GERTRUDE STEIN AND THE REAL ESTATE MARKET

On her deathbed, the redoubtable Gertrude Stein supposedly asked her companion, Alice B. Toklas, "Alice, what is the answer?" Hearing no reply, she asked, "In that case, Alice, what is the question?"

In the same way, the experienced banker becoming involved in real estate must learn at the onset what questions to ask, and then he must learn how to interpret and apply the response.

All of us to a certain extent "know" things that are not true or, more likely, that are irrelevant or misleading half-truths; and in no field is this truer than in real estate. The generation-long, post-World War II inflation obscured harsh realities that became painfully apparent in periods of slack demand and stable or declining values.

The banker of today can no longer lend on the "great fool theory" that some other lender will necessarily come by to bail him out, nor can he automatically count on having his load made good by the relentless increase in paper values reflected in the comment that "the rising tide lifts all the boats."

In the real world, some buildings depreciate physically or economically and not merely in the eyes of the tax lawyer; not all mortgage 'balloons' meet anticipations. Self-serving projections can turn out to represent hopes rather than expectations, and carefully documented forecasts often appear in the cold light of day to be mere extrapolations of the rising segment of a curve.

David Rose, our senior partner has proposed Rose's Rule – "In a free market economy, shortage tends to create surplus and surplus, shortage."

The lender is often confused by hearing unfamiliar appraisal terms such as the Ellwood Formula, the Hoskold Method, the Inwood Factor, or the authoritative-sounding Internal Rate of Return. When he asks for hard numbers, he sometimes gets impressive computer printouts (accurate to the nearest feather) of how many angels can dance on the head of a pin.

"What," the banker asks, "should I do?"

There is no easy answer, for we are dealing with an art rather than a science. Real estate values are based on anticipations of the future; and the future implies unknowns. In real estate, unlike archeology, the past is of interest only to the degree that it throws light on the future.

The goal of the lender is to improve the odds by sound judgment about the future.

New Construction

With new construction, understanding the role of the developer, his nature, and, above all, his aims, is a fundamental importance.

The usual aim of the developer is to achieve the twin goals of controlling as much brick, mortar, and land as he can with as little of his own cash as possible, while at the same time achieving the highest possible cash-on-cash return on what he does have in the job.

In the purchase of existing income-producing real estate, the unknowns involve future income and expense, and one can usually project accurate extensions of current items.

In new construction, however, the gross figures are unknown, and the numbers can be a leap in the dark.

Gross Cost, for example, can be broken down into:

a) initial land cost,

b) tenant relocation, possession, and demolition,

c) "field cost" of brick and mortar.

d) fees for a wide variety of professional services,
e) real estate taxes and building loan interest during construction,
f) interim operating losses from Certificate of Occupancy to rent-up.

The possibility of unforeseen cost increases in each of the last five items is real, and the cumulative impact of substantial errors in each can be severe.

Gross Financing can involve funds from combinations of straight fee, leasehold-and-fee, construction and permanent loans, proceeds from the sale of tax losses, cash contributions of a Limited Partner, etc.

Unless one is dealing with a standard product, Total Income figures for a job yet to be built are more difficult to estimate than those for an existing, occupied (and therefore "market-tested") project; and the same is true for expenses.

The conclusion a reasonable person must reach is that new development is anything but 'shooting fish in a barrel'; it is a high risk game with anguish for the losers, but with rewards proportionate to the risks for the winners.

For a banker, the moral of the story is not that one should not lend on new construction, but rather that such lending should be done knowledgeably and prudently.

The skills of the successful developer consist in making important decisions, key trade-offs that suit the nature of the project. Partly by experience, partly by intuition, and sometimes (when the size, complexity, novelty or uniqueness of the job requires it), by formal feasibility studies, market analyses, and the like, the developer tries to make "sufficient decisions on the basis of insufficient information." What the construction lender is lending on is:

a) the ability of the developer to make such judgments accurately;
b) the "margin for error" represented by such conditions as the percentage of fullness of the loan; and
c) where there are personal guarantees, the developer's net worth available to back any shortfall.

