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Real Estate Opinion

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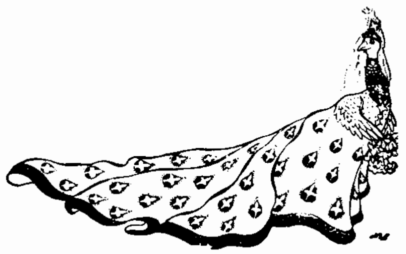
BRINGING REAL ESTATE INTO THE BUSINESS WORLD

Some years ago in business school, I studied marketing, management, labor relations, operations research, and other subjects considered necessary to prepare me for a business career. When I graduated and embarked on a successful career as a real estate investment manager, I never professionally utilized most of the subjects I studied. During the past decade, successful real estate investing has depended on noncontrollable factors such as inflation and tax benefits. What usually distinguished one real estate investment manager from another was how well the manager structured his or her investments to maximize the tax and inflation benefits, rather than how well he or she selected and managed assets. In contrast, successful real estate investing during the next decade will probably be dependent on controllable factors like the choice of individual assets and the quality of management. I, for one, am looking forward to the change.

THE CHANGING RULES FOR REAL ESTATE SUCCESS

In the pre-1986 negative-leverage inflationary environment, the success or failure of an income-producing real estate investment usually depended on events beyond the investor's control. A real estate investment typically yielded a 9 percent initial rate of return, while the investor's current cost of funds was typically 12 percent or more. The real estate investor's annual return overwhelmingly consisted of tax benefits, which alone typically exceeded the value of the equity investment[1] and the investor's long-term return consisted of the property's potential appreciation due to inflation. The potential profit opportunities from these factors far overshadowed returns from basic-property cash flow (which was taxed at 50 percent) and any appreciation that might result from applied scientific management techniques.

In the current post-tax reform, positive-leverage noninflationary environment, the success or failure of an income-producing real estate investment depends primarily on the property's cash flow. A real estate investment today typically yields a 9–10 percent initial rate of return, and the investor's current cost of funds is typically below this amount. The investor's annual return overwhelmingly consists of cash flow (which is now taxed at only 28 percent) and the long-term return from either a sale or refinancing is entirely based on potential cash flow. The investor's potential profit opportunity overwhelmingly depends on maintaining and increasing the property's cash flow by applying scientific management techniques. This cash flow dependency is magnified in leveraged investments in which a moderate change in property cash flow becomes a significant change in return on equity.



AN EXAMPLE

Let us examine this leveraged relationship between management and return in a $10 million real estate investment financed with a $8 million mortgage at a fixed 9 percent interest rate ($720,000 debt service). Assuming $900,000 in net operating income, the $2 million in equity yields $180,000 per annum, a 9 percent per annum (before-tax) return on equity. If applied scientific management can increase net operating income only 5 percent from $900,000 to $945,000, the investor's return on equity increases by 25 percent from $180,000 to $225,000 per annum. Moreover, this dramatic increase in cash flow is taxed at only a 28 percent rate.

[1] The present value of real estate tax benefits alone after the Economic Recovery Tax Act of 1981 was $202.39 per $1,000, or 20.24 percent of total asset value. See Pilzer, "Real Estate Tax Benefits and Reforms: The Long View," 15 REAL ESTATE REVIEW 28-32 (Fall 1985).

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Before 1987, when the present value of the investor's tax benefits alone ($2,023,900 or $202.39 per $1,000) exceeded his or her $2 million equity investment, there was little incentive to work on improving the cash flow, especially when any increase would be taxed at a 50 percent rate. Today, the incentive exists.

OPPORTUNITIES FOR SOPHISTICATED MANAGERS

Traditionally, the highest paid and best real estate investment management talents in a real estate investment company were located in the acquisitions and (tax) structuring areas. As the major real estate investment companies recognize that profitable opportunities now lie in sophisticated property management, they are restructuring the responsibilities of their best talent. This industrywide changeover is similar to management changes experienced by a new company when it moves from the entrepreneurial start-up stage to the second-generation professional management stage.

The emphasis on sophisticated management techniques will also affect the types of properties real estate investment companies will purchase. For example, sophisticated property management requires sophisticated local personnel whose services are not cost effective when applied to a single building. These firms will find it more profitable to purchase major properties or portfolios of properties in selected locations rather than acquiring individual buildings in different cities. As economies of scale are applied, owners of buildings in individual cities will be forced to expand or contract their local holdings to compete with larger, more sophisticated local landlords.

During the past ten years since the Tax Reform Act of 1976 effectively eliminated most non-real estate tax shelters, this journal might have been appropriately retitled *Real Estate [Finance] Review*, because most articles dealt with structuring real estate investments to maximize tax and appreciation benefits to reflect the economic interests of its readers. During the next ten years, this journal might instead be known as *Real Estate [Operations] Review*—that is, unless public policy is changed to return real estate tax benefits, or fiscal policy leads us to inflation, or both.