JAMES A. GRAASKAMP COLLECTION OF TEACHING MATERIALS

V. INDUSTRY SEMINARS AND SPEECHES - SHORT TERM

G. Miscellaneous Company Lectures

12. Transcription of Seminar for Northwest Building Corporation, Seattle, Washington, May, 1980; Includes notes on "Positive Spread", 12/13/85 and "Economic Forecast and Real Estate Investments", March 3, 1986; JAG was a long-term consultant for Northwest Building Corporation

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**Hikers into wilderness areas were given cameras and asked to take pictures of twenty of what were the most significant visual** experiences of their time in the wilderness. It was a technique which expands off of somebody that another professor at the University of Kansas developed in the St. Croix wilderness river? and which they did. We have several thousand photographs, which are now catalogued into frequency diagrams which tell how often the various backpackers seem to value the same things. There is a high degree of consensus as to what attributes contributed most to their wilderness experience. Those are the same attributes which we have catalogued on our map so we can say that in effect we are not talking about an abstraction by a bunch of professors, but in fact the actual users of the wilderness as to what it is they value as part of their wilderness experience. That's what I call forensic? appraisal. My bias, I was in shopping centers up to warehouses and office buildings,not downtown office buildings, suburban buildings you get a little better standpoint, but we seem to be going in the right direction.

How would you like to operate today? A little bit of background and philosophy, first of all, and then I'll just take role from then on as agent provacator, only to prompt a little discussion.

First of all, my background, for those of you who don't know me, I have an undergraduate degree in playwriting and then went to Marquette Business School to learn marketing, discovered I could learn far more marketing at my father's knee. My father was one of the real innovative packaging engineers in this country in the '20's through the '60's. He ran a small specialty firm in ~~Walkiegray~~ Milwaukee? in corrugated container and plastic container and folding box line. Why my pops is tops sort of thing. He was the original inventor of the six-pack, but he also designed the machinery to put the cans precisely in the six-pack container, the six-pack in the container and the container on the palace, and then when you got out to the beer peephole, you pulled the string and so forth and, of course, given your roots in

Submitted by Wayne E. Reisenauer
Vice President
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Weyerhaueser you will appreciate that my father's arch foe and best friend was Walter Keetseher? and they used to do terrible things to each other in the paper industry, and my father stole the patent for the box that opens with a string, where you pull it and it rips the box open from Walter K. by trading him about fifteen worthless patents on six-packs.

Anyway, I grew up in the container business. My uncle Lesley was the Executive V.P. of American Can Company. My father's best friends were the Eggers brothers who were in the Continental Can Company. My mother was the private secretary of the man that ran Kimberly Clark. So I just grew up in the container business, and I grew up in a business background and securities and business was table salt. My mother was a fisherman's widow; my father and I spent a good deal of time fishing, and when the fish weren't biting, he would tell me war stories and war stories always with a point. Philosophy as he espoused it. I really simply adapted that to real estate. That's my background. I'm coming out of really quite a different industry.

My father's basic philosophy was monopoly, always go for the channel, as he called it--channel to man, which a number of years ago was useful term to me in that I was the star ? witness for the Wisconsin and the first case that was brought in under the anti-trust law. You are serving by whatever subsystem you're selling or manufacturing or providing that it contributes to the cost reductions as your client to a ?,you can capitalize those costs reductions to your client into the price of your product, and therefore your product is not being priced on cost to manufacture, but rather in effect on the cost fadings to your client, or in the case of merchandising, to the incremental revenue to client--capitalizing that. He was the first man to put the photograph of the chocolate cake on Pillsbury, Betty Crocker, Swansons--things of that sort. So this was the tradition that I grew up in, and, therefore, what I say about marketing and real estate is conditioned from that standpoint. There is a good deal of overlap. I was a subdivider for a good many years and a homebuilder in Madison. My father came out and looked at one of my subdivisions and said, "you know, son, we're both in the same business, i.e. boxes, only yours are bigger!"

At Marquette, and my entire college education, I always moved toward, what I felt, was the best professor in whatever school I was in, and which is one of the reasons I was in playwriting at Wallace. And at Marquette I moved toward the finance department--Dr. Calk--and became a security analyst (my master's degree), and spent a lot of time in securities. I was supposed to have gone to Harvard School and was about to leave when the young man I was taking with me as my assistant said that he really didn't want to stay because he wanted to marry his high school sweetheart and so I said that was fine, when we get out there we'll pick up a couple of Harvard boys and put a crew together out there. My father said "nothing doing, as long as I'm paying for the difference between the Harvard scholarship and the cost of your education, I'll call the shots, and I don't think that's going to work if Harvard men don't know how to work". And it was his basic mid-western position about Harvard, and so he wouldn't let me do it. He said that as long as he was paying, he was calling the tune. And since the rule was that I was financially independent, about twelve to eighteen months after that I was financially independent and have been so ever since. That was easy to do in the days when the stock market was rising and anything you did with a little bit of logic made sense. It's not quite so easy to do anymore. Not in the stock market.

And since that time, I have realized that unless you work at it every day and do your most having intelligence in the market, you can't do it. So I have assigned all my stock and so forth to Robert Gilcupson who is now Vice President of Schroeder Ness banking interests in the United States, and he handles that for me and occassionally sends me a check which I then fritter away on deep-sea fishing. That's my fishing fun. So I am not active in securities as I once was, but I applied again the same techniques of analysis that I learned in securities analysis to real estate. That's where I am a great believer in cash flow budgeting and I don't do any normalized values or anything, I'll sit down and work my budgets out quarter by quarter and try to build in control of variance all the way. My control of variance is really the basic managerial task once you have a pro forma stategy that you are attempting to implement. And so my background, again, came out of securities initially.

I just spent the last six years as Director of Wisconsin Housing Finance Authority in which I was the Treasurer and I spent a lot of time fooling around with floating tax exempt bonds when holes in the market would suggest and structuring Section VIII primarily. ? which we bought initially to get under way and create a cash flow. We built about 3,500 to 4,000 apartments a year for six years and initially started with $250,000 borrowed from the State of Wisconsin, which has been repaid, and I think we had $6½ to $7 million surplus when I retired from the Board in January. We had another $5 million surplus buried in our fund accounting system because legislators were starting to look over our shoulder and saying, "gee, I wonder what we can do with that money," and we are saying, "sorry, we're a private, semi-private corporation and the legislature can't take our money back." Nevertheless there was some searching of the honeypot to see what was in it for the State legislature. So I have been fooling around in the stock exempt market recently, but otherwise I'm pretty rusty on my securities.

I then went on to teach insurance and risk management, and my Ph.D. was initially in risk management, but my office was next to Dick Ratcliff who was, and probably is, the most foremost land economist, now retired and living in Santa Cruz, and I ended up with a double Ph.D., partly because I started doing counselling work for ~~a~~ man named Max Karl as he started the MGIC Mortgage Guaranty Company and worked with that from the outset. I did the briefs initially on that, actually a computer simulation model of that, and made some more money in their stock.

I started my own building company as a graduate with another young man that had a good background in construction and went with $2,000 capital and did $1½ million in volume the second year. I thought that was leverage! Our banks aren't very bright, we deal with the First Wisconsin a lot, and they are not the swiftest group in real estate. We started out building Scholls homes pre-fab and then we switched to building st~~r~~ict, but we had set up our construcagreements so that we got 40% draw right off the bat because when the package arrived on site you had to give a certified, cashier's check or the truck driver wouldn't unload his trailer or detatch his trailer. And we forgot to mention that, I guess, very explicitly to the bank, and somehow we continued to draw 40% when we got our footing in the ground, so the leverage was pretty good there for a while. We set up a computerized accounting system which also awed the bank; we could tell you to the penny what it cost to hang a box soffit versus a colonial soffit versus whatever and so on. The bank wasn't very bright because I discovered very quickly in the game that all they watched was my monthly gross margin, and, therefore, they never charged my mistakes to my operating account--they charged them to a general administrative account called "tuition". I finally made a terrible mistake and it cost me about $4500 on one job because I hadn't checked to see how deep the sewer receptors on the west end of the lake and I had to go down about twenty feet of sand and run three hundred feet back to this house we were building on the lake. We built nothing but Cadillac homes, which at that time were in the $100,000 category and now would be in the $400,000 category, and it cost me a bundle and the bank manager saw that $4500 tuition expense and he said, "gosh, you must be going to every seminar in the country in these last months," and I said, "no, that's just the school of hard knocks out here on the west side." He finally caught on what we were doing to stabilize our gross margin, but by that time it didn't matter, we had enough net worth that we felt comfortable.

I sold my building company in 1971 to my partner; my land development business I sold out in 1972 to the University, of all people, who wanted to build a golf course. I had a brokerage, a land brokerage with the wife of my other partner and a consulting business. Their health failed and they moved to the Southwest, so I sold my brokerage and property management firm and kept only the consulting firm. So I have sort of run the gamut, and I did all of that while I was teaching full time. I tended to be the treasurer and strategist, and my partners tended to do all the hard work!

I have always regarded that as a fifty-fifty partnership. If I get to ask the questions and they provide the answers, that's a split, right down the middle.

Presently I just have my consulting firm, and we have three full-time people, all of whom have gotten their master's degree under me and all of whom have gone out into the field and come back. That's the way I currently operate.

We have a five-man department in real estate, which is unique, and then we have our own architect, our own lawyer, our own urban economist, an environmental economotrician and me as the basic core faculty. All of us are cross-listed in other schools at the University as well. My lawyer teaches the land use control course in the law school as well as in my department. The environmental economist is in the economics area. My institutional economist is an urban regional planner. Me, I'm over in the construction administration and civil engineering school of the land resources program. So we have a very multi-disciplinary approach to the field of real estate.

Our basic philosophy is space time is my time. Those are reversible equations. Tell me your rent, we'll tell you what your capital budget is going to be. If you show me the pretty picture and the capital budget, I'm going to tell you what the revenue has got to be, and those are reversible equations. Essentially the real estate game is attempting to tap the cash flows that are inherent in any enterprise. Every real estate project, all by itself, is a business which has to stand on its own. And that business today involves really a captive customer for services. All the profit centers in real estate are in the delivery of expertise. Delivery of expertise are the only profit centers. Otherwise all you're doing is paying for the use of capital, and I don't look at that as a profit center. I look at that as charge for the use of capital. There is no net value added per se. That means that most of the profit centers are in the outlays, in the expenses and the degree to which monopolistic practice can produce a competitive edge in terms of your pricing, why it will produce a surplus return to the investment. I am moving very quickly over a basic philosophy so you can see where I'm coming from, and then we'll have at it in terms of real estate.

I tend to deal in real estate by converting traditional real estate language into what I feel more comfortable, that is, in terms of financial investment concepts. For example, as some of you heard me yesterday, I look at a mortgage with an exculpatory clause as a straddle. First of all, because I look at real estate as a fungible kind of commodity, space/time. I talk about square foot per year, I talk about room/nights if we're talking about a hotel. If we've got a hundred rooms, you've 36000 room nights year of merchandise. That's a fungible kind of unit. A square foot of factory space, even if I'm doing raquet courts, I'm talking about court-hours, even I'm doing tennis courts or ice hockey rinks you've got, again, rink hours. That's your basic base-time unit. Whatever the real estate is, it defines itself.

There's a three-dimensional product with a fourth dimension in time. That's your product, and it's a fungible product.

So now we go back to a mortgage--it is really nothing more than a straddle in the commodoties market. You have a high-loan to value ratio. What you really have is a call on the appreciation that may occur in that fungible product called square feet or whatever, and it's a put to the lender if the project doesn't work out. The negotiation is really what's the cost of the straddle, what's the bank going to nick you for if the product doesn't go, or how soon can I work myself out of the premium paid for the straddle. For example, and for those of you who were there yesterday, forgive me if I use the same example but it's the best one I know. I travel much in Madison, and this is a roughly $4 million office building, five years old, downtown, class A building, 250 parking stalls underneath, 120,000 square feet of GLA, had its troubles when the partnership ended up with not only a first mortgage but a second and a third and the general partner had an assign on the third to cover operating deficits while he rented up and that blew the tax shelter for the rest of the partners and it fell back to an at risk basis and they had exhausted their basis.

We turned around and sold it to a consortium of doctors in Madison on a land contract for $7 million with $700,000 down, 6.3 outstanding with no payment on principal until 1988 at which time it balloons. They do pay interest on the $6.3 million balance, but - the seller rents back or leases back the building from that consortium for a net rent exactly equal to the interest being paid on the land contract. In effect the two just wash. So far so good.

Now with the $700,000 we paid off the third, bought off the second for pennies on the dollar because it was in a bankrupt trust and they would take $.25 on the dollar, and, in addition, we left the $3,6 million that was with Metropolitan with the seller, so there was no assumption of liability there. The land contract is a wrap around that for the time being. And we got the Metropolitan to go to $3.9 million, so in effect, we took $1 million cash out of the deal, and that covered the first installment of taxes of what essentially is an installment sale, and gave all the partners their money back and they now continue to own it as a positive cash flow, they had CPI indexes, or modified CPI on their office leases and it's going to spit money for the next ten years. As far as I'm concerned that's a straddle in a long term commodity market by the buyer who says, "wow, what I really have is a contract for future delivery of 120,000 square feet of GLA at $65 a square foot in 1988." Since it would/cost $55 to $60 to duplicate that building today, that's not a bad bet. But the other side to that is that in order to fund $6.3 million on that balloon, rents are going to have to be between 18 and 24 depending on where you call the interest rate--whether it's at 12 or 14 or whatever in 1988. On the other hand, if it doesn't go, if rents do not get up that high, the highrise office buildings are beginning to show traces of energy obsolescence and this building is fairly well designed from that standpoint, then they just take a walk on the land contract, Wisconsin is strict foreclosure on land contract forms--that is, the seller's only remedy, and he takes back the building. But on the other hand, his sum cost to that point isn't significant anyway, so he'd be just as happy to have it back.

The $700,000 downstroke will be amortized by the tax shelter that goes to the equitable title under the land contract, and so by 1982 they will have a zero cost of the straddle. And that's pure speculation in a commodity market called square foot of GLA.