To a wise lender, the competence, track-record, and integrity of the construction borrower are of great importance, since experience has shown that even the best-conceived project may not be able to withstand a well-intentioned incompetent or an able fellow who cockily and without sufficient preparation tackles a job unlike anything he has done before or an experienced character with larceny in his heart. If I were a lender, I would require substantial collateral from a borrower whose competence I questioned, and the assistance of highly skilled professionals to aid an able, but newly arrived entrant into the field. I would not lend money at all to a borrower whose professional integrity was in question, and I would go out of my way to encourage loans to highly regarded development teams with projects of prime feasibility. It is important to emphasize the phrase "prime feasibility," because even the best in the field can be seduced into jobs because "the money is there." The wise lender should not only have confidence in his own negative judgment, but for projects of size and complexity, should seek independent analysis of feasibility.

Our brief aside on interest rate: It never seemed to me that real risk on the part of a lender was adequately compensated by another point or two of interest. Like Groucho Marks, who wouldn't join a club that would take someone like him, I would not feel comfortable lending money to a borrower willing to pay exorbitant rates.

Assuming an able, experienced, and honorable developer whose project appears to make economic sense, the lender is faced with the question of what terms and conditions to impose. Unless he is prepared to be the lender of last resort, the construction lender should require a permanent financing take-out of an amount greater than the construction loan (ten percent is the usual difference), with loan conditions dove-tailing with those of the construction loan. Stringent inspection during construction should be understood by all parties to be an absolute must, and the disgraceful experience of the recent past (when loan advances far exceeded the value of construction in place) need never be repeated.

The question of loan guarantees is sticky even when the borrower's commitment is "to complete" rather than "to repay." One cannot ignore the recent sad examples when personal guarantees against outside collateral proved worthless because other liens had been placed against the collateral. Reasonable control over the borrower's other loss exposures is not out of order. Several of the nation's largest developers who came to grief in the recent shake-out might not have done so if their lenders had insisted on the right to monitor the cumulative total exposure assumed by the borrower.

When Loans Go Bad

The story of the American banking industry and the real estate debacle of the 1974-75 is probably destined in time to stimulate as much research and professional discussion as the Dutch Tulip Craze or the South Sea Bubble.

Developments that should never have been planned in the artificially financed "super-boom" of 1971-73 emerged from the ground to be greeted by soaring construction costs, unforeseen shortages in key materials, and unheard-of construction loan rates.

Irritation turned to despair when final demand proved inadequate to absorb the avalanche of prematurely produced product; it takes no savant to predict that the resulting headaches will be around for some time to come.

Bankers becoming involved with real estate today should be required to become familiar with the case histories of the great fiascos – not because of morbid interest, but for the same reason that a prominent New York structural engineer has made the study of engineering disasters a lifelong hobby – the better to understand sound projects.

The banker who doesn't ask himself what lessons are to be learned from the blood-letting is cheating himself needlessly.

Conventional wisdom may hold that one is better off with small participations in a number of large loans rather than in total financing of fewer big ones; but actual experience shows that some of the worst headaches were those in which the lending participants fought destructively among themselves. In *Poor Richard's Almanac*, Benjamin Franklin said that there is nothing wrong with putting all your eggs in one basket, so long as you watch the basket.

Bankruptcy, or rather the threat of bankruptcy, is being used as a form of blackmail against lenders by some defaulting owners; creative thought must be given to strategies of defense.

A number of observers feel that at the first sign of real trouble, when the developer looks to the lender for the concession, revision of terms, etc., the lender should insist on re-casting the arrangement to make it more "Chapter XII-proof." For example, in return for additional cash advances, a property can be conveyed to the lender, with the original developer having an option to re-purchase it if he meets prescribed conditions.

Obviously, each job must be dealt with in terms of its unique factors; but in general, early defensive action is advisable in dealing with a sick job or a stumbling developer.

Another important point involves the individuals (developer and lending officer) best equipped to deal with a sick job; those who were in on the launching of a project are not necessarily the best ones to be involved in the turnaround.

Individuals can get psychologically "locked in" to a view either disapproval or outdated by subsequent events; and whether for reasons of pride, rigidity or mental block, they often tenaciously hold on and "go down with the ship."

"Percussive Sublimation" (being kicked upstairs) and "Lateral Arabesque" (moved elsewhere out of harm's way) are two frequently employed management techniques in such cases in the corporate world, but in the real estate field, many people feel that the developer who got himself (and the lender) into the fix should be entrusted to get them both out (even if there is no necessary common interest).

A third generality is the tendency to forget the importance of nuts-and-bolts real estate management competence.

Politics is often defined as "the art of the impossible," but the tag applies equally well to the field of real estate management.

