REAL ESTATE ISSUES

Volume 11
Number 2
Fall/Winter 1986

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Editor's Farewell

The new real estate environment calls for a reconsideration of many long-standing assumptions. Tax reform and the overbuilt state of the office market have major implications for real estate investors and developers that could mean big changes by the end of the year.

This number of *REI* addresses several aspects of the situation from a variety of perspectives. It also marks the expiration of my term as editor in chief. Readers who are aware of how long I have served in that capacity will understand my feeling that the time has come to give up the reins. Fortunately we have found a well-qualified successor who can take *REI* into the new real estate era—Dr. Rocky Tarantello, CRE, a distinguished counselor and the new editor in chief.

Dr. Tarantello has since 1974 been on the faculty of the University of Southern California, where he is currently adjunct associate professor of real estate and land economics. Widely experienced in real estate development, investment, market research, appraisal and counseling throughout the Western United States, he is president of Tarantello & Company, a real estate market research and appraisal firm with offices in California and Arizona. His book *Real Estate Portfolio Analysis,* written with Chapman M. Findlay, III and Stephen D. Messner, is a landmark in its field.

On a personal note, it has been an enjoyable ten years. My thanks go to Linda Magad and her predecessors in the role of staff editor; to Lois Hofstetter, executive director of ASREC; to the many authors who have submitted manuscripts without hope of payment; and to the membership of ASREC, who have supported *REI* financially and allowed me complete editorial freedom at some cost to their own peace of mind.

Jared Shlaes
Editor in chief

In Appreciation

As the regular readers of the journal know, *Real Estate Issues* just finished a year long celebration of its 10th anniversary. What the readers may not realize is the tremendous contribution and dedication of its first and only editor in chief, Jared Shlaes, CRE.

Despite an active and demanding counseling business in Chicago, his selfless contribution to the journal and the American Society of Real Estate Counselors (ASREC) has been amazing, even to those of us who know and appreciate his vitality. The present format, content, and growth of *Real Estate Issues* are a direct result of his desire to see the journal become a forum for the exchange of ideas and professional concepts. His success in accomplishing these goals is underscored by the fact that almost two-thirds of the journal's readership are nonmembers of the Society who are top real estate business managers, owners of various real estate concerns, or corporate executives.

The members of ASREC are proud of the work our colleague has done and extremely grateful he was willing to undertake the task. And although he will now step aside to commit his energy to other activities, a solid foundation has been laid for the future of *Real Estate Issues.*

R. Tarantello

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REAL ESTATE ISSUES

The publication is provided as a medium of expression of individual opinion concerning empirical and theoretical approaches to problems and topics in the broad field of real estate. The articles printed herein do not necessarily represent the endorsement of the American Society of Real Estate Counselors or the majority of its members. The editors exercise only a general supervision of the material and assume no responsibility for opinions expressed by contributors whether or not the articles are signed.

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The American Society of Real Estate Counselors (ASREC) was formed in 1953 to meet the growing need for competent, independent real estate advice and guidance from qualified experts whose services are offered to the public on a fee basis. Members are qualified to use the designation CRE (Counselor of Real Estate).

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JOSEPH W. O'CONNOR RECEIVES 1986 BALLARD AWARD

Joseph W. O'Connor has been named the 1986 recipient of the Ballard Award for his article, "Real Estate Development: Investment Risks and Rewards," which appeared in the Spring/Summer 1986 number of *Real Estate Issues (REI)*. Mr. O'Connor is CEO of Copley Real Estate Advisors in Boston, New England Life's real estate investment and management affiliate. The Ballard Award is presented annually to the author whose article best exemplifies the high standards of content maintained in the journal.

O'Connor furnished the results of a 20-year research project which studied and evaluated a large real estate portfolio containing 40 investments totalling over $2 billion in developmental properties. His findings substantiated the merits of investing in real estate development. The study was segmented into six stages: planning and design, regulatory approvals, financing, construction, leasing and operation. And with the visual assistance of 14 well-illustrated charts and graphs, the article traced the risk factors through the process.

In real estate investment since 1970, O'Connor spent 11 years at The New England, most recently as a vice president where his responsibilities included the management and control of the equity real estate portfolio. With his involvement, this portfolio has grown from almost five million sq. ft. to more than 50 million sq. ft. of office, industrial and retail space. O'Connor is recognized nationally as an expert on commercial and industrial real estate development and financing. He is a frequent lecturer on real estate subjects and holds membership in numerous industry-related professional organizations. O'Connor received an A.B. from Holy Cross and an M.B.A. from Harvard Business School.

Editor in chief Jared Shlaes, CRE, made the manuscript selection for the annual award which carries an honorarium of $500. Funding for the award is provided by the generous contribution of the William S. Ballard Scholarship Fund in memory of Mr. Ballard, a former CRE.

Articles for consideration in next year's competition are now being accepted and must be submitted by August 1, 1987 to be eligible.

Reprint Information

You can order single and multiple copies of articles that have appeared in any edition of *Real Estate Issues*. For further information and fee structure, contact *Real Estate Issues*, 430 N. Michigan, Chicago, IL 60611 or call (312) 329-8431.

IMPACT OF NEW TAX REFORM LEGISLATION ON REAL ESTATE

A revamped real estate scene is about to emerge as the tax reform act takes hold.

by John McMahan, CRE

Since it became apparent Congress would pass some form of tax reform legislation this year, there has been considerable speculation as to what it would mean for real estate. Now that there is a final bill, it is important to re-examine its impact on real estate investment.

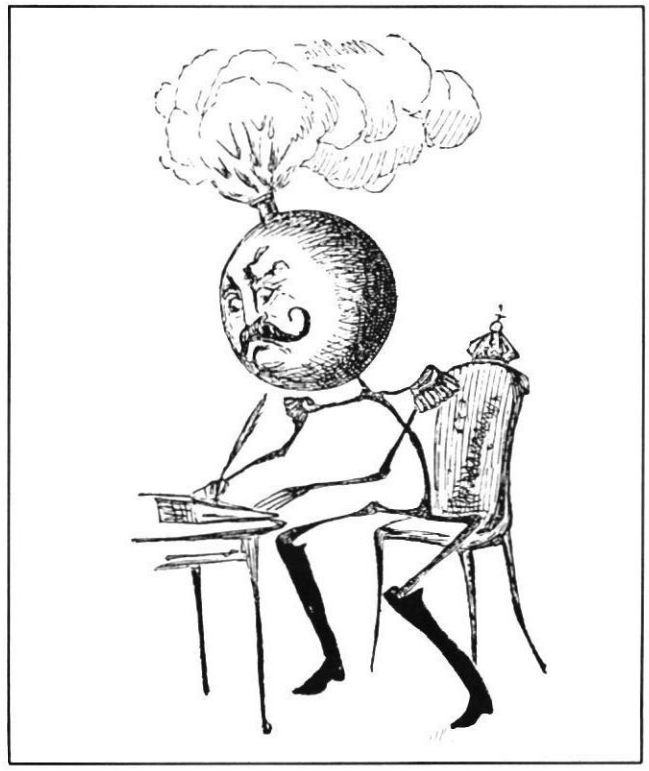
Historical Perspective

In the 60s and 70s real estate, along with other assets and industries, received moderate tax subsidy through the deduction of interest and depreciation. Certain elements were singled out for favorable treatment (e.g., housing; downtown development; etc.) to meet public policy objectives, but generally real estate was not treated any different than other investment assets.

In 1981 however, real estate received an unexpected windfall from Congress. In order to spur business investment, the recovery period for the depreciation of investment assets was reduced substantially. This was further compounded by the successful efforts of the real estate lobby to have real estate exempted from new at risk rules which would limit deductions to the amount of funds invested. The combination of large capital investment financed largely through nonrecourse debt, made real estate very attractive to taxable investors.

Although the recovery period standards were modified somewhat by the tax bill of 1984, the subsidy still was significant. This was particularly true when compared with other types of investments which were losing investor appeal. At the same time, financial institutions were investing more capital in real estate development as a result of diminished opportunities in other areas (banks) or as a response to deregulation (savings & loans).

John McMahan, *CRE, is founder and president of John McMahan Associates, Inc., San Francisco. McMahan directed early strategic research in real estate asset management. His findings have been published and provide a systematic approach to real estate investing. In addition to writing and speaking on this subject, McMahan is a member of the faculty of Stanford Graduate School of Business.*



The net result was a major infusion of new capital in the industry and the production of significantly more product development—particularly office buildings—than the market required. This spectacle of overbuilding, loudly trumpeted in the media, made it very difficult for the real estate lobby to effectively argue that investment in real estate should receive continuing subsidy from the U.S. taxpayer.

At the same time, pressure was building for tax reform.

Objectives Of Legislation

The major objective of the recent tax reform legislation

is to reduce individual rates to promote savings and economic growth. Secondary, but related goals are to restore a greater degree of fairness to the tax system and not increase the budget deficit (i.e., revenue neutral).

A concensus has evolved in Congress that the best way to achieve these objectives simultaneously is to shift a greater amount of the tax burden to corporations, particularly those that have not been paying taxes, and reduce or eliminate tax loopholes, specifically those benefiting wealthier individuals.

In attacking the loophole closing part of the strategy, real estate is targeted because it is one of the last remaining loopholes (fairness) that represents significant tax revenue (revenue neutral).

Features Affecting Real Estate

As passed, the bill affects real estate in a variety of ways.

- For most investors, operating losses from real estate investments are no longer deductible against ordinary income (e.g., wages, salary, dividends, royalties, interest, etc.) They continue, however, to be deductible against other passive income (other than interest and dividends) and can be carried forward indefinitely and deducted upon sale or dissolution.
- The recovery period for real estate is extended from 19 to 31.5 years for commercial property and 27.5 years for residential, both computed on a straight line basis.
- The Investment Tax Credit is eliminated for real estate placed in service on or after January 1, 1986. Historical buildings still will receive favorable treatment, but considerably less than before.
- The at-risk rule is extended to cover real estate, although nonrecourse financing will continue to be treated as an amount at risk if it is nonconvertible and borrowed from an independent third party lender (not a seller or related party).
- Investment interest expense is deductible only to the extent of investment income.
- Favorable capital gains rates for individuals are eliminated for real estate and other investments.

The above features eliminate the subsidy for real estate. Henceforth such investment will rise or fall on its own merits, without a friendly assist from Uncle Sam.

Impact On Real Estate Industry

Syndication

Passage of the bill creates severe near-term dislocations for certain portions of the real estate industry, namely those individuals and firms dependent upon the tax shelter business. Since few real estate syndication firms believed tax reform would pass, they did not diversify their businesses away from tax sheltered investments.

There has been some movement in the syndication community towards so-called economic or cash flow offerings in which the investor looks primarily to a cash yield rather than tax shelter. Syndicators began offering this type of product in 1985 and the first half of this year. The amount of funds raised through public syndication increased slightly in the first quarter ($2.28 billion vs. $2.25 billion in 1985), indicating that investors initially may be attracted to this type of product.

The problem with this strategy is that it is still expensive to aggregate small units of capital and these costs will no longer be offset by tax subsidy. Although syndicators have tried to reduce fees, they still have to motivate their distributors. Once the impact of these costs on a nonsubsidized yield are fully understood, investor interest will begin to wane.

In addition to the problems involved in raising new capital, syndicators could face increasing difficulty with existing investors as they try to collect on notes issued under staged contribution plans. Many investors may walk from their obligations with their investments no longer deductible against ordinary income.

The outlook for the syndication industry, therefore, is one of shake-out, consolidation, and extensive litigation with a reduction in both the number of firms and the level of assets managed.

Real Estate Development

In terms of real estate development, the greatest impact will be felt by developers involved with assets which were especially favored through tax subsidy—apartment, hotels, and rehabilitated office buildings. Undoubtedly there will be less construction of new apartments and hotels until projects can be supported on an economic (nonsubsidized) basis. Rehabilitation of older office buildings will not suffer as much because the new bill retains some subsidy features.

Other products—new office buildings, shopping centers, industrial and R&D buildings—will be less affected because they have not received as high a level of subsidy. Development activity in these areas will be more closely associated with institutional capital flows and demand/supply conditions in local markets.

With reduced development activity, architects and engineers can expect reduced demand for their services more from demand/supply forces than from the loss of the tax subsidy.

Investment brokers (not affiliated with syndicators) should be largely unaffected as the number of transactions will not change dramatically or, if anything, may increase as syndicators attempt to unload projects to obtain greater liquidity. Property managers and leasing brokers will continue to be very active in working out the problems of overbuilt markets.

Impact On Metropolitan Areas

Geographically, the near-term impact will be greatest in those markets where tax-subsidized development has concentrated, particularly apartment complexes in the sunbelt.

A more subtle impact will be how the tax bill influences

economic growth and job formation, the major driving forces underlying demand for real estate. Geographical areas dominated by firms with high capital investment in plants and equipment will be hardest hit due to lower depreciation write-offs and the elimination of the Investment Tax Credit. More favored will be areas dominated by service and manufacturing firms with high labor/capital ratios such as Boston, New York, Washington, D.C., Atlanta, Dallas, Phoenix, San Diego, Los Angeles, San Francisco, Seattle, etc.

Impact On Real Estate Returns

There was considerable discussion in the media about the overpricing of real estate as a result of the tax subsidy. Further speculation implies that with removal of the subsidy, real estate prices will decline.

It is difficult to draw this conclusion without distinguishing between various types of real estate products and considering demand/supply conditions.

Apartments, for example, are heavily influenced by the affordability of ownership housing, local employment conditions, and the vacancy level of the existing inventory. Lower interest rates have made single family housing more attractive, reducing overall apartment demand in most markets. Reduced employment opportunities in the energy industry further have impacted markets in Houston, Denver, Tulsa, and Oklahoma City. Most of these markets also have been subject to a high level of oversupply indicating a strong possibility of further decline in before and after-tax returns.

In many markets, however, apartment demand remains strong. Areas such as Boston, New York, San Francisco, Washington, D.C., etc., have not tended toward oversupply (often as a result of severe growth restrictions) and with strong local economies, they represent reasonably good apartment markets. Although after-tax yields will decline in these markets, it is expected that before-tax yields will remain relatively firm.

Looking ahead, the removal of the tax subsidy will restrict new apartment construction which will raise rents and returns to a level comparable to other real estate assets. For the investor willing to wait out this period, the appreciation potential may prove significant.

For the hotel industry, the story is different. Here there are declining occupancy levels in most markets caused by severe overbuilding. The removal of the tax subsidy will aggravate an already bad situation and further declines in yields are expected on a before and after tax basis.

For less subsidized investments such as industrial, shopping centers, and newer office buildings, the impact will be determined more by local demand/supply conditions. As a result of overbuilding, capitalization rates for new office buildings have increased about 100 basis points over the last 12 months, indicating a price reduction of approximately 12-15%. Presently, rates appear to be stabilizing (or trending slightly down), indicating most of the price move is over. Since these properties are generally purchased by tax-exempt or low-tax investors, further price erosion is not expected.

Shopping centers have not been overbuilt in most markets, maintaining relatively constant returns over the last 12 months. Lower individual tax rates are expected to translate into more disposable income which is positive for retail sales and shopping centers. This type of investment will continue to be attractive to tax-exempt investors and will maintain or improve price levels.

Industrial buildings also have maintained a reasonable level of demand/supply equilibrium with relatively constant returns. Demand for manufacturing and R&D facilities should expand because of reduced corporate tax rates and improved cash flow. The demand for distributive warehouses will decline due to the lower value of the dollar causing a slowdown or reduction in the growth of imports. On balance, a major decline in price levels is not expected as a result of the tax bill, particularly in those segments of the market where the tax exempt investor is active.

More important, the passage of the tax bill removes the market distortions created by tax subsidy and restores demand/supply equilibrium to the market place. This only can be beneficial to the tax exempt investor seeking the stable, long-term investment yields possible with quality real estate. Nothing in the tax bill removes the inflation-hedge characteristics of real estate. This enables investors to remain confident that future earnings will retain their real value, even if the nation experiences periods of unanticipated inflation.

Meanwhile, real estate cash yields are strong, indicating a classic buy signal for those investors committed to a long-term favorable view of the asset and willing to take action when others are hesitant.

A STRATEGIC VIEW OF REAL ESTATE

A detailed plan of action is suggested to encourage a new look at real estate analysis.

by Mahlon Apgar, IV

The interests of pension funds and other institutional investors in real estate is prompting a new look at traditional approaches to analysis and decision-making. Important to this reassessment is the use of real estate strategy. Fiduciaries, in particular, appreciate real estate's cyclical nature and the need for a long-term perspective. This article presents one practitioner's view of strategy as a framework for those involved with the effective management of the investment process. As a synthesis of evolving theory and practice, it is intended to provoke the reader's thinking rather than to prescribe analytic techniques.

Mahlon Apgar *is cofounder and principal of Wellington Real Estate and senior vice president of Wellington Management Company/ Thorndike, Doran, Paine & Lewis, Washington, D.C. In these positions, he is involved in real estate development, financing and consulting in the U.S., Europe, Japan and the Middle East. Apgar also is an active author and frequent contributor to numerous real estate publications.*

Real Estate As A Business

Real estate differs from most investment media in its emphasis on transactions. Investing in real estate has come to mean the acquisition, management, and disposition of specific properties on a local, deal-by-deal basis.

