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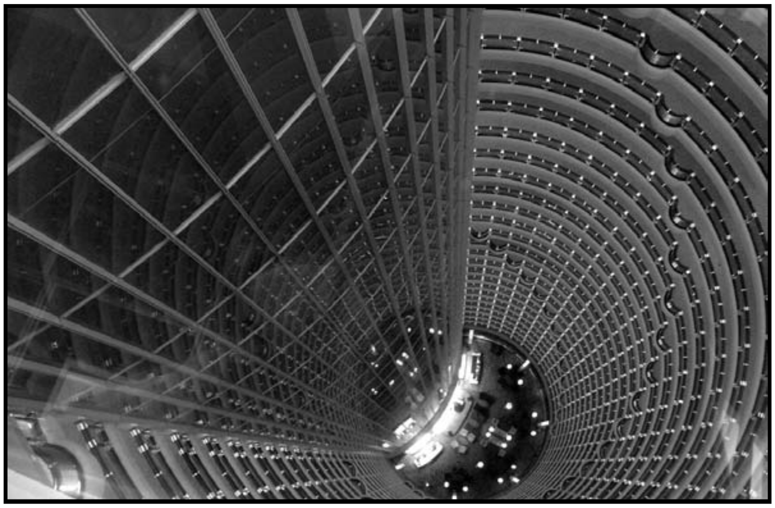

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Editor's Statement

BY MAURA M. COCHRAN, CRE

TWENTY YEARS AGO MANY CONFERENCE SPEAKERS began warning: "Do international business or perish." Hearing this mantra multiple times, I took the message to heart and tried to figure out how to expand the market I serve.

I came to the conclusion that it wouldn't work, though, partially because I didn't speak multiple languages. I also felt that to be successful I would need to find a market—say Asia or Eastern Europe—and visit three or four times a year to build the necessary relationships. So, my company's business model concentrated on North America instead.

Well, the experts of 20 years ago were right, and I was wrong. Within 10 years I was working internationally. The answer, I discovered, was to develop relationships domestically with firms that have offices worldwide.

The Counselors of Real Estate also branched out internationally, paving the way by forming strategic alliances with organizations such as the Royal Institution of Chartered Surveyors and by holding symposia focusing on matters of global importance. One such meeting was the 2006 CRE High Level Conference, held in July, where renowned speakers and delegates explored the theme "A Clash of Cultures: Understanding Life in the Global Village."

This edition of *Real Estate Issues* has a distinctly international focus. The article "Culture, Identity and Democracy in the Face of Modernization" is an excerpt of the keynote presentation that author and professor Francis Fukuyama delivered at the conference. CREs Karen Davidson, Hugh Kelly, David Kirk and Wayne Silzel also share their impressions of the program in "Modernization, Immigration and Conservation: Counselors Gain Perspective at High Level Conference." Both articles consider the complicated situations that have spurred Eastern and Western philosophies of identity to evolve, and how those differing philosophies affect the ways that groups, individuals and societies interact.

From there, CRE Steve Price transports us to China in "Shanghai Development Takes Off, Transforming the Residential and Commercial Landscape;" CRE Mark Levine offers a refresher course on etiquette in "The Impact of Cultural Mistakes on International Real Estate Negotiations;" CRE Barry Gilbertson provides an update of happenings across the pond in "The State of the UK Property Market: Key Drivers;" and Levine reviews a book titled *Managing Government Property Assets: International Experiences,* which covers typical practices in developed and developing countries.

Rounding out this issue of *REI* are six additional insightful articles written by CREs Arthur Mazirow, P. Barton DeLacy, Kenneth P. Riggs and Raymond Torto as well as academics and legal experts from outside the field of real estate counseling. The works discuss relevant issues including economic trends, property pricing and appraisal, and legal complexities related to leasing commercial space and residential land.

While we're on the topic of internationalism, the journal's electronic availability is another important feature to mention. Members can easily share any of these or previously published articles from the online *REI* archives by downloading thoughtful features, columns and reviews, then forwarding them to colleagues and clients across the continents. And soon, Counselors will be able to access articles through an electronic portal delivered via e-mail. Check your inbox in the coming weeks for details.

On a personal note, this is my last edition as Editor in Chief of *Real Estate Issues*. I would like to take this opportunity to welcome the 2007 Editor in Chief to this challenging and rewarding position, and heartily thank the REI Editorial Board and staff members who have made this assignment a real pleasure.

MAURA M. COCHRAN, CRE
EDITOR IN CHIEF

CRE

FEATURE

Culture, Identity and Democracy in the Face of Modernization

BY FRANCIS FUKUYAMA, PH.D.

Editor's note: This article is excerpted from the presentation Francis Fukuyama delivered as part of the Clash of Cultures program at the 2006 CRE High Level Conference, which took place July 13 – 16 in Park City, Utah. Read more about the conference programming in this edition of Real Estate Issues (see page 9) and at www.cre.org/programs_and_events/high_level_conference.cfm.

I OUGHT TO START WITH A BIT OF GOOD NEWS, given that if you open the newspaper this morning, it doesn't look like the world is in very good shape. But it does seem to me that—if you consider the world as a whole—a great deal of mankind is undergoing a very rapid and positive process of modernization.

India and China are the two most populist countries in the world. China's economy has grown more than 10 percent in the last calendar year and India's is up around 8 percent. They're really at the top of growth statistics for the world, and this is remarkable for countries that together have about 2.2 billion people. This process of growth over the past three decades has lifted several hundred million people out of poverty.

So for a fairly important and large part of mankind, the basic pattern is a very positive one of growth and development. Incidentally, this is what my book called *The End of History and the Last Man* is about—that this process of modernization is a unified one. When I wrote it, certain consistent things were happening; for example, the empowerment of women. One realization that typically occurs in a growing modern society is that it makes no sense to exclude 50 percent of the population from the labor force, so now we're seeing more women working outside the home in places like India, China and other parts of East Asia that have modernized.

Now, the big question has to do with politics. India has been a democracy since it became an independent country, but China is an authoritarian country and has been very successful as an authoritarian modernizer. Will China's growing wealth lead to a democratization of its political system? I don't know.

Generally speaking, democracies can happen at any level of development, but they tend to stick much better and consolidate when per capita gross domestic product reaches about $6,000. China isn't there yet; it's around

About the Author

Francis Fukuyama, Ph.D., *is the Bernard L. Schwartz Professor of International Political Economy at Johns Hopkins University. He has written extensively about democratization and international politics, the role of culture and social capital in modern societies, and the consequences of the transition to an information economy. In his most recent book,* America at the Crossroads: Democracy Power and the Neoconservative Legacy *(see review in* Real Estate Issues, Volume 31, N 1, Summer 2006*), he offers a critique of the neoconservatism that has shaped the Bush Administration's foreign policy and proposes an alternative that balances neoconservative idealism with realism. This work along with his six other books, including* The End of History and the Last Man, *are influencing the dialog that shapes how the U.S. relates to the rest of the world.*

$2,000 or $2,500 so it's got quite a way to go. But Japan, South Korea and Taiwan opened up their political systems when they hit that level; the same could happen in China simply because it's very hard to have good government over a long period of time without accountability.

That's basically what a democratic political system is all about. If the people in power are corrupt and mess up in a big way—poison a river or become embroiled in a scandal—there's a way to throw them out. China doesn't really have that kind of a system right now. So the question is: As people get more educated, as they own property, as they connect more to the outside world, will they demand to be able to participate in politics as well? As I said, I don't know the answer. China is not Taiwan and South Korea. It's a much bigger, more complex society. So we will simply have to see.

But the whole question of whether China democratizes begs a larger theoretical argument that, in a sense, I've been carrying on with Samuel Huntington, my former mentor at Harvard University and the author of several books. His two most recent are *The Clash of Civilizations and the Remaking of World Order* (Simon & Schuster, 1998) and *Who Are We? The Challenges to America's National Identity* (Simon & Schuster, 2004), which I will refer to when we start talking about immigration.

Not everybody in the world thinks of himself or herself simply as an individual. Frequently, people think of themselves as members of groups, and those group identities are much more important to them than their identities as isolated individuals. What has never been fully established in the political theory of many modern liberal democracies is the extent to which modern societies need to show deference to groups rather than individuals.

Huntington is a good friend of mine, but we disagree about some very basic issues. One of the issues we disagree about is how central culture is to the development of modern institutions. I think he would say something like: Westernization and modernization are separate things and you can have modernization without having Western values. Therefore, it's possible to imagine an Islamic republic of Iran that produces cars and semiconductors and participates in a modern economy, yet is run by a group of poorly educated mullahs. I also think he would say that Western liberal democracy, the sort of system we enjoy, is not a universal aspiration or a form of society that all people eventually will evolve into because it has very definite roots in a certain kind of European Christian culture.

The nub of the question really revolves around that view. To what extent is modern democracy the result of the evolution of people living in basically Christian societies? There's a lot to this argument if you look at it historically.

CHRISTIANITY AND THE EVOLUTION OF DEMOCRACY

Many great philosophers such as Alexis de Tocqueville and Georg Wilhelm Friedrich Hegel and Friedrich Nietzsche have argued that modern democracy is basically a secular form of the Christian doctrine that all human beings are universally equal under God. In the Enlightenment, too, this concept was shorn of its religious content and turned into a secular doctrine of universal human rights. Therefore, other societies that do not start from that Christian starting point will not evolve similar beliefs in universal rights and all the political structures based on this structure.

My view is different. I disagree because I think that Huntington is undoubtedly right that the origins of modern democracy lie in European Christian culture. But I think that once the doctrine is invented and elaborated, it becomes a kind of universal property that other societies can enjoy. An analogy would be the scientific method. The scientific method was invented in Europe at a certain point in the early modern period by people such as Francis Bacon and Rene Descartes. This method of experimentation and use of empirical data surfaced in Europe at that particular time for very specific historical reasons, but afterward anyone could use it.

It doesn't matter whether you're African or Chinese or Latin American, the scientific method produces certain results, and people use it regardless of where it came from culturally. I think many institutions of modern democracy are a bit like that. Though they may have had their historical origin in European Christian culture, they are useful for a lot of other people who don't come from that background.

