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CHAPTER 6

The Market for Investment in Fees—Residential and Commercial

Ownership of estates in fee in rented land and improvements presents a different set of investment motives and market conditions from ownership for use and occupancy. The owner of the estate retains the right to receive rent and the right of reversion, but transfers to others, for the term of the lease, the rights of use and occupancy. Ownership becomes principally a means of investment. Unlike the market for estates that consist primarily of use and occupancy, the market for rental properties of the investment type is not local but frequently extends from one city to another and in some cases is international; in the last two decades it has tended, in general, to widen.[1] It is increasingly an integral part of the general capital market and responds to those conditions and forces that influence the flow of capital from place to place and from one type of capital goods to another.[2]

The principal circumstances contributing to the flow of capital into this type of interest in land and improvements are the hope of a high rate of return and the thought of an attractive profit to be had from resale of the interest.[3] Capital tends to flow from stagnant to growing areas, from better established areas to those more rapidly developing, from areas of excess savings to those deficient in savings, and from areas where real estate facilities are adequate to those where they are inadequate. Controls over the direction and flow of

[1] A factor contributing to the widening of this market has been the enactment of state legislation authorizing the investment of life insurance company funds in rental land and improvements.

[2] The unfamiliarity of investors with the technical aspects of all types of capital uses tends to create investor specialization. Thus, some capital specializes in investment in estates in fee in rented land and improvements. Nonetheless, capital flows into this field when prospects are high and is withdrawn when other investment uses become more attractive.

[3] Emphasis placed on the latter may perhaps be taken as a measure of the "speculative" element in this type of investment.

capital—where and when interests are acquired and the prices paid for them—are mainly determined by the views of investors as to the rate of return which can be earned, or the amount of profit which can be realized from resale. Expectations are based partly on the individual investor's previous experience, partly upon analysis of the balance sheet and earnings record of a particular estate, and partly upon the general situation in the real estate market. When these combine to indicate profitable investment, sales and exchanges are numerous. When they diverge or indicate unprofitableness, the market dries up, and sales and exchanges are rare.

About the details of this behavior very little material is available. In the great majority of cases there is no record of investment motives or experience; nor are there any comprehensive data on the identity of the persons or organizations that make such investments. There are, however, three types of organizations that have invested on the basis of declared motives and have published some details of their experience. While the total volume of housing these organizations have supplied is not large, the fact that their record is the only one available justifies discussing it in some detail.

The first is the "limited dividend housing corporation," and the second, estates or foundations that have conducted housing experiments. A third type of investor, the life insurance company, also has made public some record of its experience. These three will be discussed in turn.

Limited Dividend Housing Corporations

The main objectives of limited dividend housing companies have been to improve housing conditions for lower income groups, and to earn a steady but modest return upon invested capital. Though these companies are not numerous, the record of their earnings warrants some attention. Historically, the earliest was the *Boston Cooperative Building Company,* which began operations in 1871. Until its liquidation in 1941, this company earned an average return on outstanding capital in excess of 5 percent, and in some years earnings were as high as 7 percent. It operated dwellings—totaling nearly 250 in number—that in 1940 had rentals ranging from $1.25 a week for one-room apartments to $6.00 a week for four rooms. Its upkeep and maintenance policy was restricted because of its attempt to reach the low-income groups, but most of its properties were maintained in satisfactory operating condition for the entire period of its history.

An outstanding record has been made by the *City and Suburban Homes Company,*[4] organized in New York in 1896 with an authorized capital of $1,000,000 (subsequently increased to $6,000,000) and over $4,250,000 in stock issued. This company was operating 3,822 apartments in 1946. Since its organization, the company has never passed a dividend and has paid dividends at the average rate of 4.6 percent on the par value of issued stock. It has accumulated a surplus of over $2,000,000 and a reserve for depreciation of over $4,500-000; and as of April 30, 1946, its total assets were $12,432,582. Organized during a period of agitation for housing reform, the company began its operations with the construction of two groups of low-priced model apartment buildings. Their design was a distinct departure from the tenement house planning of the time: wide courts took the place of narrow light wells, the so-called air shafts of the notorious "dumbbell"-type structure, and square structures replaced the narrow rectangular tenement which, more often than not, was crammed onto one city lot.

