Ep #75: Lessons from Real Estate Magnate Sam Zell

Full Episode Transcript

With Your Hosts

Dr. David Phelps and Evan Harris

You are listening to the *Dentist Freedom Blueprint* podcast, with David Phelps and Evan Harris. Navigating you through the uncharted waters of a turbulent economy with straight-forward advice to transform your practice into a self-sufficient cash machine, compound your net worth assets, and multiply, multiply, multiply your passive cash flow streams.

Evan: Good day, listeners. This is Evan Harris on the mic reaching out to Dr. David Phelps. Are you there, Dr. Phelps?

David: Evan, yes, sir. I am here. I'm loving being a part of this with you and I know you've brought to the table I think what's going to be a very interesting subject to discuss today. So why don't you roll into it?

Evan: Indeed. I'd like to talk about a mentor. Now, many of you have heard of Warren Buffett. I look at him as a mentor on the investing side but obviously he is more investing on businesses. So if there was a Warren Buffett of real estate, I would think of none other than Sam Zell.

You think, "Who's Sam Zell?" Well I can tell you he's 68th on the *Forbes* list. 4.9 billion. I'm not sure if I enunciated correctly, but folks, that's B—billion—not million. 4.9 billion. I'm sure it's getting even more as far as his personal net worth.

He is the chairman of Equity Group Investments. I'm just impressed with this guy. He's got an amazing track record. He's 70-something years old. He's got some lessons that Dr. Phelps and I are going to unpack. You may be thinking you don't wish to be the bigtime investor in real estate in Chicago. Well, he wasn't either. He began outside of college, but his success compounded.

I believe the magic of compounding is whatever we're doing that's just working, it will compound well. Whatever we're doing that's not working will compound to our peril. So my hope is that as you're listening here, know that these lessons are tried and true. They're not my lessons. They're not Dr. Phelps' lessons. This is from a legendary guy that's got I think some good teach points. We're going to rock through each one.

David, I know we've got a pretty healthy list here. We've got to get it all in in 18 minutes. Are you up for the task?

David: I think we can do it. I'm going to take a shot at it. I'll also say, Evan, that Sam Zell was one of the people who really accurately predicted the last market downturn in 2008 and 2009 and was a seller at the right time in the market. One of the lessons in here today we'll talk about is when to take equity off the table. So I thought I'd just throw that little teaser in there because I think that's something everybody needs to know, whether you're talking about real estate or maybe your dental practice.

So let's roll into these and start with lesson number one from Sam Zell. Lesson one is the first thing you need to understand is how little you know. The best investors understand that the more you know the more you know that there's even more you don't know. I think that's something that every healthy person on this earth should recognize and understand, Evan. Again, whether you're talking about real estate or dentistry or healthcare.

We gain and experience as we go but we always realize that as Sam, well eloquent here, is that the more we know, the more we realize we don't know. How do we overcome that, being stymied by the fact that we don't know? How do we avoid taking too much risk?

I'll throw my two cents in here, Evan, and say that the way I try to avoid that is to always have what I call a board of advisors around me. Could be a mastermind group, could be people just like you, Evan, who I know has my back. If I'm thinking about doing something, anything in life, I know that you could give me some perspective that I might not ever see. What would you say to that?

Evan: For me, I would say copy others who are already where you want to be. When I look at others that have already arrived where I want to go, my belief is they probably have a blueprint and I'm going to ask them what that blueprint was. Now is it possible they could get lucky? Sure. But once I look at their blueprint, I'm going to know, David, that they were lucky.

Most of the time, they weren't lucky. They're able to show me a blueprint that is how they got there and unless there is something entirely different in the marketplace, it's usually replicatable. It might be slightly replicatable differently, but the heart of it will most likely be the same. That's what I love about working together in a collaborative way.

David: Perfect. All right, lesson number two. When everyone is going right, look left. He says, "I've spent my whole life listening to people explain to me that I just don't understand, but that didn't change my view. Many times however having a totally independent view of conventional wisdom is a very lonely game." You know, the other person who said that well, Evan, I think was Earl Nightingale. He said, "Whenever in doubt, go against the majority. Don't follow the crowd."

` That's what Sam Zell did back in 2006 and 2007, when everybody was still going high as a kite with real estate. He saw some fundamentals in the marketplace that he just didn't like. He took a different road. It's the contrarian viewpoint that is so hard for the majority to get a grip on. "Buy when there's blood in the streets. Go against the grain." Those are the common clichés that we hear but I think they're very apt today and anytime. Any experience in that area for you, Evan?

Evan: That was one of the hardest times in my experience in real estate was that we felt that the real estate numbers just weren't adding up. We watched the indicators over hundreds of years, they have records back 100 years pretty easily. We just thought the indicators were time to sell.

