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SELDIN ON CHANGE:

A Strategy for the Rest of the 1990s

by

Maury Seldin, CRE

Dr. Maury Seldin, CRE, is President of the Hoyt Group, which consists of the Homer Hoyt Institute, the Advanced Studies Institute, and Hoyt Advisory Services. Dr. Seldin is also Realtor Chair Professor Emeritus at The American University, Washington, D.C. His numerous books include Real Estate Investment Strategy, Real Estate Market Analysis, and Real Estate Analysis. He received his M.B.A. from UCLA, and his doctorate degree in business administration from Indiana University with majors in real estate.

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A decade ago, Real Estate Issues published the last of a series of six articles, spanning three years, titled "Seldin on Change." The following quotes are taken sequentially:

First, from "Seldin on Change: Betting On Inflation"
(Spring/ Summer 1981)

> "...it should come as no great surprise that most real estate investors are still betting the inflation rate will continue its upward trend or at least fluctuate around current levels. And, of course, it is common knowledge that investors are betting on real estate as a hedge against inflation. Not as obvious is the nature of the bet in terms of risk and reward."[1]
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> "Currently, the concept of leverage among real estate investors focuses on appreciation as well as cash flow...
>
> "While inflation was pushing up interest rates, it was also pushing up rents and expenses, resulting in increasing debt-free cash flow. This rising income stream, sold at higher prices, means lower capitalization rates. Investors will pay more for a rising income stream than for one holding level. The result is prices that are higher when compared to current income. In other words, it means the overall cap rate was low."[2]
>
> "The current market has many property sales in which there is no cash flow. Some use only an amortizing first mortgage, while others have secondary financing. In some cases there is a negative cash flow and the investor has to count on tax savings from tax shelter to offset some or all of the negative cash flow. Some investors are even using 'gimmick' financing to capture the appreciation with a low down payment and in order not to have too large a negative cash flow. For example, the seller may carry back a mortgage at 12

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[1] Maury Seldin, "Seldin On Change: Betting On Inflation," Real Estate Issues, Spring/Summer 1981, Volume 6, Number 1, p. 6.

[2] Ibid, p. 7.

percent but pay only 9 percent of the interest in cash. The other 3 percent accrues so that the mortgage debt increases during the life of the loan."[3]

"...Changes in value occur at differing rates over time because income expectations and capitalization rates constantly shift. Inflation accounts for some of the changes; others occur because of changes in income-producing ability of the real estate."[4]

"...That is the stuff of which big profit is made. Yet most of the high-powered mathematical analyses used in calculating rates of return overlook dealing with the land economics aspects of the real estate investment."[5]

"...A market of expectations may run high or low depending not only on inflation but also on the expected growth of the economy..."[6]

"The danger of some kind of dramatic change during this decade certainly exists. A simple expectation of 'more of the same' in real estate appreciation through inflation with a fair to middling economy is risky. A strategy for the '80s should take cognizance of the risk."[7] [Italics Added]

Second, from "Seldin on Change: A Strategy For Using Leverage" (Fall/Winter 1981)

"In the previous issue of this journal I wrote about the risk of betting on inflation (see Spring/Summer 1981 - "Betting on Inflation"). A decline in the rate of inflation would produce income streams lower than expected. The price paid for such income expectations would also decline. The double whammy would wipe out the "equity" of many highly leveraged investors."[8]

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[3] Ibid, p. 7.

[4] Ibid, p. 8.

[5] Ibid, p. 8.

[6] Ibid, p. 8.

[7] Ibid, p. 8.

[8] Maury Seldin, "Seldin On Change: A Strategy For Using Leverage," Real Estate Issues, Fall/Winter 1982, Volume 6, Number 2, p. 42.

