control laws represent a significant risk but perhaps not as critical and damaging as the next two.

One, political subsidy to the competition. After all the price that you can provide in real estate and your ability to compete really is a function of your cost of capital. If one guy gets capital for 4% and the other guy gets capital at 10% and they build the same one, the same features, whose gotta have the lower cash flow, therefore the lower prices to survive? For example, Anchorage, Alaska--the Westward was built prior to 1964 with a conventional mortgage. Along came the earthquake and Mr. Hickles lost his little teeny tiny hotel and immediately got catastrophe financing from the SBA and I think it was a magnificent 4%--so he built a great big hotel and called it Captain Hook. The Captain Hook pretty well put the Westward on the ropes and after all you can build a really nice hotel at 4% interest and the poor guy's that laboring under a 10% interest has got himself a problem, right? But then along came the federal government and settled the natives on the land, ten year act and in addition to giving him forty million acres of land, also gave him about 1.6 billion dollars in cash and one of the native tribes says, "Gee, we ought to create enterprises in which we can hire our own natives, so I think we'll build a Sheraton Hotel--cost of capital zero." No mortgage, all equity, they built the Taj Mahal, you know, glorious. The Captain Hook is now for sale and on the financial troubles and nobody ever heard of the

Westward again. A major risk is the subsidy of your competition. That's really what the convention center fight in Madison is all about. The Concourse built its own hotel with conventional financing. Jerry Mullins build his own hotel with conventional financing. And suddenly a couple of idiots on the City Council come along and say we need a third motel. One, we don't like Darrel Wild, Mullin's hotel is kinda old and tacky and it doesn't have any sense of style, so we want something that will really put Madison on the map. So as a result we're going to pour in City money and we'll build them all of their public facilities, we'll build them a parking ramp, we'll buy them the land to do it, presumably rent them the site at a reasonable price. We'll create a TIF and underwrite some more of their costs and all you got to do is build the bedrooms, wonderful. Any idiot can make a hotel work if all he's gotta do is build the bedrooms. Bedrooms don't cost that much to build and if you're renting the bedroom at \$70 a night, and you do that 20 nights out of the year, you're getting \$1,400 a month for something less than a one bedroom apartment. It's pretty hard to fail on that basis. Well, there are guys that do it every day. It's pretty hard to do though. And suddenly Darrel Wild says, "Hey, what are you guys doing to me? I'm barely above water now and I've modernized my hotel, you know I didn't ask for any favors." Mullins has really

become the fair haired boy of Chris Talinser and Mr. Lufler, couldn't he be getting permission to make a right turn off the Square. They're trying to get to the parking ramp, the public parking ramp from the front of the Inn on the Park, you gotta make a left turn go down to the former Penney's building, make a right turn, go all the way down to Wilson Street, make another right turn, come all the way back up the back side to get to the County ramp, it's insanity. You gotta go nine blocks, literally nine blocks, to get to a parking ramp which is out the back door of the Park Motor Inn. Why? Because the City says, "Well you can't make a right turn because we promised the federal government that we were going to make this a bus mall and if we do that we might have to give some money back to the federal government and suddenly you're bothering them anyway, because they just blew \$592,000 on UDAG grant on the Manchester Building, but that's another problem." Total incompetence. Notice two hotels both of whom have made private capital investments, without any help, cooperation or even a kind word from the City, suddenly find they're going to have to do battle with a third hotel. Wild's idea is good, let's kill the damn convention center if its not going to be attached to my hotel, which is perfectly legitimate, and Jerry Mullins attitude is wonderful, if they're going to build a third hotel, by God its going to be my hotel so I can shift the

business back down on the Inn on the Park and screw the Concourse. Both of them trying to correct for something they just really want to do which is have a third hotel. Now we do that all the time. Sometimes legitimately. We say, "Gee we need elderly housing and so we'll build special units for the elderly where they only have to take 25 or 30% of their disposable income"--and they move out of wherever they were because you can hardly beat the price and depending on, of course, how loosely or laxly the eligibility rules are determined, suddenly the apartment owner who paid for his own unit and has to pay the full blown cost is competing with somebody down the street who is heavily subsidized. But the flip side is just as bad. What if your own demand is significantly subsidized? What if you own a real estate investment project in a small town which is largely dependent on the dairy industry and the revenues and the retail expenditures in that town are a direct function of the milk parity price. Or the military base just down the road, or some other government program. The miracle of the Northeast or New England isn't such a miracle because when you figure out that Massachusetts is getting more dollars of defense budget per capita than any other state in the United States, by a significant margin--that's supporting their real estate boom. That's supporting their office rents, and that's supporting their home prices,

that's supporting their retail sales and their shopping center prices and so forth. Once you get on to that, how do you get off of that? What if the next President really said hey gee we've got a lot of other problems besides defense expenditures, and so we're going to cut back and we're not going to create all these windbanks super duper defense things--where are they going to be in New England then? For that matter, where are they going to be in Texas then? Notice your real estate prices are extremely sensitive to political process. Land use controls are the obvious ones, but the less obvious ones will kill you. The degree to which government programs, which on their face are not necessarily bad, subsidize your competition, undermine your profit. Maybe Bob Linton has a good point--I built the Tenney Building and remodeled the Tenney Building myself and now you guys are pouring UDAG money into the Manchester Building to kill me. And Darrell Wild who hasn't had any help at all on the James Wilson Plaza is watching his tenants being bought out of his project by UDAG money that was given to the Manchester Building. Hey, either you gotta learn how to play the political game real well, or you have to begin to look at the political exposure of your product. Because most of your hopes could end in that process.

One of the questions asked me by First Republic; during the day I spent most of the day with the appraisal section

and the bank's investment objectives are under the gun. Some of them, of course, made bad mistakes in the energy area, I guess it was, and Republic Bank made mistakes in the real estate area and so they held out 1,600 properties presently not doing necessarily very well or anything at all and as a result they have appraisers to attempt to reappraise each of the properties each year. And even when they bring in the independent appraiser when they start to look at them those property values are coming down. I was in a bank building in Little Rock, Arkansas, and last year when it was appraised in January at \$42 million, this year it was \$34 million. Unfortunately, that's going in the wrong direction relative to the mortgage which is accruing interest at the moment which is going the other way. Very very sensitive obviously to the appraised value as to whether the bank system is essentially solvent or not. But in any event, in the afternoon I met then with the loan officers, as well as the appraisers and the loan officers are hot to make loans because that's where you get revenue for the bank. So you have this interesting battle between them that wants to produce current income and therefore hold it in for the lending staff and those that are trying to define net worth in order to keep the banks open. And they wanted to invest in Austin. And one of the questions posed was, well don't you think Austin will continue to rebound

because our lower costs in Austin will continue to attract people like Semitec, Semitec as you recall was the one that might have come to Madison, they didn't, they went to Austin. And I answered them and I said don't kid yourself, people didn't come to Austin because of your lower costs. People came to Austin because you people are politically more astute than your competition. I'm willing to bet that most of the people would rather live in Madison, Wisconsin, if you ask the staff because our summers are cooler, and while our winters may not be all to write home about, if you like cross country skiing, we're certainly the place to be. I said your real advantage was the fact that your Universities get and your University's is a tool of the state. And when Semitec came down and said gee we would like to have the following kinds of endowed chairs in cybernetics, the university was perfectly willing to do that for them. And we need to have soft money so that we can afford to buy homes with our employees, the State Housing Finance Authority stepped up and provided the soft money. And we need a plant immediately, and they said, funny you should mention that, Control Data has this little number over here that's vacant and ready to go and we'd only be too happy to convert it for you and for about \$16 million we come up with a clean room and a bunch of other stuff that you wanted, but chicken feed, you're in Texas and so on.

And they put together with the State, the University and the City of Austin all working together for the \$65 million package that was pretty hard to beat. But Major Sensenbrenner came up with, we'll make it a TIF district. We'll spend \$22 million of general obligation bonds on a convention center but we wouldn't step up and put \$10 million into Semitec. Insanity, absolute insanity. In the meantime, it's not quite clear whether the State and the University we're really talking very well together at all. You can talk to Jim Carley, he's kind of fed up with the University--that thinks we are above being used for Semitec. But to the degree that there's something in it for us, the University, maybe we'll play ball. That's not the way they do it in Texas. Everything is for Texas. The University is for Texas, the State is for Texas, Austin's for Texas. And if for some reason they decided they liked San Antonio better than Austin, Austin would have jumped right in and supported San Antonio location. The real asset they have is political savvy and they got the right chairman and the right committees in Congress. That's their answer, that's why Austin is a good place to invest. Even though right now it's a disaster zone, an absolute disaster zone. The vacancies in office space and apartment buildings have never been higher. The quality of apartment buildings has never been lower. But you don't want to bet against that

political environment. The first thing you need to have is not economic base, you have to have political base. Political base has to be sympathetic with private investors. Therefore, you want to look at the land control use mechanisms obviously, you also want to look at the willingness of the politicians to either subsidize demand or subsidize competitive supply. To the degree that they will subsidize demand is a good thing. To the degree that they want to subsidize supply you're in real trouble. Why anybody would want to invest in downtown Madison, where the City Council just doesn't understand the difference. I don't know.

The second element obviously, is that the drive wheel once you get beyond that political process is market revenue customer. The object of enterprise is create a customer, anything you do after that is redundant. There are four ways to create customers in real estate. One is direct control of the ultimate customer. That is the best of all possible worlds. Being the President of the bank I can decide where the bank is going to lease, then I choose to take lease of my building. Short of that is the grand old American tradition of reciprocity. I own the bank, I'm going to own the building, but I think it's important that my accountant, my attorney, and my investment banking connection all be in my building so that we can talk

conveniently by just running up and down the elevator. Surprise, surprise, Arthur Anderson, Robert Bard Company, and so forth, they're all in the First Wisconsin Building in Milwaukee. (The Name of some Milwaukee Law Firm) has three floors, some of their partners left because they didn't want to go and pay that kind of price per square foot and have it come off the bottom line when it came time to divide up shares and bonuses among the partners. On the other hand if they wanted to continue to be dominant in the legal work with the bank, one could understand the convenience of being in the same building. Much American real estate is done through reciprocity. Whether you lock them in directly or indirectly isn't so relevant; it's the fact that you do in fact have a lock in on your tenant mix. Now you raise your hand and say, "Gee tie-in contracts are illegal under the Constitution." That's true, but you don't state it as tie-in contract. You just let it be known by body language that it would be a desirable thing for them to do. You build relationships in the U.S. business scene. Relationships is another way of saying that there will be some degree of reciprocity.

The third element of course, of market control comes through what we will call channeled demand. Channeling because of the terrain, there is only one direction you can go, you gotta go this way, everything else is too wet. For

example, that's San Francisco. San Francisco is a very tight little island with little connection to the main land going South and as a result, very tight supply, relative to the population density. A fortune was made in Southern California in the early days of the California drought by a number of friends such as Property Research, Inc., which simply mapped each increment of public infrastructure in the direction it was going on the five year capital budget. Where would the interchanges be built, where were the interstates going to be built, when was it scheduled to be built, when were the funds appropriated, and then just follow that out. And you could go to Property Research as a professional athlete and say, "Gee, I've got five more years of high income as a basketball player and then I'm on my own and they would say great, we'll buy these little orchards right along here, by our scheduling in four and a half years they will be on an interchange and ready for residential and commercial development and so forth, and son of a gun it worked beautifully." They got five years of tax deductions carrying the property forward rather than just simply holding and puff, it blossomed into a magnificent capital gain more or less on schedule. Channeled demand. Obviously channeled resulted in utilities infrastructure, linkages. I like the term channeled demand rather than monopoly because a number of years ago in a case I was representing the First

Wisconsin, they were accused of monopolizing the downtown office market in Milwaukee and I worked for a couple of antitrust attorneys that were defending them and they were appalled to hear me say free enterprise is the art of creating your own monopoly if only for a moment. That would have been enough to drop them into oblivion. If I had to find a new term for our theory and now we talk about channeled demand.

Failing the first three--direct control, reciprocity or some natural channeling of demand, we fall back on the least desirable and acceptable method called market research. Identify a gap in the market that is not served well by the existing product. Identify folks who are unsatisfied, folks who have needs that are unmet. Actually go out there and meet a consumer. Pretty radical stuff in real estate investment. Not that many people bother to do it, some people give lip service to it, but it's certainly a major source of market control if you wish to use it. But notice you need to be able to operate in a monopolistic situation. There is chronic oversupply of virtually everything in real estate, therefore you need customer control. Never never compete on price. Question--can you give an example of what direct control means. Chief--Sure, Affiliated University Physicians, Inc., represents the 250 doctors that practice medicine at the University's Medical School and Hospital.

Okay? They have to have a major administrative facility. They have a contract with the state which says that they take their total billings as doctors, they subtract their operating expenses, etc., and then they divvy up the remainder between the state and the doctors. So far, so good? One of their expenses is rent. They used to be in somebody else's rental building so they said to the State, "Do you care where we rent?" And the State said no, as long as you don't pay more than market rent. So they built their own office building. They've got 18,000 ft. out here on the Westside. They rent it from themselves. The doctors have a partnership called Synapse Associates, which represents those doctors that practice medicine at the hospital if they care to join. They pay rent which pays off the mortgage and gives them cash dividends as well. Tough to lose on that kind of proposition. Captive market. Okay? Direct control of the client. Lots of deals like that. If I'm the President of the XYZ corporation, I probably own the office building in my own name and rent from me. In the days of high depreciation, that was one way of sheltering my effective income for one thing, besides that I'm taking money out the back door of the corporation as a rental payment which is a single back payment rather than a dividend which would be a double back payment. And if I do that correctly and I have a few pension plans and so forth

as well, pretty soon there aren't any taxable income in the corporation either. You see? Lots of goodies of that sort. If you think insider trading is unique to the stock market, you are going to be very surprised. The insider market is the market in real estate. Knowing something about the entity and play of tax. In real estate it's permissible and it not regarded as unethical, in the stock market that's something else.

Management intensiveness is the third attribute. Obviously, the high degree of instability of any enterprise is attributable to the mortality, the morbidity and the instability of the individuals who run it. The more mechanical, the more robotic the management can be, the more fungible the management can be, you can take any MBA and stick him in the spot and he can do it--wonderful. One way to make that automatic, of course, is a triple net lease back in which the tenant is responsible for all of the project management. Which, by the way, is in the AUB assigned lease in your case study. AUB is responsible for everything, including your share of the building. The rents, by the way, is indexed to the CPI, so as a result you have essentially an index bond set up for the investors in the profit. But, of course, with less risk, less return. One of the real problems with anything that is really robotic and really virtually an automatic increase/step-up

is that there's a great deal of competition for those and the yield gets very finely defined and til pretty soon it's a couple of basis points over the interest rate, etc., and the upside is relatively minimal. We can begin to move up from that triple net lease to providing perhaps a little more flexibility for the tenant. Instead of having him locked in for 25 years, he's locked in for three years. From the tenants' standpoint, maybe that he's willing to pay a premium for, and as a result you get a little more income and so on. Each time we add additional dependency on entrepreneurial foresight and ability, the return potential of the upside goes up but so does the return on the downside. Most real estate in the nation today has been moving toward some way of making it a no brainer as far as the investor is concerned. Classic example. Mountain Jacks--before it was Mountain Jacks it was the Boar's Head or something of that sort. Well, the Boar's Head, first of all was owned by Purina and Purina had a number of cattle feed operations that tested their feed which left them with cattle which then became steaks which then they needed to have a market and obviously if they could get the retail price of the steak they were going to do better than the wholesale price of the steak, so they started a real estate enterprise. So far so good? The problem with restaurants today, is that they are very unstable, generally cooks are

very unstable. Not to mention the waiters and waitresses and the rest of the crew. So they industrialized the whole process. They said first of all we don't want a cook. We'll take any idiot at the age of 18 that we can teach how to cook steaks in about three days flat and the way to do that is simply cut the steaks various thicknesses, so that if you want it rarer you use a thick steak, which is a little smaller in circumference than a medium steak which is again a little smaller in circumference and thicker than a well done steak which is smaller in circumference and thicker and as a result all steaks take the same amount of time. And then we'll buy Sara Lee and we will freeze absolutely everything else that we need to do so that the kids out of high school can thaw. We'll totally industrialize the kitchen and if he walks out of here tonight, that's wonderful, I have a 16 year old that can come in the next night and do equally as well under the supervision of an MBA in business who studied management and wouldn't know how to boil water. Now on the front end we're going to create ambiance and so we're going to stick the waiters and waitresses in little colonial outfit and the real estate investment is the core so we create the romance and we'll create a gas log fireplace for the den, we want to industrialize the fire. It's just a lot easier when you come into the work in the afternoon at 4:30 you turn on the

gas jet. Presto, we can now sell you romance of the old colonial ambiance and we can produce a very high quality dinner continually with totally unskilled help. Our big problem is going to be teaching our waiters and waitresses the difference between a butter knife and a steak knife and on which side of the plate it's supposed to go. And how to serve the soup with a ladle without actually spilling it on the client. We can crank those babies out and just go with it. We have removed the management intensiveness that characterized, let's say, a real gourmet restaurant in which the cook really had to have spent 10 years in France in which the maitre d' is really concerned about the food and so forth and so on, but he's a highly unstable individual with a tendency toward alcoholism and what else and we never know whether he's going to show up for work or not. Real estate is moving towards that kind of industrialism. If we can continue to just to spit out industrial buildings on triple net leases in which the total management required is that we have one guy in town that can change light bulbs and put patches on the roof leaks and so forth and so on, pretty soon we have a fairly viable management enterprise.

Management intensiveness. The more management intensiveness, the more we are dependent upon a single personality, the more we are dependent upon a high skill level to operate, the more of our returns go to management

and the fewer of our returns go to real estate. One of the reasons pension funds have been reluctant to invest in apartment buildings is they regard apartment buildings as intensively managed real estate. And it's true, they are intensively managed. It requires a great deal skill and art to run a good apartment project. It's a skill which they have not yet discovered in Texas. I was out with John Peterson the other night, he was looking at projects in Texas, he was absolutely appalled that they could even build them that way. Projects that are three years old look worse than some of ours in Madison that are 50 years old. They get some guy who came over the border over night, painting it with a broom, and the carpenters he has well, he probably has one on the job trying to coach the other, but somehow they never did master the idea of joists that are 16 inches off center, they are of various dimensions and the floors kind of go up hill and down hill with the joist and so forth. They could make great investment products. The limited partners really bought them up because they were really great depreciation opportunity. They didn't know how fast they were going to depreciate. Accelerated depreciation underestimated the rate of decline. Okay, in addition to being sensitive to the personalities involved, management intensive properties are also very sensitive to time. Time delay. And apartment projects in Madison if it

doesn't rent by the time the semester begins, adjust themselves through price.

Okay. The next set of attributes would be the financial attributes of the project. Notice how far down the chain they really are. Until we have some sense of the stability of our political environment, and we have some sense of the degree of monopoly that we enjoy in order to stabilize our pricing system, and we have some sense of the managerial sensitivity of our project, its obviously going to control our costs and the reliability of our proforma expense estimates, we really don't know anything more about the financial characteristics of the property. Once we get into financial characteristics, the first thing we really need to know is what profit centers are appropriate to this investor? What profit centers are appropriate to a particular investor? A real estate investment trust by law must remain passive in the operations of its property. If it's going to remodel, it's going to hire it done by an outside developer. The profit center goes to the outside developers. If it's going to lease, it's going pay leasing commissions to somebody else. Anything that looks like an entrepreneurial service that might be appropriate to that real estate must be done outside the REIT because it is defined as a passive investment vehicle. Therefore, some of the profit centers that make real estate attractive are

simply not available to an REIT. If we're looking at a project which is still conceptual, then presumably the investor in control might make a profit on the land, another one on the planning and engineering services, another one on the construction and development, another one on leasing commission and ultimately property management, and financing, etc., etc. We need to know which profit centers, we as an investment enterprise are capable of retaining and which ones are best farmed out either because we don't have the expertise or because the risk is so great that we just as soon have somebody else take the pounding. Relative to that, we need to know

the time line along which those profit centers occur. Assuming a project has a 120 month cycle, 10 years as it were, what profit centers are available in the first six months, which profit centers are available within 12 months, which profit centers are available within 5 years or 60 months? And therefore, what is our investment strategy hoping to control and capture for the benefit of the investor. Once we have some sense of the profit centers as they may be, which ones we think we can garner and where they fall along the time line. We can then begin to look at some of the financial characteristics of the property. Obviously there's going to be a reliability of revenue estimate. A reliability of expense estimate. And, a risk management device which allows us to control the variances in both revenues and expenses. That control of variance can take a variety of forms. We're all aware of leases, which have pass throughs from the landlord to the tenant. Financing structures which are non-recourse so that if the project fails you can hand it back to the lender without further liability. Master leases which guarantee us a minimum revenue line--all of those kinds of things that we talked about in 551. But each business, each enterprise, each real estate project can be characterized in terms of the customary or traditional control of variance that is available for those who are astute and good negotiators and

good business people. One of those critical financial risk measures is the cash break even point. Perhaps the critical ratio is the cash break even point. If we're talking about an FHA project in which the tenants receive substantial subsidies, the cash break-even point is always 91 or 92% of the gross rents as set by FHA and the rent control program. On the other had, if we're talking about a resort hotel it may be necessary to put our break-even point down around 50 or 55% of the potential gross in order that we can survive the early years of building, a clientele and establishing market reputation and somehow acquiring our share of the market. We need to look at that relationship of the break-even point as one of the most telling ways of characterizing the property. The other critical element of course, is the degree to which we are a fixed cost variable revenue enterprise. The more you are a fixed cost variable revenue enterprise the more critical it is that you create a monopoly for your real estate. That's true of industry around the world, not simply real estate. Those industries which are most capital intensive are the one's that have developed the most sophisticated systems of price fixing and stabilization of their own. Farming is good example of an industry which has its troubles doing that. The price of milk tends to wiggle, the cost of feeding cows does not. Cost variable revenue enterprise.

Once we have all of that, then we begin to develop simultaneously measures of risk and measures of return on the property. And I think you'll see that the center and the nature of the real estate enterprise is that which is an appropriate measure of risk, and that which is appropriate measures of return will change. If we're talking about a land development company like Gulf down in Florida and so forth, we may be really looking at ratios such as the inventory turnover or the rate of runoff on land contracts receivable, or other factors such as that that really measures the revenue risk or the cost risk of the enterprise. Then again if we're looking at a mobile home manufacturer and subdivider, we may be looking at the number of times they turn their working capital per year. Or looking at the collection lag between the delivery dates and the collection on their mobile home to their dealers or whatever, we'll certainly develop different measures of risk that try to get at the critical fulcrum, the critical dichotomy between success and failure for that particular kind of real estate. And it may have to do with occupancy rates at a hotel, it may have to do with break-even cash, break-even ratios on a hotel, excuse me on an apartment building, lots of different ratios are revealing of the balancing point that exists between success and failure. Next I expect to look at the decision point. Decisions must

really depend on two elements, one how long is the time line that we were talking about. Developers that were doing Section 8 apartment buildings a couple of years ago really were looking at about an 18 month time line, from the time they were in to the time they were out of the development, at least out in terms of any cash dollars of their own. They probably had some costs for six months while they negotiated with FHA and WHEDA and so forth for their subsidy and their insured FHA loan guarantee and so forth, they probably had nine months to build the project actually, they had three months in which to finish their audited costs and get it rented up and so forth. They then close on the loan, closed on their partnership proceeds and they were home free and they still had a residual interest in the project with a management contract, etc. Eighteen months was the time line for that and, therefore, the decision point is to whether we had to do that again, was relatively short. If we're doing a shopping center the time line, from the time we initially started on the site, until we get all of our stores in on leases and they're actually paying dollar rent, is probably five-to-seven years. And once you start moving down that time line there aren't very many ways out. Once you spend money on planning and environmental reports and feasibility studies and market studies and leasing and so forth, by the time you get to the third year you take a real bath if you

were to sell the site to somebody else. Because the land as land is worth one thing, the investment that you've made in all of those soft costs are subcosts which are not recoverable and unless you see it through to the bitter end and it gets the entitlements that you're going for, and you get the leases that create value to the site and so forth, there's no way out. There's a wonderful line about the drunk coming out of a saloon on State Street, running into a street light, feeling his way all the way around the street light post and sitting down on the pavement saying, "I gotta give up there's no way out." Many real estate projects are of that kind. Short of bankruptcy or suicide there's no way out. A limited partnership is a classic example of having a very limited way out. You can't sell it to people because that would give it marketability. The land that the general partner doesn't want to buy, you're in trouble there, etc., etc. And my friend, Bob Rogers says all you can really do is give it to your wife for Christmas and get a divorce by June and you're out. Decision point--how many points do I have not had an opportunity to reconsider. Can I structure the deal so that I can nibble my way in and nibble my way out at a minimum sunk cost at any point along the way. No wonder developers are so chincy and try to get architects on contingency fees that say draw me some pretty pictures now and if the project goes, I'll make you a five percent

partner. And the architect says, "Gee that's really nice nobody ever made an offer that way and he never sees dollar one having spent hours and hours on the drawing board and so forth." And he goes to the property owner and says, "You know your land as corn fields is only worth \$1,000 maybe \$1,500 an acre, but if we can get shopping center permits for this, its worth \$5,000 an acre, you'll just have to ride with me for about a year and a half." So he gives away an option on his land in which if it goes he gets \$5,000 an acres, if it doesn't go, he gets nothing but the option to paste on the wall and a dollar for due consideration.

