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STRATEGIC PLANNING APPROACH TO MAJOR REAL ESTATE DECISIONS

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A strategic approach to real estate investment, much like any decision process, moves from value judgement, toward explicit objectives, and then to detailed specifications, screens, or standards with which to measure and compare the degree to which objectives are met. The latter elements of yield, risk and dollar allocation issues are not the subject of this essay. Instead the intent is to focus on the somewhat more abstract but critical issues of investment positioning. Investment positioning grows out of recognition of certain attitudes about future trends and tolerance for external interference in the investment process. Positioning recognizes that there is little an individual investor can do to thwart the forces for change at work in the economy, but that most investors are unwilling to accept the systematic risks of a statistical marketplace passively and stoically. While the surprises of the future may reveal that each real estate investor is placing his chips on a roulette board or million dollar slot machine, the typical major investor feels guided by some intuitive perceptions (when playing roulette or real estate). It is useful if the investor can articulate this extra sensory perception into attitudes which might suggest strategic positions which will bias if not control real estate bets.

For example, the following convictions, which may still be difficult to document statistically or to accept as foregone conclusions, may suggest

certain positioning of a portfolio and forms of ownership:

1. A capital shy economy due to both a short fall in savings and an era in which all major problems require capital intensive solutions will lead to selective credit allocations by government and very high interest rates on non-priority capital goods, such as luxury hotels and home office buildings for institutions. Such a perception leads to policies which will capture assumable mortgages, 100% funding of luxury hotels with contingent interest limited partnership devices, or aggresive acquisition of property futures from those unable to provide estate liquidity to meet estate taxes when buyers have little access to credit.

2. Another scenario might be gradual decline of consumer discretionary income for restaurants, travel, and entertainment as a result of forced saving for retirement, higher food and shelter costs as a percentage of income, and the necessity of capitalizing household transition to energy efficient systems. Not only will that pressure rent structures but may necessitate modernization expense of the existing supply of rental units while undermining the current boom in build to suit restaurant leases for regional chains.

3. Shifting demographics and the increasing number of acceptable alternative life styles for younger families, together with an increase in the number of families eligible for retirement, could significantly undermine the broad based behavioral values placed on a home in the suburbs, factors which could undermine the retirement values suggested by paper equities accumulated in the existing housing stock. Should an investor anticipate a change of zoning which would permit subdivision of larger homes to

condominiums as a form of urban compression and equity liquidation for the detached home owner?

4. The differential between the sun states and the balance of the midwest and northeast states is leading to increasing levels of economic warfare relative to energy taxes, government spending for defense versus economic redevelopment, immigration rules, and so on. This new war between the states can't help but further tilt the economic differential in favor of the sun states and further tilt the shift of younger skills in the same direction. That could suggest investment in facilities for older citizen services, etc., or sale and leaseback of facilities which will depreciate inversely to the age of the population. Or it could suggest investing in school buildings jettisoned by school districts with declining enrollments.

5. On a smaller scale consider the continual looting of the US Treasury and the citizens by the union wage policies of postal workers. It might follow that the only counter force to labor extortion would be permitting private mail services to expand beyond the current parcel and air express system. In that case, the federal post office would abandon or fail to renew many of the leases which currently depress values of thousands of properties across the country. Such an intuition would lead to a positioning of a portfolio which bought up buildings encumbered by federal leases at current discount rates in order to capture a significant increase in rental income when the existing post office leases were not renewed.

6. Assuming a decline in manufacturing in the midwest and continuing increases in the value of exportable farm commodities, it would follow that long term investment should be in rural farm service communities and transportation hubs to anticipate an extension of the urban exodus back to true farming country rather than the urban fringe.

Attitudes are dangerous for positioning investments unless the investor is confident that he can understand his state of mind. Without some objectivity implied by "Know thyself," attitudes are really rationales for unspoken fears of change, stylish cynicism within a social circle, convenient rejection of current business patterns in response to paranoia, feelings of inferiority, or fading energies. One way to factor attitudes into smaller components for better understanding is to set up a hierarchy of subfactors which begin to profile strategic preferences for investment opportunity.

