RECAP
REAL ESTATE ADVISORS

FEBRUARY 14, 2012 ISSUE 43

State of the Market 43: Plan for more futures

By David A. Smith

If it teaches us nothing else, history demonstrates that things can suddenly change – and yet over and over, perhaps because we deal in durable assets delivering an essential service (shelter), we tend to operate on the erroneous assumption that past is always a smoothly curving prologue, and we resist planning for the unexpected. We dig mental and organizational trenches against its arrival, or pull up organizational drawbridges against unwelcome messengers from the future.

Though any given event may be unexpected, disruption is certain. Sometime in the next few months, some event will disrupt our business – for long term or for short, for bad or for good. Though we don't know what or when or how, we should think of the time between now and that whenever as our precious opportunity to prepare – by developing a robust strategy that works across many alternate futures, both the future we want and the future we'll get.[1]

Where you break away from your competitors isn't on the highway, but rather when you can more quickly respond to the inevitable detours.

What is a disruption?

A *disruption* is any discrete event that we do not control which makes a sudden and large-scale change (good, bad or ugly) impacting our business. Any imaginable disruption has three dimensions:

"We always have non-recurring events."

- **Impact**. Some disruptions, such as natural disasters, can be only bad at their impact. Others can be only good. Most are double-edged: immediate interruption and collateral damage, followed by opportunity created through the opening of new business spaces.
- **Timing**. Some discontinuities (like elections) arrive on preset schedules; others (like earthquakes) may be eventually inevitable but unexpected at any instant.
- **Likelihood**. Much has already been written of Black Swan risks, things unlikely in themselves but massively destabilizing should they occur.

What disruptions influence our industry?

Compared with other industries, multifamily residential and affordable housing face many more disruption risks than most, because we span the entire spectrum of speeds of change. At one end, we build and own the slowest asset class – physical properties, long-lived and immovable. Conversely, we finance via the fastest asset class –the capital environment, where money has become intangible, globalized, and highly volatile, both as to price and as to availability. Decisions we make based on a possibly fleeting financial environment are petrified into bricks and sticks, and that means we can be hit by disruptions of at least ten types:

[1] As the keynote speaker at the Affordable Housing Tax Credit Coalition's annual meeting, I gave a talk on *The Future We Want*; the Future We'll Get. Email me and I'll send you the PowerPoint slides.

38 Chauncy Street, Suite 600 | Boston, MA 02111
T: 617.338.9484 | F: 617.338.9422
E: info@recapadvisors.com | W: recapadvisors.com

- **New business models**. What gets an industry is not the frontal threat of normal competition for market share, but the flanking action of a complete change in the competitive landscape. While the television networks were busy fighting off premium cable, did they realize their bandwidth would be consumed by YouTube and Facebook? In our world, what if the customization and complex pricing used in hotels were brought to the apartment business?
- **New laws**. When elected officials go into a furious huddle, almost anything can come out. Further, the higher the unit of government, the more people and industries new laws will affect, *and* the more likely technical concerns will be swept aside by an over-arching principle, so when the Federal government makes a sweeping change, all sorts of business are disrupted. Health care reform is one such, both its enactment and its potential partial invalidation by the Supreme Court, which will increasingly impact multifamily residential through elderly housing.
- **New business rules**. Whom the voters blame, they tend to shackle. As people involved with residential real estate, we are right now the nation's second-least-liked industry, trailing only bankers. While Senator Dodd and Representative Frank will both soon be gone from Congress, their names will live on for decades through the cascading business-disrupting consequences of their financial reform legislation.
- **New resources**. When a problem becomes politically large enough, at it will be flung gobs of money. Some will have their buckets waiting. The stimulus legislation created the LIHTC Exchange and TCAP loan programs; Hurricane Katrina brought us the GO Zone tax credits. More such largesse is coming, especially in the single-family and small-rental inventories.
- **New technology,** both physical and financial. Green and energy-conserving technology remains so much the rage it is rendering Thomas Edison's incandescent bulb extinct. In financial technology, the Rumpelstiltskin of securitization for a time spun loans into fools' gold, and then, when we guessed his name (Credit Default Swap) evaporated in a puff of unsecured debts. Possibly the next financial technology will be via mobile banking (money stored in your phone) and virtual-world gaming, where people pay real cash for virtual-world currency. Will there be a digital CRA?
- **Value chains**. Resources and rules create new business relationships, some of which can rapidly multiply and overrun previous business areas. Conversely, value chain links can be destroyed or disrupted. New Jersey eliminated COAH, the Council on Affordable Housing, which had been the resolution forum for inclusionary zoning, bringing those functions back to the state. California recently abolished all redevelopment agencies (RDAs), bringing their money back to the state.
- **Disruptive business models**, particularly those enabled by technology. Apartment rentals are already experimenting with airline-style dynamic lease pricing; can the Groupon leaseup incentive be far behind? Or the day you can rent an apartment via Amazon?
- **Edifices that topple**, leaving either sudden demand drops or value chain voids. LIHTC prices plunged when Fannie Mae and Freddie Mac went into conservatorship. AIG's bankruptcy upset the applecart on hundreds of guaranteed investments. What if a state were to go into bankruptcy – where would the reverberations stop?
- **Price spikes or divots**. In the last half-decade, LIHTC has bounced around from 105¢ to 70¢ to 95¢. Will anyone warrant that the bouncing ball has stopped? (What if the GSEs reversed previous announcements and sold off their useless LIHTC?) For that matter, would you make a large wager concerning where interest rates will be in 12 months? 18? 24?