Obviously, everybody is looking for ways that they can bale out and have a minimum sunk cost along the way. Sometimes we call those options, sometimes we call them contingent purchase prices, sometimes we deliberately create a nonrecourse land contract so that we can take a walk on the project if it doesn't work. So we try to build decision points along the way which allow us out at a minimum cost. Sometimes we structure financial hedges to do that, so as the market changes in one direction we profit in another.

A classic of course, through the investment process is procrastination. Skillful procrastination in a real estate development deal is critical. And it takes many forms, for example--our client has a shopping center down in Phoenix and one of the clinkers in the shopping center, which we

knew when we bought it and we really looked at it as an opportunity, is that Woolworth had a two unit department store on the site which they subleased to one of these home products groups, which provide lumber and mill work and all forms of hardware for the homeowner and they marked it up considerably. Let's say that the base rent calls for \$1.60 sq. ft., the market on the space is \$5.50 presently and they're not sharing it with us as the holders of the shopping center. So we're proceeding on one front to sue them on the grounds that it violates their participation percentage lease and on the other side we're proceeding to try to negotiate with them to buy it. Well, Woolworth moves along at a rather glacial pace and one's never sure from one moment to moment whether they know what they're doing or they don't know what they're doing--the position they're taking. Well, finally we're given up on the whole thing, we've realized it was special situation when we went in, we've enhanced the whole center, cap rates have fallen in Phoenix and now's a good time to bail out, take our profit and run. Well, we have an offer on the table now and the guy comes in and says, "Gee, I need 120 days to do my due diligence. Wait a minute, hold on, wants 120 days to due diligence. He's another shopping center developer in the area and for one thing he would love to look at the leases and find out what the termination dates are of the other 80

tenants in the center, that would be a useful thing to know in terms of your procedure and second of all, he obviously sees the same thing we did. "Gee, if we could just get Woolworth out of there, this baby would really fly." Its no trick to come up with something you don't like about it and say, gee, my board rejected it because there is a crack in the left rear wall which suggests that they are directly over one of the major faults on the West Coast, or California will remain and the rest of the U.S. will fall into the sea and take your center with it. Okay? Now, notice what they're doing is building into their deal decision points so they can say, "Gee, we went and locked horns with Woolworth and that's not going to work out, so I don't think we want it." Then they're setting up, you know, they're saying, "Gee, if you close with McDonald's on that pad that's circling, that clouds the opportunity for us, because it reduces the parking ratio, etc. They're already setting up their escape point. So at that point you say, "Wait a minute, hold everything, that's not really a firm offer." So you say, "All right, tell you what we're going to do. For \$100,000 we'll give you the option and we'll warrant everything in the Center is as we tell you it is. And give you 60 days to fish or cut bait, but if you don't cut bait, we keep the option money. All right?" Notice at that point all we're doing is saying, "Great if you don't

have any luck with Woolworth that's fine with us, but we get to keep the \$100,000 and they have to pay \$100,000 to find out whether they want to go do battle with Woolworth."

Since its worth a couple of million bucks to get Woolworth out of there because of the capitalized value of the rent differential or the lease hold interest, as it were, of Woolworth, they have to decide now, gee, do we want to throw \$100,000 on the pot to decide whether we can negotiate better with Woolworth than they can. Now they may have an inside deal. They may know the Chairman of the Board of Woolworth and he'll tell their attorney these are nice guys and they're friends of mine and what's more Woolworth needs to book \$2 million of earnings in the Southwest district this year, etc., and so we'll sell. Maybe possible for them to do that, when in fact we didn't succeed in that.

Nevertheless, classic case of figuring out where is the decision point, are they procrastinating, are they drafting that offer to purchase or that offer to sell in such a way that they really have another kick at the cat? Until something else becomes more clear, or other opportunities become more relevant--decision points. When do we have to make a decision? In any real estate deal in which you can retain control and at the same time not make up your mind right away, it's a good deal, that's why people rent with option to buy. Of course, sell with the condition that, you

know, the Board of Directors has to approve it--the old ploy. Gee, Harry I thought we had a deal but the Corporate Board said no. Of course if you had been at the corporate meeting you would be hearing this guy pitch an entirely different message to the corporate board saying, "Let's get out of this one guys I've got a better offer coming down out of the pike", and so forth, and so the Board would turn up their nose and say, they didn't feel the prospective buyer was credit worthy and they couldn't agree to such and such a term, and therefore, they were rejecting the offer and in the meantime you have the 90 day option on the property. Decision point.

The last two we will talk about in more detail obviously ad nauseam a little later in the semester. The federal tax and income saving effect _____ and the so called estate accumulation and distribution plan for individuals and business entities and we will pick up on those the next time around.

Obviously the federal and state tax laws in some ways are working together and in some ways work counter point to each other, and you really need a short term and long term viewpoint. The short term view point is obviously is to minimize the tax by hopefully postponing it, possibly avoiding it. But, the long term viewpoint really has to consider the consequences of that. For example, all of you

I'm sure are familiar with the concept of the cross over point. The cross over point is that point where the tax depreciation is no longer sufficient to cover the principal payment due on the mortgage. Nobody wants to, obviously, pay on principal with after tax dollars because if your tax is 28% you obviously have to earn somewhere in the neighborhood of \$1.30 or a little more in order to have a dollar left to make your principle payment. It obviously 20 would be much more desirable to make payments on the principal with dollars that have been sheltered by the depreciation.

Most of you are also probably aware that traditionally the depreciation payment is declining with time, partly because of the nature of the format that you've taken, partly because of the fact that different assets within the enterprise have different useful lives and are on 10, 5, 3 and 28 year life and, as a result, you would have written off various components of your total investment your total depreciation component starts to decline. While at the same time the principal payment of the loan is obviously starting to rise by the very nature of fixed interest payment mortgages, is sometimes, for that matter, a highly structured mortgage. The interest payment gradually declines and the principle portion gradually increases and so obviously you have a curve as far as the principle

dollars are concerned, generally rising with time, at the same time that the curve of depreciation is declining, either in a smooth fashion or in a step down fashion as the case may be. That's the so called classic cross over point in terms of your tax law and should you burn off your depreciation too early and have nothing really to do with it, it may not be very effective, after all you can carry back excess tax losses for the last three years, perhaps carry them forward five years and now today there is also a gradual evaporation of that tax shelter in which if you can't use it you lose it sort of thing.

But the second cross over point is the point at which the tax on resale exceeds the net cash over available from the sale price. You have been very clever, you have acquired the proper property, you have depreciated it, it has nevertheless appreciated in value, it's cash flows are higher, you now borrow a new loan on it. The new loan exceeds your old basis and if it comes time to sell the property, the total tax on the gain, between the sales price and your now depreciated basis, will exceed the net equity realized on the transaction because you now have a major new loan to pay. That's the second cross over point. Can I net enough on resale to pay off my obligations? And hopefully at least break-even, on the sale. Many people are locked into their property. They don't dare let go, because the

resale proceeds will be less than the total obligations they face when you combine the debt balance due with the taxes due on the sale. Therefore, tax planning has to take not only the short term view, but also avoid the tax trap of either a cross over in which your principal payment dollars are no longer sheltered or what's worse, should you sell the property you have a negative cash realized on sale. So you have to balance those two out.

Not too many years ago when accelerated depreciation was in vogue I can remember one investment real estate trust that we were working with, which had so much depreciation to burn off they no longer had any income to shelter. So we deliberately took a depreciation method which worked in reverse. You can take accelerated depreciation and run it backwards, make the very least payment first, and the largest payment last so that, as we burned off the existing depreciation, we were able to replace it with the increasing depreciation being taken on the property. The IRS is perfectly happy to go along with anything that postponed the day of deferment, as it were, of the tax, and obviously that kind of curve really represents more accurately what happens to a property, it doesn't depreciate very quickly in the early years, it tends to obviously accelerate its obsolescence and decline in the later years and so for a variety of reasons we're taking the short term versus long

term view and this is true whether we're looking at the federal or the state rule.

Until 1986 of course you always have the ploy as to whether I want to take it as income or take it as a capital gain, since the capital enjoyed a significant preference, essentially 20% of the gain as opposed to as much as 50% of the income. At one point it was even higher than that. Taxes on income could be as high as 70% on the marginal dollar, while capital gains were 25% of the net gain and so there was obviously a desire to convert earnings, as much as possible, to capital gains. Today that urgency is not there since both capital gains and operating income are taxed at 28% on the margin, which changes the game to some degree.

The ploys available, nevertheless, for investment consideration are 1) postponement of the income tax; 2) leveling of the income to take advantage of progressive tax rates; 3) shifting of the income to lower tax entities; and 4) avoidance of the income tax or capital gains tax for that matter. For example the home owners who waits until he is 58 or more, or 62 or more, (I can never remember) and is allowed to take \$125,000 capital gain out of his house and pay no tax on it, and so forth forth, it has reached the threshold to avoid the tax. If they were so crass as to move out the year before and convert their property to a rental property, they're in trouble, they just killed the

long term gain for a relatively short term advantage and so you need to be able to interplay between the short and long term and as the tax laws change, the degree to which you can use one of those ploys obviously shifts.

Related to that is the last category which we will call, the estate or distribution plan. For individuals the greatest tax ploy going, is a one time, die to win situation, in which when you die you are granted a stepped up basis, you never have to pay the capital gains tax on your estate. So you've been in that little old duplex that you bought at \$20,000 and you depreciated down the value of the land to \$4,000 and now its worth \$100,000--you're going to have an \$86,000 capital gain which if you would sell during your life time then take a 28% whack, not to mention whatever the state takes of the whole thing. On the other hand, if you die, not only does your estate get \$100,000, but the heir takes the property at \$100,000 and can begin to depreciate it on that basis and might play the game all over again. There are many people just mean enough to cheat Uncle Sam out of their capital gains by dying (laughs). Congress tried to stop that a number of years ago and in effect to eliminate the stepped up basis and found one, there were two major problems with it. One, a good number of people now approaching the point where the probabilities are good that they will in fact die, don't have the foggiest

as to what basis is and, therefore, didn't have a basis to their form, computing or not. And under the law would have had to pay the tax on the full thing even though their basis was zero. How many people for example, who've collected stamps over their life time, or coins over their life time, could tell you how much they spent for that asset over that period of time and therefore, what their basis is against its value at the time they die. Not very many. And yet they would then have to pay, under the tax law, that would presume that at one point in 1977 they would have had to pay a capital gains tax followed by then, an estate tax on whatever residual will remain and then there would be an additional inheritance tax paid by the heir on whatever they receive. Not only was it administratively a difficult thing to do, even worse it hit the congressmen where he lived. Most congressmen didn't have any money to start with, and have been able to glob onto a major estate in the process of serving as congressmen and being well rewarded for their public service, and my God, the tack is going to fall on me, the congressman they voted for, I can't have that. What if the people really had to report how much money I've made and how much money that has no basis. Nobody has more net worth with zero basis but a congressman. How are you going to prove where that money came from, son of a gun. Even legitimately, a congressman who doesn't

spend all of his campaign funds when he retired from congress is permitted to keep the balance. If that isn't one of the most disdain pieces of crap you ever heard of. If Gary Hart pays off all of his bills and retired from the campaign and retired from the senate and still had \$700,000 left in the kitty--it's his to keep. Why wouldn't you make an ass of yourself and make \$700,000? (laughter) But, from an administrative standpoint it wasn't a bright idea, and from a political standpoint it wasn't a bright idea either at a time when the election strength got switched over to the middle class who would likely have an estate. And so congress repudiated their effort to eliminate the stepped up basis. And it's the biggest single gap in the tax laws there is. So obviously there is going to be a relationship in your investment strategy, of when I acquired the property, how is it I plan to transfer it to the next generation, to my heir or to whomever? Question--what do you mean by shifting of the income to a lower tax entities? Chief--Sure, some of these ways have been blocked by the tax because it was so prevalent. A couple of different ways-- one, you're buying in the high tax bracket, which now let's say is 28%. Okay? And I happen to run an appraisal company called Landmark Research and the tax bracket on small corporations starts down around 12%, I'm better off to leave it behind to Landmark Research, right? Now, Landmark

Research in turn says hey, you can have 25% of net income go into a profit sharing plan to the benefit of the executives, so what's the better? Now you have 25% of my income invested in something that isn't taxed at all. Okay? That's the best kind of tax rate. It's my profit sharing plan. Not only that, I could set myself and Jean up as the trustees of the profit sharing investment fund and invest in anything I want to including the duplex down the street. And what's more valuable to me? Depreciation of the duplex based on the 28.5 year life, or the equity built up in the pension fund at no tax at all until such time as I either liquidate it and distribute it or whatever. Notice I'm shifting my income down stream into entities which have a lesser tax rate than I would. All right? Until this last tax law it was common to use what is called the short term Clifford Trust. Clifford Trust says that you could put a piece of income or earning asset in a trust for ten years, at a minimum of ten years, and name anybody you want as its beneficiary so my kids aren't very bright because they're not making very much money, and so they're in a low tax bracket, so I put \$100,000 of stocks in the Clifford Trust, the income goes to my darling dumplings to buy what I should have been buying for them as a parent anyway, with after tax dollars, and at the end of ten years the money reverts to me to cover my retirement, the kid's on his own. In the

meantime the income on the stocks is taxed at the beneficiaries tax rate rather than mine. The gap between that until a few years ago was enormous. If I was a doctor in the 50% tax group rate and my kids were in the 14% tax rate, and Clifford Trust was a very substantial savings. All right? Downstreaming my income to the entities which have lower tax rates than whatever organization I do.

Now of course, every time you invent one of those, the IRS counters with a new rule. So now a trust to children is taxed at the marginal tax rate of the parent rather than the child. If you would die, gee whiz you would almost think Reagan was opposed to children. A consolidated corporations would require that I tax the various corporate entities forming the conglomerate at the maximum corporate tax rate. Otherwise in the old days if I structured it correctly, I could have one corporation owning the building and it would lease it to a second corporation and they would each be taxed at the lower corporate tax rate rather than the maximum rate tax. So Uncle Sam came up with an attribution rule which decided (unrecognizable). But there are still a few little adaptation ploys which you can follow to do that.

One of the major problems with either measuring capital gains, as it were, in the case of sale or in the case of the estate tax, relative to real estate, is valuation of the assets. A real estate investor who dies must know the value

of the real estate on the day that he died and six months after that. He's entitled to be taxed on which ever number is lower. Rolled out of the 1929 crash in which people who died two days before the crash had estates of remarkable value and following the crash had estates which were less than the tax due on the value established just prior to the crash. Many had to forfeit his estate because the taxes were greater than what he would inherit. Uncle Sam in his generous wisdom said, "Gee that's unfair, what we'll do is we'll give you a second kick at the cat, you can then elect which dates you're going to value it, either on the day that you die or the day exactly six months later whichever is lower in case there is some economic cataclysm in the interim." And that's a very expensive process. Very difficult to know, first of all, what the real estate was worth on the day that you died without spending a considerable amount of money to find out. And what's even worse is that if you have to plan for the estate taxes to be paid and the liquidity of the estate, etc., etc., etc., you need to have a pretty good idea before the fact what you're going to have to pay taxes on so that if you've accumulated cash, and the liquidity factor suitable to these payments. It's very difficult from the planning standpoint. If you have real estate that is relatively elastic in value and hopefully rises in value to be able to program a balance

with your cash resources that are sufficient to pay the taxes and the value of the assets which may be largely the real estate at the time that you die. So you have a real interesting problem not only in terms of valuation but in terms of liquidity.

You may have further problems in terms of continuity. What do you do if you're a general partner and you die in the absence of any long term planning? That becomes a taxable event, that's the end of the partnership all of your limited partners will be taxed at that point whether they wanted to or not, whether it was convenient or not--whether that was the most favorable time to liquidate the partnership. So you have to plan not only for what happens in terms of your values and your obligations if you die, you may have to plan a system by which it doesn't become a taxable event. There may be certain properties in which you want no taxable event or not and others in which you do. We had a general partner who took his airplane and plowed it into a hill out here after having put together any number of partnerships and they realized there was no provision for his death. They were into accelerated depreciation apartment syndications, and the general partner died--that was a taxable event and these boys really paid through the nose. Not only did you have to pay the capital gains tax on the reorganization but you had of course the recapture tax

on the accelerated depreciation in excess of straight line, and the limiteds all had to come up with that money right then and there simply because the general hadn't anticipated that in fact he might not be around for the longer point in time. This is why as many general partnerships set up not only with the individual general partner, but with a corporate entity that will continue to survive because it has no mortality. And that way you've got the best of both possible worlds. The corporate entity may be owned entirely by the general partner. But the corporation will survive even if he doesn't, and therefore the partnership will survive. So we need to be able to look at continuity. We want to know that we are in control of the timing of the disposition rather than events being in control. We'll look at deals a little later when we start talking about estates that freeze the value so it's predictable.

Most people keep talking about syndications and partnership, and one tax conduits. The fact is, more taxes are saved by using a corporate shell than are used by using a partnership shell. The myth created by brokers is one thing, the financial reality is quite another. At any rate, when we begin to look at taxes while it does of course have a great deal to do with how we structure things, certainly under the current era in which the income taxes have been somewhat mitigated, at least the rate, and the estate tax

has been incredibly modified in favor of the middle class and the rich, and since the administration for the middle class and the rich, why obviously you have to factor that into your plan. There was a time when it was felt that it would be in the national interest to break up large family fortunes, return the property therein to the market place so that there wouldn't be large conglomerations of property in one hand, you're going to end up with feudal tenure system by default. But that is not a popular idea. Premise is, if I made it and I want to spoil the kids rotten and give it all to him, I can do that, and kids are saying yeah, yeah. (laughter) - where do I sign up for that? Tell me how to vote. Now that I'm 18 I've got the vote and one of the things I'm going to vote for is liberalized estate taxes, and as a result we have obviously a very significant shift in the tax philosophy in the way of wealth redistributions and investment maximization. But that's not only true of the individual, that's also true of the corporate entity today.

Most corporate entities are probably not designed to be immortal, they are not designed to go on indefinitely, are intended to be temporary devices with a business plan that may be 10 or 20 years long and at some point will dissolve, merge or otherwise modify their entity with an idea of getting their assets distributed. Some of those of course

are distributed to share holders, but more typically they're distributed to the officers. To understand any enterprise you have to understand who is perceived to be the stake holder. Somebody pointed out rather effectively General Motors managed to successfully pound the unions into the ground and accomplished tremendous savings and then reward the executives for that to the tune of \$170 million in bonuses for having screwed labor into the ground. That's not exactly going to contribute attitude or the long term investment quality advantage to the share holder, but most corporations aren't run for the benefit of the share holder, nor are they run for the benefit of the employees, they are run for the benefit of the officers. So we have a variety of devices for distribution of the assets called profit sharing, voting plan, stock option plans, etc., etc., all of which are designed to distribute all or some or most of the wealth accumulation of the program.

Did I tell you about the Omaha situation? Great. I get one dumb phone call a day. (laughter). Off the wall, I don't have the foggiest idea how they got my name or whatever. Yesterday's phone call, which took about 40 minutes of my time, is from the citizens group in Omaha, Nebraska. It appears that first of all there is a corporation called Ceratgo which is a new amalgamation of the Armor Company, Cargill Grain and related products

company in Banquet Hoops, NE. And they are the largest single employer in Nebraska. And they have a president who comes out of the grand old tradition of the meat packing industry, in other words he's a son of a bitch. And a year ago he put it to Nebraska, he says guys we think we ought to be a tax exempt corporation because we do so much for Nebraska and if you don't give us tax exemption we're going to move out of the state. Set the whole legislature into a fury and they capitulated and gave him tax exempt status which where upon he graciously stood in front of his employees in the Omaha plant and said, "This is our home, this is a wonderful place to be and we're not going to move anywhere." Called economic terrorism--happens all the time, its just generally not quite that blatant. Now they decided to build their corporate headquarters in downtown Omaha and they own a hundred acres on the river on the bluff that is about six blocks from the core of downtown Omaha and between them and modern downtown Omaha are some 22 buildings which are on the national historical register which architecturally most of them, I guess are having to, do to the lady and gentlemen who are calling me on a conference call, not only are they probably superior to the Midwest, but at least half of them have now been rebuilt into apartment buildings, the art center for Omaha, and a number of other kinds of offices and retail establishments,

restaurants, the usual kind of things, and while they only have four or five buildings to go they have several million dollars worth of commitments going forward to finish those. And in addition Ceratgo is required that the city create a tax TIF district and finance about an 80 acre park including a 20 acre lake which surrounds their new corporate headquarters. Part of the master plan which is being presented right now to the planning department in Omaha calls for the City to pay for the parks but it will not be a public park, it will be a private park to benefit the employees are Ceratgo. Not so much as a jogging trail around the lake allowing the natives to at least come and see where their money went, let alone paddle a canoe or sail a boat or whatever. But the crowning piece is that they insist that the City tear down the buildings between their new corporate headquarters and downtown Omaha so that they can be seen and appreciated for what they have done for Omaha--including the 22 historical registration buildings--because some of them are as much as eight stories tall. The mayor has agreed to this. Now the mayor is dying of cancer and they have sold him on the idea that this will be his memorial--he will have rebuilt downtown Omaha single handedly. And the city council was lying over on its back and probably will agree to it and the only publication they're getting at the moment is positive sales from the

publisher of the only newspaper who happens to be a golfing buddy Ceratgo and now the president of this new amalgam has said, "We promised to stay in Nebraska although we didn't promise to stay in Omaha and we'll take our 2,200 jobs some place else and our tax base some place else, unless you tear down your downtown so that the glory of our corporate headquarters can stand tall." Their call was HELP, please come and testify to the planning commission and our city council who are moving forward on this and we can't even get a hearing on it. Classic corporate contribution and distribution of net worth. I'm sure if the mayor had any gumption the first thing that he would do is buy a one way ticket on the bus line and mail it to the president of the company but apparently that's not about to happen. Watch it in the newspapers and see what happens in Omaha it could be a very interesting confrontation of classic Neanderthal corporate real estate versus a community who's having a very tough time getting organized because the newspaper is controlled by the corporate guy--should be fun to see what happens. Anyway, that was a screwy phone call yesterday.

Now, the reason I'm referring to that I guess in part is that many corporations relative to real estate and particularly for real estate investment, use it as a method of rewarding management ego, rather than necessarily a method of advancing the aims of the corporation. The

distributions may go to the public, indirectly or obliquely in the form of real estate taxes, in the form of corporate participation in urban redevelopment, in the form of perhaps hidden profit centers to those that are involved in the process. That distribution of wealth created in real estate within the corporate framework, is perhaps one of the most subtle and yet most powerful way of distributing the assets of the corporation to the executives and the insiders, without really direct control by the share holders. I would suspect that insider gains through real estate transactions of private corporations greatly exceeds the profits of insiders on the stock itself in the market. It's probably, if not more ethical, much less likely to be criminal because they happen to be in the right place at the right time. The ability to create real estate, and the ability to create power, because of your ability to control disbursements. That power may be used to the benefit of the corporation or in the benefit of the executives. A classic example is Omaha. If I'm going to build a corporate headquarters for you, it's going to have so much tax base, now this is what you're going to do for me. And that's a very rewarding psychic income for those that have the ability to control that disbursement. It's true whether you're a private corporation or whether you're public entity. Robert Moses' "Power Broker" it's a classic example of the ability to

control the politics of the entire state by means of controlling the disbursements of the Tri Borough Authority which was involved in building bridges and tunnels and urban renewal projects. And it took the New Yorkers about 35 years to figure out, you know, how badly it was organized, but obviously the power structure knew very well. Who was then involved and who was running the democratic party in New York and it was Robert Moses who could always profess that he was a public servant, interested only in the greater glory of New York City. So you need to begin to look at the distribution aims of corporate real estate just as you do with the individual. There's a new book out that I think I mentioned earlier called "Riches and Ruin in Real Estate" by Jim Powell, and one of the big name real estate developers, who was good enough at being an very intensive creative individual, but had made himself millions of dollars in real estate, had a net worth of zero. He had given it all to trusts for his children, early on, as he said as a father the last thing I wanted to do was be in a position of having three sons all waiting for me to die so that they could have their inheritance. He said, I think, just simmer that issue right up front, gave him all the money right up front. For him the kick was running the family corporation, the fact that the trusts had looked after his kids, had nothing to that issue with them, the money was already there, now we

can get on with the business of being father and son and father and daughter and never have that barrier, that doubt, that skepticism between us. That's playing hard ball football, and nevertheless, it becomes a major issue for the families that have real estate interests.