Since its inception, the number of apartments operated by the company has increased both through purchase of existing structures and through new construction. Expressed policy has been to build only during periods of relatively low construction costs. Consequently, no new buildings were added to their holdings between 1920 and 1930, although several purchases of existing structures were made. In 1931, the company resumed construction, building six sections of the Celtic Park project in Queens by 1939. During its first decade, the company constructed 248 small, moderately-priced homes, which were sold to individual purchasers. While the company has sought to maintain its properties in good operating condition and to secure over a long period an adequate return on invested capital, it has also attempted to maintain a competitive rent schedule, which would assure it of reasonable long-run earnings rather than short-run capital gains.

The *Octavia Hill Association* [5] of Philadelphia was organized in

[4] For further details see Federal Housing Administration, *Four Decades of Housing With a Limited Dividend Corporation* (1939) pp. 17 and 20, and annual reports of the company.

[5] James Ford, *Slums and Housing* (Harvard University Press, 1936) pp. 572-82.

1896 to improve lower income class living conditions. It purchases dwellings, reconditions them, and acts as rental agent for similar accommodations. The association attempts to rehabilitate both the dwelling and the tenant and acknowledges the responsibility of the landlord in providing as high a standard of structure and maintenance as is economically consistent with a low-rent policy. As of December 31, 1946, its assets were valued at approximately $436,000; there were 8,661 shares of capital stock outstanding of $25 par value and total mortgage debt was only $22,000. Income after operating charges was $44,000 for the year 1946, and net profit after depreciation and taxes was nearly $10,000. From this amount dividends amounting to $4,332 were paid.

The association paid dividends prior to the depression of the thirties, although not always the 4 percent to which it has limited itself, but none were paid between 1932 and 1943. Earnings during the years 1932-43 were devoted to the reduction of indebtedness, the retirement of obsolete structures, and the accumulation of reserves. Since 1944, modest dividends have been resumed, first at 1 percent and later at 2 percent of the par value of outstanding capital stock.

The *Washington Sanitary Improvement Company* was organized in 1897 in Washington, D. C. From an initial capital stock issue of $500,000, the total net worth of the company increased to slightly over $1,200,000 in 1945. Dividends (computed on the basis of initial capitalization) were paid at the rate of 5 percent from 1897 to 1923, and 6 percent from 1924 to 1929, at 8 percent from 1930 to 1940 (except for a payment of 15 percent in 1938), and since 1941, at the rate of 10 percent per annum.

The *Washington Sanitary Housing Company* was organized in 1904 as a counterpart of the Improvement Company with the purpose of serving a still lower income group. This company has $200,000 in par value of capital stock outstanding, and in 1945 its total net worth amounted to about $416,000. Uninterrupted dividends have been paid since the beginning of operations: 4 percent from 1904 to 1907 (computed on the basis of the par value of initial capital), 5 percent from 1908 to 1944 (an extra dividend of 2.5 percent was declared in 1937 and 1938), and 6 percent in 1945.

Both companies have provided well-built, attractive, and adequately maintained apartments at rents which made them available to low-income groups. Older dwellings have been modernized, and those recently constructed have been equipped with central heating, electric refrigerators, and other modern conveniences. Tenant turnover has been considerably below average. Roughly 60 percent of the dwellings are available for white and 40 percent for Negro occupancy.[6]

The *Cincinnati Model Homes Company* [7] owns and operates several apartment projects, some of which are available to white and others to Negro tenants. Originally organized in 1911 with a capital of $500,000, the company's assets on December 31, 1945, amounted to $576,000, including an earned surplus of slightly more than $121,000. It has had a consistent earnings' record, paying a 5 percent dividend in virtually every year, and 6 percent for a short period prior to 1932.

From its inception, this company has maintained careful records of its operating experience, which reveal that there have been comparatively similar losses from noncollectible rents and less turnover of occupancy among the Negro than among the white tenants.

