

JAMES A. GRAASKAMP COLLECTION OF TEACHING MATERIALS

V. INDUSTRY SEMINARS AND SPEECHES - SHORT TERM

G. Miscellaneous Company Lectures

8. "Medical Site and Structural Analysis", and
"Comments on Real Estate Investment",
sponsored by Gaarder - Miller, an accounting
firm which serves many area physicians,
October 3, 1978

MEDICAL SITE AND STRUCTURE ANALYSIS

Gaarder - Miller Seminar

October 3, 1978

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I. Feasibility Problem Formats

A. Three basic real estate problems

1. Site in search of a use (market)
2. Use in search of a site
3. Investor in search of a yield

B. Components of the problem

1. People, practice, property, and package

C. Elements of feasibility analysis

1. Values, objectives, and criteria of user
2. Medical - market trends
3. Merchandising practice
4. Technical requirements of facility
5. Legal-political constraints
6. Financial plan for capital budget
7. Income tax and real estate tax strategies
8. Standards of investment returns and risk

D. Prearchitectural program

1. Define nature of medical practice in three to five years in terms of size of group, relationships to other medical groups, patient demographics, etc.
2. Define required relationships among doctors, staff, patients, and general public
3. Define nature of spacial functions (medical, business, employee support, storage, etc.)
4. Define alternatives such as remodel, purchase existing structure, or build new
5. Look for implicit assumptions in what client is saying
6. Require written program

II. Site Attribute Specs

- A. Estimate required land area for one or two story building, parking ratio, square footage of building, reserve for expansion, general location

II. Site Attribute Specs (continued)

B. Elements to consider in site comparison

1. Physical attributes
2. Legal-political attributes
3. Linkage attributes
4. Dynamic attributes
5. Off-site environmental impact

C. Identify trade offs among

1. Cost of land
2. Cost of parking
3. Height of building
4. Current construction vs future expansion
5. Formula

$$\Delta \text{land } \$ = \Delta \text{structure} + \Delta \text{vertical transportation costs}$$
 (per square foot of net usable area)

D. Site analysis begins with a specific site and structures or items from the market revenue approach as a set of site specifications which will control the search for alternatives. There is no such thing today as raw land or a vacant lot. A site suitability study recognizes every site has:

1. Static attributes - physical characteristics of size, shape, topography, soils, etc.
2. Legal attributes - public controls, private agreements and potential legislation defining use.
3. Linkage attributes - relationships to other sites which may tend to generate movements of goods and people to the subject site.
4. Dynamic attributes - characteristics which affect behavior such as visibility, prestige, or feeling of fear or anxiety.
5. Environmental impact attributes on physical, social, or economic factors off-site.

E. Physical attributes analyzed should include the facts and the implications of the following:

1. Size, shape, and area
2. Topography, soils, slope stability, potential for subsidence
3. Water table, water resources (streams & ponds) and bulkhead lines
4. All set-back lines and building envelopes
5. Access routes (proximity is not accessibility)
6. Concealed utility easements, old foundations, etc.
7. Flood plains which have been determined by Corp. of Engineers, etc.
8. Scarce environmental elements which may mean environmental impact litigation
9. Landmarks or historical structures