Okay, what were the seven basic categories of hope that we're going to look at, and as I say I categorized them because we get so involved in rationalization, so much of it is numbers that we can get 3 place decimals on, that we tend to loose track of how soft each of those computations and expectations really may be. And indeed, maybe not really the measure of storing our real estate investment at all. That, in fact, they miss entirely, the psychic income of real estate, and it may very well be the psychic income of real estate which is a thrill, a kick, the creative outlet, the satisfaction, the tangibility, and pride of ownership, the thrill of the chase if you will, the fun of the game, none of which are factored into the real investment decision at all. So let's not be too obsessed with the cleverness of our rationalizations about the real estate investment process.

One of the wonderful stories that Tony Downs said sells again and again, Tony Downs gets away with murder, he gets \$7500 a speech, generally about 40 minutes long, he generally has the topic of the year. I'm on the platform

with Tony at least four or five times a year, generally gives the same speech, I always hope to be there at the turning date, like the date when you go from winter underwear to your spring underwear, change in his speeches, but don't always make it. He tends to give the same story over and over, but he has a wonderful story that an elderly couple in their 80's shows up at one of the counselors on marital bliss and sex life and wants some counseling. They're not sure whether at 80 they're missing something or not, and they have a fairly intense session which the counsel with considerable observation of technique, and their marital life and he warrants that they're doing exceptionally well for their age and they really shouldn't have that lack of confidence and they're back the next week with the same doubts and go through another session, and by the third week when they're coming back, why the counselor says now wait a minute there's something that doesn't make a great deal of sense. I've tried to reassure you but you're certainly living life to the fullest and I don't understand why you keep reappearing. And they said well, actually they said they had to confess that a \$50 an hour session with him was considerably cheaper than a motel room, that they couldn't go to her place and he couldn't go to his, and that furthermore they could charge this to Medicare. And he said in real estate the basic principles that you needed for real

estate investment today you have to have creativity and imagination. You have to have some sense of cost control and a real knowledge of government regulation. And then on that basis you could move into real estate investment as well as a happy old age. What we really need to begin to look at is that kind of program, creativity, cost control, and ultimately a knowledge of government regulations.

The investment market goes through various fads which really aren't investment and quite often get confused with investment. We went through for an era the finance driven investment--golly, I can borrow more money with real estate than any other way and therefore, if I can get a 30 year fixed interest rate loan, ultimately I will rip off the saver because as interest rates rise I enjoy significant advantage relative to those that actually saved the money and made a loan to me through an intermediary such as a savings and loan or a bank and the finance driven investment really wasn't an investment at all, but really was simply an arbitrage between the cost of savings and what I could make on the borrowed money. Commodity speculation not an investments really, the second level of real estate investment that we went through was the so-called tax revenue investment. That if I could create sufficient depreciable assets I could lose money and make money, as long as the cash lost per year, was less than the tax

savings to other income, I was still doing well. And the tax driven philosophy is not obviously what real

estate investment is all about. We just recently completed what I would call a fee driven investment. The professionals pushing forward on projects in which they enjoyed an architectural fee, an engineering fee, and a contracting fee, and a syndication fee and a counseling fee and a marketing/leasing fee, and God knows what else they milked out of the project. And if the project fell flat on its face that was unfortunate, but the fees were at least into other entities that had not signed on the line. None of those are real estate investments. We also have a subsidies driven investment. This isn't a bad idea, but if I don't get my share of government subsidies somebody else is paying too much for it philosophy. This is what you're seeing going downtown. I don't blame Mr. Mullin, if the City wants to subsidize my hotel at 47 different ways from Sunday. Why wouldn't I sell them a hotel they don't need? We're all jealous of the fact that he's there first and if you're going to dip into the honey pot of municipal works funds.

So what we're really looking for is an investment that has two basic rational objectives if we take away psychic income. We want to evaluate the investment to the degree that it increases our spendable cash, or it increases the liquidating value of our net worth. If I look at a real estate investment to the degree that it increases our

spendable cash, or increases the liquidating value of our net worth, that is a legitimate objective of investment and those other elements may play in some part of that but are not the reasons for the investments. When you lose site of that, you lose your shirt.

Classic appraisal theory made some rather severe assumptions about that process. If you look at the classic income approach, capitalized value--it said net operating income of the property was constant, or would fall along a mathematically predictable line. That we could divide that by a capitalization factor which includes one, a constant return on capital and a recapture of capital. Three, that the investment was always an instant investment--all of the money went out, boom, at an instant rate. Not unlike calling up your broker, making the deal for a share of stock and closing on the stock by sending them a check. There's a fixed point in time when all the money went out the door and you were now in the investment. And correspondingly there was a fixed point in time in which you exited from the investment. And, finally, you held the investment for its entire useful life. In short you acquired a wasting asset. And appraisal was concerned as the economist was with the asset value created. If after you spent all that money, was the present value of the benefits equal to or greater than the present value of the outlay, if so, they have a

legitimate investment. It was asset valuation. Now think about that for a while. The economist and the appraiser at that point were really concerned with, do we need a marginal dollar of investment in let's say, a steel mill or an apartment building or so forth, or did in fact the returns at that point start to fall to a point where investment was no longer justified and we should really be allocating those dollars of capital to something that would presumably justify the investment in the capital. The investment model, the capital asset pricing model if you want to call it that, was in fact a way of allocating and rationing capital to those things which justified the use of the money.

And along came a guy named Ellwood, but he really spoke for lots of folks who were thinking about it, and he was a mortgage lender, and he still had that fixation that all of the money went out the door at the time of closing. So he didn't have any problem with the fixed point of investment and some fixed point of disinvestment or sale. But he did have some problems with the idea of holding the assets to the end of its useful life. He said that's kind of unreal. As the asset of operations become better known of we'll run finance, we'll sell, we'll modify our position. A five to ten year forecast is about as long as we're going to be in a real estate investment, and therefore, we really ought to

adjust our investment in such a way that we expect to get most of our capital back from resale rather than income. Therefore, our capitalization rate need not emphasize the recapture factor. Indeed, since both of us are now experiencing inflation, we might even have a negative recapture value. In fact we may get more capital back on resale than we ever put in the deal in the first place. So far so good? Furthermore, he said, that we're really not interested in an economic opportunity cost of money sort of thing under an asset management model, we really need to recognize the different sources of capital because they have different levels of preference of claim on the income, they'll have different costs. We can have the first mortgage and an equity position at the minimum, and that the first mortgage because of its preferential position probably will charge less in interest than we can earn on our money, then it will be positive leverage if you will, there will be an equity buildup to the benefit of the equity as we amortize the loan not on a basis of whether the asset is depreciating or not, but simply on the fact that we're amortizing the loan according some financial schedule. And we may have more than one loan. And we may have more than one kind equity interest. We may have a preferred equity interest which in the stock market we call preferred stock, and we may have the residual equity interest, which in the

stock market would be common stock but we can call that different kinds of residual partnership positions and we can have different splits of the ongoing operating income and the resale value of the property and so forth in real estate, but in any event we have a series of claimants on the income stream with different levels of preference. And if we introduce that idea, than what he's really saying is that real estate is the sum of the present value of the claims on the asset. It's the sum of the liability. Real estate value doesn't have anything to do with the asset productivity. It really depends on the arbitraging of different discount rates for the different sources of capital. If lenders want only 8% on their money and equity investors want 10% on their money, the more we can borrow the higher the value of the property. It has nothing to do with the net asset value. It has nothing to do with the net productivity value. The income doesn't have to change. Only the perception of those who will share in the income has to change, only their shares, and how they perceive the risk and the discount factors they want to apply to that risk. We only have one capital asset pricing model. Every interest in the real estate has its own capital asset pricing model. There will be slippage there, there will be arbitrage there in terms of the risk perceptions. And so we move from looking at real estate as a productive asset to

looking at real estate really as a manipulation of liability.

That proved to be a disaster, in terms of the real estate investment trusts and many of the other groups that were very very clever in structuring their financing for short terms but watched it come apart when the commercial paper rate went this way or the interest rate went that away, or people changed their risk perception. Last week in Dallas we went through a lot of data which shows that in Dallas cap rates are 75 to 100 basis points higher than the rest of the world for a leased building. That's the way people perceive Texas and the Southwest as a different rent risk category. Obviously if not all investors perceived the same risk, there's obviously bargains to be bought, and people are traipsing in from all parts of the country seeing if they want to buy an office building in Houston or apartment buildings in Austin, or wherever--simply because the differential now has perhaps exceeded what people perceived as an appropriate risk adjustment for that area.

The third position, however, is the one that we're really talking about in real estate investment today, changes in net worth, change in spendable cash. And the traditional assumptions are abandoned. First of all you would trickle into a real estate investment. You paid an option on a piece of land, maybe you sell off a little piece

to somebody that wants to develop a small portion for something or other, and that gives you enough money to find an architect and a developer to joint venture, you get their money in first, you trickle into an investment. Often times, though not totally true, there is no fixed point as to the point that you are now invested. And by the same token you can do, kind of clamber out of a real estate investment. It takes you a while to search for a buyer and then the buyer wants certain concessions or you gotta clean up the property because of the asbestos, which means you put a little money in in order to get out. And finally they want sellers financing, and they want an escrow account to guarantee that the certain warranties you made are true, and you extricate yourself over several years span of time. Gone is the nifty fixed date in, fixed date out. Which really came out of the bond psychology of many real estate investor in which there was a date in which the interest coupon rate started to run and there was a maturity date when the bond was payable. You know, neat little given calendars of events which could be programmed into your investment. Those don't exit in real estate. The real estate investment you trickle in and you kinda extricate your way out.

The next problem of course, is that income is no longer predictable along a mathematical line. We don't deal in

normalized and stabilized income statements. Part of the reason for that is that for the equity owner, some of his profits aren't even in the net income phase. Many of the equity owners returns are in the expense stage, because its his construction company, and leasing company, and insurance agency and others that are taking a small profit as the dollars pass through for performing the services that are necessary to make the property operate and create the property in the first place. Highly irregular income from period to period, depending on what kind of expertise are required, depending on what the tax bite is, and for that matter, depending of course on the lease. I've got a five year lease in which the first 18 months are free. That puts kind of a kink in your income stream. The only way to account for all that is on a cash basis. There is no way that accrual accounting can tell you really how you're doing in that case. So when we say spendable cash, we mean cash, we do not mean accrual accounting. Real estate investment and accounting fraternities are going in opposite directions at the moment. The accountants are going back to economic productivity, which is asset management and asset measurement. The real estate fraternity is going towards cash management. And there's a fundamental clash brewing in fact it's already out there, is how do you report that?

Someone asks a question. They're concerned with the net worth of the bank, not whether the current operations are solvent. So maybe life's a series of short runs, maybe it's much more important that the bank is currently solvent in making money or breaking even, as to whether its measure of value versus liability tells you anything. The major banks in Texas are solvent but they're probably not having positive net worth. So which do you want? So we're interested in cash management for real estate. And it's a highly erratic kind of cash management. So the classic capitalization rates divided into normalized net income really aren't very relevant to anything in terms of investment value. When you really need to know the present value of cash. And specifically we need to know the present value of distributable cash because a real estate property of any kind is a small business operation and as Mr. Drucker has pointed out in one of your articles, in periods of uncertainty, the enterprise needs more and more cash to provide for working capital, to provide for asset enhancement, and maintain its competitive position. To provide a cushion as it were for short aberrations in the revenue line, because tenants move out and obviously need money on whatever. So you need working capital and we're only concerned with distributable cash, spendable cash, that's the meaning of the word spendable. If we can

sprinkle it around some place other than in the business. And obviously that's going to occur on a quarterly basis or an annual basis or whatever.

Ultimately, the rational investor probably wants to accumulate a net worth, probably I should say. There are a few that say, being of sound mind and body I spent it. Therefore, I leave my heirs to conscious but unremitting regards. Perfectly legitimate position. The emphasis is entirely on spendable cash. Weight placed on net worth, zero. Obviously most investors have some other balance that they wish to set between spendable and the so called liquidating value of their net worth. The term liquidating value means just that, what's the cash value, what can I exit with by taking my cash and going? And that becomes the other component that we're trying to measure. The point in time of course, is a critical issue, am I going to do this annually or I am going to do this only when I depart this fair earth, or am I going to do at an selected points along the way? But one of the critical problems of real estate investment today is deciding how often you should take the temperature of your investment. The mind conditioned by the stock market wants to look in the paper every morning and decide whether you did well or not yesterday. I could never figure that out. A guy owns 100 shares of stock is going to decide whether he's going to buy lunch today on whether it

went up a point yesterday. At the same time you have a bank rule which until very recently said that every month the bank must report the value of the trust assets. Conditioned by a time in which you could look up in the paper that the bonds went for so much on that date, and the stocks went for so much on that date, and the CD's went for so much on that date and so on. There's something about real estate that one, the evaluation process isn't that precise, nor is it that inexpensive. Those banks who in their generosity said, don't have to determine the value every quarter, golly. If you look at \$100 million office building and you try to measure how its productivity and its value in the minds of the next buyer has changed from three months ago, come on guys, gee whiz. I looked at one the other day a bank building which was worth \$42 million in January this year is now reported by the appraiser, the same appraiser, to be worth \$34 million as of a week ago. And yet the number of tenants in the building went up. There's something wrong in the process there. Maybe we ought to just let the cake bake in the oven and every three years take a peek at it. How are we doing? Has the liquidating value of our net worth gone up? It's a really tough problem in real estate to measure performance of the asset. Because if you keep looking in the oven too often the cake will fall. And if you look at the real estate from day to day it is tough to

see what are we doing wrong now. Down at the Investment Board it has what, \$300 million a year in real estate? And out of the three hour meeting you have to spend an hour and a half wondering what the hell happened to the pet shop at a shopping center in Southern Florida which rented all of 800 sq. ft. and we're representing a monthly income somewhere in the neighborhood of \$800. And they were really upset with it--pet shop has gone away, what are we doing about that? Who cares? But then once real estate concerns with that quest, that you don't go with a sense of historical flow. Those with a sense of history about real estate in the making, have no real problem with the fact that they really don't know the underlying value from year to year. That in fact it may be better if they don't where they're at nor do their creditors. I looked at 15 major apartment projects in the City of Madison that were syndicated in 86 and 85, and 87 and there isn't a one by today's appraisal standards that has a positive net worth. That if you value them on their current net income, using reasonably liberal cap rates, the 221D4 mortgages are all greater than the appraised value of the property. So are investors losing their butt? I don't think so, most of all since they have other sources of spendable cash, so its not a major problem, I guess I'll go to Florida and lie in the sun and figure in another year or two the values will be back up because interest rates may

have gone down and inflation may have made it impossible to build that and more folks will have moved down and filled up the vacancies. Ho-hum, why worry. You gotta go with the flow. That's very hard to in real estate if you've been conditioned on stocks and bonds and looking it up every morning, it's just isn't going to work out very well. You and real estate are not going to be very compatible, but you do need to have a sense of the order of magnitude as to where you are on the liquidating value of your net worth, you won't need to plan your estate taxes at an unexpected and relatively abrupt moment.

So spendable cash, and the liquidating value of your net worth is really the rational framework around which we'll try to build a real estate investment program, and the more you want to emphasize one over the other, the more concerned you are with precise measurements of one thing or the other, we'll change the structuring, we'll change the choice of investment form, but we'll stick with those kinds of investments which essentially are backed up by equity assets, as opposed to mortgage assets although occasionally the mortgage will creep part of that flight. Okay, I quit, I'll see you on Monday. All of you should have received by now 795 schedules....(fades out.)

Computer stuff administration.

The subject matter for today is laying the groundwork for cash flow models. Certainly there once upon a time when we began cash flow modeling projects generally had rents and they had operating expenses and they had net operating income and there's a principle deduction and that was pretty much it. Then if you added back the principal and subtract the depreciation you were at taxable income and then all you needed to do was compute the taxes and presto you had cash available for distribution. Things have become more complex and see, twenty years that have past since that basic insight to the real estate occurred, and while we all tended to do ____ (can't understand tape) _____ to the abstract idea that the present value of the investments would be the differences between revenues and outlays, nobody really made that operational. Today a cash flow model of any form which presumably is going to represent first, the change in our spendable cash, second of all hopefully the change in the liquidating value of our net income or liquidating value of our assets and that should begin to account for the receipts and hopefully far more detailed back. They must also do it by converting quite often, the traditional accounting GAAP format to a cash accounting view of life. Ultimately the investments boil down, the cash in, the cash out, what falls out on the bottom line in the way of cash after everybody else got theirs including Uncle, the state, the

local community and who ever else had some prior claim on that cash stream, and that is what the investment boils down to. If you talk to Northwestern Mutual, they may have a land lease on the program, they may have a project, that may have an equitable interest in the corporation that owned it, they may have a first mortgage with some sort of income participation featured, but when they report it ultimately the investment committee, it comes all the way down to here were the negative outlays for a period, here were the positive cash receipts for a period and while the accounting may have made significant differences in terms of the regulation of their institution and perhaps the tax impact of their position when all is said and done they simply want to know which periods were negative, and which periods were positive and by how much and now if they want to convert that to some sort measure such as modified internal rate of return or some other cash-on-cash ratio, wonderful so that it's quite discouraging to take a real estate project and first explode it into an infinite number of accounting categories and timing periods etc., and then implode that to point where you aggregate everything down to a fairly basic notion of when did the cash go out and when did it come back, and nevertheless that is ultimately the essence of it. Much of the illegal structuring that goes on after that is simply to create artificial risks and regulatory categories

with which one can deal in traditional accounting formats rather than necessarily investment formats.

So now if we look at the one handout I just gave you, expected receipts can come in a variety of forms for rental properties. Base rent. On the cash accounting basis the base rent would be level if I signed a contract for \$50 rent over a period of five years but it wasn't due and payable until the third quarter of the fifth year, the income in the first year would be zero, the income in the second year would be zero and thereafter it would be presumably somewhere in the neighborhood of \$18 and something per year. \$18.33 I guess, to be exact. And GAAP accounting would have fits over that. As far as they're concerned your income is going to be \$10 a year over the five year span. That won't do you much good if you're looking at an investment standpoint as those first couple of years really represent continuing investment in the property from negative cash flow. The base rent monthly obviously may be sculptured to fit the season of the tenant and maybe sculptured to fit the fact that the project is only partially done and that abatements are being provided because the parking ramp isn't finished, or all the tenants major anchors aren't in the shopping center, or perhaps the civic improvement that were to provide truck access to the property are not completed

and so on. But in any event you need to understand how that base rent works out on a cash basis.

Today there's typically an index to that base. That index obviously will have different points in time when it kicks in it converts the base into what we call a step rent. And it will gradually step up, occasionally it steps down. In the late 60s and early 70s it was fashionable largely because of Ellwood--the Ellwood tables as you remember had a supplementary table in the back that said, "Gee if you release it at 50% of the original rent, the 21st year you will get this additional deal to equity and so forth and a lot of people structured it that way so that it steps down which are obviously disastrous currently as the tenant has the option to renew the lease at a rate which is continually falling and at absolutely no relationship to current market rents on the property at all." And next time I'll show you that provides some significant opportunities as it may be, for buy low sell high, but in any event the index to base rents becomes a very significant factor in the risk analysis for two reasons. One, you'll need to have some sense of how that parallels the potential devaluation of the currency over time and secondly how does that in fact determine the cost of occupancy to the tenant. If it's stepping up too quickly all you're doing is guaranteeing that either the tenant won't renew, or that he'll go broke or that he'll

find some device to break the lease. And somehow wiggle out from what he finds an onerous rent. For example the state's initial occupancy of the πR^2 Square, the step rent there was such that given the fact, one it's a loosely building, and two, the landlord wasn't in fact correcting his very significant physical deficiency, and three, the step had taken several dollars a square foot over the market rents available for much better quality space then the State went to war, broke the lease and moved out. Leaving a mortgage in default and equity that got wiped out and a very real problem for the Village of Shorewood. So you need to be able to look at the index not only in terms of how well you're going to do in the future, but what risks that creates in the project per se and to what degree is the value you're paying for that property dependent on achieving and collecting those adjustments.

We come back to looking at the Dilmore componentized approach to life, one of the articles found in your reading package. Percentage rents most of you are reasonably familiar with, tied to the retail sales. Percentage rent for the investor is a clue again, as to the character of the property and its risk attributes. Many properties that were leased in the 70s on the early 60s are generating large dollars on tax percentage base. That doesn't mean the tenant is necessarily doing well, it simply means the base

was set so low that as inflation perhaps exaggerated the gross sales and so forth, the percentage rent was reasonably attractive. Convert those percentage rents back to dollar per square foot additional rent, add it to the base, and you may find you're still well below the market. By the same token the absence of any percentage rents at all from a lease that anticipated that there would be some, may not be a negative factor at all for the investor, it may in fact be the clue to opportunity. That here is a tenant that would be happy to go if somebody would let him, maybe he doesn't know that that's one of his options. There's a wonderful line about the young man coming to pick up his date for the evening and the father scowls at him and says, "Young man are your intentions honorable or dishonorable," and there was silence. The father looked at him with a glare and he says, well sir he says I'm thinking, first time I knew I had a choice. It creates tremendous value for property by taking a tenant who is laboring under the lease, who may be perfectly honorable and never thought that with four years to go on a bad lease that somebody would say, "Gee Charlie, maybe you need a smaller store in a different location or you're 64 and close to retirement, maybe we can help you into your retirement. How would you like \$50,000 to go away?" And the ultimate down in West Palm when I invited K Mart to pay us \$100,000 to go away, instantly increased the

value of the guy's property by at least half million to a million dollars simply because they hadn't paid any percentage rent, they weren't doing very well, they overlapped two other K Mart stores. The fact that they were seeing percentage rent was an opportunity from the investors/buyers standpoint. May have been the whole ploy of buying that particular property. So you want to look at these items not necessarily because they have a specific dollar amount but you want to look at these items in terms of what do they tell you about the tenant and about the upside, downside risks, of the property. That's a critical element.

The next point is amortization of tenant's improvements. A good many properties that look good from the standpoint of gross dollars of receipts, from the sellers standpoint are hurting because he has to release against current operations obviously a great deal of tenant improvements that he paid for in order to get the tenant in in the first place. Asset management is your ability to buy future income by making tenant improvements now. For the individual going into the deal it's a sunk cost as far as the seller is concerned, so you don't want to look at that aspect, you look at the tenant improvement component of rent as simply additional cash flow and it's quite possible that you'll be discounting that component of rent which

represents tenant improvements at a much higher rate and therefore, discounting significantly the sunk cost as far as the seller is concerned. Flip it around the other way, what if the tenant improvements were all made by the tenant. Nothing is built into the rent and in a strong sellers' market the tenant gets that work done. That tells you a great deal about the quality of the lease and the security of lease. That tenant isn't going to take a walk on his creditors possible afford not to. The small specialty shopping center in which Ma and Pa have a sewing shop and somebody else is selling knitting materials and third one has a hobby shop and so forth, you want to get those tenant to invest heavily of their own money in that property, they'll work at that property if they're making \$2 an hour rather than take a walk on it. In effect, you have a very back handed subtle kind of guaranteed fund built into the project because the tenant finished it off at the time going in. So the fact that there's no tenant improvements built into the rent may also be a desirable factor if the tenant has made significant investments. Or an apartment building for example, which rents on a three year basis, may be a little under the market in terms of base rent but if the tenant put in his own carpeting and his own dishwasher and so forth and so on, you have very stable occupancy because they're not going to go anywhere and leave that behind. So

look at each one of these in terms of whether there's a potential risk component, and in Ellwood instability in the future of the project, or whether it really represents a statement of opportunity for the investor.

The same is true of common area maintenance (CAM). Common Area maintenance fee is often contained, as you know, a profit margin for the management. Typically 15% or 20%. You want to be careful as an investor that you don't let that profit center drop into your net income line and capitalize that at a capitalization rate appropriate for real estate but not appropriate to running a small bill me Monday accounting firm. That profit center has nothing to do with the real estate, that profit center has to do with a service component that means you've been out collecting the funds and hassling with them on the books and all the rest and that 15% or 20% is a temper profit center and should not be bought at the same discount rate that you apply to real estate. By the same token the investor wants to look at CAM agreements to see the degree to which they include various aspects of relatively high risk in the project. At one time CAM agreements covered essentially the external maintenance, the striping of the parking lot, the operation of the lights, the snow plowing, the plaza maintenance, that kind of landscape matters and so forth. It had relatively little to do with the interior of the building other than the

possible exception of the lobby and today of course, it's canned, you collect in advance, monthly and the thirteenth month adjustment for over or under absorption as the case may be, and of course get your profit monthly and so forth, it's desirable as far as the developer and owner are concerned, they have lease agreement which put everything in CAM. Go down to University Square virtually everything in University Square is in the CAM account, with the exception of some air conditioning units which the architects and the leasing guy weren't coordinated on. The architect has a couple of air conditioning units servicing more than one store so that it's getting impossible to allocate the costs of responsibility for those to a single tenant which is a classic case of too late smart and that the leasing got sharper and sharper and allocating costs and somebody forgot to tell the architect about it and as a result now you have a mismatch between what's physically possible in terms of accounting allocations and what is financially/legally would be desirable in terms of those allocations. CAM, reimbursables.

