

**Principles Of A New York City Real Estate Developer:  
How Do They Apply To The Asian Market?**

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## A. ABSTRACT

As an owner, manager and investor of residential property in New York City (Manhattan), Dr. Friedman formulates eight principals that have guided his business practices for the past thirty years. These include:

- (1) The right location and the best and highest use for that property is the starting point for the real estate investment decision. Anticipating the direction of the movement of people and jobs may be risky, but it is the way to maximize one's returns;
- (2) The recent perils of the capital markets are strikingly evident to everyone. Leverage, the availability and cost of capital are the lifeblood of real estate. More than ever before, it is imperative to have the complete financial package in place before the project is initiated;
- (3) The economic vitality of the national and local economy set the parameters of supply and demand. It is job creation, along with other basic demographic characteristics of the locality that fundamentally determines the need for housing and retail space. One must be consistent with the direction of these trends;
- (4) The tax code fundamentally determines the accounting of profitability. In the US, real estate is a tax-advantaged investment, from ownership of a single-family house to publicly traded REITS. Know the national tax codes and take full advantage of it;
- (5) In multiple ways government creates the rules of the game. Zoning and Land Use Planning and Building Codes create complexity and additional cost. Knowing how to interact with the bureaucracy is essential;
- (6) The optimism of the developer fundamentally underestimates the complexity, uncertainty and risk of the deal. Almost every project takes longer in time than planned and costs more than budgeted. Do not fall into this error of wishful thinking.
- (7) The pursuit of money and wealth is only one of the many goals of people. The search for power and dominance, status and prestige are just as evident and often interfere with judgment and decisions about profit. The self-interests of the members of the team do not converge.
- (8) The marketplace of private property rights and the voluntary exchange of buyer and seller establish the value/price of real estate. It also inherently creates periods of imbalance and cycles of boom and bust. Timing is essential for success. Good luck is also helpful.

## B. LOCATION

When I began my real estate career, an old timer in the business told me that all one needed to know to be successful could be summarized in three words: LOCATION, LOCATION, LOCATION. Today, the world of real estate is more complex, but these three words may still be the most important principle to follow.

All real estate investment has to start with the property, not just its current structural characteristics and use, nor what it can be transformed into, but where it physically exists. Some places are simply better than others. There is an American expression of “living on the wrong side of the tracks”, which illustrates the concept that one location may be more desirable than another location, even if only just across the railroad tracks. It aptly summarizes the central idea that Prime is Prime!

Price will reflect the location. A piece of property thought to be a superior location will command a greater price, partly due to the fact that an investor or buyer views limited risks for such a property. As an example, locations such as 5th Avenue and Park Avenue, the two premier residential streets in Manhattan, may be more expensive, but they will always hold their relative value. This is clearly evident on the downward slope, such as we are experiencing today, where these locations retain their value while other less desirable locations are at greater risk of decline. On the other hand, this more favorable risk profile may limit the investment gains or rewards, given that the risk / reward profile is already reflected in the higher initial land cost.

The principal of location rests on an understanding of urban spatial development. Cities are places for specialized functions. The proximity of face to face interaction creates value and this is most evident in the Central Business District (“CBD”), what is commonly identified as wherever the downtown may be. The CBD is the core around which the rest of the city revolves. The core has the greatest concentration of

economic activity. It is the place with the densest cluster of activity and, as a result, it is the most congested place. More businesses and more people need to be there, and therefore, its real estate commands the highest price. The space for the CBD is limited and often requires room for expansion. Some cities seek to direct development to a satellite location. Canary Wharf in London is such a relatively successful effort, but in NYC and elsewhere, the preference is to be higher up than further out on the street grid.

What defines the value of location is its distance to the center as measured in travel time, and not just geographical space alone. As a result, the transportation infrastructure is so crucial. There is the imperative to follow the path of public transportation. The proximity to the exit and entrances to these mass transportation lines and the on/off ramps of highways are centers of development and value.

There are natural geographic barriers that cause bottlenecks to circulation that emphasize this concept. Manhattan is an island that needs to be entered by either going under or over the waterways that surround it. No better example of this is in China itself, where in Shanghai it took a massive infrastructure investment and commitment to successfully go to the other side of the Huangpu River to Pudong.

The three L's of location are also evident that the sunny side of the street is more valuable than places that are perpetually in the shade. The front/back of the building, plus a low versus a high floor, which affects light and air, also define relative value. Being on the top of the mountain or having an unobstructed view of the sky or a park or a view of a waterway adds value. Being too close to an elevated highway or subway, the air being too noisy or too polluted, or even just being inconvenient to the services that contribute to the quality of work and living are all relevant to the meaning of a valuable location.

