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V. INDUSTRY SEMINARS AND SPEECHES - SHORT TERM

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ENTREPRENEURIAL DECISION-MAKING IN THE DEVELOPMENT PROCESS:  
THE PUBLIC/PRIVATE APPROACH

Note: The following outline references certain exhibits in the monograph "Fundamentals of Real Estate Development" which is included in your study kit.

1. Some Basic Definitions and Concepts
  - A. Real estate is artificially delineated space with a fourth dimension in time referenced to a fixed point on the face of the earth, space intended to enclose or house some activity.
    1. It is a space/time unit of enclosure, such as square foot per year, apartment per month, hotel room per night, tennis court per hour, and Lake Tahoe condominium for time interval of June.
    2. It is both tangible and intangible product of man - an artifact, a manufactured product.
    3. In a money economy the product space/time equals money/time.
  - B. A real estate project is a cash cycle manufacturing and service enterprise. Development and management is the process of converting space/time to money/time and vice versa.
  - C. The real estate business is any type of expertise which is necessary to execute the conversion of space/time or money/time requirements to the other and therefore includes architects, brokers, city planners, mortgage bankers, etc.
    1. All the true profit centers in a real estate project are in the sale of services and cash capital to the real estate project. Money is an energy transfer system.
    2. Free enterprise is the art of controlling the customer; a real estate project is a very wealthy customer for services, so to control the project is to determine which entity provides the services. (Robert Moses, The Power Broker).
  - D. Therefore equity ownership is the degree to which one enterprise can control or divert cash from another real estate enterprise. It is a dynamic concept of benefit and rights of decision making rather than a static measure such as market value less mortgage or historical cost of acquisition.
    1. Fully integrated development companies are the most stable because they tap the broadest variety of cash flow.

2. Limited partners are called owners but in fact are second mortgage bond holders.
  3. Lenders on a convertible mortgage are preferred stock holders with cumulative dividends and common stock warrants.
  4. Ownership is in the substance of control rather than in the name of the document.
- E. The public has a direct ownership of every real estate project to the degree that real estate taxes, sales taxes, user fees, etc. divert a share of project income in excess of service costs provided by the public.
1. Maintenance of free enterprise in the public sector to prevent expropriation of real estate productivity is as essential as maintaining competitive free enterprise in the private sector.
  2. Communities must compete for capital investment and capital must be free to move or increasing diversion of cash flow of existing as well as new development is inevitable.
  3. Communities must be free to fail as well as to succeed, like any other business to maintain discipline in the allocation of scarce capital resources.
  4. There may need to be legislation to control community monopolies and cartels of citizens which destroy competitive choice.
- F. The real estate process or development process is the dynamic interaction of three enterprise groups, space consumers, space producers, and public infrastructures. (See diagram on page 4 of monograph).
1. Space consumer groups include individual users in the marketplace, collective users in the political system, and future users in the judicial system or market system.
  2. Space production group includes all forms of expertise or capital necessary to convert space/time needs for money/time needs.
  3. The public infrastructure group includes all those enterprises which provide a network of tangible and intangible off-site systems to support a particular project.
- G. Each member of these three functional groups represents a rational enterprise and a cash cycle operation. Each has limited receipts and necessary outlays and in order to survive must maintain cash solvency. Cash solvency for survival is the pivotal issue in finding a negotiated equilibrium among these groups.
- H. Solvency is essential but development of a surplus with consistency over time creates credibility and power for the enterprise manager, whether it is a city manager, a hospital manager or home builder who must establish trust and confidence with a city council, a hospital board, or a bank loan committee.

- I. Cash solvency, not value, is the critical issue in development, an explicit minimum which provides a base for reconciliation. Beyond that the negotiation issues are who pays and who benefits in terms of a surplus. Hence all the recent concerns for fiscal impact studies.
- J. Since value is a technical matter which relates only to assessment and mortgage loan regulation, the concept of highest and best use can be dismissed. You will find it useful to apply the more contemporary terms, most fitting use and most probable use.
  - 1. Most fitting use is a normative concept, an economic ideal, the optimal reconciliation of relevant consumer demands, the cost of production, the cost of infrastructure services, and the fiscal and environmental impact on third parties. It assumes that all goals and limitations have been well defined and that misfits between a proposed development program and standards can be recognized.
  - 2. Most probable use recognizes that execution will fall short of the idea because of short term constraints inherent in personalities, talents, politics, and the state of real estate technology or the money market. These short term constraints invariably involve survival and survival is often an issue of solvency and current cash needs.
  - 3. The systems engineer states dynamically that at any point in time an enterprise is a compromise because the form it takes, in terms of both its configuration and its behavior reflects a negotiated consensus between two general sources of power - the power of its environment to dictate form and the power of the organization itself to decide what its form and behavior will be.
- K. If real estate development sounds complex, it is! Recall the words of Patrick Moynihan relative to housing: "...we have never learned to be sufficiently thoughtful about the tasks of running a complex society, the essence of tyranny is the denial of complexity. It is the great corrupter and must be resisted with purpose and with energy... what we need are great complexifiers..."
- II. Despite the concern with brick and mortar, ultimately a real estate project requires that each party buy a set of assumptions about the future - the softest product in the enterprise economy. Uncertainty is characterized as subjective doubt about the reliability of the assumptions while risk is the specific potential variance between assumptions and realizations, pro forma budgets and historical accounting.
  - A. One can position himself relative to uncertainty or ignore long term trends which will upset the status quo. (Site selection assuming urban compression or placement of elderly housing in small towns to meet current needs despite probable future needs).