Take modern India, which has absolutely none of the structural conditions that social scientists point to as supportive of a democracy—just this question of equality. The traditional Hindu society is stratified into many different castes; there's no universal equality. Yet India has had one of the most successful and stable democracies in the world because in this extremely diverse and complex society, it keeps government accountable and responsive to the local needs of different constituencies.

That's an example of how the political system comes out of one cultural setting and is transferred to another where it works fairly well. The big issue is how important culture is to this process of modernization and, as countries modernize, will there be a continuing convergence in the kinds of institutions that exist?

GROUP RECOGNITION IN INDIVIDUALLY DIVERSE SOCIETIES

Now, we get to the bad news. There are still a lot of problems in modernizing societies as they develop, including those in Western Europe and the United States. Many problems have to do with the continuing question of culture and identity. Though I believe culture is not fully determinative of whether you can have a liberal democracy, it certainly creates a lot of important challenges for democracies.

Now, with your indulgence, there's a bit of political theory involved here because there's an unresolved issue in the way we think about our politics and that, I think, is at the core of some of our contemporary problems with issues such as multiculturalism. When John Jay wrote *Federalist I*, he talked about the United States being blessed with one people, one language, one religion. And at that time the United States was, in fact, that. He was forgetting about African-Americans and Native Americans, of course, but basically the European settlers of North America were white Anglo-Saxon Protestants.

Cultural diversity was a non-issue, and the original theorists of modern liberal democracy—including John Locke and Thomas Hobbes—really conceived of the problem of a free society as the freedom of individuals from the power of the state. And when we think about the U.S. Bill of Rights, we think of it as rights that protect individuals from the power of even democratic majorities in a liberal democracy.

The problem is that not everybody in the world thinks of himself or herself simply as an individual. Frequently, people think of themselves as members of groups, and those group identities are much more important to them than their identities as isolated individuals. What has never been fully established in the political theory of many modern liberal democracies is the extent to which modern societies need to show deference to groups rather than individuals.

When groups want recognition, to what extent does our tolerance and pluralism—or our belief in tolerance and pluralism—require us to give official recognition rights? The issue becomes particularly acute when that minority is formerly despised or outcast or marginalized in the society and, therefore, the demand for equal recognition is particularly large. This hole in the theory about group recognition is the hole through which the truck of multiculturalism has been driven.

In some sense this concept started with Canada, which was the first country to seriously embed multiculturalism in a modern democratic political system—a policy that came about because of the demands of the Québec nationalists for a separate recognition of linguistic and other rights in Québec. The Meech Lake Accord outlined an amendment to the Canadian Federal Charter that permitted Québec to pass linguistic laws making it illegal for ethnic French Canadian citizens, and even immigrants to Québec, to send their children to English-speaking schools.

That kind of law wouldn't be legal anywhere but in Québec. If you went to Alberta or British Columbia, you couldn't have such a law. So if you say modern constitutionalism is equal protection under a uniform constitutional system, the Meech Lake Accord violates it. It allows for special rights for ethnic Francophones in a way that violates a certain basic liberal principle.

In Europe you get a lot of these variations, too, because they come out of a much more corporatist history where there's recognition of the Catholic and Protestant churches, and different kinds of corporate groups. But this general pattern of groups demanding recognition of group rights is now almost universal, and has been driven by other groups including homosexuals, women and African-Americans. Indigenous people all over the world are demanding protection. And not just as individuals under some form of constitutional democracy; they want recognition of their status as members of groups with special rights.

For the most part, these demands have been neuralgic in the U.S. political system with affirmative action and similar issues. But even in the case of the Québec nationalists, I think that though this policy might be really irritating to Anglophones in Western Canada, it's not the end of Canadian democracy. It's a small deviation from a general liberal principle, and nobody's going to go to war over stopping the Québécois from demanding these group rights. The basic liberal order is still there.

But what happens when those group rights become much more serious in ways that challenge some fundamental principles of equality and democracy in a democratic society? That's the question that is now arising in Europe with Muslim populations.

THE ROLE OF MODERNIZATION IN RADICAL IDEOLOGY

At this point I want to back up and switch to the second issue, which has to do with my particular interpretation of radical Islamism: what it is, what the terrorist problem we're facing is—and this broad foreign policy challenge that has led to intervention in Afghanistan and Iraq and that, obviously, is continuing. The basic argument I'm going to make is that the problem that we're facing from these radicals is fundamentally not a cultural problem or a religious problem, but a manifestation. It's a severe manifestation of the same kind of milder identity politics that exists in places like Québec.

Sociologically, the drivers of modern identity politics and adherence to radical Islamist doctrines are remarkably similar. That is to say, you wouldn't get this kind of radicalization in a truly traditional Muslim society. But it does occur when those traditional societies meet the modern world. Therefore, radicalization is as much a product of the modernization process as it is of any kind of traditional form of Islam.

This viewpoint gets plenty of responses from angry readers. They say: Don't you understand that the problem we've been facing since Sept. 11 is the religion Islam?

Sociologically, the drivers of modern identity politics and adherence to radical Islamist doctrines are remarkably similar, Fukuyama says.

Islam is a highly intolerant, militant religion. If you read the Koran and the Hadith, it proclaims a need for perpetual jihad and intolerance. Unless you change the religion you can't deal with this problem.

I agree that religion is an important part of what's happening, but that interpretation is just a manifestation of the essence of the religion Islam and is wrong because if you live in a truly traditional Muslim society, you don't have any reason to be unhappy with your identity. Your identity is fairly clearly set for you by the surrounding society.

Islam, like Judaism, is a very legalistic religion. What it typically means to be a believing Muslim is to follow a whole series of rules that are set down in the Koran and the Hadith as well as by countless interpreters, mullahs and fatwahs that prescribe virtually every aspect of your behavior. In a traditional Muslim society, this framing of identity begins with the family, but also includes the local mosque, the village. In many Muslim countries, local regions have their own saints that they worship in various traditions, all the way up to the state, which is the ultimate guarantor and protector of religion.

In this kind of society, you absolutely know who you are. All you have to do is follow the rules that are prescribed for you and that qualifies you as being a Muslim believer. Identity questions really don't come up. I think the problem arises when you take a person out of this traditional society and move that person to Rotterdam or a French suburb or some other place—Hamburg or Berlin—a neighborhood in which none of those assumptions about the social supports for your Muslim identity exist.

OFFERING IDENTITY TO SECOND AND THIRD GENERATIONS

By the way, this is not my original interpretation. There's a very interesting book by French Islamic scholar Olivier Roy called *Globalized Islam: The Search for a New Ummah* (Columbia University Press, 2004; see review in *Real Estate Issues, Volume 31, Number 1, Summer 2006*) that I'm borrowing from very heavily. Waugh says the real problem with radical Islam is its de-territorialization and globalization of Muslims and the Muslim diaspora. When you take people from traditional societies and move them to places in Western Europe or elsewhere, all of a sudden identity becomes a big problem because they simply do not know who they are. This problem is particularly pressing in Western Europe, where these immigrants have a much more difficult time integrating into mainstream societies than in the United States.

Obviously there are many differences in that comparison, but I think it is broadly true. And it explains why so many of the radicalized people are second- or third-generation Muslims who were born in Western Europe or other modern societies and grew up in that context.

Think about it. Mohammad Atta, the ring leader of the Sept. 11 attacks, was an engineering student, middle-class Egyptian, but he was radicalized in Hamburg, Germany. Mohammad Bouyeri, who killed Dutch filmmaker Theo Van Gogh in Amsterdam about three years ago, was a second-generation Muslim born in Holland. He went to a Dutch high school, spoke fluent Dutch and yet perpetrated this act. We've now seen the first anniversary of the July 7 attacks in London and, again, these are all British citizens, born in the UK. They ate fish and chips and watched rugby until they were 17 or 18, then all of a sudden they get seduced by this particular ideology. There's a whole series of cases like this where the radicalization is not occurring in some cave in Afghanistan. It is occurring in the heart of modern, democratic, liberal, tolerant Europe.

In fact, going to Afghanistan is something you do after you've been radicalized in the modern world. Roy's explanation is that this act as a version of identity politics. The first generation of Muslim immigrants to Europe came with the cultural values of the local village and doesn't face an identity problem. But the second- and third-generations are not successfully assimilated into the local identity. They don't feel Dutch or French or German, and this produces an acute sense of what sociologists call loss of identity, or anomie. They don't know what rules they're supposed to operate under, and that's the point at which the appeal of someone like Osama bin Laden becomes very persuasive.

He says to them: I'll tell you exactly who you are; you are a member of a universal Muslim Ummah that stretches from Tangiers to Jakarta. It's a kind of universalist, very purified version of Islam that's been stripped of all of the local saints and customs and traditions that make up life for a truly traditional Muslim. And so in a way it's a much more ideologized version.

This radicalism also involves a good deal of modern ideas. If you look at the history of Islamism, starting with the Muslim brotherhood in the 1920s in Egypt, they import many ideas from radical political movements in Europe at that time—ideas like civil society and the state, revolution, the aestheticization of violence. Hassan Al-Bana, the Egyptian founder of the Muslim Brotherhood, actually dressed his youth corps in shorts and did outdoor exercises because that's what Mussolini's fascists were doing in Italy.

So there is a kind of melding of modern European political ideas with religious ideas coming out of Islam that get combined in this modern, well, semi-modern ideology. And that is the doctrine that appeals to these second- and third-generation Muslims searching for their identity.

If you agree with this interpretation, it's a little hard to know whether it's good news or bad news. You could say it's good news because we've seen this before, not from Muslims but from other alienated people in Europe. In the 1890s, they were anarchists; in the early 20th century, they were Bolsheviks or fascists; and a generation later they were members of the Bader-Meinhof gang. These groups saw radical ideology as a way to solve their personal identity problems.

DOES ISLAM NEED A REFORMATION?

So why are these ideas that have been around for more than 100 years appealing, particularly in Western Europe? I think you have to explain this phenomenon in terms of an emergent identity problem that is precisely the result of modernization and globalization; where individuals are struggling with these issues and aren't isolated in a little village that's cut off from ideas in the broader world.

