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"Gertrude Stein and the Real Estate Market"

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On her deathbed, the redoubtable Gertrude Stein supposedly asked her companion, Alice B. Toklas, "Alice, what is the answer?" And hearing no reply, she asked, "In that case, Alice, what is the question?"

In much the same way, the experienced banker first becoming involved in real estate must learn at the outset what questions to ask, and then he must learn how to interpret and to apply the responses he gets.

All of us to a certain extent "know" things that are not true or, more likely, that are irrelevant or misleading half-truths; and in no field is this more the case than in real estate. The generation-long, post World War II inflationary boom obscured many harsh realities that become painfully apparent in periods of slack demand and stable or declining values.

The banker of today can no longer lend on the "greater fool theory" that some other lender will necessarily come by to bail him out, nor can he automatically count on having his loan made good by the relentless increase in paper values reflected in the comment heard in palmier days that "the rising tide lifts <u>all</u> the boats."

In the real world, some buildings do indeed depreciate physically or economically and not merely in the eyes of the tax lawyer; and not all mortgage "balloons" meet anticipations. Self-serving projections can turn out to represent hopes rather than expectations, and carefully documented forecasts often appear in the cold light of day to be mere extrapolations of the rising segment of a curve rather than realistic analysis of future markets.

(Mr. David Rose, our senior partner, envious of Gresham and his Law, Peter and his Principle, Parkinson and so forth, would like to promulgate Rose's Rule - that "in a free market economy, shortage tends to create surplus and surplus, shortage;" but that calls for a separate discussion in itself.)

On seeking outside advice, the lender is frequently confused by having tossed at him such unfamiliar appraisal terms as the Ellwood Formula, the Hoskold Method, the Inwood Factor or the authoritative-sounding Internal Rate of Return; and when he timidly asks for hard numbers he sometimes get impressive computer print-outs (accurate to the nearest feather) of how many angels dance on the head of a pin.

"What," the banker asks, "should I do?"

The answer, of course, is that there is no easy or pat answer, for we are dealing with an art rather than a science. Real estate values are based on anticipations of the future; and the future implies unknowns of varying degrees of probability. In real estate, unlike archeology, the past is of interest only to the degree that it throws light on the future.

The goal of the lender, in this case, is to improve the odds on the soundness of his judgments about the future.

New Construction

In dealing with new construction, a thorough understanding of the role of the developer, of his nature, and, above all, of his aims, is of fundamental importance to such insight.

The usual aim of the developer, simply put, is to achieve the twin goals of controlling as much brick, mortar and land as he can with as little of his own cash as possible, while at the same time achieving the highest possible cash-on-cash return on what he does have in the job.

Put in mathematical form, his view of life is essentially:

I Gross Cost - Gross Funding = Equity Contribution

II Gross Income - Gross Expenses = Net Cash Flow

III Equity Contribution ÷ Net Cash Flow = % Return on Equity

In the purchase of existing income-producing real estate, the formula applies painlessly, because the unknowns involve future income and expense, and one can usually project fairly accurately extensions of current items.

In new construction, however, not only are the gross figures unknown, but the numbers for each individual component can be a virtual leap in the dark.

Gross Cost, for example, can be broken down into:

A) initial land cost,

B) tenant relocation, possession and demolition,

C) "field cost" of brick and mortar

D) fees for a wide variety of professional services,

E) real estate taxes and building loan interest during construction, and

F) interim operating losses from Certificate of Occupancy to rent-up.

The possibility of unforeseen cost increases in each of the last five items is real, and the cumulative impact of substantial errors in each can be severe.

Gross Financing can involve funds from a variety of combinations of straight fee, leasehold-and-fee, construction and permanent loans, proceeds from the sale of tax losses, cash contributions of a Limited Partner, etc.

Unless one is dealing with a relatively standard product, Total Income figures for a job yet to be built are more difficult to estimate accurately than those for an existing, occupied (and therefore "market-tested") project; and the same is almost as true for expenses.

In considering the above and in reflecting on recent past history, the conclusion any reasonable person must reach is that new development in most cases is anything but "shooting fish in a barrel;" it is a high risk game with anguish for the losers but with rewards proportionate to the risks for the winners.

For a banker, the moral of the story is not that one shouldn't lend on new construction (for the rewards of successful lending are clear), but rather that such lending should be done knowledgeably and prudently.

In the course of putting new construction in place, countless decisions must be made; and the particular skills of the successful developer consist specifically in making these important decisions, these key trade-offs that effectively suit the nature of the particular project. Partly by experience, partly by intuition and sometimes, (where the size, complexity, novelty or uniqueness of the job requires it), by formal feasibility studies, market analyses and the like, the developer tries his best to make what have been called "sufficient decisions on the basis of insufficient information."

What the construction lender is lending on is:

A) the ability of the developer to make such judgments accurately;

B) the "margin for error" represented by such conditions as the percentage of fullness of the loan, and

C) where there are personal guarantees, the developer's net worth available to back any shortfall.