- F. Legal attributes inventory should include both specific controls such as zoning, and identify external public or private controls on use or potential legislation or administrative attitudes and procedures which would impact on owner alternative for use.
1. Legal uses under zoning alternative and limitations on FAR, parking, signing, etc.
 2. Special zoning options such as PUD, down zoning alternatives, etc. available at owners option.
 3. Premises of community master plans still in incubation process
 4. Tax conservancy commitments
 5. Extra territorial zoning or subdivison powers
 6. Attitudes of sewer, water, and highway commissions
 7. Contractual agreemtns among previous buyers and sellers which may or may not run with the land
 8. Planner views of physical barriers to restrict "sprawl"
 9. Existing or impending legislation should be anticipated relative to:
 - a. Septic tank installation
 - b. Ground water, depth and conservation of high water recharge areas
 - c. Salt water encroachment
 - d. Conservation of environmental edges
 - e. Conservation of prime agricultural land
 - f. Water quality standards
 - g. Air quality standards
- G. Linkage attributes have to do with functional relationships or points of interaction with activity centers which may generate users or provide the infrastructure of improvements which support the site.
1. Streets, sidewalks, rail, and transit systems serving the site.
 2. Access points
 - a. Traffic department controls, present and proposed
 - b. Rail switching and truck tariff zones
 - c. Indirect controls imposed by factors affecting behavior.
 3. Utility services are linkages, too.
 - a. Sewer and storm water capacities
 - b. Water, gas, and electric hook-ups, availability and capacity
 - c. Community energy supplies and sources
 - d. Implicit resources such as stock of wild game, labor pools, alternatives to the auto, etc.
 4. Capacity of existing transportation systems to absorb unit volume generated on site and implications for off-site improvements budgets.

5. Relationship of subject site to generators of potential needs and uses for the subject site.
 - a. Employment centers
 - b. School system alternatives
 - c. Retail services
 - d. Complimentary existing nearby uses
 - e. Recreational services
 - f. Health care systems
 - g. Security systems
 - h. Waste disposal services
 6. Neighborhood demographics (population, age, employment, income, etc.)
 7. Relationship to competitive alternatives and projects and exposure to interception of linkages.
- H. Dynamic attributes have to do with the mental or emotional responses which a site or project stimulates as it affects decision making behavior. These decision makers may be property buyers, regulators of site use, customers of establishments located on the site, or peer groups which set community attitudes or make decisions for others by proxy (Board of Elderly Care Organization).
1. Image conditioning of the approach zone
 2. Visual factors in terms of prominence of the site, views, from the site, potential for controlled sight lines, etc.
 3. Anxiety factors of access and security
 4. Noise as a function of traffic count (FHA noise pollution manual).
 5. Prevailing air currents and airborne pollution (phosphate plants or sulphite paper mills, for example).
 6. Political images established for a site by the public positions of local politicians or vested interest groups.
 7. Historical community reputation and values attached to the project site and structures.
 - a. Recycling of old buildings within existing urban areas is fashionable among architects and the upper class.
 - b. Recycling may establish historical roots and images.
- I. Impact on physical environment and compatability with community is combined under environmental attributes.
1. Physical factors of the environment
 - a. Soil stability and water tables beyond the site boundaries
 - b. Eutrophication of lakes and streams
 - c. Disruption of environmental edges, plant, and wildlife areas
 - d. Impact on energy resources
 - e. Contribution to social disintegration
 - f. Aesthetic and urban design

2. Social factors of the environment
 - a. Displacement of existing residents and neighborhood units
 - b. Contribution to social integration or mobility barriers
 - c. Contribution to land use heterogeneity
 - d. Contribution to regional and community master plans
3. Economic factors of the environment
 - a. Direct impact on real estate tax revenues
 - b. Direct impact on other governmental revenue
 - c. Direct impact on incremental government
 - d. Secondary contributions to local government revenues
 - e. Secondary cost burdens created for local communities
4. Real estate business ethic environment
 - a. Impact on supply equilibrium
 - b. Impact on associated contractors
 - c. Impact on families of project sponsor
 - d. Legitimacy of financing structure

III. Building Attribute Specs

A. Components of structure analysis

1. Foundation system
2. Structural system
3. Floor system
4. Ceiling system
5. Exterior wall system
6. Interior wall system
7. Horizontal circulation system (privacy, interaction, congestion, confusion)
8. Vertical circulation system (Handicap Code, cost, economy of scale and height)
9. Passive energy system
10. HVAC system
11. Mechanical systems

IV. Basic Financial - Yardsticks

- A. Cost justified rents - frontdoor approach
- B. Market rent justified cost - backdoor approach
- C. Investment value or use value
 1. Buying a set of assumptions
 2. Pricing alternatives
 3. Explicit differential judgments

