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Editor's Notes

An incorrect biography accompanied the article, "The Effects of Just-in-Time Inventory Procedures on the Locational Decisions of Suppliers," by Daniel L. Tompkins in the Fall/Winter 1986 edition of *Real Estate Issues*, page 33.

Mr. Tompkins is a consultant in corporate finance and real estate and a business lecturer at the University of Akron. He previously has published in the Summer, 1986 issue of *Corporate Accounting*. Mr. Tompkins earned his B.A. in economics from Ohio State and an M.B.A. from the University of Akron.

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FINANCIAL PLANNING FOR REAL ESTATE PRODUCTION DECISIONS

A new sophistication is taking hold in the financial analysis procedures of emerging real estate companies.

by Colin Balogh, John Corgel and Gregg Logan

Recently, the production and service components of the real estate business have evolved from collections of mom and pop operations to full-fledged industries comprised of highly competitive, small and medium-sized firms.¹ This evolution to larger-scale business operations has important implications for the type of financial analysis to be conducted by real estate firms in the future. Specifically, the traditional project-specific financial analysis of real estate investment opportunities will be subsumed by strategic financial planning for real estate decisions at the firm level. Even with a radical change in emphasis and interpretation, the discounted cash flow tradition, firmly established in project-specific analysis, is likely to remain since it underlies most strategic financial planning models. This article details how such a model can be used by firms to make real estate production decisions.

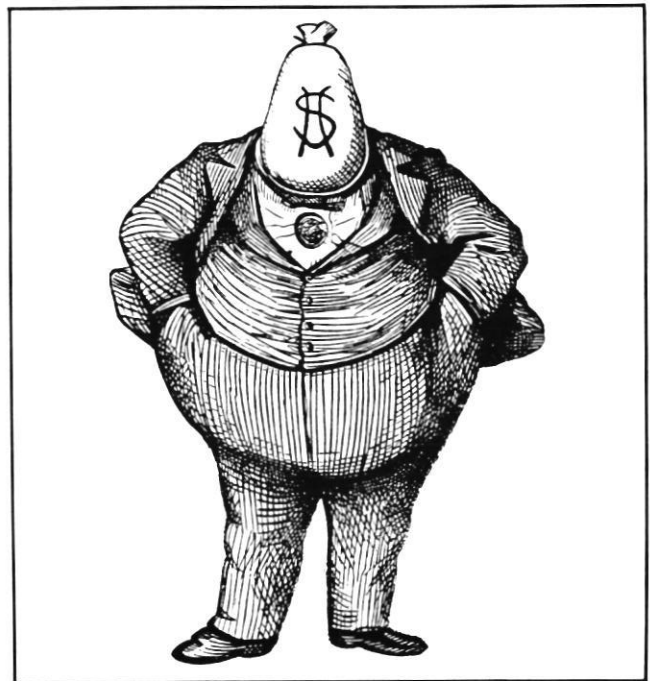
Strategic Financial Planning

Financial planning at the firm level is broadly defined as the process by which financial managers consider the overall effect of the company's financing and investment decisions. The focus, as explained in this article, is with financial decision making which is "strategic" in nature rather than "operational". Strategic financial planning

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involves the evaluation of financing and investment options that may ultimately change the course of the firm's operations vis à vis the evaluation of options. It may simply enhance the efficiency of the firm's operations while on its present course.

Brealey and Meyers define strategic financial planning more specifically as the process of:

- analyzing the interactions of the financing and investment choices open to the firm.
- projecting the future consequences of present decisions in order to avoid surprise and understand the link between present and future decisions.
- deciding which alternatives to undertake (these decisions are embodied in the final financial plan).

- measuring subsequent performance against the goals set in the financial plan.²

A good financial planning model will accommodate these tasks and possess the general characteristics such as parsimony: the model should be economical or efficient, robust and insensitive to changes in the underlying assumptions.³ Also, the model must be flexible enough to handle the unique aspects of real estate markets.

Financial Planning And Real Estate Production Decisions

Traditionally, real estate financial planning has been confined to the firm level and has consisted of consolidated analyses. However, as the cost of doing business has increased and marketing and production methods have become more sophisticated, larger development organizations have begun to dominate. These firms must maintain a production pipeline to support the various functions of the line organization.

For example, a firm may be organized with the following departments—land acquisition and processing, land development, building and construction, and sales and marketing. Also, the company needs to have enough projects at various stages (i.e., start-up, construction, sales, completion) to keep all the departments functioning.

Decision making takes place beyond the project level of analysis. Real estate development firms, particularly those that are fully integrated (taking a project from raw land, to building the homes, through sales and marketing) need to analyze strategic planning questions in order to set the future direction of the company for at least a three to five year period. Strategic planning is an ongoing process that requires new methods of financial analysis.

For a real estate firm, this requires the company to define

its industry role, expansion options, rationalization, efficiency and organization.⁴ (See Exhibit I) *Industry role* is a decision made by management concerning the role or roles it will play in the building/development industry. Often numerous roles are required to take raw land through the development process. *Expansion options* are plentiful and most firms want to grow by increasing their market share in an existing area, entering new geographic locations, serving new market segments or introducing a new product. *Rationalization* strategies consider leaving or altering how a firm serves a geographic location, market segment or product category. It is the opposite of expansion and sometimes is necessary when responding to changing economic conditions. *Efficiency* strategies deal with producing at lower costs and/or quickly. This is an important component of most strategies. *Organizational* strategies reflect the ways to organize a builder/developer company, from project management at one extreme to functional management on the other. By definition, smaller entrepreneurial firms are project management oriented, while larger organizations may have different people responsible for site acquisition, development, building and sales. Finally, any strategy needs to be evaluated in terms of the three potential economic phases—a growing economy (demand increasing), a stable economy (demand level) and a contracting economy (recession with demand decreasing).

These strategy evaluations exceed the typical requirements of project level financial analysis. The builder/developer needs to determine what shareholder value increases will accrue when different sets of strategies are followed. Varying strategies need to consider sales volume goals, which, in order to be achieved, have specific fixed asset and working capital requirements and a level of risk.

A model is presented here (see Exhibit II) that calculates a before-tax equity contribution after the target earnings

EXHIBIT I

Shareholder Wealth Increase Resulting From Implementation Of Expansion Plan

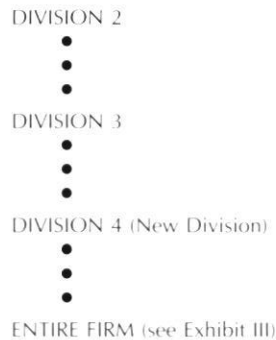
	1	2	Year 3	4	5	Total
Sales	\$57,500,000	\$66,120,000	\$76,040,000	\$87,450,000	\$100,570,000	\$387,680,000
Sales increase	7,500,000	8,260,000	9,920,000	11,410,000	13,120,000	50,570,000
Projected return on incremental sales minus minimum return ($p - p_{min}$)	.01	.01	.02	.02	.02	
Shareholder present value increase (Calculated using Equation 3)	\$ 290,000	\$ 290,000	\$ 590,000	\$ 590,000	\$ 600,000	\$ 2,360,000

Source: Rappaport (see footnote #5)

EXHIBIT II

Multi-Divisional/Probabilistic Financial Planning Model: Case Example

	Division 1				
Years	1	2	3	4	5
Pessimistic (Probability = 30 percent)					
Sales (\$000,000)	60.00	64.80	51.80	36.00	51.80
Assets (\$000,000)	22.20	22.60	22.20	20.70	20.70
Ebit (%)	10.00	11.00	9.00	6.00	10.00
Ebit (\$000,000)	6.00	7.13	4.66	2.16	5.18
Realistic (Probability = 60 percent)					
Sales (\$000,000)	60.00	64.80	55.00	45.50	55.00
Assets (\$000,000)	22.20	22.60	22.30	21.50	21.50
Ebit (%)	10.00	11.00	10.00	7.00	11.00
Ebit (\$000,000)	6.00	7.13	5.50	3.19	6.05
Optimistic (Probability = 10 percent)					
Sales (\$000,000)	60.00	64.80	70.00	75.60	81.60
Assets (\$000,000)	22.20	22.60	23.30	23.40	23.60
Ebit (%)	10.00	11.00	12.00	13.00	14.00
Ebit (\$000,000)	6.00	7.13	8.40	9.83	11.42



are achieved. A financial analysis for building/development firms needs to measure sensitivity to cycles, and therefore is probabilistic. Included in the model are pessimistic, likely and optimistic evaluations of each strategy, as well as an analysis of the probability for each of the scenarios to occur. Finally, given that different strategies will have different levels of risks, higher rates of return are assigned to reflect the increased chance.

Strategic Financial Planning Model

In a 1981 *Harvard Business Review* article, Alfred Rappaport presented a strategic financial planning model that provided estimates of the shareholder's value when management implements various business strategies.⁵ Specifically, the model yields the present value change in shareholder wealth or equity (ΔE) that results from the firm carrying out strategies to increase gross revenues.

The following equation for the firm's equity value is used to derive change in shareholder wealth:

$$(1) E_t = \frac{p(1-T)S_t}{k} - D_t$$

where:

E_t = value of the equity position in the firm at period t

p = earnings before interest and taxes divided by sales (i.e., rate of return on sales)

T = federal income tax rate

S = sales in period t

k = weighted average cost of capital (i.e. discount rate)

D_t = market value of debt outstanding in period t

Thus, the after-tax value of the equity is simply the capitalized after-tax earnings of the firm less the value of the debt outstanding.

Strategic financial planning typically involves an analysis of the methods directed toward *increasing* a firm's sales or gross revenues. Growth in sales alone, however, does not necessarily mean the shareholder's wealth will be enhanced. The change in shareholder wealth (ΔE) given a change in sales (ΔS), is determined in conjunction with an additional set of factors which includes the incremental rate of return on sales (p'). This is defined as the change in earning before interest and taxes, divided by the change in sales, the firm's tax rate and the firm's cost of capital. To increase the level of sales, it is assumed the firm must make additional investments in fixed capital (i.e., plant and equipment) and working capital.

The change in the value of equity for a given level of sales increase is defined as:

$$(2) \Delta E_t = \frac{p'(1-T)\Delta S_t}{k} - \frac{(f_t + w_t)\Delta S_t}{1+k}$$

where:

p' = incremental rate of return on sales, defined as the change in earnings before interest and taxes divided by the change in sales

f = fixed capital expenditures less depreciation per dollar of sales increase

w = cash required for net working capital per dollar of sales increase

The final form of the shareholder wealth equation is given as:

$$(3) \Delta E_t = \frac{(p'_t - p'_{t-1}) \min(1 - T_t) \Delta S_t}{k(1+k)^{t-1}}$$

where:

p'_{\min} = the incremental rate of return on sales required to break-even"

The term in the denominator of Equation (3) is a discounting factor used to estimate the change in shareholder wealth that results from the implementation of a strategy which causes a *permanent* (and infinite) increase in sales.

Hypothetical Example Utilizing Rappaport's Model

Assume a firm currently has \$50 million in sales and is considering a five year expansion plan. The expected growth rate of sales is 15 percent, the pretax incremental rate of return on sales (p') is 13.5 percent in the first two years and 14.5 percent in the remaining three years, working capital per dollar of sales (w) is 20 cents, capital expenditures per dollar of sales (f) are 35 cents, the tax

EXHIBIT III

Entire Firm Inputs: Case Example

Entire Firm					
Years	1	2	3	4	5
Pessimistic (Probability = 30 percent)					
Sales (\$000,000)	104.50	129.20	103.30	74.60	103.30
Assets (\$000,000)	33.10	38.40	37.10	34.80	34.80
Ebit (%)	12.50	12.80	11.30	9.00	12.30
Ebit (\$000,000)	13.06	16.47	11.62	6.71	12.65
Realistic (Probability = 60 percent)					
Sales (\$000,000)	104.50	129.20	109.70	90.80	109.70
Assets (\$000,000)	33.10	38.40	37.30	36.00	36.00
Ebit (%)	12.50	12.80	12.00	10.00	12.80
Ebit (\$000,000)	13.06	16.47	13.16	9.08	13.99
Optimistic (Probability = 10 percent)					
Sales (\$000,000)	104.50	129.20	156.70	181.45	209.00
Assets (\$000,000)	33.10	38.40	44.70	49.45	54.88
Ebit (%)	12.50	12.80	13.00	13.30	13.50
Ebit (\$000,000)	13.06	16.47	20.37	24.04	28.22
					Cost of Capital
					Equity
					Equity/Value: 60.00%
					Equity Rate: 11.90%
					Debt
					Debt/Value: 40.00%
					Debt Rate: 10.88%
					Weighted Average
					Cost of Capital: 11.49%
					Tax Rate: 46.00%

rate (T) is 46 percent, and the cost of capital (k) is 12.5 percent. First, p^* min is determined followed by the calculation of the present value of ΔE for each year of the expansion by using Equation (3).

The present value of the change in shareholder wealth resulting from the implementation of the five year expansion plan is shown in Exhibit I. The expansion plan is considered successful since it will increase the wealth of the firm's shareholders by \$2.36 million.

Case Study

The example just presented is both deterministic and designed for strategic financial planning of a single division firm. For the purposes of analyzing the problem to be described, the model has been extended to allow for multiple divisions and probabilistic estimates of economic conditions. These extensions are accomplished with the aid of a Lotus 1-2-3 spreadsheet routine that permits the analyst to vary the inputs for each strategy without the tedium of manual recalculation.

The case involves a regional firm whose operations consist of two home building divisions (Divisions 1 and 2), located in two different states and an investment division (Division 3) that owns a large apartment complex. The firm's management is considering the addition of a fourth division that would subdivide raw land for sale to one of the firm's home building divisions and to others in the area. While management considers the addition of a land development division would be profitable, there is concern about the effects of implementing this strategy on the company as a whole.

The firm's chief financial officer (CFO) and the

management-marketing consultant assembled the inputs shown in Exhibit II. The data were formulated with consideration given to the appropriate allocation of assets based on the division and sales potential in the market where similar home building and land development activities would take place. Also, the following states of the economy and their respective probabilities of occurrence (i.e., systematic risk) are assumed:

- Boom (moderate) economy-10 percent probability
- Stable economy-60 percent probability
- Recession (mild) economy-30 percent probability.

The sales figures were estimated for the upcoming five year period, and as shown in Exhibit II, they reflect expectations that sales will experience a structural decline in the third and fourth years of the five year planning horizon.⁷

The CFO of the firm determined the levels of assets required to produce each level of sales and estimated the percentage of earnings before income taxes.⁸ This process is repeated for the remaining three divisions.

Exhibit III displays the inputs to the model for the entire firm. The dollar values were obtained by summing the expected values for each division, including the proposed land development division. The CFO provided the capital structure and cost information and the tax rate. The cost of capital reflects the perceived riskiness of the firm with the new division in place. Equity financing constitutes 40 percent of the capital required by the firm, the required rate of return on equity is 11.90 percent, debt financing is 60 percent and the cost of debt is 10.88 percent. A 46 percent tax rate is assumed.

EXHIBIT IV

Change In Shareholder Wealth Resulting From The Introduction Of A Fourth Division

Year	1	2	3	4	5	Total
Sales	\$104,500,000	\$129,200,000	\$ 112,480,000	\$ 95,005,000	\$117,290,000	
P (i.e., Ebit/Sales) ^a	—	.1381	.1722	.1958	.2330	
fw (i.e., fixed assets plus working capital/ sales) ^a	—	.2146	.0718	.0845	.0197	
Projected return on in- cremental sales minus minimum re- turn (p – p min) ^b	—	.0971	.1585	.1797	.2292	
Shareholder present value increase ^c	—	\$ 10,112,700	\$ –10,018,900	\$ –10,647,700	\$ 15,832,800	\$5,279,900

^a Calculated using data in Exhibit IV

^b See footnote #5

^c Calculated using Equation (3)

After computing expected values, Equation (3) is used to generate the annual present value increases and decreases in shareholder wealth shown in Exhibit IV. All things considered, the addition of a land development is expected to increase shareholder wealth by more than \$5 million over the planning period. Variations of this strategy, including different assumptions about sales, are easily tested with the spreadsheet routine.

Conclusion

Formal strategic planning began with major corporations in the 1950s. The real estate industry, mainly because of the dominance of smaller firms, has been slow to follow industrial corporations in developing long-term strategic plans. However, such planning may be the key to survival for building/development firms in the future. The effect of alternative corporate strategies on the financial characteristics of the firm now can be analyzed instantaneously with the appropriate financial model and computer software.

NOTES

1. Haney, Richard L., Jr. "Real Estate Heavyweights in the Eighties," *Real Estate Review* (Summer, 1980): 35-43.
2. Brealey, Richard and Meyers, Stewart. *Principles of Corporate Finance*. New York: McGraw-Hill Book Company, 1984.
3. Morris, William T. "On the Art of Modeling," *Management Science* 13 (August, 1967): B-707-717.
4. Leinberger, Christopher B. "Strategic Planning Leads to Increased Bottom Line," *National Real Estate Investor* (February, 1986): 38-46.
5. Rappaport, "Selecting Strategies that Create Shareholder Value," *Harvard Business Review* 59 (May-June, 1981): 139-149.
6. Shareholder wealth does not change when the value of the inflows and outflows are equal such that

$$\frac{p'_1 (1-T)}{k} = \frac{(f_1 + w_1)}{(1+k)}$$

And, so a breakeven incremental return on sales (p min) can be obtained from the previous equation as

$$p' \text{ min} = \frac{(f+w) k}{(1-T) (1+k)}$$

7. In a boom economy it is assumed that a decline in sales would not take place.
8. The spreadsheet program converts these percentages to dollars.

AN EXAMINATION OF THE QUALITY CHANGES OF SINGLE FAMILY HOUSES

Research indicates that the purchase price of homes actually has increased less than the rate of inflation since 1964.

by Karen E. Lahey and James R. Webb

This article examines the trends in consumer preference for single family homes as they relate to the corresponding increases in price. A set of physical and financial characteristics were selected to represent the major changes over 19 years.

Average Single Family House

Changes in the characteristics of new single family houses were examined from 1966-84. The 10 areas studied were (1) average square feet, (2) number of bedrooms, (3) number of bathrooms, (4) central air-conditioning, (5) type of heating, (6) type of foundation, (7) fireplaces, (8) parking facility, (9) effective interest rate, and (10) average purchase price.

Two sources were used to measure changes in characteristics each year. The *Characteristics of New Housing: Construction Reports* provided information on the first eight variables. Data for all new houses is broken down by region of the country. The *Savings and Home Financing Source Book* provided information on the last two variables.

Exhibit 1, *Average Square Feet*, shows the change in the average number of square feet of floor area for new houses. In 1966, the average house had 1,535 square feet. This increased by 16% to 1,780 square feet in 1984, indicating that buyers demanded larger homes. This could be a result of increased income, different housing expectations, shifts in regional population distribution and/or changes in tastes/preferences.

Karen E. Lahey, Ph.D., an assistant professor in finance and real estate at Kent State University, earned her M.B.A. and Ph.D. from Florida State University. Her current research interests include real estate finance and international real estate.

James R. Webb, Ph.D., is a professor of finance and real estate at the University of Akron in Ohio. He is a prolific writer and has published over 50 articles on various aspects of real estate investment and income property appraisal. Webb currently serves as president of the American Real Estate Society.



The trend towards larger houses has been unsteady, and in five out of the last 19 years the average number of square feet decreased. Four of these years (1975, 1980, 1981 and 1982) saw a downturn in the number of houses completed. However, downturns also occurred during 1969 and 1974.

