

JAMES A. GRAASKAMP COLLECTION OF TEACHING MATERIALS

V. INDUSTRY SEMINARS AND SPEECHES - SHORT TERM

H. Presentations Sponsored by Other Universities

2. "Real Estate Investment Strategies and Selection Criteria for the 1980's", sponsored by the University of University of Texas-Austin, September 19-20, 1980

## CONTEMPORARY REAL ESTATE APPRAISAL SEMINAR

University of Texas - Austin  
September 19, 1980

1. Inferring Future Price From Sales Data
  - A. For residential properties there are often many sales of similar properties so that powerful statistical tools can be brought into play, such as multiple regression, factor analysis, etc. However, the simple average can also lend itself to statistical inference.
  - B. Dispersion is the variation or scatter of a set of values. Measures of dispersion are needed for the following basic purposes
    1. To gauge the descriptive reliability of averages.
    2. To serve as a basis for control of the variability itself (such as rejecting a comparable that lies outside a certain range).
    3. To summarize facts, both an average and a measure of dispersion should be presented.
  - C. When dispersion is small, then the selected average is a typical value in that it closely represents the individual values in the set and it is reliable in that it is a good estimate describing the typical case in the population. It is a useful generalization. Conversely, an average with very great dispersion is not very descriptive of the data set and may be a misleading generalization.
  - D. Measures of dispersion include:
    1. A range
    2. The quartile deviation
    3. The mean deviation
    4. The standard deviation
  - E. Consider the data on some apartment site land sales in Madison provided in Exhibits 1, 2, and 3. The range is the difference between the largest and smallest values of the variable:
    1. \$5.60 - \$6.50 per square foot of land or 90¢
    2. \$1970 - \$2208 per dwelling unit built or \$238
    3. \$3.72 - \$4.23 per square foot of gross building area or 51¢
    4. \$1226 - \$1327 per total number of rooms built or \$101
  - F. Exhibit #3 shows the mean and the standard deviation of the mean.
  - G. Quartile deviation must be applied to group data which are ranked from high to low. First the data is divided at the median and then each half of the data is split in half once again. Consider the net rentals of older supermarkets under existing leases provided in Exhibit #4.

Exhibit #4

CUMULATIVE FREQUENCY DISTRIBUTIONS  
Supermarket Net Rents for 214 Stores in Chain X

(1) New Rent per Square Foot	(2) Number in Class with Lower Limit Shown	(3) Number Earning Less	(4) Number Earning as Much or More
\$2.25	2	0	214
2.35	23	2	212
2.45	49	25	189
2.55	63	74	140
2.65	45	137	77
2.75	25	182	32
2.85	3	207	7
2.95	4	210	4
3.05	<u>0</u>	<u>214</u>	<u>0</u>
Total	214	1051	875

- H. In the full array of data, the value of  $Q_1$  and  $Q_3$  are found to be \$2.50 and \$2.70, meaning  $1/4$  of the properties generate less than \$2.50 a square foot and  $1/4$  exceed \$2.70 per square foot while the middle half fall between these values. The quartile deviation is then  $(2.70 - 2.50)/2$  or 10¢, or stated another way the range of the second and third quartile is about 10¢ per square foot.
- II. When comparable sales have only one dimension, such as net leaseable area or number of rooms, a direct mean and some of the squares dispersion test is possible. However, usually it is necessary to consider a variety of factors and discover how price changes relative to the net differences of each property. Linear regression is one such method.
- A. Ratcliff in Chapters 6 and 7 demonstrates a point system which ranks properties and is then weighted by buyers priorities. The weighted points are then compared to unit price. This system may be too elaborate for houses but can be demonstrated on a variety of commercial properties.
- B. Consider the evaluation of vacant industrial land in Exhibits 5, 6, and 7.
1. Point system should be kept simple. 1-3-5 indicates below average, average, and above average.
  2. If the appraiser is capable of making more careful distinctions between comparable properties, he can use a ten point scale such as 0, 4, 6, 8, 10 for each item, being careful not to change scales.
  3. Many small judgments are better than large rough adjustments because of the theory of off-setting errors. Too big a range in scoring implies drastic differences between the worst and the best.

