DECISION MAKING IN THE PROPERTY DEVELOPMENT INDUSTRY DURING A BUSINESS CYCLE

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ABSTRACT

The property development industry in cities such as Calgary, Edmonton, Denver and Houston experienced a boom characterized by compulsive speculative growth in the 1970's and then a dramatic collapse in 1982. In the wake of the collapse came a crisis in the financial as well as the development sector, which to 1987 is nowhere near resolved. The expansion and decline in the property development industry is seen as a subset of a classical business cycle fueled by the world oil and gas economy, Canadian government regional and economic policies, and changes in money supply and interest rates. These factors are recognized as being contributory, but not a sufficient explanation for the property boom and bust. Additional understanding is offered by an analysis of the decision making process in the development industry.

The research, focusing on key decision makers, revealed that repeated decision errors made by developers on strategies related to growth, diversification, and financing contributed significantly to the industry problems. The sources of strategic errors were found to be associated with the key developers' personalities and their perception of the business environment, as well as group and organizational behaviour.

In 1976-77 opportunities to gain windfall profits in real estate development encouraged developers to travel from city to city continent wide in search of opportunities. Their fast-paced activity brought key developers stunning successes. Their perceived brilliance attracted followers from the rest of the industry and captured the imagination of the financial community. In 1979-80, as land values began increasing at rates far faster than interest rates, land banking superceded land development as a principal activity.
Developers not only borrowed to the maximum under conventional project lending, but they also invented the concept of "appraisal surplus" (the difference between market value and debt) as a measure of their enormous "equity". This in turn permitted them to raise additional capital corporately through debentures and share offering to purchase even more land. By 1981 companies were highly levered financially making them extremely vulnerable to the slightest changes in the marketplace.

Rather than recognizing that they were swept up in a property boom developers, individually and as a group, chose to continue to believe that their "exceptional ability" to turn a profit was the basis for their successes. As the boom accelerated developers abandoned all caution committing to some of their largest and most daring acquisitions at the very peak of the boom. Then, in 1982 the inevitable happened, the bust in the property market. Those public companies with huge financially levered land banks, whose strategies were predicated on continuing inflation and ever increasing market share failed. Those companies, often private, with low debt to equity ratios, conservative financial practices, and income property portfolios survived. Since both sets of companies operated in a similar environment, but one failed and the other survived, the argument that decision making was a crucial factor in understanding the boom-bust property cycle is strengthened.

The understanding of change in the activity patterns and in the structure of the built environment is elucidated by the study of decision processes. Insights into decision making and business cycles create a new awareness of the development process.
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CHAPTER 1
INTRODUCTION

1.1 SYNOPSIS: THE PROPERTY MARKET

In the 1970's, the property development industry in Western Canada experienced phenomenal growth (1). Large-scale land development companies emerged and expanded in volume of business through diversification into new product lines and into new geographic markets. By using financial leverage, company growth rates seemed to be defying the laws of "economic gravity". The meteoric rise of these companies was held in awe by investors, bankers and stock market analysts. In the wake of the 1982 economic downturn the property development industry suddenly collapsed. Of the four publicly traded western-based companies each with property assets valued at over a billion dollars, three became technically bankrupt. Scores of other developers and builders, both large and small, went out of business as well. The recorded corporate losses of just the publicly traded companies were in the hundreds of millions of dollars (Table 5). The losses in turn precipitated a crisis in financial institutions.

In six years (1976-81) the coming together of the housing needs of the baby boom generation, the financial climate influenced by low real interest rates, and the rapid growth of Western Canada's resource-based economy set the stage for an unprecedented property boom. The subsequent three years (1982-84) in contrast were an unprecedented bust, resulting in the contraction
of the resource-based economy which in turn had a significant negative impact on the urban growth process. An indication of the magnitude of change can be seen in a representative city, Calgary, Alberta, in the statistics on net migration, dwelling unit starts, average sales prices of single family homes, and office vacancy rates presented in Figure 1.

The amplitude of this boom and bust was so great that it provides an unusual opportunity for academic analysis of the urban growth process and, in particular, corporate decision making in the property development industry during economic turbulence. Inasmuch as the property development industry is so broadly defined, emphasis is placed on the large-scale land development sector out of which emerged most of Western Canada's major publicly traded property development companies. Since most of them were based in or had major holdings in Calgary, that city was chosen for in-depth study.

The backdrop for the analysis is the business cycle. Business cycles, integral to the market economy, are characterized by a wave with the following identifiable phases: stagnation, recovery, credit-based expansion, speculative fever, and crash (Harvey 1982). Each phase elicits different behavioral responses from the business community. The nature of these responses has direct influence on the built environment, accounting for periods of rampant over-building or periods of dormancy. The most turbulent of all business cycles is known as a boom-bust cycle. The most recent business cycle in Western Canada emerged out of the 1974-75 recession into a period of rapid expansion that climaxed in wild speculation (1979-81), and crashed in 1982 (Best 1985).

It is very easy to attribute this volatility in the property development industry to powerful outside forces over which the industry has no control. In
FIGURE 1
THE BOOM-BUST CYCLE IN CALGARY

SOURCES: (a) CITY OF CALGARY PLANNING DEPARTMENT
(b) A.E. LEPAGE/ROYAL A.E. LEPAGE
(c) LARKEN REAL ESTATE LTD.
the aftermath of this latest boom, investors, developers, and bankers were
tonally characterized as just innocent victims of national and international
events (Best 1985b). Yet there is another side to the conventional view. One
tattered survivor of the boom-bust cycle confessed,

There was no powerful outside force that put development companies
under. Everybody could have prevented their problems; but everybody was
human. Money was being thrown out by the financial community. There
was great euphoria; it was very hard to resist. A lot of the people in
the industry had never experienced this. (DEVELOPER) (refer to note (2))

During the property boom developers had considerable difficulty in
perceiving and interpreting changes in the economy and the market. There
were industry critics, like Lorimer (1978), who predicted that the industry
would collapse through its own actions during this turbulent period:

Now (1978), however, it is clear that the industry the developers have
built on the basis of [overly generous financial] support can no longer be
sustained.... Its success has given it a voracious appetite for both
government subsidies and valuable Canadian investment capital, and has
convinced the investment community that the urban land development
boom will soon turn into a bust.... The eventual collapse of the industry
is more likely to come, I think, from economic rather than political
pressure. (Lorimer, 1978: 264)

Lorimer’s prediction was completely rejected by the industry at the time, when
every move for the industry seemed to be right, fail-safe, and profitable. The
views held in the industry about where the industry was heading in the
overheated economy were highly skewed towards a continuing boom. Developers
however failed to perceive a cyclical movement, even though in 1979-81 signs
were clearly evident in the Western Canadian economy. Their corporate
strategies formulated during the property boom consequently failed to
anticipate the violent changes to come -- the bust that inevitably follows a
boom (Schumpeter, 1959).
There is no question that the policy makers in property development and finance would much rather explain the 1982 industry collapse and financial crisis in Western Canada as outcomes of external factors. There is no denying that exogenous forces did bring an abrupt end to the property boom in Calgary and elsewhere. But to fully answer the question of "why did some, but not all, significant public companies in the development industry collapse in 1982?", an analysis of the corporate strategies employed by these companies during a property boom is instructive. Every company has to deal with fundamental questions related to growth, diversification, and financing. How big do we want to be? At what rate should we grow? What businesses should we be in? Should we expand our activities geographically? How should we finance our expansion? In this thesis, these fundamental questions or "strategies" will be explored with the help of key decision makers in the property development industry. The thrust of the analysis is pathogenic and pathogenetic -- to uncover the causes (agents) of and processes leading to the collapse of the industry.

The three strategies followed by development companies -- 1) asset growth without due regard for the quality and continuation of earnings, 2) diversification without due regard for market and product understanding, and 3) debt financing without due regard for the leverage effect -- are proffered as the apparent causes of the development industry's collapse. Behind these strategies, it is suggested, were decision errors: errors preventing the decision maker from achieving his goals or errors making the goals incongruent with the environment such that their achievement would be detrimental to company
survival. From the literature it could be expected that the sources of decision error are to be found in the decision maker himself, in group behaviour, in organizational dynamics, and in the decision environment. These successive perspectives -- individual, group, organization, and environment -- add greater complexity and detail to the analysis, giving in the end a comprehensive picture of the decision maker, the process and the sources of decision errors.

This etiologic study of growth and collapse provides a means of understanding the relative importance of the economic environment and corporate action in urban development. Traditionally, in research of this nature, explanations have been sought either in the abstract and reified entities of macro-structures of the economy, or alternatively, in the behavioral patterns of individuals (P. Jackson and S. J. Smith 1984). The structural approach in terms of this study might identify the changes in the world economy such as trade imbalances and energy pricing, which in turn precipitate changes in national government monetary and energy policies. The impact of all these changes can adversely or beneficially affect regional industry, including property development. The behavioral approach addresses the question of individual action, often to the exclusion of macro political, economic, and societal forces which directly or indirectly influence the behavioral patterns being studied. The approach followed in this study focuses on the relationship between agent (decision maker) and structure (business cycle and the immediate decision environment), or a Schelling (1978) stated: between micro-motives and macro-behavior. It is based upon the assumption that structure and individual action are inextricably interrelated (A. Giddens 1979). Boulding (1978) stated it succinctly when he said that "individual create structures and structures in turn influence the choices of individuals". These
structures range from mental constructs of reality, to organizations, enterprises, markets, and economies.

Conceptually, the actors (developers) are caught up in the greater business cycle and in return each actor influences in a small way its course. The collective outcome of all decision-making behaviour, orientated by strategic purposes, manifests itself in the shape of a business cycle. The cycle, the sum of individual acts, then transmits signals which either reinforce or change individual decision-making (Figure 2). This interaction has its effects on the property market, the industry's performance and the built environment.

A critical role in the creation of the business cycle is performed by the entrepreneur-decision maker in the pursuit of opportunities (Kirzner 1979; Schumpeter 1957). In a development industry context the entrepreneur-decision maker is the entrepreneur-developer (3). Within the framework of the process of deciding the developer as decision maker has freedom to make choices, but once a choice is made he is limited by that choice. His path is partially determined by the strategies and plans he prepares, just as if some external force were acting on him. The decision maker's choices are affected by the limited of his own rationality, philosophy, and personality -- in particular, by his ability to cope under psychological stress caused by the boom and bust climate. "Groupthink" and group dynamics within organizations and within an industry influence choice. In organizations, the degrees of freedom for choices are further limited by a decision hierarchy. In the cascading chain of command, those in higher authority constrict the decision space for those below (Barnard 1938). Policies, strategies, existing programs, and procedures all serve to promote, distort, deflect, or impede certain decisions relative to
FIGURE 2
THEORETICAL FRAMEWORK FOR BUSINESS CYCLES AND THE DEVELOPMENT PROCESS
others. Choices are influenced by the decision maker's perception, interpretation, and forecasting of events in the decision environment. Lastly, decisions are very much affected by the actions of other decision makers in the external environment. These influences on the decision maker can become sources of decision error. Decision errors were major contributors to the adoption and the maintenance of ill-conceived strategies which led directly to business failures and ultimately to an industry-wide collapse. The subject of this thesis -- business cycles, the urban growth process, and developer behaviour -- is a step towards elucidating the relationship between decision making in the development industry and the urban-growth process.

1.3 RESEARCH OBJECTIVE, STRUCTURE OF THE THESIS AND METHODOLOGY

The research focuses on the development industry during the boom-bust cycle. It's objective was to gain a better understanding of how a high profile industry could demonstrate such success and such disorder in a short period of time, and through its collapse have such serious implications in excess land banking, over-building, redundant but costly infrastructure, and financial crises. Structurally, the thesis is divided into four sections: Part A deals with the theoretical, conceptual, and general framework of the study, Part B with the Calgary economic-political context, Part C with the analysis of corporate strategy and the search for decision errors, and Part D the conclusions (Figure 3).

Decision-making theory and business cycle theory are seen as the underpinnings or conceptual filters for the analysis of business cycles and
FIGURE 3
STRUCTURE OF THE THESIS
developer behaviour. In Part A after separately reviewing each theory, their interrelated characteristics are explored with help of literature on developer behaviour found in cities in other parts of the world. The comparative examples underscore the generality of the Calgary experience. Western Canada's political and economic context that sets the stage for a review of development activity in Calgary during the 1976-85 business cycle starts Part B. An evaluation of the impact of the frenetic development activity experienced during this period on the built environment and on financial institutions follows. This useful background however is insufficient to understanding the times. Therefore the analysis of developer behaviour is presented in Part C, principally based upon results of in-depth assessment of the strategic actions of developers during the property boom-bust cycle. This part elaborates the essence of the thesis. Significant research conclusions, an evaluation of decision making during the boom-bust cycle, an assessment of the relevance and congruence of the literature to the findings, and implications for research are presented in Part D.

The primary method for garnering information about, and insight into, the development industry was the interview (4). In-depth interviews of business and government executives, a source of primary evidence, provide a cross section of views on decision making in the development industry during a boom-bust cycle. Access to key executives was possible because of the author's active participation in the industry over 15 years (5). These interviewees included five presidents from major land development companies, two senior banking vice presidents, the Deputy Minister of the Alberta Housing Corporation, a former Mayor of Calgary, two senior planners with the City of Calgary, a security analyst, an appraiser, a housing economist, a development
lawyer, and a number of senior executives representing the land development companies. Some of these executives are still in the industry; others are not. Some are in operations; others are in finance and accounting. Most reside in Calgary; some, in Vancouver and Edmonton. Interviews were carried out exclusively by the author.

The interview format was open-ended; the intent of the interview was to stimulate discussion within the framework of decision maker, group, organization, and environment (analytical categories). The direction of the questioning was to uncover decision errors and their sources. Each interview was between one and two hours in duration. The interviews were taped and transcribed. Transcripts were sent to the interviewees for comments, amendments and deletions. They were then edited, classified under the analytical categories, and ranked in order of importance. The analytical process was heuristic, resembling a decision tree, with iterative steps and feedback loops, refocusing on concepts whose importance became apparent in the later stages of the investigation. Information was ordered in a nested system with the individual forming the smallest subsystem, the organization an intermediate one, and the environment, the largest and most embracing. Within this framework, explanations on the rise and fall of the property development industry during the 1976-85 business cycle are proffered.
(1) The property development industry is comprised of land developers, home builders, and commercial developers (offices, shopping centres, and industrial warehouses).

(2) Throughout the thesis, the interviewed persons will be only identified by function as developer, executive, planner, consultant, etc. This is done to enable the interviewees to respond in a complete and candid fashion.

(3) Developer, as used in this thesis, refers to the individual (or group of individuals) who is/was the prime decider in the development company. The entrepreneur-developer was seen as the industry leader.

(4) The other sources of information were The Globe and Mail, The Financial Post, Canadian Building, The Alberta Report, Calgary Herald, The Vancouver Sun, Canada Mortgage and Housing Corporation, Alberta Housing and Home Mortgage Corporation and The City of Calgary Planning Department. In addition to the interviews, annual reports, security analyst reports, prospectuses, and industry reports were valuable primary sources of information on property development companies.

(5) The researcher was a senior planner with the City of Calgary (5 years) and a senior vice president for Daon Development Corporation (now B.C.E. Development Corporation) (10 years).
PART A: THEORY

INTRODUCTION TO DECISION MAKING AND BUSINESS CYCLES

A STUDY OF

INDIVIDUAL AND STRUCTURAL APPROACHES TO ANALYSIS
The developer in his search for opportunities faces a decision environment where business forces are dynamic, multidirectional, unstable, interrelated, and often unique. The information available to the developer is scanty and of poor quality. The consequences of major decisions reverberate in the industry and in turn further modify the environment. Forecasting is difficult. Time is always a critical factor in the industry because of fierce competition and the ephemeral nature of a real estate opportunity. This urgency encourages developers to rush into a decision, and once committed to a course of action not to turn back. Stress is a constant companion of the developer. The developer regularly makes risky decisions that bind him inescapably to a fixed course in an uncertain future. Therefore a developer cannot take lightly the strategic decisions he makes.

The two dynamic components of the conceptual framework for furthering the understanding of the property development industry's expansion and collapse are developer behaviour and the business cycle. The two are to a fair measure interdependent at different scales and particular geographic locations (refer back to Figure 2); however, they will be reviewed separately in this chapter and the next, and then in combination in Chapter 4. Developer behaviour, the subject of this chapter, is viewed from the standpoint of decision making theory.

The analysis of decisions in the development industry was approached systematically through five perspectives: (1) rationality, (2) individual
behaviour, (3) group behaviour, (4) the organization, and (5) the decision environment. Each perspective provides insight into the decision maker, process, and sources of error. Together they provide a framework for understanding why and how decision making in the development industry contributed to the industry crisis of 1982. Rational decision making theory offers the normative model against which the reader can compare developer decision making during a property boom. The most active contributors to decision-making theory are from the disciplines of psychology, sociology, management science, and planning (1). This chapter will focus only on those aspects of theory considered important in providing conceptual hooks for understanding decision making in the development industry (2). The particular perspectives on decision making, and their interrelations are portrayed in Figure 4.

Decision making is both simple and complex. As Barnard states in his path-breaking book, *The Functions Of The Executive (1938)*, decision making is, simply, the act of choosing one alternative over another. The difficulty in deciding is in making the right choice faced with uncertainty, risk, and conflict. The elements of decision are purpose and environment. Purposes are constantly refined, and fragmented as they evolve in the form of goals, objectives, missions, and targets in the organization. The environment of an organization is defined by its purpose. Real world choices are based on uncertain, complex, or even unreliable information about future events in which ends and means are intertwined (Barnard 1938). The art of decision making is as much knowing what not to do as it is knowing what to do. Barnard (1938, 209) defines the fine art of decision making as "not deciding questions that are
A Comparison of the Multiple Perspectives and Their Sources.

Operations Analysis  Systems Engineering  Incrementalism (Lindblom)  "The Prince" (Machiavelli)  "The Discourses" (Machiavelli)  "Presidential Power" (Neustadt)  "Management and Machiavelli" (Jay)  Nounena (Kant/Loye)

Systems Analysis (RAND School)  Control Theory  Organization Theory (March–Simon)  Technological Forecasting  Policy Analysis (Dror)  Cybernetics (Beer, Ashby)  Theory of the Firm (Cyert, March)  Bureaucratic Budgeting (Wildavsky)  "Crowds and Power" (Canetti)  "Archetype" (Jung)  Singer Inquiring Systems

Impact Assessment  Cybernetics (Beer, Ashby)  Industrial Organization (Thompson)  Group-Think (Janis)  Gestalt Psychology (Koffka)  Cognitive Dissonance ( Festinger)


Steinbruner, 1968–1974, MIT  Organizational process Model II  Cybernetic Paradigm

Andersen, 1977, MIT  Rational Perspective  Organizational Perspective

Linstone et al., 1979–1981, PSU  Technical Perspective  Organizational Perspective  Personal Perspective

FIGURE 4
Decision Making

not now pertinent, in not deciding prematurely, in not making decisions that
cannot be made effective, and in not making decisions others should make".

Schumpeter (1959, 91) implies that the entrepreneur who dominates the
development industry may be the most rational of all men. Rational decision
making is therefore a useful model for assessing developers' decisions.
Rational decision making in its skeletal form is a verbal account of the
cognitive process man goes through when making a choice, wherein the
normative and the descriptive merge. T.T. Paterson (1984) defines this process
by its stages: information, conclusion, decision, and execution. All decision
processes start from the realization of a gap between where the decision
maker wants to be and where he is. With "information" he identifies the
alternatives on the course of action best suited in his case. He either
"decides" or recommends to another authority who decides. A decision implies
subsequent action or "execution" and entails the allocation of resources.
Paterson's stages correspond to the functions of an organization, respectively:
research, planning, execution, and administration (cf. Mintzberg 1976).

Any study of decision making would be incomplete if it stopped at
rational decision making without discussing its limitations (Simon 1957, Etzioni
1973, and Lindbolm 1962). Janis and Mann (1977) have looked at certain
characteristics of cognition that bias decisions, and at the question of
behaviour and decision making. Understanding how decisions are influenced by
groups (Janis 1972) and organizations (Cyert and March 1962) is important.
Donaldson and Lorsch (1983) provide helpful concepts on organizational
stability, goals, and constituent biases. McCrimmon (1976) and Janis and Mann
(1977) consider how the decision maker in the organization misperceives and
misinterprets his environment.

To bring the disparate elements of individual decision maker, social group, organization, and environment together into a conceptual framework, several theorists (C. Gilligan, B. Neale, and D. Murray 1983, and R.N. Taylor 1984) place these elements in an open cybernetic system. The decision maker interacts with his environment through the group and the organization. The boundaries of the organization are vague -- allowing for linkages with other organizations. These extra-organizational linkages, referred to as networks, are quite prominent in the development industry.

Not only does the decision maker make judgments about the information (forecasts, plans, recommendations) received, but he also makes decisions. (Unlike a judgment, a decision has consequences which constitute the output of the system.) The consequences flow back through the system's feedback mechanism, allowing the decision maker to adjust the organization's strategy. The cybernetic system accumulates knowledge over time, and with this knowledge, it learns to anticipate events and to plan. The system develops a "feed-forward" mechanism, which enables the decision maker to act on the basis of anticipated events (3).

2.1 RATIONAL DECISION MAKING

The pedagogic decision-making model is based on a philosophy of normative rationality -- how decision making ought to be done in a manageable and predictable world -- as seen in Alexander's Business Strategy and Policy (1983), Kepner's and Tregoe's The New Rational Manager (1981), Athey's Systematic Systems Approach (1982), and Thompson's and Strickland's Strategy Formulation and Implementation (1983). Students are taught to structure
their problem, analyze their problem, make forecasts, establish objectives consonant with the goals of the organization, array the various alternative means of achieving the objectives, evaluate each in terms of the consequences, choose the best, and program the execution.

In the concept of rational decision making, values and goals can be clearly structured in a hierarchic fashion, and no ambiguity exists in the means-ends chain. Furthermore, the concept presupposes a world where the environment and the behaviour of others have predictable regularity. Therefore, consequences can be predicted within a range of probability, and risk to the individual or organization can be estimated. The key to making the right choice is having sufficient information. Notwithstanding, there will be technical errors and unintended consequences.

The rational approaches faithfully followed by many decision makers during the turbulent 1970s, much to their chagrin, were patently wrong in the light of unfolding events. Their forecasts either underestimated or far exceeded the trends materializing in the environment. It was not simply the interruption caused by economic downturns in 1974-75 and 1982-84 to an otherwise upward trend. At the heart of the problem was the inherent difficulty of predicting future trends. The ability to predict, unfortunately, is fundamental to rational decision making and crucial to property development.

Simon (1957, 1976, 1979) is the main critic of rational decision making, and, in particular, substantive rational decision making as practiced and taught by economists. Simon states he has yet to observe firms or businesses equating marginal costs to marginal revenues in decisions on optimality. The economist's use of Occam's Razor in simplifying and reducing decision-making behaviour to that of "economic" man (or the market) has rendered their
particular brand of decision-making theory of little value as a decision aid for the real world. Simon argues persuasively that environmental knowledge on any given decision problem will be fragmentary, and, further, man's cognitive capacity to assimilate this knowledge is limited. He sees no way of man being able to predict future consequences. Herein lies the paradox in decision-making methodology based on rationality or scientific reasoning. The methodology is designed to operate with clock-work precision, but, on the one hand, the decision maker is inadequate to the task, and, on the other hand, the environment is too uncertain and complex to be amenable to the approach and the available techniques.

Key concepts coming out of Simon's work are "bounded rationality" and "satisficing". Bounded rationality implies that man has a limited cognitive capacity to assimilate and make sense of all the information imploding on him from the environment. Consequently, in his selective approach to information processing and in his tendency to limit the number of alternative courses of action considered when arriving at a decision, the decision maker satisfies himself with less than an optimum solution -- hence the term "satisficing". Contrary to normative-rational methodology, then, every decision contains a degree of error by virtue of man's inherent limitations as a decision maker.

Not only does the decision maker have a problem with his own limitations, but he also has a very big problem with the decision environment or space. Most of the choices in reality are associated with "wicked problems" -- problems to which there is no rational solution (Rittel and Webber 1973). Consequently, these are not the kinds of problems solved by scientific or technical decision making. Most problems confronting developers are wicked problems.
Pondy (in Ungson 1982) identifies a number of characteristics of real (in contrast to the expected or normative) decision making in organizations. He notes that there is a shifting cast of participants in the process, many of whom are at odds with one another, that the decisions are disjointed, historically dependent on earlier decisions, and that considerable interdependence exists among the various decision problems in an organization at any given time. Since the frame of reference of a decision problem is constantly changing, any formal process of arriving at a decision may not be timely. A rational decision process idealized and touted by the management expert may not even be central to achieving the decision maker's objective. For example, a rational decision strategy from the firm's point of view may not serve the personal interests of the entrepreneur who controls the firm. A rational decision strategy may linger beyond its due. Starbuck (in Smart and Stanbury 1978) points out top managers are usually the most rigid when it comes to altering strategic choice, as they believe they had a hand in its original formulation (and most likely did).

Corporations are also victims of their own success, as Starbuck (1978, 114) states:

Probably the great majority of organizations have the potential to work themselves into a crisis, and the processes which produce crisis are substantially identical with the processes which produce success.

This is a rather unsettling conclusion for the rational decision maker. In addition, Starbuck claims that the more highly structured and programmed an organization, with long range planning routines and a proclivity to rational analysis, the more vulnerable it is to failure during periods of environmental change. One gets the feeling this last observation is counter-intuitive; however, the more programmed and standardized an organization is, the more
inflexible it becomes and the less adaptable.

Lindblom (1962, 48-54) lists eight propositions that provide a summary of the failings of the rational approach to decision making. The rational ideal is not adapted to:

1. man's limited problem-solving capacities.
2. inadequacy of information.
3. the costliness of analysis.
4. failures in constructing a satisfactory evaluative method.
5. the closeness of observed relationships between fact and value in policy making.
6. the openness of the systems of variables with which it contends.
7. the analyst's need for strategic sequences of analytical moves.
8. the diverse forms in which policy problems actually arise.

As an alternative, Lindblom proffers "disjointed incrementalism" or muddling through. Focused rather than holistic in its perspective, disjointed incrementalism is restrictive rather than comprehensive in its selection and evaluation of alternatives. It is means-oriented rather than goal-oriented, and it is reconstructive, serial, remedial, and fragmented rather than systemic and first principled in its approach. Lindblom's model of decision making characterizes the day to day decision making in a corporation, which may be routine or strategic in nature. Very seldom do decision makers "stop" the world and prepare their comprehensive strategy on a clean slate, approaching the whole matter in a logical, systematic, and rational way. Nevertheless, as Etzioni (1973), correctly points out there is a need for both approaches to decision making. He, in fact, combines rational comprehensive decision making with disjointed incrementalism and calls it mixed scanning. Etzioni's mixed scanning is applicable in the development industry.

Comprehensive-rational-decision making is no stranger to community planning and development. Because of project scale, long time frames, and large initial financial commitments, the need to anticipate how interrelated
events will unfold on a broad front is crucial to the developer. The investment decision, one of the most important decisions in real estate development, is normally subjected to a very rational decision process — muddling through is not the ideal for these kinds of strategic decisions. To a greater or lesser extent, but always within a limited time frame, developers strive to gain a comprehensive view of the economy, market, location, transportation, environment, infrastructure, community, and competitors to create an idealized model of a project's realization from which a concrete strategy is formed to serve as a guide for future action. However, since the decision environment is so unpredictably changeable, the developer spends much of his time adjusting his comprehensively derived strategy — in essence, muddling through.

2.2 BEHAVIOURAL DECISION MAKING

The decision maker described by behavioural psychologists Janis and Mann (1977, 15) is

... beset by conflict, doubt, and worry, struggling with incongruous longings, antipathies, and loyalties, seeking relief by procrastinating, rationalizing, or denying responsibility for his own choice."

The emotions of the decision maker have a powerful influence on his ability to think rationally, especially under the stressful circumstances found in property booms and busts. Unfortunately, cognition, the process of perceiving and knowing, is not always conducive to rational decision making.

Some important concepts in understanding why developers make decision errors are representative heuristics, availability heuristics, propositional heuristics, and judgmental fixation (Clough 1984, 47-54 summarizes Janis' work). (Heuristics is a self-learning method in which trial and error plays a
The concept of "representative heuristic" helps to account for differences in individual judgments about events or problems by showing that each individual sorts out his own salient features from a maze of features associated with the event to form a unique mental pattern. This concept is helpful in understanding why some developers responded differently to the same stimulus during periods of uncertainty as experienced at the beginning and end of a property boom. Considerable differences in the description of events and the action taken are evident as a result of the importance placed on different features by different individuals. The role of the chief executive in molding the corporate culture as a way of smoothing out these differences should be noted. (See "groupthink", (2.4)) The "availability heuristic" helps to account for the decision maker's predisposition to favour courses of action or things over which he has control. For example, if the decision maker has an office building site in inventory, he is likely to select data favoring the office market, and ignore data to the contrary in the decision process. The "propositional heuristic" describes a predisposition to a particular line of reasoning emanating from the decision maker's conceptual framework or knowledge structure. This predisposition leads to sticking with first impressions, preconceptions, or long standing beliefs in the face of contradictory evidence. This concept helps explain why so many developers stuck to strategies and policies long past their usefulness. "Judgmental fixation" describes the process of arriving at subjective probabilities on successful future outcomes based on past successes. If a developer does exceptionally well in condominium conversion, he would be inclined to say that this activity is a sure thing. The entrepreneur anchors himself in that particular belief. This line of reasoning spills over into wishful thinking in
the gambler's fallacy where the gambler believes that chances will self correct: condominium conversion may not be so good today but it is bound to improve! Janis and Mann's concepts are helpful concepts in analyzing and explaining developer behaviour and decision errors. They provide a clinical label to observed behaviour which, interestingly, most decision makers are unaware of.

In addition to the cognitive limits of judgment, psychological stress appears to be at the root of faulty decision making. According to Janis and Mann (1977), psychological stress varies with (1) the gap between the goal and achievement as well as the importance of the goal; (2) the commitment to old goals and new opportunities; (3) the risk and loss of hope of finding a better solution; and (4) severe threats and time binds. These conditions occur frequently in the development industry. During a business cycle as the intensity of business activity increases, decision makers' stress level increases markedly.

Janis and Mann have identified five patterns of coping with stress; the first four are considered to lead to defective cognitive action and are closely related to the phases of the business cycle:

1) "Unconflicted inertia" (maintaining the status quo) - in this state the decision maker is under no stress and therefore tends to become complacent;

2) "Unconflicted change" (to a new protective action) - the decision maker perceives a loss in continuing on his present course, and quickly and easily alights on an alternative which on the surface poses no threat;

3) "Defensive avoidance" - here the decision maker has lost all hope of finding a satisfactory solution and gives up the search;

4) "Hypervigilance" - overwhelmed by stress the decision maker cuts short the decision making process and makes snap decisions;

5) "Vigilance" - a moderate degree of stress, provides the climate for scrutinizing alternative courses carefully and working out good solutions (Janis and Mann 1977, and Clough 1984, 72).
During a boom-bust cycle it can be expected that many developers would display unconflicted inertia and unconflicted change in the early phases of the boom-bust cycle; later on they might become hypervigilant and give up (defense avoidance) during the bust.

Using these five concepts, Clough (1984, 72) has devised a model of decision behaviour under stress (Figure 5). Janis (1977) identifies several sources of miscalculation evident in the first four patterns of coping under stress: "cognitive defense" which includes procrastinating, shifting responsibility, and bolstering; "situational anxiety" leading to hypervigilance; "obedience to authority" leading to groupthink; "selective exposure to persuasion" leading to biased reasoning; and "a low state of psychological preparedness" for future stress, as found in defense avoidance. The behavioural responses identified in these coping patterns are symptomatic of a decision environment where errors are prevalent.

The very act of making a decision generates stress: "cognitive dissonance" is caused by doubt or regret after having made a decision. "Post-decision freezing effect" is an attempt to abate the fear of having made the wrong decision and leads to superficial search and biased information processing in favour of the alternative chosen. Janis and Mann found that bolstering" after a decision has been made reduces dissonance. Some of the tactics used in bolstering are oversimplification, distorting, omitting major considerations, exaggerating the positive and minimizing the negative, and exaggerating the remoteness of the action commitment. In the organizational decision process, bolstering occurs at each decision level, as a "conclusion" formed moves up or down the management hierarchy. Bolstering could have serious consequences in organizational decision making for a decision at one level often becomes a
FIGURE 5
Decision Behavior Under Stress

Original Source: Derived from Janis and Mann (5).
recommendation and the basis for making successively more crucial decision at higher levels.

Schon (1971) has identified some characteristic tendencies, which are inherent to the decision-making process, especially during periods of stress, that propel the firm towards disaster:

1. substitute slogans and war-cries for analysis;
2. repress failure and amplify success;
3. generalize from one to the many;
4. separate the project from the person, thinking that a person's ability was no longer important to the success of a project;
5. compress time because of the exigencies of performance.

A property boom offers an excellent opportunity for witnessing stress-laden decision making. All of these psychological aberrations to rational decision making, it is suggested, could have been seen in the development industry by the trained observer during the latest boom-bust cycle. Even though this deviant behaviour was prevalent in the development industry, it does not mean that the participants were aware of their or their colleagues' behaviour. The answer to this partially lies in group behaviour.

2.3 GROUP DECISION MAKING

The decision maker is not alone in the process of making a decision: he has his subordinates, directors, advisors, and peers in the industry, both friendly and rival, to contend with, to influence and to be influenced by. Peer group pressure, the politicking of subordinates wanting a voice in the decision-making process, and the predisposition of the board of directors all influence the course and content of a decision. Irving Janis (1972, 9) coined the term "groupthink" to describe negative aspects of group decision-making behaviour within organizations:

"Groupthink" refers to a deterioration of mental efficiency, reality
testing, and moral judgment that results from in-group pressures.

This applies equally to a close network of developers, consultants, realtors, and government officials.

The group pressures the individual to conform to the norms, outlook, and goals of the group. Often the originator of "groupthink" is the strong chief executive officer (CEO). The process of "groupthink" can be seen in the CEO's efforts to foster a common corporate culture. Those who conform willingly gain increased security, and experience heightened self-esteem and less anxiety. This has been found to encourage the group to shift toward riskier courses of action than any one member on his own would pursue.

"Groupthink" is prevalent among highly cohesive groups, such as a task group or planning group who have been brought together by the chief executive officer to handle a particular mission (Janis 1972, 3-6). Drawing from examples of Kennedy's Bay of Pigs invasion, Johnson's escalation of the war effort in Vietnam, and Chamberlain's inner circle on the eve of World War II, Janis and Mann (1977) describe the symptoms of groupthink:

(1) "Illusion of invulnerability" and "excessive optimism" leading to the courage to take extreme risks;

(2) "Collective effort to rationalize" and "to discount warnings" which might lead to reconsideration of assumptions;

(3) "Unquestioning belief in the groups' inherent morality", inclining members to ignore ethical and moral consequences;

(4) "Stereotyped view of rivals and enemies" -- dismissed as too weak or too stupid;

(5) direct pressure placed on any member who attacks the group's stereotypes, illusions, or commitments -- "loyalty" calls for strong concurrence, avoidance of controversial issues, the questioning of weak arguments, or calling a halt to soft-headed thinking;

(6) "Self-censorship" is practiced by members whose thinking deviates from the group consensus;
(7) a shared "illusion of unanimity" emerges, with silence implying consent;

(8) the emergence of "self-appointed mind guards" who protect the group from adverse information.

Many of these symptoms were evident among the executives of western Canada's development industry during the boom.

Janis and Mann refer to "groupthink" as a collective pattern of "defence avoidance", wherein the group fails to explore the ominous implications of ambiguous events in the environment. The group misjudges the relevant warnings of a future crisis by misperceiving signs of the onset, and by forgetting information key to its correct interpretation. Rather than reviewing the adequacy of existing policy to deal with the crisis, the group invents new and probably convoluted arguments in support of chosen policy (Janis and Mann 1977).

Janis (1972, 11) identified specific defects in decision making arising out of "groupthink":

(1) discussion limited to a few alternatives;
(2) failure to reexamine course of action from the standpoint of risk and other drawbacks;
(3) neglect of potential courses of action;
(4) failure to rely on experts in the evaluation;
(5) selective bias toward information and outside opinion;
(6) no evaluation of consequences, and no contingency plans.

A group within an organization can have a powerful influence on a company's course of action or even an industry's, where the company is a market leader. When the collective view of the group is at odds with reality, then a dangerous direction could be set unknowingly by the group.

The study of group dynamics is viewed as an important aspect of the research into decision making in the development industry during periods of stress. From the group and the individuals comprising it, come rich anecdotal
explanations of many problems manifest in the built environment after the downturn.

2.4 ORGANIZATIONAL DECISION MAKING

Barnard (1938) observes that the essence of organizational effectiveness is cooperation. The organization becomes a system of coordination with communications, authority, specialization, and purpose. Efficiency is achieved through the competence of executives, and known channels of communications, direct and as short as possible, with no interruptions.

The conditions of stability in an organization given by Donaldson and Lorsch (1983) are:

(1) a concept of loyalty to shareholders, customers, and staff
(2) internal capital markets
(3) continuity in economy and industry
(4) consistent experience
(5) executive expectations
(6) consistency in goals - attainable, credible, clear, unequivocal, objective, and measurable.

Absence of or weaknesses in any of these conditions opens the door for decision error. It will be seen that many of the conditions of stability never existed in or were abandoned by the property development industry during the boom-bust cycle.

The organization has a belief system, a basic philosophy, and a set of ritualized behaviours. Together these are referred to as the corporate culture (Deal and Kennedy, 1982). The belief system in an organization, central in establishing goals, means, and internal management, includes a vision of distinctive competence, risk preferences, and self-sufficiency. Emotional convictions, as much as cold logic, shape the pattern of decisions labeled corporate strategy.
Every firm competing in an industry has a competitive strategy, whether explicit or implicit. This strategy may have been developed explicitly through a planning process or it may have evolved implicitly through the activities of the various functional departments of the firm. (xiii)... Essentially, developing a competitive strategy is developing a broad formula for how a business is going to compete, what its goals should be, and what policies will be needed to carry out those goals.(xvi) ... The essence of formulating competitive strategy is relating a company to its environment. (M.E. Porter 1980,3)

Strategy is crucial to success. Successful strategies recognize objective constraints in the environment as well as internal psychological constraints (Donaldson and Lorsch 1983). Goals and more immediate objectives shape strategies. Just as a purposive individual has goals to strive towards so does an organization. Organizational goals are defined explicitly or tacitly by quality of management, organizational environment, competitive position, social responsibility, and financial performance. Goals are modified through experience, and usually incrementally: only hindsight can tell whether incremental changes are a fundamental change to the belief system or not (Donaldson and Lorsch 1983). Goals not only provide direction, but they also serve as criteria against which progress can be measured. They are, as will be seen, crucial to the success of the organization.

Cyert and March (1963) contend that goals are in reality imperfectly rational, constrained by an aspiration level, and non-operational. High past achievement leads to optimistic extrapolation of the past into the future. Goals are arrived at not through some rational process, but through a process of bargaining among potential coalition members in which conflicts are never fully resolved. In many organizations the goals are poorly defined or clearly defined but unachievable. Possibly, the most damaging goal is one that is reachable but dangerous to the survival of the firm when achieved! Some organizations express one set of goals publicly and follow another set
privately. Often the private set of goals emerge out of whims of the chief executive officer, letting the organization, as it moves forward, careen from one goal to another. During a property boom, goals are likely to become highly distorted because the decision maker's paradigm of reality is overly optimistic. As such, it fails to take into account the rapid changes in the environment. Consequently, the strategic goals of the organization can become totally inappropriate.

The goals of an organization can be circumscribed by three interlocking sets, called constituencies. They are the product market, the capital market, and the members of the organization. Within these three constituencies, top management's ideals are diversified product market, internal capital, and highly loyal (immobile) key personnel (Donaldson and Lorsch 1983). Goals are usually biased toward the constituency ranked highest in the minds of corporate executive. Product market dominance emphasizes a winning attitude towards growth rates, as measured by share of market and sales. Capital market dominance emphasizes earnings per share, return on investment, reserve ratios, and debt/equity ratios -- satisfying investor objectives. Organizational dominance emphasizes job security, opportunity, and upward mobility as well as money to play with. A highly skewed bias toward any one constituency can result in decision-making errors. For example, a chief executive officer who has a large stake in the ownership of a publicly traded corporation could place undue emphasis on year-end results, sacrificing the long-term survival of the organization. Over-emphasis on growth could lead to capital shortages, high debt, marginal projects, and untenable market shares. Constituent biases were clearly evident in property development companies during the recent real estate boom.
Although controversy surrounds the effectiveness of goals, no organization could operate without them (Scott 1981). Strategic-decision making is very much concerned with selecting appropriate goals for the organization given the company's life cycle and the economic climate. Having the right strategy for each phase of the business cycle, rather than one strategy throughout must help to improve the survival rate of companies.

The approval process is at the heart of resource allocation in the development industry. Each project approval, because of project size, constitutes a major allocation of resources. The capital required is usually borrowed, as the amount usually is greater than the firm's internal capacity to generate. The approval of a project, therefore, implies a significant initial commitment.

The approval process is a source of decision error. Carter (1971) found that project managers tend to promote projects, which they like and which will gain approval based on their superior's predilections, regardless of market demand. When reviewing the project manager's proposal, the chief executive officer tends to rely on external acceptance, and the project manager tends to rely on the superior's relative ignorance. The project manager focuses on the superior's perception of the project and uncertainty -- the greater the uncertainty the greater the acceptance criteria or hurdle. Usually, the higher the competence of the project manager the lower the threshold of acceptance. Through bolstering ("post-decision freezing effect") the uncertainty in the project assumptions, data, and conclusions is suppressed by the time the project is presented to the CEO; as well, goal conflict and expectations are positively resolved before the executive meeting. Co-optation and solidarity are key success tactics in getting approval. Given the positive conclusions
often preceded by a flashy presentation, the CEO most likely approves the project. He is not entirely taken in by the manager's proposal, but in the back of his mind he has concern for motivation and the need to broaden managerial experience.

The way an organization is structured, its belief system and goals, and the approval process all affect the direction and quality of decision outcomes.

2.5 THE DECISION ENVIRONMENT

Also affecting decision outcomes are the nature of the decision environment and the decision makers' perception of that environment. McCrimmon (1976) identifies three attributes in the decision environment -- uncertainty, complexity, and conflict -- which have significant effects on the decision maker's ability to make the right decision. Under uncertainty, the decision maker does not know which event affecting his outcome will occur; he does not know the causal connections; and he has very little control over the environment. According to McCrimmon, the environment in its complexity is seen as being very large, heterogeneous, abstract, and interconnected. Conflict emanating in the environment surrounds the objectives of the organization. The developer's environment tends to be skewed toward the extremes of these three attributes.

To act in his environment, the decision maker must prepare forecasts based on information coming to him from various sources. Two kinds of forecasts are helpful to the decision maker: "environmental forecasts" of future trends in the economy and the marketplace; and "evaluation forecasts" of the consequences to the company of strategic decisions. The latter type of forecasting is somewhat of a rarity in property development. Environmental
forecasts attempt to eliminate uncertainty, to help make projects "fail safe". Evaluation forecasts recognize the uncertainty and try to provide for a "safe fail".

Information used in forecasting is derived from data and theory. Misleading or erroneous information comes from poor or insufficient data, perceptual weaknesses, faulty methodology, and from misinterpretation of data because of inadequate theory. In forecasting events in the decision environment, a propensity to be distracted by irrelevant information leads to loose predictions. "The illusion of control over the environment leads to overly optimistic estimates of outcomes" (Janis and Mann 1977, 16). Perception of regularity that does not exist, as a result of wishful or ideological thinking, also leads to decision errors. McCrimmon (1976) points out that when scanning the environment too much reliance is placed on faulty categories, stereotypes, inadequate sample size, and faulty criteria. Many decision makers fall prey to the gambler's fallacy: they believe that environmental processes self-correct. Complexity in the environment is reduced idealistically but not materially by appeals to authority, expert opinion, rumour, and common sense. Nevertheless, an understanding of the environment, even if imperfect, is absolutely necessary to the decision maker. Information acts as a double-edged sword, on the one hand, providing clues to opportunities, forewarning of potential problems, and, on the other hand, misleading the developer.