IV. Overselling the Income Tax Subsidy on Real Estate

A. Depreciation traps

1. Expensing transaction costs
2. Misallocation between land and building
3. Underestimating salvage value
4. Improper use of accelerated depreciation

B. Accelerated depreciation and the recapture trap

C. The preferential income tax on appreciation and capital gain

D. Refinancing in excess of basis

1. Installment sale tax trap
2. Loss of shelter for mortgage principal payments
3. The estate tax trap

COMMENTS ON REAL ESTATE INVESTMENT

Gardner & Miller - *Accounting Firm Seminar - Madison, WI*
Audience frequently medical doctors

I. The changing nature of real estate games

- A. Real estate productivity - utilitarian contributions - neutralize in medical partnerships by renting from a trust
- B. Real estate - the captive customer for services
- C. Real estate - commodity speculation with high leverage
- D. Real estate - service income through arbitrage
- E. Notice that tax shelter or leverage is not specifically the game, as it once was but rather purely one of the gambits within a larger strategy. Indeed negative leverage is a major factor in arbitrage, or control of real estate to control a ~~customer~~ customer for services.

II. Real estate vs. securities

- A. Securities are always treated as assets to be selected for somebody else's ability to manage and exploit an opportunity. There are presumably great forces at work beyond anybody's power to control which excuse poor performance. If your helpful stock broker causes you to lose 50 percent of your capital it's one of the fortunes of the market place; but in real estate if your friendly counselor helps you lose 50 percent of your capital, he faces a significant probability of suit since real estate is supposed to be manageable. But I submit that risk management in securities is child's play compared to risk management in real estate today if those who commit to real estate are to be considered investors rather than wildcatters and crapshooters.
- B. The premise that real estate will continue to appreciate in the '80's as it did in the 70's is widely held and believed but there are only three reasons why real estate should continue to rise in value:
 - 1. Net income rises because rents will grow faster than expenses
 - 2. Interest rates will fall permitting resale at higher prices without any change in debt service
 - 3. Investor expectations will fall due to deflation (capital in excess of investment opportunities)
- C. Real estate today requires positioning relative to your statement of faith in one of the three causes of price inflation listed above. But that positioning is about as tricky as establishing a policy in the Mideast.
- D. Before discussing some of the positioning issues, let me distinguish between long term strategy matters and specific criteria for the investor or investor group.

- III. Specific criteria for investment should include the following elements ranked according to what most people perceive as the order of importance today.
- A. Political exposure
 - 1. Land use control changes
 - 2. Dependence upon subsidized demand
 - 3. Vulnerability to subsidized supply
 - B. Degree of channeled demand
 - 1. Customer control
 - 2. Reciprocity
 - 3. Monopoly of supply
 - 4. Market research
 - C. Degree of management intensiveness
 - 1. Personality dependent
 - 2. Skill dependent
 - 3. Formula management
 - 4. Triple net lease
 - D. Financial characteristics
 - 1. Degree of variable revenue - variable expense
 - 2. Scale of entry capital
 - 3. Mortgageable characteristics
 - 4. Controls on variance
and planning
 - E. Estate tax/characteristics
 - F. Income tax characteristics
- IV. Positioning in real estate investment to achieve increasing income, lower interest rates, or falling investor expectations is in large part a matter of intuitive perceptions about the economic vitality of our society in the long run given a political system which by its nature can only deal with the short run, indeed only in short run illusions rather than realities.
- A. Continued increase in income presumes that demand for some types of real estate is inelastic.
 - 1. For example office rents in San Francisco, Seattle and New York
 - B. What about middle income housing?
 - C. What about retail sales at regional shopping centers?(Does Sears move in financial services tell you something about retailing?)
 - D. Can a change in building technology relative to energy modify total occupancy costs for the office tenant and provide an alternative to inelastic demand? Will energy costs bring about urban compression around multiple nuclei of low rise buildings? (Denver Tech Center)
 - E. Will the real estate tax be used to fund the unfunded liabilities on municipal pension programs?

