JAMES A. GRAASKAMP COLLECTION OF TEACHING MATERIALS

V. INDUSTRY SEMINARS AND SPEECHES - SHORT TERM

D. The Legal Profession

2. "Economic Aspects of 'Tax-Sheltered' Investments in Real Estate", presented at the Midwinter Meeting of the State Bar of Wisconsin, Milwaukee, WI. February 21, 1974

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ECONOMIC ASPECTS OF 'TAX SHELTERED' INVESTMENT IN REAL ESTATE

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Midwinter Meeting of the State Bar of Wisconsin

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I. Some Basic Real Estate Attributes and Definitions

A. A space-time interface of land (public resource), people (cultural preference) and artifacts (improvements).

B. Convert neutral forces to identified decision makers - consumer, producer, and society with the planner as the arbitrator.

C. Some implications of this definition of the Real Estate process:

1. Land is an exhaustible resource and therefore a public utility.
2. Business of Real Estate is the process of converting space-time to money-time.
3. Real Estate Business is a service industry using manufactured products.
4. The space-time service product is the social terrarium and there-fore a public utility.
5. The money not the Real Estate is the only private property.

D. The legal concept of private Real Estate

1. Private property the residual after subtracting public rights.
2. In a service industry there is no ownership of a product - only control of a customer.
3. Twentieth Century Real Estate equity is a degree to which one controls disbursements of a captive customer.

E. Feasibility is a nonfinancial concept of matching artifact and service to a context of public priorities and customer needs.

F. Real Estate investment is "buying" a set of financial assumptions derivative of a feasible solution.

G. Risk is the variance between assumptions taken and realizations achieved, between proforma estimates and P and L realized.

II. Basic Elements of a Real Estate Financial Model Which in Turn Identify the Exposure for Risk Analysis Might be as Follows:

A. Definition of desired profit centers

B. Definition of a timeline over which events will still take place

C. Assumptions on the capital budget and sequence of source and applications of funds.

1. Direct construction or purchase cost
2. Indirect and capitalized carrying cost

D. Assumptions on operating budget and sequence of source and application
   1. Pattern of sales revenues
   2. Pattern of operating expenses

E. Financial plan
   1. Credit amounts and terms
   2. Equity amounts and terms
   3. Holding power

F. Profits classified as to type and tax
   1. Cash from operations
   2. Cash from capital gains
   3. Cash surplus from financing
   4. Cash from tax savings on other income

G. Selected measures of profitability
   1. Definition of investment
   2. Definition of profit
   3. Selected ratios of profit to investment

H. Selected measures of risk
   1. Payback periods
   2. Capacity for variance
   3. Variance controls

III. Real estate investment decisions may often finally depend on a question of the expected rate of return and the risk incurred in pursuing that investment return. There is a natural tendency in appraisal to consider the net income figure and the over-all investment as fixed numbers--as conditions of certainty.

A. An investment in a bond can be defined as to when it begins in time, when it is sold, when coupons are collectable and total costs and total receipts under alternative outcomes. Thus, yield is easily computed and risk depends on whether you can rely on the promisor.

B. Real estate financial analysis seldom enjoys such a rigid set of financial specifications and therefore seldom enjoys reasonable conditions of certainty.

C. To talk about risk and compare it between investments implies some explicit measures rather than simply subjective doubt--expressed by a shrug of the shoulders.

D. Risk evaluation or comparison grows out of the function of risk management for an enterprise. Risk management has two objectives:

1. Conservation of existing enterprise assets despite surprise events
2. Realization of budgeted expectations despite surprise events

E. The process of risk management involves systematic and continuous:

1. Identification of significant exposures to loss
2. Estimation of potential loss frequency and severity
3. Identification of alternative methods to avoid loss
4. Selection of a risk management method
5. Monitoring execution of risk management plan

IV. The risk management process is both a philosophy of inquiry or analysis and a systematic management process which is attempting to answer "WHAT IF. . . ?" questions, to anticipate surprise and to provide for a response or adjustment in advance of the contingency.

A. Identification of significant exposures by looking for implicit assumptions

1. Marketing demand estimates and product definitions
2. Underlying demand generators
3. Competitive standard of competitive edge (monopoly)
4. Direct capital cost
5. Political contraints on time line
6. Availability of personnel

B. The alternative methods of avoiding loss which everyone subconsciously uses include:

1. Eliminate risk exposure
2. Reduce frequency or severity of loss (mortgage loan closing process)
3. Combine risks to increase predictability (reserves for expenses)
4. Shift risk by contract (subcontracts or escape clauses)
5. Shift risk by combination by contract (insurance)
6. Limit maximum loss (corporate shell or limited parnership)
7. Hedging (sale and lease-back, options, contingent sales)
8. Performance incentives

C. Some basic measures for comparing risk

1. Maximum potential liability (cash equity, assumptions, and personnel liability)
2. Rate of equity payback
3. Operating cash break-even point including debt service
4. Capture rate required as percent of market potential
5. Number of profit centers available to investor participation

V. Some Current Trends Affecting Real Estate

A. Control of marketing risk through market research of special consumer groups and their motivation to create monopoly.

B. Control of discretionary expenses by motivation of professional manager through contracts with incentive compensation formulas.

C. Public control of new land development plus control of auto transit means recycling of intown sites.

D. Energy crisis will redefine linkages to utilities regionally as well as locally.

E. Energy crisis will mean redefinition of the auto and all auto dependent forms of land use.

F. Energy crisis will alter expensive character of current leisure.

G. As real estate becomes recognized as a service product, fee ownership declines in significance

H. Trend toward condominium and homeowners association means success of hardware is tied directly to success of group organization software.