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Ahead to the Past

by Paul Zane Pilzer

Nine years ago (before minicomputers), I presented a potential real estate equity deal to the investment committee at Citibank with a computer-generated ten-year projection. Most of the previous five days had been spent building the computer model rather than underwriting the local real estate market, and I was extremely proud of my "universal commercial real estate deal analysis model." My enthusiasm was not shared by my superiors, who severely chastised my approach.

The real estate equity investment, they explained, should yield a return greater than the cost of the funds invested based on existing facts, not on speculations about the future. Moreover, my computer-generated escalation of market rental income based on an inflation assumption was ridiculous. True, market rents did escalate in part due to inflation, but the overwhelming determinant of market rent (and property value) was local supply and demand. Moreover, the quality of the individual leasing and management component was also a major factor. The committee sent me back to the local market researching such things as traffic patterns, demographic trends, key development personnel, historical supply and demand relationships, and projected new construction starts.

The First Wave: 1979–1981. Unfortunately, the ravages of inflation in the late 1970s created demand for "inflation protection" by employee benefit plan sponsors and other inflation-sensitive investors. Since real estate prices had been shown generally to keep pace with inflation rates, many jumped on the real estate bandwagon, resulting in the first wave of hyperdemand for prime real estate investments. The increased demand bid prices so high that the only possible fundamentalist justification for a purchase became a decade-or-longer computer model that carried the projections out far enough until the discounted value equaled the inflated price. The computer models usually utilized an assumption for the sale of the property, then ten years older, at the same initial inflated capitalization rate of the original acquisition. Moreover, the theoretical computer models rarely took into account the many individual aspects of a given property and usually applied universal standards (such as 95 percent occupancy and "standard" tenant improvements) to all types of real estate.

From 1977 to 1985, an entire generation of real estate deal analysts was created who only learned the computer-modeling analysis approach, rather than the *real* real estate analysis approach. Some of these technical analysts rose to positions where they became actual buyers of property, using future projection techniques that bore no relation to reality, past or present, and proving (for a relatively short period of time) their own numbers.

The Second Wave: 1981–1984. The first wave of hyperdemand for real estate would have abated in

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the early 1980s with the decline in inflation, but then along came the Economic Recovery Tax Act of 1981. This Act increased the value of real estate tax benefits 223 percent[1] by allowing fifteen-year accelerated depreciation of real property without the usual ordinary income recapture. This created a second wave of hyperdemand for real estate investments by tax-oriented syndicators because the 223 percent increase in the value of the tax benefits could only be realized if the property was sold at an inflated price to a new buyer (who could utilize the accelerated depreciation schedules on a higher base).

Again, demand (this time from the tax-oriented syndicators who typically had little or no prior *real* real estate investment experience) bid prices far above real economic return levels and the technical analysts were again called in to find justification for the prices. These new buyers (syndicators) were even more sensitive to the technical analysts because the tax deferral benefits of real estate do not work unless there is enough asset appreciation with which eventually to pay capital gains taxes on up to fifteen years of tax deductions in the final single year of sale.

Learning *Real* Real Estate Analysis. I was one of the technical analysts in 1979 but quickly learned my lesson the hard way from a seventy-four-year-old widow soon after leaving Citibank in February 1981, having been hired to develop and manage a portfolio of properties for a wealthy family. My first acquisition was a 92 percent occupied, 70,000-square-foot Texas office building for my chairman's mother, who lived in Beverly Hills. She paid $5 million for the property and was told by me that she should expect a 9 percent per annum return.