The assessment of location may be made by intuition or a hunch based upon experience and judgment from knowing the streets and the pattern of movement. The notion of Feng Shui may be its Asian manifestation.

There are also perceptual dimensions to location. People live in neighborhoods that often have distinctive demographic and housing characteristics. Values differ between single-family homes, gated communities (that are emerging in China) and large-scale high rise apartment towers/complexes. In addition, certain communities have a distinct character and flavor. There is now an international branding of neighborhood into an identifiable life style. Soho is such an example. Starting off in London and then taking off in NYC, the idea of an area focused upon young, affluent, professionals who are chic or hip in style and fashion can now be found in Buenos Aires, Argentina, among other cities. There is even a development company based in Beijing called Soho China.

**The Lesson:**

Money is made not only by filling in the gaps in established, prime places, usually by assembling occupied parcels of land and building bigger and higher new structures, but more importantly by anticipating the direction of development. Making a real estate investment in the next location; that which is today on the fringe but what will become desirable in the future is where the big payoff lies. The existing prime locations were not necessarily always prime. There is a story of an early shopping center developer, who in newer cities of the South and South west regions of the US followed the construction crews of the utility companies as they were laying electricity cables and water & sewer pipes; for how else would one know whether it was North, South, East or West side of town that was the path of development.

Getting ahead of the curve is the path to take. There is certainly more risk, but also much more reward. So, for example, one may need to go beyond the coastal cities of China to the 2nd and 3rd tier of cities and

the inner regions of the country to reap the greatest investment return. The locations that are not so well established, and do not attract the media attention and thus are off the radar screen of others, may offer the greatest rewards.

## C. FINANCE

The cost of capital, its source and its availability is fundamental. After one has found the property, the immediate goal is to obtain the funds to complete the transaction. Certainly financing is crucial for all business activities; however, in real estate the added feature of leverage – the use of mostly borrowed funds to make the purchase - emphasizes the financial imperative of all real estate transactions.

All real estate is financed with a preponderance of debt, in the legal form of a mortgage. Only a small portion of the total purchase price or total project cost is cash, or so called “equity capital,” from the developer. Furthermore, even this contributed capital is most often not one’s own, but obtained from other passive investors. Real estate runs on OPM - Other People’s Money - be it from one’s partners or financial institutions.

Sources of capital are varied and, depending on market or government restrictions, unlimited. The imposition or lifting of controls over the flow of capital into or out of the country can have immediate effects on real estate values. Removing prohibitions on non resident ownership of real estate is an immediate boom to values.

While the goal was always to obtain as much leverage as possible, in the preceding years this goal was achieved at new heights of leverage. It was common to only be required to make a total contribution of 5% to 10% of the total development budget. This full amount may have been divided between the senior lender and so called mezzanine lenders, who along with high interest rates, may have taken a piece of the equity as well. But with such leverage, there was plenty of equity to give away. So, every one dollar, euro, yen or Yuan was able to acquire an asset ten times that amount. Even with this relatively modest amount required to be contributed, opportunities abounded to extract that portion through expenses and fees that flow directly and immediately to the developer. Finally, in considering the total cost of the project, the

cost of that debt (interest) was readily incorporated into the amount of the mortgage itself. An interest reserve was established to internally account for the interest payments for the project. Financial institutions were and still are reporting income, if not profits, on development projects that once completed may have little ability to pay off the principle itself.

What has occurred in the past year is a fundamental disruption in the capital markets as they have come to develop in the past two or three decades. The financial innovation that can be summarized under securitization, Collateralized Mortgage Backed Securities in its various forms, from packages of thousands of single family homes to the billion dollar office building in Manhattan, has been torn apart. How it will reconstruct itself is certainly unclear at this time. But the “housing bubble” in the US and the attendant credit “crunch” that has spread throughout the world serves to underscore the fact that the building block of all real estate investment lies in its financing.

Central banks of all nation states have the role to determine the availability of capital (liquidity) and its cost (interest rates). Focusing on the US, as the largest capital market in the world, the last ten years has witnessed the swings of interest rates, with its consequent impact upon real estate prices readily apparent. Within the context of the Dot.Com stock market bubble, the apprehension of a possible Y2K disruption and fear of a replication of the turmoil of the Japanese economy, the Federal Reserve Bank pursued an accommodative interest rate policy. In 2003, the benchmark Federal funds rate was an historic low of just 1%. In any economic calculation, borrowed money was virtually free. Non-traditional lending institutions emerged, as did cross national capital flow in search for increased yields and profit. Individuals and institutional investors alike were awash with money. And real estate saw an increasingly aggressive and risky lending practices.