Now, I think that what has happened in that most commercial property has become commodotized, if that's a word that I can coin, that its no longer being bought and sold on the basis of its utility value, its ability to produce money now or to serve or house somebody's activity now. It tends to be bought and sold on futures and I don't think that's a very good idea. My Daddy taught me you make your money when you buy, not when you sell, and I think the real estate ought to pay on its own merit as a business enterprise. You should not invest based on a non-vested, contingent interest in a future sales price which is anybody's guess. I think that there tends to be tendancy in all investment to assume that the current situation is affirmative situation and I don't think that's true. I think that deflation is as logical a scenario over the next fifteen years as inflation, and, therefore, I think any investment posture which presumes inflation to be the rule, by and large, is going to be wrong. Again, my Daddy taught me when everybody is selling, buy, and when everybody is buying, sell, because everybody is always wrong. So I get very nervous about investment postures unless you can do like the doctors have done it, they make money on the tax shelter and then if the property values or rents do go up, they have a call on the commodity. That's fine, but, I don't know, that's crap shooting and I'd rather go for the slow and certain quarter than that kind of quick nickel. I would much rather go with productive enterprise that is producing cash on its own merit rather than simply playing that kind of game.

Another aspect, of course, is that if you buy the concept of continued inflation, not only when you borrow are you speculating in the space commodity market, you're also speculating in the money market. If you can get a fixed interest loan at 9½ or 10½ in the good old days of a year ago, then what you are really doing is speculating in the money market at the same time that you are speculating in space market. If interest rates go up, you've got an edge whereas if the interest rates go down you can roll out of it and refinance. I don't know that I really want to play that game too far. I'm a conservative investor. I'm a conservative in my own way but I may seem zany in terms of where I see my opportunity. But as long as I can control my market position and market into a monopoly situation, why then I can be a wildcat. As I talked about yesterday, there are a number of ways to achieve a monopoly, but partly through positioning and partly through market research and partly by staying small. I like to think small. I think big projects, just by definition, become unmanagable, unwieldy--they don't move fast enough, and in a dynamic market you really have to take your position quickly when you see the gap, when you see the hole, and move into it and you can do that better with small projects which lend themselves to formula kinds of planning. My good friend Bob Gilkenson, who, as I said, is the Vice President of Schroeder Ness and is also the Treasurer of the Gates Company in Washington, D. C. and is quite excellent in real estate matters. They are developing the last really fine piece of ground in Alexandria, and they are doing it with small (75,000-100,000 square feet) office buildings, one at a time--boom, boom, boom--two and one-half to three stories high (no hi-rises), surface parking so you don't futz around with indoor ramps. They're getting killed with indoor ramps in our part of the country because they didn't close them in and you're getting hairline cracks, then you get the salt from the street department getting in the hairline crack and pretty soon you start to undermine the integrity of the reinforcing rods, and boy it's going to cost them a bundle to clean that up. I realize that in Seattle your climate is a little milder and so forth, but I would much rather paint new stripes on my asphalt out of doors and plow it than put $5,500 or more into an inside concrete parking stall. That doesn't compute at all. Particularly when you don't know how much longer the car is going to be the normal way in which you go to work. So from that standpoint I'm conservative--I like to think small and move in fast. I think that real estate is somewhat like the money market--if there's a hole, move into it, have your prospectus, have everything set in place ready to go and when the hole comes, move.

Question: I'm wondering your views on return on investment, return on equity in real estate at the present time. I guess I'm a radical, I'm willing to take nothing, or little.

JG: That's dumb. You make your money when you buy, if you buy right you can take something home, and still have an interest in the appreciation and the future, in fact a better chance of getting a future. Money has an opportunity cost. You can't tell me that the guy who takes nothing, when he could have gone into the short term paper market and picked up anywhere from 13-17% over the last few months is ever going to make enough when you start figuring compound interest. Where's the resale price have to be in order for him to recoup the 13-18% in the short term liquid money market that he passed by in the anticipation of appreciation over 5-10 years? That doesn't track to me. I'll take my quick profits with liquidity and safety when I can get them and ... Does that answer your question?

I'm a radical. Intellectually I have travelled the whole route of moving from present value discounted cash flow after tax theory and I can build computer models and make your head swim on that. And then we got into internal rate and threw that out and that present value has its problems because it doesn't adjust to the opportunity cost of money nor does it adjust to the reinvestment rate of money. So then I got to the financial management rate at which your discount ? lays back after opportunity cost of money compounds your receipts forward at your reinvestment rate and then solves the rate of compounding which makes the present value of the outlay equal to the future value (Reverse sides of tape)

... it's what your resale price is going to be. Though

I'd almost fallen back partly in desperation and partly out of realism, there's simply a cash on cash after tax basis, in saying to myself, OK, what have I realized in terms of hard dollar cash return. And the cash on cash rate becomes a proxy for the degree to which we expect other peripheral returns from tax shelters and from future appreciation. In other words, if we go with an office building that's yielding 6%, it's because we think we are going to do better in the long run, but how much better we aren't too sure. And we make a judgment ? this office building leases are coming up for renewal, push them up 3 or 4 dollars a square foot when we roll those leases over, maybe we'll take a 5% cash on cash now whereas in 2 or 3 years we'll have it up to 10 or 11% per cent cash on cash on our purchase price. And then to assume automatic increment in resale price seems to me a foolhardy way to go investing. We all had those paper profits in the stock market that evaporated long before we realized, and I think the tendency is to do that in real estate, so I'm hypothesizing what the resale price is going to be. I'm not suggesting you shouldn't look at it; you want to position yourself so that the opportunity for the price to decline isn't there, but to hypothesize how high is up could be a rather useless intellectual endeavor in terms of your investment. Maybe it's oversimplification. I'm much more concerned about my downside. I'm a risk manager who says, The hardest dollar I got is the one I already got, and I'm going to protect that one first. That's the highest priority of risk management. My second level of risk management is to realize the income tax flows that I am hypothesizing, on which I am basing my plans. And the third level of risk management is the capital gain which is so inextricably related to cultural phenomena, psychic position of the investor at some indeterminate point in the future, and the whole series of systematic positions and risks which nobody can really hypothesize...I'm not going to make my investment based on that. Check the ?/make the income, try to position myself so that if certain scenarios that I hypothesize about in the future come true, I won't be too badly hurt by them, and maybe I'll profit by them, but not worry about converting that into a six-decimal rate of return. Does this answer your question?

Q Yes. I like cash on cash. What return cash on cash do you think is realistic at the present time? That's another thing that bothers me. (Going out in the market and buying something right now?) Yes.

JG Well, your cash on cash on building is going to appear better than it is, because you can create investment products at a lower cost than you can buy it. It all depends on how many profit centers you can retain within your own organization, and to what your cash on cash is going to be on what you build. It's also going to depend on how effective you are in merchandising the sizzle rather than the steak. So, that's a marketing problem. If you do your consumer research well, you can get terrific returns, 20-30% cash on cash, say at specialty centers and certain kinds of recreational properties. On the other hand, if you have to go out and buy an office building right now-- Prudential just bought one in Chicago, 24 million dollar deal on a cash on cash of 6.6, that has most of its leases coming up over the next 3-1/2 years, and they're hypothesizing that by the time they roll all those leases, they'll be up to about 15% cash on cash. But right now there are some good buys and by the end of this year there's going to be some terrific buys for people who are in a cash position. I went out last night with my ? here in town, and they had all been briefed by their insurance companies,and so forth,that they represent,so forth, and it seems like all the big insurance companies, even those that were screaming 3 months ago, My God, what am I going to do with my 400 million dollar inflow to my comingle funds and pension funds,and so forth,are all starting to stall and take second looks and wait around until the price drops, cause I think they are all expecting the recession to be, like Mr. Greenspan says, considerably more severe than Mr. Carter suggests and therefore there will be better buys at the end of the year. Since you make your money when you buy and not when you sell how can you go wrong putting that money temporarily into commercial papers that are now 13, 14-1/2? Might as well just take a standby on that. Is it lower than that now? (Slightly.)

Q <u>Question</u>: Why don't I describe in 2 minutes here what we have done in the last 3 or 4 years on this very question. You might just comment on how we slipped. We refinanced this building about 4 years ago at 8.8 and a large sum of money. Steady inflow of offerings to the brokers for several years. Every time we work through the numbers we found they left out all kinds of reserves, underestimated expenses, no management costs, etc. One of my problems is that I'm a property manager for many years;

I know too much. So, I contacted some friends of mine in business situations and we started doing joint ventures out-of-town. We provided the equity capital, they had the land control, the major tenant leases organized, they had worked on the properties for a period of time and, of course, they had the job of working on 10 and finding 1 that would work. We structured them so that we got a better cash on cash (You'd get a preferential return of what?) 8 to 9. They've been resisting me because of this marketplace hovering over my shoulder for the last 4 years and they're willing to take 5 or 6 or 7 after it was up. My argument was that, Well, you can retain significant ownership if you stay in with me and provide us with a better return ...? We got some tax benefits because we were in the development phase and would not be available to you if you bought it after it was done, particularly in this state where you can deduct the state sales tax ? the government forgot about. The sales tax is 5.4 and that helps a lot. But anyway, we did almost a dozen of these with different teams so that we had access to a much broader market than potentially one in-house staff could develop. Most of them have come out OK; we've had some overruns because of the interest cost, we've had gap problems developing for the lenders because of slow leasing of the shops which was totally unforeseen, of course, in this "expanding economy" here, mainly because the banks won't lend the small merchants the money. We have tenants ready to go; these are good projects in viable locations but for the last 6-8 months the small tenant literally cannot borrow the money to get in. But anyway...(Have you ever thought of lending the small tenant the money?) Well, that's where we're at. We've avoided that

through the years (Creative property management means you create your own tenants part of the time.) Yes, you do. Anyway, to make a long story short, we were kind of walking the line between being pure developer and trying to buy on the open market. In most instances, it appears that we pencil out where we were trying to arrive. We didn't get the highest return that we might have if we had been pure development.
We are certainly coming out better than if we had bought them finished. We have had the tax benefit in the meantime of writeoff.

JG JG: Well, it's all a pretty sound strategy. The basic problem, or the basic in-house argument is, Do we have to give that much away to the development? Why can't we do it ourselves and get it all?

Q I've been resistant to that, maybe for selfish reasons, because of the tremendous amount of staff talent ...

JG JG: I was going to say, What kind of personnel base do you have to do that?

Q Well, I might also mention that we did some of that ourselves. We did one of the centers on our own, we have done all of the industrials on our own, that's pretty easy. We duplicate buildings over and over, we find that ~~s~~semi-management...

JG JG: Which is where Prudential and so forth is moving, doing their own industrials.

Q But anyway, that's where we've arrived.

JG JG: It seems like that's a good strategy. If you look at it, a goodly number of real estate fortunes in the country, and I bet at least half of all the major regional shopping centers, made their money in industrials, from basic industrial property., because your rent ratio to cost per square foot is more favorable there than virtually any other kind of property. And that's ultimately what you're looking for.

Q And short leases.

JG Most of the time. This gives you a chance to readjust and roll it up. And you end up with a very simple space frame which in itself is not vulnerable to a great deal of obsolescence cause it's easy to adapt: Changing energy to changing manufacturing to distribution patterns and so forth. I don't see anything wrong with that. Because otherwise, as you say, you are going to end up with a whole houseful of developers and contract managers and expediters...

Q Which, within the cycle, you would then have to let go. We've had 3 cycles in the state of Washington since 1969, counting this one as the third, down cycles.

JG JG: Or, if you don't let them go, you consume a good part of the advantage you've enjoyed.

Q My theory is you get a constant wave of either jumping out as the movement starts back up, trying to pick up good people, and of course the best people are doing this on their own account. Building that staff, having them trying to track more projects because that's the source of the job revenue, and then trying to make the hard decision, are they bringing us deals now because they have to have two more to make the payroll next month or whatever. And as we then have to chop back...

JG JG: Who provides the accounting systems for all those? I have one client that's a radio station chain and they spawn those kind of joint ventures on radio stations regularly. The way to keep them from going paranoid from wondering if they're getting their fair shake or not is they have an accounting service, and it's tied in, and they do all the accounting. We're doing it ourselves.

So you've got control. You know what's going through the books and where it's going and so forth. Terrific. I was going to say if you weren't doing that that would be the one thing I would add to the process. And is that computerized? (We're about to do that now. It's very difficult because it's hand posting and so forth. We're behind and everybody's mad at us.) You also manage the properties, don't you?

Q Yes, I feel that's the ultimate protection for the family...

JG JG: I've never seen any really good, highly reliable outside property manag-ement. It's always average management.

Q You know why? Cause there's no reward.

JG That's right. It doesn't pay well enough. The money is in the leasing and getting out. You see more and more of these firms specializing in initial lease up but then somebody else can handle the janitorial services. And yet that's really where you make your money cause that's what holds people in the building and makes them sit still when you roll the rent from them the next time. I don't see anything wrong with that as a basic investment strategy at all.

Q Question: Could you cover your moldable profit centers ?

JG JG: Taking the extreme case of going from raw land to a finished product, you have a profit center in the land, then you have a profit center in achieving the political entitlements that will allow you to develop. You have an automatic increment in the value of the site once you have achieved political approvals. You can get a fairly good payoff relative to your investment in legal and political maneuvering necessary to achieve that entitlement level when you get all the permits necessary to go ahead. You then have of course all the professional engineering architectural construction management services designed to improve general contracting profits. Then you have the leasing profits, insurance agency, finders fee on the mortgage, and so forth. Ultimately the property management aspects. There may be some other peripheral captive profits you can make in terms of controlling some of the tenants or simply creating some of the tenants. For example, we created our own restaurant down at Fort Meyers for a specialty center. That becomes another profit center. So that virtually any category of outlay for expertise represents a profit center which could be retained if you thought you could execute that particular function with finesse. On the other hand, if you don't have that ability, you're much better off to pay the small certain cost of letting somebody else make the profit in order to hold the cost to a fixed contract cost. Then it becomes a matter of how tightly you negotiate those contracts and specs when you lay off that entrepreneurial risk on somebody else. Does this answer your question?

Q Yes...I guess your answer was going to be a little more theoretical...

JG No, I try not to get too theoretical. That's really trade position. Are you going to be buying retail because you're passive and you can't do any of those things yourself or are you going to buy at the wholesale level or are you going to buy at the production level? For example, you could control an architectural engineering firm which gave you a price concession but also did business for others. That would be at the wholesale level. Or you could have architect engineer in-house on salary. This gives you the ultimate in control of him but unfortunately you don't necessarily get the most imaginative ones that way.

It's a trade off then.

Q Question: Getting back to Doug's statement of our strategy on our shopping centers, we're trading off 50% of the long-term value of the project for a couple of these functions. One of these functions, really the entitlement function, because we're participating in all the others. We're paying for all of the others.

