Guru Bob rises from the ashes or how to put lipstick on a pig

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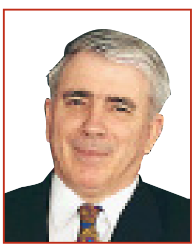

"The need to pay an unusual level of commission on relatively large investments is a warning signal that the investment itself is difficult to sell and unlikely to be worth the price paid..."

Meet Freddy and Fiona. Freddy was a good dentist and his wife, Fiona, who taught at a TAFE college, was considered to have a level head. Freddy had originally purchased his practice from his employer and then subsequently bought the premises. While not outstanding, the practice consistently outperformed key benchmarks. Freddy produced above 60% of the fees and a long-term employee dentist the remainder. They had renovated the premises, which were tastefully presented.

Freddy and Fiona owned a good-sized home without any personal mortgage debt and had two lovely children. Their block was big enough for a large garage, which Freddy used to indulge in his hobby of restoring old cars. Freddy did a car up, drove it to a vintage rally or two and then sold it and restored another. Pictures of his various cars adorned the practice and provided a local talking point. He had a marketing consultant write up an advertorial for the local press, featuring him as 'the motoring dentist'. Freddy had great hands and a good personality. Patients liked him but he wasn't obsessive about dentistry. He was sufficiently different in an interesting way to have a strong following. His fee schedules were profitable and his hourly charge-out rate impressive. Patients lying back in his dental chair viewed a picture of a beautifully maintained period car motoring on a roadway set between a green forest and a bubbling creek, suspended horizontally from the ceiling above their eyes.

Freddy and Fiona had paid off their home and had a reasonable superannuation fund, despite the global financial crisis. Practice tax deductible business related debt was about 40% of the probable value of the practice and practice premises combined. With potentially twelve to fifteen years to retirement from practice, the future looked safe.

Although their accountants and advisers had told them what to do year by year, they hadn't thought of it as being specific steps in a financial plan. However, all of the critical steps of home, practice and premises, and superannuation fund were in place.

The dental weekend

Freddy and Fiona had marked time out to attend a weekend away with a dental study group that Freddy had been involved with over the years. The members of the group were mainly old mates, many dating back to university days. Their children were being minded by grandparents for the weekend. Freddy hadn't taken much notice of the agenda. He mostly looked forward to catching up with old dental friends and usually enjoyed some of the associated dental talks. He hadn't actually noticed that Robert Skinner of 'Wizard Wealth and Property' was scheduled to speak. His topic was 'A

Financial Plan for Dentists'.

Introducing Guru Bob

In an earlier period of his life, Robert Skinner had been known as 'Guru Bob'. The organisation he'd been in had been prominently publicised for claims it made during property seminars and although Bob had been extremely clever in how he'd conducted things, his organisation had been investigated by the regulatory authorities. Behind the scenes there had been some legal claims. With smooth talk and the help of lawyers, Bob had been able to avoid having his organisation's licence suspended. A few of his aggrieved investors who'd pursued legal claims had been able to achieve a modest confidential financial settlement. Bob's reputation had been dented and he laid low for a time. His organisation had shrunk and so had his income, but he still maintained a healthy core client list. In due course, the global financial crisis spawned a new spate of financial problems, as a host of Wall Street banking financial engineers had their complex financial instruments torn apart. The fall in global financial markets exposed strategies which were heavily dependent on persuading clients to mortgage their houses, then double gear using margin loans to maximise their capital growth potential. Publicity about the failings of collateralised debt obligations, the jailing of Bernie Madoff and the exposure of the schemes of Storm Financial, together with the liquidation of Great Southern Plantations and Timbercorp, had pushed Bob Skinner way into the background, enabling him to quietly relaunch.

Meanwhile, the housing market was in trouble and Bob had been approached by developers who were experiencing significant difficulty shifting their stock of existing apartments and, more importantly, were facing the problem of selling enough new apartments off the plan to demonstrate to their bankers that they held sufficient binding contracts of sale to qualify for the bank advancing the money to commence new buildings. A steady stream of new projects were their lifeblood.

Bob's income had suffered badly during the past five or so years that he'd been largely relegated to the financial sidelines and he was stretched financially.

However, Bob had retained his ability to have an almost hypnotic effect on many of those he had advised. Despite the fact that many of his loyal clients had suffered from a series of bad investments, there were still quite a few who were unable to take even the most basic financial decision without endorsement from 'Guru Bob'.