Problems in evaluation and prediction are not only rooted in cognition but also in the developer's naturally turbulent and uncertain environment. A steady state implies no employment growth, no opportunities, and no development. Rapid growth in employment implies migration, plenty of
opportunities, and a real estate boom. Since the rate of growth of employment is not uniform, neither is development activity, making forecasting future demand difficult. Adding to the difficulty are the uncertainty surrounding the rate of transformation of employment to space demand (for housing, office, warehouses, etc.), unpredictable locational propinquity, and the unknown rate of entry of new competition. Because of uncertainty, the decision maker needs to be presented with conclusions that look beyond the forecast of market trends and the impact assessment of particular decisions on the firm, to the aggregate impact of past, present, and contemplated decisions. (For example, there may be nothing wrong with the decision to buy 160 acres of residential land per se, but 160 acres on top of a 1,000 acre inventory may put the firm at risk.) Furthermore, the decision maker needs to be aware of competitors' moves, as their actions as well as his own change the predicted trend or market share (Schelling 1978). Probably the two most important points to realize about forecasts have to be that they are rarely accurate, regardless of technique, especially in the kind of environment the developer operates in, yet they are necessary (Oxenfeldt 1979, 107).

2.6 SUMMARY

Decision making was viewed from a number of different perspectives. The key concepts coming out of the review are outlined in Table 1. All of these concepts are helpful to understanding corporate decision making. Its simplest form is the fine art of choosing one alternative over another. Rational decision making is the normal approach used in pedagogy and by many decision makers. Limitations to rationality include, on the one hand, the limited cognitive capacity and ulterior motives of the decision maker, and on the
### TABLE 1: KEY DECISION-MAKING CONCEPTS

(1) **RATIONAL DECISION MAKING**
- bounded rationality and satisficing
- disjointed incrementalism
- mixed scanning

(2) **BEHAVIOURAL DECISION MAKING**
- representative heuristic
- availability heuristic
- propositional heuristic
- judgmental fixation
- coping with stress
  - unconflicted inertia
  - unconflicted change
  - defensive avoidance
  - hypervigilance
- sources of decision error under stress
  - cognitive defense
  - situational anxiety
  - obedience to authority
  - low state of psychological preparedness
- post-decisional problems
  - cognitive dissonance
  - post-decisional freezing effect

(3) **GROUP DECISION MAKING**
- "groupthink"

(4) **ORGANIZATION**
- strategic purpose (goals)
- constituencies
  - product market
  - capital market
  - organizational market

(5) **THE DECISION ENVIRONMENT**
- uncertainty, complexity, and conflict
- gambler's fallacy
other, the complexity and uncertainty of the environment (Simon 1957). As Rittel and Webber (1973) point out, the decision maker involved in urban development has to deal with "wicked problems", problems for which no easy solutions exist, and problems difficult to frame.

Whereas rational decision making focuses on man's intellect, behavioural decision making looks at the whole man with conflicts, doubts, and worries. The emotional side tends to distort rationality. Behavioural theories on how decision makers perceive, frame, and solve their problems offer considerable insight into the actions of developers. They also help to explain common decision errors arising out of the decider's cognitive limits and his inability to cope with stress. Decisions made under stressful conditions tend to be less objective and could easily compound the difficulties facing the decision maker. Once made, decisions are often supported by bolstering, a tactic that includes distortion, omission of major considerations, and over-simplification.

Not only does the decision maker's normative pattern of decision making become distorted by his own behaviour, but it is also influenced by the behaviour of others: his behaviour ultimately influences the decisions of others and these decisions in turn affect him. "Groupthink" leads to a deterioration of mental efficiency, reality testing, and moral judgment (Janis 1972). Most developers operate in some organizational framework. Consequently, some knowledge of organization is valuable to analysis of the development industry. A most difficult problem for decision makers in the development industry is understanding the decision environment and forecasting future trends. Because of the randomness of events and the ephemeral systems relationships in the environment, the decision maker can only partially understand his decision environment.
Each of the perspectives -- rational, behavioural, group, organizational, and environmental -- provides conceptual filters through which decision making in the development industry can be studied. Each perspective provides for understanding of how and why decision makers make errors.

NOTES

(1) Rational decision making, the most prevalent methodology of decision making, is represented in the works of Clough 1984; Donaldson and Lorsch, 1983; Harrison 1981; Kepner and Tregoe 1981. It defines how decisions ought to be made. Most textbooks on decision making, business policy, and planning theory follow the rational model. There are several schools which investigate particular aspects of decision making (The organizational behaviour school includes Cyert and March 1963; Miles 1980; Pfeffer 1982; and Simon 1976). The individual decision maker/psychological-cognitive school includes Janis 1972; Janis and Mann 1977; and Kahneman 1982. There is also a group of scholars looking at the effects of the decision environment on decision making, which includes McCrimmon 1976; Schon 1971; and Drucker 1980). Their raison d'etre is to improve the quality of decision making by drawing attention to problems, pitfalls, and solutions in the rational decision making process.

(2) When the term "decision maker" is used in this and other chapters it refers to a "policy maker" or more correctly, "policy decider", one who determines the strategic direction of the firm. When the term "developer" is used, it is in this context.

(3) The open system described here is purposive or goal seeking and responsive in unpredictable but measured ways to the environment. It is in contrast to an ecological system which can only act on or react to its environment in a prescribed, reflexive manner. It is also in contrast to the systems model that assumes rationality within a closed system.
During the administrations of Presidents Kennedy and Johnson, as Jane Jacobs (1984,19) points out, the business cycle was thought to be under control and demystified. Neo-Keynesian economists "scientifically" manipulated the economy by fine tuning fiscal and monetary policy. In theory, it was simply a matter of moving the economy around by way of interest rate adjustments, money supply expansion or contraction, and government spending and taxation to get the appropriate, politically desired relationship between unemployment and inflation. The Keynesian approach to the management of the economy failed miserably in the 1970s to bring inflation and employment into acceptable balance. Faced with Hobson's choice of either high inflation or high unemployment, governments in the western world opted to lower the inflation rate in the late 1970's, and this act gave the business cycle its classical sine-wave symmetry, documented by Schumpeter (1959). The crash, when it came in 1982, completed the business cycle which began in the mid 1970s in the stagnant aftermath of the previous cycle's conclusion (Thurow 1984).

If we are to understand what happened to western Canada's development industry, it is important to become reacquainted with the nature of the business cycle. The purpose of this chapter is (1) to describe and analyze the important cycles where real estate development occurs; and (2) to describe the role of entrepreneurs, capital markets, and government in business cycles.
3.1 THE BUSINESS CYCLE

Business cycles are an integral part of a market economy. They are a reflection of the adjustment of individual businesses, governments, and other enterprises to supply and demand. The "wave" form typifies the shape of the cycle and is a measure of the intensity of economic activity. The intensity of economic activity in turn is determined by the decisions and actions of businessmen, public administrators, and consumers. Excess accumulation, bottlenecks, and shortages create instability or disequilibrium in the economic system. In times of economic turbulence, such as witnessed in the 1970s and 1980s, the amplitude of the business cycle dramatically increases and uncertainty grows. Under these conditions the economy is most likely experiencing a boom and bust. On the supply side of the property market fierce competition during the boom among entrepreneurs is driven by the perception that opportunities of making extraordinary profits arising out of a strong demand exist, and that these opportunities are limited so they must act quickly. The actions of competitors are, themselves, one of the causes of uncertainty. However, the entrepreneur is not the sole creator of the boom for without credit and a compliant financial community the boom would never materialize. Governments during a boom behave in a schizophrenic manner: their regulatory side is, as ever, resistant to change while their "chamber of commerce" promotional side is spurring the private sector on through glowing speeches, through persuasive statistics on growth potential, and through financing infrastructure.

Any boom, according to Schumpeter (1959), leads easily to a crisis and
necessarily to a depression (or recession) and hence to a temporary position of relative steadiness and the absence of development. Near and often beyond the peak of the boom, uncertainty about how the future will unfold is expressed in high interest rates for borrowed funds, and these high rates coincide with high prices and high wages. Market values at this point exceed economic values. Price and wage structures are maintained beyond the peak by the banks continuing to lend money at high rates to entrepreneurs who in turn use the credit to pay wages, other operating costs, and even dividends as cash flow from operations dries up.

The depression (bust or recession) is a "normal process of reabsorption and liquidation characterized by outbreaks of crisis -- panic, breakdown of the credit system, epidemic of bankruptcies and its further consequences -- abnormal processes of liquidation. This leads to spiral contraction of prices and credit, demand, and penetrates the entire economic system". (Schumpeter 1959, 233). Credit deflation occurs because both banks and entrepreneurs are anxious to gain liquidity, and at this time few borrowers come forth to replace the ones lost. Ironically, the depression fulfills what the boom promised: goods which were at one time scarce become plentiful; production is partly reorganized; costs of production are diminished; and real income is increased (Schumpeter 1959, 256). But this comes at the price of devaluation of real assets -- the disappearance of "real" wealth as seen in things and the re-evaluation of paper money.

The business man at this point is prone to make mistakes because he is confronted with a non-routine environment and these mistakes are an important secondary cause of trouble (Schumpeter 1959, 238). Schumpeter believes the firm which is well supported financially, and not the one that is
most perfect in itself, has the best chance of survival (1959, 238). Consequently the weakest and the least supported firms fall immediately after the downturn; others linger for years after. Schumpeter describes the process:

Mortal wounding of firms does not necessarily cause immediate flight to bankruptcy court. They themselves hope -- and with them their creditors -- for more favorable times. They deliberate, resort to shifts, seek new supports, sometimes with success, sometimes at least with such success that liquidation by consent is possible -- more frequently it is true, without success, but even then the death struggle results in postponing the bankruptcy or reorganization, often into the next upward movement so that the drowning takes place in sight of dry land. (1959, 256)

At the base of the business cycle is accumulation taken in a very broad sense to include fixed, variable and circulating capital, and consumer goods. Harvey's stripped down version of the accumulation cycle reveals:

a tightly interwoven texture of interaction between employment and accumulation, between technical change, the rate of reinvestment and the state of competition, between production and (sales) ..., between the circulation of capital and the circulation of revenues, between supply of and demand of interest-bearing money, between the relative power of industrial capitalist and financiers, between capital and labour, between money as a medium of exchange and as a measure of (economic value), and finally, between money and commodities as an expression of capital (1982, 305).

Harvey conveys the true complexity of the dynamic relationships between various parts of the economy. Harvey sees the business cycle as a means of social transformation, implying that the political economy existing before the accumulation cycle is not the same coming out of the cycle. Schumpeter (1957) saw the business cycle as tracing the introduction, growth, saturation, and decline of some great innovation, like the automobile, culminating in new social, economic, and political relations. Harvey says that the accumulation cycle provides the "open space" for the forces of change:

"The speculation activity associated with the upswing allows individualized and private experimentation with new products, new technology, new organizations, new physical and social infrastructure, even whole new cultures..."
"This atomistic ferment of experimentation creates much that is superfluous and ephemeral but simultaneously lays the material basis for later phases of accumulation."

"The crash rationalizes and re-structures production, so as to eliminate extraneous elements -- both old and new alike." (1982,326)

The important thing to note is that changes during a business cycle are not just quantitative. The implied social transformation is reflected in the increment of the built environment created at this time, to the extent that our actions spill over into physical space.

The recurrent business cycle problems experienced by developed economies arise out of over-accumulation which cannot be spirited away by inflation. High prices alone will not slow the production process down because the demand for goods and services is grossly inflated by the availability of consumer and producer credit. To meet the surge in demand, businessmen, including developers, set out to expand their overtaxed capacity, often at the height of inflation, and at a time when governments are seriously thinking about curbing inflation by slowing down the economy. Government intervention is considered necessary to bring supply and demand together. However, more than likely, the short-term result of state interference in the marketplace is further disequilibrium, only the obverse of what existed before: by curbing demand, the supply becomes greater than the demand. The state brings on a "controlled" crisis (Harvey 1982, 314). Most remedies to cure inflation act in a direction to slow down the economy faster than perhaps it otherwise would have. But the timely introduction of these measures should have the effect of lessening the severity of the slump that would have materialized with or without government intervention.

After the crash, most national economies are no better off in terms of
aggregate employment and debt than they were after the last recession. The temptation to re-inflate the economy to solve these two endemic problems is always lurking close to the surface during the stagnant aftermath. This action would start the cyclical process over again.

3.1.1 THE DEVELOPMENT CYCLE

Real estate development is very much influenced by the business cycle, often responding to a demand initiated in some other sector of the economy (derived demand) or by demographic changes which are themselves induced by some economic, social, or political change (Thompson 1965; Goldberg and Chinloy 1984). Depending on the strength of demand for real estate products, the development industry tends to accentuate the amplitude of the business cycle in a particular urban region by its multiplier effect on the local economy (Smith 1975; Gregsby 1967). Once the momentum in the real estate industry grows, it can become self-generative: the real estate construction force eventually makes up a sizeable portion of the labour force, creating its own demand for real estate product.

Urban development tends to occur in cycles, fluctuating from states of undersupply to states of oversupply. The failure of the market clearing mechanism to bring about a state of equilibrium reflects the nature of property development as well as the nature of the market economy. For the most part, development cycles are short-lived and "lumpy" in the sense that the product seldom matches the real demand. By developers focussing on the same opportunity, development becomes concentrated in time and space, resulting in overbuilding near the end of the expansionary stage. The extreme case of the development cycle is the real estate boom and bust.
The property boom is characterized by a frenzy of activity in the real estate market. This frenetic activity is evidence of the collective efforts of developers to satisfy a large perceived demand. The shortfall between the supply and the demand creates opportunities for the developers first in the market to make profit. The magnitude of the property boom appears to be somewhat immaterial to the magnitude of the increase in economic activity; rather, the property booms' size and intensity seem to be related to the availability of credit, the developers' perception of growth potential, and their inability to gauge the actions of competitors. Its timing may lag a general business boom or occur simultaneously. For example, the 1978-81 office booms in Calgary and Edmonton occurred during the latter years of a resource-led boom in Alberta; whereas, a surge in office development in Vancouver and Toronto occurred during a period of relative economic stagnation after 1982. Although the boom-bust phenomenon is most often seen as an isolated incident, multiple and wide-spread occurrences have been experienced. The most surprising aspect of boom-bust cycles as observed in the most recent cycle is that few of the active participants realize they are in a cyclical process until the cycle has run its course. Still fewer decision makers are cognizant of their role in shaping the dimensions of the development cycle (macro-behavioral pattern) by their individual actions (micro-motives).

3.1.2 THE HOUSING MARKET CYCLE: A DEVELOPMENT CYCLE SUBSET

Factors causing the extremes in amplitude in the housing market cycle are both exogenous and endogenous -- both feeding each other. The occurrence of housing market cycles is related on the one hand to low interest
rates, government subsidies and the availability of mortgage funds; and on the other hand to the inability of builders to control supply because of existing stock and the easy entry of new builders into the market. There are phased lags between the market's perception of new housing opportunities, demand for new construction, and new construction. The lags give rise to decision errors. Overbuilding and underbuilding are characteristics of the market (Ratcliff 1961; W.F. Smith 1975; W.G. Grigsby 1967).

Builder awareness of housing cycles does not seem to act as a safeguard to prevent overbuilding. The control problem, leading to the mismatching of supply and demand, appears to be caused by (1) the difficulty in determining market share in a market where the number of builders is continually fluctuating; (2) the time-lag between planning, construction, and sales, which makes forecasting difficult; and (3) the uncertainty of home buyer and seller behaviour in the resale market. (Most buyers and renters buy or rent existing units.) Unlike many industries that have eliminated or reduced market uncertainty and failures by internalising market behaviour through enlarging the scale of their organizations to the point where one or a few firms monopolize the market, the housing industry remains atomistic, small scale, and competitive (Chandler 1977; Williamson 1975). The herd instinct prevailing among many small builders plays havoc with an individual builder's rational plans and actions. And even when housing industry concentration occurs through growth, acquisitions, mergers, and the forming of cooperatives during good times, the large firm oligopoly is blown asunder during bad times.

The business cycle, the development cycle, and the housing cycle reflect market activity caused by the decisions of buyers and sellers. Key factors in the dynamics of business cycles are the entrepreneur, capital, and government.
3.2 THE ROLE OF THE ENTREPRENEUR IN BUSINESS CYCLES

Although macroeconomic or political events create the preconditions for an upswing in business cycles, the entrepreneur is the catalyst who starts the process rolling. The entrepreneur finds enjoyment in the act of creating, getting things done, or just applying his energy and ingenuity.

The entrepreneur has the dream and the will to found a private kingdom, with the will to conquer, the impulse to fight, to prove oneself superior to others, to succeed for the sake, not for the fruits of success, but of success itself -- from this aspect economic action becomes akin to sport (Schumpeter 1959, 93).

The entrepreneur may indeed be called the most rational of all and the most egotistical of all. For as we have seen conscious rationality enters much more into carrying out new plans, which themselves have to be worked out before acted upon, than into the mere running of an established business, which is largely a matter of routine (Schumpeter 1959, 91).

As a result of the successful exploitation of an opportunity, the entrepreneur enjoys "entrepreneurial" (high) profits for a brief period, which not only give him the incentive to continue producing, but they also encourage other entrepreneurs to go after the same opportunity. This magnetic attraction to opportunities not only creates the boom, but also brings with it structural changes to the economy, organizational changes, and perhaps lifestyle changes. Old businesses may disappear, while new businesses emerge in the competitive struggle. The transformation is by no means smooth and predictable: many of the innovators may become victims of counter movements to the development trend (Schumpeter 1959). Eventually, the entrepreneurs outdo each other in producing an enormous surplus, but even before the glut the entrepreneurial profits had been gradually syphoned away by other players in the industry. Over time, the quality of the entrepreneurs entering the market diminishes. This results in a lower quality product or service produced.
at higher costs, contributing to a further lowering of profit.

The developer is very much an entrepreneur. Through his initiative at seizing profit-making opportunities our cities get built. By the very nature of entrepreneurial behaviour in the development process, city building occurs in concentrated spurts during development cycles.

3.3 THE ROLE OF FINANCIAL CAPITAL IN BUSINESS CYCLES

Typically, the entrepreneur has the idea and the driving force but not the financial means to achieve his objective.

Credit is essentially the creation of purchasing power for the purpose of transferring it to the entrepreneur... By credit, the entrepreneur is given access to the social stream of goods before he has acquired the normal claim to it. The creation of purchasing power characterizes, in principle, the method by which development is carried out in a system with private property and division of labour... It is a means of entrusting him with productive force. It is only thus that economic development could arise from the mere circular flow in perfect equilibrium (Schumpeter 1959, 107).

Today, the broadened role of credit in stimulating final demand tends to somewhat obscure the fundamental purpose outlined. Nevertheless, the main purpose of the money market or capital market remains the trading of credit for the purpose of financing all types of development. New urban development invariably involves land. As Schumpeter notes, there is no lack of causal connection between credit and land. The development industry creates the built environment; financial capital, the life blood of the development industry, makes it possible.

The economy grows by virtue of the accumulation of surplus capital; it is this surplus which circulates through various financial networks within and between different sectors of the economy. Capital is created by industry, transferred to labour in the form of wages, to government in the form of
taxes, and to owners in the form of profit; the surplus usually ends up being deposited in financial institutions, where it is deployed to earn the highest return. Those who invest capital tend to invest it where it is safe, and this traditionally has been in known industries in the core regions. Past investment in fixed assets encourages continuing investment to protect the past investment. The result is a concentration of capital in dominant world cities.

As the accumulated surplus increases -- and this increase can easily be augmented by the creation of credit by the central bank through lowering interest rates and reserve requirements -- investors and financiers run out of satisfactory places to invest in either the production sector or within a particular geographic area. Capital then flows to other sectors and other regions, guided primarily by rates of return on investment capital and the level of risk. Several examples of capital switching follow: the investment capital channeled into Hongkong in the late 1960s and early 1970s -- reflected in the increase in bank deposits, the swarming of offshore banks to Hongkong, and ultimately, the office boom in the early 1970s -- occurred because the rate of return on investment was substantially higher in South East Asia than anywhere else in the world (Beenstock 1982). When the Organization of Petroleum Exporting Countries (OPEC) increased the price of oil four fold in 1973, capital poured into Calgary and other oil capitals from all business sectors and financial centers. A final illustration was the massive shift of investment capital to Western Canada when Central Canada was entering a recession in the late 1970s, and the reverse of that in the mid-1980s. This kind of switching in part accounts for uneven development -- regional booms and busts.

However, some kinds of switching have a pervasive global-effect.
Another outcome of the OPEC crisis was a world-wide money glut created by the price increases. OPEC nations dumped surplus funds during the 1970s on to capital markets, which had limited flexibility to expand rapidly in an orderly manner. This action lead to a massive re-switching of financial capital to the built environment and third world governments, both having a gluttonous capacity to absorb financial capital, but a limited capacity to pay it back. The OPEC money contributed to a world-wide boom in urban development, and a subsequent worldwide crisis -- the bust that invariably follows a boom.

Surges of financial capital can cause crises of varying magnitude in different geographic regions and economic sectors. Occasionally, these surges are so great as to cause worldwide booms and recessions lasting for years, for example the 1930s depression. These pulses come at such regular intervals that they have become known as business cycles.

3.4 THE ROLE OF GOVERNMENT IN BUSINESS CYCLES

On a world-wide basis, one of the prominent actors in the boom-bust drama has been government. It has been variously blamed and absolved of creating booms or their preconditions. In North America, on this issue governments have been attacked from all sides for their liberal management of the money supply and their profligate fiscal policies. Indeed, immediately after the 1982 downturn most developers who got into difficulty were quick to attribute blame to government policy and programs.

The national governments have a key role in orchestrating the economy. Unfortunately the instruments they use are not only blunt but are based on much disputed macro economic theory (Bell and Kristol 1981; Thurow 1984). The methods used sometimes cause more damage than the diseases afflicting
the economy. Of these diseases, inflation, balance of payments deficits, and budget deficits are of particular concern: all three erode currency value and ultimately the wealth of the nation.

To a significant measure, national governments create inflation in the first instance through their fiscal and monetary polices by deficit spending and by borrowing from foreign countries. Profligate spending during the boom, generally, was the approach of many national governments in the 1970s. Left without contingency funds to keep up the safety net, they went into deficit spending in a big way: for example, in Canada, the Federal debt went from $19.2 billion in 1975 to $193.7 billion in 1985. Over 30% of revenues now go toward debt servicing. The debt problem is exacerbated as income from traditional sources shrinks, and expenditures necessary to keep the social safety net in place thrust upwards. At the provincial level as well huge debts have been amassed. The actions of governments and corporations in the accumulation of debt were markedly similar during this recent business cycle.

In the late 1970s, inflation was the primary side effect of an overheated economy stimulated by government policy and programs. Behind this outward manifestation were disturbing signs of weakness in productivity, overseas markets, and the relationship of prices to wages. Some years before the 1982 downturn, inventories began to build up; the prices of certain commodities (in the property market, serviced lots and houses) were out of line with both buyer income and the price of other goods; and unemployment was increasing at an alarming rate. When these changes were occurring, many regions in North America were still experiencing a boom. Bewildered economists labelled this state of the economy "stagflation". To this phenomenon, economists said that Keynesian theory no longer held; many economists went searching for a
new paradigm for macroeconomic theory, in monetarism and supply-side economics (Thurow 1984). Part of the problem was that, during the boom many governments were doing what Keynes reserved for recessions: they were priming the economic pump, thus amplifying the boom and accentuating the crash, and floundering without means in the recession.

The boom waned because the United States Federal Government applied the brakes to runaway inflation not once but three times (Thurow 1984). This was achieved by withdrawing support to housing and other sectors of the economy, increasing taxes and interest rates, issuing bonds, and restricting credit -- all of which shrank the money supply. The first occasion when the brakes were applied was prior to the 1974-75 recession. The Canadian Government followed suit, taking its cue from the U.S. Government. On the second occasion (1980), however, President Carter reversed the restraint policies before they had a chance to take effect because he was fearful of the negative consequences of restraint on the upcoming elections. This failure to slow inflation, and the second OPEC oil price shock (1979) led to an even greater rate of inflation accompanied by greater turbulence in the economy. Unfortunately, many businessmen assumed from this that inflation could not be stopped and continued to follow inflation predicated business strategies well past the turning point in 1982. On the third occasion, President Reagan applied more or less the same anti-inflation policies imposed by President Carter, but for a sustained period of time. In the United States, inflation came down to the disbelief of many investors, developers, and experts from over 13% when the brakes were initially applied in 1979 to 3% in 1984 . Canada's inflation rate also dropped somewhat later by the same magnitude. Along with the fall of inflation came the fall of a sundry of speculative
activities, including real estate investing and development.

The business cycle can be influenced by government policy and programs. It is apparent that government measures are more effective when they are applied in the direction of economic trends than against those trends. It is also apparent that only powerful measures taken by influential governments have any effect on changing the direction of the business cycle. Smaller nations and regions, such as Western Canada, can only react to cyclical forces.

3.5 IMPLICATIONS FOR PROPERTY DEVELOPMENT

The expansion and contraction of credit or financial capital account for the development cycle in the built environment -- for periods of rapid growth and for periods of stagnation. Where the urban economy is strong, liberal credit policies promote growth, and tight credit policies, stagnation. Interest rates, instrumental in credit expansion and contraction, lie at the heart of cyclical movements. A rhythm is set in the economy induced by interest rates influencing innovation, expansion, and renewal in the built environment. This rhythm is not without its disturbances: industry overcapacity, inventory surpluses, and devaluation of real estate assets.

Property development is very responsive to the local economy. A boom in manufacturing or resource development could easily trigger off a boom in the property market by creating demands for warehouses and industrial space, office space, and residential units. Venture capital finds its way into the property market as seed money. Frequently, this capital comes directly from investors in the manufacturing or resource industry seeking to diversify. The seed money acts as a door-opener to credit. In the 1970s, the Canadian and Alberta Governments were a major source of investment capital and credit,
redistributing the surplus from the primary sector into the secondary sector through various housing and industrial park development programs, mortgage lending, and infrastructure programs in highways and public works. This redistribution had a significant affect on property development.

However, massive shifts of financial capital from both the private and public sectors into real estate could have a foreboding message. Opportunities in the resource sector of the economy might be drying up, as signaled by a diminishing rate of return in that sector, or the money supply may just be too great for the available opportunities. In both cases, the underpinnings for the property boom are not substantial, as was the case for the property boom of 1978-81 in western Canada. Few investors realized that this property boom, well into its stride by the early 1980s, was really on its final leg, unable to sustain itself without impetus from basic economic activity. Unfortunately, the impetus was not forthcoming as Canada’s GNP dropped progressively through the late 1970s to a zero growth rate in 1980-81.

Real estate is quite often the last economic sector to experience the boom because it is dependent on the build-up of a capital surplus in the economy, greater employment opportunities in a region than a region can supply thus leading to migration, low interest rates, credit availability, and higher rates of return in relation to other sectors of the economy. This could mean that the property market is experiencing a boom while the rest of the economy is slipping into a recession.
The developer's disposition, beliefs, outlook, goals, aggressiveness, spirit of adventure, and inclination to take risks vary with the phases of the business cycle. These phases, according to Harvey (1982), are recovery, credit-based expansion, speculative fever, crash and stagnation. The purpose of this chapter is to bring together the dynamic process of the boom-bust cycle and the developers' behaviour during that cycle, in order to: (1) demonstrate the relationship between business cycles and developer behaviour by empirical observations, (2) demonstrate the general (nomothetic) nature of the boom-bust phenomenon, and (3) provide a knowledge base for grasping the significance of the research findings. An appreciation of what happens to the economy, in general, and to the development industry, in particular, during a business cycle is helpful to understanding the property developer's strategic behaviour.

In this chapter, for each business cycle phase, the general characteristics of the state of the economy and the property market will be described. Each description will be followed by examples of property market activity from different geographic regions. The empirical examples are drawn from (1) the 1973-75 and 1978-84 North American urban property booms and busts (In the 1970s, many North American cities experienced significant boom and bust cycles in real estate development: Houston, Phoenix, Los Angeles, San Diego, Denver, Calgary, and Edmonton were among these cities); (2) The 1978-82 Hong Kong Office boom (Hong Kong is noted for its spectacular booms and busts,
high real estate prices, bank collapses, runs on stock exchanges, and laissez faire government policy); and (3) the 1968-74 Sydney property boom and bust (This property boom and bust was extensively documented by Daly (1982) and has remarkable parallels to Calgary's recent boom and bust.)

4.1 THE DEVELOPMENT INDUSTRY DURING RECOVERY

In the general economy, recovery emerges sporadically out of a period of contraction and stagnation. The industries which form the leading edge of the recovery start taking advantage of the opportunities created by falling prices, wages, and interest rates. Structural adjustments in the economy increase the profitability and cash flow of businesses. With improved liquidity, the producers who weathered the storm are in an excellent position to acquire devalued capital assets. Eventually, conditions in the capital markets improve to the point where long term investments in fixed capital look favorable. In the commodity markets, inventories are being reduced differentially and modest expansion begins in some industries. At this point most of the expansion is being financed internally (Harvey 1982, 301). Without initially furnishing any element of supply, the investment in fixed capital formation helps to create an effective demand felt in the consumer goods sector through the expansion of employment. "The tendency toward explosive oscillation between the two sectors of the economy (production and consumption) is gently set in motion" (Harvey 1982, 302). Competition is relaxed, gradual, and uneven. Circulation of revenues picks up as does the demand for money. The effective demand strengthens for final consumption and this sector begins to take a leading role in directing economic activity (Harvey 1982, 302).

Very little property development is evident during the early stages of the
recovery phase. Excess supply created during the last boom still exists, particularly lower quality inventory. Tenants and buyers take advantage of the prevailing low rents and reduced selling prices to upgrade their premises. The excess supply acts as a barrier to the expansion of credit in real estate. Financial institutions find it hard to accept any level of market demand when so much empty space supported by unproductive loans still exists.

Throughout the economy as new jobs are created and regional shifts of employment occur, the demand for new housing appears on a geographically selective basis, depending on where the jobs are being created, the level of unemployment in the region, and the housing stock in inventory. The selective recovery of the economy does not necessarily induce a general recovery of the real estate sector. Certainly, developers continue to speculate about future possibilities but few of the survivors of the last economic slump are anxious to start new projects. Quite likely, the new thrust when it does come, will originate in some entirely new enterprising firms: firms not bound by the constraints of a turbulent history, and the resulting psychological impairment to risk-taking.

Although origins of property booms are varied, certain preconditions were found to be common at the point where the economy was well into the recovery phase of the business cycle:

(1) Expectations about future events were rising.
(2) Opportunities to invest appeared to be better in real estate than elsewhere.
(3) The money supply was expanding, credit was loosening, and the nominal interest rate was going down.
(4) Price inflation was increasing and the real rate of interest was moving in the negative range.

(5) Employment opportunities were increasing, encouraging in-migration.


In North American cities, inventories of real estate products (office space, housing, serviced lots, etc.), especially in the west, were relatively low, and appeared to be disappearing quickly. On the other hand, the perceived demand appeared to be increasing quickly, especially in those regions known as the Sunbelt and the Energy Belt. Developers started to rekindle their interest in the market (Globe and Mail 1976-77). In Hongkong, four factors contributed to the office boom: the high growth rate among local companies; the invasion of foreign banks, jostling for position in the fastest growing regional finance centre; the influx of foreign firms wishing to trade with China after normalization of relations; and the high growth in government employees with office occupations (Jao 1980). In Australia, Sydney's greatest property boom was an extension of a mining boom, spurred by the discoveries of iron ore, oil, nickel, and bauxite.

4.2 THE DEVELOPMENT INDUSTRY DURING CREDIT-BASED EXPANSION

By the time the credit-based expansion phase occurs, faith has been restored in the general economy. The business outlook is bright. Revenues and profits are up, and so are employment and wages reflecting a growing demand. New investments are made to expand capacity and eliminate the bottlenecks in the system of production and supply. These capital expansions
are of such magnitude, that except for the most cash-rich firms, industrialists are compelled to turn to the banks. "The balance of power now shifts toward the financiers as the credit system comes into its own as the general coordinator of commodity production and exchange" (Harvey 1982, 303). As the demand for money increases, the amount of credit in the financial system eventually exceeds the value of goods and services the economy can produce. The result is inflation, as Harvey (1982, 303) points out:

The quantity of fictitious capital (credit) moves steadily ahead of actual accumulation and the gap between the monetary basis as a real measure of value and the various forms of paper money in circulation begins to widen.

Because of the strong demand for credit, interest rates rise causing profits to decline, thereby forcing firms into fiercer competition. The struggle is exacerbated by high wages, and lower quality caused by labour shortages (Harvey 1982, 303). As profit rates of producer and consumer industries fall, near the end of this phase, capital is switched to the real estate industry where prospects appear extremely attractive. Only during this expansionary period, does the effective demand for real estate product of all kinds become apparent. The development industry literally explodes out of the doldrums of the previous phase. Rapid price rises in land create the illusion of tremendous profit potential in land development. The aggressive firms set their sights on increasing market share, but find out rather quickly that competition and the limited size of the market can impede their progress. To overcome the inherent problems of a thin market, these firms tend to expand into different product lines and geographic areas. It is not uncommon to see eastern firms moving west, and western firms moving east; each moving for the same reason -- the perceived lack of opportunity in their own region. Also, it is not uncommon for developers in the same product line to follow each other into other
product lines. This wave-like activity is created by the common perception of investment opportunities. Timing becomes everything. During this period, city building reaches its productive peak. The risk and rewards appear to be comfortably in line. Later, when the speculative period is reached, the delivery system begins to overheat and break down.

Stock markets throughout the western world reflected the transfer of capital from the sagging industries to property development companies. As a group they were accumulating assets at breakneck speed and making record sales and profit. Their share values became grossly inflated, possibly trading as high as 100x earnings (the norm is less than 10x) (Wilson 1980). High expectations about the firm's future value, determined by the appreciation of property asset base, fueled the increase in stock prices. The combined index of Hongkong's (four) stock markets, dominated by property companies, was indicative of what was happening in the property market (P. Wilson 1981, 39):

<table>
<thead>
<tr>
<th>Hang Seng Index:</th>
<th>1980 (Jan)</th>
<th>879</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>1980 (Nov)</td>
<td>1,654</td>
</tr>
<tr>
<td>Record high:</td>
<td>1973</td>
<td>1,774</td>
</tr>
</tbody>
</table>

The growth of assets on the balance sheets of development companies created the illusion of strength, but the assets were almost completely offset by debt. In spite of their large debt burden, investors and lenders became attached to the successful corporations.

Outside capital had an important role in facilitating the development boom. In Hongkong, the money supply increased by 30 per cent per annum since 1977, much of it coming from outside investors. In Sydney foreign capital played a major part: about 40% was of foreign origin (Daly 1982).

Property markets absorb considerable amounts of credit during
inflationary times, without a concomitant increase in real value. As the boom advanced, property values became increasingly difficult to justify on the basis of economic rent. Developers, lenders, and investors assumed that rents and, hence prices, would only ratchet upwards. Land values mirrored this assumption. Developers tended to ignore the implications of higher prices on the purchasers' ability to pay, the consequence being market shrinkage.

There was also the mistaken notion that land values everywhere were moving toward a general equilibrium price. In Sydney, British developers, with their experience in higher priced land markets in London and Hongkong, bought up downtown sites without quibbling over asking prices, probably much to the surprise of local owners. Inadequate market knowledge, poor negotiations, and excessive credit caused land prices to soar (Daly 1982).

As the boom continued, improved share value (based on greater equity and earnings) gave firms the ability to borrow more money for more property investments. The increase in debt-financing possibilities attracted the banking community. To the development firm, the enormous expansion in the use of debt financing increased the probability of insolvency, but during the boom this did not seem to bother the lender or the developer. In time, competition to lend more money, to gain a greater market share, fostered a "devil-may-care" attitude among the supposedly conservative financiers. Some lenders became so enthralled with the prospects of huge profits in land that they jumped right into direct investment in land. In Canada, the collapse of a number of trust companies has brought attention to the incestuous relationships the trusts had with their wholly owned real estate development companies. In the United States in the early 1970s, the Real Estate Investment Trusts (REITS) were also running along side, and sometimes ahead
of the speculators, stumbling, eventually, into financial bankruptcy. This "devil-may-care" attitude was not limited to North America. Financiers in Sydney, impressed with the stock performance of development companies lent, liberally to all developers. Financial leverage was high -- 80-100% of total development costs. No difficulties in the office market were encountered in getting someone to profit share or joint venture, because bankers were just as anxious to realize a profit as the developers were. Developers could borrow sufficient working capital to carry on with several projects at the same time (Daly 1982). In effect, many developers with so much of their own product on the market probably ended up competing with themselves. The abundant supply of credit helped to drive the industry toward speculation.

4.3 THE DEVELOPMENT INDUSTRY DURING SPECULATIVE FEVER

The amount of money circulating in the general economy in the form of credit by this time has far exceeded the value of production. Unemployment has virtually disappeared. Wages and other costs of production are soaring; prices absorb the increases in costs. The economy is moving rapidly away from equilibrium. The high demand for money drives up interest rates. High wages, high interest rates, and sagging sales force the businessmen to desperately seek out innovative solutions to falling profits. One solution is to lay off marginal workers, thereby creating a situation of rising unemployment coupled with rising inflation -- stagflation. Other solutions lie in diversification, divestitures, mergers and acquisitions, and the greater application of technology. For certain, the business man cannot stop at this point, because only imminent collapse stares him in the face when he looks to the status quo. The business man is compelled to gamble on uncertain
outcomes; in short, he must speculate.

Certain industries are a magnet to speculative investment; the real estate industry is surely one of the most attractive. (Sigafoos (1976) provided a long list of the Fortune 500 companies dabbling unsuccessfully in real estate in the speculative phase of the 1970-75 business cycle). Massive injections of speculative investment into the property market all at once creates a frenzy of buying and selling. The rational basis for forecasting, planning, and decision making goes awry. The speculator is apt to forget about the high risk accompanying high profits in a rising market. The movement in the market can be compared to a wave about to break, and when it does, a myriad of speculators from the most "sophisticated" to the first-time investor is swept under. The economy at the end of the binge is, as Harvey says, in such bad shape that "only paper money covers the cracks and it is only a matter of time before the bubble bursts" (1982, 304).

Speculation in property is one of the leading causes of boom and bust cycles in the property market. Investor overconfidence and market uncertainty are the necessary ingredients of speculation that lead to overbuilding and financial crisis. Speculative fever grows over the course of the cycle.

Manifestations of this trend can be observed in property price escalation. In Hongkong, some property values were increasing at rates as high as 333 per cent per annum. Office property went from:

<table>
<thead>
<tr>
<th>Year</th>
<th>US$</th>
</tr>
</thead>
<tbody>
<tr>
<td>1977</td>
<td>1,000/sq.ft.</td>
</tr>
<tr>
<td>1978</td>
<td>1,500</td>
</tr>
<tr>
<td>1979</td>
<td>2,600</td>
</tr>
<tr>
<td>1980</td>
<td>3,800</td>
</tr>
<tr>
<td>1981</td>
<td>5,500+</td>
</tr>
</tbody>
</table>

Downtown land sold for nearly US$6,000 per sq.ft. in 1981. During this period of office development, Hongkong gained the distinction of having the highest rents in the world. Rents were increasing at a rate of 136% per annum. Office building value went considerably higher than the value of the capitalized rental stream in Hongkong (US$877/sq.ft. of net leasable space verses US$624/sq.ft.). The trend in market value of buildings paralleled that of land: one building in 1978 sold for US$143/sq.ft., traded several times, and was last sold in 1981 for US$850/sq.ft., an increase of 164% per annum (Wilson 1981, 36). The embeddedness of the boom state of mind can be seen in the purchase of the Exchange Square site in Hongkong's central district for HK$4 billion (U.S.$847 million for 144,000 sq. ft. or U.S.$5,881/sq.ft.). This transaction was concluded when the market was visibly weak and a long term oversupply unavoidable (Bowring 1982, 64)! Overly optimistic expectations about continuing increases in land value are the basis for these transactions.

In Sydney, the office market was also extremely active during the boom, experiencing A$2,000 million worth of new construction in the central business district (CBD). Downtown land prices in the financial centre peaked in 1970 at A$5,500/sq.ft. up from A$2077/sq.ft. in 1968. Interestingly, all of this occurred while the downtown work force decreased by 11,000 employees (1966 - 202,000; 1971 - 191,000) (Daly 1982).

To control speculation in Australia, a betterment tax on land equivalent to 30% of the increase in value was imposed over the boom years (1969-73). But this tax only succeeded in heightening price inflation as it was passed on to the end consumer. The tax, meant to cure inflation, did not even mask the symptoms. The land value tax was eventually dropped.

The effects of the 1968-74 boom and the rising prices through 1978-81
pushed the median price of a home in Sydney to a level 85% higher than in Melbourne in mid 1981. The competition for resources -- land, labour, and capital -- drove prices higher and higher (See Table 2).

**TABLE 2 : HOUSING AND LAND PRICES IN SYDNEY (1950-74 MEDIAN PRICES)**

<table>
<thead>
<tr>
<th></th>
<th>1950</th>
<th>1966</th>
<th>1974</th>
</tr>
</thead>
<tbody>
<tr>
<td>Lot</td>
<td>$A690</td>
<td>$A5,000</td>
<td>$A20,200</td>
</tr>
<tr>
<td>House</td>
<td>4,670</td>
<td>13,000</td>
<td>33,000</td>
</tr>
<tr>
<td>%Land/House</td>
<td>14.7%</td>
<td>30.8%</td>
<td>60.0%</td>
</tr>
</tbody>
</table>


Nearing the end of its course, speculation has touched off many panics in financial markets. In Hongkong, speculation and crisis have characterized the property market over the years (Youngson 1982):

1965 - Bank panic, 25 branches closed.
1967 - Many banks illiquid because of property investments.
1972 - Bank lending expanded from HK$11,800 million to HK$17,700 million directly caused by speculation.

Real estate agents, securities analysts, forecasters, and above all, the press have a significant role in generating unfounded optimism about the future of the real estate market. They stimulated the investors' appetites, causing speculation to rise dramatically. No small part in the speculative process is played by the developer himself. Development companies, by subtle and sometimes not so subtle means, used the media to create positive images about their leaders, the financial and management strength of their firms, and their future growth prospects. Outsiders, including the bankers, began to believe that some developers had an innate understanding of real estate.
In Hongkong, for example, a new wave of Chinese property companies became giants through the skillful use of government credit on land purchases (Wilson 1980, 39). Many of these companies were under capitalized and depended heavily on borrowed money. Carrian Investments and Eda, two interrelated Hongkong development companies, amassed financial obligations of HK$8 billion (US$1.21 billion) with an initial equity of HK$500 million and the balance secured by shares of questionable value. The chairman of Carrian Investments, an ebullient salesman, created three myths about Carrian Investments through the deft use of the press -- massive backing, brilliant trading touch, and high profit expectations -- which helped to expand its borrowing capacity. The Carrian empire was built overnight with other people's money in a rising property market. The image of corporate dynamism and profitability pushed shares to extravagant levels. The high share prices and land prices attracted outside money further driving up land and share prices in a never-ending spiral (Bowring 1982, 64).

In Hongkong, not only did development firms soar into prominence in the property market, but so did the banks and the government. All three had an interest in keeping land values high. Besides worrying about the security of their loans, some bankers worried about their investments in property. These bankers used the banks as a convenient channel for securing public funds for their own speculation (Youngson 1982, 33). The Hongkong Government, for example, worried about property values because it received up to 30% of its revenues from property leases.

As the speculative fever grew, even cautious investors lost their caution and invested in a highly inflated market (after 1980), on the assumption that each successive year was better than the last, contrary to their predictions, so
therefore they must have been wrong. (The conservative pension funds in Canada were among the last of the financial institutions to enter the real estate market.) It was at this juncture that the boom began to wane. Yet the competition for financial resources continued to be fierce; everybody wanted a piece of whatever action remained.

