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

h. "New Concepts in Real Estate Analysis", no date

NEW CONCEPTS IN REAL ESTATE ANALYSIS

I. INTRODUCTION

Comments on what is happening in real estate investment.
Ivory Tower--Big words, prophecy, and new mathematical techniques.
Discount--the African bit

II. ECOLOGY, EKISTICS, AND ETHICS

Cities are built like reefs, by accretion, as the result of many small individual investment decisions. We have become a city society. You all are optimistic for real estate value because of the population explosion. We make fun of the word togetherness but there is nothing funny about our present failure to prepare for growing togetherness with ourselves and the rest of life on this planet.

Ecology is the science of the togetherness of living things and their environment. Nature made man. Man made culture. Culture is shaping man. More and more man is replacing nature with a manufactured environment - namely the city which he builds.

Man's health as a species, his physiological, emotional, neuerological stability depends on his environment. In fifty years we can be living in several thousand Harlems, Calcuttas, or Chicago south sides.

We must believe, because it is true, that people are affected by their environment - by space and scale, by color and texture, by nature and its beauty. People can be uplifted, made comfortable, made important as individuals, made more productive, made more agreeable clients, more free spending as customers by the right environment.

Therefore to have great cities in a great society there is always more to investment in buildings and land than maximum yeild and lower cost.

The first need for real estate investment today is a sense of social ethic, an awareness of the need for improved zoning, modern building codes, comprehensive planning ordinances, and real belief that good esthetics means good economics.

There is no justification for the quality of much that is being built today. The equity investor, the lender, and the real estate broker have left one criteria out of their ratios, the long run community value of a particular project.

Only yesterday civilized countries were losing forests or creating dust bowls in dry farming regions. We are now teaching plant ecology to prevent further rape of our resources. Accellerating population growth will make man's escape from man impossible and force him to accept responsibility for every phenomenon. This means a responsibility to make every urban form part of a fully functioning environment. In real estate this responsibility has been recognized in the new term, ekistics. Ekistics refers to the combination of sociology, anthropology, land economics, planning, architecture, and engineering that represent the science of human settlement.

The real estate broker can be the man in charge of the team of planners, economists, sociologists, educators, and investors. He can keep the sciences from flying into the wild blue yonder with the prophet motive. James W. Rouse is one of the most successful realtors--his criteria are to respect the land, to provide the best possible environment, to build a balanced city economically, and to make a profit. His projects are standards for the industry and yet he always makes money.

III. MERCHANDISING BROKERAGE SERVICES TO IMPROVE THE INVESTMENT DECISION

Perhaps you have noticed growing public resistance to brokerage commissions. Think of the growing frequency of "for sale by owner" signs, non exclusive listing arrangements, or shaving commissions to save the deal.

Some brokers admit they are playing listing roulette; if they can obtain the listing on a sufficient number of properties, they are bound to sell something every month. People are beginning to ask what they get for $12,000 commission on the sale of a $20,000 house.

Therefore I see the real estate broker shifting the emphasis on salesmanship to counseling, bringing about a new emphasis on

1. Marketing analysis, not market gossip
2. Investment analysis, not financial cliches
3. More cooperation in creating a community data bank by(Columbus, Cali means of better use of multiple listing services.
4. Specialization of brokerage houses including staff people for market and investment counseling.
5. New licensing standards, separating residential brokerage from commercial brokerage.
6. Fees not commissions, direct costing rather than flat community rates.

IV. NEW TOOLS FOR REAL ESTATE INVESTMENT ANALYSIS

a. Ellwood Tables for leverage and yield analysis
b. Standard computer program for cash flow forecasting
c. New marketing study techniques by computer, by consumer preference studies, and by weekly computer review of multiple listing data for each community
d. New emphasis on real estate management to support real estate sales
e. New use of banking computer service bureaus for tight financial control
f. New methods of analysis of the down-side risk of real estate investment due to functional and economic obsolescence
g. New zoning and planning controls which will favor large scale development, better aesthetics, and higher land use population densities

In recent years tax privileges of real estate have been a major factor in investment decisions. Because it created on premium on short term considerations, the quality of real estate investment has suffered. The tax law of 1964 has changed this in part. Future tax laws will reduce these advantages further. Therefore the investor must better understand the sources of profit and the distribution of cash flows.

Must reading is the book Ellwood Tables. The wealth of information this book gives can only be suggested here. Some of you are familar with it, all of you should be.

The insurance companies and the progressive savings and loan companies are now using Ellwood as the first check on feasibility. If it doesn't make sense by these tables, the loan application is rejected without further investigation.

BASIC ASSUMPTIONS OF ELLWOOD TEXT

I. Purchase for investment for dollar profit has two income sources:
   A. Rent earned during term of ownership
   B. Proceeds of sale or reversion
   C. Profit is defined as the amount by which rent and reversion exceed the cost of investment.