A focus on single properties, however, obscures the strategic view. The property portfolio is better seen when viewed as a collection of businesses that operate in a large, dynamic industry. Thus strategic analysis of real estate begins with an assessment of the industry's size and scope, its changing structure, and international potential.

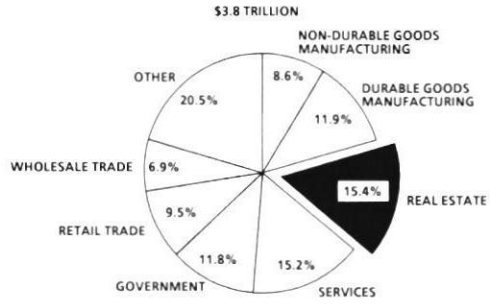
Size and Scope

Because national economic data is not presented on an industry basis for real estate, it is impossible to perform a conventional industry/company analysis. One proxy is

to define real estate as a sector of the gross national product by reorganizing it and the national income data. The results are revealing. Real estate products and services in 1984, the last complete year of data, exceeded 15% of the GNP, making it comparable to or larger than services, retailing and other sectors that occupy the investor's attention (see Figure 1).

FIGURE 1

Composition of Gross National Product – 12/85



As defined here, the real estate sector includes construction, professional services and real estate finance accounts for designing, building, managing, brokering and financing residential, commercial and industrial properties that are built or traded for investment. Building materials and public facilities construction are not included.

This industry definition may be debatable, but the strategic insight from such analysis is clear: real estate is too large an industry to be ignored and too broad in scope to be examined solely on a property-specific basis. Once recognized, conventional analytic methods can be applied to geographic, customer and competitor segments to aid in strategy development.

Changing Structure

There have been significant changes in market and industry structure. In response to market growth, investors, developers and managers exhibit the hallmarks of other industries—national scope, diversification and fee-for-service economics.

Institutions fund projects nationwide to maintain effective investment styles in multibillion dollar portfolios with discrete properties in numerous locales. Developers pursuing multimarket/multiproduct strategies must attract and organize entrepreneurs on a decentralized basis within large national entities. Property managers, who bear the brunt of maintaining real estate values, are becoming contract managers for large-scale services and systems. Consequently, traditional roles are fusing and strategy has become a dominant concern with the appearance of new competitors and the quest for current income.

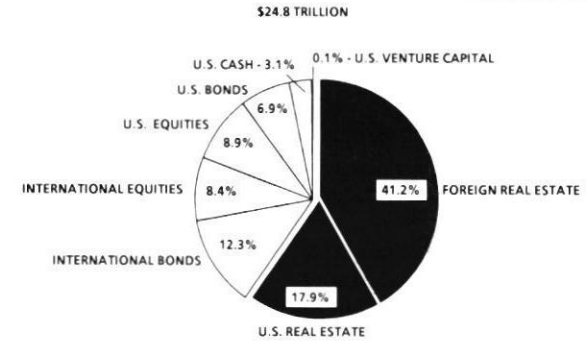
From an analysis of structure changes, ideas may arise for new programs encompassing individual deals, i.e., sector-based acquisition programs, developmental joint ventures, and specialized securities portfolios. To succeed, such programs must rest on a firm strategic foundation.

International Potential

An extension of the industry view is real estate's global role. This, too, is an unorthodox analysis but as the world economy unifies, real estate's importance should grow. Few investors realize real estate's dominant role. Figure 2 shows that in 1985 nearly 60% of the world's capital market values were based on this industry. But national restrictions on property transfers and the complexities of real estate finance, mask this fact.

FIGURE 2

World Capital Markets – 12/85



The value of foreign real estate is double that of the United States. Even with the barriers to entry in many foreign real estate markets, their scale and development pace suggests vast potential. Facing saturated domestic markets, U.S. investors and developers are beginning to look offshore. Indicative of the many possibilities are Boston's initiative in the London Docklands and Disney's project in a Paris new town. Real estate opportunities are no longer limited to the single property or investment vehicle. With an active strategy and systematic analysis of the business, the investor can build on industry-wide and global trends in structuring a portfolio.

Factors That Shape Strategy

Three important factors influence the strategic view.

Real Estate Paradox

Real estate is a paradox to many investors and analysts. Each building is a unique physical, economic and social unit that achieves a specific objective in its local market. The *physical asset* has location, boundaries, raw materials, uses, design and legal entitlements. Its *economic enterprise* has a specific cash flow pattern, capital structure and management style. As a *social organization*, groups compete and collaborate in various ways for use and operation. The interplay among these factors creates a distinctive mosaic of values and risks; investment decisions therefore need to reflect both the unique and the extraordinary complications involved.

However, the collection of properties that emerges from

an ad hoc, deal-by-deal investment process may not reflect the investor's overall policies for return, risk, and timing. Like any diversified business, the real estate portfolio needs an organizing theme, clear objectives, a product/market rationale, and a viable financial structure. Many institutions find themselves with unfilled office buildings in weak markets, or an underweighted position in strong markets. They did not evaluate transactions within a strategic context.

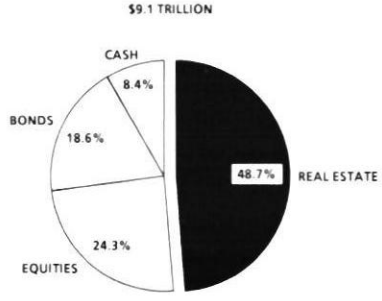
Real estate analysis generally is limited to property-specific tools, i.e., securities analysis before the advent of portfolio theory, rating services, and daily reporting. Without a structure for industry/company comparison and analysis, individual properties, pooled funds, limited partnerships and REITs have to be assessed in isolation, and often potential moves of strategic importance are missed.

Search for Hidden Assets

The second factor shaping strategy is the investor's search for hidden assets. Real estate's impressive scale in the world capital markets is mirrored in the U.S. As shown in Figure 3, nearly 50% of U.S. capital market values are real estate-related. But only a fraction of these asset values can be tapped in today's markets.

FIGURE 3

U.S. Capital Markets – 12/85



Mortgage debt (see Figure 4) represented 44% of market capitalization in 1985. Active equity funds from pension plans, public and private syndications and REITs represented less than 3% of the total market. These components are less than half of the total real estate capital market. The remaining share, which exceeds $2.5 trillion, is the latent equity value of real estate assets held by corporations, other organizations, and individuals. But these assets are outside the investable market.

Compelling forces are at work to unlock them. Equitization of corporate property assets is now a corollary to mergers and leveraged buyouts as financiers look to real estate sale/leasebacks and refinancings as a primary source for new funds. Securitization of commercial property only has scratched the surface of a $500 billion market. As owners search for hidden assets, major new opportunities arise for the institutional investor with a watchful, active strategy.

Shift to Asset Management

The third factor is the shift in emphasis from transactions to asset management. Institutions investing in participating loans, joint ventures and other equity positions are exposed to long-term real estate risks. With significant amounts of capital at stake, passive, hands-off management is not possible, nor can property be regarded as a readily tradeable commodity.

Consequently, performance, not deal-making, has become the critical investment skill. Because a property's performance only can be measured over time, a definitive strategy is essential. High performers are distinguished by professionalism in the skills of asset management—from analysis and financing to redevelopment and tenant relations.

To complement these skills, good information is essential. Astute real estate investors always have profited from proprietary information and the inefficiency of local markets. The flow of information is one key to increase market efficiency and institutional performance. National institutions are undertaking cross-market data collection and research at a cost of $600 million annually.[1]

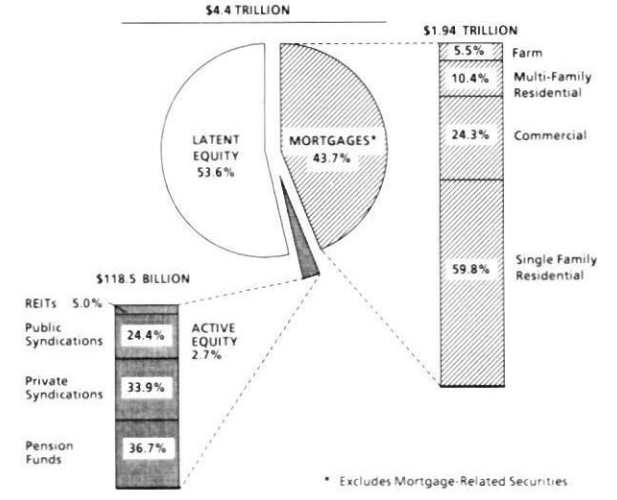
Elements Of A Real Estate Strategy

Strategy is defined as the formulation of objectives and how they are attained by operating policies.[2] This discipline is especially important in real estate where strategy provides guidance, coherence, and consistency to an otherwise disparate assemblage of deals. Moreover, an innovative strategy may reveal unforeseen opportunities to increase returns, reduce risks or reorder priorities to improve overall results.

The following framework consists of five strategical elements which effect real estate investment decisions—*sectors* and *products* , *role*, *vehicle*, and *stage* of *development*.

FIGURE 4

Real Estate Capital Markets – 12/85



Sectors are best defined by land use—office, retail, residential, etc. Further breakdowns—mid-rise suburban office or neighborhood strip retail—are useful. Sectors have both geographic and economic facets. Combined they comprise the market potential of a specific property and portfolio. A recent innovation is the sector strategy which involves specialized multimarket acquisition and property management programs in a single sector. By tracking sectors on a national, regional and local basis, competitive trends can be revealed from regions that have a broad impact in a single area (e.g., strip center vs. regional mall absorption), or multisector opportunities.

Products also are examined to determine competitive features that enhance value in one or many settings. For example, hotel development has shown that real estate products are more replicable than realized. Although each site is unique, certain single use products—multifamily units, strip centers—have similarities which can be modeled, reproduced and marketed.

Winning strategies are based on prototypes and management controls that can be adapted to many sites with only marginal alterations: simplicity of the product adds value to the user and investor; replication of successful products increases the productivity of both the developer/manager and the investor. Mixed-use products—office/retail, office/R&D/industrial, residential/retail—benefit from the same analysis of customer features and value enhancements. But their complexity requires a more thorough evaluation of marketing and operational risks.

Roles traditionally have been differentiated by professional customs and regulations. But the fusing of real estate products and services has lowered these barriers, and multiple roles often are played by the same organization. Developers embrace mortgage finance and commercial brokerage as integral functions. Mortgage lenders have become equity investors, developers, and property managers. The magnitude of financial, management and service needs, as the real estate business perspective suggests, is sufficient to attract the largest and most diversified service enterprises to these roles through acquisition and internal growth. Pension plan sponsors are closely eyeing a direct development role as they gain experience through joint ventures and acquisitions.

Vehicles bear scrutiny because of marked differences in their application by fund size and experience. Open-end funds are useful for plans below $200 million in assets and those new to real estate where liquidity, diversification and limited exposure are critical. Closed-end funds allow timing of market entry and exit—an important feature because the long-term, illiquid nature of the asset may require a year or more between the recognition of a strategic change and the completion of the action steps. Separate accounts and internal management allow large funds with $1 billion or more in assets to tailor their strategies by property type and risk structure.

Stages in the investment cycle determine the potential level of returns and risks. Most institutions (see Figure 5) invest in fully leased operating properties (Stage 4) because there are fewer unknowns: cash flows, operating costs and maintenance tasks are relatively predictable in light of market conditions and current tenants. The best stage may be in markets where there is stiff competition for releasing, or where it is difficult to find good properties. Moreover, the compressed period of market, technical or functional obsolescence—particularly in offices—highlights the importance of a decision in competitive markets.

Institutions with established real estate programs can best use the investment cycle by site acquisition three-to-five-years ahead of production. Renovation or recycling can be employed as anchors to programs with the opportunities that increase total returns with tolerable risks. Strategies that position each stage of investment along with overall portfolio mix, respond to cyclical changes in real estate values.

Aids In Strategic Thinking

To aid the strategist in defining these elements, two analytical tools have proven useful—the strategy grid and strategy statement. These go beyond conventional techniques of property analysis and help crystallize new programs and revise current strategy. If used in a flexible yet disciplined manner, such tools can ensure that important investment issues are addressed before commitments are made. The investor thereby controls the key variables such as uncertainties and exposure.

Strategy Grid

The strategy grid (see Figure 6) organizes the choices of sector, product and role to guide data collection, tradeoff analysis and objective setting. It clarifies ends and means as each intersection of the grid is defined.

For example, diversification is a means of reducing the risks of market concentration, not an end in itself. To diversify a residential portfolio within a given risk/return objective, the strategist might select cities with stable local economies, anchored by an institutional employer (e.g. state government, university), and at least one other local industry. Then he might specify well established properties whose rents, location, and features are

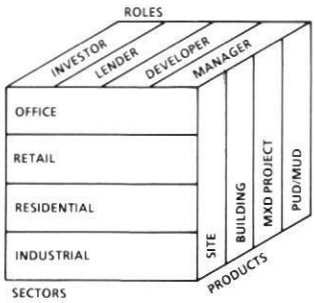
FIGURE 5

Real Estate Investment Cycle

STAGES	ACQUIRE	PLAN	BUILD	OPERATE	RECYCLE
TASKS	• Position in market • Capitalize project	• Rezone • Design • Finance	• Construct • Lease	• Maintain • Refinance	
RISKS	• High	• Moderate	• High	• Low	• High
REDUCTION MEASURES	• Develop scenarios • Identify partner • Track market	• Verify concept • Analyze trends	• Plan for contingencies • Prelease space • Establish marketing program	• Select manager • Establish reports	• Reevaluate concept

FIGURE 6

Strategy Grid



targeted at the institutional employee but can be upgraded to follow local economic growth. Using the grid, several products and roles are pursued to achieve the objective.

Strategy Statement

The strategy statement (see Figure 7) provides a consistency check among the grid's three dimensions, knits together the other strategic choices, and forges a chain between the investor's intent and the buy/hold/sell actions that managers pursue.

FIGURE 7

Strategy Statement

CONCEPT: Overall summary, core product, special situations

INVESTMENT STRATEGY
- Target Returns: current, total, index
- Acquisition: cost, timing
- Improvement/Development: costs, benefits
- Financing Structure: equity/debt, sources/uses
- Holding Period/Disposition

INVESTMENT STRUCTURE
- Vehicle
- Responsibilities: asset management, acquisition, property management

TARGET MARKETS
- Search Areas: cities, sub-markets
- Tenant Profile: income, age, unit size, turnover

TARGET PROPERTIES
- Type/Size/Age
- Unit Economics: costs, rents, NOI

Though simple in outline, the statement may be difficult to prepare and requires a review of management policies, market conditions, and opportunities. Such reviews could produce "what if" questions to test in supplementary scenarios. In practice, the statement itself can range from a careful, one page summary to a full exposition with models, research results, and action plans. The important requirement for each link in the chain is how it relates to the five elements of strategy.

Strategic Vision

While analytic tools are useful in evaluating major choices, they do not provide the inspiration or strategic vision that drives a winning strategy. Such vision differentiates an investment portfolio from a group of unrelated properties. It also combines insight and prudent judgment with understanding how to create value in an industry where playing hunches, sifting facts, and acting decisively are still the *sine qua non* of success.

Strategic vision is, by nature cosmopolitan. It possesses the attitude and experience to see new sectors, products, or roles as normal and profitable rather than risky or difficult; the curiosity to assess other locales; and the ability to think beyond the conventional. For example, the emphasis on highest and best use can obscure product/market forces that fall outside the boundaries of site analysis. A Japanese institution acquired moors on Nantucket and farmland near Williamsburg. While searching for community retail centers, a Japanese strategist reasoned that properties with unusual attributes in growing tourist centers have certain underlying values with great potential. His acuity has been rewarded by significant gains.

The tendency to extrapolate from current experience is challenged by strategic vision. One pension fund acquired a number of quality office buildings with a portfolio diversified by geography, size, risk level, and financial structure, sufficiently funded to compete nationally. The professional staff was competent and experienced. However, their original strategy, based on success in the commercial sector, overlooked two factors: early warnings of overbuilding in office markets where the holdings were vulnerable to cyclical changes; and less intensive competition for residential and industrial product in equivalent markets with more sustainable long run demand. The fund has established a pioneering, sector-based strategy by refocusing on other sectors, and redefining the criteria for location, property type and size.

Strategic vision benefits from solid grounding in quantitative techniques and analytic skills, but the mechanics of modeling and forecasting do not make a strategy. Likewise, objectives, acquisition criteria, performance evaluation, and other steps in strategic planning provide guideposts but do not chart the course. By contrast, the strategist defines the ultimate aim and visualizes alternative routes. Intellectual rigor is needed to follow through the logic and "what ifs" of each route, but the application of strategic vision may be circular and kaleidoscopic, not linear.