In New York City, a number of limited dividend corporations have been operating under special legislation that placed them under the supervision of the New York State Division of Housing or of its predecessor, the State Board of Housing. These corporations include: Academy Housing Corporation, Amalgamated Dwellings, Inc., Amalgamated Housing Corporation, Boulevard Gardens Housing Corporation, Brooklyn Garden Apartments, Inc., Farband Housing Corporation, Hillside Housing Corporation, Knickerbocker Village, Inc., Manhattan Housing Corporation, Stanton Homes Corporation, and Stuyvesant Housing Corporation. These companies operate on a somewhat different basis from those previously described, including some tax advantages. For the most part, they were organized to build and operate a single project—varying in size from 44 to 956 dwelling units—and, as a result, the fortunes of each are tied to a single undertaking. Notwithstanding this fact, all projects have operated fairly satisfactorily and most of them have paid dividends (Table 44).

The one exception to this satisfactory record of limited dividend

[6] See the annual reports of each company.
[7] See annual reports of the company, 1930-45.

TABLE 44 – Operating Expenses, Interest, Depreciation, and Net Operating Income per $100 of Total Income, and Mortgage Debt as a Percentage of Total Investment for Limited Dividend Housing Corporations Operated under the Supervision of the New York State Housing Authority, for the Years Ending August 31, 1939 and 1940 [a]

Project	*Operating Expenses*		*Interest*		*Depreciation*		*Net Operating Income*		*Mtg. Debt as % of Total Investment*	
	1939	1940	1939	1940	1939	1940	1939	1940	1939	1940
Academy Housing Corp.	$40.43	$41.52	$23.38	$22.06	$18.41	$18.62	$17.78	$17.80	67%	67%
Amalgamated Dwellings, Inc.	45.61	45.25	27.76	26.35	17.40	17.36	9.23	11.04	67	67
Amalgamated Housing Corp.	44.51	44.15	29.00	26.23	22.51	22.80	3.98	6.82	64	64
Blvd. Gardens Housing Corp.	38.28	39.92	22.63	21.73	18.03	17.77	21.06	20.58	83	83
Brooklyn Garden Apts., Inc.	42.47	44.68	16.52	13.94	18.80	18.70	22.21	22.68	57	57
Farband Housing Corp.	55.03	52.33	28.81	27.90	19.97	19.49	–3.81	.28	66	66
Hillside Housing Corp.	41.05	43.49	26.26	24.71	21.27	21.05	11.42	10.75	89	89
Knickerbocker Village, Inc.	37.22	36.69	29.25	27.99	9.84	9.87	23.69	25.45	85	85
Manhattan Housing Corp.	35.59	42.22	27.27	25.83	13.13	13.20	24.01	18.75	75	75
Stanton Homes Corp.	40.03	50.93	38.25	38.73	15.58	16.96	6.14	–6.62	77	77
Stuyvesant Housing Corp.	40.25	38.21	29.93	27.55	12.90	13.00	16.92	21.24	70	70

[a] State of New York Division of Housing, *Operating Statistics of Housing Company Projects* (March 1942) pp. 3, 17, and 18.

corporations is the *City Housing Corporation,* organized in New York in 1924 with a 6 percent dividend limitation. Between 1924 and 1929, it developed the community known as "Sunnyside," which houses about 1,200 families and, beginning in 1928, "Radburn," at Fairlawn, New Jersey. As of December 31, 1928, the statement of the corporation showed capital of approximately $2,400,000, surplus of $334,000, and total assets of $8,000,000. In July 1931, dividends were passed and, while reorganization was attempted, the corporation was essentially in liquidation.

Estates, Foundations, and Individuals

Housing experiments by individuals and estates are not numerous, nor is their investment record uniform. The record is complete in only a single case—Chatham Village in Pittsburgh, Pennsylvania, initiated by the Buhl Foundation—which will serve to illustrate the complexities of such enterprises. The project was intended, according to the *Report of the Director for the Year Ended June 30, 1931,*

1. To demonstrate the social and economic advantages of the large-scale planned garden homes community;
2. To demonstrate the advantages of social and economic security that are to be had from rental rather than purchase in a community managed from a long-term investment viewpoint;
3. To demonstrate that it is possible to build and operate such a community so as to yield a moderate but satisfactory investment, nonspeculative return. The project is in no sense philanthropic. It is designed to be commercially practicable.
4. To develop new ideas and higher standards in house design and large-scale community planning;
5. Particularly to develop an appreciation of the contributions which may be made by competent site planning to large-scale hillside developments.

