

## **Real Estate Value**

Oklahoma City is young real estate. New York City's Manhattan was completely built out about the time the first stake was driven into the Oklahoma Prairie! Our young history and unique geography define Oklahoma City's current real estate valuation.

### ***Location, location, location***

This phrase is the simplest and most reliable way to determine value in real estate. As tired as this phrase seems, it is always true. But what is it that makes a location favorable? The answer to this question is one of the most complex answers anywhere in business.

### **Landlords and tenants - whose value is it, anyway?**

Landlords and tenants (customers and users) value real estate value differently. Simply put, tenants like it cheap and landlords like it expensive. Because empty buildings have no cash generating value (only speculative value), most of the value in a property is created by tenants, so the tenant market drives value in real estate. In the case of tenants who are owners, their occupation value is secondary to the potential uses by higher paying tenants. Just ask all the warehouse owners who moved out of Bricktown to become landlords after the rents shot up in the 90's!

Oklahoma City real estate valuation is strong on cash flows and weak on appreciation. We have so much land and such great roads that very few locations in the city are "scarce real estate resources" which is what it takes to create rapid real estate appreciation. Older coastal cities are the opposite of Oklahoma City as dilapidated inner city real estate becomes redeveloped to reposition it to for higher rents. In a small way, this is what happened in our own Bricktown after the city invested in the Canal and the other downtown MAPS (Metropolitan Area ProjectS) improvements.

### **Undeveloped land**

Our abundance of land is spectacular. Most of it is very developable with excellent access to services and roads. Location, location, location was never more true than it is with undeveloped land. Undeveloped lands' value is purely speculative, so an investor has to determine why any land will appreciate. In Oklahoma City, it is usually due first to road improvement or rerouting (as in the relocation of I-40) or secondarily due to the increase in population new roads service. Occasionally, new installations or improvements will increase land value rapidly, like Tinker AFB did for the land around Midwest City in WWII or Remington Park did for Martin Luther King Street and I-44.

Usually growth is slow and steady, creating wealth over time. Land is usually a good way to leave wealth to your heirs, not create it in your lifetime!

### ***Financial influences on value***

No discussion of real estate value would be complete without a discussion of real estate finance. Real estate is some of the best collateral available for loaning money. It is the

ultimate “hard asset”. Financial considerations rule the ability to build new real estate and control what buyers can pay for existing real estate.

### Leverage and the cost of money

#### *Developers*

Let’s take a typical new development investor’s scenario. If a building and land cost \$100/SF (per square foot of interior space) an investor will generally be able to borrow \$80/SF at 5% interest cost of money over 25 years. This means his annual cost for that foot is about \$5.68 per year in mortgage costs. The investor put in \$20/SF of cold hard cash that *could* have gotten 2% in low-risk CDs. For taking risk with the \$20/SF, the investor wants to make 10 % over the cost of money or 15% on his invested \$20/SF cash:  $\$20/\text{SF} \times 15\% = \$3/\text{SF}$  so the investor adds \$5.68/SF of mortgage costs to \$3/SF of expected cash return to arrive at a base rental rate of \$8.68 per year.

Using the same assumptions at 10% interest cost of money over 25 years, the investor has to ask for \$11.02/SF mortgage costs and seek \$4/SF of cash return, making base rental costs \$15.02/SF, almost twice as high as the 5% interest scenario.

Low interest rates encourage development of new real estate.

#### *Buyers of existing real estate*

Lets say the developer above decided to sell that new building when the cost of money went from 5% down to 4%. A buyer would consider the existing \$8.68 per year, run his numbers and arrive at a price per square foot of \$109.58 per square foot due to the lower cost of money. So the seller could realize almost \$10/SF gain on the building *just due to interest rate fluctuations*.

Low interest rates increase the market value of rented property. This is the current situation. Because of leverage, 1% of interest rate change influences the value of real estate by about 9%.

