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

o. "Public Real Estate Corporations", no date

Circa 1972-73

Rough Draft

PUBLIC REAL ESTATE CORPORATIONS

I. Investment in real estate equities by means of publicly held real estate corporate shares can begin with at least three basic viewpoints in terms of objectives:

A. One could select a firm specializing in land development, investment properties, building materials, finance, etc.

B. One could invest in large corporations which have a subsidiary interest in real estate.

C. The owner of real estate might wish to merge his operation into a larger entity for additional finance, security, expansion or state planning.

II. Each of the specialty interests in the building industry have their own special economic strategy. These strategies are not often appreciated by the investors so that their behavior is fickle, fadish, irrationably flabbergasting.

A. Investor interest in stocks caused stock prices to soar. From January 1967 to January 1968 the housing stock index rose 90% and from 1968 to 1969 the index increase runs slightly less as price earnings ratios have shifted direction. For example, Kaufman & Broad the nations largest home builder had a PE shift from 7 to 30 to almost 50.

B. In January of 1965 House & Home magazine created an index of 25 leading housing stocks with an index value of 100. The handout shows the current collapse of the industry as an investor's disaster but perhaps future opportunity area

C. Land developers once depended on control of vast acreages which would appreciate at a rate higher than carrying charges and could be liquidated quickly enough to generate tax for operations and dividends. Land is not appreciating much these days and a variety of federal restrictions on marketing have heavily reduced sales volume or increased cost of sales to as much as 40%. The new formula is to think small and convert it quickly to development.

D. Merchant builders have the most volatile results because they depend on high leverage, low interest ratio, and cost control.

1. Kaufman & Broad had a return on euqity of about 30% with equity representing 40% of assets. U.S. Home & Development nade 34% but sefveral formerly profitable builders which were taken over by non-contruction firms made no money at all.

2. The opportunity for a small error in costing causing a significant change in results can be indicated by the following figures:

a. A bulder building 500 houses a year who is off by $1pp per unit has shot $50,000.

b. 500 houses at $20,000 is $10 million in sales but the average after-tax profit margin is 2.3% or $230,000. A $100 budgeting error can nick profits by almost 25%.

E. Mobile home dealers have very little debt, but make as much as 50% on their equity per year because of high turnover since their dealers provide floorplan financing for their inventory. However, there is a relatively low cost of entry and turnover means cost increases appear quickly as they restock with material and there is little capital to withstand a slow up in collection or delivery of finished trailers.

F. The smallest prefabbers make the most on equity because they don't have any. For example Techbuilt made 72% on its equity but it had recently undergone receivership and had an equity of 11%. The largest prefabber, National Homes, made only 1.1% on its equity.

G. The mortgage bankers and the guarantee firms depend on large volume and therefore a very active home building market. It is estimated that about 1/5 of personal disposable income or $100 billion represents mortgage payments for the debt service protions of rents. Just receiving a quarter per cent premium or service fee on such volume means a steady income stream.

H. The mainspring of growth is the home builder who has the expertise to produce a real product rather than supply a service for which there is only a derivative demand. As Lewis Goodkin has noted a home builder can specialize in a particular product and diversify into several communities or diversify his product and specialize in a single community.

1. A home builder is analagous to a retailer. Additional market penetration increases sales and profits or the builder can open new projects.

2. A growth in earnings might occur when:

a. Companies have projects with different life cycles and different penetration sales patterns.
B. Profit margins differ depending upon the stages in the project life cycle.
c. High backlogs at certain projects can increase deliveries in sluggish housing years.
d. By-product sources of revenues and earnings.
e. Larger companies must open either larger projects or more projects to have a meaningful impact on revenues.

I.
The cost of planning when subject to environmental controls, politcal treachery, and volatile financial markets meant the aggresive home builder after 1968 needed a strong equity base and some protection for the hard run profits of the 60's which had been reinvested. Most of the home builders depended on one or two key executives with credibility and entrepeneurial nerve. These firms began to merge from 1968 to 1972.

III. The outstanding characteristic of the merger boom was the the rise of the conglomerate corporation . The merger-aquisition of home builder firms was primarily possible because of the high price earnings ratios and the misleading of counting rules which were finally changed by the accounting principals board in 1970.

A. In the most important reform, "pooling of interest" was greately limited. Under the old rules an aquiring company could add the assets of the other firm into its books at original cost rather than current value. It could then sell the assets at a high price and report the difference as profit. These earnings sustained a high price earning ratio without any real internal growth. Moreover the sellers would recieve prefered stock or convertable debentures to protect their price and prevent dilution of the paper earnings to the other stock holders.

B. The accounting rule makers have now prohibited the use of pooling if merger plans call for disposing of aquired assets within two years of use any form of funny money. And mergers ineligible for pooling the company is forced to adopt purchase accounting which may include good will. Good will is not tax deductable so the 40 year write off becomes a direct drain on profits.

C. At the same time land development operations were permitted under accounting rules to include an installment sale at gross price and take the paper profit directly into earnings as in the case of Boise Cascade.

D. Other motivations for mergers from the viewpoint of the surviving corporation included :

1. The ability to leverage industrial network without showing any debt on the parent corporation's books. Affiliation was enough to gain credit even though no direct guarantees were given.