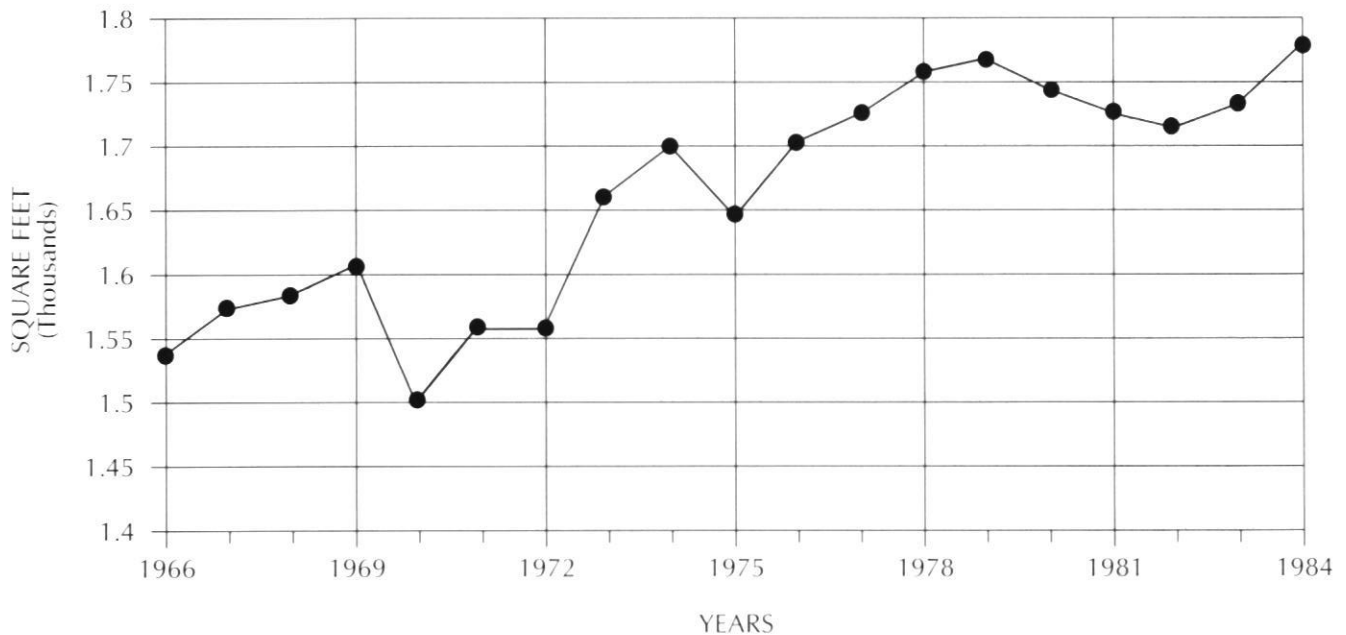
Exhibit 2, *Number of Bedrooms*, provides the weighted average number. This graph represents houses having two bedrooms or less and three and four or more bedrooms. In 1966, 13% of the houses had two bedrooms or less; by 1984, this category had risen to 24%, reflecting the decrease in the average household size from 3.7 to 2.7 persons. Or, it may be attributable to an increase in the average age of the population and the decrease in the birth rate. The increase in two-bedroom houses and square footage suggests an alternative use of space, such as family rooms.

The average house is described as having three bedrooms. In 1966, 63% of new houses had three bedrooms; by 1984, this had decreased to 58%.

New houses with four or more bedrooms accounted for 24% of all houses built in 1966, and this dropped to 18%

EXHIBIT 1

Average Square Feet



in 1984. Demographics suggests a continuation of this trend.

The weighted average number of bedrooms is decreasing while the average number of square feet is increasing. One explanation may be found in the average number of bathrooms (see Exhibit 3, *Number of Bathrooms*). This graph is a weighted average of the number of homes having one, one-and-one-half, two, and two-and-one-half bathrooms. In 1966, 29% of homes had one bathroom, and by 1984, the percentage fell to 14%. This is of particular interest in light of the decreased number of bedrooms and the average household size.

A half-bathroom is defined as a bathroom with a sink and a toilet, although it also can have a shower stall. In 1966, 22% of new houses had one-and-one-half bathrooms. In 1978, the percentage dropped to 11% and since then it has fluctuated between 10-11%. In 1984, 24% of the houses had less than two bathrooms, compared with 51% in 1966.

Two full bathrooms were found in 31% of new houses in 1966. By 1984, this increased to 48%. Since 1978, nearly half of all new houses have two bathrooms which explains the increase in average square footage of homes. Two-and-one-half bathrooms allows a house to have a master bath connected to the master bedroom, another bathroom for the remaining bedrooms and a half-bath for the public areas of the house. In 1966, 19% of homes had two-and-one-half bathrooms; this increased to 28% by 1984. This rise supports the concept that buyers have placed more importance on the bathroom.

Exhibit 4, *Air Conditioning Installed*, shows an increase in the number of new homes with central air-conditioning. In 1966, 25% of new houses had central air; by 1984, that total grew to 71%. This characteristic may be influenced by the region of the country as shown in Table 1: in 1984, 12.6% of the houses were constructed in the Northeast, 15.2% in the Midwest, 22.6% in the West, and 49.6% in the South. The statistics support this view: in the Northwest, 34% of houses have central air, 55% in the Midwest and West and 92% in the South.

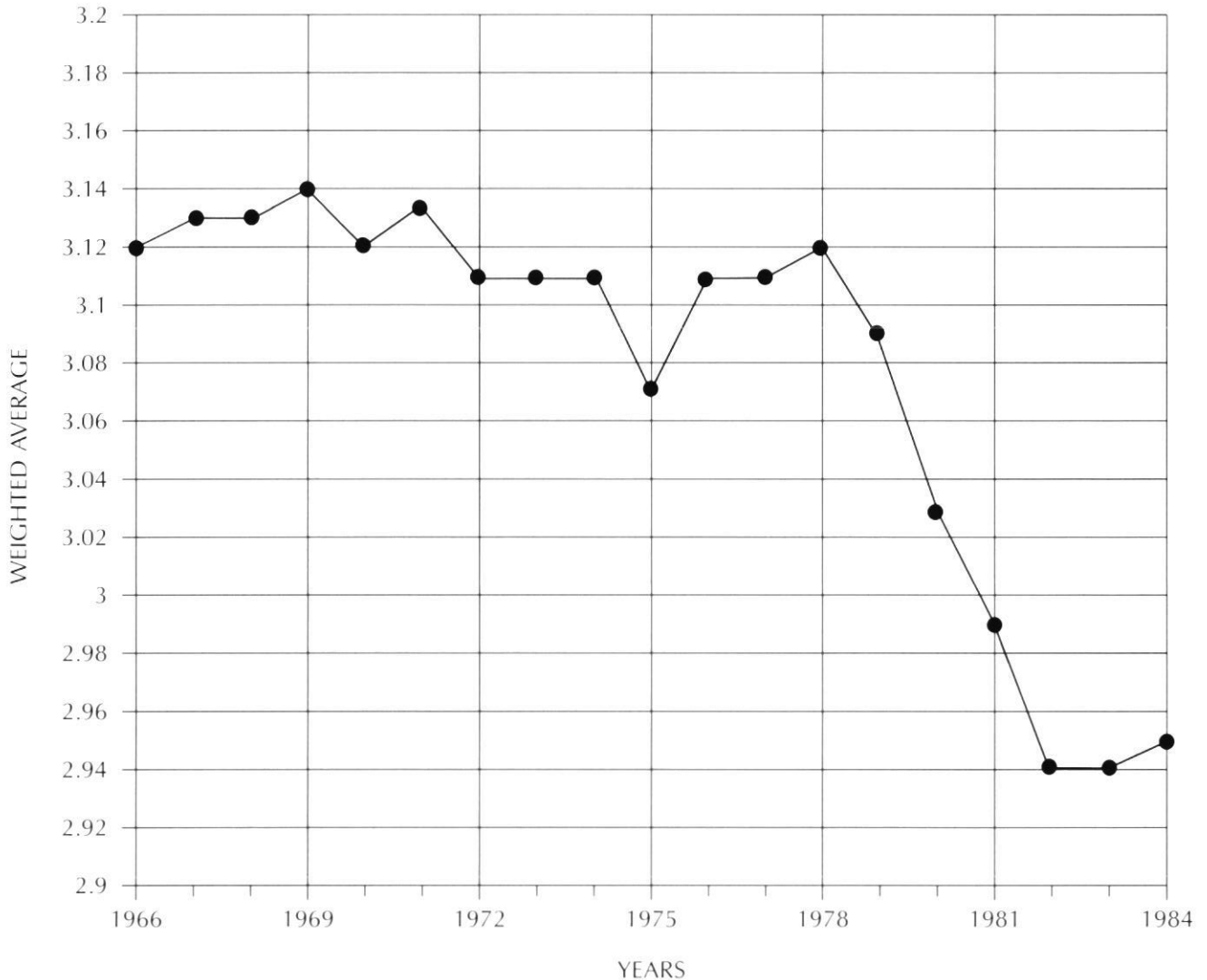
The Northeast, West, and Midwest are much more concerned with heating. Exhibit 5, *Type of Heating*, shows changes in the type of fuel used in new houses. In 1966, 64% had gas fuel, 20% had electricity, 13% had oil and 3% had other types or none. By 1984, 45% of houses had gas fuel, 48% electricity, 2% oil and 5% had other types or none.

This shift exhibits an interesting pattern. With the sharp increase in oil prices in 1973 and 1979, use of this fuel could have lessened; however, this was not evident until 1980. Conversely, with increased emphasis on energy efficiency, a greater increase could have been expected in other fuel types. While there was an increase in 1980-82, it accounted for less than 10%.

The choices are evenly divided between gas and electricity in 1984. In many parts of the South—50% of the houses—piped-in gas is not available, and electricity is chosen by 62%. Electricity accounts for 36% in the Northeast, 19% in the Midwest and 39% in the West.

EXHIBIT 2

Number of Bedrooms



Regional differences also explain differences in foundations (see Exhibit 6, *Type of Foundation*). In 1966, 44% of houses had full or partial basements, 28% had slabs, and 28% had crawl spaces. In 1984, 32% of houses had full or partial basements, 50% had slabs and 18% had crawl spaces. In the South 65% had slabs, 20% in the Northeast, 12% in the Midwest and 62% in the West. The South and West, with the largest number of new houses (73%), had over 60% slab foundations. It is not possible to dig a basement in some areas of the country.

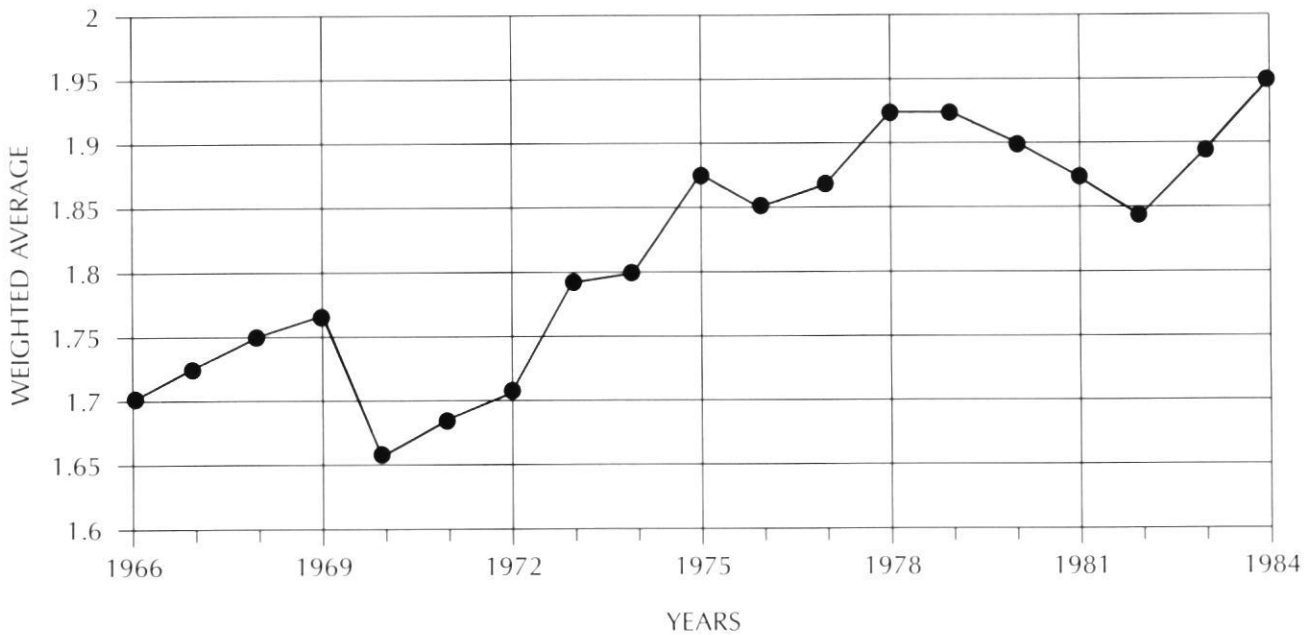
The fireplace, as a characteristic, does not appear until 1969. The weighted average shown in Exhibit 7, *Number of Fireplaces*, is composed of zero to two or more fireplaces. In 1969, 56% of houses had no fireplaces, 39% had one and 6% had two or more. By 1984, 41% had none, 54% had one and 5% had two or more. Fireplaces have increased from 45% of new houses in 1966 to 59% in 1984.

An interesting pattern is shown in the regional data. More homes in the Northeast and Midwest would be expected to have fireplaces because of their colder climates, yet in the South 63% have fireplaces. This percentage drops to 57% in the West, 46% in the Midwest and 44% in the Northeast. Thus, the area of the country with the warmest climate has the greatest percentage of fireplaces.

The last physical characteristic is the type of *parking facility*. Data is recorded as one car, two or more, carport and no garage or carport. Exhibit 8, *Number of Garage Spaces*, focuses on the increase in space. In 1966, 64% of houses had garages, 17% had carports and 20% had neither. In 1984, 70% had garages, 5% had carports and 25% had neither. The shift appears to favor garages over carports.

EXHIBIT 3

Number of Bathrooms



Regional differences impact on the choice of a parking facility. Garages account for 58% of the houses in the South, 71% in the Northeast, 84% in the Midwest and 86% in the West. Climate or more two-car families may explain the increase from 48% for two-car garages in 1968 to 56% in 1984.

One additional feature that has changed is the inclusion of selected appliances. While not part of physical characteristics of new houses, they reflect buyer preferences. Table 2 indicates stoves now are included in most

houses. The greatest increase occurred in dishwashers—38.8% of new houses in 1966, 90.5% in 1984. Refrigerators have increased from 5.2% in 1966 to 22.2% in 1984.

Given the eight physical characteristic changes of new houses from 1966-84, what is a reasonable description of the 1966 house and the 1984 house? The 1966 average new house had 1,535 square feet of floor space, three bedrooms, less than two full bathrooms, no central air-conditioning, gas heat, full or partial basement, no

EXHIBIT 4

Air Conditioning Installed

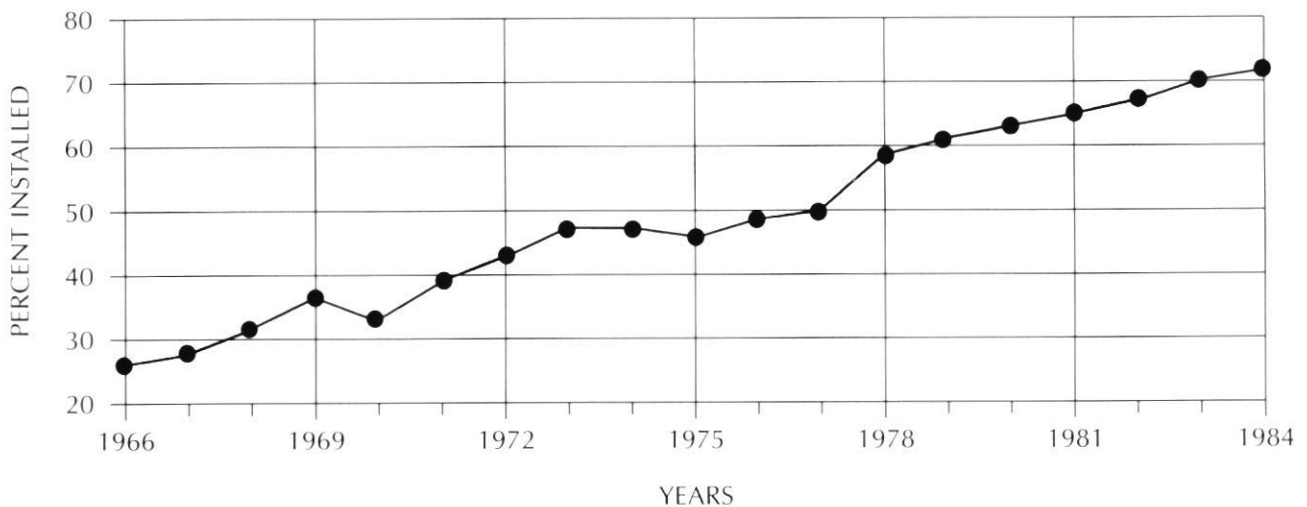


TABLE 1

Proportion of New Privately Owned Single Family Homes
Built for Sale by Location, 1966-1984

Year	Inside SMSAs	Outside SMSAs		Northeast	Midwest	South	West
1966	74.8%	25.2%	I	18.0%	24.5%	36.0%	21.5%
1967	77.4	22.6	I	15.8	23.0	36.8	24.4
1968	79.2	20.8	I	14.9	24.3	36.1	24.7
1969	76.1	23.9	I	13.8	21.7	39.1	25.4
1970	75.5	24.5	I	12.6	20.6	41.9	24.9
1971	73.8	26.3	I	12.8	19.7	41.9	25.5
1972	73.7	26.3	I	12.5	18.3	43.5	25.9
1973	77.7	22.3	I	12.7	18.9	41.9	26.5
1974	79.2	20.8	I	13.8	18.5	42.1	25.6
1975	79.1	21.1	I	13.1	20.1	40.4	26.3
1976	79.8	20.2	I	11.4	20.7	39.8	28.9
1977	81.7	18.1	I	10.8	18.9	38.9	31.3
1978	80.2	19.8	I	9.6	17.8	40.5	32.1
1979	80.7	19.3	I	9.5	15.8	42.9	31.8
1980	66.1	33.9	I	10.5	17.7	47.5	24.3
1981	64.7	35.3	I	10.6	17.2	49.8	22.4
1982	64.7	35.3	I	12.5	14.6	53.8	19.1
1983	72.9	27.1	I	11.5	15.4	51.5	21.6
1984	75.2	24.8	I	12.6	15.2	49.6	22.6

Source: "Characteristics of New One-Family Homes," *Construction Report C-25*, U.S. Department of Commerce, Bureau of the Census, and U.S. Department of Housing and Urban Development.

