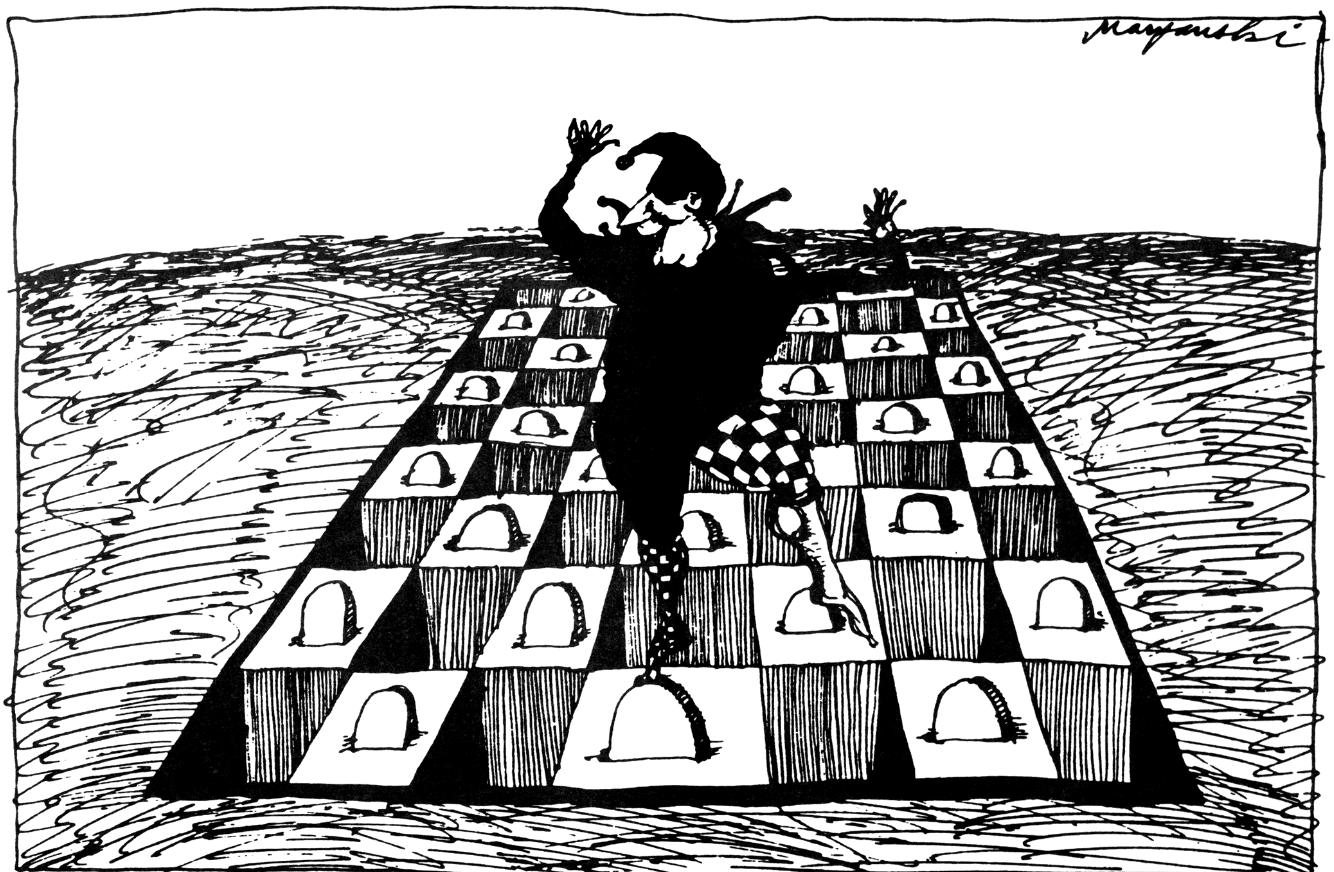
A guide to the risky art of resurrecting dead properties.

