Re-Thinking Real Estate – The Implications of Emerging Trends
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1. Introduction

At the time of writing (June 2013), the United States economy is growing moderately but fears of a relapse into recession remain. Markets fear a sudden, sharp increase in interest rates. A sharp rise in interest rates will, all other things being equal, lower the price of all assets, including land and buildings.

The market for real estate of all types is changing significantly. Some of the trends at work are:

- More people are choosing to rent, rather than buy, their home.
- Urbanization, the movement of people from rural to urban areas, continues.
- Easy credit for the purchase of real estate is no longer available.
- Cost pressures are forcing commercial tenants to get by with less space.
- Changes in technology mean that real estate requirements are radically altered.
- Real estate taxes appear to be steadily increasing.

The objectives of this booklet are to:

- Highlight the difference between profitability and cash flow.
- Examine the emerging trends and their implications for both owners and users of real estate.
- Assist owners to optimize their real estate holdings and prompt users to get the most appropriate real estate for their needs.
- Empower people to manage the risk of owning and using real estate.

The ideas, tools, tips and techniques in this booklet are based on many years of research, observation, and work experience.

2. Using this Booklet

This booklet is a general guide to owning and using real estate and is not a substitute for your own informed decisions. It is important to get the facts and ask the right questions. Real estate and financial matters are complex, mistakes can be expensive, and expert advice can be extremely valuable.

Links to reference sources are included and Chapter 16, Further Reading and Other Resources, contains suggested reading material where you can obtain detailed information on specific topics.

You can print this booklet or read it using either Adobe Acrobat Reader. If you are connected to the Internet while reading it, clicking on the underlined links will bring you to the web page referenced.

So that you fully understand the issues and make informed decisions, please read the full booklet.

3. Before We Begin

Just some quick words on success. Many people want change, but few people want *to* change. If you wish to improve any situation, some action is necessary.

- Focus on what you can control, and do not worry too much about what you cannot control.
- Plan as best you can – life is uncertain and unpredictable.
- Change slowly, and monitor results. Stay with what is working, and quickly modify or stop that which is not bringing the desired results. (In the words of the famous investor Dennis Gartman, "Do more of that which is working, less of that which is not".)
- Remember that most things fail from lack of discipline, not from lack of knowledge.

Profit Point: Be prepared for an uncertain future and take action as events unfold.

Profit Point: You do not have a business unless you have customers. Who will rent your property? How much will they pay? For how long will they rent it? You may own and also use your real estate (and this may be the right decision, or it may not be).

4. Real Estate Ownership and Use – Think Like a Business

Like it or not, running a business requires focus and discipline. There is generally very little room in business for decisions based purely on emotion.

All real estate owners and users will benefit greatly from learning and applying the skills required to run a successful business. Do not worry – these skills can be easily learned, and this chapter contains a short primer! The basic steps are:

1. Establish a clear sense of purpose. What are the objectives of the business?
2. Develop plans to carry out those objectives.
3. Periodically compare the performance of the business to the objectives.
4. Take corrective action as necessary.
5. Manage your risk – be aware of what can go wrong and have contingency plans.

In business, it is vital to ask questions. Questions will bring out the information that you need to understand what is happening, to manage the business, to bring in profits and cash, to reduce expenses, and to keep out of trouble. So remember:

I keep six honest serving men
(They taught me all I knew),
Their names are What and Why
and When
And How and Where and Who

From Rudyard Kipling, "The Elephant's Child".

(I've seen so many expensive mistakes occur because people did not take the time to ask the question: are the pipes insulated? are the permits in place? are we insured? Will I be able to pay the rent, etc.? The only silly question is the one that is not asked.)

Profit Point: It is fine not to know but it is critical to ask the right questions!

Profit Point: Survive and thrive by being scared!

All business owners need to understand and appreciate the differences between profit and cash flow. You can be profitable but you can go out of business because you did not have the cash to pay the bills.

Employees should also think of themselves as a business. Their wages or salaries, less their cost of doing business, (housing costs, transportation, etc.) is their "profitability". An employee's skills must be in demand in the labor market for the "business" to prosper.

The next two chapters examine the concepts of profit and cash flow.

5. Profit and Cash Flow are Very Different

Two key definitions:

- Profit equals rents minus expenses. When profit is negative it is called a loss.
- Cash flow is the movement of real money into and out of the business.

<u>Profit</u>

Profit is an accounting term. First, rents earned in a stated time period are determined. Second, the expenses necessary to produce those rents are calculated.