Naturally, prices rose. Whether investing in more structured vehicles, such as partnerships, REIT'S or stocks of home builders, or buying one's own personal residence, or becoming an investor/developer

oneself, real estate was the name of the game. There were more and more players with greater and greater access to increasingly varied sources of capital who were chasing the same deals. As Adam Smith would tell us, purchase prices had no place to go but up. An individual's home became an investment to be bought and then resold, and then bought again. Home ownership in the US rose to the historic high of 69.3% of households in 2004. New vehicles for investment developed, such as fractional interests and condominium hotels that included the promise of a "free" vacation. High-rise multifamily condominium developments proliferated, allowing individuals to buy a unit, not for occupancy, but for resale, several years in the future when the construction was completed. Prime Class A office buildings in the major cities of the US traded at over \$1,000 per square foot. These are situations and prices that could only be supported by nominal debt costs.

New exotic and impenetrable debt instruments developed to take advantage of the capital markets at the time. As now known these appealed not only to the average homeowner, but also evidently to the most educated and experienced financial players, who may have designed them, but apparently did not understand how they would operate when capital costs rose. Individual mortgages were "sliced and diced" and packaged as securities. Derivatives, credit swaps and interest rate hedges were additional layers of financial wizardry. Finally, purchasers were increasingly undertaken with short-term debt, called "bridge loans", that matured anywhere from six months to three years. These short terms loans most often immediately adjusted to a negotiated spread over the three-month LIBOR rate and were expected to be continually "rolled-over." Even professionals came to rely upon a continued asset appreciation to either sell to one another, or become more credit worthy for long term permanent financing.

Expecting an uninterrupted appreciation in asset prices to pay for all this debt is unsustainable. When the central bankers "tightened" as the result of macro economic conditions, the balloon had no alternative but to burst. So, starting in 2004, the US Federal Reserve bank increased interest rates by one-quarter-percentage point every three months, until at its peak it stood at 5.25%. When one day, a seemingly small

negative event occurred and the bubble unexpectedly and precipitously burst. All such expansions of asset prices have to end; and they often do suddenly and rapidly. The direct and indirect consequences are harsh and substantial upon real estate investments.

### **The Lesson**

Do not, because one cannot, fight the central bankers. Follow the direction of interest rates. Once “tightening” starts, it’s time to take defensive action and lock in long term financing. Small developers are squeezed first, for they are undercapitalized and vulnerable. Many will fail.

Line up all the financing needed from the very inception of the development project and include a large margin of contingency. It’s better to have excess financing than not enough. If more funds are needed later, it will be very costly.

## D. THE ECONOMY

The macro economy establishes the conditions within which the real estate industry functions. The demand for residences, office buildings and shopping centers are fundamentally determined by the health of the national economy. The rate of growth in Gross Domestic Product, employment (and unemployment), wages and disposable income, and the inflation rate are major variables that can be identified.

In particular, the number of jobs, their growth and the characteristics of employment make up the engine that drives the demand and supply of real estate, especially housing. If there are jobs, then people have to have someplace to put their heads down at night. Absolute employment numbers and the wages that it represents are directly connected to the amount and quality of the housing stock. Not only is the housing stock modernized, as measured by the age of the dwelling unit, but as income rises, expectations of the middle class and the affluent exponentially increase. People want bigger and bigger homes, with more and more conveniences. Appliances become more sophisticated and the materials used for interior surfaces become more elaborate, all combining to increase the value of the home.

Demographic characteristics of the population are also crucial to guide real estate investment. Population growth itself, plus the age distribution of the population, affects household formation in determining the demand for dwelling units for newly created families. In the same fashion, as the population ages, housing needs also change, whether it is retirement residences or smaller living spaces. Migration within the country, from rural to urban areas is vital to take into consideration. The US, in the past fifty years, has also experienced significant population movement from the Northeast and Midwest regions of the country to the South, Southwest and Western regions.

Cities and regions have specialized roles in the national economy that create unique opportunities for investment, and to some extent have distinct micro economies that can be different from broad national trends. New York City is the financial center of the country and has the largest share of the total class A office space in the U.S. Detroit stands for the industrial heartland, while Silicon Valley (centered in San Jose, California) is symbolic of the high technology/research center. There also exist entertainment cities, such as Orlando, Florida (Disneyworld) and Las Vegas, as there are also places that cater to those who retire and move to another climate. College towns are plentiful throughout the country and there are governmental centers (50 state capitols) abound.

### **The Lesson**

There is practically nothing the individual investor can do to affect the macro economic environment in which all business activities function within, except to understand that environment and make investment decisions with as complete an understanding of the economy as possible.

The buoyancy of the national economies of Asia today need not be stated. Every real estate investor needs to fully understand the rapid growth and infrastructure development of these countries. There is a vast migration to cities, as the economy shifts from agricultural to manufacturing and then again to a service employment base. As wealth increases, and with the natural cycle of housing formation, residential development is assured.