"Since most of us don't really expect the inflation rate to subside in the '80s, we are not ready to give up on real estate or on leverage. Yet, it is prudent to prepare for the unexpected and such preparation is called strategy."[9]

"One way to avoid potentially disastrous results of a downside price movement is to plan on it happening. Prices would drop sharply if the market switched from expecting a rising income stream to expecting a stable or declining income stream. Declining income may come about with individual properties, but if it happens in the market as a whole, many developers who purchased at current prices would simply have to let their real estate go to foreclosure."[10]

"The prudent investor should design staying power on an individual property by not overfinancing it, or for a portfolio by providing for cash flow from some investments in the portfolio to meet the negative cash flow requirements of other investments. Substantial liquid resources are advisable in the portfolio approach because in difficult times the cash flow producing investment may produce less cash than was anticipated."[11]

"A focal point for defensive tactics is the strategic use of leverage."[12]

"Some investors such as pension funds and wealthy individuals who wish to protect their assets buy for all cash and thus do not have much risk of negative cash flow..."[13]

"What makes sense is to plan on a sales price and date with which the investors can live..."[14]

"In developing a safe strategy for the '80s, the projected sales price should be based on current income adjusted only for relative price changes because the location gets better, and on long run capitalization rates. Such projected prices are lower than acquisition costs. The only way the number will work is for the projected sales date to be far in the

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[9] Ibid, p. 42.

[10] Ibid, p. 42.

[11] Ibid, pp. 42-43.

[12] Ibid, p. 43.

[13] Ibid, p. 43.

[14] Ibid, p. 43.

future - so far that one could live with the income stream of the property. Living with the income stream is not just a matter of rate of return but also of liquidity."[15]

"Lenders have learned the hard way about the interest rate risk..."[16]

"Count on time being on your side..."[17]

"To approach timing so that it's on your side, be a bit early rather than a little late. Your rate of return will accelerate with time. If you want to get the absolute highest rate of return, then you need to get in just before the upsweep and get out fast. After the upsweep, time is going to lower your rate of return. If you paid too much and too late, any softening of the market will hurt you."[18]

"Using leverage - sometimes even high leverage - makes sense but everything should not be levered all the way and at once..."[19]

"The currents of the '80s are treacherous and investors who don't paddle somewhere are in trouble. Real estate as a vehicle for moving along is excellent but one must use it properly to achieve the objectives within the risks one is prepared to bear. *Since there is a substantial downside risk, the question is how to prepare for it. Aside from keeping substantial liquid assets, the strategy calls for diversifying the real estate portfolio not only by type of property and location but by leverage.*"[20] [Italics Added]

Third, from "Seldin On Change: New Ratios: What Are They Telling Us?" (Spring/Summer 1982)

"Residential land prices as measured by the Homer Hoyt Institute Land Price Index turned down in late 1981 after a decade of sharp increases. The price increases were greater than inflation rates but less than housing price increases."[21]

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[15] Ibid, p. 43.

[16] Ibid, p. 44.

[17] Ibid, p. 44.

[18] Ibid, p. 44.

[19] Ibid, p. 44.

[20] Ibid, p. 45.

[21] Maury Seldin, "Seldin On Change: New Ratios: What Are They Telling Us?" Real Estate Issues, Spring/Summer 1982, Volume 7, Number 1, p. 39.

"At these prices, a number of things seem to be happening:

> "...Price-per-square-foot pressures are causing tenants to seek economies in amount of space and location, with some shift to lower-priced suburban areas for backroom activities.
>
> "...The pace of building construction looks out of line with long-run requirements, although some structural changes are occurring in local markets."
>
> "...Prices have hurt many retail operations, resulting in greater economies and turnover in space."[22]

"In regards to financing, long-term fixed rate mortgages are basically out; 100 percent financing with equity participation is in, as well as pension funds and foreign money with heavy or all-cash investments."[23]

"Changes Seen As Cyclical And Structural

"The ratio of debt to equity has changed, interest rates have changed and capitalization rates have changed. The price per square foot has changed for residential, retail, office and especially for land. It is not just change over time, but changes in structural relationships. The old rules-of-thumb don't help much.