JG JG: But the problem is how much diversity would you have if you had 100% of all those? Are you better off to have 9 centers in 9 different communities, each of which has 9 different variance potentials in their economic base, or are you better off to wholly own 4 in 4 communities?

Q I guess my point is that if we're paying for it on the front end anyway, aren't we doing it anyway?

JG JG: Is this whay you mean, for example: we have a little shopping center development over in Madison. Two million dollar deal, maybe 1.6 million more means you have 400,000 to go. It sells of at 50% interest at $400,000 which gives up 36,000 out of maybe 60,000 cash throwoff on the deal initially. You got a guaranteed preferential return of 9% on 400,000. At that point the developer has financed out and still has a 50% interest in the future residual. Is that what you mean? (Yes.) And you're saying, since we have to put up the 400,000. why don't we just sell the whole thing? The problem is one of how long does it take you to get control of that site and what's your search cost. Now he's making his profit. He's leasing hoping to cover all his salaries out of his profit centers from ~~building~~ the center. It probably only cost him 1.4 million, he took $200,000 out as a contracting development fee. That's what washes against his carrying charges. I don't think you could do as well as he could in finding sites and leasing. (Why not?) Well, part of the reason is there seems to be a certain amount of reciprocity and old school tie there. A shopping center developer, once he's established relations with the leasing agent for (Pay n Save Corp. is the name of the store in this town) Once you've established that tie and you can bring him along with you because he trusts your judgment, you may be able to do the same as somebody else. The trick is establishing that rapport and relationship and I have a sneaking suspicion that like everything else in American business it isn't entirely a rational relationship. They feel comfortable together, they go fishing together, there's reciprocity going on there which is a difficult tie in which to break into.There's an awful lot of shopping center develop out there that are chasing a limited number of deals that you become one more while you have stability because of the size of the organization that the moment that you don't have a presence in that market you are not known as the guy who practices it, rather as the guy who invests in it. It is hard and expensive to break into that right at the moment. In order to get their attention the first time trouble comes around it might involve leases which would be less than favorable. Does this get at your question? (Yes, but I don't, I am not convinced that we shouldn't be doing it). You may want to give it a try somewhere it won't jeopardize your current access to investment product

Q (But our primary contact has been so successful that he is apparently not going to deal with us anymore because he can find other investors who don't have our ? .)

Unless we put up the money 2 years in advance to tie up the land.

JG JG: So then we're taking away one more of the 5 profit centers that is ostensibly being provided by the developer. I don't know what the ultimate answer to that is. I'm always worried about maximization. I think in real estate you operate on a satisfizing basis, not a maximizing basis, that when you reach for the last buck is when you lose the first three, so I'm conservative. And when you're getting access to products to the present formula you're also getting diversification to the present formula and you are doing the accounting, you've got control, and that's all to the good. Now, if they're starting to cut you off because other people are now coming in, I have a feeling that he's cutting his own throat if he doesn't realize who got him started.

Q Question: I think to answer Gary's question, how to tie these together, the relationship with this outfit was established at a time when the Northwest was coming out of the Boeing recession. The California developers left us alone for many years up here. These guys were scurrying around getting the sites in advance, establishing their relationships for the local power. We made these deals, most of these centers, at a time when the developers, and this particular developer's marginal value was very high, they had inventory ready to go, sites, a demand, and almost over a year or so they became the largest convenience center developer in the Northwest. When good times came through up here, they were in position. Also the land was cheaper. All the ingredients there, it was a good marginal buy/for their services at that time. What's happened now is that they're ? marginal value has declined. There isn't the demand for convenience centers. The sites now are double or triple the price, so the relationship has gone but that's fine because they aren't worth it to us anymore. The basic problem is we didn't create the residual gain in land value to allow the matching funds pro forma to pay their x% interest. They don't pencil out today the way they did 2-1/2 years ago. They don't work the way they were working. But that's what Jim's saying. Conditions are going away, which means a good thing to do....everything has to cycle.

JG JG: Have you done any recycling of old centers? There's been a couple of really good deals made in our part of the woods. You take the old community center and mixed-up store front and so forth and they've closed those in, made them single loading inside malls and maybe in the corner put in a little extra construction which gives them a sense of being an inside mall and renegotiated the leases on those things by getting the merchants to concede that if they went to a contemporary storefront and if they coordinated their signage and improved their lighting...there's been some really good deals made on that because some of those up to fifteen, to eighteen-twenty/year old age are still sitting in the center of a good retail area. The families have the money, the center has just obsolesced relative to retailing standards today. A lot of people who have bought those originally sell them at the capitalized income value under their present modus operandi of proven location and obsolete facility and jazz it up.

Q The state of Washington has been undercentered for years because of our low population count, and there's a very limited product of available allied stores control the bulk of regionals still do. I would say there's only 2 or 3 in the entire state that could be converted into malls. In one case it's happened in another case it doesn't seem to work but...

JG JG: This is the regional type thing.

Q We didn't have any community malls. We have a mild climate here, in most instances we'd get by pretty easily with an open mall so they weren't designed in such a way that you could enclose them. There are very few community size malls in the state of Washington.

JG JG: You don't have an inventory of old stock?

Q No. I think you're down to a pretty fundamental question here. If we find ourselves for example in a situation where our ideas of the proper ROI are higher than the prevailing market. And therefore we're not having the ideas fed to us, we don't have the opportunity. My question is, should we go down to the market, first of all, the prevailing market, and thus keep the flow of information and the flow of ? , or should we defer on a short-term basis ...?

(End of tape)

Q No matter where it flows, it flows to better opportunity. So what should we do now? Should we lower our ideas of R.O.I. on real estate? One possibility. Should we be in a position where we're always just following the market and accepting the market independent of our own desires? You see how I mean that on the R.O.I. in real estate. That's one thing as a perpetual process. Should we be in a situation where we say that our ideas or to put it the other ways R.O.I. of a certain amount, anything under that is unacceptable. So, momentarily we're just simply going to be out of the market. We're going to be out of the market because we think what is being accepted now will change in the recession that's ahead. Have I put my question so that you understand it?

JG Yes-

Q What should we do?

JG Again, I can only work from bias from my own personal bias to that kind of question. I don't know that there is a scientific systematic answer for it but my position would be I think to say don't go down to the market when everybody is buying, stay out, and one solution is his solution. Build your own product so that you're going in at a cost which produces the rate of return, but you're going to be doing less of thoses kinds of deals because I don't think you want to staff up a big flock of people to do that. You may be able to find one or two persons that can put it together and you have to do it patiently, one at a time, one project every three years, or whatever it takes a on the certain time line of one of those and so forth, and then I would go looking someplace else for something to do with my money. I think you should never lose sight of what the price earnings ratio is in real estate relative to what the price earnings ratio is to carefully selected securities inthe stock market, because it doesn't make sense to be capping real estate at 12 and 13 times earnings when there are some good stocks out there capped at 6, but I think if you want to look and still stay in the real estate type of thing, I still think there are good buys out there in the real estate trust area. The equity trusts when they're still selling at barely book value and some of them are selling at less than book when you know that book value is a freak of accounting and has absolutely nothing to do with the underlying resources that if in a period of inflation you want to buy assets, then why not buy assets that are in a real estate equity trust. And I think other people are beginning to look at that, you saw one of the trusts get raided I guess out of Philadelphia, a small trust out there that got bought up and sold off and certainly monumentals sell off raised some eyebrows that the recent grab for general growth in Des Moines of course which is exceptional. I don't know why they grabbed for that one. You know it's priced higher than practically any other major real estate trust in the country. But, I think if you want real estate because of potential believers, potential for more asset appreciatio in a period of a devaluation of the dollar so that you may want to look at the equity trust as one way to go in that hiatus, as you say, between the times that the market goes lower than you are willing to accept.

Q - Addressing Gary's question, as it relates to the thing you talked about yesterday, risk management, doesn't that seem to tie in though, about being able to control the variables more?

JG -you mean going in to produce your own product?

Q - Well, if that's the answer. That' s why I'm concerned because yesterday you seemed to lean towards the fully integrated company if it's feasible from a standpoint...

JG -If it's feasibile, yes. But the problem is putting together a fully integrated organization With the properties you have do you have a insurance agency?

Q -No but we get a very good rate because we're buying large bulk.

JG You buy on a blanket basis over everything.

Q -Yes, but two policies for $150 million worth of real estate and we get an excellent rate in my opinion.

JG -OK Would there be any advantage in having an insurance agency because of the contacts you estabilish with your tenants etc.?

Q -Pass - except for the office building - we pass all the insurance costs on to the tenants, and therefore any extraordinary effort to save money or any effort to make money in that area would be a real can of worms cause most majors have the right to step in and insure themselves if they feel you're not doing the right job.

JG -What about architectural engineering services? What do you have in house on that?

Q -We don't ...

JG -What about leasing, then?

Q -We, Frank and I, do most of the industrial leasing. We did one shopping center, it took us two years because of not being able to do it full time. We saved the fees. The delay inherent in the project cause it took about twice as long to do it as if we'd had a ....we made up the saving s bacause the rents we got were then behind market.

JG -Behind market in what's worse is yet the opportunity cost of having your project in limbo while you bounce tenants.

Q - We do our own in house leasing once we have a project so we do save that once we've got it and we do of course our office leasing when we can here; and another facet of this would create quite a bit of overage in the market place because they're extremely sensitive to our cutting leasing commissions in these various areas and in our industrial properties, the local guys don't pick up the phone because they know we're trying to cut part of their fee out, which kind of makes me unhappy because we end up doing all the work for x months once a guy walks someone in the door and they re·ent our suggesting even ½ a commission.

JG -Well, brokers are not my favorite people in the real estate game. They probably collect more for doing less than any other segment of the industry. And, particularly in the residential area, are extremely vulnerable to the change in marketing. Sears Roebuck and a couple of others are looking at that really closely and will be able to blitz the residential brokers market in five years or so. In terms of office leasing, I thought it was interesting that IBM did their own leasing in Chicago; and did such a good job of it Standard Oil have come over from their building and have now provided the counseling on the marketing of Three FIrst National Plaza, across from the First National Bank of Chicago. They really have a jazzy marketing effort there with the back lighted screens and thirty carousals and random access and the whole can of worms.

Q -Part of that question, when someone brings or has theirown in house staff of leasing agents which many do, I'm not prejudiced in that /don't they reward in house staff with some form of percentage of the leasing addition rather than a straight salary basis.

JG -oh yeah. There'll be salary plus a bonus.

Q -Right.

JG -The donkey always runs faster if the carriage isn't ?

Q -So you don't cut out 50-60% of leasing costs cause you've got to pay the guy commensurate with what his talents would earn him if he went to work for Coldwell Banker.

JG -Yeah, but how much is Coldwell Banker putting away? Coldwell BAnker picks up half of it right there, so if you can save that half why that's a significant exchange.

Q -I'm talking about trying to cut into the other half.

JG -No, I don't think you want to cut into his half, then your're killing the goose that's laying the golden egg for you.

Q -Thank you.

JG - But you could pick up the first half, and I'm not so sure they earn that either.Some awesome commissions change hands of what seems to be, what is the rate out here, 7% on the first year and 3% on the balance?

Q -Industrial?

-5 and 3

JG -Chicago is 7 and 3, 7 and 2.

Q -Industrial, 5 or 6 on the first 5 years, 2½ thereafter, but that gets awesome again.

JG -Yes ___?___ block of space times the sq. footage and so forth.

-Okay, I would tend to get out of the market if the market is forcing you to take a rate of return you don't want. If you have enough in house security people. and so forth, I think you're prepared to move in and out of the market.

Q -HOw would you go about analyzing equity trusts because I can't disagree with that, out here, out west we get somebody's brochure and pictures. Do you try to go back over buildings that they own?

JG _There's a service out of NYC. Yes, I think you have to if you're going to go into it at all.

There's a service published by Audit Investment Services in NYC. Campbell is the security analyst and they will do portfolio studies from 350 equity and sometimes hybrid trust and keep track of them and then rate them for appreciation and they'll also identify the special situations, the ones that are abnormally depressed. They happened to have 3 Grant stores when Grant went under and the market tends to overreact on those kinds of things. I think there's opportunity there. The other area is that real estate ? is too narrowly defined. You people would know best of all. It ties back to Weierhauser and elsewhere. Resource companies are real estate companies. What do you do about Burlington Northern? That ship may have sailed but until a year ago anyway that seemed to be grossly underpriced. You bought the railroad for a couple of pennies per share and the land was the balance of the book, the value that you pay in the marketplace. What do you do about Consolidated Paper Company in Wisconsin? 700,000 acres of timberland but at the moment with the new air reconaissance prospecting for metal I would bet that their ore deposits are worth more than the paper company. That to me is a real estate thing.

Q Hospital chains would be another example.

JG JG: Hospital chains are a little if-fy. There are good ones and not so good ones, and in many cases now we have overcapacity in hospitals. You really have to look at that one carefully to see which communities they're in and how medicine is practiced. As soon as you start moving toward clinic practice, a private hospital's in trouble because they don't get a broad penetration into the market. For example, Phoenix in Maricopa County, their medical practice is still 2 or 3 doctors. You can still build up a coterie of doctors using your private hospital. But in Madison, Wisconsin the private hospital's dead because they have 8 clinics, every one of the clinics is attached to the hospital, there's no way for that taking place and the hospitals dominate now these medical councils which determine whether or not you can build another medical facility. So in many areas now a medical facility is virtually a monopolistic franchise because if you're not approved by that council, you're not eligible to receive payments from Blue Cross, Blue Shield, and a variety of other insurance compensations and you're dead in the water. Private hospitals make me nervous. One thing that's ? money like it's going out of style at the moment is the so-called outpatient surgical center, which is a really interesting way to make money. Those are being countered by changes in price structures in hospitals ? outpatient departments when those come in, but then a number of those are just printed money in the -basement.

Q One question I've got on the normal type of industrial or corporation that has large asset bases that may not be recognized in price, the problem I always have conceptually with that in the real world often those asset bases go for decades without being recognized in the market price of the stock because the market views those companies primarily ? _ earnings basis. For exambple, take Burlington Northern, if their RR earnings are down for an extended period of time, regardless of the fact they have the real estate, the purchaser of the stock recognizes that unless there's a big ? and some mineral discovery or something of that sort on the property they own...

