Seldin On Change
A STRATEGY FOR USING LEVERAGE

by Maury Seldin, CRE

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.

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.

In this issue I will discuss the strategy of using leverage to capture the gain from increasing inflation while at the same time considering the downside risk.

Downside Price Movements

A downside price movement of real estate is less likely to occur than runaway prices. But the low probability is no consolation to the investor who has to live with disastrous results.

This article is the second in a series by Dr. Seldin, which will focus on the problem of change in the real estate industry.

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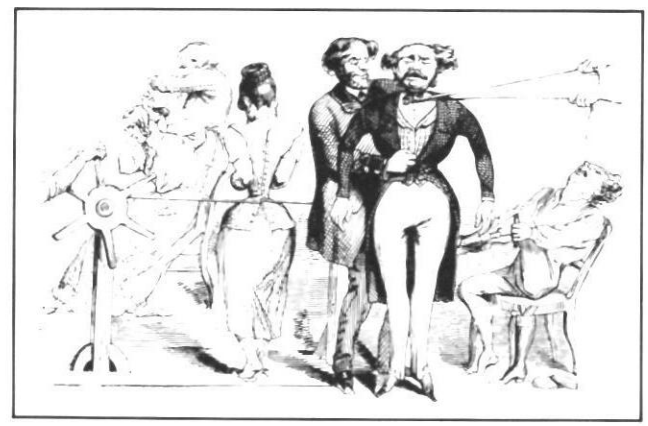

One way to avoid potentially disastrous results of a downside price movement is to plan on it happening. Prices would drop sharply if the market switched from expecting a rising income stream to expecting a stable or declining income stream. Declining income may come about with individual properties,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

A sharp price drop would be a reflection of changed income potentials and the prices paid for income potential. The prices paid would drop sharply because of the combined effect of a lesser income expectation and an increase in the capitalization rate. Thus, it would be the worst time to unload investment real estate.

Over time we could expect a recovery: the income expectation would rise and capitalization rates would move back toward their long run trend. The investor could obtain a reasonable price.

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.

Leverage As Part Of Defensive Tactics

A focal point for defensive tactics is the strategic use of leverage.

If one has an aggressive strategy, that is, fairly high risk in order to get high reward, then all of the cash flow may be sacrificed in order to capture the appreciation with as little cash as is practicable. The extent to which cash flow has to be given up is first limited by the amount a lender or seller will finance and then by the extent to which the annual constant exceeds the overall capitalization rate.

The annual constant is the ratio of annual mortgage payments to original balance of the mortgage. The overall cap rate is the ratio of debt-free cash flow to acquisition price. To the extent that the annual constant exceeds the overall cap rate, additional borrowing disproportionately reduces the cash flow. With interest rates rising more rapidly than capitalization rates, investors find that the mortgage repayment requirements sop up cash flow so fast that loan-to-value ratios are being reduced.

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. More and more investors either will be buying for all cash or will go about half way by paying cash for the seller's equity and taking over low interest rate assumable loans

The big benefit is to control the property with little cash in order to capture the appreciation with a small investment. The cost of borrowing money is deductible and 60 percent of the long term capital gain is excluded from taxable income. Thus, it doesn't take much appreciation to compensate for high interest rates — at least not numerically.

If the property doesn't appreciate and the debt-free cash flow was not at least equal to the interest cost, then the only benefit will be the tax shelter. Even the tax shelter can become insufficient to produce any profit if the price at which the investor gets out is substantially below the acquisition cost.

What makes sense is to plan on a sales price and date with which the investor can live. The sales price does not have to be the target or most likely sales price; it needs to be only large enough to protect the capital and perhaps a nominal return.

Most projected sales prices are extrapolations of the past and are as useful as projecting the Dow-Jones Industrial averages by extrapolation. They work except for the turning points, and it is the turning points which count.

Projecting Sales Prices For A Defense

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 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.

For aggressive investors prepared to risk all of the down payment to capture substantial equity gains, the approach recommended is to hedge with extreme rather than average leverage.

A 10 percent down payment will capture the gain. The equity will get wiped out fast on the downside. A little more equity will not help much and a lot more will keep the investor there. An investor with 30 percent equity is in both the best and worst positions: the best position because he can probably get enough income to carry the property through difficult times yet give up all cash flow during the most troublesome period; the worst position because he is taking all the downside risk. He would do better to buy with 10 percent down (and the price may be inflated for the terms) and hedge his bet by putting 50 percent down on a comparably priced property. If inflation runs wild, he has two winners, one bigger than the other. He could have made more by using greater leverage on the second, but the foregone profit is a modest price to pay for the security of being able to handle a significant downturn where the 10 percent down property is gone. It is presumed that the property was bought with a sole security clause so that the investor escaped personal liability. The second property produces a positive cash flow through thick and thin.

The plan on the upside called for the high cash flow on the second property to offset the negative cash flow of the first property. In a substantial downturn, the first property is let go, and the second still produces positive cash flow. Although the dollar amount of the cash flow has lessened with hard times, there is not the other property to carry.