Unfortunately, we sold at the end of 2005. Now most people might think that is genius but imagine watching my peers crush it for like another year and I'm on the sidelines and I'm just watching them get returns after returns and they're looking at me like I'm 100 years old. Like I'm some scaredy-cat. But I just didn't think it was sustainable.

Now of course, fast forward, 2007, 2008, 2009, well that looked genius then but I can tell you going left when everyone is going right may sound great in the moment but I can tell you it felt so hard when they were getting validated for their action even though I really wanted to—there were moments I wanted to get back in. So thankful that I didn't, so thankful that I did get back in toward the end of 2008.

I mean I timed it probably slightly wrong. I got out a year early and I got back in a year late. All in all, I'll be thankful for that but I can tell you, listeners, listen to this guy Sam Zell. When everyone is saying one way, take a good hard look at the other.

David: Lesson number three. Sam says, “Listen. Business is easy. If you’ve got a low downside and a big upside, you go do it. If you’ve got a big downside and a small upside, you run away. The only time you can have any work to do is when you have a big downside and a big upside.”

So he’s basically relating, what I think he’s talking about, is are you an investor? Do you look at mitigating risk on the downside and looking where you have more upside? Or are you a speculator where everything has big risks, both big upsides but also a big downside? He says the latter, big upside, big downside, there’s a lot of work to do. You probably ought to stay away from that, you better run from that but do your due diligence.

Understand your marketplace, again, whether you're talking about real estate or your practice arena. Know your market and when you see the opportunities there with small downsides, take those, run with those.

Evan: Yeah, a lot of times we’ll run numbers from a pure mathematical standpoint and we’ll say, “What’s the upside if this goes and what’s the chance that it will or won't?” We’ll do the math. Then we’ll take another decision that might be in an opposite direction, what’s the chance of something moving forward and what’s the return on that if we’re trying to decide A or B, let’s say it’s two properties.

If A has a lower chance of going forward but the win is exponentially higher, we may choose A. Because all in all, it’s a better move even though maybe B might have a 90 percent chance of win, but it has a really small return. So that’s how I’ve always ran it, it’s just mathematical. So it takes my emotion out of it and it’s helped me make better decisions in the long term.

David: Excellent. Lesson number four. “At all times, we are keenly aware of what our exposure is. We’re very focused on what the liquidation value is.” He says, “The real issue is what’s the downside?” We just talked about that in lesson number three. He says, “My own formula is very simple. It starts and ends with the replacement costs because that’s the ultimate gain.”

People would ask him, “How could you buy it? How could you project yields, rents?” He said, “For me, it came down to these issues: One, is the building well built? Number two, is it in a good location? Number three, how much less than the cost of replacement is its price? If I bought stuff for 30 cents on the dollar and 40 cents on the dollar, how can you lose? The value investing formula is simple, buy at a bargain and wait.”

Now again, that’s hard, Evan, for people who want to make what they call quick and easy money. That’s the speculator’s game. I love what Sam Zell says because that’s the way I look at investing and real estate which is the asset class that we both love. You buy it well with low risk, more upside, but you buy and wait. You let the market or let your forced appreciation take place, then you take your profits.

Evan: Yeah, we’ll even kind of lay out a plan where we will acquire at this price and we will sell at this price and our time horizon is going to be estimated at X. We’ll even write in, before we do the deal, we’ll try to take our emotion out of it and just already create a plan, like a treatment plan. That way when we hit certain indicators, we take action rather than the property—let’s say it increases at 30 percent and that was our cue to go ahead and sell but instead we think that we’re going to hold on and squeeze a little more.

But if our emotion was out at 30, then we're at a 30. So we really try to predetermine our ins and outs well ahead of time. If it's going to be a long-term hold, then we write that in so that no matter what the value is on paper, we know this is a cash flowing property. It's not our goal, not really our focus, to look at price fluctuations.

David: Got it. Lesson number five. He says, "I pound on my people. Taking risk is great. You've got to be paid to take risk. The risk return ration is probably the most significant determinate of success as an investor. Measuring and gauging the risk reward ratio is the biggest margin of safety issue every investor has." So, I agree.

Every person has to determine their own risk tolerance, right, Evan? You've got to determine where you fall in line. When you feel like you're taking a bigger risk, there's got to be a bigger upside to do so if that's where your risk tolerance is. If you've got lower risk tolerance, more of an aversion to risk, then you take a lesser return but you're more predictable and you're safe.

You've just got to determine where you fall on that but risk is part of any investing or part of any business. Just mitigating that risk through what we talked about earlier about having a board of advisors around you is a great way to offset some of that and have more predictable long-term returns.

