JAMES A. GRAASKAMP COLLECTION OF TEACHING MATERIALS

I. MANUSCRIPTS

C. Published Journal Articles

21. "Land Investments in the Path of Employer Emigration,": James A. Graaskamp as participant on Salomon Real Estate Roundtable on January 15, 1988 with proceedings edited by David Hartzell, April, 1988

Salomon Brothers Inc

Research Department

Salomon Brothers Real Estate Roundtable

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This report is based on the proceedings of a roundtable to discuss current issues in real estate markets held in New York City, January 15, 1988. The views expressed by the participants are solely their own and not necessarily those of Salomon Brothers Inc.

IN MEMORIAM

Jim Graaskamp, our friend and colleague, passed away on April 22, 1988. His teachings, research and guidance have greatly contributed to our understanding of real estate, and his life was a tribute to the human spirit.

The editor wishes to thank Ann L. Pegg for her editorial guidance, and Carmela Nardi and Joanna Steves-Kennedy for the preparation of this report.

Salomon Brothers Real Estate Roundtable

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Professor James Graaskamp

Thank you. I would like to begin by addressing some of David's points. The move for Kimberly Clark was fostered more by Wisconsin's tax system than it was by double careers. The Fox River Valley is our fastest growing area in Wisconsin, and I think that double careers are very feasible there. However, a counter-argument is that a move to the more rural, smaller communities offers a slower-paced, counter-lifestyle to your lifestyle here in New York.

Historically, raw land has not been regarded as a suitable investment for institutional or fiduciary accounts. Indeed, when one of the great buys of the century, the Irvine Company, was available for the first time, a number of life insurance companies wanted to acquire it. But the State of New York's Insurance Commissioner ruled that such an investment was a land speculation, and hence an inadmissable investment for life insurance companies. I suspect that the attitude may have changed since then, but nevertheless there is a basic bias against raw land investment as a suitable program. Private investors and lawyers have also regarded raw land development as a high-risk specialty, probably not suitable as an investment so much as a special situation or wildcat adventure.

But there has been a recent spate of interest in raw land investments. Laventhol and Horwath indicate that national land syndications have experienced new interest. There were three land syndications in the summer of 1985, 36 a year later and 57 national syndications of land pools through the third quarter of 1987. Many of these syndications are marketing to institutional investors rather than the survivors of the tax shelter group.

One syndication group — the Heartland Group — has done more than 100 limited partnerships in raw land in the past eight years. The Aries Group commissioned Real Estate Research Corporation to do a study that suggested rightly or wrongly that land investment was similar to a zero-coupon bond, with fairly substantial returns that probably exceeded the requirements given the risks.

There are three basic formats to buying raw land. One, of course, to coin a phrase from John Jacob Astor, is "buy by the ranch and sell by the acre." This has occurred primarily in the Southwest where there are still ranches to be found. A second strategy, utilized by the land pools, is to buy infill sites, such as golf courses and race tracks, and convert the areas to higher density uses such as research parks or similar uses by promising the local government a larger real estate tax base.

And the third is land investment in "the collar counties." Picking up on what David Shulman was saying, there will be job migration out of the urban cores for a variety of reasons, but the employees are not going to move very far. On the other hand, they cannot move to the immediate suburban development areas because those land prices and housing costs are not compatible with the objectives of relocating. But the third tier of counties, the rural or collar counties, provide the opportunity for a reverse commute for the management group, which typically has a great investment in suburban housing that they are reluctant to abandon. Furthermore, raw land prices in that third tier of counties are very attractive for growth and development.

The reasons to consider a long-term land investment are varied and sometimes positive as well as negative. In the past, capital gain was a significant expectation of most real estate investments for several reasons. Systematic increases in employment and inflation that could be immediately captured in rent structures, as well as the willingness of lenders to be exploited through fixed rates during an inflationary period, contributed to increases in value. The preferred capital gain tax rate provided some financial incentive to invest in real estate for a capital gain.