The master salesman

Bob was a master salesman. He had that rare ability to absorb a great deal of financial and economic data and spin it out in a convincing story on a whiteboard, with what appeared to be an effortless flow. He interspersed his speech and the rapidity of putting numbers on the whiteboard with key power words and phrases and as he uttered each power word or phrase, he could look into his audience's eyes. Regardless as to what he was selling, Bob conveyed the underlying message that he had the knowledge and the skill to present clients with outstanding investment opportunities. Even his most faithful clients, who had suffered in a series of property syndicates, other property investments, failed viticulture trusts, liquidated eucalypt plantations and even a China venture, seemed to accept that in each particular circumstance, Bob had been correct but he had been let down by the incompetence or dishonesty of others.

There were other investors who adopted the once bitten, twice shy approach and having had one thing go wrong had been able to sum up Bob's presentation for what it was; a highly crafted, extensively rehearsed sales presentation designed to win clients' confidence prior to them being subtly directed into whichever investment scheme Bob had in the wings at that moment.

Sufficient time had elapsed and with luck, it transpired that only one member of Bob's audience in the study group with previous experience of him was one of his faithful clients, who although he had purchased some bad investments from Bob, had had other advice on personal and business issues which was pleasing. This dentist introduced Bob. Bob had quietly obtained a list of the audience and through his client had got sufficient background to understand which dentists in the group were successful. He'd been introduced to the group at morning tea and the vibes already felt good. There was the added bonus that the previous speaker, a dental specialist with an array of slides, although technically excellent, had been a somewhat heavy presentation. Bob was a lot more entertaining.

Bob commenced his presentation and was in excellent form, buoyed by the vibes at morning tea. The speed with which he wrote the numbers on the whiteboard suggested familiarity with all things financial. Apart from his one client, nobody else in the audience had ever seen anything like it. The periodic power phrases and words sank into the audience's consciousness. When he paused, each member of the audience felt that he was making eye contact with them personally. Most of the dentists and most of their spouses were thinking that they'd better hook up with Bob.

In reality, Bob had had one single presentation for many years. Periodically he added a new power phrase or an interesting fact and he was skilled at subtly altering a few bits to throw a better light on whatever was the investment in the back of his mind that he wished to sell. However, this investment didn't figure heavily in his presentation.

Although he'd struggled to survive over the last five years, he was ever ready to spring back given the opportunity, and he badly needed a big pay-off to get creditors off his back as well as to resuscitate his business, which was badly in need of capital. However, to that dental audience Bob came across as successful, confident and fully in command of all of his facts.

Bob soon had the audience's full attention. There was plenty for him to cover, including selected recent financial disasters. He dealt with these thoroughly and seemingly touched on property very lightly, yet the audience got the message that now was a great time to buy property, just when interest in housing seemed to be falling. Obviously they had to choose wisely. Somehow many in the audience understood that they should seek Bob's advice as to which properties to buy and buying property with Bob's help was definitely the right answer. Bob had explained that financial markets sometimes got their timing wrong and those who had geared shares on margin loans just prior to the global financial crisis inwardly agreed. The fact that property had been falling in value suggested that it was a great time to buy.

The crumbling real estate façade

Meanwhile, behind the façade of agents, there was deep, industry-wide gloom. Employment in the property sector had dropped by over ten thousand in the past year. Rents were actually falling in some areas, with properties remaining vacant for long periods. Uncertainty about employment meant that youngsters were living in their parents' houses for longer and therefore increasing rental vacancies. The incidence of potential buyers inspecting houses open for inspection pursuant to auction or sale had halved, while in Melbourne where attending auctions was a traditional pastime, the number of people attending the auctions had also halved. Other cities were similarly affected. Despite optimistic noises in the real estate section of Sunday papers talking about still good clearance rates and billboards proclaiming that apartments in yet-to-be commenced high-rise buildings were selling quickly, there was a sense of gloom. Whichever way you looked, the actual numbers of real estate sales on binding contracts were far fewer than developers needed to get the banks' green light to build. The banks were looking for above 80% sales on binding contracts before they would give the go ahead and advance money to commence building.

