JAMES A. GRAASKAMP COLLECTION OF TEACHING MATERIALS

V. INDUSTRY SEMINARS AND SPEECHES - SHORT TERM

F. Miscellaneous Professional Associations

1. "Forces for Good and Evil Affecting the Soul of Real Estate Finance", presented to the Wisconsin Mortgage Bankers Association, May 16, 1983

Wisconsin Mortgage Bankers Association
May 16, 1983

FORCES FOR GOOD AND EVIL AFFECTING THE SOUL OF
REAL ESTATE FINANCE

I. Mortgage banking has been wandering in the wilderness the past several years searching its soul for an identity, tryin gto identify its satanic foes in the marketplace and looking ofr new guardian angels in a time of momentous forces surging through the economic system. Presumably the forces for good are winning in this great morality play of finance and it is my role today to hopefully identify some of the angels and the devils in this purgatory called the marketplace.

   A. The general topic areas may be:

      1. Deflation versus inflation
      2. Segmentation of effective demand
      3. The Wisconsin economy
      4. The reorganization of ~~the~~ real estate financial institutions
      5. Redirection of regulation of real estate investment
      6. New tools of the trade for the mortgage banker

II. Everyone in the money game is pondering the relative strength of inflation factors versus deflation factors.

   A. Economist Heller says that unemployment and underutilized industrial base of 30% will permit considerable upward turn of the economy without inflation - a traditional measure of capacity to expand before dollars chase a limited supply. Presumably the recovery will be labor intensive, increasing demand, increasing tax collections, and reducing the deficit as a percent of GNP to a typical 2.5 to 3% a year. That scenario depends on Reagan reducing his $200 billion deficit by chopping defense spending by $50 billion or more.

   B. But other economists suggest that we have shifted to a post industrial society so that some recovery need not be labor intensive, but rather capital intensive in a period of deflation when refinancing existing properties may be more sifnificant than building new since office, retail, and hotel capacity is over-built throughout the country. Given federal and state government needs to monetize deficit spending, the capital pool available for reinvestment will be greatly reduced and generally preoccupied with refinancing rather than building new.

   C. A third group contends that the forthcoming presidential election will require expanding supplies of money and an expanding economy to the fall of 1984 and that the inflationary impact of that will not be recognized until after the election by the majority of ~~the~~ voters. Reagan can feed the cyncism by failing to reappoint Volcker, insisting on his full defense budget or most of it now rather than later and concealing the structural changes in employment needs by implementing the new programs for new employment passed by Congress three years too late. Assuming a capital intensive recovery with continued deflationary employment the Mortgage Banker should be in a position to benefit from the opportunities to refinance commercial properties and market new residential loans in the greatly expanded secondary markets.

D. The deflationary cycle with intensive capital action for refinancing is particularly appropriate to Wisconsin where the profitability of farming is held in check by the new federal farm support program, major industry elements continue to retrench in the face of technological and structural market obsolescence, and significant expansion of employment occurs in small businesses providing special services.

E. All of this suggests that in Wisconsin investors must buy well - at the right price, at the righ financing, at the right income to price ratio rather than simply position themselves for significant inflation in real estate prices. Wisconsin will benefit less than most states from:

1. Increases in defense spending
2. Price support programs for agriculture which are already reducing seed, feed, equipment, and supply purchases by corn and dairy people
3. Some of our unemployment is structural rather than cyclical since some of our heavy industry not truly competitive in the international markets
4. Areas that heavily unionized will continue to face wage readjustments as a condition of reemployment or characteristic of underemployment in steel, construction, and agri-industry areas

F. In short, I predict that instead of inflation or deflation, Wisconsin will enjoy flation, tottering along sideways while politicians, industrialists and bankers take gas.

III. The economic forces for good and evil will require greater care in the selection of projects for which there is effective demand. Costs of relocation today are very high - think of just the cost of moving your telephone. Moreover, if firms have pared down staffs to bare bone efficiency where is there the capacity to absorb the waste time of arranging a move and still getting the job done? As a result there has to be a significant cash advantage to relocate:

A. Feasibility has nothing to do with price per sq. ft.in terms of rent but rather the total cost of occupancy in a specific space for the tenant. Now that you have so cleverly shifted all the costs with passthroughs the tenant knows what he is paying for and there is a premium to be gained by reducing space requirements, lighting costs, heating and air conditioning costs, partitioning costs, costs of stringing cable between data processing equipment, etc.