Reimbursables generally involve an outlay by the management, the ownership, that can then be recovered by proration in one way or another to the tenant, typically on an annual basis, so you have a tremendous lag and float problem. You make the expenditure let's say in June and

August and son of a gun now in December we add those all up it's January before we got the bills out to the tenants, it's February and March before they have paid us again and the landlord or owner investor is obviously banking those in the interim.

Escalators with a stop may be a blessing or otherwise depending on what level the stop was negotiated at. Everybody know what a stop is? The landlord pays up to a certain point and stops, so if you'd agree that's \$2.50 a sq. ft. when the classified expenses under that stop clause reach \$2.50 at that point they shift over to the tenant. Many buildings particularly the buildings leased to smaller less sophisticated tenants often set the stop base on the first year of operation, which in the case of the new building means that real estate taxes are relatively low, you get your real estate taxes lagged by a year. You start your project on January 2nd and you finish it in September, the assessed value in January 1 for the succeeding year's payment is the value of the land on January 1. None of the improvements go up on the tax roll. Now if you can collect from your tenant one-twelfth of the estimated taxes wonderful or you can say, "Gee, look at that, stop in the first year expenses only \$2.47 and the stop was \$2.50 and you didn't pay anything and why on the following year now the real estate taxes come in and \$1.25 a foot jump right

off the bat." In other cases many of the buildings stop provisions have been indexed in years past. So even if you come into the project today, you'll find the stop clause index must pay off 1980 or 1978 so that the appearance that you're paying \$3.50 sq. ft. is just that. The stop clause has long since been operational and you will pay the full boat above \$2.50, \$3.00, whatever it is. Again, the investor coming into the project needs to read those leases and find out where that stop clause kicks in and where the tenants are on that. Again, there may be a way out of there. If a tenant is particularly irritated about something or wants a new store front or needs other factors to negotiate their way out of the stop clause this onerous and given some other intangible element.

Today, as we learned in real estate finance, many buildings are required to have reserves. FHA would require on all subsidized and 221D4 projects that a certain portion of revenues be set aside in a sinking fund that is available for short term modification and renovation of the project. They control the principal, but the interest being earned on the account, belongs to the project and can be swept into the project and can be capitalized in the income stream for mortgages and valuation of the property. Indeed the wise seller pays to get you to first of all to set a price on the property, and then when you get your closing statement you

discover that in addition to the price of the property you are now buying the reserve which travels with the property. HUD would not let you cash out the reserves simply because you sold it. As far as HUD's concerned it's there to protect the mortgage and the sale would essentially transfer the right of requesting to HUD to use the funds to the new buyer. HUD would then approve capital expenditures for deferred maintenance or asset enhancement, and those funds can be substantial on a project that's been around for 10 or 15 years. In projects which do not involve HUD but have let's say a significant component of relatively depreciable property, a hotel, or a restaurant, or something similar, the lender may require a satisfying sinking fund. In properties that you purchase as an investor which have yet to meet the occupancy clauses that are required to generate the full amount of the financing and so forth, again, there may be reserves which are generating interest. The interest can be swept into the income pool of the property.

Government transfer payments, some of which may be negotiated, some of which may be deferred in one form or another are also available for the benefit of cash flow. For example, in Minnesota, the TIF Fund which might be created by the difference of the project, may be able to pay directly into the income stream an annual amount of money necessary to carry financing for the project that made it

possible when the basic income during the early years of the project would not have been adequate to provide the leverage necessary to go forward with the project. It may well be that the small business administration has guaranteed the lease of the restaurant on the first floor and guaranteed the timely payment of that, and even though the restaurant may not be doing well, it may not be making its payments, the small business administration will be making transfer payments to the enterprise and so on.

In effect the receipts of the real estate investment today are much more complex than something called rent roll and our clues not only to the potential cash revenue of the projects but also to the opportunities of the project. The asset enhancement possibilities or in many cases the leasehold elements. And once one understands those, you can make some very different kinds of deals that don't fit what the Institute of Appraisers say is value and so on. Let me give you a couple examples. One you probably heard me talk about before is the old Sears Roebuck warehouse out on Fordem which was done by a local investor who wasn't very sophisticated in fact had a knack for making the wrong contracts I think for real estate left his children with an estate full of properties everyone of which was a disaster. Maybe with one or two exceptions, that accidentally turned out all right, and in that case he essentially had gross

rent lease on that warehouse with Sears made in the early 60s and then refinanced it with an adjustable rate mortgage, so the mortgage is going up, the taxes are going up and so forth, he had agreed to replace the roof and do all new exterior maintenance, all those kinds of preventional clauses. By the time he had died it was at a break even basis with interest rates rising, the group was now 25 years old and expected to leap momentarily. Sears was really no longer using the building except on a very small corner for an appliance repair shop and had leased out the remaining space at market rents to a point where even after all of their payment they were making money on the warehouse and enjoying their appliance area for free. The estate appraisal indicated the value of the warehouse was a million dollars at market rent of which there was a \$900,000 leasehold value to the benefit of Sears and a \$100,000 net equity value, which the IRS challenged and when they perceived the box that the estate was in concurred, particularly with the roof coming up for repair, and the estate having no money. But if you understand Sears they don't want to be in penny ante accounting and real estate business. So we simply wrote Sears a letter after they had tried to sell the building a couple of times to others, and we said, "Hey, you got a \$900,000 interest in the building but you are going to have to be in that rental business to

the year 2017 or whatever it is, which is a tough way to earn a buck. You must have other things to do with your real estate staff and so forth, tell you what we're going to do--we'll give you our equity for \$100,000 and make a \$450,000 payment for our share of your leasehold interest and for \$550,000 you can buy a million dollar property. It was a good deal for both sides. Notice it enhanced the liquidating value of the net worth of the seller. It certainly enhanced the liquidating value of Sears, whether I couldn't sold the leasehold thing for very much anyway, because who wants to buy into a property that's going to evaporate in the year 2015 and what's more you're not sure whether the landlord is financially strong enough to maintain it like he said he would anyway. You need to look at both sides of the situation as an investor to see whether you can't reshape that revenue line, add to the seller or the buyer.

Property which our fund owns down in Phoenix had a Woolworth store on it. And the Woolworth store went out of business for one reason or another and released to a home lumber products group at a significant rent over and above the base rent that they were paying. Let's say that they were in some years back at \$1.60 and the new tenant is now at a \$4 base, pays their own operating expenses and so forth. We went in simply on the basis of a couple of legal

cases which said hey, if you got a percentage lease clause in it and all you're doing is paying base rent and not producing any percentage rent and at the same time you're making additional income from the new tenant, that has violated fiduciary character of the percentage rent clause and therefore you have to pay them their share of the take over and above your base rent. Now first of all we enforced that, then we back on 'em and said, "Hey you guys really don't want to be in the real estate business in Phoenix. So what will it take to get you out of the property?" They said a million we said five hundred thousand, we settled at \$600,000 and created \$2 million worth of value for the property by taking the sandwich out of the middle. So the revenue line represents the source of opportunities, as well as source of risk as far as the investment is concerned. And we'll spend more time talking about risk in just a little bit.

The loss of potential receipts obviously is a significant element. Vacancy losses today are certainly one item, but more likely today are the concessions. In a chronically over built market the necessity of competing for tenants by providing concessions in the form of tenant improvements, lower rent during early years, reshaping of the curb, sometimes even participations in the bottom line of the project has much more impact on the net receipts than

perhaps the vacancy problem does. Vacancy losses of course include not only loss of the base rent, percentage rents and so on, but today also represent significant losses in terms of some of the reimbursables and so on. But one of the interesting features of CAM is that the well drafted CAM clause distributes the burden among the existing tenants so with 80% occupied you're still collecting 100% of the CAM expenses. In this case the tenant is going to come back typically represented by a tenants broker and say OOPS hold everything here, 95% occupancy is typical for this project and therefore I'll pay my pro rata share for the first 5% vacancy but after that vacancy losses are paid by the landlord and he protects himself from having increasingly high CAM expenses as the project becomes less and less occupied.

Rent collection losses today are a major encroachment. Rent collection losses stem from the nature of the tenants, do they have the resources to make good on the contract amendment. With the majority of the tenants today being relatively small, service oriented enterprises, they typically don't have the net worth, nor the inclination to pay the rent if they don't keep the pace. If you have a law firm or an engineering firm, and of course this what happened in Houston and Dallas and so forth, most of the offices were occupied by service firms, professionals,

engineers and so on that were involved in some aspect of the oil business. At the end of the year the partners divided up the profits and distributed them. They maintained whatever net worth was required to operate the office and they don't leave assets behind in a corporate shell, not only because they don't want to be liable for rent and so forth, what's worse is they could be liable for professional consequences of what they were doing and the cheapest form of protection against professional liability is a good corporate shell so that when they're sued there's nothing there and you're relatively judgment proof. So when the oil business went to hell there simply wasn't the staying power in the tenants, not to mention the will to make the payments on the loan. It doesn't matter if he had a 10 year lease from the XYZ engineering firms that employed 100 people at the time they signed the lease. What really mattered was they had a net there and cash available in terms of working capital and so forth was really \$300,000 and that was adequate to cover two months rent and after that they were gone and you had this nice piece of paper that said they owe you for another four and half years but it's not collectable and therefore, you really need to evaluate your tenancy in terms of your ability to collect. Some of you saw the appraisal in 856 with the Coast to Coast store, there you have a national credit on the basic lease who then has a

style subleased it to the local operator entrepreneur and after he went on his way Coast-to-Coast was still continuing to pay the rent even though his lights were out and so on. So you need to look at the potential for collection losses that are eroding the expected receipts.

Receivables also become an interesting asset to be acquired. Some managers are better able to collect past rents than others. I've seen a number of buildings in which the net rents were 105% of gross rents because the new management was so effective in collecting, the collections losses from previous periods. In any event you need to analyze all potential sources of losses of receipts to come down with the actual revenues from operations. The gross outlays from operations are relatively apparent obviously, but it is extremely important that as an investment you never net those out, you never report CAM as a net item because of the time delay between the time you make the expenditure and the time you get the receipts. Now in the case of CAM they're generally ahead of the tenant, they're generally getting 1/12 of the cost long before the cost is incurred, that's what you try to do obviously depends on the seasonality of it. Reimbursable, just the other way around. You generally collect considerably after you actually made the expenditure. Escalator items also typically are over and above a base cost.

Owners costs are a tricky item. More investors and appraisers fall afoul of that than any other item and it's important for you to delineate what is the entity that I am evaluating? Obviously the first entity, the goose that laid the golden egg may be the real estate. The second entity however, may be the partnership or corporate entity that owns the real estate. And the third entity may be the entity which owns an equitable position in the real estate. Each of them has certain management costs. If I were to own the property outright as an individual and I've decided my management costs were 6%, they could be all charged to the real estate. But if I own the real estate in the partnership, the actual costs are about 5% of the partnership and the accounting and liability costs are charged to the partnership, in other words the real estate as a functionally operating entity has one set of costs, the ownership entity has a second set of costs. Communication with the partners, legal tax finagling with the partnership and so forth and so on and finally you're down to a distributable revenue to whoever owns it. But now if I have an asset manager in the way, the asset manager may be nicking me for another 1%. The asset manager is getting paid for having selected this investment, and monitoring its performance, and providing other advice and so forth to the investment side. You have to be very careful in looking at

a statement in terms of the potential investment receipts as to whether I'm on the right level in terms of what I'm evaluating. Am I evaluating the real estate, am I evaluating the partnership, or am I evaluating the performance of the commingled fund which happens to own a partnership as a result of being advised by an outside advisor to own it. There's considerable shrinkage obviously as you move through that process.

The fees charged today for management of the asset are incredible. In fact once you see those you'll decide, "Gee, I don't think I want to own real estate I just want to know folks who do. I'll advise them and make them feel better about it." Just a selection of which commingled fund to buy and monitoring it is worth ten basis points a quarter to Frank Russell or somebody. So they take in \$20 million worth of real estate and ten basis points a quarter on that's what? \$20,000? Right. So you get \$80,000 a year for telling you what it is you should have bought and how it is it's doing once you bought it. And the hold harmless clause on that is pretty good. There's no guarantee that it's either going to go up or down or sideways. Any operating errors those are the problems of whoever is really operating the real estate and so forth. You build up a good portfolio of management you can do very well. You can spend a lot of time interfering with the managers and still have a net for

the year. So you need to know what the owner's (end of side one) costs are and should they be allocated at this particular level of an analysis. Refurbishment is typically something that is left out of outlays for operations but if you think about it it really is simply an ongoing expenditure which doesn't fit the annual fiscal period kind of thing but it's critical for maintaining market position and stability of the revenue stream. The hotel with its refurnishings, the apartments with its persistent upgrading of the facility, and for that matter for an industrial building or retail building the continually upgrading of the HVAC and the other relatively volatile operating costs become a critical element. Too much refurbishment means somebody chinsed obviously in the construction of the building. Judge Patuba (?) of course used to rebuild the building out of income, and he built such a shoddy building in the first place why you could see expenditures on his outlays for insulating the building always seemed to me that would be original construction cost and exterior painting, doors. The First Wisconsin had several cases in which Judge had a chattel mortgage on the door and windows which had to be added later after the project was built. The quality of the original installation was unacceptable.

Tenant improvements for renewal--renewal lease commission obviously become significant outlays. Property

management is concerned with executing today's contracts. Asset management is concerned with buying tomorrow's contract. You buy that obviously by acquiring new tenants or renewing existing tenants, by refurbishing the property, etc., but they are all part of the real operating outlays of the property, and it comes down to total cash from operations. Again the singular characteristics of the property will give you an indication of opportunity, as well as a significant indication of risk. Each of these, of course get extrapolated out over at least of all 1/8th per year. As you get more refined in your estimate, probably over six months.

Capital charges include interest payments, principal payments and capital improvements. Interest payments and principal payments are not defined necessarily by a fixed interest mortgage with progressively lower interest and progressively higher principal. As you know today the interest payments may be on a regular adjustment basis. Principal payments may be on a sporadic quarterly payment or whatever and the result is that each of those have to be programmed from the contracts that are involved. Most purchase agreements today include some rather stylized principal payments at specific points in the future rather than a regular amortization of the debt. Indeed that may be one of the significant opportunities. The seller looking

down the road and seeing that he now has to raise so many dollars by 1991 may find it opportune to bailout now and let somebody else worry about what interest rates may be in 1991 after we come back to some economic reality. And the buyer, of course, has to anticipate that he may have to pay down the existing mortgage to come up with the appropriate amount and that may not be a bad thing at all. If you have a pension fund which has commitments to get so many dollars from his sponsors for let's say the next four or five years, the fact that there's a mortgage coming due in 91 is wonderful, it knows where it's going to go with its money-- it's going to pay off its mortgage and become an all equity deal, and that gives it a significant bargaining advantage over the private sector who might otherwise have to be concerned about refinancing the property now rather than later, or might be concerned about the fact that there's a very substantial prepayment penalty that he would have to discount against the price of the property, were he to get out from under that particular loan currently and so on. So again, the capital payments schedules, principles payments scheduled becomes a very interesting bargaining edge in one case or a seller's cross in another.

That brings us down to net cash from operations before taxes. The computation of the tax payment may have very little to do with any of the above. The net cash from

operations refers obviously to what's being generated by the business. The incremental contributions to cash available, one are going to be transfers from cash reserves, which may have anticipated some of the expenditures above, sinking funds set aside in one form or another and net increases in loan balances that may be possible as a result of either reaching certain occupancy levels of the building, perhaps negotiating a new schedule with the lender, it may even be settlements from tenants who wanted to buy their way out or buy successive favors in the project. For example, shopping centers--anchors on the shopping center are a Byerly's and a Target. The investor owns the middle, sandwiched, Target owns its own store, Byerly's his own store, the sandwich owns the land that's not covered by the pad or the building per se and the parking lot, and the parking ratio has been set by the Target lease which say thou shalt have six stalls per thousand. Target comes in and says to equity owner, we need 3,000 sq. ft. on the back side for new truck wells and so forth, we would like to pay you \$10 sq. ft. for the land. Owner says to Target, we'll give you the land, tell you what you do, reduce your parking ratio to 5 to 1 instead of 6 to 1 and the result of that is that they now have 8,000 sq. ft. pad to put more retail on the front end of the center on a free standing basis which in that case was worth somewhere in the neighborhood of \$500,000 more than the cost of

building the structure. Okay? In effect you now have created instant value of something like, \$900,000 in increase against the \$400,000 construction costs about \$50 a foot and the capitalized value was there and as a result the lender was only too happy to roll up his loan for another \$500,000 and so you have a net increase in the loan of \$100,000 more than it cost you and in effect what you've done is you've sold 3,000 feet of land on the back side for zero and created \$500,000 of value up front which isn't a bad deal, so you may be able to finance out on it plus that gives you net increase in the loan balance which feeds right into the cash, but it's not from operations obviously but from a one time transaction. A great deal of real estate is really advanced by one time transaction of a sale of a pad to a McDonalds on the front end. The provisions of some other access point for one of the tenants, etc.

Once we're net up to how much cash is available from operations obviously there are two elements which are going to reduce that that is available for distribution. One of course is going to be the taxes actually paid and those taxes are going to consist of one, federal taxes on operations, two, state taxes on operations, and occasionally assessments on the property. Disney for example in Buena Vista assesses all of the hotels which are all on 99 year leases from Disney and assesses them for participation in

their advertising program and so forth. The same is true on Maui, I don't think of the name of the hotel development on the west side of Maui, but it's a unique situation in which you have a subdivision for hotels, which the developers on the inland side created golf courses and other types of recreational amenities and then sold off hotel sites all along the ocean, to progressively bigger and more elaborate hotels and assesses the hotels for the ongoing development of recreational amenities and so forth. This is obviously an exception rather than the rule, but it's not unusual. Once you've computed the taxes, then the second element is what reserves are going to be retained in the enterprise before we have a distribution.

The reserves to be retained are critical entries as you will see again later when we start talking about partnership quite often the share of the general partner is computed not on distributable cash less taxes less reserves to be retained in the building, but generally on gross cash resources available, so that there's a significant discrimination between the general partner and where the limited partner's come in because the limited partners are going to share after whatever taxes have been assessed to the entity and after reserves have been set aside out of earnings to anticipate future redevelopment of the project. One of the things that is very important in negotiating

joint venture provisions is defining the base, base line, before and after taxes, before and after reserves, before and after capital income as opposed to operating income in which the managing partner and the investment partners and so forth, participate. And again, all on a cash basis obviously there really is no opportunity for disbursement and people that disburse without revenues quickly dig themselves into a hole. A good example of that, the Irvine Foundation which has a magnificent resource of Irvine California and the Irvine Ranch was required by law to distribute 5% of its net worth each year to charitable and _____ opportunity in order to retain, at that time, their tax exemption as a charity, and the McCarthy Foundation currently faces the same problem. Unfortunately most of the real estate was land which was not generating a 5% return after all of the other deductions and so forth were made and they were borrowing from the bank on a cumulative basis to make the 5% distribution to conform with the law, and of course each year you do the interest the costs the following year is higher and the income wasn't necessarily tracking with the incremental costs so eventually you get boxed into a corner in which you're going to have sell something in order to even the books again. And the McArthur Foundation has had some of the same problems, in terms of assets, incredibly wealthy, in terms

of cash available to meet the requirements of the internal revenue service not for taxes mind you but for maintaining their tax exemption. They're extremely cash shy.

Okay, the basic cash flow analysis then needs some kind of model which is capable of representing the dynamic changes in each of these items period by period. The investor is not interested in a week-by-week, month-by-month, kind of accounting. The investor is obviously much more interested in quarterly, half yearly and annual fiscal budget expectations with a model that's capable of calling the term. And the general magnitude of revenues, outlays, and the items there in. But none of the model are really interested in the specific dollar amount, they're much more interested in the ratio of various elements to analyze the project. Robins is heard to say that essentially you can judge the computer model not by the number of lines of output or cash flow but by the number of lines of ratio and analytical indexes which they provide, and I think there was recently an article in the Pension world that says the whole excitement of cash flow models that go lease by lease have passed and people were now looking for models that were analytical in character rather just simply simulating future operations.

Okay, what kind of ratios do we need, obviously we need two that are interrelated, we need ratios of risk and ratios

of return, and obviously those would be somehow interrelated as we believe or we probably shouldn't believe that. Yield is a function is risk.

Real Estate Club meeting Monday night at 7:00 in room 19. Learn about Manchester Place and the Convention Center. Other announcements.

We've been talking about the conclusions of projections about a property including a pro forma in order to arrive at some measure of yield and some measure of risk. Subdivided yield into retrospective viewpoints of the yield as reflected by how many dollars had been received or made out for a historical ownership period terminated of course by sale or disposition. And prospective yields of looking at the incremental yields of one more fiscal period as it related to the liquidating value of the asset at the end of the previous period and we were able to define that in several different measures. Which either you take, you have a very real accounting problem for the investor in terms of defining that which is income attributable to the real estate, and that which is attributable to other elements of the total combination. Not unlike appraisal, we need to be able to match revenues and time of receipt to a presumption as to historic or contributor of that. You have obviously land and building as a portion of your investment. You have personal property as a factor in that investment, and you

had intangible assets as a contributor towards that investment. Intangible assets being good will, perhaps a preferred access to a certain tenant; perhaps unusual management skills which provide greater efficiency or lesser efficiency, and how to report that on your balance sheet as to what was the return on the real estate investment, as opposed to what was the return on say a small business investment. You buy a hotel you come down to the bottom, the net income stream at that point, by the nature of the accounting, is an amalgam of returns partly from renting rooms, partly from selling meals, partly from running bars, partly from providing parking spaces, and partly simply because you can market individual instead of the state. Good example, Boca Raton Club in Florida is very exclusive, you can't use the facilities unless you are a guest one, at the hotel, two a member in the Boca Raton Club. And the Boca Raton Club you can become a member for \$2,000 a year, entitles you to nothing but paying the same bills that everybody else is paying to use any of the facilities. And they sell about a thousand of those a year, at a substantial piece of income. Is that real estate income or is it a business income? The ability to market an abstraction, a concept, a goodwill, a prestige factor. Why is that important? Because unless you make that distinction how do you measure the risk? The real estate will be there and be

able to rent hotel rooms on and on and on and on. What would it take to kill the prestige factor of a the Boca Raton Club in which for \$2,000 you are allowed on the premises to spend money like anybody else. That's a very fragile product. If you're looking at the total income of the Boca Raton Club would you apply the same capitalization or discount rate, the same risk ability, as you would to an industrial park in which the only commodity provided was concrete floor space with a ceiling 22 feet higher that was dry and insulated and you have a pretty fungible kind of commodity that was clearly real estate. There was no prestige, there were no purposes, tenant provided for everything and so forth.

In real estate we've gotten very sloppy about trying to attribute returns to the real estate as distinct from returns on the management ability, as distinct from returns perhaps on other related assets of personal property, the furnishings, the ability to merchandise the brand name of a club, etc. Our accounting systems don't allow us to do that very well. The appraiser would approach that problem and say OOPS let's back all the way up and say hey, we've valuing the land and buildings for tax purposes we really have to come down and say what's the rental value on the restaurant. We have a specialty shopping center that's really what we have in the first floor of a hotel. We have

high priced woman's and sporting goods, we have high priced low priced restaurants, we've got an ice cream shop, a pro shop, with a golf course and a tennis room, etc., etc. And you would assign rents to each of those spaces. And any revenue in excess of those rents would be small business revenues because of your marketing ability to sell T-shirts at twice the price that you have paid for them just off campus at the local sport shop and so forth. If we don't make that distinction how do we create comparisons of risk both risk internally to the project itself and comparative risk comparison. If we are going to believe in some of the malarkey about capital asset pricing that they contain various revenues and use a risk weighted discount rate to put this capital asset on some kind of parity with that capital asset. How do we do that? When our accounting systems are not capable of identifying that kind of income which is primarily managerial in character or primarily related to our personal property and related services and that which is truly related to space and land which is what real estate is all about. We have more and more merger of business management with big piece real estate and it's very hard to tell when the business of managing whatever goes on in real estate merges with the real estate return itself. That's my way of introducing, therefore, really some way of looking at risk.