The developers enlist Bob

Several high-rise apartment developers had spoken to Bob. In the past when selling syndicated commercial property, Bob had argued strongly that commercial property gave far better net yields than residential property and that residential apartments were at the bottom of the property investment spectrum by long-term performance. This was generally true. He'd now changed subtly to telling about some of the advantages of residential property; talking up evidence of shortages of rental housing alluded to in some studies and mentioning gross rental yields. The timing of the data in the studies was a little bit out. He casually dropped in an anecdote of a person who'd purchased several inner suburban properties close to the CBD over 25 years ago. Based on recent estimations of capital growth, these properties were now worth an impressive amount compared to the original purchase price and gross rental yields were also impressive when compared with that purchase price. There was no mention of the cost of the significant renovations which had occurred to each and in any case, nobody was sure of the identity of the particular properties. Bob was playing tricks with numbers. However, he was an old hand at convincing an audience and the audience had insufficient knowledge to detect his financial sleight of hand. At the end of the talk, the whiteboard was covered with tightly-packed numbers. It was an impressive performance.

Bob then dealt with questions for about fifteen minutes, giving polite and direct answers. The group then broke up for a buffet lunch. Bob was able to move among them and his targets in the audience all seemed to want to meet him. In response to warm endorsements about his talk, Bob graciously suggested that if they liked they could have a follow up meeting at his office. Each was pleased to receive his card. Bob didn't seem to be selling, but rather politely responding to their wants. Freddy and Fiona were pleased to receive his card. In the next two working days, five of the six target couples Bob had identified rang his office for an appointment for a comprehensive review of their financial affairs. This included Freddy and Fiona. Naturally each was prepared to pay Bob for his services.

The information Bob gained in the meetings enabled him to know exactly how many rental properties each could afford to buy. Bob explained to each couple that their finances were sound but that they needed to speed up their progress toward what he termed 'EFC' (economic freedom of choice). This could best be achieved by buying a portfolio of properties which would appreciate in value, as had the sample of properties Bob had quoted in his talk to the dental study group. Bob had quoted median price statistics to show that with modest capital investment and significant gearing, their expected growth rate would put them into a nice situation by the time they were ready to retire from dentistry. Bob knew that the median price statistics misrepresented capital invested in renovations as capital gain, but his clients didn't.

Each couple in turn wanted Bob's assistance in sourcing their properties. Bob gave some generalised information. He also indicated a bit diffidently that he had been retained by some developers to give advice on what to produce for the market. Bob told each couple in turn that he felt a little bit hesitant about mentioning these developments because he had consultancy arrangements with each of the developers. Each of the clients assured him that they found his honesty refreshing and asked to be introduced. Bob hinted that he had connections to developers of many projects, but there were three in particular which he thought offered the best investment potential. Naturally each of the clients wished to be introduced to the three. *In actual fact, the developers had contacted Bob because they had invested substantially in land, plans and building permits and were desperate to get pre-sales in order to meet the requirements of their bankers. In spite of their well-oiled selling organisations, the market had simply turned off. They needed somebody or something to turn on a market for them. Bob was their last, desperate chance.*

Bob's consultancy arrangement with each of the developers was based on a commission scale, part of which would be paid when his clients signed a purchase agreement and paid a deposit and the bulk on settlement. Bob referred each of these new clients to the particular developer's sales office, having suggested that it was best to spread their risk by buying properties in different developments. Meanwhile Bob, who was a consummate networker, had been able to engineer invitations to talk to other groups of doctors, medical specialists and some miscellaneous investors in various forums. As a result of Bob's activities, the sales staff of each of the developers received a steady stream of buyers. In the general excitement nobody noticed that these three developments were the only ones across the city experiencing this surge in demand. Naturally, the developers added Bob's fees into their prices. When occasionally one of his clients expressed interest in a project not on Bob's consultancy list, he was able to look the client in the eye and say:

"I've heard that project isn't selling very well, so it may not get off the ground."

Since nearly all the other developments were struggling, the answer was undoubtedly correct. The clients were impressed that Bob had so much detailed knowledge and invariably bought into the projects which he had steered them toward.

In due course, each of the projects received final approval from the banks and building commenced. Bob was able to pass general comments about other projects which had been stalled or cancelled and this suggested to the clients that they had indeed been wise in following Bob's lead. Since these projects had achieved the sales necessary for banks to approve finance, the developers were able to announce that construction had commenced. In practical terms, this meant that the last 20% of apartments in each were now able to be marketed on the basis of certainty of completion, whereas competing projects were still struggling to get to the necessary level where banks would approve finance.

The hidden holes in Bob's presentation

None of the investors concerned was sufficiently alert to pick the holes in the presentation they had been given. Indeed, at no stage had Bob actually recommended that they purchase specific apartments; he'd merely introduced them to the developers at their request. A well-aimed rifle doesn't miss its target and they bought because the purchases fitted the criteria that Bob had laid down, even though much of his presentation both at the group sessions and to them personally had been verbal. It was only much later that they began to wonder about what they had been told, much of which had been in the form of a whiteboard presentation. It was the developers' sales staff who had sealed each deal. Furthermore, they'd dealt with separate sales staff in each of the projects.