Follow these trends, for in the foreseeable future they appear they will continue uninterrupted. They portend the wide-ranging opportunity for successful real estate investments.

## E. TAXATION

Real estate, like all other forms of economic activity, is profoundly influenced by the structure of taxation. Although tax policies vary greatly across countries, the classification of income, deductions to that income and the rates that subsequently apply are central to the final determination of profit.

All governmental tax policies are intentionally, if obscurely, designed to offer incentives to some forms of economic activity (industries) and by the same token are neutral at best or create absolute disincentives to other industries. In the US, real estate, from the individual single-family home to the largest office building, has long been favored. Ownership of real estate in the US, in all its various forms, is a way to make money and pay less tax than most other investment vehicles, including stocks and bonds.

Home ownership is a cherished value in American society, as it is elsewhere around the world, and as a result it has been heavily subsidized by the national government tax policies. Interest payments on a mortgage and local real estate/property taxes are deductions from reported taxable income. The real cost is not the nominal amounts paid, but the final, after tax cost. As a consequence the rent/buy equation is skewed toward a purchase. An equal monthly rental payment, compared to a mortgage/property tax payment, is more costly because there are no tax benefits to the individual.

The national government in the US further encourages an overinvestment in home ownership by shielding the individual on the gain from the sale of their personal dwelling. Specifically, the first \$500,000 in profit on that sale is exempted from taxation. This is a tax break not available to other industries and activities. The individual is encouraged to view his home as a tax advantaged investment.

For the investor, the tax incentives are even greater. In addition to the deductibility of mortgage interest and local property taxes from gross revenue, there are numerous other benefits evident throughout the tax

codes. One such benefit is the ability to depreciate the structure (not the land), thus creating a non-cash expense, for income tax reporting purposes, establishing a small, but not insignificant, tax shelter. Then there is the fundamental difference between the tax rates on those assets held for more than a year (called long term capital gains) and the annual operating cash flow that may derive from those assets. Today, in the US the capital gains rate is 15%, while the rates for ordinary income can climb up to almost 50% in some states and local jurisdictions. This promotes the buying and selling of property, in order to realize the benefits of a lower tax rate of the capital gain. There are also benefits from assuming greater debt burdens. While there are some restrictions, the interest payment cost of the debt is tax deductible, while the cash flow supporting that debt is not. Furthermore, there are myriad and obscure accounting provisions, especially for property just put into service that provide “losses” that are again deductible for profit reporting purposes.

There is also a National tax code provision, called the Exchange of Like Kind Assets (commonly called “1031”) that shelters the profit on a sale by deferring the Capital Gain. With cumbersome rules and regulations, it operates so that if one sells a property and then re-invests the full proceeds in another property there is no taxable event and no tax payable on that transaction at this time. There is considered to be a seamless linkage between the initial investment, which could have been many years ago, and the current and all future transactions. Eventually, taxes will be owed, but this can be far in the future while today there are no taxes to be paid. Tax laws may change, usually to one’s advantage. The future will take care of itself, while one enjoys the benefits here and now.

Specific tax provisions also exist to encourage specific forms of real estate investment. These are national tax credits for the restoration of historic structures and for low-income housing. In some localities, reductions on the property tax for new residential construction are also evident. These may extend to commercial and industrial uses. For example, local governments pay for most athletic stadiums in US cities, even though the teams that play in them are privately and profitable owned.

Finally, there are Real Estate Investment Trusts (REITS), which have extended themselves throughout the globe. While they are structures devised to raise capital, they are also tax advantaged vehicles for the investor. Specifically, they avoid the double taxation of corporate earnings that exists first at the entity level and then again by the individual stockholder. Cash flow from the property, now called dividends, is distributed to the individual stockholder to be reported and taxed only once, by that individual owner. All other publicly traded entities are taxed twice. Only real estate enjoys this substantial tax benefit.

### **The Lesson**

Know the tax structure of the country one is investing within. Be sure to make the best possible use of all the complex and obscure provisions embedded within the tax code that promote real estate investment. Beware of sudden administrative decrees and reinterpretations that could adversely affect one's holdings. And finally, to the extent possible, try to influence the policy decisions being made.

## F. GOVERNMENT AND REGULATION

Having discussed the impact of government taxation, the second mechanism by which national and local government impacts real estate investment is through Regulation. Deriving from legislative authority, administrative units have the authority to establish the rules and codes of conduct governing the particular public policy objective. Regulations establish the ground rules of economic activity. They are, first of all, meant to maintain the market system by ensuring the openness, transparency, honesty and competition of the marketplace. In so doing regulations both discourage and provide prohibitions of some forms of economic activity at the same time that it encourages and promotes others. Government regulations fundamentally alter the nexus of profit.