*Historical real estate market conditions and interest rates*

The following matrix explains the effects of interest rates on values in real estate and gives some historical perspectives for OKC:

	<b>Interest rates up</b>	Interest rates down
Market rates up	<p><b>The condition in a balanced growth economy.</b> If an investor's interest rate is fixed, then they get to keep the increase in market rents as added income. Tenants struggle with higher rents. New investors pay higher mortgage costs but get a reasonable return. This was the stable growth scenario from the 1950's to the 1970's.</p>	<p><b>Strong economy with high saving rates.</b> Tenant businesses struggle with higher rents. Investors can refinance and have lower mortgage payments and higher rents – great for investors! Recently this has been the situation.</p>
Market Rates Down	<p>Oklahoma Oil Collapse of the 1980's. Interest rates soared while the economy plummeted – <b>A real estate investor's nightmare.</b> Good for healthy tenant businesses who get cheaper rents as market rates drop!</p>	<p><b>Deflation – symptomatic of a weak economy.</b> Healthy tenants enjoy cheaper rent. Investors get lower returns on cash invested. If investors have to refinance to stay afloat, lenders are generally unwilling to refinance while rents as values decline. This can create a liquidity crisis which is what happened in the Great Depression of 1929 – 1939.</p>

Tax considerations

Real estate is not easily convertible to cash. Taxes must be paid on all cash gains. If you exchange for a like-kind real estate investment, you can defer the taxes until later, but you are still invested in real estate, just a different piece of real estate. Like-kind means a commercial property for a commercial property, so you can trade commercial land for an apartment complex. **Consult your tax advisors before any real estate transaction.**

Previous Generation Buildings

Because Oklahoma City has always had such good roads and abundant developable land, we continued to build farther and farther out as our population grew. Several generations

of quality buildings have been built in Oklahoma City over the years and because our communities have stayed strong, many of them are still in use. Since many of these buildings have been paid for, the landlords can afford to rent them out for less cost per square foot than newer, leveraged buildings. If landlords sell these buildings, the buyers value them on rents and price them accordingly, thus keeping the sales prices low and the subsequent rents low. Rents will continue to increase moderately since users will continue to opt for this older, more affordable real estate over nearby newer real estate. In some cases akin to Bricktown, older structures will soar in value as they become redeveloped.

### ***Housing Value***

Everyone is involved in the housing markets. Housing may be Oklahoma City's most remarkable property type compared nationwide. This is because of the exceptional values we enjoy in terms of price for quality.

### **Single Family Residential**

Oklahoma City's abundant land and our great skilled labor base shower huge rewards on our residential markets. We may be unparalleled nationwide for home and community value. New land is accessible, schools are generally excellent or aspiring to be, the quality of the structures is very high (due in no small part to our excellent Vo-tech system which trains tradesmen and tradeswomen). Currently there is a land boom going on in single family residential development land in the South Oklahoma City, Northwest OKC and West Edmond, East Moore, and East and West Norman. Low interest rates have enabled many young and lower income households to buy their homes. In so doing, these new rooftops have spawned additional retail developments and have redefined the perimeters of our metro.

### ***Residential Investment***

Homes in the \$100,000 range are still in great demand even after nearly a decade of strong home construction. These "starter homes" are particularly in demand in Edmond and Norman. Many older homes in these areas that need rehabilitation are purchased by individual investors for rehab and resale or for investments/rental property.

### **Apartments (Multifamily)**

During the past few years, multifamily housing has grown to accommodate population growth. New developments all over Oklahoma City have kept up with upscale needs while older multifamily housing has provided affordable housing. Multifamily housing is profitable if it is managed well. It is like running an intensive care unit – if you pay attention things go well but if you don't the outcome is uniformly bad. Well managed affordable apartments are available throughout the city and have sold for historic highs in the last few years. Low interest rates and investors from out of state have bid up the prices for older multifamily units. In the midtown area, investors have purchased somewhat dilapidated buildings and renovated them for more upscale renters.

