JAMES A. GRAASKAMP COLLECTION OF TEACHING MATERIALS

V. INDUSTRY SEMINARS AND SPEECHES - SHORT TERM

I. Other Presentations In Which Either The Date And / Or Sponsoring Organization Is Missing

1. Risk Management/Investment Related Topics

f. "Don't Buy Real Estate - Buy a Set of Financial Assumptions", no date

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DON'T BUY REAL ESTATE - BUY A SET OF FINANCIAL ASSUMPTIONS

There is a mystique to the ownership of land and a misleading permanence to brick and mortar which motivate investors in real estate enterprises to their disadvantage. The product in real estate is artificially manufactured space over time, a room for a night in a motel, an apartment for a month, or square foot of office space for a year or more. The usefulness of this product depends on a very complex and volatile relationship between characteristics of a site, characteristics of the improvement to the site, and attitudes of those who both use and manage the product. Peoples' preferences for both building styles and locations are very volatile and quick to change and are affected by the attitudes of project management. As a result, the improvements are often too durable relative to the life style or social activity to be housed, the improvements are inflexible and difficult to remodel to new uses and the site is fixed and cannot be moved to where the people now want to be. As a result the improvements are shop-worn and obsolete merchandise for much of its physical life and sites come and go in public favor.

However, the product of real estate is not to be confused with the business of real estate. The business of real estate is a cash cycle business, going from money in the bank to goods-in-process (construction) to inventory (property management) back to cash. In real estate the cash cycle is much longer in time than would be true of a push-cart flower pedaler, a retail store, or a manufacturer. The problem in real estate investment is to convert <u>space-time</u> of the product to a forecast of <u>money-over-time</u> for proper business management or investment. When investing in a bond, it is possible to know the cost and date of acquisition, the amount and date of the interest coupon, and the amount and date of repayment if the bond is called or matures. All the elements for determining yield on a bond are fixed by contract and transaction documents. In real estate almost none of the elements necessary to forecast yield and risk are provided by the nature of the transaction and it is necessary to supply these elements by assumption. A proper set of financial assumptions for a real estate investor about a proposed venture should include:

A. Time line of financial events for investor
B. Profit centers available within time line
C. Capital budget including deficits
D. Operating pattern of receipts and expenditures
E. Financing package
F. Basic tax strategy
G. Selected measures of yield comparison
H. Selected measures of risk qualification

To make assumptions about all these details about a product as volatile as real estate, to expect all of them to be achieved is unrealistic. Risk in a real estate investment is the variance between an acceptable set of assumptions and realizations that might occur. Risk management is concerned with anticipating alternative outcomes and providing features to control or prevent variance and tolerance to accept variance. Thus, a real estate investor should buy a set of financial assumptions which have some ability to survive, absorb, and adjust to variation in results.

If you can't "buy" the assumptions as presented, you cannot afford the real estate product about which those assumptions were made, no matter how "good" the site and "attractive" the building.