

Real Estate Review

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The Real Estate Institute of New York University



Available high-ratio mortgages revalidate grandmother's advice.

Holding On to Prime Real Estate

Paul Zane Pilzer



THE DOMINANT INDIVIDUAL owners of commercial real estate in virtually every market rarely, if ever, sell their property. This observation seems to hold true for the Harry Helmsley's and Trammell Crow's of our major cities as well as for the individual families that typically dominate our smaller towns. Often an individual

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owner of a prime property will quote her grandmother's deathbed request that she "not sell anything."

In these days of deep shelter real estate investments, ten megabyte personal computers, and probability distributions of expected internal rates of return, could it be that grandmother's advice still holds?

This article is concerned only with prime income-producing commercial real estate. Such real estate consists only of leased-up shopping centers, office buildings, and industrial properties, all of which have the

following two attributes in common: They require a minimum of management and they have maximum appreciation potential because of their locations and large quantity of fee-titled land. This type of real estate is the only property worthy of the designation "passive investment." Properties like garden apartments, condominiums, land holdings, and single-use properties are forms of "active venture" capital investments in the real estate business.¹

TERMS OF THE PARTICIPATING/ACCRUING MORTGAGE

Historically, the major insurance companies were the traditional providers of funds for long-term non-recourse investments in prime commercial real estate. Typically, these companies had specific, predetermined long-term yield requirements built into their cost of funds (actuarial tables on whole life insurance policies), and they therefore were long-term, fixed-rate lenders. As fixed-rate lenders, they required generous coverage ratios of 125-130 percent in their underwriting.² This meant that a traditional fixed-rate mortgage could be obtained only for approximately 70-75 percent of a property's total value.

Today, the providers of funds for long-term non-recourse investments in prime commercial real estate are mainly pension funds, savings and loan associations, and major insurance companies which do not have specific predetermined fixed-rate costs of funds. These lenders no longer commit to terms as long as they did a decade ago. The shorter term is accompanied by the desire for a floating, indexed interest rate with accruals above a fixed constant, or some sort of equity participation in the collateral property that provides the lender with inflation protection. In order to obtain the floating rates or the equity kickers (whereby they effectively purchase some part of the equity ownership above their own fixed-rate mortgage investment) in a competitive environment, the traditional long-term lenders have lowered their coverage ratios to 110-115 percent. This means that they now offer loans equal to 85-90 percent of appraised property values. This amount is close to the gross amount that a property owner may realize from a sale.

Mortgage transactions that include equity kickers are really partial sales/partial acquisitions of real property. But when they are properly structured, the taxing authorities do not treat the borrowers as if they have made partial sales, and the financial regulatory agen-

cies, which usually frown on nondebt investments, do not consider that the investor-lenders have made partial acquisitions.³

ADVANTAGES OF BORROWING OVER SELLING

The new higher-lending-limit mortgages are not quantitatively superior to property sales. But the advantages can be shown by comparing the relative numbers of the alternative options. Assume that an investor owns a property with a \$5 million depreciated basis that he can sell for \$10 million. The sale would net the investor only approximately \$8.76 million after he pays a \$300,000 (3 percent) brokerage commission and \$940,000 in capital gains taxes (\$4.7 million capital gain after commission times 20 percent capital gains tax rate) and he probably would have other selling expenses such as title insurance. The same investor could borrow (tax-free) \$8.5 million to \$9 million in a participating/accruing mortgage, and have as a cost perhaps an \$85,000-\$90,000 (one percent) mortgage brokerage fee. Furthermore, the owner/borrower may be able to take advantage of the fact that properties often are sold on "audited last year's numbers," but can be refinanced on "projected next year's numbers."

There are additional advantages to refinancing. The investor who refinances instead of selling still owns his property, and he can usually refinance it again and again for more money every few years. Another reason for refinancing rather than selling a property is the federal tax rule that grants estates a "stepped-up basis" on the death of an owner. For the purpose of computing capital gains tax, the estate of a deceased property owner may step up the basis of an asset to its market value at the time of the death without paying any taxes. This means that an investor's tax deductions based on the depreciation of real property are permanently forgiven from income taxation if he can hold onto the depreciated investment until his death.

WHEN SHOULD AN INVESTOR SELL A PROPERTY?

Notwithstanding the foregoing analysis, there are three circumstances in which an investor should sell a property even though he can refinance it with nonrecourse debt that produces almost the same amount of money. They are the following:

- The real property value is declining.
- The property requires excessive management.
- The property has "windfall" value.

¹ For a discussion of real estate appreciation and passive investments, see Paul Zane Pilzer, "Characteristics of Properties Suitable for Syndication," 14 REAL ESTATE REVIEW 44 (Winter 1985).

² A coverage ratio of 1.25 or 125 percent means that a lender requires that expected net operating income be at least 1.25 times the debt service before it makes the loan.

³ Generally, a lender whose loan contains an equity kicker is not considered to be a partner for tax purposes unless the loan agreements contain certain "elements of ownership," including the right to participate in management and sales decisions and to receive continual benefits after the loan is repaid.