In a sense, it's familiar. The problem with that familiarity is that it's also extremely dangerous. The wars of the 20th century were consumed with neutralizing radical ideologies that took hold of entire nation-states and made international relations extremely difficult.

Islamic radicals now are influential in one important nation, Iran, and may gain power in others. But at this point they're not taking over like in the Soviet Union or Nazi Germany, and I question whether that's in the cards. Nevertheless, we need to realize that even though it's a familiar problem, it's still a very dangerous one.

It also means that in a certain way, the Bush administration's analysis of the problem is 180 degrees off. After Sept. 11, the Bush administration analyzed the problem and implemented a policy to try to fix it. Bush and his advisors based their policy on the theory that the root cause of this kind of Islamic radicalism was the lack of democracy in the Middle East. If this interpretation is correct, though, the causal relationship is almost exactly backwards.

I'd argue that modernization and democracy produce the alienation that leads people to be susceptible to this kind of radical doctrine. In fact, more modernization likely would encourage more terrorism, not the reverse. I support the Bush administration in trying to promote democracy because I think in the long run it will lead to a more stable situation. But in the short run, it probably will spur additional problems.

There's one interesting suggestion that Roy makes about where this all may lead. He and other scholars who study the world of modern Islam have lamented the fact that there's been no equivalent of the Reformation in Islam—no Martin Luther who stood up and argued for a more modern version of the religion that would be compatible with modern capitalism and democracy. Roy actually suggests that we do have a Muslim Luther living among us. We just haven't recognized him. His name is Osama bin Laden.

Luther was not a modern liberal or a believer in pluralism and tolerance and everybody getting along with everybody else. What Luther did was disconnect the practice of the Christian religion from the external observance of social rules. The Catholic Church at the end of the Middle Ages was all about confessions and rosaries and buying indulgences. Luther said no, that's not the essence of the Christian faith. The essence of the Christian faith, he said, is the direct connection that every believer can have with God by reading the Bible—not external observance of any rules laid down by the Catholic Church.

Roy's argument is that, in a sense, this is happening in Western Europe with the evolution of Islam in these secular lands. Many modern Islamists have argued in a way parallel to Luther that what it really means to be a Muslim is not obeying all of the social rules laid down by the outside society. It's the inner belief that matters.

If this understanding of what it means to be a Muslim takes hold, it may eventually, as in the Christian West, lay the basis for a much greater separation of church and state. Observers often criticize Islam for not clearly separating the realm of private belief from politics, but it's possible this practice may be evolving.

TRANSCENDING RELIGIOUS-BASED VALUES TO BUILD NATIONAL IDENTITY

The next question is how countries will deal with this kind of challenge, not just the Muslim challenge. When considering identity politics it is important to distinguish and talk a little bit about where identity comes from in modern societies because it's very different in the United States and in Europe.

In any modern society that is open and pluralistic, identity has always been weak. But I think that in the United States, people have a stronger or clearer sense of national identity—and one that is easier for individuals who are culturally different to adopt—than immigrants in Europe.

So what is American identity? A great sociologist, Seymour Martin Lipset, wrote that America's strong identity is built around a political creed that focuses on values such as individualism, equality, liberty, laissez-faire and populism. These are creedal ideas not rooted in ethnicity, and are potentially open to people around the world. They're about loyalty to the American Constitution and the founding principles of liberty and equality, which are the foundation of the country. Therefore, it's a political identity that is much more accepting of people who leave other countries and settle in the U.S.

Now, to get back to Samuel Huntington, the first half of *Who Are We? The Challenges to America's National Identity* discusses the question of American identity in detail. Yes, he writes, there's this creedal identity that Lipset talks about, but religion and the Anglo-Protestant culture also are important. He says if North America had been settled by Portuguese, Spanish or by French immigrants, it would look like Brazil, Mexico or Québec.

The unquestioned cultural value of a work ethic and the belief that it is work—your labor—that gives you dignity as a human being, is something that is very broadly shared. And not only among white Anglo-Saxon Protestants; it's a general legacy that all Americans have.

But it doesn't. It looks like the United States because it was settled by people who came from a dissident sectarian Protestant tradition in England and formed the dominant culture in the United States. Many people don't like to hear that our culture is religiously rooted, but I think as a matter of historical fact that is absolutely the case.

I agree with Huntington that religion was important, that in many respects that culture has been torn away from its original religious and ethnic roots and has become a more general property of Americans as Americans. For example, Huntington has a chapter that revisits Max Weber's argument that American work ethic is linked to this Puritan form of Protestantism coming out of the Reformation that was particularly important in the Puritan sects that settled New England. Empirically, there's no question that this is true. Americans just work their heads off. If you look at hours worked per year, Germans work about five or six weeks less than Americans and virtually every other European country works a great deal less.

But if you think about the United States and who works hard in this country right now, it seems to me that it is as likely to be a Russian cab driver or a Korean grocery store owner or a Mexican day laborer as a white Anglo-Saxon Protestant. The cultural value, the unquestioned cultural value of a work ethic and the belief that it is work—your labor—that gives you dignity as a human being, is something that is very broadly shared. And not only among white Anglo-Saxon Protestants; it's a general legacy that all Americans have.

MOVING BEYOND ETHNIC NATIONALISM

On the other hand, many Europeans think that dignity comes through the support that the state gives you through social solidarity rather than your own work. I think this values dimension is important, but you also have to be a little bit careful about associating it too closely with religion or ethnicity.

Another important aspect of American culture is our tremendous ability to associate in informal voluntary organizations. Alexis de Tocqueville wrote about this after visiting the United States. He said that in his native France you couldn't get 10 Frenchmen to work together for a common cause, and that was one of the problems with French democracy. But the United States had numerous Bible study and abolitionist and temperance groups.

If you ask where these organizations came from, the dominant answer probably would be some form of Protestant sectarianism because American Protestantism wasn't organized as a centralized state religion like the Roman Catholic Church or other state churches in Europe. It was organized on the basis of a pluralistic competition of different sects that had to appeal in a very decentralized way to get members.

I think Europeans are much more confused about these identity questions because at an official level all European governments subscribe to the basic notion that nationalism and national identity is what got them into the World War I and World War II as well as the Holocaust. The whole European project since 1945 has revolved around rebuilding European identity on a non-national basis; to transcend being German or Italian or English and, in some ways, resemble the American political identity. The goal is to have an identity that's grounded on political ideas—not race, ethnicity or religion—and is potentially universal and open to all people.

Yet for the last two generations, the national-level identities have not been quite politically correct. That's particularly true if you were on the losing side of World War II or had a fascist dictatorship, where people had a national identity that they wanted to run away from.

Germans typically have taught their children not to cheer for German teams, though I heard they started to come around at the 2006 World Cup tournament. Another example comes from a friend of mine who was a child in Spain during Francisco Franco's rule. She says that as a young woman she was ashamed to travel around Europe with a Spanish passport because of the bad associations linked with Spanish identity. In different ways, national identity has really not been a comfortable thing for many Europeans.

On a popular level, though, nationalism absolutely has not disappeared. Italians and French and Dutch all understand that they do have a set of cultural traditions. They're not officially written down or defined, but are embodied by things like holidays, foods and various inherited social practices that remain very much linked to ethnicity and religion.

In fact, these traditions were legally linked in Germany until the country changed its citizenship law in 2000. Before then, people had to have a German mother to be eligible for German citizenship. If you were a third-generation Turk immigrant who grew up speaking only German, you could not become a German citizen, but an ethnic German coming from somewhere in Eastern Europe could get instant citizenship without being able to speak a word of German. Even in the legal structure there was support for this ethnic understanding of national identity, and I think this one of the problems that makes it difficult to integrate Muslims today.

AS POPULATIONS DECLINE, IMMIGRATION IS KEY FOR SUCCESS

I also shouldn't overlook the matter of numbers. Nobody really knows how many Muslims live in France, but it could be as much as 10 to 12 percent of the population. That's a larger percentage than the U.S. African-American population. Meanwhile, less than 1 percent of the U.S. population is Muslim so it's a little difficult to draw generalizations about how well the United States has integrated Muslims.

Another factor is labor laws, which in Europe discourage low-skill workers from getting jobs. Many Muslim immigrants come basically for the welfare system; in Rotterdam, for example, something like half of the immigrant population is on welfare rather than having employment in the regular economy. In the United States, I think most people who immigrate, including the ones that immigrate illegally, come here because they want to work.

To wrap up, I think that first of all, in dealing with these cultural issues, there is no question that immigration and the way that you deal with culturally different minorities is one of the most crucial problems that modern liberal democracies face. I know of only one modern liberal democracy—Japan—that has tried to deal with it by simply excluding immigrants, and Japan has had a declining population for the last five years.

The Japanese workforce is getting smaller every year and that rate of decline is going to accelerate. There are entire villages where residents are 70 years and older, and there are no children being born. The total fertility rate in the greater Tokyo area has fallen to something like .98; that's the average number of children per woman per lifetime.

Europe also is experiencing a population decrease. Total fertility rates in Mediterranean Europe are around 1.2, and the situation is similar in Russia. Taking this into consideration, the idea that somehow countries can get along without infusions of people appears illogical.

It's always seemed to me that dealing with minority populations in a positive manner is crucial to countries' long-term success. And countries that can assimilate people into a dominant culture that can put them to work—and encourage them to accept the dominant cultural values—will most likely remain strong socially and economically. It's never something that happens in the first generation; it's always a multi-generational process. But that kind of democracy is the kind that in the next 20, 30 or 40 years is going to be successful. ■

Modernization, Immigration and Conservation: Counselors Gain Perspective at High Level Conference

BY CREs KAREN G. DAVIDSON, DAVID S. KIRK, HUGH F. KELLY AND WAYNE W. SILZEL

"The program—themed A Clash of Cultures: Understanding Life in the Global Village—was a highly stimulating and mind-stretching session," said High Level Conference Chair Marc Louargand, CRE. "We heard from world-class thinkers, writers and Counselors. It was a stellar group, full of energy and ideas."