EXHIBIT 5

Type of Heating

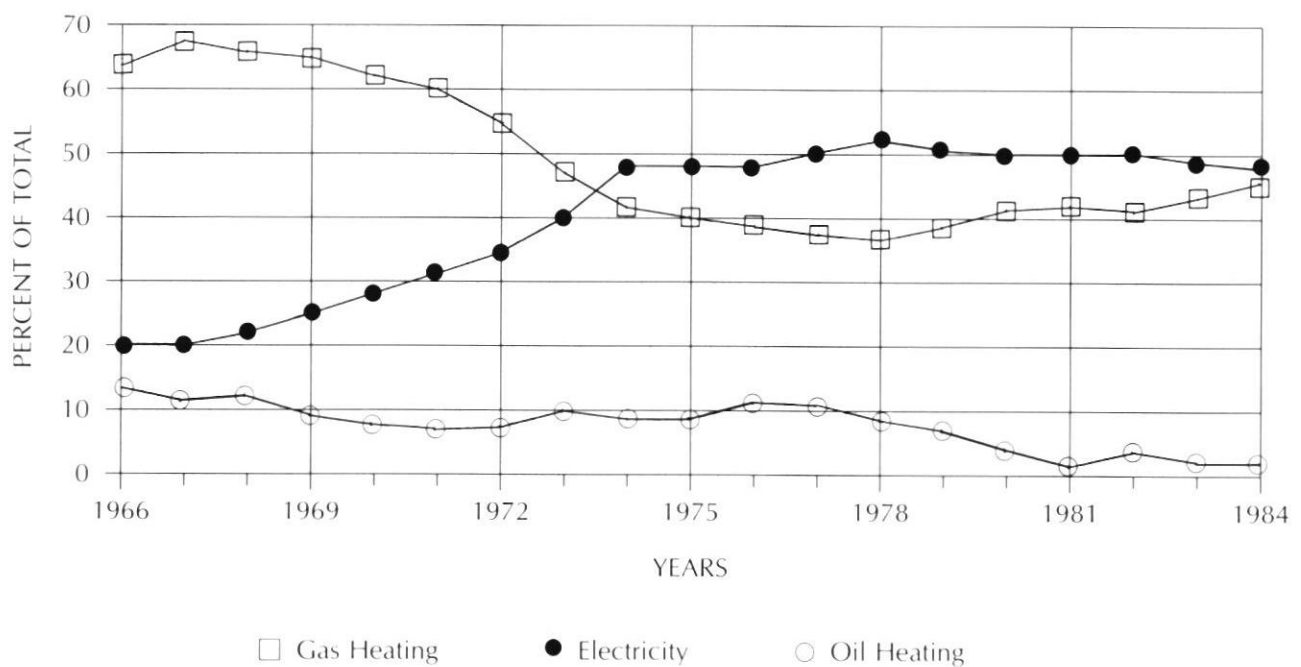


TABLE 2

Proportion of All New Privately Owned Single Family Homes With Selected Appliances Included in Sales Price, 1966-1984

Year	Stove	Dishwasher	Refrigerator
1966	85.1%	38.8%	5.2%
1967	85.8	45.4	6.2
1968	88.4	50.5	6.4
1969	88.4	51.5	9.0
1970	85.3	42.0	10.4
1971	88.5	47.8	11.2
1972	89.4	53.3	11.7
1973	89.0	65.0	15.9
1974	88.1	72.4	13.3
1975	89.8	72.7	10.9
1976	90.6	78.0	9.9
1977	91.6	81.7	11.4
1978	91.9	83.7	11.4
1979	92.0	84.9	13.3
1980	92.5	82.2	13.9
1981	91.3	82.3	15.4
1982	92.7	84.0	16.0
1983	94.1	88.6	20.9
1984	94.8	90.5	22.2

Source: "Characteristics of New One-Family Homes," *Construction Report C-25*, U.S. Department of Commerce, Bureau of the Census, and U.S. Department of Housing and Urban Development.

fireplace, a one-car garage and a stove. The 1984 average new house had 1,780 square feet of floor space, three bedrooms, two or more bathrooms, central air-conditioning, gas or electric heat, slab foundation, fireplace, two-car garage, stove and a dishwasher.

Two of the single family house characteristics are financial. Exhibit 9, *Interest Rates*, shows the effective rates for new houses. In 1966, the rate was 6.25%; by 1984, the rate almost doubled to 12.38%, reaching a high of 15.14% in 1982. Until 1979, however, the rate was less than 10%, and it dropped in four of the 19 years (1971, 1972, 1983, 1984). The highest rates occurred in 1980, 1981 and 1982. In 1979 it was 10.85% and in 1984, 12.38%.

The late 1970s and early 1980s saw rapidly increasing interest rates, so buyers could not borrow as much as before, assuming their income did not change. The number of houses completed started to drop in 1979 with 1,301,000 houses and continued to drop until 1982 with 632,000 houses. In 1982 the lowest volume of houses were completed.

The other financial characteristic of interest in single family houses is shown in Exhibit 10, *Purchase Price*. The average new house in 1966 cost \$26,600; by 1984 it rose to \$96,800. This increase is shown on a yearly percentage basis in Table 3, which also provides the increases in the Consumer Price Index (CPI)-All Items.

EXHIBIT 6

Type of Foundation

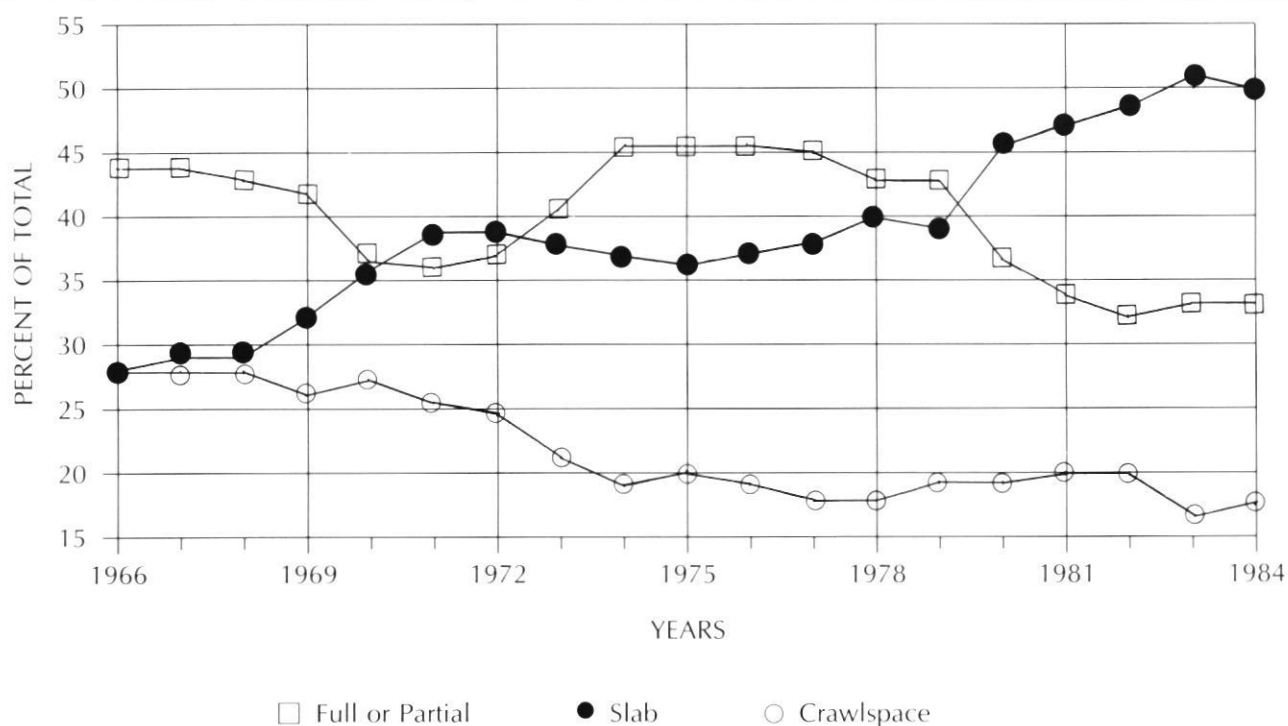
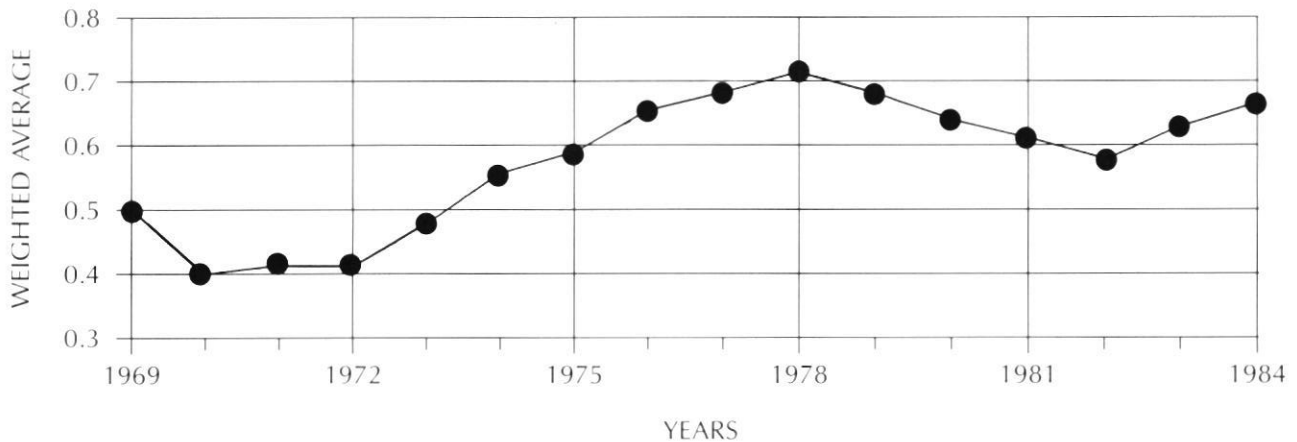


EXHIBIT 7

Number of Fireplaces



The CPI measures the rate of inflation in the economy. This gauge increases every year, while new house prices decreased in two of the years (1973, 1983). In fact, in 10 of the 19 years, house prices increased less than the rate of inflation.

The most volatile period for purchase prices of new houses occurred from 1974-81. During this time, house prices increased 225%—more than half of the 364%

increase for the entire 19 year period. The CPI increased 325% for the 19 year period, and 184% from 1974-81. This represents an average yearly increase of 19.2% for house prices and 17.1% for the CPI.

The combined impact of increased purchase price and effective interest rates shows a decrease in the volume of houses produced from 1977-83. Furthermore, given the increase in the quality characteristics of new houses, the purchase price actually increased less than the rate of inflation. This suggests new single family houses have not been a good investment.

TABLE 3

Percentage of Change in the CPI and the Price of New Single Family Homes Sold, 1966-84

Year	CPI—All Items	New House Price
1966	2.9%	6.0%
1967	2.9	5.3
1968	4.2	9.3
1969	5.4	11.4
1970	5.9	4.1
1971	4.3	2.3
1972	3.3	2.8
1973	6.2	-0.6
1974	11.0	8.4
1975	9.1	10.7
1976	5.8	9.8
1977	6.5	10.8
1978	7.7	15.4
1979	11.3	18.5
1980	13.5	11.8
1981	10.4	8.5
1982	6.1	4.2
1983	5.0	-0.2
1984	4.0	3.1

Source: U.S. Department of Labor, Bureau of Labor Statistics and Savings and Home Financing Source Book, Federal Home Loan Bank Board, 1984.

Conclusion

The average single family house has responded to changes in consumer preference for physical characteristics and geographic location during the period 1966-84. In 1966, a new house had less square feet, more bedrooms, fewer bathrooms, no central air-conditioning, gas heat, a basement, no fireplace, a one-car garage, an effective interest rate of 6.25% and a purchase price of \$26,000. The 1984 new house had more square feet, fewer bedrooms, more bathrooms, central air-conditioning, gas or electric heat, a slab foundation, a fireplace, a two-car garage, an effective interest rate of 12.38% and a purchase price of \$96,800.

While most of the price increase can be attributed to inflation, clearly consumers are demanding the more expensive features of larger houses with more bathrooms, central air, fireplaces, two-car garages and built-in kitchen appliances. Additionally, some increase may be due to increased costs of regulations and land/site. The improved quality of new houses has occurred in spite of higher interest rates. This suggests the need to decrease features to reduce price, however, consumers are willing to pay the higher price for houses with improved features.

EXHIBIT 8

Number of Garage Spaces

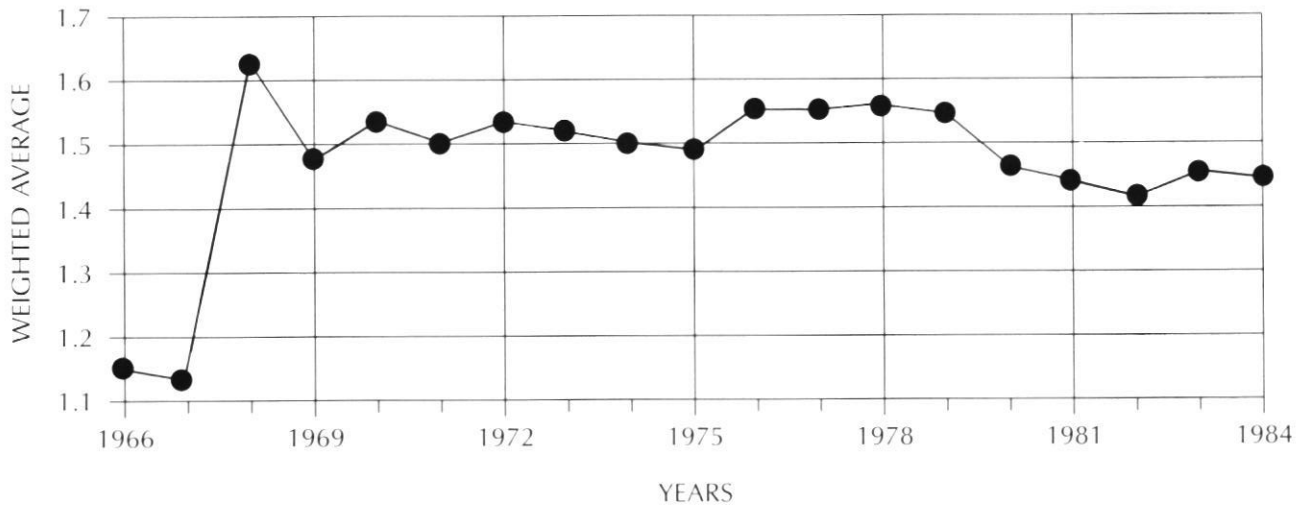


EXHIBIT 9

Effective Interest Rate

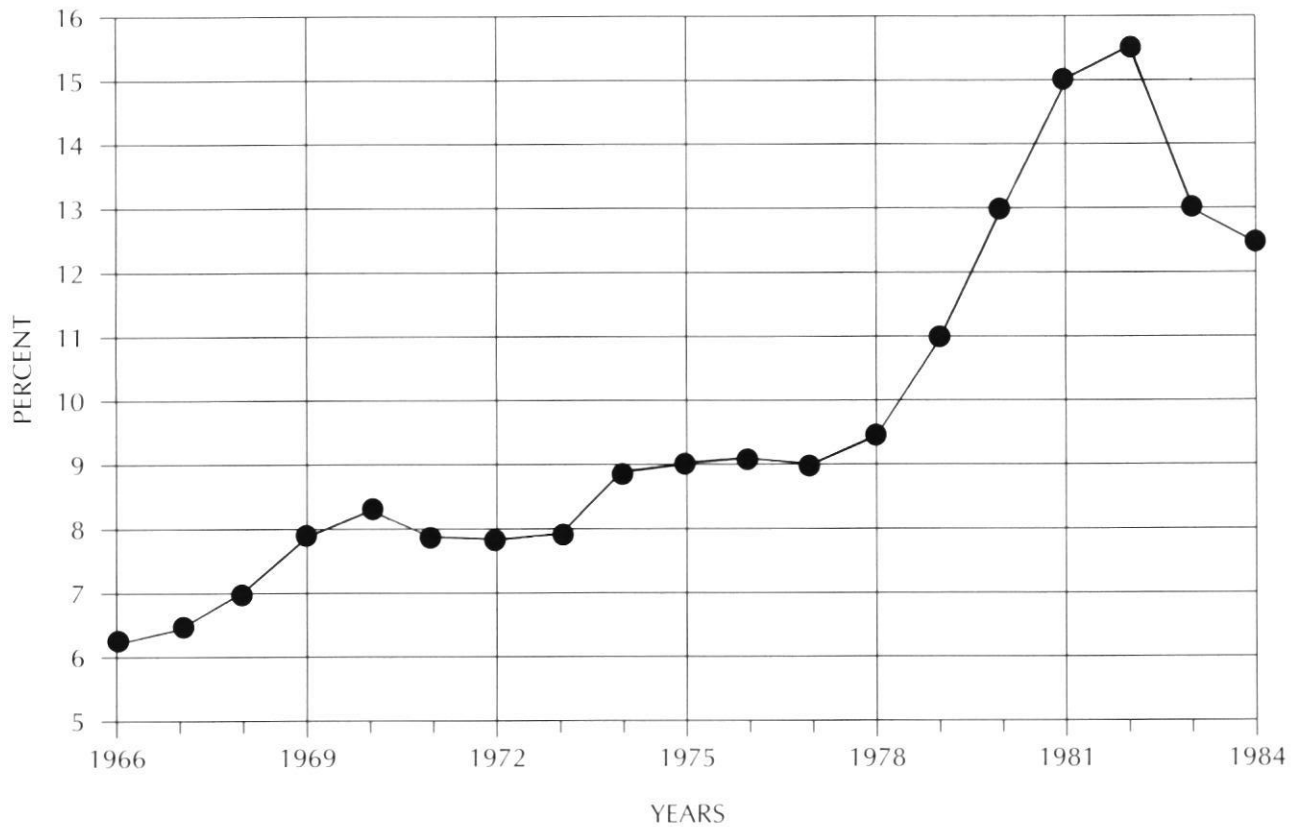
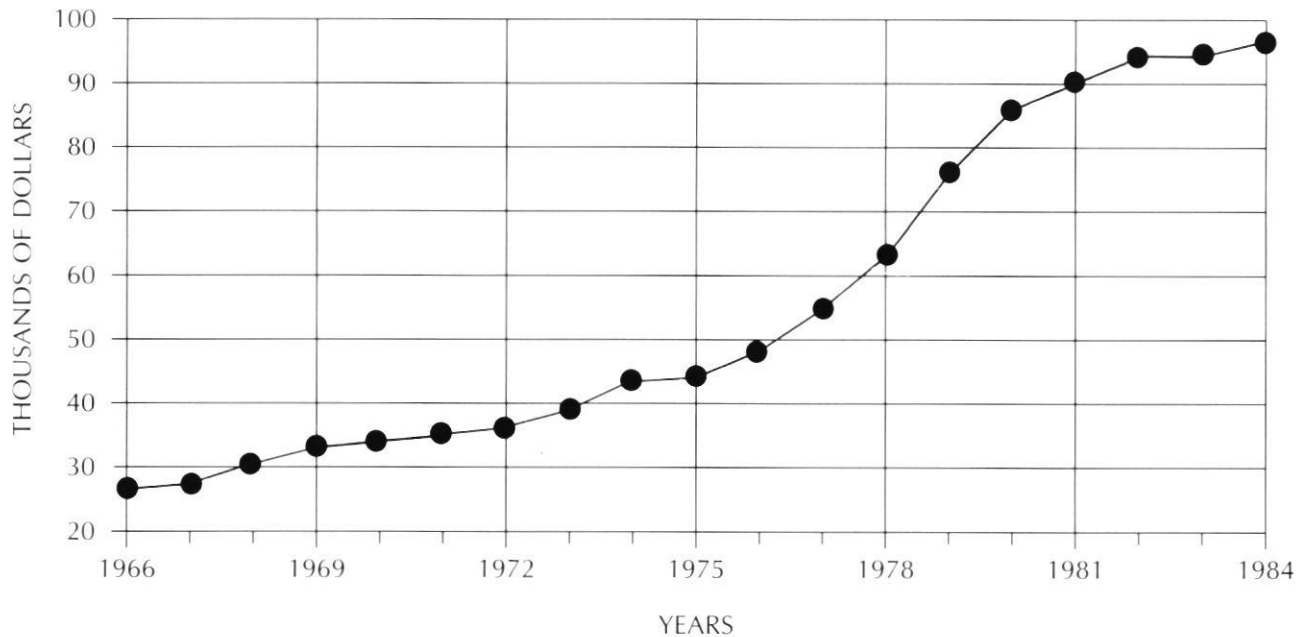


EXHIBIT 10**Purchase Price**

**NOTES**

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LEASE VS. BUY: THE CORPORATE PERSPECTIVE

Advocates who argue that leasing real estate is cost-effective are dispelled with arguments favoring ownership.

by Larry P. Ebert

A surprising number of real estate professionals believe that leasing real estate assets costs less than ownership. This is surprising because the assumption is fallacious—especially for the large corporation. The widely acclaimed benefits of leasing do not hold up under close scrutiny. Those benefits include freeing capital for investment in higher yielding projects; 100%, off-balance sheet financing; tax deductibility of lease payments; and the avoidance of risks inherent in real estate ownership. The leasing advocates, comprised of real estate developers and syndicators, have persuasively presented their case and pervasively distributed it throughout the real estate industry. Many real estate executives buy these arguments without careful examination. This article presents arguments which advocate ownership of real estate assets by large companies.