"Much of the discussion these days is of boom or bust: the Great Depression Syndrome. Are we going to get it again - or worse, are we already there?

"A look at any of the markets will show cyclical activity. In general, amplitudes have increased, and we are getting wider swings in the cycles and maybe different time spans for the cycles.

"Then there are the structural changes. *Long-run structural changes are occurring in the economy. This does not mean that we necessarily have a Great Depression on our hands, but that rather the relationships are different. The national economy is producing different products. Our international position has changed economically. We may be going through an adjustment process different from anything we have previously experienced.*

"We are manufacturing different products and services at different locations and changing our real estate requirements. We are financing the real estate differently. Real

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[22] Ibid, p. 40.

[23] Ibid, p. 40.

estate investment has become riskier. What concerns me is that the decision makers may see only the short trends and extrapolate them. There is no more certain recipe for disaster."[24] [Italics Added]

Fourth, from "Seldin On Change: Implications Of Changing Land Prices" (Fall/Winter 1982)

"Land price increases generate a great deal of interest. Land price declines generate a great deal of concern. Currently, there is a great deal of concern about land prices.[25]

"The downturn in land prices is yet to be fully documented, but a few related points are of considerable interest:

> "*First*, the ratio of land value to building value has increased, at least for housing. In regard to land value as a proportion of land and building value, the housing market is experiencing a situation similar to the boom of the 1920s.
>
> "*Secondly,* the scale of projects and accompanying increases in intensity of land use have increased substantially. The skyline is seeing changes similar to those which occurred in the '20s.
>
> "*And finally*, there are some real questions as to how much additional land is really needed in order to add to the inventory of buildings. Construction activity has declined, which may be partially due to high cost of financing and may also indicate that much more space under current conditions simply is not needed. With the decline in construction activity, there is a resultant decline in the demand for land.

"From an historical perspective it is interesting to note that according to Homer Hoyt's *One Hundred Years of Chicago Land Value*, land value peaked in 1836, 1856, 1873, 1892 and 1926. It may well have peaked again."[26]

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[24] Ibid, p. 40.

[25] Maury Seldin, "Seldin On Change: Implications Of Changing Land Prices," Real Estate Issues, Fall/Winter 1982, Volume 7, Number 2, p. 19.

[26] Ibid, p. 19.

"Inflation and inflationary expectations account for a substantial portion of the change in land prices..."[27]

"Current Trends

"Forecasting by extrapolation will show good results, except for the turning points, and sometimes only the turning points will count.

"It is too early to tell if the back of inflation has really been broken...

"Nevertheless, the expectation surrounding inflation has changed and that tempers the rate of price increases in land. But there may also be some real changes in the demand for land."[28] [Italics Added]

"Now, however, the rise in unemployment is for some communities an overriding concern. The decline in the relative strength of the environmentalists is a tempering force on the pressures for extensive land use."[29]

"Land Policy Implications

"The makers of land use policy are thus receiving signals from a variety of forces that land prices should be declining...

"We have a lot to be concerned about."[30] [Italics Added]

Fifth, from "Seldin On Change: An Era Of Transition"
(Spring/ Summer 1983)

"*The next few years are likely to bring about dramatic changes in real estate investment. These may well be of the magnitude of those experienced in the last half century. We are in an era of transition, and only the character of the transition and the emerging real estate investment opportunities are uncertain.*"[31] [Italics Added]

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[27] Ibid, p. 19.

[28] Ibid, p. 20.

[29] Ibid, p. 20.

[30] Ibid, p. 20.

[31] Maury Seldin, "Seldin On Change: An Era Of Transition," Real Estate Issues, Spring/Summer 1983, Volume 8, Number 1, p. 3.