The expenses of a rental business often include recognition that to produce rents, buildings, fixtures and fittings, and such has been used and are consequently less valuable (commonly known as "depreciation"). Depreciation allowances frequently do not involve an immediate payment by the real estate owner, but ultimately the building will need to be repaired, fixtures and fittings will need to be replaced.

To calculate the profit (or loss) for the period, the total expenses are subtracted from the total rents.

Note that expenses do not include items that increase or enhance the value of our property. Items that increase the value of a property are called capital expenditures.

If, over time, a business makes losses, it will not survive. Loss-making businesses are destroyers of value. (Start-ups are often initially unprofitable and even established businesses can have a bad year or two).

A profitable business will also not survive unless it is generating sufficient cash to pay its bills.

Cash Flow

Cash flow is the collection and payment of money. Cash will flow in from rents and disposals of assets. Cash will flow out for the payment of the expenses of the business, (such as repairs, wages, salaries, utilities, fees, and taxes), purchases of assets, and the repayment of loans.

For ease of analysis, it is best to classify cash receipts and payments into one of two groups:

- Operating cash flow, those receipts and payments resulting from the day-to-day activities of the business. Examples are monies received from rents, payments for repairs, and the payment of wages and salaries.

- Investment cash flow, those payments arising from the start-up, expansion or contraction of the business. Examples of such payments are the repayment of loans and lines of credit, purchases of new premises, improvements to buildings, and the payment of partner or shareholder dividends.

Cash and cash flow is what enables a business to survive, thrive, and seize opportunities.

The classification above will also help you to prepare your tax returns.

6. Follow the Money – Cash is King

Business owners and managers are often focused on profits. Profit is important, but cash flow reveals much about the quality and security of the operations of a business.

For example, it is very easy to rent property if you are not "careful" about your tenants. If the tenant is slow to pay, or never pays, or causes serious damage, the business has serious problems.

Equally, a poorly drawn lease can leave your business at serious risk of loss. Imagine a commercial lease where the tenant had the right, with six months' notice, to leave without penalty. This arrangement might work in a tight rental market, with rents flat or rising, but certainly not in a declining rental market.

Any accountant will tell you that it is quite easy to manipulate profit numbers, but much more difficult to falsify the cash numbers.

Cash is the blood of business. Ensure that you monitor profits, cash flow, and cash balances.

7. The Emerging Trends Impacting Real Estate

Just like the Indusial Revolution, the Technological Revolution has sparked tremendous changes in our society and throughout all around the world. I believe that the trends below are significant for both owners and users of real estate:

- Urbanization
- Digitization
- Cloud Computing
- Mobile Workforce
- Income Compression
- Credit Constraints and Interest Rates

A chapter on each trend follows.

8. Urbanization

According to the United Nations, well over 50% of the world's population lives in an urban, as opposed to a rural, setting. In many minds cities and towns equal opportunity: to find work, for leisure activities, to and to socialize.

Source:
http://www.unfpa.org/pds/urbanization.htm

Just an aside, but this great migration from the countryside into towns and cities has been greatly assisted by an enormous increase in agricultural productivity: we produce more food than ever with fewer people than before.

Those who live in urban communities tend to own fewer automobiles than rural residents.

Implications for RE Owners:

- If your real estate depends upon attracting visitors from a town or city, the business case needs to be periodically re-examined. Some incentive, such as subsidized transportation, may have to be offered to attract visitors.

- Urban residential property may be well-supported by demand, provided it is priced at levels affordable by the local population.

- Urban commercial property should be space that can be rented by a wide variety of tenants, ideally being scalable (so that the space used by any given tenant can be easily increased or reduced.

Implications for RE Users:

- Many commercial businesses benefit from locating close to their customers. Convenience is generally appreciated.

- Plan for flexibility: you may need to rapidly expand or shrink your real estate holdings.

- In a growing city, residential rents are not likely to be a bargain.

9. Digitization

Information is now stored in digital form, and people have become very comfortable interacting with data in digital form.

Consider the following:

- In the early days of the Automatic Teller Machine ("ATM"), many people requested a receipt for their transactions. Now few do.
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- Government agencies often mandate that forms be filed electronically. (For example, New York State personal income tax).
- Scores of newspapers and magazines have gone out of business and a few remain "online only".
- Sales of CDs and DEVDs for music and video are falling sharply, while millions use YouTube, Netflix, iTunes, or Hulu to stream the music, film or television of their choice.