Apples vs. Oranges

The general premise of the proleasing argument is that the internal rate of return implicit in owning real property assets does not exceed typical corporate hurdle rates (the minimal return acceptable on capital investments) and, therefore, real property should be leased. But this compares apples to oranges.

The apple is the corporate capital allocation process which determines what capital projects will be funded. The orange is the corporate financing process which determines how to raise the needed capital. You cannot compare a capital allocation decision to a corporate financing decision because each has its own distinct parameters.

Larry P. Ebert is manager of real estate acquisitions and marketing for Boise Cascade Corporation in Boise, Idaho. He is responsible for the acquisition of the company's real estate assets—leases, development and implementation of long range real estate plans and the marketing of surplus properties. Previously Ebert was manager of corporate real estate for Mead Corporation and vice president of its real estate subsidiary, Mead Land Services, Inc.



The Capital Allocation Process

All major corporations have a process that allocates capital available for spending among various investment alternatives. It is the means by which the money pie is divided among competing capital projects.

The capital allocation process begins with the development of a strategic plan for each group or division of the company. This plan outlines the strategy by which the corporation plans to achieve its ultimate goal, optimization of the company's long-term value to its shareholders. Typical strategies include items such as being the marketshare leader or the low cost producer, adding value to products or developing a distinctive competence within a market, emphasizing high-growth businesses and pruning those with limited potential, acquiring counter-cyclical businesses, maintaining a strong and flexible financial structure and balancing capital intensity and business risk.

After management approves the strategic plan, each operating division prepares a three- or five-year capital plan. These plans identify the major capital projects that will compete for funds. Executive management reviews the plans, considers the strategic plan and financial capabilities of the company and establishes a long-term capital program. This long-term capital program allocates capital spending and approval amounts to each division over the life of the plan.

The execution of the capital program is monitored by an approval process for each capital project. The division prepares a document briefly describing the project, identifies the amount of capital required for its funding and the timing of the expenditures, and calculates various returns on the invested capital such as ROI, IRR and payback period. If the project is included in the capital plan and provides a return equal to or greater than the division's hurdle rate, it usually will be approved by management. If it was not contemplated in the capital plan or if the return is less than the hurdle rate, the division will have to show special circumstances to gain management's approval.

Obviously, since no company operates in a vacuum, the long-term capital program is subject to continual refinement and revision. Flexibility in the program is essential to take advantage of unplanned opportunities—such as strategic business acquisitions—and to avoid unforeseen risks—such as sudden downturns in domestic and

world markets. Conversely, the successful implementation of the company's strategic plan requires management's pragmatic adherence to a realistic long-term capital program.

The Corporate Financing Process

After the capital budget is established, it is sent to the corporate treasury department for use in developing a financing plan. The financing plan analyzes the company's capital needs, what funds will be available from the operations to meet these needs and where additional funds will be obtained. The plan focuses on obtaining outside funds upon favorable terms and conditions at the lowest competitive cost to the company.

It is within the context of the financing plan that the lease vs. buy issue must be addressed. The decision on whether to implement a project is based upon the total return provided by the project—the decision on how to finance the individual pieces of the project is based upon the competitive cost of all alternative forms of financing available to the company. Leasing, therefore, competes with unsecured financing vehicles such as private placement financing, foreign and domestic public debt issues, tax-exempt bonds and bank revolving credit lines. (Note: all of these forms of financing provide 100% of the project cost. Major corporations do not use conventional mortgage financing for the following reasons: loan compliance covenants frequently restrict the

EXHIBIT I

Lease vs. Buy Analysis

	<u>Month 0</u>	<u>Month 1-60</u>	<u>Month 61-120</u>	<u>Residual</u>
Acquisition cost	3,000,000	—	—	—
Residual value	—	—	—	4,250,000
Income (rent)	—	29,167	35,612	—
Expenses				
Depreciation	—	11,574	11,574	—
Sales costs	—	—	—	297,500
Income before tax	—	17,593	24,038	3,952,500
Tax	—	8,473	11,577	655,589
Income after tax	—	9,120	12,461	3,269,911
Plus depreciation	—	11,574	11,574	—
Cash flow	(3,000,000)	20,694	24,035	3,296,911
I.R.R.	9.34%			
Borrowing cost (after tax)	5.18%			
Lease/buy	Buy			

Notes:

1. Acquisition cost—assumes a cost of \$3,000,000 for a 100,000 square foot distribution facility.
2. Residual value—assumes the facility could be sold at the end of the 10th year for \$4,250,000.
3. Rent—assumes an absolute net rental of \$3.50 per square foot per year for five years, with a one time escalation in the sixth year based on a 4% inflation factor.
4. Depreciation—assumes straight-line depreciation over 18 years on a building value of \$2,500,000.
5. Sales costs—assumes total sales costs, including brokerage commission, gains.
6. Taxes—assumes a rate of 48.16% on ordinary income and 28% on capital gains.
7. Borrowing cost—assumes 10-year money costs 10% before tax.

pledging of assets; rating agencies frown upon the use of secured financing; and conventional mortgage financing provides only 70-80% of the asset's costs.)

The Leasing Decision

Leasing is a financing decision and the competitive cost of leasing is the interest rate implicit in the lease. This is calculated by deriving the internal rate of return provided by the lease on the cost to purchase the asset. Exhibit I illustrates a simple lease vs. buy analysis. If the after-tax interest rate implicit in the lease exceeds the lowest competitive cost of alternative forms of financing over the same period, the asset should be purchased. In almost every instance, financing by borrowing will be cheaper for the large corporation than the leasing alternative.

However, the lease vs. ownership decision impacts other corporate functions—financial measurement and reporting systems—which tend to add confusion to the purely financial considerations.

Confusing Issues

The most overstated benefit of leasing is that it provides off-balance sheet financing, whereas borrowing must be reported as debt. Thus, ownership adversely impacts a company's debt to equity ratio. However, off-balance sheet financing must be distinguished from off-credit financing. True, if a lease meets all the tests in FASB Statement Number 13, as amended and interpreted, the lease can be accounted for as an operating lease and kept off the balance sheet. Publicly issued financial statements will not reflect the net present value of lease payments as debt of the company, but will reveal total lease commitments in footnote disclosures.

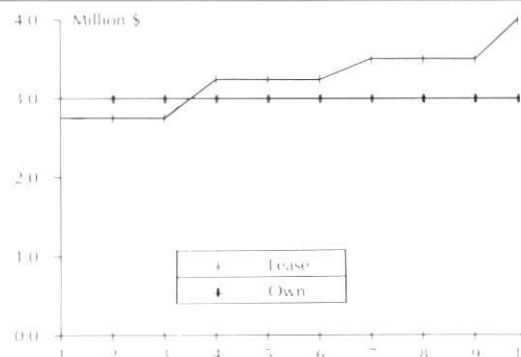
Keeping a lease off the balance sheet is like putting a fancy paint job on a junker car you are trying to sell. The unwary neophyte might fall for the ploy, but the sophisticated buyer will look under the hood. Rating agencies and lending institutions examine financial information going far beyond that disclosed in public documents. In judging the credit worthiness of a company, Standard & Poors and Moodys will take the current annual operating lease commitments, capitalize the total payments at a fixed rate and treat this capitalized lease amount as debt. For example, the rating agencies multiply Boise Cascade's annual lease payments on operating leases by eight to arrive at the capitalized value. Figure 1 indicates how, over the course of a 10-year lease, debt is affected by leasing vs. ownership.

Lending institutions also treat operating leases as debt when calculating interest coverage and other loan compliance covenant tests. In fact, lenders especially dislike leases because they represent a form of secured financing—there are no attachable assets for general unsecured creditors.

So while leases may be accounted for off the balance sheet, they directly impact on the company's ability to borrow money, i.e., they are not off-credit financing.

FIGURE 1

Effect On Credit
Lease vs. Own



Note: Assumes a cost of \$3 million for a 100,000 square foot distribution facility versus a rental starting at \$3.50/SF/YR and escalating every three years at a 4% annual rate.

FIGURE 2

PROTC
Lease vs. Own

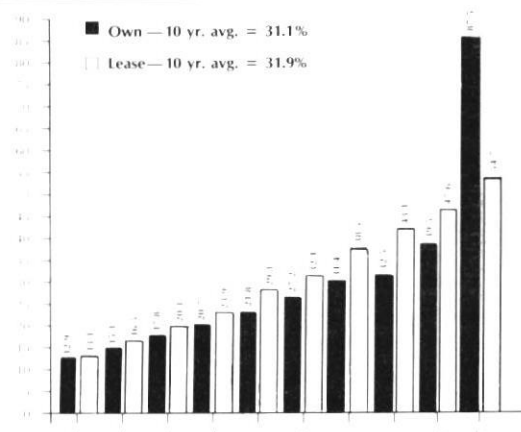


EXHIBIT II
Ownership
(\$000s omitted)

Year	1	2	3	4	5	6	7	8	9	10
Gross profits	4,000	4,240	4,494	4,764	5,050	5,353	5,674	6,015	6,375	6,758
Residual—net	—	—	—	—	—	—	—	—	—	2,170
Operating expenses										
Depreciation—Bldg.	67	67	67	67	67	67	67	67	67	67
Depreciation—M&E	201	201	201	201	201	201	201	201	201	201
All Other	3,000	3,120	3,245	3,375	3,510	3,650	3,796	3,948	4,106	4,270
Total	3,268	3,388	3,513	3,643	3,778	3,918	4,064	4,216	4,374	4,538
Net Income	732	852	981	1,121	1,262	1,435	1,610	1,799	2,001	4,390
Working capital	1,510	1,765	1,900	2,062	2,214	2,372	2,500	2,740	2,962	3,186
Net PP&E	4,162	3,894	3,626	3,358	3,090	2,902	2,634	2,366	2,098	1,830
Total investment	5,672	5,659	5,526	5,420	5,304	5,274	5,134	5,106	5,060	5,016
PROTC	12.9%	15.1%	17.8%	20.7%	23.8%	27.2%	31.4%	35.2%	39.5%	87.5%
10 year average PROTC	31.1%									
Operating income	732	852	981	1,121	1,262	1,435	1,610	1,799	2,001	4,390
Interest income—net	(250)	(168)	(94)	11	86	194	298	417	552	704
Net income before tax	482	684	887	1,132	1,348	1,629	1,908	2,216	2,553	5,094
Book tax (net of ITC)	39	330	427	545	649	785	919	1,067	1,230	2,016
Net income after tax	443	354	460	587	699	844	989	1,149	1,323	3,078
Net income before tax	482	684	887	1,132	1,348	1,629	1,908	2,216	2,553	5,094
Excess depreciation	(230)	(230)	(230)	(230)	(230)	141	141	141	141	141
Taxable income	252	454	657	902	1,118	1,770	2,049	2,357	2,694	5,235
Tax (net of ITC)	(72)	219	316	434	538	852	987	1,135	1,297	2,207
Net income after tax	324	235	341	468	580	918	1,062	1,222	1,397	3,028
Plus: Depreciation (tax)	498	498	498	498	498	127	127	127	127	127
Less: Debt amortization	—	—	—	—	—	—	—	—	—	2,500
Cash flow	822	733	839	966	1,078	1,045	1,189	1,349	1,524	655
Cumulative cash flow	822	1,555	2,394	3,360	4,438	5,483	6,672	8,021	9,545	10,200
Equity (retained earnings)	443	797	1,257	1,844	2,543	3,387	4,376	5,525	6,848	9,926
Return on equity	100%	44.4%	36.6%	31.8%	27.5%	24.9%	22.6%	20.8%	19.3%	31.0%
10 year average ROE	35.9%									

Note: Simplified example taken from an actual proposed capital project.

And because leases use up a company's ability to borrow money, they must be compared to the cost of other forms of borrowing.

Another factor confusing the lease vs. buy issue is the typical corporate measurement system. Most companies measure their operating divisions on pre-tax return on total capital invested (PROTC) and require the divisions to carry owned assets on their books. Over the short-term, PROTC is higher if assets are leased. Over the long haul, however, ownership and leasing have comparable PROTC results, but ownership enhances both cash flow and return on equity (ROE). Maximizing ROE is better for the company. Exhibits II-III show simplified examples of ownership's effect on PROTC, ROE and cash flow. The results are illustrated in Figures 2-4.

The problem is that most managers manage for short-term results. Convincing a manager to make short-term sacrifices today to benefit his successor in future years is a Herculean task, especially when his bonus compensation is tied to PROTC targets. A solution is to carry all

real estate assets on corporate books—whether owned or leased—and lease the facilities to the operating divisions at a fair rental value. This system treats all divisions equally and removes the short-term incentives to lease assets.

Finally, leasing advocates claim additional tax benefits are provided by leasing assets since rental payments are fully deductible but land cannot be depreciated by the real estate owner. This is certainly true; however, the lease vs. buy analysis takes these tax differences into consideration. It is usually cheaper to own despite the loss of tax benefits. And if tax benefits are needed, the facility owner can structure a long-term land lease for the building site.

Summary

Leasing is an alternative form of financing an asset. Because most major corporations have investment grade credit ratings, their cost of financing is as low or lower than the lessor's. Add in profit for the lessor and the residual value of the asset leased—which in the case of

EXHIBIT III
Lease
(\$000s omitted)

Year	1	2	3	4	5	6	7	8	9	10
Gross profits	4,000	4,240	4,494	4,764	5,050	5,353	5,674	6,015	6,357	6,758
Residual	—	—	—	—	—	—	—	—	—	—
Operating expenses										
Rent	375	375	400	425	425	481	481	513	545	545
Depreciation—M&E	201	201	201	201	201	201	201	201	201	201
All Other	3,000	3,120	3,245	3,375	3,510	3,650	3,796	3,948	4,106	4,270
Total	3,576	3,696	3,846	4,001	4,136	4,332	4,478	4,662	4,852	5,016
Net Income	424	544	648	763	914	1,021	1,196	1,353	1,505	1,742
Working capital	1,510	1,765	1,900	2,062	2,214	2,372	2,500	2,740	2,962	3,186
Net PP&E	1,729	1,528	1,327	1,126	925	804	603	402	201	—
Total investment	3,239	3,293	3,227	3,188	3,139	3,176	3,103	3,142	3,163	3,186
PROTC	13.1%	16.5%	20.1%	23.9%	29.1%	32.1%	38.5%	43.1%	47.6%	54.7%
10 year average PROTC	31.9%									
Operating income	424	544	648	763	914	1,021	1,196	1,353	1,505	1,742
Interest income	—	70	131	201	280	371	454	551	660	784
Net income before tax	424	614	779	964	1,194	1,392	1,650	1,904	2,165	2,526
Book tax (net of ITC)	11	296	375	464	575	670	795	917	1,043	1,217
Net income after tax	413	318	404	500	619	722	855	987	1,122	1,309
Net income before tax	424	614	779	964	1,194	1,392	1,650	1,904	2,165	2,526
Excess depreciation	(186)	(186)	(186)	(186)	(186)	185	185	185	185	185
Taxable income	238	428	593	778	1,008	1,577	1,835	2,089	2,350	2,711
Tax (net of ITC)	(78)	206	286	375	485	759	884	1,006	1,132	1,306
Net income after tax	316	222	307	403	523	818	951	1,083	1,218	1,405
Plus: Depreciation (tax)	387	387	387	387	387	16	16	16	16	16
Cash flow	703	609	694	790	910	834	967	1,099	1,234	1,421
Cumulative cash flow	703	1,312	2,006	2,796	3,706	4,540	5,506	6,605	7,839	9,260
Equity	413	731	1,135	1,635	2,254	2,976	3,832	4,819	5,941	7,250
Return on equity	100%	43.5%	35.6%	30.6%	27.5%	24.3%	22.3%	20.5%	18.9%	18.1%
10 year average ROE	34.1%									

Note: Simplified example taken from an actual proposed capital project.

real estate is usually substantial—and leasing an asset is almost never cheaper than ownership. So why do so many major corporations lease real property assets?

Valid Reasons for Leasing

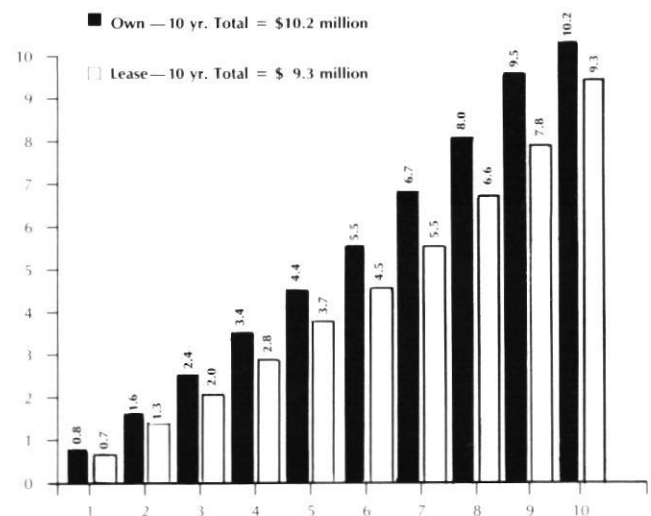
Off-balance sheet financing, implicit interest rates lower than the company's cost of capital and 100% financing all are bogus reasons for leasing a real estate asset. However, there are a number of valid reasons for leasing.

Short-term Flexibility

If a company is entering into a new market with a new business venture and is willing to pay a premium for flexibility, leasing its real estate assets over a short period of one to three years is a valid business decision. Short-term leases provide the flexibility to quickly expand or contract a business in response to market conditions.

However, as the term of the lease extends outward in time, the flexibility benefit switches to ownership. If the term of the lease is five years or more, the real estate user usually has more options available to him if he owns the

FIGURE 4
Cumulative Cash Flow
Lease vs. Own



asset. If a tenant needs to relocate prior to the end of his lease term, he only has two options: buy out of his lease position or sublease the facility. In either case, the tenant must deal with the landlord. If the user owns the facility, there are more options available to him, i.e., he can sell the building, he can lease it out to one or more tenants, or he can trade the facility. In all these cases, the owner controls the process and does not have to deal with a third-party landlord. And if the owner selected and designed the facility with creative re-use possibilities, a handsome profit or long-term income stream will accrue to his benefit.

Size

Frequently, the size of the use requirement does not justify ownership. It does not make sense to build a 2,000 square foot office building or a 10,000 square foot warehouse facility. These operations are more economically housed in larger, multi-tenant facilities.

Reaction To A Competitive Threat

If a business unit must react quickly to meet a competitive threat and there are no purchase alternatives available in the marketplace, business considerations will override those financial. The typical scenario goes like this: XYZ division learns that a hated competitor is imminently entering one of its markets and it needs a much larger facility to beat off the competitive threat. There is not sufficient time to build a new facility (9-12 months) and a site selection study prepared by the Corporate

Real Estate Department reveals there are no existing facilities available for sale in the targeted area which meet all site selection criteria. The best alternative is to lease a building for three years while the company develops long-term relocation strategies for implementation at the end of the lease term.

No More Cash Or Credit

Many corporate charters restrict the amount of debt the company can carry. If a company's debt-to-equity ratio is at the maximum level or if it is strapped for cash and cannot borrow money upon favorable terms, leasing assets may be its only means of financing a facility. Even though leasing assets usually exact a premium, corporate survival is the paramount concern of companies in this position.

Conclusion

The widely held beliefs about leasing real estate assets do not apply to major corporations with large borrowing capacities. Leasing is more costly than borrowing; it directly affects the corporation's ability to borrow money; it reduces long-term returns on invested capital and equity; and it diminishes the redevelopment alternatives for the asset when it is no longer needed. But most important, leasing impairs the asset manager's ability to carry out his prime function—effectively managing the corporate real estate portfolio in order to maximize the long-term value of the company to its shareholders.