To a wise lender, the competence, the track-record, and the integrity of the construction borrower are of immense importance, since time and again experience has shown that even the best-conceived project may not be able to withstand the onslaught of a well-intentioned incompetent, or of an able fellow who cockily and arrogantly and without sufficient preparation or support tackles a complex job unlike anything he has done before, or of an able, experienced character with larceny in his heart. If I, personally, were a lender, I would probably require substantial outside collateral from a borrower whose competence I questioned, and the assistance of highly skilled professionals to aid the able but newly arrived entrant into the field. I would not lend money at all to a borrower whose professional integrity was seriously in question, and I would go out of my way to seek and encourage loans to highly regarded development teams with projects of prime feasibility. It is important to emphasize the phrase "prime feasibility," because even the best of the field can be seduced into doing jobs because "the money is there;" and the wise lender should not only have confidence in his own negative judgement, but for projects of real size and complexity, should seek expert independent analysis of feasibility.

One brief aside on the question of interest rate: it never seemed to me personally that real risk on the part of a lender was adequately compensated by another point or two of interest. And like Groucho Marx, who wouldn't join the kind of club that would take someone like him, I myself would not feel comfortable lending money to a borrower willing to pay exorbitant rates.

Assuming, then, an able, experienced and honorable developer whose proposed project appears to make economic sense, the lender is faced with the question of what terms and conditions to impose. Unless he is indeed prepared to be the permanent lender of last resort, the construction lender should require a permanent financing take-out of an amount greater than the construction loan (ten percent is the usual difference), with loan conditions dove-tailing with those of the construction loan. Stringent inspection during construction should be understood by all parties to be an absolute "must", and the disgraceful experience of the recent past (when loan advances often far exceeded the value of construction in place) need never be repeated.

The question of loan guarantees is a sticky one, even where the borrower's commitment is "to complete" rather than "to repay." One cannot ignore the recent sad examples we all know, when personal guarantees against outside collateral often proved worthless because other liens had been placed against the collateral. And it would seem that reasonable control over the borrower's other loss exposures would not be out of order. Several of the nation's largest developers who came to grief in the recent shake-out might not have done so if their lenders had insisted on the right to monitor the cumulative total exposure being assumed by the borrower.

When Loans Go Bad

The story of the American banking industry and the real estate debacle of 1974-75 is probably destined in time to stimulate as much research, printed material and professional discussion as the Dutch Tulip Craze or the South Sea Bubble.

Developments that should never have been conceived and planned in the artificially financed "super-boom" of 1971-73 emerged from the ground to be greeted by soaring construction costs, unforeseen shortages in many key materials, and unheard-of construction loan rates.

Irritation turned to despair when final demand proved inadequate to absorb the avalanche of prematurely-produced product; and it takes no savant to predict that the resulting headaches will be around for some time to come.

Bankers first becoming involved with real estate today should be required to become familiar with the case histories of the greatest fiascos - not because of morbid interest, but for the same reason that a prominent New York structural engineer has made the study of engineering disasters a life-long hobby - the better to understand sound projects.

The banker of today who doesn't ask himself what lessons are to be learned from the blood-letting is cheating himself needlessly.

For example, "conventional wisdom" may say that one is better off with small participations in a number of large loans rather than in total financing of fewer big ones; but actual experience shows that some of the worst headaches were those in which the lending participants fought destructively among themselves. In "Poor Richard's Almanac," Benjamin Franklin said that there is nothing wrong with putting all your eggs in one basket, as long as you really watch the basket.

This is not the occasion for a full-dress study of the causes or cures of distressed properties, but a few general points may be in order.

A) Bankruptcy, or rather the threat of bankruptcy, is clearly being used as a form of blackmail against lenders by some defaulting owners; and creative thought must be given to strategies of defense.

A growing number of observers feel that at the <u>first sign</u> of real trouble, when the developer looks to the lender for some concession, revision of terms, etc, the lender should insist on re-casting the arrangement to make it more "Chapter XII-proof." For example, in return for additional cash advances, the property can be conveyed to the lender, with the original developer having an option to re-purchase it if he meets prescribed conditions.

Obviously, each job must be dealt with in terms of its own unique factors; but in general, early defensive action is advisable in dealing with either a sick job or a stumbling developer.

B) Another important point involves the individuals (developer and lending officer) best equipped to deal with a sick job; for those who were in on the launching of a project are not necessarily the best ones to be involved in the turn-around.

Individuals can get psychologically "locked in" to a view either disproved or out-dated by subsequent events; and whether for reasons of pride, rigidity, mental block or whatever, they often tenaciously hold on and "go down with the ship."

"Percussive Sublimation" (being kicked upstairs) and "Lateral Arabesque" (moved elsewhere out of harm's way) are two of the most frequently employed management techniques in such cases in the corporate world, but for some reason, in the real estate field, many people continue to feel that the developer who got himself (and the lender) into the fix in the first place should be entrusted to get them <u>both</u> out (even if toward the end, there is no necessary identity of interest).

C) A third generality is the tendency to forget the immense importance of plain "nuts-and-bolts" real estate management competence.

Politics is often defined as "the art of the possible," but the tag applies equally well to the field of real estate management.