- B. Risk management is an explicit analytical philosophy which examines each assumption and then shifts the variance to others or provides a tolerance for surprise in the financial plans of the enterprise.
- C. For this first session it will be useful to structure an initial set of assumptions for which risk management concepts will be applied later.
- D. There are only three basic real estate problems:
  - 1. A site in search of a use
  - 2. A use in search of a site
  - 3. An investor in search of a real estate investment opportunity
- E. Refer to Figure 5, page 15: The Search for a Site for a Use
  - 1. Note necessity of detailed profile including user management objectives.
  - 2. Anatomy of a decision - alternative courses of action and outcomes ranked by criteria representing objectives generated from value judgments.
- F. Comment on Figure 6, page 16 - Site in Search of a Use
  - 1. Definition of alternatives or most probable use
  - 2. Definition of most probable user - buyer - ultimate investor - collective consumer
- G. The ultimate investor today ranks his choices as follows:
  - 1. Political exposure
    - a. Land use controls
    - b. Subsidized government competition
    - c. Subsidized effective demand
  - 2. Degree of market control
    - a. Identity of interest with user
    - b. Pre-leased
    - c. Reciprocity
    - d. Monopoly through research
  - 3. Degree of management intensiveness
    - a. Dependence on a personality
    - b. Marketing intensive for high-turnover tenants
    - c. Labor intensive for high-turnover skills
    - d. Industrialized management for stable tenancy
    - e. Triple net leasing
- H. Cash flow characteristics of project components (For further ranking)
  - 1. Maximum exposure before commitment
  - 2. Maximum cash exposure during development
  - 3. Cash flow constraints on tenant or user/price sensitivity to rising rents

4. Cash flow required by money partners
  5. Cash flow characteristics in an inflationary economy  
(Cash flow and rising resale prices depend on increasing net, falling interest rates, or reduced investor expectation).
- I. Degree of trade-off of liability, need for capital, income tax law, and estate planning objectives.
- III. Preliminary analysis of a project should begin with some basic pre-tax models which can be done with a pencil at your desk. As the basic financial parameters can be known, it is then possible to move to a wide variety of cash planning models available on computer time sharing systems and mini computers alike.
- A. Figure 8, page 18 - Loan to Cash Ratio Approach - the old-fashioned way.
  - B. Figure 9, page 20 - Debt Cover Ratio Approach - the lenders point of view.
  - C. Figure 10, page 21 - The Default Ratio Approach - the contemporary risk management view.
  - D. These models allow you to test the sensitivity of basic feasibility to a change in real estate taxes, the debt service constant advantage of an economic development loan, a write-down on land costs, or the real estate taxes available for a tax increment.
    1. A good source of basic financial parameters for different types of properties on a quarterly basis is Table M, Commitments on \$100,000 and Over on Multi-Family and Non-Residential Mortgages Made by Twenty Life Insurance Companies, Loan Size Class Within Major Property Type, 1st Quarter, 1980, 1850 K Street, N.W., Washington, D.C. 20006, published by American Council of Life Insurance.
    2. The cash cycle impact from the community, see: The Fiscal Impact Handbook, Robert W. Burchell, David Listokin, The Center for Urban Policy Research, P.O. Box 38, New Brunswick, New Jersey 08903, 1978.
  - E. Traditional appraisal capitalization methods have nothing to do with the development process. The developer and municipality must make systematic estimates on an accounting spread sheet by year and then quarterly of the cash receipts and the cash outlays in the deal for each party with whom they have major relationships in order to measure the pleasure, pain and bail-out points of their associates. Each cash outlay and receipt by category must be profiled:
    1. Amount and possible variance
    2. Schedule time and possible variance
    3. Lead and lag times
    4. Funds available to cover gaps
    5. Funds available to cover over-runs
    6. Funds available for latent defects and motivational pain