The Grave Dancer

Samuel Zell



A REVIEW OF THE CURRENT LIST of best-selling fiction reveals a novel that needs to be written. Titled *The Grave Dancer*, it would be a story of an individual or organization immersed in resurrecting the real estate corpses created by the greatest explosion of real estate lending and building in this country's history. Somehow, Arthur Hailey and Harold Robbins have both missed this great idea for a best seller containing all the excitement and intrigue of their other chronicles.

The volume of real estate development in the United States has always been related to the availability of funds, rather than to demand. During periods of easy money, excess capacity has been created; during periods of tight money, the decline in new construction has allowed for the absorption of this excess capacity. The years 1966-1967 and 1969-1970 were classic tight-money periods. Following each period, the country entered a time of easier money when substantial quantities of funds

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were made available to real estate by traditional sources.

Unfortunately, this new loosening of funds was accompanied by the simultaneous blossoming of the real estate investment trust as a construction lender. When the trust form was created by Congress in 1960, its primary focus was long-term ownership. In the late 1960s, however, many REITs shifted their sights to short-term construction lending.

Neither Wall Street nor the general investing public possessed a clear understanding of the difference between an equity trust that owned real estate on a long-term basis and a short-term trust in the high-risk business of financing construction. Neither recognized that participation in the construction lending business requires much greater supervision than other types of real estate investment.

Within three years, more than 200 REITs, with a debt-equity capitalization of about $20 billion, were created. Most of this $20 billion was new money entering the real estate market at a time when traditional financing sources were also putting funds back into the industry.

The amount of real estate development that can be absorbed in any one year is finite. But the easy availability of funds encouraged massive development during a period when demand was shrinking. While inflation was reducing the absolute purchasing power of the consumer and limiting the amount of disposable income available for shelter, the costs and availability of both shelter and supporting facilities were increasing substantially and rapidly.

During this period, the growth of new funds and investment entities stretched the demand for personnel experienced in the administration, underwriting, and policing of loans far beyond the available talent. As a general rule, such rapid expansion of demand for executives will tax any system, allowing for a lowering of ethical standards and generally reducing the level of competence. Easily accessible funds also attracted unsophisticated, incompetent, and undercapitalized borrowers who were not qualified to be real estate developers.

OPPORTUNITY FROM ADVERSITY

Consequently, since mid-1973, the real estate industry has been in a shambles. But opportunity arises from every adversity, and real estate is no exception. Because the magnitude of current industry problems exceeds the problem-solving ability of traditional real estate lenders, there is both need and opportunity for individuals with management skills, capital, and real estate savvy.

The fact that opportunities exist is obviously no secret. Unfortunately, just as there was a shortage of capable administrators during the recent period of excessive growth, so there is now a shortage of individuals capable of alleviating problem situations.

INITIAL INVESTMENT ANALYSIS OF DISTRESSED PROPERTIES

Investors in distressed property are motivated primarily by the expectation that the equity value of a real estate asset acquired at less than its original cost-to-construct will in time increase to a point that justifies its original indebtedness. Thus, the successful "grave dancer" must generate cash flow by achieving and maintaining high occupancy rates in an overstocked market through good management. And he must be able to carry the property long enough to realize equity value appreciation.

The investor in distressed property walks a thin line between the extremes of success and failure. His best bet for surefootedness lies in the initial analysis of the potential investment. Most important to the eventual outcome are five major considerations:

- Physical characteristics of the property;
- Marketing strategy;
- Competition;
- Competent management during the turnaround period;
- Cash flow during the work-out period.

Physical Condition of the Property

Determining the physical condition of a distressed property is perhaps the most difficult aspect of the investment analysis.

In the resurrection of an incomplete project, the first step is arranging to finish construction. A basic tenet of an equity investor involved in a workout must be that under no condition should he undertake the financial risks of completing construction. Regenerating the construction of a project curtailed prior to completion is difficult, costly, and unpredictable. Even the most sophisticated construction consultant or developer cannot accurately predict what it will take to finish a stalled project. A buyer investing in an incomplete property should insist on an open-ended financial commitment on the part of the original lender.