It seems unglamorous, and lacking in entrepreneurial razzle-dazzle to point it out, but the turkeys laid by the wheeler-dealers can often be turned into something fit for the banker's Thanksgiving table by such prosaic steps as careful, highly professional attention to personnel selection and supervision, preparation of realistic and appropriate operating budgets, imaginative but cost-effective advertising and promotion campaigns, institution of honest and efficient purchasing and control procedures, and so forth.

(Regarding honesty and controls, incidentally, it may be well to point out that the Lord's Prayer does not say "let me be good," but it <u>does</u> say "lead me not into temptation." In real estate as in anything else, poorly-conceived or sloppily enforced controls may provide such great temptation to dishonesty that they render the supervisor responsible, almost an "accomplice-in-fact.")

A banker cannot be expected to get mired down in determination of respective capital and operating costs of fluorescent vs. incandescent lighting; carpet vs. resilient floor tile; #6 oil vs. electric heat vs. New York Steam, or the hundred and one other details that constitute the day-to-day concerns of the management professional. It is terribly important for him, however, to realize how significant to the "numbers" on a sick job these mundane questions can be.

There is an old adage in the field to the effect that "good management doesn't cost; it pays;" and that is one of the few real estate generalities that does admit to no exceptions! Which brings me to:

Rules of Thumb

One significant danger to the new entrant to the real estate world in his natural but sometimes harmful tendency to rely on "rules of thumb" or on unsupported generalizations that, while true enough, may be irrelevant or misleading.

My favorite example of this kind of thinking is the statement that "the average American has one mammary and one testicle;"

I also like the fellow who refused to let his wife have more than four children, on the grounds that every fifth child born today is Chinese; and it was a friend of his who drowned crossing a lake whose average depth was only one foot!

Kidding aside, when one speaks of dollars-per-room, do we mean large rooms or small, in efficiency apartments or in four bedroom duplexes?

A popular rule says that for a large residential subdivision, one should allocate 20 percent of the gross land area to streets. Depending on shape, topography, governmental requirements, perimeter facilities, etc., actual requirements can run from below 15 percent to over 30 percent.

Everyone used to "know" that in a suburban shopping center 5.5 parking spaces were required for every 1,000 square feet of gross store area. Experience has since proved that availability of mass transit can be an important factor, and (less obviously) that adding office space by as much as 20 percent of the total area may not require one extra parking space.

Percentage of income people spend on housing is another "rule of thumb" frequently applied, yet in practice the poor spend a much higher and the rich a much lower percentage of income than we used to think.

The conversion factor between the rental value and the condominium sales price of a given apartment unit is another "rule of thumb" that can be terribly mis-leading, as is the corollary of what a condominium converter can afford to pay for a rental building he plans to flip. In each case, the specifics of the individual project must be examined carefully, in terms of the particular structure, the neighborhood, the current market, the financing available, and so forth.

It must be strongly impressed on the individual becoming involved with real estate that each plot of ground, and usually each structure, must be considered unique in its important specifics even if it can be grouped as a class in one important way or another.

<u>Use of "Outside" Professionals</u>

Woodrow Wilson used to say that in tackling a serious problem, he tried to use all the brains he had and the best he could borrow.

The wise banker, too, should avail himself freely of the best talent available. His problem is to determine <u>who</u> should perform <u>what</u> service <u>when</u> and at <u>what cost</u>. The often misunderstood fact of life is that it takes skill to be a good client.

What the property is worth (appraisal), what the property is worth to a given user (investment analysis) and how much can safely be lent on the security of this property (underwriting analysis) are three separate questions.

Project X is not able to meet its objectives. Is it a bad loan, is it bad real estate, or is it a fundamentally sound parcel either badly handled or hit by short term negative factors (marketing, financing, etc.) that in time will right themselves?

In school examinations, a student who gives a brilliant answer to the wrong question gets little sympathy, and the same is true in the real estate world. The statistical material prepared for one purpose (the development process) may not really relate specifically to another problem (the lending process).

Then, too, academic types are not always equipped to deal with renting and management problems, whereas they may be ideal for hotel or shopping center market analysis; similarly, of course, the reverse would be true of operating people.

For general guidelines, be sure that:

A) the right question is being asked; and

B) the one being asked is properly trained to deal with that particular problem.

Conclusions

Where, then, does all this lead us? To the realization that the effective lender must develop in-house competence; that he should make good use of properly qualified outside professional assistance of proven soundness; that he should be aware of events and trends in the field generally; and, above all, that he must seek that happy balance between deep-seated mistrust and enthusiastic optimism that all of us aim for but few achieve.

In the Rubaiyat, Omar Khayyam wrote:

"Myself when young did eagerly frequent
Doctor and Saint, and heard great argument
About it and about: but ever more
Came out by the same door wherein I went."

Perhaps he was saying that in real estate as in life, those things worth knowing must be learned without being taught; that the chief value of one's own experience and that of others is to ripen the judgment; that common sense and imagination must be applied to all situations; and finally that a gentle, good-natured skepticism may be the best frame of mind with which to approach real estate as well as life generally.