Now what kind of risk do we pay for the real estate, and for which we might need ratios of one form or another. The first kind of risk is a revenue risk. Under revenue risk we have several different sources of business income, space income and land income. Traditionally the appraiser has always said we'll take the income approach, we'll take the market value of the land as though vacant and determine that say 8% is an appropriate return on fee simple on a number, etc., and therefore, if the land worth \$1 million. The first \$80,000 of net income should go to the land. Relatively sure thing. And indeed the premier blue chip investment is a ground lease, unsubordinated to the improvements that are above. Because at that point what's collateralizing your property is one, not only the asset which has been placed on it, but the mortgages that have been placed on the asset. If you've got a \$20 million office building on a piece of ground and somebody planted \$18 million on the building, the land is gotta be worth more than \$18 million or the guy that has the mortgage is going to keep making payments on the land just to keep control of his collateral. You may have a \$2 million piece of land collateralized by the \$18 million debt to the mortgage lender because it's unsubordinated, right? Therefore, the risk and the rate of return character of that component is quite different than step number two, which is the building

space involved and so forth. Again, one of the blind spots that we have is the presumption that the building will always be technically in tune with the technology of the time, and yet there probably in the last ten years has been no more rapid area of obsolescence than major commercial buildings.

Buildings built before 1973 with the steps, with windows that do not have insulating glass, with roofs that have low U factor so the heats leaking out, with fire safety systems that wouldn't meet today's codes but are grandfathered in. With more layouts that do really meet the trend away from large cargo kinds of desks arrays; but what's needed to fit the small entrepreneur is 1500 sq. ft. or 2,000 sq. ft. and everybody wants a window. This thing about the shape of the building. A building with 50,000 sq. ft. per floor built in a perfect square doesn't have very many tenants that can handle that space and make reasonable use. Saturday I'm going up to look at a shopping center in Fond du Lac that was built in a day in which the spaces were like 220 ft. deep, and the assessor says well, lady's shop gets so many dollars a square foot and he multiplies that times the whole sq. ft. But in fact the Lerner's store up there which is 6,000 sq. ft. presently if it were leased today would be about 3,500 sq. ft. Inventory policies have changed, marketing strategies have changed, and ability to

deliver on order from a limited stock therefore has been greatly accelerated. Tremendous built in obsolescence so that obsolescence factor lags significantly the income factor, but nevertheless it's really there. Think of the little strip centers that have 12,000 sq. ft. supermarkets and they're playing out to the end of the 20 year lease, but there aren't going to be many 12,000 sq. ft. supermarkets. You can see in Milwaukee over on the west corridor, Kohls just went in with 50,000 sq. ft. on the one end National Avenue and Sentry is coming in with a 60,000 sq. ft. food store on the other, what's happening to the rest of them? They're being converted to engineering and architectural offices is what is happened. Think about the inherent obsolescence in a shopping center where the land parcel was originally configured to anticipate a 12,000 sq. ft. store with X number of parking places. And that's not the way we sell groceries anymore. We really have to look at the land and feel great. The land still is getting its 8 percent return. But we need the total net income from the project. The building may already be useless, it just doesn't know it yet.

But now the third element will be what we'll call business income. Now while the land may be valuable and the building is worth zilch - zero, the business income may be very significant. I, as the general partner, otta get a

property manager fee, I sell it the insurance policy on it and therefore, get a commission on the fire and liability coverages on it. I get leasing commissions as I may go through a rollover tenant, not based on the net productivity of that tenant, but based on the gross. Property managers don't get compensated on net they get compensated on gross. Terrific, the business income may be well worth while, and simply if you look at the nature of a property management firm, or an insurance agency firm or a leasing firm, they're very definitely fixed costs variable revenue enterprise. And the base cost--they got a secretary, and a telephone and an office space, and at least one guy doing the stuff and so forth, but he can manage it, the infinite capacity and growth and if he moves over that threshold of that basic six months of operation, wow that's a money machine. And you see many commingled fund people looking at their investment not so much from the diversification advantage of the ultimate investor whose saying gee I'll have to protect myself against regional economics and so forth and so on and so on, he's saying hey, I already got a property management firm in Louisville and it's just barely makes breaking even and so forth, but if I get another building in Louisville, that same guy and the same secretary can take care of that project too and now presto the business income is a very significant motivator for that acquisition's guy to go out

and buy that building. And in fact, the business income may have a much lower risk characteristic to it than say the building and building rent is fickle. Win, lose or draw you're going to have insurance, win, lose or draw you're going to pay leasing commission because you've gotta keep the building filled some how. But typically we don't look at a real estate investment that way, but that is the way we should look at it before we start discovery of risk. When we talk about a prospective rate of return or a retrospective rate of return we have to identify which components are included in that return. Have we boiled it down to land and buildings, or do we have land and building and enterprise. Otherwise capital asset pricing model and all the derivatives thereof, the works. We're not pricing capital assets anymore, we're pricing a business called management and leasing and we're pricing land which is something else again and so on.

The second major problem with risk and real estate, once we get beyond the revenue risk which I've talked about to this point, is obviously the financial risk. The adequacy of net income and the reliability of net income could meet our debt service commitment, financial risk. We talk about debt cover ratios--there is a ratio measuring financial risks. We talk about cash break even points which really is what a combination of the revenue risk and the

financial risk, isn't it? We're saying here are all of our costs for operations plus our debt service and interest and principle as a function of gross revenue, right? Since the financial risk is really first a function of the business risk or revenue risk of the enterprise, the cash break even base point makes much more sense than talking about the interrelationship.

The third risk for the investor is interest risk. It can be very painful. We have a building down in Tampa which is a nice sweetheart of a new office building about which is about 50,000 sq. ft. and a couple of years ago we very adjointly renegotiated the mortgage to a 12% mortgage-- terrific, that was a good rate then, everybody else thinks 13.5% we got 12%. The problem is we got locked in for about 10 years. If you sold the building today you would have to pay the difference on approximately five years remaining to go on the mortgage between the 12% rate and about the 11% maybe 10 3/4% going in to get another 10 year mortgage. Now we're talking about a \$450,000 deduction on the purchase price. Anybody going in that's what they're going to take great, this baby's worth \$8 million less \$450,000 for the interest risk. You took the interest risk, you lost it. There's \$450,000 right off the value of the property because you're locked in, no prepayment penalties, etc. allowed unless you want to pay the equivalent difference between

that and current Treasury, etc., etc. Interest Risk. Where does that show in the discount rate?

Next element to the interest rate risk is the monetary risk or probably better stated as purchasing power risk. The dollars that I had going in, whether they represent a purchasing power relative to the dollars that I'm taking out. Subcategory of that which is extremely dangerous, is the exchange rate. Japanese investors that came in two years ago, taking a 40% beating on their assets, just on the exchange rate. The exchange rate again has dropped 40%. Then in today's international market we're not only concerned with what's happening to the currency in which we're working but we're interested obviously in the currency in which we stated and we want to repatriate our earnings. More investors coming in today are usually coming in not with a single exchange rate but are coming through as many as three to five different currencies. Where they can arbitrage and win on some and lose on some, so a Japanese investor might put in 25% of his investment in yen, 25% in Marks, 25% in Swiss dollars, and 25% in something else and hope that the ups and downs of those relative to the dollar will soften the total risk of the purchasing power of their initial investment. Again an ending cap rate doesn't say anything about that, for that matter where the capital asset pricing model does it say anything about that. You could

make a very good argument, a simple minded view of course of life is that gee they only get 2.5% in Japan on a savings treasury from the Japanese government and you get 8% on a US Treasury, therefore why wouldn't they invest in the US? Well, I'll tell you why they wouldn't invest is this 5.5% gap really represents their international measure of risk in the US buck, in terms of the purchasing power its exchange rates relative to the rest of the world in terms of the ultimate stability of that borrowed capital over a long period of time. They don't expect the purchasing power of the yen to change very much, so 2.5% is the real rate of return, 5.5% on a US Treasury over and above that is your risk premium. For all the things likely to go wrong with US dollars over the term of the investment and as a result Japanese Treasury and American Treasuries are priced the same. Purchasing power risk. Therefore, you really need to know what kind of dollars went into the investment. Does my discount rate include a loading not hopefully. Recognizes that it's a possibility.

Once we get past the interest rates and the purchasing power risk today we have another risk, that of course is the tax risk. Will the rules change as the game progresses? And the answer's yes. We just proved that between 1986 and 87. We're still proving that, Mark showed me today an article relative to taxation of M_____ partnerships what

are called publicly traded partnerships and retroactive to 86 and 87 Uncle Sam had said OOPS wait a minute those are not conduits those are like corporations and will be taxed double tax basis and depending who will have the rules out in a few days and then we'll figure what you owe us from 86 and 87 then. A real estate investment trust for example has very specific criteria that it must meet in order to maintain its character as a tax conduit. In the old days if it missed one of those and that was discovered in an audit three years later, it blew its cover all the way back to the point at which the mistake was made. Today it has, I believe, one quarter, three months to correct for whatever error and it doesn't take much. Says you gotta pay out 95% of your taxable income to be a real estate trust, right? What if they determine that your depreciation taken in a given year was too great, that you used the wrong formulas, therefore your taxable income was more than it appeared to be to you when you did it initially and therefore, your pay out was only 93.5% and you blew it, you're not a real estate investment trust, unless you go back and correct that. Out of the generosity of the tax law saying I'll give you 90 days to correct that, tax risk. Very significant problem which generally is retroactive and generally it provides for no cure other than paying the incremental tax, which may be very disruptive to your whole organizational payment thing.

And finally a broader category of tax risk or maybe tax risk is a subcategory of this risk, I don't know, is entitlement risk. The right to use your property for some specific purpose. Well, the hot topic for land use control for those of you who are in 852, is there a point at which a developer is guaranteed that the building that was on the property when he bought it is a vested interest. By and large it's not. By and large he bought the property assuming that it was going to be zoned so and so let's say for a density of 18 apartments per unit and now along comes the master plan that says gee, we'd much rather have a green way there, and so forth, and this looks like 6 units per acre density type land and there's no reason why they can't down zone it and there's no taking. Or they just simply decide a little investor, that gee, it's certainly in the public interest that you have sprinklers, and that you have smoke alarms, and that you have locks and bolts on all the windows and doors, and so forth and so on, and you've got a project then which is now going to cost you \$500 a unit and you got 100 units and you're out \$50,000, but I'm sorry baby, it's a good thing to do so we did it. You may have five years to meet those norms or may not reach at all until you try to sell them, at which point you're non-conforming and there's a lien on your title and you don't have marketable title. But it's a very real entitlement risk. If the _____ says

it's non conforming and if you don't find a new tenant for it in a year, you'll want the grandfather status as it reverts back to whatever the grand plan calls for and there's no compensation for that. Entitlement risk. The rules change. Economic police power there is virtually no compensation for a change in the rules. Very high real risk of equity investment.

Now, given all of those elements, how do you construct the discount rate that reflects that? What ratios do we want to look at that reflect that? What ratios do we want to look at? Obviously each project has its more or less risk in each of these categories. And the analyst is going to have to look at the project with those inherent characteristics and develop ratio which first of all, provides a comparative measure of risk. The presumption is the cash break even point goes higher, the property is somewhat more vulnerable to changing the rent rates, occupancy levels and so forth. If we assume that the density of that particular project is approaching the maximum limit on that particular site, wouldn't take very much down zoning to suddenly become nonconforming. A good example is the shopping center which you appraised in Middleton. The parking was 150 as I recall, the minimum required was like 142. There had already been a taking off the corner of the property which cost them about 8 units but

there's another little provision that says if you have a restaurant, it's not one in three hundred, one parking stall for 300 square feet, there's one parking stall for 99 sq. ft. or per 99 sq. ft. or something like that. So you could conceivably put in a restaurant at the same time that you were going in for a renovating remodeling permit and all of a sudden find out you were nonconforming in terms of the required public ratio--parking ratio for the property. It doesn't take very much to trigger that, that element of nonconforming. Raulac suggests that at least one way to be sensitive to the varying degrees of that is to go about building a discount rate like a buildup rate of old. Remember the old stylized appraisals of the late 30's and early 40's talk about build up rates. And he said okay, long term 20 year Treasury bond which parallels in terms of the term of the bond, the projection series of real estate that Treasury bond is yielding 5.5% and then we think the developer or owner of the property ought to get let's say a half percent for giving up liquidity on the real estate and adding a one percent for the incremental risk that's involved in a real estate bond and another one percent for the management hassle that's involved in a live asset rather than one you can stick in your safe deposit box and all of that adds up to whatever it might be say 7.5% and you have a build up rate. It was making conscious recognition,

explicit recognition, of some of the concerns of the investor at that time. More experience tells us perhaps that we're looking at the wrong problems. Liquidity really is the problem for a good piece of real estate today.

You can have a high silhouette attractive piece of property and there are more than enough buyers out there and many of them could close a deal in 30 days if you wanted to sell your 400,000 sq. ft. office building on Michigan Avenue in downtown Chicago, there is no real liquidity problem there at all. But there may be no real management problem there at all either. In fact you may have to be more clever in managing stocks and bonds but its insider trading than you have to worry about in real estate. So what are the risks we should be loading. As Roulac suggests we would start out with a real rate of return and the economists will debate considerably as to what the real rate is. But traditionally it's been somewhere between 2.5% and 4.5%, you can pick one. Then to that you really ought to begin to add one, something for the marketing or business risks of the property. We're in an overbuilt market and your tenants may leak away as their leases come due and so forth, you may want to add 2% or 3%. If its monopolistic, elderly housing, Section 8, and years to run on a subsidy and so forth, you're reasonably assured of your revenue line. Then you want to look at the financial risk, how much of a loading do

I want to put on it for my ability and the adequacy and the reliability of my income relative to my debt service? Then you may want to load it with a change in purchasing power-- that's quite common today. Question--How can you peg a number for financial risk and real rate of return, and competition. I don't understand how you arrive at a number? Chief--What is the spread and yield between a AA and BAA? A. BAA bond is one in which there is significant possibility of lost principle, right? Where the top grade bond presumably has almost no probability of lost principal, right? How many basis points can that be? Not a perfect measure obviously, but it's certainly one measure of the way investors might look at the possibility of default. We try to find analogy in the other financial markets which do require it. Another way of looking at it would be saying gee, what's the difference between a mortgage rate and a bond rate of the same maturity. Our next problem of course is what kind of loading do we want for the purchasing power risk? One might be the index for currency de-valuation from the federal reserve board, what's the past five years experience on that or the last three years experience? How many basis points should have been added in to cover that. The same would be true of interest rate risk. Where are we on the curve of interest? Do we think we're at the very bottom of the curve because we are at 7.5% mortgage and its

got another 20 years to run and so forth, why we probably have no loading for interest rate risk at all because our view of the world is such that interest rates are not going to fall below 7.5% and what's more maybe we're not locked into that. On the other hand you were singing along there with a 14% rate and we're locked in because at the time you did the deal that was the only deal we could get and they wouldn't give us repayment privileges and so forth, there's a high probability that we're going to have our difficulties with that. For example, there are a number of real estate investment trusts out there such as [UK2, or EGK] in which most of the financing was done with a zero coupon bond otherwise the current cash on cash yield would not have been acceptable. When you look at that bond it's yielding close to 13% currently cash-on-cash, before you adjust for the fact that you're really going to have a sinking fund to anticipate that zero coupon bond. You set up a sinking fund which will reduce that zero coupon bond by the amount of compound interest on its term that will occur between that date and the maturity date on the zero coupon bond, now you're setting aside about 2.5%, 2.75% a year, its allowing you 13% yield and subtract 2.75% you've really got a 10.25% against the interest rate risk but the property won't appreciate to cover the compounding base of the zero coupon

bond, correct? Classic interest rate risk in the investment, factoring that out.

The entitlement risk is extremely hard to obviously evaluate. It generally occurs on a property where you have physical anomalies which reflect obsolescence, or obsolete technology or density which are inconsistent with current standards. Nobody's quite sure when they should take a "pass" on the building. The public health people have been kind of craw fishing on it. How much asbestos is too much asbestos? In most cases if you were to take a reading on ambient asbestos you would find more in the street outside the building than inside the building. Indeed much of the ambient asbestos inside the building may have been pulled in by the air conditioning because right in front of the building is a stop light at the end of a long run and people are really applying the brakes and most of the brakes today have asbestos in them. So as a result the automobile outside is distributing all of the asbestos which gets picked up in the HVAC and now you got ambient asbestos in the building which under some standards would say gee, we ought to tear the building apart to find out where that's coming from and all you've really got to do is close the front door and turn the HVAC ducts around. Okay. Those kinds of problems we really don't know where they're going to come home to roost.

Energy problem. We certainly have an energy standard for new buildings, when will we have an energy standard for old buildings? And how much would it cost to bring the building up to code? And it may be one of those optional things. GSA doesn't say that you have to take the asbestos out of your building. What they say is they will not lease in any building that contains asbestos. If 50% of your building is GSA and you have asbestos, you obviously have a releasing problem coming down the pike relatively quickly. How do you finesse your way out of that babe. I know one project in Washington DC in which there's asbestos tile on the floor which was a government required spec at the time they moved in. Their lease comes up for renewal in three years, management is quietly going through picking up the asbestos tile and carpeting out of the goodness of their heart. So that they don't wave the flag and say "YuHoo, we have asbestos on the floor. They are just quietly working their way through the problem. All of those represented entitlement risk. What's a proper loading for that is anybody's guess. But obviously a function of what (end of side one) you know about the building, what you know about the property.

All of these things then begin to build a discount rate, which at least for the decision maker is a useful way of evaluating alternative investments, and which ones he

should buy. It does nothing of course for that other function that we would like to have out of net present value in terms of how are we doing relative to somebody else's project? Did we pay more or less than someone else would have paid for the property? Is in fact the discount rate in the market so efficient that different rates paid for different buildings truly reflect the loading that people are putting over and above their real costs or real return on land? That's where real estate hasn't solved the puzzle much at all. It has no real effective way of bridging its performance or it's relative performance. Not only does the real estate, but many other forms of investment. How are we doing relative to bonds, how are we doing relative to stocks, what's the risk payoff matrix that makes the capital asset pricing model presumably a logical, analytic tool for selecting investments. Up to this point, those that investment in real estate, have simply reduced their risk to the degree of variance in the net income from the property. How volatile is the annual or six month, or whatever fiscal period they want to choose, net income from the property, net distributable income from the property. On that basis they argue that real estate is relatively more stable than stocks. Obviously, not quite as stable as bonds which by their very nature are set on a coupon basis. But they 're a

little hesitant to examine what's going on above the net income line to figure out what's causing the variance.

One thing we know for sure is that risk in real estate has nothing to do with property types. The premise that hotels are riskier than apartments or industrial buildings are safer than anything, are generalizations which simply don't hold up. The systematic risks are much less significant to real estate than are the non-systematic risks. The risks peculiar to a particular property. Believe it or not, and this is not meant to be a derogatory statement at all, Prudential has no idea of what diversification was even though they had now invested \$2 billion in PRISA I and we're counting it as a diversified fund. The entire asset management area still doesn't know what diversification is for risk management. There was a time when the premise said gee if I bought a mix of properties that were industrial, apartments, office, and hotel properties, and I scattered them all over the landscape geographically, this naive sense of diversification would somehow stabilize my returns. Yet the initial studies by Mike Miles and others indicated, you could have gotten as much diversification by buying five industrial buildings of different size in Chicago. It was much more important to have different markets for the same type of building than it was to have different buildings in

different markets. So they're starting over, they're saying gee, maybe risk is inherent in economic fate and dependency of different communities on specific SIC codes of employment and so on and that if we had thought about that in the past we would have realized that the heavy dependency of Houston on SIC codes related to energy was not as well diversified base then we wouldn't do very well there. Then we should have stayed in Chicago where the SIC codes were much more diverse, and employment was is much more evenly distributed over many categories of endeavor. We're just now beginning to say hey, maybe not all of you wanted to be diversified by SIC code, but I really want to be diversified by tenant. If I have five shopping center all by Dick Jacobs or five Centers by General Roe and 85% of the tenants in each of those shopping centers are the same national chain, am I diversified? Grants went out of business, they went out of business all over at one time. Maybe diversification should be by tenant type and owner. It certainly is easier to put together a shopping center if I have a codery of tenants who follow me around the landscape and go into everything that I do, but on the other hand maybe that suggests that as an investor I don't want to own 17 general store shopping centers. Because as a matter of fact even though I have all of those different shopping centers 85% of my revenue may be dependent on 60 firms. And retailing firms haven't been

going for their longevity. The department stores seem to be going out of business quickly. I'll tell you one other monetary risk story, it's a true story showing how subtle it can go - I'll give you two of them right away. In El Paso, Texas the RREEF Fund (Rossenberg Real Estate Equity Fund) bought a shopping center which was the greatest thing since sliced bread, it was doing just great and the revenue per sq. ft. was way up it cost very little to build down there, the retail help doesn't cost very much. The profitability was marvelous, only one small technical problem, the Mexican economy went to hell in a basket and the value of a peso relative to a dollar meant that nobody that lived in Mexico could come across the river and shop there anymore. 50% of their trade, gone, from the exchange rate. So they went into bankruptcy. And yet they had the greatest thing since sliced bread. Great trade area, good looking shopping center, all the National tenants, they never even looked at the implicit assumption that if 50% of your businesses is on either side of the national border, that something could happen to the ability to move across that National border. Gone. Second one, a happier ending. In the 1920's it was common to index a lease against changes in dollar values against gold. We were on the gold standard and everybody expected the dollar to devalue and therefore most leases had what was called a gold clause in the lease. And the

gold clause said that at any time the landlord could require payment of the rent in gold rather than in dollars in an amount equal to 25 3/8th grain of gold per dollar of rent due. When we went off the gold standard in 1930 umtiumpt, obviously many of the landlords pursued that choice and first as a government dictum and then as a congressional legislation they ruled impossibility of performance because Americans were no longer permitted to hold gold for commercial purposes and therefore the clause was no longer operational and congress later passed legislation to that effect. Then in 1966 as inflation began to take hold, Congress says gee, if they want to index the gold that's not such a bad idea. So he abolished the previous legislation and said if you want a gold clause you can have one but, to become operational in an old lease you would have to in effect confirm that. What's called an ovation. Reactivate that clause. So far so good? Now a family owned the land under Frederick's department store in Seattle and made the lease for 99 years back in the mid-20s and ultimately Fredericks sold to Batta the British American Tobacco US retail giant. And in the process of taking over the properties they just automatically reaffirmed the existing leases including the ground lease under the store. By this time the third generation heirs to the family that owns it the hot shot MBA students at Seattle, it has always ground

them down that they have this fixed rent which was in 1900 \$20 was wonderful but today was not keeping him into the styles of which he would like to be accustomed. And he sues and he says "when you confirmed the lease, and Fredericks went off and Battus came on, that is an ovation, that is a new contract." And Battus' initial attitude was yeh, so what? The director of marketing says, "I'll tell you so what, 1966 says that if there's a gold clause there and an ovation it's operational again, and your rent at some ridiculous number like \$26,000 a year, in fact should be 46 times higher given the current price of gold, annually. And that has been true since you converted the lease, so you owe us about \$6.5 million for things to be current. And Battus lost. The gold bar once confirmed, is operational again. Very interesting currency problem--purchasing power of the dollar. Would you write a lease today in which you index it to gold? Obviously a couple of years ago that looked like a real bright idea, gold kind of went down but it sure isn't the \$35 an ounce it was when I was a boy. You could have done very well by buying coins in gold. In fact I wish I had done that instead of going into the building business I think. But, nevertheless, those kinds of changing environmental situations create some very real risk problems relative to real estate.

Now let's go back and look at business risk problems or market risk problems a little further. Real estate is relatively unique to the degree or extent that most contractual negotiations are concerned with the risk allocation between the partners. Part of that of course is because the time period, the duration of a real estate agreement is so much longer than the typical agreement. Most real estate agreements are in a continual state of being executory contracts--things to do in the future sort of thing before they're complete, as opposed to other transactions in commerce which are kind of open and shut. I bought a car, I owned it for five years, I sold it, bang, relatively short term kind of deal in an interrelationship between a car buyer and a car seller is rather short. Real Estate obviously relatively long term. If risk is the variance, between your expectations and your realizations, between pro forma budgets that you set out for the property and the actual income achieved - certainly the modern American lease does a beautiful job of stabilizing the expected performance for the investor. He has laid off virtually all of the variable costs on the tenant. [Problem with the tape - goes blank] If he has done his job in terms of selection of tenants and the credit capacity of the tenant, then the variable risk for the owner, the landlord, the investor, isn't the traditional business risk at all, it

is in fact the legal risk of being able to enforce the contract. Largely a legal risk partly a credit risk obviously in terms of, are there going to be funds to support the debt? That's a somewhat different type of marketing risk - true, once we go into hotels in which every night is a new deal and people decide not to come because they heard the report that everyone got Legionnaire's disease last week, you have a real marketing/business risk. Remember talking about these office buildings or industrial buildings with 5, 10 or 20 year leases on the building. That's not the same kind of marketing risk in which there's a continual instability because of the turnover, it really is the enforceability. That enforceability is another kind of entitlement - there's an interrelationship there.