In addition to the problems of completing construction, there are substantial risks involved in evaluating the condition of the existing facility. Financially beleaguered developers and builders have been known to go to great lengths in order to reduce their cash requirements as a project evolves. Investors should inspect the project carefully, looking for missing, deleted, or diverted materials and for substitution of materials.

There have been projects in which the developer has moved appliances from place to place so that the construction inspector could certify that all appliances were actually in place, when, in fact, most of them either had never been purchased or had been bought and used at another site. An inspection to determine the current personal property inventory requires methodical analysis, but at least the inventory is visible and, therefore, determinable.

Latent defects or use of inappropriate materials pose greater risks, and run the gamut from inappropriate piping systems to inadequate drainage systems to unconnected air-conditioning condensation lines to undersized water heaters and ill-designed electrical and plumbing facilities. In many cases, it seems unbelievable that these projects were inspected during construction, either by local authorities or by the lender. Often, substitutions of such grossly inadequate materials have been made that physical operation of the project could not possibly have been contemplated.

Unattended perishable commodities at the construction site must also be inspected. Materials on site and in place can deteriorate from exposure to the elements, and vandalism often adds substantially to the cost of project completion. The investor must make a careful determination of whether the partially completed project requires restoration and replacements before construction continues.

Marketing Program for a Distressed Property

Prior to going ahead with a project of this nature, it is necessary to put together a marketing program with reasonable objectives, i.e., objectives that reflect the fact that marketing must overcome the stigma carried by a project that has been in trouble.

The rental structure should be highly sensitive to the current market; rents probably will be totally unrelated to original project cost or the amount of outstanding debt. If anything, the rental schedule should be slightly below the prevailing elsewhere in the market area in order to get a rapid movement of tenants into the building.

It is almost impossible to apply normal marketing cost standards to a distressed property. More advertising, more individual assistance, and more management is required. These activities create high personnel costs which must be included in the budget.

Competition

The marketing plan must consider the competition created not only by all existing units, but also by proposed new construction. An important consideration for a residential property is the existence of a substantial inventory of unsold condominium units. One way to restructure an unsold condominium is to convert it to a rental property or into a lease-purchase project. This type of temporary program adds superior facilities at competitive rates to the market. Although these condo-rentals must ultimately be sold as condominiums, for the short-term, they materially affect the absorption rate of rental units. The generally higher quality of condominium facilities makes them difficult competition.

Management Requirements

Distressed property requires perhaps two or three times as much management effort as would normally be necessary for a rental project. Consideration must be given to overcoming the bad reputation of the project. There may be latent physical defects that require constant monitoring and work. Furthermore, tenants in a distressed property often lose their sense of discipline. It is not uncommon to find anywhere from 25-50 percent of the tenants paying less than the going rent or running substantial arrearages. The initial phase of management may require six months of intense supervision by high-level, high-quality personnel to make the project sufficiently attractive to invite the discipline, attention, and cooperation of the tenants.

Rent-up programs for distressed properties need a different approach from those designed to fill up properties that have not experienced problems. Prospective tenants may attempt to take advantage of a distress situation by making low-ball occupancy proposals. This is particularly common in office buildings, where rent concessions, tenant improvement allowances, cost escalation limitations, and rental rates provide tremendous opportunities for tenants to work deals to their own benefit.

Management must also aim for long-term acceptance in the community. High-quality maintenance and detailed attention to all tenant services is absolutely necessary to overcome the property's image as a problem.

Cash-Flow Projection for the Work-Out Period

A venture into the rehabilitation of a distressed property requires careful preparation of a projection of the reasonable net gain that can be achieved during the work-out period. Attention should be given to the following considerations in making this projection:

- A substantial time lag usually exists between the leasing of a unit and actual occupancy. The effect of this delay in revenue generation must be assessed.
- Occupancy and operating costs do not move hand in hand. The difference between the operating expenses of a 100-percent-occupied project and one that is 50 percent occupied is small.
- Adequate funds must be allocated to cover marketing costs, promotional activities, additional personnel, and both on-site and off-site generation of prospective tenants. These costs usually run higher than for nonproblem properties.
- Net gain calculation is the proper measure of progress, not merely gross units leased. No matter how successful a rent-up program, turnover occurs that will add additional cost and slow down the achievement of the full-time occupancy goal.