There are numerous specific aspects of the exercise of government's regulatory authority that directly affect real estate development. First of all, almost every local government in the US engages in Land Use Planning and implements these plans through Zoning ordinances and codes. The goals of land use planning is both to promote the economic development of the city, through a model of specialized and differentiated land use designations, and to ensure the health and safety of its residents, through specification of light, air and safety (fire). The idea was to divide residential, industrial and commercial uses of the land into distinct zones. For example, there are industrial zones where people are prohibited from residing. In NYC, there are restrictions on the location of retail stores on the residential side streets, requiring them on the broader avenues and thoroughfares. The clear result is a scarcity of retail establishments in NYC, driving up rents, as well as the indirect promotion of shopping malls in further reaches of the city.

Zoning codes go much further by specifying for each and every distinct parcel of land, not only a legal use for that parcel, but the limits of bulk. Each parcel has a Floor Area Ratio (FAR) that takes the lot size, and prescribes the allowable dimensions of the new structure, with lot coverage and setbacks. Each of

these specifications will vary from any particular site and for any designated use. These may be called subdivision regulations, when it comes to dividing a large parcel of land into individual home lots. Here these site requirements specify such features as roadway width, sidewalks, curb and gutter drainage standards, and parking requirements. Even in Manhattan, where buildings seem to get taller and taller each year, they somehow conform to the zoning ordinances.

The NYC Zoning Handbook is 139 pages in length. The complexity and ensuing ambiguity of these rules and the inherent flexibility of interpretation spawns an army, not only of bureaucrats who administer these rules, but also of lawyers, architects and those who are themselves called “expeditors,” all of who are requisite for any development to be approved. The cost in time and effort of coordination is staggering. Some development falls into an “as of right” category while others require some action from The City Planning Commission, or its equivalent. There are always avenues for exemptions and appeals, including court challenges. Depending upon the structure of local government, there may exist a neighborhood Community Board, who gives advisory, but often politically influential recommendations. Finally, the locally elected legislature has to make a final decision and vote.

After one has attested to the conformance with the zoning ordinance, the construction of the building has to satisfy a separate set of building codes. These are local in origin, so that each jurisdiction not only has its own zoning requirements, but specifications as to the means, methods, and materials of construction. It can take several months of meetings to gain acceptance that the construction drawings and ancillary documents are in conformance with the prescribed local ordinance. Only then is the actual building permit obtained that allows the physical work of construction. Afterward, follows a host of inspections and re-inspections to ensure that the structure is actually being built in conformance with the approved plans and that site conditions ensure the safety of the workers. The end result is further cost in terms of effort and time. Possibly even more significantly, such a process impedes innovation in the construction process.

Nowhere is this more evident, than in the current impetus for energy efficient architecture and materials.

As of today, “Green” buildings often do not satisfy existing building codes.

Other governmental regulations that affect real estate development include the designation of landmark buildings and neighborhoods. These designations typically prevent any alteration to the envelope/façade of these structures in order to preserve their historical accuracy. It would be almost impossible to demolish such a building, although their interiors can be redone.

Additional local government regulatory authority is exercised to give residential tenants certain rights. These tenant rights vary greatly among local jurisdictions; however, NYC is one such place that tenants have more rights than most other localities. These too create numerous procedures and legal court decisions to be followed. There exist numerous formal reporting requirements that generate yet another specialized army of bureaucrats and assorted experts to be hired to ensure compliance with the rules; for the penalties far outweigh the economic benefits obtained from strictly adhering to the rules. For example, owners of rental residential properties cannot simply choose not to renew the lease agreement with the existing occupant. The tenant has a legal right to continue renting the apartment unit. Then again, the rents themselves are regulated according to a complex formula and public process. It is extremely difficult, as a consequence, to vacate such a rent regulated building in order to assemble parcels to build a newer and obviously bigger structure. The only solution is to enter into an arduous negotiation with tenants to reach a financial settlement. That is why today in Manhattan new residential construction most often takes place on parking lots and garages, or other commercial structures that happen to lie within residential zones.

Other forms of government regulation cover issues of access for the handicapped and what are called Fair Housing laws that are designed to prevent discrimination and bias in renting or selling homes on the basis of sex, ethnicity and religion.

Finally, Government and Financial institutions require inspections, reports and explicit certification by another host of independent expert consultants that the property is free of environmental hazards. These range from oil seepage into the soil to asbestos surrounding pipes, within roofing materials or vinyl tiles. These containments have to be removed/abated in an environmentally secure fashion.

