

# Real Estate Review

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The Real Estate Institute of New York University



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## Editor's Corner

NORMAN WEINBERG

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We are repeatedly impressed with the ability of Paul Pilzer to spot trends in the real estate and financial markets and to describe their root causes so precisely that we are forced to ask ourselves why we also had not recognized the self-evident direction of change.

### A TWO-PREMISE ARGUMENT

Paul Pilzer's argument in this issue ("Why the Volume of Real Estate Sales Will Decline") is logically developed and its thrust seems indisputable. But his position is stated so strongly that the reader is tempted to examine the evidence carefully to find exceptions. Pilzer's argument has a major premise and a minor premise. Major: "Buyers and sellers of institutional-quality commercial properties" are unlikely to hold "widely differing opinions about the value of specific properties," therefore their properties trade only if there is a "functional reason for the exchange." Minor: Most of the important functional reasons have disappeared or are disappearing.

Pilzer clearly demonstrates that his minor premise is true, and the disappearance of certain institutional relationships certainly reduces motivation for institutional property transactions. But some observers argue with the major premise, and some assert that new functional reasons will emerge when old ones disappear.

### *Do Sophisticated Buyers and Sellers Really Always Agree?*

What is a sophisticated buyer or seller? One definition is, "Someone who agrees with me." If we assume that all parties to all transactions are institutions with similar goals, similar time frames, degrees of risk aversion, and accounting systems who employ teams of number-crunchers using similar computer programs, all institutions will arrive at the same conclusion about each and every problem they analyze.

But institutions do differ. Japanese firms, for example, have become major purchasers of U.S. properties because, although they have access to the same discounted cash flow analyses as other investors do, they have been bringing different standards (time frames, return requirements) to their analyses.

During times of uncertainty, the differences among analysts decline. Everybody has a short horizon; everybody is risk averse. During periods of growth and optimism, however, divergences emerge. How long will the boom last? Two years, four years, indefinitely? Advocates for each view emerge. The identity of opinion, not only about the value of an institutional-quality building but about what *is* an institutional-quality building, begins to evaporate. And so, a basis for transactions is created.

No one can quarrel with Pilzer's conclusions, but the extent and directions of the decline in investment-quality building transactions may be exaggerated by his arguments.

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# Real Estate Dealing

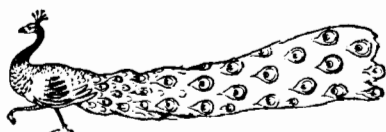
PAUL ZANE PILZER

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## WHY THE VOLUME OF INSTITUTIONAL REAL ESTATE SALES HAS DECLINED

Commercial real estate brokers selling institutional-quality properties had a tough time in 1987 following tax reform and a decimated real estate market in some formerly booming areas of the country. Many listed properties may not really be for sale. Furthermore, there are long-term forces that point to a permanent decline in the number of institutional-quality properties that change hands.



During the first half of 1987, the author's company submitted written offers to purchase forty-two different commercial properties ranging in price from \$8 million to \$224 million. Virtually all of the properties were owned by major domestic financial institutions and were exclusively listed with known commercial real estate brokers or investment banking firms. As of January 31, 1988, only one of the forty-two properties had been sold to anyone. The company was able to purchase only one property in 1987, although it had purchased sixty-two properties from 1982-1986. Other real estate investment firms report similar experiences, although they have significantly increased capital availability for real estate investment.

### ARE LISTED PROPERTIES REALLY FOR SALE?

Most investors consider that a property is for sale when an owner lists it with a broker at a specified price. Sophisticated investors are aware that a property is really for sale only when there exists a functional reason that would cause a reasonable buyer to pay more for it than a similarly reasonable seller with the same underwriting criteria would believe it was worth to retain it. Absent

these functional reasons, the market for institutional-quality properties has become so sophisticated that rarely do a buyer and seller disagree fundamentally on a property's current or future operations.