The digitization of data has enormous implications for the amount of office space required, and to a lesser extent the size of residential apartments and houses.

Implications for RE Owners:

- Modern commercial spaces require far less space for the storage of documents.
- Access to the digital data is vital. Consequently careful consideration must be given to telecommunications networks (ideally wireless for maximum flexibility and reduced installation costs).
- Individual workspaces can become much smaller. Viewed another way, in an office the workspace per employee will shrink.
- Electric power consumption will rise.

Implications for RE Users:

- Digitization provides a tremendous opportunity both to reduce operating costs and to operate with smaller premises. Doctors and lawyers, for example, will need smaller offices.
- Buildings with excellent electronic networks and power supplies will be essential.
- With less need to store books, papers, movies and pictures, your space requirements can be reduced. Small is beautiful!

Profit Point: Where possible, digitize. It makes it so much easier to store, search, sort analyze and share information.

10. Cloud Computing

A bewildering array of devices has been used over the years to store digital data: magnetic tapes, hard disks, floppy disks, compact disks, digital video disks, laser disks, and USB drives. The current trend is to use cloud computing.

Cloud computing may be thought of as a central repository of personal or business data than can be accessed with a computer, tablet (such as an iPad) or a smartphone.

Implemented correctly, digital data stored in a cloud should be accessible by any authorized person at anytime, anywhere.

If you want to watch "Titanic", (again? really?) you do not need to go searching for the DVD. You simply call it up on your tablet or internet-enabled television.

Cloud computing accentuates the implications of digitization, as the cloud is remote, not hosted in the local office, home or apartment. Smaller space requirements, with more focus on electric power, communications networks, and climate control.

Data accessible from anywhere may mean that employees can work from home or other location. Shared workspace, were people may a rent to use space for a few hours, become a viable alternative to an office.

11. Mobile Workforce

The era of continuous, long-term employment with one employer is over.

The pace of change in the corporate world is both exhilarating, and terrifying.

Exhilarating, in that new products and services are being delivered, and opportunities for people are opening up. Terrifying, in that companies restructure rapidly, leading to layoffs and downsizings. Work is moved to its cheapest location consistent with the expected quality, which is often outside the United States.

Those in search of employment will have to follow the work. Length of employment at any one employer will be relatively brief. This means people will be more mobile than in the past.

Implications for RE Owners:

- Lack of stable employment opportunities will reduce consumer confidence. Consumers will be more inclined to save money. Long-term commitments, such as marriage, having children and home ownership, will be deferred.
- More people will prefer to rent, rather than buy, their apartment or home.
- In a rising rental market, quicker turnover of rented accommodation will give owners pricing power.
- Houses and apartments that are easily shared will have a pricing advantage over others. Renters and buyers will look for ease of access, an adequate number of bathrooms and showers, and privacy.

Implications for RE Users:

- People are going to be moving around, and we'll call many places "home".
- Plan for flexibility: you may need to sub-let, share or move. This applies to both residential and commercial users.
- Due to strong demand, housing will continue to be expensive. Uses would be wise to downsize.
- Lack of steady employment will make it more difficult to obtain all forms of credit.

12. Income Compression

It is no secret that the median income in the United States is stagnant.
Source: http://www.census.gov/prod/2012pubs/p60-243.pdf

See Figure 1 in the document above, and focus on 1995 and later. Frightening. The standard view that each successive generation can look forward to a better lifestyle is now called into question.

With prices rising and incomes stagnating, the standard of living of many consumers is falling. This trend forces consumers to "trade down" replacing branded goods with store brands for example.

The full extent of income compression is not yet clear. The Affordable Care Act ("Obamacare") may actually increase consumers' costs. Another possibility is that employers cut the length of the workweek to avoid providing coverage under the Act.

With unemployment historically high, (7.6% at the time of writing), and the constant threat of relocation or outsourcing, employers are not pressed to give generous pay increases.

The implication is simple but profound: the majority can afford less.

13. Credit Constraints

It is instructive to briefly review the role of easy credit in the real estate boom and bust from 2002 to 2008.

To be absolutely clear, a mortgage is the transfer of land or real property as security for a debt. A mortgage is an encumbrance or limitation on the right to the property. A mortgage ends when either the terms of the mortgage are fulfilled or the property is taken in foreclosure.

Convinced that everyone who wanted to own a home should be able to do so, public policy makers enacted a series of incentives to encourage home ownership. The list is lengthy: tax deductions for mortgage interest, grants and other incentives for first-time home buyers, subsidized loans, and securitization with guarantees.