JG But all that invariably happens is that as the investment banking fraternity gets sensitized to for example the commodity aspect of real estate, they then search out other areas in which to apply that analogy. Remember we first had tax shelter in real estate and suddenly athletic teams became hot because that had more tax shelter in it than real estate and pretty soon cowboy arithmetic became hot. Investment bankers are a bunch of sheep. Resource speculation is what real estate's all about. I think you're going to see an investment fraternity that is more sensitized to that in the future because it's going to become a greater and greater issue in our own society. People are looking at the oil companies and saying, hey wait a minute, letting them own the oil is giving them a license to steal in this country and when you let the oil companies own the coal companies too, what could be a sweeter set-up than that. And now that the oil companies also own the Congress, they've really got it their own way. There's going to be a reaction to that, I'm sure, in this country.

Q I guess what I mean is, I wasn't meaning to rule out the possibility if you think a company has got say, mineral resources or oil resources...

JG My fundamental approach to security investment was (1) I wanted industry in which there is increasing per capita demand in continental United States for the product that they produce (2) I want the company within that industry that has the best R & D program going (3) it has to have the best working capital division so that it can exploit what its R & D program is proving out, and I'll give you a growth stock which will take off. Now I can't say it's going to take off tomorrow or a year from now but you'll be there first, which is the object. And that's all I did when I was playing the market, was just range far and wide in my reading to find data, and as a result we picked up on the electric organ phenomenon, on the musical instruments phenomenon on the high school level, when the kids came through, made a killing in ? made a killing in Hammond, Cessna aircraft, in the paper industry, of course my father could tell me who's doing what in the paper industry, he could tell me how many tons of cartons of various kinds ?? or any one of the others was doing cause he made it for everybody. Their orders went up or down we had some sense of what was going on over there. We just use a lot of data that tried to measure growth stock. The only definition of growth stock that works is increasing per capita demand in the continental United States. We can turn that around a little bit and say, increasing pressure for resources within the continental United States. Because obviously the way we're going in the long-term foreign policy is an increasing level of isolation. We seem incapable of relating to others or maintaining ties for a long period of time. And that means increasing pressure on what we have within our own geographic control. A resource company seems to fit that beautifully. I will agree with you, I always thought that we would get caught off of our oil from the time I was 17, so I bought Ohio oil. It went nowhere for 10 years. Finally sold it. It took off. I also owned a dairy farm for about the same period of time. Never did get milk parity up so I sold it. Year and a half later they bribe Nixon and the rest of the crew and the price ceiling went off of milk and I could have made money like it was going out of style if I only had my 150 dairy cows.

Q I was not commenting so much on the resource question as the idea of an alternative to investing it in real estate directly was to buy companies with the real estate assets.

JG There is a problem. You can get there too soon.

Q I can see that much more readily say, on the equity trust where those are people investing in real estate as their primary objective ....

JG No, that's the ironic thing. Most of the people who have bought those as the small investor bought those as income and they were being valued on the dividend rather than on cash flow, which is insanity. The other element is to look for a small equity trust that let's say is roughly at par, in other words its market price is about where its book value is, and make a deal for a closed sale, private placement of a secondary issue of their security. We've done that a couple of times and it gives you access immediately to a broader portfolio. You may be able to buy it at less than book but more than the market or something of that sort. One of the big problems with the equity trust has been their inability to make ? ___ work, because the market tends to price them at book or less, and book itself is well below its asset value. Therefore, for somebody who has money who wants to come in and take a position for a million or a million and a half or two million and a small good trust, you're in great shape. And the little trusts that tend to stay in their own little baliwick do the best. Denver Trust, for example, stays right there in Colorado and just about everything in Denver with maybe one or two in Colorado Springs. Capitol Trust in Washington D.C. never gets out of D.C. They just stick doing their thing in their own territory, one or two million at a time, they just keep coining money. These guys who have to flit all around the country make big deals coast to coast don't know what the hell they're doing and they get cut up in little pieces.

Q I guess that starts my next question. In trying to establish our new groundrules now that we've merged our company, obviously we're conservative, we're worried about the safety factor, etc. One obvious answer is various operations within the real estate field. We are established in shopping centers, we are established in warehouse, we have some office building holdings and we dabble in a couple other areas. There's also the question of geographical diversification:As the operators we've found that the ability to manage something is in direct inverse ratio to the distance from the home office. Selfishly,we now,our offerings, our bulk of them are in the state of Washington and are manageable in trying to establish a regional small office in eastern Washington so that we can....

JG I would be in favor of this. I think diversification in real estate ought to be by property type rather than geographic area...

Q And that's my basic question...

JG But we had clients that are flying all over the country, and half their people on airplanes half the time and so forth, and it just doesn't work. One: You waste an awful lot of executive talent flying around, and energy, it's tiring after awhile. And second of all, I think, and let me run through this because this would be the hierarchy of constraints on which I would formulate an investment policy. The first one is political exposure. There is no way to be in real estate today and be a political industry, and political,perception of the political power structure and knowing who you know and how you get the job done and how you communicate with them and political infra-structure is the first source of wealth in real estate. I mean that's, you're getting the entitlements and avoiding the harassments is critical in the development process. You obviously have land use and building codes and so forth as one aspect on it, and there's only one way to do that, and that's stay local. ? at your hotel. Have you read recently "The Conservative Investor" by Schubeck and somebody else, it came out last year? Their position, also, is that in securities analysis, integrity of management is perhaps more critical in many cases than having the right quick ratio or the right,so forth.

well, I think in real estate, in an organization like yours, you've got a deal in both political climates which have integrity. And I don't know why you're in Honolulu, frankly, I really don't. I'm sorry, I've just got to say that. That isn't your strong suit and Honolulu is crooked as Chicago, right?

Q That's very true

JG And I don't see why an organization like yours which has integrity cannot survive in that market.

Q There are some elements to suggest with catching up around here.

JG In Seattle or in your organization?

Q Maybe both, I don't know.

JG Anyway, I think your number one protection politically is when you have established a recognition as one of the peer groups in Washington that you ought to operate in Washington, because you do have that image of integrity, but you also have good knowledge of what the conduits are legitimately in politics to assure yourself of the ends that you desire and that is an incredibly valuable resource that doesn't show up on the books.

Q How do you compensate that? How do you determine the value...?

JG It's much lower cost, and you can move quickly. You're not moving quickly in Honolulu. Your ship has sailed a couple of times on that site in terms of incremental land use regulations and so forth, in Honolulu. It has also sailed in terms of what's happening to over-capacity in hotels. I don't know of any hotels in Waikiki that are really making money, I mean big money. A hotel is a fixed cost variable revenue operation and I don't know if there are that many of them over there that are making big money. They're not making big money, why go to all the effort at this point. That's the question, I guess. It's a great piece of ground, super piece of ground, no doubt about it, but I don't know if I want to be in the hotel business on that piece of ground. I don't know if I want to be in the hotel business in a climate in which a very small change in air rates has a very profound impact on the flow of folks in. You can argue, well, once again Hawaii will become a playground for the rich because they're the only ones who can afford to fly over there, and so on. But you can also argue, maybe not convincingly, that the United States has a peculiar anti-snob/

snob tradition that if we are in a period of belt-tightening and energy conservation that it becomes socially déclassé to squander energy on a big vacation. A lot of people with a lot of money that drove Volkswagens because it was stylish to thumb your nose at Detroit, not because they couldn't afford a bigger car, but because there was a fraternity of anti-snob/snobs that drove Volkswagens, right? Americans have that little tradition. A super luxury environment and high cost of transportation, and so forth, just isn't approved in upper middle income circles, then they won't do that because their peer group won't envy them for having made the trip. And I think that's a real risk that you run in going that route....

Tape #2 Continued

....and so on the second thing, of course, is that you have price control and profit control. That may take the standpoint of rent, I mean rent controls in residential, and therefore my basic view is build no apartment housing for a variety of reasons. At the low income line you're going to have it socialized sooner or later, it's inevitable, simply because there are more of those folks out there who can't afford to live anymore than there are folks that own them. You'll be able to stave it off, sooner or later some form of profit control which is what rent control is all about is going to come into play. At the upper end of the line there's been more rent strikes catering to the rich than there have been to the poor because they can hire more attorneys, and therefore trying to cater to the rich on an apartment building is just a big pain in the butt. There are smaller people with more money on that end of the scale than there seem to be at the other end of the scale. I happen to be the assessor of Madison's upper-income community called Maple Bluff, and all the folks are college educated, and all the folks are ? but I never met so many small people in my whole life, and it's fine I'm using them as guinea pigs to test the new computerized market comparison assessment system and I got up to one hundred per cent of value in two years and they're dying, but there isn't one of those smart attorneys that's willing to take me into court and challenge me on it and I'm just daring them to because I want to get a court precedent that says "Hey, this is a legitimate automated ? system." It's so hard ? one of them into court. But never-the-less I'm not overly happy about catering to the rich as far as apartments and so forth go, so I'm going to have a basic rule: Build no apartments. I also have a basic rule: Build no hotels. Frankly, I've worked for several hotel operations, The Abbey, The Pioneer. The Abbey is a high style hotel at Lake Geneva that caters to the rich from Chicago and caters primarily on the many indication in the business seminar, and that's a rough game but it's a fixed cost variable revenue thing and that was making money like it was going out of style but you certainly met a lot of people you didn't like. Chicago ? money controls Lake Geneva like controlling liquor distributorship. They control it by controlling the garbage disposal guys and the price you pay for having your garbage hauled away and getting your liquor brought in on time and so forth, is all part of their cut and at some point father says, "You're going to meet twenty per cent of the people in this world are smarter than you and the best way to handle that is to have nothing to do with them, and if that isn't true of the hotel and the entertainment game I don't know what is." That's my personal bias, I'm sorry, I'll probably never get invited back again, I just don't like hotels and I don't like Honolulu in terms of a political climate in which to develop one. Now you also have to ask the question: I talk to people all the time when I'm on trips, I like talking to the bartenders and the waitresses and the guys in the back room and so forth. I have a wonderful time learning what's going on from those guys. You also talk to the folks in the elevator and so forth and they always said "Gee, Honlulu was nice but when I come back to Hawaii I'm going to go to Maui or Kawai." Waikiki has become carnival time, it's Las Vegas without the tables. And the classic example is The Cinema which is just down the street from you. That has got to be the worst hotel I've ever seen outside of Las Vegas. That's a disaster zone. It's Schlak, Inc., and there's just more of that around there. The other problem with Honolulu that I don't like is the people that are there who have money don't know how the hell to manage it. Like Alexander Baldwin, for example, I was talking with them. They're doing some Maui and Kawai condominiums. Now the back log in Maui has gone from about five hundred to fifteen hundred on MLS at a rate of about three hundred a month increase of condomiums for sale. They have about twenty-five hundred new ones coming on stream all around the island. And so here's Alexander Baldwin with about one hundred and fifty unsold building another hundred and fifty. And I asked the fellow how come that was so. Gee, nineteen plus four and half for construction money, that's going to be a pretty expensive carry, and he says, "Oh, we don't use construction loan, we got sixty seven million in the bank and so we decided to put it in condominiums. He didn't know what opportunity cost of money was. The Bishop Estate doesn't know what the hell opportunity cost of money is, and it's pretty tough to do business in that kind of market when your competition doesn't know its cost. And that really worries me. There's some big money over there that, to me, didn't seem to know what it was doing. Now maybe that's arrogant on my part. Obviously they got sixty seven million and I don't.

Q I was on the Board over there, in the islands, in Honolulu for about eight years, from about 1958 to 1966, and it was outside money in substantial amounts. Everything you said I found to be true, even now. If you're not part of the Establishment in the Islands, you're not anybody. I don't care, you could be J. Paul Getty, it wouldn't make any difference. You're fair game, and a person after a few experiences came very quickly to a conclusion, you know, they form Hooey over there, they call them. Well, the first thing that happens when anybody comes in from the outside with any money, a Hooey is formed at the Establishment. A Hooey only has one objeetive: How do we make things difficult for the newcomer and let's get rid of him. So everything you say, in my experience, and I have a condominium in Maui for example, I'm over there three to four months of the year now, and have been a substantial stockholder in Alexander Baldwin and have known the people. I couldn't disagree with a single thing you say about the climate over there, or the possibilities. It was true twenty years ago, fifty years, ago, and it's still true today. They've never busted it!

JG The classic example is the Land Reform Act that's going to backfire on them. The Bishop Estate controls all the land under those leases just north of Waikiki, all those beautiful mansions going out towards the Kalua Hilton. Those all come up in '80, '81, and '82 and they're not renewing any of them, with the idea that maybe they could make that the next hotel row. So now all these millionaires go to the State and petition the State to condemn their land so they can buy it back on a residential premise at subsidized interest rates from the State and once those boys all get that together again ten years from now, that's going to be your new hotel row.

Q Let me ask a question, though. Granting that everything that you believe in and everything I believe in is true over there, when you start out with the fact that you already have a substantial piece of real estate, the real estate per se as it is now just simply won't pay off, frankly, what do you do? Do you go forward, for example, and build the hotel?

That's one possibility. The second possibility is you do nothing, you just sit there. The third possibility is you sell. What would you do?

JG My first choice would be to sell. I asked Ed when we came in here what your position on that was when you came in. I don't know what it would go for now, but I would suspect it would be Japanese interests or condominium interests over there that would pay a goodly price and you could take your profit and run and my Daddy taught me: You never go broke taking a profit. Second of all, it is a capital gain you're concerned about, then I would ask myself: Hey, what is it I would like to be in in Honolulu? And trade out of it. Tell your Buyer: You go get me that one, and see, okay, then we got a deal, and swap out of it. But then the question is: What would I swap into? One: I wouldn't swap into hotels. Nobody's going to part with any shopping center. The best thing you could probably swamp into right now would be some from on industrial warehouse type space.

Q You're not constrained to Honolulu, are you?

JG No, you're not constrained to Honolulu. You can trade anywhere you want. Now, if I had my druthers and I was going to trade, I would rather trade right back here in the mainland. Maybe, just maybe, I'd go take a look at Anchorage right now, who are hurting, really hurting, and there might be some good buys up there, maybe some need of corporations up there that had gotten their tail feathers burned in their venture in real estate and might like out, and I like what's up there at the moment because I think Anchorage is going to come back. Fairbanks and Anchorage are hurting right now but I think they're going to come back and maybe now is a "buy" point in Anchorage.

Q What you're really saying to me is that you would take this out of this unfavorable political atmosphere back into an area wherever it is where the politics are such that you think that you can prosper.

JG Right. Exactly. And that may be ? in the State of Washington. No problem there at all, but if I wanted to find some place that was still under-priced and might be vulnerable for a good buy, Anchorage is one of the places I might look.

Q But I think in Anchorage you've got the "dumb competition", which are all the natives, who may have made mistakes, but they're going to make a whole bunch more.

JG That's a good point.