Conclusion And Summary

Real estate people are not inclined toward a strategic view because their business traditionally has been transaction driven. Performance today, however, is greatly influenced by the active participation of institutional investors, and the pace and nature of industry change. These forces open new opportunities for managing investments in sectors, products and roles, and structuring the vehicle and stage to fit desired objectives. If the investment boundaries always are drawn around

specific properties, it is easy to lose sight of potential improvements in the portfolio.

Thus, for many a strategic view of real estate provides insight to consider new or unforeseen opportunities with the discipline to follow through. Strategy enables the investor to anticipate the impact of market and industry forces before they affect specific properties, and to accommodate cyclical changes that affect overall portfolio performance.

NOTES

1. This estimate is base on an unpublished client study undertaken by the author in 1983 covering expenditures on real estate publications, on-line services, market research, valuations, and related data collection.

2. For the classic definition of and rationale for business strategy, see K. R. Andrews, *The Concept of Corporate Strategy* (New York: Dow Jones – Irwin, 1971); and M. E. Porter, *Competitive Strategy* (New York: Free Press, 1980).

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ADVISORY, MANAGEMENT, AND FINANCIAL SERVICES AVAILABLE ON AN INTERNATIONAL SCALE

A suggested list of resources aids the international real estate investor in the decision-making process.

by Mary Alice Hines

To invest in international real estate often requires an investment in specialists to advise and manage for growth and stability. Such services are available from numerous sources—international accounting firms, property management companies, financial institutions, and real estate consulting and advisory firms, portfolio managers, and law firms. The description that follows presents an overview of the available functions and services.

Accounting Firms

Many accounting firms have offices worldwide to assist the international real estate investor or representative. Local offices often have brochures available on subjects such as foreign exchange rates, major stock exchanges and guides on taxation to provide advice on tax strategy, feasibility studies and financial services. Some firms have developed computer models to analyze company data and outline the lowest tax payment required within a particular country. Financial advice can include gathering information on dividends, interest, capital repatriation regulations, and alternative strategies to reduce tax payment and increase profits.

Property Management Companies

International real estate investors often must acquire property management services to handle the economical administration of the site. An investor requires frequent reporting on rent collection, operating costs, management problems, suggestions for upgrading commensurate with rent increases, knowledge of the area and building vacancy rates, and the projected cash flow from the property. The management firm functions to

preserve the capital. Appropriate maintenance and surveillance of the premises by the on-site team can forestall physical deterioration. Effective management also may lengthen the economic life of property by noting new market trends and suggesting improvements. Normally investing in property improvements produces increased rental rates and fewer vacancies to increase net revenues, or the estimated economic life of the investment may be shortened.

Since the property manager also is able to increase the productivity of the space, he/she is constantly looking for cost reduction techniques and methods to increase rent and lengthen the property's economic life. He/she keeps abreast of tax laws and looks for ways to reduce the tax burden. While the owner cannot change applicable tax rates, the assessed value can be re-examined for fairness and equity. The property needs to consistently increase its cash flow to keep up with inflation which impacts on rent and operating costs. It is the manager's responsibility to keep a profitable balance between the two.

The property management company normally plans marketing strategy, sets the rent levels, plans the reasonable sale prices, advertises the availability of vacant

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units, and shows the available space. The company will accept lease applications or purchase contracts and negotiate the final terms.

Financial Service Firms

Commercial and merchant banks, investment banking houses, and mortgage companies can provide many worthwhile financial services to the international real estate investor. While the mortgage company focuses on funds and terms availability and the investment banking firm's service centers on listing and selling equity and debt securities for clients, each offers a wider list of services. The mortgage company may sell mortgage-backed securities, mortgage bonds, and other real estate securities, and the investment banker can advise on a full range of real estate financing methods.

Commercial And Merchant Banks

Found in every major city, commercial and merchant banks provide a full range of accommodations: personal finances, trust department, business financing and investment advice, international services for the multinational investor/company, and publications dealing with investment and finance within the country. Merchant banks offer investment banking and real estate investment and security listing capabilities, but commercial banks may not be allowed to engage in investment banking in the United States. A bank's international department offers foreign exchange services, and can transfer funds as needed. International banks have branches throughout the world, clustered in the international financial centers of the world, i.e., Singapore, Hong Kong, Sydney, Tokyo, New York, London, Zurich, and Luxembourg.

Investment Banking Firms

Many international real estate investors prefer local partners. This may originate from national regulations or from individual or institutional preference. The investment banking firm can suggest reputable investors who are not currently associated with or who have only minor participation in foreign investment. The investment bank can provide background on the suggested partner, especially in reference to equity and debt securities and in the secondary trading in blocks of stocks or bonds.

The prospective real estate investor should ask for suggestions on the availability of alternative financing. The investment banker may suggest the sale of real estate syndicate, partnership, or corporate shares in the incorporated real estate venture, sale-leaseback with an institution, bank commercial loan financing, mortgage loan financing, or the sale of mortgage bonds to finance the property. Since investment banks deal in business financing daily, they are a good source for financial advice.

Real estate securities may be sold on a local exchange near the investment property or in another country. The investment banker may suggest the preferred forms of security financing, and outline listing requirements to finance the entire investment.

The same bank may syndicate real estate, prepare credit analyses on possible joint venture partners, and rate the various types of securities—mortgage bonds, mortgage-backed securities, collateralized mortgage obligations, and real estate syndicate offerings.

Mortgage Companies

Mortgage companies provide important advance information to real estate investors, especially in the United States, West Germany, and Sweden. Mortgage companies are well versed in equity as well as debt servicing, for large real estate projects, and can advise the investor on yielding equity investment and real estate debt with appropriate yields.

Real Estate Consulting And Advisory Firms

Several worldwide, regional, and national real estate counseling firms are available to the international real estate investor. They are well versed in local and national property markets, and can calculate the going yield on property, given the general cash flow characteristics in the market place. They also can provide independent market and feasibility studies which may be required by prospective equity and debt investors.

Advertising Agencies

Major advertising agencies are located in key metropolitan centers to aid the real estate investor in developing and promoting image, property potential, the prospective resident's desire for a property's characteristics, and the real estate environment. The agency can establish a marketing plan, an appropriate budget, and commercial presentations for appropriate media. Commercial art, slogans, advertisements, coordinated displays, printed literature, and other materials can be coordinated by an agency in-house for a uniform presentation to insure maximum market exposure with the greatest financial results. Once the client establishes advertising objectives, an agency can create a campaign reaching those goals within an established time-frame and budget.

Real Estate Brokerage Or Estate Management Firms

The real estate brokerage firm, peculiar to the United States, offers leasing and selling services to a client on a contract basis. In contrast, traditional English estate management firms contract for a broad range of services, hoping to represent the client over a long period. In the United States, real estate brokerage stops as soon as the contract is fulfilled, i.e., the subject property is leased or sold.

The estate management firm has fees related to full service functions while the brokerage firm charges for each contracted activity. Usually the broker contracts to sell or lease property and is paid a commission when the transaction is consummated. Brokerage commissions,

common in the United States, are 3-8% of the final sale of a house and 3-5% of the final price or lease value of a commercial property. The commission structure is much lower percentage-wise in Europe than in the United States.

Trade Show And Exhibition Hall Operators

International real estate often may be marketed through real estate trade shows in cities easily accessible to prospective purchasers and lessees. These are annual or biannual events, i.e., the Realex Real Estate Trade Show is held each spring in Hong Kong.

Real Estate Portfolio Management On A National Or International Scale

There are expert portfolio managers for international equity and debt securities, stock and bond mutual funds. Financial institutions worldwide also deal in national and international security analysis for their clients, trust department portfolios, and mutual funds. Often portfolio managers who analyze regional and international equity and debt securities have dealings in real estate securities. (See Table 1)

International real estate portfolio managers are found mainly in the investment departments of the large life

TABLE 2

Top-Ranked U. S. Real Estate Portfolio Managers (Millions of U. S. Dollars)

Company/Address	Total Assets Under Real Estate Portfolio Management	Number of Pension Fund Real Estate Clients	Total Pension Fund Real Estate Assets Under Portfolio Management
Aetna Life and Casualty Co. Hartford, CT	$16,000+	427	$2,197
Coldwell Banker New York, NY	650	40	650
First Equities Institutional Properties, Inc. Atlanta, GA	81	8	81
Mellon Real Estate Investment Management Corporation New York, NY	700	7	700
Frank Russell Trust Co. Tacoma, WA	39	13	39

Company/Address	Breakdown of Assets Into Real Estate Holdings	Participation Offered	Geographical Diversification
Aetna Life and Casualty Co. Hartford, CT	Properties–$585 million Partnerships–$379 million Participating Mortgages–$347 million Mortgage Loans–$82 million	Open-end commingled equity and mortgage accounts, closed-end equity accounts, separate accounts, individual property and/or depositor separate accounts	National
Coldwell Banker New York, NY	Income-producing properties—100%	Limited partnership interest	National, concentrating in areas in excess of 1 million population
First Equities Institutional Properties, Inc. Atlanta, GA	Income-producing properties–100%	Direct or commingles; equity, debt or hybrid debt including land sale-leaseback/leasehold loan	National
Mellon Real Estate Investment Management Corporation New York, NY	Income producing properties–60% Mortgages–40%	Individual direct real estate investment accounts participation in closed-end commingled funds	National
Frank Russell Trust Co. Tacoma, WA	N/A	Open-end; units of participation	N/A

Source: Adapted from: *Pension World*, December, 1985, p. 55.

TABLE 1

Main Institutions Providing Beta Estimates

Institution	Area
AMRO Bank	Europe
BARRA	Europe
Data Stream	Europe
Gestion Financiere Priveee	Europe
Hengst Investment	Europe
London Business School	Europe
Munchmeyer	Europe
Quanto	Europe
Schroder	Europe
Wells Fargo	Europe
A. G. Becker	United States
Boston Company	United States
Keystone	United States
Merrill Lynch Pierce Fenner & Smith	United States
Morgan Guaranty	United States
Oliphant	United States
Paine Webber Jackson & Curtis	United States
Barr Rosenberg & Associates	United States
Value Line	United States
Wells Fargo	United States
Wilshire Associates	United States
Burns Fry	Canada
Canavest House	Canada
Wood Gundy	Canada
Daiwa Securities	Far East
Nomura Research Institute	Far East
Nikko Securities	Far East

Source: Dimson, E., "The Trade-Off Between Risk and Return," unpublished paper, London Business School, 1980, and personal correspondence with the author. Appeared in: Dobbins, Richard and Stephen F. Witt, *Portfolio Theory and Investment Management*. Oxford, England: Martin Robertson, 1983, Table 7.1, Main institutions providing beta estimates.

insurance companies and pension funds. With the development of collateralized mortgage securities and international real estate syndications, these portfolio managers are able to analyze new international offerings and start selective investment of securities originating in various Eurocurrency capital markets.

Possible sources of international portfolio management involving real estate ownership and securities include full service real estate brokerage and estate management companies, real estate syndicate managers, property trust managers, merchant or investment bankers with large real estate and securities departments, and large pension fund managers and advisors.

Law Firms

Many major law firms, like accounting firms, have personnel specialized in real estate investment and security areas. Often attorneys or solicitors conduct real estate feasibility studies, as a part of their full service to clients. An investor needs advance assistance in his home country while he acquires his portfolio, and then needs legal advice in each foreign country where he holds property.

Real Estate Trade Associations

Most countries have real estate trade associations. The investor can find such associations headquartered in major cities of the world. They can provide information on their country's government and business affairs, growth and development patterns, legislative developments and regulations, financial and tax incentives, and contact with their counterparts in related international real estate trade associations in other parts of the world.

Associations usually collect data from their members and publish it for general use. Information is available on industry performance and productivity, which is important to the investor.

Conclusion

The international real estate investor has professional, accurate and reliable information and services available from all aspects of the real estate and business worlds to assist in making sound investments worldwide.

THE DECLINE OF CYCLES IN THE HOUSING INDUSTRY

Lending institutions have restructured their methods to adjust to the rises and falls of mortgage interest rates.

by Lee Sternlight

For the past four years, the housing-industry was in a down cycle due to the major changes in financial institutions. A decline trend is an important development since it reduces housing construction costs and is reflected in lower housing prices. This decline in cost partially offset the sharp rise since 1978 in real mortgage interest rates—a rise that is not unlikely to disappear in the next decade.

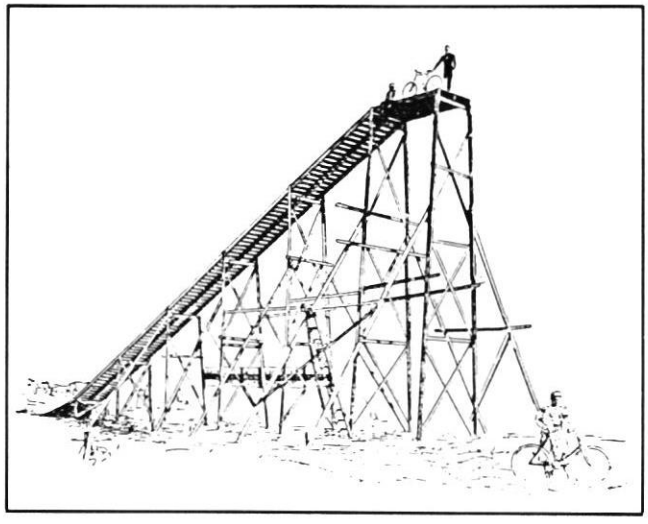
Also significant is the reduced sensitivity of the economy to the Federal Reserve's monetary policy. Interest rates need to rise substantially to rein in booms and inflation as well as fall considerably to stimulate recovery from recessions. The impact of Federal Reserve policy will be broader in future recessions and housing will no longer be its scapegoat.

An Analysis Of The Cycles

Most housing construction in the United States is carried out by contractors who seek profits. Changes in this industry typically have led business cycle peaks and troughs by about one year.

Previously, the magnitude of housing industry cycles was most severe. Private housing starts at troughs amounted to an annual rate of one million and at peaks rose to 100% or two million.

Before 1978, pent up demand and renewed availability of low-interest mortgages allowed housing construction to pick up at the bottom of the business cycle. Housing construction was cut off ahead of the business cycle peaks because of disintermediation, an outflow of funds from savings institutions, resulting in fewer available home mortgages. Disintermediation, in turn, resulted from the gap at cyclical peaks between high market interest rates and low regulated rates at savings institutions.[1] Figure 1 illustrates the cyclical variability of net savings deposit inflows and the corresponding variability of housing starts until 1978. It also indicates declines in housing starts as disintermediation proceeded, and the pickups as savings flowed back into savings institutions.



After 1978, Regulation Q interest rate ceilings were dismantled and disintermediation ceased to cause problems in the construction industry.[2] There was some variability in savings inflows but little corresponding irregularity in housing starts. When savings inflows appeared in 1980, housing starts kept on sinking and in 1981-82 they averaged only 1.1 million, or nearly 10% below three previous cyclical lows.

Cyclical variations in housing starts now are related to interest rates on housing mortgages which have risen to match other long-term rates. Borrower resistance to increases in the interest rate costs is feasible since the decision to buy a house can be postponed. As shown in Figure 2, before 1978 there was no obvious relationship between home mortgage yields kept down by state usury laws and housing starts. However, a sharp rise in new

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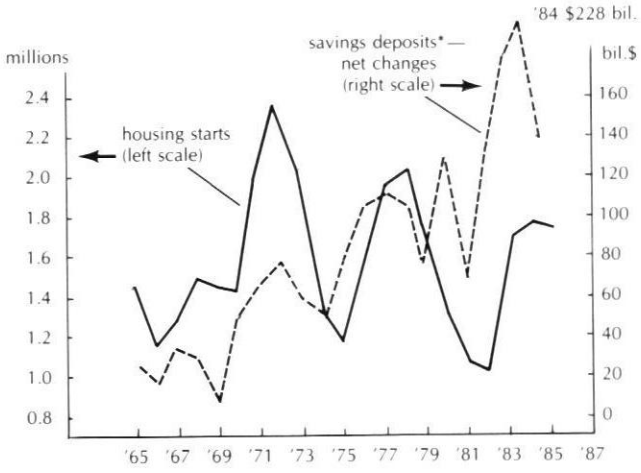
FIGURE 1

Private Housing Starts and Net Changes in Savings Deposits

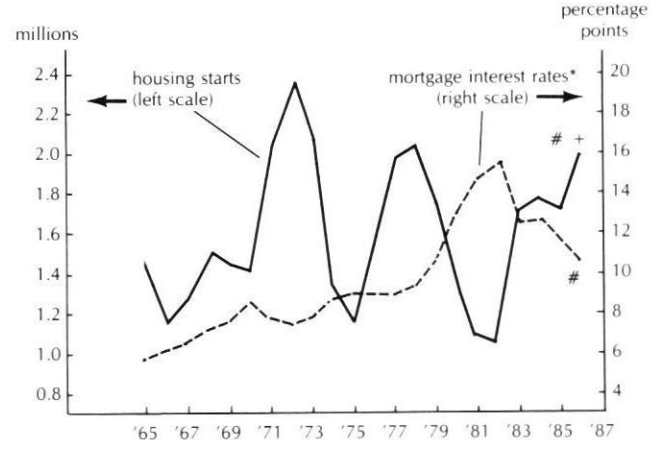


*Time and savings deposits of households
Sources: Dept. of Commerce and Federal Reserve

home mortgage yields from 9.5% in 1978—before a federal override of state usury ceilings on mortgages—to 15% in 1982, was associated with a drop in housing starts from 2.0-1.1 million.[3] Declining mortgage rates to 12.5% in 1983 and 1984 were associated with a rise in housing starts to 1.7 million each year. Mortgage rates kept dropping to 11.5% in 1985 and 10.5% in the first half of 1986. Housing starts leveled at 1.7 million in 1985 but, apparently in delayed response to the rate decline, increased in 1986 to 2.0 million between January and June.