"It is not intended here to forecast what the change will be, but to consider how the existing stock may be used more intensely..."[32]

"The action in the construction of retail facilities has also changed. At the end of World War II, there was a continuation of the old style strip developments in suburbia, which were street-front oriented. But it did not take long before the shopping centers were in, and the earlier ones had the street-front orientation. What was different was the setback and parking. Then the design changed substantially, and the stores faced inward. Also, the type of centers which were being built kept increasing in size and changed from neighborhood centers to community and then regional centers. Then came the mini-covered malls, the multi-story malls, and, of course, the unique specialty centers of San Francisco, Boston and Baltimore. The only thing consistent about the types of facility being constructed is that they change."[33]

[As a sidenote, the Homer Hoyt Institute of Maryland has published a monograph titled Opportunities in Changing Space and Capital Markets: Retail Single-Tenant Properties.]

"At today's land prices and construction costs, do the numbers work? Maybe they do, if one can find a niche in the market. But, how much more net new space is really needed now?

"The answer for emerging investment opportunities may not be net additions to space but different space. And it may not be new construction. Conversions or reuse may be where the activity is."[34]

"Thus, if there is a great prosperity, a modern day 'era of good feeling,' we could have a boom for additional units on the order of the post-World War II boom, or could it be greater?..."[35]

"...We are in a sense beginning to return to the cottage industry - an ability to work at home, if not all the time, then part of the time."[36]

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[32] Ibid, p. 3.

[33] Ibid, p. 4.

[34] Ibid, p. 5.

[35] Ibid, p. 5.

[36] Ibid, p. 5.

"The Economy

"As this is being written, recent reports indicate that unemployment dropped from 10.9 percent to 10.4 percent and then held steady at 10.4 percent."[37]

"Yes, we are becoming more dependent on the international economy. That means that we have less control today over our own destiny..."[38]

"The U.S. deficit is obscene. It is one of the great shames of our time. Can we overcome it? Perhaps, but not quickly."[39]

"...And if the other forces are also mitigated, inflation could really be brought into line.

"Now what does that mean? Does it really mean that we will achieve high levels of income, output and employment with price stability?

"We might! But, it could be a long slow road rather than a quick transition after a painful adjustment. However, a successful rapid transition to get the necessary institutional reform could give the economy a boom the likes of which we have never seen.

"Will it happen? I don't know. We have a resilient society. Some signs are discouraging yet others give us great hope. *Thus, while the character to change is uncertain, we do know that it is totally unrealistic to extrapolate the underlying forces which have been giving us the great changes in recent years. So we will not get more of the same.*"[40] [Italics Added]

<u>Lastly, from "Seldin On Change: A Time To Buy, A Time To Sell" (Fall/Winter 1983)</u>

"Timing and location are the two most critical variables in an investment decision. If one is able to pick the right time and the right location, one can absorb any loss associated with most errors and still do quite well.

"A substantial body of literature about location exists. A close look at current analyses, however, reveals an inordinate amount of stress placed on numerical analyses rather than spatial analyses. Little hard analysis of the location and the reasons that it is expected to

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[37] Ibid, p. 5.

[38] Ibid, p. 7.

[39] Ibid, p. 7.

[40] Ibid, p. 7.

get better exist. Although the spatial aspect is a favorite topic of mine, I intend to deal with the variable of timing here."[41]

"Judging Location, Timing Factors On Real Estate

"In the case of real estate, it is not so easy to know exactly what the pace was because we don't have the same array of indexes from which to choose. The existing indexes do not have the breadth of coverage of the Standard and Poor's 500. One cannot obtain the details by segments of the real estate market comparable to segments of the stock market, that is, by industry.

"In general, land prices had been increasing for a long time before the recent turndown. Just how long it will be before there is a resurgence is anybody's guess. It could take some time before a long upward trend takes place. It is probable that some locations are not going to improve substantially and that land investments are not appropriate. Indeed, opportunities exist today but timing was better a quarter century before the recent downturn. During that time period, one could hardly go wrong since most locations actually did improve."[42]

"*Currently, however, when one looks at the relationship between rent and financing cost, it is only the favorable depreciation rules and the hope of inflation that give such investments a chance...*"[43] [Italics Added]

"It was a great time to buy when money was cheap. For decades lenders were taking short-term deposits and lending long with only a modest spread. They took the risk of rising interest rates. As the rates for money rose with inflation, lenders increased the rates they charged for money, but they could only increase the rates on new loans. They did not charge enough to be adequately compensated for the risks being taken."[44]

"...When money was cheap, it was the time to borrow..."[45]

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[41] Maury Seldin, "Seldin On Change: A Time To Buy, A Time To Sell," Real Estate Issues, Fall/Winter 1983, Volume 8, Number 2, p. 29.

