CREs & Non-Profits:

Counseling Denominational & Educational Entities in Today's Changing Real Estate Environment

by Frank J. Parker, CRE, & Alanna McKiernan

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Non-Profits in American Life

Drawing from its historical English constitutional roots, the United States has always pursued a public policy of favoring non-profit organizations in order to serve the public good. The Internal Revenue Code in Chapter 501-C(3) provides Federal tax exemption to a large number of such organizations considered to be adhering to "eleemosynary purposes." Traditionally, in its broadest sense, the word eleemosynary has been defined to include organizations engaging in activities devoted to the general spiritual, cultural, and charitable betterment of the population as a whole.

Throughout the spectrum of traditional mainstream churches in the U.S., there has been a notable decline in attendance in the past few years. Inevitably, revenues have plummeted also. At some point, the need for them to address real property questions becomes paramount. Many times their property has been long held and is extremely valuable. Without proper real estate counseling advice, wrong decisions risk being made at a time when the struggling church group desperately needs every cent it can obtain in order to carry on its mission and goals.

In the past, denominational religious groups of all persuasions reached out far and wide to provide for the schools, colleges, and hospitals which served so many. Gradually these services have been assumed by governmental entities and for-profit service provider competitors. Ever since the start of the G.I. Bill after W.W.II, there has been a major shift toward public funded higher education. Recently, this trend has adversely impacted some private colleges and universities. As tuitions rose, enrollment at some such colleges and universities has slipped, especially at institutions not of the highest quality. A similar situation of deterioration has occurred in the past few years with a number of

non-profit hospitals that have been caught in the backlash of the health care revolution.

NON-PROFITS AND THEIR REAL ESTATE

The key tactic for assisting these groups is to recycle disposable realty either by sale, adaptive re-use, or creative joint venture entrepreneurial projects. However, carrying out this suggestion is often not as easy as it may seem. It is imperative that the non-profit organization in question and its advisors are able to conceptualize the various complications that may arise during any real estate transaction, especially those to which non-profit organizations are particularly susceptible to encounter.

With regard to denominational institutions, problems of ownership almost inevitably occur when joint-ventures under any guise are undertaken with profit making companies. Who within the church has the authority to sign as owner of the property? Similarly, who makes decisions for the church? The lack of a chief decision maker or the need to defer to the opinions of people within or without the organization, and who lack knowledge of real estate, can make it difficult to do business with such non-profit organizations.

To illustrate the point, recently, an ugly public dispute on property ownership took place between the University of St. Louis, its Trustees, and president on one side and the Roman Catholic Archdiocese of St. Louis and the Vatican on the other side.

The medical school of the University of St. Louis was losing enormous amounts of money. In order to continue it as a viable entity, the decision was made to sell the hospital attached to it. The buyer was to be Tenet Health Care Corporation, the second largest health system in the Untied States. The Archdiocese and the Vatican said that this hospital could not be sold without their permission because everything at the University of St. Louis was connected directly to the Catholic Church. The University of St. Louis replied that when the Board of Trustees of the University took on non-clerical members in 1967 and incorporated separately, (thus separating the university from its Jesuit Community), the University became a totally lay organization. By this reasoning, there was no need to ask the permission of the Vatican or of the Archdioceses before the hospital was sold.

Eventually, an uneasy compromise was forged. However, from now on, anyone giving advice to Catholic institutions should keep the ramifications of this decision foremost in their minds. No one wishes the local Catholic Diocese or the Vatican to sue to stop a sale.

DISPOSAL OF SURPLUS REAL ESTATE

A number of non-profit institutions, if they were accurate in self-appraisal, would admit that some of their greatest mistakes have occurred in connection with the disposal of real estate. An old truism in real estate as valid as the location truism is that, "They are not making any more real estate." Its corollary is that, "Once the property is gone, it is gone." Both sides of this coin apply to a number of misguided sale decisions by denominational and educational entities made under short-term pressures that, in retrospect, have led to error and regret.