REAL ESTATE INVESTMENT STRATEGIES AND  
SELECTION CRITERIA FOR THE 1980'S

University of Texas Center, Austin, Texas  
Saturday, September 20, 1980

Presented by: Professor James A. Graaskamp  
University of Wisconsin

- I. Any investment reflects a set of assumptions about the future, expressed or implied, as well as a set of personal values and attitudes of the investor.
  - A. There is little we know for sure about the general future so we attempt to position ourselves relative to the unknowable. Positioning may take several terminologies:
    1. Diversification and liquidity
    2. Systematic risk vs. industry risk (covariance strategies)
    3. Estate planning
    4. Maintaining holding power for external shocks
  - B. Investors or investment committees may establish policies or screens for managing risk
    1. Political exposure
    2. Degree of channeled demand
    3. Degree of management intensiveness
    4. Degree of equity capital exposure
    5. Cash flow enterprise characteristics
    6. Degree of leverage
    7. Degree of tax compatibility with portfolio
    8. Degree of fit to estate plan (individual)
  - C. Specific investment selection investigation
- II. Each investor should have attitudes about future trends, such as:
  - A. A gradually aging population with an increasing municipal employee pension liability distorting the real estate tax
  - B. The use of gasoline passenger autos, urban compression? multiple nuclei towns? rate of energy obsolescence on high-rise buildings?
  - C. How will rising food, energy, and housing costs and fewer children per family affect discretionary income sales at department stores? Goods vs. services vs. experiences
  - D. How will rising isolation of the U.S. affect the economy?

E. What about the lack of immigration policies to the U.S.?

Etc.

### III. Investment preference screens

#### A. Political exposure

1. Direct land use or rent controls
2. Indirect controls on effective demand
3. Indirect subsidies of competitive supply
4. Vulnerability to political extortion

#### B. Degree of channeled demand

1. Source of monopoly position (site, permits, technology, timing, . . . , etc.)
2. Captive customer
3. Reciprocity
4. Competitive edge from merchandising research

#### C. Degree of management intensiveness

1. Term of leases and specialization of property
2. Cost of necessary expertise
3. Income stability correlated to a specific personality
4. Continuity vs. mortality of tenant management

#### D. Degree of equity capital exposure

1. Equity exposure while acquiring permits
2. Expected equity contribution to finished project
3. Holding power for cost overruns or revenue underruns
4. Personal liability

E. Cash flow enterprise characteristics

1. Fixed cost, variable revenue
2. Variable cost, fixed revenue
3. Dependency on specific returns on capital (operations, tax shelter, refinancing, capital gains, or sale of services)
4. Financial ratio analysis (break even, profit sensitivity, and ruin)

F. Degree of leverage

1. Selection of leverage measure (overall return vs. interest cost, before or after taxes, overall return vs. debt constant, tax leverage, portfolio leverage, etc.)
2. Indirect leverage in terms of economies of scale, assistance in public financing such as TIF or UDAG, etc.

G. Degree of tax compatibility with portfolio

1. Passive or business classification
2. Allowable leverage
3. Need for shelter
4. Need for tax credits
5. Need to salvage existing tax carry-forwards

H. Degree of fit to estate plan

1. Liquidity problems
2. Pressure for pass through of small business or farm opportunities
3. Divisibility for bequest purposes
4. Management continuity and specialized expertise
5. Structuring to achieve transfer of equity built up (Subchapter S versus corporation with two classes of stock)

OR Investment banking plans

1. Cash flow or taxable earnings growth curve
2. Conversion of submerged equity to book equity
3. Advantages of merger vs. purchase
4. Relationship of cash return on real estate investments vs. cost of capital

#### IV. Increasing investor competition for real estate

- A. Historically prudent men invested in stocks and bonds
- B. New recognition that diversification includes wide variety of media including real estate, precious metals, natural resources, research and development of new technologies, etc.
- C. Stocks and bonds are often argued to be an efficient market where expensive research and selection does not provide superior investment results
- D. Some writers have argued that real estate is attractive because it is bought and sold in a very inefficient market place, providing superior returns for those with careful selection, pricing, and timing expertise
- E. There may be several market levels and degrees of efficiency in real estate depending on minimum investment, cost of search, degree of personal involvement, and in-house skills
  - 1. Major foreign investors and domestic American funds want properties in excess of \$5 million in office, retail, industrial, or hotels (very efficient)
  - 2. Syndicators tend to prefer slightly smaller properties for retailing shares to slightly less knowledgeable buyers (efficient search, inefficient distribution costs)
  - 3. Local developer-broker agencies want projects as customers for their services rather than depositories for their capital
  - 4. Small investors seek to trade in small properties as in a camel bazaar
  - 5. Let's talk about investors in classes 3 and 4
- F. Research by the selected investor is intended to minimize risk and then maximize cash returns
  - 1. The basic philosophy of inquiry and search is risk management
  - 2. Risk management provides rationale for the financial ratios we seek
  - 3. In real estate, the risk is basically nonsystematic or can be made so for short periods of time
  - 4. Selection as well as diversification is critical