The project was thoroughly studied before operations were begun, including the architectural and site-planning possibilities, and the income, housing expenditures, etc., of the group which it was designed to accommodate. Under the auspices of the Bureau of Business Research of the University of Pittsburgh, a careful study was made on the basis of questionnaires sent to employees with salaries of less than $5,000 in large Pittsburgh establishments. From this information it was possible to estimate what rent the group could be expected to pay and what they preferred in housing accommodations.[8]

The problem of architectural and site planning was ingeniously solved, and, in the light of cost studies, it was decided to build not detached single-family houses but a combination of row and apartment houses. Ownership policy was carefully considered and the conclusion was reached that "more amenities at lower cost and a far greater degree of social and economic security were . . . possible under a rental than under a home ownership program." [9]

The operating record of this enterprise was given as follows by Mr. Charles F. Lewis, director of the Buhl Foundation in 1946:

". . . it was opened in May, 1932, when the country was plunging into the trough of the depression and . . . completed its first year with a productive occupancy record for its homes of 97.5 per cent. In the second year, occupancy was 99.1 per cent. In the third, 99.7. In each of the following six years, occupancy was 100 per cent. In 1942 it was 99.8; in the following two years, 99.9; and since then has continued at 100 per cent.

"The record of return on the investment of $1,700,000 has been equally satisfactory. Planned in days in which money earned a higher rate than is now the case, the Foundation reasoned that if the large-scale residential community is a sound investment medium, it should be content with a moderate return. Particularly, it committed itself to seek not more than 5 per cent after depreciation. Originally rentals were set at the average rate of $11.35 per month per room, and those rentals prevail today. Voluntarily, during the worst depression years, the owners put into effect a series of depression discounts which reduced the rents at one time to as low as $9.65 per month per room. In spite of depression and wartime and postwar higher operating costs and frozen rents, the return on the original investment after depreciation was high at 5.91 per cent in the first year, low at 3.9 per cent in 1936, was 4.5 per cent in 1943 and 1944, 4.4 per cent in 1945 and 4.2 per cent in 1946—all after annual depreciation charges, and all calculated on the original investment. More than two million dollars in rentals have been collected with a write-off of less than seven one-hundredths of 1 per cent for uncollected rents.

8 A description of the questionnaire and the results secured from it will be found in Theodore A. Veenstra, *Housing Status of Salaried Workers Employed in Pittsburgh*, Bureau of Business Research Monograph No. 1, University of Pittsburgh Bulletin, Vol. 28, No. 20 (University of Pittsburgh, June 1932).

9 Charles F. Lewis, "A Moderate Rental Housing Project in Pittsburgh," *The Architectural Record*, Vol. 70, No. 4 (October 1931) p. 4.

"Turnover of residents, one of the major items of expense in any housing project, is substantially below the goal figure, the average residence of present tenants being almost seven years. The average residence of tenants who have left the Village has been more than three years. Of departures, almost exactly 50 per cent were because of business transfers to other cities, slightly more than 17 per cent built or bought homes, 14 per cent left reluctantly because of illness, changes in financial situation or similar personal reasons, and about 7 per cent of the total number of departures over the whole 14-year period were due to wartime calls to military service." [10]

The *Improved Dwellings Association*,[11] founded by philanthropist Alfred T. White, was another important early venture into the construction and operation of low-rent dwellings on a limited dividend basis. Mr. White's two projects—"Riverside" in Brooklyn (1890) and "Tower and Homes" in Manhattan (1877)—were precursors of the modern garden apartment arrangement of multiple dwellings. They were built around a central garden, each of the 499 apartments being no more than two rooms deep. Although the facilities originally provided appear rather primitive today, at the time of their construction they were a great advance over the housing available to low-income groups.