The reasons for miscalculations in buy or sell decisions are numerous. Often, it is an immediate panic move. Attendance is down. Cash flow is perilous and endowment fund returns are disappointing. What to do?. . . Sell real estate?. . . What else?. . . Sometimes it appears that no other answer exists; but often one does. Among other possibilities are sales and leasebacks, joint-ventures, and ground leases. All three strategies are frequently employed alternatives to outright property disposition, straight forward property leases, or the trio of alternative deployment options just mentioned.

The sale-leaseback alternative, as its name indicates, describes a legal transaction in which the property in question is sold to a buyer normally interested in it for value appreciation purposes. Then, this piece of land is leased back to the seller, (in this case the educational institution), normally because it desires to retain classroom space. A variant of this transaction would be a joint-venture in which the partners, (normally a corporation and the denominational or educational institution with which it is involved), would divide ownership of the lands and buildings in question as agreed upon.

A ground lease is another option. It occurs in two different situations. Either there is a lease of undeveloped land on which a ground tenant will construct improvements or, in the alternative, there is a lease of improved real estate that covers the land alone and not the improvements upon it. In either case, the term involved usually extends from 25 years to 99 years.

For any denominational or educational non-profit that is looking ahead, before resorting to fire sales or the bailout variants discussed above, it

is recommended to view the land involved in terms of its capacity to be adaptable for scientific and telecommunications technology. One should also not forget to investigate residential subdivision opportunities. In addition, educational institutions may be able to take advantage of their tax exempt status to prepare land they own for eventual sale to commercial buyers unable to obtain the necessary regulatory approvals for the desired usage. Strategic value enhancement of this nature could substantially increase the price of an eventual commercial sale. Also, denominational and educational organizations should not forget to explore the possibility of golf course or automobile garage construction on the property in question. Currently, both are red hot items in today's pleasure-driven environment.

Non-profit organizations are always concerned that whenever they sell their property or enter into a joint-venture concerning it, the Internal Revenue Service will tax the proceeds. They should not be unduly concerned. A recent IRS ruling indicates that institutions of higher education will not be charged with "unrelated business taxable income" (UBTI) from the sale of a property held in trust. Therefore, the property in question will not be considered as debt-financed property during the time it is owned by the educational entity. Answering a hypothetical question, the IRS stated that when a college was both the trustee and the charitable remainder holder of a charitable remainder annuity trust that held farm land, the college acquired fee simple title to part of the farm for cash and a promissory note.

Since the college seeking the opinion did not intend to use the property to satisfy its tax-exempt purpose, it planned to sell it. This college then entered into a joint-venture with a commercial developer. At the end of the transaction, the college would retain a minority beneficial interest in this transaction. In its Opinion Letter, the IRS stated that the college in question would not have to pay any taxes, including UBTI, at least until the point at which the transaction in question had been consummated. Presumably, it would later be taxed for profits received thereafter as a minority interest holder of the new entity.

THE ENTREPRENEURIAL APPROACH

Among a certain number of financially well-capitalized colleges and universities and a few well-endowed church groups, movement into wide-scale aggressive real estate investment and development projects is a natural evolution of the need for asset diversification. This especially is so when the institution's underlying endowment holdings exceed $1 billion. Such entities usually treat their real estate subsidiary as a semi-independent grouping - almost like a normal commercial real estate development company. The only difference being that the sponsor usually has placed dedicated funds in the hands of its separately created real estate development entity. Accordingly, there is a strong fiduciary obligation involved in such a relationship, exceeding that associated with any publicly funded company.

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A number of financially secure colleges and universities all over the country are diversifying their portfolios with real estate investments. These investments are not limited to property within the immediate campus, but can include office parks, commercial sites, and retail outlets in the towns and cities surrounding the campus. Let us pick a selective sample of states and examine these trends. All of these colleges and universities and many others like them will have significant need for sophisticated real estate counseling advice throughout the construction process.

