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

2. Appraisal Topics

z. "Discount & Capitalization Rates", no date

DISCOUNT & CAPITALIZATION RATES

I. Evolution of capitalization rates

   A. Price earning ratios extracted from sales.

   B. Built up rates reflecting capital markets.

   C. Benchmarks influencing buyer patterns.

   D. Reliability from market.

      1. Engineered sales prices must be corrected to reflect cash equivalent price.

      2. Appraiser must define income actually available at the time offer is made or income available 6 months later - reflecting expectations of buyer. ~~(Cain and Scott reports both on Seattle apartment market.)~~

      3. Investment band rates should reflect debt cover ratios rather than loan ratios.

   E. Cap rate method should reflect back door approach driving from achievable rents to distributable cash allocated between mortgage and equity using a debt cover ratio or cash break-even point ~~(see Exhibits 1, 2 and 3).~~

   F. A key element is the cash on cash rate before taxes since it reflects anticipated external benefits such as tax shelter, inflated resale price, or risk cushion required by borrower for variance in revenues and expenses.

   G. Terminal cap rates are rising and should be higher than going-in cap rates to reflect risk of future projections and probability of long-term secular increases in the interest rate.

   H. The concept of the built-up cap rate is beginning to reappear in discussions of how to set a discount rate annuity factor for long-term cash flows.

II. The discount rate should reflect the quality and duration of contract income for a specific type of property. The key word is distributable income available for payment of debt service. Historically the lender has looked to value rather than liquidity for security. Drucker has pointed out that in times of uncertainty the business manager pushes for liquidity, future income stabilization, and reinvestment of earnings to buy stabilization rather than debt.

A. A format for defining distributable income is provided in Exhibit 4.

1. Accrual statements vs. cash accounting statements.

2. Property management vs. asset management.

3. Asset management prior to financial management.

B. Critical ratio is cash break even ratio and tolerance it provides for down side on price per unit, occupancy, and extra carry charges ~~(see Case 5).~~

III. Discounted cash flows should be the predominant method for mortgage loan underwriting and sensitivity ratios should be the critical financial criteria, reflecting both credit officer's evaluation of the people in the project and the real estate underwriter's analysis of the property.

A. AIREA has issued Guide Note 4 suggesting DCF is investment value rather than market value technique. Shows bias but many studies have shown DCF is the dominant method for investment properties. John Robert White indicated in LXL Model is the most significant innovation in appraisal in a decade ~~(see Exhibit 6)~~.

B. Roulac would argue that discount rates should reflect built up components for real rate of return, inflation rate, market risk, real estate risk or other risks peculiar to the property ~~(see Exhibit 7).~~

C. To force explicit thinking about ratios and risk, we teach our students to use a point system converted to a cash break-even point.

D. A discount rate really assumes that net present value is the best method for ranking investments. For the lender that is true because the payments are reasonably regular and profit centers are limited. Indeed secondary profit centers are generally recognized in loading the base cost of money or unloading for credits given for offsetting balances, other service income, etc.

1. Net present value also assumes immediate reinvestment of the money or termination of the loan which supplied the money. Remember that net present value has the least distortion when:

a. All funds are paid out instantly.

b. All funds return in a regular series of payments as to amount and time.

c. There are no indirect agendas of profits in other nonaccounted for sectors.

d. Change in net worth now rather than later is the criteria.

e. Money below the line rather than above the line is the object of control.

f. Investment returns rather than business profits are the objective.

2. For the equity investor, a modified internal rate recognizing lower reinvestment rates and irregular returns is preferred.