- F. When will the disinvestment in public infrastructure lead to special assessments to rebuild streets and sewers?
- G. How much depreciation will occur to real estate values when we lose Saudi Arabia due to higher fuel costs, lower discretionary income, higher electrical costs, underdeveloped public transit (Sears Building kilowatt consumption compared to Rockford, Ill.)
- H. ~~xxxx~~ If inelastic demand depends on discretionary income, let's shift the topic to falling interest rates.
1. Certainly the Economic Recovery Act of 1981 is revolutionary legislation favoring the formation of capital. The creation of ~~xxxx~~ capital should reduce interest rates. One of my more cynical friends sees the independence of Folker at the Federal Reserve and the Reagan legislative putsch as a classic team play, and every time Congress gets balky Folker stings him with an increase in the prime rate. However assuming that dollars flow into capital intermediaries via IRA, KEOGH, individual savings, and tax free certificates, we are nevertheless faced with a three year backlog in demand for capital and the lending fraternity that has no desire to return a fixed rate mortgage.
 - a. All our problems are capital intensive so that credit will be rifled by use of tax exemptions and local political controls such as economic development loans, Section 8, or state housing loans.
 - b. Deterioration of the international scene will increase our trade deficits which is the same as creating a hidden tax on our surplus.
 - c. The military build up will frustrate Reagan's hope for a balanced budget so that deficit spending will soak up much of the capital and military investment kills the capital pool (see New York Times article). from
 - d. The power to create wealth is shifting ~~xx~~ those with credit to those with cash
 2. ●. Why should investor expectations fall? Investors have slowly learned to anticipate inflation by loading their desire to return for expected rate of deflation. Why should that change? The Reagan goal is 8 percent inflation - assuming 4 percent real return, the minimum interest rate should be 12 percent.
- V. The new tax law provides some interesting opportunities for real estate investors but closes many of the avenues previously available for honest disagreement with the IRS.
- A. Benefits for users will hurt the build and rent to suite market
 - B. Professionals will have an extra incentive to structure an ownership position even for a floor of a multistoried office building.
 - C. Recapture tax

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Dear Jim:

Thank you for your recent gracious letter. The trip to Madison was a real treat for both Joan and me, and we are grateful for the invitation and your usual warm hospitality.

I have enclosed a Xerox of the article from Medical Economics which is now six months old and frankly not very helpful at this point. Most of your doctor audience will be familiar with Medical Economics. It has a circulation in the tens of thousands.

It seems to me that there are a few areas where doctors and other professionals really need help regarding real estate investment.

First: they really need advice on where to get advice. Rarely do stock and bond advisors have the expertise and knowledge to analyze a deal and advise on its investment merits. Rather, stock and bond types are usually driven by the prospect of a fat commission being offered in a public deal with a lot of water in it. This is fine for the salesman but not fine for the doctor. They are better off hiring an independent real estate expert to go over the deal for them. Other possibilities include joining partnerships put together by local successful developers they can trust.

Secondly, doctors tend to be mesmerized by tax shelter and forget that there are other ways to profit from real estate. Pure shelter deals are rarely good investments and usually have a huge amount of water in the deal.

Dr. James A. Graaskamp

-2-

October 7, 1981

Third, doctors should be warned against getting into real estate investments which will require their own time in property management. Often the prospect of a half dozen townhouses or a few condominiums will seem so easy and attractive. After all, depositing a half dozen checks per month can't be too hard. But as we both know property management involves much more than that and can take what a doctor rarely can give--time.

I look forward to seeing you soon.

Sincerely,

A handwritten signature in dark ink, appearing to read "R. C. Gilkison", with a horizontal line underneath the name.

Robert C. Gilkison

RCG/jc