The following summaries give Counselors who were unable to attend a glimpse into the stirring presentations and conversations that took place July 13 – 16 in Park City, Utah, and describe the three major themes that emerged: modernization, immigration and conservation.

More information about the program, presentations and how to obtain audio CDs of the sessions are on the CRE Web site at www.cre.org/programs_and_events/high_level_conference.cfm.
A downloadable PDF file summarizing the conference sessions is at www.cre.org/publications/the_counselor.cfm

Security, Work, Multicultural Populations and Values

Summary by Karen Davidson, CRE
Moderator: Terrence Wilmer, Ph.D., CRE, *The Louis Berger Group Inc.*
Panelists: Daniel Rose, CRE, *Rose Associates Inc.*
Margaret Nydell, Ph.D., *professor of Arabic Languages at Georgetown University and author of Understanding Arabs*

LISTEN TO THIS SESSION ON THE CRE WEB SITE:
www.cre.org/programs_and_events/high_level_conference.cfm

THIS ABSORBING AND THOUGHT-PROVOKING SESSION pointed out the polarization of opinions and obstacles to finding solutions to the threats we face today. CRE Daniel Rose's discussion focused on the assimilation of Muslims in Western society and Margaret Nydell, Ph.D., discussed distinctions among the Arab culture, Islamic religion and radical Muslims.

Rose said divergent and sometimes opposing cultures is an issue that deserves attention. The problem will not go away if we ignore it and could become a growing threat. He cited former Sen. Daniel Patrick Moynihan, who said: "The central conservative truth is that it is culture—not politics—that determines the success of a society. The central liberal truth is that politics can change a culture, and save it from itself."

Rose expanded that concept. "The United States today faces three separate confrontations of culture," he said. "The first confrontation, between radical Islamists and the rest of our 'open society,' is a culture clash. The second, between different ethnic or religious groups in our society, and the third, involving new immigrants, are

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not culture clashes so much as sources of social and economic friction that must be resolved as painlessly and as civilly as possible."

The United States today is facing two separate and distinct types of culture clash. The first is relatively minor and likely to be resolved over time. It involves those who basically accept Western culture. The second is clearly more urgent, and unlikely to be resolved. This threat involves those who seek separation rather than integration, and promote behaviors that Western society cannot tolerate, such as the martyrdom of children, domination, destruction, beheadings, suicide bombings and destruction of artifacts deemed unacceptable to their beliefs, but are revered by others. The criminalization of acts enjoyed by people around the world, such as the recent dictate in Somalia that watching the World Cup soccer games on television was a crime, further underscore cultural differences.

CREs Daniel Rose, from left, and Terry Wilmer, and professor Margaret Nydell discuss global challenges, Islamic radicalism, Arab culture and related topics as part of the Clash of Cultures program.

One of the most difficult factors to address is that the terrorists are not only from outside the borders of Western countries, but also from within. Native-born residents of the United Kingdom and Spain—not extremists from faraway totalitarian nations—carried out bombings in those countries. What causes this to happen?

In Western society, rights are tempered by the rights of others. The religious beliefs of radical Muslims are harder to assimilate because they do not accept others' rights to have their own beliefs. Different groups identified largely by strict adherence to religion, such as the Amish and Orthodox Jews, are accepted because their religious practice does not threaten others' rights to believe differently.

Radical Muslims believe everyone who doesn't follow Islamic practices must be destroyed, and that doing so brings martyrdom and rewards. This sect is much more difficult to deal with, Rose said.

Some consider Singapore's approach—that the nation comes before ethic groups—an ideal solution. But can Western society embrace this ideal when tradition places utmost import on the rights of the individual?

"In the United States today, a number of questions perplex us," Rose said, including:

- What do Americans have in common that distinguishes us from other peoples? At one time, the so-called American Creed would have been the answer; today that identity is less ubiquitous.
- Can a cohesive open society be based only on a political and social contract among individuals? Today, some feel legal rights should be ascribed to groups as well as individuals.
- Individuals and groups can have multiple identities: "ascriptive, territorial, economic, cultural, political, social and national," Rose said. To what extent, by law or practice, should we extend to all groups the recognition and approbation they want—and demand?
- In an age of stifling political correctness, to what extent can we discuss these issues openly, frankly and dispassionately without hurling charges of racism, ethnocentrism, sexism or classism?

Western societies are increasingly acknowledging group rights. Evidence of this trend in the U.S. includes recent demonstrations over immigration. To what extent, by law or practice, should governments extend rights and recognition to various groups? Group rights are by nature at odds with the Western tradition of individual rights. Complicating the matter is the fact that individuals and groups can have multiple identities. If every group demands equal treatment, how do we balance the demands of various groups? A nation's single most unifying factor is a common language, yet we cannot demand a common language without offending groups.

POLITICAL CORRECTNESS HINDERS DISCUSSION OF COMPLEX ISSUES

Considering these questions and the environment in which they exist, the number of taboo subjects has reached an alarming level. We cannot discuss differences among groups or differences among segments of groups. Yet without discussion, we cannot find solutions.

"One can acknowledge the existence of a group known as Hispanics," Rose said, "but it is unacceptable to point out the diverse attitudes and outcomes of pre-Castro Cubans in Miami, South Americans in the Midwest, Mexicans in the Southwest, and Puerto Ricans in New York. One can discuss American blacks, but it is taboo to examine the differing social and economic outcomes of Caribbean immigrants, of recent immigrants from Africa and of native-born American blacks."

Society is treating history and literature as therapy instead of fact. Compensatory history, morale-building and raising the esteem of groups has become paramount.

Terrorism does not reflect traditional Islamic culture, but the acts of extremists have caused many people to associate violence with Islam. Terrible acts in the name of religion, however, are not new. During the Albigensian Crusade in 13th century France, knights asked Arnaud-Amaury how they could tell the good Catholics from the heretics. His reply: "Kill them all. God will know his own." Since then, the Irish Republican Army, Chechen soldiers and Basque separatists have all used violence to further their agendas.

Historically, such fervor has burned out over time. But modern technology fans the flames of radicalism. The Internet distributes propaganda worldwide in an instant, and allows it to continue circulating perpetually, inflaming potential followers around the world.

Groups that are prepared to live harmoniously in Western society will assimilate while retaining their identity. Each group will find its niche based on the way and degree to which they conform to societal norms. Previous immigrant groups did not assimilate immediately, but took several generations. This pattern likely will repeat.

MUSLIMS DON'T EMBRACE ISLAMIC RADICALISM

Nydell said Muslims are not crazy or evil, and Rose's comments do not apply to most Muslims in the United States. Fanatics represent less than 1 percent of Muslims and though that proportion is growing, most Muslims find the actions of fanatics horrifying. The vast majority of Muslims don't hate the United States, but they do understand the grievances that some Muslims express toward Western societies.

Fanatics represent less than 1 percent of Muslims and though that proportion is growing, most Muslims find the actions of fanatics horrifying. The vast majority of Muslims don't hate the United States, but they do understand the grievances that some Muslims express toward Western societies.

Nobody knows how many Muslims live in the U.S. Estimates range from 3 to 7 million; Nydell estimates 5 million. Of U.S. Muslims, only about 15 percent are Arabs, with the balance divided nearly equally among Southeast Asian, African-American, and individuals from other countries including Africa. Approximately 20 percent of the world's population is Muslim.

Islamic and Arab are not the same because religion and ethnicity are not a part of being Arab. Rather, Arabians are all people who speak Arab as a native language. About 70 percent of Arabs are Christian, Nydell said.

Muslim populations tend to be concentrated in areas such as New York, Cleveland, Detroit, Chicago and Washington, D.C. A tendency to cluster by nationality also exists. The majority of Muslims in Texas, for example, are from Southeast Asia; Iranians are the largest Muslim group in California. About two-thirds of Muslims in the U.S. are first-generation immigrants who came to the country after immigration laws were changed in 1965.

Approximately 3,000 mosques and Islamic centers exist in the U.S. The fact that about 80 percent receive funding from Saudi Arabia has contributed to public unease because Saudi Arabia practices an extreme form of Islam known as Wahabi. The sect, named for founder Muhammad ibn Abd-al-Wahab (1703–1792), regards all other sects as heretical. By the early 20th century, Wahabi had spread through the Arabian peninsula and remains the official ideology of the Saudi Arabian kingdom. U.S. politicians do not address this concern because we need Saudi oil, Nydell said.

Yet Islamic radicalism is not a religious issue. In true Islam, advocating hatred and martyrdom of children is against the law. And though most Muslims believe their image has been hijacked by fanatics, they typically don't protest because they are afraid. They have family members living under regimes that could harm them.

Hope lies with the younger generations in college who understand U.S. culture, Nydell said. Most Muslims come to the U.S. with two to three times the education of other immigrants. If they are not professionals, their children will be. They are coming with a stake in the U.S., and plan to stay. They have no problems or issues with democratic society.

Mainstream Muslims, not Western political policy, is the best counter-measure to Islamic radicalism because only they can effectively gain control of the governments that impose rule. Still, democracy is not the solution to terrorism because a functioning democracy must trust the opposition, and that scenario is unlikely in the Middle East.

TECHNOLOGY, OIL AND POWER ARE AMONG THE CAUSES OF FANATICISM

Terry Wilmer, Ph.D., CRE, summarized the discussion by saying the panelists agree that there is not a monolithic group of Muslims out to make Western society miserable. He cited author and professor Francis Fukuyama, who said the source of radicalism is a lack of identity, and this problem is what drives fanaticism around the world. One of the reasons for Adolf Hitler's success was the lack of identity in Germany after World War I. He provided an identity and the rules for society to follow.

In a world where communication is instantaneous, a terrorist can perform a single act and have it replayed around the world. It heightens the sense of fear, and when people feel weak and vulnerable, they like to form constructs. On the other hand, communication can expose restricted societies to outside experience. The Cold War did not end with a clash of arms between the West and the Soviet Union; it ended because of communication. People in the Eastern Bloc were asking why those in the West lived so much better.

Other global issues contribute to the establishment of fanaticism, too—especially energy dependence. If there were no oil in the Middle East, Wilmer asked, would the U.S. be as involved in the region as it is? U.S. policies don't sufficiently address increasing environmental issues, either. As wealth in India and China grows, so does the impact their enormous populations have on the environment.