FINANCIAL RESTRUCTURING

When the investor is satisfied with his initial investment analysis, he must arrange financing tailored to the characteristics of the projected income stream and capital costs. Financial structuring is the most difficult stage in taking over a distressed property. It can be made more difficult by the inability of lenders to face reality.

Often, lenders ask for down payments or other "up front" money, totally unrealistic demands in a bail-out situation. Although it is necessary for the new investor to evidence his continued interest and risk in the venture by putting up cash, the money he invests in the distressed property should not be used for reduction of principal or to reduce arrearages. Rather, it should go toward operating deficits, capital improvements, and project management.

A lender involved in financial restructing for a problem property should be concerned with who is taking responsibility, rather than with how much cash is being put up. The shortsightedness of entrusting a major asset to unsophisticated investors should be obvious. The lender who gives little consideration to the talents and abilities of the investor, but is principally concerned with the amount of cash put up, may find that the deal is disastrous for both parties.

There are three important rules for structuring the financing of distressed deals:

☐ *Guillotine clauses.* The investor must avoid arrangements that offer substantial lender forebearances in the first year, but require unrealistic future payments. Lender assurances that renegotiation will be possible if the investor is unsuccessful are worthless unless they are legally binding. Although a lender today may initially be reluctant to take back a property, he may be much more willing to foreclose a year or two later.

☐ *Investor liability.* Personal liability is not usually imposed in real estate financing and should be avoided by investors. An exception might exist in a situation where the investor agrees to make up a fixed amount of operating deficits in the future.

☐ *Long-term financing.* The principals in many bail-out negotiations should not assume that long-term financing will be available in the future. It seems probable that during the next ten years, the amount of money available for long-term, multi-family investment property financing will be inadequate to the demand for funds. Consequently, a continuation of high long-term rates appears likely. During periods of capital shortage, real estate must compete with long-term corporate and government debt for available funds, and current corporate debt yields force mortgage rates higher than real estate economics often can justify.

Future availability of funds will also be affected by political pressure for local lending. A large portion of commercial real estate funds have traditionally come from savings banks and savings and loan associations located on the East and West coasts. Funds were invested in capital-short areas all over the country at yields not available in local markets. Legislation requiring local allocation of assets is a likely prospect that may restrict the interregional flow of funds. Thus, an investor should weigh his financial structuring decisions carefully and analyze the likelihood that the project can take out the lender at the end of the mortgage term.

Lender Contingency Fund and Interest Accruals

In bailouts of not too badly distressed properties (those in which the original owner was unable to carry the costs of renting up, but the property is viable as it stands), current yield to the lender is possible. In these cases, deals can be structured so that the new investor-owner makes a certain sum available for operating deficits. Should operating deficits continue and additional assistance be required after this sum has been expended, the deal can require the lender to provide additional money from a contingency fund. (See the "Example of an Office Building Workout," accompanying this article on p. 36.)

Lenders often reduce cash requirements for the new investor by accruing future interest payments. The investor should analyze the likelihood of the property increasing in value to the point where its worth equals cash investment plus these accruals. The accruals must be analyzed and extended to make sure they do not preclude any realistic hope of ultimate debt repayment. Thus, even though a break-even posture within the first five years is attainable, the compounding of accruals can increase the ultimate balance to a level where there is no possible economic justification for the principal balance owed at the time. As a rule of thumb, it is reasonable to assume within a given ten-year period an improvement of 20-25 percent of value, i.e., taking of a property with a low interest rate today which is overfinanced by approximately 125 percent could increase in value by 25 percent in ten years.