Deep Deuce is the most notable recent development project in Oklahoma City due to its location in the city core, 294 unit size, relatively high rents and high occupancy rate. This project is an indication of the type of innovative, quality multifamily housing Oklahoma City's core can expect in the next few decades. These new residential communities will cause a revolution in downtown living, eventually creating demand for a whole spectrum of downtown retail from grocery to fashionable shops.

River development, I-40 relocation and downtown rejuvenation will all provide surroundings for stylish and innovative downtown housing.

### *Multifamily Investment*

Older downtown and Midtown housing offer renovation opportunities throughout the metro area. Apartments are now available from Boyington properties on the NW corner of 4<sup>th</sup> and Broadway and at 11<sup>th</sup> in the Lofts. Upscale development is in progress west of downtown in the Old Montgomery Ward building on Main and the Legacy Summit at Arts Central apartments. Others are promised in Bricktown in the Bricktown Brewery block.

Many 1960's and 1970's multifamily housing projects pose unique challenges and opportunities for management, repositioning or total demolition and redevelopment. Properly managed by capable managers, these older projects offer an affordable, safe low income housing with good returns.

New and existing mobile home parks throughout the metro offer excellent opportunities for investors and lower income groups to mutually benefit through good management. This is an essential part of our overall profile of affordable and abundant housing.

### **Retail Value**

Most people have a shopper's familiarity with what makes a retail location valuable. The most important retail shopper's aspects are, in general order of importance:

- Roof tops nearby or daytime population – are there any consumers nearby?
- Traffic counts – does anyone go by there?
- Entry and exit convenience – can they get in and out easily?
- Façade appearance – would YOU or the nearby demographic want to go in?
- Co-tenancy – can you get lots of stuff accomplished with one parking job?
- Drive-through capabilities – can you get it done without getting out?
- Delivery and service locations – can the business easily re-stock without inconveniencing customers?

## Retail – where is the value?

When you are the purchaser of a retail property, all of these things are important along with one more – what is your goal in investing in retail? If your goal is to ENJOY the value of the real estate for income, you are probably also interested in the:

- First rate traffic and flow into the center which promises long term stability
- Quality of the tenant's credit
- The longevity of the tenant (s) leases and
- The number of tenants to manage and provide more income stability (the more tenants you have, the more management you have to do, and the less income is tied to the fortune of one tenant)

If you are a little more adventurous, you might want to purchase a property to “fix up”, so if you want to ADD VALUE to retail real estate, you might look for:

- Routes and rooftops - Traffic arteries create additional customers like the Kilpatrick did way out Northwest Highway or constant growth like West Norman experienced over the last 10 years
- Tired façade on good construction (there are lots of 60's-80's shopping centers that fill this description in OKC) which can be rejuvenated economically.
- Short term leases or under-market leases that can pay the way until the center is repositioned as a better center
- Locations that are great bets for long term use by other retailers (corners for fast food, for example)

These strategies are excellent at either realizing or creating value in retail real estate.

## **Office Value**

If you have ever had an office job, you probably have formed an opinion about what makes an office valuable. But you might not have been the boss, so there are a few subtle things to consider as well:

- How close is it to the boss's house (that's right, this is really high on the list!)
- Does it serve any status needs of the business (is it upscale enough or too upscale)
- How close is it to existing workers' houses
- How safe is the area
- How suitable is the physical layout of the building for the operation of the business (size of the floors, abundance and cost of parking, work environment within the community, possibilities for growth, open or individual offices, air conditioning on weekends, does it have proper power and telecommunication capabilities and backups)
- How easy is it to get to and park (this is really high on the list in OKC)
- How abundant are the knowledge workers for the business (computer companies locate in the Simi Valley, oil companies locate in Houston, auto companies in Detroit, financial traders near New York and government in Washington, DC)
- Cost per square foot (yes, this really is last because a poorly configured office is far more expensive than a properly configured one!). Included in this cost is the considerable cost of compliance with modern building codes and asbestos abatement for older buildings.