It seems unglamorous and lacking in entrepreneurial razzle-dazzle to point it out, but the turkeys laid by wheeler-dealers can often be turned into something fit for the banker's Thanksgiving table by such prosaic steps as careful, professional attention to personnel selection and supervision, preparation of realistic operating budgets, imaginative but cost-effective advertising and promotion campaigns, institution of honest and efficient purchasing and control procedures, and so forth.

In real estate as in anything else, poorly-conceived or sloppily reinforced controls may provide such great temptation to dishonesty that they render the supervisor responsible, almost an "accomplice-in-fact."

A banker cannot be expected to determine capital and operating costs of fluorescent vs. incandescent lighting; carpet vs. resilient floor tile; #6 oil vs. electric heat vs. New York Steam, or the hundred and one other details that constitute the day-to-day concerns of the management professional. It is important for him, however, to realize how significant to the numbers on a sick job these mundane questions can be.

There is an adage in the field to the effect that "good management doesn't cost; it pays"; and that is one real estate generality that admits no exceptions!

Rules of Thumb

One danger to the new entrant to the real estate world is the natural but sometimes harmful tendency to rely on unsupported generalizations that may be irrelevant or misleading

My favorite example of this thinking is the statement that "the average American has one mammary and one testicle." I also like the fellow who refused to let his wife have more than four children, on the grounds that every fifth child born today is Chinese; and his friend who drowned crossing a lake whose average depth was only one foot!

Kidding aside, when one speaks of dollars-per-room do we mean large rooms or small, in efficiency apartments or in four-bedroom duplexes?

A popular rule says that for a large residential subdivision, one should allocate 20 percent of the gross land area to streets. Depending on shape, topography, governmental requirements, perimeter facilities, etc., actual requirements can run from below 15 percent to over 30 percent.

Everyone used to 'know' that in a suburban shopping center 5.5 parking spaces were required for every 1,000 square feet of gross store area. Experience has since proved that availability of mass transit can be an important factor, and (less obviously) that adding office space by as much as 20 percent of the total area may not require one extra parking space.

Percentage of income people spend on housing is another rule of thumb frequently applied, yet in practice the poor spend a much higher and the rich a much lower percentage of their income than we used to think.

The conversion factor between the rental value and the condominium sales price of a given apartment unit is another "rule of thumb" that can be misleading, as is the corollary of what a condominium converter can afford to pay for a rental building he plans to flip. In each case, the specifics of the project must be examined carefully, in terms of the structure, the neighborhood, the current market, the financing available, and so forth.

It must be strongly impressed on an individual becoming involved with real estate that each plot of ground, and usually each structure, should be considered unique in its specifics even if it can be grouped as a class in one way or another.

Use of Outside Professionals

Woodrow Wilson used to say that in tackling a serious problem, he tried to use all the brains he had and the best he could borrow.

The wise banker, too, should avail himself of the best talent available. His problem is to determine who should perform what service when and at what-cost. The often misunderstood fact of life is that it takes skill to be a good client.

What the property is worth (appraisal), what the property is worth to a given user (investment analysis), and how much can safely be lent on the security of the property (underwriting analysis) are separate questions.

Project X is not able to meet its objectives. Is it a bad loan, is it bad real estate, or is it a fundamentally sound parcel badly handled or hit by short-term negative factors (marketing, financing, etc.) that in time will right themselves?

In school examinations, a student who gives a brilliant answer to the wrong question gets little sympathy, and the same is true in real estate. The statistical material prepared for one purpose (the development process) may not relate to another problem (the lending process).

Academic types are not always equipped to deal with renting and management problems, whereas they may be ideal for hotel or shopping center market analysis; the reverse would be true of operating people.

Be sure that

a) the right question is being asked; and

b) the person being asked is trained to deal with that problem.

CONCLUSIONS

The effective lender must develop in-house competence; he should make good use of properly qualified outside professional assistance of proven soundness; he should be aware of events and trends in the field and, he must seek that happy balance between deep-seated mistrust and enthusiastic optimism that all of us aim for but few achieve.

In the Rubaiyat, Omar Khayyam wrote:

"Myself when young did early frequent
Doctor and Saint, and heard great argument
About it and about: but ever more
Came out by the same door wherein I went."

Those things worth knowing must be learned without being taught; The chief value of one's own experience and that of others is to ripen judgment: Common sense and imagination must be applied to all situations; finally, a gentle, good-natured skepticism may be the best frame of mind with which to approach real estate as well as life.

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