Experienced buyers recognize that many property listings are merely broker/seller-generated listings rather than real listings. A broker-generated listing is a listing obtained by a broker because of his supposed ability to procure for the seller a price higher than the seller's perceived valuation. A seller-generated listing occurs when the seller who has no functional reason to sell decides that since the broker's time costs him nothing, he may as well put the property "on the market" at a ridiculously high price. A real listing exists when a seller has a functional reason to sell a property by a specific date and contracts with a broker to assist him in getting the highest price available during his time frame.

### THREE TYPES OF FUNCTIONAL REASONS FOR PROPERTY SALES

Functional reasons for *property* sales can be classified into three categories: utility, managerial, and financial.

#### *Utility Reasons*

One utility reason for a sale occurs when an owner is moving from a certain location and has no further use for the property. Another utility reason is that the owner is no longer the highest and best user of the property. Institutional-quality properties (which by definition exclude single-family homes and most single-user commercial properties) are rarely sold for utility reasons. Moreover, most institutional-quality properties are usually developed to their highest and best use.

#### *Managerial Reasons*

A managerial reason for a sale occurs when a nonuser investor no longer has the interest or the capability to manage the property. Sales for managerial reasons of institutional-quality properties are steadily declining due to the increased availability of sophisticated third-party management by specialized companies and developers themselves.

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*Financial Reasons*

Three examples of financial reasons explain why a sophisticated seller would sell to a similarly sophisticated buyer: (1) The property is worth more to a new buyer because of his ability to receive higher tax benefits related to his higher purchase price; (2) the seller is making a significant book profit on the sale primarily because he carries it on his books at lower-than-market value due to general accepted accounting principles (GAAP); and (3) the seller has a genuine need, unrelated to the sale, for the funds.

Sales for financial reasons, the primary force behind the real estate sales explosion that occurred in the first half of this decade, are declining because of three developments:

- The Tax Reform Act of 1986 (TRA '86);
- Changing accounting methodologies for the new types of real estate owners; and
- The increased availability of nonrecourse, fixed-rate, and participating debt instruments.

These three reasons explain the dearth of real estate sales in 1987 and the declining expectation for financially based real estate property sales.

**THE TAX REFORM ACT OF 1986**

TRA '86 ended the effect on the real estate industry brought about by the Tax Reform Act of 1976 (TRA '76) and geometrically compounded by the Economic Recovery Tax Act of 1981 (ERTA). TRA '76 effectively eliminated the syndication of tax benefits in non-real estate partnership investments because it disallowed limited partner losses in excess of the amount those partners had at risk. As a result, the tax-oriented syndication industry shifted almost exclusively to real estate investments. The effect of TRA '76 on nonresidential commercial real estate was that the present value of the tax benefits per \$1,000 of gross asset value could be sold for \$90.81,<sup>1</sup> which was more than the required equity investment on a real estate investment leveraged at more than 91 percent. However, TRA '76 had a negligible effect on real estate sales because the \$90.81 per \$1,000 tax benefit was available equally to existing and new owners.

ERTA had an enormous effect on nonresidential real estate sales because it raised the present value of the tax benefits per \$1,000 of gross asset value in nonresidential commercial property from \$90.81 to \$202.39 or 123 percent.<sup>2</sup> However, the

benefit was available only to new owners of the real estate. (The effect was even greater for commercial residential real estate.) Even if two commercial property owners sold each other their identical properties, each received an immediate gross value increase of approximately 11 percent, or \$111.58 (\$202.39 - \$90.81) per \$1,000 of value. Moreover, to remain competitive, the owner of a typical \$10 million commercial property was virtually forced to sell because the present value of a new owner's tax benefits alone was \$2,025,900, far more than the prior owner's maximum \$908,100 in tax benefits. Indeed, it was usually more than the new owner's total equity investment. The commercial real estate brokerage business surged from 1981 to 1986 as the increased value of a property that merely changed hands was a minimum of 11 percent, whereas the cost of the sale was a typical one percent to 3 percent brokerage fee.