Ultimately, the exercise of this regulatory authority has two major impacts. First, either intentionally or not, it results in scarcity. There is a creation of an imbalance in the supply/demand equation, especially by limiting the supply of housing. Hard as it may seem in the current housing bubble in the US and elsewhere, the complexity generated in the process and the excess time required to gain approvals for construction reveals itself in extra and higher costs, limiting the creation of necessary developments. Secondly, the regulatory process creates a barrier of complexity that requires a specialized expertise in these very same rules to penetrate. An industry of specialized consultants has developed just to navigate the regulatory process.

### **The Lesson**

One needs to understand the regulatory process of the region in which they are investing. The specific local regulations create barriers to entry. As a result, there is opportunity for those that understand the regulations and adjust their business models accordingly.

In foreign markets, as well as familiar ones, hiring good, local consultants is crucial. A great expeditor is key to navigating the regulatory process.

The governmental process creates timing uncertain with which you often cannot control. As a result, factor a lengthy approval process into your budget and development plan.

## G. COMPLEXITY AND UNCERTAINTY

The inherent optimism of the entrepreneur fundamentally underestimates the complexity and uncertainty of the development process. The risk of the deal is always minimized or simply ignored.

Real estate investment is somehow thought of as simple. The availability of leverage makes for easy entry into the business. There is no specific knowledge or education one needs to know to call oneself a developer. Only recently in the US has real estate entered University degree programs. The numerous rags to riches stories in the media of individuals and families who started with very little and now command vast fortunes add to the lure and luster of real estate. There is no denying that real estate is a vehicle for the generation of wealthy. The fact that 44 of the 100 richest individuals in China amassed their fortune through real estate development only further popularizes TV reality shows, and “How To” books to the public. But, as those who have survived the initial burst of enthusiasm know, it is the execution of the project that is so difficult and which defines the resulting profit.

Development projects always take longer than planned and cost more than budgeted. The initial difficulties of solving regulatory problems soon seem trivial when the construction process begins. The design and then elaborate preparation of architectural and construction drawings and specifications takes a significant amount of time and money. There is probably not a single building project that did not experience cost overruns and delays in completion (even The Great Wall).

Information is usually incomplete and limited. Unlike a stock market, where there is a single price that is readily available, in real estate these same buy and sell prices are often unavailable or out of date by the time the government’s recording of deeds and mortgages becomes available. As a result, there is little transparency of immediate market conditions. Most often one needs to rely upon the real estate broker, who is little more than a salesman, providing word of mouth, rumors and self-reported and self-serving

information. Until the apartment is sold or the space rented, reliable information about the actual and final price, nor the rate of absorption, is available.

The future is uncertain.. The only information possessed is of the past, which becomes the baseline; for what is most often a straight-line projection into the future. Unfortunately, the list of uncertainties is great and the future direction of the macro economic environment is only guesswork. The availability and cost of materials, weather conditions, and the exigencies of the actual construction process, such as soil conditions are totally unforeseeable and beyond anyone's control. Whatever is placed in the contingency line item of the budget will most assuredly be insufficient.

Furthermore, as much as the developer would like and hope, sales prices cannot continue to increase at the same compounding rate, without interruption into the future, or at least until the project is completed and sold out.

However, there is no analytical basis to anticipate the shift points. Thinking ahead ultimately comes down to different perceptions and expectations of decision makers. There is little way to assess their hopes, feelings and beliefs about what lies ahead and, as a result, be able to respond to those shifting conditions. In the not so distant past, new residential buildings in Manhattan contained studio units for the single, young professional. It was correctly thought at that time, that once people married they moved across the hallway into a one-bedroom apartment. Then when they had children, they once again moved, but this time to the suburbs and commuted to their jobs in the city. Today, for reasons that could only be guessed at, that has changed. Children are back in Manhattan and new buildings are often built without studios or even one bedroom units. Family size apartments are in vogue. Who knows how long that will last?

In the design of the interior space there are no facts. The architect, interior decorator, advertising consultant and selling agent all have their own opinions and personal aesthetics. For that reason, the media and advertising is increasingly important as they play the role of "tastemakers," shaping and

defining the fashion of the time. The materials used and the amenities offered become a matter of the style of the moment, which will change in the future when the definition of fashionable is something different.

While some have faith in the apparent certainty that emerges from Excel spreadsheets and PowerPoint presentations, they hide as much as they reveal. With a skilled analyst, which one always must have in one's employ, any set of numbers can be made to look good. Change the assumptions, which are most often impenetrable to anyone except the individual who prepared the spreadsheet and the project becomes (more) profitable. After a while the developer will start to actually believe the analysis. Remember, what's on the paper are only projections.

Many a project is bailed out, simply by rising market prices. That is why a declining market is so devastating.