WHY REAL ESTATE VALUES WILL GROW

The rules of economics and true yield rather than artificial subsidy will slowly take over the entire real estate industry. If a first-class New York City office building costs $70 per square foot ($70/SF) on a turnkey basis, then it must generate approximately $14/SF in rent, in order to yield a 10 percent overall return on the investment. The current rental rates in New York City, which vary from $6-$12/SF, do not begin to justify the construction of any new buildings nor do they provide an adequate return for those buildings that have been constructed in the last four or five years.

In housing, the same relationships are prevalent. Perhaps the clearest example of the disparity between the rental rates currently generated and actual costs is the condo conversion phenomenon. In the Chicago market, a 1,200/SF prime Lake Shore Drive apartment will convert at a sales price of approximately $60,000. The carrying cost to the individual purchaser of this unit including the use of his capital is $12,000 per annum, or approximately $1,000 a month. This same unit previously rented at $450 per month. The sales pitch to the prospective buyer is heavily oriented toward ownership appreciation and tax benefits that will accrue as a result of owning rather than renting the unit. These benefits have an economic value, but certainly not one justifying an occupancy cost more than double that which was previously imposed. Clearly, rents must escalate anywhere from 30 to 50 percent to bring the ownership-rental ratio more in line.

In the shopping and commercial area, the past few years have seen a continuing trend toward the construction of major regional shopping centers, where the anchor tenants are subsidized by the smaller tenants. This has made it more and more difficult for the small tenants to survive, while the major tenants continue to prosper at rental rates substantially below the cost to the developer of maintaining their existence within the center. A very common arrangement today permits the anchor tenant either to buy his own pad within the center and build his own structure or rent the building at a cost less than the cost of construction, thereby passing a disproportionate share of the center's operating costs to the smaller tenants. Although majors become the drawing power for the shopping center, the disparity between occupancy costs is too great. It is not uncommon to see a major shopping center structure wherein a 200,000/SF anchor tenant pays $2.50/SF, while a 5,000/SF tenant is paying anywhere from $11-$15/SF.

All of these disparities—in office and apartment buildings and in commercial properties—will eventually be resolved in the direction of higher rentals and a consequent rise in asset values. Or so the grave dancer hopes.

MOTIVATIONS OF INVESTORS IN DISTRESSED PROPERTIES

Obviously, most of the distressed property deals that can be made with lenders do not provide any immediate cash-flow incentive to an owner-investor. Most arrangements limit cash return until full debt service is being paid. But there are a number of other incentives. One is the availability of substantial tax shelter from depreciation, interest, and operating losses. But tax benefits are meaningless unless the project can be ultimately successful. Thus, the guillotine clauses mentioned above are critical; a "short fuse" financial structure with a foreclosure followed by recapture of deductions provides only short-term deferral and is not worth the risk and effort involved in putting a problem property back on its feet.

A more realistic incentive to the distressed-property investor is the prospect of long-term growth in asset—"brick and mortar"—value. Given the over-

Example of an Office Building Workout

The following example of an office building workout illustrates the type of arrangement that can be made between the original lender and a new owner where the project essentially is a viable one, with the cause of distress being the inability of the original owner to carry operating deficits and capital costs of the property until break-even occupancy is reached.

The figures in the example are based on the following assumptions and projections:

- Rental income will gradually increase in each period shown as a result of increasing occupancy and space upgrading.
- Total expenses will be level beginning with 1977 due to broad escalation clauses in leases.
- The property is subject to a ground lease which calls for a fixed ground rental of $90,000 a year until a step-up to $96,000 in 1982.
- The debt service on the existing first mortgage will continue to be paid.
- The lender, in consideration of an additional cash advance of $500,000 (see the next paragraph), receives a standing second mortgage with interest payments to be made on the funds as advanced.

Based on the projected figures, the property will have an aggregate cash flow deficit of $1,613,600 through the end of 1981; in 1982, a small positive cash flow of $18,100 is projected. The work-out problem thus becomes how to fund the anticipated deficit through 1981. The agreement between the lender and the new owner provides this solution:

☐ The new owner agrees to invest up to $500,000 to cover initial operating deficits. This is the total amount of new equity that the new owner will provide.