### Where is the office value?

In Oklahoma City, most office value is driven by proximity to desirable neighborhoods and access to infrastructure. Prior to the 1960's almost all office space was in downtown proper. With flight to the suburbs and the destruction of many downtown areas, most of the new construction and new office users moved to in North OKC. The Oil Collapse of the 1980's was particularly hard on the office market and caused Downtown OKC great hardship in particular. Recently investors have purchased downtown and bricktown buildings for re-development and are offering them at reasonable rates. The new Federal Campus, Bricktown buildings and buildings built on the west side of Downtown are offering new horizons for office growth. Much of this rekindled downtown interest is due to the MAPS reinvestment in downtown and the realization that Downtown OKC is equally convenient to everyone in the Metro area. This convenience allows Downtown employers to draw from the entire Metro labor pool.

### ***Industrial Value***

Manufacturing and industrial real estate value is controlled by the addition real estate makes to the bottom line. If the value is added by refining a raw product, the manufacturer locates near the raw product. If the value is added through labor, then the manufacturer is located near sources of reliable and inexpensive labor. Distribution companies want warehouses near the places their goods are sold, transported or imported.

Industrial Real Estate is highly varied and is useful for specific purposes. Some considerations for industrial real estate are:

- Is "high cube" warehouse with high storage racks and lots of storage space needed or high transfer, "cross docking" with low racks and lots of doors needed by the marketplace?
- Are the roads adequate to withstand the weight, turning rates and traffic volumes of the business?
- Will the zoning allow the activity?
- Is the activity allowed environmentally?
- Is the labor available nearby?
- Are tax and employment incentives available to the site?

Recently environmental reasons have loomed large for manufacturing firms' relocation. The ability to deal governmentally or practically with waste and environmental issues has heavily impacted the location of manufacturing plants.

Oklahoma's natural industrial strength is distribution. Our location along I-40, a main southern E-W route and I-35, the NAFTA (North American Free Trade Agreement) Highway, and I-44 to Chicago makes it a "natural" for distribution. We already have the roads, labor and land to accommodate it. Things that need to happen to help OKC reach the distribution "big time" are, in approximate order:

- 3 million people within 75 miles (currently there are 1.6 million people in 75 miles). When this happens, distribution is local as well as national.

- A consolidated rail/truck switch where all railroad and truck lines can trade freight. The natural place for this is at Eastern, I-35 and I-40. This would be a great source of jobs for OKC.
- International and Regional Hub airport.
- The “northwest passage” to Denver which would shave 144 miles (two hours) off the trip and make Oklahoma City a one day trip for the Rockies.

It is important to point out that previous obstructions to distribution development such as right to work, employment and investment incentives are already in place and have already helped Ardmore to lure business from Dallas.

### ***Appraisals***

Individual property appraisals are essential parts of the real estate value process. They carefully evaluate building costs, profitability, property history and market forces. Individual property appraisals document the specific facts about a property and reach careful opinions about the probable value and risk associated with properties. In so doing, appraisers enable sellers, buyers and financial institutions to approach the market with confidence and plan for long term goals. Appraisers are very useful in evaluating the costs associated with condemnation and public redevelopment.

### ***The intrinsic value concept for real estate***

Residential real estate value is the center of our communities, giving us a home and a sense of belonging. For the retailer, real estate offers an entry into a market and garners status, a piece of the market share and flexibility to better serve the customer. For the office user, the value of their real estate confers status, grants competitive advantage or gives long stability to its business. For an industrial producer, real estate offers a tool to control production costs, provide operational flexibility, guarantee quality control or deliver to the customer. For institutions like schools, hospitals, airports and government, it offers a specific location to serve the public in a very specific, meaningful way.

Every person values real estate in many ways; everyone has a stake in real estate value.