These reasons do not apply today. The result of overbuilding is that it is not likely that the inflation component will be captured in the rollover of the leases. There are certainly no systematic value increases as a result of trends favoring the downtown core. Population core hardships are making that less possible.

Wealth transfers from long-term fixed-rate investors to borrowers are less likely today with shorter maturities on real estate debts. So capital gains have to be made the old-fashioned way: by earning them through asset enhancement. And, asset enhancement explains the interest in the existing shopping center that needs refurbishing or in office buildings with unfavorable leases that you hope to be able to buy out.

The biggest pick-up in asset enhancement, however, is the ability to take raw land and create entitlements for the development of that land with higher densities. You begin with a low capital cost — particularly when sellers provide terms. Also, the creation of value through entitlement is a relatively low-cost investment in expertise rather than in capital enhancement. Therefore, you can create some element of monopoly by co-opting the community into essentially a joint venture with the developer in a large scale expansion, with Plano, Texas, being a good example.

The entitlement for higher density in market areas that have some potential for in-migration offers a significant hope for capital gain. When it can proceed with systematic selection and have the political expertise to bring the infrastructure to the borders of an otherwise rural property, each dollar spent increases the value of that property. The value moves closer to the point when it leaves the rural category and moves into the urban category. So, the possibility of recapturing your investment is much higher for raw land than in capital-intensive acquisitions that then depend on releasing and refurbishing.

Land values are going to be driven by job migration and affordable life quality, and I think those are two parallel and important factors. For the investor, it is also important to note that job migration today implies movement of jobs and people from one place to another. Therefore, the investor is speculating on location whether property is selected in a downtown core from which the migration will occur or whether property is chosen that will benefit from expansion of the collar lands around an urban center.

Either way, lead data that indicate where and why the out-migration will occur as well as where and why the in-migration may occur is needed. This has already been taken note of in several recent publications. One is a book by a *New York Times* reporter, John Herbers, called *The New Heartland* (Times Books, 1986). He observed and interpreted population migration and dispersal beyond the outer ranges of suburbia. The book discusses the movement of corporate jobs to the suburbs and the relocation of employees to affordable housing.

This is why, in picking up on what David Shulman said, a move to New Jersey makes sense, but only if you are not going into the present areas of development. One of our recent graduates moved to work in Newark, New Jersey, at a very substantial salary increase from his job in the borderlands of Texas. Even with generous company-provided mortgage benefits, the closest affordable house he could find was one hour away by car. Once the couple made the payment on the house and commute each day, life quality is not what it was on the borders of Texas. And you have to begin to wonder how long a corporate structure of any sort can continue to attract executive talent into that kind of environment.

At some point, corporations are going to have to perceive that the commute to New York is not particularly pleasant. Certainly those of you who experienced difficulties this morning because the subway was closed because of a water main break can appreciate this. There has to be an easier way, and perhaps western Connecticut is an attractive alternative for the corporate office, with the reverse commute from the home in Connecticut or New Jersey a far more workable solution.

The attraction in New York is always going to the theater and the museum, but I suggest that most of you who live here have not been to the theater or museum recently. If you wanted to partake in the cultural activities, you could fly to the city for a weekend at considerably less expense than working here in order to have that opportunity available.

A second book that is less philosophical about the political and life quality issues of that migration is one called *Targets of Opportunity* by Professor Jack Lessinger. He has set up a computer model to evaluate which of some three thousand plus counties show the highest population gains over the 1970-80 decade. He establishes a mean rate of change in population for those counties and then measures the number of standard deviations from that mean reflected by each county. Then, putting the county and city data base on computer, Professor Lessinger sets up a qualitative rating system to at least make some suggestions about the quality of life and the affordability of living in each of those counties. He proves fairly clearly that the 50 leading counties in terms of rate of population change and the highest affordable life quality are in the rural hinterlands rather than in the traditional and metropolitan zones.