The fierce competition led to too many overpriced residential lots, houses, commercial sites, office buildings, and warehouses, which in turn soured the market. The transition near the end of the speculative period was marked by perceptual change: the future was no longer unfolding out of the past as the development community expected. In North America, nearing the end of the 1970s developers began to experience difficulties: a series of setbacks began to form a picture of impending disaster. Not only were the unfamiliar environments ventured into beginning to plague developers, but the pressures on the organization caused by rapid growth were reaching serious proportions.

Corporations were going out of control: overbuilding, running out of working capital, and floundering in thin or unfamiliar real estate markets across North America -- even in the burgeoning western cities overbuilding was endemic. Developers had exacerbated their problems by investing in marginal projects partly because they had run out of better places to invest in and partly because even the intrinsically good investments were grossly overpriced. Some firms exceeded the level of activity management was capable of handling. How developers and bankers got to where they were, was through a process of reality distortion. This distortion can be seen in the 43 million sq. ft. of office space built in New York over a three year period when the historical demand called for 18 million sq.ft. (the actual absorption was about 20 million sq.ft.) (Kelly 1983). Overbuilding was not at all unique to
New York: the "hot spots" in North America -- Southern California, Houston, Dallas, Denver, Edmonton, and Calgary -- have experienced the same thing.

During the economic perturbations just before the downturn, opinions in the business community about future expectations varied with business trends. In December 1973, 52% of Sydney's businessmen surveyed predicted a downturn in the following quarter. Nothing happened for over a year. However, just before the downturn in March, 1974, only 36% expected a turn for the worse. This, Daly attributes to an upturn from January 1974 through March 1974, which clouded their perception. The conflict of opinion at the change point of the business cycle is dramatized by the verbal interchange that took place between the Chairman of the Australian Institute of Urban Studies and the Queensland President of the Urban Development Institute: the latter to a remark of the former on the possibility of a 50% reduction in land values, "described (the Chairman's) prognostications as grossly misleading and surprisingly inept..."(Daly 1982, 21). But shortly after this exchange of words, the banks moved to improve their liquidity: deposit rates went from 9.5% to 15% and call money went up to 22% by June 1974. The tight money policy had its desired effects on speculation and development: land prices instantly fell by 14%, and 73% of new homes remained unsold over an extended period. The speculative phase was over.

4.4 THE DEVELOPMENT INDUSTRY DURING THE CRASH

Speculative fever spurs the boom to great artificial heights. At the peak of the boom, the crash marks the abrupt change of both economic activity and perception of the present and future economy, one influencing the other.
The boom paradigm is shattered and replaced by doom and gloom. The crash is often triggered by a spectacular failure, such as that of the stock market in 1929. The rate of interest, the harbinger of the crash, as well as the cause, is at its zenith when the economic structure begins to collapse.

The crash focuses attention on the quality of investments and the extent of debt in the economy. Investors, realizing belatedly that their investments are on shaky grounds and they themselves are overextended, move, in concert, to transform their investments into money. This monetization of debt causes a devaluation of real assets in the built environment, as the supply of various real estate products vastly exceeds the real demand. Insufficient real money exists in the circulation system of capital to effect exchanges in the market. The market ceases to act as a clearing mechanism: large quantities of fixed capital and commodities become surplus in the economy. "The extended chain of payments is broken and the circulation of capital lies momentarily broken into a thousand disconnected pieces." (Harvey 1982, 304) With investment funds cut off, firms scramble for revenues to pay for their mounting debt obligations.

The early signs of a crisis can be discerned in the spate of mergers and acquisitions, as firms, realizing their industry is headed for trouble, diversify, or amalgamate with other firms to gain strength in an adverse and extremely competitive environment. Insolvencies and bankruptcies come later, when the cash flow dries up. In this process, the economy weeds out the weak, the redundant, and the careless firms. The thinning out process violently strives to bring production in line with demand; however, at this juncture, positive achievements are not forthcoming. Only time will allow the market correction to take effect: "titanic struggles" during the period of crisis seemingly produce
nothing but heat in the economy and ulcers among the decision makers. But all this is a necessary prelude to recovery, as Harvey states:

"The crisis, as the irrational rationalizer of the economic system, cuts a grim swath across the economic landscape..." (1982, 305)

In the most recent boom-bust cycle, the many years of prosperity came to an abrupt end in 1982. As demand dropped off in the general economy, more and more labour was released from employment, further decreasing the aggregate demand. Through the transition period real estate markets were crashing sporadically across North America and elsewhere: weaker, recession-prone markets fell first, and eventually even the stronger markets went down. Everywhere, the downward spiral ended in a crisis of confidence and credit -- the two go hand in hand. The change in the fundamental conditions shattered the presuppositions upon which the developer's plans and world view were based.

The world economy was in the grips of a recession. In Hongkong, the Gross Domestic Product drifted downward. Manufacturers were having a difficult time holding on to their market share, as world markets shrank and protective barriers went up. Capital began to flow out. Private sector building tapered off but not before chronic over-building, which drove inventories up and caused the real estate market to collapse (Bowring 1982).

Developers everywhere, at first, refused to accept the collapse of the real estate market. Some fought on; others were bowled over by it. Lenders panicked, and the relationship between the developer and lender dissolved in a cloud of suspicion. The gap between the perceived reality and actuality closed quickly. The developer faced a new set of problems related to the disintegration of property markets; his unfamiliarity with these problems increased the probability of making mistakes, as he tried to muddle through.
Given the magnitude of the callable loans, interest payments, and principal repayments outstanding, even the strongest companies had to take drastic action. Some desperate development firms painted such a bleak prospect of recovery in the immediate future that the banks, very reluctantly, continued to pour money into these firms to keep them afloat. The tension between the defaulted companies and the banks, needless to say, was taut.

Some observers said that the most astute developers had recognized the liquidity problem first; others countered that firms first to react were usually the ones that ran out of money, primarily because of their financial leverage. Whatever the answer, there were many bankruptcies, call them real, technical, or silent. All property companies were highly levered and therefore required large cash flows to meet debt charges and sustain profitability. In the United States in the period leading up to and following the 1982 downturn, 60% of the builders went out of business and over 2 million housing-related jobs were lost (Hawkens 1983, 68).

Both developers and bankers hoped the situation would right itself in the immediate future. Because the problem was oversupply, not temporarily depressed demand, only time or a dramatic upturn in the economy could cure the problem. In the trough of the business cycle, banks had no choice with their large debtors, really, other than holding on until the market returned to a point where they could put the firm into receivership and recover their loans. The debtor-firms, on the other hand, attempted with the help of bankruptcy experts to persuade the banks to enter into long term loan modification and debt restructuring programs before the market improved, thereby giving them a chance of riding up the next cycle without the threat of bankruptcy. Since the firms at this point were technically bankrupt, if not
legally, the decisions concerning survival rested with the banks and other creditors.

In Canada, the banks decided, out of necessity, to support the large developers. In Australia, they did not and the development companies collapsed (Daly 1982). In Hongkong and other South East Asian cities, finance and real estate are protected from market operations to a degree by cronyism and strong vested interests. When Carrian Investments got into difficulty in 1981, for example, the banks including Barclays, Paribas, the Hongkong and Shanghai Bank, and the China-backed Bank of Communications pumped more money into the corporation (Bowring 1982). However, Carrian's liquidity problems, like many other undercapitalized and highly leveraged companies, did not abate. Carrian Investments was not the only company to experience a negative cash flow, but it was certainly one of the biggest. The banks were caught on the horns of a dilemma. Too swift a reaction to the liquidity problem would cause a chain reaction of bankruptcies. But, with the devaluation of property, the banks would be pouring good money after bad. In 1983, Carrian Investments went into bankruptcy along with many once-prosperous Hongkong companies, including a number of secondary banks (Business Week, 21 May 1984, 59-60). The shock waves were felt by the banking community around the world.

Not only did the young, speculative, and levered companies get hurt but also the established firms with blue chip assets and considerable equity. Hongkong Land Co., one such company, experienced such a battering from the 1982 recession that in 1984 it was still reeling:

In 1982, Hongkong Land Co.,-- the Colony's oldest and largest real estate developer, with $3.4 billion (U.S.) in assets -- was acting like a high roller on a spree. Blind to the coming crash, Managing Director Trevor Bedford invested $1.1 billion that year, gobbling up development sites for top dollar and, for the first time, joining Hongkong's rich Chinese in joint ventures. Hongkong Land's investments went unchecked because its
huge central city property holdings remained 99% occupied. And with profits leaping to $261 million in 1981 from $39 million in 1977 on a jump in revenues to $1.1 billion -- nearly a fivefold increase -- even the spectre of China taking over the Colony did not daunt Bedford. "We are here to stay," declared Bedford. Today, Trevor Bedford is gone -- and so are Hongkong Land's big profits and massive spending. (Business Week, 21 May 1984, 96)

After losing $164 million in 1983 and having its equity shrink from $3.49 billion in 1981 to $1.76 billion while its debt tripled to $1.78 billion, Hongkong Land, in 1984, is going back to fundamentals. The objective of David Davies (the new managing director) is to turn away from speculation and toward long term investments to produce solid rental properties. So far he has managed to convert the company's short term debt into long term debt. To achieve this, property assets were used for the first time to secure debt. The banks showed some reluctance to increasing their exposure to Hongkong Land's financial difficulties, but as one Hongkong analyst said: "It's like Mexico. The banks have too big a stake in Land to pull out now". One of the assets causing the haemorrhaging was the US$1.2 billion Exchange Square building started after the market turned down. To cover the debt servicing on the building, rents need to be US$60 or greater; Hongkong Land would settle for just half that in 1984, if only someone was prepared to enter into a lease (Business Week, 21 May 1984, 96 and 101). Y.C. Jao, professor of economics at Hongkong University, summed it up by saying, "Most of the big British companies have made appalling mistakes in Hongkong" (Business Week, 21 May 1984, 101).

As with all booms the denouement was oversupply, collapse in values, and a crisis. After New York's spectacular office boom between 1970-72, over 20 million square feet of office space was vacant -- nearly equivalent to all the office space in downtown Vancouver. The vacancy rate for the subsequent six years never went below 10%, up from the 1960s average vacancy rate of 2%.
Interestingly, a five fold increase in absorption in 1967 most likely triggered the construction boom (Kelly 1983). Vancouver’s office construction boom of the post 1982 period (i.e. during the recession) created a surplus of over 3 million sq.ft. Its rather unique origin in contrast to New York’s seems to lie in desperation and the faint hope that proceeding with construction during a recession is preferable to answering to one’s superiors or the banks for misjudging the strength of Vancouver’s office market. A former Vancouver security analyst suggested that too many developers left over from the boom with nothing to do were responsible. Clearly, with the major office employers laying off staff, there was no evidence to suggest that a pent-up demand existed. Denver’s property boom, which saw many Canadian developers take part, was caused by the energy boom. It ended, like the others, with a surplus inventory (in Denver’s case the vacancy rate exceeded 20% in 1983). Houston, Oklahoma City, Calgary, and Edmonton were among the cities that fared poorly after the collapse of oil prices. In each city property values plummeted.

Sydney’s experience was no different from that of the boom cities on the North American continent. The office vacancy rate in the core rose to an extraordinary 31% (cf. Calgary’s vacancy rate of 24%). The Sydney planners had approved 51 million sq.ft. between 1967-75 at a time, as was mentioned, when employment was falling in the CBD. The collapse in property value in the core was estimated at A$300 million. This drop in value affected everyone -- developer, investor, financier, and tenant. By gearing its future budget revenues to office completions, even the local government found itself being squeezed financially. On balance, only the tenants who renegotiated their leases or found new accommodation after the collapse came out ahead. From
the viewpoint of society, as Schumpeter alluded (1959), the provision of new office space at reduced rates was the desired outcome, however unexpected it was for the development industry. On the negative side, the over-investment in offices did represent a gross misallocation of resources and did contribute to a massive devaluation of property. During the torrent of competition, planners had difficulty in judging the real merits of each new project presented to them. Consequently, many projects built were unattractive, integrated poorly into the urban fabric, and constructed in ignorance of topography, light, open space, and recreation. Ironically, the deluge of development permits was caused by the imminent approval of tougher bylaws (Daly 1982, 60). (4)

Australian financial institutions fell heir to a vast quantity of overpriced and unmarketable land. Besides becoming owners of unwanted land, the financial companies suffered from the inversion of interest rates: they were borrowing short and lending long when short-term rates were climbing more rapidly. At the peak, short-run rates went to 24% and long-term rates stayed somewhat below that rate. Devaluation of property was accentuated when financiers dumped their land at bargain basement prices. Many of the foreign-owned merchant banks and financial companies (CAGA, and IAC, now the Continental Bank in Canada) staved off bankruptcy by being rescued by their parent banks (Daly 1982). This scene has been repeated over and over in other cities and regions experiencing a bust.

4.5 THE DEVELOPMENT INDUSTRY DURING STAGNATION

In a crisis demand evaporates quickly, leaving most businesses, including the real estate development industry, with excess inventory. The resulting
stagnation phase is characterized by severely curtailed production and ongoing business losses. Prices are forced downward, as producers dispose of inventories at less than the cost of production. Unemployment is wide-spread and wage levels are cut back by management. Effective demand is weak because of diminished disposable income, not just from wage cutbacks but from heavy debt servicing arising out of the excessive use of credit during the boom. Although loan money is available at relatively low interest rates, the use of credit in the economy is at a low point. Devalued capital stock and property can be purchased at attractive prices, but buyers are few and far between:

Faith in the credit system is severely shaken, while demand for loan capital is much reduced because of pessimistic expectations as to future revenues. Money is used primarily to measure values and strip away extraneous fictitious capital from the economy. (Harvey 1982, 301)

Slowly, inventory levels recede. As inventories are reduced the liquidity of firms increases, as most will pay off debt. The increased liquidity reflects the lack of investment opportunities during this period. Eventually, healthier firms produce cash surpluses. Slowly, industry adjusts its operations to the new demand. Gentle technological and organizational changes are made, as opposed to the violent shake outs that accompany crises. (Harvey 1982, 301)

During stagnation, vacant space in offices, industrial buildings, and apartments is shifted around to the point where users have better accommodation at lower rates, while the preponderance of vacancies are ultimately found in inferior buildings and locations. Hence, the filtering process works well from the standpoint of supply during stagnation. Indeed, filtering of space may be the only development activity in cities with high inventories. Since housing sales are at a virtual standstill, building lot inventories remain idle. Only the better located lots sell and then only at
favorable prices. The raw land market, except for "non-market" transactions by banks trying to rid their balance sheets of foreclosed properties, is absolutely dead. In this process, the banks convert non-performing loans into non-performing assets, and then when a new buyer is found, back into performing(?) but highly subsidized loans. Alternatively, the banks form joint-venture holding companies into which all of the foreclosed properties are put to await the return of an improved market.

The outlook for the development industry is bleak. By the time stagnation sets in, the market would have weeded out a high percentage of companies. The surviving firms are either on a life support system provided by creditors, or have severely diminished cash flows. If the source of cash is from one-time-only sales, then the asset base of the company is being eroded away. This erosion will continue until all of the marketable assets are sold; then the flow dries up and the firm joins the growing list of bankruptcies. The prospects for a turnabout remain bleak, particularly if no sign of recovery on the leading edge of the economy is evident. As real estate follows the rest of the economy, it must wait for external stimulation.

The corporate slogan within the industry at this stage is reform: the development firm must get out of the businesses that failed and into the ones that fared well during the crisis. Paradoxically, these latter businesses were not the ones that shone during the boom. Furthermore, developers with diversified portfolios must face the grim reality that those product lines which they wish to retain are the only ones that have market appeal to buyers; consequently, to survive through the recession, the attractive product lines were sacrificed. The net result is not just a shrunken asset base for the development firm, but also an inferior one.
No new activities are commenced. The strategic emphasis becomes marketing. Some projects where the land had been purchased may be completed in the faint hope that the market might come back. Outwardly, the illusion of an improved market is created, but in reality, the developer is only playing his last cards in an attempt to keep ahead of his creditors. The corporation, at this juncture, has only a skeleton staff to maintain a greatly reduced operation. The absence of activity in the development industry idles city planning, development, and engineering departments (all growth oriented); consultants; and the construction industry and their suppliers.

During stagnation, the development industry paused to consolidate, retrench, contract, and reorganize. Many firms not wiped out by the initial downturn in the economy later succumbed to their chronic financial problems. Much of the inventory created during the boom remains unsold and unutilized. Sydney's high vacancy in the office market, for example, was absorbed nine years after its creation. The outcome of the office boom was a long period of stagnation in the office market, a series of heavy losses for developers, the movement of capital out of office development, and a fall in rents, coupled with a rise in operating costs leading to a drop in cash flow and hence, value (Daly 1982, 67). Recessions often mark a break-point with the past. Entirely new firms emerge, operating at much smaller scale in niches created by an increasingly differentiated and reduced market.

4.6 PROPERTY BOOMS AND BUSTS: IMPLICATIONS FOR CALGARY

Property booms and busts were significant urban processes in the urban "hot-spots" of the global economy during the 1970-84 period: New York, London, Hongkong, Southern California, Houston, Dallas, Denver and Sydney.
The preconditions for the property booms were unrealistically high expectations about the future, expanding money supply, loosening credit, inflation, low real interest rates, low inventories, and few alternative opportunities outside of real estate to invest in. Real estate values escalated rapidly, and tended to become detached from economic value as determined by the income-producing ability of property-assets. During the booms, overwhelming amounts of financial capital, as reflected in increases in stock values and borrowed funds, were transferred to the property market. Development companies in these cities became finance-driven -- borrowing and buying indiscriminately. This lack of discrimination eventually caused serious financial difficulties for the development companies and their lenders. But during the booms, money-surplus and under-valued -- acted as a shield preventing developers and bankers from realizing their predicament.

At the points of inflection in the boom-bust cycle, events no longer unfolded according to forecasts. At the start of the boom, entrepreneur/developers were pleasantly surprised with their achievements. Their aggressive spirits became aroused. At the end of the boom, panic set in as repeated failures were experienced -- developers and bankers either become hypervigilant or practiced defensive avoidance. Faced with a new and uncertain future, they were prone to compound their mistakes. The bust brought home the revelation that real estate markets were experiencing chronic over-supply. The unsuccessful dumping of assets to gain precious liquidity that followed ended in the devaluation of property assets. Many development companies became illiquid, insolvent, and bankrupt. However, depending on the size of the problem facing the banks, not the developers, some developers were allowed to ride through the recession on their creditors' coat tails.
The Hongkong office market presented a picture of heightened speculation, unfettered by government intervention. Firms, both young and old, small and large, highly levered and moderately levered, got into trouble as a result of over-zealous managers who misinterpreted and misjudged markets and economic trends, as well as their own vulnerability. Carrian and Hongkong Land present illustrative examples of what happens to development companies when their chief executive officers lose touch with reality. Ironically, during the boom these same managers were highly thought of for their abilities to assess opportunities and make profit.

Many parallels can be drawn between what happened in Hongkong and what happened in Western Canada: for example, the myths that build up around the chief executive officer -- "the Midas touch" -- during the boom. The buying spree of highly speculative properties just before or at the peak, for example, was commonplace. Another parallel was that the company's financial strength will not prevent severe losses, but may prolong the struggle to stay alive: Hongkong Land and Genstar in Canada for example. In contrast to these companies, financially immature companies in HongKong, Canada, and elsewhere levered their financial position by using their property as collateral. Their equity bases, minute in relation to their debt, disappeared in the bust. Carma Developers of Calgary, as an example, ended up with a negative net worth of over $200 million. Contrary to the view held immediately after the downturn by some Canadian developers that commercial office development is fail safe, the Carrian and Hongkong Land examples clearly illustrate that office development can be just as risky, if managed improperly, as other kinds of development. The vested interests of government in perpetuating the boom can be seen in Alberta as well as Hongkong. Lastly, the role of capital and
financial institutions has a strong influence on the entire process in both places.

The Sydney examples should give western Canadians a feeling of déjà vu: both causes and outcomes differ only by degree from the recent North American experience. Foreign financial capital played a major role in fueling speculation in spite of attempts to control it in Sydney's case. Government played a major role in fueling speculation, but only through the unintended consequences of poorly framed but well intended decisions. House prices soared to great heights in Sydney. Overbuilding of offices in downtown Sydney resulted in a 31% vacancy rate, forcing developers who financed their projects on short-term debt to sell out to major financial companies. A seemingly common problem developers faced everywhere was in gauging what was happening in the marketplace near the peak of the boom, a time of shifting currents and outlooks. When the bust came, the banks were swift to secure their positions, and in so doing precipitated the bankruptcies of even the largest development firms in Sydney. The banks further exacerbated their problems by dumping foreclosed properties on the market all at once. All of these observations, as well as the following ones, could be made 18 years later in Calgary.

A post mortem of the deaths of several Australian development companies revealed (Daly 1982, 60):

1. companies used excessive financial leverage, permitted by the ease of obtaining funds attributed to the "crass" ignorance of financial institutes;

2. companies displayed great artlessness in corporate management;

3. the rapid spread of companies into diverse fields and into various parts of Australia and other parts of the world stretched the company's resources;

4. the companies had no recurring cash flow, making them dependent on
asset sales;

(5) the accepted accounting practices failed to convey a clear profit picture.

Profits could be 2%, 25%, or 51% ahead of the last six months depending on the way assets were evaluated, in relation to total assets and capitalization of interest. The capitalization of development costs and interest charges on future development permitted companies to show profits in years, where perhaps they should have shown a loss or reduced profits. In boom markets they were able to get away with this practice because the market value remained above book costs and the projects were ongoing. The practice of capitalizing costs is done here in Canada, and results have been much the same. Unfortunately, the typical shareholder is not cognizant of the accounting procedure; to him profits are profits.

Daly saw the legacy of the boom as a loss in real estate value in the order of A$2 billion to investors and developers; as empty office buildings and stunted subdivisions pock marking the expanded fringe; and as a mishmash of conflicting architectural styles and dwindling light and open space in the inner city. The development frenzy that created this legacy was motivated by greed, supported by atrocious planning, and fed by financial credit. What Daly saw in the Sydney boom and bust of ten years earlier is remarkably similar to what North American cities and developers experienced in the 1976-84 boom-bust cycle.
CHAPTER 4 NOTES

(1) The writer is indebted to Harvey (1982, 301-05) for the classification and general characteristics of each stage of economic activity.

(2) Very little research has been done on the behaviour of the development industry during a boom-bust cycle. The general observations at the start of each section come from the author and are based on 15 years of industry experience.

(3) Harvey (1982, 303) vividly describes the sequence of events, following the monetary crisis which, at first glance, appears to be the primary cause of the crash. The demand for liquidity, now the only secure form of wealth, destroys the basis of value of capital in commodity form. The switch from consumption of commodities to the accumulation of money causes glutted markets, falling prices, and idle real capital. These, in turn, force the closure of plants, unemployment, and eventually falling wages. The circulation of capital is severely disrupted: creditors, subcontractors, investors, and employees often fail to be paid because firms no longer have sufficient cash flow to cover their expenses. This sets off another round of crisis as the effective demand on a much more pervasive front diminishes.

(4) The very same glut occurred in Canada when the termination of the Federal Government's Multi Unit Residential Building (MURB) program was announced.
CHAPTER 5
THE 1976-84 PROPERTY BOOM AND BUST
IN CALGARY
A CONTEXTUAL ANALYSIS

Two decades of steady economic and demographic growth in Calgary built a sense of buoyancy such that a major recession in the United States and other regions in Canada in 1974-75 was seen as nothing more than a cyclical pause in an upward trend. That pause was the prelude to Calgary's greatest real estate boom in living memory. A burgeoning oil and gas industry, credit expansion, and speculation fueled the property market until it reached its zenith in 1980-81. By 1982, the market was in the grips of its worst recession. For the first time since the depression of the 1930's the regional economy faltered on a broad scale. At the time, oblivious to the growing stresses in the economy, the development industry kept right on acquiring land and producing what turned out to be surplus inventory. This was not the first time in the history of the West that resource industry-led booms and busts rocked the real estate industry.

The purpose of this chapter is to provide a context for the analysis of strategic decision making during the 1976-81 property boom in Calgary. Moving from the general to the specific, this chapter includes (1) a brief survey of the major economic events leading up to the property boom and bust; (2) a review of the role of the three levels of government in this latest boom-bust cycle; (3) a statistical overview of the boom and bust in Calgary; (4) a detailed study of residential and office development in Calgary during that period; and (5) an assessment of the impact of the property boom and
bust in Calgary on the built environment and on the financial institutions.

5.1 ECONOMIC EVENTS LEADING TO THE PROPERTY BOOM

In the early 1970's, the mining, forestry, oil and gas, coal, hydroelectric power, and agricultural industries were all operating at or near capacity -- to the point where the resource economy was beginning to overheat. Rapidly rising commodity prices were being transmitted throughout the price structure of the economy in the form of inflation. Wages were scrambling to keep up, thereby adding to the inflationary trend. In 1973, the Organization of Petroleum Exporting Countries (OPEC) acted unilaterally to raise oil prices four fold. The shock wave of increased oil price reverberated through the world economy, forcing the non-oil to initiate energy conservation programs, and to strengthen their currencies to discourage further price increases (Foster, 1983). In most places these actions had the immediate effect of slowing down economic activity. High interest rates and reduced money supply, part of the solution for firming up the monetary base, brought the property boom in North America to an abrupt end in 1974.

One exception was Calgary, a direct beneficiary of the oil price increases. The underlying cause of sustained growth was the sheer size of demand facing the oil and gas industry (Western Economic Review, 1983; 2). The oil industry in turn acted as a magnet to laborers from all parts of Canada and overseas. The migration plus the post was baby boom caused an unprecedented demand for housing in Calgary. The net result was a property boom on top of a resource boom.

For Calgary, the multiplier effect of the oil economy resulted in new jobs in the social services, government, management, and producer services. Most
of the new producer services -- consulting, scientific research, legal, business -- were related to the primary resource sector. In addition, industry-related manufacturing and other more tangible producer services expanded. The "post-industrial society" attracted a proliferation of new consumer services and products. Many of the producer-service occupations were drawn to downtown locations, and in turn contributed to the construction boom in the office markets. During the 1976-81 boom, it was not uncommon to find more than 30 pages of career advertisements in the business section of the Calgary Herald. Unemployment was particularly low; consequently, many of the new jobs had to be filled by migrants. The net migration continued to climb in Calgary right up until 1982 (Chapter 1, Figure 1, Page 3).

5.2 THE IMPLICATIONS OF FEDERAL GOVERNMENT POLICY FOR CALGARY

During the 1976-84 business cycle, the Canadian Government had a key role in orchestrating the economy by increasing and decreasing the money supply and by lowering and raising the interest rates. Although the increases in the money supply were without geographic specificity, during the latest boom cycle large portions found their way to Alberta, simply because the energy boom to follow the O.P.E.C. price increases created an exceedingly attractive environment for investments. In Alberta, both Federal and Provincial Governments were extremely active in stimulating the housing market through various programs, including the Alberta Home Ownership Program (AHOP), Multi Unit Residential Buildings (MURBs) and mortgage subsidies. Tax shelter programs, especially MURBs, were very popular in Calgary. Federal Government policy and programs encouraged investing in real estate, perhaps for the wrong reason. Paralleling the generous property
development policies were Federal incentives for the oil and gas industry (Foster 1983).

The Federal Government abruptly changed policy direction in the 1980's, adopting a restrictive monetary policy for the economy and the National Energy Program (N.E.P.) for the Western energy industry. The disruptive N.E.P. was introduced at a time when markets for petroleum products were shrinking. This lead to curtailment of Western oil field activity and the shift to frontier exploration as the latter was heavily subsidized by the Government. With an added tax on natural gas exports, Canada priced itself out of the foreign natural gas market: United States utilities declined to purchase their usual quotas. In the oil and gas industry, high debt charges, the collapse of investor confidence, shrinking markets, high taxes, higher risks in frontier exploration, and substantially reduced cash flows were sufficient conditions to cause the industry to falter (Hayes and Jenish 1983, 11). With the oil and gas industry, fell Calgary's economy along with the rest of the provincial economy (Wilson 1983, F3; Orr et al. 1984, 20).

5.3 PROVINCIAL AND LOCAL GOVERNMENT INVOLVEMENT

The Alberta Government of Premier Peter Lougheed saw in the earlier OPEC price increases an opportunity to create great wealth for the Province and strengthen the West's power base in the continuing East-West struggle for economic sovereignty. To this end the Premier established the billion dollar Heritage Fund and led the efforts to diversity the provincial economy. Lougheed's vision rallied the business community, and gave businessmen a common purpose. Although a Conservative, Lougheed did more to create a planned economy for Alberta than any other premier. His economic
development blueprint had a profound effect on decision makers' view of the future. The property development industry leadership was among his most staunch supporters because his goal translated into billions of dollars worth of property development projects. Developers became deeply committed to the Province's growth strategy and could not envision an external force that could stop its momentum. Each investment decision was buoyed and reinforced by the economic progress created, nurtured, and directed by the Province. When, one by one, the scheduled mega-projects were shelved, the development industry went into a state of shock. No one was prepared for the reversal. All of the development decisions made, based on the economic program, were now so terribly wrong in the new economic reality. Not only did developers' investment decisions become problematic, but so did the development infrastructure decisions made by the Province and local municipalities (Roberts 1984, 10).

The Alberta Home Mortgage program provided most of the mortgages granted for low priced housing (60% of the total market). When the high interest rate levels in the early 1980s began to adversely affect home sales, rather than taking the high interest rates as a signal to cutback on lending, the Alberta Government imposed a 12.5% interest rate ceiling on government mortgages, which allowed the housing industry to continue producing houses in a deteriorating market (Roberts and Orr 1984, 20). The mere act of reducing interest rates did not get at the underlying problems facing the buyer, job security being foremost (Wilson 1983, F3). Not only did potential buyers withdraw from the market, but many of those buyers who purchased under the Alberta Home Mortgage Program subsequently lost their jobs and defaulted on their mortgage payments. The lag in perception between buyer and builder led
to oversupply. The interest rate subsidy helped to prolong an unstable market long enough to get all kinds of organizations and individuals in trouble, including some of the major developers who were deeply committed to the housing program, for example, NuWest (Phillips and Jenish 1984, 19). Many of the 13,700 foreclosures between 1981-84 are found in government subsidized housing (Diotte and Orr 1985, 22).

At the peak of the boom, the Alberta Government decided that it had to intervene in the development process to accommodate new development and to stabilize land prices. The Government adopted a two pronged approach: firstly, it provided monies for infrastructure extensions according to growth requirements estimated in metropolitan plans; and secondly it assembled large tracts of land on the outskirts of Calgary and Edmonton with a view to influencing land prices (Government Official interview, June 1985). Both of these schemes failed. Land prices were influenced, but in the wrong direction, triggering off a spate of speculation just before the market collapsed. In the deflation, the government land assemblies lost hundreds of millions of dollars (The Vancouver Sun, 12 February 1985, 5). Furthermore, millions of dollars were spent through the Alberta Government Revolving Trunk Fund on metropolitan utility systems that are now under-utilized and have mounting assessment charges which, in the future, will discourage if not stop development (Chairman, Edmonton Chapter, Urban Development Institute, interview September 1986). Where the Province was directly involved in land development, it made the same decision errors as the private sector developer, and suffered almost the same consequences.

During the boom, the Federal and Provincial Governments created a decision environment that was very favorable to property development,
particularly housing. While the Federal and Provincial governments orchestrated and greatly facilitated the property boom by stimulating demand directly through their housing programs and indirectly through the oil and gas industry, the City of Calgary was attempting to control the land supply. In consequence, property prices in Calgary escalated to an all time high. Houston and Denver, for example, did not experience the high land prices that Calgary did, even though both cities were several times larger than Calgary with commensurately higher development activity levels.

The property boom of the late 1970s grew out of a local crisis: housing demand was up, serviced land was in short supply, production levels were inadequate, and citizens's groups who were against urban growth had attacked the industry in the press and at City Hall. The City became so embroiled in the anti-growth controversy that it withheld the approval of area structure plans. This policy decision was to have a far-reaching effect: the supply of land became constricted at a time when more land was needed to satisfy both the immediate needs of industry and the long term needs of the city. Furthermore, an annexation proposal introduced by the City in keeping with Council's policy of one urban area, one municipal government was assailed by the anti-growth faction (Manager, Long Range Planning, interview, July 1985).

During a heated Council debate on the annexation issue, one alderman who was pro-growth (and later became the executive director of the Urban Development Institute) unwittingly recommended that the annexation question be put to a plebiscite. The plebiscite was defeated, leaving Council without a mandate and the administration without direction. The timing of this defeat could not have been worse: hiring new personnel was top priority in the oil industry and housing them was top priority for the development industry.
Arising out of the vacuum created by the defeat came a power struggle between the developers and the planners. The planners wanted to control the priority of growth-corridor development on an efficiency basis (referred to as the efficiency strategy). Further, they wanted to control the nature of development and to an extent, who develops, through development control -- a British system of land use control which gives planners more discretionary powers than they otherwise would have had under a zoning bylaw. Planners did get their development control, as the zoning bylaw was ruled ultra vires by the courts because it was not preceded by an approved general plan (1). In the end, against the planners' recommendations and after a year or so of infighting, Council chose the marketplace strategy, which allowed the market to determine priorities, over the efficiency strategy. The Council went against the spirit of the plebiscite and instructed the planners to prepare a modified annexation policy and to support all developer-originated annexation proposals before the Local Authorities Board -- the Provincial approving agency (Manager, Long Range Planning, interview, July 1985).

The City's about-face in adopting a market-based growth strategy facilitated the entry of more developers and created a surge of development. This resulted in overbuilding and the opening of environmentally undesirable lands, including land in sour gas fields, land near a fertilizer plant, and spot development in marginal areas on the periphery and on previously zoned industrial land. The large land development companies, given the increased supply, found that they could no longer meet their projected sales and the reduced revenues could no longer service the debt on their large land banks.

The pent-up demand and the sudden release of supply accentuated the frenzy among developers, causing them to over-react to market signals, and
thereby creating the conditions for a very deep recession in the industry. Except for this crucial delay in recognizing the extraordinary housing demand, Calgary aldermen behaved no differently than most politicians in boom towns. Here is what a former senior planner saw:

In the municipal process things were happening so quickly, the decision makers really had no opportunity to know what was going on. They were drawn by so many forces: community affairs, new development, urban services, and transportation. They did not seem to understand planning, and therefore, did not place a great importance on the form and quality of the city, nor on long range planning. It was the politics of survival. We attempted to introduce planning to the new aldermen .... But we did not do a very good job ... most of the aldermen still did not understand.

They had no broad perspective on where the city was going. Many of the actions taken during the boom were counterproductive. For example, ... the low density growth policy and an LRT (Light Rapid Transit) transportation policy. The downtown was growing very quickly; again the aldermen had no notion of what the issues were or what the public benefit was ...

We (were) choked with statistics that nobody understood. We devised the most elaborate information systems; what we have not discovered is how to interpret the information being spewed out. We have surrounded ourselves with "state of the art" trappings but the ability to produce sound, convincing concepts of the city is absent....

In the midst of the civic turmoil, the city was experiencing its greatest growth spurt.

5.4 SOME MEASURES OF THE BOOM AND BUST IN CALGARY (1976-84)

In the late 1970s and early 1980s Calgary experienced the largest real estate development boom of its history wherein the volume of construction rivaled that of cities many times larger. A vivid picture of the boom's buildup and collapse can be gained by looking at the change in the value of building permits issued during the development cycle (Figure 6).
In 1981, the peak year, residential building permit applications were issued for 22,800 dwelling units (2). For comparison, at the beginning of the boom (1976), permits were issued for 11,400 units. Immediately after the boom (1982) permits were issued for 5,100 units, after that the market experienced a steady decline in the number of permits issued: 1984 saw a record low in the number of permits issued (1700 units). Commercial building permit applications (offices, shopping centers, and warehouses) followed the same trend as housing, peaking at $1 billion and falling to a low of $32 million in 1984 (City of Calgary Building Permits Statistical Summaries 1979-84).

The crisis following the boom invaded every aspect of the lives of Calgarians. The local economy spiraled downward. Job losses started in the oil industry, with some sectors experiencing a 50% decline, and rippled through
the economy. The unemployment rate in Calgary went from 5.7% (1982) to 15% (1983); 44,000 jobs were lost in that period (City of Calgary InfoPak 1985, Table 1). Unlike the slow attrition experienced in the rust bowl cities of the U.S. midwest, job losses came in convulsive waves leaving the highly optimistic Calgarian in shock.

The exodus out of Calgary during and after the downturn was dramatic:

<table>
<thead>
<tr>
<th>Year</th>
<th>Net Migrations</th>
</tr>
</thead>
<tbody>
<tr>
<td>1980</td>
<td>24,071</td>
</tr>
<tr>
<td>1981</td>
<td>23,783</td>
</tr>
<tr>
<td>1982</td>
<td>-12,730</td>
</tr>
<tr>
<td>1983</td>
<td>-10,103</td>
</tr>
<tr>
<td>1984</td>
<td>-4,637</td>
</tr>
</tbody>
</table>

Source: City of Calgary InfoPak 1985, Table 10.

The immediate impact of the out-migration was the rise in apartment vacancies (the rate went to 15%). This in turn lead to the foreclosure of numerous MURB projects, making the Canadian Mortgage and Housing Corporation the largest landlord in the city (Diotte and Orr 1985, 22). In the single family market, foreclosures reached epidemic proportions -- 13,700 in three years (unpublished Alberta Housing Corporation report, 1985). Alberta Home Mortgage reports that it loses about $20,000 dollars on each foreclosure and The Mortgage Insurance Corporation of Canada recorded substantial losses (Jenish 1984, 18)). Vacancy rates soared in office buildings (from near zero in 1981 to 25%) and warehouses (Office Space Review, 1985). Retail sales in Calgary dropped precipitously by 288 million between 1982 and 1983 (City of Calgary InfoPak 1985, Table 1) and hotel occupancies in Calgary declined to an
unhealthy 47% rate in 1984 (Orr and Teeter 1984, 17).

Then came deflation:

What is extraordinary is the speed with which real estate deflates. Yet it should not be thought of as extraordinary because it has happened every time there has been a deflation. The boom prices we had in Calgary in 1912 were not met until 1980 after the 1912 collapse -- 68 years! For the excessive elements in the recent speculative market, I would not be surprised if they wait another 30-40 years. Some of the prices paid were absolutely ludicrous. And it is not as if they were prices for well located property (CONSULTANT).

Residential lot prices in the moderately priced sub-market in Calgary went from $7,000 in 1973 to $34,000 in 1981 to $25,000 in 1983. The typical bungalow went from $27,000 in 1973 to $110,000 in 1982 to $75,000 in 1985 (Alberta 1985, 34). Raw land values on the periphery of the built-up area, which absorbed most of the shock of devaluation, went from $7,000/ac. in 1973 to $60,000/ac. in 1981 to $10,000/ac. in 1983. Office building sites showed a similar but not as steep decline from $1,200 in 1981 to $500/sq.ft. in 1983. (J. Owsley, appraiser, interview, June 1985).

The wealth that development companies created overnight disappeared even more quickly. The massive devaluation of property, corporate wealth, and personal wealth, is estimated to be in the tens of billions of dollars. The devaluation led to many business failures. Not only did the private sector experience financial woes, but so did the City of Calgary whose per capita tax-supported debt of $1,500 (1985) became highest in the nation, over seven times that of Vancouver. This is a far cry from 1979 when Calgary had the lowest (Teeter and McCarthy 1984, 11).
5.5 RESIDENTIAL LAND DEVELOPMENT IN CALGARY

During the boom period (1979-81), Calgary experienced the greatest outward expansion of its built environment in the city's history (Figure 7). Between 1976 and 1982, Calgary's population grew by 150 thousand (5%+ per annum) compared to 80 thousand between 1970 and 1976 (3%+ per annum). The total housing stock increased by over 88 thousand units during the boom period (av.12,600 units/year) (City of Calgary Planning InfoPak 1985, Tables 18, 19). Without question the boom years were the heyday of the property development industry. During this period the industry went through a structural change.

In Western Canada, Calgary was one of the growing cities to have the prerequisites for large scale land development -- strong demand, low cost land, and large tract ownership. The buoyancy of the housing market provided the impetus for the rapid growth of the development industry. For individual companies, growth meant an increase in the scale of operations, and going public to raise capital. The privately owned homebuilder-developer could no longer supply the demand. With increasing size of land development companies in Calgary, industry concentration grew to a point where 80% of the market was controlled by 20% of the developers (3). One reason for this concentration was the cost of servicing and carrying land for extended periods restricted entry to firms with access to capital.

Five companies dominated western Canada's land development scene: Carma, Daon, NuWest, Genstar, and Qualico. To raise capital companies like Daon, Carma, and NuWest went public in the late 1960s and early 1970s. Genstar was already an established public company. Qualico alone remained a
FIGURE 7
Residential Growth 1946-1984 in Calgary

- Beginning - 1946
- 1946 - 1968
- 1968 - 1981
- 1981 - 1984

SOURCE:
Residential Land and Housing Survey Report, 1984, December 31

THE CITY OF CALGARY
PLANNING & BUILDING DEPARTMENT
private company. Land development companies confined their activities to the integrated operation of servicing land and constructing housing into the early 1970s. All five companies had their special strength, but it was in land development where they acquired the revenues from lot sales which made future expansion possible. The strategic purpose of the developer-builder organizations began to alter in the middle 1970s as they outgrew the western Canadian housing market. Before this time, the consistently high demand for housing and the increasing cost of land encouraged expansion within the housing market through mergers and acquisitions. This was the state of the industry prior to the 1974-75 recession.

By the middle of the 1970s spatial oligopolies had been established in every growth corridor in Calgary, each containing at least one dominant company: Carma and NuWest had a controlling interest in the northwest, west, and southwest; Daon, the northeast (up to 1980) and east; and Genstar and Kelwood (now a subsidiary of Genstar), the south, southwest (southern part), and northeast prior to 1975 (Copper 1982). Most of the large developers had a land position in each of the corridors (Figure 8). Developers wanted to be in each of the geographically defined sub-markets so that they could maintain or increase their overall market share and so that they could protect themselves in the event the City decided to set development priorities on the corridors. Needless to say, the direction of growth had strong political overtones. Developers were instrumental in identifying growth corridors, defining the population holding capacities, producing the first structure plan, and initiating the trunk servicing.

Some idea of the scale of land development and the structure of the industry can be gained by reviewing Table 3.
FIGURE 8
Lands Controlled by Major Developers 1976 - 81

- Land In Areas With Approved Planning Studies
- Land For Which Planning Studies Are Underway
- Land Not Approved For Development
- Transportation And Utility Corridor

Residential Land and Housing Survey Report, 1984, December 31

THE CITY OF CALGARY PLANNING & BUILDING DEPARTMENT
<table>
<thead>
<tr>
<th>Developer</th>
<th>Lot Production 1973-83*</th>
<th>Market Share</th>
</tr>
</thead>
<tbody>
<tr>
<td>Carma</td>
<td>9815 lots</td>
<td>20%</td>
</tr>
<tr>
<td>Daon</td>
<td>6990</td>
<td>14%</td>
</tr>
<tr>
<td>Genstar-Kelwood</td>
<td>11444</td>
<td>23%</td>
</tr>
<tr>
<td>Jager</td>
<td>2523</td>
<td>5%</td>
</tr>
<tr>
<td>Melcor</td>
<td>1975</td>
<td>4%</td>
</tr>
<tr>
<td>NuWest-Cairns</td>
<td>5304</td>
<td>11%</td>
</tr>
<tr>
<td>Qualico-Sterling</td>
<td>5582</td>
<td>11%</td>
</tr>
<tr>
<td>Remainder (55 firms)**</td>
<td>6367</td>
<td>12%</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>50000</strong></td>
<td><strong>100%</strong></td>
</tr>
</tbody>
</table>

Source: Residential Lot Inventory, City of Calgary Planning Department.
*Lots fully serviced for which building permits have been issued
**Includes all joint-ventures with the major firms.

In Calgary, 7 companies produced just under 90% of the residential lots, not counting joint-ventures.