FIGURE 2

Private Housing Starts and Mortgage Interest Rates



*New home mortgage yields
#1986: first half
+annual rate
Sources: Dept. of Commerce and Federal Home Loan Bank Board

A reasonable conclusion is that before 1978, when mortgage yields stayed below 10%, house buyers considered home mortgage rates to be a bargain. This seems especially feasible after considering the expected impact of inflation on housing prices and the inflation caused by declining real cost of mortgage payments. Drops in housing starts before 1978 stemmed mainly from the lack of available mortgages. As of 1978, mortgages became continuously available at market rates due to the end of the disintermediation phenomenon. Nonetheless, high nominal market rates discouraged home buyers since they substantially added to monthly carrying costs and limited the number of potential buyers financially acceptable to lending institutions. After 1980, there was evidence that the value of home ownership as an investment was lessening due to the slowing of inflation.

Assistance From Expansion Of Secondary Mortgage Markets

Savings institutions now may obtain savings if they pay market interest rates matching those paid by other financial intermediaries, primary business borrowers, and the U.S. Treasury. However, savings institutions have become increasingly unwilling to make and hold long-term, fixed-rate mortgages at rates acceptable to borrowers. They were badly burned when they used short-term savings inflows to invest in low-rate, long-term, fixed-rate mortgages.

Until the mid 1980s, home buyers refused to borrow on any other terms. The situation was saved when a secondary home mortgage market was developed dominated by three government agencies: the Government National Mortgage Association (GNMA or Ginnie Mae), the Federal National Mortgage Association (FNMA or Fannie Mae), and the Federal Home Loan Mortgage Association (FHLMC or Freddie Mac). Home mortgage lending institutions, especially the financially troubled savings and loan associations, shifted from originating mortgage loans and holding them, to originating mortgages and selling them in secondary markets. For VA and FHA mortgages guaranteed by GNMA, savings institutions and mortgage bankers often created mortgage pools, selling certificates of participation to investors. Another disposal route was to sell conventional mortgages to FNMA or FHLMC. In turn, the institutions held the mortgages and guarantees and sold mortgage-backed securities to investors. During 1985, approximately 80% of all originations entered the secondary mortgage market.

Assistance From Adjustable-Rate Mortgages (ARMs)

Savings and loan institutions were allowed to offer ARMs beginning in 1979. Even though they may be formatted in different ways, ARMs have become increasingly acceptable to borrowers following a lengthy education program by lending institutions. In the fourth quarter of 1983, for the first time[4] originations of ARMs exceeded those of fixed-rate mortgages. In the last quarter of 1985, 55% of all savings and loan association

mortgages and 60% of all savings bank mortgages were structured as ARMs.[5] Thrifts unwilling to add their fixed-rate mortgages often will keep variable-rate mortgages since they shift much of the risk to the borrower. ARMs appear attractive to some borrowers because of lower rates initially; if taken out during booms, they do not lock borrowers into high interest rates as do fixed-rate mortgages.

Outlook For Future Housing Construction Cycles

Cyclical fluctuations probably will remain modest in the next five years if there are no dramatic changes in government policy toward housing i.e., sharply reduced government role in the secondary mortgage market. The rise in housing starts from trough to housing cycle peak may reach 50% rather than the previous 100%. Variability could increase from a trough of 1.5 million annual rate to 2.2 million.

The cycles of housing construction should diminish for two reasons. First thrifts and banks will be able to obtain funds during the business cycle either for fixed-rate or adjustable-rate mortgages. If they are converted to more liquid MBSs, or simply disposed, they will often be sold to FNMA or FHLMC. Secondly, home buyers will be able to obtain mortgages during booms. Though market interest rates may be as high during past cyclical peaks, home buyers will not be locked into high rates by taking out ARMs. If this happens, housing starts may become a coincident rather than a leading indicator of the business cycle.

In making this forecast, it has been assumed that legislation reducing the ability of quasi-governmental agencies to sustain secondary mortgages will not become law. Another assumption is the U.S. Congress and the president will agree on a program to substantially reduce federal deficits. Most economists anticipate that providing the economy approaches full employment in the late 80s, large structural federal deficits would displace a substantial share of private investment, including housing construction, and reverse the recent decline in the cycles of the housing industry.

NOTES

1. The relationship between interest rate gaps and net savings inflows can be seen in Chart 5-1, *Economic Report of the President, 1984*, p. 152.
2. By the end of 1983, fewer than one-fourth of interest-bearing deposits were in rate-restricted accounts. *Economic Report of the President, 1984*, p. 153.
3. The state usury laws were overriden for FHA mortgages in 1979 and for other types of mortgages in 1980. *Savings and Loan Sourcebook, 1983*, U.S. League of Savings Institutions, p. 53.
4. Cited in Henry Kaufman (1984, February 3). *Comments on Credit*. Salomon Bros.
5. *Savings Institutions Sourcebook*, 1986, p. 10.

RETIREMENT COMMUNITY DEVELOPMENT: NEW TRENDS IN MARKETING AND FINANCING CONCEPTS

An analysis of marketing techniques is directed at the growing and evolving development of life care communities.

by John A. Rasmussen

The risks of developing or expanding continuing care communities can be reduced by testing alternative financing concepts with primary market research before deciding on a consumer financing plan.

Previously, retirement community residents were required to turn over all their assets to the religious or fraternal-sponsored retirement home in order to receive life-care. Help when needed is still considered important but changing consumer attitudes toward nonrefundable entry fees have resulted in changes. Newer retirement communities now offer alternative plans such as refundable entry fees, market rental plans without entry-fees, and guaranteed fixed appreciation ownership.

A national survey of more than 60 retirement communities and 70,000 retired households indicates that success correlates higher with sponsors who employ consumer research and resident participation in the planning process. There is more to retirement center marketing than slick, glossy brochures; primary market research can predict future sales absorption even before advertising campaigns are planned. While refundable entry fee plans have produced successful retirement communities, some consumer preferences are for alternative concepts, and this form of payment is only one alternative to the traditional life care financing concept.

Early in the planning stages of a retirement community, alternative financing concepts need to be identified. To be considered are those with the strongest consumer market support and the highest likelihood of achieving the desired annual absorption rate for sell-out or rent-up. It is no longer safe to assume the absorption rate will be 30, 40 or 50 units per year. Some projects have been funded, built, and never opened.

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Alternative Marketing And Financing Concepts

There are three basic consumer marketing and financing concepts. While the end financing for each project will be different, it is important to evaluate which concept provides optimum market absorption. The plans are endowment entry-fee, market rental, and ownership (fee simple, condominium, and cooperative).

Entry Fee

Life Care Plans

The life-care entry fee concept originally offered prepaid housing and health care. Now there are as many variations as facilities and some provide guaranteed access to nursing care. The fee may differ with the age of the resident (i.e. the same apartment could be priced higher or lower based upon the resident's age).

Traditional Endowment Plans

The traditional endowment plan entry fee prices the initial charge at 80% of the development cost and the housing units must be resold to amortize the debt. If the financing plan assumes a resale turnover in 10 years and the actual turnover is 14 years due to good care and supportive environment, the project may be a humanitarian success but a financial flop.

Contemporary Endowment Plans

Newer endowment plans price the entry fee at 100% of the estimated development cost attributable to the individual unit without difference for age. This is obviously a safer pricing strategy. The question is whether enough people are willing to pay $80,000-$180,000 for up-front fees.

Refundable Entry Fee Plans

Refundable plans offer a 50-95% refund, but require a higher entry fee. Variations include interest free loans with optional gift provisions and refunds contingent upon resale.

Market Rental

Here there is no entrance fee, only a monthly payment plan that includes debt coverage and services. The monthly fee usually depends on the services offered and is higher than for endowment entry fee plans. The higher monthly payment usually shrinks the market penetration.

Ownership

In this plan an entrance fee (downpayment) represents ownership equity. The downpayment may be 100% of the housing cost or a lesser amount depending on buyer resources and available financing. The amount of the downpayment can be similar to an entry-fee plan, and the monthly payment typically is lower than for an entry fee or market rental plan. Equity is refunded with possible appreciation upon resale.

If sponsors and board members consider consumer marketing and financing other than entry fee plans (refundable or otherwise), risk and sell-out or rent-up absorption time can be reduced. Whichever option is selected should be tested and supported by primary research.

Primary Research

What is primary research? Financial feasibility and market studies may or may not include primary research. Most are based on secondary analysis of population data, rather than measuring demand by identifying a target market and surveying potential residents. Merchandising research is described as primary research of specified subsets of customers and competitive supplies in order to confirm appropriate ratios for the disaggregation of aggregate data to identify location, space and amenity needs, and to specify levels of effective demand.

It is important to use primary research to test alternative marketing and financing concepts as well as location, product, and amenities. Surveying potential residents does not in itself supply key information; research findings must relate to client goals and objectives.

The feasibility of a project depends on the likelihood of the client accomplishing the stated objectives.[1] Thus if the client's budget is predicated on absorbing 264 retirement housing units within 36 months, he could examine the consumer financing plan with the greatest likelihood for an annual absorption of 88 or more units per year.

Primary market research can indicate a potential acceptance of sales and alternative financing. It is risky to judge by gut feeling or substitute direct comparison without site-specific research. Appraisers, real estate consultants, lenders, and clients need to recognize the weakness of the theory that says if it works in Peoria, it should also work here.

The reasoning is if Green Pastures can sell 132 new retirement homes using a refundable entry fee (or condominium plan), then a similar plan will sell here. This is only a variation of the Peoria assumption. The extent of market demand, the *willingness to move* based on preference for location, product, price, and financing, could vary significantly in different communities with similar demographics.

Another form of unsupported reasoning might conclude that if no local sponsor has developed a retirement community using an ownership plan, then a market rental or entry fee plan will work. Do not throw out primary market research because other similar projects do not exist.

Also, if you question the market research findings, review the methodology and the assumptions. When reviewing a merchandising research analysis it is important to look at more than the sample size and the actual number of responses. The quality of the sample may be more important than its size.

Survey	Sample Size	Response Rate	Number of Responses
A	10,000	10%	1,000
B	3,000	33.3%	1,000

The response rate is one indication of the reliability of the survey data. If the response is 30-40% it is safer to assume the merchandising research will provide a more accurate view of market demand than if the survey response rate is 10%.

In describing merchandising research, the objective always is to define a subset with the highest level of interest in the subject matter to maximize survey response rate and intensity of execution of survey formats.[2]

Sample

A Age 65 and over; income over $20,000

B Age 65 and over; Methodist

C Age 65 and over

An age and income qualified sample or a subgroup of retired Methodists will provide a better indication of effective demand than a random survey of the over 65 population. The reliability of a mail versus a telephone survey is another issue. The mailed survey is preferable for retirement housing research and more cost-effective than other methods of data collection.

Comparison Absorption Rates

The cash flow of a new retirement community depends on the size and timing of income from entry fees, rentals, or sales. Absorption time is key. How long will it take to break even? For 250 new independent living units, this could range from two-to five years, depending on the market, the competition, and the four "P's" of marketing strategy: position (location), product, price, and promotion. Research indicates that marketing and financing have a major impact on absorption rates.

Absorption Projection	Rate of Sale Projection	Support Behind Absorption Projection
A	50 units/yr	Census analysis of 2,500 households over age 75 living within 25 miles of the site; assume 2% will move.
B	50	Another project sold 50 apartments in the past year.
C	50	Telephone survey of 5,000 senior citizen households. Fifty percent of households support additional senior housing; assume 2% will move.
C	50	Mail survey of 1,500 retired Methodist households. Five hundred responses; 150 indicate willingness to move to a new retirement community in two-to-five years.

It is risky to base absorption time on census data extrapolation or experience from similar developments. A better method is to rely on telephone surveys rather than on an arbitrary percentage of the elderly from census data. Mailed questionnaires require the most time but can provide quantitative support of a realistic absorption rate. However, many questionnaires test for one financing plan. Thus, primary research indicates the support and risk levels of alternative marketing and financing plans.

Primary Research Test Of Alternative Marketing And Financing Plans

A consumer mail survey of 1,156 retired Methodist households indicates what is expected in terms of alternative payment plans in a new retirement community. A tabulation of 547 responses taken from a sample of 1,156 provides a response rate of 47%. The survey reflects the following demand:

Alternative Financing Plans		
Life Lease Plan	An entrance fee and a monthly payment for a continuing care contract providing housing, services, and the availability of nursing care	5%
Market Rental Plan	A straight rental with no downpayment	23
Ownership Plans	A downpayment or the full price in one sum	45
Other and Not Interested		27
		100%

Survey response indicates the life lease concept has the least appeal of the above three plans when tested. While strong sponsor and partially refundable entrance fees may increase the appeal, it is unlikely that support will approach the demand for the market rental or ownership plans.

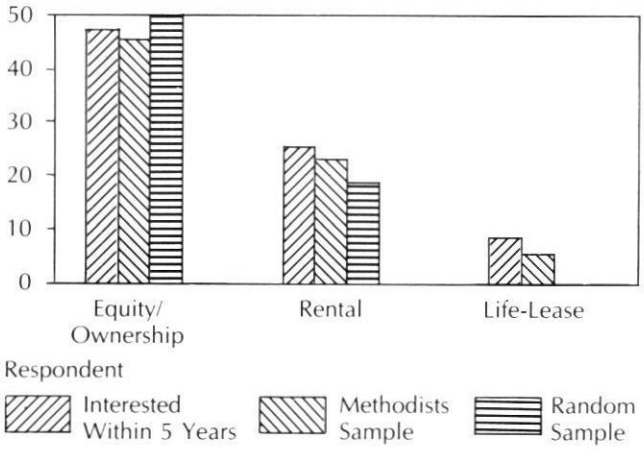
Testing only one financing concept, e.g., the life lease plan, may underestimate demand for market rental or ownership plans. Market rentals with no downpayment are supported by 23% of the respondents whereas an ownership plan is shown to have twice as much market support. Furthermore, primary research allows subgroups of respondents based on preferences for equity ownership, rental, and life lease financing. The three subgroup markets are persons interested in moving within five years; Methodist sample respondents; and random sample respondents.

Endowment Financing Plan Absorption Rates

Between 1971 and 1980, 1,062 endowment plan financed housing units were developed in one market. The five retirement facilities developed averaged 212 units, not counting supportive care and nursing beds. One 225-unit project with an on-site nursing center failed and was converted to a market rental plan. A second center, offering 225 units with endowment plans, changed management twice, was restructured and now is successfully operating under the endowment concept.

EXHIBIT 1

Payment Plan Preference Among Three Groups



Absorption averaged 84 units per year between 1971-80. Between 1981 and 1985, 523 endowment plan units were proposed for five projects; three represented expansion of existing communities, of which two projects were built totaling 105 units. Two new endowment projects were proposed. One with 136 units and onsite nursing, subsequently, was not built. A second 252-unit community was constructed by an organization already operating two nonprofit nursing homes. Four years of combined presale and marketing absorbed only 83 units, and it is now being promoted as a market rental.

While the 1970s revealed an absorption rate of 84 units per year, 1981-85 showed only 33 units per year were being sold. This slowdown indicates increased risk for new larger retirement communities marketing endowment plans.

The low occupancy 252-unit and the unbuilt 136-unit facility relied on census projections to support the number of units developed; no primary research was done.

Retirement communities which offer endowment plans that require residents to prepay 100% of development costs, represent phased expansion of existing retirement centers. One 30-unit expansion was financed successfully with a 50% endowment and a 50% noninterest bearing loan. A similar financing plan for a 75-unit independent living expansion achieved a 75% presale level prior to construction being started. Both sponsors involved potential residents in the planning process and one incorporated mail surveys and focus groups.

The most successful endowment plan projects represent small phased expansion of 75 units or less, rather than new developments of 136-252 units. The most successful developments incorporated surveys and other forms of potential resident participation in the planning process.

