JAMES A. GRAASKAMP COLLECTION OF TEACHING MATERIALS

IV. UW REAL ESTATE ALUMNI ASSOCIATION

C. Fieldtrips

6. Minneapolis, April 21-23, 1988

b. "Factors Affecting Real Estate Values and Pricing", Speech prepared on April 19, 1988, for Minneapolis trip. Graaskamp died on April 22, 1988 in Madison

Index

4/19/88
in preparation
for MN alumni
reunion

FACTORS AFFECTING REAL ESTATE VALUES & PRICING

JAG died 4/22/88

I. Despite the many successes in real estate, finance and development, investment real estate is in trouble on many fronts in terms of losses to loan institutions, marginal performance of equity investments for many asset managers and pension funds, and abuses of real estate in the Wall Street game of churning with leverage buyouts. These pressures are changing both the strategy and tactics in the game as well as the rule making by accountants and appraisers.

A. Strategy now recognizes that supply is the enemy when it crushes the opportunity for price/quality distinctions and that the only defense is to be the lowest cost producer. As Jay Shidler lectured our students, the lowest cost supplier buys existing property with potential for intensive management and structures to keep down the cash break even point.

1. LBOs are driving the cash break even point in the wrong direction by adding debt for uncertain time which means a lot more troubled real estate.

2. Consolidation of anchor real estate chains in control of developers means the misfit of store style to demographics since the shopping center developer is not serving the site choice of the department store - instead the department store is being used to entice financing for the site.

3. Safety as well as profit will be achieved if the purchase price is right and that means gradually rising cap rates rather than dependence on high rates of inflation and pass throughs.

B. Financing will no longer reflect aggressive projections because of a significant change in accounting rules. In late 1986 FASB defined the difference between a forecast and a projection.

1. A forecast must be supported at each point by ~~i~~ emperical evidence and explained in the footnotes.

2. A projection may involve hypothetical what-ifs. An accountant is not permitted to do a projection if it is to be circulated publicly or privately and the accountant is not available to explain his work. As a result, prudent lending would require loans be based on a forecast and I doubt if the SEC will continue to permit projections with questionable assumptions about price trends, cost inflation, and similar matters.

C. The accountants are pushing hard for accrual accounting so that net operating income measures economic productivity but distributable cash measures the ability of the enterprise to fund outside capital sources. Two exhibits attached demonstrate some of the necessary adjustments. I think it can be shown that many income properties have failed in recent years because lenders and appraisers related to net operating income rather than the ability of distributable cash to meet debt service payments.

1. Cash flow lending rather than loan to value will be the new buzz word and that will flatten prices or lead to more blanket mortgages which link a small portfolio of proven properties to a new development property.

2. Cash flow lending will rely more on credit enhancement and credit analysis than on collateral as capital markets become more removed from local real estate.

D. Accounting rules create many opportunities to deal with corporations who may wish to use their real estate positions to modify their corporate P&L or balance sheet. 1. The purchase of leasehold positions set in the late 60s and early 70s can produce profits for the corporation and acquisitions at less than market price for the professional.

2. The ability to close quickly may permit a corporate executive to sell a project which had been written off for sufficient earnings per share to stabilize his growth rate or for enough cash to improve his quick ratio and a forthcoming bond issue.

3. Accounting consolidation rules will require corporations to bring their real estate subsidiaries on to the corporate balance sheet.

4. As Jay Shidler puts it, to provide real estate services you have to solve the property owner's problem and it may not be real estate. The consultant will take the lead in the relationship rather than the broker.

E. Market value accounting for real estate assets is an idea whose time has come, although the techniques need to be refined.

1. It is interesting to note that stock markets don't always agree with appraisers. The Rouse Real Estate Trust reported market values in the neighborhood of \$27-\$28 and the market readjusted to \$18-\$19 a share because not all the seaport centers were doing well so that replacement cost as reported was being readjusted by shareholders to an anticipated income value.

2. Real estate asset management groups like NCREIF and PREA are struggling to establish standardized accounting rules in order to have standardized comparisons of cash invested, cash available for distribution, and cash available at various points along the cycle depending on the need to compare performance of individual buildings over time, portfolios over time and managers over time.

3. Major issues are:

    a. How to capitalize deferred maintenance, capital improvements.

    b. How to expense, amortize or capitalize tenant improvements and commissions.

    c. How to amortize or write off concessions and delayed concessions.

    d. How to recognize special value added by non-market financing.

    e. Should values be reported at market and with leasehold deductions so an investor can see the potential upside on renewals?

4. Pension fund asset committees use outside appraisers as advisory but only one major fund is bound by the annual independent value.

5. As pension investors turn toward cash on cash yields rather than capital gain issues, interest will focus on holding down resale estimates to have a lower base for the ratio. Conversely, if change in equity is the goal, then all capital expenditures may be added to the capital account without amortization.

6. One can expect a fairly tight set of accounting and appraisal rules will be promulgated to provide standardization and reflect the current trend toward better financial information, better matching of revenues and cost, and more consistent reporting on the capital side to reflect either value assuming immediate sale or value assuming the scenario plays out.

II. Real estate appraisal has always been manipulated by the industry to serve a variety of purposes. There was hope that R41C, a coordinated appraisal program among all federally insured agencies, or federally sponsored standards and certification would allow appraisal to reclaim control of its own integrity. Except for the federal government who currently pays the losses, none of the real estate organizations could afford to have an objective non-controllable appraisal process so it is doubtful that the Barnard Bill will be passed or that the new foundation will become operational in the immediate future. The foundation is working with volunteers while the federally sponsored program anticipated costs of $19 to $20 million.

A. Federal agencies will set up their own standards board which will not require state participation.

B. Accountants will establish standards for accounting firms doing appraisals.

C. There will need to be several major due diligence trials with substantial losses to lenders for lack of real objective appraisal standards before we get back to a detailed set of appraisal specs.

D. Auditing of our weekend banking system will have so much difficulty with real estate lending that regulations will gradually push banks and savings and loans out of most commercial real estate development as a non-approved asset so that financing sources will shift toward the non-bank banks including some securitization.

1. One of the more interesting proposals is to strip rents off a AA credit tenant and create a security pool with these rents discounted at the best corporate ~~real estate~~ opportunity rate. A residual real estate trust would only underwrite the remaining equity not funded by the sale of a ten-year lease. Like a zero coupon bond, the asset would appreciate as the leasehold estate was paid off. The result is lower cost to the tenant and protection against calls on the income or the asset.

plus 25-50 basis points

III. As case law begins to develop on due diligence and liabilities to those who fail to exercise it, we are also beginning a new era of concern about toxic waste, hazardous materials, and building failures where new techniques didn't necessarily have the durability of the tried and true.

A. Perceived risks for many of these problems often lead to market discounts in excess of cost secure, therefore putting pricing out of line with values.

B. Escrows and other hold harmless arrangements in the closing documents may conceal substantial price adjustments from the public eye, distorting comparable sales prices.

C. Corporate balance sheets may need to recognize long-term liabilities for old industrial sites, waste sites or even areas with common problems like diesel tanks.

D. The real estate professional must understand the increasing influence of new accounting rules on real estate suppliers and indirectly on the SEC. Appraisal will continue to be a battle ground, but due diligence will ultimately force rising standards to protect the lender against the disappointed expectations .

E. The inability to rely on market or cost to replace means much more careful construction of pro forma forecasts.