The delay in designating more land for development put considerable pressure on the housing market, contributing to the escalation of housing and land prices. Figure 9 demonstrates the inventory situation the city had in the early 1970s; it also points to why so many developers swarmed into the market in the mid 1970s and why so many developers went bankrupt in the late 1970s and early 1980s.
During the period 1970-76 lot production was sufficient to meet a 5,000 (+/-) single and two family home building program. Year-end inventories were less than one-half of next year's demand. After the 1974-75 recession, house construction started a steady climb from a low of 4,304 units in 1976 to a peak of 7,323 units in 1981. The lot inventory at the start of each construction year crept up to the point where it actually exceeded the demand (this happened in 1978). In spite of surplus lot inventory, house prices continued to escalate until 1982 when the bottom fell out of the housing market. House prices over the intervening years plunged to 1976 levels, the average price existing before the boom! Lot prices remained fairly constant during 1980; some price reductions occurred in 1981 and 1982. The profit margins on lots fell in absolute terms to what they were in 1973, before they completely disappeared, eaten up by carrying costs. Many developers tried to dump their lots, but there were no buyers.
The price escalation attracted developers from far and near: Wimpey, Markborough, Cadillac Fairview, Campeau, Costain, and Metropolitan Properties entered the market. More smaller companies were able to get credit to buy land, but all that remained were leftovers -- hold-outs, overpriced land, and environmentally marginal land. Rather than give up, the small developers worked out ingenious schemes to make their land acceptable and profitable; but, typically, densities were too high, the use was unacceptable, or some environmental hazard existed.

Many of the large developers were in an enviable position of having large land banks purchased before the boom. In 1973 residential land could be purchased at less than $2,000/acre, and at the height of the boom one large parcel with a development horizon 10 years into the future sold for $60,000/acre; smaller residential land parcels sold for over $100,000/acre. Only two major developers stood steadfast during the boom and never bought any new land in Calgary -- Genstar and Qualico. The rest for a variety of reasons bought land through the boom period. A number of developers borrowed money using the land as collateral to buy more land. Very few developers were able keep their cost base down. The optimistic projections for lot absorption used as justification for new land purchases failed to materialize even during the boom; as a result, land development projects did not generate enough cash to cover the interest expense on the balance of the land inventory. At the end of the boom excess lot inventory aggravated the cash flow difficulties. Table 4 gives some idea of the magnitude of the inventory surplus.


TABLE 4: VACANT LOT INVENTORY, MAY 1983

<table>
<thead>
<tr>
<th>Company</th>
<th>Number of Lots</th>
</tr>
</thead>
<tbody>
<tr>
<td>Carma</td>
<td>1817</td>
</tr>
<tr>
<td>Daon</td>
<td>425</td>
</tr>
<tr>
<td>Genstar-Kelwood</td>
<td>855</td>
</tr>
<tr>
<td>Jager</td>
<td>660</td>
</tr>
<tr>
<td>Melcor</td>
<td>105</td>
</tr>
<tr>
<td>NuWest-Carins</td>
<td>1462</td>
</tr>
<tr>
<td>Qualico-Sterling</td>
<td>714</td>
</tr>
<tr>
<td>Remainder (55 firms)</td>
<td>4291</td>
</tr>
<tr>
<td><strong>TOTAL</strong></td>
<td><strong>10329</strong></td>
</tr>
</tbody>
</table>

Source: Residential Lot Inventory, City of Calgary Planning Department.
* Joint-ventures not included.

In Calgary, the lot inventory in 1983 stood at 10,329 lots (in 1979, 7,709 lots; in 1980, 8,183 lots; in 1981, 7,292 lots; and 1982, the worst year, 10,858 lots). The seven key firms responsible for 90% of the production over the 1970s and early 1980s carried 58% of the vacant lot inventory. Of that 58% Carma and NuWest, responsible for about 31% of the lot production, ended up with 32% of the inventory. The 55 remaining firms responsible for producing about 10% of the lots ended up in the depths of the recession with 42% of the vacant lot inventory. The city-wide inventory represented an estimated $250 million cost.

In the years 1982-83, house production was down by over 50%, consequently in these two years there was very little turnover and therefore very little cash flow. Developers had considerable difficulty in selling lots in these years: even free options failed to interest builders. Lot returns and defaults exceeded sales. Builders were in trouble and so were developers (Jenish 1983b, 20; Jenish 1983c, 16; Jenish 1984, 18). Banks were swift to foreclose on inconsequential (to the banks) builders and developers who
defaulted on their loans. Many long-standing quality builders -- Arcan, Britannia, Kentron, Pilot, Spindler, Springer, Tower, (the list goes on) -- with high-priced inventories declared bankruptcy (Fennell and Jenish 1984, 21). The larger developers fended off the banks by making the banks aware of the consequences of any drastic action on the part of the banks. Daon was the first to come out with a loan modification and financial restructuring plan. This was seen as the best solution to prevent the ruination of many investors and to prevent substantial losses to the banks (Jenish 1983a, 20). Carma followed with just a loan modification program, believing at first that restructuring was unnecessary; however, they too had to proceed with restructuring their debt. NuWest has gone through the same process Daon went through (Trigueiro 1984, E1). The other four companies -- Genstar, Jager, Melcor, and Qualico -- are liquidating their debt.

5.6 THE CALGARY OFFICE MARKET (1976-84)

Many developers were convinced that office development offered an opportunity for secure income, asset appreciation, and lower risk. The problem was that too many of them thought the same way and acted at the same time. During the boom years (1976-81) over 30 million sq.ft. of office space was added to the existing inventory. In the downtown area alone a further 10.4 million sq.ft. was under construction and an additional 14.5 million sq.ft. had approved development permits (Calgary 1982, 1). The magnitude of the office boom was significant: no other city of Calgary's size (630,000) in North America experienced such a surge in office construction. To give an idea of the magnitude of the increase, Vancouver's increase was 8 million sq.ft. and Edmonton's, 16 million sq.ft. (A.E.LePage 1984, 38). In 1978, Calgary had the
lowest vacancy rate in Canada (1.1%) and the highest building rate. In 1981, the peak year in Calgary's office boom, total office building permit value (about $1 billion) was only exceeded by New York on the North American continent. In that year 4.6 million sq.ft. of office space were absorbed. In 1982, the boom in office space was over: only 300 thousand sq.ft. were absorbed, leaving a surplus inventory of 6,000,000 sq.ft. of newly constructed, unoccupied space. This inventory was enlarged by some 2,500,000 sq.ft. of rented space offered by tenants who no longer needed extra space. The 8,500,000 sq.ft. surplus is equivalent to 7 years supply, given the average absorption rate of the last 10 years; or 4 years, given the boom-years rate; or 37 years, given the recession-years rate. (The spread in the rates is indicative of the forecasting problems developers face.) The projects under construction (10.4 million sq.ft.) added the following for office space upon completion:

<table>
<thead>
<tr>
<th>Year</th>
<th>Square Feet</th>
</tr>
</thead>
<tbody>
<tr>
<td>1982</td>
<td>1,700,000</td>
</tr>
<tr>
<td>1983</td>
<td>4,300,000</td>
</tr>
<tr>
<td>1984</td>
<td>2,700,000</td>
</tr>
<tr>
<td>1985</td>
<td>1,700,000</td>
</tr>
</tbody>
</table>


Much of this additional space was uncommitted at the start of construction. Seven million of the 14.5 million sq.ft. in the design stage scheduled for development between 1982-86 has been postponed indefinitely. Geographically, the highest vacancies were found in the suburbs (27%) where some 3.5 million sq.ft. remained unused in 1985. Total inventory of downtown and inner-city office space (Beltline) in 1985 stood at about 29.6 million sq. ft. of which about 5 million (17%) were vacant (Office Space Review, 1985). To induce renters, generous tenant allowances, free rent periods, and substantially reduced rents were offered. In some buildings rents were reduced to just over
a dollar per sq.ft. per year in 1982-83 from a market rent of $20-$24/ sq.ft. per year just prior to the downturn. Clearly the leasing situation had become desperate. The inducements drew tenants out of older and less conveniently located buildings to the new space. The final results of the relocations were partially or fully occupied new buildings with rental incomes insufficient to cover both fixed and operating costs, and older less attractive buildings either vacant or occupied with rental rates even lower than the subsidized rates found in the new buildings. The relocations did not take place all at once because most tenants were on long-term leases. When the reversion date came round, the landlord had to make a painful but necessary decision to reduce his rates to remain competitive.

5.7 IMPACT ON CALGARY’S BUILT ENVIRONMENT

The boom left its mark everywhere in the built environment. The downtown was transformed by gleaming high-rise office towers. The urban fringe was greatly expanded by large-scale-residential developments. At the same time that the fringe was expanding in-fill housing assisted by government programs was being constructed at a rapid rate. New varieties of multi-family housing were introduced on a significant scale into this predominantly single-family home city. The transportation system was measurably changed by the introduction of the freeways and the light-rail-rapid-transit system. Major business centers appeared for the first time along the main transportation routes. Public amenities were lavishly improved by the construction of several major recreational facilities (costing in excess of $20 million and containing a wave pool, a diving pool, hockey arenas, day care, craft rooms, racket ball courts, and a gym), the Saddledome hockey arena, the Olympic pool, and the
performing arts center. Last but not least were the new city hall, the Third Avenue mall, and the civic plaza -- conceived in the boom and completed in the bust.

The boom marked a period of rapid, large volume, and innovative building construction: both good and bad projects were built. In the rush, mistakes made by private and public decision makers were repeated before the negative feedback brought about a change in strategy. The rationale behind many of the public sector (and private sector) decisions on new projects was based on two major assumptions, which proved to be wrong:

(1) that the rapid growth would continue to provide revenues and (2) that the costs of construction would never be lower. (The City came close to getting into trouble in 1982, but it applied the brakes very quickly through cutbacks and staff layoffs.) (PLANNER)

5.7.1 OFFICE DEVELOPMENT: THE DOWNTOWN CONTROVERSY AND DECENTRALIZATION

Over the development cycle (1976-85) about 21 million sq.ft. of office space at an estimated cost of $2 billion were built in downtown Calgary (Office Space Review 1985). These figures reflect a huge allocation of resources to downtown office development. From a distance the skyline of Calgary is truly impressive, yet in either driving or walking the streets of downtown an entirely different impression is formed. Too many tall office building were built on relatively small sites, blocking out the sunlight, and adding to the already intolerable street level congestion (One such proposal never built had a Floor Area Ratio of 47, three to four times greater than the previously approved maximum (18), itself considered high). Office building development spilt over into adjacent residential and wholesale commercial
districts. Not only did these incompatible office uses create zones of conflict, but they proved to be poorly located for office uses. The spread of the downtown core introduced inefficiencies and a lack of coherence.

Without a zoning bylaw, the determination of use and density was a "crapshoot". Speculators went far outside the core to get office approvals. Interestingly, these outlying buildings are the ones that are suffering today. The people who transgressed the rules of location were disciplined by the market. The results of... pioneering (in the western fringe of downtown) were empty buildings that are still empty today. In the Beltline (southern part of the core fringe), land speculation was rampant. We controlled four sites in the Beltline while we were negotiating with four junior oil companies (before the downturn). Today, junior oils will only look at the core, as effective rates of $8.00 sq.ft. are still available. In the northern fringe of downtown, because the huge investment made in O'Clair (the largest downtown project) and the long waiting period, it is doubtful whether this 40 acre project will ever recover its costs. (DEVELOPER)

The question of environmental quality often arises in discussions about Calgary's downtown. It is not that the more recent buildings are poorly designed, but that no over-arching urban design theme exists to bring the collection of office towers together. The planners tried to come to grips with this in a plan for downtown. They proffered design goals and guidelines for future building development, but failed to get City Council approval, even after several attempts (Orr 1983, 14). Here is one planner's assessment of the downtown planning:

I have been highly critical of downtown planning. We lost a tremendous opportunity in Calgary to steer a fantastic amount of investment dollars into what the developers wanted but at the same time achieve some significant public benefits. On the City's side you can lay the blame on the poor way the Planning Department handled its responsibilities. On the developers side, you can lay the blame on shortsighted people who are interested in turning a fast dollar without the commitment that was shown by some of the larger companies -- Oxford (TD Square), O&Y (Esso Square), Hammerson (Bow Valley Square). The good projects were more a result of the vision of the individual developers than any effort of the Planning Department. That vision could have been realized in other developments in downtown had the Department done its job.

A number of reasons account for the failure to create a quality
environment with the billions of dollars spent: the pressure to get on with the process of building to meet the overwhelming demand (which in the end proved to be somewhat illusory but at the time was perceived to be gargantuan); the inexperience of some of the players including aldermen, planners, developers, and bankers; and the lack of commitment to a quality environment. This lack of commitment can be seen in the "carpet-baggers'" projects:

The worst development decision in Calgary was associated with the Sandman office/hotel building. Not only was the office market misjudged, but the developer also built a very poor building in a poor location. Structurally the building vibrates and shakes. It may never be leased. The developers of the Sandman broke the rules and even if the City had tighter rules, slips like this could happen during a boom when everyone was scrambling over each other to do one bigger, better, and more shiny.... (DEVELOPER)

Not all out of town developers were uncaring. On balance,

Calgary was fortunate in having the best developers in Canada; also the tenants (employers) were responding to their employee office needs. These two factors lead to a better quality of building in the last 10 years than in the previous 10 years.... Although the city planners never got a downtown plan approved, many of the principles set out by the planners were adopted by the more pragmatic developers. (DEVELOPER)

While downtown office development was mushrooming, outlying office development was also moving apace. But office developments did not fare very well in the suburbs and in commercial strips. Clearly, the developers overestimated the demand for suburban office-building space as evidenced in the many vacant free-standing and suburban-park office buildings.

Midnapore (suburban community) has had office space advertised for lease for a couple of years for $1.99/sq.ft. - it was like a special at Safeways. There are see-through buildings throughout the northeast. ...The mistake that developers made was in perceiving that the market was so hot anything could be built and leased anywhere. Even in (the boom) market this was not true: everything out of the downtown core was a risk. (DEVELOPER)

High expectations were held out for the city's first office parks. However, the office park theme as it turned out could not be sustained
because of the weak demand for suburban office space. One remedial approach was to introduce different uses, but the result was a mix of visually and functionally unrelated uses. Intermediate locations in the old commercial strips leading to the downtown were also exploited for office development. Among the mix of old and new retail and service commercial buildings can be found squat imitations of the Toronto-Dominion tower hugging the roadside. Invariably, the circulation and parking problem spilt over into the adjacent residential community. And with each new office use reclassification, the strip was extended and the problem grew. Many of the empty or partly empty buildings stand out as anomalies in the landscape: monuments to poor planning and decision making which will not disappear with time's passage.

5.7.2 RESIDENTIAL DEVELOPMENT

About 13,100 dwelling units were started in each of the boom years (1976-81), over twice the volume before the boom and over four times the volume after the boom. To meet the development rate a high degree of standardization had to be imposed on the process and the design of new communities. Getting the job done was facilitated by having only one municipal jurisdiction, the City of Calgary, as the approving authority. Contrast this with Greater Vancouver, with its multiple jurisdictions. Although Calgary was able to avoid some of the visual and functional chaos that one sees in Greater Vancouver (eg. Surrey or Maple Ridge), the city did experience some boom-related problems. The most serious was the granting of planning permission for community development in environmentally incompatible areas -- areas which would not have been considered for housing in a more placid economic climate. Such areas were within sour gas fields (both the wells and
pipelines contain lethal hydrogen sulphide), adjacent to a major fertilizer plant (which emits corrosive nitrates), and adjacent to a steel plant (Fennell 1984, 12). The other major problems were the proliferation of small lot subdivisions, the glut of Multi Unit Residential Buildings (MURBs), the premature subdivisions, and the burden of a large redundant land inventory.

Small lot subdivisions (minimum lot width 25 ft.) were the last desperate act by developers to sell land before the bust. They occurred everywhere, even in estate areas. Many registered subdivisions containing normal-sized lots were converted to small lots to make them saleable. The small lot subdivision was a product of affordability: near the peak of the boom only the home-buyer with a qualifying income of $50,000+ could afford a typical single family home. A great many buyers, who in other cities or at another time would have had greater choice, were limited to small homes in relatively unattractive areas. Realizing the effects of income constraints, builders turned their energies to the narrow-house market. Alberta Government mortgage subsidies (12% interest ceiling when the conventional rate was over 18%) facilitated the purchase by buyers who in the downturn would be among the first to be laid off work. The results of the proliferation of small lots were not good: over-building on a large scale occurred; thousands of these small homes were abandoned and foreclosed in the recession (Fennell and Jenish 1984, 17); small lot subdivisions were concentrated, along with multi-family accommodation, in the most undesirable areas of the city (e.g. in the environmental areas mentioned); and in the estate areas the narrow-lot house is a major distraction and an impediment to future marketing. Although it may be too early to say with certainty, some of the less desirable areas might become tomorrow's slums.
Not only did subsidized mortgages contribute to overbuilding during the boom, but so did Canada Mortgage and Housing Corporation's Multi Unit Residential Building program, which was heavily subscribed by builders to meet the perceived needs of tax shelter investors rather than the demand of the marketplace (Diotte and Orr 1985, 22). Many of the hastily put-together projects blighted the environment the moment they were completed, and many of them were subsequently foreclosed by Canada Mortgage and Housing Corporation when the tax shelter investors could no longer subsidize the shortfall in rental income.

Several new communities, approved under the City's "free-market" policy and started during the boom on the basis of boom-time projections, were languishing in 1986 with only a few hundred residents, with no support services, schools, or bus transportation. Among these premature subdivisions are the developer-annexations that were so urgently needed during the boom.

Of the major developer-annexations, today, because of the bust, none is actively being developed. NuWest's Scenic Acres has some planning approvals, but no development; Genstar in north Calgary installed utilities, constructed a lake, and rough graded their first phase before halting in 1982 and nothing has been done since. Daon's Homesteads has not gone beyond completion of the initial phases. (PLANNER)

(Earlier fringe communities of Bowness, Forest Lawn, and Montgomery, started during a 1920's boom, were not built-out until the 1970s. History could repeat itself.) The unfinished look of the partially developed subdivisions acts as a deterrent to future sales. It is conceivable that completely new communities could be started and completed before any interest is kindled in these isolated pockets. In the meanwhile urban infrastructure is underused; residents are inconvenienced; the banks holding the mortgages on the land are forced to wait it out; and the City is faced with the problem of recovering the costs incurred in sewer and water trunk extensions. These
residential subdivisions, like the empty office towers in downtown Calgary, are a physical manifestation of hasty and ill-conceived decisions.

The few hundred residents in each of these partially developed subdivisions represent the tip of the iceberg of the potential lot inventory. Just below the surface were the 10,000 serviced single- and two-family lots (1982); these were part of the 24,000 registered lots in the urban fringe. There were a further 20,000 lots in approved outline plans and tentative subdivision plans, making a total of some 44,000 lots (4). It would take 35 years to absorb this inventory at the current rate of absorption of 1250 units per year. All of this inventory is readily available for housing construction. In addition to the immediately developable inventory held by developers is the land inventory with plans in process (6,500 acres or about 26,000 lots). The absorption period extends to 56 years. This still does not represent the entire inventory held by developers (and now the creditors), for the balance of the iceberg is made up of some 17,500 acres (another 70,000 lots). Another 56 years are added to the absorption period making a total of 112 years. Some developers (creditors) will be waiting a long time to see the outcome of their boom-time decisions. Even if the preboom rates of housing production return (5000+ single and two-family houses per year) 28 years would pass before the last lot is absorbed. Not only were bad real estate and financial decisions made with respect to individual projects, but the city growth pattern has been determined for decades to come by decisions made during a heated boom at a time when the long-term future of the built environment was of little concern to many decision makers.
During the boom, aside from the normal addition of shopping centers at the neighborhood and community levels, major changes in retailing occurred. A structural shift saw at the bottom end of the retail hierarchy the replacement of the neighborhood- and community-sized shopping centers by the soon-to-become ubiquitous convenience center, and at the top end, by the regional shopping center. The new centers drew business away from the older centers and the commercial strips. Vacancies, visual blight, and functional obsolescence came to plague these older retail outlets. Each major developer vied to get the regional center in his large-scale community project. The regional center was seen by most developers as the center piece of their project: it was a must for attracting higher order uses and homebuyers. Some developers staked the viability of the entire project on the regional center. Consequently, the fight over who would get the regional shopping center sites was fierce during the boom.

The arenas for the battles were city hall and the board rooms of the potential major retail tenants because a commitment from a major retail tenant was a condition of planning approval. The approval process started years (now decades) in advance of anticipated construction. The arguments for and against were hypothetical and had little bearing on present-day reality. The aldermen listened to the futuristic scenarios and planning criteria, but decided on the basis of down-to-earth politics. Sometimes the aldermen approved all of the proposals; at other times they picked one site over the others, but the planning reasons were not always clear. The results, however, were clear: too many centers were approved for the city as a whole, and too many centers
were approved in certain sectors; some approved centers were built or will be built in poor locations (eg. in the middle of neighborhoods with relatively poor access to the arterial road network); some centers were approved too close to existing regional centers; and lastly all existing shopping centers suffered or will suffer from the additional competition. (4)

A new hierarchical order of shopping centers came into existence, which threatened the stability of both the old and the new. There is no question that consumers have much more choice in terms of the number of centers in their market area than they ever had, but many retail outlets are now redundant. What this means to the retailer is a continuous state of aggressive competition in which business failures frequently occur.

5.8 IMPACT OF THE BUST ON THE FINANCIAL INSTITUTIONS

During the boom a cartoon appeared in the Calgary Herald showing dozens of construction cranes towering over the downtown skyline; the caption read, "The New Calgary Bird". Calgary's vacant office space was about 8.5 million sq.ft. in 1984. A further 10 million sq.ft. of potential office space distributed over some 43 sites were approved for development when the boom came to a halt. Rough estimates of the replacement value of the vacant built space is $850 million and the land value of the 43 vacant sites is between $700-900 million -- making a total of about $1.7 billion. Most of the funds used in land acquisition and construction were borrowed; consequently, the cash flow required to service the loans, assuming 85% financing, would be in the order of $200 million annually. Since few of these projects are generating enough cash to cover debt servicing and few development companies have the financial strength to make up the difference, the financial institutions involved
have an enormous problem. Added to the liquidity (cash flow) problem is the solvency problem: a 50% drop in land value resulted in a 20-30% drop in overall value, which means the building in a number of instances is worth less than the loan amount. The vacant land and buildings valued at $1.7 billion a few years ago are now (1986) worth about $1.35 billion. The financial institutions will eventually have to write down the asset values and record losses. The debt servicing presents a very serious on-going problem. If, for example, it takes 10 years to absorb the 8.5 million sq.ft. before any of the 42 sites are touched -- a plausible scenario -- then the accrued interest expense on the vacant sites would become astronomical. (5)

For land development, the situation is no better. The book cost of the serviced inventory could easily exceed $250 million and each year the inventory remains unsold about $50 million in interest charges accrue. (6) Add to that the developers' serviced land inventory in other market areas. The serviced lot inventory is only part of the inventory problem: land banks were the other part. The book value (original purchase price plus accrued costs) of 7 key developers’ land banks (land held for future development) is estimated to have exceeded $2 billion prior to the 1982 downturn. The market value during the boom could have been three times higher. As much of the property was used as loan collateral, the debt against the land banks would be somewhere between $2 and $4 billion. In the bust raw land values dropped as much as 75-80% of market value in the Calgary region where a substantial portion of the inventory is located. The result is an aggregate debt on the land banks much larger than their present market value and larger than their book cost. A good-sized portion of the debt on the land banks came as a result of new loans used to buy more land.
Now add to the developers' immediate liabilities the capital expenditures made by the City of Calgary to extend roads, trunk sewers, and water mains, and the problem becomes significant not only to developers and their bankers, but also the City and its taxpayers. Capital expenditures to facilitate private development and a mini-boom in public facilities development culminated in the highest per capita debt of any city in Canada (Teeter and McCarthy 1984, 11). Like the developers, the City was borrowing from a perceived future that never came.

The total potential loss to developers, investors, financial institutions, and taxpayer is in the multi-billion dollar range. Is it any wonder that our financial community finds itself in serious trouble (and our governments deep in debt)? And who do the banks publicly blame? In a Vancouver Sun interview with the then President of the Canadian Commercial Bank, he detailed:

> how the bank's financial woes came about, citing the recession, the collapse of the energy sector and real estate markets in western Canada, the softening of the oil and gas market in the United States.... (The Sun, May 7, 1985: C1)

What else would one expect from a President who was desperately trying to keep his bank from going into bankruptcy? But every so often another side to the truth is revealed, as when a former director of the now defunct Pioneer Trust admitted in a C.B.C. interview on May 8, 1985 that the officers of the trust were guilty of mismanagement.

The Canadian banks, which purportedly saved the developer from himself in the 1973-75 boom-bust cycle, in the next boom became just as caught up in the speculation as the developer (Lorimer, 1978: 74). The banks were not the only financial institutions to be drawn in. Trusts, insurance companies, and pension funds, with fewer restrictions on direct equity participation than the
banks, participated as both lender and investor in development (Jenish 1983d, 18). This desire was particularly strong in office development because of the greater prestige associated with it, and the generally accepted view that office development is safer than most other kinds of property development. Many more lenders became involuntary participants when the developer defaulted. In 1982 developers had serious financial difficulties. By 1983 the developers' problems became the banks' problems (Best 1985, 1).

There is no question that many financial institutions got into serious trouble to a large measure because of their involvement in the property market during the 1976-81 boom: the Canadian Commercial Bank of Edmonton, twice rescued by the Federal Government and a consortium of banks, was forced into bankruptcy by the Federal Government; the Northland Bank followed; the Mercantile Bank merged with the National Bank; the Continental Bank merged with the Lloyds Bank of England; the Morguard Bank merged with Security Pacific, an American bank; and the Bank of British Columbia merged with the Hong Kong Bank (Glerson 1985, 1; Orr 1984b, 13). The big five banks are recording a high number of non-performing loans. The Alberta Credit Unions are being supported by the Alberta Government (Philip and Jenish 1984a, 21). The trust companies were no better off: Pioneer Trust, Western Capital Trust, Columbia Trust, and Fidelity Trust plunged into bankruptcy; and NorthWest Trust and Heritage Trust have failed to file their 1986 financial statements (Diotte and Orr 1984, 21; Whyte 1985, 20). Most of the small mortgage companies went under.
5.9 SUMMARY

All of the preconditions for a major boom in western Canada were in place during the turbulent 1970s. Oil prices had sky-rocketed upwards; other resource markets were strong; the urban centers in Alberta and British Columbia were attracting migrants from other parts of Canada and elsewhere. As well, the post-war baby boom was about to enter the housing market. Calgary more than any other western city exemplified the boom that was to follow. In the years 1976 through 1981 that city experienced record construction volumes in all facets of property development.

The Federal Government’s monetary policies and housing programs were conducive to property development. The Alberta Provincial Government was in the forefront of the boom: providing leadership, an economic plan, financing, and enthusiasm. In the midst of anti-growth movement, the City of Calgary was confused as to what policy direction it should follow, but in the end it joined the Province in its pro-growth strategy. As the boom gained momentum, both governments created a favorable environment for the development industry. Many of the west’s large development companies grew to prominence in Calgary. It was from Calgary that many of them launched their expansion programs into the United States.

The nature of the residential market changed on the supply side from a preponderance of small builder-developers to an oligopoly in which 7 major companies produced 90% of the building lots during the 1970s. After a number of very profitable years, the industry found itself swamped with too many developers, high costs of production, and political controversy centering on affordability. By 1978, the results were clear: the industry for the first time in 8 years produced more lots than the market could absorb. By 1981, housing
production had dropped dramatically, leaving many developers with large inventories of serviced lots and raw land. By 1982, the industry was in a rout and bankruptcies were endemic.

The growth of the office market parallels the growth of the oil and gas industry. Considering Calgary's size, an extraordinary amount of office space (30 million sq.ft.) was built between 1976 and 1981. When the dust settled, however, some 8.5 million sq.ft. were vacant.

The financial failures in the development industry total in the billions of dollars. Tens of thousands of mortgages became both overvalued and non-performing. Surrounding Calgary are tens of thousands of acres of raw land and about 10,000 serviced lots in inventory with loan commitments in financial trouble. In downtown there are 43 office sites with financial commitments "moth-balled". All of this adds up to a staggering misallocation of resources and a terrible burden for financial institutions.
NOTES

(1) Ironically, development control came back to haunt the planners when developers started using development control to their advantage, particularly in the downtown area.

(In land use reclassifications), decisions, illogical and unsustainable, happened in an arbitrary fashion. The lawyers had a field day (after the zoning bylaw was abandoned for direct control). A new activity area was created for these hired guns with their direct control applications -- because every project was "so unique" they all merited special attention, and, of course, greater density! This part of the process had become a travesty, the greatest hypocrisy. (PLANNER)

(2) The extraordinarily high number of permits was prompted by the planned withdrawal of the MURB program (apartments accounted for over half of the applications).

(3) Lorimer (1978) noted the increased scale and organizational complexity of the land development industry. Its composition, according to Lorimer, changed from many entrepreneurially led private-builders to a few large joint-stock companies run, mainly, by professional managers. What Lorimer failed to perceive was that the entrepreneurs were still there. The managers in these large companies were no less entrepreneurial, as this was the appeal of the development industry to bright, aggressive, and ambitious young managers. Lorimer, nevertheless, was quite right about the scale and organizational changes.

(4) The author was directly involved with the rezoning of two regional shopping centre sites in Calgary and attended most of the council hearings on rezoning major commercial sites.

(5) The Presidents of Larken and Owsley Appraisers provided the basic information upon which the estimates were based.

(6) The debt on each lot could be higher than its book costs (original and accrued costs) because during the boom developers were borrowing on a market value basis. The estimates come from the author’s knowledge of the inventory and construction costs.

(7) These estimates are based on information derived from the corporate annual reports of the seven companies.

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PART C: ANALYSIS AND FINDINGS

ANALYSIS OF CORPORATE STRATEGY

AND

 Sources of Decision Errors
Diversified public real estate companies emerged in response to the booming property market of the 1970s. The new corporations were spurred on by an unprecedented demand, government housing programs, tax shelters, and most of all, the abundance of financial credit. After exploiting almost every real estate market in Western Canada, they went on to make major inroads into U.S. urban markets, mainly in the Sunbelt (Calgary Herald 1983, B1). The large land development companies amassed tens of thousands of acres during the property boom. Large scale enterprise was achieved through creating similar operating divisions in different geographical areas. Had the 1982 recession not intervened, several of the growth-oriented companies would have achieved multi-national status.

When the boom came to an abrupt end in 1982, almost all the property development companies in Calgary had become insolvent and many went into bankruptcy (Bergman 1984, 16; Calgary Herald 1983a, D1; Globe and Mail 27 September 1983, B5; Jenish 1983a, 20). The casualties ranged from most of the small builder-developers to the major, publicly traded companies and included residential, shopping center, office, and industrial developers and builders (Jenish 1983b, 16; Jenish 1983c, 16; Fennell and Jenish 1984, 21). The collapse of the development companies in turn helped precipitate the bankruptcy of contractors, subcontractors, investors, consultants, several trust companies, mortgage companies, and two banks. It also triggered a spate of mergers among the financial institutions. The non-performing loans (many of which are real estate loans) of the major banks is estimated by the author to be in

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excess of $1 billion in Alberta alone. Thousands of small investors, many of whom were involved in the Federal Government’s Multi Unit Residential Buildings (MURBs) program, lost all of their savings and more. The combined losses of just the major publicly traded development companies for 1982-83 was also in excess of $1 billion dollars (Table 5). The survivors all experienced setbacks, some very serious.

It is apparent that exogenous forces brought an abrupt end to the property boom in Calgary and elsewhere. But to fully answer the question of "why did some, but not all, significant public companies in the development industry collapse in 1982?", an analysis of the corporate strategies employed by these companies during a property boom is instructive. Every company has to deal with fundamental questions related to growth, diversification, and financing. How big do we want to be? At what rate should we grow? What businesses should we be in? Should we expand our activities geographically? How should we finance our expansion? In this chapter these fundamental questions or "strategies" will be explored with the help of the decision makers who participated in the interviews. The orientation of this chapter and the next chapter is pathogenic and pathogenetic -- to uncover the causes (agents) of and processes leading to the collapse of the industry.

The only way to gain an understanding of the corporate strategies of the failed companies was through interviews of key executives who experienced the property cycle. To ensure that all viewpoints were covered, candidates were selected from (1) those managers who continued to be employed in executive positions in the selected firms; (2) those managers who were executives in the selected firms; (3) executives of surviving firms; and (4) knowledgeable outside observers among whom were a business consultant, an appraiser, a security
analyst, a politician, an economist and a development lawyer.

Prior to the interviews, all available information on each company was reviewed: company financial reports, security analyst's reports, trade journals and business newspapers (The Globe and Mail and The Financial Post). The review covered the period 1976-82. The information gained helped to focus the interview and check statements made by interviewees.

Although the interviews were open-ended and loosely structured, they did address two fundamental questions: What strategic decisions adversely affected the firm during the cycle? and what were the sources of these strategic errors?

To assist interviewees, questions were couched within the framework of four categories: (1) individual (2) group (3) organization and (4) environment. Each interview was typed and transcribed on a word processor. The transcripts were given to the interviewee for editing and elaboration. The information from the interviews was classified and collated under the explanatory categories that became evident during the analysis (Gloser and Strauss 1967).

Three publicly-traded companies -- Carma, Daon, and NuWest whose market shares in residential development in Calgary were respectively 20%, 11%, and 11% (see Table 3) -- are the specific focus as they, of the companies mentioned here, are the ones that failed. They will be referred to collectively as the land developers. The three are representative of many development companies dependent on the sale of real estate. They and Genstar (23% market share) were the largest land developers in Calgary (combined market share of 65%). The other key actors on the Calgary scene were Jager, Melcor, Qualico and Trizec (1).

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The impact of the boom-bust cycle on the publicly traded development companies can be seen in the earnings statements (Table 5). The financial losses for 1982-83 of Carma, Daon and NuWest, the subject companies, approached $1 billion dollars before the financial restructuring of Daon (Annual Report, Daon Development Corporation 1982).

**TABLE 5 : CORPORATE EARNINGS 1978-83 ($,000 Before Taxes)**

<table>
<thead>
<tr>
<th></th>
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<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Carma</td>
<td>21,949</td>
<td>29,790</td>
<td>43,886</td>
<td>32,972</td>
<td>(136,526)</td>
<td>(170,661)</td>
</tr>
<tr>
<td>Daon</td>
<td>15,482</td>
<td>42,203</td>
<td>51,340</td>
<td>17,224</td>
<td>(85,459)</td>
<td><em>(35,690)</em></td>
</tr>
<tr>
<td>Genstar</td>
<td>148,600</td>
<td>187,200</td>
<td>193,000</td>
<td>89,400</td>
<td>(84,296)</td>
<td>103,040</td>
</tr>
<tr>
<td>NuWest</td>
<td>27,124</td>
<td>36,689</td>
<td>51,993</td>
<td>4,604</td>
<td>(255,187)</td>
<td>(282,181)</td>
</tr>
<tr>
<td>Trizec</td>
<td>17,700</td>
<td>25,170</td>
<td>33,120</td>
<td>57,460</td>
<td>64,530</td>
<td>67,500</td>
</tr>
</tbody>
</table>

* after financial restructuring

Source: The Financial Post Corporation Services

The early years of the boom were record years. The first break in the upward trend in earnings came in 1981; however, as far back as 1979, the operational sources of earnings -- lot and housing sales -- were showing signs of weakness. All companies except for Trizec suffered a loss in 1982. Genstar recovered in 1983; the other three land developers continued to show losses. The magnitude of the losses prior to financial restructuring for the three were in excess of earnings for all previous years. Only Trizec showed a constant earnings-growth profile. The critical differences between these companies will be taken up in the subsequent analysis.

Behind the statistics on corporate earnings is an industry transformed by the property boom into a highly competitive and aggressive state. An industry executive captures the problems depicted in the data.

Inflation created a compulsive urge to buy properties now, otherwise they would become priced out of reach. The desire was to do bigger things, much like in the South Sea bubble. The decisions on the individual
projects were not necessarily bad, but what did become apparent was that if there was little attention paid to the health of the overall company in the middle 1970s, there was no attention paid in the late 1970s and early 1980s. What happens if the profit forecasts are not met?... Do not forget that the company now had over 1000 people.

The psychology of going after ever-larger projects was matched in the psychology of having larger and larger departments.... The project rivalry spilled over into a status game where one-upmanship became as important in the size of office as it did in performance...

When signs began to appear in 1979 indicating that the boom might be slowing down, there was not an immediate concern. In fact some were only remotely aware... The president in 1980 recognized that with the high interest rates there could be a downturn but it was felt that it would not affect the company. At this point the company had so much in the pipe that it felt somewhat immune...

The banks were thought as money-printing machines ... (much like) ... the federal government -- this tells you something of the psychology of the time.

The prevailing corporate mood in the early days was every one pulling together. Later this began to fall apart... partly caused by the president's allocation strategy which pitted project manager against project manager. ... bad deals were being made. Maybe the number of deals being made contributed to overall decline.

Friction appeared between ... divisions. Individual rivalry was heightened by the nature of the person hired, the profit center concept, tying compensation to performance, and the proliferation of chiefs.

Very few people in the organization had an overall view of the corporation. The president spent most of his time looking at individual projects rather than the company. The executive committee approval system broke down on a number of occasions when one or other member made a decision on his own. The president overrode criticisms by pointing to the track record. If the company had a few lean years perhaps the outcome would have been different. Although 1974 was a cash-poor year the profits were still there. I remember the president saying of the 1974-75 recession that "we would come out of this wiser men".

Developers had become imbued with a single-minded urge to grow bigger. The growth process was highly individualized, dependent on star performers. Rivalry among the stars was intense. They all had a blind faith in their own abilities. They were only remotely aware of and little concerned with the dangers of operating in a boom environment. They felt the upward trend
would go on forever.

6.1 CORPORATE STRATEGY

A corporate growth strategy is an abstract term defined by a set of objectives encompassing programs, methods, and criteria formulated by senior management which provide all management a direction and a framework to operate in. Strategies are derived from senior management's perception and interpretation of the environment, their assessment of the company's strengths and weaknesses, and their collective aspirations.

To highlight the problems found with the key corporate strategies -- asset growth, diversification, and financing -- excerpts of the interviews of former executives of NuWest and Carma are presented below. The other interviews revealed that elements of these strategies and their accompanying problems were common to all land development companies.

6.1.1 CORPORATE STRATEGY: CARMA CASE STUDY* (Senior Executive interview, June 1985)

The strategic policy of the key actors in Carma, which proved to be a myth, was increasing the asset base -- to growth by the acquisition of assets. The Company moved to the U.S. with no particular regions in mind other than finding opportunities in the growth centers of western United States. The product line was land. The basic modus operandi was forming "the builder-shareholder group", originated in Calgary and considered to work anywhere. In Houston, the strategy did not work because we ended up with the dregs of the Houston builders who could not see the merits of what we were trying to do for them. The strategy was not dropped in Houston or in any other area.

The directors, who were house builders, forced the strategy on the chief executive officer and expected the managers to carry it out. The Carma board was very strong; the decisions were generally unanimous. The same pattern of activity (diversification) was followed by the board members not just because they were board members, but because they were friends. There was a very strong old boys network that kept the group together. They took riskier decisions because their friends were doing it. Ralph
Scurfield (director) had a strong influence on board members on the issue of diversification. Joe Combe (chief executive officer) tried at first to keep diversification at distance but before long the strategy became very much a part of Carma.

Carma was very successful: most of the profits came from operations in Northwest Calgary. Those profits were used to expand. Carma lost sight of the keystone to profitability -- residential development in one area. They thought profit was coming from all areas, but it wasn't: it was coming from one area and the cash flow came from that area -- Northwest Calgary. The geographic diversification could have been a positive thing, but it is really hard to tell whether it was or not. A lot of the U.S. assets were good assets; however, on balance, the company attempted to do too many things in too many places.

The Allarco (a large diversified Edmonton firm) acquisition, coming at the peak of the business cycle, was partly a result of greed and partly, an implementation of the diversification strategy. The strategy was to use Allarco's commercial land to start a new nucleus, and clean out the corners of Carma's land bank and other odds and sods in Carma and sell them off to pay for the acquisition. Unfortunately, it was the greed that caused a delay of that strategy. Perhaps, the board members wanted to have a better look at what was there. The acquisition of Allarco was not a bad decision in itself: it was acquired at a good price; but the decision making respecting the assimilation of Allarco into Carma did not get delegated down into lower levels. The key executives were swamped in their attempt to handle the integration of Allarco. Because Carma grew too fast, the executive did not have the trust in their managers. Carma would have done very well if we would have sold off 50% of Allarco and another 50% of Carma's land, shifted gears in commercial real estate, developed only the better residential subdivisions, and avoided being all things to all people in 10 U.S. markets.

The problems in the commercial program had a lot to do with the incentive plans based on profit, which worked well on residential development where the object was to turnover the land for a profit. There was no incentive to keep commercial properties for cash flow as the bonus was based on profit on sales. No attention was paid to the method of financing. Carma wanted to get into commercial development, but they did not ask why they were getting into commercial development: there was no commercial strategy. It was growth for growth's sake.

The management of the commercial division was very weak. Because of the buddy system of the board, they continued to favour managers they felt good about even though their experience was in the land development field: no attempt was made to hire commercial experts. Control was established through trust, keeping it in the family, not by way of a profit center, an accepted mechanism of control. Trust was held higher than competence.

The Deerfoot Commercial Center, though objected to by the chief executive officer, was pushed through by the board. He felt
uncomfortable with the commercial managers and never really identified with it. The project went sour partly because it was premature. It was also an ill-conceived project: Gleaming office towers over a vast office park within five years was a concept not in touch with reality. It was visualized as a nice commercial node (a Dallas fringe-type project without the population), well located, with a five year time horizon and financed accordingly. However, it was definitely a long term project (25 years). We presented the project to Urban Land Institute advisory panel who said the project was much bigger than the company could do. It is the kind of project that could kill even the most knowledgeable commercial managers because of its magnitude. Nobody in Carma paid attention.

In downtown Calgary in a joint-venture with Princeton, we had spent about $5 million of a $60 million building before we got the first tenant: we had no tenants when we committed to construction. Leasing early was felt to prevent the partnership from realizing on the upside. I located financing of $70 million in Europe at 10% with equity participation to replace 22% floating rate short-term financing, but that was turned down by the joint-venture partner because he felt that we would lose some control. The building was about 40% leased when leasing stopped; rates went down from $30/sq.ft. to $15/sq.ft. The project could not pay for itself because of the high interest expenses.

*Carma is in 1986 under the complete control of its creditors

Some further observations were made by former employees:

Under the influence of Nuwest and through exposure to the Harvard management course, Carma became attracted to a corporate strategy emphasizing diversification. When the downturn came they were still mainly just a land company, which became overextended in its attempt to diversify into new product lines. Carma got caught with the wrong product in the wrong place at the wrong time. In the late 1970s and early 1980s they bought Allarco in Alberta and Christina in southern California. However, it is hard to say whether they would have been better off had they not diversified geographically; had they stayed in land in Alberta they would have been nailed hard.

Carma's diversification into commercial properties never got off the ground: their commercial park in Calgary was a failure, many of their shopping centers were small and inconsequential, and their major office buildings were built either prematurely in the case of the Deerfoot park buildings or at the peak of the boom in the case of the Carma-Princeton joint-venture in downtown Calgary. In Contrast, Daon made the transition to industrial park, commercial office, and shopping center development very successfully.

Geographically, Carma expanded to Edmonton, Vancouver, Hamilton, Denver, Texas, Washington and Southern California. Hamilton was not successful because of unsuspected bedrock found under the tract of land they bought. Texas was a new market: Carma was stung by the local operators; their local manager was pompous and vain; Carma tried to use
its magic formula (which worked simply because the demand was greater than supply in Calgary) in Houston where it failed because of unlimited supply and severe competition from many developers. Carma interestingly was never more successful than on its home turf. Prince George was an unmitigated disaster -- 800 acres which went no where -- a buddy buddy deal by the old guard which was opposed by some of the young turks. (DEVELOPER)

Carma's strategy was opportunity oriented, concentrating on the accumulation of raw land for future development. The company attempted to apply the same proven success formula everywhere, with spotted results, partly, because it was trying to do too many things at once. It got into businesses it did not understand and exacerbated its problems by using inexperienced managers to run some of the new operations. Managers made uncritical assessments of projects and markets. Organizational policies related to management incentives were shortsighted and counterproductive. Closely knit and overconfident, the board exercised too much power and made riskier decisions than the chief executive officer and other senior officers would have made by themselves. Carma failed to respond decisively to changes in the decision environment. The company failed to take stock of its strengths and weaknesses and provide adequate safeguards. It failed to measure the impact of various acquisitions on the survival of the firm. The Allarco acquisition, which would exhaust the firm's financial resources, highlights the difficulty all development companies had with digesting large companies. The acquisition of a company is a complex process -- it looks simple if you have not done it before, as Carma found out. Their joint-ventures proved to be misadventures. Carma was still very much dependent on the home base, like NuWest and most other companies that sprang out of Calgary.
6.1.2 CORPORATE STRATEGY: NUWEST CASE STUDY*  (Senior Executive
interview, June 1985)

Calgary was the most active and most profitable market for Nuwest: 75-90% of the profits came from Alberta. When Alberta went to hell, the corporate engine that carried all of the other activities went to hell. NuWest's dependence on Alberta and on government programs (70% of housing starts) was a contributor to its demise. NuWest violated one of the basic rules of business: don't become too dependent on one market. However, much of NuWest's expansion was being supported by Alberta because it was not self-sustaining.......