Market Rental Financing Plan Absorption Rates

A search was made for market rate rental congregate housing offering meals and support services. Between 1971-80, five projects containing 707 such units were built and absorbed within the surveyed metropolitan

EXHIBIT 2

Endowment Plan Absorption Rates

Year	Endowment Plan Retirement Residences	New Units Developed	New Units Absorbed	Absorption Rate	Comments
1971-80		1,062	837	84/yr	Five Projects
1981	—	—	—	—	
1982	Frankenmuth	252	83[1]	20/yr	Four years of marketing efforts, three marketing firms
1982	Grand Rapids	30	30	30/yr	Expansion of existing continuing care community
1983	Battle Creek	136 proposed (not built)			Project dropped
1984	Grand Rapids	30 proposed (not built)			To be restructured as a market rental
1985	Grand Rapids	75[2]	52	52/yr[3]	Expansion of existing life care community
Total New Endowment Plan Residences 1981-85		357 Built (523 Proposed)	165	(165/5yr) 33/yr	Three projects

[1]New contracts converted to market rentals in 1985
[2]Under construction in 1985
[3]First year absorption rate. Sold out in 1986.

market. The early market rate residences were one-of-a-kind. Three projects were developed in conjunction with existing nursing homes; the other two included a school converted into 88 units and the building of a new structure featuring 375 congregate apartments.

Since the late 70s, one developer, American Retirement Residences, has successfully developed, marketed, and managed 10 congregate residences with other proposed projects in Michigan and Florida. Their experience is probably the best indicator for acceptance of the market rate rental concept.

In addition to the 552 units developed by American Retirement Residences, a second developer converted a private Catholic school into 108 units. Primary market research, which tested entry fee and rental marketing and financing concepts for the building, indicated greater support for market rentals. Model units were built to be preleased in 1984, and the project opened in September 1985 with 50% occupancy. In six months, occupancy reached 75%. The monthly rentals of $800-$1,500 were substantially higher than other apartments in the area. While the absorption rate was slower than the rent-up rate of apartments without central dining, fill-up was faster than absorption for congregate units with entry fees.

American Retirement Residence rentals range from $900-$1,100 per month, with three meals daily. The units consist of efficiency or one-bedroom with private baths; each location offers central dining, a social director, housekeeping staff, and minivan service. The depth of management experience and the economies of scale of a multisite operation contribute to the success of residences.

The eight congregate market rate rental retirement projects built between 1981-85 in Michigan averaged 70 units, an overall size that helped achieve full rent-up absorption in less than a year. A development of 375-units built before 1981 rented slowly, perhaps because of its architectural design where some apartments were located a distance from the dining room. In Florida and California, congregate apartment-communities with 200-570 units have achieved satisfactory absorption with improved architectural design, good locations, and experienced management.

Congregate rentals require longer rent-up time than most developers expect; sometimes they may require the same absorption time as entry fee plans. The decision to offer market rate rentals rather than entry-fee or ownership plans should be evaluated carefully against the results of primary research and analysis of the competition. Increasing the advertising budget is a poor trade off for a project that lacks adequate market support.

Ownership Financing Plan Absorption Rates

Ownership financing plans include fee simple ownership for single family residential use, condominium units in condominium plats, and cooperative units on cooperative owned or leased land.

Fee Ownership: Single Family Detached

While the Del Webb Development in Sun City, Arizona, is a successfull example of single family, fee simple ownership, few new large scale retirement cities exist in northern states.

EXHIBIT 3

Market Rental Financing Plan Absorption Rates
Market Rental Congregate Housing

Year	Market Rental Locations	Building Conversion	New Construction	Total Units Developed	Total Units Absorbed
1971-80	Metro area	1	4	707	682[1]
1981	Royal Oak	62	—	562	62[2]
1982	Royal Oak II	38 (80 Bed NH conv.)	—	38	38[2]
1983	Lincoln Park	99 (160 unit motel conversion)	—	99	99[2]
1984	Livonia	—	84	84	84[2]
1984	Stone	58	(29P)	58	58[2]
1985	Elmwood	44	(25P)	44	44[2]
1985	Farmington Hills	61	30	91[2]	
1985	Dearborn Heights	46	30	76[2]	
1985	Monroe	108		108	81[3]
(P = Proposed)		516	144	660	466

[1]Includes 375-unit project which experienced slow rent-up (see text).
[2]Data Source: American Retirement Residences
[3]Project opened in September 1985 and is still in rent-up stage. A 50% occupancy level achieved at opening resulted from 18 months of preleasing efforts.

Condominium: Cluster Housing And Apartments

Leisure Tech's planned unit development at Leisure Village in Southern California is a successful adult and retirement community of cluster housing in the $139,000 to $190,000 price range. It features platted lots and association ownership of the community building, dining facilities, and recreational amenities. Planned for a build-out of 1,700 units, similar concept developments are being constructed in Lakewood, New Jersey and Long Island, New York. The concept targets preretirement (age 50 and over) and retired households. In Florida, condominiums are marketed to empty nesters, single professionals, retired households, and second home owners generally from northeastern and midwestern states.

Cooperative: Cluster Housing And Apartments

An ownership concept now being targeted to retirees and empty nesters is the market rate cooperative. Not to be confused with government subsidized cooperatives developed in the 60s and 70s, the market rate cooperative began in 1978. Its prototype is the successful 338 apartment highrise, 7500 York, developed by the Ebenezer Society in Edina, Minnesota. This building features central dining and secure underground parking, where the residents serve on the board of directors and on 17 committees.

In a cooperative, residents purchase shares and pay a portion of the mortgage. Unlike older cooperatives, the residents are not now personally liable for the underlying mortgage. Resale of cooperative apartments was a problem in the past. Now that shareholder loans are available, sellers may offer up to 90% financing on their equity, resulting in a 95% loan-to-value ratio of the total price. The cooperative shareholder only needs to refinance his equity value, not the underlying mortgage as required when selling a condominium.

Of the four market rate cooperatives in Michigan, the largest developer is Centaur Builders. With three developments totaling 1,848 units proposed and 600 units sold, the cooperative is reaching higher absorption rates than condominium or market-rental concepts.

With 1,048 proposed cluster homes, Centaur's Colonial Acres marketed to retired households in 1974. Since then, the market has shifted to 50-to-65-year-olds. Of the 470 cooperative cluster homes sold through 1985,

EXHIBIT 4

Market Rate Cooperative Housing

Year	Market Rate Cooperatives	New Construction	Total Units Sold
	Colonial Acres	All New	
1974-80			295
1981			52
1982			20[1]
1983			20
1984			48
1985			35
			470
	Centennial Farms	All New	
1980			12
1981			18
1982			10[1]
1983			10
1984			30
1985			40
			120
	Red Cedar	All New	
1984			—
1985			6
	Geddes Lake	Conversion	
1982			100[2]
1983			80
1984			75
1985			46
			301

[1]The absorption rates for new construction are as expected, at a slower rate than for conversion sales.

[2]The slow housing market of 1982-83 impacted upon new construction, but because finished product and favorable financing were available, the cooperative sales absorption was not hurt.

EXHIBIT 5

Comparison Absorption Rates For Alternative Financing Plans 1981-85

Financing Plan	Total Projects Developed	Total Units Developed	Total Units Absorbed	Absorption Rate per Year
ENDOWMENT	3	357	163	33[1]
MARKET RENTAL	8	493	466	93[1]
		167 to open in 1986		
OWNERSHIP				
New construction	3	596	301	60[1]
Conversion	1	360	291	73[2]

[1]Total combined absorption of all projects
[2]Excludes sales to investors prior to resale to individuals

the developer estimates 80% are occupied by retirees with a mix of 75% couples and 25% single person households. Colonial Acres had a slow sales start because of a limit on sewer and water taps (48 per year), and the depressed housing market conditions of 1982-83.

Centennial Farms, a cooperative cluster housing community also developed by Centaur Builders, is a self-contained community of 440 units built in several phases. Since development began in 1979, 120 units have sold.

Red Cedar Cooperative began with four models in 1984 and included 20 additional units of which six were sold. In 1986 the developer expects to market 20 units at Red Cedar and 80 units between Centennial Farms and Colonial Acres.

Geddes Lake Cooperative, with 360 townhouse clusters, is the first successful market rate cooperative conversion in Michigan. Sales began in 1982, and in spite of the then depressed housing market, 100 units were sold. Absorption totaled 80 units in 1983, 75 units in 1984, and 46 units in 1985. The remainder were acquired by investors for short term holding and resale. This cooperative was marketed to all market segments—empty nesters, retirees, families, and single person households.

Summary Of Absorption Analysis

Data indicate that the *total absorption* of 163 units is less for the endowment financial plans than for market rate rentals or cooperative ownership plans. The *average annual absorption* for endowment financing plan retirement communities is approximately 50% lower than either market rental or cooperative ownership plans. This data base includes all known endowment projects and market rate cooperatives marketed. Additional market rate rental communities, developed or in the planning stages, would increase the overall number of units.

Considering the 1,062 endowment plan retirement community units built in Michigan between 1971 and 1980, the data for 1981-85 indicate that endowment financing is declining. Refund plans may slow the rate of decline, but are unlikely to reverse the trend.

Market rental congregate housing appears to be growing in popularity, with an average annual absorption at triple the rate of other projects with endowment-financing plans.

The cooperative housing financing concept has easily surpassed the endowment plan absorption rate. The potential of the ownership concept (cooperative) appears to be even greater than for market rental. The future of the ownership concept could approach an

EXHIBIT 6

Projected Absorption Rates By Financing Concept
(Impact of Financing Plan on Absorption Rates)

Financing Plan	Share of Market[1]	Potential Absorption	Acutal Absorption 1981-1985
Endowment Plan	5%	33 units/year	33 units/year
Market Rental	23%	152 units/year	93 units/year
Ownership Plan	45%	297 units/year	60 units/year new construction 73 units/year conversion

[1]Market share ratios from survey responses of 547 retired Methodist households.

absorption rate of 297 units per year in Michigan. In Minnesota, with 772 retirement cooperative units built or under construction, 690 have sold. Additional cooperative retirement communities are planned or are under construction in Florida, Pennsylvania, and Wisconsin.

To project the potential market for the ownership concept, one assumes absorption of 660 retirement housing units per market. Not known is how much the type of financing offered will impact or if the same building design and services are offered, what extent the financing plan increases or decreases the absorption.

Financing Concepts Of The Future

The future for retirement community financing appears to be headed in the direction of market rate rental and cooperative ownership alternatives. Given the same location and facility design, the financing plan appeal to the potential customer must be examined from a consumer point of view. Which is more appealing—a life lease with a 50-95% refundable plan, a market rate rental, or a market rate cooperative? Primary market research indicates placing your bet on market rate rental and market rate cooperatives.

The future is here. The increasingly sophisticated consumer will vote for his/her favorite financing with dollars. Primary market research provides the decision-maker a more accurate view of the market.

NOTES

1. Williams, Thomas P., MAI and Rasmussen, John A., (1985, July). Feasibility and Valuation of a Continuing Care Retirement Community. *The Appraisal Journal*, p. 364.
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MARKETING OPPORTUNITIES IN THE RAPIDLY CHANGING PRACTICE OF MEDICINE

Providers of healthcare are finding newer, more cost-effective ways to market their services to the cost-conscious consumer.

by Lawrence P. Darrow, CRE and J. Robert Pellar

Medical practice is in a state of major transition as hospitals unbundle services and create a vast potential for new market ventures in health care. Services such as diagnostic testing, treatment, emergency care, and surgery, now are being offered in freestanding centers. Hospitals and physicians can either gain a foothold in this fast growing health care market or risk losing a major portion of business to new providers.

Modern Trends

The emergence of health care as a competitive industry is partially a reaction to the escalation of medical costs over the past 20 years. Government spending in this area has risen from 8.6-10.2% of the Gross National Product (GNP) between 1975-82; and real costs more than doubled. Projections by the Center of Health Policy Studies in Washington, D.C. indicate total care spending will reach 13% of the GNP by the year 2,000, and will rise substantially in real terms at 4.7% per year. Personal health care expense also is expected to increase to 10.3% per year; spending on hospital service will rise 11%; and costs for physician care will increase 9.9%.

The health care community, government, the insurance industry, employers, and consumers all have supported legislation to curb rising costs by greater regulation and

by providing incentives for consumers to shop for more competitive service. Consequently, legislative changes have caused a decline in hospital admissions which typically provides the highest-priced service. It is projected that hospital admissions will continue to decline 25% over the next five years, while outpatient services will increase proportionately. While hospitals formerly depended on inpatient services to provide 80-90% of their revenues, outpatient and ambulatory care now must capture those funds.

Several other factors also have contributed to the new emphasis upon ambulatory care: an increase in physicians providing specialized services which do not require a hospital setting; the technological advancements that allow diagnostic tests and therapeutic regimens to be performed on an outpatient basis. Since outpatient care is cost-effective to the consumer and provider, such services could present many market opportunities for

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providers of these needed services. The general economic situation in the U.S. has resulted in consumers not seeking hospitalization unless absolutely necessary and deciding against elective procedures.

Business, developers and venture capitalists view health care as a potentially lucrative profit source. Now that medical institutions are allowed to advertise, the medical system is innundated with aggressive marketing of products for profit, especially in the area of ambulatory care. The trend toward decentralization of health care is expected to continue, as evidenced by the more recent proliferation of freestanding health service facilities. Hospital outpatient services are vulnerable to competition from these centers, therefore, many hospitals are building their own immediate care, surgicenters, and freestanding and mobile diagnostic and treatment centers.

It is especially important for hospitals to expand into new markets and build satellites. Of the 221 surgery centers built in 1985, 162 were hospital based, with 284 additional centers being planned of which 196 will be hospital affiliated. A similar trend exists with ambulatory care; 159 centers were built in 1985 and were hospital-based. Medical office buildings are another source whereby hospitals can ease into the new market. They not only provide increased revenues, but can furnish improved relationships with physicians. Typically, the hospital purchases or develops a property and leases it to their affiliated physicians.

Freestanding facilities attract investors and consumers. Such entrepreneurial enterprises are easy to identify and are more flexible to market change than a large hospital. It is easier to change procedures in small facilities, and prices can be adjusted immediately to outside competition.

Convenience and low cost services are their primary advantages to the consumer. The centers may be built in convenient areas—shopping areas, suburbs, even outlot pads of shopping centers. Since such locations do not have an overhead comparable to hospitals, they are able to charge less for services. Major reasons for building a freestanding facility are to develop or protect existing markets, enter new geographic areas and new lines of business, promote to certain age or income groups, develop new sources of revenue, or respond to consumer requests.

The expansion of the health care sector is not expected to shrink despite the furor over the economy, high health care expenses, and the Medicare cost crisis. Investors favor the health industry for its growth possibilities; not for cost containment. The total capital investment required by most new service ventures is less than $3 million. Local financing becomes easier than a public offering or institutional placement of securities. Also, since venture capitalists may not be interested in a project this small, members of the medical profession become the most likely revenue source. Physicians seem responsive to ownership since it may provide additional income and a tax shelter while offering significant managerial control. Similarly, real estate investors may seek a return in the form of a tax shelter or additional cash flow. The venture typically is divided into two parts, real estate and operations. A limited partnership is most often used to finance the real estate, whereas a corporation or operating partnership normally houses the operations.

The trend to freestanding facilities already has had an impact on the building industry. In a report cited in *Modern Healthcare*, large architectural firms indicated their nonhospital health care business rose dramatically during 1980-85; from 5-10% to one-third of total health care square footage. Smaller practices, which historically have done more nonhospital health care work, reported a shift from 15-20% nonhospital work in 1980 to almost one-half in 1985. According to a survey of construction managers and builders, building activity fell 10.5% from 87.3 million sq. ft. in 1984 to 79 million sq. ft. in 1985. However, the total value of construction increased 8% from $7.8 billion in 1984 to $8.4 billion in 1985, reflecting more projects devoted to outpatient services and fewer to hospitals. New contracts for hospital construction fell 5%, in contrast to nonhospital health-care construction which has grown 4% since 1984. The value of nonhospital construction contracts signed in 1985 increased 12% over 1984.

Construction costs of freestanding centers vary depending whether a facility is new or renovated. Rebuilding of available space is 60-75% of the cost of new construction and is sometimes as high as 85-90%. Total project costs—financial, legal and design fees, equipment—run about twice the cost of general construction.

A major concern in planning any freestanding facility is the population needed to support the center and this may vary considerably. A five-physician medical office building may successfully serve only 5,000 persons, whereas a high technology center with comprehensive services generally would require a base of more than 100,000. Most immediate care centers require a population of at least 30,000.

Types Of Ambulatory Care Facilities

Freestanding Immediate Care/Ambulatory Care Facilities

The National Association for Ambulatory Care claims freestanding ambulatory care centers are becoming primary care providers that network with each other and provide improved relationships with hospitals. Also, the emergence of HMO and PPO, alternative delivery systems, have provided contract medicine alternatives in traditional primary physician care. In a Health Maintenance Organization (HMO), an individual pays a monthly rate and receives all health care. In a Preferred Provider Organization (PPO), companies or insurance agencies contract with physicians to provide care at a pre-agreed upon rate-per-service, offering total coverage to an individual using those physicians, and only partial coverage if the individual seeks care from others. Each alternative delivery system easily may be offered outside a hospital while maintaining an affiliation for acute care.

In 1984, hospitals comprised only 10% of the freestanding facility industry; two years later, almost every hospital has considered satellite centers. Because of potential regulation problems, the early emergency care centers now are known as ambulatory care centers. Such centers dominate the market in freestanding facilities with urgent care centers up 65% and primary care centers up 27% between 1985-86.