In our experience the following general hierarchy typically reflects priorities of both institutional and individual investors, although certainly any particular investment portfolio may rank these factors differently. Nevertheless positioning will consider the following elements which will then be further broken down into sub-categories in Section 4.

A. Degree of exposure to political risk

B. Degree of market control or channelled demand

C. Degree of management intensiveness required

D. Financial characteristics in economic terms

E. Sequence and cost of escape points

F. Suitability of tax parameters for preferred tax ploys

G. Suitability for estate planning program

The sharpness of a vision, perception or attitude about the future will depend on what level the strategist perceives the implication inherent in the conventional wisdoms listed above as the significant strategic concerns. Therefore it may be useful to quickly sketch, with only a suggestion of line and water color, some of the themes to be found at different levels.

The degree of exposure to political risk begins at the first level with all manner of land use control laws and the degree to which expected investment uses are vested, are unique relative to alternative sites, or yet to be determined with all the uncertainties that reside in something called due process and civics. The first level may be reasonably apparent, but at the second level there is a concern for the degree to which effective demand is vulnerable to political control. For example dairy farms ultimately depend on the parity price for milk, and midwest agri-business may depend on foreign policy relative to grain exports, etc. Subsidized housing depends on the inclination of HUD to extend or cancel the Annual Contributions Contract due to budget constraints or the shift of rent supplements from HUD to Welfare programs. An alteration in public transportation subsidy will alter trade areas for shopping centers or dependency on subway, light rail, bus or car. Home building ultimately depends on the willingness of government to subsidize credit for the home buyer or tax deductions for the vacation home owner and so on. Level three is more subtle because it has to do with the direct and indirect political subsidy of competitive supply. For example in Alaska huge sums paid to the native corporations in cash have meant the opportunity cost of money available for investment in Alaska has overpriced hotels, overbuilt recreational faclities, as well as exaggerated home building at the expense of rental property. The lack of political control on capital efficiency

of financial institutions permits financial institutions to build office buildings with features that could not be justified in terms of market rents. This double standard for capital efficiency has now spread to the public sector so that the New York Port Authority can build World Trade Centers and community economic development agencies can provide less than market interest rates to medical clinics or any other employer with negotiating ability. As a result, the most skillful and profitable developers currently pursue those kinds of projects for which they can seduce some legislative council or agency for a political subsidy, knowingly or unwittingly.

The degree of channeled demand is a euphemism to avoid the stark truth that free enterprise is the art of creating your own monopoly to avoid price competition. The best way to create monopoly today is by shaping government regulations, such as land use laws or bidding eligibility to create a legal monopoly. Failing that, there is the opportunity for an identity of interest between user and investor, such as the doctors who own and occupy their own clinic buildings. Failing that, there is the time-honored American way of reciprocity between the owner of the building and his creditors, which explains why the bank's law firm, accounting firm, or stockbroker are so pleased to be tenants in the bank's building. Reciprocity may be difficult to distinguish from the tie-in contract. The best way to create some reasonable control of a market is through careful research of market segmentation. It is well known that markets are segmented demographically but only in the 70s have we begun to segment within a demographic cell in order to reach a particular life style or set of behavioral codes. Market segments in American real estate are highly programmable and it is critical to develop an idea of that program as a pre-architectural or pre-marketing management scheme. Capital

efficiency requires that monopoly, by finding a need through market research and filling it, become the preferred method of channeling demand.

Degree of management intensiveness begins at the first level with project dependency on a unique personality or talent, such as a chef, resort personality, or close relative of the mayor. The second level of dependency may be on persons with high technology levels and skills, whose sudden departure would leave the project floundering. Some real estate demand is tied to a short term, high turnover tenancy which is responsive to service rather than location, so that rental income lacks the stability or inertia of apartment homes. Much real estate really lacks product differentiation, and thus requires a constant stress on fictitious differentiation through advertising. Fungible real estate spaces do lend themselves to all the investment strategies of conventional commodities. A land contract for future delivery of Class A office space ten years hence is a straddle position, a call on appreciation and a put to the seller if future income will not support the close-out price.