There are terrorists, and Western nations will be attacked. That is a given. The question is: What should we do about the issues that cause the problem?

Individuals are responsible for assimilating, but elements that unify the U.S. population are disappearing. Common language is the strongest unifying factor, and bilingualism is increasing across the country. Subtle changes in U.S. society are leading to increasingly isolated groups, Wilmer warned.

Oil and power are linked, and are a large part of the collective problem. Terrorism will not recede until the larger issues are resolved, but this era of extreme political correctness has made many important subjects taboo and hampers the ability to discuss solutions.

How Other Cultures Have Adapted to American Life

Summary by **David S. Kirk, CRE**

Speaker: **Peter Skerry, Ph.D.**, *professor of political science at Boston College and Brookings Institution senior fellow*

PETER SKERRY, PH.D., WELCOMED THE OPPORTUNITY to communicate clearly and candidly about domestic multiculturalism. Acknowledging that assimilation is a loaded word and has been for some time, he said that U.S. immigrants are indeed assimilating. Further, assimilation is part of the immigrant success story and the success of U.S. society.

Skerry defined assimilation as something between a coercive, painful and undignified shedding of individual identity and a benign, positive, nurturing embrace of freedom-seeking masses. It is a complicated and extended process that takes many forms. U.S. society, more open than any other, allows for groups and pluralism, Skerry said. Though immigration groups certainly change, assimilation has been a two-way street—a multidimensional evolution with cultural, social, political and economic aspects. The history of U.S. immigration includes conflicts and competition, rambunctiousness and outspoken opposition.

Assimilation is a loaded word, Peter Skerry says.

ASSIMILATION BY THE NUMBERS

When considering separatist elements in the U.S., it is interesting to compare Hispanic and Muslim immigrant groups. Hispanics typically assimilate quickly, but many Muslims reject the basic tenets of U.S. society. A large segment of the U.S. Muslim population is uneasy with some aspects of Western culture and society, but appreciate religious liberties guaranteed by the U.S. Constitution. Many Muslims in the U.S. aren't experiencing a clash of civilizations, but do retain different cultures and values.

The Hispanic immigrant population numbers 35 million people mainly from Mexico, Cuba and Puerto Rico. Because of the language barrier and general lack of education among Mexican immigrant households, the second generation often assumes authority over the first in matters such as health, medicine, shopping and securing family services. As an indication of Hispanic assimilation, 50 percent of third-generation immigrants marry outside the immigrant group and many become Protestant—evangelical Protestant.

The Muslim population in the U.S. numbers at least 2 to 3 million, and the bottom line is they assimilate. Most Muslims in the U.S. are not Arabs, and most Arabs in the U.S. are not Muslims. The larger if not dominant group of Muslim post-1965 immigrants is middle class with professional heads of household. Muslim parents are successful in slowing their children's assimilation—particularly with regard to social behavior such as sexual activity and alcohol consumption—and they retain parental authority, which often is lost in Mexican households.

The Muslim community experiences greater cultural gaps than the Hispanic community, Skerry said. Muslims appreciate religious freedoms in the U.S., but many feel targeted, and some are rejectionists. Their general response to the Sept. 11 terrorist attacks has been to open up mosques and become politically active. They are sensitive to surveillance and suspicion.

Skerry's knowledge of immigration data and the stories behind the data is derived from his extensive research. He said that U.S. schools and health systems are overburdened by immigration, both legal and illegal. The issues are complex, and vary from place to place and group to group. Assimilation for second and third generations can be more challenging than the first generation, he said, because first-generation immigrants know they're better off. But later generations who are driven to compete can be under-equipped and undereducated when compared with others in their age groups.

U.S. society tolerates group identity, which leads to a form of multicultural integration. Still, expectations for immigrants' success may be too high. To better support assimilation, communities could offer language and outreach programs that help immigrants achieve their financial, educational and societal objectives. The issue of immigration should be a high priority and needs greater order and accountability at all levels of government, Skerry said.

Adapting American Business Practices to a Multicultural Future

Summary by Hugh F. Kelly, CRE

Speaker: David K.Y. Tang, Esq., *partner at Preston Gates & Ellis LLP, chairman of the Federal Reserve Bank of San Francisco board of directors and past president of the American College of Real Estate Lawyers*

DAVID TANG, ESQ., OUTLINED FOUR CRITICAL ASPECTS on the international scene: the movement of capital, ideas, cargo and people. To elaborate:

Capital is available as never before. The volume and velocity of capital flows have increased, forcing asset values higher than ever—with the consequence that returns are lower than ever. Barriers to capital flows have decreased substantially in recent decades. The only time capital flows were comparable was 1910–1914, a brief period that ended suddenly when World War I broke out.

David Tang asserts that to date, China is the biggest winner in globalization.

Modern technologies transfer ideas with remarkable speed. CNN is ubiquitous, and the Internet gives everyone with a connection access to information worldwide. Wireless phones enable communication capability that is not tethered to location. Many governments see these breakthroughs as threatening. The so-called "color" revolutions—the Green revolution, the Orange revolution and so on—are facilitated by information access that governments can no longer control.

Cargo movement between nations links them economically. The explosion of world trade in goods is a tangible measure of this linkage. Tariff barriers are low, and this situation is emblematic of open borders. Containerization has allowed this movement to increase exponentially.

People take advantage of easier, cheaper travel—especially with international fares that are low compared with domestic transportation. Even putting immigration aside, the movement of people for personal and business travel has exposed millions to first-hand experience of other countries and cultures.

All these trends suggest that national borders are losing their relevance—a frightening prospect for those concerned about immigration flows. These are globalizing forces. Tang cited Thomas Friedman's book *The World Is Flat: A Brief History of the Twenty-First Century* (Farrar, Straus and Giroux, 2005), which recognizes that there are winners and losers, but globalization is a fact and is not going to go away. It also raises the question: What happens when a homogenous society encounters other cultures?

China is the biggest winner in globalization to date, Tang said. The country has net inward investment annually of $700 billion per year, its gross domestic product growth has been 9 percent per year for more than a decade, and it has a 40 percent savings rate. By all measures, growth is continuing and broadening. On the information front, Internet and cell phone use is soaring, and Microsoft and Google have set up research centers to take advantage of China's technical talent. The nation already has a 21 percent share of world semiconductor use and has become known as the factory to the world.

DISPELLING MYTHS: ECONOMIC ASPIRATION DRIVES BUSINESS PRACTICE

Some myths about China need to be dispelled, Tang said. Some still think of it as the "mysterious East" where familiar Western concepts do not apply. But Chinese acceptance of the profit motive is clear and, thus, businesses have adopted Western principles and instincts. It is getting faster to complete deals and, at least for business, the legal system is reflecting an "imperialism of the American legal system." Chinese business practice incorporates contract terms, financial terminology and measurements common in the West.

"The caravan is moving," according to Friedman, and as it does, many nations in the Middle East are watching. But China is on the caravan. Though democratization is lagging, Tang expressed interest in Francis Fukuyama's observation that a $6,000 per capita GDP threshold could be a trigger point where economic prosperity lays the condition for democratic politics. He noted that U.S. Treasury Secretary John Snow's comment that "China should be more like us—use more consumer debt" is unlikely. It is a mistake to believe China will become like the U.S., Tang says.

He also discussed problems that the government has swept under the carpet, including:

- Social order and stability for 1.3 billion people outweighs individual liberties.
- Income and urban vs. rural disparities spurred 70,000 riots last year.
- Corruption is widespread.
- 70 percent of rivers are polluted, and industrialization is exacerbating air and water contamination.
- Citizens lack a common belief system—not only in religion, but also in the legitimacy of political order.
- All land belongs to the state; there is no private property.
- Entrepreneurs cannot incorporate a business and own shares; the Chinese language doesn't even have a word for "stakeholder."

- "Rule of law" means something different than in Western societies. In actuality, a more accurate phrase would be "rule *by* law," meaning law is the instrument by which power is exercised.
- Because Chinese culture regards competition differently, a friend-or-foe mentality exists with regard to trade balance, resource scarcity, commodities, and energy, which affects world prices.
- The Chinese government's oil partners are countries such as Sudan and Kazakhstan, which have poor or nonexistent relations with Western countries.

Our Post-Ethnic Future

Summary by **Wayne W. Silzel, CRE**

Speaker: **Joel Kotkin**, *author and Irvine Senior Fellow at the New America Foundation*

THIS SESSION PROVIDED INSIGHT into the effect of immigrant groups on the shape and characteristics of U.S. cities and suburbs. Joel Kotkin has studied the multigenerational patterns of ethnic groups and immigrants in U.S., Canadian and European cities, and has developed a vision of a post-ethnic future.

Kotkin is the author of two books, *The City: a Global History* (Modern Library, 2006) and *The New Geography: How the Digital Revolution Is Reshaping the American Landscape* (Random House, 2000), which outline in detail his position and thoughts. He considers the term "future"

With immigration fueling 50 percent of U.S. population growth, Joel Kotkin says the issue should receive a great deal of attention from national policymakers.

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to mean 30 years hence, and said that what occurs in the post-ethnic future will not be a racial or ethnic problem.

He perceives U.S. culture as most similar to that of Canada and Australia, and most closely aligned with Australia. These countries have focused successfully on the integration of immigrants into a common culture. European countries do not follow the same pattern; instead, they isolate immigrants. Racial, ethnic and nationality distinctions are much greater in Europe than the U.S., Canada or Australia. Europeans don't embrace the legal and social structure of the U.S. or the alignment of immigrants with U.S. national identity—meaning that Americans are Americans regardless of origin. Europe is composed of ethnic states, and Europeans don't perceive the unique aspect of U.S. culture, which crosses state and local lines to form a national identity.

IMMIGRATION FUELS NATIONAL GROWTH AND DIVERSITY

Even the first wave of immigration to the U.S., from 1640 to 1840, was diverse; non-English citizens accounted for one-third of the signers of the Declaration of Independence. The second wave, from 1840 to 1880, was key to settling major eastern cities and sparked the industrial revolution, providing labor and expertise. The third wave, from 1880 to 1920, brought the highest percentage of non-Anglos: Italians, Yiddish, Balkans and others.