In Arizona, the University of Phoenix is moving its northwest Valley campus to a new facility that will be four times larger than its existing campus. Paramount Partners is developing the two-story, 40,000 square foot facility on four acres in Phoenix. The new facility will more than double the number of existing classrooms, and provide administrative service areas and computer lab space. The University of Phoenix is the sixth largest private university

in the country, with more than 250,000 students nationwide. Their niche consists of mature students who work full-time at the management level, with an average age in the mid-30s.

Arizona State University has plans to transform a Tempe strip center into an upscale mix of shops, restaurants, and offices, and a link between downtown and the university. The university is negotiating with developers who plan to invest $40 million in the facility. The entire project will include about 150,000 square feet of retail and 50,000 square feet each for restaurants and office space. Developers are signing an agreement to lease half the land from ASU and will pay ASU a percentage of the rent collected.

In California, a Toronto company, Lauridon Sports Management, will pursue construction of a 5,000 seat basketball arena and three ice rinks at the University of California, Riverside (UCR). The University could not afford to build the facility on its own. Lauridon would pay UCR rent and let the school have use of the rinks and give input on the facilities design. The deal is worth approximately $20 million.

Ventura, California, will have a new college campus, California State Northbridge, constructed on a property which was formerly a state hospital. Approximately $6.5 million will be needed in the fiscal 1998-1999 state budget to convert the buildings to classroom and administrative facilities. To reduce costs, Cal State planners will seek partnerships with private firms interested in leasing space at the campus.

Pasadena City College is building a new gymnasium as part of the final $21.7 million phase of the community college's 10-year improvement project. The 65,000 square foot athletic facility will include several basketball courts and a fitness center, plus classrooms for sports medicine and other physical education courses. The project was financed with $19 million in state bond funds earmarked for higher education.

In Connecticut, Yale University and a well known real estate developer have acquired the Whitney Grove Square office building and adjoining retail shops at Whitney Avenue and Grove Street. Under the contract, Yale will own the office tower, while the developer's limited partnership will own the retail stores at the ground level. In 1984, Yale sold this same property to Whitney Grove Square Associates Limited Partnership to facilitate its development. Yale was a large backer of the partnership, investing about 30 percent of the funds initial capital.

In Illinois, The University of Illinois has expansion plans of approximately $700 million on the Chicago campus. The project will include university buildings, student and private housing, parking, and new commercial development on 30 acres of vacant rundown land. The University intends to create a new south campus with a goal of getting staff, faculty, and about 25 percent of the student body to live in the area, in an effort to clean up the vicinity where it owns 15 buildings along the Maxwell and Halsted area.

In Massachusetts, Harvard University secretly purchased land in the Boston blue-collar area of Allston in the late 1980s through an undisclosed intermediary. The disclosure of these purchases was received with hostility from the city and the residents in Allston. The mayor specifically was angered by the secrecy and residents in Allston felt they deserved a premium for their property which would be used by the well-endowed Harvard. Total purchases include 14 parcels comprising 52 acres. The true purchaser was kept secret in an effort to keep prices down. Harvard owns 220 acres in Cambridge and now 192 acres in Allston.

Over the past five years, Northeastern University in Boston has developed $100 million worth of real estate. The University has a 55-acre main campus in Boston and a 200-acre campus in suburban Ashland, Massachusetts, which serves as its planning and educational retreat center. According to school officials, most of the urban development has been in dormitory housing, an effort to establish affordable housing options for students, as off-campus housing costs rise and may be a deterrent for potential students. Northeastern's intent is to blend into the community surrounding its Huntington Avenue campus in Boston. Neighboring Suffolk University is continuing its expansion in downtown Boston, and has purchased the former Department of Public Health building. Its goal is to convert it to student housing.

Plans currently are being made for the biggest real estate development project in Boston's history. There are to be several buildings, one taller than the Prudential Tower, in the south Boston waterfront district by South Station. The combined hotel, office, and research space would total three million

square feet and cost approximately $600 million. TUCD Inc., a for-profit subsidiary of Tufts University, is working with the Hines Interests Limited Partnership of Houston to develop the complex.