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MARKETING IDLE CORPORATE REAL ESTATE

Respondents to a survey provide the answers on how to unload a company's unwanted real estate holdings.

by **Hugh O. Nourse and Dorothy Kingery**

Corporate real estate directors were surveyed last year on their techniques for disposing of company real estate.¹ What follows is a report on the extent of the problem, their attempts at finding alternative solutions, evaluations of these alternatives and a review of other procedures.

Questionnaires on marketing idle corporate real estate were mailed to members of the National Association of Corporate Real Estate Executives (NACORE), the Industrial Development Research Council (IDRC) and the American Institute of Corporate Asset Management (AICAM). The mailing lists were screened for duplications and 2,176 questionnaires were mailed and produced a 10.6 percent return.

Table 1 shows the percentage distribution of respondents by type of business. Nearly half own properties worldwide and the remaining are equally divided between those with companies whose properties are in less than 10 states and those with companies whose properties are in more than 10 states and Canada. Not unexpectedly, conglomerates and manufacturers are mostly represented by worldwide companies, service businesses are represented by local firms operating in less than 10 states and retailing is represented by firms in 10 or more states.

To grasp the scale of real estate activities in corporations, executives were asked to estimate the total number of leases, lease renewals, purchases and sales transacted by their corporation last year. The survey included

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those firms who recorded no transactions, those with more than 1,500 and one with over 10,000. The median number of transactions was 60 per executive. Those institutions with more than 1,500 transactions mostly were public or quasipublic agencies or real estate companies; all were included in the service sector.

The Problem

Of the 288 executives who responded, 198 attempted to sell or lease 9,187 properties last year. Although two executives accounted for 2,000 of the 9,187 properties disposed, the remainder still is very large. The median attempts were 10 per executive. As shown in Table 1, manufacturers attempted fewer sales or leases than retailers, conglomerates or service industry firms. This is expected since they are more likely to have fewer facilities.

The problems involved in disposing of the properties were revealed in response to the question, "For these 'as is' dispositions with the longest time on the market, what problems made disposal of the properties difficult?" The most common problems were locations in depressed areas (the oil patch, farm areas), inner cities, small cities,

TABLE 1

Percent Distribution of Executives by
Number of Properties Attempted to Sell or Lease
And by Kind of Business

Number of Properties	Kind of Business				Total %
	Conglomerate %	Retail %	Manufacturing %	Service %	
0	.5	.9	5	2	8
1-5	5	5	11	8	29
6-25	6	13	10	11	40
26 or more	3.7	7	3	8	22
Total	15	26	29	30	100

Total number of executives, 216 (12 missing)

rural areas with old properties, over 50,000 square feet, inadequately maintained or where new or existing comparable vacant space existed. Forty-nine percent of the problems mentioned were for the above reasons and, if poor market was included, this accounted for 57 percent of the responses. Finding a skillful broker also was a significant problem.

TABLE 2

Alternative Choices for Disposition

Alternative Choices	Number of Executives Successful	Number of Executives Attempting	Properties	
			Disposed	Attempts
Sold "as is"	173		5044	
Leased "as is"	155	198*	2242	8497*
Renovation, sub- division, etc.	47	60	412	538
Donation	42	51	93	152

*Estimated for both sales and leasing "as is" together.

Alternative Choices For Disposition

Three main alternatives of disposition were explored: disposition "as is"; disposition by renovation, subdivision or other modification; disposition by donation. How did the respondents utilize these approaches? Of the 9,187 properties where disposal was attempted, 7,286 (79 percent) were sold or leased "as is." Six percent of the properties were considered for renovation by 26 percent of the executives and, 78 percent who tried this approach succeeded with 77 percent of the properties. Few tried to donate the property. Only 1.7 percent of the properties were considered for donation by 22 percent of the executives and 42 (82 percent) of these executives succeeded in donating only 61 percent of the properties. In terms of moving properties, real estate executives were successful, however, 1,396 (15 percent) of the properties were not sold or leased at the year's end.

There were no discernible differences in companies attempting to renovate, but there was a definite pattern in donation attempts. Conglomerates and manufacturers attempted to donate more proportionally than retailers

and service companies. This may be because large tracts of land are easier to donate and such holdings would tend to be more common among conglomerates and manufacturers. Nonetheless, there was no industry pattern among the successful donations.

Evaluation Of The Alternatives

Selling "As Is"

The great advantage of selling "as is," when the technique quickly yields a good price, is that additional resources are not used for the sale. No new capital is expended to renovate, subdivide or modify the property. This also means that new skills or staff are not needed in real estate development.

Another advantage is that the corporate officers are pleased with the real estate department for generating the quick cash flow, especially when it is needed to improve the year's performance for the stockholders or financial analysts. Also, this quick sale takes less of the real estate director's time and he is free to take on other responsibilities.

One disadvantage of this approach is that the company may lose an opportunity to generate profits from the redevelopment, subdivision or modification of the property.²

Another disadvantage is the corporation may be underutilizing its talents. Not every real estate group has the skills required for redevelopment, but many do. A major problem for keeping skilled executives in corporate real estate is the stifling effect of seeing opportunities become available without being able to utilize them for corporate profit.³

Also buyers may not be able to visualize the potential for alternative uses without first seeing the necessary renovations and changes in zoning and other environmental constraints already accomplished. It is possible that the increased uncertainty will lower potential selling prices relative to the available opportunity. Similarly, large plants with more than 50,000-100,000 square feet may be slow to move, whereas the same space subdivided into smaller sizes may sell quicker.

Plus, the property may be on the market a long time producing carrying costs for security, etc., that create a cash drain each month the property remains vacant. Or the property could be vandalized which would increase the costs for maintenance and result in a price loss when sold. Of the 155 responses to how executives overcame obstacles to selling or leasing "as is," 71 (46 percent) indicated they somehow changed the terms of sale.

Leasing "As Is"

It may be easier to lease property "as is" than to sell. By leasing, the company keeps control of who uses the property. This could be important if the property was adjacent to other corporate property or if the company wanted to prevent their competition from using a particular site. (This can be more important for retailing than manufacturing.) Also, the company does not give

up the potential reversion value of the site at some later time. Another approach, subleasing, may be the only way for a company to get out from under current lease contracts for property that is unneeded and idle or is underutilized.⁴

In offsetting the advantage of leasing "as is," there is the same disadvantage as selling "as is," plus the top management may be unhappy at not receiving a lump sum payment. The company does not perceive that the risk of waiting for the reversion at a later date is reward enough. Because the property is being managed as real estate for other business use, the leasing solution puts the company directly into the real estate business, an option not wanted by most non-real estate corporate managements.

Of course, the corporate management may consider the lease solution as an intermediate step to a final sale. In fact, the lease "as is" may get around some of the disadvantages of the sale "as is" because potential investor buyers can actually see the lease revenues and be willing to pay an appropriate price for the present value of those benefits plus potential reversion. A better price may be received by taking this step before selling.

Renovation, Subdivision And Other Modifications

To overcome the disadvantages of selling or leasing "as is," it may be necessary to consider subdividing, renovating or other modifications of the property. Some responses from the survey indicated this approach only was used when necessary for a particular situation. Of the 155 responding to ways of overcoming selling or leasing "as is," only 28 (18 percent) indicated they altered the property for the buyer.

The greatest advantage of subdividing or renovating is the higher price received for the property and the return on the marginal investment in redevelopment. Over half the executives who were successful indicated it was the market for the change that made it work. Other advantages, however, also are possible. The renovation process keeps the property ready for the buyer and reduces vandalism. Although the time for redeveloped properties to be on the market ranged from 1-36 months, the mean only was nine months, and the median only six months. Eighty-three percent of the executives indicated that the time on the market for these properties averaged one year or less. Redevelopment also makes very visible the properties potential alternative uses.

Since corporations tend to invest in businesses rather than projects, they often reject redevelopment as outside the mission of their business even when it can be profitable. Of the 159 executives who would not redevelop idle property for disposition, 61 (38 percent) indicated such risk was outside the skills of their business and an additional 18 (11 percent) indicated their company was "not in the real estate business." Thus, 79 (50 percent) said this was a reason for not using that approach. This was particularly true among manufacturers who, rather than retailers, conglomerates, or service sector executives, more often suggested they were not in the real

estate business. This is true since retailers are more concerned about position in space for strategic reasons and are more inclined to set up branches and new stores. Nonetheless, a number of these companies should look more closely at the extent of their real estate dealings.

An additional advantage of redevelopment is the goodwill it can yield for the corporation in a local community. The attempt to renovate older property where appropriate in inner city or small town areas, may spark a turnaround for an area that generates community support. In addition, it can make the location more attractive and can replace lost job opportunities.

The disadvantage of redevelopment is the need for increased resources—capital, time, talent and judgment of development risk—which may not be necessary to sell the property for a good price. Or, even if redevelopment is considered, the return relative to risk may be less than other alternative options. But this argument only was given by 34 (21 percent) of the 159 executives who did not use this approach.

Development certainly is a risk, and there is no guarantee of success even after physical, zoning, pollution and other obstacles are overcome, i.e., older properties may be unsuitable for renovation, and this may not be discovered until the work begins; internal staff skills may not be sufficient; the market for the finished renovation may have disappeared by the time the work is completed.

Conversely, several executives indicated they were successful in subdivision or renovation because few changes were required so the resources needed weren't extensive. As one executive said, it may be possible to take the risk out of a sale by solving environmental and zoning regulatory problems. Just reducing these uncertainties can increase the price more than proportionate to the effort.

Donation Of A Property

The executives responding to the survey resoundingly recited the disadvantages of donation. This option usually is not considered unless selling the property will be difficult and its final price would be below book value. Unfortunately, the tax law is such that if the price is below the adjusted basis, it is better to sell the property for a loss and give the money to a charity than to donate the property.⁵ Of the 135 executives who indicated they did not use donation last year, 93 (69 percent) recited its economic disadvantage; several indicated it would establish a bad precedent; 20 said that donation is not an option for leaseholdings or for certain institutions and public agencies.

Yet, some executives found donation to be a useful approach since the tax write-off was an advantage. The Trust for Public Lands, to whom two properties in the sample were donated, suggests the best donation is a bargain sale when the property is sold for a price equal to adjusted basis or slightly higher. This reduces long term capital gains taxes. They point out that the present value of such sales may be greater than a direct sale at

market price.⁶

From the corporation's viewpoint, no new resources have to be invested in the property to donate and the donation creates goodwill in the community. Properties were usually donated to municipalities, churches and other civic organizations, while a few were presented to educational institutions. The Conservancy was mentioned three times and the Trust for Public Lands was named twice.

The Best Alternative

With the alternatives for disposition subject to the variety of advantages and disadvantages that have been enumerated, how is the best one chosen? Theoretically, the solution is arrived at by estimating the present value of selling "as is" compared to the present values of leasing "as is," subdividing, renovating or other redevelopment or donating the property.⁷ Other advantages and disadvantages also have to be considered. As already mentioned, redevelopment may be eliminated because the company is not in the real estate business. Does that mean considering alternatives is wasted? Quite the contrary. A disadvantage of selling or leasing "as is" is the inability to identify potential buyers and to have those buyers visualize what can be done with the property. So the present value analysis becomes a selling tool to show the possibilities for the property.⁸ The technique also may identify a higher selling price by targeting a particular market. Nonetheless, one executive who was interviewed said this approach might be an implied warranty that if the buyer failed in a suggested development approach, the corporation might be sued.

Implementation

The first question to ask when trying to sell property or when deciding on alternative approaches is who are the likely buyers? Executives were asked what procedures they followed in this search for potential buyers. Their responses are shown in Table 3.

Most executives said brokers were used to indicate buyers but identifying an excellent broker often was a problem in selling or leasing properties "as is" since many contracted out the marketing function. Still 53 percent of the executives kept track of who is looking for space in the same business, and six percent utilized networking among comparable executives at like companies to identify potential buyers for "as is" sales or leasing. Also nine percent employed advertising techniques as a way to identify buyers.

Over half of the executives undertake in-house or contract out for a study of the site's highest and best use. Manufacturer and conglomerate executives are more likely to use such studies than those in the retail or service sectors. For some properties the highest and best use study is unnecessary because the characteristics of the property indicate a particular buyer. Nonetheless, sometimes selling "as is" without considering other possibilities only may be the easiest and not the best way.

Some companies, especially those in retailing, avoid selling to competitors. Of the 44 executives who said they avoided selling to a rival, 24 were in retailing, 7 were in conglomerates, 8 were in the service sector, and only 5 were in manufacturing. The choice is a marketing consideration and reflects geographic placement by companies who do not want to give a position to a particular competitor.

TABLE 3

Procedures Used In Identifying Potential Buyers

Procedure	Executives Responding	
	Number	Percent
Identify excellent brokers	210	92%
Keep track of who is looking for space in the same business	120	53%
Undertake or contract for study of highest and best use of site	119	52%
Avoid selling to firms in the same business	44	19%
Selling techniques—sign, phone, mail, etc.	20	9%
Networking	13	6%
Adjacent landowner	5	2%
Other	3	1%

Since so many executives responded by citing the necessity of choosing a good broker, the follow-up question to corroborate their answers was, "What role do brokers play in the disposition process?" Only six percent of the executives did not need a broker, and often the broker was used as a consultant or sales/leasing agent or as both.

The respondents had definite opinions on the usefulness of alternative techniques for notifying potential buyers on the availability of property. Putting a sign out was identified by the executives as the most useful technique. As shown in Table 4, when the very useful and useful responses were combined and the not useful and no responses were combined, putting a sign on the property was a clear first.

TABLE 4

Usefulness in Establishing Contact with Buyers

Techniques	Very Useful/Useful	Not Useful/No Response
Sign on property	88%	12%
Flyers	65%	35%
Ads in local newspaper	59%	41%
Surplus property lists of professional associations	52%	48%
Ads in trade journals	45%	55%
Notify State Department of Industrial Development	43%	57%
Telephone canvass	40%	60%
Ads in <i>Wall Street Journal</i>	27%	73%

Using this same approach, flyers, ads in local papers and association surplus property lists also were found useful. The techniques considered less helpful were ads in trade journals, state departments of industrial development, telephone canvassing and ads in the *The Wall Street Journal*.

As expected, executives in retail and service industries did not find state departments of industry useful; flyers also were less helpful to retailers while conglomerates found them most beneficial; retailers found signs more useful than other executives.

A sign on the property is effective relative to the other techniques, since it is a notice of availability to all who pass by the site. It is so useful that often a sign is the only technique used to sell a property — no brokers, no flyers, just a sign. With retail site selection being so sensitive to position, retail searchers will designate a target area and look for available locations. Signs are an effective mode of advertisement for this purpose. However, manufacturing sites, depending on the situation, may be close to market, transportation, labor or materials. In this case, signs may not reach the potential user.

Property Disposal In Communities Where A Closing Has Significant Impact

A sensitive situation occurs when a firm closes in a community where the company significantly impacts on the area's total employment. Retail firms saw no problem here, but one firm responded that corporate policy on the issue could not be disclosed and another indicated they had a systematic policy of not establishing plants in such situations. Since this argument has not appeared in location literature, it would be useful to know whether it is common for firms not to locate in small towns because of the closing problem. When a company had to shut down a facility, survey respondents indicated it was wise not to create any surprises, to work with local community leaders to find another user for the facility who would hire the displaced workers, to give generous severance pay, to assist workers in finding new jobs and relocation, and to hire local lawyers to assist in the negotiations.

Summary And Conclusion

The real estate executives who participated in the survey disposed of 85 percent of the available properties. However, not known is whether this disposition obtained the greatest present value net of costs. There is information that donation, the least used disposal approach, also showed a poor record compared to the attempts made.

Property redevelopment was tried by more executives with more properties and with a much better record of disposition than the donation approach. However, redevelopment was minor compared to selling or leasing "as is." The latter requires an important marketing effort to identify what the buyer of a particular property

might demand, and then to use the corporation's resources to meet the request and produce a good profit. Properties moved fast once redeveloped, nonetheless, most executives considered the approach unnecessary, or not usable because the funds were not available. Companies were reluctant to invest in the redevelopment of surplus property because they were not in the real estate business; the return relative to the risk was considered not appropriate; or either the development skills, or ability to understand the risk were not present.

Redevelopment is not necessary for all properties, but it might be a solution for those aging or large facilities with over 50,000 square feet in inner cities, small towns, rural areas and other depressed real estate markets. It is not known if the executives who sold or leased their properties "as is," chose this approach because it provided the quickest and greatest cash with no investment on the part of the seller, because it was the easiest solution or because their company would not allow real estate development.

The best solution may be the quick sale of property "as is" to another firm in the same industry. But some of the responses suggest that more effort could be directed at identifying the potential users of a property. Whether or not such ideas are used for redevelopment, they would help suggest target selling prices, and they would yield cash flow estimates that could be used in selling the property to potential buyers.

NOTES

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HOTEL/MOTEL MARKET SALES UPDATE

A data base provides an information source and a watchful eye on tracking transactions in the hotel/motel industry.

by **Stephen Rushmore, CRE**

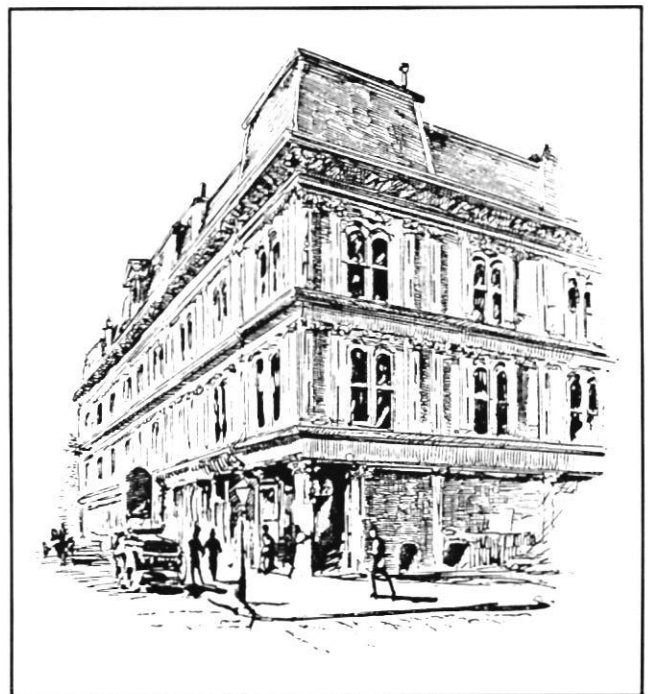
In the last 10 years, the average sale price for hotels and motels, on a per room basis, has more than doubled. The greatest value gains were experienced by smaller motels of less than 100 units and those located in the Mid-Atlantic Region of the United States. Generally, Marriott, Hyatt and Hilton hotels sold for higher prices per room than most other chain affiliated lodging facilities.

These findings are from the latest updated Hospitality Market Data Exchange (HMDE), a central clearinghouse of market sales information relating to transactions involving hotels and motels.¹ The HMDE has accumulated data on more than 1,400 sales of lodging facilities throughout the United States. Information pertaining to each transaction—property identification, room count, sales price, date of sale, location—is maintained in a computerized data base and periodically published.

National Data

Data arranged on a national basis produces the most definitive findings because of its large sample size. The HMDE data base contains a total of 1,299 sales that occurred between 1975-85. When these are arranged by year, 1982 has the largest number of transactions with 227 and 1975 has the least with 11. Table A shows the result of this national sampling of hotel/motel sales.

The changes in sales price per room are related to both the supply and demand of transient accommodations and the overall health of the national economy. Between 1975-77, when the average price per room dropped 28%, the hotel industry was in the midst of a severely overbuilt market and the nation was heading into a



recession. Yearly price gains were recorded from 1978-81 as the existing inventory of hotel rooms was absorbed and inflationary gains reached record heights. A slight price downturn occurred in 1982 followed by strong growth in 1983-84. Hotel prices were off again in 1985 as overbuilding and the pending tax law changes menaced the lodging industry.