### **The Lesson**

Do not believe your own hype and press releases. Always estimate the risk involved in any venture by preparing prudent and conservative analysis. Consider longer time frames and downside scenarios.

Finally consider multiple exit strategies in case market conditions change unexpectedly.

## H. PEOPLE

Ultimately, and inherently, real estate investment, like any other avenue of business activity, is all about people; their personality, character, or as we say in the West, their psychology.

Individuals exist within a context of time and place and the specific culture and traditions of the nation they were born into. There are norms and styles of doing business that are different from NYC to Asia, as they are different from NYC to the rest of the US.

The real estate entrepreneur has a different personality than the architects, lawyers and expert consultants retained for the project, who are themselves different from the bureaucratic/salary men met in the halls of the planning and building department. This real estate developer is not the rational decision maker, nor is anyone else, that is simplistically derived from classical economic writings. He is far from single minded in the pursuit of maximizing profit. This is not to conclude that the developer is not pursuing his self-interest, but that self-interest is self-defined and multi-faceted. There are other goals that are just as important and which can interfere in the attainment of profit.

It seems that once one has realized the level of wealth for an affluent /luxurious standard of living and life style, and attained financial independence and security for generations to come, most people seek to continue to amass wealth. Perhaps, it is inherent in human nature or the capitalist culture of commerce and consumption to rarely be satisfied;

However, it may be that the developer is also ego driven. It may be that the accumulation of wealth is not about what material goods it can buy, but what it buys in terms of power. Individuals exhibit the desire to be in control and to dominate others. The wish to be “the decider” may be as important as anything else.

There is the competitive urge to be on top among Alpha males, who then posture and pose as proof of their own self esteem.

Then, the ego is similarly often driven toward the pursuit of status and prestige. The rags to riches stories are also about the goal of being respected and accepted in society. Sometimes it takes the form of wanting to be noticed and to be glamorous - to be written about in the popular media and to be talked about and looked up to by the ordinary person and to become a celebrity themselves. This may take the form of becoming patrons of The Fine Arts or of making large (tax deductible) donations to philanthropies and charities. This often becomes expressed in having one's name adorn the entrance to a building on a college campus. The need to be boastful about one's accomplishments may derive from money, but it is no longer about money itself.

One has to look no further than Donald Trump, who is probably known and recognized around the world more than any other business person. . Few of us analyze the rate of return of his investments, but still read his "How To" books and watch The Apprentice. The Kwok family in Hong Kong and Wang Shi of The China Vanke Company, may be similar examples.

Often, these other goals of power and status cloud the judgment and interfere with decisions about the immediate and direct goal in hand- the profit from the project. One's personality can lead to bad decisions - decisions that are not thoughtful, not analytic and just plain uninformed. It's common to see many examples of smart, yet edgy and ultimately extremely risk prone developers that engage in transactions that are more like the gambling and betting in high stakes poker, than anything else. The history of NYC real estate is replete with fortunes lost in a short while. Even today, the Macklowe family risked, seemingly everything, on the purchase of a large package of premier office buildings in Manhattan that quickly became overpriced and under financed. Perhaps it was the thrill of the game itself; the need to out

smart the other side in the negotiating process that became the paramount goal. They certainly didn't "need" to come out on top at all costs and make the purchase.

Entrepreneurs are by nature and choice optimists, maybe even, by character, risk takers. In the tug and pull of The Bulls and The Bears, real estate investors seem to only see the bright side of life and that markets only and always going up. Pessimism and prudence are eliminated by personality and by spin. One needs to buy now, for prices will only be higher in the future. One consequence is over-paying and the other is over-leveraging. In the reality of market cycles, this leaves little leeway for a downside. There is no way out, but to lose.

Each member of the extensive development team put together for a project pursues their own self-interest, as they uniquely define it. In the interaction of all of these participants to the deal, these self-interests do not converge. Everyone has a different set of values and goals that are most often different and distinct from each other and from that of the developer. It is only the developer with money at risk. He is the only individual that will receive the rewards by bearing that risk and, as a result, the others involved do not see the situation with the same lens. These are "fee for service" professionals whose bills have to be paid no matter how much final profit emerges. Often, these professionals seek to protect their relationship and reputation with the bureaucracy and other professionals and this takes precedence with the interests of the developer. The developer is the client, who has one job and may not reappear. However, those in the bureaucracy, who review and sign-off the documents and approvals required for the project, are there everyday. That is why the developer has hired the outside professional in the first place; because of these connections to the bureaucracy, a connection that must be maintained and nurtured. These professionals have to walk a fine line between advocating the interests of the client without putting at risk the long established relationship over a single decision or a single project. Loyalties are divided and, in a tough spot, they may go against the interests of the developer.

