JAMES A. GRAASKAMP COLLECTION OF TEACHING MATERIALS

V. INDUSTRY SEMINARS AND SPEECHES - SHORT TERM

F. Miscellaneous Professional Associations

8. "The Outlook for Real Estate", Life Officers Investment Seminar, June 15, 1982

Index

THE OUTLOOK FOR REAL ESTATE
Life Officers Investment Seminar
June 15, 1982

Professor James Graaskamp

I. Outlook Implies Perspective

A. Economic premises as to where we are

1. Some time ago the savings and real estate investment patterns which prevailed for decades changed, and the real estate markets came unglued.
2. The critical date in the real estate revolution is probably October 6, 1979 when the Open Market Committee decided to target the growth and the money supply rather than the level of the interest rates.
3. As a result savings banks and savings and loan associations, which supplied more than 50% of at least residential mortgage money, have been in decline for reasons that are clear:

    a. Loss of Funds - The past five years have seen a massive, multibillion dollar withdrawal from savings institutions in favor of more market sensitive instruments. From September 1980 through 1981, mutual savings banks suffered deposit overflows totalling 11 billion dollars.
    b. Shift in Liability Mix - The bulk of deposits not withdrawn shifted from day of deposit accounts at more or less 5½% to time deposits at current market rates.
    c. The general inadvisability of borrowing short and lending long is now well recognized with a devastating impact on both new construction and sales liquidity of housing. Creative financing is essentially art of extracting the brokers commission in cash while the seller waits for his money and the buyer waits for "a hole in the interest market" which doesn't come.

4. At the same time the life insurance industry has suffered several fundamental changes of fortune:

    a. Disintermediation - As interest rates soared, policyholders borrowed massively against cash values at rates of 6% or less to reinvest in new financial instruments at 10% or more.
    b. Policy Mix Change - Most importantly, the past few years have seen a dramatic change in the mix of business from whole life to term, and more recently, to universal life. The purchaser of insurance began to realize that, in inflationary times, a yield of 6% or more on the savings component of a whole life policy was not too attractive. Policy loans, coupled with the change in the business mix, reduced radically the flow of investable funds to life insurance companies.

5. Nevertheless the pace of real estate development in the commercial area, as compared to residential, has accelerated. Even as the traditional participants lost interest in mortgages, lost traditional market shares, a new set of players was emerging.

a. ERISA accelerated funding schedules, diversification, and emphasis on investment growth exceeding the rate of inflation.
b. Inflation and high interest devastated the bond market and sent them on a search for indexed funds and real estate has appeared as a surrogate bond with indexing.
c. Tax laws were modified to eliminate tax penalty on leverage real estate as unrelated business income for pension funds (still exists for everybody else).
d. Development of new investment products by banks and life insurance companies who established unitized commingled funds.

6. Equally significant is the ongoing massive restructuring of financial service business, including:

a. The emergence of the financial hybrid such as the Sears/ Coldwell Banker/Dean Witter conglomerate, American Express/ Shearson/Firemen's Funds, National Steel/S&L acquisition, Prudential/Bache, and Phibro/Salomon Brothers.

Interstate banking which will greatly reduce the number of banks. East Coast banks are already staking out locations of their major offices on the West Coast and vice versa.
b. Broadened banking powers - A bill now in Congress would broaden significantly the power of savings banks and make them similar to and more competitive with commercial banks. Also, both commercial and savings institutions may, in the near future, be permitted to own property other than banking premises.
c. The investment products also are changing, almost as fast as the participants. For example, we now have: money market funds; All-Savers certificates; tax shelter syndications; and universal life or term insurance plus a cash value or savings fund.

B. Investment Attitudes About Where we are Going

1. Ten years ago real estate investors expected a minimum cash return of about 9% and a total expected return of 12% - i.e., 75% of yield was hard dollar flows and 25% was sought in an inflationary reversion. Real estate investors repudiated the theory of stock investors who are buying futures.
2. In '81 and '82 a complete reverse in the real estate equation had taken palce - cash yields were 6% and the magic number was an 18% IRR.
3. In the last six months we have seen cash yields move from 10% to 13%, and targeted yields have declined slightly as investment managers have dropped their forecasted increase in income from 8 to 5 to 3 or 0% assumed rate of increase.
4. Deflation of reversion expectation and risk management and discussions on strategic positioning of diversification are now heard as qualifications on internal rate and the competition for dollars among different investment products must be considered turbulent and essentially out of control as far as SEC or bank regulation is concerned.