In the early 1980s, nobody in Alberta thought we were in a down business cycle of lasting consequence. Most of our income and profits were from Alberta and the downturns there were never of great duration or depth during the last 15 years...Everybody knew in the company that housing and land, in the long run, were going to decline as indicated in CMHC reports that stated housing starts would go from 275,000 to 150,000 by 1990. The whole basis of diversification was to get into oil and gas, and other investments (Abitibi Price, TransAlta, commercial office, and industrial projects) which were not in the same cycle as housing. However, the downturn came much more quickly and was deeper than expected. The Alberta operations carried the investment in Voyager and TransAlta.... (Although Voyager earned $12 million after tax, which NuWest promoted because oil and gas multiples were more attractive than housing, Nuwest had on its balance sheet a $200 million debt for the acquisition of Voyager, costing $40 million in interest expense when the interest rates were 20%).

Not only did the new businesses in diverse fields drain on NuWest's resources, but the housing and land operations in Ontario, Vancouver, and in certain areas of the United States also were still being supported by the Alberta operation. This made NuWest extremely vulnerable. Buying Voyager because it was counter-cyclical proved to be flawed because the N.E.P. and the government-induced recession brought oil and gas down, which in turn brought the housing market down: instead of being counter-cyclical it became a contributor to the development problems. TransAlta, the Rock of Gibraltar, was bought with borrowed money with a variable interest rate that was not matched to the dividends. Suddenly you have the Rock of Gibraltar earning 13-14% come hell or high water, and you have the loan that turned into a bucking bronco because of 22% interest rates. So here were the two legs of the corporate diversification strategy that weren't carrying themselves, plus the Alberta engine quit.

Other contributing factors to the NuWest problem were the purchase of a $65 million debenture in a Carma issue with money raised by NuWest outside of the corporation. The paper profit that NuWest and Carma (48% owned by NuWest) made gave NuWest unlimited borrowing capacity. Ironically, Carma was buying land and competing against us. The money that went to Carma never came back. The Headway purchase was the first big loss, estimated to be in the order of $50 million.** This
purchase occurred when their bank refused to honour the payroll -- in a week the company was bought.

If the three legged strategy had three years to run, the company might have survived: diversification worked for Atco. The idea was right, but nobody anticipated the depth of the downturn caused by: the international recession, the NEP designed to kill Alberta, the population exodus, and the folding of government programs....

NuWest catered to the medium to lower end market-- mass produced housing. We had no operational problems in Calgary. You always do better in your home market: stronger market and better people. We were never really successful in B.C., with one good year and three bad; Edmonton was slightly more successful. Cairns in Saskatchewan, their home base, was successful every year, but lost their shirt in Alberta in the downturn. If we would have closed down in the other areas and just carried on in Calgary and Saskatchewan, we would have been as well or better off. The move into to new markets looks easier than what it is.

*NuWest is now under the complete control of its creditors.
**At the time of the Headway purchase a Globe and Mail headline (June 4, 1980, p. B6) read, "NuWest Felt Getting A Bargain In Proposed Share Exchange"

NuWest realized that it was too dependent on one region (Calgary), one product (housing), in one submarket (government subsidized housing) and was looking forward to the 1990s when housing starts were forecasted to decline. Management decided to expand into income properties, different geographic areas, and the energy business. Although the principle was right, the execution failed: few of the projects became self-sustaining, including the much publicized Voyager Petroleum purchase. This meant that when the untimely downturn came in 1982 the "engine" (Calgary housing) stalled and brought everything else to a halt. What also became apparent after the fact was that housing and the oil industry in Alberta are not independent of each other. NuWest's acquisition of Headway, one of many company acquisitions, reveals a common tendency among certain developers of thinking that they can heal sick companies or projects. In this latter example, Nuwest lost millions of dollars. The last point to be made is that developers traditionally did better in their
home markets.

6.2 AN EVALUATION OF ASSET GROWTH AS AN OVERRIDING STRATEGY

To most corporations growth in an all-embracing sense is fundamental to survival. Growth translates, on the positive side, into greater earnings, larger borrowing capacity, an attraction for equity funds in the capital market, and an on-going challenge to management. Growth translates, on the negative side, into ill-conceived acquisitions and development programs in scantily researched markets, excessive debt and less than satisfactory cash flows, greater uncertainty about the external environment, and severe growing pains. Almost all development companies pursued an aggressive growth policy and in their pursuit, they experienced both success and failure. Four aspects of the asset growth strategy having a direct link to widespread company failures were the unmanageable growth rate, land banking and a fascination with appraisal surplus, a singular reliance on one-time sales, and an uncritical view of success.

6.2.1 THE UNMANAGEABLE RATE OF GROWTH DURING THE PROPERTY BOOM

The right game to play when inflation was so rampant was to build up real assets faster than the others and thereby benefit from the appraisal (DEVELOPER).

Both the corporate policy and the incentive system for managers favored acquisitions over all else. Asset build-up meant land banking (land banks of 20,000 to 30,000 acres were not uncommon), and to a lesser extent the development or acquisition of existing buildings. Developers accumulated assets at a breakneck speed to the point where high growth rates became difficult to
manage if not unmanageable.

All companies grew rapidly during the boom years. The asset growth of
the major development companies can be seen in Table 6.

<table>
<thead>
<tr>
<th>Company</th>
<th>Assets (000's) 1977</th>
<th>Assets (000's) 1981</th>
<th>% Change</th>
</tr>
</thead>
<tbody>
<tr>
<td>Carma</td>
<td>$179,011</td>
<td>$1,373,382</td>
<td>667%</td>
</tr>
<tr>
<td>Daon</td>
<td>464,306</td>
<td>2,370,574</td>
<td>410%</td>
</tr>
<tr>
<td>Genstar</td>
<td>1,249,000</td>
<td>2,858,800</td>
<td>129%</td>
</tr>
<tr>
<td>NuWest</td>
<td>482,800</td>
<td>2,524,680</td>
<td>423%</td>
</tr>
<tr>
<td>Trizec</td>
<td>931,610</td>
<td>2,495,860</td>
<td>168%</td>
</tr>
</tbody>
</table>

Source: Financial Post Corporation Services

Carma, Daon, and NuWest had extraordinarily high growth rates.

NuWest's growth policy, probably more explicit than the others, was
indicative of the industry's. Its stated corporate goal was to achieve an asset
growth rate of 15% over the rate of inflation each year. This meant that over
the boom period the expected asset build-up would have to exceed 40% because
of the high rate of inflation. A former NuWest executive officer concludes:

When the company was small, it was not a problem going from 40 to 170
houses per year because you were adding economies of scale. But it was a
different story when the assets of the company reached $2 billion.
Achieving the goal became a problem when you had to add a NuWest
Canada every year to keep to the growth rate. Nevertheless, managers
were expected to attain the goal. In that kind of environment you
weren't criticized for making mistakes as long as you could make two
home runs after you struck out. You were only criticized when you did
not accept the goal as being realistic. The CEO started it and it became
the accepted thing. You really found out how deeply rooted the goal was
when a year after we got into trouble, managers continued to prepare
budgets from the bottom up, based on what the head office expected not
what the market could produce.
Achieving these near-impossible rates of growth was a source of difficulty for management. The dogged adherence to an unrealistic goal was a threat to survival. Forecasting was not based on market reality.

In the initial stages of the boom, the market accommodated rapid growth. Increased competition in the marketplace lead to increased competition for resources, and this eventually led to shortages and higher costs of production. Some developers even stockpiled materials in short supply. Land owners, contractors, and suppliers began to squeeze the developer's profits. Faced with diminishing margins on sales and higher carrying costs, a number of developers saw the solution as producing more lots and thereby reducing unit costs -- mass production. This necessarily meant increasing market share. However, the construction volumes of companies, like NuWest and Carma, became far too large for the market, exposing them to both local and regional disturbances. In the end, the greater production volumes only exacerbated the inventory problem:

In the short term we never carried more than a 6 month inventory of serviced lots. When everything went to hell, since we were doing 2,400 housing units in Calgary alone that meant we had 1200 lots inventory. With the passage of another 6 months during which time the market went to zero, the lots in the pipeline pushed our inventory to a staggering 2,400 lots (DEVELOPER).

Ultimately, asset growth amounted to mere accumulation as development could not keep up with the ambitious acquisition programs, and this was reflected in the financial statements: the portion of projects held for future development was becoming increasingly larger than the portion under development. Too much land was being assembled.

The zeal to become giants afflicted both large and small companies. A former vice president recaptures the moment:

The company's track record and a much larger borrowing base gave
confidence to the managers. These in turn encouraged the movement to larger and larger projects. Some of the largest acquisitions (Florida, California and Alberta land) came just before the decline. Small projects were ignored. Inflation created a compulsive urge to buy properties now, otherwise they would become priced out of reach.

As the scale of projects became larger, the risk to the company grew. A point was reached where one acquisition or project, if it failed, could cripple the company. Not only did the mega projects not sit well with the company, they also did not fit the markets they were planned for:

In large-scale land development the production program is long term yet the market operates on a shorter cycle. We were doing California-styled land development, without the financial resources of some of the large firms operating there and without the population base. This kind of development could not, for example, be carried out in Vancouver. The scale of development and the perception of development was uniquely Calgarian (DEVELOPER).

In the rush mistakes were made by everyone -- developer, investor, and banker. The magnitude of the mistakes increased as the boom intensified: managers had become more self-confident and took greater risks. The scale of each project posed a serious risk to the company. A much higher volume of work increased the pressure on management in the decision making process and the possibility for more decision errors.

In the beginning the board approved all new investments; however, as time went by the volume of approvals became so large that the executive committee ended up approving most of the projects. A point was reached where there was little time for evaluation of their strategy because of the surge of new projects to be managed. (DEVELOPER).

Near the peak of the boom developers paid too much for the property they purchased and they let construction contracts locking in the costs at extremely high levels when, shortly thereafter, prices tumbled. But had prices continued to inflate, developers might have only bought some more time; which is to say the crash was inevitable. Development companies had purchased a lot of "moose pasture", overpriced office sites never built on, overpriced
residential lots, and rental projects for conversion either poorly located (e.g.,
high crime districts) or so poorly constructed that the developer became
embroiled in class action law suits with the unsuspecting buyers. On balance,
the untrammeled growth strategy had failed.

6.2.2 LAND BANKING AND APPRAISAL SURPLUS

Part of the reason I was skeptical about appraisals was that in the
residential market a limited number of developers was buying and selling
to each other, naturally inflating the values and creating their own
market. Furthermore, you had builders who should have been building
houses wanting to be developers, and developers going quite a ways out
to buy land. As these lands appreciated in value, the increase was
reflected in the appraisal surplus. The appraisal surplus when lending on
corporate operating lines gave you the feeling that there was something
out there besides the security of asset, receivables, work in progress, lot
sales, and other investments -- excess margins. But when it all hit
the fan there was not enough asset value to go around. (BANKER)

Land banks were an integral part of the asset growth strategy. In Calgary
land banks extended for miles in all directions, even beyond the city limits.
Values for "potential" urban land were inflated up to 60 times the value of
agricultural land near the city limits and up to 5 times agricultural values
many miles from the city limits. This pattern of speculation was familiar in all
of the high growth urban areas in North America. Because of speculation,
developers found it increasingly expensive to replace inventory. Property
development would have quickly become unprofitable had not serviced lot and
house prices increased commensurately. Near the end of the boom land prices
had, in fact, become out of line with house prices. However, the necessity to
replace inventory in order to stay in business overrode concerns of future
profitability. Developers were counting on inflation to rescue them. They
were vulnerable to the smallest changes in demand, inflation rates, or interest
rates.
The key rationale for land banking was the assumption that land values would inflate at a higher rate than the rate of interest. All you needed to do to become rich was to buy land and hold on to it. One prominent local politician and consultant assessed land banking in the following:

Did business judgment fail developers? Yes and no. Bear in mind the ground rules changed. Take Daon and Melcor. In the early 1970s Daon and Melcor were invited by me to develop land in Calgary to foster competition. Both companies were very cautious in their decision making -- worried about cost, time-frames, and calculating when they would get their money back. Both companies assembled land in the city. What happened in the middle 1970s, in the planning climate we had, was the emergence of perceptions of great, continuing economic growth -- completely irresponsible projections in my view. (I was never very popular with people who churned out this stuff. I was like a skunk at a garden party. I did not believe it). Then we had our development control system which immensely complicated and lengthened the planning approval process. And we had this climate of optimism for the future. The companies went into land banking instead of saying as they always did before: we will only take into inventory what we can realize in a very short time frame. They instead said: "look money is plentiful; prices are escalating so fast that even high interest rates are not a problem; the demographic forecasts are for continued growth at a very high rate -- how can we lose? We no longer have to worry about getting our inventory turned over within a short time and with a profit; from now on we are land banking."

Land banking meant you did not have to calculate the short term economics: you simply used debt, unlimited debt, to buy unlimited land. You did not even have to look at the question of whether the land was approved for development or not, or likely to be approved for development within a reasonable period of time. Take the sour gas fields --they should never have been developed; but the pressure was on city hall to approve land which should never be developed. All the rules of prudent conduct were scrapped in the climate of optimism, continued growth, and continued increases in land values covering all the interest and removing the cost of excess inventory. In fact, many builders made more money on paper, having excess inventory, through appreciation than they ever made in using the inventory to build houses. I don't know how many builders told me that they made more money than in 20 years of building houses by holding on to a few lots without building on them. That is sick. Its wrong. They were living in a proverbial fool's paradise because what happens when the music stops. Suppose that you cannot carry the excess inventory; suppose that the annual increase in land values slows down or stops -- automatically, your carrying costs are going to become a burden because the appreciation is no longer making your inventory cost free. What happens if this happens to everyone at the same time, then who is going to buy it? Nobody is going to buy it -- the market is gone. What is it worth then. It is nothing but raw land
and a huge debt. That is exactly what happened.

Now who are the guilty parties? The lenders certainly: they provided money on an unsound basis; they broke all the rules they built the business on. What about the borrowers? They borrowed for inventory. They too broke all the rules they built their business on: they borrowed beyond their projected needs. Why did they do it? Because of the academic forecasts; but why did they not put the business element into those forecasts. The forecasts are raw material; they are not the end product. All the demographers' and planners' work is basically a raw material; they tend to behave as if they have the answer. But they don't; all they have is information. It is not the answer, yet it became treated as if it were the answer. They claimed it was the answer. Of course, many of them got into development companies and then they were able to call their own raw material a final result. They believed their own forecasts instead of subjecting them to a business test.

In the early and middle stages of the boom, the land bank was a major source of the appraisal surplus, representing potential profit and equity (In 1981, NuWest's appraisal surplus was $864 million and Daon's was $573 million as reported in their respective 1981 annual reports). Together, the appraisal surplus of publicly traded companies controlling over 110,000 acres could have been as high as $3 billion. The land bank was viewed as the insurance policy -- like gold and other precious metals in inflationary markets. The supposition was that, if pressed, all the developer needed to do was sell land to improve liquidity (the cash position of the company). Some developers carried the logic one step further: why bother to liquidate the land bank when you can use it as collateral to borrow the needed money. At this point they ceased being developers and became speculators. The appraisal surplus was also used as a marketing ploy to assuage the investors' fears of frightfully high leverage. The debt/equity ratios for the companies ranged from highs of 10:1 to 30:1 where 4:1 is now considered maximum by some banks. So the developers had the money by borrowing on the assumed surplus, and they had the land -- or so they thought. Later, debt devoured the appraisal surplus, as well as the company's other financial resources.
By 1979, revenues from land operations no longer covered the carrying costs associated with the land banks, and margins on sales had shrunk to an uncomfortable level. Rather than reducing their unserviced land inventory to maintain earnings, some developers resorted to quietly selling off their income property portfolio. Very few developers tried to dispose of their excess inventory to reduce the risk of carrying so much, until after the market dried up. A former executive of Carma Developers recollects:

We did sell some of our raw land in 1981, and, I think, we could have sold more and don't think this would have affected the market. In early 1982 some buyers were scared but again we could have sold some land. But Carma wanted to have its cake and eat it. They wanted to maximize their dollar, when they should have been off-loading the land at a saleable price. If the land was worth an average of $30,000/acre, a price of $20,000/acre for the further out land was not acceptable to the board. When someone offered the asking price, the executive automatically assumed that it was under-priced.

[For NuWest, the disposition of land created more problems than it solved:]

About 2 years before the downturn, Nuwest sold several land parcels to CanLea Pension Fund with a guaranteed return, management and 25% carried interest. In the downturn, the income guarantee came back to haunt NuWest. They were sold to maintain the company's income, not because NuWest thought it had too much land. We unfortunately went and bought higher priced land in 1980-81 to replace the inventory we sold to the pension funds. Any land that was purchased after 1978 was a mistake and anything bought after 1980 was a terrible mistake.

Genstar disposed of a large portion of its Alberta land interests worth about $150 million in joint-venture with ATCO (a large Alberta company specializing in portable shelters). This proved to be a shrewd move, but much of the money from the sale went to acquire more land in San Diego County. Developers truly were fascinated by land!

By 1982, everyone was trying to sell their land banks but there were no buyers. In 1981, Carma offered a 600 acre parcel with peripheral services and roads for $70,000/ac. "Nothing happened; then they dropped their price to
$50,000/ac. but nobody talked to them; then they again dropped their price to $35,000 but no offers; and by 1983, they were asking for best offers, but again without success" (DEVELOPER). Contrary to expectations, the land banks could not be converted to cash. They proved to be about the most illiquid of all real estate assets.

How did the survivors differ from the failures? Both groups had land banks; however, the more cautious developers refrained from buying high priced land in Calgary during the boom; whereas, the aggressive developers continued to amass large assemblies at ever increasing costs. Needless to say, the developers who bought at the top of the cycle did not survive at the bottom. The cautious companies tended to concentrate their buying in large Western cities; whereas, the aggressive companies bought wherever they found opportunities. The cautious companies had other sources of income to support their land banks and were not highly levered with debt. This does not mean the cautious group did not experience considerable value losses in the deflation, but it does mean that they were able to survive.

6.2.3 SALES VERSUS INCOME AS THE BASIC SOURCE OF REVENUE

Even though we discounted NuWest's cash flows, and everybody at the bank accepted that Nuwest's construction volumes would drop as the interest rates went up, nobody expected that volumes would drop from 2,000 to 200. No business in the world could handle that kind of drop and be able to cut back overhead fast enough. Since house building was experiencing such a decline, lot inventories rose quickly. This was not just happening in Calgary, but in every market Nuwest was in. (BANKER)

A reason why Cadillac-Fairview, Bramalea, and Campeau survived is that they had a secure income property base which saw them through the residential collapse and high vacancy rates of new commercial properties. (DEVELOPER)

In the 1982 downturn, sales in every product line dried up. Those
companies in financial trouble had depended mainly on one-time sales rather than recurring income from revenue properties. In contrast, Trizec, Oxford, Marathon Realty, and Olympia and York -- all active in Calgary -- concentrated on and succeeded in building up an income property portfolio providing adequate cash flow to carry on through the downturn. However, some income property developers were either at such an inchoate stage of growth or they were developing so fast that no surplus was being generated to cover projects under construction. These developers found themselves in much the same position as the land developers who depended on sales.

In hindsight, many developers now wish they would have switched to income properties earlier or exclusively. To quote one president:

If I were to do it all over again, I would just build office centers and shopping centers. Land without a current use is the riskiest form of investment. If financed right and if you have got the staying power, you can bail out of office buildings, even if you paid too much for the land or had too much invested in them. Given time, even buildings constructed at the height of the cycle could be sold to yield an institutional return. Shopping centers did not suffer at all.

But the choice was not so clear during the boom:

The income projects did not show much cash flow because of the high interest rates. They could not compete with land investments during the early part of the boom. The company could not afford to tie up too much of its valuable cash in income properties in view of its need to produce a satisfactory level of earnings. Income property investments require patient money. (OFFICE BUILDING DEVELOPER)

Few western Canadian developers had access to patient money. Its shortage led to many unfortunate decisions regarding acquisitions and dispositions of assets: Daon, for example, was forced to dispose of all of its major income properties in order to repay its creditors. Ironically in 1985, when it was too late for Daon, patient money did come from Bell Canada Enterprises.

Although many companies publicly extolled the merits of developing income properties during the boom, they pursued a strategy deemed to bring
the highest expected return. When high-return product lines such as residential land development became low return, the developers' interest switched to income properties -- mainly shopping centers and office buildings. But they were too late; the recession interceded. Many developers both large and small have nothing to show for their efforts but an empty office building(s) or a vacant site.

6.2.4 SUCCESS BREEDS FAILURE

Behind many of the overt strategic moves was the notion of building on success. Ironically, the well-worn saying that "success breeds success" did not pertain in the boom environment, rather "success breeds failure" was truer. Unfortunately, the idea of replicating successful strategies time after time in different geographic areas was one of the main contributors to the collapse. To take one example in land development:

The Properties (a residential development in northeast Calgary) was the single most successful project of the company in terms of profits and longevity. Each of subsequent land projects was viewed as being another Properties. The Properties and Norwester (Edmonton) were the only successful long term projects the Company had. The success of the Properties could be considered, in a sense, the undoing of the company. In replicating this 1400 ac project, the tendency was to purchase larger and larger tracts. Several of the new assemblies were over 3,000 ac. Some of the acquisitions were far too large for the market they were located in. Some had environmental problems which were impossible to overcome. (CONTROLLER)

Failure resulting from the continuous and indiscriminate application of successful strategies can be seen in the apartment conversion business as well as in the land business. At first conversions were considered fail safe because one was buying an existing building usually fully rented at a price based on economic value (the capitalized net rental income stream). The purchaser had eliminated development and income uncertainties attendant to all development
projects. With the down-side risk protected, a sophisticated marketing program would ensure successful conversion. Daon, for example, started converting apartments in Vancouver during the rent freeze, and after its initial success, moved to Edmonton and Calgary where again it was successful. In 1976, Daon moved to southern California where its conversion program was an astounding success. "The decision to go into southern California was one of the best decisions the company made" (DEVELOPER). More convertible properties were purchased in Arizona, Texas, Illinois, Washington State, and Florida -- success breeds success. Only this time nothing seemed to go right: law suits, moratoriums, fierce competition, changing markets, cost overruns, excessive financing, purchase prices far exceeding the value of the project as a rental, and poor timing. In the words of a senior executive:

In the Florida example, we went in there on a mission to do two or three buildings on the water -- get in and get out, in a hot market. ... They (the tenants) rallied, fought us in the courts, and kept us off the market for almost two years; by then there was no market. Had we stuck to our game plan, we would have done all right. It was the right thing to do but we did it wrong.

When we went into Texas it was with the view of buying apartments, holding them for five years, and then selling. The idea was to take advantage of inflation. But we acquired the product and became impatient and started converting at a time when the market was not ready for it -- that is how we assessed when we went in. (In Texas), we (also) were the victims of an ill-timed and poorly executed development program. We did not have cost controls and management was bad.

Losses began to mount, "in 1979-80 we started de-emphasizing (conversions) and by 1981 we were getting out." (DEVELOPER) On balance, the conversion program was not such a success, based on the return on overall investment. And the losses coming when they did, in the latter years of the boom, accentuated the company's problems in the economic downturn.

Examples of success breeding failure in the financial strategy can also be cited, but suffice to say: developers, like other decision makers, structure their
strategies around their successes; however within a business cycle the environment conducive to the initial successes changes without developers being aware. This can be seen in the acquisitions over time: assets purchased at the beginning of the boom were great, but assets purchased near the peak of the business cycle were overpriced and probably too large for the market to digest in the approaching glut. A number of factors account for the change: (1) markets had become overworked; (2) some companies were bailing out "dogs"; (3) acquisitions were made on "the greater fool theory" (if the acquisition did not turn out right there would always be someone else to buy it from you); and (4) the larger projects had greater instability and posed a greater threat to survival -- paradoxically, the trend toward larger acquisitions was favored by the executives because of easier senior management control.

Not only did a deteriorating business environment create problems for developers, but so also did their own careless and inadequate execution. As the boom intensified, developers became overconfident and careless: many of them relied on the "buddy-buddy system" as a basis for deciding on what to buy as opposed to rigorous analysis. The quality of evaluations lapsed: they became mechanical, sloppy, and lost touch with reality, especially as the corporate staff grew, and untested managers became numerically predominant. The exercise became pro forma, lacking substance, but this was masked by the lexicon of the young "turks", and the "hype". Senior management in making room for the young "turks" backed away from routine acquisitions leaving crucial decisions to relatively junior managers with unproven judgment. Senior management however maintained its aggressive stance, keeping junior managers on edge, at the same time distancing themselves from the day to day operations. The pressure was there but the hands on management was not
Evidence of numerous decision errors originating from sloppy and overconfident management in the execution of strategies can be found in the property inventory of all of the major developers.

Developers, like the rest of us, do not learn much from their successes. As one developer said, "people seem to learn from experience rather than theory"; and moreover, "people learn from their mistakes: in good times they learn less....The crux is how much do we learn and how quickly do we forget....my worry is that people have short memories." Moreover, the boom climate conditioned developers to move at break-neck speeds, compounding their mistakes as they leaped from opportunity to opportunity. Those who failed to keep up were called snails, but at the end of the race the snails had survived.

6.3 AN EVALUATION OF THE DIVERSIFICATION STRATEGY

Was the diversification strategy a safety net or a cobweb?

In hindsight, Carma and Nuwest did not diversify at all when they moved into the oil industry because both industries were still dependent on the petro dollar. Genstar in contrast is highly diversified -- building products, development, finance, waste management, and industrial services. Daon's geographic and product-line diversification albeit still in real estate saved us. We have a lot of assets in California which have over the years preserved our equity notwithstanding the development cycles experienced there. Had we invested that equity in Alberta we would have lost it. (DEVELOPER)

As local markets became saturated, diversification was seen as a way to continue growing. It started in a grand manner with plenty of fanfare in the press, only to end in failure or questionable success. For some developers, diversification was response to anticipated changes to housing demand in the 1990s. For others it was a means of diluting and spreading corporate risk. Whatever the reason both large and small companies diversified during the
boom by product line within and outside real estate, and geographically within and outside of their market area. The approaches to diversification were outright purchases of assets, joint-ventures usually with smaller locally based companies, and acquisition of companies. Some companies, like Genstar, were well diversified before the 1976-81 boom. Some companies, like Daon, took advantage of the boom climate to accelerate their diversification programs into the United States and into income properties. Some companies, like Nuwest and Carma, initially spread their basic business to a number of different urban regions, then near the peak of the boom they decided to diversify outside of real estate. In addition to exploiting all of the major urban markets in Western Canada, every one-industry-resource-town -- Bonnyville, Cold Lake, Grand Centre, Fort Saint John, Fort Saint James, Peace River, Fort McMurray, and Grand Prairie -- presented opportunities, which arose overnight and disappeared just as quickly, but unfortunately not before developers had spent millions buying what turned out to be a 200 year supply of land.

In the latter half of the 1970s, the land developers (Qualico was the only exception) along with office developers, Oxford and Trizec, sought out projects mainly in the fastest growing cities in Western United States, primarily in the Sun Belt: southern California, Houston, Dallas, Denver, and Phoenix. Many smaller developers followed, and so did the large eastern companies -- Cadillac Fairview, Bramalea, Costain, and Olympia and York. Behind the U.S. move was the perception of unlimited opportunity. Canadian firms that pioneered the American market after the 1974-75 recession provided intelligence to the rest of the industry about the mortally wounded American developers who left a legacy of potentially good projects in limbo that could be quite attractive should the U.S. economy turn around. The timing of
Canadian developers, particularly, Daon and Cadillac-Fairview, could not have been better. The U.S. economy was coming out of the recession and, unable to respond to the improving real estate market, the American development industry watched as the Canadians scooped up the good deals. The consistently high performance of the Canadian developers helped to gain the confidence of the Canadian banks who followed the developers into the United States and without which the expansion into the United States would have been short lived.

Initially, in the United States, the four western land companies kept to their familiar product lines: Carma -- land development in Houston; Daon -- land development and condominium conversion in southern California; NuWest -- land development and housing in Denver and Phoenix; and Genstar -- land development in San Diego County and Vancouver, Washington. From their initial bases, they expanded outward to different geographic regions. Daon, for example, took its apartment conversion business from Orange County, Northern California, Seattle, Albuquerque, Dallas-Fort Worth, Miami, Washington D.C., and Chicago. From geographic expansion and diversification within real estate, the land development companies moved into the oil and gas industry, finance, and stock market investments.

Diversification extolled in text books as an important survival strategy is readily accepted in principle but much more difficult to achieve in practice. New and unfamiliar businesses were acquired and new geographic markets were committed to without adequate reconnaissance and market analysis. Typically, a few days in Dallas, Miami, Houston, Montreal, or Philadelphia was all that was taken to analyze a market and a project, and do the deal. Developers were buying on faith, on the advice of a friend, as result of peer pressure, or
a hot tip from a reputable local businessman. The logic behind much of the
diversification was missing, as the following excerpt reveals:

On the question of moving quickly into different geographic markets, we
would not go, for example, into New York to develop a building (but we
might acquire an existing building with only a leasing risk) because we do
not know how to do business there. In the western part of the country
the way you do business in Dallas is much the same as you would do
business in Calgary, San Francisco, or Vancouver. The process is pretty
well identical. Montreal is the same as New York. We should only have
done the Montreal office deal with a local partner who knows his way
around the jungle. Whereas we went to Philadelphia bought a building,
leased it up, and made a fortune. Philadelphia is quite different than
New York -- just like operating in your own back yard. (DEVELOPER)

If they were successful then that was the right place to be!

What were they doing wrong? Developers were letting their egos get in
the way of sound business philosophy. Developers had too many targets and
too few resources. The emphasis was on acquisition, not development.
Hundreds of bad projects came back to haunt developers after the downturn.
And human nature being what it is, the few good ones were held up as
examples in the after-the-fact rationalizations of the developers' actions. Not
only does the execution of the diversification strategy warrant criticism, but
so does the strategy itself. Geographic diversification of land development,
the replication of a high risk business in different places, does not necessarily
satisfy one of the important goals of diversification -- stability -- as the
events in the 1982 downturn clearly demonstrated. Some companies
anticipating having to pay taxes (a rarity for some developers) scoured the
continent for companies with tax-loss-carry-forwards -- much like the
thousands of MURB investors in the 1970s and early 1980s. Some developers
believed they could heal the sick; others thought the sick could heal them by
sheltering their income. The problem assets or companies they acquired likely
cost them more than the tax benefits they received. Going into unfamiliar and
risky businesses such as oil and gas or hotel operations is not necessarily a wise gambit. As one developer said "you have to have deep pockets". None of the development companies busily diversifying had deep pockets: they had little internal capital and were all highly levered. Consequently, many of the acquisitions were made by purchasing companies with the assets of the company being acquired: the most infamous case being Abacus Cities' acquisition of Imperial General Properties (DeMont 1985, 15). All acquisitions were debt financed; there was no room for errors or unforeseen changes in the decision environment; of course, both occurred.

In the speculative fever phase of the business cycle, all of the major acquisitions were made: Genstar's purchase of Canada Permanent Trust, Daon's billion dollar buying spree across the southern United States, Carma's acquisition of Allarco, Nuwest's attempted purchase of Abitibi Price and TransAlta, and its purchase of Voyager and Headway. The companies that failed tried to take on more than they could manage. They were indiscriminate as to where and what they bought. Partly because they did it with other peoples' money with no strings attached to individual accountability. They were buoyed by optimism, the corporate ego, a touch of romance about faraway places, and driven by the demands of stock market performance. Many companies, especially those whose management thought they could survive the downturn by spreading their risk to other investors (e.g. MURB investors), are now finding that contractual obligations to honour guarantees to investors are forcing them into bankruptcy. Imperial Properties of Winnipeg was one such company.

The surviving companies were either highly diversified before the boom, like Genstar, or refrained from entering the mad rush to diversify into
Keith (the owner of Keith Homes which became a subsidiary of Genstar) stuck close to his home market after a bad experience in communications with out of town subsidiaries. He concluded that he could do better in the Southeast Calgary market without the geographic diversification -- let the other developers go to Cold Lake, Lethbridge, Grand Center, Kelowna etc, we can make more money where we are! Genstar's philosophy is much the same -- stick to major markets like Calgary, Toronto, Edmonton, Vancouver, and Winnipeg. We cannot be everything in every market so let's be a major force where we operate -- that's our underlying philosophy. (SENIOR DEVELOPMENT EXECUTIVE)

Surviving companies stuck to major urban centers.

Today there is much soul-searching among developers about the "Calgary" developers' assault on urban America. Many have concluded they would have been better off not diversifying:

Jager is in Phoenix and Florida. Phoenix has the Calgary syndrome with 30,000 building permits issued -- there is no way that the market will absorb that many units. We are not doing that well in Phoenix and we had to take out our joint-venture partner in Florida. In both areas we are in the process of getting out: we have decided to consolidate. To operate successfully in a different geographic region you have to spend time there learning the local rules and business environment. There was some romance, an ego trip, in being in these exotic markets. However, I no longer subscribe to the old theory of spreading your risk by being in different areas. (DEVELOPER)

Others felt they were caught between a rock and hard place -- damned if you do and damned if you don't. Few developers doubted the role played by the oil industry in Calgary in creating an extraordinary demand for real estate product. Calgary became the engine: it generated most of the income during the boom; it supported the diversification program long past what could be considered a healthy start-up; and it served as a bank for troubled operations elsewhere. Calgary, the city where great real estate fortunes were made and later lost, served as a launching platform into other urban places.

When developers moved into other geographic markets, their experience in Calgary was the model for the diversification strategy. Regrettably, the
Calgary experience was extreme and consequently a dangerous model, except if used in similar "hot spots" like Houston, Southern California, Denver, and Phoenix. But even in these places serious mistakes and errors of judgment were made when developers tried to replicate their experiences. The model was more of a detriment in Seattle, Vancouver, Winnipeg, or for that matter in most cities to which western Canadian developers flocked, if only because the Calgary experience encouraged developers to throw caution to the wind. Unlike Calgary, land prices in these other cities did not double in six months; 400 lots could not be sold in two hours; and Calgary land prices were not the bench-mark toward which prices in other cities were heading. Many acquisitions were made in cities like Winnipeg solely on the basis of replacement costs. (No where else could a developer purchase convertible units in an apartment building for $24,000 per unit -- and no where else would they NOT sell for $19,000 per unit!) When Calgary collapsed in 1982, it not only meant the end of corporate diversification, but also the end of an entire industry based on the strategies of untrammeled growth and indiscriminate diversification.

6.4 AN EVALUATION OF THE FINANCIAL STRATEGY

At the project approval level it seemed that if the financing could be arranged the project was approved. (CONTROLLER)

Companies with a lot of cash behind them make their decisions very differently than the under-capitalized firms -- the flippers and dealers. (DEVELOPER)

But they took the good financing out of Alberta and took it somewhere else and blew it. (DEVELOPER)

There was never a great concern about the possibility of amassing too much debt for fear of not being able to pay it back. (CONTROLLER)

If we had an opportunity to do things differently we would make sure
that all assets were financed to term and that every asset could stand alone -- that no asset could jeopardize the company. We would strive to use non-recourse financing even if it cost more. (FINANCIAL VICE PRESIDENT)

Developers worked hard through the early 1970s to gain the confidence of securities brokers and bankers. With some hesitation prior to 1976, the bankers threw their full weight behind developers and their product-line strategies -- in fact they were counting on them. Not only did developers capture the hearts and minds of local financiers, brokers, and investors, but they eventually got the attention of international financiers. Near the end of the boom developers expanded their search for funds to the Eurodollar market and the Far East. Also, near the end financiers took the initiative in seeking out developers to offer them unsolicited loans. Without a great deal of support from the financial community, developers could not have built up their assets and diversified at the rate they did in the late 1970s and early 1980s. The important dimensions of the corporate financial strategy were the following: (1) the pressure of stock market performance, (2) the use of debt financing -- the leverage game, and (3) from development to finance -- the transformation.

6.4.1 THE PRESSURE OF STOCK MARKET PERFORMANCE

"The stock market prices on the basis of what is happening today." (SECURITIES ANALYST) This iron law of stock market was recognized by developers in their efforts to attract investor interest. Articles on the publicly traded companies appeared at regular intervals in the Globe and Mail, Financial Post, Financial Times, trade journals, and the business sections of local papers. The aim was to upwardly influence prices. With the exception of Genstar, the other three development companies (Carma, Daon, NuWest) were newcomers to the stock market, which at first viewed them much the
same as the banks did, with some healthy skepticism, but all this changed in
the mid 1970s when they became "the darlings of the stock market and the
media loved them; every move was looked at as a precedent." (DEVELOPER)
How much of the imagery was engineered by the companies themselves, their
stock brokers, and their public relations' experts remains to be seen;
nevertheless, the publicity was an important adjunct to the raising of equity
capital in the stock market. The amount of equity capital determined the
amount of borrowing.

The corporate publicity was not without substance: it was tied to
performance. Not only did the western Canadian developers come out of the
1974-75 recession unscathed, but they were also making attractive earnings.
Before long they were out-performing other sectors of industry. Developers,
however, got themselves into a "catch 22": because earnings came from
nonrecurring sales, they were compelled to work harder to overcome the
dISCOUNTING of their shares by investors:

Carma was an expansion-minded company and a stock market success:
from an obscure stock issued in 1972, with no believers or backers
certainly east of Alberta, to a very robust stock trading after a split at 4
or 5 times the issuing price. The dividend policy was fairly generous.
The dividend plus the need to show growth put Carma on a treadmill.
(DEVELOPER)

(Land development companies) trade at a low price to earnings ratio,
largely because of the influence sales (rather than rental income) had on
the bottom line. The compounded growth rate on earnings was very
significant in maintaining investor interest. The stock market literally
demands an increasing profit trend line. Once you establish the trend
line it is awfully difficult to change the policy from sales to rental
income and then hope for an increase in the stock price/ earnings
multiple to raise your stock price. It is a tough decision to change the
nature of your business both in the way the stock market perceives you
and the way you would go about it. Cadillac-Fairview took several years
to unload its residential portfolio, and 1985 is the first year that they
are seeing the fruits of that changeover. (DEVELOPER)

For a number of years the land developers were able to sustain an
The extraordinary record of earnings growth, which can be contrasted with the more controlled growth of Trizec. (Table 7)

TABLE 7: EARNINGS PER SHARE AND STOCK PRICE RANGE

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<td>Carma Earnings</td>
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<td>*1.92</td>
<td>0.98</td>
<td>(5.25)</td>
</tr>
<tr>
<td>Stock Price (H)</td>
<td>*5.00</td>
<td>9.25</td>
<td>*10.75</td>
<td>19.50</td>
<td>*17.13</td>
<td>20.63</td>
<td>12.00</td>
</tr>
<tr>
<td>Stock Price (L)</td>
<td>*4.25</td>
<td>5.50</td>
<td>*4.15</td>
<td>8.75</td>
<td>*5.00</td>
<td>7.25</td>
<td>1.31</td>
</tr>
<tr>
<td>Daon Earnings</td>
<td>3.11</td>
<td>*2.22</td>
<td>*1.80</td>
<td>*2.28</td>
<td>*1.32</td>
<td>.38</td>
<td>(2.49)</td>
</tr>
<tr>
<td>Stock Price (H)</td>
<td>9.25</td>
<td>*17.00</td>
<td>*15.00</td>
<td>*20.75</td>
<td>*12.25</td>
<td>13.63</td>
<td>5.38</td>
</tr>
<tr>
<td>Stock Price (L)</td>
<td>5.12</td>
<td>*4.30</td>
<td>*5.87</td>
<td>*7.00</td>
<td>*4.80</td>
<td>3.85</td>
<td>.78</td>
</tr>
<tr>
<td>Genstar Earnings</td>
<td>2.53</td>
<td>3.02</td>
<td>4.21</td>
<td>4.77</td>
<td>4.77</td>
<td>2.92</td>
<td>(3.36)</td>
</tr>
<tr>
<td>Stock Price (H)</td>
<td>13.88</td>
<td>19.00</td>
<td>27.75</td>
<td>47.00</td>
<td>42.63</td>
<td>24.75</td>
<td></td>
</tr>
<tr>
<td>Stock Price (L)</td>
<td>11.13</td>
<td>12.88</td>
<td>18.38</td>
<td>25.00</td>
<td>18.38</td>
<td>8.88</td>
<td></td>
</tr>
<tr>
<td>NuWest Earnings</td>
<td>#3.79</td>
<td>#3.01</td>
<td>#2.67</td>
<td>*1.83</td>
<td>*1.27</td>
<td>(0.10)</td>
<td>(5.65)</td>
</tr>
<tr>
<td>Stock Price (H)</td>
<td>#12.63</td>
<td>#12.88</td>
<td>#14.50</td>
<td>*17.00</td>
<td>*15.38</td>
<td>17.38</td>
<td>8.50</td>
</tr>
<tr>
<td>Stock Price (L)</td>
<td>#8.00</td>
<td>#7.13</td>
<td>#7.50</td>
<td>*5.25</td>
<td>*5.63</td>
<td>5.25</td>
<td>1.16</td>
</tr>
<tr>
<td>Trizec Earnings</td>
<td>.52</td>
<td>.51</td>
<td>.61</td>
<td>.74</td>
<td>.84</td>
<td>* .57</td>
<td>.70</td>
</tr>
<tr>
<td>Stock Price (H)</td>
<td>15.87</td>
<td>13.00</td>
<td>17.12</td>
<td>25.50</td>
<td>54.00</td>
<td>*33.50</td>
<td>25.75</td>
</tr>
<tr>
<td>Stock Price (L)</td>
<td>9.00</td>
<td>9.12</td>
<td>10.25</td>
<td>15.25</td>
<td>25.50</td>
<td>*20.00</td>
<td>14.25</td>
</tr>
</tbody>
</table>

Source: Corporate Annual Reports; * following 2-for-1 split; # following a 3-for-2 split.

The earnings growth was reflected in the stock price. (Each asterisk indicates a doubling of the number of shares. Stocks were split annually to ensure that their price per share remained attractive to the average investor. Were they not split, the value would have doubled in each of those years)

Both Genstar's and Trizec's earnings were far more constant than the others. Unlike Trizec's earnings, Genstar's earnings plunged in 1982, along with the others, reflecting its greater dependence on sales as opposed to rental income.

The exponential rates of growth did not last. As early as 1978, real-estate-securities analyst Ira Gluskin was raising a red flag:
- The market notes the collapse in real estate and real estate values in the United Kingdom and the United States and believes that Canada is to undergo a similar experience in the near future.

- The market is very concerned about overbuilding in all the principal areas of real estate; i.e., office buildings, hotels, shopping centers, and industrial.

- The market believes that residential land values are overstated. They believe that house prices are beyond the earning power of most consumers. Thus it is felt that the collapse in both housing and land is imminent. (Lorimer, 1978: 256)

What Gluskin saw in foresight developers were admitting in hindsight in 1982:

(One developer) summed up the reason why land and residential development companies got into so much trouble: "the nature of residential property development does not lend itself to the stable growth the stock market likes to see". Developers of publicly traded companies are often forced to structure their business plans on the requirements of stock market performance rather than by what they sense is best from a real estate market perspective. Companies like Cadillac-Fairview could no longer take the risk and invest money in a volatile market while at the same time appease the analysts. (DEVELOPER)

Yet right up until 1982, most securities analysts extolled the virtues of the public development companies and painted a generally favorable picture of the industry and the market. To sustain earnings performance over the later years of the boom (1979-81), some companies were forced to adopt a strategy of liquidation that, given a choice, they would rather not have. Many publicly traded development companies habitually sold their more valuable and marketable assets at an inopportune time -- just before the financial year-end -- to meet stock market expectations. Many property buyers aware of this tendency waited for year end.