Unfortunately, few in the real estate industry recognized that all of these tax benefits to owners of commercial property came at the direct expense of the citizens of the United States and were accompanied by no corresponding social benefits. There is evidence that Congress never contemplated accelerated cost recovery system (ACRS) depreciation benefits for anything other than new construction<sup>3</sup> but made a legitimate mistake. This mistake added approximately \$100 billion per year to the federal deficit from 1981-1986, or put another way, it put \$500 billion (approximately 25 percent of the national debt) in the hands of already wealthy real estate owners at the expense of the American public.

TRA '86 drastically reduced real estate tax benefits for existing partnerships for a 1987-1989 phase-in period, but its immediate effect was to eliminate them for all post-1986 acquisitions. This effect was massively felt in 1987 as existing real estate values fell. The real estate brokerage industry may recover from the financial reduction in real estate values as sellers grow accustomed to their reduced property values, but it will not recover from the elimination of the massive 11 percent gross value increase that used to occur when a pre-1981 owner sold to a purchaser eligible for tax benefits.

<sup>1</sup> See Pilzer, "Real Estate Tax Benefits and Reforms: The Long View," 15 REAL ESTATE REVIEW 28 (Fall 1985).

<sup>2</sup> *Id.*

<sup>3</sup> Under the Economic Recovery Tax Act of 1981, real estate that was sold after 1981 by, and leased back to, a pre-1981 owner was ineligible for ACRS depreciation benefits, reflecting the fact that no new construction (stimulating the economy) had occurred.

**THE EFFECT OF CHANGING ACCOUNTING METHODOLOGIES**

Historically, most of the institutional-quality commercial real estate in the United States has been owned by public companies or the larger life insurance companies for their general accounts. Under GAAP, these owners must carry their real estate on their books at original cost less an annual deduction for depreciation, although, usually, the property is actually appreciating in value. Thus, for these owners, the most important determinant of the book value of their real estate is the length of time they have owned it, and the book value is far less than the intrinsic value of the property.<sup>4</sup>

When a real estate owner subject to GAAP sells a property, it usually books a large profit even though it may have sold the property at a substantial loss. For example, a public company may have purchased a property for \$10 million in 1981 and depreciated it \$600,000 per year for seven years down to \$5.8 million. If it then sells the property for \$8 million in 1988, it can report a \$2.2 million extraordinary profit from the sale.

A life insurance company traditionally purchasing property for its general account finds itself in the same situation. Not too long ago, a major life insurance company sold 600,000 square feet of industrial buildings with a book value of \$7 per square foot for approximately \$17 per square foot; it simultaneously purchased virtually identical adjacent property for \$21 per square foot. It was able to report a \$10-per-square-foot (\$6 million) profit on its wise sale.

Unfortunately for the real estate brokerage industry, both of these types of accounting methodology-motivated sales are rapidly declining because (1) fewer public companies own real estate, and (2) the larger life insurance companies are now purchasing property primarily for special accounts (usually commingled pension fund accounts), which reappraise their property on an annual basis.

During the past decade, public companies with large real estate (and other asset) holdings realized that they were sitting ducks for corporate raiders who could see the value that the stock market would not let them publicly recognize on their GAAP-prepared statements. Many of these companies have shed their real estate through sale-leaseback transactions, which, in addition to letting them sell the tax benefits during the 1981-1986 period, let them put the difference between book and market values on their financial state-

ments. Today, sophisticated corporate treasurers rarely own their commercial real estate or, if they do, find creative methods of keeping it on the books at its market value.

The majority of the institutional-quality commercial real estate purchased today is bought directly by employee benefit sponsor plans (pension funds) themselves or by special accounts owned by them but managed by real estate advisory firms or large life insurance companies. These pension fund owners annually reappraise their properties at market value and thus do not have accounting methodology-based motivations for selling.

**INCREASED AVAILABILITY OF NONRECOURSE FINANCING**

Perhaps the most important reason for the reduction of the number of sales of institutional-quality properties has been the increased availability of nonrecourse financing. Nonrecourse financing today is available in virtually limitless forms, reflecting both the maturing of the real estate finance industry and the massive tax and accounting advantages for both borrowers and lenders.