2. Many companies had unused tax losses in oil, transportation, and retailing which could be applied in a consolidated return to the builder copporation to provide internal financing.

3. Building provided a captive market for products and rental properties could provide tax shelter for high profits of material companies during building booms.

4. A few financial geniuses used a merger into home building for a window dressing, such as Dr. Arnold Hammer at Occidental.

E. From the standpoint of copporate ethics one should question mergers where the public treasury gets burned by misapplication of tax shelters or for investment banking razzle-dazzle for stock promotion and inflation of the PE ratio.

F. Sound reasons for merger for conglomerate, or more typically today the congeneric merger produces real economic gains because:

1. Reduction of risk for the builder
2. Cheaper money adn holding power

3. Economics of scale for the congeneric building firm.

4. Specialized professionalized services in markdting research, operations research, marketing etc.

5. Broaden the financial base of the building firm while achieving estate planning equity for the builder.

G. The typical building firm typically must choose merger because it does not qualify in size or scope to be publicly held. The Kaufman and Broad formula for success of the public firm means:

1. Management depth and expertise in marketing, production, and administration.

2. Expertise in corporate finance.

3. Willingness to commit to a long term growth program of 15-25% a year, a pressure which can burn out the keymen and dilute middle management

4. A willingness to program a stabilized growth curve in earnings per share and dividends per share

H. Investment by merger is a two way investment decision. Ultimately, Lewis Goodkin asserts that risk is inverse to the talent in both merger partners and directly correlated to the age of the party.

1. Is the surviving corporation looking for earnings per share or rate of return?

2. Is the surviving corporation capital intensive?

3. Is the surviving firm willing to learn the real estate business before it starts making changes in the management operations?

4. Do the indentures of the surviving corporation permit new depth for the subsidiary?

5. What is the minimum growth rate to be required to realize corporate expectations and would an occassional bad year cause serious repercussions because of the variance-covariance characteristics of the two businesses (MGIC)?

6. How firm a financial committment is made to the new builder and how explicit are definition of project feasibility and date for delivery of promised working capital?

7. Corporate control vs. builder autonomy

   a. The corporate committee process vs. a single corporate division officer.
   b. Corporate politics and the seagull syndrome
   c. Corporate politics and the shirttail system

I. The major problem with investment merger is motivating and directing the builder after the merger as most large builders are domineering dynamos of action and intuition "with the same leadership style and regard for bureaucracy as General Patton".

1. The reaction of the older builder is to relax and enjoy money when he suddenly finds himself a cash rich millionaire.

2. Another reaction is for the builder to take his success and assume that he is a corporate tycoon which threatens the officers of the aquiring company. Lewis Goodkin reports one builder who was paid too

much told the new board of directors "any company that pays this mush for me needs new management".

3. Many mergers use the earn out by paying a certain amount down plus an equal amount if the builder achieves certain goals over a five year period. The disadvantage here is that it locks the builder into a program of rapid growth without refard for market conditions, subordinating the risk position of the parent corporation to the drive to earn the contingent stock.

4. Many aquirerers provide a package of thrills such as placing the builder on the board of directors and giving him protocol rank equal to other top managers to boost his status and therefore his desire to gain peer group approval.

5. However motivation of the builder starts by achieving a younger man, preferably under 40, who is not ready to cash in his chips and then providing the right control device rather than immediate pay offs. Generally this means leaving the builder as a partial owner, as much as 50%. For example Bethlehem Steel owns 80% of Multicon and CBS owns 49% of Klingbeil with an option to buy more later. Gulf and Western created a company in which they put in ten million in capital for 50% ownership and gave the other 50% to Richard Wasserman and Richard Bernhardt, the top operating officers at Levitt. The name of the company is the Richards Group. Says Wasserman "Its our business and G and W has invested. We'll have no interference in company operations as we do not intend to be a subsidiary."

6. The key people who run building firms are also motivated by equity position. Typically they're understaffed, overworked, and overpaid relative to industrial managers. Building management cannot be put on a salary structure comparable to manufacture.

   a. For example a division of project manager with Leadership Homes in 1971 would have a base of $45,000 plus a bonus of 100% if he achieved his projections.

7. Trammel Crow takes a 50% position in each project and gives the other 50% ownership to a division manager who in turn gives it to a project manager who may share a portion of his share with key people on the job. Often these positions are put in a trust which vests prorata over five or ten years.

J. Almost all of the mergers of big builders with big corporations have failed because of the people problems. On the other hand some of the congeneric mergers are working because the merger partness did not have to teach each other the basics of the business.

K. Out of the wreckage an analysis of corporate-builder mergers some very good investment principles of analysis of land and building companies in general come to light.

   1. Because of diversed markets and rapidly shifting economic and political circumstances, past performance has little bearing on present and future success.

   2. Building firms look good because the competitive advantage on land cost provides a better product for the money or conceals lard in the overhead.

3. The cost of labor and material change so rapidly a successful product can be priced out of its market.

4. Foolish man or an angry god can destroy the potential of other captive sites.

5. Quarterly earnings reports must not control at the expense of poor timing or rushing the project.

6. Beware of the phantom organization where the executives are actually ordcer takers.

7. One insurance executive summarized corporate investment in real estate. Joint ventures "are a partnership to whcih the corporation brings money and the developer brings experience. And at the end of the deal, the developer has the money and the corporation has the experience."