5. As interest rates soared, reverse leverage became apparent and for the first time in recent history real estate became extensively financed with equity, and debt was retained only where old paper provided extra value or capital leverage.
6. Not only did capitalization rates on good quality income property fall, but the rates cut loose from their normal relationship with long term interest rates. Prime rates above 20% in 1980 and '81 caused little waver, so cap rates were still at 10% or less when the long term debt markets were at 13% or more. Cap rates traditionally were 150 basis points below mortgage rates but today it is closer to 600 basis points. Real estate has undergone a dramatic change in status - it is now regarded as a growth investment, and that is a very dangerous assumption.
7. Growth stock may not be appropriate since the rising price is primarily a response to the inflation which is transforming the capital structure of America's capital markets. Commercial real estate has become a rough substitute for a capital indexed and interest indexed security, and the shortage of alternative investment capable of doing this job may make commercial real estate respectable.
8. There is no adequate measure of performance in real estate but the highly touted PRISA has published charts that will catch your eye:

   a. In the first quarter of 1980 PRISA's unit value, which reflects growth in income and capital combined after deducting management expenses, recorded a gain of 7.9%. In the same troubled period, Salomon Brothers' long-term bond index recorded a 13.5% fall after allowing for reinvestment of income, while the Standard and Poors 500 index of common stocks showed a fall of 4.3% on the same basis. In fact, PRISA's unit value has never shown a decline between one quarter and another at any point since the fund was set up in 1970. It even sailed through the real estate crisis of 1974-75 without serious upset. True, the performance was thoroughly dull until 1978 and the figures in the chart on the preceding page are partly based on unrealized appreciation thrown up by valuations carried out by independent appraisers. But even the most hardened sceptic must feel a twinge of interest in a fund that claims to have outperformed common stocks, long-term bonds and three-month treasury bills by a mile in the decade since its inception, and to have beaten the consumer price index by more than 400% over the same period.

C. Strategic constraints on how we will get there

1. Acceptability of political risk
2. Degree of channelled demand
3. Degree of management intensiveness
4. Size and character of capital pool available to exploit opportunity
5. Sensitivity to taxes

D. Alternative gains which can be played with real estate (affecting investment value)

1. Housing an activity as part of a larger system or process
2. Captive customer for services
3. Bond surrogate (portfolio theory)
4. Long term commodity straddle
5. Small business investment with warrants
6. Tax shelter leverage for estate accumulation and distribution

II. The Medium Is the Message--Control or Risk Aversion

A. Proprietorship, general partnership, joint venture

B. Limited partnership, SBIC, and real estate trust

C. Financial corporation, product corporation, service corporation and finite corporate fund

D. Collateral trust, commingled funds, closed end funds, spread funds

III. Emerging Sophistication in the Control and Sharing of Real Estate Risks

A. Old mortgage theory--pleasure, pain and bail-out

B. New mortgage theory

1. Risk defined
2. Negative variance in cash flow planning shifted by contract
3. Positive variance incurred through incentives
4. Mutual risks allocated by expertise, capacity and profit share
5. Interest risk--controlled by lender through matching, hedging, programmed interest deferrals and surplus participation
6. Money risks controlled by indexed loans, participating loans, convertible loans
7. Business risks--pooling of expertise and private-public co-development
8. Market risks--research of needs and market gaps
9. Political risks--product compatibility with perceived needs

IV. Market Risks and Opportunities

A. Retail and commercial markets overbuilt, overpriced, under engineered (life safety, HVAC, height)

B. Special industrial markets (under-built, relocated, subsidized demand)

C. Housing trends

1. Return to some type of subsidy for the middle class
2. Reduction of large units to duplex accessory housing
3. Segmentation of the singles market
4. Shift from production subsidies to consumption subsidies
5. Funding media available as an incentive
6. Changing income tax laws as incentives and disincentives

D. The reorganization of real estate professionals

1. The inevitable collapse of commission rates
2. Restatement of appraisal principles and procedures
3. Further intrusion of regulations by securities dealers and pension funds regulators

Recommended Readings:

Jaffe, Austin J., and Sirmans, C.F., Real Estate Investment Decision Making, 1982, Prentice-Hall, Inc., Englewood Cliffs, N.J.

ULI-The Urban Land Institute, Community Builders Handbook Series, Industrial Development Handbook, 1975; Shopping Center Development Handbook, 1977; Residential Development Handbook, 1978; Downtown Development Handbook, 1980; Recreational Development Handbook, 1981; Washington: Urban Land Institute.

The Economist, "The Recession-Proof Boom", February 8, 1981.