The University of Massachusetts Medical Center recently increased its real estate holding in the purchase of the Massachusetts Biotechnology Research Park, a 75-acre park, with the purchase of an 80,000 square foot research building, located west of the University of Massachusetts campus for $3.83 million. The building was recently valued at $9 million by city assessors. The University still has plans to build a $12 million, 32,000 square foot neuropsychiatric research center on grounds near Worcester State Hospital.

The University of Missouri decided to buy 36 properties on the south edge of the University of Missouri-Kansas City campus for $1.32 million. The intention is to clear the two-block area for use while a new parking structure is built. The decision has been met by opposition from residents living in the houses to be demolished. The University, under the State of Missouri's power of eminent domain, has the power to acquire buildings even if owners do not want to sell.

In New York, Cornell's Business and Technology Park, a real-estate link between Cornell University and private commerce and research entities, currently owns 200 acres, with 76 tenant companies, the majority being technology companies. There is a two percent vacancy rate. Private funds in the facility are valued at approximately $23 million. Park amenities include a child-care center, a medical clinic, the main U.S. Post Office for Ithaca, and Federal Express, all bordering a three-acre pond.

In Wisconsin, a real estate developer, Told Development, has donated a $17.4 million, two-story, 156,000 square foot building in downtown Eau Claire to the University of Wisconsin-Madison School of Business. Once the mortgage on the property is paid off it should generate about $1.7 million yearly in revenue for various UW-Madison programs. The building's one tenant, a firm which manufactures high tech components, has a lease which extends through the mortgage expiration. The donation is one of the largest ever made to the University.

Smaller educational institutions who choose not to establish their own real estate development arms still possess a number of opportunities for entering into limited scale real estate development entities, either on their own or in conjunction with a joint-venture partner. Such well defined small scale development should compliment the academic strength of the educational institution involved. Obvious examples are scientific research parks linked to academic physical science and computer science departments and outreach health care facilities linked to university hospitals. In any such venture it is important that the underlying professors involved possess sufficient academic and entrepreneurial skills to make the university supported facility financially viable. The failure of so many of the first wave of university sponsored research and industrial parks is attributable to forgetting this precept.

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In another area of controversy, many church buildings are officially designated as historic by the relevant landmark commissions. Normally, alterations to historic sites must be approved by appropriate governmental agencies and this, in many cases, can delay projects for years. Nevertheless, because many pieces of church property occupy downtown, potentially upscale, choice commercial locations, the effort of negotiating with landmark commissions and other regulatory agencies can be worthwhile. Moreover, many of these historic sites offer tantalizing opportunities for public-private partnerships. This adds to their attractiveness and marketability.

Higher education is by no means immune to arduous challenges regarding its real estate holdings. On the private college and university side, tuition increases and financial aid subsidization requests have forced these institutions to search

for profitability and efficiency in all aspects of their operation. On the public college and university side, legislative budget cuts and increased student insistence upon smaller class sizes, sparked by the realization that a quality education is essential for most worthwhile positions these days, have placed huge demands for the proper utilization of real estate.

THE COMING OF VIRTUAL UNIVERSITIES

In addition, it is a cold, hard fact of life that the Internet and the communications superhighway, over-hyped as they may be in some regards, do possess the potential to alter radically, most often negatively, the space requirements of a number of colleges and universities. Very few institutions have looked realistically at the real estate changes being sparked by instantaneous technological advances. Make no mistake! A revolution in higher education space allocation is forthcoming.

Distance learning is the general name for the trend in education which includes the establishment of "virtual universities." The range of technology that is included in distance learning is varied, and includes both high and low technology delivery mechanisms. On the low-tech end, are correspondence and television courses that do not allow for synchronous interaction between the teacher and student. The high-tech end of the spectrum can include fully interactive remote delivery systems implemented via electronic teleconferencing or sophisticated fiber optic networks, as well as the Internet or World Wide Web as a means for classroom instruction and student interaction.