The design of an ambulatory care center is very important. The facility should be a freestanding structure, easily visible, rather than a store front in a retail development strip. Usually between 2,000-5,000 sq. ft., it should be substantial, distinctive, and of high quality. Identical looking structures help establish an identity. The site also should be highly visible and accessible, and located on a major transportation corridor in a commercial district free of competition.

Freestanding Surgery Centers

Surgery centers are expected to increase from 330-682 facilities between 1984-88. Industry observers (AHA) believe 30-40% of all surgeries can be handled on an outpatient basis, whereas less than 2% are presently done in centers. Purchasers, particularly employers, are a major force behind the shift to outpatient surgery since it is more cost-efficient. Ambulatory surgery was covered in 96% of company policies in 1985, compared to only 35% a decade earlier. Of the 39% of the companies who provide incentives for outpatient surgery, 84% reimburse fully, while only 80% pay for inpatient surgery. Many companies apply outpatient incentives to all such procedures; others specify procedures which must be performed on an outpatient basis for full coverage.

Marketing considerations include close proximity to a hospital and the amount of available space. The closer a surgery center is to hospital-based surgeons or those in private offices, the more likely it will be used. In case of complications, close distance to a hospital is critical. Optimal size for a surgery center is between two to four surgical suites with appropriate support space of 11,000-17,000 sq. ft.

High Technology Centers

The high technology center, with highly sophisticated diagnostic and therapeutic services, might be essentially an acute care hospital without beds, or its scope of services might be limited to diagnostic, oncology, and imaging. Location is paramount in this type of facility which may have substantial equipment start-up costs. The market area must have enough people to support a 200-bed hospital. Also, many medical specialists with established referral networks are needed to support the facility, and it should be the only one of its type in the area. However, a high technology center ideally should be located near a hospital because it can expand the hospital's capabilities at minimal cost.

The center must look high tech to give an image of providing the most sophisticated service available, yet its size will vary depending on the services provided. A radiology unit averages 4,000-5,000 sq. ft. while a cardiac rehabilitation center typically runs 1,200-2,000 sq. ft.

Medical Office Buildings

A physician has many advantages in maintaining a medical office building. The facility may enhance his/her referral base, provide a better medical/professional image, offer accessibility to a wider population, and provide an ownership advantage.

Freestanding facilities increased by 52% in 1985. While

TABLE 1

Characteristics Matrix
Freestanding Ambulatory Care Facilities

	Ambulatory Care/ Immediate Care	**Surgery Center**	**High Tech Center**	**Medical Office Building**
LOCATION	Major transportation corridor	Proximity to hospital/ emergency unit	No similar facilities nearby On hospital grounds or close by	Proximity to hospital
SIZE	2,000-5,000 sq. ft.	11,000-17,000 sq. ft.	2,000-4,000 sq. ft.	Varies with area
DESIGN	Freestanding structure High quality	2-4 surgical suites Comfortable, warm interior	Modern high-tech appearance	Modern, prestigious
MARKETING STRATEGIES	Operate chain, using same building design	High surgical use-rate for area Young families in market area Lower cost	Look high tech, sophisticated	Strong hospital/physician referral system

medical providers are dependent upon these centers for cost reasons, such facilities must maximize their real estate investments or sacrifice opportunities for increased income; therefore, proper financing and management must be given ongoing consideration. Investors typically have utilized private sources and industrial revenue bonds (IRBs) to finance the centers.

The Role Of Consulting

In determining the success of a freestanding center there are three techniques most frequently used to assess the property's viability—preliminary market analysis, market research, and financial impact analysis.

> A *preliminary market analysis* includes a demographic and competitive profile which tells whether the population is growing, provides the economic status of the residents, and identifies the competition.
>
> *Market research* provides a glimpse into the future by asking consumers how they would behave in hypothetical situations. This enables developers to plan according to consumer preference.
>
> The *financial impact analysis* examines the financial viability of a center and its impact on the parent corporation, often a hospital. Developers need to know what revenues will be lost or gained.

It is imperative to incorporate all three methods into the planning process. Mail surveys, focus groups, and telephone surveys all are useful to pinpoint the opinions held by people in the market area, and to provide the necessary qualitative and quantitative data to analyze market potential. Research is essential to define the market—that is, whether patients would use freestanding centers, what services they would prefer, how satisfied they are with existing facilities, and to identify the competition.

Demographics must be analyzed carefully. Since younger age groups are more likely to use a freestanding center, those facilities should be located in middle to upper-middle income neighborhoods where families are young and mobile. Lower income and upper income older consumers are poor targets; the former because of low profitibility potential, the latter because cost and convenience tend to be less important than physician accessibility and continuity of care.

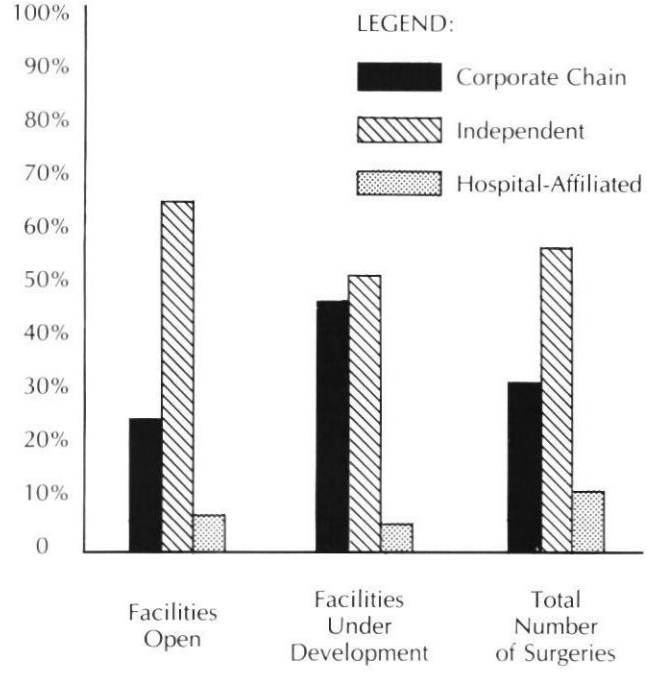
Another important aspect of market research is to determine the interests of physicians in the target area and to include them in the planning process. For instance, there is no way to estimate potential use-rates for a new center without extensive surveys of the doctors who control the demand for care. Service concepts must be presented to the physicians to determine their appeal. Furthermore, an investment analysis should be prepared to show participating physicians their investment opportunities. Capital requirements, risks, and returns will depend upon the nature of the venture. A common mistake is to select a site and plan a facility based only on national consumer research. The public's attitudes and ties to physicians can vary markedly even between markets that appear identical in demographic characteristics.

The financial analysis needs to focus on equally important issues since hospitals must consider market options. Even though the hospital may lose money when they first divert outpatients to lower costing ambulatory care centers, they can recapture it by building their own centers. Otherwise revenues may be lost to competitors with freestanding facilities who offer Medicare (which uses a fixed-rate reimbursement) or from sharing revenues with physician-limited partners. The growth of HMOs and PPOs has made it increasingly difficult for hospitals to generate revenues because they cannot provide the same low-cost outpatient services that is possible in a freestanding center.

Finally, ownership of the facility must be resolved. Full ownership is appealing because it implies maximum control but it also means maximum risk. Hospitals can reduce their risk by offering physicians limited partnerships while retaining the role of general partner. In this way, hospitals can reduce their share of debt and equity, strengthen physician relations, and minimize competition. Joint ventures typically are made between a hospital and a proprietary organization that operates a chain of centers between two or more hospitals, or between a hospital and a physician. However, physician group practices also operate freestanding facilities and compete successfully with hospital-managed centers. By developing these centers through joint ventures with

TABLE 2

Freestanding Surgery Centers
Type of Ownership



Source: *Modern Healthcare*/June 7, 1985

TABLE 3

Assessing Occupancy Options
Relative Ranking Against Criteria of Ownership

Evaluation Criteria	Capital Requirements	Time Until Entry	Financial Risk	Financial Returns	Control
Techniques					
Sole Developed & Operated	High	Long	High	High	High
Acquisition	High	Short	High	High	High
Joint Venture	Medium	Short	Medium	Medium	Medium
Contract Management	Medium	Short	Low	Low	Low
Franchise	Medium	Short	Medium	Medium	Medium
Affiliation	Low	Short	Low	Low	Low

Source: Louden & Company, American Health Care Association Journal, March, 1986.

physicians, hospitals can preclude potential competition from their own staff doctors.

Summary

The tremendous changes in today's health care provide excellent investment opportunities. As the trend continues toward more outpatient facilities, it is anticipated that freestanding centers will continue to become a viable option to traditional hospital care. However, it is important during the planning process to gain accurate information concerning the viability of a facility within a targeted market area and carefully access all the factors before making the real estate investment.

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THE EFFECTS OF JUST-IN-TIME INVENTORY PROCEDURES ON THE LOCATIONAL DECISIONS OF SUPPLIERS

A new era in American manufacturing efficiency is developing by relooking at old procedures governing inventory control and industrial location.

by Daniel L. Tompkins

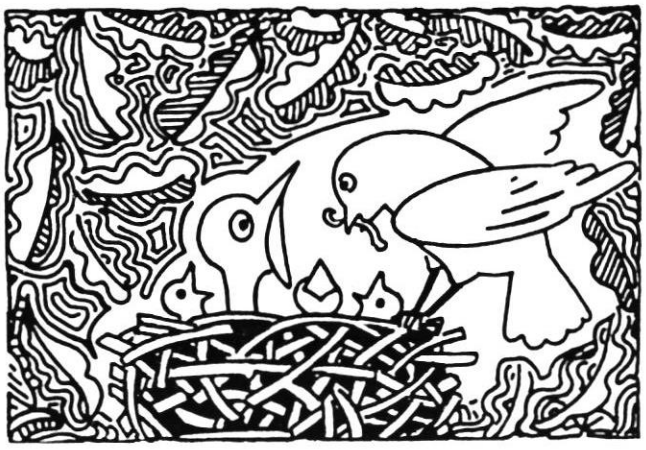
The J.I.T. procedure depends on producing the necessary quantity at the needed time, i.e., the manufacturer will produce only what is needed and will not stockpile finished goods or parts. In this environment, one piece is the ideal lot size. A worker will complete his/her task and pass the piece along. The timing is paced so the piece is passed along to the next worker when needed.

The object is to keep inventory at a minimum by viewing anything that does not directly add value to the product as waste to be eliminated. Since inventory only adds cost, it needs to be depleted. Therefore, the only inventory a firm will have are materials required for work in progress, and suppliers will deliver only what is needed for a day. One advantage of this system is that with less inventory available chance of damage is lessened and the product will not become obsolete while waiting for shipment.

The use of J.I.T. saves the manufacturer money. "To produce 11 million cars and trucks a year, the Japanese auto industry has $800 million in inventory. The U.S. companies need $8.5 billion to do the same."[1] Ford estimates insurance and interest equal an additional 26% to the value of the stored parts or $2.1 billion that could be used for working capital.[2]

Characteristics Of J.I.T.

Toyota's kanban system uses cards similar to those found in stores which tell clerks when to reorder. With kanban, each part container has a card needed for manufacturing and assembly; employees cannot use a piece without a card and never can have more pieces than the card indicates. The parts that are stockpiled must be used on a first-in, first-out basis.



The J.I.T. system can be implemented with or without a computer. Buick adopted an automated storage/retrieval system along with the J.I.T. At their Flint engine plant, they replaced 60,000 sq. ft. of storage space with a 10,000 sq. ft. area next to the engine assembly. The former storage space now is used for additional assembly and testing. As a result, part shortages were reduced and capital freed that previously was tied up in inventory.[3] J.I.T. also promotes manufacturing flexibility so a company can adjust production according to demand without worry about excess inventory.

Relationship With Supplier Companies

The establishment of these economical procedures requires trust and flexibility between firms. The manufacturer must be assured suppliers will deliver according to schedule based on changes in market demand.

Similarly, the supplying company needs to trust its customers. The use of J.I.T. procedures could reduce the

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number of suppliers a firm uses, yet the supplier needs to count on a stable market in order to amortize the cost of production over a long period.

Many critics of the system contend the procedures merely push the inventory problem onto the supplier. Not so if they also adopt the system. If the supplier provides a warehouse for parts, nothing is gained. The extra handling involved in storage may result in damage, and since the system disallows extras, damaged items would stop production.

The manufacturing firm adopting J.I.T. requires its suppliers to ship parts daily which also necessitates a strong working relationship with freight carriers. Usually, the supplier is located within 300 miles (one day's drive) of the firm.

Weber's Model For Industrial Location

The question remains, where will the supplier decide to locate? In 1909, the German economist, Alfred Weber, wrote the first theory on how industrial decisions are made in terms of agglomeration activities, transportation and labor costs.[4] An industrial firm's location was at the lowest cost.

The theory relies on several explicit assumptions: first, there is an uneven distribution of raw materials across the plain; second, the markets for products are provided as points on the plain and they exist before any industrial decision is made; third, there are several fixed locations for labor with a given wage rate at each location. Between these points the wage rates may differ, however, labor is immobile and unlimited as long as the firm pays the given rate.

Weber assumes the plain has a uniform race, culture, climate and political and economic systems. A rational decision-maker seeks to minimize total cost and maximize profits. On the plain, a perfectly competitive economic environment exists; no one obtains a monopoly or enforces an oligopoly; labor and transportation are the only varying costs; land buildings, equipment, interest and depreciation are uniform. Weber assumes a uniform transportation system exists over a flat surface, therefore distance is the only factor in transportation costs.

He theorizes the decision-maker first will locate the plant at a site that minimizes transportation expense. If labor cost or agglomeration activities affect the decision, the industrialist will look for an area that will minimize total cost. If labor costs are significantly higher at the location offering minimum transportation expense, it pays the industrialist to look elsewhere. Another site might have higher transportation fees, but offers cheaper labor. Similarly agglomeration, which may affect total cost, is the savings that can occur to firms operating in the same area. Such activities represent common services used by companies such as utilities, financial service, and linkages with each other.

Locational Decision With Linkages

Agglomeration linkages are key to locational decisions, according to J.I.T. procedures. Linkages are defined as the external contacts of an organization of its component parts, which collectively define the space within which it operates. Indeed it has been maintained that linkage patterns are a measure of spatial behavior demonstrating the role of other places in the operation of commercial enterprises.[5]

Weber believed the decision-maker was a rational profit maximizer. Accordingly, linkages were just channels where spatially variable costs and revenues occurred. The theorist assumed external economies of scale existed and the industrialist merely responded to concentrated activity. However, later researchers found agglomeration usually follows, not precedes the location decision.[6] In other words, the industrialist wants others to locate nearby in order to reduce his/her risk and uncertainty.

Three major sources of risk and uncertainty are found. First, other decisions are made at the same time; second, the implicit risk of changing technology; and last, unlike earlier assumptions used in locational theory, the decision-maker has imperfect knowledge of the market. The outcome of the decision is based on its context which is influenced mostly by uncertainty.[7]

Under Weber's assumptions, decisions are made in an open system which allows for receiving, processing, and transmitting information and material to other organizations. However, the open system sometimes lacks information; and external circumstances may influence the decision. An example is the need for top management approval. The staff conducting the search finds a site that will reduce risk and minimize cost. However, if senior executives do not want to live there, another place will be chosen. Under these conditions, the "attributes of external sites are less relevant than the nature of the industrial and organizational environment within which the decision is made."[8]

Linkages also help determine how the firm conducts itself in terms of process, the movement of goods between firms in stages of production; service, the supply and repair of machinery and equipment; marketing, selling and distributing support; and financial and commercial support, including accounting and insurance.[9]

The J.I.T. procedure primarily influences processing and marketing. Since the manufacturing firm will not keep an inventory, selling and distribution systems need to change.

Each category of linkages has nine characteristics that influence the locational decision:

1. value of any particular contract
2. volume or magnitude of the contract
3. frequency or regularity
4. the type of goods involved in the linkage
5. the type of counterpart organization involved
6. the mode or form of interchange
7. the formality or the legal status

8. the time budget
9. spatial dimensions[10]

The significance of each characteristic depends on the nature of the transaction. Of particular importance is the value and volume of the contract. If the firm adopting these procedures represents a large volume of the suppliers's business, the latter will relocate to comply with the requested delivery schedule. If the supplier values its relationship with the other firm, it will make the changes necessary to keep the business.

Using the J.I.T. system increases the frequency of delivery and the importance of transportation costs. If the product is small and light, the supplier still may be able to use air freight, thus the supplier could be located anywhere in the country. However, the mode of transportation must be selected to allow for prompt delivery. For example, a semi-conducter firm could locate in the Silicon Valley and send chips by air to Detroit. However, since inclement weather conditions could restrict air traffic the auto manufacturer may be forced to select a closer supplier.

The time budget also changes. In addition to the accelerated pace for receiving supplies, the system needs flexibility, which requires changes to be made quickly. Even though communication costs are decreasing, the manufacturer may desire a supplier nearby; closeness can assure all parties that changes are understood and being made.

Of course, J.I.T. procedures affect the last characteristic, spatial dimensions; the other limitations placed on the locational decision limit the space in which the firm can locate.