The first month after purchasing the property I wrote her an exciting letter with her monthly disbursement check explaining that we had upgraded a tenant from 3,000 square feet to 5,000 square feet, raised his rent by 15 percent, and upgraded overall occupancy to 95 percent. She phoned to ask me why her enclosed monthly check (multiplied by twelve) showed only a 4 percent per annum return. I explained that the tenant upgrade required us to spend money on new tenant finish and leasing commissions but that *next month* she would notice it in a higher than expected monthly check. The next month I wrote her that we had leased the former tenant's 3,000-square-foot space, raising total occupancy to 99 percent, and that the enclosed monthly disbursement check was not higher as previously promised because of additional unexpected releasing expenses. But, I promised, the *next month* would more than justify her reduced disbursement. As the months went by, I eventually told my secretary to save each explanatory letter on the word processor for modification the *next month.* My chairman's mother complained that she "hadn't gone to Wharton," so she could not understand why she never got a monthly check even approaching a 9 percent annual return.

I finally recommended selling the property at a substantial profit when I realized that this and most multitenant office buildings do not throw off cash flow at projected levels. Rather, properties are purchased on numbers created at a moment in time; they are always *improving*, and eventually they are sold to a greater fool on the same basis as the original acquisition was made. Later, when investing my own money, I only purchased net-leased properties, industrials, and certain special situations.

Several friends who went into apartment syndications had an even more rude awakening. Apartment buildings outside of major cities are typically of the "garden type." This type of construction usually has a limited real life because 60–70 percent of the costs of construction are for replaceable (every six to seven years) items such as kitchen appliances, carpeting, asphalt parking lots, etc.; by contrast, office buildings typically have 15–20 percent of their original construction costs in "replaceables." Even if rents continued to escalate at 10 percent per annum and operating expenses never increased, the maintenance expenses of replacing 60–70 percent of the property (at inflated prices) linearly over a six-to-seven-year period would eventually consume most of the net operating income.

This was not a problem for the original apartment buyers of the late 1970s because they were able to sell their units to greater fools, who did not un-

[1]Prior to 1981, the present value of the interest-free deferral and conversion of ordinary income to capital gain tax benefits per $1,000 of commercial property was $90.81. The 1981 ERTA fifteen-year ACRS schedule raised this tax benefit per $1,000 of property value to $202.39. See Pilzer, "Real Estate Tax Benefits and Reforms: The Long View," Real Est. Rev., Fall 1985, at 28.

derstand the dynamics of older buildings. Moreover, the second wave of hyperdemand for all types of real estate created by the 1981 Economic Recovery Tax Act escalated prices to levels that even a computer model discounting into the hereafter could not justify. (Many of these apartment syndications were sold on the basis of tax benefits alone.) Unfortunately, the initial success of some early apartment syndications in disposing profitably of their property fueled a massive increase in apartment syndications and the industry is only now coming to grips with the realization that the majority of these will fail.

Where Do We Go From Here? Ahead to the Past. The real estate investment business, like the majority of all industries in the current, relatively stable economic environment, is a zero-sum game. Just as sales of Crest toothpaste can only increase at the expense of Colgate, rents in one location can only increase at the expense of another. If more people are shopping at one shopping center, then fewer people must be shopping at another center. For every person moving into a new neighborhood, one person moves out of an old neighborhood, unless, of course, new housing units are being created. The realization that overall real estate investment is a zero-sum game is the key to returning the industry back to the sanity of the past.

The real estate investment business is not a generic business any more than is manufacturing or sales. A proper analysis of an individual potential real estate investment begins with the realization that each piece of real estate is a unique business unto itself. Occupancy levels for different types of real estate in different locations vary as much as do hamburger sales per hour for different McDonald's restaurants at different times of the day. Additionally, the rental and income levels achieved from a given property are almost as much a function of management quality as sales and profits are for an operating business.

Real estate investment analysis in the future will return to the fundamentals that my older investment committee members tried to teach me at Citibank, even though I had to go out and learn it for myself. The winners in the future game of real estate investment analysis will be the underwriters who are willing to do the research into the fundamental intrinsic dynamics of specific properties, one by one. Unfortunately, the unavoidable crash from the two waves of hyperdemand of the past decade will permanently sour many of the new investors that recently entered the market, particularly the employee benefit plan sponsors and the individual syndication investors. ■