Universities participating in this trend are not limited to the big names and range from Pike's Peak Community College in Colorado Springs, Colorado, to Stanford University, California. Degrees range from Masters of Science in Quality Assurance to MBAs to undergraduate degrees for 18 year-olds and baby boomers, to professional degrees for parents working full-time. Classes taught range from turf management to geography, accounting, history, and Latin.

Also significant for new virtual universities is the wealth of corporate funding available. Companies like Intel and Sun Microsystems and endowments like the Sloan Foundation, are eager to make donations to technologically innovating programs like virtual universities. The best example is the California Virtual University, benefiting from its deep pocket location in Silicon Valley. Such companies are also interested in using these systems of training their own employees and developing their own continuing education facilities. The advent of the virtual university and the high technological requirements needed to service the program look to be prime opportunities for high-tech companies to make tax deductible contributions for development, as universities look to expand their endowment.

The cost benefits of distance learning are only felt as enrollment is increased and universities are able to realize economies of scale in their technology investment. U.S. colleges and universities spend approximately $12,500 per local student, while distance students typically cost the university approximately $350 annually. This amount can increase exponentially as the number of enrolled students decreases. It is likely that once the initial investment in the technological infrastructure is complete, and universities have consistent enrollment, costs should drop dramatically and reflect the lower operating expenses they incur. The overall impact on college and university needs is not yet completely clear. Certainly good outside real estate real estate counseling advice will be needed.

As competition among educational institutions for quality, paying students intensifies and the service demands of all of the constituencies served by the higher education community increase in our consumer society, a number of colleges and universities have expanded their role in involving themselves actively in the neighborhood and municipality in which they are situated. Purchase and renovation of adjacent neighborhood real estate is often part of such a plan.

Many times the university's official linkage with the surrounding community is announced with great public fanfare. Often the "town and gown" partnership can be tied to active participation in the appropriate, already incorporated, neighborhood association. Seeking to stabilize deteriorating communities around the campus before they become a student recruitment deterrent, some forward-looking educational institutions are providing substantial housing subsidies to faculty and staff willing to relocate there. Contractually, they commit the institutionally contributed subsidies to rehabilitating the exterior of their homes and to establishing or improving their gardens. Frequently such plans specify that the educational institution has first refusal rights on re-purchase if the faculty or staff member later chooses to sell the house. In similar manner, if the institution purchases neighboring

properties for its own administrative or classroom purposes, it stands to profit significantly if the general neighborhood appreciates in quality and a sales strategy for the offices in question becomes appealing.

KEY REAL ESTATE COUNSELING PRINCIPALS

Whatever type of outside real estate venture is pursued by a denominational or educational institution, two overriding concepts must be kept clearly in mind. First, risk is a factor in all profit-driven real estate ventures. Colleges and universities, especially those with limited endowments, must be very prudent in exposing at-risk funds to speculative ventures.

Second, excursions into profit making ventures by denominational and educational entities often can cause resentment on the part of local merchants placed in competition with an educational entity that may not need to pay property or revenue taxes. Colleges and universities sponsoring hotels and restaurants have been particularly vulnerable to such complaints. The subject of taxable liability is becoming increasingly contentious between non-profit organizations and their sponsoring municipality.

Except for the entrepreneurial approach as a semi or total autonomous investment vehicle, the use of real estate by a denominational or educational institution must be carried out in accord with the statutory and charitable mission of the institution in question. Since the trustees of any non-profit organization are the definers, keepers, and refiners of the institutional mission, they should examine scrupulously all aspects about buying, selling, constructing, and renovating property before a final decision is made. In a similar manner, the real estate activities of the institution should always agree with its educational and financial strategic plans. Counselors of Real Estate have an important and most challenging role in helping non-profit organizations adapt to today's changing real estate environment. REI

NOTES

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