The Declining Value Property

When the investor forecasts a long-term decline in the dollar value of a property, a decline that may occur even in an inflationary economy, possibly because of a changing neighborhood or the expiration of a major unreplaceable lease, the investor should sell rather than refinance. The investor may be tempted to gamble on the potential gains from the possibility that the property may turn around, because he has downside protection from the fact that nonrecourse financing and subsequent foreclosure would yield almost as much money as a property sale. But this gamble is not worth the risk to the investor's reputation if he has to relinquish the property to his lender.

The Management Problem

When a property's continued viability requires a degree of management that the investor is no longer able to provide, either by himself or through third parties, he should sell it. This circumstance usually arises in management-intensive, nonprime properties like garden apartments. But even the owner of a first-class (prime) property may discover that because of changing circumstances, such as severe overbuilding in the area and the emergence of competitive properties or because of the termination of a long-term major lease, he must now undertake substantial active management for which he may lack either inclination or expertise.



Windfall Values

An investor should sell a prime property if it has acquired a "windfall" value to a specific purchaser/user who will be forced to go elsewhere if the investor does not sell him the property. For example, an investor may own an industrial, retail, or office property adjacent to another similar property to which its owner-user has made substantial improvements. The neighbor's business has greatly expanded, and the only way he can accommodate its growth is to expand onto the in-

vestor's property. The value of the investor's property to the neighbor, when he considers the cost of abandoning all his improvements if he must relocate, may be two or three times the value of the investor's property to an independent purchaser. The investor should sell the property to the neighbor at a higher-than-market price because the windfall is evanescent, and, should it disappear, the value of his property will drop back to market levels.

Of course it may be possible for this investor to have his cake and eat it too; that is, to receive the benefits of the windfall sale *and* the benefits of a tax-free refinancing. The investor should arrange a short-term lease of the property to the neighbor while he searches for and locates a nearby larger property for a 1031 tax-free exchange and subsequent refinancing.⁴ The double windfall that may occur here is that if the investor sells his property (via a tax-free exchange) for twice its third-party market value, he also should be able to refinance his newly acquired property for almost twice the market value of his original property. In such an extreme windfall case, the investor nets the double benefit of the windfall sale and a subsequent tax-free refinancing.

WHY ARE GOOD PROPERTIES STILL OFFERED FOR SALE?

If an investor can net virtually the same funds from refinancing a property as he can from selling it, why do owners continue to offer good properties for sale? The three circumstances above are special situations and account for but a small proportion of sales. But we have been thinking of the owner as a long-term investor. Corporations, financial institutions, developers, and limited partnerships all encounter circumstances in which they wish to dispose of properties. Following are the four major reasons why prime commercial properties are still sold rather than refinanced:

GAAP. The property is owned by a financial or corporate institution governed by generally accepted accounting principles (GAAP) or other regulatory accounting principles (RAP), which allow it to recognize a property's appreciation only upon sale. Since most of the major investors in real estate are financial institutions, this is the major reason that prime properties are offered for sale.

GAAP again. The property is owned by a financial institution governed by GAAP or other RAP, which do not permit the accurate recognition of non-recourse refinancing as tax-deferred profit-taking.

⁴ Section 1031 of the Internal Revenue Code allows an investor to exchange a property for a similar property (like for like) without any tax consequences provided certain conditions are met.

□ *Developer's needs.* The average creator of new prime commercial properties (the developer) is much more sophisticated in construction and leasing than he is in finance and tax. He may fail to focus on the after-tax effect of a sale versus a refinance even though it may be even more significant to him than to the ordinary owner/investor because the developer has usually expensed many costs of the property's development which will be recaptured upon sale. The developer is certainly an owner who encounters the management problems that were discussed earlier. He either cannot or does not want to be burdened with management problems.

□ *The limited partnership dilemma.* An internal conflict arises in a syndicated limited partnership that owns a property after the limited partners have received virtually all (99 percent) of their tax deductions. They are in the position of the owner/investor whom we have been discussing. But the general partner, who usually receives a residual profit upon sale, makes the refinance/sale decision. In such a case, the best solution for the limited partners (tax-free refinancings until death) is not the best answer for the general partners who have no depreciation to recapture upon sale and may not want to pass an illiquid partnership interest through their estates.

The first three reasons account for the overwhelming majority of sales of prime commercial properties. The last reason will probably become more important as some of the properties acquired during the syndication boom of the 1980s increase in value.

CONCLUSION

Properly chosen prime real estate investments rarely lose their appreciation potential. In fact, their investment stability is so great that financial institutions compete to make nonrecourse loans up to 90 percent of their total value. Current estate taxation rules allow an investor permanent tax shelter on the tax deductions from a real estate investment if he can hold onto the property until his death. The ability to borrow, non-recourse, up to 90 percent of total value plus the potential for permanent tax shelter means that few individual investors today can justify selling a prime property.



Fortunately for individuals, the current accounting and financial regulatory environment does not encourage financial institutions and other public entities to take advantage of this outstanding leverage opportunity. Publicly regulated companies are not allowed to "book" the appreciation of their real estate until sale. This forces them to sell prime properties with remaining appreciation potential in order to satisfy shareholders' needs for continual earnings increases.