Q ...they live next door to you and they don't care whether they make any money, they've got a thousand guys they want to put .... dumb competition.

JG That's a good point.

Q ....you've got the dumb competition.

JG That's probably true. Then I'm back in Washington again.

Q Hopefully there's a slow learning period because they sure made ?

JG But they still have a lot of installments coming from ? ? . that's the problem.

Q You've got one factor that you're right in is that the market up there is depressed for reasons other than the native...

JG When it goes, it ought to go good. But any rate, philisophically, I would trade the hell out of Honolulu.

Q Could you comment on condominiums, condominium conversions, if you don't like apartments. Is that something that's going to increase? More viable?

JG Well, what are you going to do about condominium conversions? Are you going to convert them and market them? That's a peculiar breed of cat that does seem to do that. You might be able to do that if you had a talent that knew how to do that. Again, American Invesco put away a hundred million dollars after taxes last year. I don't think I really want to work with American Invesco. That falls in the twenty per cent of the guys that are smarter than me, and I met that whole crowd, and so forth. If you thought you wanted to do something like that, I know, I think, of a couple reputable converters who would be looking for participations where you could provide some banking for them because right now if you want to be in that, what do you call it, interim capital, which necessairily isn't a bad idea if you want to maintain a certain pool of funds that have interim liquidity as opposed to short term liquidity, there's no reason why you couldn't be a developer bank. For participation, just as there are a lot of people out there who are short on the down-stroke.

Q I was going to ask about rehabs. In all of these kinds of projects you have the same sort of problem if you don't have the expertise in-house...

JG Rehabs, I think, are a fairly exciting thing if you buy right, and that means you really have to have a good engineering saavy as to whether the base-base on the structure is sound and the location is sound. And you've got enough ceiling height that you can go in with an all new HDAC system and you've got enough floor loading that you can do something with it from that standpoint.

Q But all that takes....

JG Well, it also implies a typically much older community than you have. The same problem of being relatively young in the shopping center game applies to the existing stock of appropriate building. That game is easier to play in Chicago than it is here. Does this answer your question?

Q Yes, or San Francisco.

JG Yeah, well even San Francisco is very dangerous because most buildings are out of brick rather than concrete, earth-proof construction and the cost of earth-proofing to the new Seismic Code, a brick bearing structure is so prohibitive you're better off to tear it down and start over again. So that's the problem there.

Q Before we leave condos, I was curious to get your opinion, it's always been a cloudy picture in my mind, what happens to all this condominium stock that's being built now, and is going through the first and second user cycle and is not the greatest stuff in the world. What do you feel is going to happen to this tremendous condominium market when it starts to deteriorate? There's been an awful lot of speculation in it, there's been a lot of...

JG I guess I'm in trouble out here on the west coast when you're talking about condominiums as to what end you're talking about because we haven't had that in the mid-west. We have had the condominimizing of a few deluxe apartments in Milwaukee. We have had not truly a condominium but the sale of townhouses on pads which are part of a homowner's association which effectively works like a condo but isn't, but it's a townhouse type project, and then the only successful condo in Madison is the project that my partner and I started shortly before we sold out, and I sold out to him, because I was tired of being land-poor and so forth, and that's the only one in Madison of any scale. We have three hundred and fifty units there, and it's a pad-type thing. The smartest thing we ever did when we went into that was employ a group called "Community Planning Associates" out of Reston, Virginia, who specialize in setting up condominium management things, and they were super. They just helped us with an attorney who had done a lot of condominium stuff, avoid a lot of mistakes, and they came and engineered the first meeting of the condominium homeowners association. Beautifully handled from a sociological standpoint, getting them involved in the management early in the game and so forth and it was really relatively inexpensive and they've been very active with the Urban Land Institute in setting up this association of condominium associations to teach them how to manage their own affairs because the problem with the condominium is that is is a social organism as delicate as that of a country club, and it doesn't take much to sour that social synergy that's necessary to make the condominium work effectively, and as soon as you get internessing warfare within that condominium your property values go right down the pipe. Essentially, it's a social organization within a real estate structure and that's a delicate thing to create and maintain.

Q Don't you see that as a real problem as the properties themselves begin to deteriorate thirty or forty years from now?

JG It's pretty hard to make a rule on that. Some of the condo guys went for price and therefore the materials they used needed constant maintenance, you know, the stained woods, and so forth, and the bloom is going to come off that rose after they assess everybody for the first round of stain and replacement of the gutters and the whole thing. Others went with a much better material mix with the aluminum and the brick and so forth. In some cases, for example, one of the things we did with ours, we even set up a small cemetary-memorial fund so that we have sort of an interest income coming in to do special things, so if they want to hire a summer playground director,they have funds,they don't have to go back and assess everybody on, because only a minority of them have children. And you get that tremendous battle between them that wants that facility and them that don't and then you always get the wise guy that says: "Well, you vote it in but I'm not going to pay my assessment,"he just doesn't regard his assessment as a credit obligation. This is a hell of a thing to manage. We did the same thing with all our subdivisions. With every one of our subdivisions we set up a cemetary-memorial fund and put aside three hundred, four hundred dollars a lot and gee, those were producing money like anything and in the subdivisions which really have very little common area to be concerned about other than a tennis court of something like that. Build no swimming pool is another basic ranchcamp rule. It's a nice gathering. The homeowners all get together every spring to decide what to do to spend the money. Nobody has to dunn anybody for it, no collection problem is there, and that provides a happier social event because it holds the subdivision together. One year they actually used it for attorneys to help fight the city dump that was going to come down the road, but it wasn't a matter of going and assessing somebody for it, the money was there, now the question was how they were going to agree to spend it for this year. And you can't do that entirely with a condominium, obviously, because the maintenance problem is so much greater. I've got my mother in a condominium right now in which there are two buildings in the condominium each with about twenty units in it and they're separated by a little, old lady who wouldn't sell, ? a condominium developer who built this. And now it's the east building vs. the west building. The president lives in the east building and all the ladies in the west building and they're convinced the janitor spends more time in that building. I don't know if the condominium idea is going to survive simply because the converters that have been rolling it over have mainly made no provisions to train the residents in the subtleties of management of that organization, and that's what I see as the real danger of condominium and the assumption that the price will appreciate, because of the social difficulties they're going to get into internally.

Q Switching again quickly, when I got here and got into office buildings, we had this one, ten years old, and then two, built in '29. And I guess I was shocked at the great difficulty we had in the sixties and earlier seventies in raising rents beyond those costs beyond the amount of money necessary to pay the increasing operating costs. We ran good buildings, we didn't chintz on them, our cost of operation expenses ran in the high forties and in one instance with a medical-dental building approaching sixty per cent pre-debt service, and in a couple of instances we did sell the two older buildings at a very small real residual value. This instance right next door here would be a fascinating case for you. We figured out no money that's spent on it except to maintenance since '29. We sold it for three million bucks and they put nine in it to modernize it to show you the ? . Well, anyway, to make a long story short, I have a personal bias against the numbers that I think have flowed out of the office building business for at least the last twenty years. Finally in this building we're getting a chance to pass the original, on an appraisal basis, the original cost twenty years later on an appraisal value because of our current tight market and our ability to get this last three dollar rent increase.

JG What's happening, the price of building is, what, sixty-five dollars a square foot, or higher, here in Seattle?

Q Higher.

JG ? put an umbrella over you ,and it's starting to shut off the increment and supply.

Q But anyway, I guess what I'm saying is, am I crazy or do a lot of high rise office buildings not pencil out as well as they might on return on investment if you had to leave significant money behind?

JG Well, I don't think any of them have penciled out very well, for three reasons. One: You have every financial institution off on an ego trip building surplus space which doesn't cost thousands and it's like my Daddy said: " You got to compete on price in the office market, and if the other guy doesn't know his costs or doesn't care, you get killed, and so you've been competing against a whole series of institutions who are not accountable to their stockholders in terms of what they do with their money. Call them banks, call them life insurance companies, call them whatever you want, their mistakes are terrible. They're encouraged by the architechitural fraternity which never did understand money and they just get blitzed with the renderings and the glamour of the drama and excitement of building the building ,and so you're in an area in which there's no control on supply and it used to be at least that money was a control on supply, but for a lot of these institution that isn't even a constraint. And so I don't understand downtown office buildings. The illustration I used yesterday in a seminar: There's something fundamentally wrong with the economics of the John Hancock building when it uses more electricity in a day for ten thousand people who live and work there than the city of Rockford does with a hundred and fifty thousand people and a whole manufacturing base. There's got to be something wrong with that, it doesn't compute. I don't care what anybody says, land costs, in other words, what you have to do is look at an office building and see that an increment in land costs is only justified when it is less than the increment in vertical circulation cost plus the change in structure cost and the higher you go the higher your structure cost and the higher your vertical circulation cost because every time you run an elevator in you're punching holes through every floor below it, and obviously you reach a point where adding one more floor to the building and one more elevator will produce net loss in leaseable area. Now, furthermore, it doesn't make any sense why we should pump our water up and pump our sewage down and so forth. Architects have no understanding at all of what they do when they put in a five-horse motor versus a four-horse motor, but a five-horse motor today costs three hundred dollars a year to run. And they don't know if it should have been five or three and a half so they put in five to be on the safe side. Then the whole building is so over engineered in terms of what it's supposed to be doing it doesn't make sense, and therefore I don't see why anybody wants to be in a high rise office building. I would much rather have two and a half floors in the suburbs with a square building so that I've got maximum floor area for minimum ceiling or roof area so that I won't have the heat loss, and I control my window apertures so that I can heat the building on the heat from the lights and the heat from the bodies and all I've got to do is move some heat from one side of the building to the other on cool days or whatever, and have no elevators to run up and down other than an emergency one for the handicapped or whatever. But I don't have to pump my sewage, gravity worked fine for years, it should continue to work that way as far as I'm concerned. I just like to keep it simple. An office building is supposed to be a machine for making money and the relationship between the rent to cost per square foot is such more favorable ratio in a suburban office building than it is to a downtown office building that I don't understand why anybody who is not a goofy life insurance company or a bank build one. Does that answer your question?

Q Right on, and I was just going to add the next following question: What are the advantages of the suburban buildings, and it's obviously low rise.....frames construction, your parking lot saving...

JG We're moving to a multiple nucleii concept of life because people want to live reasonably close to where they work and I'm sure you see that here. I think Bellevue is doing perfect, a beautiful example...

Q ....Seattle and ? office built last year. But how do you explain the ceiling phenomenon based on what you just said? You got to call it an aberration.

JG What is the ceiling...?

Q We've always struggled with our rents in this town and the competition of, just as you say, the Sea-First who never costed out their buildings. A very shrewd investor got started, Martin Seely of Seattle, built, but maybe this is part of ? He started his first office projects in much less land cost out in what we call the Regrade area north of the ? He built eight-nine-ten story buildings and kept his costs down

(End of tape)

DLR: ...he is not building the monuments, our company is in one of them and it's not a fancy building

JG: Vinyl takes the place of marble and so forth

Can I go back to my list for a moment? We have been talking about political exposure, I think is the number 1 criteria in terms of investment philosophy and the best way to that is to stay in the territory where you are known and where you know what you are doing. That is the No. 1 strength. Then avoid those areas which are subject to price and profit control, also avoid those areas that are vulnerable to subsidized demand. Section A for example, where its fair market rent and that sort of thing because that comes and goes with the will of the wisp of congress, once they have started to involve themselves in subsidized demand, it's no longer a natural marketplace. Finally, what is your vulnerability to public competition. Which is another thing that worries me about Hawaii. Hawaii panics about the decline in the traffic coming from the East, dropped 14% the first half of this year and picked up 7% coming the other way, but now they want to use the resort as a way to repopulate the other islands and hold down the labor force in the other islands and relieve some of the pressure on Oauhu which means, eventually, you are competing with public capital. I don't like that either so I try to avoid areas like that.

The second most important thing is market control. You can have the demand channelled by terrain, fantastic! If I have the only flat spot in town, or I'm at the end of the road coming out thru the valley, that sort of thing; if I can get some kind of exclusive permit; there is a limitation on alternatives; those kinds of things.

If I can have control of the tenant, either because he is a subsidiary of mine or because of reciprocity, this is what gives banks the right to go off the deeep end, they build their building, they let their law firm, their accountants know they'd like to see them there. First Wisconsin idiots, first three floors are their attorneys, two floors Arthur Andersen their accountants, couple more floors are the stock brokers who want to deal with their trust dept., not too hard to build a building in the wrong place under the good old American law of reciprocity. There is nothing wrong with that if its my building, I'm only opposed to it if its their building.

In the absence of any of those, you've got to have really fine tuned market research -- to take advantage of the monopoly in real estate is to think small. I mentioned yesterday, think about it for a moment. A 24 unit apartment building today is virtually half a million dollar project and will have to take home a minimum of $125,000 gross to carry, if it's going to wash, break even, right? Now look at the capital structure which is a half million dollar enterprise selling $125,000 sales a year, represents more sales and more capital than is characteristic of 60% of all the businesses in the United States, yet you are doing it on only 24 customers and - when you can define the market into that small a subset, that is when you can monopolize it. Maybe not like Mr. Hunt tried to control the silver market for the world, but you can sure control the 25¢ market on a single block for at least a short period of time and it therefore lends itself to a monopoly game quite legally simply because specialization is possible in the micromarket.... is there, and you can do that with good market research plus taking time to find out what people turn off and turn on about. Some really good developers in S. California doing some really good things with it. I started ten years ago with a lakefront developer in the midwest who finally got killed by the politicians - he wouldn't listen to my "stay the hell out of government..." He went in and developed on a man made lake the Indians tried to do in the Menomenee reservation and failed - he went out and cleaned out the lake and got himself in a war between the on and off reservation Indians ... he went busted and he was there by the invitation of the governor. We got in early and even using clinical psychologists we couldn't understand why 50% of our lake lot sales were to people who had never shopped a lake lot before, they bought on impulse, $1 down and $1 when you catch me sort of thing. We found some fascinating stuff which was able to channel our advertising. We found families with their kids between 8 and 10 that started to panic about the advent of those youngsters into Junior High School systems, where they say that, 1, maybe dad hadn't established the roots of communication that maybe he should have earlier and Mother saw this as a way of isolating Dad with the kids for the weekend to establish that communication base and that common experience base before they hit the Junior High School system.