The effect of the emergence of new financing firms may be best explained by examining the options of a typical potential seller of a \$10 million property that the owner developed five years ago for \$7 million and that he depreciated down to a book value of \$5 million. If the owner sells the property for \$10 million, he incurs a minimum ordinary income tax liability of \$1.4 million (28 percent) on his \$5 million gain. His tax liability may be significantly greater if he has taken accelerated depreciation or received any investment tax credits, which must be recaptured. Thus, after paying a typical 2 percent brokerage fee (\$200,000), the seller stands to net \$8.4 million (\$10 million - \$1.4 million - \$200,000) before title fees, transfer fees, and other sales expenses. The same owner could probably obtain a nonrecourse, fixed-rate loan for \$7.5 million (75 percent of value), or he could borrow up to \$9 million (90 percent of value) on an equity participating basis. These sums are available to him tax-free, usually for a one-point financing brokerage fee. Moreover, if the owner could hold onto the property until his death, the IRS grants his estate permanent forgiveness for all of his

<sup>4</sup> See Pilzer, "Holding On to Prime Real Estate," 15 REAL ESTATE REVIEW 62 (Winter 1986).

prior tax deductions and excess refinancing profits.<sup>5</sup>

In response to the existence of these advantages for tax-oriented owners who refinance rather than sell, the institutional real estate investment market has developed numerous equity participation debt programs that offer owners virtually unlimited options for obtaining (tax-free) 90 percent or more of what they could receive (pre-tax) from a sale. Although the tax advantages of refinancing over selling existed prior to 1987, they were increased greatly by the elimination of the tax rate differential on capital gains and by the fact that the depreciation deductions themselves taken on post-1981 acquisitions were increased over 200 percent.

More important, these participating debt programs offer advantages to investors subject to GAAP accounting for the same reasons that penalize such investors for owning real estate. An investor subject to GAAP who wishes to participate in the ownership advantages of a building can offer a better deal to the owner if it gives the owner equity-participating refinancing rather than buying the building. The obvious advantage to the institutional investor is that it does not have to depreciate its appreciating investment. It can even creatively structure its participating debt investment with an accrued interest feature that allows it annually to book a part of the property's appreciation.

The development of a sophisticated liquid market for participating mortgage instruments has had advantages for both existing owners and potential investors, but the market for these participating mortgage instruments has become so efficient, it is not unusual to see a pension fund that wishes to diversify its portfolio obtain participating debt on its own real estate investments rather than sell them, with no obvious tax or accounting advantages. This development alone has drastically reduced the number of sales of institutional-quality commercial real estate.

Since an institutional-quality property is by definition stable and third-party management is easily obtainable, even tax-insensitive institu-

tional property owners, when they seek extra cash, sometimes find it advantageous to refinance rather than to sell their holdings.

#### CONCLUSION

In today's sophisticated real estate market, it is unlikely that sellers and buyers of institutional-quality commercial property hold widely differing opinions about the value of specific properties. Thus, although many properties may be listed with brokers for sale, wise real estate principals steer clear of those properties if they perceive no functional reason for a sale. Functional reasons were categorized above as utility, managerial, and financial.

However, with respect to the much sought-after institutional-quality commercial properties, there are virtually no utility reasons for sales, and managerial reasons for sales have declined with the development of quality third-party management firms. Financial reasons for sales may also be waning with the elimination of unique tax benefits for new owners, the adaptation of different accounting methodologies for new types of purchasers, and the increased availability of non-recourse financing.

Institutional-quality properties have never been easy to acquire and have typically traded at values above those suggested solely by their current cash flow. The evidence suggests that some of these higher prices may have been justified. The prices for the blue chips of American real estate are continuing to increase as fewer are put on the market. Additionally, the recently developed participating debt market may become even more attractive for owners of real estate as rates decline. This development reflects increased competition among financial institutions who want a piece of the real estate appreciation market but are unable to justify purchasing the properties themselves. As a consequence, even fewer institutional-quality properties may be put up for sale.

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<sup>5</sup> *Id.*