Seldin On Change
BETTING ON INFLATION

by Maury Seldin, C.R.E.

The Mouse That Roared, now a vintage movie, depicts how a tiny country is going to escape its economic difficulties by declaring war on the United States. The country plans to lose and then become prosperous with U.S. aid. But someone asks in the movie, "What happens if we win?"

Inflation Rate Continues Climb

No one has seen many "WIN" buttons lately — those emblems of President Ford's "Whip Inflation Now" program which did not work. Neither did President Carter's program, which relied heavily on the Federal Reserve Board policy. Since October 1979 that policy has been to observe the money supply as the salient indicator for monetary control. This may be a step in the right direction, but the road is long and hard.

Factors causing inflation include OPEC, the federal deficit, and the lack of gains in productivity combined with domestic wage pressures. It is to be hoped that President Reagan will be more effective in containing inflation. Until there is concrete evidence, however, 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.

This article inaugurates the Seldin On Change *series which will be a regular feature in REI. Through these articles, Dr. Seldin will attempt to explore the problems of change in the real estate industry and evaluate plans and strategies for survival.*

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Cash Flow Early Benefit

Thirty years ago, investors expected from 10 percent to 12 percent cash-on-cash, also called cash on the down payment. The rate of inflation in the early '50s was low, and although some investors who were astute in location and property selection expected substantial appreciation, most investors looked to the cash flow as *the* major benefit. Properties of lowest quality would return the down payment through cash flow in the first five years and those of better quality in periods up to 10 years or longer. Measurement of the payback period is a crude method for an investment decision. Although users may have considered the tax shelter, it was viewed as an added benefit that went along with the type of investment.

Some investors used criteria beyond cash flow. Aside from tax shelter, the other benefit is proceeds of sale, the importance of which varied considerably. Combined measures of total benefit were not commonplace, however. The after-tax internal rate of return was not a popular analytical tool. It could be estimated using tables and a desk calculator, but such laborious work was obviously not worthwhile to most investors because the results were of specious accuracy.

Borrowed Money As Later Leverage

As the inflation rate rose in the '60s and '70s, an interesting phenomenon occurred. A new variety of leverage, commonplace in the financial community, occurred for real estate investors. In dealing with securities and non-real estate investments, the finan-

cial community traditionally defined leverage as the use of borrowed money to magnify gains or losses as it related to total gains. No concern existed as to whether the stock dividend produced enough income to pay the interest on funds borrowed to acquire stock. If more money eventually was made on the borrowed money than it cost in interest, then the financial leverage was viewed as favorable.

Real estate investors used a different concept of leverage. To them the garden variety of leverage was the use of borrowed money to magnify cash-on-cash which fit into the "get your equity out fast" approach. This worked because the annual constants were lower than the overall capitalization rate or the ratio of debt-free cash flow to purchase price. Thus, the more borrowed, the higher the ratio of cash flow to down payment. For example, a $60,000 loan at 8 percent interest with an annual constant of 9 percent has monthly payments of $450 or annual payments of $5,400. If the property has a $100,000 price with $10,000 net operating income or debt-free cash flow, the overall cap rate is 10 percent. Under these circumstances, a $40,000 down payment would get $4,600 cash flow or 11.5 percent. A $30,000 down payment would get a higher cash-on-cash return; the $70,000 loan would take $6,300 a year and the $3,700 balance on $30,000 would provide a 12.3 percent cash-on-cash return.

Because institutional lenders generally lend only up to 70 percent or 80 percent of the purchase price, some buyers would get sellers to carry back financing so the down payment could be low and still get cash flow. If payments on the second were interest only or otherwise low, the cash-on-cash, that is, cash on the down payment would be further increased. Generally, the payment on the second was 1 percent per month of the original unpaid balance including interest. Thus, the annual constant of 12 percent hurt the cash flow but was most suitable for investors who considered the leverage to encompass the benefits of proceeds of sale. They controlled more property with less money and were betting on appreciation.

Focus Now On Appreciation

Currently, the concept of leverage among real estate investors focuses on appreciation as well as cash flow. The rising inflation rate has caused a situation in which borrowing money generally hurts the cash-on-cash return. The increase in the rate of inflation has led to an increase in mortgage interest rates. These rates were the lender's protection, which did not work out well for the lender. Thus, the annual constants rose by amounts commensurate with rising interest rates.

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 high when compared to current income. In other words, it means the overall cap rate was low.

When the annual constant exceeded the overall cap rate, borrowing began to hurt the cash-on-cash return. Borrowers would gladly give up the cash flow as long as they are paid for it in appreciation supplemented with tax shelter. This leverage is unfavorable if evaluated only on a cash basis. It may be called "leverage unfavorable to cash flow," which may still magnify gains but diminish the ratio of cash flow to the down payment.

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 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.

Investors are betting on inflation; some accept a low cash flow, while others take a negative cash flow, using what was described earlier as leverage unfavorable to cash flow. The final rates of return on the investment are sensitive to proceeds of sale, especially if "gimmick" financing causes mortgage debt to increase rather than amortize.

Rates Subject To Constant Change

Proceeds of sale are frequently forecast by extrapolating or projecting a rate of appreciation. Although convenient for mathematical analysis, this treatment

bears little relationship to reality. 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.

The change in rental income from non-inflation-related causes is based upon changes in the productivity of the real estate: the location may get better; the demand for the type of space may increase sharply; the supply of competitive space may be choked off by sewer moratoria or restrictive zoning. 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.

Such changes affect income-producing ability, but what is sold is the income-producing potential. A market of expectations may run high or low depending not only on inflation but also on the expected growth of the economy. These are all implicit in any expectations of future income-producing ability. Furthermore, these expectations are much more variable than the income-producing ability itself. The result is that both the income that is being capitalized and the capitalization rate for converting that income to value are subject to change. The cap rate will change with the supply and demand of investment capital and the expectations of future economic conditions. It is apparent that the general health of the economy and inflation expectations are factors again.

So what happens if inflation is contained or even reduced? What happens if there is a slow growth in the economy even without a deep recession? The answer is that some investments and some investors won't make it.

Spirit For Survival Still Exists

It is unlikely that inflation will abate or that the economy will stagnate in the '80s. The economy is hyped up on the drug of deficit spending and has a cancerous attack of "economic distortus energitus," attributable to "cartelistic stick-it-to-em-itus." It is not fatal, however, because enough spirit still exists to keep this country from dying a whimpering death in bed. Rather, it will fight for survival. While it doesn't necessarily mean war, a war sure would change the economy. Even with a peaceful '80s, that is, a no-combat situation, the drastic adjustment might well take place in the '90s, if at all.

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 this risk.

Coming in the next REI: Strategy Of Using Leverage