Evan: Indeed. Warren Buffett says investments aren't risky, investors without the proper information are risky.

David: That's right, exactly. All right, lesson number six. You can have all of the assets in the world you want but if you have no liquidity, it doesn't matter. Liquidity equals value. Everything comes down to exit strategies. Everything comes down to knowing when you get in, how are you going to get out? Evan, I'm going to let you take that one because I know you understand that to a T.

Evan: For me, it's really knowing what makes value, what adds value. When we look at a property and what's liquid, if we were to have to fire sale something, what could it sell for? When we're lending on a project, we're looking at worst-case scenario. We're looking at property values have gone down, and in a historical negative way, when real estate typically moves rather slow. But you know, we always look at what is the downside?

So if we had to liquidate it and sell it, what we would sell it for and does that cover all of our investors? Does it cover all of our capital and we're all coming out whole, if not profitable, which it always comes out profitable. Or, if we had to hold and rent it, would the cash flow exceed any expenses? If those two answers are yes, even though we've never had to activate those, I like knowing that that's the case.

So going in that's really our checklist, all the things that could happen. Not because we want to be negative but we want to really be prudent and then make sure that we're ready in any of those cases.

David: Well said. Lesson number seven. "The problem with leverage is that you need to pay it back. The biggest measure of success or failure is how entrepreneurs address and deal with leverage. If you're in the real estate business without leverage," he says, "that's like being a boxer in the ring without a glove. Leverage in business is not avoidable."

I agree with that. I totally agree that using prudent leverage is the key to growth, whether you're talking about your business, your practice, real estate investments, you've got to at some point use leverage if you're going to really get ahead, stay ahead of inflation, make up for lost time, those kind of things, Evan. But there's a right way to use leverage. You want to add a little bit to that?

Evan: As long as someone is using other people's money that they look at it from a perspective of if it was theirs, would they be able to cover it in a bad time? Also, I'd say we're talking about leveraging money but also leveraging time. There are services, there are people that are so efficient at what they do that to hire them or outsource to them I have found to be so effective where my quality has increased and my time has decreased.

In addition to that, managing intellect, where I can reach out to people like David, run an investment by him and he doesn't have a dog in the race. He doesn't have any reason to say yes or no other than he's just caring about my income. He can say, "Evan, this just doesn't seem congruent with your overall outlook of what you're investing in. I don't think this is a good fit."

I might have put hours of due diligence into it and I'm trying to make it work but David can come in and go, "No, this is a dog. This is not a win." I appreciate that. So I'm leveraging a friendship.

David: So many ways to leverage, you are so correct. Lesson number eight. Anytime you don't sell, you buy. Think about that. I love this one, Evan. Anytime you don't sell, you buy. Realize the converse is true. Anytime you don't buy, you're really a seller. So what he's talking about here is opportunity cost. There's no one size fits all here.

What you really have to do is you have to weigh what you currently have and weigh that against what you could put that capital, that equity into, that possibly could be better. If there's something that's better out there, then you should be a seller. If not, then you don't. That again, that could go for your practice. I think there's a window of opportunity for everything, Evan, in the market cycles.

We have to be brave and courageous enough to identify those to determine when it is right to take equity off the table and be a seller. But there's other times, Evan, I look at some of the assets I have that are performing very, very well and even though I could sell them in this market for a nice chunk of capital, I've got to turn around and reinvest that capital. Am I going to do as well? Is it worth going through that? Sometimes it's not. Sometimes it's nope, I'm keeping what I've got.

So I love that scenario where you have to determine if you're not a seller then you're essentially a buyer for what you currently have.

Evan: Indeed.

David: You like that one?

Evan: I do. I like that a lot. A lot of times a question we'll ask is, if we're saying yes to something, what are we saying no to? If we're going to invest in project A, then we're going to say no to project B or a project that may be coming that we don't know could be coming. We want to make sure that our yeses are more valuable than our nos.

David: Good. Lesson number nine. Sam says, "I would tell you whatever business I've been in—real estate, barges, railcars—it's all about supply and demand. When there's no supply, real estate performs very well, almost without regard within reason to the economic conditions. When there is over supply, it doesn't matter what's going on and real estate is going to suffer."

So he's just saying it comes to supply and demand. Again, you can see that there's factors obviously that we're not going to go into today, economic factors that weigh into supply and demand, and government regulations, and interest rates, and lots of things like that. But when you look at it overall, he's exactly right.

Right now in this current environment, even though interest rates are low, there are sectors of the marketplace that are not being served well by conventional lending. Evan, that's where you and other people, we get in, we take those opportunities. We can do lending; we fill the voids where the conventional markets aren't filling. Do you agree with that?