Aftermath

Freddy and Fiona had signed up to buy apartments in three separate developments, which in total meant an outlay of $2.2 million. Initially they had little difficulty in putting up a deposit of 10%. Later, as the buildings were nearing completion and they needed to stump up the remainder, they found that banks were strangely difficult when it came to financing the full amount. They had to re-mortgage their house, put a second mortgage on the practice premises and had to accept a higher interest rate in order to complete the deal. Bank lenders it seemed had introduced strict rules on lending on rental units which required significantly bigger deposits and/or more security together with higher interest rates than standard loans on owner occupied dwellings.

Freddy and Fiona's accountants and advisers had only been advised what was happening when they'd already signed binding contracts and were horrified. They saw the warning signals, but it was fait accompli.

Rents lower costs higher

Much later, as the projects were settled and the apartments were offered for rent, Freddy and Fiona were disappointed to find that the rents the market was prepared to pay were significantly lower than they'd expected. In the year after the settlement, ownership costs were higher than they'd figured. Their accountants and advisers gently pointed out that the apartments were producing poor outcomes. As each of the apartments had been completed and they'd gone to inspect, they'd realised that they were much smaller than they'd appeared in the sales brochures.

Uncovering the truth

They sensed that they'd been victims of a well-oiled marketing machine. Their long-term adviser suggested that they seek advice from a real estate advisory group. The consultant they met seemed to know an awful lot about the three buildings in which they'd bought apartments. He'd already been consulted by other investors and he was able to point out that units in the three buildings had been sold at above market price. He was also able to point out examples of better real estate investments scattered across the city and that in the current re-sale market, each of their apartments would need to be priced at between $150,000 and $200,000 less than acquisition cost to have a chance of selling. Indeed, some of the apartments in all three developments were already listed for resale in the normal real estate market. He was also able to point to some which had already been advertised at well below the acquisition cost of the apartments which Freddy and Fiona had purchased.

Freddy and Fiona decided to test the market by selling one of the units, for which they'd paid $770,000. It hurt them to put it on the market at $600,000 but they were then disappointed to learn that there was little interest in it at that price. Alarmed, they spoke to several of their friends who had been at the dental seminar with them and found that four other couples from that dental weekend had also followed up with Bob Skinner. Three of the couples had ended up buying apartments in three, two and three of the developments respectively and each was now having doubts as to the wisdom of their actions. Including their own three apartments, Bob had effectively achieved the sale of eleven apartments, germinated by his talk.

Freddy and Fiona went back through Bob Skinner's report to them, couched as a 'Statement of Advice' and found that while Bob had dealt with their overall financial situation comprehensively and included some advice related to the streamlining of aspects of their existing finances, which were straightforward, they had not been advised by Bob to buy the three apartments. Indeed, Bob's correspondence indicated that he was referring them to specific consultants at each of the developments' sales offices on their request. They found difficulty in recalling Bob's exact words in their meeting which preceded the purchases, nor in brief subsequent contact. The whiteboard presentation had been erased at the end of Bob's talk and Bob had indeed covered himself with appropriate disclaimers.

Meeting with Bob post purchase

They made an appointment to see Bob, who greeted them effusively. When they voiced their concerns, Bob looked them in the eye and explained that they had been let down by global economic events which had damaged our economy. Bob explained that people were afraid to spend; retail sales figures were down, and retail staff were afraid for their jobs. The expected real estate recovery had been snuffed out by greedy banks tightening lending restrictions still further and by the Reserve Bank being too slow to act with respect to lowering interest rates. Bob indicated that there were many people willing to buy real estate, but they were being frustrated by unbelievably tight lending restrictions. Somehow they came away from the meeting feeling sorry for Bob, who had tried so hard to help his clients, yet he had been thwarted by dark forces beyond his control.

Later as they reconsidered, they consulted a family friend who was a lawyer, but after perusing the correspondence he advised them there was insufficient evidence linking Bob's advice to their actual purchase and indeed Bob did not seem to have an interest in the sale other than a consultancy arrangement with the developers, which he'd properly disclosed. The correspondence indicated that Bob had been hesitant to even make the introductions until they entreated him. That may not have been quite how it occurred, but that's how it read. The lawyer advised Freddy

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and Fiona that legal action was unlikely to be successful and was certainly likely to be very costly.