Implications For Real Estate Counselors

Real estate counselors can use the trend toward J.I.T. to their advantage. Once a manufacturing firm decides to adopt this procedure, the counselor knows the supplier may choose to build a plant close by or depend on transportation for delivery. In most cases, the supplier will build a plant near its customer unless reliable transportation can deliver the goods inexpensively.

The real estate counselor should know how J.I.T. affects market segmentation. Obviously, geography is one sector influenced, and the counselor knows suppliers of local manufacturing companies are targets.

Other segmentation strategies can be used. The success of inventory control depends on the ability of the supplier to turn out quality goods; thus, a market-factor segmentation based on quality may work to attract these firms. The counselor also can point out the services available to the firm on-site, i.e., the closeness of accounting, advertising, and legal assistance.

Other segmentation strategies are benefits, volume, the location's status, and accessibility to highways or rail lines. The firm needs to be near one or the other to meet the customer's schedules. Also, the real estate counselor must find a location that fits the heavy volume produced by most suppliers.

Other Implications

J.I.T. also will effect the growth of industrial parks. Instead of heterogeneous companies locating in parks; an industrial area can include a manufacturing firm and its suppliers.

However, it negatively impacts upon the need for distribution facilities since less storage is needed throughout the production and close proximity provides convenient delivery to customers and markets. Distribution centers will have to add value to the product and warehouses either will be converted to other uses or torn down.

As long as building costs are related to square footage and less capital is tied up in inventory, the return on investment should increase. Firms should generate more internal funds and reduce the pressure on the capital markets. Hopefully this will decrease interest rates and encourage expansion into new markets.

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INTEREST RATE SWAPS

An innovative financial technique is one way to hedge against a mercurial interest rate dilemma.

by Milton A. Scott, Jr.

Volatile interest rates of recent years have increased the risk sensitivity of financial institutions. The prime rate soared to over 20% in 1980, fell to 11%, and surged back to over 20%.[1] Earnings and the cost of funds have become subject to wide, unpredictable swings causing institutions to develop innovative techniques to insulate their investments from the wide fluctuations in rates.[2]

Interest Rate Futures

Interest rate futures is one approach introduced in the 70s. While successful at coping with volatility, they are limited as hedging vehicles. Futures contracts end after 18 months and must be rolled over if they are to be extended past maturity. In using a futures hedge, there is the basis risk when rolled over[3]. Interest rate hedgers also have to mark the value of their futures positions daily, which causes exposure to substantial losses.

Interest Rate Swaps

Interest rate swaps, introduced in the early 80s, are more flexible than futures contracts since they can be tailored to individual circumstances. Swaps can be made for extended periods of time better matching asset maturities, whereas using futures contracts for the same time span can expose a financial institution to unwarranted risk.[4]

This technique is a contract between two institutions to exchange payment streams on a note for a set time, usually 2-12 years. It is neither an investment nor a borrowing method, and only cash flows are exchanged,

not principal. A swap is merely a way to change the rate on an asset or liability from fixed to variable, vice versa, or from one variable rate to another.[5]

In less than four years, the interest rate swap market has ballooned from a few million dollars to over $100 billion, with some estimates as high as $120-$150 billion.[6]

Classical Swap

Swaps are most commonly used to close balance sheet gaps between liabilities and assets with different maturities, eliminating interest rate exposures. Swaps also may transform floating rate funds, i.e., money market deposit accounts, and certificates of deposit into fixed rate term debt at attractive levels.[7]

A typical classical or plain vanilla swap is relatively simple. Suppose that First Savings Bank is paying interest rates on money market deposit accounts (MMDAs) tied to a three-month 7%, Treasury Bill rate. These liabilities are funding 12% fixed rate mortgages with an average life of 10 years; the spread is 500 basis points.

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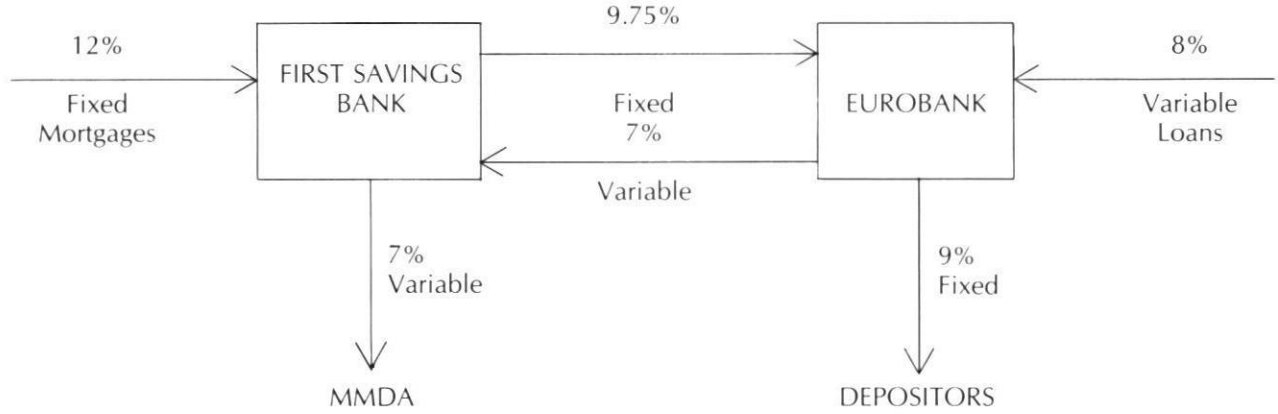
FIGURE 1



However, if the Treasury Bill rate rises higher than 12% over the next decade, the spread narrows and becomes negative. To avoid this, First Savings Bank enters an interest rate swap with the foreign bank (Eurobank), which usually would have excess fixed rate liabilities. Eurobank has access to long term, fixed rate funds but interest payments are tied to the London Interbank Offered Rate (LIBOR).

First Savings Bank agrees to pay 25 basis points less than the current 10-year Treasury rate of 10%, or 9.75% to Eurobank for the same time period. Eurobank agrees to pay First Savings Bank a variable rate, 100 basis points less than the three-month LIBOR. The interest paid is based on an agreed upon notional principal because there is no actual exchange of principal in an interest rate swap. Because the variable rate swap payment and the MMDA rate generally float together, a rise in payments to depositors will be offset by an increase in the payments from Eurobank.

The swap allows First Savings Bank to preserve a 225-basis point spread over 10 years between its 12% mortgages and 9.75% liability cost. Eurobank's floating rate debt is at the three-month LIBOR, less 100 basis points, or initially 7%. Eurobank pays First Savings Bank 7%, receives 9.75%, and pays its depositors 9% for an initial spread of 175 basis points. (See Figure 1).

Another financial institution normally acts as an intermediary arranging the transaction. To reduce the exposure, an intermediary locates institutions with opposite exposure to interest risk and gets them together. The intermediary would receive a fee up front for arranging the swap based on the size and complexity of the transaction.[8] The intermediary also may act as settlement agent collecting and paying the net difference to the appropriate party at agreed upon intervals.[9]

Swap users include thrifts and commercial banks, sovereign governments and their agencies, insurance companies, and industrial corporations.[10]

Other Swaps

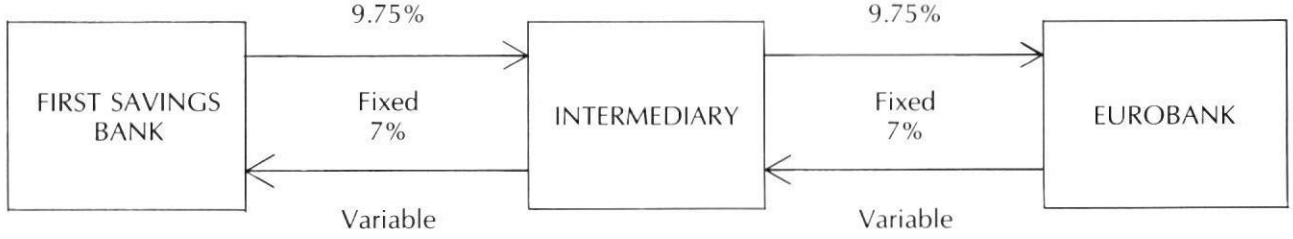
While the straightforward, plain vanilla, interest rate swap still comprises 90% of the market, reversals and swaps of one floating rate for another are two new popular techniques.[11]

Reversals

Inevitably, a bank may find that its circumstances have changed several years after doing a swap and wish to undo it. It can do this by executing another swap in the opposite direction.[12] Suppose a bank made a 10 year fixed rate loan to a major customer. The bank entered into an interest rate swap to minimize its interest rate exposure agreeing to pay a fixed rate at the six month Treasury Bill rate. Four years later, the customer wishes to repay the loan. This leaves the bank exposed and wishing to end its interest rate swap.

If the original fixed rate payment was 12%, four years later the six year money costs 13%. The bank enters into

FIGURE 2



a reversal six year swap by which it agrees to receive a 13% fixed rate in exchange for the six month Treasury Bill rate, and settlement dates for both are made to coincide. Thus, the Treasury Bill payments cancel out each other and the bank has a contract to receive 13% and another to pay 12% for six years. This results in a 1% annual profit for the bank. However, if interest rates moved the other way, the bank could as easily have locked up a 1% annual loss. All reverse swaps create a profit or loss, depending on whether fixed rates for the counterbalancing swap are higher or lower than those at the time of the original swap.[13]

Floating-to-Floating Swap

A financial institution often can better manage the basis risk or transform its assets and liabilities from one to another more attractive index through a floating-to-floating swap. Participants each pay a floating interest rate based on a different indice.[14]

The first floating-to-floating swap occurred in 1983 between a U.S. regional and a foreign bank. The U.S. bank successfully attracted deposits for the new money market accounts and needed a high yielding outlet for these funds. Since the future of money markets was uncertain, the bank was unwilling to put this money into prime related loans. Yet, it still wished to receive a prime rate. The bank was willing to pay LIBOR because of other LIBOR-based lending. Meanwhile, the foreign bank had good access to the LIBOR market but no natural access to U.S. money markets. The foreign bank was willing to receive the LIBOR in exchange for paying a rate tied to prime. The effect of the swap was that the foreign bank locked up its profit margin on the prime related loans, and the U.S. bank received prime related rates without having to lend at prime, thus, the prime-LIBOR swap.[15]

Although the most popular transactions in the floating-to-floating swap market involve such swaps, it is possible to structure them involving any two floating rate indices — certificates of deposit, commercial paper, Treasury Bill rates, and federal fund rates.[16]

Fees And Expenses

A financial institution serving as intermediary to an interest rate swap may act as broker, settlement agent, or guarantor. As broker, the intermediary brings participants together to transact a swap. Arrangement fees paid up front vary according to the size and complexity of the transaction. Previously banks earned more than 50 basis points on even the most straightforward deal. Now, increased competition has drastically reduced fees to 1/8-1/4% of the notional amount.[17]

As settlement agent, the intermediary collects and pays the net difference to each party at agreed upon intervals. The intermediary is not obligated to remit payments not received unless it also serves as guarantor. Settlement and guarantor fees may be paid periodically or built into the rates paid by swap participants. Such fees typically are less than .25% of the notional amount but vary depending on the credit risk of those involved.[18]

Each party also is responsible for paying legal counsel for preparation, negotiation, execution, and delivery of an agreement, usually a short document consisting of standardized terms.

Documentation

An interest rate swap transaction normally is arranged over the telephone and begins to accrue immediately. The parties sign the necessary papers governing the exchange of cash flows at a later date.[19]

Documentation for an interest rate swap is straightforward and generally specifies the notional amount, the fixed rate to be used and the mechanics of setting the variable rate, settlement procedures, fee arrangements, assignment privileges, compensation paid in the event of default, the extent of the settlement agent's liability, and any other arrangements. A typical swap agreement contains 6-8 pages and may be completed quickly.[20]

Accounting Considerations

Since the underlying principal does not change hands, an interest rate swap is not disclosed in financial statements unless the notional amount, disclosed in a footnote to the balance sheet, is deemed material.[21] The net interest differential is treated as an adjustment-to-interest expense. Thus, swap payments flow through other income/other expense categories on the income statement.[22]

Brokerage or origination fees paid by a swap participant are treated as an adjustment-to-recorded-interest differences over the life of the agreement. Intermediary fees should be recognized as services are performed, while fees for issuing guarantees, i.e., standby letters of credit should be deferred and amortized over the commitment period.[23]

Risks

The primary risk in an interest rate swap is if one party defaults leaving the other with its original position. Because no principal is exchanged, the credit risk is limited to the payments each will receive from the other according to the agreement. If one defaults, the other stops payment. An intermediary, letter of credit, collateral, or any other form of guarantee can provide additional protection against credit risk. Most swap agreements specify penalties for defaulting.[24]

The direction of movement of interest rates also carries risk. If rates move unfavorably and the counterparty does not default, there is no problem. If the counterparty defaults when interest rates move favorably, the nondefaulting party may profit. A problem arises when the counterparty defaults and interest rates are unfavorable; the nondefaulting party then must find a new partner at less favorable terms.

As with any hedging strategy, participants must be willing to forego a more favorable move in interest rates. Once a swap has been executed, the party receiving

variable-rate payment should be unaffected by rate changes, however, as rates decline significantly, borrowers may refinance at more favorable rates. If that party funds those loans with liabilities whose cost is affected by a swap, the result could be negative.[26]

Another risk associated with interest rate swaps is basis risk. If the floating reference index on the underlying source of funds is different from the reference index on the swap, the rates will not float exactly the same. This risk is eliminated by matching the reference indices.[27]

The risks of misjudging rates or credit worthiness can have an adverse effect. An interest rate swap can have substantial benefits when properly structured.[28]

Benefits

A bank benefits from an interest rate swap by altering interest rate sensitivity thereby reducing asset/liability mismatch. [29]

- An interest rate swap consists of only an agreement to exchange future interest, not principal. The amount at risk only is the interest, not the nominal amount of the principal upon which a deal is based.[30]
- If matching floating rate indices are used, sensitivity to interest rates is eliminated.[31]
- The transaction is not a lending, therefore, it is possible to keep documentation reasonable.[32]
- It does not create a contingent liability, accordingly, the deal can be kept private.[33]
- As a hedging device, swaps are more flexible than futures contracts because their terms are longer and daily margin calls are not required.[34]
- The obvious benefit for intermediaries are the fees earned from the transaction.[35]

Secondary Market

Major investment and commercial banks have formed the International Swap Dealers Association to standardize swap documentation. As more dealers adopt these standards, swaps will become generic like U.S. government securities and open the way for the next generation of the swap market—secondary trading.[36]

Secondary trading of interest rate swaps originated when market conditions changed and some swap participants decided they wanted out.[37] As the swap market grew, more participants found themselves in this situation. Now, a participant also may sell a swap contract in the secondary market. The market values a seasonal swap contract as it values a fixed-income security; as rates rise or fall, the contract gains or loses value relative to the level at which new contracts are executed.[38]

Summary

The interest rate swap market continues to develop rapidly. Swaps are effective at managing a bank's net interest margin, are private transactions which can be negotiated quickly, and can be tailored to meet specific needs.

Standardization of terminology and legal contracts already is taking place among swap market makers, brokers, and market participants. Greater standardization will create greater liquidity; and interest rate swaps eventually may be quoted and traded on an exchange like futures contracts. All evidence within the market indicates that interest rate swaps are here to stay.

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REAL ESTATE AND THE AACSB'S COMMON BODY OF KNOWLEDGE

The merits of including real estate related courses in a university's business curriculum.

by Neil G. Carn and Joseph S. Rabianski

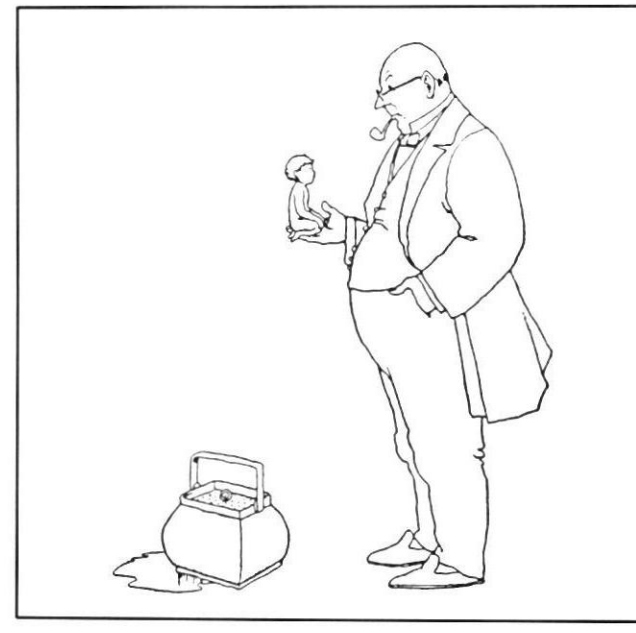
Real estate analysis is not included in the common body of knowledge as defined by the American Assembly of Collegiate Schools of Business (AACSB). Real estate principles, the most common industry course taught in colleges, is only an elective and not a requirement in the curriculum of most business schools. This article will explore issues that relate to real estate education and its role in a business program. For example, there are business programs that offer real estate courses but do not provide a real estate curriculum that is comparable to the requirements imposed for other business courses.