The total initial investment in both projects amounted to approximately $600,000.[12] Rentals were less than commonly demanded for slum quarters, ranging from $2.00 to $4.00 per week. In the first year of operation, the Riverside project grossed approximately $39,000, and netted nearly $11,000 after depreciation, a return of 3 percent on the $350,000 invested.[13] Except for the year 1935, Riverside has yielded a net profit, which in some years reached as high as 6 percent. The deficit was incurred at a time when extensive remodeling, amounting to almost $182,000, was undertaken—71 per-

[10] Charles F. Lewis, "The Large-Scaled Planned Community as an Investment," *Proceedings of the 41st Annual Meeting of the American Life Convention* (October 1946) pp. 260 ff.

[11] Further details on Mr. White's work will be found in Robert W. De Forest and Laurence Veiller, *The Tenement House Problem* (New York, 1903) pp. 97 and 364; James Ford, *op. cit.*; Edith Elmer Wood, *Housing the Wage Earner* (New York, 1919) pp. 96-98; and Alfred T. White, *Improved Dwellings for the Laboring Classes* (New York, 1879).

[12] "A Tenement Turns Inside Out," *The Architectural Forum*, Vol. 71 (November 1939) p. 406.

[13] Subsequent financial discussion is limited to the Riverside Apartments. The histories of both projects have been almost parallel.

cent of the remodeling costs having been charged against current earnings. In 1938 the rent levels were $3.00 to $4.80 per week on the unremodeled apartments and $23.00 to $37.00 per month, including utilities, on those remodeled.

The *Michigan Boulevard Garden Apartments*[14] were erected in 1929 in Chicago for Negro occupancy, and financed by Julius Rosenwald at an original cost of $2,700,000. This cost was met by a common stock issue of $1,500,000, a mortgage of $1,000,000, and an unsecured note for $200,000. No financing fees were charged. The development occupies an entire city block in the Negro section. Ground coverage is low and the open spaces are landscaped; provision is made for a children's playground and other community facilities. The 421 apartments—from three to five rooms—are attractively arranged and fully equipped with modern facilities. Tenants are carefully selected and the management has been successful in generating considerable community spirit among the occupants.

During the early years of operation, the project earned roughly 4 percent on the common stock and paid 5.5 percent interest on the mortgage; interest paid on the note is not indicated in the annual reports. From 1932 to 1934 earnings dropped to a very low level, and losses were incurred in 1935 and 1936, the last year for which public reports are available. Full interest payments were made on the mortgage throughout this period and total indebtedness was reduced by $645,500, $200,000 being paid on the unsecured note and $445,500 on the mortgage loan.

Average rent per room per month was $16.25 in 1930, but was lowered to $10.40 in 1934 in an attempt to reduce vacancies. By 1936, however, the project was virtually 100 percent occupied and rents were increased to an average of $11.55 per room per month, exclusive of electricity and refrigeration. Owing to the rent levels, moderate rather than low-income families are attracted to the project. Most of the tenants are civil service or railway employees, but there are also a number of laborers connected with the stockyards and the meat-packing industry.

[14] For additional information see Edith Elmer Wood, *Recent Trends in American Housing* (New York, 1931) pp. 235-36; and Edith Elmer Wood, *Slums and Blighted Areas in the United States*, Federal Emergency Administration of Public Works, Housing Division Bulletin No. 1 (1935).

In 1929 the Marshall Field Estate built a large apartment development on the north side of Chicago. The *Marshall Field Garden Apartment Houses*[15] consist of ten five-story structures and contain over 600 apartments. Units range from three and one-half to six rooms and have modern conveniences; they are fireproof and are serviced by elevators.

The cost of the land and improvements is reported to have been in excess of $5,600,000. Original rents averaged $13.50 per room per month. The rate of return earned by the project during the first five years of its operation varied from 2.37 percent to a loss of 0.38 percent (1933). A small net return was earned in 1934, the last year for which data are available.

The *Paul Laurence Dunbar Apartments*[16] built by John D. Rockefeller, Jr., in 1928 occupy an entire block in New York's Harlem. The project's six buildings cover only 50 percent of the land within the building line, and are arranged around a central garden court. Apartments are carefully planned and well equipped and many community services, including a nursery, children's playground, club rooms, and shopping and banking facilities are available. The initial cost of land and construction has been estimated at about $3,300,000. At first the apartments were sold on a cooperative basis, each tenant making a down payment of $50 per room and subscribing to stock amounting to the cost of the apartment selected. The initial monthly payment averaged $14.50 per room, which was about equally divided between maintenance cost (including taxes and insurance) and debt service.

