JAMES A. GRAASKAMP COLLECTION OF TEACHING MATERIALS

V. INDUSTRY SEMINARS AND SPEECHES - SHORT TERM

G. Miscellaneous Company Lectures

3. General Electric Credit Corporation, No title to the lecture given in Naples, FL, March 17, 1987; mix of topics including investments, RE as an asset class, trends for the RE finance industry and contemporary appraisal analysis

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GENERAL ELECTRIC CREDIT CORPORATION
Ritz Carlton Hotel
Naples, Florida
March 17, 1987

Notes for Prof. James A. Graaskamp
University of Wisconsin

I. Whenever real estate investment has troubled times, it is necessary to bring about accounting and appraisal reforms to conceal the financial problems.

   A. What is unique about the current troubled times is that there may very well be real appraisal reform and real accounting reform, at least for real financial institutions.

   B. Thus General Electric Credit Corporation as a non-bank bank will have an interesting choice of finding a competitive advantage in old style phoney accounting and appraisal or opportunity for underwriting reform that nevertheless leave you competitive with your cousins in the banks and the savings institutions.

II. The management has provided an agenda of topics to which I would like to relate to a number of premises:

   A. That real estate is a long-term asset for positioning against long-term cycles and unexpected fractures in the projected pattern, such as inflation, technological obsolescence, or institutional and demographic shifts.

   B. That we need a better recognition that the business of running a building needs to be more sharply concerned with the distinctions between property managing, asset management, and financial management over a typical time period.

   C. That the fiscal period of real estate performance should not be monthly, quarterly, or annually but rather the average term of a lease since the real asset is an enforceable contract for a revenue stream over a stated period of time, say 3 to 5 years.

   D. That smoothing the current misunderstanding between accountants who believe in accrual accounting and real estate people who believe in distributable cash and spendable cash is useful to distinguish between operating management, asset management, financial management, and tax management.

III. I submit the pro forma statement for real estate should look like Exhibit A.

   A. Financial ratios for debt coverage and solvency should be based on distributable cash rather than net operating income.

   B. Distributable cash less debt service is cash throw-off before tax or spendable cash after taxes.

1. The most damaging element of tax reforms is the loss of capital gains preference. Individuals will find the major tax shelter to be the stepped-up basis when they die and, therefore, will hold property for the longer term or exchange property on a tax free basis for a security interest in a larger pool of property with somewhat more liquidity for estate planning purposes. Corporations may use 30 day and 12 month strategies more often.

   a. This will reduce the number of properties being sold on a conventional brokerage basis.
   b. This will increase the opportunity for a creditable securities group to create a roll-up corporation or master partnership vehicle.
   c. Alternatively refinancing on a basis sufficient to qualify for a rated REMIC and exchange for REMIC shares may be attractive.
   d. Stan Ross points to FASBI 66 as a way of selling on sufficient contingencies that you may not have a sale but the accountants and the IRS may differ as to when a realized gain is a taxable gain.
   e. Real estate will continue to provide tax shelter opportunities because I don't believe the 5 percent surcharge will ever be removed. Now that the yuppies have been suckered out of their deep tax shelters, the higher interim rate will permit reduction of the deficit and real estate will provide a shallow shelter which is better than none.

B. WHAT IS THE REAL ESTATE OUTLOOK ON REAL ESTATE ASSETS?

1. One has to believe that the retail economy is deflationary while government deficits will become inflationary after 1990 in a classic stagflation economy.
2. Oversupply of real estate will not permit a systematic rise in real estate prices due to inflation; most appreciation in real estate will come from the ability to recapture leasehold values in existing properties or enhance the operating efficiency in order to retain more distributable cash.
3. The value of the asset in a period of oversupply depends on a low cap rate which is a function of the length of the remaining term on leases so that leasing will become proactionary and initiate renegotiation three or four years earlier than before and negotiate for longer terms in exchange for flatter indexes and spreading of concessions over time to stabilize and improve distributable cash.
4. Distributable cash and retention of asset management client will require more backloading of fees against future sale or refinancing and absorbing more operating costs within traditional property management fee schedule.
5. As basic fees get shaved, property management firms will have more captive painters, carpenters, drywallers, insurance agency, and janitorial subsidiaries.

C. WHAT REAL ESTATE MARKETS HOLD THE BEST POSITION?

1. Specialized multi-family residential for the yuppies without equity the elderly with lots of equity, or the short term recreational resident.
2. Light industrial buildings near new auto plant locations or underutilized labor pools as trade restrictions and union contracts bring home more jobs.
3. Second tier cities that are socially stable and have adequate land to permit suburban office space to be built downtown with surface parking.

D. HOW WILL FUTURE TRENDS AFFECT REAL ESTATE ASSETS?

1. Significant social unrest in larger cities may follow the current Reagan administration and the uncontrolled unwed birth rate, drug trade, and breakdown of the justice system or prison system.
2. Breakeven points will drop to reflect more realistic base of distributable cash rather than net operating income as a control on debt service.
3. However, inflation expectations will leave pension plans to reimpose 50 percent loan to value ratios if other institutions continue to make 9 percent 15 and 20 year loans.
4. Changing trends in the regulation of mortgage lending by financial institutions including rigorous appraisal will tend to deflate values, better pace development, and require more cash up front. Facilities managers may be in a better position to construct appraisal cash flows and, therefore, expand services to feasibility and financial analysis because of in-house resources.

E. REAL ESTATE AS AN ASSET CLASS, HOW DOES IT COMPARE WITH ALTERNATIVES?

1. For the small mom-and-pop investor, it will be a preferred investment because of their ability to enhance and manage it themselves based on very specialized local market knowledge and based on special tax privileges remaining to shelter income or use the small corporation as a holding device.
2. For non-real estate corporations, a primary source of financing and improved earnings will come from intensive management of real estate assets, including reuse or disposition of under-utilized property and intensive use of leverage, leasebacks, and stock markets to convert real estate assets to earnings per share.
3. For the very rich real estate individual the emphasis will be to convert real estate gains into formats most compatible to an estate plan using stepped up basis and distribution vehicles matched to heirs.
4. Those who would securitize real estate will become a very sophisticated part of the Wall Street establishment and provide an escape route from the sobering disinflation of honest appraisals driven by demand analysis. The camel bazaar still exists in Wall Street.
5. Re-emphasis on listed corporations and REIT's dealing in development and management of "keeper" or non-fungible properties.