During 1975-85, the average price per room increased a total of 102% or an average of 7% per year compounded annually. Adjusting for inflation, the real gain in the average price per room for this period was a total of only 1%, which indicates the gain mostly was absorbed by inflation.

The recent decline in mortgage interest rates could push

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TABLE A

Hospitality Market Data Exchange
Hotel/Motel Sales for the United States

Year	Number of Transactions	Average Sales Price Per Room	Percent Change from Previous Year	Compounded Average Annual Change From 1975
1975	11	\$23,832	—	—
1976	23	22,656	- 5%	- 5%
1977	47	17,155	- 24	- 15
1978	79	21,441	+ 25	- 3
1979	140	32,876	+ 53	+ 8
1980	162	37,283	+ 13	+ 9
1981	217	38,410	+ 3	+ 8
1982	227	36,943	- 4	+ 6
1983	211	40,999	+ 11	+ 7
1984	128	58,953	+ 44	+ 11
1985	54	48,229	- 18	+ 7

the hotel sales prices upward. However, offsetting this potential gain in value is the negative impact of overbuilding, low room rate inflation and further erosion of tax benefits.

Regional Data

Data, arranged by seven geographic regions, produced some irregular findings. Because the size of the data base for several regions was limited, findings were sometimes skewed upward and downward depending on the type and class of lodging facilities in the sample. The following conclusions were drawn from the analysis of the regional data.

Using the period 1979-84 where the number of transactions each year exceeded 125, and making some small adjustments where insufficient data tended to skew the findings, Table B shows the growth in the average price per room by geographic region.

The Mid-Atlantic showed the greatest growth during this period with an overall gain of 162% or about 21% per year. New England followed with a 19% yearly gain.

The North Central portion of the United States, which suffered from the economic slowdown during the early 1980s, registered an annual price increase of 8%. It is expected that this area will show a strong recovery as its economy becomes stronger. Hotel/motel prices in the South Central and the Mountain regions will be adversely affected by the oil and energy depression and overbuilding.

Property Size

When the data was arranged by property size (i.e., number of rooms), the findings consistently showed the average price per room increased as the property size became larger. This is because larger hotels generally have more restaurants, function and recreational space which tend to increase the sales price per room. Table C shows this average price per room for three size ranges (less than 100, 100-249 and 250-500) at three different times.

TABLE B

Hospitality Market Data Exchange
Hotel/Motel Sales by Geographic Region

Region	Average Sales Price Per Room		Total Percent Change	Compounded Average Annual Percent Change
	1979	1984		
New England	\$13,600	\$32,000	135%	19%
Mid-Atlantic	32,000	83,700	162	21
North Central	22,000	32,000	45	8
South Atlantic	24,900	44,000	77	12
South Central	21,500	43,000	100	15
Mountain	26,000	46,600	79	12
Pacific	50,100	98,100	96	14

During 1975-85, lodging facilities with less than 100 units experienced the largest increase in average sales price per room followed by properties with 100-249 rooms. During 1980-85, these 100-249 hotels posted the greatest price gains while the larger 250-500 room properties ranked a close second.

TABLE C

Hospitality Market Data Exchange
Hotel/Motel Sales by Property Size

Number of Rooms	Average Sales Price Per Room			Percent Change	Compounded Average Annual Change
	1975	1980	1985		
Less than 100	\$ 7,394	\$22,391	\$30,610	314%	15%
100-249	15,389	25,822	40,781	165	10
250-500	28,562	42,797	66,267	132	9

TABLE D

Hospitality Market Data Exchange
Hotel/Motel Sales by Chain Affiliation

Chain Affiliation	Range of Average Sales Price Per Room
Marriott	\$75,000 – 107,000
Hilton	52,000 – 87,000
Hyatt	43,000 – 86,000
Radisson	32,000 – 53,000
Sheraton	39,000 – 52,000
Holiday Inn	34,000 – 46,000
Days Inn	19,000 – 39,000
Best Western	23,000 – 35,000
Ramada	21,000 – 29,000
Quality	15,000 – 28,000
La Quinta	16,000 – 28,000
Howard Johnson	16,000 – 26,000
Rodeway	15,000 – 25,000
Econo Lodge	14,000 – 17,000

Chain Affiliation

The data base also was sorted according to the property's chain affiliation. Table D shows the most recent average sales price per room for some of the major United States hotel chains.

Marriott, Hyatt and Hilton Hotels commanded the highest average sales price per room when compared to other U.S. lodging chains, while the Days Inn, a budget chain, ranked in the middle. Independent hotels with no chain affiliation had an average sales price per room of \$39,000-\$49,000 which places them just above Holiday Inns.

While market sales do not establish market values for lodging facilities, they do provide a macro view of price changes and trends in the hotel industry. During the past 10 years overall price growth has been good, but when expressed in constant dollars, the real gains have been minimal.

NOTES

1. The information was compiled by Daniel H. Lesser of Hospitality Valuation Services Inc., of Mineola, New York and San Francisco, California.

DIVESTITURE COUNSELING FOR MORTGAGEES IN POSSESSION

As an outside authoritative resource, a counselor brings his expert skills and services to the decision making process.

by J. Christopher Curth, CRE

The divestiture counselor has the role of active advocacy on behalf of a lender who is in possession or contemplating foreclosure. He quickly becomes a vital team player of the institution and acts as a temporary staff member who brings his experience and national perspective to the city where the problem real estate is located. Often in foreclosure a simplistic "we can do it ourselves" approach is taken to solve critical issues. But this inexperience and lack of skilled staff time can produce action plans that are poorly documented or researched. The counselor's function is to fill a void so staff time can be spent conducting the daily business activities rather than analyzing a problem property and its surrounding community.

Defining The Problem

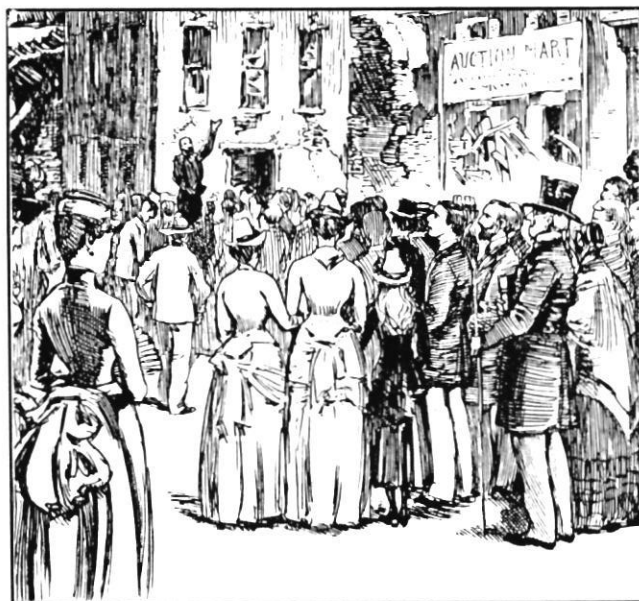
The first hurdle the counselor has to overcome is the desire by senior management to sell the project in question and take whatever loan loss results. This approach usually is the worst possible alternative for the new owner.

Initially the counselor meets with the appropriate officers for a healthy dialogue on the property. If the original loan officer is available, his input can be vital to understanding the loan's history. During this meeting, the counselor needs to obtain answers to questions on the project being scrutinized.

Typical questions to ask are the following:

- When was the loan originally made to the borrower?
- What was and is the relationship of the lending institution to the developer?

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- Was the project ever viable?
- Has it failed as a result of developer negligence, the collapse of the community's economy or a combination of both?
- Has a senior official inspected the project in recent days?
- Is the project currently under management by an experienced and qualified company?
- Has the institution made an effort to speak with the tenants, particularly those who are disgruntled?
- Has the project been inspected by a qualified representative of the institution to determine if dangerous maintenance problems exist that could jeopardize the new owner?
- Has the lender considered that now may be a poor time to sell?

- Does the lender recognize that capital improvements and deferred maintenance may be required prior to disposition?
- What is the immediate objective of senior management with regard to the development?
- Who at the institution is responsible for the project?
- Does the institution have available all the operating histories, surveys, plans and specifications, leases, easements, etc.?
- Are major leases expiring near term and are the respective tenants being accommodated?

These are a sampling of the critical questions that need answers to establish an understanding between counselor and client and to define the project's major problems. Subsequently, the counselor can outline the scope of his services that will be needed to provide a plan for corrective actions and ultimate disposition.

Scope Of Services

The counselor fully informs the client of the actions to be taken during this assignment. Since lenders who are unfamiliar with distress real estate usually are anxious about the outcome, it is helpful to walk the client through an outline of possible services. Subsequently, the officer(s) begins to grasp exactly what needs to be done, by whom and when the answers will be available. They will know that after the investigative process is undertaken, a well-documented report will be presented with findings, conclusions, available options and recommendations. When the client and counselor have agreed on the assignment's scope and the anticipated completion date, the actual analysis can begin.

Familiarization

Frequently the foreclosed holding is not located in the same city as the lending institution and the counselor has to familiarize himself with the community, neighborhood and site characteristics.

The Community

The economy of the city or community needs to be scrutinized to understand the area's overall trends. Thus, the counselor applies his experience and carefully examines the area's economic status observing the following factors: a broad employment base produces a more stable economy; a solid balance between trade, services, government, construction and manufacturing is less susceptible to sudden economic pitfalls. For instance, the southwest portion of the United States is in the throes of economic chaos because of an overdependence on the energy industry, but five years ago, few envisioned the collapse currently underway. Predictability of the economy is extremely appealing. When there is a well established diversity, the future forecast is easier to determine and the counselor can anticipate future employment trends with greater confidence.

Growth in employment generates long term population

and household increases. If the project is situated in a community suffering from high unemployment, chances are the vacancy level for the office, industrial, retail and multi-family sectors is unhealthy. It is also likely a number of these projects are for sale, in foreclosure or unfinished. The counselor inventories such competitive projects for application to the leasing and disposition potentials of the client's holding.

The Neighborhood

The counselor examines land uses in the surrounding area; investigates population and household trends; studies road and utility expansions; understands existing commercial, office, retail and multi-family projects; comprehends the school systems and real estate development activity. The client's holding is measured in terms of its locational appeal within the surrounding area. Hopefully, it is well located and easily accessible from stable and desirable subdivisions and condominiums and apartment projects. Its locational attributes, particularly exposure and accessibility, are measured against all existing and proposed competitive projects. The client receives a detailed survey of these projects along with comments on how his complex ranks with that of the competition. Accompanying the survey is a location map that indicates the location of the subject property and its competition along with a description of each project, its current occupancy and leasing trends.

The Site

A counselor conducts a thorough physical inspection of the project for his client, and when possible the designated property manager is present. The inspection will note the property's overall appearance, architectural style, blend with the surrounding land uses and any needed capital improvements that require immediate attention.

Tenant Survey

An extremely important duty for the counselor is to interview the project's tenants. Often, they are very displeased since the original owner probably has not kept his promises. During the foreclosure period, no one usually is willing to take decisive action on behalf of the tenants. And since predatory leasing agents from competing projects are familiar with the vulnerability of the distressed property, they often will take this opportunity to solicit the unhappy tenants. To avoid a deterioration of the occupancy after foreclosure, a lending institution should authorize an officer to talk with the tenants and assure them that their grievances will be resolved. Meanwhile, the property manager should have apprised the owner of any such problems long before the counselor was retained.

When the counselor meets with the tenants, he informs them that the lender is pursuing professional guidance to

prepare a plan of ownership and that their input is critical to the decision-making process. This also is an excellent opportunity for the counselor to inform the tenants that the lender sincerely is interested in obtaining their input. A sampling of questions asked the tenants can include the following:

- What originally attracted you to the project?
- Are you satisfied with the physical features of the space?
- Are you satisfied with the response time of the property manager?
- Would you renew your lease if it were expiring?
- What needs to be done to improve the property?
- How would you rank the property with others you have considered?

Tenants are excellent sources of information, and their responses can assist the counselor in estimating the public's perception of the project and in uncovering design or functional problems. Any critical problems should be forwarded immediately to the lender for prompt resolution, and the overall findings and conclusions of the tenants' survey will be summarized in the counselor's final report.

Economics Of The Project

An important function provided by the experienced counselor in foreclosed property analysis relates to the economic potentials the holding can generate. A detailed survey of the competition will enable the counselor to determine the type of rental structure the leasing agent and lender should offer. Historic operating statements and capital budgets are carefully studied to measure the efficiency of the day-to-day operations.

By the time the counselor has studied the community's economic vitality, the degree of competition from existing or proposed projects, and the holding's operating trends and probable rent levels, a well documented cash flow can be prepared for review by the lender. This cash flow illustrates what might be expected from the project given the community's current economic climate. The lender now is able to make a quantifiable, objective decision on how much money needs to be expended to bring the project in line with the premier competitive

projects, how long it will take to achieve stable occupancy, the probable selling price under current conditions and the expected pricing once rentals are brought to more attractive levels.

Conclusions, Options And Recommendations

The counselor will have maintained a constant dialogue with the client throughout the assignment's duration. His final report provides conclusions that relate to the community's present economy and the probable near to mid-term changes that impact on the area's employment.

Any conclusions relating to the overall strength of the area surrounding the property, i.e., the health of competitive projects, would be presented in narrative and graphic form. The report's findings might conclude that a severe imbalance of supply over demand would emerge if a large number of announced competitive projects were started. Other findings would focus on the present property manager's competence, the operation's efficiency, major capital expenditures, the tenants' survey and any dangerous maintenance problems.

Also, all available options, i.e., the immediate sale of the project or waiting for a stabilized occupancy, would be submitted in order of preference. For example, if the cash flows indicate a probable value enhancement near term if a more aggressive and market-oriented leasing strategy were launched, the option to hold would be more advisable than a liquidation sale.

Based upon his conclusions from working the project, the report concludes with detailed action recommendations. These can be extremely important to an absentee owner who needs guidelines to create a viable project from a distress situation.

Conclusion

The importance of sound divestiture counseling can save a lender millions of dollars. The counselor thoroughly scrutinizes a problem property. He measures the timeliness of disposition, the steps needed to preserve and expand the equity in the holding and concludes with an objective prudent decision on how and when the lender should divest the project. And, the assignment should not end with delivery of the final report since a counselor also can provide meaningful advice as the disposition program proceeds.

HOW REAL ESTATE STABILIZED A SMALL, BLACK COLLEGE IN MISSISSIPPI

One school's answer to funding its budget when faced with shrinking federal assistance.

by Robert W. Jones, CRE

The nation's private black colleges have had to review their methods and find new sources of funding to replace the shortfalls in revenue that have occurred from the reduction in federal funding for higher education. The more fortunate black colleges have embarked on a program to increase their financial support from corporations; others have strengthened their alumni giving program for those willing and able to augment their contributions.

However, most private black colleges lack the ability to attract sufficient foundation or alumni support to replace the previous federal, corporate and foundation funds. This does not mean that foundation or alumni support for black colleges has not grown, but that it is not sufficient to fill the gap.

A Review Of The History Of Private Black Colleges

Most of the nation's private black colleges are located in the southern portion of the United States. The history of these institutions varies from being "land grant" colleges, which was an attempt after the Civil War by northern white social institutions to set up schools for the freed blacks, to "church related colleges," which had the same purpose in mind. In the 1860s, the newly founded colleges were administered by northern whites on either the trustee or administrative levels.

In the 1960s however, a spirit of social change spread through the black college campuses and their trustees realized it was time to start the transition from having a white administration and trusteeship to one that was black. The 1960s also was a period when the philosophy and spirit of the country assumed unlimited growth and prosperity.

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Within this atmosphere the transition occurred and most private black colleges became independent from their original charters. The responsibility for the growth, direction and financing of these changes was put into the hands of their new leadership. With the country's significant growth, inflation, employment and student enrollment filtered down to the black community and most colleges embarked on a program to make the necessary changes and capture their share of the market. During this period, a great building program of dormitories, libraries, gymnasiums and classrooms was accomplished. It was assumed that federal, corporate and foundation support would continue and that increased student enrollment would be sufficient to amortize the debt.

In the 1970s however, it became apparent that what had been forecasted as a continuing condition of growth was misleading. By the beginning of the 80s, the slowdown in student enrollment and the retrenchment in the traditional sources of financing made it very clear to college trustees and their administrations that changes must occur to manage an accumulating debt.

EXHIBIT 1

Total Income And Expenses 1978-87

Year	Income	Expenses	Surplus/ (Deficit)
86-87	7,700,366	7,700,366	0
85-86	8,265,803	8,961,907	(696,104)
84-85	7,534,384	7,983,239	(448,855)
83-84	7,191,997	7,602,473	(410,476)
82-83	6,642,880	7,089,594	(446,714)
81-82	7,751,866	8,040,426	(288,560)
80-81	7,564,323	7,718,534	(154,211)
79-80	7,539,416	7,593,667	(54,251)
78-79	6,733,332	6,858,964	(125,632)
77-78	5,928,928	6,472,669	(543,741)

Reorganization took the usual route of program, staff and faculty reviews to shed those programs and personnel that no longer were affordable. The student/teacher ratio was realigned to its maximum and work loads of faculty teachers were increased. However, even with all this accomplished, it still was apparent that the biggest continuing budget problem was providing student aid and scholarship grants. These programs were necessary to attract the better students and maintain the existing students, but adequate funding for these programs was not available.

Year-end deficits clearly became identified with these shortfalls in income for scholarships and student aid. As the deficits accumulated over several years, any attempts to balance the budget with unknown gifts and grants rarely was attained. The accumulated deficits, when added to the long-term debt, made it clear that the life expectancy for many black colleges was severely threatened.

These deficits challenged the leadership of private black colleges to look at their assets, as opposed to their liabilities, and seek new profit sources.

EXHIBIT 2

Tuition and Fees / Enrollment 1978-87

Year	Enrollment	Tuition/Fees
86-87	691	4,855
85-86	661	4,660
84-85	611	4,660
83-84	608	4,460
82-83	649	4,460
81-82	793	3,770
80-81	868	3,770
79-80	946	3,250
78-79	896	3,250
77-78	893	2,700

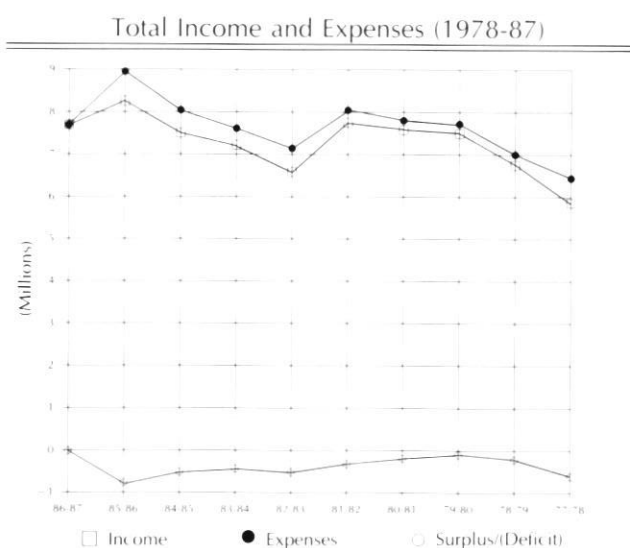
A Case Study

Most black colleges were founded in suburban or rural areas, and generally, they had more land than was needed.

A classic situation was Tougaloo College in Tougaloo, Mississippi, located on the city line of Jackson, Mississippi. Tougaloo, caught up in the 1960s spirit of expansion, had constructed a much needed library and dormitories at substantial expense. It also had started to upgrade several of its classroom facilities when it became apparent that the combination of the new long-term debt, the declining enrollment in the 1970s and the budget overruns were creating an expensive short-term debt.