By the same token, the empty nesters were going for this sort of thing, partly as a dream - being in the north woods sort of thing, but in large part because it was a socially acceptable way of ignoring their friends. If their friends called and said, "Let's play bridge Saturday night." She could say, "I'd love to, but Charles is going up to the cottage Friday night". Not only a socially acceptable rejection, but one that raised a little envy among their friends. But when you quizzed them about the design of it, they wanted one bedroom and maybe a bunkroom for the grandchildren - you could program exactly what they wanted. We applied the same techniques in Florida Looking at defunct condominiums, two of them, side by side, same size, same number of bedrooms, same bathrooms, same price. One died, the other one was sold out but the difference was that one had no dining room, basic kitchen, serve over, pass thru thing. Bedroom faced the gulf along with the living room and the master bedroom was big so they could lie in bed and see the gulf in the morning and the water and the whole atmosphere. The second bedroom was a little cubbyhole facing the parking lot on the inland side. Whereas the other building had both bedrooms facing the parking lot (equal size) and a dining room. The lady came in, looked at that, said I'm not going to entertain my relatives who are all going to come down and visit us in our condominium. I'm not going to cook meals on my vacation, and turned off immediately on that floor plan. Had really no sense of how people were responding and I don't think to this day why his condominium failed because he did not know how to program the behavioural system of the customer he was dealing with. Once that is done, its gangbusters. Hoffman, the builder in Chicago, never believed in it, finally three years ago, started looking at his market, found out he had 13 single family buyer types of which only 5 had kids. Within that group he found they bought at different seasons of the year so if he managed to alter his advertising he could maintain his rate of sale rather than having typical drop off after school started and so on. We took the same model of a detatched-attached townhouse, 37½ ft. wide, two car garage, joining only at garage. Decorated it 4 different ways to reach everybody from the family with kids to the young bachelor CPA, lawyer. Couldn't stop demand, they had been programned to build out in three, they were selling them at a rate that they would have sold out in a year and they couldn't do that because they didn't have the production capacity, so they raised the prices $15,000 across the board over night and it never slowed down. By programing on consumers and finding out what kind of codes turn people off and avoid that kind of thing. I think that is where you get market control today is by programing that consumer.

The third element is management intensiveness; what kinds of talents are necessary, are they what I would call "fungible" or "personality". Those kinds of things which can be run on a good industrial basis I think are the kinds of things that you want. Those things that depend on personality, you have to be very careful about. A specialty center is a personality kind of thing; to create the ambiance of the Ghiradelli, very very difficult, its easy to see after the fact. Quite something else to have the sensitivity that does it... and may be you do it by accident - while its very glamouress and attractive and has a certain eliteness to it, extremely difficult to do within an industrial organization. An organization like yours, which I'm sure, probably works by committee, isn't going to do that very well. That kind of real estate is almost always the product of a single dominant ego or personality. There is nothing wrong with that, just doesn't seem to work well in an institutional frame work. There are a few institutions which can do that, ? Hammer, for example, has a division of guys that come and go, ? machine shop, couple of machinists, they report to nobody and their game is creativity, but it takes a rather patient organization to wonder what is going to come out of the lab that pays for all that and you have to have a tremendous amount of self confidence not to get paranoid after awhile that maybe that guy who looks creative is taking me for a ride - difficult to carry off. So kind of management that involves personality you almost have to avoid. You can fund another organization that may have that. Notice for example how you can conceal that, look at the number of chains in foods at the moment with tremendous emphasis on decor but its the same old hamburger and french fries, its industrial food in what is supposed to be an "atmosphere" setting. You are attempting to create "personality" without relying on people. Put the waitresses in cutesy uniforms, everybody goes around like a sailor, or old Normandy, but the crepe still comes out of industrial food kind of thing - trying to create personality with an industrial process, not something your institution would try to do. That's what I call management intensive.

Financial Attrbutes come next and I think you really have to classify. First of all you have to say, is this a trading property in which case we are simply going to buy well and turn it over which we call trading securities I suppose; is this an investment in new technology, where non-financial factors are primary - the guy's built a new widget. For example, friend of mine in Florida has now developed a new glass technique for creating glass that has very high temperature extreme tolerance, very easy to get a vacuum in and his idea for solar heating and tremendously cheaper than copper - that would be an investment in new technology, there may be some of that from time to time in real estate, concrete modules for hotels which everyone lost his shirt in. Next, would be the work-out or special situation where you have inside knowledge and bargaining position. That, I think, is one of the major opportunities you have. Inside knowledge and bargaining position.

The fourth cyle of financial attributes would be where you were looking for spendable cash; tax exempt being the most simple minded tax shelter Section 8 type of things, refinancing, or creating a captive customer for services, that type of thing.

Then finally, growth investment, and growth investment as far as I can see is one in which there is increasing per capita demand per space time unit. For awhile it was hotels for transient travel, then it was PDQ's, small neighborhood spot centers and so forth but increasing per capita demand.

Those are really the five basic sets of financial attributes. Then within that you begin to look at what is the time line for investment - is it a fixed cost variable revenue enterprise, is it a totally variable revenue variable cost enterprise, what is the degree of leverage, what kind of opportunity do you have to straddle, all those kinds of things. After you get through that whole set of analyses, then you come down to the income tax attributes, is the shelter within the investment, does it come outside to other investment, what is the adverse impact on investor status, does it make you a dealer, so forth, what kind of tax traps are there potentially adversely affecting the liquidity, where are your cross over points, not only in terms of depreciation viz a viz amortization but where is your cross over point in which your basis is well below the mortgage balance and if you were to sell you would end up probably having to put more money in the pot, that sort of thing.

JW: You are suggesting this is a hierachy of considerations?

JG: Right, the thing has to make money on its face. I have never seen an investment that was justified by having the only profits being a tax incentive, with the possibility of buying a totally defunct corporation with tax losses which you can absorb into your operation. Never seen an investment justified on tax shelter. If it isn't a viable economic enterprise, the paper losses are going to turn out to be real ones. Finally, the estate planning issue which obviously in this case, I suspect the history of Metropolitan Northwest, has been to avoid the problem of continuity of management liquidity etc., might otherwise have attendent family problems. Less significant problem.. although could still have the problem of having to buy back stock from family members or whatever.

Now, that's the hierachy with which I would approach an investment. If I can't control my political exposure, if I can't find market control, and if I can't reduce management intensiveness then I ain't going to look. The rest of it is the typical kind of analysis that everyone does.

I am open to comment, critique.

⁻: I'd like to go back to your theory on the assumptions of the future on our real estate bridges you talked about yesterday - what do you vie our position in the shopping center market?

JG: I like it. If I had my druthers and had your money, I think I'd be maybe a quarter in shopping centers, neighborhood ones; I like neighbor hood shopping centers because, 1, very low profile, public identifies centers with the tenants not with the owner; relatively short term leases, you can roll a percentage lease return now into base rent on the next roll; I think you will see certain amount of urban compression in which people will be travelling less and less for more and more of the basics, so sale per square foot and the variety of things sold at the community/neighborhood shopping center is going to increase It will come at the expense of the regional in those items which are not shopping goods, the bigger, furniture, hardware, kinds of occasiona purchase items. I would much rather be in the neighborhood. If you look at ULI, the neighborhood shopping centers have consistently produced more cash flow per dollar invested than the regionals. The regionals may have more glamor and excitement and therefore their prices get driven up and their earning multiples down because foreign money wants it and big institutions want it and they don't want to fool around with a few million dollars investment - scattered all over town, but I would rather have 15 neighborhood centers scattered all over than one regional. I like the neighborhood because its directly tied into the retail price index which few other investments are, tied right in thru the percentage lease and people will always buy food and hardware. Then I liked industrial buildings, guess I would be happier to see greater diversity of location than one single 170 acre park because you are reaching only one side of town. Friend of mine ... they have three in Milwaukee, one on the south, one on the north and one on the east so they've got it. They have their indusrial park split so that the frontage on the main road is office park and the back land is industrial park and right in the middle they have the kind where you have the office in the front and so much industrial higher ceiling clear span space in the back and you can buy so many multiples of that like slices off a sausage and its been very successful. With one on either side of town, you have the market bracketted very effectively. Plus you are protected a little better - peculiar cases develop, e.g. bottlenecks on the expressway going one direction; if you have to ride into the sun going home and coming to work. Once you get into the idiosyncrasies of the particular community you can protect yourself with that kind of diversity. The third thing I like are suburban office buildings. I think this is going to be an increasing trend for more and more businesses that say I don't have to be downtown, my only link downtown is my luncheon club and my doctor has me on a low calorie diet, solve that problem by getting 20 miles away. More and more people examining why they are downtown and driving both ways and some companies have found makes no sense at all. ___________ Smith for example was in the Inland Steel building in Chicago for years and I asked them why and they said they needed the prestige, clients like to see the Mies chairs, I said when was the last guy who bought a glass silo or 47 miles of glass pipe in your office - over a period of six years no customer had been there. They were had gotten into that at \$6½ s.f. they subleased it for \$14, went out to suburbs, got free parking for everybody, and all the people who used their product are out in the suburbs too, they got a cheap old office, rented it for \$8 s.f. which leaves them \$6 s.f. ahead.

BF: Isn't there a trend back to downtown again?

JG: Planners would like us to believe that, been trying to sell us that bill of goods for some time. In my experience, that in large part the folks that moved into the newer downtown apartments already lived downtown in an older building, by and large. In Chicago commuting is a factor - and big boom mini vacations. I'm not sure how severe your commuting problem is, though east-west is a problem which is why Bellevue is doing so well, right? I suspect you are more outdoorsy - not high rise oriented. Madison, we have a hell of time selling anything over two stories high, except to the elderly - we did lots of research and elderly couldn't relate to high rise but they had no experience.. but they realized it was a way to get to all their friends by riding elevator up and down, moving vertical corridor. But young people don't relate to elevators, want to get right out side.

JW: When you mention a preference for suburban office buildings, would you qualify it any further. You've talked about the two story building being your preference, there are suburbs and suburbs, there is middle rise in downtown Bellevue for instance--

JG The change in land costs is going extensive - has become prohibitively expensive as compared to going midrise. I don't know where your building code breaks but ours its 3½, 6 and up so, at the 3½ level you can still be operating with semi residential type construction, once you go to 6 you are in light steel frame and so forth, but if you go over 6 the fire code starts to really kill you, so stay down to 3 storey, and stay under where you have to sprinkle. That is one constraint. The next constraint in remodelling, anything over 20,000 gross s.f. you have to have elevator to everything, the handicapped have to be able to get everywhere. I helped draft the ordinance, but nevertheless, if you don't do that in our city you are dead because maybe a third of the office space market is govt. related and they must provide equal access and employment to the handicapped and therefore they can't rent any building without elevators; therefore have to say, what is economic

....one hundred thousand square foot so it depends on my market and how much I got ? lease.

Q Do you see a more dynamic management of real estate by people like Burling Northern and Consolidated Paper. Isn't that their real problem, that they haven't had dynamic management of their real estate?

JG Yeah. The problem is talent. Now Consolidated Paper has been a client of for a good many years and I finally found them a guy who was one of my former students who was terrific, as their land-resource manager. Dick Killiger, who's got a PhD in forestry so the foresters trust him. I had a terrible time communicating because I wasn't a forester. They knew I'd been a developer and they knew I was going to cut a tree down somewhere. Immediately I had two strikes against me. If he cuts down trees, we're going to lose part of our domain, and so I had a real problem communicating with foresters, so I found a guy who had a PhD. in forestry and a masters in real estate, but had spent the previous ten years in lake development with Isaacson and then with the Carly Group doing mixed used commercial developments from coast to coast as an executive VP and he wanted to live in a small town and bring his kids up in a small town and he's terrific. He's articulate, he has faced every conceivable political situation in his ten years in the business beforehand, ? his charming, he's got his head screwed on square, loves to tromp around out in the woods and swap stories with the foresters, they all love him. It's perfect, and Consolidated Paper is doing some imaginative stuff. I never thought thy'd be in the potato growing business but they are. We were able to prove to them that some of their six-forty's in the center part of the state had a much higher and better use rating in potatoes than in raising pine trees because you can pump water into a potato a hell of a lot faster than you can pump water into a pine tree, and potatoes sell by the pound and pine trees don't, so we finally got that across. He's super. But you can't find that kind of talent and if that's the problem and then when you do find that kind of talent, I'm not sure he could be patient with a railroad mentality. The kind of guy that you find on the Boards of a lot of railway boards of directors could drive you up a tree before you could ever get your point across and got things going. That's the problem, I think, there with the resource company, so we're starting to see, I've got a couple of young guys coming through my program now that are hybrid land resource / real estate/ majors and they're looking at just that kind of opportunity. They're excited about that kind of thing, and so Dick Killiger is a patron saint. He takes a couple of them as summer interns every summer. But there aren't many of those kinds of people around. Most of them hire Landau or somebody to come in an d tell them what to do. It doesn't go very far, only about a six inch thick report.

Q ? some changes going on in the increased government and public involvement in planning and so forth, and you get into rehab in old buildings and you talk about engineering. Can you talk about what you feel is the proper mix of talent or proper structure of an organization to deal, in say, the fields you've been talking about in the future? Or the next few years? What development....

JG Obviously the renaissance man would be ideal, someone who was articulate in the arts, engineering, political science, sociology. There aren't very many of those kind around anymore. It's a tough question, I don't think there is any one kind of personality. I think you want a personality who is primarily an eclectic, who comes at you from at least two different disciplines, who, if his undergraduate degree was architecture so that he can talk about form, and you know, bang the technician into the head until he can communicate with them and at the same time, has his masters in finance, or has two careers, because real estate is so multi-disciplinary that you really want somebody who relates to appreciates what the other disciplines have to offer. Does that answer your question?

Q Yeah, a little bit. I guess I was trying....

JG Each organization's got to be different in its own style...

Q What are the disciplines you feel are going to be key in dealing in the future with others ? an ability to relate to the governmental agencies and to the public demands....

JG I would like to see a good civil or mechanical engineer. We're talking about land and land development kinds of things: A good civil engineer. We're talking about your area of property management office buildings and so forth: A good mechanical engineer, in terms of basic underlying undergraduate discipline, and then on top of that I would like something in the business area or communication area. Anything in communication, and I know this might be heresy, but I've seen a couple of young kids, for example I had one boy working for me a number of years ago, did a super job in the business school. He's been down with Baker as the assistant director of the Baker Theater in Dallas for the last five years and now he has a masters in fine arts in drama. I think he could run anything. His fine tuning in terms of his radar relative to people is super. He communicates beautifully. I've never seen anybody who has the sense of being a social chamellion that he does, not in the bad sense at all, but if he moves into the Pendleton crowd that are all sipping bourbon and telling stories about duckhunting he's instantly that person, a kind of actor, the body movements, the poses, everything, are natural. And by the same token, if he moves into the locker room, he's immediately Joe Jock and if he's in the banking crowd, he carries off the three piece dark blue suit just beautifully. He has that kind of radar, so I would like to see somebody who's in communication, arts, TV, communiation and so forth, that type of thing, somewhere in his background, and that add to that some type of technical proficiency where there'd be finance, engineering, whatever. Does this get at your question?