Evan: I do. I think we're always looking for opportunities and when there's movements in the industry that's not a bad thing. Actually, I find that when industries aren't moving, when properties aren't moving, that's the worst time. Anytime that there's movement, just being on the right side of the movement is usually the most profitable.

David: Perfect. Okay, number ten. He says, "Arthur Miller did a huge disservice to entrepreneurship by writing the book *Death of a Salesman*." He says, "Salesmen are not scummy and dirty—people that you would not want to ring your doorbell. In fact, all successful entrepreneurs are salesmen. Selling is a highly underrated skill in life.

"Everyone can benefit from learning how to sell better since in addition to products and services, people have to sell ideas, causes, many other things in life. Salespeople tend to be highly compensated since the activity is 1) hard and 2) it requires real skill." Sam Zell has gone as far as to say, "Nothing is bought, everything is sold." Evan, what do you say?

Evan: I say people have their own reality. If they consider a salesperson only those that are really a hard sale that are going door to door that will probably work for a week or a couple months and they're not trying to build rapport or even seek for a mutual benefit, then that's their experience.

But in reality, I think everyone is selling. Whether someone is a secretary or they're selling knives or cars, that we're all trying to build value. That secretary is building value for why he or she should be paid the wage that they're paid. They sell that that's an advantage that they are better at that than somebody else or they're more affordable for the skills that they bring than somebody else.

So I think at the end of the day, even my kids, they're going to sell me on why should they stay up later. Last night was a prime example. Why they should be allowed to stay up later and how their behavior is going to be so much more phenomenal the next day.

David: Great example. Lesson number eleven. Business schools are beginning to change but particularly he says in the 80s the business schools focused on if you could just turn a page there's the formula that tells you how to do it. The answer is there are no formulas. Success and failure are a combination of judgment and an external event but starts and ends with a simple idea. Don't get confused by education, simpler solutions are most often a better solution.

I think that says it all. Academics for the most part are really a license or a pathway to the next. Hanging one's hat on their ability to take tests or regurgitate information are missing the point, you've got to learn how to solve problems and take the information and the knowledge that you gain wherever you gain it and be able to put the pieces of the puzzle together. Solve problems. Bring value. That's where it comes down to in the world of entrepreneurship.

Evan: Agreed. When I went to college, I really didn't feel like there was that much world wide web at the time and I think much of the learning was assumed to take place within the walls of a college. But nowadays, what's available, I think colleges still have their own value but now it's available on the web. My goodness, David, from videos to tutorials, there's such a connectivity now that never was before.

So if someone feels that they're holding back because they don't have a degree or they haven't achieved something from a scholastic standpoint, gosh, they are a click away. If they have a smartphone or a computer, there's a master's degree waiting for them in any kind of investment vehicle they want.

David: No doubt about it. All right. Drumroll, Evan, this is lesson and final number twelve. Here we go.

[Evan makes drumroll sound]

Thank you, sir. "Entrepreneurs basically not only see the opportunities but also the solutions. A critical element to a successful entrepreneur is that he or she thinks in themes, not single events."

He says, "I don't know too many insecure successful entrepreneurs. Fear and courage are very closely related." He says, "Entrepreneurs don't fail it's just that sometimes things don't work out. Entrepreneurs look for change that will make a difference. They think outside the box. They don't accept the conventional. The entrepreneur constantly asks what if, could I, or should I." He says, "If you don't get in the game, you don't win."

I think that's so, so true. That's what I love about being in mastermind groups and with a board of advisors is we could be true entrepreneurs and put our ideas out there and not be shamed or told that you can't do that or that can never be done. We can really get a basis for whether we go forward or what I call "go or no go" points where you want to test something to see if it might have relevance to your marketplace. So much wisdom in I think that lesson number twelve, Evan. What do you say?

Evan: Absolutely. I think really hanging out with peer groups, peer pressure. Who are you around? Do they see opportunities or do they see only problems? Or when they see a problem, do they bring it so that together we can solve it? And really do we have the courage to dig in? Do we have the courage to take the first step to at least learn more?

I'm not saying throw money at stuff that you have no really experience at but have the courage to be able to say, "I don't know." Raise your hand and be able to dig in and find more and surround yourself with people who do know more. Then when you have the information—not being perfect, but enough—go for it. And keep grinding. Keep learning.

Well, David, we are at time. Listeners, I admire you for staying with us for the twelve lessons from Mr. Sam and know that these kind of things are all around you. Go and search. They're all available. This guy, Sam Zell, I think he's done pretty well and he's left a blueprint behind. This is a blueprint that we want to build as well, the *Dentist Freedom Blueprint*.

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