The college set out on a twofold objective to stabilize and then increase its enrollment and to find a creative way of dealing with its financial problem. The first objective was met by administrative reorganization and alumni help. The second required a review of the college's assets. Tougaloo is situated on 500 ± acres of land of which 50 are required for campus use (based on a master plan study). The remaining 450 ± acres therefore were surplus and available to the college as excess land.

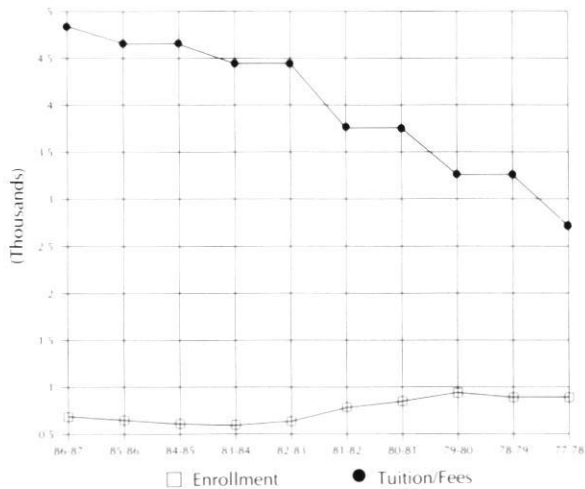
FIGURE 1



In 1975, the college secured a grant to study the alternative uses for this extraneous land. A report provided data which stated that the progression of growth in the City of Jackson was moving toward the college community. Tougaloo then commissioned a land use planning study to identify what alternative uses were compatible with the college and the surrounding community in order to take advantage of a potential for development. Shortly after the study's completion, the economy sputtered and the projected growth stopped. In 1980, Tougaloo commissioned a new development study which indicated again that expansion and development were moving toward Tougaloo College.

FIGURE 2

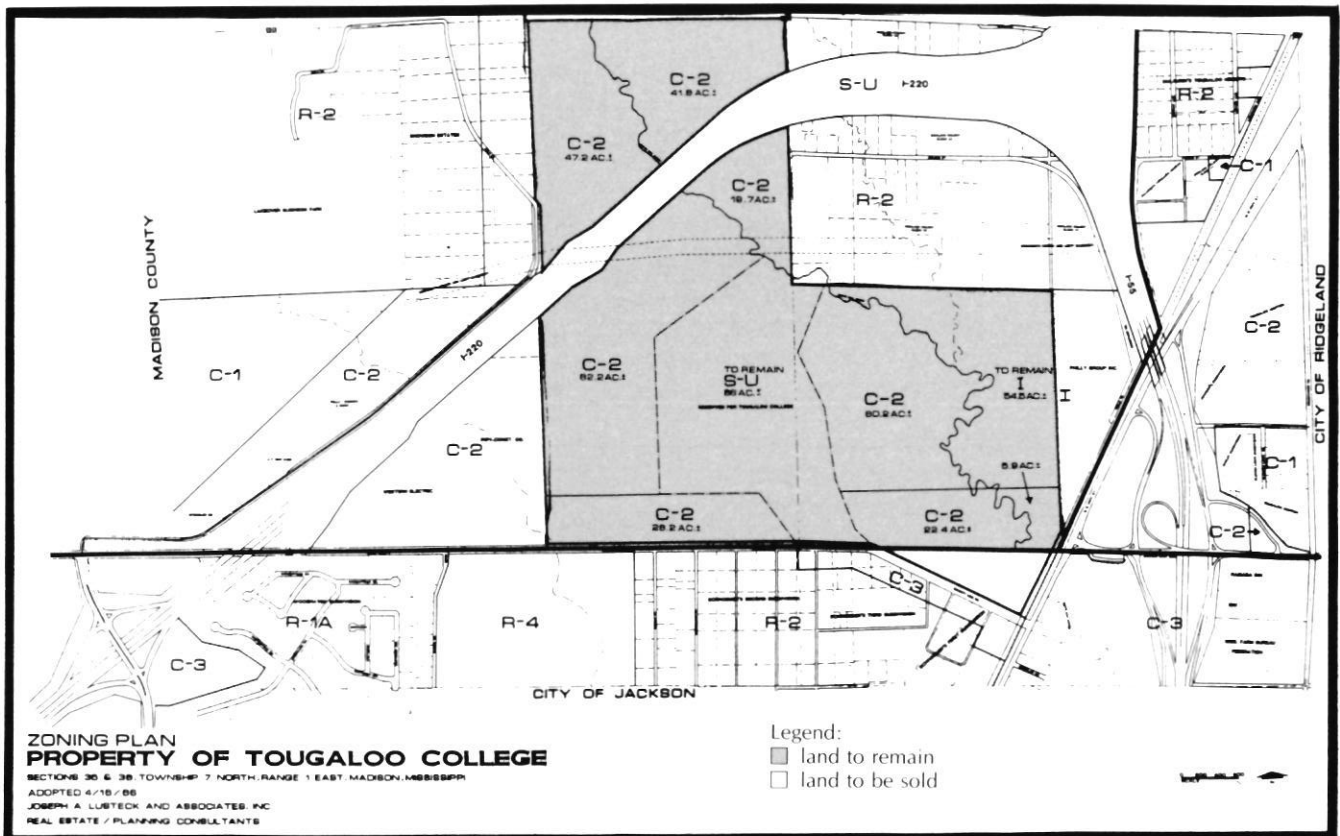
Tuition and Fees/Enrollment (1978-87)



The college, because of financial pressures, had the excess land appraised and due to its substantial appreciation in value, a land mortgage was arranged from a leading insurance institution. This enabled the college to consolidate its short-term debt and provided the breathing room to properly carry out a marketing plan. The results of this plan would allow for the development of the land to repay the loan, and provide an increase in the endowment fund for student scholarships.

The marketing plan accepted by the Board of Trustees recommended a strategy for land development that required substantial rezoning of the excess acreage. It indicated that total development would take 10-12 years, depending on location and market factors. The following recommendations were made and accepted.

- Proceed with the development. Be patient with the expectation that the projected marketing period will be prolonged.
- Hire a local project coordinator to assist with all subsequent approval, development and marketing activities.
- Obtain zoning changes necessary to implement the proposed development.
- Engage engineers to prepare and process a flood plain revision study and subdivision approvals.
- Meet with appropriate government officials and others to obtain support and public funding for necessary improvements including County Line Road extension, the required railroad crossing and off-site utility services.
- Continue discussion on the potential for joint development.
- Prepare and distribute sales material that give the property maximum marketing exposure.
- Market the property in phases. Consider sale of the parcels north of I-220 and east of White Oak Creek



and joint development of the remaining property.
(See Map—Property of Tougaloo College.)

To follow these recommendations, Tougaloo hired a local coordinator, a CRE (Counselor of Real Estate) and prepared the necessary maps for appropriate zoning changes.

Subsequently, many obstacles have hindered the development of the land such as community regard for its new use, student and faculty concern over the possible sale of the land (this is very important to southern blacks), community politics related to other developers' progress and an economy that runs hot or cold in short cycles.

The college was successful, however, in meeting with the various constituencies and obtaining agreements that allowed it to appear before the city's zoning board and receive permission to rezone the excess land.

Tougaloo now is confident that all this time and effort has been worthwhile. The school's trustees are aware that the length of time involved can be extensive and that even with professional assistance, it is a protracted process. When finished however, Tougaloo will have achieved a development package that satisfies its students, faculty and local community, and at the same time, is attractive and responsive to the objectives of potential developers.

The value of the land, when developed, will be sufficient to not only repay any outstanding debts, but also to make a substantial contribution in endowments for student and scholarship programs. Tougaloo no longer is looking solely for non-refundable aid. Now it is seeking assistance from corporations who wish to take advantage of the opportunity to locate next to an educational institution and profit from an environment where the cost of doing business justifies the investment.

INVESTMENT RISK IN OLDER BUILDINGS WITH ZONING NONCONFORMITIES

Updated zoning ordinances place new demands on existing structures.

by **Dudley S. Hinds**

The presence of nonconforming provisions in a local zoning ordinance is a risk that often accompanies the investment in an older building. A "nonconformity" is a characteristic of a structure that was in accord with the zoning requirements when built but since has become contrary to the present regulations. Some nonconformities may have existed prior to the adoption of any zoning ordinance. Although a nonconforming use could not legally be recreated today in its present location (nor a nonconforming structure in its same form), the provisions of the ordinance permit a continuation subject to certain limitations. Such provisions comprise what is termed a "grandfather clause." However, the risk of investing in nonconforming properties arises from the limitations that are placed on continuation.

Limitations On Continuation Of Nonconformities

Limitations on continuation are designed to prevent any increase in the degree of nonconformity and eventually to bring about conformity. The limitations on continuation are usually applied separately to two major categories of nonconformities—uses and development standards. Provisions may vary from locality to locality, but some typical limitations are as follows.

1. A nonconforming use may be increased in extent or converted to another nonconforming use.
2. A nonconforming use which has been discontinued for a specified period of time (e.g. six months, one year) may not be re-established.
3. A nonconforming use may not be re-established after its structure has been destroyed in excess of a specified percentage of replacement cost.



4. A nonconforming use must be terminated after time has been allowed for the owner to amortize whatever investment there was in the structure when it became nonconforming. No attempt is made to ascertain the actual amount invested; instead, an arbitrary period of time is selected. Periods can vary from 40 years for uses in substantial buildings, to as little as two years for signs and for used-car lots where small structures are incidental to the use of the site.

Development standards include height of structure, floor area, lot coverage, setbacks, off-street parking and loading, buffers adjacent to residential districts, etc. Typical limitations on the continuance of structures that do not conform to development standards are similar to those pertaining to use. A nonconforming structure may not be

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enlarged or substantially altered to prolong its economic life unless it is being made to conform.

Like the IRS Code, there often is a distinction between a repair made to keep a structure usable and an improvement or substantial alteration made to increase its value or its economic life. The exact distinction can vary from place to place and is a potential source of disagreement. Many cities rely on the definition of the word "repair" as contained in their building codes. The definition of the International Conference of Building Officials, as used in various model codes, simply states that, "Repair is the reconstruction or renewal of any part of an existing building, structure or building service equipment for the purpose of its maintenance."¹ Stewart Stein defines the word alteration as "any change or modification in construction or building service equipment."² Stein, who has examined approximately 500 sets of construction regulations (including both zoning and building codes), offers eight representative definitions of the word repair.³ While they vary in specificity, all are open to considerable interpretation when used to designate the differences between repair and alteration or improvement.

Another common provision relating to nonconforming structures provides that, following destruction in excess of a prescribed percentage of replacement cost, a nonconforming structure may not be rebuilt except in accord with the regulations. Destruction normally means damage by wind, fire or other so-called acts of God. In at least one case, however, a builder who was rehabilitating a complex of low-rise apartment buildings was challenged by neighbors who claimed that the very act of rehabilitation resulted in a temporary destruction and thus, the remodeled units needed to comply with all new development standards. The neighbors appealed to the zoning board of adjustment and the ruling of the building inspector was reversed.⁴

Risks For Investors

As indicated by the example just cited, nonconforming provisions can pose serious risks. An investor could possibly lose cash flow from operations and even a portion of the capital invested as a result of various combinations of events. But, some investments in nonconforming property may involve little risk. For example, a nonconforming single family residence in a commercial zoning district may be considered an underimprovement of the site and, parcel size permitting, might be replaced by a use and structure that would generate a higher new present value.⁵ Where, however, a building represents an overimprovement of the site (nonconforming ground coverage, setbacks, offstreet parking, height or floor area), or where a nonconforming use, even in a conforming structure, permits higher rental income than could be obtained with a conforming use, an investor can face significant risks. Operation of the zoning provisions described previously could result in one or more of the following situations.

1. Inability to continue or restore a use could greatly reduce periodic cash flows. Vacancy could be

prolonged while an attempt is made to adapt to a new set of conditions.

2. A damaged structure that is not permitted to be replaced must be written-off in its entirety by the investor even though the property insurance may treat it only as a partial loss. Generally, property insurance is designed to cover damages. Where an economic loss exceeds damages, the excess is not likely to be covered.
3. Where a structure has not been damaged but its use has been terminated, the structure may not be adaptable to a permitted use and must be written-off in its entirety.
4. Inability to expand a nonconforming use may result in refusal of a tenant to renew a lease and difficulty in obtaining a new tenant.

Existing Literature

Existing literature is sparse on investment risk posed by nonconforming provisions. A computerized search found few articles that even touched upon the risk involved: one dealt briefly with risks for lenders;⁶ two dealt with the challenge to appraisers;⁷ one discussed legal issues.⁸

Since nothing was found to indicate the scope of the problem nationwide, a survey was conducted of local governments. A questionnaire was designed and mailed to 46 cities as a pilot survey. The 36 responses were analyzed and resulted in modifications being made. An additional 1,555 questionnaires then were mailed out, making a total, including the pilot, of 1,601. The sample market was selected from an alphabetical listing of 2,558 cities grouped within an alphabetical roster of states. The list for the selection came from the 1982 *Municipal Year Book*, Table 1/4.⁹ The cities chosen were classified by size of population as follows:

Category	Population	Cities in Sample
Large	100,000 +	158
Medium	25,000-99,999	902
Small	less than 25,000	1,498

TABLE 1A

Summary Of Mailouts And Returns
By City Size

City Size	Number of Cities	Sample Size		Usable Returns	% Of Sample
		Number	%		
Large	158	158	100	130	82.3
Medium	902	549	60.9	332	60.5
Small	1,498	894	59.7	446	49.9
Total	2,558	1,601	62.6	908	56.7

TABLE 1B

Summary Of Mailouts And Returns
By Region

Region	Number of Cities	Sample Size		Usable Number	Returns % Of Sample
		Number	%		
Northeast	742	454	61.2	201	44.3
North Central	737	462	62.7	293	63.4
South	646	409	63.3	236	57.7
West	433	276	63.7	178	64.5
Total	2,558	1,601	62.6	908	57.7

TABLE 2

Switching Occupancy From A
Nonconforming Use To Another Use

City Size	Permit Switching To:		Prohibit Switching	No Response
	Any Use	Use In Same Or More Restricted Class		
Small	6.5%	51.6%	41.0%	0.9%
Medium	6.3%	62.7%	30.7%	0.3%
Large	6.9%	71.5%	20.8%	0.3%
Total	6.5%	58.5%	34.4%	0.7%

TABLE 3

Restoration Of Nonconforming Uses
After Destruction Of Building

City Size	Not Permitted	Permitted If Destruction Not In Excess Of					No Response
		50%	60%	2/3%	75%	Other	
Small	5.8%	55.2%	4.9%	9.9%	3.4%	19.5%	1.3%
Medium	4.5%	51.2%	5.1%	7.5%	2.7%	26.5%	2.4%
Large	4.6%	36.9%	8.5%	7.7%	5.4%	34.6%	2.3%
Total	5.2%	51.1%	5.5%	8.7%	3.4%	24.2%	1.9%

Because large cities are important to investors in older structures, it was decided to have a 100% sample in this category. However, budget constraints limited the medium and small categories to a 60% sampling, so the first three of every five cities were selected from the master list. Mailouts, returns and usable returns are summarized by the size of the city in Table 1A. Replies also were coded according to major census regions (Northeast, North Central, South and West [See Figure 1]) and these results are summarized in Table 1B.

Findings As To Nonconforming Uses Of Buildings

Re-establishment After Discontinuance

Most cities permit nonconforming uses to be re-established after they have been discontinued for less than some prescribed period of time. The most common limit is one year (44.3%) and the next is six months (28.7%). Other periods cited were one month, 18 months and two years. Only 8.4% prohibit re-establishment. The size of the city makes little difference in the responses. The six month limit is more common in the South (36.9%), while the one year limit is favored in the Northeast and North Central states (50.2% and 50.9%, respectively).

Changing One Nonconforming Use To Another

Approximately 34% of the cities in the sample prohibit a switching from one nonconforming use to another. Another 58% allow a switch, but only to a use in the same or a more restrictive category. Only 6.5% of the cities

permit switching occupancy from a nonconforming use to any other use (see Table 2). The prohibition category includes 41.0% of the small cities, 30.7% of the medium cities and 20.8% of the large cities. Switching to another nonconforming use in the same or a more restrictive category is allowed by 51.5% of small cities, 62.7% of medium cities and 71.5% of large cities. The refusal to permit switching is most prevalent in the Northeast (43.3%) and least common in the North Central region (27.6%).

TABLE 4

Cities Permitting
Additions Or Alterations To Structures
Containing Nonconforming Uses

Category of Response	% Responding
Yes, Permitted	45.4%
Without Significant Qualification	12.9%
Alterations Only	7.9%
Only with Variance or Special Permit	12.7%
With Limitations on Size	10.2%
Miscellaneous Qualifications	1.7%
No, Not Permitted	53.3%
Without Exceptions	50.0%
Except Alterations Required by Law	0.8%
Except by Variance or Special Permit	2.1%
With Miscellaneous Exceptions	0.4%
No Response	1.4%
Total	100.1%*

*Error in total is a result of rounding.

Mandatory Termination After Prescribed Period Of Time

Only 13.8% of the cities have a mandatory amortization period for termination. The percentage ranges from 12.8% for small cities to 15.4% for large cities, and from 6.0% in the Northeast to 21.3% in the West. Answers on the length of the amortization period are open-ended and require further processing before they will be suitable for tabulation.

Restoration Of Use After Destruction Of Building

A majority of the cities permit restoration of a use after partial destruction of a building but not after full destruction. Those allowing the restoration differ, however, as to the degree of partial destruction tolerated and on the conditions to be met. Table 3 summarizes the responses as a percentage of the cities in each size group. Responses in distribution from the Northeast are similar to those from the large cities. Responses from other regions are much closer to the distribution for small and medium cities. The "Other" category includes a variety of answers not yet analyzed. Some do not limit restoration;

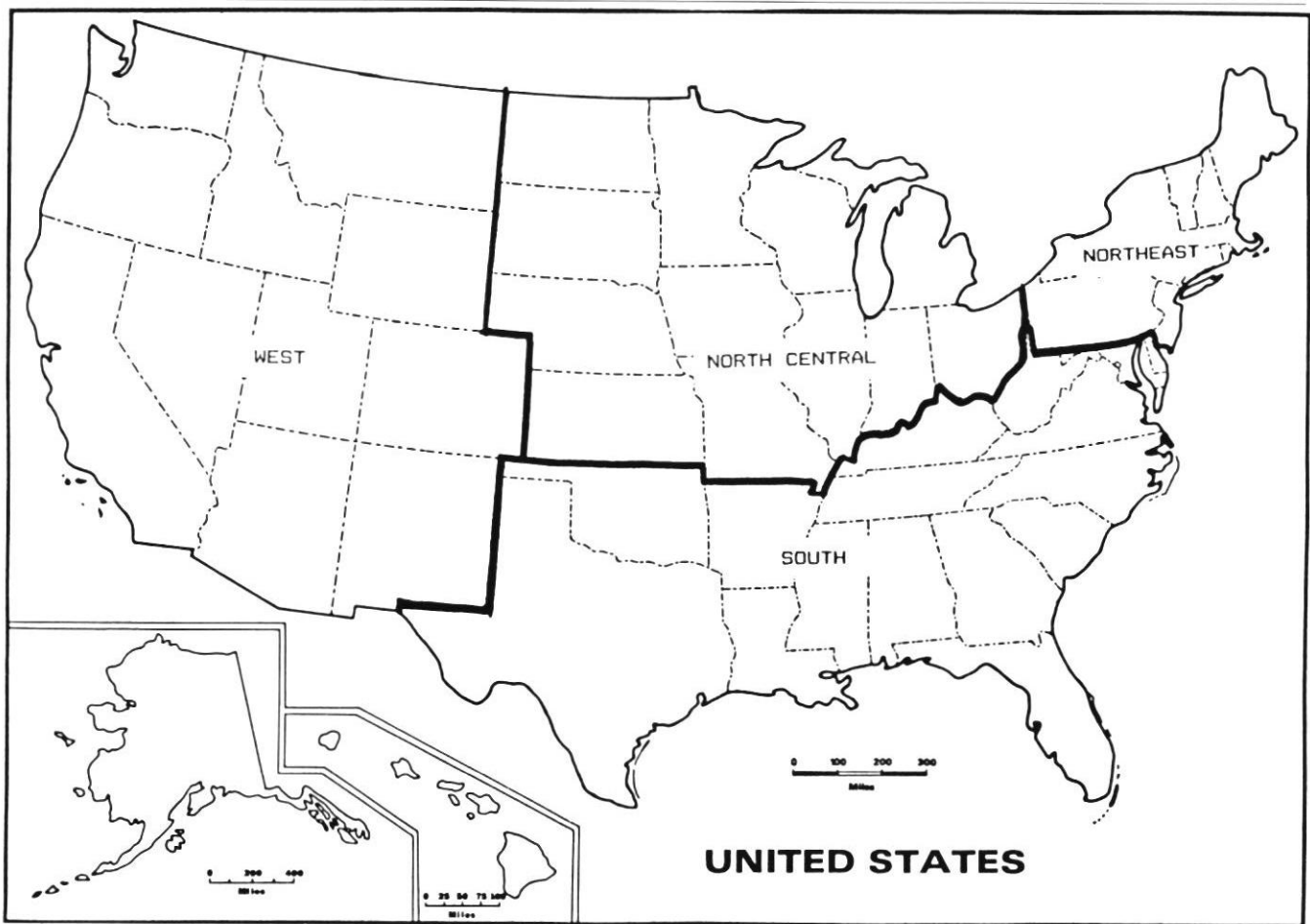
others permit the restoration only within a prescribed time period; some require approval by a board. The destruction percentages, used as limits, generally apply to replacement cost, but some cities use market value or assessed value. Some exempt the building foundations from the calculated replacement cost.