Securitization is the process of buying a loan from an originator, packaging it with other loans to provide diversification, and selling the bundle of loans on to an investor. In the case of Fannie Mae and Freddy Mac they added a guarantee of full repayment of principal and interest on the underlying loan.

A more complete description and analysis of securitization is given here:
http://www.imf.org/external/pubs/ft/fandd/2008/09/pdf/basics.pdf

Two private corporations operating in the public interest (really?), Federal National Mortgage Association ("Fannie Mae") and Federal Home Loan Mortgage Corporation ("Freddy Mac"), were the main actors in the mortgage securitization market. These organizations were believed to enjoy the implicit back of the United States Government. (They were both bailed out at taxpayer expense in 2008.)

Securitization enables the initial lender to transfer the risk of non-repayment to someone else. Originating and selling mortgages, pocketing fees and commissions along the way, became a major industry.

Furthermore, a prevalent belief was that home prices were almost always increasing. If the borrower did not pay then just take back the property (foreclose) and sell it on to someone else.

The consensus was that housing finance was profitable and relatively safe business. We all know that many borrowers ran into difficulties, defaults soared, house and apartment prices fell sharply, and the taxpayer had to rescue many financial institutions.

This sorry saga has resulted in a return to the basics of prudent mortgage origination: substantial down-payments (typically 20% of the acquisition cost), limits on loan-to-value, and limits on debt service costs as a percentage of the borrower's income. More generally, there is a return to the 5 Cs of Credit:

The Five Cs of Credit

	Definition	**Measurement**	**Comment**
Character	The honesty and integrity of the borrower.	Credit reports and references from others with business dealings with the borrower.	Often overlooked but vital. "My word is my bond".
Capacity	The ability to pay the debt.	Cash flow, income and assets of the borrower.	Closely linked with Capital. (See next item).
Capital	Customer's financial situation and pre-existing loans and lines of credit.	Financial statements of the borrower.	Independently prepared and audited financial statements are highly desirable,
Conditions	The state of economy and the industry of the borrower.	Economic indicators, industry reports, press clippings.	Can be subject to sudden change.
Collateral	Security given for the loan.	Periodic valuation of the collateral.	Worthless unless the lender has clear legal title.

Sources: 1St Pacific Bank of California, author.

Just to make it a little easier for you, dear reader, here are two write-ups on the 5 Cs, one for business and the other for individuals:

Business:https://www.pnc.com/webapp/sec/ProductsAndService.do?siteArea=/PNC/Home/Small+Business/Financing+Your+Future/The+Five+Cs+of+Credit

Individual: https://www.wellsfargo.com/financial-education/credit-management/five-c/

Thanks to PNC Bank and Wells Fargo, respectively.

Additionally, we probably have seen the lows for interest rates – there has been a sharp increase in 5 to 30 year interest rates since mid-May 2013. Thus, the price of credit will most likely increase. Be prepared!

Implications for RE Owners:

- Stricter lending standards and higher interest rates will reduce the pool of people able to purchase properties.
- Enormous properties ("jumbo") will be more difficult to finance.
- Financing all types of new construction will require rigorous business plan.
- Rentals will be relatively more attractive to tenants.

Implications for RE Users:

- It is going to be more difficult to obtain a mortgage. As soon as possible start accumulating the down-payment, paying off other debts and developing multiple streams of income. A second job will not only bring in extra income, but keep your skill sharp and broaden your networks.
- You will think of real estate as a service – a place to live, a place to work, a place to shop, a place to play. Real estate will not be an investment, (buy, because prices only go up), or a cash machine (get a home equity line of credit).
- Unfortunately, due to credit constraints and rising interest rates you will only be able to afford smaller spaces.

14. Know Your Neighborhood

"Tablecloths do not work on Broadway", a local restaurant manager once told me. This observation showed keen insight into his clientele: his customers do not want and will not pay for luxury. Accordingly he has to keep his prices down (and his costs down) if he wants to survive and prosper.

You may have a great business idea but the choice of neighborhood is critical. 'Build it and they will come" is a very risk strategy. (I just witnessed a business start and fold within six months because expensive produce does not sell in a low-income neighborhood. A little research would have prevented this expensive mistake.)