The long-term impact

Eventually over several years, Freddy and Fiona sold out of each of their apartments. They estimated that in addition to the headline loss on the sales, their holding costs net of tax benefit, including costs associated with financing, legal advice, etc, had left them $850,000 worse off. Their friends had similar outcomes and while each had sound dental practices and were able to secure their future financially, the event put each of them years behind in their progress towards the decision point at which they could elect to sell their practice and/or retire.

Teflon coated

Bob Skinner seemed to rise above it all on Teflon-coated wings. Just as various commercial real estate syndicates and trusts had been oversold with much resulting pain and suffering, when that market collapsed or fluctuated severely over the years, he'd been able to transfer readily to other forms of investment, including agricultural schemes, then after a pause, to the apartments. The developers who had put together the three projects for which he'd been instrumental in introducing buyers had eagerly retained him for another round. While the first three developments had been building, Bob had taken advantage of the interlude to spruik these newer developments for each of the developers with similar results. Later, just as the apartment market had been revealed to be dramatically oversold, Bob had transferred his attention towards selling a couple of industrial parks. In due course, as the property cycle changed again, he transferred his interest back into the commercial arena, where he'd been given an option to purchase a $140 million commercial building which was under construction. The developers of this project had committed to its building, but a contractual difficulty with the construction company and an industrial accident on site had seriously delayed them. This meant that several other major projects were now ahead of theirs and winning the race for tenants. Hardheads in the commercial real estate industry recognised the warning signals that commercial property was about to be significantly over-supplied in the city's markets. Professional investors were now quietly avoiding it.

With his finances back in good order after influencing the sale of about $87 million worth of apartments and achieving fees to his organisation of about $2.5 million, Bob's personal confidence had been restored to the level of his glory years. He had regained his magic touch for achieving amazing sales and had been able to target potential investors with good incomes for the commercial project. These included many who had bought apartments and Bob, as a personal reward, was giving them a special opportunity to invest in 'premium income-producing commercial property'. The property was creatively parcelled into the 'Premium High Yield Property Trust'. However, the outcome of this venture of Bob's is another story.

Putting lipstick on pigs

Property spruikers always find a way to get paid well for selling an investment, but usually manage the sale in such a way as to make the investors feel that they are personally responsible for the decision that they took. In order to have a product to sell, they require a market which is already under subtle stress and in order to be able to add a significant commission for themselves into the process (be it called something else), the price at which the investment is sold must be substantially above the price at which it can be on-sold in the market. The real talent of property spruikers is their uncanny ability to 'put lipstick on a pig'. This applies whether they are selling units in commercial property syndicates, acreage in eucalypt plantations, high-rise apartments, industrial estates, viticulture trusts or other exotic forms of property. Invariably, these investments fail to hold their price in the secondary resale market. In some cases, such as the plantation investments, there was no secondary market. In hot markets, property developers don't need people like Guru Bob to round up investors. Neither would the promoters of the eucalypt plantations have needed to pay extraordinarily high commissions to accountants to 'sell' these investments to clients unless the investments were sub-standard to begin with. The need to pay an unusual level of commission (typically nine or ten percent in the eucalypt plantations) on relatively large investments is a warning signal that the investment itself is difficult to sell and unlikely to be worth the price paid. The property spruikers and consultants like Guru Bob, certain property advisory organisations and the accountants who sold vast amounts of plantation investments to clients, were and are each 'putting lipstick on pigs'.

About the author

Graham Middleton personally has been advising dentists on strategic, practice management, valuation and conflict resolution processes for 24 years, the last 17 as a partner and director of Synstrat Management Pty Ltd and Synstrat Accounting Pty Ltd. He was once a regular army officer, and later Director Human Resources Manager, Attorney General's Department of Victoria. He is considered an expert on dental practice valuation and practice performance benchmarking. He has spent many years advising dentists in respect of their business and financial strategy and measuring their practice and financial performance. He is the author of the Synstrat Guide to Practice Management, 50 Rules of Success as a Dentist and Buying & Selling General & Specialist Dental Practices. He is a long-term contributor to the Australasian Dental Practice magazine. The Synstrat Group is an independent data-based organisation providing management, benchmarking, valuation, financial and accounting services to the dental profession. Synstrat Management Pty Ltd is a Licensed Dealer owned by its directors who work within the Synstrat Group. Tel: (03) 9843-7777 Fax: (03) 9843-7799 Internet: www.synstrat.com.au Email: dental@synstrat.com.au