The bankruptcy laws changed and said - heh - you can't have a clause in your lease that says if a tenant is bankrupt you can throw him out on his ears. In fact, the fact that he has that lease may be one of the principal assets of the bankrupt and that should be protected for the benefit of all his creditors and therefore, one can't throw the tenant out and until the court says one can throw the tenant out and in the meantime the rents which are due following the declaration of bankruptcy will have a preferred claim on the asset, etc. but the fact that he's leaking on the ropes isn't sufficient grounds to throw him

out of your shopping center or your office building even if he's giving the place a bad name. Burden of proof is on you to show a hardship, uncollectability, etc. etc., etc., change in the rules, and we see that all the time.

Is the public mall of a shopping center truly a public mall? Or can you argue that the mime, the dancers, and people of Central America and people buying ice cream cones are not entitled to wander down the way and eat it. Rouse went to court, said you can only eat an ice cream cone in an ice cream shop - carpeting is mine. The ice cream shop says heh, that's unfair because nobody will wander in and wander out - I haven't rented enough space for them to have a place to sit down, I just have enough space for them to look through the glass and pick out which flavor they want. Enforceability. Now there's a typical context to that, really is a large part of business risk today. We've gotten very sophisticated in identifying the potential variance in our revenues and our expenses which with our traditional definition of risk, and we allocate those and we share those in some reasonable way, maybe unreasonable way depending how much market power you have. But then the next thing of course is to make those arrangements enforceable, some of them are not enforceable because they're in violations of fair trade if it comes right down to it. Those of you who had Emmanuel Helpert last year, one of the common clauses in

a shopping center lease is that the tenant must remain in operation and keep his store fully stocked, etc., etc., etc. Normal operations guaranteed - totally unenforceable now in the courts. If they want to shut their store or pay their rent there's nothing that can be done. Question: Who won the ice cream thing with Rouse? Chief: Rouse won the legal victory that if you sold an ice cream cone they had to eat it on the premises, but the human cry was such that from a PR standpoint he had to capitulate and say, if the kid wants to eat the ice cream cone wandering down the mall, the only way to control that is to not have an ice cream parlor in the mall. So quite often you can win the legal point and lose the practical battle which is what happened in that case.

OK. Now having discussed the kind of risk that we characterize with an investment, we've looked at the possibility of having a loading on our discount rate for each of those risks, what is left of the real estate investor of course is a realistic way of measuring how many basis points he should add to the real estate and the devaluation or inflation rate to cover these other factors. And I doubt if you'll find very much literature on that. So these are the kinds of things they're talking about in portfolio management today and talking about in terms of the goal to acquire assets, it's a whole new subject area for

real estate. We've now convinced everyone that discount rate is the way to go and we really want to talk about distributable cash - we have two problems, distributable cash from what? And what does the discount rate contain? Is it simply a discount rate that everybody in the market says, today's pension funds are buying at a threshold yield of 13%. Where does 13% come from? What does it contain? How much real return? How much devaluation return? How much as a risk premium for the different risk attributes of equity positions? And is that relevant to that kind of real estate, or is anything you put in a pension portfolio called a 13%, there's a leading suspension right now, everybody calls it 13%, but nobody knows why except Blake Eagle said so at the last CREA meeting - it moves from an offhand remark to a consensus and to be a fiduciary all you have to do is stand in the middle of a consensus and you can do not wrong. Your honor, call me guilty of negligence but all the idiots around me made the same mistake, as long as you're with the majority of idiots, you're safe as a fiduciary.

...to financing the property and so I have taken it upon myself to subdivide the files into four groups so if you will make a note this relates to the first letter of your last name. And A through C will cover option one. D through K will cover option two. L through Q cover option three. All those that do not fall into one of those three

categories will be option four. Not all of the options may in fact meet the specifications of Mr. Diller and Shaker and therefore if you fail to _____ I guess the question basically is how close did you come but you may not do that. From the standpoint of the development committee, why they should do what they do and over see as they do. (Talking about homework and assignment) Three to four pages would be more than sufficient, the computer program can be Mr. Cap or Project and you can build your own Lotus system and work it out. And other comments, inputs. Due on Feb. 22 I will hopefully wind up tax matters and hand out the Clifford case and expect to receive your Diller and Shaker so make a note of that the 22nd and the 24th are reversed.

One subject we haven't really talked about is the options available to the individual investors and probably for your own safety you might want to set up some sort of matrix which matches the options against certain alternative attributes a private investor might want to have. Obviously the first option is sole provider. The second option would be a general partnership, a third option a limited partnership unit. A fourth option would be a joint venture, but when we say joint venture as an individual we're essentially talking about tenants in common, as distinct from general partnership for example, or we're talking about a ground lease of some form or master lease. A ground lease

technically being a vacant site which someone else is going to develop and which the individual then receives rent and possibly some participation in the revenues and the improvement. A master lease would suggest an individual property perhaps improved in another time say 30-40 years ago and the family doesn't have the money to improve it, reposition it, market it, manage it and so forth, so they master lease it off to a developer who as 30,40,50 years of ownership of the structure and can invest and improve the property with the individual still getting a rent with some kind of kicker related to the index and some small participation, but generally the master lessor says hey, I'm creating the value for it, I'm providing the budget for improvements and so forth, the old American way is them that takes the risk takes the profit and therefore aside from a possible index for devaluation of currency you're not going to participate on the upside, since you didn't do anything for my upside other than stay out of the way. But those are the two kinds of joint ventures which an individual can do that are small scale enough that they can get into it as distinct from some major project that the heavy player might be into. Next you can invest in a real estate investment trust. You can invest in a SubChapter S Corporation. Notice all of these up to this point are single conduit entities. And finally of course you can go into a double

tax entity which essentially is a small family owned corporation. We are ruling out for the moment other types of securitization that might involve participation in a CMO or something of that sort, we're suggesting those are more financial instruments than they are real estate per se and we're also ruling out for the moment an investment in a publicly traded stock although obviously would be an alternative you can go and invest in Rouse or Northern Pacific or Disney for that matter which is a fairly good sized real estate operation. But as far as I'm concerned for the moment we're treating that as a stock market play as opposed to an ownership of real estate play per se. Somewhat arbitrary but nevertheless in terms of format.

Now what are the attributes. The first attribute is scale. I've only got \$10,000, what can I do with \$10,000? It's a scale, how big a unit, how big a chip do I have to play and how much am I wise to put into a single entity. The second thing is control. The third is intensity of management, that should be distinct from control. I might go into a master limited partnership in which what the Lessee was going to do with it is going to be very carefully spelled out and let's say the family doesn't want the exterior changed because of its historical significance, etc., and they want this and they want that and that could be built into the agreement before hand and there's some

degree of control as opposed to an REIT in which you put your money in and you sit down and you shut up. In a limited partnership you've got three options. You can vote with the rest of the limited partners to displace the general partner for malfeasance, you can vote when you gotta refinance, you can vote when you get it dissolved, and otherwise you shut up because if you do anything more than that you are now a general partner at the voting level. I think you ought to distinguish between the degree of control in terms of the over all strategy and the intensity of ongoing operational management. The master lease provides no intensity of, you might as well go to Florida and wait for the check. Once we get by those elements obviously we're concerned with liability. Under liability I would put two items, number one obviously is liability on debt. Number two and perhaps much more significant than the decision process even though it adds a lower probability of coming home to roost, its liability for third party torts. Okay, once we get by those items the next may be simply if you want to look at it from the stand point of risk. The variance in our financial development relative to our financial plan. And the last major item is the ease of transfer by gift or by inheritance. The ease of transfer by gift or by inheritance.

Owning a building outright is a sole proprietorship, that means you have an appraisal problem, immediately you have the possible gap in consistent management of the property, you certainly have a problem with the administrator that you have to bring in a provision in your will that he's permitted to retain ownership and operate the real estate and do whatever is necessary without concurring further liability to the estate if it doesn't go well and so forth. With an REIT share, nice clean valuation on the date at which you died and you can look it up in the paper. And if you're working through off shore trust or something of that sort there's no estate tax, no transfer tax on it to get at all and so on. One other element that you would add to that if you were probably, although not entirely many _____ or US citizen as well. You might intake as another attribute, degree of anonymity. If you're working for Coldwell Banker and Coldwell Banker says that you cannot own real estate because there will be a conflict of interest potentially between you as an owner/operator of property and our clientele in the mortgage banking and the brokerage business and you're not going to own property that's on the record, etc., etc., you're going to have to find a way to hold real estate with anonymity. And if you're coming in from overseas and you brought your money in cash and your government says you can't, from foreign countries say you

can't take the money out. The U.S. government has a 30% tax on withholding if you sell the property or whatever you may want to A.) Conceal who you are from your government and B.) Conceal the fact you're foreign from the American government. Degree in anonymity.

Now you can mix and match all of those attributes against each of those property holding types and an individual investor can begin to put together his strategy if you will, how they are going to go about investing in a real estate asset, a hard asset. I just finished a good book called the Storming of the Magic Kingdom which had to do with the attempt to raid the Disney corporation and break it up following Walt Disney's death by a guy Sol Steinberg out of New York. And its a good philosophical as well as a high drama discussion of raiding and exposing cons and his methods and so forth, but what's interesting is one of the players didn't really believe in the movie business he said was a hard asset man and in movies he said all the assets walked off the lot at 5:00 in the afternoon, he didn't invest in movies. He was a hard asset man. So I guess what we're talking about in real estate today in this course is higher asset.

Any questions up to that point? Question--where do tax considerations come in in buying the attributes for each ownership? Chief--Well, there a little or no tax to be had

other than the estate tax. However you structure it there may be minor variations between the corporate and the individual tax rate, but as soon as you decide to go the individual route rather than the corporate route, you belong to anonymity for one thing and complicated your estate problems and so forth. One suspects that if we ever get an honest President, which of course is remote, the distinction between those two tax rates will differ and what's more the 34 versus 28% tax rate really isn't a true statement of the differential because the individual in a corporation can vary so many other things. For example, 25% of your net income can go in a profit sharing plan which isn't taxed at all. We can invest in more real estate. You can even have your own trustee or have your own pension fund, and so at that point now you're really stating the rate of the Corp. 25% less than that so subtract another 8% and that is a whole lot lower than the individual rate. In addition you can buy your medical insurance and rent a car and a variety of other things that you can do, and tax ratio really isn't very significant. It's the base line that the rate applied to and how much you can monkey with that that really counts. But otherwise you can put tax rate in the list the tax game has pretty well fallen out except for the value in the proposition. You get a stepped up basis and pay no capital gains tax and start the depreciation game all over again.

You can raise grandchildren who are able to exploit that, terrific.

Okay, now let's talk a little bit about the tax laws. Given the format by which you choose to invest, obviously you want to structure it in such a way that one, you acquire it with an audit trail that supports your basic strategy. When we talk about planning your anticipated tax strategy in the acquisition process. While you operate the property you also have certain elections to make. Revenue, what's expenses, what's capitalized, what you postpone. And then once it becomes time to dispose of the property, again there are obviously disposition ploys which can mitigate to some degree the overall tax status. Many of those gains obviously have changed significantly with the new tax law and I have handed out two of those that you can look at, the hierarchy of critical decisions in that process of acquisition, operation and disposition. One basic element and why its certainly relevant in this course that we're discussing what the individual can do is the tax law has completely flipped its perspective and while it was perhaps particularly favorable to the well to do and the very rich and the very high income tax bracket, today's laws very definitely is biased in terms of the small investor--the middle class investor that presumably votes for Reagan and therefore, again the _____. The application here on

part four is what I've done is taken out something of some of my notes that I've prepared for something else and think small. The real estate investor with \$125,000 of active income or less. The double taxation of small corporations isn't too serious, but there's a 15% tax rate on the first \$75,000 of small corporate income. That is not a bad thing as an individual that can create a corporate holding vehicle for his duplexes and buy another rental property and with the joint handling of his pension fund, his lease car and a few other things, that can bring that net income line down below \$75,000.

Risk rules require the general partnership with no more than 10 partners so a large equity investor generally prefer the general partnership form and looks like the new tax laws that is going through will penalize the master limited partnership and some of the larger limited partnerships even further and the real estate with a family business orientation may still take a relatively desirable tax shelter position and so the basic law is certainly orientated to the smaller investor like you, for example.

Okay, the outline in here which was done by our accountants here in Madison for me at one point, essentially says there are three buckets worth of income under the new tax law, one which we will call passive activity, which has to do with all rental in real estate, limited partnership

and all businesses where the tax payer does not materially participate. And materially participate is narrowly defined so it comes with a good many of them--regular, continuous and substantial involvement. A general partner by assumption has regular, continuous and substantial involvement, hence the goal of the general partnership and for a certain thing. When we talk about real estate only dealers can be determined to materially participate and therefore at one time it was anathema to be a dealer, today that may be a very useful device if you have more income in the passive category than otherwise. The general rule is that net losses from passive activity are not allowed as a reduction to other income and the exception of course is the small income individual active real estate owners are allowed up to \$25,000 of active rental property losses, and they have to have a significant and bonafide involvement in the property, they have to own more than 10% of the property which means any partnership is going to have less than 10 people in it and the active rental property loss is phased out between \$100,000 and \$150,000. So as your income going up your ability to allow tax losses from the real estate to slop over and shelter gradually evaporates and disappears altogether after \$150,000.

To determine whether that activity is active or not, if a net amount is a loss, the adjusted gross income on

occasion is applied. If the net amount is income, the amount is combined with other passive activities. To determine the net other passive activity the net amount is a loss, the loss is not allowed except for a certain phase in possibility. If the net amount is income, it's taxable. The phase-in rules allow 65% of the net passive loss in 1987, 40% in '88, 20% in '89, 10% in '90 and after that zilch. Passive activity is engaged in after the date of enactment do not qualify for the phase out rule. Nondeductable passive losses carry forward until passive income absorbs them or the activity is disposed. You have an unused portion of passive income loss you can apply it against the capital gain on sales to compute the base for the capital gain.

Market number two is portfolio activity--interest dividends, gains and losses from portfolio assets and ground lease rent. That was kind of clever of congress because otherwise you could have converted a good deal of your real estate income to ground lease income and therefore had enough passive income to soak up the tax shelter that you might have had from your other property and there's still active pushing by the National Association of Realtors to get ground lease rent reclassified as passive income. In which case you would then have essentially a tax free bond because the shelter on the building just might be 20 to 1

relative to the value on the land would be more than sufficient to cover the rent on the land.

Everything else falls into bucket three, though it's either passive or portfolio or it's _____. Now to decide whether its tax deductible there essentially is four level screen. First of all in the at risk rule. At risk essentially disallows the interest deduction from any long term or related parties, sellers or persons receiving contingent fees. That was one of the favorite gains in the partnership game was to invent a series of fees for the seller. So he got a consulting fee, he got a property inspection fee, he got an advisory on the organization of the partnership fee, etc., etc., etc., and put that all out in front, it was all deductible for the buyer as a first year expense and that really allowed you to hide significant the tax shelter in the first year, all that's gone. There is a provision in the tax code that says that a related party could make the loan to the buyer, the mortgage loan, and it might be treated for interest deductions but it would have to meet all of the criteria of a third party independent arms length loan and the burden of proof would be on the borrower. He would have to demonstrate that it met all of these criteria and that it did not cause an increase in price because the seller had provided this financing and that in fact it could have been obtained

somewhere else in the market place and so forth. So it's very difficult to get. The option is there for a specific set of facts. Those facts have to be relatively unique or all such related lending is not a deductible interest factor. We can have nonrecourse financing only as long as it's obtained from a legitimate third party institutional lender who's in the business of making loans. Can't create just a specific entity just for that specific deal owned by the seller and then argued a third party lender. That makes a fairly narrow window for full deductibility of interest and for that matter full deductibility of depreciation on the total property. Now, what happens if you don't meet the at risk rule? Well one, there's a cap on how much shelter the individual owner can take. He is limited to the maximum amount at risk. So if you have a \$1 million property but the seller gave in \$900,000 worth of financing, maximum of \$100,000 in depreciation shelter or other tax shelter factors could be taken and at that point the buyer has no more benefit of shelter. It was striking directly at the ability of syndicators to artificially structure excessively high prices by providing less than market rates of interest on wrap around loans provided by the seller. That exaggerated the tax base for depreciation purposes for one thing and quite often it meant that virtually all of the income on the project went to the seller and the buyer was

simply getting the shelter. And if you structured that right on a nonrecourse basis the buyer could step away from the property seven or eight years later and would have gotten one, all of his money back, two, a return of at least 10% of his money and the property would then revert to the original seller, did not have the property back. If it was done on a land contract, land contracts can be renegotiated between buyer and seller without a tax penalty on the reduction of the balance due and therefore there was no constructive receipt by the seller or by the buyer either so it wasn't a taxable event, so this plugs that one pretty good.

The second hurdle is the passive loss limitation which we talked about earlier and that passive loss application to other income presumably portfolio or current is being phased out. So that by 1990 virtually none of it is eligible beyond dollar for dollar. For every dollar of income you'd have a dollar of depreciation you can't in the passive, category but you can't then translate negative income in the passive bucket to positive income in the portfolio or your earnings bucket. For the little fella if your adjusted gross income is less than \$100,000 and your active rental loss is less than \$25,000 don't cash in your bonds to pay off the mortgage on the property. It won't reduce your tax bill. Pay of the mortgage debt if your non passive income

exceeds \$100,000, your active rental losses exceed \$25,000 and anytime you have a mortgage debt on passive rental property. In other words what happens essentially is that when you take the soft loss of the depreciation which is a non outlay kind of expense, and you tack it on top of the interest rate, your losses exceed your available income, at that point you're just burning up the depreciation opportunity until such time that you sell the property and can recoup the unused part of your shelter. What you have to do is then get less debt therefore, you have a lower hard dollar deduction on the interest rate and therefore, the shelter can slide in and cover real earnings and be used immediately. Everybody with us? I suggest than that leverage is, not the game and not as necessarily played at this particular point as it once was. Okay, passive activity income is earned from rental activity or other passive activity but notice does not include interest on escrow accounts. You might be able to negotiate some small advantage by putting part of that purchase price in an escrow account. Gains on sale of rental real estate are passive activity assets. Interest earned on installment notes from sale of such assets are included here.

Okay, hurdle number three--investment interest limitations. These were never taken seriously before, they are now a significant constraint. The new law prohibits

deductions for investment interest expense in excess of investment income, and for this purpose net passive losses which are deductible are deemed to be negative investment income. So if you have \$100,000 of investment income but you have a negative passive income of say \$25,000 you then have only \$75,000 worth of passive income net, and therefore you'd only have \$75,000 of interest deductible in that period. Notice there's more than a few places where its lopped over, you cannot carry the negative tax loss from the passive category over to shelter income, but it does carry over to reduce the definition of how much interest is deductible because what they don't want you doing is borrowing money on your life insurance, say on the cash values, and paying interest to your lender under the investment account and then using that as a down payment to hike the depreciation in the passive account and carrying back that depreciation over to shelter something else to the degree that you have that opportunity. So notice what this is doing is discouraging you from collateralizing your real estate with your bond portfolio or your stock portfolio or whatever. If you get too much passive loss it will reduce the deduction of the interest, and therefore discourage you from over collateralization of the real estate with securities. There is no \$10,000 allowance as there use to was. Interest paid to related passive activity is not

investment interest. For example, if you make a loan to your own SubChapter S corporation and you get the money out of the SubChapter S in the form of interest income rather than calling it rent income then the SubChapter S is getting, doesn't count. Again, can't borrow on your investment portfolio by changing the character of the way in which you repatriate money from the real estate tax to your investment account and make it something that it ain't, doesn't count. Interest disallowed carries over indefinitely. In other words speculative land becomes very expensive game to play where as in the olds days obviously if you bought investment land, has a 10% interest rate let's say on a land contract and you are in 50% tax bracket, the real cost was only 5%, as long as the land continue to appreciate at a rate greater than the net cost of your interest after the shelter factor had been applied, why you were doing well. You can't do that now. That's what generate investment interest expense are second in line to consumer loans when it comes to retiring debt. Now I notice consumer loan interest rate is no longer going to be deductible and therefore the first thing you want to get out from remember the home mortgage loan interest is still deductible as long as the mortgage does not exceed the basis of the house. Any questions up to that point?

And finally, hurdle number four is becoming a much more meaningful factor, is the alternative minimum tax. There is one for personal folks that we're talking about today. There are two alternative tax factors as far as corporations are concerned. All tax payers must recompute tax liability under the AMT and you take the greater from the two, if your personal tax is less than AMT you pay the alternative. A deducted gross income, add that to tax preferences, subtract your allowed deductions, subtract your standard exemptions, that includes the alternative minimum taxable income and you multiply that by your tax rate which is applicable to the minimum tax its not the regular 28% rate but in this case 21% and that equals the AMT. In 1987 capital gains will no longer be preferences. So if that doesn't get built back in there accelerated depreciation on all the property is a preference. Notice on all property it use to be the accelerated depreciation taken on office buildings was not it was a preferential factor but not on apartment buildings. Installment gains on dealer property or rental real estate-- that was never before a preferential item, they sold your farm and you got five annual payments from the buyer of the farm you were taxed at the progressive tax rate which applied to the lower level payment, the 1/5 of the principle the net worth minus what ever your basis was, but now that installment gain over and above the amortized basis against

that gain is preferential income. Passive losses without any phase in credit and to the extent the AMT exceeds the regular tax and minimum tax credit and carry over to the future years to offset the regular tax, that's _____.

This provision adjusts for timing differences which may cause AMT in one year and regular tax in another year, so if you have sporadic aims you sell your text book and you have a spike in income one year you begin to level that out. It's really kind of a back sided income leveling device, can't average income any more but where you have a big year and owned the AMT rather than your regular tax you can begin to kind of recover that payment against future regular tax. So its kind of a backsided income averaging thing, it's a tax averaging thing instead, it's the flip side.

Interaction with the Wisconsin minimum tax and the new Wisconsin rules comes in effect with assessed for 55% of any excess of AMT or a regular tax. And Wisconsin will assess tax on the timing difference without any future relief. And finally by 1988 when the regular tax rate falls 28% the impact is obviously going to be much more noticeable.

We'll go into key terminology here. Remember these are sample individuals as opposed to corporate folks. So here we have the MBA who managed to snare \$70,000 as he got out of school and his interest dividends and so forth on land contract that he got from his wife as a joint return better

than \$25,000, other income \$5,000, capital gains real estate \$16,000, others \$1,000 gross income, \$117,000. So far there's no difference with the previous law. At that point capital gain credit of \$10,000 is for the 60% that wasn't taxable, as opposed to the 40% that was under the old law. The rental and partnership losses in his real estate from apparently soft cost accounting, accelerated depreciation, and a terrific accounting scheme was \$64,000, the married couple deduction was \$2,000 which tells you something about the relative value of the wife's first property, I guess. So the adjusted gross income is \$41,000. Now, under the new law notice the depreciation cut is a little higher, the taxable income is significantly higher, but the alternative minimum tax in this case would have been \$15,500, is the minimum. Accelerated depreciation is a preferential item. Itemized deductions--pretty much self-explanatory. Interest on the home mortgage is still deductible, interest on land contract still deductible, the minimum tax however, does not consider that. The investment factor (end of side one) notice \$9,000 in the first case, we're only \$5,900 in the second case because of the investment income is less than that--that's that interest and dividends thing and so forth. And the consumer's deductible interest \$2,000 under the first plan which was the old law, and \$1,300 under new law is being phased out _____ 65% in the first year of '86

was still deductible, now it would be less than that. And the miscellaneous is further deducted from \$3,000 to \$1,800, so the total itemized deductions were \$32,000 under the old law, \$26,500 under the new law. The personal exemption, however, has gone up considerably, but the taxable income when all is said and done in '86 was \$5,000, \$23,400 under the new rule and \$31,500 under the alternative minimum tax and the income tax is \$500 in '86, \$3400 in '87 or \$6600 under the alternative minimum tax and so they would have to pay the alternative minimum tax. Supporting notes and assumptions are on the previous page.

Similar case, what happens now if the tax payer is positioning himself for real estate, refinances the house, pays off the consumer loans and has more investment interest and we go through virtually the same scenario and where his '86 tax thing it doesn't change its still \$500. Under the '87 tax law it's down to \$2800, but the alternative minimum tax has dropped from \$6300 or whatever it was to \$4300. So he's obviously better off to refinance the house, pay off the consumer loan and modify his investment interest factor.

Now at that point example three says having repositioned himself relative to that aspect of the law, what happens now if he cashes in his other interest and dividend assets and buys a passive income asset or pays off rental debt obligation. Here he is again with \$70,000

income, land contract at \$25,000, we don't know what the other was but he's paid that off and his real estate is \$16,000 and his other is \$1,000, gross income \$117,000 versus \$112,000. His capital gain deduction of course, is nonexistent under the new law. His married couple deduction has gone up, his partnership losses have gone down and his adjusted gross income is now \$41,000 in '86, as opposed to \$55,000 in '87. Now we look at his itemized deductions virtually all of his taxes are deductible. His interest deduction has gone way up, notice \$13,000 for his home mortgage versus \$2,000, the underlying land contract, etc., as a result his total itemized deductions are a little bit higher, and his personal exemption is still of course what it was before and his taxable income has dropped a little further to \$2,500 and his alternative minimum tax has dropped all the way down to \$3,100. Obviously just looking at that format when you get to Mr. Clifford you may have to reconstruct Mr. Clifford the same way in terms of structuring the individual, positioning him for real estate and then coming up with a balance asset account. Assets obviously we'll build so that his shelter matches his income in real estate. That's a little tougher to do than it once was, but obviously a critical element in trying to avoid the alternative minimum tax. Questions up to that on the exam a fairly typical basis. Question--(can't hear it). Chief--

That's right, there isn't one available any more and it just dropped out of the _____ I believe as well. The last time you will vote for Reagan right? Can't afford it now. Okay, any others?