[42] Ibid, p. 29.

[43] Ibid, p. 30.

[44] Ibid, p. 30.

[45] Ibid, p. 30.

"Lenders have learned to shy away from the risk associated with interest rates. Using variable rates or call provisions, they try to pass on the risk to the borrower. As an alternative, they go to the long-term capital market and issue pass-through securities, so that those who were willing to lend long-term funds are matched off with those looking to borrow long..."[46]

"If one believes that the current long-term rates of interest are really low, then one may decide to borrow lots of money and hope that the rates really do turn out to be low..."[47]

"At current rates of inflation, the real rate of interest is high. Borrowers are paying substantial premiums to lenders for long-term funds because lenders are wary of taking the risk of interest rate again. One might argue that an explanation for the premium at the shorter end of the market is that lenders who have been burned by inflation are taking an opportunity to recover from losses or obtain compensatory profits.

"Many real estate investors who don't think that this is the best time to borrow a lot of money are putting down a substantial portion of the purchase price and, in some cases, they are paying in cash. This practice is aside from pension funds which by their nature are required to buy for all cash. A look at the changing mix of benefits indicates why higher down payments are required."[48]

"This situation leads me to a major point: More attention needs to be directed toward the time to sell. *Many investors who bought real estate at peak prices in the past, now find that inflation has abated and prices have receded. These investors may wish that they had not bought, and the would-be sellers may wish that they had sold."*[49] [Italics Added]

"Real estate should not be so financed that the investor might be forced to sell since the conditions forcing one to sell are the same conditions that make it the wrong time to sell. One must be able to choose the time to sell. Making a good choice may be hard because the future is uncertain. One way to deal with this situation is to sell when one feels that he/she will be under pressure to sell anyway but at a later date."[50]

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[46] Ibid, p. 30.

[47] Ibid, p. 30.

[48] Ibid, p. 30.

[49] Ibid, p. 31.

[50] Ibid, p. 31.

"I believe that real estate investors currently face another risk which potentially could be hazardous to the decline in the rate of inflation. This risk is the change in the tax law. [Italics Added] If one runs the numbers through on the extent of the benefit that one receives with a 15-year depreciation period as opposed to a 40-year period, one will find a substantial difference in annual depreciation. If the difference in tax savings with a 60 percent exclusion is compared to savings with a 50 percent exclusion, one will see that some real estate investments produce a substantial portion of their income because of the favorable treatment of the tax law. That tax law can change.

"If a change to less favorable tax treatment does take place, the mix of benefits will change. There will be less shelter in real estate. If the inflation problem is really solved or abates for a long period, then the proceeds of sales are not going to be boosted up by rapidly growing price levels. Now might well be a good time to sell."[51]

"Importance Of Well-Structured Investment Portfolio

"This is not to say that I am recommending that investors immediately run out and start selling real estate because the battle against inflation is being won and the favorable tax treatment of real estate will be removed after the next election. It may happen, but then again it may not. What I am suggesting is that the real estate investor have his/her total investment portfolio (real estate and non-real estate) so structured that those changes will be tolerable."[52]

[As a sidenote, the Homer Hoyt Institute of Maryland is publishing a working paper titled Real Estate Portfolio Investment Strategy: A Real Estate Paradigm.]

"Similarly, if an investor is going to need substantial amounts of money and he/she has alternative investments which are liquid as almost all alternative investments are, then one could afford to wait it out.