1. The office user is shifting toward semi-enclosed movable desks for work stations, with task lighting and computer type raised floors for stringing various cables and utilities without a star drill. Ceilings have no lighting features - only extra-heavy sound proofing. Light industrial building may do the job best when rents of Class A office space reach $18-22/sq. ft.

2. Our growing population of elderly may egin to recognize that investment income from the equity value in their homes may make congregate housing with personal support services more feasible in their own community so that more existing homes will come on the market of a size and location which is preferable to new construction.

3. Retailing is becoming more specialized in terms of an emphasis on economy or recreational spending, smaller stores, better service in terms of replacement of inventory so that procedure and management is replacing the place for square footage.

B. The choice of space to be occupied is now recognized to influence every revenue and expense item on the income statement of a business. At the same time the amenities people seek will be modified by a new set of values and priorities among those coming out of colleges who anticipate working couples unstable employment, the constant need for reeducation, and a desire to reduce fixed expenses like mortgage payments in favor of discretionary income.

IV. For the moment you are more concerned with the ongoing reorganization of financial institutions the redirection of regulation of real estate investment, and new tools of the trade. But it should be noted that ultimately the cash flow on which mortgages and equity dividends depend as well as resale prices depends on how well you fit the product to the consumer as dividuals and as a collective group operating through government.

A. As you are aware real estate financial institutions are shifting from managers of a general pool of savings deposits to managers of a whole series of segregated funds. The insurance industry may segregate by customer, the thrift industry is segregating by type of deposit - IRA, KEOGH, CD, service corporation capital etc. And the bank trust department is not only concerned with investment management for the corporate client but for the middle class individual with an inheritance or other capital pool. Bank trust departments are the sleepers. a common unit real estate fund is now possible for the investor pays only an annual management fee with no front end load, no profit participation and no flip flop or back end load.

B. Thus the savings and loan has become a mortgage banker, the mortgage banker has become a commercial broker, the bank has become a syndicator, the insurance company lender is now the buyer, the real estate broker is trying to be a mortgage banker, the builder is now a property manager and the Harvard MBA's who specialized in leverage and liability management to destroy the real estate trust are back as asset managers.

C. Those of us who teach real estate finance are looking for another speciality, like ancient history, where the lecture notes don't have to change every semester. Traditional functional delineations in the textbooks are gone and the differences seem to be only in how different groups charge their fee and regulate their industry while bringing money to bear on real estate problems.

V. The regulation of real estate investment at every level is becoming more sophisticated in terms of allocation of risk, cash flows, and personal accountability.

A. At the federal level ERISA has imposed new definitions and sensitivity to the accountability of fiduciaries in the management of funds with the result that research is beginning on the need to interface accounting conventions of full disclosure with the lack of standardization and skill in the appraisal field. Within two years there will be standardized letters of engagement for appraisal services which will specify how to construct rent roll data, set up expense statements, provide proper accruals and cash writeoffs of tenant improvements, and select the parameters for the presumed conditions of resale. The market approach is suspect and the cost approach irrelevant.

B. This push by users of appraisal services to bring appraisal into the twentieth century is already happening and it represents a perfect illustration of the Naisbett thesis that we are a grass roots society bringing about change from the bottom up. The consumer is still king and centralized appraisal societies will go the way of network television and the Saturday Evening Post.

C. In due course standardized accounting will produce indexes to measure the performance of asset managers and full disclosure will extend to lease details, senstivity analysis, and deflation as well as inflation scenarios.

D. Land use regulations are becoming much more sensitive to planning for the fiscal cash flows of the community as well as the cash flows as related to density for the developer. As mixed use and conditional zoning spreads to provide equitable cash flow impacts, the use of private/public consortium to share the risk is also growing.