Additions, Alterations And Extension Of Nonconformity

More than 53% of the cities prohibit additions and alterations that would extend a nonconforming use or prolong the useful life of the structure. The figure is 54.9% for small cities, 54.2% for medium cities and 44.6% for those in the large category. The South and North Central regions have the highest rates (58.1% and 58.0%, respectively), and the Northeast has the lowest (44.8%). Because of the many qualifications made to the responses, a simple tabulation of yes or no answers is misleading. For example, of the 412 "yes" responses (45.3% of the total), only 12.9% are without significant qualifications. Table 4 summarizes the major categories and subcategories of responses. Note that the "yes" response (but only with variance or special permit) is

FIGURE 1

Major Census Regions



Georgia State University, Department of Geography, Cartography Laboratory, 1974
Source: U.S. Department of Commerce Bureau of the Census

almost the same as the "no" response, except by variance or special permit. Together they comprise 14.8% of the total. Special permits require approval by a planning commission or by the local governing body; variances require approval by a board of adjustment.

Repairs Considered To Be Alterations

As mentioned earlier, the definitions of repair in general use do not appear to make a clear distinction between repair and alteration. A question was asked to ascertain if any cities had clarified the distinction by placing a limit on the value of repairs that was permitted. Approximately 28% of the cities responded that repairs in excess of a specified amount or percentage were considered to be alterations. There was a small range in this answer among cities of different sizes (from 26% in large cities to 30% in medium cities). But among regions, the answer ranged from 34% in the West to 30% each in the North Central and South, down to 17% in the Northeast. When the response stated that such a limit existed, an additional question was asked about the size of the limit. These answers were difficult to interpret. Of the 254 cities with a limit, only 186 provided clear responses on size, and some of the 186 confused this question with one earlier that dealt with restoration. The responses for the percentage of value above which a repair would be considered an alteration were as follows:

50%	93 cities
25%	27 cities
10%	25 cities
15%	7 cities
other %	23 cities
dollar limits	12 cities

One city (counted twice) has a 10% limit for nonresidential repairs and a 15% limit for residential repairs. Two cities reported that all repairs were considered alterations. Among the cities reporting dollar limits, amounts ranged from \$100 (five cities) to \$12,500.

Findings For Buildings Nonconforming As To Development Standards

Restoration Of Building After Full Or Partial Destruction

Most cities permit nonconforming buildings to be restored following partial destruction. Only 11.5% do not permit such restoration (14.0% in the South, down to 5.0% in the Northeast), but of those who do allow restoration, there is a difference in opinion on how much damage had to occur before the building is made to conform when refurbished. The variances in answers, arranged by city size, are displayed in Table 5. Except for the higher percentage in the "Not Permitted" column, the distribution is much the same as it was for the restoration of nonconforming uses. As before, the responses for the Northeast resemble those for the large cities.

Additions Or Alterations Without Making Entire Building Conform

Most cities (65%) permit an addition or alteration to a nonconforming building without requiring that the entire building be brought into conformity. A significant number, however, do not. Where applicable, this ranges from 32.3% for small cities, down to 25.4% for large cities, and from 38.9% in the North Central region, down to 16.9% in the Northeast.

Findings On Administrative Relief From Nonconforming Provisions

An overwhelming majority of the cities have a variance procedure for obtaining relief from the nonconforming provisions. This includes 86.3% of small cities, 81.0% of medium cities, 83.1% of large cities and 83.9% of all cities. The proportion is highest in the Northeast (92.0%) and lowest in the West (72.5%). Responses to a question about the success of requests for administrative relief are displayed in Table 6. Regionally, the "Usually Successful" figure was highest in the East (57.7%) and lowest in the West (39.9%). Table 6 offers some hope that the risk

TABLE 5
Restoration Of Nonconforming Buildings
As They Were

City Size	Not Permitted	Permitted If Destruction Not In Excess Of					No Response
		50%	60%	2/3%	75%	Other	
Small	11.2%	46.9%	4.0%	11.0%	3.1%	22.0%	1.8%
Medium	11.4%	45.5%	4.2%	7.8%	2.1%	26.8%	2.1%
Large	12.3%	30.0%	6.9%	9.2%	5.4%	36.2%	0%
Total	11.5%	43.9%	4.5%	9.6%	3.1%	25.8%	1.7%

TABLE 6

Success In Obtaining Variances
From Nonconforming Provisions

City Size	Usually Successful	Usually Unsuccessful	No Opinion	Not Applicable
Small	50.9%	9.4%	26.0%	13.7%
Medium	47.3%	6.3%	28.9%	17.5%
Large	56.2%	5.4%	21.5%	16.9%
Total	50.3%	7.7%	26.4%	15.5%

might be manageable in part by appeal in many localities. As the destruction (and therefore the need for an appeal) might not occur for several years, there remains the risk that the political environment could change in the interim. A possible solution is to request a waiver in advance, although this may present legal problems in some jurisdictions. In the survey, a question dealt with the number of requests received by municipalities in the past five years for advance waivers from the destruction/restoration provision for nonconforming buildings to meet lenders' conditions for obtaining mortgage loans. Only 4.8% replied "yes." For large cities, the figure was 9.2% and for small cities 3.6%. In the West, the figure was 10.1%; in other regions between 3.4-3.8%.

In Summary

To invest in buildings with zoning nonconformities involves the risks described earlier. Such risks will vary according to the size of the city and the region of the country. There also are individual differences between cities of the same size and in the same region. Property insurance will not protect against many of the risks. Effective risk management will require an analysis of the applicable regulations and political environment of the city where the investment is to be made to assess the magnitude of the risks; and, where possible, to obtain

waivers in advance from any regulations that might prevent restoration after full or partial destruction.

NOTES

1. International Conference of Building Officials, *Uniform Administrative Code* (Whittier, California: 1985): 11.
2. *Ibid.*, 10.
3. Stein, J. Stewart. *Construction Regulations Glossary*. New York: John Wiley & Sons, 1983: 564.
4. Sandler Associates et al v. Thomas B. Branch III et al, U.S. District Court, Northern District of Georgia, C 74-1838-A, 1975.
5. Quinlivan, J. Mark and Johnson, Vance R. "The Concept of Positive Economic Obsolescence," *The Appraisal Journal*, 49 (January, 1981): 46.
6. "Don't Get Trapped by Code Violations, Nonconforming Uses," *Savings & Loan News*, 97 n. 2 (February, 1976): 90-91.
7. Quinlivan and Johnson, op. cit., 45-51. See also Mourray, James W. "Legal, Nonconforming-Use Appeal," *The Appraisal Journal*, 34 (October, 1966): 592-595.
8. Aron, Jerry E. "Eliminating Nonconforming Uses by Amortization," *Florida Bar Journal*, 55 (April, 1981): 339-342.
9. International City Management, *Municipal Year Book* (Washington: 1982).

The author wishes to acknowledge the research efforts of Bryan J. Cohen and Benny Paktong Lui, graduate students at Georgia State University, whose assistance led to the development of this article.

SELECTING REAL ESTATE INVESTMENT ANALYSIS SOFTWARE

A menu for self education assists the novice and more experienced shopper to decide on the right software package.

by L. Ried Schott

If you have been looking for real estate software to assist you in analyzing investment properties, you realize it is a laborious and confusing task. And if you do not realize this yet, you probably will — much too soon. In the past few years, hundreds of real estate software programs have been developed. There are over 60 real estate investment analysis programs alone. So, what is the best way to find a program that will suit your specific needs?

Determine Your Needs

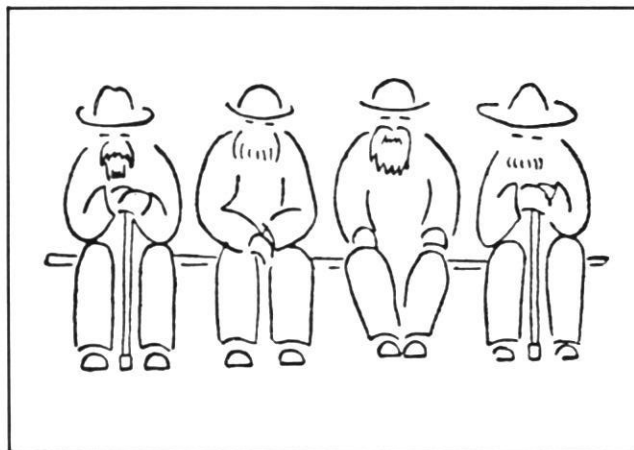
There are several approaches to take. First, try to identify your precise needs. With respect to real estate investment analysis software, the basic types of programs include the following: lease analysis, cash flow, valuation, development/construction, partnership/syndication and portfolio analysis. Select the types of programs in which you have an interest and list them in order of significance. Then, beginning with your immediate concerns, list the important features you desire in a program. Also, try to anticipate future needs.

This may sound simpler than it is, particularly if you have limited experience with computers and real estate software. Consequently, it may be necessary to become familiar with the programs in which you are interested by reading reviews, attending seminars and possibly by using some programs. It will soon become apparent that not all programs are created equal.

In looking at the fundamental aspects of the program, consider:

- Performance
- Documentation
- Ease of Learning
- Ease of Use
- Support
- Error Handling

L. Ried Schott is vice president of the Commercial Mortgage Financing Group, Drexel Burnham Lambert of New York. He has a wide range of experience in valuations, market studies and computer consultation.



The technical capabilities can be equally important, especially the maximum number of items the program will handle (including tenants, expenses, escalations, etc.) and user defined capabilities (including escalations, pass-throughs, etc.). Transferring the data to a report generator, such as a word processor or Lotus, also may be important.

The bottom line, however, involves the added productivity the program will eventually provide. Unfortunately, it is difficult to estimate the cost effectiveness of a program without already having previous experience. Therefore, unless you hire a consultant, or put considerable faith in the experience of a user, expect to spend a lot of time in trying to evaluate real estate software.

Sources Of Data To Help Identify And Evaluate Software

If you are willing to take the time, you will need to know the major sources of data that will help identify and evaluate real estate software. These sources, and brief comments about them, are contained in the following publications.

Real Estate Computer Software Directories

You may want to consult one or more of the real estate computer software directories. There are at least five including:

- Directory of Software Vendors by Kenneth Leventhal & Co.
- Guide To Real Estate and Mortgage Banking Software from Real Estate Solutions, Inc.
- Mortgage Banking Software by the Mortgage Bankers Association
- Real Estate Applications Software Directory by the Texas Real Estate Research Center
- Software by Moore Data Management Services

The latter publication does not contain as many investment analysis programs as the others. Addresses, phone numbers and the costs of these directories are contained in the Exhibit.

Real Estate Computer Publications And Reviews

It is most helpful to supplement your search by reading publications that have reviews of various programs. Publications devoted to computers and real estate include:

PC News

GLARECUG c/o Richard Sorenson, President
(Great Lake Area Real Estate Computer User's Group)
First Chicago
One First National Plaza-Suite 0151
Chicago, IL 60670-0151
(312) 732-7330.
Frequency: Bimonthly, Annual Subscription-\$25.00

Quarterly Byte

American Institute of Real Estate Appraisers
430 N. Michigan Avenue
Chicago, IL 60611-4088
(312) 329-8559
Frequency: Quarterly, Annual Subscription-\$30.00

Real Estate Computer Review

Miller Freeman Publications, Inc.
500 Howard Street
San Francisco, CA 94105
(415) 397-1881
Frequency: Monthly, Annual Subscription-\$97.00

Remug

c/o Mary Dum
948 Hilldale Avenue
Berkeley, CA 94708
(415) 526-4523
Frequency: Quarterly, Annual Subscription-\$50.

Other real estate publications that occasionally contain computer reviews are: Appraisal Review Journal from the National Association of Review Appraisers and Mortgage Underwriters, St. Paul, Minnesota; Real Estate Issues from the American Society of Real Estate Counselors, Chicago, Illinois; Real Estate Review from Warren Gorham & Lamont, Inc., Boston, Massachusetts; The Appraisal Journal from the American Institute of Real

Estate Appraisers, Chicago, Illinois; and The Real Estate Appraiser and Analyst from the Society of Real Estate Appraisers, Chicago, Illinois.

Reviews can be helpful since the directories have limited information about the programs. Of course, the vendor can be contacted for information and, usually for a nominal cost, possibly a demonstration disk. Also, names and numbers of some users can usually be obtained from the vendor. But, the vendor information can be limited and biased. Unfortunately, some reviews are not entirely objective.

Computer Seminars

Another possibility in helping make your decision on computer software is by attending a seminar. The American Institute of Real Estate Appraisers and The Society of Real Estate Appraisers have seminars including Lotus 1-2-3, but do not cover more sophisticated programs such as lease analysis.

Two seminars that cover more in depth real estate software are Evaluating Real Estate Investment Analysis Software sponsored by the Northwest Center for Professional Education (NCPE) and a seminar by Real Estate Software Associates (RESA). The latter includes the directory—*Guide to Real Estate and Mortgage Banking Software*. The former includes a 500-page manual with printouts from about 60 programs.

The NCPE seminar lists programs in the following categories: development/construction; lease analysis; partnership/syndication; limited capability cash flow; advance holding periods; income investment appraisal programs; and spreadsheet templates and financial models. Some programs are listed in as many as four of these categories.

The RESA seminar concentrates on only 10 of the leading software programs, all of which they sell, including: Center, Pandex, Fin-Sim II, Lotus 1-2-3, MicroREAM, ProfitLine, Real Decisions, Realdex/Pase, Pro-Ject and Dynamis. RESA runs detailed "back to back" runs of the noted programs and illustrates the differences and similarities in each.

The NCPE seminar is designed to appeal to individuals with more varied interests. It provides an overview to real estate investment analysis software but covers so many programs that it may be confusing. If you have narrowed your program search down to a few of those covered in the RESA seminar, then that seminar probably will provide you with a more detailed perspective of the programs. But, it would be advisable to attend the NCPE seminar first if you are interested in both seminars or if you have limited knowledge of real estate software.

Word Of Mouth

Another method of finding good real estate programs is by word of mouth.

- 1) Ask your peers at meetings, conferences, seminars, visits, etc. A difficulty with this approach is

that what may satisfy one person's needs may not be adequate for another. Further, your peers may not be as expert on real estate software as you thought.

- 2) Contact a real estate organization. Unfortunately, it is doubtful that many staff members are familiar with real estate programs.
- 3) Also, your clients may have considerable experience with real estate software. It may be advantageous or necessary for you to use the same program as a client, but you may still want another program for more support or for other clients.

Word of mouth is most useful in finding others using programs you are considering since that can give you candid responses. But be aware that one person's needs may not be the same as yours.

Real Estate Computer Consultants

Finally, if you do not have the time to investigate the leads from the sources furnished in this article, you may want to hire a real estate computer consultant. The costs vary considerably, from \$30 to over \$100 per hour. For an individual or small firm, this cost may seem unreasonable at first. Yet, if you consider the time and costs involved in going through the steps that have been presented, the advantages become much more reasonable.

In selecting a consultant, beware of those that sell particular programs and/or hardware. If they operate on a commission basis, their objectivity can be affected.

When hiring, do not only look at the possible service costs for selecting a program, but consider the cost of the software, hardware, training and support as well. Sometimes the vendor supplies training and support without an additional fee; this can reduce the consultant's fee and your start up time. A good consultant can help you evaluate these considerations, and most important, help you determine what computer software and hardware are most cost efficient.

The final decision in buying real estate investment analysis software may not be up to you; it may involve a decision of a committee or supervisor. As the factors presented here indicate, this is a difficult decision to make especially for those with limited computer experience. This increases the importance of choosing a capable consultant.

Costs, Timing, And Deciding About Real Estate Software

The costs of some of the more sophisticated programs usually vary between \$1,000-\$5,000. Surprisingly to some, these costs, plus consulting fees, easily can be recouped over one or two large assignments, especially if you already have a computer such as an IBM PC or compatible. (The great majority of all software runs on IBMs; consequently, the choice of hardware is not as critical as previously.) If you require a computer and printer, you can get by for under \$3,000, possibly as low

as \$2,000. Once the program is learned, future assignments should require less time and revisions can be greatly simplified. It may not matter if the program is the ultimate one that fulfills every conceivable need of yours as long as it performs your basic wants. When a better program becomes available, you will be in a better position to evaluate and use it if you have some prior experience.

There will be other programs in the future that will be more powerful, less expensive and easier to use than what exists now. If you can get by for another year or so, it might be to your advantage. But can you afford to

EXHIBIT

A Listing Of Real Estate Software Directories

Directory Of Software Vendors

Kenneth Leventhal & Co.

Available from:

Northwest Center for Professional Education

13555 Bel-Red Road C-96870

Bellevue, WA

(206) 746-4173

Listing 180 vendors

Cost \$89.00

Publication Date: January, 1986

Guide To Real Estate And Mortgage Banking Software

Real Estate Solutions, Inc.

2609 Kingle Rd. N.W.

Washington, D.C.

(202) 362-9854

Listing 525 programs

Cost: \$95.00; Annual Subscription: \$135.00

Publication Date: Twice Annually

Mortgage Banking Software

The Mortgage Bankers Association of America

1125 Fifteenth St. N.W.

Washington, D.C. 20005

(202) 861-6500

Concentrating on loan servicing/production

Cost: \$115.00

Publication Date: August, 1985

Real Estate Applications Software Directory

Texas Real Estate Research Center

Texas A&M University

College Station, TX 77843-2115

(409) 845-2031

Listing 277 vendors

Cost: \$30.00

Publication Date: April, 1984

Software

Moore Data Management Services

1660 S. Highway 100

Minneapolis, MN 55416

(612) 540-1000

Listing 537 programs from 339 vendors

Cost: \$29.95

wait? Avoiding real estate software can decrease your productivity in the near future and provide less desirable results. It also is possible that you may lose clients who do not believe you to have the level of the sophistication they deem desirable.

However, to acquire real estate software can be costly

and time consuming. So, in deciding upon real estate computer software, try to look at the whole picture. Through the sources indicated, proper investigations and possibly through the assistance of a consultant, you can improve your decisions in selecting real estate software.



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