Financial difficulties occurred during the depression, and in 1937 the entire project was sold to the Methodist Episcopal Church, which has operated it on a rental basis since that time. There was some difficulty in renting the apartments on the top floor of this six-story walk-up, but by the end of the thirties virtually 100 percent occupancy was attained. Current rent levels range from $10 to $12 per room per month.

[15] For additional information see Edith Elmer Wood, *Recent Trends in American Housing* (New York, 1931) pp. 234-35; and Edith Elmer Wood, *Slums and Blighted Areas in the United States,* Federal Emergency Administration of Public Works, Housing Division Bulletin No. 1 (1935).

[16] See Edith Elmer Wood, *Recent Trends in American Housing* (New York, 1931) pp. 224-28; and James Ford, *op. cit.,* pp. 743-48.

Life Insurance Companies [17]

Within recent years it has become possible for life insurance companies and mutual savings banks in certain states to invest a portion of their funds in housing. It can be assumed that the primary considerations of these institutions are for security of funds and regularity of income rather than for speculative profit. The first such operation was undertaken by the Metropolitan Life Insurance Company in 1922 in the Borough of Queens in New York. This development was an outgrowth of the company's desire to make some contribution to the solution of the housing shortage existing at the time and of specific enabling legislation passed by the New York legislature.[18] Some 2,000 families were provided for in five-story buildings containing three- to five-room apartments, which, under the Enabling Act, could not exceed a rental of $9 per room per month. Reports indicate that there have been relatively few vacancies from the time the building was ready for occupancy and that the income has been satisfactory to the officers of the company. It was reported to the Temporary National Economic Committee, however, that during 1933 the net return on the mean admitted asset value of the premises was only 0.67 percent.[19]

During the early part of the depression, the Prudential Insurance Company of America undertook a similar development in Newark, New Jersey. A complete record of operating experience is not available, but the Institute of Life Insurance reports that the company has realized a net return on the project of close to 4 percent.

Both of the above undertakings must be considered as experimental. In 1938, life insurance companies in New York were given general authorization [20] to invest a portion of their funds in housing. Prior to the beginning of World War II, the Metropolitan Life Insurance Company had expanded its housing operations and was building rental projects in the metropolitan areas of Washington,

17 A more complete statement on rental housing projects constructed and operated by life insurance companies is in a study made by the Institute of Life Insurance for the forthcoming *Encyclopedia of Housing,* edited by Joseph H. Bunzel.

18 N. Y. Laws, 1922, c. 658.

19 U. S. Congress, Hearings before the Temporary National Economic Committee on Public Res. 113: *Investigation of the Concentration of Economic Power,* Part 10-A, 76th Congress, 3rd Session (1940) p. 260.

20 N. Y. Laws, 1938, c. 25.

D. C., Los Angeles, and San Francisco. In 1945, Connecticut [21] and Massachusetts,[22] following the lead of New York, authorized life insurance companies with home offices in these states to invest a portion of their reserves directly in housing projects.

In the meantime, legislation was passed in 1941 and 1942 by New York State enabling local government units to make tax abatement concessions to corporations building housing projects in slum or blighted areas under the Redevelopment Acts.[23] Acting under this authority, New York City entered into a contract with the Metropolitan Life Insurance Company which stipulated that taxes would be frozen for twenty-five years for the redevelopment project known as *Stuyvesant Town* at the amount assessed prior to the undertaking.[24] Subsequently, under their general powers, Metropolitan undertook two other projects in New York City, *Peter Cooper Village* and *Riverton.*

At the end of 1949, legal reserve insurance companies had $338,000,000 invested in housing projects completed and occupied, plus $142,000,000 committed in projects under construction. Projects planned but not yet under construction were estimated at an additional $15,000,000.[25]