1. The Milwaukee Grand Mall is a classic example of tiering cash flows and risks to match the particular skills and responsibilities of the various parties.

2. Notice the tremendous Legislative fight about TIF districts and about who pays and who benefits.

E. The real estate tax system in urban areas is becoming more equitable, more efficient, and people are beginning to understand the advantage of having assessments at market value to avoid the errors of equalization. At the same time, assessors are learning about cash equalized value and the need to adjust prices that reflect creative financing. Eventually even mortgage bankers will learn to cooperate and to share information with assessors to avoid miscalculation of real estate taxes; you may even learn to avoid underestimating real estate taxes deliberately to secure financing since attorneys for disgruntled investors will eralize due diligence includes realistic planning for real estate taxes. Even lenders who expect a share in cash throwoff have a vested interest in understanding real estate taxes and planning appropriately.

1. One irony is that ERISA, the source of so many dollars for real estate investment, will soon be the cause of rising real estate taxes as communities find it necessary to fund the handsome pension programs granted the rising municipal labor force.

2. Do you realize that there are companies that cannot afford to go out of business even though their plant is obsolete because of their obligations to fund pensions; indeed a primary reason for funding Chrysler at the expense of US taxpayers was that the loan might be cheaper than funding the pension guaranteed by ERISA for employees of firms that go out of business?

F. Federal, circuit, and real estate tax courts are becoming far more sophisticated about cash streams as the fundamental element of commercial real estate. With that realization comes the need to plan, budget, audit, allocate, and balance returns against risk and effort. Often it requires tough decisions by fair minded people if unnecessary litigation is to be avoided:

1. Cash equivalency values of subsidized housing
2. Bankruptcy values of real estate in the TIF district
3. Asset allocations for a shopping center or hotel between land, building, personalty, intangibles, and management
4. Public improvements to be funded by the developer and his customer
5. The equity of subsidized competition
6. The equity of subsidized demand

VI. New tools for the mortgage banking trade

A. The impact of the mini computer, spread sheet models like Supercalc and cheap software packages to do specific types of analysis will be incredible. It will soon be unprofessional and premafacie malfeasance to fail to provide sensitivity analysis of cash flow budgets. The assumptions of each projection must be clearly understood. A federal in Los Angeles once said in a recent case involving a partnership dissolution "I cannot buy the assumptions of fair market value as presented by the MAI; I can accept the financial planning assumption of an after tax cash simulation of the investors expectation..."

B. Data base management systems will one day provide meaningful records of occupancy and absorption and energy efficiency from electric meter records, natural gas consumption in discreet physical neighborhoods, traffic counts, and highly detailed information about consumers of every product and service. Building permits will require justification of demand estimates.

C. Communities and states are creating loan funds for special situations to insulate projects from market interest rates. At the community level block grant funds are available for rehabilitation loans, small business development, etc. administered by local sources; at the state level there are sources like WHFA, CHAP, and other funds such as veterans loans, and at the federal level there are a variety of sources including UDAG, Farm Home Administration, and other sources focused on specific needs.

D. The residential market is forever inventing new secondary markets such as themutual fund, guarantees of limited partnership interests, etc.

E. Other new ideas include the west coast innovation of matching of equity trusts and a limited partnership; the equity trust makes a convertible mortgage to the partnership in exchange for virtually all of the income and some of the residual; the partnership gets the tax shelter and a portion of the residual.

F. An interesting competitor with mortgage bankers who refinance the estates to pay estate taxes is the new feature in estate tax law which automatically provides a 10 year loan at 4% interest in the amount of estate taxes due if the net estate owns real estate for more than 35% of its value, or farm or small business.

G. The master lease of an existing improved property to someone wishing to improve the property is an excellent way to preserve legal title for an estate or family and shift the tax credit for renovation for an older building to a developer and marketing entity. It finances 100% of the purchase price and could be convertible to the equity side of the redeveloper after achieving some preferred rate of return.

H. The new mortgage banker is licensed to sell securities, broker real estate, serve as investment counselor, and sell time as a business consultant as well as be compensated on commission. Indeed he is a specialiat in small business investment banking.