Okay, let's start to build on that. The basic elements of the tax strategy first of all is the acquisition, really has to do with what kinds of shelter do I want, if any, are determinant of my investment. Second of all, recognition that once you buy a property you are likely to be in it for a relatively long period of time. There's no advantage in taking the capital gains anymore since the tax rate is the same as on income, you usually obviously get the benefit of a multiplier if you create move the income from \$10,000 to \$20,000 and double the value of the property, why you can sell it and take the capital gain and pay the tax all in one lump sum, but presumably you would have saved the same number of dollars in tax if you had taken that income of \$20,000 a year on out for 10 or 15 years and so forth. So obviously in looking to real estate, you want real estate that one, has durability and it will be able to sustain its value over the longer term and two, can be enhanced, that by careful tender care and some further investment in the property, you will be able to increase the value of the property and transfer it to your heirs at a price significantly higher than you paid for it so that they one,

will not pay the capital gains tax and two, can begin whatever depreciation there may be available at that point in time all over again from the new basis on which they may have paid inheritance tax.

Duration we mean the ability to improve the property. Talk about improving real estate property by the way Disney for a variety of reasons had to buy Arvida in order and issued stock on a merger of interest or exchange, so that the Bass Brothers would not have to pay a capital gains tax on the Arvida interest and the Disney people could dilute the ownership of the hostile ownership position that was attempting to dethrone the existing leadership. And the Bass Brothers received some percentage of ownership in Disney, which I can't remember the exact percentage of, but going in to the deal they had a basis of \$14 million in Arvida, they obviously made some money there, and I forget what they got paid for it but it might have been in the neighborhood of \$100 million, and so forth, which they then traded for Disney stock at a time when Disney stock was at its lowest, probably in the low 40's and two years later after all the shooting had stopped and the new management got them back on the track and the stock market once again had confidence in them, they had gone to something like \$125 a share for Disney split more than once. The capital gain of the Bass Brothers was \$850 million on a \$14 million

investment. That's how to make money. Only if we would have known that at the time. That's hard to imagine people churning \$850 million capital gain for having done nothing but meddle in the management of the company, engaged essentially in what is called politely green mail in the stock market.

Now having decided that you want a property with durability and fixability if you will, or enhanceability, the next thing you really have to decide in the acquisitions process is what mix you want between land which is nondepreciable, structure which has obviously a useful life of 27.5 years I guess as a residential sector and 31.5 for commercial property and then of course, how much can I put into personal property. Any personal property that has a relatively short useful life of 3, 5, or 10 years, the more I can allocate to the personal property side, perhaps the more quickly I can provide shelter for whatever taxable income there may be on the property. As you begin to look at that, obviously some properties lend itself more to that kind of formula than others, certainly slightly run down apartment building which you can now begin to refurbish and refurnish and perhaps provide new appliances and so forth and so on will be a more attractive blend of opportunities within the tax laws than say a commercial shell building in which there is no personal property and in which may be

doesn't really lend itself to any significant enhancement at a particular point. It certainly puts the premium on the older buildings with the good location versus the new building which is shinny and new but not necessarily as well located and so forth.

The acquisition process has to anticipate how you are going to present the building, there are several basic issue. One, what class of structure do you want to talk about, we still have four classes of structures, we have single family legal residence, we have farm and extraction properties, we have residential, we have commercial, and we have subsidized. What category do you want to be in? What category is most appealing? Let`s say for example, you buy a single family residential home, you want to make that your legal residence so that as you pass 55 you can take all of the gains as a one time life time exemption from the capital gains tax, or do you want to rent? What if you're 51 years old, or excuse me 47 years old and you want to sell your house and then you say gee, no maybe I'll just rent it for a while the market's kind of lousy. And you move to a new town and now you rent the house, the legal residence changes over to the next house, what do you do with the one you just left behind, you rented it for a few years, I believe there's a what, three year carry back on that so you can rent it before you sold it as long as you don't run over

that time period, but you just blew all of your shelter in that house. Renting that single family home which you owned as your legal residence and now you changed the legal residence you made that a commercial property you just lost all of the capital gains shelter and so forth. Obviously you don't want to do that so it's important to know what the category of your investment is and do you want to maintain it, how do you want to establish it. You buy a home, how many months do you have to make that your legal residence in order that you can begin to protect the capital gain exemption on resale. They want to call it a farm and extraction property. We have what are called hobby farms because for a while that was a popular thing to do--buy a farm, raise a couple of horses, run up the net losses and charge it off to the income taxes maintaining it being a bad deal--you can't do that any more. Gotta make money on the farm 3 out of 5 years so it's a hobby farm. Okay, how do I do that? What if I lease the farm to a farmer, what kind of income do I have? I have passive income - I have rents. On the other hand, if I go to a joint venture with a farm and he and I own 50% of the cattle and 50% of the equipment and so forth and so on, now I have a joint venture, that's not rent, that's operational income from operating the farm, taking a little bit more liability but it does two things for me--one, I can own the farm in SubChapter S and protect

myself on the liability, I don't have rental income so it doesn't run afoul of the constraint on the rental income on the SubChapter S and so forth. The first thing I want to know is what category am I in? Do I really have a farm? Or is it a resort? Or is it an extraction property? How do I prove it's an extraction property? Sometime you can be just too smart for your own good. I bought an Applewood Hill Orchard I wanted to make sure it was a farm property so that I could depreciate the trees after all trees are depreciable. It said I had to try and raise apples for a minimum of three years after I bought it. Then I found out there was a hell of a lot more to raising apples than I had ever imagined before, including something like 17 sprays that cost me \$150 each and when you're all said and done then the question was who was going to pick the apples. If you succeeded in raising apples you were in big trouble because there was nobody to pick them. The priest from Holy Name Seminary came over the fence and had a wonderful time and sold cider at the church social and they made a hell of a lot of money. So God bless my orchard. Then I discovered gee, if I had just given a double dose of DDT after the first bloom, somehow those blooms never became apples so our sprayer made a terrible mistake, he hit it with a double solution of DDT and I never had any apples again, but at least I had made my three year effort to raise apples and

fall in the farm category rather than the hobby farm category. But then I made my first mistake. I sold the lot, before the three years was up now I had to go back and count the apple trees on the lot by species mind you, figure out what the depreciation base was on each tree by species and refile my income tax for the previous two years and compute how much I owe the government for the depreciation I had taken which had been on trees which were not in business for three years. Do you have any idea of what the accounting costs on that little operation was relative to the tax savings, no match at all. I spent about \$3,000 at being clever, so you really have to begin to figure that out and question is do I want to be a farmer, do I want to be an extraction property, how much gravel do I have to take off the property before I'm an extraction property, do I have prove up the _____. Residential isn't too hard. I believe to be residential is at least 80% of the property has to be residential. It grows out of the leave of the old FHA rule that you weren't entitled to FHA insurance on a residential property unless at least 80% of the income and 90% of the space was residential use rather than commercial. If on the other hand, you fall below that if I recall rightly you have to split the building between the two categories. Then we're too commercial. Then we're finally down to subsidized property, well there's a variety of

subsidized types of property, obviously there are the Section 8's with direct rental subsidies in one form or another, there are those properties which are financed with below market loans by the state housing finance agencies, small business administration, farm home administration, possibly local agencies and so forth, the government is fanatical about double dipping so that if you fall into that category, if you have one of those loans, then the investment tax credit that you could take on the other side is reduced from as I recall 9% to 4% on let's say a new residential property for low income, followed by low income people and so on. So you gotta know which category you're in.

The second thing you gotta know in your acquisition process is for what purpose am I acquiring the property. There are three general categories: One, for use in a business. A property acquired for use in a business has slightly more generous write-off terms and you're entitled to take the ordinary losses on sale of that property against other income. That's true even if it's a proprietorship. At a corporation in which passive income doesn't come into play at all which is another good reason why you might want to go in joint over status _____. Second reason would be for investment and appreciation. And the third reason is called dealer status, i.e. the property is simply on their

inventory, its available for sale like any other kind of trade goods as opposed to the retailer that can have it up on the shelf you've got the building out on a lot, you took it on a trade and so forth and he can obviously turn it over and sell it again.

Now, think of a Realtor, think of yourself, approaching any one particular property you could be any one of all three of these or indeed the property could be two of these. You might buy the building to house your operations as a real estate broker and developer, in which case you bought it for use, and therefore, whatever little goodies there are under that category would be applicable. On the other hand, you could maybe split the property in two and have the office building that's yours as a purchase for use and then have the balance of it and you and mama's pension account as an investment for income and depreciation and be an investor for investment for a position in which case you're entitled to capital gains tax and so forth and so on although that's not much of an entitlement being put all your eggs in. Or third, you bought it as a dealer in which case you never get capital gain status. A subdivider of lots as a general rule is a dealer. He has created stock and trade. His whole product line is there to be sold just like somebody else created cheese and somebody else created cars and whatever, he's not entitled to capital gains. Two exceptions to that,

one, if a business acquired the land for another business purpose which became unnecessary, technically obsolete or whatever, they would be allowed to dispose of the land as a subdivision and so forth and not be a dealer that could take a capital gain on it, in effect its simply a disposition strategy to the benefit of an investor for use where that use is no longer applicable or relevant i.e. the rubber company that bought all the irrigated farms in Tempe, Arizona, to raise cotton for tire cord and then we went to rayon and nylon and so forth, they were allowed to subdivide all of Tempe, Arizona, and take it as a capital gain. The second is where you inherit the land, again inheriting a piece of land which you then further subdivide is simply a way of disposition, more optimal disposition for you and one of course, your basis is the value of the land at the time you took it and it and gain over and above that is the capital gain not an ordinary income gain for what little advantage that may give you today. It's important to know how you are categorized and it has been suggested one of the ways to move real estate income out of the passive category into an earnings category is to be a dealer. So it may be in the old days you leaned over backwards never to be categorized as a dealer. Guys who had never gotten their broker license for fear that was prima facia evidence that they were a dealer. Now today you kind of like the options

of whether you get your broker's license and try to establish an audit trail, you really are a dealer. Take the income out of the passive category and eat that through and through. So we need to know those three categories.

The next thing that we need to know in the acquisition strategy is really to anticipate when we had planned to acquire and when and how we plan to dispose. And where we want the profits to fall. We're going to structure our acquisition to accomplish whatever the purposes of those may be. For example, if I decided that I would like to have the income only on my retirement to support my fishing vice and so forth, I might to decide to acquire his property through my little pension fund in my corporate shell and the income would go to amortize the mortgage, etc., etc., etc., but none of it would be available to me at this time. Only when I bought out of the pension fund would it then be subject to a pro rata tax. On the other hand, if I didn't want it for my pension fund, and I wanted to give it to my kids and this was a wealth transfer device, at that time I might use a tax freeze holding device such as a family corporation with two classes of stocks--preferred and common--and I give my kids the common, the preferred stock would be exactly equal to the purchase price of my property and gradually I would call the preferred, any appreciation in the property would all go to the benefit of the common, and when I died the only thing

in my estate would be the common stock and would be automatically valued at the call price and all the wealth increment would have been transferred to my children without benefit of the gifts tax, without benefit of the inherent tax, and no charge in terms of administration on my estate. So I want to know hey, where is this property going to go, where is this wealth going to be diverted to? On the other hand, if I say gee the play is to give me a little leverage so that I can trade up now what do I want to trade? Well maybe I want to trade stock for stock. Or maybe I have to acquire it through a corporation and so forth, so that the basis is in the corporation. If I acquired it in my own name and then put it in a corporation later, the only basis the corporation gets is the basis I had when I bought it. So the question is, you know, which set of books do I want to keep or which is a particular advantage. So I need to know, when do I want to acquire it when do I think I'm going to dispose of it, and where do I want for that profit to land? Corporations do this all the time of course. Trying to decide how to register it for their own particular corporate purposes of earning per share at a certain quarter. Perhaps getting an out from the corporation and hiding it as a submerged asset. In some cases they want it to appear as a big bonanza and in other cases they don't want it to appear at all. The less the people know what my

real net worth is the less likely to have a raid-- corporations today are very sensitive to that. As soon as people figure out wow there's a lot of real estate in that corporation, the raiders are there to say maybe if I acquire the corporation and then leverage the real estate, why then I only have buy-outs right? And you may just want to spin off some of the crown jewels of the corporation and bury them here and there, so that's its not quite so apparent anyway from those that don't do a great deal of research as to what your real estate position may in fact be. Now, given those considerations then the acquisition of piece of real estate gets to be a fairly sophisticated play even for something as basic as a four unit or an eight unit or small commercial property with a triple net lease on it or whatever else the investor is still looking at in his range of price and down payment available.

A further element in the acquisition formula obviously is to refine the kinds of assets acquired. What class do I want them to fall under in the IRS code? Three, five, ten year category? What evidence can I have to allocate the purchase price to those categories that will with stand the IRS scrutiny. Do I need a bill of sale for the equipment and furnishings? Do I need perhaps a statement as to what the land was purchased for as vacant before I acquired the property? To what degree is the assessment ratio of land

versus buildings apply, do I need that piece of evidence to establish again the audit trail of my allocation, the IRS doesn't necessarily be bound by it but they may be. There's one comfort that you have as a small investor is that it maybe not worth the effort by the Internal Revenue Service to pursue you and the one so you want to push it of course as far as you can to your advantage which is the holler theory of tax allocation. Allocate it the most favorable way until the IRS hollers then you holler back and then you decide if they're really going to make an issue of it or decide that the revenue benefits to the IRS don't match the cost benefits of sending an agent out there to do all that and you arrive at some small compromise which allows them to indicate that they collected some additional tax from you at no great loss face for their agent. The holler theory - most tax _____ are based on this basic premise. But obviously the initial move is for you to push them as hard as you can under the law until they holler and most accountants and most CPA would tell you if they haven't hollered you haven't pushed them hard enough. If you didn't get them this year try them again next year. Okay, we'll pick up again on this on Wednesday. (end of tape).

Announcements for jobs at Prudential in Atlanta. Four full time jobs posted on the job board.

Today we've imported expense and cost. He has graciously agreed to take the pressure off my poor voice as I'm supposed to be lecturing in Atlanta tomorrow and to pick on investment tax credits, I'll turn you over to Mark and then chip in from the sideline. (Mark makes a few announcements.) Mark says people had questions on the case studies one of them was effective versus contract rents. Contract rents are the rent stated on the contract so if you've got \$12 a year that would be your contract rent. Your effective rent is your contract rent less your free rent, so if you have, let's say, two months per year free rent, you would have effective rent of \$10 per year. Also, another person asked about the squeeze down formula. Chief-

-A squeeze down is a joint venture agreement in which both parties agree to provide a certain amount of equity capital initially, and then if the project doesn't run according to budget and additional funds are needed, one party, probably the financial partner, puts in the additional funds for a stated amount, let's say another \$500,000, and party number two goes from a 50% position to a 25% position. And then they if they have to go through a third stage of funding, let's say the carrying costs because the project isn't marketing very well or isn't filling up and so forth, maybe the second time around he's out all together. You know, he ends up with a zero position in the joint venture or

sometimes gets reduced to a slow pay subordinated note as we'll talk about later. Courts will not generally enforce total application or wipe-out of your equity position as being too hard to remedy for failing to meet the call for additional funds, but will allow you to change your position from that of the joint venture partner to a limited partner or change your position from an equity position to a subordinated slow paying note in which interest is at 5% and accumulates for payment ten years down the road, and so on, so they can't say they cheated you out of it, they still owe it to you but it's going to be a long time before you see it, so that's called a squeeze down.

Mark -- are there any more questions? Further clarification of effective rent. Free rent normally comes at the first part of the contract and then the free rent is pro rated over the life of the lease. Chief -- It used to, but now today they've found today that what happens is if they give you six months free rent up front, you'll leave at the end of six months and argue that for some reason they've breached the contract because they didn't do that, and so forth, so if they were going to give you six months free rent on a three year lease, for example, they'd probably give you two months free rent at the beginning of each year. So you work it out over time. I think what you have to do is just assume it's leveled and the effective rent is the

controlling factor. Question--So depreciation on the buildings is 7, 19 or 31.5 effective right now. Chief--no we're assuming today 31.5. When they said in 1986 when they were doing the deal, remember the depreciation wouldn't start until the development had been made so even if you cut the deal in '86 you would not have been entitled to the depreciation until '87, in which case the new law would have applied any way.

Mark--we'll cover three areas of tax mainly. First would be a real short thing on deductions, and some on credits, explain a little bit more in depth passive losses and then maybe some miscellaneous things. First off deduction and credits--deductions in depreciation are subtracted from the gross income to reduce taxable income. So a dollar deduction is worth \$.28 if you're in the 28% tax bracket. A credit, because it's a rehab credit, is a dollar for dollar deduction in tax liability no matter what your tax rate is. So if you have dollar credit, you have a dollar in cash savings. Real quick on depreciation--real property for nonresidential is 31.5 years, for residential it's 27.5 years. Personal property, as Chief mentioned the other day, is mainly 7 year property. There are 3 year, 5 year, 7 year, 10 and 15, 20 year, but it's mainly 7 year property. There are other nonstatutory ways to depreciate real estate and a good example would be the Hertz

Corporation, when they purchase their cars and rent them for a year they quickly realized that the depreciation that they were actually taking on these vehicles was greater than the amount of the depreciation that they were allowed per the debt and hence they used what they have had proven over the years to depreciate their cars. So instead of using a statutory 5 years that they could use, they use something greater than that for their own formulas. And the way that comes in real estate is that tenant improvements and leasing commissions and those would be improvements specifically for the rental of estate in which improve the life of a building or wouldn't be capital improvements, it would also be depreciated over their life. If they have a three year lease and you put in \$3,000 worth of tenant improvements, you depreciation over the life of the least of the 3 years. Chief--By the same token when McDonalds changed their marketing strategy to include seating in-house they were able to show the rate of obsolescence of fast food configuration and structural things was perhaps 7 or 8 years before they went into a new cycle of changing your image and so forth and so on. As a result, they can use say an 8 year useful life on what most of us would have considered real estate simply because the rate of obsolescence relative to marketing was that quick in that business. So, if you keep the historical records and can demonstrate that historically

your useful life of that particular component is shorter than allowed per the code why then you can establish your own useful life.

Mark--Next on the outline is what is called Section 179 Rapid Expenses. And that's was expanded per the '86 tax law and it's used mainly by small businesses or individual businesses, a small appraisal office would be a good example. And what rapid expensing is, is you are able to take Section 38 property which is personal property used in a trade or business and take a \$10,000--up to a \$10,000 expenses. Chief--that's tangible personal property. Mark--A good example would be let's say you bought a computer and printer which totaled \$12,000 of cost for your company. Instead of having to depreciate that over the five year depreciation schedule you can actually expend up to \$10,000 of that in your first year. That also does reduce your basis so your depreciable basis must be \$2,000. If you purchased more than \$200,000 of personal tangible equipment used in trade or business, you start to lose this benefit. So it's mainly for the benefit of smaller businesses.

Credit is the next thing on the outline and as most of you already know, the investment tax credit was repealed retroactively to 12/31/85 and most of you know these new tax laws took effect on Oct. '86. Like I say the investment tax credit was repealed retroactively 10 months so in the future

don't be surprised if they do implement different statutory items that are actually retroactive. So it does pay to keep yourself in tune to the tax law changes because it does make a difference on your investment scenario. The investment tax credit was mainly used as a device to stimulate the economy. It's been implemented and repealed many times over the past couple of decades. And one of the credits that is law and mainly for real estate is the rehab credit and it covers somewhat less than in 551. The old law gave a pretty generous 25%--we'll cover the old stuff first and then we'll go to the new stuff-- 25% investment rehab tax credit if you were on the national register of historic places. And you only had to reduce your basis in the property by \$.50 on the \$1.00. So if you put in \$100,000 worth of stuff you got a 25% investment tax credit, plus you were still able to depreciate \$87,500 and from there was a 20% rehab credit for buildings over 40 years and a 15% rehab credit for buildings over 30 years. The new law you get 20% for certified structures, again on the national register, and 10% credit for buildings built before 1936. So you have to have a building that is 52 years old. Chief--There's an additional constraint in there, isn't there, that your total rehab costs has to exceed the purchase price or the improvement price - the rehab cost has to be greater than or equal to the adjusted basis of the purchase price which

means that, obviously, if you're negotiating a building for rehabilitation purposes you want to negotiate the lowest price for the building possible and if necessary compensate the seller through other means so that you're not forced into a rehab budget that really exceeds the needs or what the project can carry in terms of extra dollars, so at that point it becomes very important to shift the purchase price away from the building and the land underneath it. Mark-- There is 100% reduction in basis for every dollar taken of rehab credit so if you do get 20% rehab credit on \$100,000 you have reduce your depreciable basis by that \$20,000.

Moving on to passive losses. As Graaskamp went through in lecture on Monday, there's three vested incomes, and I'll try to put some examples on the board to clarify a few of the issued held therein.

First off there's compensation which is way to tally portfolio income which is stocks, bonds, and securities in general and it's passive income, which would be limited partnership. You cannot offset passive losses with other types of income, portfolio income and compensation income and the only person who this doesn't apply to, would be to those who materially participate in the deal. And as Chief was saying you almost have to be a dealer in real estate even to be a material participate or a general partner. Even in many instances the general partner does not need to

materially participate. In order to keep the classification of passive income on a limited partnership, let's say you bought a \$100,000 limited partnership, you also have to actively manage or actively become part of the management and once you become an active participant in the management you start to get on that very fine line of whether you are a general partner or a limited partner when it comes to liability on property. Chief--Or you will become a general partner whether you called yourself a limited partner or not. Limited partners are permitted only three decisions, three areas of discretion, sell, refinance, or get rid of an incompetent general partner, and that's all. And they had cases in Milwaukee, for example, in which one of the limiteds after the big snow storm went over and commissioned someone to plow out the drive in the parking lot to get things going and signed a receipt for the snow plow. The driver had completed the work and that blew his cover, he was at that point a general partner, as far as the IRS was concerned and so forth. Passive income is virtually any kind of rental income whether you're a limited partner or not. So the form of ownership isn't the critical thing, it's the source. Darrel Wild can be both, he can be a general partner and he can be a limited partner up to 20%. 20% of ownership. Question--on management service is that considered passive income or not. Chief--If you're a

property manager and managing your own property and you're managing it in your own name as opposed to the company name which manages property for other folks too? (student clarifies) I would think they would still call it passive income because you have in effect offering that service to a wide variety of people. Well all your earned income can go up to \$125,000 before you've lost all tax shelter, as it were, from the tax category. If you make \$100,000 or less, \$25,000 of negative shelter from the passive income to cover your taxable earned income. Again, designed for the little guy rather than the big guy and it's hard to recognize that you have a lot of husbands and wives filing a joint return, both working, they own a couple of duplexes and they take the income from the duplexes and so forth they're getting close to \$100,000. You know, today that's covering the blue collar family. Dad may be at \$40 mother's at \$20 and the real estate carrying \$40,000 net income, okay, that at a point they're \$100,000 and the tax shelter steps into their advantage. Once you go above 125 as I recall you're phased out. Mark--From there, for real estate only is one exception and that's real estate can take up to \$25,000 of passive losses against other income and that's if they own more than 25% of the deal and also are not participants in the deal. And as Chief said any \$100,000 starts to pay out at \$.50 a \$1.00, \$150,000 where it's a \$25,000 write off and

from there let's put a few examples on the board that make this clearer.