Within recent years, life insurance companies have also acquired by state legislation the specific power to invest funds in estates in fee in rented nonresidential land and improvements.[26] The first of the state Enabling Acts was passed in Virginia in 1942. By the end of 1947, specific enabling legislation existed in thirty-six states. These enabling statutes vary considerably, but, in general, they authorize life insurance companies, both domestic and foreign, to invest a stipulated percentage of their assets in land and improvements in fee. This percentage varies from 3 to 20, with the more important states falling in the 3 to 5 percent range. Many statutes require that the funds so invested be amortized or "written off" at a specified yearly

21 Conn. Gen. Stat., Supp. 1945, c. 218, sec. 826h.

22 Mass. Acts, 1945, c. 654.

23 N. Y. Laws, 1941, c. 892; N. Y. Laws, 1942, c. 845, as amended by N. Y. Laws, 1943, c. 234.

24 Contract approved by the Board of Estimate, June 3, 1941, Calendar No. 4.

25 Data provided by the Institute of Life Insurance.

26 For a summary of this legislation, see Willis H. Satterthwaite, "Investments by Life Insurance Companies in Income Real Estate," *The Insurance Law Journal,* No. 296 (September 1947) pp. 771-75.

rate, usually 2 percent. In some states, the authorization applies only to real estate held for lease, and in a number of instances the term of leases, or the range of terms, is specified and the legislation requires the entire capital cost to be written off during the original term of the lease.

In operating under this legislation, life insurance companies have not pursued identical policies. In some instances, their primary concern has been with the credit rating of the lessee and the likelihood of his fulfilling the obligations contained in the lease, which need not depend exclusively on the net revenue-producing capacity of the property in question; in others, the principal emphasis has been on the net revenue-producing capacity of the land and improvements, whether leased to a given tenant or offered for lease in the open market.

In both cases, the insurance companies take the position that the net return from leasing the premises must be sufficient to amortize the capital investment and pay a satisfactory interest rate on the outstanding balance over a period ranging from fifteen to thirty years. The leases executed at the time of purchase of the fee provide this net return, the tenant paying all operating costs and taxes levied against the land and improvements. When the credit of the tenant is the prime consideration, the insurance companies are not so much concerned about the price paid for the fee as they are with the rate of return, which determines the net rent. Since the price must be amortized during the original term of the lease, the principal item to agree upon is the interest rate. The amortization schedule plus interest on the outstanding balance must be met by the net rent.

For the seller-lessee the important considerations are the amount of cash received, which can be used as working capital, the tax advantage gained through sale and lease-back, and the prospective burden upon operating revenue arising from the rental schedule.

The same reasoning applies to the seller-lessee when the main consideration is net earning capacity of the land and improvements rather than credit rating. In these cases, however, the insurance company is limited in the price it will pay for the fee by the further consideration of the rent-paying capacity of the land and improvements, if offered in the open market. The alternative chosen depends upon both the credit rating of the seller-lessee and the character of the land

and improvements involved. The more highly specialized the land and improvements, the greater the likelihood that their use and occupancy would not be readily marketable in the open market; hence, the more important the credit rating of the seller-lessee.

From the point of view of the insurance company, the transaction offers an opportunity to invest funds at a higher return than that obtainable from government bonds, and more comparable to the yield from traditional mortgage investments, presumably with a comparable degree of safety. At the end of 1949, it was reported that life insurance companies had invested about $500,000,000 in this kind of estate.[27]

Operators and Promoters

There is a very meager record of experience covering the ownership in fee of rented land and improvements in which the principal motive is that of speculation or capital gain. It is common knowledge, however, that there is much speculation in real estate from time to time. The two principal forms of this speculation are the purchase and sale of interests in existing land and improvements, without any major change in the improvements, and the construction of major improvements which frequently involve the razing of existing improvements, referred to, respectively, as "operating" and "promotional" activities.

In periods of expansion, activities of the operating type consist principally of securing title, or the right to title, in the expectation of quick resale, sometimes in a matter of days. At the height of some speculative booms resale has not even waited upon the completion of a transaction, including the search of title and the final closing. At the height of the Miami boom, in 1924 and 1925, it became common practice to execute a simple option to purchase, with a modest sum paid as a binder, and to transfer this from hand to hand, always on payment of an increasing consideration. In less highly speculative situations, resale is not so likely before completion and closing of the transaction, but it is not unusual for several transactions affecting the same property to occur in a few months.