- F. Figure 11 is only one example of a variety of cash flow models available on the computer, main frames or minis.
1. Select consultants and appraisers who use such models
  2. Learn to look for critical ratios appropriate to the problem
  3. The objective of such models is to test many alternative scenarios about the future, given changes in project concept or external conditions you may wish to anticipate.
- IV. All assumptions for economic development which depend on creating revenues for real estate cash flows must begin with a customer. More projects fail for lack of sensitivity to the customer than for any other reason. Nevertheless the real estate industry spends less on effective and skillful marketing research about the preferences and choice behavior of its customers than any other major American industry.
- A. Market research is analysis aggregate data from secondary sources such as population by age group or some other natural segment of the market. It defines the scale of the market but never reveals very much about the profit.
- B. Merchandising data is primary research of the consumer preferences and recent past choices to determine:
1. The competitive standard
  2. The competitive edge
- C. The private sector has been able to be insensitive to the ultimate user in strong markets where consumers have few choices. However economic development is dealing with areas which already have merchandising problems so that it is essential to know at the start what those problems are and which ones are remedial and which ones are not.
1. Downtown will never be what is once was; before renewal starts find out what the new market is and what elements in the cost of friction can be removed or softened by increasing the attraction of the destination. (Santa Maria)
  2. For those in the public sector the attitudes and needs of the collective consumer will have just as much influence on permissible projects as those of the space user. (Office versus residential - save the trees).
  3. Fear of change is as significant a research problem as motivation for specific improvements because in the political sphere that fear is the motivation of most voters in an age of accelerating change.

- D. The fundamental issues in a pre-architectural marketing program research study are:
1. Who needs it and can they afford it?
  2. Who signs the check for it and what are their unmet needs?
  3. Who can perceive a loss as a result of the project and can they block it? What are their unmet needs?
  4. Who might be a future user and are his basic needs adaptable?
- E. The project manager desperately needs a profile of the consumer if the project is to maintain sensitivity to the occupants because:
1. The financial analysts are inclined to improve their ratios and cash flows by building to the limit of the envelope rather than the needs and efficiency of the user. (Office buildings 85' wide with 40' bays when 32' is more efficient is the result of building to the limits of the site rather than absorbing surplus land costs).
  2. Architects presume what's best for the occupant if not held in check by a type of pre-architectural program. Buildings are too important to be left to architects.
  3. Citizen boards are easily misled with renderings, models, and well rehearsed professional graphic presentations.
  4. Most fitting use and feasibility is ultimately an ethical framework of suitability to those who are most impacted by the development. Housing for the elderly is good on a simple unit basis but sensitivity to the elderly and the detailing is ultimately the measure of success - not simply the existence of the project and consumption of the Section 8 quota.
- F. California residential developers have been particularly innovative in researching the housing consumer, the housing market segmentation process, the specific needs and trade-offs, and the visual and social codes which trigger effective demand.
- G. Few of these research techniques have been brought to bear by professional office building, industrial park, or retail development specialists. Often the best office and retail complexes, in terms of sensitivity to a predefined consumer profile, have been done by single family home developers sliding into other areas of development. We do the following kind of market and merchandising study for an MXD development:
1. A regional economic model and SMSA model which forecast employment by SIC code.
  2. A census of facilities in the subject area to determine space and current employment by SIC code.
  3. Linkage of SMSA forecast by SIC code to a space needs forecast for subject area by SIC code to explain past absorption and future capture rates for selected building types.



4. Profile of motivations for relocation and/or growth by survey intended to profile prospects, define location and product necessities, identify unsatisfied segments.
  5. A survey will sensitize prospects to potential projects, and test marketing communication channels.
  6. Consumer panel sessions to respond to alternative plans of the subject property for projects competitive to it.
- H. Economic development with a private/public interface depends on knowing the amount and timing of cash flow generated from the ultimate consumer. If the available cash flow in the form of effective demand is less than the rent required for the project in mind, the area of public participation through cost sharing capital cost write-downs, interest rate subsidies, or direct subsidies to the consumer can be determined.
1. Too great a subsidy inflates production costs and profits
  2. An inadequate subsidy creates a shortfall with very expensive long term consequences in terms of absorption, operating efficiency, or project failure which taints the image of economic development and future phases of the development.
- I. Space over time must change uses so beware of over-specialized design or covenants; money over time may be devalued by continued inflation but inflation per se does not cause resale prices to rise.
1. The trend is toward participatory democracy; public value on who benefits and who pays from a given allocation of resource is open for discussion.
  2. The manufacture of real estate is a high silhouette industry in which each and every product provides the public with a new opportunity to discuss the issues of who pays and who benefits.
  3. Cash solvency is the final arbitrator and short term surpluses (gains) for each enterprise are the incentive to find solutions in the short run.