Body Of Knowledge Requirements

The AACSB's common body of knowledge requirements in business administration include at least one year of work encompassing the following areas:

- production and marketing of goods and services and financing of business enterprise;
- economic and legal environment with ethical considerations and sociopolitical influences;
- accounting, quantitative methods, and information systems, including computer applications;
- organization theory, behavior and interpersonal communication;
- managerial policy determination and administrative processes under uncertain conditions[1].

Common body requirements need to be reflected in



accredited business programs since all business students, regardless of their specialty, need to receive substantive training in each subject to acquire general principles. These courses are applicable to most business decision-making situations. AACSB has not adequately addressed the following two major categories of questions.

1. What are the accepted ways to satisfy common body of knowledge requirements in a business program? What types of courses should contain these subjects? When, or in what sequence, should the subjects be taught? Who (i.e., what business disciplines) should teach the courses? Could some or all of the subjects be included within a particular program or major such as real estate?

2. When and under what conditions should the common body of knowledge requirements be expanded, contracted, or otherwise modified? Are technological

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sophistication and rapid changes in business environments encouraging specialized training in business degree programs? What is the impact on these requirements to changing educational needs in various fields?

There are specific questions about how common body of knowledge subjects should be applied to real estate education.

- What similar elements should be included in real estate coursework, and where in the curriculum should these subjects be placed?
- Are there real estate subjects which have general business application and should be included in a core business curriculum?
- What role should real estate educators play in teaching common body subjects to their own majors and to other business students?

Well Rounded Curriculum

Most real estate faculties encourage AACSB requirements to insure their majors will be well founded in the general areas of business. However, business students usually are not exposed to any real estate topics except as electives. Presently, the number of electives for business students are diminishing since there are increased requirements in business core areas such as information systems and international business. Entire courses often are added even though the AACSB only requires concepts or topics which could be included in other courses. Also, many nonbusiness courses are available as electives and in competition with real estate classes in the junior and senior years. Consequently, it is very difficult for real estate education to become integrated into the business core or elective area.

Many business students and faculty from traditional fields regard an education in real estate to mean learning the techniques of buying and selling houses. In reality, real estate classes are concerned with the production, financial structuring, investment decision-making, distribution, and ongoing management of real property that requires intricate business decisions and utilization of skills and training.

Real estate subjects are applicable in business situations since the decisions about production, marketing, and financing are critical components. Space utilization and facilities planning are essential in any strategic business planning process, yet these topics are not explicit in core business courses. Companies must occupy real property to perform, and how they acquire, organize, and manage real property has extensive financial and operational impact. Thus, the whole process of real estate decision-making is involved in the operation of all enterprises. A business student should be aware of the salient issues involved in acquiring and occupying space as the decision-maker should know how to provide for changes in space requirements. These concepts can be taught in courses concerned with real estate principles.

The Real Estate Principles Course

The real estate principles course is a microcosm of business and professional applications. Properly designed and taught, it provides the student with a view into the unique characteristics of real estate, the market and legal environment in which real property transactions occur, and the specialized knowledge and training needed to properly manage real estate assets. It is important to understand the principles governing utilization of real assets from the viewpoint of internal real estate management which includes facilities planning for physical expansion or contraction of the enterprise. It also has value from an investment management viewpoint where real estate is a productive component.

For many general business students, this course would be their only exposure to the principles of financing, managing, and analyzing real estate assets. For students who continue on to advanced real estate courses, the principles course provides the foundation for further studies in areas as real estate finance, investment analysis, appraisal, and market research.

Table 1 illustrates the major topics in a business-oriented real estate principles course which include

- business law topics in the real estate law section;
- legal environment concepts in the real estate development and regulation section;
- microeconomic analysis in the appraisal and market analysis section;
- accounting procedures and analysis of financial statements in the investment and finance sections;
- compound interest theory in the investment and finance sections;
- capital market concepts in the finance section; and
- management planning and development in the property management, production, and investment sections.

When the principles are so presented, they can be characterized as focusing on a commodity that is

- traded in a highly institutionalized but noncentralized market;
- evaluated as an investment opportunity;
- purchased through debt and equity financing;
- physically and financially managed in an organized fashion;
- regulated in its use and transaction procedures; and
- produced through a highly complex process.

Such an orientation uses concepts introduced in business core courses and applies them to a real property asset, or it introduces these concepts in the course and then puts them into application. The approach varies depending on whether the course is geared to a sophomore or junior level. For a junior level course, the principles of accounting, economics, and decision mathematics are prerequisites. Typically, the other common body

TABLE 1

Content of the Real Estate Principles Course

Real Estate Terminology

Real Estate Law
- –rights and forms of ownership
- –private limits on ownership (liens, easements, and restrictive covenants)
- –contract law
- –description of legal instruments used in transactions (deeds)
- –discussion of the transaction or exchange process

Real Estate Development and Regulation
- –public sector limits and controls on the individual's rights of ownership (zoning ordinances, subdivision regulations, and construction codes)
- –condemnation and eminent domain
- –land development standards

Real Estate Appraisal
- –value determinants—physical, locational, legal, economic, social
- –market analysis concepts
- –appraisal techniques—value estimation of a specific property

Real Estate Investment Analysis
- –investor objectives
- –income/expense statements
- –rates of performance
- –rate of return
- –measurement techniques (ratio analysis, NPV, IRR)
- –tax code impacts on the investment decision
- –deal structuring and negotiation

Real Estate Finance
- –measurement of default risk
- –financing alternatives
- –financing institutions in the mortgage market
- –sources of funds

Real Estate Brokerage, Marketing, and Property Management
- –law of agency
- –listing agreement
- –lease law (residential and commercial)
- –lease provisions and their effect on the asset's cash flow

Real Estate Production
- –site selection and subdivision
- –site and architectural planning
- –construction management

courses—principles of management, marketing, legal environment—are corequisites. At the sophomore level, the real estate principles course has no business prerequisites and often is consumer orientated.

A principles course also covers brokerage, marketing, and property management. Even though many business concepts may be presented, these topics can turn a business orientated course into a consumer-orientated class, even at the junior level. Topics such as licensing regulations, brokerage practices, and sales techniques, should be itemized, however, they will displace investment and financial analysis if given too much emphasis.

The real estate principles course contains many of the business core concepts contained in the AACSB's common body of knowledge requirements. Economic analysis, sources of financing, and income/expense statements are presented in other business core courses. Some concepts, i.e., development regulations and

TABLE 2

Content of the Real Estate Core Courses

Course Title	Major Topics	Tools of Analysis	Contributing Disciplines
Real Estate Investment Analysis	Income/Expense Analysis, Risk and Return Analysis (Performance Ratios, NPV, IRR, FMRR), Tax	Income and expense statements Discounting techniques Computerized programs	Accounting/Finance Decision Mathematics Information Systems
Real Estate Finance	Sources of Funds, Mortgage Market Analysis (Primary and Secondary), Future Market Impacts, Lenders' Use of Risk/Return Analysis, The Mortgage	Discounting techniques Income and expense statements Micro and macroeconomics Contract and financial law	Decision Mathematics Accounting/Finance Economics Legal Studies
Real Estate Market Analysis	Analysis of Local Economic Activity (Circular Flow of Income Model, Export Base Theory, Input/Output Analysis), Residential and Commercial Market Analysis, Residential and Commerical Location Theory, Consumer Research Techniques, Forecasting Techniques	Microeconomics Descriptive and inferential statistics Market research Strategic business planning	Economics Decision Mathematics Marketing Management
Real Estate Appraisal	Value Concepts; Physical, Locational, and Legal Value Determinants; Three Appraisal Techniques; Mass Appraisal Using Regression Analysis	Microeconomics Discounting techniques Regression analysis	Economics Decision Mathematics
Public Policy Aspects of Real Estate	Government Land Use Powers and Roles, Public Objectives and Planning Processes, Provision and Maintenance of Land Infrastructure and Site-Specific Services, Regulatory Approvals, Cost/Benefit Analyses, Impact Analyses, Public/Private Development Roles and Relationships, Legal Precedents, Trends	Cost analysis Economic impact analysis Evaluation of legal and political risks Environmental impact analyses Strategic project planning	Accounting Economics Decision Sciences Legal Studies Public Administration Management

management of activities, are more specialized and require focusing on real estate's peculiar legal environment and production techniques.

Senior Courses In Real Estate

Table 2 identifies the five courses that comprise a full real estate curriculum offered beyond the principles course. Often the areas of investment and finance are combined into a single course. The major topics for each are shown in Column 2, the tools of analysis are identified in Column 3, and Column 4 identifies the business discipline where the tools are obtained.

The five courses analyzed in Table 2 utilize a variety of skills fundamental to a business curriculum. This is especially true of investment, finance, market analysis and appraisal courses whereas a course in development regulations applies a different analysis. This subject matter is real estate orientated but employs techniques peculiar to legal and governmental analysis and investigates court cases that establish the basis for developmental restrictions in zoning, subdivision regulations, building codes, growth control techniques, and eminent domain. It also introduces the student to technical materials important in analyzing the physical development potential of a site. This course and others listed here contribute to the strategic planning process in business organizations which hold real estate assets.

Real estate core courses provide concepts to use in making important business decisions.

- Does the return from a real estate equity investment meet the investor's financial objectives? How is return measured? What risks must be faced? How is risk evaluated?
- Can the form of ownership affect the rate of return from a real estate equity investment?
- Can the financial structuring of the deal affect the rate of return?
- How is the mortgage market funded? How is the fund affected by economic circumstances?
- What factors affect the level of new residential construction? How is the construction market

related to the financial markets?

- How is the economic strength of a local economy and market analyzed and measured?
- How can a specific parcel of land and structure be valued? How does the value of real property change when economic circumstances change?

These five real estate core courses expand the topics introduced in the real estate principles course to give the student workable knowledge and provide specific skills in real estate management. The courses build on the common body of knowledge topics discussed earlier in the same way that senior level courses relate in other functional areas of business. Therefore, it is plausible for real estate majors to take these courses to meet some of the AACSB's requirements for finance, marketing, and legal studies.

The Argument

The AACSB needs to give more direction to common body of knowledge concepts for business students in each of the business fields. The AACSB should respond to the following questions:

- It is important to know the legal environment of business, or should students only be instructed in their functional area—accounting, finance, insurance, or real estate? Is a combination of these approaches more desirable?
- Is knowledge of finance in a corporate sense the only way to fulfill the common body knowledge, or can financial principles be taught in a specialized way, i.e., can courses in real estate finance and investment adequately fulfill basic requirements?
- Can marketing principles be taught in the context of real estate markets, or must the focus remain on personal property items that typically have no investment aspect added to their consumptive use?
- What aspects of microeconomics are needed by business students? Can these concepts be integrated into specialized courses such as real estate market analysis?
- Should factory-oriented production topics comprise the only approach to teaching production concepts, or could real estate construction constitute a possible alternative?

Real estate majors could be exempted from some basic classes because the training they receive in senior level courses fulfills common body requisites and provides specialized real estate training. For example, the development regulations course focuses on a legal environment specific to real estate; a course in mortgage markets, syndication, and real estate investments is a finance course specific to real assets; and the real estate market analysis course embraces general marketing principles and provides training in techniques peculiar to real estate. Students majoring in other business areas should have the same option when coursework in their field provides advanced training in general business foundations and techniques specific to the discipline.

In addition, it would be valuable for general business students to acquire specialized training in real estate analysis; or topics from a real estate principles course

TABLE 3

Specialized Real Estate Courses

Course	Major Topics
Legal Environment of Real Estate	Real estate law and legal precedents; Law of Agency, Real estate securities and syndication laws; Real estate contracts and lease law; Legal and political powers of government; Legal procedures of governmental real estate actions; Legal case studies involving regulatory issues.
Urban Land Theory and Location Analysis	Economic theories of urban space markets; Basic value and land economic theories; Central place, and urban agglomeration theories; Industrial/residential/commercial location theories and determinants; Land use theory and models; Development decision-making processes; Site selection and development strategy procedures.
Real Estate Production and Development	Property development processes and procedures; Site and architectural analysis, site planning procedures; Cost estimation and value engineering; Construction contract negotiation and management; Construction management and scheduling; Rehabilitation and redevelopment processes; Governmental assistance programs; Historical renovation.
Real Estate Organization and Management	Strategies for maximizing potential of real estate assets and business opportunities; Organization and management of real estate investment entities; Real estate asset and property management; Management of residential/commerical/industrial brokerage operations; Organization and management of real estate functions in large diversified firms; Strategic planning for real estate organizations and projects.

should be included in common body of knowledge requirements. The real estate principles course is the easiest, most available method to meet any such requirement.

Optional Courses In Real Estate

Once a business student has completed a real estate principles course, he/she may benefit from advanced topics. Table 3 identifies courses which offer real estate

TABLE 4

Service Function of Major Real Estate Courses

Functional Area of Business	Rank Ordered Service Courses	Relevant Information
Accounting	Real Estate Investment/Finance	Nature of analysis for equity decisions; Measures of profitability: Profit recognition
	Real Estate Appraisal	Valuation techniques: Historic cost calculation, fair market value, net realizable value
	Real Estate Market Analysis	Revenue and operating cost—historic cost analysis and comparable data analysis; Revenue and expense forecasting techniques
Finance	Real Estate Investment/Finance	Nature of analysis for equity decisions; Institutional factors affecting market transactions; Performance and profitability measures; Ownership entity selection; Real estate taxation provisions
	Real Estate Market Analysis	Analysis of local economy; Revenue and expense forecasting techniques; Demand and supply in residential, commercial, and industrial markets
	Real Estate Appraisal	Real asset valuation techniques
Marketing	Real Estate Market Analysis	Application of market segmentation techniques; Evaluation factors for competition and market potential; Focus of consumer survey techniques
	Real Estate Brokerage	Marketing the physical asset: lease negotiations, tenant selection, space allocation
Economics	Real Estate Market Analysis	Demand and supply factors in residential and commercial markets; Residential and commercial location theory
	Real Estate Finance/Investment	Analysis of the primary and secondary mortgage markets; Discounted cash flow analysis (an application of cost/benefit analysis)
	Real Estate Appraisal	Valuation techniques; Physical, economic, and locational value determinants
Computer Science/ Information Systems	Real Estate Investment Analysis	Nature of decision-making analysis; Structure of commercial models to undertake analysis
Management	Real Property Management	Managing the physical asset
	Managment of Real Estate Business Organizations	Strategic planning for the organization and the project(s); Managing real estate organizations • Investment entities • Mortgage lending entities • Professional and business service entities • Production and entreprenerial entities • Public, non-profit, and other quasi-public institutional entities
Legal Studies	Development Regulation	Basis and procedures of regulation; Role of government and legal basis for guiding development and providing essential services
	Real Property Law	Use of technical agents in real estate activities; Types and nature of legal interests and investment entities; Instruments and contracts used in real estate transactions

majors and business students opportunities for diversification. These courses are usually available only in large real estate programs or at the graduate level. The presentation in Table 3 provides topics in these specialties; relationships to other business fields are not discussed, even though there are links to legal studies, economics, and management. This is not a comprehensive list of real estate specialization courses, but it identifies the principal classes that exist in some business schools and could be offered in others with the required faculty and resources.

Advanced courses expose the student to ideas for the analysis of business decisions involving real property.

- Can local government regulation affect the rate of return on a development project? How do you evaluate this impact?
- What physical limits can a site impose on the development process?
- Should excess acreage be purchased as a means for future expansion? If so, what is the value of this land in the future? What are the direct costs and the opportunity costs of holding excess acreage?
- When should the firm divest excess acreage of facilities?
- Should the corporation diversify into property development? What risks would it face?
- If an expansion of production facilities is warranted, should that expansion occur on-site, should the plant relocate, or should a branch plant be established? Where should that branch plant be located? Where should the firm relocate? What are the criteria and standards that need to be analyzed in making these decisions?
- Can design features of the site and structure affect the rate of return by influencing revenues, operating and/or construction costs?

Real Estate Courses As Service Courses

Real estate courses also can provide a body of electives for students majoring in other business disciplines. Table 4 identifies the service function that specific real estate courses can provide these students. The topics covered are identified in the column entitled Relevant Information. Real estate investment is the course that interests most business students, followed by real estate finance and real estate market analysis.

Summary And Conclusion

This article has explored the role of real estate education in meeting common body of knowledge or core requirements in the business curriculum. As a business field, real estate's educational programs usually embrace general business core requirements. However, these students often graduate with little if any exposure to important topics, and real estate educators are rarely involved in teaching core subjects.

Such topics have a place in the business core, i.e., the basic concepts of space utilization and facilities planning, since these subjects are frequently encountered in business decision-making and are critical concerns in strategic planning. Placing a real estate principles course in the general business core is the most appropriate and readily available method of integrating real estate topics into core business requirements.

NOTE

1. American Assembly of Collegiate Schools of Business, *Accreditation Council Policies, Procedures and Standards:* 1985-86. AACSB, 1985, p.29.