"One may hope for the best, but one should plan for the worst. Instead of just focusing on a time to buy, more thought should be given to a time to sell."[53]

The foregoing series of quotes tells a story - actually a number of stories. What one sees depends on where one stands, much as with an Agamogram - a work of art by Jacov Agam which looks different depending on where you stand. Or, it may look different depending on light

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[51] Ibid, p. 31.

[52] Ibid, p. 31.

[53] Ibid, p. 31.

and/or perception much like a Vasarely - a variation of optical illusions. Whatever the case, a brief reading and single viewing will not give the whole story.

Quality of Decisions

Forecasting. No one is blessed with (or cursed with) clairvoyance. Flawless forecasts do not exist, at least not with consistency. But, any player who is not dealing with forecasts is destined for trouble because he/she does not know what to expect and how to deal with it.

Strategy. Strategy is a way of dealing with the unexpected. One's strategy may be an aggressive strategy, or a defensive one. It may deal with the risk variables of greatest concern and plan for the unexpected. Without a suitable strategy, unacceptable losses are assured, sooner or later.

Analyses. Understanding the system is the first requirement in understanding forecasting and strategy. The set of analyses

necessary to understand the system is the vehicle. Then comes the strategy.

Results. The results for most players in the 1980s were dismal. They simply did not do their homework. They did not pay their dues in advance. When it came time to settle up, the cost was much higher than if they had done their homework by paying the price to learn how the system operates.

The developers, investors, and lenders were not the only ones who paid for the mistakes. Society also paid. The costs associated with the fiasco handled by RTC are enough to seek an indictment of legislators and regulators as well as any fiduciary in a decision making/policy making position. They should have done better. But many decision makers do not listen or understand; or, if they do understand their interests are not aligned with those of their constituency or that of their fiduciary. The decisions could have been better.

The Next Round

Real Estate Depression. Are we in a real estate depression? Certainly! There is enough underemployment of real estate assets and shortage of demand to make the market depressed for longer than a typical cycle.

Will the market recover? Certainly! Some markets will, but as noted earlier, shifts in real estate products occur all the time and some submarkets fade even without depression. Actually, it is nonsense to talk about "the market." There is a series of markets and some will recover. "The market" is some kind of agglomeration of the series of local markets.

Real Estate Opportunity. Yes, Virginia, there is opportunity. It just appears in a different form. It is not development opportunity. It is selective investing and repositioning the properties. It is not debt financing. It is equity investment without debt. It is not syndication, it is securitization.

Some markets are starting to recover, and some segments even justify new construction for special niches. But, the opportunities are different. And, strategy and analyses are still key concepts.

The Players. The structural changes which have occurred give us new roles, if not new players. As an example, institutional investors, particularly the pension funds, did the right thing, but at the wrong time. Now they are wary, and rightly so. But, those that do their homework can profitably get in on the next rise in values.

The old arrangements did not have a suitable alignment of interests between deal maker and investor. Most investors will not tolerate it anymore. But, investors who find the right to get into sound real estate investments can do well. The flurry of initial public offerings of equity REIT's is providing an exceptional opportunity. But, players would do well to understand the system because you can be sure that in time the cap rate arbitrage situation will reverse itself. And if one does not understand how that happens it is not a good idea to be a player.

New Rules

The new rules not only require an alignment of interest, they require analysis, analysis more rigorous than that which had previously prevailed. Investors have not traditionally paid much attention to rigor, particularly not to the rigor of academia which frequently forgot the relevance. The industry has not, as yet, had the revolution in approach. But it is coming. Decision makers are asking for the numbers, particularly for indices. Some even want to understand the system and develop strategies.

We will see what the next decade brings, but I will tell you now there will be some "big killings" and "lots of bodies", to mix the metaphors - the killings will be in the market and the bodies will be of the unsuccessful players. The bodies will in effect have committed suicide because they did not learn how to stay alive. Players who want to stay alive, should start doing their homework.

Good luck with your homework. Trust me on this - it pays.