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Dr. James A. Graaskamp, associate professor of Real Estate, University of Wisconsin, addressed students, faculty, and members of the community at Northern Illinois University on March 14, 1973.

CHANGING CONCEPTS OF REAL ESTATE INVESTMENT STRATEGY

James A. Graaskamp
School of Business
University of Wisconsin
Madison, Wisconsin

Real estate investment currently has great popular appeal, but investor understanding of the opportunity is confused by both mythology about wealth through real estate and by many obsolete theories as to value. In one sense, real estate is the classic interfacing of land, labor, capital, and management. The product is artificially differentiated space over time. It is described as an apartment per month, a room for a night, a square foot of office per year, or even a recreational second home condominium apartment on Lake Tahoe with the right to use in January, June, and September, while three other families enjoy it during other three-month periods. While the product is space-time, it is not to be confused with the business of real estate which is money over time. As in any enterprise, the business of real estate is concerned with the cash cycle and the cash cycle can be shown to have significantly different value investment implications than the principles of the traditional land.

The cash cycle forecasting problem for the real estate business is converting space over time to money over time. The investor in an equity position, as opposed to a creditor position,

seldom has any contractual specification as to cost, profit dollar or timing of receipts and outlays. He must supply all of the numbers and dates inherent in a bond or mortgage contract by creating a set of assumptions. Thus, when he invests in a real estate enterprise, he is not actually purchasing ground and brick and mortar but rather he is "buying" a set of financial assumptions about the cash cycle of the real estate enterprise. The risk of such an investment is the potential variance between the assumptions in forecasting a pro forma cash cycle and realization of an actual cash cycle. Analysis requires identification of the most significant points of potential variance and selection of risk management methods to control variance.

While potential changes in operating expense can be shifted to the tenant by increasing rents or providing escalator clauses in long term leases and construction costs can be controlled in part through design and bidding, the most significant variance or risk in real estate investment is not inherent in the space-time product. Rather, the risk is in the social context in which that space product must function. Thus, the economics of the real estate firm are those of a firm operating on a non-price theory of economics or perhaps that of cash profit optimization within a complex web of institutional constraints.

The layman tends to view real estate as a static, solid and tangible vehicle for long term investment because the land doesn't move and the structure appears permanent. However, the nature of ownership as well as the utility of the product is a function of the

interface between population trends, culture, and technology and these elements are changing at an accelerating rate. Moreover, the decision systems relative to land, labor, capital, and management are changing on the supply side. The result is that the apparent static and stable real estate suffers from obsolescence at an accelerating rate because it is immobile, inflexible in use, too durable for the use intended, and thus shopworn relative to its market in the future. Therefore, its revenue stream is unpredictable at best over the period of time necessary to recover the mortgage lender's investment.

Changing lifestyles affect both the type of facility and the locational preferences of population to quickly alter the nature of demand. The rate at which demand characteristics shift is accelerated or reduced artificially by the effective demand caused by income allocation within the society and the ability to pay relative to the cost to construct. The result may be that premium properties may filter down to groups with less effective demand and therefore with relatively lower price structures more quickly. As the transience of people relative to place and objects increases, the long term stability of real estate as an investment decreases since value is a direct function of cultural preferences.

Perhaps the most dramatic shift as a result of growing cultural sophistication is the awareness of land as a finite natural resource and a public utility rather than a private commodity. As a result, society is attempting to reimpose controls on the use of land

by an exponential increase in the use of police powers and condemnation as well as internalizing public cost through real estate taxes and special assessment. Creation of wealth through the conversion of raw land to more intensive urban use becomes a very high risk political adventure so that land itself has significantly less appeal for the passive investor than recent history would suggest that it might. Land use decisions more and more will reflect opportunity costs to society in the aggregate rather than the consumer surplus created for entrepreneur and a small group of site users, be they tenants or owners of one form or another. Once again, forecasting is difficult even for the short term which is incompatible with long term investment.

If trends on the demand side and the supply side make long term investment in capital improvements difficult business at best, then wealth through real estate must lie in entrepreneurial ability. What is left to manage to investment advantage if operating costs, real estate taxes, and debt service have absorbed the bulk of receipts? Where is the cash return for the equity position? Ironically, much of the profit of real estate is found in the expenses or outlays and in the income tax savings as the result of taxable losses. Each real estate enterprise involves huge outlays for the purchase of land, construction services, management services, and supplies of all kinds, and these outlays are revenues to other enterprises. Control of the real estate project provides a captive buyer for services of a land speculator, general contractor,

engineer-architect, insurance agent, mortgage bankers and property manager. Thus, ownership can be defined as the degree to which one can divert the outlays to a captive supplier of these services. Most of the profit centers are found in the outlays which characterize traditional valuation methods. Unless one can view a consolidated profit and loss statement on a cash basis for all the enterprises involved in a real estate endeavor, there is no accurate way of viewing the investment return on the project.

By viewing real estate as a set of related cash flow enterprises and ownership as the creative manipulation of these cash flows in the relatively short run, the conclusion must be that the passive investor is at great disadvantage to the creative developer so far as investment return is concerned. The passive money investor is either supplying risk capital to create a new enterprise or he is actually in the position of a subordinate creditor. Viewed from the standpoint of control and priority of claim on cash flow, the limited partner in a real estate syndicate is actually in a position of a second mortgage revenue bond holder who not only bought a contingent interest in real estate as a speculation but purchased the present value of his future losses as well!