☐ The lender agrees to make available $500,000 in cash for tenant improvements in space not yet leased. This cash will be secured by the standing second mortgage, with interest to be paid on the funds actually advanced.

☐ The lender also agrees to make available an additional $750,000 to cover operating deficits and additional tenant-improvement funds in excess of the $500,000 to be provided by the investor. These funds will accrue interest but will call for no debt service.

☐ The cash to be put up by lender and new owner totals $1,750,000, sufficient to cover the projected deficits through 1981.

☐ In 1993, all of the outstanding debt due the lender (the balance of the first mortgage; the entire principal of the second mortgage; and the entire principal and interest on the additional $750,000) will become due and payable. At that time, the lender agrees to write a new loan for the entire amount due at an interest rate that would fully amortize the loan in twenty-nine years for a debt service not to exceed $549,000 a year.

For the lender, this workout has the virtue of preventing a complete wipeout of its existing first mortgage and of permitting the loan to be carried on the books without a write-down. For the new owner, the investment promises not immediate return but the prospects of very large future profits. The rental increases projected through 1982 reflect only the hope of increased occupancy and the upgrading of the quality of the space in the building. No general increase in the base level of office rentals is assumed. Consequently, the projected $18,000 cash flow in 1982 building of 1970-1974, the likelihood of long-term capital shortages, and the bloodbath recently suffered by both lenders and borrowers, another expansionary period in real estate construction in the near future is not likely. Thus, an investor in a bailout situation must be asset-oriented.

In the United States, real estate units have traditionally been built in anticipation of demand. The rest of the world has always built to satisfy an existing demand. During the next ten years, the form of real estate business in this country will approach that found in Europe, and new construction will be built and developed primarily in response to demand.

Thus, there will probably be a substantial reduction in construction for an extended period of time. New housing starts will not see a 2 million unit per annum level for many years. The major retail expansion that has occurred over the past decade has substantially saturated the market, and the declining

on the $500,000 investment is a reasonably conservative one. Should the situation change (as the grave dancer hopes), with rentals rising to reflect the increasing value of the bricks and mortar, the leverage could be very substantial. For example, if the base rental rate in 1982 were to rise to $2 per square foot, then the net cash flow would increase by approximately $400,000, yielding an astronomical percentage return on investment.