Q Yes,

JG I think you have to be that kind of social chamelion if you're going to communicate to such a diversity of groups.

Q .......If you're really trying to create space use in the future, you've got to have certain disciplines. You have to have engineering, leasing....

JG You can teach leasing, you can teach real estate in a very short span of time, but you can't teach engineering in a very short span of time. Well, you can even teach finance in a relatively short period of time. Environmental sciences, architecture, political science is not so easily taught, so I would rather find my disciplines outside realestate, outside business first, and then give him the added veneer of being able to converse in the lingo of real estate which is nothing more than common sense made a little difficult, right? It takes four or five or six years to make a good engineer. I can make a good real estate man out of an engineer in six months.

Q I have some questions regarding money, leverage, your talk about the default ratio yesterday, and that was a question as to what you feel is an acceptable ROI stand in today's market. Let me kind of put all this together. Could you speak to us a little bit about what your view is of the use of leverage? ? both sides of the equation now, and I know there's a lot of bankers in the room yesterday that you were addressing: What your reaction is to the present money market and what you think the long term rates will do and how that will affect developers?

JG WOW! You guys sure think I know something, I don't know.

Q And maybe some discussion as to leverage, and what you feel, since you say this is really kind of a people business when you get down to it, understanding personalities. What appeals to the lenders these days, and what do you do to satisfy their needs without cutting your own throat?

JG I don't know that you could satisfy a lender without cutting your own throat. I'll say that facetiously. The game of leverage in real estate which would have been defined traditionalist by the traditionalist at being able to borrow money at a lower cost than you can earn on it is over, assuming passive capital from the bank's side and passive investment from your side. So, I don't think you can play the leverage game from that standpoint any longer. The equity position seem to be willing to take less in terms of the cash constant than the lending position, largely because they hope to recoup on the resale price, so that aspect of leverage doesn't work. Leverage, however, does have several other strategic applications: Now the very significant one is risk management, using leverage to become a straddle position where you have the exculpatory clause and you can take a walk on the ? ,not that that is what you want to do or intend to do, but you should have that option so that you don't sit there and bleed to death on a project as a matter of pride. After all, they made the big loan to you, they went in with their eyes open, you went into it with your eyes open and they gave you an exculpatory clause and if that's one of your rights, use it. That's the game of business. I don't regard that as being dishonorable, they negotiated the deal, they can live with it. So it becomes a risk management device.

Q It also increases your default rate.

JG Yes, to some degree, but you can control how much of it is going to ? the default ratio but it becomes a way of speculating and saves time. Now, the other side that leverage does for you is create effective demand for your own services. By creating a project for a low down payment and getting a loan, let's say a construction loan to make the most ? construction loan creating effective demand for the expertise that you're putting in the project which is your profit center. It creates demand for your architectural firm, for your contracting firm, etc., to the degree that you're using that as a way of creating effective demand for your services and creative a captive customer, then borrowing serves a purpose. Now, if you want to take the conservative view I would agree with you, that the best position to take is no debt, then your default pointdrops to what your expense ratio is, and you can hold out virtually against any conceivable economic contingency. The problem is that should you typically sacrifice diversification because nobody has all that much money in real estate that they can do it on an all cash basis. You either have to do it in very small projects or they have to do very few projects, and unless you have a broad enough base of space/time units you can't support a staff this big. So you have to find where that economy of scale is that justifies the management staff that you're carrying as overhead and that probably will require some use of debt with some increment of risk in order to maintain the staff of character and scale you choose to carry. Does this get at your question? The classic example of leverage I don't think is relevant at this time, and I don't think it will be relevant for quite awhile. There aren't too many things that are going to pay twelve to fourteen per cent interest, return on capital out-of-earnings...

Q Are we running into a number of things where we're down to fifteen

per cent equity and some of the projects; that's about right.
I'm just trying to generate discussion.

JG You mean you're paying fifteen per cent down and eighty-five per cent funded......the neighborhood center,..

Q ....The neighborhood center, but we got seventy per cent .......

JG What's the cash break-even point on the project at that point? What's the default point?

Q We can live with half the small shops vacant, I would say sixty five per cent probably.

JG Sixty five per cent. But aren't your small shops typically paying more than the big tenants? Total rents? I mean they're really subsidizing, in some ways, the big tenant, right?

-Q .....thirty per cent of the shopping center in L. A...

JG The little one there. Yeah, within a small vacancy and that leaves a much bigger impact on income, doesn't it?

Q Well, those big shops, big stores now pay us, say, five dollars, a small shop, eight dollars. It's not that large a difference.

JG No, but essentially one point six feet vacancy of a big tenant is equal to one foot of a little one, right? So a ten per cent vacancy is going to be a sixteen per cent loss of income. So, working it back that way, again, I would think the small tenant would be rather vulnerable over a long period of time, and therefore you keep your default point relatively low...seventy five per cent, something of that sort.

Q The default point is, I think, a new concept ....
We've been looking at concentrating, probably, on rate of return rather than the default point. That's something we learned yesterday.

JG The rate of return never makes sense unless you dimension it with risk somehow, and you can have a rate of return with virtually no risk. If you have nothing in it, no way they can get at you...

Q .....go in circles! The more we leverage it, the less we end up having in it and you cross a curve at a certain point. If we leave twenty-five per cent equity in it, then we've got a lot more in it, more dollar risk, bigger tax problems, we cross the taxable income curve sooner, there certainly are variations on this thing.

JG Why would you have taxable income ?

Q Because less interest deduction.

JG Yeah, but who cares? INterest is a full dollar expense: If I'm in the fifty per cent tax bracket and I don't pay interest, I still got fifty cents more than I had before. We have no tax which is one hundred and ten percent of taxable income yet that I know about. Therefore if I don't have a hard dollar outlay in the form of interest, it's true I lose a fifty cent deduction, but I also have fifty cents more to keep.

Q OK, but if we're asking for cash flow of say, nine per cent, and the government takes forty six per cent of it, we're getting four point five. That's not too acceptable in today's....

JG Yeah, but be careful you don't just look at ratios, look at dollars. I can have a nine point nine per cent return but, on the other hand, if I've paid all that money out to the bank just to get a tax deduction, and I'm in the fifty per cent tax bracket I pay two dollars to the bank to get one dollar in tax deduction, that doesn't compute. A hard dollar outlay doesn't count as shelter. A hard dollar outlay is, you know, gone. There's a book out, isn't there, called A Penny Saved Is Two Pennies Earned , isn't it? Which is Benjamin Franklin brought up to date with current taxes.

Q We seem to be having a problem here. I'm saying that in this instance where we think the neighborhood center has a high ratio of safety factor because it's a high percentage of hopefully ? we borrow the most against that one. I'll leave less money in it. I don't cross the taxable income curve until I'm seven or eight years out. If I left twenty five per cent equity in the project for a higher safety factor, I'm in taxable income maybe the second year.

JG Great! That doesn't bother me in the slightest because I'm still not getting taxed one hundred and ten cents on a taxable dollar. I got more dollars to keep, even if my rate of return went down, I still got more hard dollars to keep.

Q Not if you pay forty eight per cent to Uncle Sam, you don't.

JG You sure do, because if I paid it out in interest I would have lost the whole dollar, instead of forty eight cents.

Q Well, let's say a dollar of return vs. a dollar of investment.

JG I agree there's a tradeoff point but if you want to take it on a purely safety basis, then say, your default point ought to be the same as the ratio of your triple A tenants is to the gross rent, and then your trade off point falls in there very close, somewhere in there.

Q Well, isn't part of what he's saying that instead of putting fifty thousand dollars in a project, if you could put twenty five thousand in it, that enables you to do another project...

JG It may enable you to do another project, yeah, but the problem of shortage of investment products of quality right now.

Q I can't disagree with that.

JG That's the problem. Until such time as you have that other deal and you want to refinance your existing portfolio and so forth, then I would try to keep as many dollars back from the bank as possible. I think the best deal I've seen is the one I put together with two million dollars of limited partnership money, no construction loan, no slider, and so forth, I paid a dividend the first year of a limited partner. The second year, of course, I had almost sixty per cent of my gross available for evidence, and the third year I financed out. By that time, with a seventy-five per cent loan or a little better, and the cash payments already made plus their tax shelter they had their pay-back at the end of the third year and never had any risk of losing that profit. And the limited partners still don't understand how we did that. It was miraculous, how do you do that? You don't give it away to the bank. When a bank wants to lend at twelve or fourteen per cent I have an awful lot of investors who would be delighted to get twelve to fourteen per cent when a large part of it is sheltered in the first couple years of the project. So do it all equity, that's what I'm saying. Financially ? doesn't work any longer. It may create effective demand for my services yet nobody else wants me. It may give me a risk management device or a way of speculating in long term futures and look at it as future delivery of a space time product, but other than that, there's nothing that can beat the hundred per cent equity right now, which is damn conservative. And I'm not in love too much with rate of return. Ratio analysis is good up to a point, and then you just can't beat keeping the buck.

Q You said you were giving us your ideas on investment posture: Twenty five per cent neighborhood shopping centers and you didn't give percentages for industrial warehouses, suburban offices...

JG No, I realize I was getting myself into a trap there...

Q Is there anything more, any more items to be put in there?

JG Well, I think shopping centers, industrials, and suburbans, and maybe some judicious purchase of land here and there, depending on how much I want for income immediately...

Q Do you have any other thoughts that would tie...?

JG The easiest way to make a buck right now is residential lot development, really, when you're right down to it. If I went back in the game again that's what I would do, is residential lots and industrial land. Build no buildings, lease nothing, have no tenants, just either lease my land or sell it, depending on whether I need the cash now or later, because that's where the money is. If I can buy land at, say, ten thousand dollars an acre and I upgrade that I should be able to take twenty thousand dollars an acre out in cash on that over and above development and selling expenses, and so forth. The rule applied still seems to work: Raw land price is about twenty per cent of the finished market price.

Q Tying into that, could you comment on the environmental and other, you know, the movement, is it slowing down, or picking up, or...?

JG No, I don't think so, that doesn't bother me in the slightest, I'm quite comfortable with the environmental movement because the faddists are moved out of it. And I think by and large we are groping towards a more intelligent use of our environmental resource. That doesn't bother me, I don't see it threatening, I don't see why anybody should have to build on a marsh if it's a high water recharge area, if we need that for our substrata, and I don't see why we can't have controls on our slopes, and so forth. It doesn't bother me in the slightest. There are engineering solutions to those problems and you analyze your sight better before you jump in and buy it, and so forth, but those are technical questions and they can be surmounted. As soon as you tell me the rules of the game I have no difficulty playing the game for profit. What is unfortunate is when the rules of the game keep changing, because them that's making the rules don't know what they're doing, but that's a political problem, not an environmental one.

Q Jim, if I can interrupt...

JG Yeah, I'm sorry, I'm delighted to have a captive audience who thinks I know what I'm talking about. I have to come at least this far from Madison before anybody will listen.

Q It is twelve o'clock, so why don't we all break for sandwiches, you can chat with Jim as long as he isn't eating actively...

JG Thank you all for being patient with me.

Q I think yesterday we all got quite a bit of background, or enough information on the various computer models that ? designed, or something, and I think that you and Dale, or something, have a chance...

JG I talked to Don Spencer yesterday about that.

Q Jim has to leave here to get to the airport at 12:30...

JG Don has one of my grad students, Kim ? who's been indoctrinated with that, and he's just gone on ? here. As I am working out here anyway, currently, I will be coming and going through Seattle in the summer, if you'd like to talk about something like that in the future, I'd be happy to be available.

Q We've certainly blitzed you today.

JG Well, I'm surprised that I can even stay on the same track with you guys, because I always respect money. If somebody has the money, why ... (LUNCH)

(End of Tape 3)

THE END

NORTHWEST BUILDING CORPORATION

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MEMORANDUM

TO: File

FROM: Wayne Reisenauer

DATE: 1/15/86

RE: Dr. Graaskamp's Discussion on Positive Spread 12/13/85

Negative Leverage - Whether or not a project is feasible - what are the determinations for that?

Question - You shouldn't even consider a project unless you can show a positive spread in the first year (meaning a higher return than your cost of debt, basically).

Jim - No, that isn't so because that's arguing that leverage has only one dimension...leverage, obviously, is multiple dimensioned in terms of future resale price, tax consequences, ownership control and profit centers that you may have above the net income line (in other words, including the profits that you would make in your leasing departments and so on). It really is a function of how you costed them (the leases). If the leases were full serviced in the projects, then you'd have profit centers above the net income line. This is another dimension to leverage. If what you're trying to do is create a value increment, on the second roll of the leases, what you really want to do is to look at the over all returns and how well you levered. It depends on when the roll of the lease occurs. If the leases are three years, then the proper time period would be four or five years.

Question - Isn't the basic premise that the equity position can take a lower return in that initial year for a higher upside?

Jim - The way to argue and take Dale's statement about spread is that he is not including in spread all the elements that should be included. Take the anticipated upside over five years and then add to your spread the sinking fund factor that will accumulate to that amount. Then you can say, all right now we're talking about peaches and peaches. Otherwise, you're talking about the cash spread when there are other dimensions: capital and tax factors, and so forth, that are involved.

Question - You would take the anticipated spread in the future years and add to it?

Jim - Example: Here is the cash you're going to get in the early years, but now let's convert to a sinking fund component what you're going to get out of the expected capital appreciation. Let's take a sinking fund component as to the tax savings on other income over the life of the investment or the depreciable life of the asset. Use a sinking fund equivalent, now look and see whether the annual spread is positive.

Question - That is done strictly on the basis of...we have been saying internally that the threshold rate is 15%...

Jim - What sinking fund factor at 15% - would accumulate to the expected capital gains. And what sinking fund factor at 15% would accumlate to the total tax savings--on a straight line basis. In other words, take the tax savings to other income on a straight line basis so it's like an annuity, and treat that as a sinking fund contribution, and then bring that back to the present.

Question - And then add that on to the initial cash dividend...