The internal rate of return (IRR) could be calculated on each of the two properties under various assumptions. The objective is not to maximize but rather to optimize. Under the most likely scenario, the IRR would be above a minimum level. This threshold strategy permits one to plan on adversity and pay for protection.

Optimization And Factors Affecting IRR

A number of mathematical relationships occur because of the amortization of acquisition and selling costs and the tax structure which augurs for longer holding periods. These are in conflict with the short run gains from rapidly rising prices when one can shift from property to property. Such shifts are not easy and the benefits of time may be too valuable to give up.

The first benefit is amortization of acquisition and selling costs. Acquisition costs vary by jurisdiction and how the investor calculates the cost, with one or two percent being a bare minimum. If the investor's time is worth anything, then the total may be three to five percent or more. We will assume the acquisition cost is three to four percent.

Depending on commission, the selling cost is usually much more. The total of acquisition and selling costs could easily be 10 percent. If the total were 10 percent and the investment period were two years, the result is that about five percent of the average price would be deducted from the total gain when calculating the average annual return. If the holding period were five years, that number reduces to two percent. At 10 years, it is one percent. Short holding periods are expensive, and the average costs decline sharply with time but become of minimal importance after five years or more.

A less obvious benefit related to time is income taxes. For a given projected rate of increase in income and sale price, the IRR increases over time if other factors are equal. That means that unless the rate of appreciation accelerates, the IRR increases with the holding period.

This occurs because IRR is calculated on an after-tax basis. If a property is sold at a gain, some taxes are paid even if at a long term capital gains rate. Reinvested, the money will earn anew but there will be less money on which to earn more profits. The longer holding period uses the would-be-tax money to earn more money.

Investors have known this intuitively and have met the situation by trading, which transfers the tax basis and postpones the gain. Although trading is a good way to go, it usually requires a third party to purchase the traded property and some new financing. Unfortunately, long term debt financing at fixed rates may become an anachronism for the '80s.

Lenders have learned the hard way about the interest rate risk. They are setting the due dates so short that investors have cause to worry. It's true that there may be rollover provisions or a variable rate so that the balance does not have to be paid in a lump sum. But what may have to be paid in each successive period is a rising interest rate.

Rising rents are expected to offset rising interest rates. Rents either change because of the change in the price level or the change in the real market for property services. Overfinanced properties facing excessive competition or located in declining parts of town are bad bets since they will not necessarily be able to support the rising cost of money.

An excellent handicapper, who can pick properties better than the market in general, can be aggressive with the financing. He or she can also get in and out frequently and afford to bear the transaction and tax costs.

Whether achieved by luck or astute analysis, a winner is a winner and picking them is not easy. Sometimes stubbornness *not to sell* accounts for a great windfall. Or the risk-prone buyer who buys without adequate information may also get a windfall. One cannot count on these fortuitous circumstances.

The Best Use Of Timing

Count on time being on your side. If you bet on a metro or subway stop being close to your property, a resurgence of downtown or shopping centers, a shortage in moderate priced housing units, or a development of a particular community, there are some risky decisions to be made. It's difficult to pick the type of property and location, and even more difficult to get both the location and timing.

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.

Leverage is a two-edged sword that magnifies losses as well as gains. The potential loss should be considered as a real price for the use of leverage. An additional consideration is that the benefit of leverage dissipates over time and its greatest contribution is in acquisition and the early holding period. As the loan ages, the amount of borrowed money reduces although slowly in the early periods. As equity rises because of appreciation or inflation, the ratio of borrowed money to equity changes and the high leveraged investment becomes a low leveraged investment.

Using leverage — sometimes even high leverage — makes sense but everything should not be levered all the way and at once. Staging leverage by time is an excellent approach. The high leveraged properties which become low leveraged in time run into tax shelter problems, and the depreciation may no longer exceed the amortization so that taxable income from the property would exceed

the cash flow. This so-called tax crossover is usually a pressure to sell or refinance.

The sale should be on its own rather than tax merits. Refinancing may not be attractive at high rates. The lost shelter may be offset with shelter from new real estate investments. There is a natural force for staged investment especially with high leverage.

Developing A Strategy

It is assumed that the investor seeks a profit through investing in real estate. Once the basic decision has been made, the investor may be passive and have others manage the investment, or he or she may be active and do more than make the basic policy. The implementation is included. The investor may also be a developer who builds for his own account and with partners. In any case, the common thread is an estate building activity.

Rather than being directed at the high flyers, these comments are meant for major investor/developers and institutions with substantial assets to protect.

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.

It can be okay to pay the seemingly high rates for mortgage money and to buy with no cash flow. Unless one is prepared to put it all on a single spin of the wheel, plan on adversity by using different amounts of leverage on different properties. An effective way of doing this is to stage the buying period or if one can't wait, then vary the leverage among simultaneous purchases.

Whatever the approach decided on, one should plan in order to be able to live with the choices. Luck may be more important than being smart. But as the pro said in response to a comment on his sinking a 22-foot putt: " 'Lucky putt.' That's true — it was lucky. And the more I practice, the luckier I get."

Look for the next Seldin On Change *article in the Spring/Summer 1982 edition of* REI.