Henry Goddard tested the immigrants moving through Ellis Island in 1912 and determined that 87 percent of Russians, 80 percent of Hungarians, 79 percent of Italians and 83 percent of Jews coming to the U.S. were "feeble-minded" because of language barriers. The current wave of immigration, which began around 1970, reflects an ethnic diversity that is wider and deeper than any previous waves of immigration.

Now, 50 percent of U.S. population growth is fueled by immigration, either newcomers or their first-generation birth rates. However, birth rates of second- and third-generation immigrants decline and are in line with national statistics.

This growing population is fueling construction. Researchers estimate that by 2050, 50 percent of all real estate development in the U.S. will have been built after 2000.

How the Emergence of the Chinese Economy Will Change the World

Summary by **Wayne Silzel, CRE**

Speakers: **Patrick Cheung**, *executive director of QED Global Ltd.*
Rick Schulberg, *Executive Director of the China-U.S. Center for Sustainable Development*

THIS SESSION EXAMINED THE NEAR- AND LONG-TERM prospects for the Chinese economy and how its evolution will impact the U.S. and the rest of the world economically, politically and socially. Speakers addressed the workings of the Chinese economy and transaction market, and the emerging role of the Chinese middle class.

Patrick Cheung—a U.S. citizen living in San Marino, Calif., who leads a Hong Kong-based advisory firm specializing in Chinese real estate matters—said several key questions are looming. Is China the next superpower? How will its economic emergence affect the world? Though China is not a superpower today, Cheung said it has the potential to be in as little as 25 years. But can China sustain its development? And how will it interact with other nations?

Statistically, China's gross national product has tripled in recent years to approximately $1,700 per capita, creating a $2.2 trillion economy compared with the U.S. economy of approximately $30 trillion. Experts project that China's economy will grow to $16 to $21 trillion in the next 20 to 25 years.

China is undergoing globalization and experiencing a growing demand for oil, importing about 3 million barrels of oil a day compared with 8 to 9 million in the U.S. The U.S. economy has benefited in recent years from lower-priced products imported from China, perhaps providing a check on inflation in the U.S. However, these low prices are coming to an end as costs for labor and materials rise in China.

China faces some unique situations:

- The country comprises 3.7 million square miles, about 200,000 square miles larger than the U.S., and is home to 1.3 billion people, up from 1.1 billion in 1991.
- About 50 percent of China's area is occupied by only 3 percent of its population. The vast majority of people live near the coastline in densely packed cities.

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- The challenges facing China are rural vs. urban interests, and the disparity between the very rich and the very poor. The country can be viewed as a glass half-full or half-empty depending upon one's focus on its assets or liabilities.
- 23 percent of China's population is 14 or younger, 69 percent is between 15 and 64 years old, and 8 percent is 65 and older. Thus, 92 percent of the nation is younger than 65. By 2030, the age grouping will invert.
- Since China's economic emergence began, 10 percent of the population has moved from agriculture to service industries. China has 800 million farmers, many more than in the U.S., and only 10 percent of the land in China is tillable, which is much smaller than U.S. agricultural areas.
- China imports as much in resources and products—half of its oil, copper, etc.—as it exports, whereas the U.S. has a $185 billion trade deficit.
- China has $800 million in reserves, and concentrates on using those reserves opportunistically. Combined reserves of China, Korea and Hong Kong total $1.2 trillion.
- Economic reform and growth is a priority, but is hampered by a weak legal system.
- Air and water pollution are acute and a source of significant economic loss.
- China is exhausting its own resources at a rapid rate. Other countries are not draining their resources as critically. For example, Japan is 11 percent more efficient in its use of resources than China.

CENTURIES OF STRIFE CREATE DESIRE FOR POLITICAL STABILITY

The primary goal and motivating factor for the Chinese government and its people is political stability and the need for order. The population is cautious about change of any kind, fearing that change may lead to instability. The Chinese are basically hard-working people full of aspirations but willing to accept the status quo.

Patrick Cheung, left, and Rick Schulberg talked with Counselors about the rapid changes occurring in China and the impact they have on citizens and people around the world.

What drives China's development?

- People have suffered for centuries because of instability, so political stability and control is extremely important.
- An engineering mentality keeps science and technology at the forefront of Chinese culture.
- Regions and individuals place a high priority on and compete for economic growth.
- The Chinese diaspora comprises more than 50 million people living around the world.
- Hong Kong serves as a conduit for attracting capital and trade.
- Exports lead the economy, and the Pearl River Delta area leads the nation in the development of export markets.
- Political and economic focus is on regional not national growth.

China has a one-party socialist government that must exert total control to maintain stability. In recent decades, China's government has achieved two changes of authority without violence—a significant step. This concern with domestic tranquility causes the government to focus inward; 90 percent of the government's decisions are rooted in how each decision affects China, without regard for how it affects other countries.

Because the Chinese consider science and technology to be crucial to success, political leaders are trained as engineers. Provincial and city officials are appointed, not elected, and compete fiercely for foreign investment. And because each province operates as a separate entity without national oversight, duplication of services reduces overall efficiency.

China's most vital economic region is the Pearl River Delta area. It comprises less than 1 percent of the country's total land mass and is home to 3 percent of the population, but is responsible for one-third of all Chinese exports. The economy in the Pearl River Delta is built almost entirely on private enterprise. Shanghai is less privately driven and is home to publicly-owned businesses. Hong Kong is the largest investor in China's economy; Taiwan is another important investor.

The regions that drive the Chinese economy—including the Pearl and Yangtze River Deltas, and the rich coastal areas—are adjacent to very poor areas where the residents are one-third as much as their neighbors, or even less. However, a growing middle-class in China is spurring consumerism. Auto factories are producing over capacity and banks are being privatized. Government officials have expressed concern, however, about whether they can build the banks up again if they fail as private endeavors.

Cheung summarized by saying that China will not become a superpower but will become a player in the world market. He does not foresee China becoming a democracy partly because one of the most pressing issues in China is political vs. economic freedom, and the government is likely to place precedence on the latter.

In the meantime, an aging populace questions whether it will grow old before it grows rich. The 50- to 60-year-old age group has lost its values, and China as a national entity has no inherent value system to replace it. This reality may be why the fastest growing values-based group is the Catholic Church.

Cheung projects that China will become more nationalistic as it absorbs Taiwan. And though U.S. culture is popular in China now, he expects Chinese culture will grow in popularity as young people form a national identity where one does not currently exist. Many Chinese companies and businesses are becoming international in scope, which is altering the nation's inward focus. The U.S. cannot afford a failed China and has the greatest influence on China's foreign policy, trade and other global practices. It is this U.S. influence that will guide China to a stable position as a world market player.

RESOURCE CONSUMPTION AND POLLUTION LEVELS SOAR

Rick Schulberg followed with a slide presentation of demographic, economic and sociological statistics about China. (Download Schulberg's slides at www.cre.org/programs_and_events/hl_06_presentations.cfm.) He outlined the role of the China-U.S. Center for Sustainable Development, which was created to build cooperation with the Chinese government, and explained that the only choices in dealing with an emerging China are to clash, compete or cooperate. The center is working to ensure that the economy, community and nature thrive in harmony.

To build a middle class, incomes must triple compared with traditional averages. In addition, China has a "floating population"—people who are always in transit and not rooted in a given location or occupation—of about 150 million. Rural residents have not benefited from China's growth because government hasn't provided services to improve the peasant class.

China is home to one-fifth of the world's population, and the country is undergoing astonishing change. More and more Chinese are moving to urban areas, which has led to massive construction efforts. Last year, 5 billion square feet of new housing was constructed, and another 9 billion square feet will be completed in the next year. Personal incomes have risen 250 percent in the past 15 years and—except for oil—China is a larger consumer of products and services than the U.S. By 2010, experts project that China will be the largest personal computer market in the world and by 2030, the largest economy.

China's biggest challenge lies in controlling pollution as its population and economy grow. Schulberg referenced a book titled *The River Runs Black: The Environmental Challenge to China's Future*, by Elizabeth Economy (Cornell University Press, 2005), which discusses that the country has only one-fourth of the world's water supply per capita and is experiencing water shortages of 70 percent in most cities. The loss in GDP because of air pollution is acute; pervasive haze inhibits photosynthesis and causes the loss of 15 percent of agricultural crops. These limited resources, coupled with high population, make it impossible for the Chinese to reach the per capita consumption levels of the U.S., where only 3 percent of the world's population consumes 25 percent of its resources.

The center (www.chinauscenter.org), which receives support from the James E. Gibbons Educational Development Trust Fund of The Counselors of Real Estate, provides training to the Chinese, using urban new-town models for development in cities and demonstration villages in rural areas. These concepts involve the use of straw bales, Styrofoam construction and other inexpensive, energy-efficient materials, offering an alternative to fossil fuels. The program involves U.S. and Chinese investors, and is education oriented rather than philanthropic. Through the past eight years, more than 450 participants have visited 21 of 23 provinces in China. ■

FOCUS ON CHINA

Shanghai Development Takes Off, Transforming the Residential and Commercial Landscape

BY STEVE PRICE, CRE

MY FRIEND CHARLES RAGEN QUOTED ME THE OLD SAW: "Travel to China for a week, and you'll be able to write a book. Travel to China for a month, and you'll be able to write an article. Travel to China for a year, and you won't be able to write anything at all."

I cannot adequately describe the scale of what I saw in Shanghai. Its enormous size and rapid change—and its leaders' ability to make decisions and execute—is amazing. This city is undergoing a massive program of demolition, depopulation, resettlement and redevelopment—a carefully designed strategy to make it a first-class business hub for Asia, beating out Hong Kong and Singapore.