He argues — and one can take issue with this — that this finding represents a counter-culture, or a more spartan consumption pattern in which life in the city is being rejected by a professional class as well as a retirement class. The accountant, the doctor, the veterinarian who can take his trade with him where he goes will move to the smaller town and enjoy a significant difference in life quality.

That brings us to today's point about the larger corporation's choices in the small cities. I suggest that there are many employers that are doing fine in Wisconsin, thank you, and actually find that as long as they employ people who fish, hunt and cross-country ski they are in an excellent position to attract a significant labor force.

Aside from the positive draw of rural areas, there is now a negative stress factor as well. Using New York as a laboratory but certainly characteristic of many other areas as well, studies have shown that stress statistics are going to make the cost of doing business in the urban core a negative factor, pushing out the corporate employer. Although many corporations maintain a visible presence, they are already moving their back office operations and clerical and computer functions out of the city, reducing the total employment within those urban cores.

If only 5% of the employers in New York locate significant parts of their staff in suburban areas, the marginal reduction in total office employment will put a cap on the rent structures relative to the available supply of office space. It will also take away the promise of any capital gain on that property through asset enhancement and rolling of those leases in the next succession from this market to the next market.

It is those negative statistics that I think must give the investor pause. It would seem that a reasonable hedge in a portfolio strong in the downtown core would be positions in the collar counties where the core might relocate.

Acreage can be carefully and systematically selected along the commuter routes that link collar communities and the residential areas, where the management staff currently lives, to downtown cores. This represents an interesting possibility to exploit the reverse commute.

There are really two formats of interest. One is a format of five hundred to a thousand acres in a selected array of collar counties so that you have sufficient diversification to capture that movement. The suggestion is not that New York is going to go away, but that four or five percent of employment is likely to relocate according to the pattern that I have described.

The alternative stems from our belief that the fourth-, fifth- and sixth-tier cities — counter to what David Shulman believes — are going to be highly attractive and very competitive. In talking with lawmakers in Madison, for example, and having gone through the exercise with Sematech, we learned very quickly that housing affordability is a positive attraction for professional staff. The collapse of family structure hastened by problems related to drugs is creating a powerful negative incentive from first-tier cities with high transfer payment populations.

For example, in Madison, Wisconsin, a very handsome home within ten minutes of work for $100,000 would cost $350,000 in New Jersey. In terms of what that means in the shift of salary scales, Madison offers strong competition for corporations located in the urban centers. The well-educated managerial professional and technical people that many of the newer industries require have an expectation of life quality beyond that offered in places like New York City. A significant element of life quality will be a sense of personal safety from social unrest.

When a large space user begins to think about relocating out of the city to find 120,000 square feet someplace else, places like Madison, Wisconsin, provide strong competition in terms of the life quality that we offer. So I think that you need to begin to look at land investment in key areas that would be attractive in terms of labor and affordability as a critical element. We are also able to draw on a high quality, underemployed labor pool in the Midwest. Not everybody has left Iowa or Wisconsin as a result of the farm situation.

In conclusion, one comment John Robert White made in the selection process for the Saturn Plant in Tennessee was that a major cultural factor sought by General Motors was a work pool that had not had a generation of time clock punching. The company sought people who defined a task as starting a job and getting it done no matter what it took, rather than defining the task as going from 8:00 in the morning until 4:30 in the afternoon. After three generations of time clock punching, you have significantly changed the mind set of productivity in worker groups in many of the urban centers. Tennessee presumably did not have that mind set. I think we are beginning to look for other cultural values to enhance our productivity, and perhaps the vacant lands in the collar counties provide an opportunity for some corporate employers to improve employee selection and productivity with lower payroll and occupancy costs. Thank you.

The *What* of Real Estate

Professor Sherman Maisel

Our next topic is the "what" of real estate. We are going to focus on two particular types of property that have recently experienced an increase in institutional interest. First, Joseph O'Connor, president and chief executive officer of Copley Real Estate Advisors will discuss industrial markets. He