JAMES A. GRAASKAMP COLLECTION OF TEACHING MATERIALS

V. INDUSTRY SEMINARS AND SPEECHES - SHORT TERM

G. Miscellaneous Company Lectures

9. "Real Estate Trends", for Office Network, New York, N.Y., circa 1986

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CIRCA 1980s
~1986

OFFICE NETWORK - NEW YORK MEETING

I. Intro --- imagination, conservation of working capital, knowledge of government regulatory processes.

   A. Lee Kendall story

II. Taxes, trends and talent for the future

   A. We don't quite have a tax bill but on balance, some observations can be made:

      1. Lower rates for individuals will be raised in the future after the playing field has been leveled to remove deductions.
      2. The higher capital gain tax will encourage individuals to hold, refinance, and take the stepped-up basis in the estate tax.
      3. The loss of consumer interest deductibility will also encourage holding and refinancing and moonlighting businesses.
      4. Corporate taxes on small corporations with less than $75,000 net income encourage the little guy to incorporate and take advantage of défined benefit pension programs, etc. - perhaps with groups of small pension plans buying real estate, such as land in Phoenix, to avoid capital gain.
      5. Low interest rates, CMO's, changing depreciation rules, and fewer incentives toward leveraged buyout will lead to corporate refinancing of real estate.
         a. Corporations will pay rent rather than take depreciation. Tenant improvements may be recognized as loans from the landlords
         b. Pension funds may take capital gains through fee ownership while owners create income through special rent structuring.

      6. If income tax were only factor, then apartments and office buildings would have to decline in value or see some increase in rents. The latter is not likely but lower interest rates and refinancing opportunities will take away the downward pressure.

IMPACT OF TAX REFORM ON REAL ESTATE (Salomon Brothers)

	Senate		House	
	Apartments	Office	Apartment	Office
Internal Rate Of Return	-55.0%	-39.4%	-46.3%	-41.8%
Present Value of After-Tax Cash Flow	-44.4	-29.8	-37.3	-31.7
Value	-16.0	-8.1	-14.5	-8.3
OR				
Rent	+19.1	+8.8	+17.0	+9.0

Assuming the following: a ten-year holding period; a 78% loan-to-value ratio; a 10.5% interest rate; a 5% vacancy rate, and 3% inflation in rent and expenses per year.

7. The relative price of real estate and relative yield compared to bonds and stocks has fallen sharply. Cumulative return on commercial real estate from 1977-82 was 100.9%, as compared to 53% in stocks and -2.6% in bonds. However, from 1984 to 1986 the FRC index would indicate a cumulative return to real estate of 18.3% as compared to 66.1% for stock and 77% for bonds. Cash on cash rates on real estate have moved from 6.5 to 9.5 or 10 while cash on cash rates on treasuries have fallen from 12 to 6.5. However, these adjustments have now assimilated the impact of interest rates and anticipated the tax law so that the interest rate risk is now behind us.

8. The tax transition risk is relatively minor and apparently the transition rules and phase-in rules will continue to provide the adroit investor in real estate certain special favors. Within a year or two special interests will cause big limps in the level playing field so that the tax risk is a minor inconvenience.

9. The real risks to the real estate investor for the longer term will be found in:
   a. How financial institutions will attack the problems of over-supply and delinquent loans.
   b. How the politicians will respond to the increasing potential for social instability.
   c. How the citizens will respond in terms of savings, discretionary spending, and further tax reform at the state and local level.
10. The financial consequences to the banks, savings and loan associations, and private pools of capital have yet to be fully understood relative to over-building.
   a. FSDLC faces losses in excess of $30 billion with reserves of $6 billion from a relatively limited number of fraudulent or incompetent S&L's. Should they dump the real estate at any price? What will that do the effective rental rates of other buildings at breakeven level currently?
   b. If appraisal reforms go through, which institutions can make loans which would justify sunk costs in the newest buildings?
   c. On the older buildings with asbestos and toxic waste exposures, what lending institution can afford to be a party to the risk?
   d. Would financing by Wall Street, subject to due diligence and full disclosure, be any easier than regulated institutions which are attempting to switch resources out of real estate?
   e. How far should rents fall before tenants should seriously consider becoming owners?
   f. Although inflation can be expected to reoccur, themajor overbuilt urban markets will not be able to pass through increases in operating expenses or effective rents due to oversupply.

11. Demographic ans social trends will be negative relative to real estate:
   a. The next 10-15 yeras will be volatile. There are numerous monetary, fiscal, political and social issues that will be out of hand. Either inflation or deflation is expected by the end of the decade. There will be disintermediation of funds due to real estate loan problems. The markets for the next 40 years are here now.

b. Social stress, due to many of the known future facts, will affect investment value. Business stability will require proactive involvement in social issues.

c. Regulation will get tighter, and intervention will happen more often as cities and citizens attempt to control land use decisions. Creative negotiation in the public and private sector will be required for success in the future. Entrepreneurs creatively implement public policy.

d. The Reagan administration has been compared to the Eisenhauer administration where social neglect led to the urban uprising of the late 60's. The new social organization created by our prisons, are movies and television and a counterculture based on drugs will require very expensive countermeasures. The number of poor people continues to increase and 55% of all minority children are born out of wedlock to socially disfunctional parents.

12. The loss of federal social and educational funding means new responsibilities at the state and municipal level; state legislatures representing a population districution in the suburbs will reduce state aids to metropolitan cores. These cores will need to double the real estate tax by using assessments systems and property classifications that hit the high silhouette commercial properties and favor the smaller single family owners.

a. Higher real estate taxes means lower debt service capacity, smaller mortgages, lower prices and higher down payments.
b. Higher costs of housing and food will mean reduced discretionary retail spending.
c. Relatively smaller age cohorts following behind the baby boom will mean less and less support for residential resale prices.
d. The loss of IRA accounts, home asset appreciation, or discretionary savings may shift all taxes towards higher income corporate entities.

13. The result is a trend toward to fewer real estate transactions at a declining rate of increase in value.

a. Brokers will have to be in a problem solving mode rather than a transaction mode. Fees will be restructured, with a non-contingent fee at the front, and a graduated contingent fee at the rear. The user side of real estate will become more sophisticated, but will maintain much of the traditional appearance for brokerage companies. The investment side of brokerage is subject to invasion by other organizations.

b. Network brokers should consider utilizing Consulting as the lead, funneling clients to specific services of network brokers. Consultants will become brokers more than brokers will become consultants. Network brokers must expand into business problem solving, while providing real estate problem solving.

c. The amount of services network brokers can provide will be linited only by business protocol. A fully integrated firm is the way network brokers should go, controlling as many profit centers as possible. Access to capital, the ability to arrange financing, do appraisals, etc., all are parts of the pot. Network brokers needs to project itself as an imagineering, problem solving firm, that happens to be in the real estate business. Brokerage must be perceived as only a part of all the services provided.

14. Real estate is one of the few investment areas where an average investment can be quickly enhanced in value by creative management without a long span of management and control.

    a. The value increase depends on a favorable lease and the lease depends on how well the broker can tie the productivity of the tenant to the building.

    b. While macro markets may be negative relative to real estate, micro markets will be found to be favorable.