Low-density industrial and housing neighborhoods are coming down, and high-rises with plenty of surrounding green space are going up. This green space and spectacular new architecture appeal to the Chinese elite, foreign corporate workers and domestic Chinese tourists. The city's master plan, as shown in the new four-story Shanghai Planning Museum, calls for 35 percent to 40 percent green space in what was once the most densely settled city in the world. Replacement housing for this depopulation of the central city is going up in massive tracts 10 and 20 kilometers outside the city. The area around urban Shanghai is a broad river delta and floodplain, formerly a huge agricultural area. Suzhou was once the center of the silk industry. I saw an incredible amount of multi-family residential and manufacturing construction during the 90-minute drive between Shanghai and Suzhou. Engineered neighborhoods of six-story apartment buildings go on to the horizon. It's like Le Corbusier on steroids.

Looking at the immense infrastructure and real estate development occurring in China, I cannot fathom how a centralized government can manage the process. Clearly, I don't know enough about how Chinese officials prioritize, organize and carry out their projects, but I can't understand how this much development can occur without contract law, master plans, building codes and infrastructure planning. How do they avoid or limit construction defects? How do they handle construction disputes? How is financing applied to profitable projects, and diverted from poorly designed and unsupported projects?

And the development is more than just new buildings. The Shanghai city government has spent $160 million in 2005 and will spend another $200 million in 2006 to support the development and establishment of creative

About the Columnist

Steve Price, CRE, *is a principal with Terra Property Analytics LLC with expertise in consulting and appraisal of large land transactions, complex office and industrial projects, eminent domain, and nonprofit and government acquisitions and dispositions. He is the board president of the Chinese Information and Service center in Seattle and directs the organization's Facilities Committee.*

The city's master plan, above, is housed in the new four-story Shanghai Planning Museum. It calls for 35 percent to 40 percent green space in what was once the most densely settled city in the world.

businesses. "We hope to develop the creative industry as we can gain more profit through intellectual property rather than processing or manufacturing," says Le Jing Peng, deputy director of the Shanghai Economic Commission. According to an article in the *Shanghai Daily* newspaper, 18 newly built creative industrial parks provide space for 800 design companies from 30 countries. Another 18 creative industrial parks are scheduled for completion in 2006.

WHAT TO EXPECT IN THE COMING DECADES

In the next 20 years, China should continue to have an enormous supply of unskilled, semi-skilled and skilled labor. Remember: the surplus Chinese labor supply is larger than the entire U.S. workforce. As the government continues to make massive plant, equipment, and education investments, the overall gross domestic product and productivity per capita will grow. Increased productivity will partially offset rising labor and materials costs, which will result in continued low pricing on traded and manufactured goods. The definitions of value-add and traded goods will continue to expand, spurred by the efficiency and low cost of digital communications.

The cost of living will escalate rapidly, especially in urban areas. Real estate, transportation, education and medical prices have skyrocketed in the past 10 years, partially because of inflation and partially because the government is withdrawing social support. As growth continues, the government will move farther away from providing and subsidizing housing, education and medical services, and state-owned enterprises will employ fewer people.

For the bottom 80 percent of the income distribution, purchasing power parity between China and the U.S. is probably six to eight to one, or just under the actual exchange rate between the yuan/renminbe and U.S. dollar. This huge difference in cost of living and production costs is important because it underlies the major competitive advantage China has with its low production cost environment. This advantage will not disappear any time soon, especially as the U.S. continues to face very high inflation in non-CPI goods and services such as single-family real estate, medical costs and education.

As China grows, changes course, adjusts the way it deals with foreign governments, and tries to support numerous domestic industries that no longer are economically viable, many of today's issues and debates take on added dimensions. U.S. labor groups and manufacturers complain about Chinese workers' low wages and poor working conditions. But huge numbers of Chinese farm workers view factory jobs as a big step up. While visiting the Shanghai offices of a small Seattle-based importer/manufacturer, I was surprised to meet the corporate compliance officer, who inspects all of the company's contract factories to ensure working conditions are acceptable and U.S. corporate customers can buy their products with confidence. The cost advantage of Chinese manufacturing is so large that raising working standards doesn't add much to overall costs.

In Shanghai, low-density industrial and housing neighborhoods are coming down, and high-rises with plenty of surrounding green space are going up. This green space and spectacular new architecture appeal to the Chinese elite, foreign corporate workers and domestic Chinese tourists.

CHALLENGES INCLUDE MANAGING PUBLIC OPINION AND URBAN GROWTH

Managing public opinion and popular participation is the biggest single issue facing Chinese leaders. Threats range from villagers protesting pollution and growth to organized religions, trade unions and Falun Gong—a quasi-religion, quasi-exercise program. The government (i.e., the party) knows that if enough people get angry and have a common voice, they can create a big problem. And China has a lot of people to get angry.

But don't anticipate revolution. Singapore, Hong Kong and Taiwan are all successful examples of authoritarian Confucian governments that have produced massive amounts of growth and moved huge numbers of people from poverty into the middle class.

China also needs to invent a civil legal system. Right now, several old and ineffective systems are in place. The lack of rule of law and the arbitrary use of authority are serious problems. The leaders of China are ruthless and brook no dissent. At the same time, there is more internal discussion of problems in China than we are aware of. As individual wealth and communications grow, the business leaders and public likely will grow impatient with patently indulgent and all-powerful political and business leaders.

Managing the environment of urban growth is another big challenge. This issue doesn't revolve around environmental and green concerns, but infrastructure requirements. Building out infrastructure is clearly a priority and Chinese governments at all levels are certainly outspending the U.S. federal government.

GOVERNMENT'S ROLE UNCERTAIN IN COMMERCIAL REAL ESTATE

In China, appraisers are licensed through the government. After meeting with colleagues from CB Richard Ellis and Colliers International, I learned that the brokerages are required to run all valuation work on the mainland through their Hong Kong offices, where they have an appraisal license. Most of the firms' work in Shanghai is market research and feasibility analysis.

Shanghai residents gather for a morning Tai Chi session. Managing public opinion and popular participation is one of the biggest issues facing Chinese leaders.

Some of the trends they talked about sounded familiar and others were very unlike the U.S. market. China is experiencing a fairly low-yield real estate investment environment; 10 percent overall rates of return are typical for central business district office investments. Goldman Sachs recently purchased an office building on a 5 percent cash-on-cash return, but planned to make money on rolling over many older leases in the building and pushing them up to market. Second- and third-tier office buildings are being converted to residential condominiums, and capitalization rates for small multi-family and single-family residential structures are around 4 percent to 5 percent.

The land markets are largely government-controlled with most improvements constructed on ground leases from the local government. So from the onset, the local power structure is extremely influential. Fifty-year tenure is normal for office ground leases, and 75-year terms are typical for residential ground leases.

To control massive increases in residential condominium prices in the past several years, the government has tightened residential lending, decreased the loan-to-value ratio, increased transfer taxes on the sale of properties held for short periods of time, and prohibited re-sales and swaps of pre-sale/pre-construction purchase contracts. Recently they put restrictions on foreign ownership of residential units purchased for investment.

I had heard rumors in the U.S. that many of the new projects going up in China had very weak fundamentals. However, experts at CBRE and Colliers disagreed. They said that in Shanghai maybe 10 high-profile foreclosures or bankruptcies occur each year, and the market is more self-disciplined than outside investors might think.

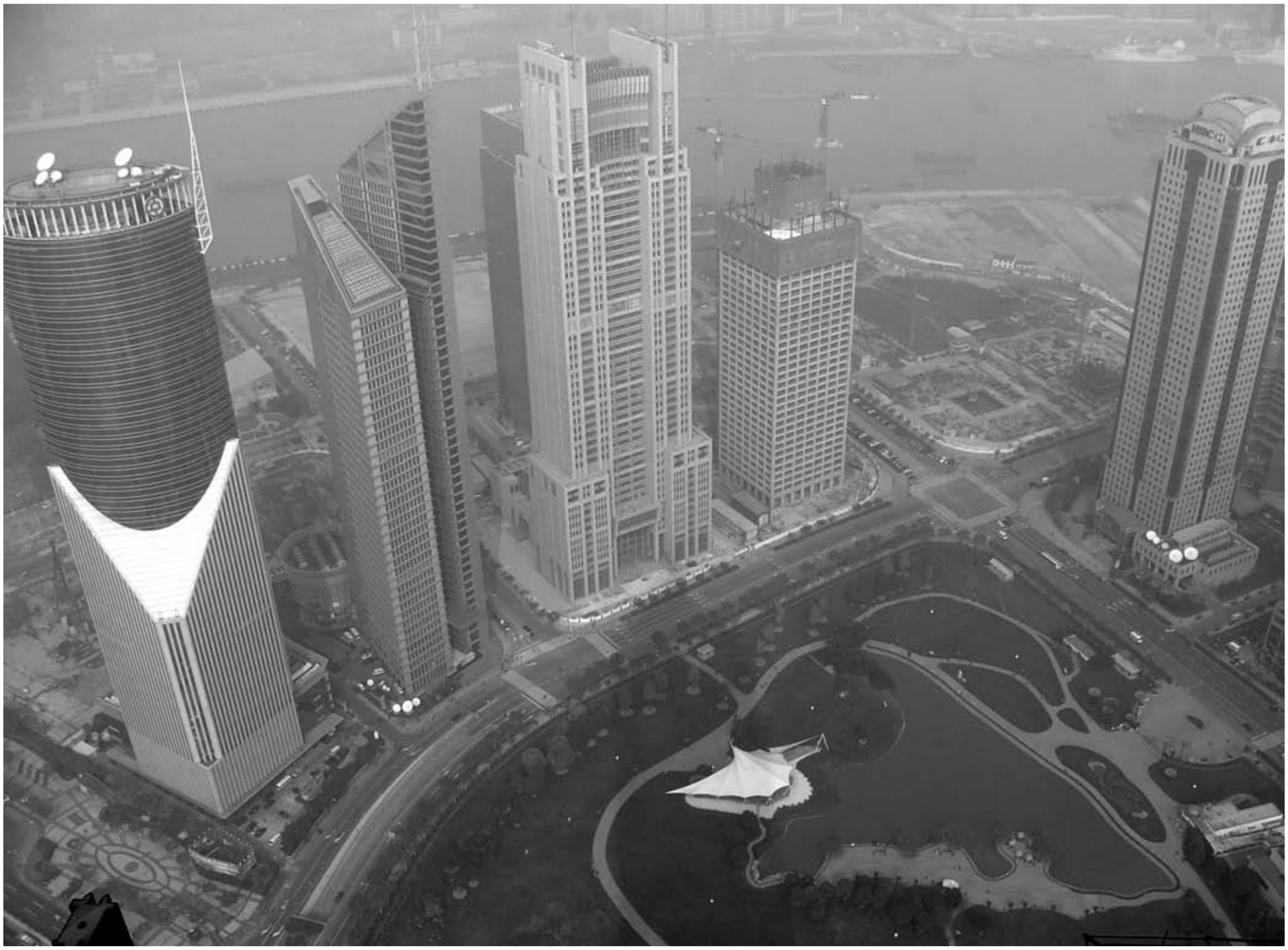
Though the market appears to be fairly orderly on the macro level, it differs from the U.S. in that the number of property transfers is low and the market is not highly liquid. Large and politically well-connected U.S. and European investors such as investment banks would like to buy more in this market, but very few merchant builders or developers construct, lease up, then sell their assets.