The corporation was forced to sell its income producing properties, contrary to diversification strategy, because of the need to show tremendous earnings for the shareholder, and to insure the corporation's high bond rating -- it became a never ending circle, we had to earn more to borrow more. The fixed cash flow for debt servicing grew enormously. To a degree this debt service was masked by perfectly acceptable accounting rules which allowed the company to capitalize the interest payments rather than offsetting them against current income. (CONTROLLER)
Unlike public companies, private companies do not have the same stock market pressures; they do not have to sell off their best assets at unpropitious times to please the market. For the publicly traded company after the year-end sell off, it was like starting from the beginning, only each year the stakes were higher and the task harder. The stock market rather than the property market was dictating corporate strategy. The publicly traded companies had put themselves on an accelerating treadmill.

6.4.2 THE USE OF DEBT FINANCING -- THE LEVERAGE GAME

The use of debt financing is inevitable in property development because of the large size of projects and the scarcity of equity capital. The question is, how much debt? Some developers thought no limit existed:

The paper profit that NuWest and Carma (48% owned by NuWest) gave NuWest unlimited borrowing capacity. Scurfield (President of NuWest) wanted to maximize the use of borrowed funds -- no idle cash. Divisions were charged for the use funds at high rates so that they would maximize their mortgage draws and buy land with maximum financing. It was cheaper for the divisions to borrow at 12% outside of the firm than to borrow at 16% inside. On the one hand, it was good business for the divisions to be aware of the cost of money; on the other hand, we should have had a cap on borrowing. For example, we should have had a 75% limitation borrowing based on original costs. But we had this penchant for appraisal increments. (DEVELOPER)

Long term corporate debt showed a dramatic increase between 1977 and 1981 (Table 8). What the table does not show is the even more dramatic increase in the floating-rate bank debt and other short-term debt, and the dramatic increase in the cost of borrowing (Daon, for example, had over $800 million in floating rate debt at a time when interest rates moved from 11% to 24%. A 10 percentage point increase in interest rates translated into over an $100 million increase in interest expense.)
TABLE 8: THE INCREASE IN LONG TERM DEBT (’000s) -- 1977-81

<table>
<thead>
<tr>
<th>Company</th>
<th>1977</th>
<th>1981</th>
<th>% Change</th>
</tr>
</thead>
<tbody>
<tr>
<td>Carma</td>
<td>$ 84,637</td>
<td>$ 787,953</td>
<td>831%</td>
</tr>
<tr>
<td>Daon</td>
<td>366,667</td>
<td>1,802,096</td>
<td>391%</td>
</tr>
<tr>
<td>Genstar</td>
<td>244,000</td>
<td>633,100</td>
<td>159%</td>
</tr>
<tr>
<td>Nuwest</td>
<td>220,717</td>
<td>1,478,215</td>
<td>569%</td>
</tr>
<tr>
<td>Trizc</td>
<td>656,000</td>
<td>1,673,490</td>
<td>115%</td>
</tr>
</tbody>
</table>


The trend in long term debt of the five companies parallels their growth rates. Carma, Daon, and NuWest have exceptionally high rates of debt accumulation; whereas, Genstar and Trizc have modest rates in comparison. Not all companies were heavy users of debt financing, at least not at the start of the boom.

Carma was not a levered company in the early years up until the mid 1970s. They used their own cash flow: negotiated credit lines (up to $20 million) would not be utilized. Often raw land purchases were all cash, something unheard in real estate. Their rapid growth in the late 1970s, bigger projects and more managers making deals, made it impossible to fund the growth out of internal cash flow. (DEVELOPER)

In the year of the downturn the equity of Carma, Daon, and NuWest was eaten up by devaluation and interest expenses. Trizc and Genstar were able to absorb the shock of declining revenues.

On the more important question of how much debt can a firm prudently take on, one NuWest Executive found an answer:

After the 1974-75 downturn, I did an equity to asset ratio analysis on US companies for the directors. I found that any company that had a greater than 25% ratio, survived the recession. Ryan Homes, which had a 50% ratio, hardly had a blip in earnings. If the ratio was between 20%-25%, you had red ink until you were swimming in it; and below 20% you were bankrupt.

In Table 9 the equity to asset ratios expressed as a percentage tell the story.
<table>
<thead>
<tr>
<th>Company</th>
<th>1977</th>
<th>1981</th>
</tr>
</thead>
<tbody>
<tr>
<td>Carma</td>
<td>26%</td>
<td>20%</td>
</tr>
<tr>
<td>Daon</td>
<td>7%</td>
<td>7%</td>
</tr>
<tr>
<td>Genstar</td>
<td>29%</td>
<td>34%</td>
</tr>
<tr>
<td>NuWest</td>
<td>16%</td>
<td>12%</td>
</tr>
<tr>
<td>Trizec</td>
<td>19%</td>
<td>17%</td>
</tr>
</tbody>
</table>

Source: Financial Post Corporation Service.

Using the thresholds outlined above, Daon and NuWest should have been bankrupt in 1977; and Trizec should have been in trouble. In fact, Daon and NuWest were at the beginning of their (precarious) ascent, and Trizec had been in very serious financial difficulties stemming from the collapse of its British parent firm; however, Trizec was rescued by the Bronfman family in 1975 (Goldenburg 1981). Carma and Genstar were financially secure according to the criteria and in fact. Carma should have been in trouble in 1981; Daon, NuWest, and Trizec should have been bankrupt. Genstar should have survived the crisis. In fact, Carma, NuWest, and Daon became technically bankrupt; Genstar had an unprofitable year; and Trizec sailed right through. The latter two's ability to maintain long-term profitability can be attributed to the solid income-property base in Trizec's case, and the low debt to equity ratio in Genstar's case. Daon and NuWest were highly levered and had the potential of being endangered by the smallest downturn in the economic environment. Most development companies were in the same financial situation as Carma, Daon, and NuWest. Balance sheet ratios were important indicators of unsound strategies. Incidentally, when the NuWest executive who did the debt analysis put forward the recommendation that the company adopt a 25% equity to asset ratio, the response was:
We had a $400 million appraisal surplus, therefore no problem; but the surplus evaporated overnight. (The company did set up a $100 million safety fund that was supposed to keep you going if things went sour, but with a $2 billion debt, the $100 million did not last very long, just a few months.) (SENIOR EXECUTIVE)

6.4.3 FROM DEVELOPMENT TO FINANCE: THE TRANSFORMATION

Over the boom the focus of activity for many companies shifted from development to finance.

It's hardly a matter of buying and selling anymore... We're very much in the money management business. We fit the investment requirements of major financial institutions to the real estate requirements of the market. In a sense, we're a vehicle for the long term institutions to put their money to work... We're a good market for short and long term lenders -- and a pretty safe one. (Interview of a Daon executive by Stephen Dewar, of Canadian Business, 1979: 78)

Development companies were becoming less involved with real property development and more involved with paper manipulation using real property as a means rather than an end in the corporate strategy. Increasing emphasis was placed on corporate financing rather than on project financing and on appraisal surplus rather than on earnings and cash flow. The shift in strategic focus led to a glossing over of the development process.

The key ingredients of the transformation were appraisal surplus and capitalization of interest. When starting out as a fledgling company, project financing would have been the only financing available; low capitalization would most likely have discouraged bankers from lending on a corporate basis. The loan ceilings on project financing were established by property appraisals. Because loan limits were determined by market value, and during the boom appraisers had ample evidence to confirm the upward spiral of land values, developers were able "to finance out", i.e. to have no equity in the project. The company limits to growth therefore became the capacities of the financial
institutions and their willingness to lend. One corporate financial officer's main concern was running out of sources to borrow from after the company had already borrowed from over 40 banks.

Some companies started off by borrowing conservatively, only to get caught up in the leverage game. As land values were appreciating quickly, rather than borrow to develop projects, companies started to borrow money to buy land, to borrow money to buy more land. Raw land and underfinanced buildings were used as collateral. In Calgary, where land values had moved upwards since World War II, land was looked upon as a low-risk investment with an exceptionally high return. The appraisal report was key to borrowing during the period of high inflation.

If appraisals worked so effectively in raising money at the project level -- so the reasoning went -- why not use the aggregate appraisal surplus as a means of raising money corporately.

October 1978, the use of appraisal surplus was introduced in the marketing of preference shares. The decision to use appraisal surplus was made by senior corporate managers with no input from operations. What the use of appraisal surplus in financing was doing to the company was not considered. Probably not more than three or four people in the company knew what the chief financial officer was doing in building up the debt. Only one or two senior managers raised the question of the use of appraisal surplus in securing debt; the rest never thought of it.

(CORPORATE ACCOUNTANT)

The corporate loans or debentures would not be tied to any one property but would be a floating charge on a specified number of property assets. They became a popular method of raising large sums of money which could be used where and when the company pleased. The raising of debentures became an annual event. Even though some banks specified that the debentures were operating loans, in practice there was no attempt at tracing the use of the debenture funds. Much of the money raised in this way ended up as equity to
a real estate purchase where a loan for the balance of the purchase price was either arranged with the vendor or another bank. With their initial equity, developers were able to pyramid loan after loan until the credit crunch.

The financial strategy of borrowing against the appraisal surplus eventually became the corporate strategy:

During the period 1976 to 1981, Daon measured its success, primarily, in appraised value per share, that included realized and unrealized profit. We were aiming to maximize the appraised value. (FINANCIAL OFFICER)

Development companies were being transformed into conduits funneling the money surpluses into real estate, where the surpluses would accrue by virtue of inflation, if nothing else. At this point in the cycle, developers were plainly speculating. And time proved that many developers were not so clever at speculation: in their frenzy of buying, they themselves were inflating the value of land. But many developers could not make the connection between their activity in the marketplace and the price of land. Developers, as one banker pointed out, were too concerned about supply and appraisal surplus:

When borrowing on appraisal surplus the big fear was running out of land, especially if you looked at the profits being made (e.g., Carma always had the highest profit margins because of its land development focus). However because there were so few players, one could argue that the market was very artificial: the amount of land being flipped around had no relationship to the amount of land that could be developed in a reasonable period.

The appraisal surplus turned out to be a will-o'-the wisp. The emphasis on the appraisal increment unfortunately brought about the neglect of cash flow. Companies were not creating enough cash flow to keep going, nor was their use of funds creating lasting value in the company. A reason for this neglect was the cost of money. Although most consumers looking at inflation saw only increasing prices, borrowers looking at inflation saw only the diminishing value of money. Money was cheap and borrowed money was cheaper as long
as the real rate of interest was negative (nominal rate minus inflation rate).

Inflation, the capitalization of interest, and the use of borrowed funds covered the cracks in company operations. But it would only be a matter of time before the financially precarious state of the developer became apparent.

The financial problems for most companies first appeared in the United States prior to the 1982 downturn. Large quantities of money were sent down from Canada, particularly Alberta, to resuscitate the U.S. operations. As one developer recollects:

I took over the US operation early in 1981. At that time there was no corporate cash flow statement for the U.S. subsidiary; of course, project cash flows had been prepared to sell the board on acquisitions. To get a corporate cash flow projection was like pulling hens teeth. When it was finally done we all realized that we were going to be short $20 million in cash for the year in the U.S. profit center. Typically, we would go to the home base, Calgary, to see if the guys could "lever" some Calgary land. That's when we discovered that we did not have anything more for security to get loans to cover the shortfall, and that's when things hit the fan with respect to the company overall. That was in mid 1981. However, at the end of 1981, a complete cash flow analysis revealed that the Canadian operations had $100 million borrowing capacity. The funds were borrowed and reallocated to fill the hole in the U.S. operation; this put the Canadian operation in trouble and the U.S. operation was already in trouble: a number of long range projects were not coming on stream as forecasted. Things ground to a halt.

The capitalization of interest, an accepted accounting principle allowing for the accrual of expenses on a particular phase of a multi-phased project until sales are recorded, caused difficulties for the developer in two ways. Firstly, the magnitude of the capitalization as companies land banked became enormous (Daon's capitalized interest was over $160 million in 1981). Had interest only related to office buildings in a good market it would have been another matter, but it did not. By deciding to capitalize interest -- a somewhat subjective call as it depends on how conservative the companies want to be -- companies could manipulate their stated earnings. Genstar's attitude about capitalization of interest in contrast to the other's was very
conservative:

Additionally, Genstar has always expensed carrying costs annually in contrast to Daon and other development companies that capitalized them; this meant that Genstar had a much lower book cost historically. Whereas the others could only show a few very profitable years before their increasing book cost eroded profits. (SENIOR EXECUTIVE, GENSTAR)

Secondly, as the assets built up and the cost of financing rose, the interest expense snowballed, becoming a material problem in realizing profits from future phases. Companies were living on borrowed time. Investors in and out of industry really did not understand the implications of capitalization in the case of risky land projects.

Liberal lending policies and "no strings attached" corporate loans were at the root of the financial crisis. In hindsight, some executives felt that most loans should have been restricted to projects where each loan would stand on its own; had this been done, many of the financial problems experienced would not have occurred.

If you had good project financing and the financial checks and balances in place, you should reduce some of your risk. The test on the manager is the project; if it is not a good project it should not go. With project financing, a discipline is imposed both in terms of approval of quality and in terms of keeping the project on target. With corporate financing, the project manager does not know the status of collateral financing placed on his projects nor what impact this financing could have on his project. Furthermore he had no responsibility in financing. The equity of many projects was removed through corporate financing and spent somewhere else. (DEVELOPER)

The added costs of corporate financing ultimately made the projects which secured the debentures difficult to sell in an increasingly competitive market. Initially, project managers were told that the carrying costs of corporate loans would not be reflected on their projects, but when the music stopped, there was no other place to allocate these costs.

Given the volume of corporate financing in the latter part of the boom,
allocating monies for projects and keeping track of funds became a very
difficult task: firstly, there were too many dollars chasing too many mediocre
projects, and secondly, corporations had little idea as to which of the many
projects in their portfolio were performing the way they were predicted to
behave at the time they were approved. The financial institutions exercised no
control over how and where their loans would be spent.

In the early 1980s, some companies sensing that the economy was headed
for trouble began increasing the cash and credit lines to shore up the cash
flow from operations. Many of these companies prematurely assumed that the
recession was over in 1981 and used the cash and credit to buy weakened
companies or their assets at depressed prices, as they had in 1975. As events
unfolded, developers misjudged the duration of the recession; they spent their
cash and used up their credit in acquisitions, only to realize belatedly that
they were headed deeper into the recession. Most financial analysts and
investors had no idea at this point of how financially stretched most
development companies were. The end for many developers came precipitously
in bankruptcy. To a great many other companies struggling to stay alive was
just as painful.

There are a lot of silent bankruptcies during the recession. A great
transfer of ownership from the developers to the banks occurs. On
many properties financed with debt, the banks will stand still, they will
not call the loans, the interest builds up, erodes your equity, and at the
end of the day you owe more than the equity in the business; you are
still there, you are still doing business, you have all your employees and
all of your toys, but you are broke. Those who survived clearly had a
lot of equity in their business and did not buy at the high point of the
cycle. (DEVELOPER)

For the survivors with perhaps more serious financial difficulties for both the
borrower and lender than those companies declaring bankruptcy, financial
restructuring and loan modifications were the only way out. These financial
strategies consumed an enormous amount of energy and money; but, for the company's survival, they were far more important than any other course of action. As one president stated:

We took an entrepreneurial approach to our debt. When we saw that we were in a squeeze we really managed that situation and created some substantial value for our shareholders. If we had not tackled that in an entrepreneurial way there would have been no net worth for the shareholders. Today there is $250 million net worth, having come through that terrible time. Renegotiating the debt was the main business for us in 1982-83. (DEVELOPER)

In the end, the banks and other financial institutions have to bear the financial burden of the insolvent firms; when the financial institutions fail, the depositors, the government, and ultimately the public make up the losses.

Robert B. Reich (1983) coined the expression "paper entrepreneurialism" to describe the sickness afflicting American industry. Paper entrepreneurialism describes the strategy and action of corporate finance during the final stages of the boom. Developers lost sight of their primary objective -- development -- and became money rustlers.

6.5 CORPORATE STRATEGIES: CONCLUSIONS

The three strategies -- asset growth without due regard for the quality and continuation of earnings, diversification without due regard for market and product understanding, and debt financing without due regard for the leverage effect -- were the apparent causes of the development industry's collapse.

Unrestricted growth through asset accumulation became the overriding strategy of the land developers. When the thin real estate markets of western Canada began to show signs of saturation, a number of developers expanded into the United States and eastern Canada. Some developers diversified into other product lines with the intent of stabilizing their income and spreading their
risk. The expansion was carried out using borrowed money. The object was
to lever every equity dollar to the maximum extent. This was seen as the
efficient use of capital.

The initial purpose behind the growth strategy was development; however,
over time development became secondary -- the goal became increasing asset
value per share. Economic conditions were right for just accumulating real
property as land values were increasing faster than carrying costs. This
strategy was based on inflation, land banks, nonrecurring sales, appraisal
surplus, and leverage. The wealth of a corporation was the appraisal surplus.
It was used extensively to demonstrate corporate strength to investors and the
financial institutions. What developers and others failed to realize was that
through their own efforts at trading property in these rather thin markets,
characterized by few buyers and sellers, developers were bidding up the price
of land, and in so doing creating an appraisal surplus for the earlier
purchasers. This was just another form of pyramiding. For a time in
residential development the additional land costs could be passed down to
house buyers and renters, as the system had some slack. When home-buyer
borrowing limits were reached, the financial institutions accommodated both
buyer and seller by adjusting the income requirements (from 25% to 40%) and
by allowing a spouse's income to be part of the lending criteria. In
commercial development no preset limits existed or were presumed to exist --
the sky was the limit, at least so it was thought. Of course the real limit for
both residential and commercial development was the market. And it was
being stretched like a rubber band into a position of extreme disequilibrium.

For publicly traded companies, the drive to show stock market
performance led to the frantic acquisition and development of real property
assets. However, the rapid rate of growth was difficult to sustain and manage properly. The scale of projects increased to the point where each project could endanger the firm. Whatever the end use, when compared to need, too much land inventory was purchased at too high a price. The haste at which project land was purchased resulted in waste and misallocation of resources. Mass production led to insupportable market shares and potential instability. The growth goal itself became inappropriate. But developers clung to their proven businesses, expecting favorable future changes. The inertia of "game" plans, caused by the fear of breaking away from familiar strategies, created problems as the business cycle changed, markets became overworked, developer and speculators began dumping "dogs", and developers employed the same plan indiscriminately in each new market.

Land banks were originally looked on as cash generators, but they became cash absorbers. Everyone thought they represented a reservoir of liquidity, but they were illiquid. Inflation lulled developers into believing short-term economics were no longer a worry. When developers awoke, they characteristically moved in concert to sell their land banks, but by then there were no buyers.

Complete dependence on sales made land development companies very vulnerable. Those companies with income properties who were not over-committed in new projects were very safe from the effects of the business cycle. Although income properties were part of many strategic plans, they were not developed as quickly as other product lines because of their lower rate of return on invested capital. Later on, income property portfolios were sacrificed to maintain earnings performance.

Development companies were right in their concern about being in one
product and one region, and depending on government programs; however, what they did under the guise of diversification was far from providing stability. They got into product lines with similar performance and risk profiles, and they expanded into different regions with the same risky product lines. Much of their diversification was done too late in the business cycle. The projects proved to be too large for the companies to digest. They moved too quickly on to other projects to gain from an assessment of the performance of the last big acquisition. Companies were getting into unfamiliar areas of knowledge with inexperienced staff. Market and product analysis were inadequate. The buddy system often overrode rational conclusions. Diversification in some cases amounted to buying sick companies or projects in unproven markets, or to forming joint-ventures with local entrepreneurs who always had the right answers, at least at the beginning.

The financial strategy made asset accumulation and diversification possible. The more development companies grew, the more money they needed to borrow, the more they needed to demonstrate performance, the more they needed to grow -- circular and cumulative causation. Many companies went public so that they could raise more equity money so that they could borrow more against that enlarged equity base. This process left companies tied to the treadmill of stock market performance. As a consequence, planning was geared to quarterly and yearly cycles. Not much mattered beyond a year. This was a paradox for companies with land banks which had life spans of up to 30 years. Development companies depending solely on sales revenues did not meet the requisite of consistent performance in the stock market. Even the most conservative and careful investor did not appreciate this.

To sustain the ambitious growth plans, borrowing became a principal
activity. The effects of leverage and the ability to pay back the loans "should the music stop" were only remotely pondered. The size of the debt reflected the growth of the company. The amount of floating rate and short term debt reflected the degree of vulnerability. The debt to equity ratio or asset to equity ratio measured the extent to which companies financially levered. Some companies were set to fail. Yet few decision makers appreciated the danger; fewer still acted to change the situation. Those companies surviving the downturn had fairly stable income sources, manageable debt, or a large equity cushion.

As the boom progressed, many companies went through a transformation from development to financial entrepreneurialism. The assumption made, possibly the most dangerous one to survival, was that present income sources were secure, and all forecasted income would materialize. Operations were put in the economist's "ceteris paribus" category. The "game" plan became wheeling and dealing in high finance in the Euro-market, New York, or Toronto. Elaborate international circuitry for moving capital through tax havens was set up. The key to it all was the ephemeral appraisal surplus. Upon reflection, if the purpose of the developers' financial strategy was to get as much capital as the company can dispose of, then the financial strategies were highly successful. But this obviously is a too restricted criterion for measuring success.

On a less grandiose scale, accounting practices of capitalizing interest and other expenses on land banks grossly distorted reported income. If the interest on land loans was expensed in the year incurred, as it was in the more cautious companies, the aggressive companies would not have reported any income during the boom years. What would that have done to their ability
Developers were ill-prepared for a downturn in the economy. The financial safeguards that went into contingency planning for survival were totally inadequate. The cushion of cash and credit held by publicly traded companies served only as an illusion of strength.

Ironically, the loan modification and debt restructuring plan turned out to be one of the most successful financial strategies to come out of the boom-bust cycle. This truly was a complex, conflict-laden, and uncertain process of preparation, acceptance, and execution, which succeeded in keeping alive developers who surely would be legally bankrupt today without the plan's implementation. The creditors and investors made the sacrifice. They were on the horns of a dilemma in a lose-lose game.
NOTES

(1) The key development companies had a common basis in residential and commercial land development, but some diversified into product lines other than real estate. Genstar was the most diversified in this respect, and Daon, the least. Daon had successfully diversified into income properties, condominium conversions, and land development, but never ventured outside real estate. The land developers had ambitious growth strategies, the only constraint being the availability of credit. Trizec, in contrast to the others, concentrated on producing income properties for its own portfolio. Both Qualico and Jager were private firms and as such they did not have the pressure of stock market performance facing the other developers. Collectively, the developers spread to most of the major cities in western North America, Florida, eastern Canada, and to some eastern U.S. cities. Judging by the frequency of press stories in the Globe and Mail during the expansion period, these companies were doing everything everywhere. In essence, they were opportunity seekers on a broad map.
CHAPTER 7

SOURCES OF ERROR IN DECISION MAKING
IN THE DEVELOPMENT INDUSTRY DURING A BOOM AND BUST CYCLE

The three strategies followed by development companies -- asset growth without due regard for the quality and continuation of earnings, diversification without due regard for market and product understanding, and debt financing without due regard for the leverage effect -- were the apparent causes of the development industry's collapse. Behind these strategies were decision errors: errors preventing the decision maker from achieving his goals or errors making the goals incongruent with the environment such that their achievement would be detrimental to company survival. The sources of decision error are to be found in the decision maker himself, in group behaviour, in organizational dynamics, and in the decision environment. These successive perspectives -- individual, group, organization, and environment -- add greater complexity and detail to the analysis, giving in the end a comprehensive picture of the decision maker, the process, and the sources of decision errors. In Chapter 6, the analysis focused on strategic errors contributing to the downfall of the development industry. In this Chapter, the analysis probes deeper in search of reasons for adopting such ill-fated growth, diversification, and financial strategies.
7.1 THE DECISION MAKER

The essential characteristic of the developer as a decision maker, which sets him apart from other decision makers, is his entrepreneurial flair. A senior banker who had dealings with many entrepreneurs in both the real estate industry and the oil and gas industry commented:

Everyone of Western Canada's real estate companies during the period of "hype" was lead by a pure entrepreneurial type; he was not a professional manager, not one who had experienced other business cycles in other industries; but rather the kind of a guy who had a gambling instinct and had a way with him that developed followers -- a messiah type who spread the euphoria to his employees, and naturally it rubbed off on everybody, including the bankers, who touched him. The entrepreneur was very successful in building up volumes in your bank. He became an idol in the eyes of all bankers. So we tried to fight to keep him, by cutting interest rates, changing pricing etc. There was always the pressure of going elsewhere. Entrepreneurs don't like to think too long about loyalty; they seem to be inclined to think that I got here through my own abilities and efforts, and if you don't ride with me, I'll go elsewhere. They appear very confident with themselves. In contrast, the professional managers tend to be a little slower, more relaxed, a little more willing to remember yesterday, and five years ago, when they were helped. The entrepreneur was very difficult to control, everyone of them in real estate and oil and gas. They do not accept balance sheet ratios as a way of life. However, the oil and gas industry and real estate are the most challenging and interesting areas of banking to be in.

A development lawyer had this to say about his developer-client:

He was a very brilliant person with a high aesthetic appreciation, and tremendous drive; he so much wanted to be at the top of the heap. I don't think there was very much in the way of analysis done on any of his projects. ... He might have survived the downturn had he not spread himself too thinly... He inspired people more than anybody I know; everybody had total confidence in him. He had a tremendous personality, in terms of bringing in investors. His intelligence allowed him to grasp the nature of office development after two projects. He was faithful to his consultants and his contractors. He built quality projects, but like other developers, he did not have tenants. (LAWYER)

The developer is an entrepreneur in the true meaning of the word: he unearths opportunities, puts together and manages an organization, and raises the capital to fund the undertakings. He is a risk-taker (or a gambler), an optimist, an egoist, and a salesman. He is also a man of action and a leader.
as well as a manager.

None of these characteristics within normal limits leads to bad decisions; all of these characteristics are a necessary part of the make-up of a developer. Only when the normal limits of rationality are exceeded does the probability of making bad decisions increase dramatically. When the developer sees nothing but "blue sky", and believes he has an "unique vision and unusual ideas", he makes nothing but "brilliant decisions", he has a superior intelligence, he has an "uncanny understanding" of the market, and he has a "tremendous ability to sell", then the problems start. Not all developers were blue-sky optimists. For some, an optimistic attitude was a thin veneer that hid the anxieties associated with risk and uncertainty.

The delusion of one's own superiority naturally leads to a belief in the rightness of one's decisions. The developer got to this psychological state and stayed there by being successful. A great deal of inertia was evident: "We had a situation where nobody really challenged (the president) because he was right for so many years and the philosophy was right for so many years. To predict the end of the inflationary period, for example, you would have been branded a heretic." (SENIOR MANAGER) A form of megalomania can be seen in the developers' strategy of taking on larger and larger projects as the boom intensified. These projects, however, depended on high volume sales (this applies equally to rental projects), their long duration increased the possibility of markets changing for the worse, and by virtue of their size each project was a threat to the firms' existence. What could have happened did happen. Sales dropped drastically during the recession, leaving these large assets in an illiquid state and leaving the company without cash flow.

How did the developers get to this psychological state? Everyone, even
the worst cynic, is susceptible to the influence of the hyperbolic praise showered on him or her by the press, securities analysts, and by peers in the development industry. The imagery created by the media and word of mouth made messiahs out of the industry leaders. Pervasive optimism, the positive feelings about one's self, the imagery, the entrepreneurial drive to seek out novelty, to create, the urge to succeed -- all combine to make up a powerful internal force. Under these conditions, there could be no middle ground between success and failure. When feelings of invincibility and superiority mix with the excitement present in a boom environment, the conditions for making repeated errors in decision making are set. These conditions were not limited to the few entrepreneurial developers. The wide-spread collapse of the development industry is attributable not just to the environment but to the overpowering influence of the entrepreneurial developers. Their charismatic personalities infected all those with whom they came in contact.

The decision maker's perception is profoundly influenced by his mood. And his mood is conditioned by the intensity (or phase) of the business cycle.

The stress of increasing competition during the boom led to more problematic decisions. The time to assess a project became compressed. The best example of where people used blind faith to help decide was the real estate tax shelter. During the recession, the pendulum swings in the other direction: people become so scared they don't want to do anything or panic sets in. The boom and the bust make for bad decision environments. You have to take that extra moment to reflect about the decision you are about to make.... You should have a dependable critic or devil's advocate on which to test your moves. (DEVELOPER)

Pessimism pervades the business community during the stagnation phase of the business cycle. A search for causes and a rethinking of reality ensues during which time the decision maker consolidates and redirects his efforts. In the following recovery phase a hopeful decision climate exists. Optimistic decisions flow from the observation of positive business growth in the credit
expansion phase. During the speculative phase wild, over-optimistic decisions are prevalent. Such decisions proved to be in a number of instances central to the downfall of the company. And finally bewilderment comes out of the crisis phase, when old strategies crumple in the absence of any hopeful signs pointing to a future direction. Assumptions developers make vary from one phase of the business cycle to the next, quite apart from what current demand is. Erroneous assumptions then become a major source of decision error. Since the assumptions change according to the mood, disposition, and beliefs of the decision maker, doubt is cast on the interpretation and evaluation of trends in the decision environment during boom periods.

In 1982 we knew there was going to be a recession, so we prepared three scenarios, but even the most pessimistic was optimistic. Now (in stagnation) you have the reverse psychology taking effect where managers consistently underestimate demand. (DEVELOPER)

Past events and conditions also influenced the developers' judgment. Bounded rationality limited the "problem space" or decision environment to the immediate concerns.

During most of the latter 1970s there was a primary concern with getting land developed -- you had a production constraint, both physical and political. Under these circumstances you tend to assume the growth rate and the demand will continue. The postwar baby boom, smaller households, a strong Alberta economy unscathed from previous recessions, and inflation making housing attractive, were all factors propelling the growth of the housing industry. I recall little cycles in the housing market in 1965, 1971, and 1974, but these were inconsequential to the housing industry, even though, for example, in 1965 there were 150 foreclosed homes per month. All of these downturns were short-lived, and were followed by a shortage of housing. When the 1982 downturn occurred, no one thought that it would persist as it has. No one saw this as the obverse of the 1973 OPEC price increase. No one in our company was asking "what if" because our company was concentrating on production -- we could not get lots produced fast enough because of constraints. At the same time, the senior executive were questioning the rate of production given the (large) amount of land the company held. (DEVELOPER)

Bounded rationality was evident in the developers' view of the economy.
and the property market, and was reflected in project evaluations. Their conception of the economy and the property market was biased in a positive direction -- they were looking for opportunities not problems. This predisposition influenced the critical assumptions in their evaluations. Their model of reality (the inflation model) was a closed system which excluded a number of important variables -- the what "ifs". Furthermore, the assumptions made within this closed system were based on highly uncertain information. Without seriously questioning the dubious premises, developers made important investment decisions based on the bottom line because the numbers satisfied the investment criteria or "hurdle rate".

The assumptions about debt financing and inflation were limited. The logic of the argument was: the real interest rate is negative and property values are increasing faster than the cost of borrowing; therefore, all we have to do is liquidate at some future date, pay off the debt and pocket a sizeable profit. A one-time speculative venture predicated on property appreciation is one thing; however, making a multi-million dollar company's growth and survival dependent on what amounts to a symptom of a sick economy is another thing. The foundation upon which the large scale development companies were built was fundamentally flawed. Rather than creating organizational certainty and stability, development companies internalized market uncertainties as they grew.

Developers failed to recognize the impact of their decisions on the firm. It was as if each project stood alone and the organization was some external administering entity, immune to the problems the projects may have. In reality projects were bound to other projects through umbrella financing and all assets were inextricably bound to the organization. The orientation of the
policy makers was either toward the project (even though it might have been
framed by an overall strategy) or financing, but rarely both. The question of
what happens "if" was only asked in the context of justification for further
growth. Not many developers restrained their activities on the basis that this
or that decision could threaten the survival of the firm, or that a
constellation of similar decisions, even though each decision alone was fairly
innocuous, could also threaten the survival of the firm.

Furthermore, threats from the outside environment were heavily
discounted. Few policy makers took President Reagan's vow of curbing
inflation seriously, not even when the interest rates soared over 20%. Few
policy makers believed that Alberta's growth spurt based on mega-projects in
the oil and gas industry would end so abruptly.

In the early 1980s we were very interest rate conscious, all of the profit
plans had boiler plate assumptions respecting trends in interest rates. We
thought the interest rate problem could be overcome by "interest rate
buy-downs". We tended to overlook consumer confidence, a more
important aspect, which today has a bigger impact on sale of homes and
ultimately the sale of lots. Consumer confidence was directly tied to
jobs. (DEVELOPER)

Decision makers were caught off guard. The assumption was that the
organization could adapt. In the end, the developer found out that there were
limits to adaptation.

The way decision makers approached new markets was inadequate: market
awareness was lacking or superficial, and major gaps were found in the market
analyses of new markets. Pat execution formulae most likely drawn up for the
home market were employed, and decisions were often influenced by the advice
of cronies and newly found partners. Some of the decisions made not only
raised the eyebrows of local developers, but also, on occasion, made fools of
Canadian developers. Nevertheless, Canadian developers refused to accept that
many of their geographic exploitations amounted to nothing more than games of chance. They were in too much of a rush to be concerned. Habit led developers to repeat their innovative but failure-prone strategies in different geographic areas. Owing to the frequency and the relative ease of making investment decisions in a boom climate, and the relatively long time for results to appear at the end of the development process, the mistakes made in the home market were spread far and wide before initial strategic decisions were modified.

The pervasive optimism present during the boom stemmed from misreading the environment and from over-confidence about one's abilities. As success grew on success, uncertainty in the decision environment tended to be ignored. However, regardless of the developer's ability to arrive at the right decision, the element of risk is always present because uncertainty in the decision environment never entirely disappears. What happens with the build-up of confidence in one's self is a change in perception: the environment no longer feels so threatening. As a result of their experience in the 1974-75 downturn, for example, most developers thought they could detect the signs that would foretell of a forthcoming recession. Interestingly, the signs were there as early as 1978, but very few developers took notice. Most were beginning to panic in the fall of 1981, though many did not react until 1982, in the downturn. Some also thought they could steer the right course by "recession-proofing" through diversification, by setting aside cash and credit reserves, by conducting "what if" analysis on the corporate balance sheets. The contingency measures taken by the developers proved to be woefully inadequate, serving only to provide a comfort zone before the fact to those concerned both inside and outside the companies. They overestimated their own abilities. The
industry was lulled into a false sense of security. The problem at this point for a number of developers was that they had built up an asset portfolio made of straw and a capital structure made of cards. When the winds of change came no one was able to prevent the collapse.

7.2 GROUP BEHAVIOUR

The CEO is greatly influenced by the managers around him; after awhile you begin to drink the same bath water.(DEVELOPER)

To the question why did so many informed managers make decision errors. The answer lies in mass psychology, in the behaviour of crowds. ... The survivors tend to be the odd balls. I remember them being criticized in the boom times:... (That residential developer) never does anything; he is just building the same old crap he always built -- he is not going anywhere. (That office developer) doesn't build unless he has tenants. How is he going to get anywhere that way? The herd instinct is conditioned by the projections from the academic experts, by the statements made by the premier, by spokesmen for governments, by optimistic promotion, by the fear of shortage, of being left out. If you don't have a land bank you can end up without any land where its being approved for development. The process is perceived as being highly political and highly personal. How can you protect yourself? How can you buy insurance? Only by owning land everywhere. Spread your risk -- actually they concentrated risk in land. If the banks will lend, then it cannot be unsound because they always used to be careful about what they lent on. They were victims as much as anyone else of the herd instinct. (POLITICIAN AND CONSULTANT)

During the boom, subsequent to 1978, everybody shared the same scenario about the magnitude of growth. Both the private and public sector bought into the same stories. With the adoption of the competitive strategy, the planners had a political instruction to buy into that set of values. There was not the feeling that developers had greater knowledge of what was going on, but they did have a better political pipeline to the aldermen. One of my favorite expressions is that if Developer X wanted to annex part of the moon we would be up in front of the Local Authorities Board doing our best. The industry's influence and world view were not orchestrated in any way; there was no back-room conspiracy, it's just that everyone held the same view. (PLANNER)

A fine dividing line exists between "groupthink" and the collective thinking processes inherent in team work or "networking". At one end of the continuum is healthy cooperation and at the other end is pathological
"groupthink". "Groupthink" is the single most important explanation for the developers' pervasive optimism, collective action in swarming to different geographic and product markets, and feelings of the midas touch and invulnerability. Behind "groupthink" are the influence of a strong leader, friendships based on similar experience, the docility of management, and the common lust for profits. The profit motive affected nearly everyone in most companies as stock purchase programs were widely distributed among management and staff. The harm this caused the company was difficult to perceive as profit sharing is looked upon by most everyone as a good. Nevertheless, the emphasis on profit detracted from cash flow management and long range planning, both of which are crucial to the survival of the firm.

"Groupthink" was prevalent with certain corporate boards (especially where the founding members were still on the board), in executive teams, and in management teams where consultants played important roles. For example, the Carma board, comprised mainly of builders, was a closely knit, working board strongly influenced by the President of NuWest.

The Carma board was very strong; the decisions were generally unanimous. The same pattern of activity was followed by the board members not just because they were board members, but because they were friends. There was a very strong old boys network that kept the group together. They took riskier decisions because their friends were doing it. Ralph Scurfield (Chairman of NuWest and a Carma director) had a strong influence on board members on the issue of diversification. (DEVELOPER)

All of the builders who were closely associated with Scurfield became caught up with his hype -- if Ralph would do it, it could not be wrong! How could you argue with a guy who obviously has been successful. (DEVELOPER)

When the bust came not only did Carma go down but so did the businesses of several of the board members (including NuWest). All of these businesses followed the same policy blueprint.

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In making up executive teams the need for a devil's advocate was often overlooked. Some chief executive officers assumed this role, but many of these entrepreneurial leaders tired of the role, for they wanted to see only the positive side. The worst move the CEO can make, and this was done in one of the major firms, is to form an executive committee comprised of salesmen. Every executive team needs a naturally cantankerous accountant.

"Groupthink" can also be found in project teams, comprised of management and outside consultants. At the extremes, depending on the experience and personality of the manager, consultants are either brow-beaten into a submissive state or they take charge. Sometimes, the "cult of the expert" lent a mystique to the views of the out of town consultant with high credentials; their advice was accepted at face value by developers, financiers, and approving authorities. More often, developers programmed their consultants to think the way they think. The developer was told what he wanted to hear and the truth escaped both parties.

The reaction to group pressure is revealing:

One investor initially was dead against and would not touch investing in Alberta; then he would not touch but he was not dead against; finally he was ready to bite the bullet, for how can so many people be wrong. When you saw school teachers building spec houses you knew there was something wrong. Another (astute) investor sold out his real estate portfolio when a banker phoned him to ask if he wanted to borrow some money for property acquisition.

When property values are skyrocketing, it is very very hard to hold back. Why do people in their late fifties who are thinking of retiring suddenly abandon all of their conservative investment policies and jump on the real estate bandwagon, lose their entire portfolio in three or four years, and consequently, are forced into working in their retirement years? (DEVELOPER)

It would be wrong to assume that "groupthink" is entirely a subconscious process of reality distortion. Many managers and consultants resigned themselves to the prevailing view (coercion), or found an advantage in going
along with the prevailing view (self-interest). These individuals adopted the group's outlook, and as such ceased to be effective counterpoints to unbalanced decisions. To the outsider what appears to be "groupthink" might be just the party line. In a complex and uncertain environment the appearance of control, stability, and progress are important to the outside world. Self-interest and "groupthink" can be a destructive combination.

The networks that chief executives form through such organizations as the Young Presidents Organization, Canadian Institute of Public Real Estate Corporations, and the Urban Development Institute foster a common view of the decision environment. The chief executive officer by virtue of his station deals with many authoritative persons in his network of friends. He tends to form his paradigm of reality based on his conversations with his acquaintances. The process involves making great intuitive leaps and accepting generalizations at face value as many acquaintances are in different businesses and are from different cities. The information accepted by virtue of the source often overrides empirical evidence or the need for empirical evidence. For example, the say-so of an "expert" was often all that was needed to extend the search for opportunities into new markets. Or an economist's favorable prediction on interest rates at a prestigious conference could trigger the start up of an acquisition program. Deals between peers made over dinner often led to indigestion sometime later.

"Groupthink" helped to round out the rough edges of reality and made for the easy transmission of ideas -- ideas which simplified the world in which the developer operated. As success piled on success, development appeared to become so simple that many chief executives felt they no longer needed to be around. This was also evident among successful builders, as one observer
stated:

I was surprised to see all of the ... builders go down: immigrants who built up their companies through hard work and cautious dealings. However, if you look at them individually, many of them were living the good life during the boom, turning their companies over to their sons or hired managers... For some reason, they thought the businesses could support them without them being there. (CONSULTANT)

The view of the detached leader was common knowledge within the industry.
Since so many leaders detached themselves, could this be interpreted as another result of "groupthink"?

"Groupthink", a manifestation of the herd instinct, led to swarming by developers after every available opportunity. The ultimate results were overbuilding, the collapse of an industry, and a financial crisis.

7.3 ORGANIZATIONAL DYNAMICS

The decentralized structure of the organization and the rivalry among the divisional presidents were important factors in the rapid growth....

The yearly forecasting exercise was not taken seriously by many. None of the senior managers sat down and analyzed the impact of the accumulated purchases on the company.

The budget approval process was biased towards operations. The Controller acting as devil's advocate was listened to at the budget meetings, but afterwards, the managers reverted back to their project myopia.

Financing was in one orbit and projects in another and nothing linking the two. (CONTROLLER)

The character of the development organization reflects its leader. The performance of the development organization is also influenced by the way it is structured, and the quality, experience, and orientation of management.

Genstar is a very diversified company where the corporate office acts very much like a banker to the product-line companies, allocating resources to maximize return-on-invested capital and ensure long term
survival. Each separate operation is a profit center that once established should stand on its own. Genstar with its hierarchical control was better able to detect weaknesses in certain product lines. The top management of Genstar did not come out of development; their emphasis was on manufacturing. Consequently, the land division was judged on the same basis as a manufacturing company, in spite of the fact that real estate is not a production line activity. The attitude of the executive has had a sobering effect on land management: less emphasis on speculative activities and land appreciation, and more emphasis on sales and production. (DEVELOPER)

Genstar, however, is not a typical development company. Traditionally, entrepreneur-led development companies have few employees. A small management group with limited support staff ensures short lines of communications within the organization. Such organizations are geared to moving swiftly, seizing new opportunities, and divesting marginal product-lines. Their leaders were tuned to the market. Those managers who lacked entrepreneurial spirit, insight, and drive were quickly culled. Those who remained had superior management ability in property development.

"The deal" is central to the property development business. The craft of the entrepreneur is in using his intuitive thinking to uncover profit opportunities. Typically in the process of growing, the entrepreneur-leader took on deal after deal under his direct control. To achieve maximum expansion while still retaining personal control, he perforce had confined himself to deal-making, leaving the follow-up to subordinates. As the volume increased, the organization grew bigger, yet the brain remained the same. Many mid-sized development companies reached a growth plateau at this stage because the entrepreneur-owner was reluctant to share decision making in any but the most routine areas of business.

A major breakthrough came when a few entrepreneurs decided to share key decisions with other managers. They created a hybrid organization by grafting entrepreneurial-top management to a hierarchical organization. The
reorganization of key responsibilities and authority among the leader and senior managers permitted these companies to make strides toward ambitious growth targets unfettered by the old organizational constraints. When this variant reached saturation, the organizational structure was revamped into decentralized profit centers. Each profit center was led by an "entrepreneur" who was given enough authority to carry out all of the responsibilities and tasks in deal-making originally within the purview of the president. Further enlargement was accommodated through the bifurcation of old profit centers or the addition of new profit centers. As these centers proliferated, additional levels of management were added to coordinate. Whereas in the early stages of organizational development, an accountant or project manager had one layer of management to go through to reach the top, near the peak of the boom that same accountant had to go through seven layers. Consequently, communications, so important in an entrepreneurial organization, became a serious problem.

