# Lessons from the Trenches and a discussion of investing madness

*By Gerald Guterman*

***Lessons from the Trenches and a discussion of investing madness….due diligence, internal rates of return and other investment fairy tales. Gerald Guterman***

**SOME HISTORY**

My name is Gerald Guterman. My company, Guterman Partners, LLC together with its processors in interest, have been active real estate investors and operators for more than forty three years. About thirty five years ago, the company completed its first condominium conversion of an existing rental apartment building. Since the beginning, the company has successfully completed the conversion and sale of approximately 15,000 rental apartments in the Greater New York area as well as apartment communities in the South and Mid-West of the U.S.

**THE TRANSACTION**

With this information as "light" background, I would like to tell you of my latest experience with the current climate for real estate investing and the madness that has overtaken it.

A few months ago, I was involved in a real estate transaction that twisted and turned into oblivion when after the bells rang and in spite of my prior experience with a particular real estate broker, I submitted a Letter of Intent, to purchase a New York high-rise apartment building.

I received the Offering Memorandum for this building about two months earlier and after a thorough review of the financial information and other miscellaneous information provided by the broker, I made the formal offer in the last hour of the last day of the open offering period.

The property is a vacant 28 story building originally completed in 1930. During these last two years, the owner/seller completed an extensive renovation and rehabilitation that included a new central heating system and air conditioning system, new windows, new elevator cabs and a completely rebuilt elevator lift and signal control system, new hallway lighting and carpeting, complete renovation of every kitchen and bathroom in all of the apartments, including all new appliances and a newly decorated lobby with a concierge and reception desk. Lastly, a pressure washing of the entire exterior structure.

I thought the price was high, but I always think the price is high. However, I submitted the offer and waited for almost a week (usual with New York brokers).

I was invited to participate in a second round of bidding called a "best and final" offer.

After a little soul searching, because I have always believed that the profit is made when I purchase a property, never when I sell, (and where was I getting the additional capital?), I increased my offer by slightly less than five percent.

For those of you familiar with Manhattan residential real estate and for those who are not, a high rise residential building in a higher than average disposable income area, will trade to an investor for amounts in excess of one thousand to eleven hundred dollars for each interior, rentable, square foot of apartment space (Net Square Feet), regardless of the cash on cash return.

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There are one hundred twenty apartments with each having an average size of about nine hundred fifty Net Square Feet, or a total for the building of approximately 114,000 Net Square Feet.
My original bid was $125million which equates to $1,096.00 per Net Square Foot. A Five percent increase in the purchase price makes the property $6,000,000 more than earlier in the day. Now I am at 131million or $1,149.00 per Net Square Foot, but with a “finished” and upgraded property. However, because the building is vacant and there is no revenue to pay for the operating expenses or the taxes, insurance and of course the debt service on the loan [$110million dollars+-] during the condominium sales period. Of course the lender knows me and the company and knows that the building is being purchased for a condominium conversion. Therefore, the interest rate will settle at about 7.8 percent per annum. My team estimates that we will deliver the significant portion of the apartments to the purchasers of the condominium, no later than the first day of the thirteenth month from the date of our purchase. We further estimate that the balance of unsold apartments (about 30% to 35%) will be evenly sold and delivered during the succeeding eight months.
[Without anyone voicing an objection, I will appreciate the reader accepting that we understand how to price and we do the demographic studies well in advance, so that we always sell the product that best fits the specific area where the property is located and at a price that is slightly under the market.]
The total amount of capital that is needed is $145million dollars including the total purchase price and closing costs, fees paid for the loan and equity raise, operating costs for at least a year and a debt reserve equal to at least twelve months of interest or $8.58milliion dollars.
My formal best and final offer contained the following terms and conditions;

1. Purchase Price: $131,000,000
2. Additional capital: $14,000,000
3. Initial deposit: $3,000,000 at contract, refundable to last day of the Due Diligence period
4. Additional deposit: $3,650,000 payable to last day of Due Diligence period, thereafter, non-refundable together with the initial deposit
5. Closing date: 45 days + 30 additional days after due diligence period with time is of the essence for the final 30 days.
6. Due Diligence Period: 10 days + 5 days to complete and sign the contract.
7. Environmental report: preliminary report delivered during initial period with written report delivered 5 days after contract signed
8. Engineering report: preliminary report delivered during initial period with written report 5 days after contract signed

**THE MADNESS**

- During the open bidding period a group unknown to us made a best and final bid for the property that was accepted by the seller.
- Purpose: To rent the apartments long term income.
- The offer:

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1. Purchase price: $137,500,000
2. Additional working capital: $3,000,000 + rent to cover operating costs
3. Initial deposit: $8,000,000 due at contract, non-refundable
4. Subsequent deposit: $7,000,000 due in 21 days, non-refundable, time is of the essence
5. Closing Date: forty days from contract, time is of the essence.
6. Due Diligence period: O
7. Environmental report: None ordered
8. Engineering report: None ordered
9. No loan commitment obtained