Mark--Let's say you've got two partnerships, Partnership A and Partnership B, and Partnership A is putting in \$20,000 of income and Partnership B has losses of \$50,000. And let's say your taxable income is \$100,000, so it stays up but it's not yet started. What you can write off here is you can write off up to \$25,000 of your passive losses against your taxable income and you come up with a \$75,000 taxable annual and you'll have to carry forward and the carry forwards are on an indefinite basis \$5,000 which is the net difference here between 50 and 20 or 30,000 and you can use \$25,000 in losses, coming to \$75,000 taxable and you have \$5,000 of passive losses that are carried forward. On another example, let's say we keep this same example, but instead we have \$120,000 of taxable income. We have \$120,000 of taxable income due to phase out between \$100,000 and \$150,000. We have lost an additional \$10,000 of passive write offs that we could take so this year we only could take \$15,000 of losses against \$120,000 and that's \$105,000 and then we would have a carry forward. Carry forward of \$5,000 and here you have a carry forward of \$15,000. \$25,000 coming from your passive losses. While here's a gain and here's a loss and you have a net passive loss of \$30,000. Chief--so he can pool that and arrive at a net

loss or gain. Mark--So he can write off \$25,000 per the statutes against other income--your compensation income or portfolio income coming up with taxable income of \$75,000. In the second example I could take _____ \$15,000 in passive losses in that year. Because right here you have a net passive loss of \$30,000 you can use \$25,000 this year, which would mean you have \$5,000 left to carry forward in the future years. So let's say next year now you have \$100,000 of income again, but this property has given you \$25,000 of income and this one will have \$40,000 of losses. You can use the carry forward the next year. Chief--You have nothing to gain by postponing it and everything to gain by considering the present value of money and reducing the tax this year. Mark--The carry over would be net and the most you could possibly take would be \$25,000 in the second year for this example. With this other carry forward you would add this together and your accumulated carried forward would be \$20,000. And that is carried forward indefinitely or till sale. And on the sale of the property we have an example, all your passive losses can then be used. So let's say you have a property with a net sales price of \$180,000 and let's say your adjusted basis of the property is \$100,000 coming down \$80,000 of taxable gain but you also have \$60,000 of passive loss carry overs or what they call suspended passive losses. At this point you would net the

whole thing out to a sales price and come up with a \$20,000 taxable gain. To carry this out one step further, let's say you only a selling price of \$120,000 and you had your same adjusted basis and you come down with a tax gain of \$20,000, but you still have the \$60,000 passive loss, can you use the whole thing? Yes. Upon sale the \$25,000 limit does not apply so what you have you have a net loss of \$40,000 of which you could net this \$40,000 from your other income at that time. Chief--Notice one of the things that is in the acquisition process that you want to begin to think about is what do I want to acquire, the tax entity or the real estate? If let`s say this is a real estate entity that was set up in 1985 and enjoyed the tax law that was in place at that point in time, perhaps I'd rather buy the stock or buy the whole partnership and continue forward on the accounting entity that was in place under the old rule. By the same token let's assume that the real estate has a substantial suspended carry forward and you might want to buy a corporate entity or the business entity in order to have that carry forward available at some point in the future and the seller might have reasons to do that to, or you may want trade stock for this corporate company and go forward with that extended entity so that if valuable, you may want to sell that extended entity for reasons that might be appropriate to one seller or another seller. In the

acquisition now you not only want to consider do I want to buy the real estate per se, or do I want to buy the asset directly or do I want to buy by myself or whatever other entity it comes in. Mark--From there _____ differ from the handout we got the other day, you can take credit, that's a rehab credit for passive losses is also, what you have is a credit and as I was mentioning before that was a dollar for dollar reduction in taxes so what you have to do is you have to take your, let's say you have a \$1,000 credit, you actually have take that and divide by your tax rate and point two eight to determine how large of a deduction you need to cover that credit and you would come up with \$3,571. So in order to cover a \$1,000 credit you would have to use up \$3,570 worth of deduction because of the difference in the two. Is that clear? And when it comes to using the deduction versus the credit, deductions, are passive loss deductions always used first and then the credit they use that. Any questions on the passive losses? Question--I'm confused does the passive loss rule apply to individuals as well as corporations? Chief-- It does not apply to corporations at all. You might want to be a corporation and apply as individuals. Striking directly at the sale of real estate positions that were denied a shelter current income, so if go to the corporation thing, the whole issue drops away. We're talking about only individually

properties and single conduit factors. I'm sorry I'm talking about the tax investment credit. In another words, if the corporation had depreciation rules that applied some 386 rule or tax investment credit that they haven't used yet and so forth, you much rather by a corporate entity rather than the asset. Mark--you can deduct \$25,000 in any one year of passive losses and that's a deduction and when you have a credit, that's dollar for dollar reduction especially have to do you have to make the credit that same as the deduction in order to do that when coming up with the \$25,000 maximum loss you can write off against other income, you have to end up dividing by .28 and this is what it would take to use \$1,000 worth of credit of a rehab credit or a tax credit. The application would be say let's say you have a property where you have deductions or losses of \$10,000 and you also have another \$1,000 of credit. You can write off up to \$25,000 of against that income. So you have \$10,000 of your deductions and how much of your credit can you use. In this case you can use the whole thing because it doesn't go greater than a \$25,000 limit. Now let's say you have \$10,000 and it becomes \$35,000 of losses now you only can \$10,000 of your deduction but \$15,000 to \$35,500. Chief--then you fall into what the ultimate tax formula. They're going to get you one way or the other. Mark--If you're in the 28% tax bracket you wouldn't be using this.

As you reveal the tax bracket you won't need these deductions or losses anyway. Chief--Essentially the individual and you might work through that for them, show them that essentially by the time you're over \$100,000 you have an average tax on everything of 28%. You get a reduction initially in the first part and then you get a hyped up tax rate on the next portion and that averages all out and by the time you go over \$100,400 or something like that then every dollar you pay in taxes is 28%. Essentially there are no progressive tax rates.

Mark--For the individual who makes between zero and \$17,000 you're going to pay 15% taxes on that money. For the individual who makes between this is for a single person, assuming a single person is similar to the married person brackets are higher. For the person making between \$17,850 and \$43,000 you have to pay \$2,677 and 28% tax on anything over \$17,850. From \$43,150 to \$100,480 there's actually a 33% tax rate and you go well I thought we down to a two tax rate system, this isn't 28%? What is being done here is on the \$17,850 they pay the 28% tax bracket less the 15% tax bracket, in other words they're trying to come up with a flat tax remodified flat tax here. And they say the difference is 13%. And you multiply that 13% times \$17,850 and you come up with an additional tax of \$2,320 and they take that number, divide it by .05, because the .05 is the

difference between the 28% tax bracket and the 33% tax bracket where they're actually beginning to recapture you difference between the 28% tax bracket in the medium range and the 15% tax bracket in the lower range. Then it comes to you have to make an additional \$46,000 to recoup this \$2,300 that you would have been taxes at if your whole income was taxed at 28%. Additionally what they have is a personal exemption, we always take one. In 1988 of \$19,500 and they do the same thing with that coming up with Chief-- \$19,050 or 1,950? RATS (laughter). Mark-- \$1,950 And when you add them all up and you come to this amount what you'll have at anything over and once over \$100,000, once again taxed at the 28% tax rate, but every dollar at this \$100,000 mark is taxed at 28%. Your marginal tax rate is 28%, your average tax rate is 28% at this point. And that would include taxes on your personal exemption. Chief--It's only you that has elected poverty as a student that enjoys the 15% rate with no further recapture. But who said Reagan never did anything for you. The other big favor is that real estate of course was the neutron bomb, but that's _____.

Mark--A few words on some miscellaneous things, the first thing I want to bring up is the No Compete Clause, that's kinda of in a buy but let's say you're selling a shopping center and you're a develop or I'm buying one and

I'm a pension fund syndication and I realize that if I buy the shopping center for \$2 million that I have to depreciate the shopping center over 31.5 years. But now let's say I buy the shopping center for \$1.7 million and also pay the developer another \$300,000 to not him compete with me for let's say over the next three years within a three mile range. Because I know if he comes in and builds another center I'm dead in the water, he knows all my tenants better than I do and he'd just take them all. And what you would have is you would have \$300,000 which would depreciate over its life and since the No Compete Clause for three years you can depreciate that \$300,000 over three years. That's one way that a lot of syndicators were playing with the numbers but what was happening is the IRS was tripping them up a little bit and that they would look at both sides of the transaction and the developer who comes and not compete for \$300,000 was taking that income as a capital gain income and an No Compete Clause is the ordinary income and they were tracing the transaction back and forth but that today that won't make it much of a difference but let's say you were back in 1985 where there was a 50% tax reduction for capital gains versus ordinary income, you have to be careful to make sure that he's going to recognize this No Compete Clause as ordinary income and you're able to depreciate it over three years to make your numbers work easy in the early years of

the transaction. Chief--He can also charge you other fees for example from consulting fees to let's just deal with the take over of the management, you might pay in leasing commissions on the remaining income from rental contracts already being in place and in effect being purchased and assigned for the acquisition of the rental building and so forth, all of which allows you to accelerate the depreciation on that portion of your investment and the total dollar paid still adds up to what you were going to pay for the shopping center. So there's great deal as I mentioned in one of the earlier lectures creative accounting year in terms of whether did I buy a tangible asset which would be the brick and mortar and the land, or whether I bought an intangible asset in the form of leases or in the form of consulting purposes and an No Compete Clause and whatever, the more inventive you could get, the more fees were being closed out of the transaction and the lower the real estate prices appeared to be from the seller's standpoint, if it was ordinary income maybe he was able to sell to that in another way, and from the buyers viewpoint it gave him an accelerated write off which meant that the limited partners were coming into pay for their development or investment for three years and generate enough shelter over the rapid write off to, in effect, be just simply transferring into the partnership and tax savings for

another income. And we're trying to balance those off.

Uncle can be spiteful as he rapidly as he can.

Mark--From there I have just a few notes on syndication costs. The first one is what I'm going to label as three different types of costs to the syndicator. The first one would be to organize the partnership. And in organizing a partnership you can write those costs off or amortize them off over a period of 60 months or longer. The second area is for the costs incurred to acquire real estate. Those costs must be added to the basis of the real estate. So if you bought the property for \$2 million and it cost you an additional \$20,000 to purchase to get all the legal and everything else for the acquisition, you add that \$20,000 to the \$2 million purchase price and have a basis of \$2,020,000. Chief--If you segregate those costs which are for the lender's purposes, would be amortized over the term of the loan. Costs which are for the equity purposes would have to be amortized over the depreciable life of the real estate. If you have a 10 year loan on the residential property at 27.5 whatever year life, the engineering inspection of the property would be relative to the longer term - the appraisal cost for the loan because it was specified by the lender and would be amortized over the life over the loan. There is some ability to match those expenditures. Mark--The third category we have here are the

costs incurred in marketing fees limited partnership and that would be the brokerage commission that goes to the financial planners or to the people that actually sell the property and those you can't write off at all. You simply deduct those from the sales price and there's no deductions as you go along over time.

The last category I have here are the master limited partnerships and for all practical purposes at this point, I think they're dead in the water, but I think they're worth pretty much as an example of the way things can happen with other investments. Originally, master limited partnerships were set up to be passive income generators. In other words generate passive income to offset passive losses such as the example that I set up here earlier on limited partnerships that many people bought and the deep tax shelter partnerships were in vogue. And per December '87 regulations, master limited partnership income of NOP's were considered to be portfolio income and as the master limited partnership is a partnership that's traded on an organized exchange mostly, like the New York Stock Exchange, the over the counter market - they deemed it to be a corporation for those purposes and have put income back in the bucket of portfolio income. Additionally, starting in 1988 maturities master limited partnerships dead in the water is that they will be deemed corporations. They're given the title of

master limited partnerships, they're going to be given as far as the tax courts are concerned, they're going to be deemed a corporation and as a corporation they will be double tax entity and that would be a double tax entity for the most part. Chief--Most of the knowledgeable people in the tax business knew that was coming but the syndicators of course jumped on the MLP, as a loophole, and the other problem of course is they generated so many dependent fees putting together that the more people that got suckered into an MLP before the door was closed, pocketed the fees and as long as they had a big paragraph on prospectus that said tax status of these isn't quite clear, that the tax status change at any time and that's part of the investment risk test and that's all they have to say. And Charlie Cluts doesn't read the prospectus and doesn't know what it said why that's his problem. Mark--That's about it as far as I what I needed to do. Chief--Thank you. Question--Can you give an example of that _____. Mark--Okay, let's say you're selling a limited partnership shares and you sell one for \$50,000 you have a financial planner or Merrill Lynch or who ever sells these things, he'll sell them usually at a commission rate of 6% to 9% and let's say 6% in this instance it will cost \$3,000 to sell this particular limited partnership share. This share, this \$3,000 is not deductible currently as an expense, you cannot amortize it,

the only time it comes into play, let's say that whole limited partnership is later liquidated for \$1,000,000 and it's \$30,000 of total commission, to come out the detailed price at the end which will be whatever, 7 or 8. Chief--It becomes part of your basis for going in. Thank you Mark.

Chief--In looking at the acquisition of the property, of any property, there are two things, considerations to keep in mind. One, of course, is the tax consideration to the seller and what he chooses to account and the second, of course, how do you want to structure it for your future tax considerations. And which works out best for both? As we argued in 856 innumerable times, ultimately the price they arrive at is engineered to lessen the impact on the seller and maximize the benefits for the buyer, depending of course on their general priorities. For example, the seller may have _____. Let's say you're buying a one day medical/surgical center type facility where in the state of Wisconsin, until recently did allow one of those let's say for community, that's a franchise, not strictly a real estate enterprise, but franchises are never entitled to capital gain, they're always taxed on sale of ordinary income. So it's really important to load the price of the purchase of that particular _____, into the real estate so that the operator of the abortion clinic or the one day surgical center or whatever, takes his gain on the real

estate value as capital gain and receives as a little as possible in terms of profit on the sale of the business where he's going to be taxed on the ordinary income basis. On the other hand, if you were buying a business which was involved with, say, manufacturing and you bought an industrial plant, with the inventory, and the machinery and so forth, it would be very useful to load as much of the purchase price into the inventory, into the purchase of existing contracts and retainers that were in place for that concern and as little to the real estate as possible so that in effect you could write off much of the purchase price against sales as a reduction in inventory value as opposed to depreciating over 31.5 years the real estate you bought. Now obviously you can't be absurd in how far the pendulum swings to one side or not, but there's a lot of room for erring on one side or the other depending on the deal and then daring the IRS to find it and then fight about it. And so the parties need to find out what their purposes are, for example, the deal of the year in terms of the SIR a couple of years ago was when Gordy Wright bought the old Gesholt Johnson plant. Gesholt Johnson had been absorbed by Giddings and Lewis who had moved all of their operations except the foundry up to Oshkosh or wherever they're headquarters was, and now they got a plant on their books which at that particular time had a book value higher than

the market value. Giddings and Lewis didn't want to take a hit on the surplus for the one time write down because the security analyst would be on top of that immediately and so they said well, tell you what we'll do, you buy it from us at our book value so it's zero balance as far as our surplus is concerned, that even gives us a small profit and we'll lease it back to you, above you, for a certain annual rent so that in effect the losses of the empty building were being feathered out again operating years in which they had taxable income. And they were converted essentially what would have been a capital loss to an ordinary loss in the form of rental expense. Then they had a release clause built in the says if Gordy Wright rented up the space and began collecting rents why then they would be released from their rental contract so it gave in effect Gordy a positive cash flow on a vacant building on the day he took it over. And he was smart enough to know that he could give away two to three months free rent and, in effect, Gesholt Johnson was paying the rent for that concession because he didn't have to take a credit against the rent he was getting from Gesholt Johnson until the tenants started to pay \$5. That's not too hard to make the deal work on that kind of basis. But at the same time the seller got what they wanted. They were allowed to extricate themselves from a surplus industrial facility where Gordy Wright took over the

operating costs, eating taxes and one thing or another they did not have to take a hit on the surplus which might have alarmed the securities analysts. They were allowed to write off the loss, in effect, as an ordinary loss against future income. And, for that matter, they were allowed to use the foundry then for another 5 or 10 years as a matter of fact before they actually closed out of that. So notice what's happening both side are looking at the tax consequences and then structuring the deal in such a way they optimize on either side of the equation. And again, cash flow available from the project Gordy was able to borrow enough money to make tenant improvements to further subdivide the building into a multiple tenant facility rather than obviously a single tenant one. Most deals are structured in that way ultimately. What does the seller need? What does the buyer need? How does FASB accounting treat that? You're going to hear a lot of that from Jay Shidler when he's here later this spring and that's really his whole game - is understanding the corporate culture and FASB accounting rules specifically to know when there's a buy point in which he can buy the property at a price lower than market price, making it appear that the seller took a profit. So let's say you have an industrial building that was bought on a sale and lease back and let's say it had a 25, 30 year term on the sale and lease back a lot of these deals were cut

from 1967 to 1971-72. The accounting rules at that time required that you take the present value of the rent payments, treat them as though they were, in fact, an amortized level payment mortgage and create a liability from the liability side of the ledger equal to the present value of those future rent payments. Prior to that time you did not have to recognize more than one month of one year's rent on the books as a liability. At the same time, to offset that, you put onto the asset side the true value of the facility - whatever the cost is to buy the land, build the plant, put in the machinery, whatever else that had gone on. Because you were allowed to depreciate the asset as though you had bought it, and therefore on an accelerated basis, you ran the asset side of your ledger down very quickly. But the liability side was being run down just like an amortized mortgage in which most of it was interest in the first year and obviously, the large principal payments did not occur until later. So in effect, you were understating your surplus because your liabilities were out of kilter relative to your assets. Right? Furthermore you had to do that if you had a lease for longer than three years. If I had a corporation that needs a quick hit and a little juice to its earnings for this year, he can go in and say "gee," I'll tell you what I'm going to do - I'll buy that leasehold position from you for X dollars and re-lease the property to

you for 23 months, or 33 months, or 36 months, or whatever and give you the option to continue to renewing that to what would have been the end of the original 30 year term or whatever it was. And what that does is instantly take the asset off the asset side and the liability off the liability side. Since the liability is significantly larger than the asset, it drops right into surplus as earnings. Now Mr. Shidler is sitting in a position of a sandwich lease and he is now making the payments to whoever made the sale/leaseback in the first place and the guy that was in the property originally is now making rent payments to Mr. Shidler. Those rent payments undoubtedly in a deal cut in 1968-69-70 are significantly below the market rent for that space today. So his only risk is the guy doesn't renew at the end of three years, the reason for going into the deal was to escape the long term lease. All he has to do is worry about releasing the property at something greater than the rent which was left over from the olden days and he's home free, his cash flow is even better than it was before. Now he turns around and looks at the guy that owns the building, let's say it's otherwise a nice building, a good location, a relatively good structure, after he's owned it for a couple of years he thinks gee - this isn't a bad deal and there's 15 years to run on a lease that was set to yield 7 1/2%, to the insurance company at the time they made the

deal - which was not a bad deal in 1968. Now he goes around and says, "Gee - the leasehold value in this building is pretty substantial." Let's say it's a \$5.0 million warehouse, industrial type facility and currently gives him the present value of the rent stream to you to the end of the term, even assuming a resale price that's relatively favorable, is \$3.5 million. And I have a leasehold value of \$1.5 million because that's present value of the rental increment I can make over and above what I have to pay new. So I'll tell you what I'm going to do, I'll pay you \$4.0 million for it, you can reinvest the \$4.0 million and make up time by being able to invest at the current rate and I'm buying a building which has a \$5.0 million market value and reassembling the fee for a \$1.0 million less than market. And in most cases the seller would go through with that. He hasn't been able to extricate himself because the hit would have been too great. But the chances are good that he has already depreciated the property below the \$4.0 million mark so he's going to register a profit too. So the fee holder comes out with a capital gain less than he would have liked but at least he has his money back to reinvest at current rates which are more opportune. The tenant is out from under. He's just taken a little hit in the surplus to improve his earnings, he's happy and what's more he's improved his corporate flexibility, in that, he now has a

series of three year leases in which any time he wants to pick up and move or relocate or whatever, he can do that. He hasn't noticed Mr. Shidler in the meantime bought the leasehold out at less than it's value and now he buys the fee at less than its value (. . . tape problem) and given the fact that he bought the asset at less than market, he can effect finance out on the whole deal and never have a nickel of his own money in it. But notice he's playing the FASB rules on one side and he's playing the fact that the asset manager on the other side looks bad 'cause he got an asset of X dollars which is generating a rather miserable cash-on-cash yield and his investors let's say in pension funds, might want more cash-on-cash and _____ I'm not quite so anxious for the upside of property and realize there's no upside left on the property. They're much happier to get their cash out and reinvest at the current yield. So he looks better because he's improved his cash-on-cash yield, even though he's given away possible capital gains ten or fifteen years from now, everybody wins. It's totally engineered. _____, just sold for \$4.0 million, therefore, that's market value, baloney. OK? So you have to look at the acquisition, how do I want to set it up? How do I want to set it up for tax purposes? How do I want it to look on the sellers books and notice if the seller doesn't work consistently with you, as Mark pointed out, Uncle Sam

smells "rat", he'll go back and unwrap the transaction on both sides and say, "Hey, he's treated as a capital gain and you treat it as a fee, what goes on here? Obviously, there must be a capital gain, so you can't write it off in three years, you're going to write it off over 27.5 years. You really have to make sure that doesn't occur. For example, one of the classic leaseback cases involved Minnesota Mining leasing a warehouse in Minneapolis and the developer came in, whom they had worked with before, wanted 100% financing on the deal, went to his friendly bank who was happy to do that. The bank said "All right, tell you what you're going to do. We'll make that a simple net lease for 3M and you assign us the full amount of the lease income until 100% of the financing on the warehouse has been amortized. Any time you want to step in buy down the mortgage or put some equity in, why then we'll restructure the deal and he can save on the capital. Now, the owner of the building, the developer, he depreciated the whole thing and deducted all of his payments to the lender as interest and took all of the payments from Minnesota Mining as rent. The IRS came in and said, "Wait a minute, nominally that lender who has title to the property as the security for his loan, he doesn't have any operating risk at all. Minnesota Mining has agreed to pay all of the operating, all of the maintenance costs, it's a triple net deal. The guy in the middle made his profit up

front - the construction fee and so forth, and the lender says, in effect, that while he has title you can have the property back any time you want to give him X dollars and make it an 80% loan again. So your deal with the lender really isn't wed to the lender at all. It doesn't match up. The lender has no ownership risk. Therefore, the lender ain't the owner, therefore the payments to the lender ain't rent. And indeed, the lender's books showed it as a mortgage loan. It didn't matter the fact that they were holding deed. As far as they were concerned, it was a straight mortgage deal - interest and principal. The developer, had in effect, deducting all his payments to the lender as rent. That didn't match up with their documentation as far as their in-house accounting was concerned. The deal was off and the lender had to go back and obviously pay taxes on the principal payments that he had been making to amortize the loan. You have to be confident in the acquisition that the seller is going to be treating the various dollars received in the same way as you are acknowledging them for your tax purposes as outlet. And that's part of the negotiations in the final folding. How each party will handle those elements.

The second element that you're going to be concerned with is timing - one element of timing is, of course, that's changed slightly is the fact that depreciation works on the

half year rule or the quarter year rule - if you buy real estate in the 7th month, you're allowed to depreciate it only for 6 months of that year. If you buy in the first half of the year, say in the first half of the year, you would be allowed 12 months depreciation on it. If you buy it in the last three months of the year, you're allowed only depreciation to 25% of what might have been possible on an annual basis. That's a change because in the old days, you could buy it on the 28th of December and depreciate it for the full fiscal year. So they chopped down on that. So now if you need a little extra kick early on, you may want to close part of the deal on December 28th which is the end of one calendar year and close the other part of the deal in the next fiscal year. So if you're limited to \$25,000 of tax losses, you get that to fall in two different tax years and you time your closing accordingly. By the same token, if you need to take the expenditures for certain elective items, you want to make sure you get them to fall in the tax year which has the income. There's an offset. One of the advantages of perhaps the so called convertible loan is that if a pension fund comes along and funds that shopping center while technically they may be willing to come in as a joint venture partner, put up 90% of the money and own the damn thing, their depreciation is going to get burned right up the chimney. They don't really need it, they're not

taxable. So by making it a convertible loan, the interest payments made to the lender which may be all the net income in the property, are totally deductible for the developer. He retains control and the depreciation such as it may be and the other tax investment credits and so forth as they may be, may all go to the developer or to his equity partner, depending on how he structures it. And then seven or eight years later, the lender has the right to call on the property and say, "OK, I'm going to take a 75% ownership position and forgive the debt, or I want my money back, it didn't turn out as well as you guys said and you're going to have to refinance it." But notice they've structured it by this deferred ownership position so that the tax benefits are going one direction and the income is going another direction. Another way to do that is split the ownership of the land and the building. One party that doesn't need shelter owns the land and takes land rent plus a participation and the other party owns the building and therefore is able to take the depreciation relative to his entity, but may get very little of the income during the depreciable phase of the project. So there's different ways to carve up the interest to provide 1) allocation of tax, income and capital gain benefits and 2) modify the timing as to when each party receives it. For example, with foreign capital, if it's structured right, there may be no capital

gains tax at all if you dissolve the total entity, sell of the whole thing and take your money home. As a result they may structure their deal largely as debt with a kicker of participation in the resale and then, in effect, simply liquidate the whole enterprise and take their profit home in the form of a one-lump liquidation dividend. And that was also possible in the old days for the American entity having a single 30 day liquidation obtain no double taxes on a corporate structure, but that's not possible any more. For foreign investors, it still is. So again, his timing and the character of the distribution is something that you want to build in up front. OK we'll stop for the moment. See you on Tuesday.