The corporate culture, molded by the CEOs and their intimates, bolstered the egos of the profit center managers by offering independence, responsibility, authority, and reward. In reality, the profit centers were not true profit centers.

We were all rewarded for making acquisitions; so it became a game between competing managers to convince the board to approve his acquisition, and once the acquisition was made the game was over. So you go out and find another acquisition. It wasn't any fun carrying out the program you said you would. Your competitor was not the developer on the street, but another manager in your own firm. This led to the misallocation of resources: the articulate manager with the glossy presentation, well presented on a fishing trip got the money. (None of the land development companies) had profit centers as they said they had, rather they had incentive centers -- acquisition centers! (DEVELOPER)

The incentive system encouraged project managers to buy assets; consequently, that is where management concentrated its time and energy.
The lack of follow-through at the operations level, because regional managers were too busy accumulating assets, meant an absence of useful feedback at the corporate level. The net result of all this was a corporate myopia preventing senior management from forming a realistic picture of the firm's performance and vulnerabilities. Some executives, of course, may not have been looking!

Basically, it was naive on the part of the entrepreneur-president to think that an entrepreneurial organization could be created much like an assembly plant organization, using relatively inexperienced managers in key roles. Neither inspired leadership nor a grand strategy could make up for the lack of experience in decision making, substantive knowledge of markets, and familiarity of development processes. Furthermore, inexperience was not confined to the new recruits. The CEO and the handful of project managers comprising the original management core had little experience or skill in managing large-scale organizations. Every manager was going through a learning experience. Many of the "functional" managers who surrounded the CEO in the early days had limited capacity to take on management tasks requiring conceptual thinking.

Because of the buddy system of the board, they continued to favour managers they felt good about even though their experience was in the land development field: no attempt was made to hire commercial experts. Control was established through trust, keeping it in the family, not by way of a profit center, an accepted mechanism of control. Trust was held higher than competence. (DEVELOPER)

Many of the new managers hired to fill the voids were intelligent, well educated, well meaning, ambitious, and influential but not in tune with the reality of property development. Several took some companies some distance down a path of destruction before they were stopped. Mistakes were made at all levels of decision making.

The strategic error was in mortgaging properties in Canada up to the hilt
and taking all the money down to the United States and buying properties they were ill-advised to buy. Young managers there, like the ones in the oil industry, did not have enough ability or knowledge; they were getting slaughtered. At the same time Nuwest bought Headway, where Ralph Scurfield (President of NuWest) was director. Out of the acquisition they got a bunch of junk in the east and in Florida. Scurfield thought he could make Headway work. (BANKER)

Management consultants were continually brought in to solve organizational problems. The turnover of managers, as mentioned, was high -- three years service qualified a manager as an old timer. Stress levels were high, especially, at the beginning of the boom before the track records were established, and at the end of the boom when the world stopped unfolding as it was supposed to have. Inflation and long lead times kept many of the pioneering mistakes and problems from coming home to roost until the crisis stage was reached near the peak of the boom. At this juncture changes in the decision environment began to uncover earlier decision errors.

Momentum towards the goal of bigness was never lost. CEOs worked around the problems of alienation and inertia that accompany bureaucratization by instilling the entrepreneurial spirit in the managers. However, there was a price to be paid for this approach. Many profit center managers in their zeal to make a name for themselves became uncontrollable. Internal competition, at one point fostered as being healthy, became destructive.

Most importantly, the strategic focus continued to be the deal in spite of the size of the firm. Moreover, the deal or project was almost always considered in isolation. As one executive said of project approvals: "80% of the acquisitions were judged on their own merits; 20% were compared with other opportunities or other assets in the firm; none were judged in terms of the impact on the firm. In hindsight, the single most damaging failing, according to another executive, was the failure to judge the risk to the firm:
If all projects were on a stand-alone basis -- non-recourse financing, long-term lenders, or partners, where we shared the risk with someone, and had we quantified our down-side for each investment, we would have corrected many of the errors made in our business originating in the belief that inflation was given and would never stop. I believe that failure to judge the risk to the firm of each investment made was the principal error. We could have second guessed ourselves on individual projects, and said some were poorly executed; however, I would not say that that was our principal problem. When you have a lot of projects, some are going to be better than others, and some could have been done differently. The principal problem was putting the whole company at risk every time we made an investment. We did not do proper risk analysis.

As the organization became more specialized, the powerful leaders of each pyramid (division) began to build empires, which not only added to general overhead and made communications more difficult, but also grossly distorted resource allocation in the firm. When competition switched from between firms to within firms the atmosphere became explosive. Moreover, the accumulation process lost any connection it might have had with rational decision making from the firm's point of view. Battles erupted over territory, status, control of product-line, and the share of financial resources. Power struggles were evident at various levels of the management hierarchy. The more ambitious project managers wanted to be profit centers, and some successfully wrested power from their superiors, further devolving the authority to make key decisions. Because of the inward orientation encouraged by internal rivalry, managers demonstrated little awareness of the external environment during the up-swing:

Once you are part of the industry, especially in a large corporation, you are not aware of the development cycle even though the large corporations are creating it in their acquisition strategies. The large corporations not only bid up market prices, but in the process their managers also have been found competing against one another for the same piece of land. (CONTROLLER)

Power was being dispersed throughout the organization and the chain of command was becoming ineffectual.
What we had was a number of mini-companies. Decentralization went below the regional level -- it was not just an Alberta, California, or Texas company -- it was fragmented below that to the vice-president level or even the project manager level. Project manager was competing against project manager for corporate funding. (CONTROLLER)

However, no one was minding the overall health of the firm!

Decentralization through delegation was part of entrepreneurial strategy, initiated and encouraged by the CEOs not, as one may think, an uncontrolled movement towards anarchy. Subunit managers were able to control their decision space as long as they continued to perform. The unexpected end result, however, came very close to anarchy. The CEOs thought they had overall control but they did not -- for there were periods where no one did.

As the focus of activity shifted away from projects and towards finance and administration (paper entrepreneurialism), the organization went through a further division, creating new separate spheres of activity. Finance departments, for example, considered themselves to be profit centers and took on a life of their own, independent of their original function. Some financial executives thought they were on the road to becoming J.P. Morgans. Too many senior executives in the industry seemed to become singularly preoccupied with projects, financing, or personnel, at the expense of an overall corporate strategy. Everyone seemed to be on a "power trip".

7.4 THE CORPORATE DECISION ENVIRONMENT

Decision errors associated with the decision environment are of two distinct types: errors arising in the perception and forecasting of trends in the economy and the marketplace (the corporation/environment interface error); and errors arising out of the actions of others in the developer's environment (external error). Developers, like other businessmen have to think globally and
act locally. Errors were created by misperception of the economy and the local markets. Within the external environment, the influence of financial institutions had a significant effect on the CEO’s outlook and decisions.

7.4.1 THE DECISION MAKER AND HIS ENVIRONMENT: INTERFACE PROBLEMS

All developers held an optimistic view of the economic future of Alberta in particular, and of North America’s sun belt and energy-oriented cities in general.

The Alberta economy continues to outperform that of any other province… energy money rolls into Alberta … industrial growth on an unprecedented scale.” (Jack Poole (Daon) in Canadian Building, Feb. 1976:5)

Bustling at a spectacular pace for more than a decade, the Alberta construction boom shows great promise for at least another 10 years. According to government, construction industry, and business officials the province faces an accumulating backlog of hundreds of billions of dollars worth of construction (Globe and Mail, Dec. 1, 1980: B5)

The forecasts for Alberta’s two major cities (Calgary and Edmonton) were glowing in the 1970s and early 1980s. Whenever developers met, they talked incessantly about the bright future. These views were echoed daily in the press by oil industry executives, provincial government spokesmen, and various analysts. With the proliferation of supposedly "hard" data about oil industry prospects and housing published in technical reports, developers joined other speculators in the belief that the province was about to explode with activity. The rosy picture of the economy became embedded in most decision-makers’ mind and colored their decisions.

The economic paradigm was confirmed by the positive trends in the property market. Developers believed, "It is difficult to do anything wrong … the surge in demand is erasing all mistakes." (Nelson Skalbania in the Globe
and Mail, Feb. 25 1978: B1). With environmental complexity and uncertainty removed from the mind's eye, the anxiety level in decision making went down. The climate of optimism encouraged developers to take on larger, riskier projects. As pointed out in Chapter 6, many of these large acquisitions were made near or at the peak of the boom: Genstar's decision to buy Canada Permanent Trust, Daon's billion dollar buying spree in 1981, Carma's acquisition of Allarco, and NuWest's acquisition of Headway Corporation, and TransAlta and Abitibi-Price shares. As mentioned in Chapter 3, Hongkong Land also went on a buying spree in 1981. The most spectacular acquisition had to be in the oil industry with Dome's billion dollar purchase of Hudson's Bay Gas and Oil, which concluded three weeks before Dome announced its financial difficulties. At this point, the decision makers had lost all fears of failure: the tendency appeared to be universal.

A number of prominent entrepreneurs-developers lost sight of what the environment was doing for them, and began to believe they were endowed with a special gift -- the midas touch. They were not the only ones to hold this view. Other developers and bankers, who can be classed as followers, believed the entrepreneurs were gifted as well. (Had there been no heroes in the industry during the boom, there would have been no followers. Perhaps there would not have been a boom.)

The media and the securities analysts were strong supporters of the entrepreneur-led companies and contributed greatly to the climate of optimism. Most of the authors and those written about would probably squirm today after rereading some of the following published articles:
Canada has a large number of aggressive companies of world caliber with excellent futures ahead. ... Land is becoming more attractive as project managers shift from housing to land...The energy belt is more sheltered from recession which North America is almost through. (Frank Mayer, Globe and Mail Aug.18, 1980: B7)*

Daon flush with cash takes advantage of economic conditions by picking up assets at bargain prices (Globe and Mail, Jan 16, 1981: B3)**

Daon's meteoric rise has made its youthful executives proud to the point of being supremely confident and engagingly boastful. Real estate analysts also tend to exhaust every superlative in praising Daon -- Young, aggressive, the track record is truly superior to most companies in real estate or industry in general. ... Climb based on the ability to identify and then grasp opportunities and shift quickly to new regions and product lines. Daon knows what to avoid. (Susan Goldenburg 1981, 225-6)

On a recent convertible stock issue... NuWest's impeccable record of profitable growth and diversification ...rather than reacting negatively to this issue, we think the market should react positively to another indication that the NuWest empire is growing on the basis of a consistent, methodical corporate strategy. (Bunting Bi-Weekly, May 1981:5)

There is ample evidence in the 1980 annual report (to state) that Carma made the deal of the year in acquiring Allarco. (Bunting Bi-Weekly, May 1981:10)

NuWest's annual report reads like they were geniuses (Gluskin); ... enhanced general perception of NuWest as one of western Canada's emerging financial empires (Mayer). (Globe and Mail, June 6, 1980:B6)

*Every one of these predictions turned out to be wrong.

** Exactly 11 days later in the Globe and Mail (Jan. 27, 1981:B1), the Executive Vice-President announced that the high interest rates were causing a problem in the United States. He thought interest rates would drop in a Presidential election year.

This is heady stuff. At the time the plaudits served to reinforce the developer's image of himself.

Through the boom period, the climate of optimism and the track record dissuaded developers from critically reviewing their strategies. They might have recognized that their picture of reality had holes in it. They had accepted the big economic picture, the favorable view of their own strengths and weaknesses, the market as it was, and they concluded that their strategies
were in line with what they saw. They did not appreciate the existence of the business cycle, the possibility of being hurt by exogenous forces, the precarious situation they had gotten themselves into by buying too much land, by stumbling into new markets, and by going into debt. Their view of reality went only so far as accepting an incurably high rate of inflation, a buoyant economy, a continuation of past trends, and, if worse came to worst, a super company that could turn on a dime. The rules of real estate development were flagrantly and knowingly broken:

We would not have land-banked sites, but we were afraid that all the sites would be gobbled up. You ended up with two or three sites ahead of yourself. Land banking is something a commercial developer should not do. We realized that we were breaking the rules; we were getting into projects without equity and we were capitalizing interest -- all on the basis of continuing inflation. The land that we bought for $500/sq.ft. would sell for $700/sq.ft. We knew that this was not right and that it could not happen for ever. While you sat there, someone else was selling a site for $50/ sq.ft. more than he paid three weeks earlier, even before he closed on the original deal. The temptation was too great for most of us -- even the most cautious. The only people who failed to get on the bandwagon were the ones that were too slow. (DEVELOPER)

"Inflation made people feel safe; it covered your mistakes." (DEVELOPER)

When the decision environment began to change for the worse, the outward view of the economy in Western Canada and in other "hotspots", and the inward view of the strength of the development company helped to maintain a disastrous course well past the point where prudent businessmen would have taken remedial action. Indeed, as pointed out earlier quite the opposite occurred, some developers took their most daring steps when the future of the economy was the murkiest. Within the bounded thinking of the decision makers and observers these moves at the time were seen as being brilliant. In hindsight, the moves appear irrational. At the root of many of the decisions made at the peak are inaccurate forecasts and misperceptions.
I became concerned about the direction of interest rates in March 1981 during a trip to Switzerland. At that time in North America there was confusion as to which way the interest rates would go. Although the inflation rate on housing declined by 6%, the basic commodity rate was still at 13%. Yet, an... economist at a YPO conference stated 1981 year-end prime bank rates would be around 10%. The (CEO) had been influenced by this economist. The company had adopted his guideline in its planning (FINANCIAL OFFICER). (The interest rate continued to climb to 24%).

Up until late 1980 we were all in step with the world -- oil prices would go up and so would inflation. From 1976 to 1980 nobody was putting on the brakes not even the Chief Financial Officer whose responsibility it is to manage the fiscal reins (DEVELOPER).

In the early 1980s, nobody in Alberta thought we were in a down business cycle of any lasting consequence. Most of our income and profits were from Alberta and the downturns there were never of great duration or depth during the last 15 years. So another one comes along. ... If you look at the segmented financial statements of 1980, the US operation was losing money in 1980. The downturn for the industry in Alberta started in 1980, but we powered through thinking that the downturn would be of one year duration. We were on this power ascent, when the rest of the industry had already gone through one year of downturn. In the first year of the downturn sales were not a problem as most of the houses were government subsidized. By the end of 1981 we were in freefall, with three consecutive drops in the 40% range over the next three years (DEVELOPER).

There was a feeling that the market was turning sour; but no one thought that the drop would be more than 10% and last longer than a year. No one knew where it would stop until it hit bottom. There were virtually no transactions. In rental apartments, the owners had to keep dropping the rent as the vacancy rates increased due to the out-migration of the unemployed. As the rents decreased the economic value of the rental projects declined (CONSULTANT).

The early signs of change in the business climate appeared in 1978, but they were not clear. The economy was seen at a "crossroads" or "poised at the middle of some kind of cycle"; "changes" were occurring at a dizzy rate; "uncertainties not experienced before" were appearing (Property Forum 1978). Had developers riding the crest of the business cycle cut back at this juncture the boom would have subsided without the devastating crash. From this point forward, developers commenced their strategic annihilation. The fall became inevitable -- the question was "when"? In the Autumn of 1979 interest rates
moved up. The reduction of credit was a deliberate attempt on the
government’s part to curb inflation. Red flags were raised by securities
analysts who saw the high interest rates as a retardant to earnings growth and
stock performance. In assessing the impact of the high interest rates some 6
months later, Gluskin saw:

a disaster looming for some large Canadian Companies in the United
States. … The magnitude of what has happened in the real estate market
is worse than predicted. Only Trizec will have increased profits in 1980,
Genstar, Carma, Daon will show lower profits … Most of the companies
refuse to acknowledge that (my) forecast is correct. Each has a special
set of factors in its favour. … The bottom for public real estate stocks
will coincide with the peak in interest rates. (Globe and Mail, 5 May
1980, B1)

The first indication from a public corporation that anything was seriously
wrong in the industry came from Cadillac-Fairview. In a July 1980 press
release, it announced that it was getting out of land and housing development.
The Western developers were quick to rationalize staying in by arguing that
this was an Eastern company with assets concentrated in Ontario. "Our assets
are in the West and the West is less recession-prone than the East"
(DEVELOPER). How wrong could Western developers be! Throughout this
turbulent and uncertain period, developers tried to separate themselves from
the general problem by claims of uniqueness.

The developers, furthermore, misjudged the actions of the U.S. Federal
Reserve in bringing inflation under control. Conventional wisdom, and the
advise of some prominent economists suggested interest rates would start going
down in 1981 and the economy would pick up. The "technical" recession of
1980, the one felt mainly in Central Canada, was over and the next one was
assumed to be sometime in the future.

When the interest rates started going back up in July of 1981, I realized
that we were headed for trouble. We were fooled into thinking that
history would repeat itself in 3 to 5 year cycles. We had a recession in
1980; interest rates started going down in the spring of 1981 and I thought we were back to growth for 3 years, but before we knew it we were heading back into the trough again. This was the first time in my business career that two cycles ran so close together. The economic outlook at a (business) conference in April of 1981 reinforced my view about interest rates going down. Even though Reagan said that he was out to lick inflation, nobody believed that any government would have the spine to do what he did. (SENIOR DEVELOPMENT EXECUTIVE)

So in that brief moment between interest rate spikes, many companies resumed their acquisition strategy, using up the cash and credit they had reserved for an economic downturn. They were hoping to repeat their earlier successes in the post 1974-75 recession period when they swooped down on a decimated U.S. development industry.

The renewed spurt in activity however was short-lived. Ironically, one of the few business leaders who foresaw a serious downturn in the property market was the chairman of the now defunct Canadian Commercial Bank.

In April of 1981 at the first annual meeting of the CCB Mortgage Investment Corporation, Howard Eaton, the chairman of CCB, gave a speech predicting the very imminent decline of real estate values in North America -- values were going to drop in half. Nobody believed him, I did not believe him. He was very severely criticized by developers for making this out of line statement. (DEVELOPER)

By the middle of 1981 when interest rates began to go up again and the inducements failed to draw buyers, most developers realized that they were headed for trouble. For most developers, "the first indication of a downturn is when the man on the street stops buying; and this is reflected in the increase in inducements to buy property" (APPRAISER). Of course, at this point it is too late to react. But, before then very few developers saw the end to the boom coming:

As far as we chose to look ahead, we thought the economic trends would be upwards. Over the next 24 to 36 months, no one in the industry thought that oil prices would do anything but continue to go up. I realized that the economy was headed for trouble in mid 1981, when interest rates started going up. Previous to that people were willing to and able to absorb high interest rates. If you believed that inflation was
built into the economy, you could rationalize high interest rates. By early 1981 this view seemed to change. (INDUSTRY EXECUTIVE)

Up until this time (1981) we thought our decisions were all perfect. The demand in Alberta was there in the marketplace for oil and gas, and housing. However, what we failed to perceive was the extent to which the declining demand in other parts of the world would affect us here in Alberta. Our vision would not let us accept that the whole world market would go into a down cycle; most cycles in the past had been geographically isolated. (BANKER)

In the prevailing business climate, developers were guilty of geographic determinism in believing that just because the project was in Alberta it was fail-safe. They were guilty of historical inevitability in believing, firstly, that business cycles were always three to five years in duration and, secondly, that after the downturn all they needed to do was to repeat their earlier acquisition strategy of preying on recession-weakened companies.

The change in the developer's perception of the environment produced very stressful conditions to work under. This high stress coming upon decision makers as suddenly as it did created a state of hypervigilance.

It is hard to go from a 5% growth rate, with 30,000 people entering the city in a year to zero. Going from a mind set of "you have got to have inventory because these home buyers want to move in tomorrow" to "where are the buyers?" is hard. I don't think the builders could accept the fact that the houses would not sell, and held on too long. A lot of them were victims of the banking community. If the bankers had not panicked some of the smaller builder-developers would still be alive. (DEVELOPER)

Developers and bankers panicked all at once and altogether. In the process, they introduced a second wave of insolvable problems, arising out of the "solutions" for the first wave.

Not only did developers have difficulty in perceiving the trends in the economy, but they also had difficulty perceiving and interpreting changes in the property market. The first developers into the market in any boom cycle
made large profits, encouraging others to enter the market. Developers flocked from other regions, builders became developers, and novices became builders. With these dynamic changes, forecasting of trends in the industry became difficult. During the early stages of the boom forecasting by extrapolation of past trends, and building to the forecast volume was a safe procedure because demand invariably exceeded supply. Many development managers were criticized for being too conservative. Consequently, as the boom progressed the tendency was to increase both the forecasted volumes and market shares regardless of changes in the market. As one prominent western developer said: "if you have 30 developers each one will claim 10% of the market."

The highly optimistic readings of markets led to fierce competition. Swarming, as Schumpeter (1959) referred to it, contributed to building starts being highly concentrated: no developer wanted to be left out nor the last to start. The inevitable result, evident in the bust phase (1982), was oversupply and collapse of capital value. It was simply a lesson from basic microeconomics, which tended to be overlooked in the aftermath, when everyone was looking around for a scapegoat. Although the devaluation of real assets occurred in the bust phase, its origin lies in the boom phase, in over-production caused by unrealistic perceptions of the market and faulty assumptions -- mainly in giving validity to unpredictable future events. This was how it happened in office and residential land markets.

In the overheated office markets of the late 1970s, prospective tenants were deluged by developers desiring to build them an office building or to rent them space. Some potential tenants signed leasing commitments prior to the construction of the building, others sat back, waiting for better terms. In the
heat of competition, developers began to believe that all firms other than the ones that had committed were possible tenants for their proposed office space. The developers convinced the bankers to drop the traditional requirement of a leasing commitment prior to financing, using the argument that the would-be tenants are playing a wait-and-see game. The first buildings to start were substantially "preleased". This served to build up false hopes, as the developer generalized from the few to the many. Numerous buildings were started, consequently, with no certainty of being occupied. The pressure is always there to commence construction once millions of dollars have been committed to site acquisition. The building process continued until overbuilding was obvious. In the overheated residential land markets, builders were infrequently asked, and never agreed if asked, to enter into contract sales with the developer prior to servicing a subdivision. Therefore, the risk of overestimating or underestimating the market traditionally rested with land developers right from the start of their projects. Since World War II, with few exceptions, developers assumed that builders would buy, and builders in turn assumed that home buyers would be there. To reduce the uncertainty, at least in their mind, the cautious developers solicited market information from their regular builder-clients in determining development programs. During a boom, builders' lot estimates became wildly exaggerated. Not only did builders perceive the pie to be bigger but their perceived share of it was enlarged, at the expense of others. In short, they suffered from the same syndrome as developers -- overoptimism. Awareness of the tendency to exaggerate market share usually came after the damage was done -- after the houses were built. The reasons for this were, firstly, the long duration of the development program, about two years, resulted in bad news taking a while to percolate to
the surface. Secondly, every development project had some "unique" features, at least to the developer, which led him to rationalize the other developers' project failures on the absence of the saleable features, unique location, or sub-market orientation. Many overly confident developers proceeded with their expansion plans when they should have been withdrawing from the market.

What are the implications for forecasting and long range planning?

You have to forecast, but you also have to know the limitations of forecasting and don't put so much weight on the forecasts. You must have an appreciation of the upsides and downsides of what could happen in your market area and remain flexible. You have to distinguish between long trend lines and short cycles, and have an appreciation of where you might be on the curve. If you have not covered yourself off with your cash flow to overcome a rise in interest rate, then you could be in trouble. (DEVELOPER)

The environment in Calgary allowed managers to get away with unrealistic forecasting. ... Nobody in the real estate development believes that they are overproducing. However, their perception of the market is always out of sync. Long after the market has disappeared they are still producing. (DEVELOPER)

We used to grin at the developers' forecasts: if you added up the individual developer forecast, the city would have to grow at a rate of 60,000 persons/year. (PLANNER)

Positive forecasts set within the logical framework of long range planning provided developers with the rationale to assemble large tracts of land for future community development and to inventory office building sites. The forecasts lent support to the wide-spread notion about land value appreciation. Yet regardless of whether the forecasts and plans were prepared using a sophisticated computer model, or a table napkin, they ONLY reflect the past and present. Forecasts, particularly long range forecasts, were patently wrong: during the boom, they were overly optimistic, and during the bust, they were overly pessimistic.

The company forecasts when approved served as a resource allocation guide. However, the two year rolling forecasts were highly inaccurate because of over-optimism about the continual high rate of inflation and
market absorption. Not only were the profit levels off but also the
timing was as well. (CONTROLLER)

In Winnipeg, we compared the five year forecasts made in each of years
1979 (the beginning year of Winnipeg's recession caused, in part, by the
Conservative parties austerity program) to 1983 (when the city was
experiencing a mini-boom). Interestingly, each year's forecast trended
downward from 1979, including the forecast for the boom year.
(DEVELOPER)

Market analysts were not the only professionals whose forecasts were off.
Of 17 economists surveyed in early 1982 about trends in the Canadian economy
in that year, one saw a recession looming, one saw only a small downturn, and
the rest (15) expected another year of moderate growth (The Sun, Oct. 2,
1984: 2). City of Calgary demographers also found it impossible to forecast
population growth with any degree of accuracy during and after the boom.
Securities analysts were no luckier. As one Banker said:

I don't remember any of the forecasts from financial houses at the peak
suggesting that Alberta was headed for trouble.

Forecasting and long range planning are an integral, but controversial,
aspect of business strategy and rational decision making. It appears, in
hindsight, that forecasters were unable to predict the medium or long-term
future with any consistent accuracy. Developers now are of two minds about
forecasting and planning: at the one extreme is the attitude that forecasting is
nothing more than a "SWAG" (scientific wild assed guess), and at the other
extreme, complete dedication to the five year plan. Drucker (1980:1) explains
the nub of the problem with forecasting and long range planning during the
1970s.

Conventional planning requires a high degree of continuity that no longer
existed in the 1970s, an era of turbulence: irregular, non-linear, and
erratic. .. Many managers have not yet understood the devastation that
inflation causes in conventional planning and control systems. .. Our
economy uses money as a common measure for many things, but inflation
destroys this measure and makes continuity an illusion... Executives
depend on figures,... but during inflation figures lie -- the illusion of
record profits may lead to wrong actions, wrong decisions, and gross mismanagement.

The illusion extends right back to the demographics that served as the basis for profit projections. Given the difficulty with forecasting, is it any wonder developers and others had problems in perceiving changes in the business environment? Forecasting trends in a turbulent environment, characteristic of a boom, was impossible. Yet, forecasting was done, probably with greater vigour as the magnitude of the boom increased -- the call for forecasts increased as uncertainty increased -- this was only natural.

A former politician and consultant has the final word on forecasting:

Anyone who bases his investment plans on demographer's or economist's forecasts ought to have his head examined. It is nice to know what they say. But you are supposed to have the experience when you are managing other peoples' money to put that in some context related to what you are about to do. You don't believe it; you are dealing in probabilities as they are; and if you want to get precise about their prediction, you ask them on what assumptions have you based this. Then, you look at some of these economists and ask, would you trust them with your life's savings? And your answer usually comes then and there: most of them you would not trust to go to the corner to buy an ice cream cone!

What we are looking at are basically statistical techniques coming from academically inclined individuals with no business experience. Management needs what could be reasonably relied on to justify spending money and getting it back within a reasonable time. Market analysis and forecasts are to be used with discretion and judgment. You do not accept them as being the answer: you accept them simply as being among the other indicators that you combine to come to a judgment. A much more important indicator may be your own business experience or your feel for finance. In the end it's judgment -- exactly what management is for.

In (the company I worked for), the academic analysis was converted into a business plan and tested. Most of the people I saw in the seventies did not do this; they took the academic analysis as if it was the answer. There was none of the business and financial input, and none of the accountability that says that I am going to lose my job if they put their money in and don't get it back when I said they would.
7.4.2 THE EXTERNAL ENVIRONMENT: THE FINANCIAL COMMUNITY

In the broader environment, government provided the necessary preconditions for a property boom to occur; the entrepreneur-developer and the financial institutions working together made it happen. In the process, financial institutions committed gross decision errors that contributed to the collapse of the development industry. In general, financial institutions extended too much credit to Western Canada's economy. By sector, they extended too much credit to the real estate industry. Within the industry, they lent too much to individual companies. In particular, they lent far too liberally on a corporate basis, giving development companies the discretion of where the money was to be spent, and they financed too many risky and marginal projects.

There is no question about the availability of credit and its role in fueling the property boom. The central question is, why did the financial institutions lend so much to certain developers, with so little concern as to where, how it was to be spent, and what were the chances of getting it back? The answer appears to be a lack of experience, poor judgment, over-optimism, fierce competition, and greed:

Ten years ago some Canadian banks did not know very much about the real estate industry. Today they do. Near the peak of the boom they became very very aggressive and threw caution to the wind just as the borrowers did. They were caught up in the belief that everything was going up. There was a measure of over-lending on assets. The very thing that we should not have done, they should not have done: they should not have made huge floating rate demand loans on land, that would take 15 years to pay back. It is not a proper loan for the banks to make and it is not a proper loan for a borrower to ask for. The kind of land that Daon, NuWest, Carma, and Genstar had (1,000 or 2,000 acre tracts) proved to be very illiquid. Bank money is for assets that rollover quickly. (CHIEF FINANCIAL OFFICER)

The bankers were much their own worst enemy just as we had become. They became wound up in this never ending cycle of inflation as much as any one. They were competing with each other. It got to the point
where they would take a shaky deal because they knew if they did not take the deal they would be denied the opportunity to finance a better deal, say an office building. Their greed was there as well. They were as much an architect of their own downfall as others in the industry. (CONTROLLER)

It was not that all bankers were unaware of the strategic errors being committed at the time. As early as 1978, one banking executive who specialized in real estate was saying that "the spreads (between lending and borrowing) were too small to compensate for the risk"; "inflation skewed many marginal projects on side"; and that there was "a need to pay attention to the sheer viability of projects" (Bill Poole, CIPREC Property Forum, reported in Canadian Building, 1978:14). What he said was true but very little was done about it. A knowledge barrier existed between the few experts and the rest of the financiers. The few experts were located outside Western Canada, and all of them were overworked. Many developers dealt with local managers who were "jacks of all trades and masters of none".

In the early stages of the boom, financiers as whole not only had a sketchy appreciation of the development industry, but they also had only a vague idea of where the economy was going, and were under pressure to make loans.

I realized we were in a business cycle; but when the cycle is going up, it is very difficult to see it coming down. You are in the midst of it. You have peer pressure, client pressure, and pressure from your boss to build volumes, especially when you are in the territory where all the action is, while the rest of the bank's geographic markets were soft, and this was particularly so in Alberta in the mid to late seventies. There was then a natural tendency to be not as prudent as you might be. My previous experience with business cycles was in manufacturing in Ontario. In this industry you could easily detect changes in receivable coverage, which forewarned us of cyclical change, whereas in oil and gas and real estate it is much harder to detect these changes. (BANKER)

In the 1970s, the competition between Canadian banks was quite fierce.... Market share and increased volumes were the strategic emphasis for Western Canada, as this region was seen as the performer in an otherwise sagging economy (BANKER).
The competition led to an eagerness to do deals. If loan negotiations came to an impasse, developers would just threaten to walk across the street. The threat was usually enough to conclude the negotiations. Clearly, the falling profits in the banks’ Eastern regions was the wrong reason for lending more money in the West. But Western bankers were being pressured by their Eastern bosses. Moreover, neither Eastern nor Western bankers appreciated that the underlying strength of the Alberta economy could be eroded.

Financial problems arising out of incompetent decision making were pervasive. One appraiser observed, “The credit unions, trust companies, and junior banks were not sophisticated real estate lenders: they did not have the expertise. They placed a lot of money against non-cash flow producing properties. They made some foolish loans with local developers.” The financial problems went way beyond the near banks and the junior banks. A former director of the Canadian Commercial Bank Mortgage Fund pointed out that all financial institutions got into serious difficulties:

The Canadian Commercial Bank was just a regional bank too dependent on the region they were in, and they were new. Perhaps they expanded too quickly in the USA. The CCB however did not do anything that the major banks did not do; their decisions were no worse -- you just have to look at the moose pasture that the big five have. If one could examine the balance sheets of the big five you would be surprised to see that they are in just as bad shape as the CCB, but they are big and have time to repair their mistakes.

The Canadian bankers had no previous experience to fall back on as the American bankers did.

Some banks had very competent managers others did not. Sometimes loans were delegated to very junior persons. When we had our problems, the banks had become overloaded with problems; they were thinly stretched and had a difficult time dealing with their problems. There was a different approach in the United States generally. They had faced similar problems in the early 1970s; they knew how to deal with the problems and were very decisive. They just wanted to get their assets back quickly, which they could because they were mainly project lenders,
and they just forgot about guarantees. The Canadian banks did not have this early experience to fall back on. (CHIEF FINANCIAL OFFICER)

Bankers were easily taken in by the "charisma and the keen insight" of the chief executive officers of the development companies as well as their corporate strategies. They deferred to the developers' "superior" understanding. They thought developers understood what they were doing.

Developers also held misconceptions about bankers and government officials:

A familiar expression among the builders and developers was: "It's probably all right, after all the banks would not be lending us the money if it were not". Even when they had their own misgivings, they tended to look to the lenders and the government (officials) as if they were the experts. (CONSULTANT)

The language and concepts used by the development industry conveyed a sense of perpetuity, lulling the bankers into a false sense of security -- no one foresaw a downturn. They swallowed the myth of big and strong and getting stronger. They liked the strategy of diversification especially when it was advanced as "recession-proofing". "We banked on the diversification strategy because we thought it made sense. We never expected the demand for real estate to fall off everywhere all at once " (BANKER). Diversification provided the rationale for lending more money to companies already heavily in debt. The banks and other institutions lost sight of debt to equity ratios. They also made a mistake in adopting a blanket policy on geographic expansion. When they lent money ostensibly for operations little did they realize that it would become equity in land projects in California, Phoenix, Houston, or Denver, equity that later would disappear in the real estate crash.

The expansion into the United States was made possible by the Canadian banks; without them Canadian developers would never have expanded into the U.S. The banks accepted what the developers told them at face value; they had no reason to doubt them given the past performance of the development companies. However with the rapid expansion of these firms the banks should have taken another approach. The bankers did not have
an awareness of the nature of the development industry. They lost sight of thinking about the "what ifs" in their decision process. (DEVELOPER)

Although some banks went into land banking knowingly, others were unaware of the use to which their corporate loans were being put. "We did not think we were getting into land banks because we were only advancing operating credit; however, the clients were investing these credits into land. The banks did not control the land banks even though they had the power" (BANKER).

Western Canadian bankers not only became caught up in the hype and optimism of the times, but they were also feeling the pressure of outside competition.

To prevent developers from using too many lenders, banks could control this by: debt to equity test, coverage tests, covenants to limit lenders, or permission to increase lenders. However, the banks doing this would run the risk of losing the client. When companies were growing rapidly, many foreign banks would project-lend against the property; they were not overly concerned with the overall balance sheet and this left them in jeopardy if the company had a high debt to equity ratio... You can write securities as tight as you want to, but in the high flying times nobody would have signed such a loan agreement. However, the banks collectively saw no need for increased controls: We were caught up in the same euphoria developers were caught up in. (BANKER)

One predisposition of Canadian banks was to cater to their clients, even if it meant greater exposure to risk. This traditionally was the way Canadian banks operated, and can be contrasted with other national banks which emphasized syndication of risk and project lending. By not having to worry about each project, Canadian bankers could make quick decisions, reflecting the confidence they had in their clients at that time. However, the snappy decisions became part of the problem as they permitted developers to forge ahead at dangerously fast rates. The acts of reviewing project and forming syndicates, at the least, would have slowed the rate of growth.

Credit decisions swung on a vision, profitability, and the track record. Bankers believed what developers believed about project or corporate
profitability. Since there are no assured ex ante measures of profitability, the 
only objective criterion to depend on was the track record. Consequently, it 
was used extensively as the grounds for lending. The aggressive, high 
risk-takers who were amassing property at breakneck speed were the ones 
receiving the lion's share of the loans. They were the ones who as 
entrepreneurs performed exceptionally well during the early stages of the 
property boom. Unfortunately, the foundation of their performance was not 
permanent. In the frenzy of the latter years of the boom, even track records 
had become unimportant. One interviewee, a lawyer whose experience in 
development was limited to zoning bylaw amendments for developer-clients, 
got to one of the major banks with a vision and was lent $3 million on his 
signature. Another interviewee, this time a well-known developer-consultant, 
was lent $1 million over a cup of coffee. Many developers were encouraged to 
take on more debt by their trusted bankers. Such was the compulsion to make 
loans.

The banks lent far more money than they should. Their criteria for 
lending changed drastically in the seventies to the point where it became 
easy for someone without a track record or a project to borrow far in 
excess of what his track record or circumstances warranted. Cash flow 
was not a factor in the dealings I have had because the assumption was 
that you would be selling in a rising market; the loan would be repaid 
out of capital. If you were required to pay for these projects out of 
income most of them would not have gotten off the ground. But once you 
abandon cash flow you are at sea without a paddle. You are relying on 
liquidation to pay, and you can only liquidate in a rising market. Regardless of whether it was an energy loan or a real estate loan, the 
banks were all relying on huge increases in equity value through 
'inflation, not income, to pay off the debt. There is something 
fundamentally wrong with this. It's like a juggling act: you keep adding 
balls, until one falls, and then what happens is the rhythm is upset, and 
they all fall. (DEVELOPER-CONSULTANT)

The subjective causes of lending behaviour ranged from extreme naivete 
and ignorance, to deception founded on individual greed. Some trust companies 
developed borderline-fraudulent relationships with their development
subsidiaries in which interests in assets acquired by the development company were sold to the parent trust at considerably higher prices achieving, on the one hand, a higher capital base for the trust which would allow it to lend more money, and on the other, a higher market value for the assets which would permit the trust to lend more money to the subsidiary. Pioneer Trust was a case in point.

The Government should not have bailed out Pioneer Trust. The taxpayer should not have picked up the cost of the mess. There should have been a public inquiry and prosecutions. Pioneer Trust and a host of other Trusts (Greymac, Fidelity, Seaway Trust) are all self-dealing and speculating in real estate development with the depositors' funds. Many of the managers consciously breached the trust of their depositors for the lure of big money. When they lose it, they panic and try to cover it up with other deals. It was exactly that which brought down the Penn Square Bank, with which Pioneer was involved. Trust companies have insufficient controls: they own and develop real estate and lose sight of their trust obligations. (CONSULTANT)

It has been suggested that the lending practices that got these financial institutions in trouble could not have taken place without appraisals as they legitimized the transactions. Obviously, the historical record of land price movements, the data of appraisers, is not a sound basis for lending in a property boom.

Clearly, the banks and other financial institutions were as much a victim of their own greed and ineptness as they were of someone else's. They have a shared responsibility in the collapse of the development industry and its consequences. As one seasoned developer bluntly stated: "The fact financial institutions also got their noses blooded is a lesson for everyone. Too much money was made available for almost any project without sober thought on what was happening."
7.5 SOURCES OF DECISION ERROR: CONCLUSIONS

The ambitious, driving, and captivating personality of the entrepreneur-developer flourished in the untrammeled business environment of the 1970s. The entrepreneur-developer saw only opportunities and looked forward to immediate success. Initially, his leadership style led to spectacular business achievements. The early successes fixed the winning strategies in most developers' minds. However, an astute observation by one entrepreneur-developer, "we always do things the best the first time", contained a foreboding message about the developers' strategies. It underscored the ephemeral nature of development opportunities and the importance of being first in the market.

As the boom intensified, developers became possessed by the need to accomplish larger and larger feats. The original winning strategies continued to be applied, often on a broader scale, even though conditions had changed. Blue sky optimism and a stunning track record helped to detach developers from the reality of business cycles. Their world view was limited to notions of continuing inflation and with that, increasing appraisal surpluses. This view was translated into their market forecasts, income projections, and feasibility studies that served as a basis for investment decisions.

During the speculative phase of the business cycle when no clear economic trend existed, many market assessments for acquisitions and development programs were superficial at best. They all reflected assumptions and rationalizations based on the gambler's fallacy -- markets will continue to improve! The desire to do the deal overrode rational decision processes.

Developers in acquiring more land and other assets broke all the rules of fiscal survival. To make matters worse, survival appeared not to be high on
the priority list -- at least not until the threat was clearly evident. The developers' judgment had become impaired. Under these circumstances repeated decision errors were made. The process of "groupthink" helped to spread the errors throughout the industry. Everyone was of the same mind on what the future held.

The logical outcome of "groupthink" was group action. "Groupthink" caused swarming and swarming created the property boom. "Groupthink" was also at the root of the sudden disengagement and withdrawal of development firms from a collapsing market during the bust. Over the course of the boom-bust cycle, a wave-like motion can be traced in the marketplace, as developers in unison flitted from opportunity to opportunity until their final withdrawal.

"Groupthink" had the effect of simplifying reality. As everyone held a common view, conclusions about projects or strategies could be telegraphed. This in turn greatly sped up acquisitions, which led to a surfeit of land inventory and projects right at the peak of the boom. Since the major decisions all came very close to one another, the feedback came all at once and too late in the business cycle to permit an effective response. There was no way of benefitting from the experience. The potential for large-scale error was in place. Since nearly everyone was thinking the same way, when the conclusions, judgments, and decisions were wrong, the outcomes were catastrophic and system-wide. "Groupthink" is key to explaining the rapid growth of development companies, the expansion into the United States, the financial strategy, and the wide-spread industry collapse.

During the boom, the corporate incentives and the excitement were in making deals. Little thought was put into project execution and financial
management of a large land portfolio. This orientation proved to be unfortunate: no one was looking out for the survival of the firm. Organizational decision making suffered from inexperienced and ambitious managers, inadequate communications, and internal competition. The large-scale entrepreneurial organization, which concentrated solely on land development, now appears to be a contradiction in the up and down property market. It was a product of the boom environment. It satisfied none of the conditions of organizational stability, nor did it reduce market uncertainty. Development companies had become critically dependent on an enormous volume of uncertain sales coming from an uncertain market environment to cover very certain and staggering costs. But, paradoxically, those in power failed to see, or more accurately, failed to respond to this precarious situation until it was too late. As time went by the leaders, in their overconfidence, became increasingly detached from the reality of day to day business.

Other sources of decision error were found at the constantly changing interface of the decision maker/organization and the environment. The developers along with other participants changed the decision environment so rapidly that the environment they thought they were operating in at the beginning of the decision process was no longer there. They let down their guard and accepted the notion of a fail-safe environment. But to assume away uncertainty was a dangerous step for all environments are uncertain and uncertainty in the environment means just that: it can neither be wished away by attitude nor can it be assumed away.

The buoyant attitude about the future was a necessary condition for the occurrence of decision errors of the magnitude experienced. Optimistic expectations encouraged developers and others to overreact, build, and spend
as if the presently held vision of the future would materialize. They were all "extrapolators": the rosier the present was, the rosier the future appeared, and the riskier and less carefully thought-out were the decisions taken. The climate of optimism became more pervasive as the business cycle intensified: the largest and riskiest decisions were made at the peak of speculation.

Personal success was difficult to separate from environmental inevitability. Decision makers mistakenly attributed success to their own talents rather than to the business environment. So when the market changed for the worse, these developers erroneously felt detached and invulnerable. The process of arriving at this state was aided by the press, public relations people, and securities analysts who parroted back essentially what the developers gave them in the way of newsworthy information. The echoes served to further reinforce the decision makers' view of themselves.

Forecasting in the early part of the boom gave developers a zone of comfort -- "a hip-pocket" -- because the errors were conservatively biased. But as the supply grew faster than the demand, forecasting errors became significant. As these errors became apparent, developers became panicky, calling for more forecasts at a time when forecasting had become impossible. Willing consultants readily obliged in producing market studies which protected the vision or paradigm of the rosy future. But the rosy future had vanished. Inaccurate forecasts, misperceptions about trends in the environment, and bounded thinking in interpreting events in the environment led to many wrong decisions, which at the time they were made were thought to be brilliant. Judgmental fixation prevented developers from seeing the clues in the environment foretelling of economic change. The more the environment changed for the worse, the more developers resorted to bolstering and
rationalizing that it couldn't really happen in Alberta or to them.