II. While income and reversion are a matter of judgement, the mathematical evaluation can be checked for accuracy.
   A. While cash market value implies all cash to the seller, it rarely presupposes all cash by the buyer.
   B. There is an equity component and a mortgage component, the latter having one or more contracts.
   C. Terms of the mortgage contract are generally defined by current market factors and therefore not a matter of conjecture for the borrower.
   D. Therefore, the overall capitalization rate involves the following variables:
      1. Available ratio of mortgage money to value.
      2. Interest rate that will attract mortgage money.
      3. Maximum available mortgage amortization term in money.
      4. Income projection term in years.
      5. Proportion of purchase capital to be recovered through mortgage amortization during the income projection term.
      6. Increase or decline in market value during the income projection term.
      7. Range of prospective yields that will attract the equity component of purchase capital.

III. You all are familiar with the idea that income devided by capitalization rate equals value. Ellwood analyzes the rate so that it is a rated average of the rate required for owners and lenders.
   A. In addition he allows for the deferred profits realized from amortization of the morggage at the time of resale.
   B. Unfortunately his formulas can not allow for the impact of individual tax considerations on value.
   C. For example, if you could borrow money for 20 years at 5 3/4%d monthly installments, and you wanted a 15% return on your equity, and you wanted to sell in 10 years-the Ellwood table would tell you that the basic rate was .0944. If you wanted to assume depreciation, you would take some percentage of :0493.
   D. It is possbble to chart a possible rang and yield you may except from angiven investment. You may determine a reasonable down-side risk and the maximum possible yield in the event of appreciation. It provides an opportunity to measure the risk.

Real estate investment must compete with other forms of investment opportunity. The typical real estate ivvestor does not know what his annual income yield can be nor what his affective yield was once he sold the property.

Some real estate consultants argue that you cannot forecast for more than eighteen months. However, you can make reasonable projections of the best and the worst that you can expect. Ellwood talks of overall decline or appreciation, but without regard for tax position of the owner or annual changes in revenues and expenses.

Therefore the next step in analysis is to talk in terms of cash flows for alternative real estate projects over a series of income periods. Today this can be done with standard computer programming. The output can indicate not only the annual cash flows but the degree to which you can earn a cash return on your money.

Our graduate students built a model of an apartment house project which was intended to point out the best mix of units, type of construction, financing plan, depreciation treatment, etc. an judged by net cash return as a percentage of project net worth at the end of each period.

A recent office building in Houston used the same approach to determine the most efficient building height. (30 floors in that case)

Today engineering firms can compute the entire construction bid for standard building types on the computer.

The computer will also provide more comprehensive, current market analysis. Multiple listing service is the natural place to start. Our students are experimenting with multiple regression techniques that can predict the volume of real estate sales from month to month with great accuracy. Smolkin can predict housing starts with 92% accuracy a year or more ahead of actual event.

Realtors, lenders, developers, and material supply people have a common interest in market analysis. In Columbus, Ohio the Saving's and Loan have divided the city according to planning district, cencus tract, plat maps, block and lot numbers. All mortgages, sales, construction starts and listings are calalogued so that the lenders enjoy a weekly report on their market penetration in each area, market activity, supply and demand for housing, and other data.

There are now aids on how to do well focused marketing studies to determine gaps in the available supply relative to effectibe demand. (Smolkin books)

Real estate is a dynamic, wasting resource. If it is not managed well and consistently, all the fancy income projuctions of the world will fail. The real estate broker who lures money into real estate investment must also provide better real estate management services than he has in the past. It is my poinion that in the coming years as much money will be made in real estate management as has been made in the past in servicing mortgages and no capital is required to get started. Management will be compensated largely on skill. It is the best opportunity today to make money in real estate on somebody else's capital.

For example the larger management firms are beginning to use the computer service bureau of local banks to keep current records, make out payroll, and study characteristics of tenants. These services can be so cheap that even the small manager must understand their use.

The downside risk in real estate due to functional and economic obsolesence is growing. Homes are depreciating faster and pre World War 2 investment buildings are selling at much higher cap rates or lower gross rent multipliers. New buildings are designed for flexibility of use and off-site prefabrication.

Finally sophistaced zoning and planning control on performance standards will favor large scale development, better esthetics, and higher land use population densities. At the same time higher densities will not raise land prices but rather justify present prices.

With time we will see real estate taxes reflecting more of a penalty on open land held for speculation while subsidising open space improved for general enjoyment. For example the downtown plaza, the suburban industrial plant, and the privately owned city golf coarse.

The F.H.A. M.P.S. standards with its minimum ratios of space, open area, parking areas and the like for given land use intensities is a taste of things to come. An understanding of zoning and planning objectives will require the realtor to be understanding of many fields, including sociology, criminology, the land scaping arts, and so on.

V. CONCLUSIONS: THE TECHNILOGICAL MANAGEMENT REVOLUTION IN REAL ESTATE INVESTMENT

James Thurber has written about the little Red Riding Hood in our day who wondered about gramma's long nose and who then shot the wolf dead. Thurber concluded the little girls in our time are not as easily fooled as they once were. The same is true of the prospective real estate invester.

As real estate investers make more use of mathematical analysis, cash flow projections, investment yield comparisons, management analysis, and depend less on tax gimmicks, real estate values will change. So will appraisal techniques.

Stabilized income statements and capitalization without leverage or cash analysis will produce erroneous answers. Advancing skill levels will be required of appraisers, so that for those of you who double as appraisers and brokers, you are faced with tremendous educational responsibilities.

To this end I have suggested some essential current reading, and perhaps some comments are in order. My own copies of these books are on the desk for your inspection.