In some cases, the operator improves the property or introduces new uses in order to justify setting up a larger gross rental schedule.

[27] Institute of Life Insurance, *Life Insurance Fact Book, 1950,* p. 67.

The extent of such improvements or changes depends in considerable measure on the difficulty to be encountered in resale. Success depends on the operator's ability to judge general trends in the market, and to select individual parcels for which repurchasers are most likely to appear at an early date.[28]

Other operations, appearing in the last stages of contraction or in early recovery, depend more on long-term market changes than on quick resale. These usually involve the acquisition of a nominal equity on a basis that does not require, either at time of purchase or subsequently, the investment of a considerable amount of funds. The transaction is likely to be completed under distress conditions, frequently those in which mortgages have been, or are about to be, foreclosed. In any event the decision to purchase is more likely to depend on the terms on which the purchase can be made than on the price, since success depends less on price changes in the immediate future than on the operator's ability to meet the carrying costs of the property out of income until market conditions have changed sufficiently to enable resale at a profit.

Both types of operation, where resale is immediate and where it is deferred, involve trading on the equity, and it is to the advantage of the purchaser to use as little equity as possible. Risk is the essence of the operator's activity, and to the extent that he can transfer risk to others (that is, the more he can reduce the amount of his own funds invested) the more he cuts his loss, in case of loss, and the larger his profit, in case of profit.

Promotional operations, on the other hand, usually involve making new improvements. In the typical case, the promotional operator secures a fee or long-term leasehold interest in a parcel of land and has plans drawn for its improvement. Next, financing is arranged and a campaign is conducted to lease the space.[29] When leases have been executed covering a considerable portion of the space, the fee or long-term base is offered for sale by the operator as an investment or speculation. In many instances architects, contractors, suppliers of material, and the original landowner may be parties to the transaction, at least to the extent of taking their profits in some form of in-

28 The operator who appears to be proceeding upon this basis is sometimes acting as a blind for the long-term investor who already has his plans for development of a project and who uses the operator to conceal the identity of the ultimate user.

29 The various financing devices are described in Chapter 2.

terest in the enterprise. The promotional operator's remuneration may be an interest in the enterprise, or cash fees collected at different points in the development of the transaction.

In any case, those who participate in the promotional development realize that its profitability will depend on the selling price, and this mainly on the actual or prospective gross rental schedule, at whatever stage in the process the sale may occur. If this process extends through to the rental campaign, and through at least partial filling of the space, every effort will be made to build up as large a gross rental schedule as possible. The space produced, therefore, will be priced as high as the market will bear. If necessary, rents may be modified by large concessions, the owners may undertake to pay the rent due on unexpired leases elsewhere of new tenants, and any other means available may be taken to make gross rents look as large as possible.

Expectations, Debt Service, and the Landlord's Interest

The price of the landlord's estate depends upon the income which it is expected to produce and the rate at which prospective purchasers capitalize future income in calculating present worth. When rents are rising and interest rates are falling, and when either or both of them are expected to continue on this course, the price of the landlord's estate rises at an accelerating rate. As indicated above, if the landlord's estate is mortgaged at a fixed rate of interest, the burden of debt service diminishes as net operating revenue rises; in other words, net revenue, which governs present value on any capitalization basis, increases at a more rapid rate than gross revenue (rents). Furthermore, the larger the indebtedness on which the debt service is fixed, the greater the rate of increase in net income after debt service and consequently in capital value during periods of rising gross revenue.

On the other hand, if rents and net operating revenue decline, the fixed charges become increasingly burdensome in relation to total operating revenues, and the more heavily the property is mortgaged, the sooner decreases in gross rents wipe out net revenue and reduce it to a point where the operating costs plus taxes and debt service cannot be met out of gross revenues. As net income declines, and expectations of further decline appear more likely, the price of the landlord's estate goes down at an accelerating rate. In a sense, then, the relationship between debt and equity is the measure of the speculative element in the investment. An investment made for long-run earnings is ordinarily protected by a wider margin of equity than one made in the hope of large profits from a quick turnover.