During the early stages of the boom, development companies proved to be too attractive for financial institutions to ignore. The latter extended great quantities of credit to the industry. Bankers and other financiers were as much caught up in the excitement and fierce competition as developers were. The national banks were under additional pressure from their head offices to make loans in the West because performance in their other market areas was sagging. The anxious-to-please Western bankers unfortunately lacked experience in property development lending. They did not appreciate how vulnerable their loans were to deflation and nonpayment. They believed the developer had special insights; they were not sure of the environment they were lending in; and it appears they allowed credit controls to be relaxed. By lending on a corporate basis rather than a project basis, they distanced themselves from learning about development because they only dealt with corporate financial specialists who knew about as much about development as they did. All of these factors led to money being advanced in large quantities to companies with inappropriate strategies, unstable organizations, and whose leaders suffered from impaired judgments caused by unbridled optimism and overconfidence. The decision errors of the bankers commingled with the decision errors of the developers. Together financiers and developers made errors that helped to bring about the overbuilding and associated problems in the built environment, the collapse of the development industry, and the financial crisis, which was still being sorted out, 4 years after the economic downturn.
PART D: CONCLUSIONS
CHAPTER 8
BUSINESS CYCLES AND DEVELOPER BEHAVIOUR

The rise and decline of the development industry in Calgary is better understood by an assessment of major errors in managerial decision-making in the context of a turbulent business cycle. These errors are manifested in the overbuilding preceding the collapse and the financial crisis that ensued. The most critical errors were strategic, related to growth, diversification, and financing. The sources of strategic errors were found not only to be associated with the behaviour of the individual decision maker, but the group, the organization, as well many of the errors arose from misperceiving and misinterpreting trends in the decision environment.

8.1 SUMMARY OF FINDINGS

This study confirms that the business cycle spanning the late 1970s and early 1980s was the pervasive environment within which the boom/bust development cycle was set. Through its course the classic stages of over-production, resulting in excess capacity and inventory, that in turn inevitably lead to a recession were present. A crisis becomes the "irrational rationalizer" of the mismatch (Schumpeter, 1959, and Harvey, 1982). The research reaffirms conclusions from empirical studies of other North American cities, Hongkong, and Sydney that booms and busts in real estate are similar respecting causes, characteristics, and outcomes.

In the 1970s the relatively stable environment, which developers had become used to since World War II, was transformed. In Calgary, a property
boom was precipitated by the rapid growth of the resource sector -- the oil and gas industry in particular. After an early taste of success, Calgary's development companies deliberately set off on a course of rapid growth leading to geographic expansion into the major centers of North America and diversification into different product lines and businesses. A few development companies unknown in the early 1970s grew to become multi-billion dollar businesses. These firms changed the character of the industry and the property market from numerous small scale development companies to an oligopoly where a few large firms dominated the industry and accounted for a significant portion of the market share of residential land production in western Canadian cities. They achieved spectacular growth rates, but, as they grew, they remained fundamentally unstable because most were under-capitalized.

The rapid growth of these firms was made possible by the inflation of land prices, the appraisal surplus, and the availability of debt financing. The impetus for public companies to grow came from the desire to increase shareholder wealth as quickly and as dramatically as possible: consequently, the business strategy was oriented towards stock market performance. Initially, their corporate goals were short-term, geared to quarterly and annual reporting requirements with emphasis on quick turnover and high profit. The rapid inflation of property values and the negative real rate of interest later encouraged the mere accumulation of assets. Cash flow became a secondary concern. Developers pointed to the appraisal surplus and rationalized that if liquidity was needed they could always sell assets.

The early stages of the boom cycle bred supreme confidence in the successful decision makers' abilities and created an aura of optimism
throughout the investment community. The boom psychology afflicting developers, financiers, and investors was really no different from that afflicting the gold prospectors and miners during the Klondike gold rush, only today airplanes are used to get to the "diggings" instead of mules. They were all drawn by the chance to get rich.

Geographically, in addition to exploiting all of the major urban markets in Western Canada, every one-industry-resource-town presented opportunities for the developers. Every Sunbelt city in the United States was viewed as a bonanza. Even some of the older industrial cities were seen to present opportunities, primarily on the mistaken basis that property values were below North American averages or below replacement costs.

The quality of decision making deteriorated as the boom intensified: developers became more aggressive and made bigger and riskier decisions. At the peak, fragile, shortsighted decisions involving hundreds of millions of dollars were made. These decisions subsequently were to adversely affect the survival of the companies. Most developers showed little awareness of the property boom-bust cycle; as a result, during the boom many of them got into untenable positions through a limited or distorted perception of the external environment, and displayed poor judgment when both choice and means seemed to be unlimited.

In the bust, the industry expunged itself of the weaker players and stronger players whose strategies were weak. Many firms were dealt a mortal blow by the market, yet managed to keep alive with the banks' support. Other firms never recovered from the initial blow. Some firms merged, found new sources of financing, or were acquired by stronger firms. The industry was left in a state of collapse. When the process starts anew, it will more
than likely be with a new set of developers.

8.1.1 CORPORATE STRATEGIES: THE APPARENT CAUSE OF THE COLLAPSE

The corporate strategies related to growth, diversification, and financing, employed by entrepreneur-developers during the boom were central to the demise of many development companies, including three of Western Canada's largest companies. The strategic goals are difficult to fault fundamentally, but when pushed to extremes -- emphasizing the worst and riskiest aspect of each -- the goals became a nightmare to their originators. The firms' problems were exacerbated by using inadequate means and by playing down the importance of the decision environment. Developers assumed that the favorable investment climate would continue forever.

THE GROWTH STRATEGY

The growth strategy, the most important of the three strategies, amounted in the end to mere asset accumulation in an inflationary environment. Inflation, however, proved to be an impermanent foundation on which to base billion dollar development programs. An integral part of asset accumulation was land banking. Huge inventories of land were assembled in the fringe areas of rapidly growing cities. For a number of developers the size or strength of the urban region's economic base really did not matter. Any town or city demonstrating development potential, regardless of how ephemeral it might be, was exploited. In the frenzy of the boom, the land assembly, timing, ease of servicing, and production volumes were often over-estimated. Land was just accumulated and appraisal surpluses, skimmed off through borrowing, were often used to buy more land. Corporate financial
managers used the land banks as collateral to borrow more money whenever companies ran short of operating cash. When inflation was brought down by government policy and over-supply of land in the marketplace, the contingency solution to debt repayment by liquidating the land bank failed. When the need arose, everybody wanted cash and nobody wanted land. Property sales had ceased absolutely. There was no recurring income to fall back on in the bust because most income properties had been sold earlier either for liquidity or demonstrating earnings performance. For companies with $1-2 billion in debt the growth strategy was risking too much to fate.

THE DIVERSIFICATION STRATEGY

Diversification as a corporate goal made sense, especially for development companies seeking stability of income. However, the diversification strategy was often flawed in concept and in execution. Some companies saw diversification in buying the shares of another development company or a company with a similar high risk profile. The same applied to company mergers, acquisitions, and joint ventures. Most developers were not familiar with the new businesses and markets they were expanding into. Moreover, they compounded their ignorance by using inexperienced staff. They wrongly expected their success-formulae developed in one over-heated market to work in all markets and for an indefinite period. The joint ventures with local entrepreneurs were particularly one sided. The local entrepreneurs under the typical arrangement where the company assumed 100% of the risk and financing for 50% of the profit had nothing to lose.

The timing of diversification for many companies could not have been worse -- right at the peak of the boom when prices were sky-high and debt
burdens were crushing. These factors did not stop developers from making their biggest and riskiest decisions. Not only were diversification strategies poorly thought-out and executed, but the goal itself was abandoned for other exigencies, such as selling the income property portfolio each year-end to demonstrate performance. This tactic was self-defeating as it made development companies singularly dependent on sales in a volatile market. Each year was like starting anew, only with a more precarious asset base.

THE FINANCIAL STRATEGY

The financial strategy based on stock market performance and debt financing was successful only insofar as the capital needed to carry out the operational strategies was raised. In the long run, the financial strategy proved to be disastrous. The very nature of publicly-traded land development companies made them high risk. Additionally, the demands of stock market performance put these companies on an accelerating treadmill, causing them to adopt inappropriate strategies for the property market. The huge debt, amassed by financial leverage of a relatively small equity base, brought companies down precipitously when revenues declined. The appraisal surplus, which extended the borrowing capacity, disappeared overnight in the deflation following the boom, leaving companies insolvent. Contingency plans based on cash and credit reserves and disaster forecasting were woefully inadequate and mainly served to assuage the fears of investor and financiers. Certain banking practices tended to extend the length of the boom and encouraged developers to take on larger projects: for example, when the size of the real estate loan increased and the risk of lending became too high for the individual bank, multi-bank ventures or syndicated loans were arranged. Strange as it may
sound, near the peak of the boom, the more aggressive developers became genuinely concerned about financial capital shortages at a time when capital appeared to be abundant. These developers simply had exploited every source imaginable--shareholders, debenture holders, foreign and domestic banks, trusts, syndications, private sources, the Eurodollar market, and the capital markets of the Orient--to find someone who had not invested or lent up to their limit in the firm.

Near the peak of the boom, many companies switched their strategic emphasis from development to finance, and in the process, they erroneously assumed that present and future revenues were assured. They saw their new responsibility as deciding on the disposition of the banks' surplus funds. The financial strategy had become detached from the reality of property development.

8.1.2 SOURCES OF DECISION ERRORS

The principal sources of decision error were found to be the entrepreneur-developer, group behaviour in the industry, organizational dynamics, the perception and interpretation of the decision environment, and the actions of other actors in the decision environment. Each will be dealt with in turn.

THE ENTREPRENEUR-DEVELOPER

Only a few developers stand out as true entrepreneurs who became industry leaders in the boom--the rest were followers. The entrepreneur-developers' perception, spirit, and driving force were responsible for uncovering and exploiting market opportunities. Their charismatic
leadership and successful track record attracted followers. They were over-confident, blue-sky optimists, good at selling ideas and images. Many entrepreneur-developers were here and now individuals: they did not dwell for too long on the past, and their view of the future did not extend beyond a few months. They had great intuition and formed seemingly successful short-term strategies which, unfortunately, failed to take into account the trends in the economy and their own vulnerabilities. Within their closed systems of thought, these policy makers were decisively correct; however, the problems in the decision environment which raised so much havoc in the industry were lurking just outside. Furthermore, they believed subconsciously in the power of their own intrinsic qualities in overcoming the vicissitudes of the environment. For example, by their actions in the previous recession (1974-75), some developers had gained a false impression about their abilities to deal with crises (1). In the intervening period, as success piled on success, the attitude about the correctness of one's decisions was reinforced for each of these firms. Past crises and the lessons learned were forgotten. The entrepreneur-developers' early successes biased decisions towards pat formulae used wherever the companies expanded; however, developers found out, often too late, that the formulae did not work in all markets and at all times.

All developers became caught up in the speculative fever, making high risk and grandiose decisions -- decisions that only worked in the intense atmosphere of the boom. The extent to which reality was distorted is noteworthy: some developers thought they could heal sick companies or sick projects and become wealthy in the process. All that was needed was the right dosage of superior management -- the midas-touch syndrome. Taken in by the urgency and euphoria of the times, decision makers had become
hypervigilant and were displaying signs of megalomania.

Through the emulation of the entrepreneurs' strategies, the development industry's collapse became widespread. The entrepreneurs' initial discoveries set off a chain of events starting with swarming, leading to fierce competition, price inflation, dissipation of profits, overbuilding, and collapse. The influence of the industry leaders went beyond the immediate development community into the world of finance and investment: many financial institutions and individual investors in trouble today were followers of entrepreneur-developers.

The entrepreneur-developer would have had few followers if each behaved like rational economic man. However, the followers characteristically displayed the herd instinct; rationality took a lowly second place and rational thought, when it occurred, was severely bounded by the "inflation model". In the turbulent boom environment, the decision maker has limited cognitive capacity to assess and act on all of the information directed at him; consequently, he selectively creates a simplified model of reality, and tends to accept only that information congruent with it. He introduces various biases originating from his background, personality, philosophy, habits, and present milieu. This model of reality helps to form the firm's strategy. Over time the decision maker's stake in the model increases as an ever-increasing number of decisions have been made based on it. His vision of reality intermingles with that of his peers and the many common elements go to make up the industry paradigm of the present and future.

GROUP BEHAVIOUR

Group behaviour steeped in optimism and over-confidence contributed to wide-spread decision errors. A key ingredient of group behaviour was this
common paradigm of the future. Information flowing from government agencies, real estate brokers, financial analysts, and developers themselves went to make up the paradigm. Articulate industry spokesmen shaped the paradigm, providing its internal logic and its appeal. Later, informal discussions -- "club talk" -- reinforced the common view.

By having this common understanding of the real estate market, developers could move toward their goals at breakneck speed. As this year's successes piled on last year's, more converts fell into line. Competition increases as many converts were also competitors. As the number of competitors increases, each strives to gain a greater market share. In the process, developers took greater risks and made bigger mistakes. The similar micro-motives of the individual developers translated into wave-like macro-behaviour in property markets. The process of getting to a similar point of view is called "groupthink" (Janis, 1972). "Groupthink" and charismatic leadership were at the bottom of swarming and over-building. Ironically, through their individual actions, conditioned by the group paradigm, the developers themselves changed the collective reality such that the paradigm was no longer congruent with it. Blue-sky optimism and over-confidence tended to linger anomalously after the decision environment changed for the worse. Uncertainty grew as the crisis approached, accounting for the different views, decisions, and actions near the climax of the boom.

ORGANIZATIONAL DYNAMICS

Out of the common paradigm came the organizational goals and the strategies surrounding them, which formed the basis for organizational decision making over the boom period. Because the development industry was doing so
well, policy inertia set in over time. When the environment changed, the organization's strategic goals remained unchanged and ill-suited for future action. Some companies had ill-conceived strategies from the start, but their goals did not pose a threat to survival in the overheated boom environment where the liberal use of credit, the flux, and the capitalization of interest covered the cracks. Only when the environment changed for the worse did the threat become evident.

The importance of individual achievement overrode that of the organization. Strong and ambitious managers competed fiercely with each other for the company's financial resources. Resources were misallocated when decisions were made biased by the strong personalities, aggressiveness, and internal rivalry. Managers subverted the goals of economic rationality for self-aggrandizement. Further problems arose when the CEOs let go of the reins, as happened in several companies near the end of the boom, at a time when organizations had the greatest number of inexperienced managers and new profit centers were staking out new territory to conquer. This paradox is accounted for, in part, by the CEOs' supreme confidence about the abilities of his senior managers.

The approval of development projects entailed on the part of the project manager, divisional head, and the executive decision-making committee (or board) a complex rationalization where fact and fiction intermingle. In this process both perceived uncertainty and risk of failure were played down. Projects were approved for both the right and wrong reason. Sometimes a project manager's enthusiasm infected the decision maker. At other times an overbearing executive officer intimidated the project manager into getting more projects underway than was warranted by the market. When confronted with
convincing forecasts and evaluations, the decision makers looked for positive signs -- reasons to proceed -- occasionally turning a blind eye to all but the most blatant obstacles or problems. Optimistic, risk-taking leaders along with "groupthink", and other organizational dynamics helped to generate strategies which in the end proved to be the undoing of an industry.

PERCEPTION AND INTERPRETATION OF THE DECISION ENVIRONMENT

The perception, interpretation, and projection of market activity was profoundly influenced by the business climate. The business climate varied with the business cycle: pessimism pervades the business community during stagnation; hopeful decision climate exists during the recovery; optimistic decisions flow from the observance of positive business growth present in the credit expansion; wildly optimistic decisions flow out of speculation; and bewilderment comes out of crisis. The environment during the boom made decision making easy: most major investment decisions seemed to be riskless. Furthermore, assumptions developers make vary from one phase of the business cycle to the next. Since the assumptions change according to the mood, disposition, and beliefs of the decision maker, doubt is cast on the interpretation and evaluation of trends in the decision environment during boom periods. The problem is compounded by the length of the typical development project, especially when the acquisition decisions are made in the speculative phase and the sales occur during stagnation.

Problems of evaluation not only arise during cyclical change but often arise out of unfamiliarity with new markets. Sources of decision error were found in the investigative process in failing to ask the right questions and making the right assumptions about the nature of the market, the demand,
market share, competitor behaviour, the quality of the location, and the (market, economic, and political) risks to the firm. Developers did not recognize that the uncertainty surrounding all assumptions about future events and new markets cannot be spirited away by introduction of computer models and hard data. All property development decisions remain risky, and this fact was not always accepted when decisions were made.

During periods of parametric change (such as when the inversion of the real interest rate from negative to positive occurred), uncertainty clouds the decision maker's perception of reality. Responses to the signals are often panicky, and could be somewhat chaotic. Strategic decision making is thrown into a state of confusion, leading to erratic and incongruous decisions. Forecasting and evaluation become problematic. Problem decisions were found to originate in faulty perception, weak or incorrect assumptions (believing that the Reagan Administration would not bring inflation down or believing that the Alberta mega projects would not be stopped); generalizing from one to the many (assuming that the other urban markets were like the Calgary market); conversely, not accepting the general case as applying to one's "unique" situation (not accepting the possibility that the problems afflicting eastern developers in the 1980s could also affect them); and mistaken attribution, that is assuming certain events will follow from the occurrence of other events (assuming the recession was over in 1980, when "anti-inflation brakes" were first applied, and expecting the next one to appear, according to theory, 4 to 5 years hence). The perception of the external environment, the interpretation of trends, and the assumptions used in the projection of economic and market activity all had a profound affect on corporate strategy. They proved to be a significant source of decision errors leading to the demise of the development
industry in the 1982 downturn.

ACTIONS OF MAJOR PLAYERS IN THE DECISION ENVIRONMENT

The key sources of decision error in the external environment were the government and the financial institutions. In Canada, governments, functioning at different levels, helped create the financial and business climate for a boom through monetary and fiscal policies, economic plans, various urban-oriented programs, direct participation, joint-ventures, funding, and gate keeping. When governments became caught up in the excitement, they were a powerful ally of the developer. Such was the case in Alberta where the government took a leadership role in orchestrating the economy. The Alberta experience demonstrates that the greater the government inducements the greater the boom-bust cycle. Both the Provincial and Federal Governments heightened and prolonged the property boom by maintaining inflationary housing policies and programs in an inflationary environment. The unwanted side effects were bankrupt investors, foreclosures, surplus inventory, poorly built and located projects, and a massive drain on public funds arising out of insurance claims and direct mortgage defaults. Certainly, without the government programs the extent of overbuilding would have been smaller and the financial crisis would have been less severe. However, without the programs there might have been an acute shortage of affordable housing concomitant with a glut of higher-priced homes.

At the municipal level in Calgary, the decision environment was in flux. In the early days of the boom, anti-growth feelings were strong. The municipal administration was emphasizing fiscal restraint in the face of a growing demand for public services, particularly better transportation. Planners at the
time were desirous of controlling urban development through development control, giving them greater discretion in determining what, where, and when development projects may proceed. The growth surge created by the oil and gas boom, however, proved to be overpowering: the anti-growth faction was overridden, and the City spent much of the remainder of the boom trying to catch up to the backlog of needed public works. The planners lost control, as evidenced in the planning of downtown. The approval process became highly politicized: lawyers took over from planning consultants as lobbyists and expediters.

As the boom progressed, the senior administration and developers began to share similar concerns about accommodating urban growth, but there were no grand strategies or plans. Development priorities were negotiated without too much argument. As the master planner and approving authority, the City did very little to stop the development industry from self-destruction. As a developer in its own right of public projects, the City outdid the development industry in monumental schemes, and ended up with its own financial crisis.

In the financial market, capital flowed into real estate development in western Canada in anticipation of continued high rates of return. This occurred at a time when real estate was more attractive than other economic sectors: activity levels in manufacturing and mining concentrated in the Quebec and Ontario regions were declining. The capital flows to the West were reflected in credit expansion. The competition to make loans was as fierce as the competition to get loans. The threat of losing a loan to a competitor encouraged bankers to make imprudent loans. All companies large and small, knowledgeable or not, old or new, got loans with little difficulty.

During the boom, the rapid credit expansion quickened and intensified the
tempo of "swarming". As a result, all kinds of ill-conceived, poorly executed, poorly located and surplus projects were built -- the desire to make a profit exceeded the ability to make one. The bankers, unfortunately, knew too little about the nature of the development industry. They gave too much money to certain companies based on "comfort" with the company's executive rather than on sound business judgment. Ironically, by making bad loans to inexperienced and incompetent developers and speculators, financiers endangered their good loans. The availability of easy credit and its indiscriminate use contributed to overbuilding, the failure of the property market, and the collapse of the development industry. The collapse of the industry helped to precipitate an unprecedented financial crisis in the West.

8.2 EVALUATION AND POLICY IMPLICATIONS

Billions of dollars were lost in the devaluation accompanying the 1982 crash in Alberta alone. Like dominos, development companies and their financial backers fell on hard times. The bust affected every company in the development industry -- only the financially strong or financially supported companies survived. The costs of the boom's excesses ultimately were and still are being borne by depositors and taxpayers. The bankruptcies, foreclosures, the increased costs of doing business, the huge reserves needed for non-performing loans, the writeoffs, the soaring debt-burden of both private businesses and governments are manifestations of these excesses.

To a large measure the future urban pattern has been fixed, in a number of instances for the worse, by the decisions made during the boom. Large areas of resource-based cities like Calgary, Edmonton, Denver, and Houston were and will probably continue to be built during booms, when long range
planning, far-reaching economic and fiscal concerns, and urban design tend to be subordinated to expediency and immediate gratification. Rational decision making gives way to impulsive decision making during booms. Decision errors and ill-conceived decisions could just as easily determine environmental outcomes as correct and well-conceived decisions.

Mistakes were made in prematurely developing new communities, and in allowing development to occur almost anywhere. Some poorly located residential communities have not been able to and might never overcome the stigma imposed by nearby environmental hazards, or by being on "the wrong side of the tracks". The decisions made by zealous public and private managers during the boom on the extension of major utility trunks in the fringe areas of most large Alberta cities have created an insurmountable financial problem today. The accrued costs of these premature extensions far exceed the revenues anticipated from lot sales budgeted to cover these costs. In 1986, the replacement costs of these extensions is less than one-half of the original capital costs plus interest. Under these circumstances, no one is likely to develop land within these serviced development basins, unless the government and developers (if they can) absorb the excess cost. There is some question on whether either party will, as the sums involved are in the $100 million range (Chairman, Edmonton chapter of Urban Development Institute, 1986). Other land use problems were apparent. The indiscriminate spread of office and other commercial uses created a less functional arrangement of land uses as well as zones of conflict between uses. Building too many shopping centers has led to suboptimization and eventually, this could lead to business failures and commercial blight. In many instances, developmental quality was sacrificed for quantity. In the built environment
some development choices made during the boom cast a permanent shadow.

At the root of many financial and environmental problems arising out of the boom is speculation. During the boom, developers turned into carefree speculators, failing to consider the outcome of their actions, the impact on their firm, or the degree of risk involved.

Excessive speculation in the land market effects a transfer of capital into nonproductive activities, such as land banks, unfinished subdivisions, vacant building sites, empty buildings, unused roads, and excess utility capacity. Decades might go by before a demand for this excess supply materializes. Property speculation leads to a misallocation of resources and a reduction in the wealth of society. During the boom, there is a redistribution of wealth based on luck and daring, which follows neither the principle of equity nor the principle of merit.

Speculation, however, remains a real component of rational decision making in complex systems and cannot be entirely eliminated. Real estate development is a process of creation where all outcomes are not known before the process starts. The developer, banker, and investor, not knowing what the future holds, tend to rely on historical analogues. Their forecasts are extrapolations which make possible trial and error progress towards a goal. During a boom, trends become distorted: the future is neither the past extending itself, nor is the future defined by some authority's willful attempt at modelling it. The developer has to depend more on his instinctive feelings because logical analysis and evaluation no longer solve the problem of defining proper courses of action. Many an embarrassed economic forecaster who lived through the perturbations of the late 1970s and early 1980s will attest to this fact.
The strategies of the development companies are reflected in the structural instability of the organization. Many development companies grew in assets, sales, and personnel to a size to rival many of the Financial Post 500 Companies. Yet they were no more stable than they were when they were a fraction of the size. The basic conditions of stability are not met by the development organization. Increasing the size of the organization does not necessarily improve stability, if anything it could be argued that instability increased with size, as the development organization just internalises the uncertainty of the property market. The sources of growth -- appreciating land values (appraisal surplus) and non-recurrent sales revenues -- turned out to be ephemeral. Size of company under these circumstances does not lend stability. An industry made up of smaller companies might be more stable and certainly less threatening to the stability of the financial community. Yet size to most decision makers, especially bankers, implies stability.

Who is to blame for the debacle? The development industry has to shoulder much of the responsibility for the magnitude of the 1982 crash in the property market. The severity of financial crises that followed the property market decline is shared by the financial community. Financiers directed the credit that fueled the boom. Government made the credit available through inflationary monetary policies. Also, consumers and investors -- those who created the market and those who helped support it financially -- were also caught up in the speculative fever and must equally share the blame.

Developers tended to view the banks as money-printing machines, as large quantities of money were being dispensed to the industry. The developers' error was not in its acceptance but in the use to which it was put. The bankers' error was in issuing a loan under circumstances where they did not
know or understand the use to which it was put. The bankers and other financiers lost sight of their fiduciary responsibilities. With the extension of credit by society through banking intermediaries comes a moral covenant to extend credit wisely. This was largely ignored during the boom.

The allocation of capital in the real estate sector needs to be more guarded by banks and other financial institutions. The allocation process needs to take cognizance of developer behaviour: the messiah complex, midas-touch syndrome, and the process of reality distortion that appeared during a business cycle. It needs to take into account the risks development firms and banks are exposing themselves to in the investment decision. Company growth based on highly speculative real estate ventures has to be looked at askance. By being generous, financiers just increased the magnitude of failure. Far too much emphasis was placed on the attraction of a high rate of return, without appreciating the reason for that high rate of return. The reason, of course, is that the investment was risky.

The investor and financier both need to be wary. During the high point of the boom real estate stocks and debt instruments did NOT reflect the risk in their price to earnings ratios or in their interest rates. The investment community was remiss in selling development company "junk" debentures at rates slightly higher than utility bonds to ignorant investors. Surprisingly, banks were one of the major purchasers. A test for the issuance of a bond has to be some assurance that a company has and can maintain an ongoing income stream over the life of the bond. Bankers should also pay more attention to markets, the nature of the industry, and to project feasibility and impact on both the company and the bank. Bankers and developers should look at the question of "safe-fail" as well as the question of "fail-safe".
Development companies have to learn to curb their appetites and lower their risk-taking habits (2). How many bet-your-company risks can a development firm take on? Near the end of the boom every project was high risk. Even moderately risky investments can add up to a high risk situation for the firm or the bank. The industry has to do more thinking about risk ex ante than worrying about it ex post facto. Corporate decision makers must focus on the organization's survival rather than on individual projects or grand strategies. They need to evaluate the impact of a particular project or a group of similar projects on the firm.

The chief executive officer's personality (gambler, entrepreneur, measured risk-taker) and orientation (sales, marketing, production, finance) have a lot to do with the risks firms take. Everyone in the business community should become aware of the risk-taking profiles of decision makers. Self-awareness could also help to curb decision errors originating in personality. It must be recognized, alas, that the reformist approach has its limitations as some decision makers never change!

8.3 CONGRUENCE AND RELEVANCE OF LITERATURE TO FINDINGS

The literature on developer behaviour and business cycles is reviewed from the general to the particular, and from the macro scale to the micro scale. In the general literature, a number of writers (Newman 1975, and Goldenburg 1981) saw the developers' behavioural attributes as the basis of their success. In contrast, Lorimer (1978, 9), although grudgingly admiring the track record of Canadian developers, saw in their behaviour the actions that could lead to serious problems. He predicted their downfall. The main thrust
of Lorimer's argument was that what the developers were doing was not right, therefore they deserve to fail. Lorimer wrote during the boom at a time when few signs on the horizon of the impending bust were evident. This thesis confirms Lorimer's forecast. The success story turned into a tragedy for the very companies and leaders who were idolized by Goldenburg (1981) and Newman (1975), and criticized by Lorimer.

The substantive findings confirm Daly's (1982) conclusions in his particular study of Sydney, as well as the conclusions of various Hongkong studies (Youngson 1982; Jao 1980; and Bowring 1982). Their findings differ, for the most part, only in detail. Suffice to conclude that property boom-busts and developer behaviour are general phenomena with predictable outcomes. These studies acknowledge both the business cycle as well as the role of the individual developer. Daly sees the outcome of a boom-bust cycle as a consequence of inept decision making (by government, bankers, and developers) in response to external forces. Several of the Hongkong observers see the outcome as a result of "out of control" developer behaviour. Foster (1983) provides a parallel account of the oil and gas industry boom and bust in Alberta. Clearly, Calgary's developers were not innocent victims of powerful external forces. To a large measure they were responsible for the industry's condition in the economic collapse.

The substantive findings at the macro scale concerning the business cycle and entrepreneurial behaviour support arguments in the complementary, if somewhat opposing viewpoints of Schumpeter (1959) and Harvey (1982). Harvey's structural analysis offers a description of the boom-bust cycle similar to that observed in western Canada, and so does Schumpeter's account. In Harvey's thesis causality flows from the structure; in Schumpeter's thesis it
flows from the entrepreneur. The outcome for Harvey is a crisis; for Schumpeter, a fulfillment of the boom's promise. Both studies are deterministic in that market forces (created on the one hand by the collective behaviour of individual entrepreneurs and on the other by the structure of capitalism) produce predictable conclusions. But this thesis does not entirely accept the notion of inevitability. If the boom can be subdued by prudent decisions, then the bust will not materialize. But how do you prevent a property boom? And if there is some success in this direction, are the results perpetual shortages, as found in many planned economies?

The research concludes at the micro scale that development companies dependent on land sales do not have the attributes of internal stability appropriate in a public firm (Donaldson and Lorsch 1983), and furthermore, size of organization (contrary to the findings of Chandler (1977) and Williamson (1975)) does not reduce uncertainty and improve stability. All six of the conditions of stability for a firm identified by Donaldson and Lorsch (Chapter 2) concept of loyalty to shareholders, customers, and staff; executive expectation; consistency in goals; continuity in economy and industry; consistent experience; and internal capital markets) were often not present in the development company. The CEOs were asking managers to achieve ends and were going about it by means that were at odds with the discontinuous nature of the development cycle. The inherent conflict between purpose and environment made it difficult for the organization to satisfy executive expectations as well as shareholder, customer, and staff expectations. The question of consistency of goals was replaced by a short term, "what business are we in today?" Uncertainty in the decision environment could not be spirited away by enlarging organizational scale through the probability concept.
of large numbers as insurance companies had (or in light of today's skyrocketing premiums thought they had). High staff turnover in companies makes consistent experience difficult to attain, and if attained, of somewhat dubious value, in the ever-changing environment of the developer. Lastly, internal capital sources in the development industry were nonexistent.

The research indicates that in the development company organizational hierarchy was not used to reduce uncertainty of the marketplace (3). From an operations standpoint, control and communications were difficult because of the highly decentralized structure. The centralization of control, when it came, was too late to rectify the problems created by unfettered growth. This is not to say that centralized management is better, but somewhere between the anarchy created by bargaining coalitions represented by profit centers and absolute control of bureaucracy there lies an optimum balance.

This research basically affirms the conclusions about behaviour of deciders made by Janis (1972), Mann (1978), Schon (1971), and Simon (1957). Further, it suggests that the greater the intensity of the boom and the closer to the climax, the greater the risks that were taken by decision makers. Seemingly, at that point decision makers were more out of touch with reality than at any other time. They had no fear of uncertainty or failure. Judgmental fixation, putting a higher probability on success than the action would justify, and Gambler's fallacy, going so far as to believe the probability would increase in the future, were evident in the climate of optimism. They offer an explanation for the developers' risk-prone behaviour. Even when events started to turn for the worse the developers' bounded rationality prevented them from seeing the dangerously vulnerable situation they were in. In a changing and no longer receptive environment, the developer was caught
doing the things he did best -- so the very things that produced success in
the past now serve to bring the company down (This was Starbuck's (1975)
view about decision makers in general). In the end the developer was doing
the wrong thing well.

The developers' line of reasoning was similar to Janis' propositional
heuristic in which the decision makers clung to their strategies grounded in
earlier beliefs about the decision environment in spite of real changes to that
environment -- changes which rendered the strategies dangerous to the
survival of the firm. As one developer observed, "in the early stages of the
boom, developers would develop on the assumption that builders would buy; and
builders would buy lots on the expectation that the home buyers would be
there to buy." This line of reasoning led to inertia in Daon's case, and
unconflicted change in NuWest's and Carma's cases. Daon saw no reason to
change its basic strategies until it ran head on into trouble. Nuwest and
Carma saw a need in the more distant future but were caught with a strategic
"smorgasbord" in 1982.

When the speculative climate began to disintegrate, these companies tried
to allay any concerns about their performance raised by the investment and
banking communities. The rationalizations used fall into the category of
"exceptionalism": they were either bigger, stronger or smarter, had huge credit
reserves, or were in geographically "safe" areas. The rest of the industry
might go down but not us! To an extent this was a facade. All this amounts
to bolstering.

The research found that both forecasting and long range planning during
turbulent times not only failed to provide direction into the future, but
actually mislead developers by affirmation of historical continuity. Drucker
(1980) in his analysis of the turbulent 1970s makes similar observations.

8.4 RESEARCH IMPLICATIONS

In this thesis, the urban development process is shown to be influenced by individual decision makers, and specifically, how their strategic decision errors contribute to systems failure, and by extension, to problems in the built environment. Not very much research has been published on the process by which the built environment is formed and how urban system failures occur. Studies by geographers, land economists, and planners often approach the subject at so broad a level of generalization (by reification) they miss important explanatory linkages between cause and effect. Some studies take a doctrinaire approach that sheds no light on the subject. Consequently, these studies fail to explain what really went wrong or why the built environment appears the way it does. For example, if the structural explanation given by some developers, bankers, and government officials for overbuilding, industry collapse, and financial crisis is accepted at face value, no one would be the wiser. By documenting the actions of entrepreneur-developers and related financial and planning actions in the boom and bust experience, the property development process in Western Canada, in particular, is better understood.

For urban geographers, it is important to realize that behind the abstract and reified theories of urban process and pattern lies a dynamic interactive process, which often defies rational expectations, involving the developer as a decision maker and the business cycle. Many decisions affecting urban process and form arise as often as not in the intense uncertain environment of property booms, at a time when only fleeting thought is given to long range consequences. If our cities appear somewhat chaotic and wanting, the root
cause could very well be the decision process in the development industry during the expansionary phases of the business cycle. It is during this time that large areas of our cities are built. Should this expansionary process intensify to a boom state, the likelihood of decision errors related to quality and quantity of property development being made increases markedly, as the developer's perception becomes detached from market reality. The kneejerk reaction of most developers is to respond to the immediate indicators in the marketplace, principally land price inflation and appraisal surplus, without recognizing their own part in creating the inflationary spiral and the inevitable bust that follows.

Most of the hastily conceived and often poorly executed decisions affect the urban growth process and the built environment, not infrequently in some significant ways. Growth patterns can be distorted, creating systems inefficiencies, inconvenience and higher costs to users and the public. Overbuilding leads to devaluation, and financial crises. Too much capital is directed into real estate which, subsequently, evaporates in the deflation, leaving both investor and lender in the lurch. The urban development process falters and falls into a period of dormancy. The urban spatial structure and landscape becomes fixed not only over the dormancy period, but for sometime into the future, in a mold which, in hindsight, appears incongruous: environmental problems often arise out of hastily conceived projects in poor locations; and quality of design and materials are often sacrificed in construction.
8.5 A MODEL OF INDUSTRY BEHAVIOUR: TOWARDS A DECISION THEORY OF DEVELOPMENT

Out of the literature review and this research a sufficient number of general observations are made that enable a model of development industry behaviour during a boom-bust cycle to be proposed (Figure 10). In the model it is assumed that the objective of the industry is to uncover and exploit an opportunity. The key actors are the external change agent (e.g. the oil and gas industry), the entrepreneur-developer, the follower-developer, government, and financial institutions. The familiar stages of the business cycle are used: recovery, expansion, collapse, and stagnation. The psychological processes entailed in deciding are perception, interpretation, projection, "confidence-building", "groupthink", "swarming", "rationalizing", "bolstering", "hypervigilance", and "resignation".

PHASE I: RECOVERY

Discovery is the main characteristic of the recovery phase. An entrepreneur-developer perceives an opportunity created by some external agency before other developers do. He acts and his success eventually attracts the attention of others. At this stage no clear picture of the future exists. The entrepreneur-developer just made an intuitive leap -- he gambled and won. This win is the beginning of the track record of success (Figure 10, Phase I(A)).

PHASE II: EXPANSION

Since there are no secrets in the development industry, other developers join in to exploit the newly found opportunity, which is often perceived to be
FIGURE 10
Development Industry Behavior During a Boom-Bust Cycle
bigger than it really is. The mood is optimistic, but the optimism is based more on emotions aroused by the hunt rather than rational thought. Group behaviour is predicated more on reflex action than on groupthink. Some positive trends are evident, but the big picture is still fuzzy. Development companies report record profits, and this fact attracts the interest of the financial community (Figure 10, Phase II(A)).

At this stage, the change agents often emit a series of positive signals, attracting the attention of developer, banker, and government. The government intervenes in the process to facilitate market expansion by enabling more buyers to participate (demand side), and by enabling more investors and developers to produce greater volumes (supply side). Tax shelters are an example. The financiers are given the mandate to expand credit to both buyers and sellers. Many development companies become finance-driven. Understanding the underlying market and development process takes on secondary importance.

With greater and easier access to credit even more developers swarm after the enlarged opportunity. The newcomers may be from different cities, or may be newly incorporated. Logic takes over from intuition as the dimensions of the opportunity become quantified -- "If $200 billion is going to be spent by industry and government, then ..." Action becomes based on groupthink, and groupthink is spreading to the more conservative elements of the industry and financial community. The impressive track record of the entrepreneur-developer prompts him to make riskier decisions. Many developers, financiers, securities analysts, and the press become ardent, uncritical admirers and followers of the entrepreneur-developer. All have an important role in creating the "hype" surrounding industry prospects. (Figure
Sooner or later, the entrepreneur-developers realize through sales results and sales margins that the opportunity in one region is withering, and they set off before the others to find new opportunities in different sub-markets, regions, or through diversification outside the industry. The followers are in quick pursuit as the response time in the industry has been shortened by the acceptance of a common paradigm based on an elaborate rationalization of the economy with very positive implications for the development industry. The paradigm reduces uncertainty in the developer's mind and with this reduction, the fear of failure evaporates. The resulting diversification is looked at as strictly growth-inspired, and not as the disappearance of the initial opportunity. Meanwhile in the original market, new entrants continue to crowd each other, some taking over the positions of the entrepreneur-developers. This activity in the marketplace is deceptive. Blinded by the profit motive to the fast approaching over-supply, financiers insist on profit sharing. They, along with government, stimulate development at a time when market activity is winding down. The basis of this process of failure is the "greater fool theory" (Figure 10, Phase II(C)).

With access to capital through a well-established pipeline, the entrepreneur-developers literally explode into new markets and new regions. In a wave-like motion they move from opportunity to opportunity -- houses, apartments, residential lots, shopping centers, office buildings, and industrial parks. When one sub-market becomes saturated they move on to the next; when one region becomes saturated they move on to the next. By this time the entrepreneur-developer is thoroughly convinced of his innate superiority. Blue sky optimism and over-confidence override any fears of uncertainty. The
gap between reality and the developers' perception grows to its widest extent. Bounded rationality prevents them from appreciating their relationship to the business cycle, in general, and the property boom-bust cycle, in particular.

Developers become carefree speculators. In the frenzy of competition for new assets, revenues from normal business sales decline, but assets grow by leaps and bounds, debt increases commensurately, and individual projects become larger and riskier. Credit masks their precarious position. Cost inflation drives up housing and building prices, and discourages more and more buyers. Banks, developers, and governments move to induce the buyers back through low downpayments, subsidized interest rates, extended payments, lower borrowing requirements, rent free periods, tenant allowances, and give-aways.

PHASE IV: COLLAPSE (DISENGAGEMENT AND WITHDRAWAL)

The development company, spread thinly on its internal sources of capital, finds itself in an increasingly hostile environment. The paradigm of the industry begins to show cracks, but they are often misperceived and rationalized by many developers. The common activity in the industry becomes bolstering. Some developers seemingly unperturbed continue to charge ahead; others become hypervigilant in this search for solutions. Panic selling ensues as developers try to disengage from the market and liquidate assets. The market virtually ceases for all but the sales of most attractive income properties, often at below replacement costs. The large development companies built on product sales experience contraction after contraction as they adjust to the reality of their situation. For them, the only solution lies in loan modification and debt restructuring. Smaller companies collapse instantly!

(Figure 10, Phase III)
PHASE V: STAGNATION

The period of stagnation is a period of reflection for survivor and loser alike. Old practices are renounced. New promises are made. Developers ruminate over possible new strategies. Creditors are fought off. Lawsuits are engaged. Nothing much happens in the marketplace. The odd unfinished project is finished. More companies go bankrupt. A few remaining prime assets are sold. The development companies are left with a portfolio of unmarketable assets. Their only hope lies in gaining further concessions from creditors; in getting the banks to take over the assets or in finding new equity money. In some instances, the banks have taken property and released the developer of his obligations -- presumably reasoning that the property is more valuable than a stake in the entire corporation. New equity money, for the most part, will go into plugging the financial holes until the market comes back. The question remains will the market ever come back to the point where the decision errors made at the peak of the boom can be erased? (Figure 10, Phase IV)

8.6 DECISION MAKING: CHOICE VERSUS DETERMINISM

There is no question that the policy makers in property development and finance would much rather explain the events leading up to the 1982 downturn in western Canada as the outcomes of external factors. Clearly, the wave created by the boom broke at such a high amplitude that few firms in the development industry had the strength to recover. Many companies well run in their judgment were smashed against the rocks of bankruptcy by fate, and not by their individual actions. This was as it was. However, the conclusion
of this study is that there was choice before the cresting of the wave, and those that positioned themselves so as not to experience the full force of the breaker survived. Those who did not, succumbed. Somewhere between the ebb and the flow, developer-entrepreneurs and their followers could have charted a safer course. And by so doing, both the financial crisis and the environmental problems could have had less significant dimensions.
NOTES

(1) A number of companies were in trouble in the 1974-75 recession to the point where they had to restructure their debt, modify loan payments, and joint-venture key assets. These developers managed to turn their companies around only to be caught in the same difficulties 8 years later. Perhaps, the relative ease with which solutions came might have something to do with not learning from history. The belief that there would be a lender of last resort caused the lesson of fiscal caution to be lost on some developers.

(2) Some specific solutions offered by one of the survivors for reducing risk in land development are:

(a) buying only reasonably priced land,
(b) not capitalizing the carrying cost on land,
(c) keeping overhead and administration under control,
(d) staying with larger diversified urban centers,
(e) having a stable of complementary builders (building in different price ranges) rather than competing builders in the same neighborhood.
(f) developing on an as needed bases; have your production coincide with the builders pre-sales. Land has become too expensive to inventory (costs run at $400 front foot). The critical decisions become the size of a phase, and when to start,
(g) thinking in terms of quality rather than quantity,
(h) not becoming overextended,
(i) maintaining stringent controls in good times as well as bad.

(3) In Williamson's argument (1975, 257) over which is more effective and efficient -- markets (ie. small competitive firms) or hierarchies (ie. large scale organizations) -- he concludes that the latter are more effective and efficient:

(a) Organizations through specialization and better communications handle the problem of bounded rationality.
(b) ...Hierarchy permits additional incentives and control techniques to be brought to bear in a more selective manner, thereby curbing small numbers (market) opportunism.
(c) ..Hierarchy provides for unforeseen contingencies in a coordinated way and absorbs uncertainty.
(d) Hierarchy resolves small numbers bargaining indeterminancies.
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