## **The Lesson**

The culture of doing business in Asia may be different from that of the US. Perhaps it is more hierarchical, where rank and deference are more important. The web of relationships and the ensuring norms of trust might be more significant in the transition to a more open marketplace.

However, people are still people throughout the world. As a result, one needs to always consider the dynamics of a situation and the conflicting interests of those involved. The team involved in your project can be the most important piece in determining its success. Pick your partners carefully and find consultants you can trust.

## I. THE MARKETPLACE

Real estate investment in the US functions through the private ownership of land and the structure built on it. The government owns only a small portion of the land in and around urban areas. The land they own is primarily for public purposes, such as schools and police & fire stations.

Real estate transactions are based upon the voluntary exchange between buyer and seller. The usual process is an advertised notification of the property for sale by a real estate brokerage firm, which is retained by the seller to obtain the highest sales price. The long established laws surrounding property rights preclude the element of compulsion in any sale. As a consequence, in older, pre-built cities the assemblage of large parcels of land, that are almost always separately owned, for redevelopment is extremely difficult.

The market place determines the price, through the give and take of the negotiating process. There is no objective notion of “value”. How much a property is worth is how much another party is willing to pay for it. Potential purchasers have their own perceptions and beliefs of such value and offer prices accordingly. The buyer, the ultimate winner of a sales process, has by definition offered the highest price. For why else would the seller accept a lower price than has been offered by someone else? The highest price always wins out.

The marketplace speaks for itself. Capitalization rates over the past few years have compressed, causing a decline in the rate of return on net operating income. This only means that the investor is willing to accept less of a return on their capital than they once did and in comparison to alternative investment opportunities, such as savings in a bank or the stock market.

Markets are prone to excess. Developers believe that if they, "build it and they will come," losing sight of the economic fundamentals underlying the purchase. But, the basic laws of gravity still apply—whatever goes up must eventually come down. It is only an issue of when, how fast and for how long. The cycles of expansion and the severity and duration of contraction may have been mitigated over the past twenty to thirty years, but they still occur with significant impact upon real estate investment. There is a psychology of the market, as expressed by Alan Greenspan as "froth" and "irrational exuberance". People seem to be afraid of missing out and not getting in the game, and as a consequence, stay in too long and fail to recognize and assess the risk of the downside.

On the upswing, the size of the market itself expands. There is more activity, as holders of real estate become sellers in order to take advantage of the higher prices. Sales as a percent of the total housing stock increase. Property owners want to take advantage of the "paper" increase in the price of their asset and "cash-out". Often, individual homeowners "trade up" by repeatedly buying and selling, each transaction representing a bigger and more expensive property and thus propelling the market to attain a higher plateau. The same holds for the developer, for there is no reason to make a sale for anything but the highest offered price.

Recent events have shown what happens on the downside, both in price and activity. The market "freezes" up. It is not just that the price drops, but the volume of activity diminishes too. The sentiment of the market changes, as no one wants to "overpay" and buy before the bottom is reached, however that may be determined. Prices eventually flatten out; but there is no way to know when that point is reached. There can be a prolonged period of inactivity; when both buyers and sellers disappear.

The marketplace has an intrinsic bias toward a disequilibrium of supply and demand. Boom and bust cycles are endemic to the system. They have been witnessed in the US in the late 1980's in what is called The Savings and Loan crisis that led to the establishment of The Resolution Trust Corporation and in the

1990's with the Japanese Housing and Stock Market Bubble. The late 1990's also witnessed the collapse of housing prices throughout Asia as well.

For example, in New York City, as a result of regulations, limited supply of land and the high costs of construction in the confines of a congested inner city, the normal situation is one of scarcity. In the past years, the sharp decline in the cost of capital, minor adjustments in the regulatory process and a robust local economy with extensive, high paying job growth, sale prices rose. This brought forth a spate of residential construction (condominiums). Within a few short years, the equilibrium shifted to over-supply. As a backlog emerges, prices go down and new construction disappears. Once the pipeline of projects is eventually absorbed, scarcity once again appears. Prices then go up and a period of development begins anew. Like stock markets, but at a slower pace, the up and down swings of the marketplace is unavoidable.

In places where there are fewer constraints on the development process and where vacant land is more readily available these cycles are even more pronounced. The acquisition of "raw" land, absent any cash flow to support the debt, and only held for future development is undoubtedly the riskiest of all real estate investments.

### **The Lesson**

It is difficult, if not impossible, to anticipate the change points in the cycles. The future is always unknown. No one knows the peaks and valley and when to enter or exit the market.

Timing is almost everything. However, now may be the time to at least prepare to enter the US real estate market. It may be the time to seize the opportunity and buy in.

A little bit of LUCK is always essential for success.