- **Stabilization expirations without renewal**. We're familiar with this at the level of individual properties, with the mini-shock of §8 contract expiration and rent reset or vouchering out. Looming in the next months and years are billions of dollars' worth of bullet or balloon loans, plus those that have already reached maturity and are in the netherworld of 'extend and pretend' short-term rollover.

The sample discontinuities listed above are only a subset of what the universe could have in store for us. Just because it's illogical doesn't make it impossible.

How do you plan for disruption?

Disruption planning isn't clairvoyance. Instead it requires envisioning the future as a cluster of possibilities – call each a Plausible Future – then choosing a robust action strategy (a set of tactical actions) where your business prospers in many of them. Developing such a strategy entails activities like these:

- **Find the fault lines where pressure is building, and assume they'll crack sooner or later**. Things that can't go on forever, don't. Some things are known to be inevitable eventually, the only questions are when and in what form. If you live on the San Andreas Fault, you buy earthquake insurance and you seismically reinforce your building. Higher taxes, lower Federal spending, and higher inflation are all coming – at issue is only when and in what form.
- **Scenario-plan the consequences of a few big nasty shifts**. Identify something unlikely-but-thinkable, assume it occurs at Time Zero, and ask, *what happens next?* Say that Congress, in a grand-bargain spasm of tax reform simplification, repeals LIHTC along with all other tax preferences. What concurrent disruption takes place (repeal of mortgage interest deductibility for second homes)? What market consequences follow sequentially? Put your smart executives in a room, give them each a role to play (regulator, competitor, investor, lender), and improvise what they do when.
- **Have well-thought-out and periodically-refreshed contingency plans**. Choose a set of futures, preferably ones with widely varying disruptions that do not necessarily correlate (e.g. interest rates, tax reform, CRA reform, Federal funding levels). Develop contingent business plans that you can execute swiftly if called upon to do so: *We can do This with That much lead time and These resources.* Then lay your plans, one by one, against your set of futures, one by one, and prioritize accordingly.
- **Spend some money creating business capacity for environments that don't yet exist**. Think of it as stealing a march on the future. To do so, your budget will have to include some money you can afford to 'waste' on ventures designed for seemingly frivolous counterfactuals.
- **Diversify each business line's customer and supplier bases**. While it's tempting to have only a handful of large customers, and only a few suppliers, customers are fickle and suppliers fluctuate. Paradoxically, individual risks become less disruptive as an enterprise diversifies the types of risks it takes.
- **Diversify your business lines by sector and by business cycle**. Enterprises that have multiple business lines not all tied to the same resource cycles are better able to weather revenue or cash interruption that often follows disruption, and to maintain capital and resource-management discipline. Too many developers do the next deal to pay for the last one.
- **Modularize your organization**. Boil down your internalized activities to the essentials, then keep those functional units small and focused on those core activities. That way you are paying on salary only those control-booth executives who coordinate the disparate pieces.

- **Outsource any technical activity that has variable demand**, and build relationships with vendors whom you may not need immediately but whose ability to ramp up quickly may be a lifesaver in a crisis. Shelf contracts – a pre-approved menu of services cleared by your contracting department – can enable you to pounce on a fast-moving opportunity. Conversely if you are downsizing an activity, it's not you laying off employees, you're just shrinking the contract of an outside service provider like an asset manager. In turn, that asset manager can take the downsizing risk, because it will have many accounts or different business lines and can flex the people.

What big discontinuities will be forthcoming in our world?

Want some ideas to get you started? Here are some whose possibility ought to figure in your intermediate-term planning:

- **Elections**. The voters elect President Romney, a Republican House, and a Republican Senate. What would their housing priorities be? What would that trio do in their first hundred days? (President Reagan's first hundred days gave us big tax cuts and accelerated depreciation.) Then flip it around: President Obama, a newly Democratic House, and a filibuster-proof Democratic Senate. Where does your business go then?
- **CRA two point zero**. Assume that it's much broader, covering many more financial institutions and financial products, and no longer tied to geography but instead to poverty levels. And it levies a millage tax on all deposits and assets, which creates a capital source that regulated institutions must use on affordable housing and community reinvestment. What does that do to cost and availability of capital?
- **Tax reform: passive losses junked, brackets increased, tax preferences eliminated**. The Federal government will be looking for money everywhere, from everyone. If the mortgage interest deduction is cut in half, what does that do to rental demand?
- **Public housing is decontrolled in a big bang**. Imagine that all public housing authorities are block-granted sums from Congress and instantly converted into non-profit corporations – both liberated and uncoddled. Can you eat them, or will they eat you?
- **Bankruptcy of a state**. The new tough-talking governor of a large state (if you want to envision a specific, try Illinois) declares a state of emergency and suspends payment of all bond debt service and pension obligations pending investigation into alleged previous corruption. How does that affect the state's agencies, and those of neighboring states?

Conclusion: always anticipate the unlikely

What you can't control, you can nevertheless anticipate. If you don't, you can be sure your competitors will.