**THE RESULT**

- No closing occurred.
- Additional deposit not was paid on time
- Extension of two weeks for the buyer to pay the additional deposit, time is of the essence
- Initial deposit released (out of escrow) to seller, as a condition of the extension
- Additional deposit was not made
- Buyer was called in default
- Seller kept $8,000,000 deposit

1. Seller relisted property for sale

**LESSONS FROM THE TRENCHES AND THE RULES**

If I accomplish nothing more than holding your attention for a few minutes, I sincerely hope that you will take what you think is worthwhile and remember some of the Rules I live by, as a professional real estate investor.

The first and most important rule of real estate investing……

"EVERY SELLER IS A LIAR AND EVERY DEAL IS A BAD DEAL"

I have found that there is no exception to this rule. Every seller or his representative will lie in some way, either by outright misrepresentation, slanting the facts to direct your attention away from unfavorable information or simply failing to deliver unfavorable information (called a lie by omission). You owe it to you to insist that all of the appropriate information be delivered to you. For instance, if you are buying an older building or even if the building is fairly new, you must receive by purchase or otherwise an environmental report concerning the materials in the building (walls, floors, roofing) or any adverse material in the land, such as gasoline or oil seepage. If the property is a multi-unit


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residential building and has been operating for a number of years, you must receive the monthly and annual income statements for at least three preceding years as well as the vacancy report for the same period so that you can determine if the current vacancy rate is an aberration or is consistent with prior years and if there are any apartments that are consistently vacant and why. Finding asbestos, such as in floor tiles or in older buildings or finding asbestos insulation can either cost you money in the future or you can reduce the price to account for the defect and change the deal to more in your favor. The facts and if required adjusting the price will often turn a bad deal into a good deal. If you can't get the necessary information from the seller or his representative, assume they are lying and have something to hide. Either receive the appropriate information you requested or let some fool buy the property. Don't be intimidated if the seller tells you that you're supposed to "know" these things. Nonsense…
Your knowledge of the property before closing should be guided by hard, in-depth, confirmed reality (facts). "Perception is not reality".

**DUE DILIGENCE**
Which brings us to Due Diligence and the fact that the buyer in the transaction I described above, didn't think Due Diligence was necessary. I was told directly by the buyer that he received sufficient information from the seller.

*"Due Diligence is a must"*

- If you are inclined to purchase a property without reasonable time to inspect the property and the books and records, I suggest the following remedy….

*"Immediately after the closing, check yourself into a mental institution….*
*It's safer for you".*

**YOU MAKE THE MONEY WHEN YOU BUY**
The seller informed me that cash flow wasn't important because of the continuing rise in real estate prices and that he would make a high enough internal rate of return when his company sold the property in five or so years.

My only answer to this absurdity goes back directly to one of my rules.

*"A professional real estate investor makes the money on the day the real estate is bought, never on the day the real estate is sold".*

Think about this rule… think about whether you purchased a property recently or ever purchased a property and then read a magazine or weekend article in a newspaper. Did you think; "does everyone else know something I don't?" "Did I buy at the top of the market and should I worry about resale value?" "Did I use my good judgment and at least some of these rules?" "Did my emotions alone guide my check book?" Remember,

*"It's hard to get out…. after getting in at a getting out price".*

If you followed the rules about value, then be comfortable. You were thinking like a professional. You based your purchase on "Real Value". Those who worry are those who listened to the "dreams and promises" of advisors who told them not to worry about current cash flow, but to base the value on tomorrow's "projected" cash flow and tomorrow's projected value.

"Tomorrow has a funny way, of not coming tomorrow"

Which leads us to:

**INTERNAL RATES OF RETURN**

The *"Disaster Creators"* call this phenomenon an *"internal rate of return".* Seasoned Investors call it a fool's errand.

How strange, your belief that other disaster creators (at a future point in time), will gladly pay you a profit based on their equal lack of knowledge and no "hard current value" facts.

You were able to "shoot from the hip" and you knew the property's future value, because of your superior judgment and ability to foretell the future. You didn't waste time with significant and in depth due diligence. The cash on cash return was questionable but the market never goes down….

You already know the answers and you do have to protect your image. Certainly, purchase for present value is old fashioned and lacks the sophistication normally available from a Gypsy fortune teller.

**About the author:**

Gerald Guterman is a Sr. executive and RE professional with 36 years of expertise and experience. Transactional and analytical specialist and specialist in operational strategies and performance management. Verifiable history of successful complex acquisitions (individual and portfolio properties, multi-phase development (mixed-use properties) with multi-stakeholder participation and relationship management. CEO/COO, National real estate investment company employing approximately 3,800 employees.



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