Jim - Then you will have a cash dividend--let's say at 8.2% or $8.20, and then you'll have a sinking fund component for capital gains at $2.00 and another one for the tax factor at $1.00. Now, if you add all of those up--maybe it will be $11 or $12 return--gives you a positive spread relative to your cost of funds. Then I think you can make his requirement work, but right at the moment he has loaded the gun against the project by being one dimensional in how he defines spread. So, I think what you have to do is say that positive leverage, yes (as a requirement for a project). But then, you have to define what components there are in leverage, and there's a minimum of three: current income, capital appreciation and tax shelter. Possibly a fourth one would be profit centers to other divisions that otherwise appear above the net income line.

Wayne - He has consistently stated--if you include in the pro forma an appreciation or inflation assumption, then you can make anything look good. What he is saying is: Sure a lot of people in the past have made money based on inflation. But if you can't show this positive spread in your stabilized year, then you shouldn't do the project.

As you say, the argument is one dimensional. I haven't found the argument around it, other than to say, there are some other things besides this initial positive spread.

Jim - I think there is a difference between inflation per se and appreciation as a result of asset enhancement. If asset enhancement is a part of the game, then I think you have to include that in that product (the spread calculation). I would convert it for his benefit to an annualized statement by using the sinking fund equivalent like Ellwood does. That allows you to talk in his terms of measuring spread. Where he's got you is--if you start talking about appreciation, but you don't change his argument relative to spread, you don't win. I would take his argrument of spread and say fine. If we're going to measure spread, let's measure each element of spread in annual terms.

Question - And make that sure that's discounted to the present for a stabilized statement?

Jim - Yes, the sinking fund factor is a way of converting that capital factor to an annualized number.

Question - And the capital factor is determined just by... what the fifth year, or some year...

Jim - I like to take the roll of the lease. You're strategy should be to look at what you're going to roll the leases for at the end of the first lease term. You may have under rented it to get it filled and are relying partly on inertia, partly on momentum and partly, perhaps, on the market shortage at some point in the future. To roll those leases at some increment--if the average lease is three years, then that should be your forecast (term for the sinking fund analysis). If the average is ten years, then that should be your forecast.

Question - What about the argument that when you roll leases you have an assumption built in already and the market rates are going to be higher because of either, appreciation-- because of, like you say, some real capital gain or difference in project value, monopolistic pricing element or something?

Jim - I would make two arguments: 1) What you're really doing is recapturing the devaluation of the dollar, and the reason you went to a fixed interest rate mortgage in the first place is to take advantage of the fact that they're repaying with cheaper dollars, and, therefore, rather than using an inflation factor why not use the FRB's inflation index. So this devaluation index is geared to what happens to currency. It's a different thing than inflation per se. Second of all, all you're doing is making the argument that the supply and demand factor is no different three or five years from now than it is currently. And so you should be able to get at least a dollar equivalent. If you're forecasting a 4% deflation or inflation per year, therefore, deflation of purchasing power, five years from now you would have a 20% increase in rents just to offset the decline in purchasing power. The only argument he has against that--I notice there is an article in Questor this time that shows that real rents for office buildings have declined.

Wayne - I think we have to change our perception on what makes a project go. This is a development opportunity. This is the land lease deal I mentioned a long time ago in the Port of Tacoma area. I have been trying to show that first, there are some things that are related to the site that might enable us some monopolistic pricing because it's within a foreign trade zone, and it's so close to the Port's docks, that the dryage costs and cartage costs are much cheaper than any competing sites around us. It's still difficult to show this "elusive positive spread" as Dale has called it, in that stabilized year. It caused a great amount of argument because everybody who has been working on the project feels that in the long term it's going to be a real good deal, but in that first year you might not get 12% or greater cash on cash.

Jim - Try my theory and if that doesn't do it, let Sperling call me and I will argue with him.

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# NORTHWEST BUILDING CORPORATION
## PRESENTATION BY JIM GRAASKAMP
## MARCH 28, 1986

You need a marketing monopoly with a spread (diversification) in the portfolio. In the next couple of years, it will be easy to buy real estate low. The trick will be in reselling it at a profit.

Real estate is currently the largest single investment. It has out-performed the stocks and bonds in recent years.

Interest rates will not slide much more. Bonds have realized their gains and stocks are somewhat suspect.

Management needs to anticipate small (group) movements within a city when looking for a market.

The supply of institutional quality investments is evaporating as they are purchased by pension holders where they will stay for a while.

Low interest rates will continue for a couple of years because the banks are trapped by the Third World oil crisis. If they raised rates, it would precipitate defaults of Third World debt. Rather than the defaults, they would renegotiate at lower rates.

Jim feels that the real estate downside is fairly stable. The question is how to get the prices to move up. During the 70's there was a general inflationary trend. In the 80's real estate value is created by those who have skills rather than in just being in the right place at the right time with a fixed interest rate.

The upside on real estate investments will depend on the ability to exploit the current inefficient market. It will require the ability to move quickly if a financing opportunity comes.

There are a couple of long-term threats to the real estate market. One is explosive inflation (almost a certainty) and the second is significant changes in the institutions and in real estate taxes.

Regarding inflation, the deficit cannot continue and the banking situation must change. Most of the deficit occurred before double digit inflation.

The oil supply is limited and OPEC will get their act together. He cautioned that in the early 1990's management must build into its scenario explosive double digit inflation. He noted that most of the debt being set up today is on a ten-year fuse. They are being written with five, seven or ten-year terms at current interest rates. As these short-term loans mature, there will be a great deal of pressure on refinancing. The rules will change, and people may not be able to refinance with the cash flow of their project.

Jim Graaskamp feels that one-half a point for a twelve to fifteen-year financing package is a better deal right now. He sees an interest rate of fourteen and one-half percent twenty years from now as looking good. This is a red flag point for real estate, and could cause some decline in the overall real estate values.

The second problem is a semi-political and semi-financial problem. As the federal government backs off from revenue sharing, and the Gran Rudman Act changes the tax laws, there will be an increasing load on the local government to provide services which had previously been provided by the federal government. This will cause a tremendous revenue burden on the communities which should blossom forth in about a year or two. Real estate taxes could increase substantially.

Jim Grasskamp predicts the doubling of the real estate tax rate to replace federal aid to the local communities. There will be a tax payer rebellion because older people will be wanting to stay in their homes. He believes there will be situations similar to that in Minnesota. They have a system in which all properties are appraised at market value, and then the statutes allow the indexing of the rate of taxation as follows:

| | |
|---|---|
| Resident of owned home | Assessed at 50% |
| Absentee owner | Rental unit assessed at 90% |
| Multi-family (8 or more) | Assessed at 110% |
| Income properties (office buildings, etc.) | Assessed at 150% |
| Major out-of-state owners | Assessed at 200% |

The residential tax payer (the largest single voting element) will rebel against taxes on residences and therefore target the income property. Jim Graaskamp questions how much of these increased taxes can be passed on to the tenants.

He believes that needs for office space may be reviewed. You may see less finishes in the buildings; the finishes would be more portable and would be the property of the renter. These practices make it more difficult to assess for tax allocation.

He noted that in Palo Alto two-thirds of their services were being paid for by the high-tech industry. There was a 7,500-acre development left but inasmuch as the residents there did not want to share their tax base, they voted in restrictions on development.

The real estate taxes will continue to grow and be a major area of political in-fighting

He noted that the outstanding personal debt in the US over the last seven years through 1984 is up by 115% and is increasing at an increasing rate. Last year the debt increased 27 1/2% from a totally bloated base. This is not only true of the government but equally on the industrial and consumer side. The debt rates are much higher than the GNP as follows:

| | DEBT | GNP |
|---|---|---|
| 1983 | 11.3% | 7.7% |
| 1984 | 13.8% | 7.7% |
| 1985 | 12.1% | 6.1% |

He advised that a net increase in state and local government bonds is a record $93 billion. There was a $120 billion increase in consumer debt in 1985 exceeding all new corporate debt. This indicates an extremely unstable consumer group. The average consumer is so loaded with debt that it will slow purchases in the next couple of years.

There is a concern that foreign investors might liquidate their holdings as interest rates drop. The US is a low-saving and low-investment society. He stated that the deficit is negative savings and causes a gradual erosion of the quality of life.

The substantial lay-offs have produced increased productivity among the blue-collar workers. However, the same firms hired white-collar workers for a net loss in productivity. He noted that Ford has ten times as many white-collar workers as Toyota. White-collar work must be redesigned. It cannot be increasing twice as fast as output. There must be more efficient use of the middle-management base. We have reached the limit of mid-management absorbtion.

The tax law change threat has evaporated and he quoted a statement by an accountant "more of us with brains work for the tax payer than those with brains work for the IRS, so whatever tax law they pass we'll figure out how to get around it." NWBC needs to watch the availability of depreciation relative to amortization of debt - watch for the point where you lose the shelter. You need to achieve a lower rate of amortization.

Refinance or roll the portfolio for a new depreciation base.

"Amortization" is taxable income without cash to pay it. - per Dale Sperling.

Graaskamp is on Soloman Brothers new Advisory Board for real estate. They believe $800 billion worth of business in the next five years will be refinanced (the commercial property debt). He noted that Soloman guarantees that they will buy a building package back from a purchaser at the price paid for it by that investor.

CMO's - Jim discussed serial bonds for principal in the residential market. He noted that these bonds are now going to be used in the commercial area. Large mortgages can be used to create a bond issue which is serialized in order to reduce the interest rate. He agreed that it takes a package of approximately $100 million to make a good bond pool.

He commented on the New York infrastructure which he stated is badly deteriorating. It has been a long time since they have spent any money, in rehabilitating the streets, etc. Ultimately the need to refurbish will be a major burden. The unfunded pensions of public workers is tremendous. Graaskamp questions investing in New York. The utility costs are excessive.

Management should be concerned with the fiscal state of the community in which you are going to buy. You must be concerned about the municipal health and long range appreciation possibilities of the community. The municipal health of the community may not be as critical on the short-term, but it will be in the long-run.

Most people feel that real estate is a good investment but the upside is much more dependent on astute management compared with previous times. He noted that an investor must relate to a project emotionally to make it an easy sale.

Regarding leasing versus fee ownership - Look at a master lease where depreciation has expired. Provide a master lease to a tax exempt entity.

Suggested NWBC look at HMO's for potential tenants in a build-to-suit project. This is one of the few areas which will outgrow the economy by the factor of two. Their 501(3)(c) status is helpful. HMO's control the tenants in the building.

Regarding asbestos toxicity - he suggested that NWBC refer to the purple book from the EPA (NWBC has the book). There is an industry book published by the Institute for Plastering which has good information on this (WW has this information).

Regarding toxicity - the buyer of the land takes the liability with the ownership. This suggests a more careful review of the site. There are firms specializing in developing histories of the use of sites. A major source of lawsuits have been over industrial buildings with transformer stations in them. You must watch for not only what has been dumped on the land, but what usage was made of the land. Liability is in a state of flux in the courts today.

He stated that bank trust departments are being sued because real estate trusts are not suitable investments for a trust department.

OPEC - Graaskamp indicated that it wouldn't take very much if the Iran and Iraq wars escalate to change the supply of oil. If the US decided to buy from Mexico and Venezuela to support the debt of those countries to the US this could change the situation.

Clerical people (including insurance and mortgage banking processors) will reduce in numbers because of high-tech software now being produced. Management at the top of the ladder will protect their own jobs better.

Paperwork "factories" are moving into the suburbs where they can reach the "yuppie" housewife. Straight industrial buildings with surface parking will be utilizied. They will move towards increasing productivity and reducing the space per worker rather than laying off people. He pointed out that the per-square-foot rental space cost is a major factor.

He noted that short-term dollars are going out of real estate.

He pointed out that the reason an investment doesn't succeed is much more significant than just whether the investment succeeds or loses.

Some parameters if he had $50 million to invest:

He would locate in the North half of the US rather than in the South half. He prefers Oregon and Washington over Southern California.

He would locate in areas that have very tight controls on land use which helps limit oversupply. The permit process alone can keep the supply in check.

He would invest in smaller buildings rather than in major urban areas. He would prefer twelve-40,000 square foot buildings around Seattle rather than one in the middle. This investment would also give greater liquidity.

He would diversify within one or two metropolitan areas. After that you don't achieve much improvement in the portfolio by diversifying to other areas.

Multi-family residences continue doing well - 150 to 200-unit projects that are well designed hold up well. He suggests that the NWBC management take a look at the Heritage in Appleton, Wisconsin - a 165-unit project next to an upper income area. This home for the elderly has been gauged toward people who are homeowners ($75,000 or more) and have minimum incomes of $15,000 to $18,000. He noted that these are relatively slow at first to rent up because of the time it takes to sell the owners' homes. However, once it is full it can be a very high cash flow project. The rates per square foot are comparatively high. You get a good return and still provide a good service to the community. He noted that Kane and Scott in Seattle is one of the most knowledgeable groups around with respect to housing for the elderly.

Graaskamp does not like regional squares. He prefers a retail strip neighborhood center. These are the lowest cost to build and the least amount of management responsibility for the owner. They have the highest possibility for increased rents. Almost all the space is rentable. The major local tenant does most of the management. The identity of a retail strip is generally related to the key tenant rather than to the owner.

He feels the use of cars will be come less and less attractive as gas prices climb again.

He prefers rehab over new construction. Graaskamp, himself, buys "tainted" area projects and does the upgrading.

He feels investors will be accepting lower yields. Some drop in rentals as leases roll. "Stagflation" means you will accept lower yield.

Graaskamp said you can trade your share in limited partnerships for an interest in a corporation without taxes in order to get liquidity for limited partners.

He commented on Federal Asset Disposition. $8 billion in real estate to be unloaded (Mrs. Paine heads it up). Dale Sperling noted that some of those properties have been poorly conceived. NWBC has Nick Scales and Lindy Gaylord presently doing research.

Graaskamp said NWBC needs a project that is free of hard competition. They need to set up targets; do research - owner, building, area; and then hold for opportunity.

Graaskamp sees potential in the elderly market but would not include medical services initially, would add those services as the tenancy ages. He would provide the housing for independent elderly and provide some personal services - band, meals, game room. You need expansion possibilities for medical areas.

There is lots of information now available on designing housing for the elderly. He referred to a Mr. Zeitzo out of Harvard Design School. Elderly tenants like to be on the edge of activity without appearing to be a part of it. There should be no long halls - have elevators instead. The main door should open to the living room for eye contact. Special kitchen features - bathroom off the bedroom (90% of the units have only 1 person living in them).

Project owners provide management - the services are subcontracted out. The owner has no part of medical care.

The elderly group is often referred to as:

Go-go group
Slow-go group
No-go group

ECM:jt