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

t. "Real Estate Equity Trusts", no date

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Real Estate Equity Trusts

I. Origins

A. Massachusetts Investment Trust

1. Real Estate Investment Trust of America 1884

B. Mutual Investment Fund Act

C. Failure of large public syndicate

D. 1960 REIT Act to provide conduit status

II. Structural flaws created by IRS fear of conduits

A. 90% of earnings must be paid out

1. Principal payments on mortgages must be less than depreciation so that older buildings enjoy little leverage
2. No opportunity to build loss reserves
3. Little opportunity to generate internal financing of new projects

B. Passive investment role

1. No profit centers from management or development
2. Real profits go to outside management firm
3. IRS even questions participating loans, stock participation with tenants, or percentage leases if they are not customary for type of property involv-
4. Earnings insensitive to inflation for long term investments or unstable from short term leases

C. Investors buy dividends not growth as slow turnover of assets leads to significant understatement of book value. Indeed, depreciation leads to declines in book value.

D. Decline in book value increased where part of cash dividend is depreciation in excess of principal payment.

E. IRS limits sale of assets and annual percentage contribution of capital gain so that submerged assets cannot be converted quickly; indeed, capital gains must also be distributed under 90% rule

F. Growth requires future sales of stock without dilution of current shares - encourages managers to overstate earnings or pay dividends out of capital in order to support new security floatations

G. Management fees provided negative incentive

1. Were based on total assets rather than change in net worth or bottom line earnings
2. Conflicts of interest between sponsors who were developers, banks, insurance companies, mortgage bankers, etc. and trust investors

III. Mortgage trust designed to take advantage of arbritrage between commercial paper and bond markets and mortgage market

A. Original trusts used historical spread between insured home mortgages and bond market

1. Money managers became greedy and saw construction loans had greater spread and more rapid turnover
2. Short term construction loans justified more reliance on short term commercial paper
3. Loans did not require write-down of book value for depreciation and interest only financing meant all earnings were available for distribution

B. Growth for the mortgage trust and advisor management fee came through theory of contra-dilution

1. Book value of existing shares leveraged by selling a reduced number of shares for the same price
2. Lenders required a ratio of debt to equity so that every new dollar from sale of stock created four dollars in assets
3. Many trust sponsors were banks so that new debt was issued under conditions and terms that would not be true in an open market
4. Accounting and appraisal rules for trusts were unrealistic and lax

IV. Accounting and appraisal rules for trusts were unrealistic and lax

A. Appraisal on basis of as developed, marketed and highest quality

B. Absence of loss reserves

C. ~~Acrue~~ Accrual of income

D. Restructuring of loans in default by incorporating past due payments into new balances

E. Sale of distressed property to captive buyers with recation of loan terms

F. Regulators then flip-flop to require a write down in assets to represent not only current present value but in addition the present value of future holding costs. Capital surplus was wiped out overnight and operating losses could not be carried back to share holders.

G. Shareholders have opportunity to refile income taxes for previous three years to the degree that dividends were paid from capital rather than earnings, once earnings have been redefined .

V. Current investment strategy for real estate trusts

A. During period of inflation you should control tangible assets with as much leverage as possible. Tremendous discounts on understated book values of equity shares makes them good investments for some purposes.

B. Trust shares are priced both on dividend and in part like a commodity, rising and falling in the market without regard to quality differentials. Therefore, many quality shares are under priced.

C. In mortgage trusts, those with less than 35% of their portfolio in distress have more chance of surviving. In addition to bank loans, many of the bank sponsored trusts have subordinate bond issues which still receive their interest payments but uncertainty as to value recoveries and willingness of banks to fund the trust have depressed bond prices to a fraction of paar. In the long run many of these bonds will be sound and bankruptcy courts will be reluctant to cram down on the subordinated debt to favor the bank loans when bank sponsors cause the problem and bank loans are 1% of interest plus all earnings for the next ten years.