	3/20-6/30 (3 mos.) 1975	*7/1-12/31 (6 mos.) 1975*	*1976*	*1977*	*1978*	*1979*	*1980*	*1981*	*1982*
Rental income	$243,100	$486,100	$1,076,900	$1,238,500	$1,270,200	$1,333,000	$1,389,100	$1,422,600	$1,492,300
Garage income	3,600	7,200	14,400	15,000	15,000	18,000	18,000	18,700	18,700
Electricity profit	3,800	7,600	16,300	18,200	18,200	18,200	18,200	18,200	18,200
Other income	2,500	5,000	10,000	10,000	10,000	10,000	10,000	10,000	10,000
TOTAL INCOME	$253,000	$505,900	$1,117,600	$1,281,700	$1,313,400	$1,379,200	$1,435,300	$1,469,500	$1,539,200
Expenses									
Cleaning	$ 28,900	$ 57,900	$ 123,400	$ 138,600	$ 138,600	$ 138,600	$ 138,600	$ 138,600	$ 138,600
Electric (common area)	4,600	9,200	18,400	18,400	18,400	18,400	18,400	18,400	18,400
HVAC	23,000	46,000	92,000	92,000	92,000	92,000	92,000	92,000	92,000
Elevators	8,300	16,700	33,400	33,400	33,400	33,400	33,400	33,400	33,400
Plumbing	1,900	3,700	7,500	7,500	7,500	7,500	7,500	7,500	7,500
General & administrative	36,000	72,000	144,000	144,000	144,000	144,000	144,000	144,000	144,000
Repairs, maintenance & decorating	12,500	25,000	50,000	50,000	50,000	50,000	50,000	50,000	50,000
Tuck-pointing	50,000	—	—	—	—	—	—	—	—
TOTAL EXPENSES	$165,200	$230,500	$ 468,700	$ 483,900	$ 483,900	$ 483,900	$ 483,900	$ 483,900	$ 483,900
NET CASH FLOW BEFORE FIXED EXPENSES	$ 87,800	$275,400	$ 648,900	$ 797,800	$ 829,500	$ 895,300	$ 951,400	$ 985,600	$1,055,300
Other expenses									
Deductible legal, acctg., administrative	$ 47,000	$ 85,000	$ 68,000	—	—	—	—	—	—
Tenant improvements	33,000	67,000	200,000	$ 160,000	$ 170,000	$ 170,000	$ 170,000	$ 170,000	$ 170,000
Insurance	2,200	4,500	9,000	9,000	9,000	10,000	10,000	10,000	10,000
Real estate taxes	—	250,000	230,000	241,500	241,500	252,500	252,500	265,100	265,100
Ground rent	45,000	90,000	90,000	90,000	90,000	90,000	90,000	90,000	96,000
1st Mortgage debt service	96,900	193,800	436,100	436,100	436,100	436,100	436,100	436,100	436,100
2nd Mortgage interest	8,800	17,700	45,100	54,600	60,000	60,000	60,000	60,000	60,000
TOTAL FIXED EXPENSES	$232,900	$708,000	$1,078,200	$ 991,200	$1,006,600	$1,018,600	$1,018,600	$1,031,200	$1,037,200
NET CASH FLOW	$(145,000)	$(432,600)	$(429,300)	$(193,400)	$(177,100)	$(123,300)	$(67,200)	$(45,600)	$18,100

population growth rate should continue to further reduce the development and need for these facilities. In the next ten years, a reorientation of priorities will lead to a major emphasis on the rehabilitation of existing facilities, rather than on the construction of new ones.

If these assumptions are valid, the intrinsic value of brick and mortar in place, well-designed and well-maintained, will grow substantially. The slower rate of new construction, expansion, and development will force an increase in the rentals and sales prices of all forms of real estate (see accompanying box). It is this shift in the revenue side of the equation that provides the greatest lure to the grave dancer. Although he structures deals predicated upon current revenues and current expenses, radical improvements in revenue may occur in the future. To those with staying power, patience, and management ability, the potential rewards are tremendous.

CONCLUSION

The thesis advanced here is distinctly different from the concept that "inflation will bail out past mistakes." Inflation bailout is the expectation that rents will rise faster than total expenses, because a large portion of expense is fixed debt service. The grave dance relies on the theory that a major increase in rents is probable because of a significant shift in the demand-supply equation for real estate.

The opportunity of acquiring real estate in its current distress offers the greatest single economic opportunity for investors in our time, one that is not likely to occur again. As with any opportunity, however, there are substantial pitfalls. The decisions and structuring of specific deals must be made with care and sophistication. Grave dancing is an art that has many potential benefits. But one must be careful while prancing around not to fall into the open pit and join the cadaver. There is often a thin line between the dancer and the danced upon.

FROM LEMON TO LEMONADE

Preservationists have long known that the best way to save architectural landmarks—great structures that catch the eye and stir the soul—is to find modern uses for them. Now the lesson is being increasingly applied to lowly warehouses, seedy hotels, abandoned stables and other cavernous buildings. These are the very structures that not long ago would have been judged blighted, then torn down and lost.

What makes the difference today is money. Because the price of building materials has skyrocketed—structural steel now costs 45% more than it did last year—developers see the old buildings as readymade packages of materials. Even after knocking out walls, putting in new wiring and plumbing, and meeting tough new fire codes, recycling a structure can cost 25% to 35% less than building anew. Says Chicago Developer Ed Noonan: "It's making a lemon into lemonade."

—*Time*
July 7, 1975