Our Federal and State governments collect a wealth of data about our communities and you should use this data to your advantage. For example, type in a zip code of your choice here, and explore further: http://factfinder2.census.gov/faces/nav/jsf/pages/index.xhtml###

If you are uncomfortable with statistical data then hiring a college kid in math or social science will be well worthwhile. Armed with relevant data you will tend to make smarter decisions.

Another important method for obtaining neighborhood data is to walk around, observe, and speak with local residences and businesses. A traffic count may be useful – knowing the numbers of people who pass by a specific location throughout the day.

A nearby shopping center has a bank, a supermarket, a post office, a drug store, a dry cleaner, a sandwich shop and a nail salon. There is ample parking and two bus stops. A new restaurant opens up that does only lunch and dinner? It only took a few months for this restaurant to go out of business. The rent reflects the footfall throughout the day, why ignore a significant part of it?

Whether an owner or user of real estate, you need to know the neighborhood and monitor changes. Changing demographic trends may signal a good time to enter or to leave a location.

15. Summary

Many people have been traumatized by the events resulting from the bursting of the real estate bubble. Jobs, homes, businesses, savings and pensions were lost. People will think twice before rushing in to build or buy.

The world is and always was uncertain and unpredictable. Perhaps now, due to technology, the pace of change is quickening?

The days of the large corner office are numbered. In an uncertain and unpredictable world, large corner offices are large fixed costs. The relentless march of technology has reduced the space requirements of most offices.

For the commercial property owner, uncertainty means having space that can be rented by a wide variety of tenants, ideally being scalable, so that the space used by any given tenant can be easily increased or reduced. The commercial tenant does not want to pay for any more space than needed. Commercial tenants may push for short-term leases and greater flexibility to sublet unused space.

> Profit Point: Given the rapid change in business, try to maintain space that is standardized, modular, and scalable.

Our housing needs change over time. For example, a married couple with young children may live in a house. Once the children have established homesteads of their own, perhaps it is time for the couple to move? Why bear the costs of a large home when a smaller home or an apartment would suffice?

Illness or disability may also force a change of residence. It is not wise or fair to ask an elderly person to walk up several flights of stairs. Accidents in the home can be very expensive, not only in terms of money but in lost quality of life.

Other questions arise, such as convenience to work, schools, public transportation (if applicable), friends and family. Another important question is, honestly, do you have too much space? Space equals cost. (There are other was to resolve this issue besides moving, such as taking a roommate, sub-letting (if allowed), renting the garage, etc.

> Profit Point: If you cannot reasonably manage it, do not own it!

Retailers face particular challenges. As consumers become comfortable shopping online, the traditional retailer has been relegated to a showroom. Many retailers incur all of the selling costs but little or none of the revenue from purchases. This situation is not sustainable. Many retailers will be forced to retrench or go out of business entirely.

All owners and users need to ask themselves the following question very often:

> "Is this the right property for me?"

Only an ongoing, honest and comprehensive evaluation of the costs and benefits of the real estate that you own or use can avert disaster.

Profit Point: Strive to eliminate emotional factors in your analysis of people, situations, problems and events.

16. Further Reading and Other Resources

Web Resources

The Association for Financial Professionals maintains a web site filled with informative and timely articles on a wide range of topics. Visit the AFP here:
http://www.afponline.org/

Understanding and Controlling Cash Flow by Ramin Maysami, Assistant Professor of Economics, Sangamon State University, Springfield, Illinois.
http://www.sba.gov/idc/groups/public/documents/sba_homepage/pub_fm4.pdf

Books

Your local library probably has many books on business management, and finance. I like books that are focused and clear. Below are some personal recommendations:

Real Estate

Real Estate Principles and Practices by Ralph A. Palmer

Legal Rights and Interests

Fundamentals of Real Estate Appraisal, by William Ventolo and Martha Williams

Real Estate Appraisal

Fundamentals of Real Estate Appraisal, by William Ventolo and Martha Williams

Investing in Real Estate

How to Find and Manage Profitable Properties by Robert Irwin

Mortgage Qualification

All about Mortgages by Julie Garton-Good

How to get a Mortgage in 24 Hours by James Lumley

The New Rules for Mortgages by Dale Robyn Siegel

Foreclosures

How to Find Hidden Real Estate Bargains by Robert Irwin

17. The Final Word

We can make it through this recession, provided we do not think that tomorrow will look like yesterday. Be creative. Take small experimental steps, replicate what is working and quickly stop activities that do not bring the desired results. Good luck!

If you have any questions or comments, please email me at billyfitzgerald@yahoo.com or write to:

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