JAMES A. GRAASKAMP COLLECTION OF TEACHING MATERIALS

V. INDUSTRY SEMINARS AND SPEECHES - SHORT TERM

A. Appraisal Organizations

18. Dates and/or Groups Unknown

a. "Joint MAI-SREA Dinner"

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Circa 1980

Joint MAI-SREA Dinner

I. I regret to report that the traditional real estate appraisal process finally died on October 6, 1979, the day the Federal Reserve Board raised the discount rate and began a tough monetary policy. By April,1980 the prime was a 20% and real estate funds for financing debt are in extremely short supply.

   A. The real estate market can no longer perceive real estate values as cash to the seller with a simple debt-equity relationship.

   B. In the residential field there will be increasing use of shared appreciation mortgages and for income property lenders share in the income over and above debt service while remaining creditors and then convert their creditor position to ownership when it appears advantageous to do so.

   C. Fee simple title is not important; control and entitlement to assumable loans, building permits, sewer capacity, shopping center agreements, and franchises are important but they are not real estate.

   D. Market comparison analysis assumes simple motivation for prudent men viewing the real estate property in isolation from all other events when in fact buyers are operating at multiple market levels to maximize their total position rather than their real estate position.

II. The market comparison approach requires that you properly define the market and the rights to be appraised.

   A. Today there are three basic markets for income property.

      1. Those who buy for use
      2. Those who buy as a commodity speculation
      3. Those who buy to arbitrage

   B. The most common entitlement is credit from the seller and/or assumable financing, therefore the appraiser must consider the cash equivalency of comparable sales.

   C. However, fair market value considers only the economic productivity, the economic surplus of the real estate, and does not consider its use as a commodity or the premiums involved in arbitrage so that these sales must also be brought back to cash equivalency based on economic productivity.

   D. Most sales of major commercial property are engineered to serve a variety of business purposes in terms of tax consequences, financing packages, estate planning, or partnership fees relative to security law constraints. The appraiser is obliged to research evey comparable sale and relevant data bearing on most probable buyer.

      1. The Pelton water wheel
      2. The Castle Rock Flowage

III. The definition of income attributable to real estate as compared attributable to the activities within real estate. Working with Phil Adams, a Chicago CPA, and several areas of interest we came up with the following six rules:

A. Is the income space or retail space units? Parking ramp vs parking space, observation tickets vs. observation floor, tennis court hours vs. tennis building, etc.

B. Are the entitlements and public permits transferrable and portable? Bar license, preliminary plat, dam permit.

C. Is the revenue for a service typically provided or a discretionary extra? (Cleaning the corridors vs. maid service for the apartment)

D. Is the income for ancillary functions rather than those which must be integral with the project?

E. How does the IRS classify the asset as real property or personal property, or tangible or intangible assets?

F. Is Income attributable to governmental agencies in exchange for contractual entitlements of control or use to the public interest for the term of the contract?

IV. The conventional wisdom is that people buy real estate to protect against inflation and that gamblers in real estate expect prices to rise mysteriously. That's mush, there is only three reasons that prices will rise:

A. An increase in net income

B. A fall in interest rates permitting generation of a refinancing surplus or change in cash throw-off

C. A fall in investors expectations, the last two are non-vested interests which cannot be taxed by the assessor. Only the first lends itself to any kind of forecasting.

D. Presumably the equity version from resale would be net proceeds from sale less total dollars due and payable to lenders, payable to professionals as fees for their services, the costs of transfer, and possibly the tax authorities. If so, how do you answer these questions?

1. Does the syndicator's share of the net reversion represent deferred payment for his management which created the value, because he invested his time rather than his own money and which was subordinated to cash returns to the investors from operations? This could be a sizable 10-20%.

2. Were the variable rate mortgages negotiated to use an index that reflected the cost of money? If not, the share of sale or refinancing proceeds might provide the lender with more than an acceptable return on capital invested at the expense of land and management.

3. Is the premium paid for real estate suitable for syndication or condomium conversion? Is the payment attributable to the real estate or the business opportunity of retailing market shares or market units?

4. In subsidized housing there is little reason to believe the resale price will increase for 20 years or more. Rents are allowed to

increase only enough to cover increased operating costs and subsidized loan agreements, and rental contracts place a variety of penalties on conversion to conventional market use. Prices paid for the unit represent primarily the present value of tax shelter plus a small cash dividend, and resale values and profit centers for the limited partners attributable to anything but tax shelter are virtually discarded in the investor calculus.

5. Many leases today feature full pass-through of increasing expenses to the tenant, and so the cost of occupancy can become unreasonably high. Is it the terms of the lease or the cost of occupancy that represents fair market rent? Just as property is appraised on the basis of market rent rather than contract rent, should not the appraiser reduce income by an amount attributable to income derived due to insensitive negotiation of escalator clauses? For example, in California Proposition 13 reduced taxes, but many tenants received no benefits because their leases passed through the increases from the status quo.

6. The issue of whether to lease or buy is a function of current cash needs, salvage value of the asset, and the opportunity cost of money. As interest rates fluctuate, a bank could find ownership or leasing more attractive, depending on net bank earning power rates and rates assumed by lessors providing building space. Should a bank own half and lease half to average the loss of the rental postiion versus the short term straddle?

7. How does one define equity when the mortgage lender decides to take that portion of resale value necessary to modify its yield on the financing to an internal rate of 18%, given a 12% interest only mortgage?

E. All of these problems require handcrafting of cash flows and reversions from the facts in the case. October 6 was the death of value equals NOI/OAR and comparison of sales OAR based on NOI/V.

1. Those of us in acadamia are not greedy
2. Many appraisers haven't heard the news
3. Sophisticated appraisal customers could care less - their accountants have been using discounted cash flow to value their real estate for years.
3. But what will the assessor s do for fair market value? October 6, 1979 will make a shambles of January 1, 1981.