Financial characteristics in economic terms begin at the first level with recognizing particular real estate enterprises as high fixed-cost, variable revenue enterprises such as hotels and restaurants or highly stable revenue and cost entities such as triple net leasebacks of industrial buildings and so on. Obviously these characteristics are interrelated with the degree of management intensiveness, and at the second level it becomes useful to distinguish which revenue dollars are attributable to space attributes of the real estate, which are attributable to services, and which are attributable to peripheral enterprises. Parking revenue by the floor at a lease price to a parking operator is real estate income while retail revenues from stalls and observation decks are from peripheral marketing enterprises. Is income from retailing electricity actually real estate

income or a peripheral enterprise? At the third level of analysis is the tolerance of the real estate revenue and capital structure for risk or surprise in future operations. Cash break-even points or the maximum exposure to total loss of investor equity are suggestive of this level of risk tolerance. The fourth level is into the legal framework which shifts variance in operations from the initial investment assumptions to others, absorbs variance in portfolio construction, or neutralized variance through various hedging devices in the money market or even in the markets for fungible construction materials.

The ultimate risk management process is the sequencing of decision points which will permit escape from the venture at an acceptable cost. At the first level we have options and land contracts which explicitly recognize contingencies which call for escape. At the second level investors may have maximum levels of sunk cost which can be incurred before making a firm commitment or rejection of an opportunity. The cost to abort before closing contracts which do not contemplate default as an acceptable option is typically minimal. At a third level the project may be designed for diversion to alternative uses, such as the tennis club which might become an industrial warehouse or discount retail outlet. It is wise to anticipate that most investment structures will outlive the uses for which they were originally intended, so that flexibility in adaptation to other uses in terms of floor loading capacities, utility chases, ceiling heights, and column spacing may represent additional costs at the front end that represent the risk escape route for the investor facing obsolescence in the marketplace. At the fourth level is the objective of liquidity through sale, say anticipating conversion to condominium retail financing of the rental apartment in a rent control area, buying down loan commitments which can be assumable by the next purchaser, or life insurance funding of cross purchase plans, etc. At a still lower level is the

art of negotiating contracts in which the penalties for cancellation or liquidated damages are well within the investor's acceptable payoff matrix, although that fact may somehow not have been communicated to the other parties.

Income tax parameters should never be the primary basis for real estate investment although they must be considered in generating tax-equalized dollars and ratios for comparative analysis. Certainly the income tax options available are going to be rather volatile during a presidency of economic experimentation and legislative majorities in a state of flux. For the individual, and ultimately for his institutional shadows, the estate planning tax considerations will be far more significant in positioning real estate investments. The real estate tycoons created by the urban explosion since World War II are just entering a time of accelerated actuarial liquidation, and it remains to be seen how the liquidity required for estate taxes and the structuring requirement for administrative efficiency and continuity may trigger considerable transfer of investable properties to younger investors and institutions still in the accumulation phase. Estates represent a major source of investment properties in the future for financial institutions or insurance companies who can provide instant cash. Investment pools will have a significant edge in acquisitions if they position themselves to do so by means of stock exchange, convertible loans, purchase payment with flower bonds, or life insurance in exchange for first right of refusal or fixed option price on demise of the property owner.

¶ In short, positioning is the degree to which the investor wishes to depart from systematic diversification to avoid all non-system risks and to perform at a par with the market. It is explicit introduction of a bias to acquisition and management decisions based on some rational scenario of long term movement and feedback systems which the investor sees "through a glass but darkly." Positioning may be rational, but Mr. Keynes pointed

out that rationality for investors in an irrational world leads to disaster, so that positioning may well reflect solitaire, gypsies, or the insights of a very attractive psychic.