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

j. "Investment Simulation", no date

Investment Simulation

I. The distinction between simulation and normative is some evidence that the method used reflects the methodology and selection criteria of the selected buyer group.

A. Most smaller investments are bought on the basis of income multipliers rather than long term cash flow.

1. Net income multiplier
2. House profit multiplier
3. Monthly income multiplier
4. Income per slip, tennis court hour, per kiosk, etc.

B. Some simulations may reflect indirect controls on price, such as:

1. Debt cover ratio required by lender
2. Land value per bedroom criteria for appraisal of subsidized housing sites
3. Permissable number of bedrooms on sites requiring septic tank, etc.
4. Animal unit months capacity or average production in bushels or estimated board feet removable

C. For any system discounting income from real estate, the three major problems are:

1. Defining the income attributable to real estate
2. Defining expenses to be incurred by the buyer in the scenario selected for most probable use
3. Choosing a discount rate appropriate to the buyer viewpoint

II. Defining Gross Income Attributable to Real Estate

A. Fair market value of fee simple title assumes market rents rather than existing rents and requires an allocation of total value between or among owner of the fee and leasehold interest.

B. Investment value looks at contract rents until they can be replaced by market rents and market terms in order to estimate value to the investor in the fee. Thus most probable price at which the property would sell is not always identical to fair market value.

C. Many real estate properties are tied to business operations carried on within and there is a significant problem in assigning income to business operations and entrepreneurial management and to real estate.

1. When appraising a hotel one obviously uses the rental rates for bar and restaurant space and not the actual income generated; other income must be attributable to the chattels and the reservation service and the franchise title.
2. Valuing a sand and gravel business is clearly a different problem from valuing a real estate used in the business.

D. It is useful to set up generalized cirucmstances which suggest the presence of non-real estate income:

1. Is the business a retailer of space or a wholesaler (parking ramp vs. parking ramp operator, the John Hancock observation floor vs.

John Hancock income from TV stations aerials

2. Are entitlements that go with the land point specific or transportable? (permit to build a dam vs. a liquor license)
3. Extraordinary features or services rather than customary (refrigerator stove may be customary but maid service is not)
4. Ancillary rather than integral - such as janitorial service or utilities which could be contracted for from off-site contractors
5. IRS classification as 1250 property or 1231 (real) or 1231 property (personalty).

III. The operating expenses from the history of the building are not necessarily appropriate for a new buyer if the prudent management rule for fair market value or profile of the prospective purchaser for the most probable price may suggest changes in the modus operandi.

A. Currently manually operated elevators may be replaced by automated elevators

B. Budgets for kilowatt hours and BTU consumption may be modified downward by instituting improved procedure even though the cost per unit may be rising more than most expenses.

C. Accounting systems of many owner occupied buildings are used to hide various items which may be weeded out including salaries to children, rent-a-plant, etc.

D. Sale of a property may trigger reassessment and a whole new real estate tax, which leads to an interesting problem in circular reasoning since income value will be a function of real estate tax and the real estate tax is probalby tied to value.

E. It is necessary to read each lease to determine renewal options, the degree to which increased expanses can be passed through, or other concessions which may have been made which will cost money in the future. Ultimately expenses will need to be compared for normal level for that type of building and patterns analyzed.

IV. Discount rates must be chosen that are consistent with the treatment of income and the viewpoint of the appraisal.

A. Straight capitalization presumes reserves in expenses for any item replaced before the end of the useful life.

B. The Ellwood discount factor assumes reserves only for items replaced within the protection period.

C. Investment analysis assumes only cash available for distribution is discounted after a decision to internally finance improvements has been reached. Reserves and expense policies must be kept consistent with resale assumptions in the scenario.

D. Viewpoint gets tricky in terms of prudent investor vs. trader vs. institutional investor, all with different opportunity costs of money. Emminent domain appraisal is clearly from the viewpoint of the buyer but net liquidating value is from the viewpoint of the trustees and what he must do to protect himself against charges of waste (prudent man) or delay.