Professionals from both brokerage firms said the role of the central government is uncertain in setting economic policies and structuring the environment for commercial real estate development. But they reported the situation is gradually becoming more transparent, especially in the central Shanghai area. But buyers still must be large enough to have political muscle. Neither firm thought nationalization was a big risk anymore, but mentioned numerous other risks. Beyond the lack of good quality available product is the relatively uncertain due diligence process. For instance, when buying a building, making sure the rent roll and the leases are accurate can be a challenge; obtaining financial information about tenants also may be difficult. Some foreign investors find it safer to buy poorly performing class B or vacant class C buildings, then rehab them and find new tenants.

This is a very odd and segregated market. Its major players have diverse views of the future and very different investment objectives. Colliers and CBRE reported vulture/opportunity funds and long-term growth investors shopping in the same markets for the same assets. Both want to purchase, but for opposite reasons and based on opposite long-term assumptions.

WHAT A U.S. BUSINESS AUDIENCE SHOULD ACKNOWLEDGE

- We have to learn how to make good decisions in the U.S. political, private investment, and public investment/infrastructure realms. Once those decisions are finalized, we need to figure out how to execute them efficiently and promptly.



The Shanghai city government has spent $160 million in 2005 and will spend another $200 million in 2006 to support the development and establishment of creative businesses. "We hope to develop the creative industry as we can gain more profit through intellectual property rather than processing or manufacturing," says Le Jing Peng, deputy director of the Shanghai Economic Commission.

- We must emphasize investment in education and expand the franchise of education as widely as possible because manufactured or traded goods will continue to go to offshore factories with unskilled or semi skilled laborers. Furthermore, more goods and services will become traded goods subject to competition from offshore.
- We must forget our assumptions of innate superiority. Next week, we'll need something from China that we won't be able to make or do ourselves, be it software code, a drug patent or financing a deficit.
- Many of the reoccurring U.S. critiques of China are designed to serve U.S. domestic political needs than on substandard business practices. ■

The Impact of Cultural Mistakes on International Real Estate Negotiations

BY MARK LEE LEVINE, PH.D., CRE, FRICS, CIPS

WHEN CONDUCTING BUSINESS, INDIVIDUALS often focus on how they think, not how the other party views the situation. This built-in bias is generally very detrimental and highly toxic for international real estate transactions, and can contribute to the possibility of making cultural blunders that have a negative impact on business relations.

Those who fail to be cognizant of cultural differences and concerns will frequently destroy what could have been a successful transaction. More important, the injured party—often the real estate consultant, investor or broker—typically is not aware of the blunder that spoiled relations and caused the loss of the transaction.

ILLUSTRATIONS OF TYPICAL CULTURAL BLUNDERS

Numerous elements form the foundation of etiquette in various cultures. They are crucial to conducting business successfully in countries with different traditions and communication norms than those in Western culture. Though many blunders can be humorous or simply embarrassing in some situations, others could be highly volatile—and could even destroy a business relationship. Following are some of the more common cultural sensitivities that anyone conducting business on an international level should know.

Family and Gender

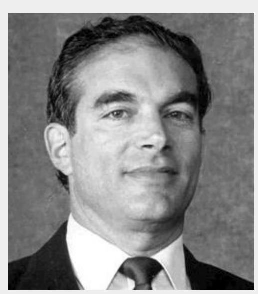
Recognize the importance of the family structure and authority within the business structure. Addressing the wrong person in the family—asking the son rather than the father to make a decision, for example—may destroy the transaction. This scenario exists in many South American countries. In other areas such as South Korea and Japan, it may be extremely difficult to undertake business transactions with women, because they are not readily accepted in certain business settings.

Financial Issues

A focus on only net financial benefits, such as a rate of return analysis, may be extremely short sighted. Though a return on investment is crucial in most business circumstances, other issues such as family relationships or prestige may be of more import at least in the short term. This is especially true in most Asian countries.

Legalities

In the United States it is generally not an insult or unusual for a long legal document to outline real estate acquisitions. However, in many Eastern European and Asian countries, it could be considered an insult to have



About the Author

Mark Lee Levine, Ph.D., CRE, FRICS, CIPS, *is the director of and a professor at the Burns School of Real Estate and Construction Management at the University of Denver. He has taught in international real estate for more than 20 years and is the author of many books and updates, including* International Real Estate, a Comparative Approach *and* Real Estate Transactions: Tax Planning and Consequences.

an extremely detailed document, which could imply that the person presenting it doesn't trust the other. In the United States, Canada and England, for example, the contract is the document that ultimately defines the transaction. But elsewhere, it can be the starting point of the discussion.

Proper Names, Titles and Addresses

Familiarity and the use of first names may be popular in the U.S., but that is not the case in many other countries. In Asia and even many European countries, addressing people by their first name is an insult until or unless the relationship grows to a level where such familiarity is proper. Note, too, that many Asian countries list surnames first and given names last. Make a point to confirm surnames in advance whenever possible.

Similarly, failing to address someone by his or her proper title—such as a doctor, professor, prince or chief executive officer—can have a devastating effect.

Touch

Business people in the United States tend to be more inclined to touch a person or move into their personal space. Touching in many countries, especially in the Middle East, is not acceptable, whether through a handshake or otherwise. In many cultures or religions, one example is the Jewish orthodox community, it is improper for men and women to touch members of the opposite sex other than their spouses or close family members.

Introductions and Business Cards

Formal introduction—using surnames, not first names, of the parties being introduced—is usually a sign of proper respect and etiquette. Presentation of business cards often accompanies this practice. It's common in the United States for professionals to casually hand out cards with one hand. But in many Asian countries including Korea, Japan and Indonesia, it's customary to hand the business card to the recipient with two hands and, in many instances, also give a slight bow. Present the business card so that the recipient can read the name on the card, and make sure it includes a proper title such as chief executive officer, president, doctor, professor or manager.

When on the receiving end, accept the card, acknowledge the card, review the card and perhaps even compliment the card. In some countries, it's poor taste to put the card away during the business meeting; instead the card should remain on the table in front of the recipient, until the meeting concludes. Above all, never place the card in a back pants pocket.

Professionals who practice in different countries should have cards that are printed in multiple languages. When working in Hungary, for example, a card with Hungarian on one side and English on the other can be very helpful.

Don't write on a business card while that individual is present. Doing so would likely be considered disrespectful.

Inappropriate Exposure

Certain parts of the body can be off limits. Touching the head of a young child in most Asian countries is not acceptable behavior. Likewise, women should be careful about exposing their arms, legs or even faces in many Muslim countries. Often, the degree of exposure deemed acceptable depends on the culture, age of the woman and religious doctrine.

Showing the bottom of a shoe when crossing the legs also is an affront in many Muslim countries as well as in Thailand. Know whether custom requires removing shoes and socks when entering religious areas and homes. Some countries even have specific traditions for washing hands and feet upon entering the home.

Wearing shorts or other types of casual clothing is not acceptable in many cultures. The most sensitive situations apply to women in orthodox settings in the Middle East, where proper attire for women does not include shorts or short skirts.

Colors

Colors are important in many settings and can convey positive or negative messages. For example, black often symbolizes mourning in many western countries. But in Asia, red or white typically are worn to funerals. So wearing what might be considered light, cheerful hues in the West could have a much different impact in China, for example.

Numbers

Certain numbers are considered lucky or unlucky in various countries and in various settings. Labeling a house or office with an unlucky number may prevent the lease or sale of a property. For example, in the United States it is quite common for many buildings and hotels to avoid a numbered 13th floor; elevator buttons jump from 12 to 14.

The number 4 signifies death in some Asian countries. Therefore avoiding this number in addresses and documentation can improve chances of success.

Gifts

Types of gifts, timing in giving gifts and the setting for gift-giving are all very important in various cultures. Don't make mistakes such as giving alcohol in Muslim countries, where drinking is prohibited, or giving pork products in Muslim or conservative Jewish communities.

On the other hand, gifts could be considered bribes in some countries. The United States Foreign Corrupt Practices Act and similar laws in other countries often make giving money or other expensive gifts illegal. A thorough understanding of laws and practices is necessary before giving gifts, especially when they are valuable or involve money.

Types of gifts, timing in giving gifts and the setting for gift-giving are all very important in various cultures. Don't make mistakes such as giving alcohol in Muslim countries, where drinking is prohibited, or giving pork products in Muslim or conservative Jewish communities. A thorough understanding of laws and practices is necessary before giving gifts, especially when they are valuable or involve money.

Gestures

Gestures such as pointing, especially with the index finger, are taboo in many Asian countries, though directing with the full hand usually is acceptable. And a kiss on the cheek in Central and South American countries, France and Mexico often is proper and perhaps even necessary to avoid insult. But in countries such as Korea and Japan, a slight bow would often be proper etiquette. Placing the hands together and bowing slightly would be an acceptable gesture of welcome in countries such as India and Thailand.

Shaking hands is an acceptable practice in many jurisdictions, especially in the United States and other Western cultures. Yet it is unacceptable in many countries where contact between nonrelated men and women is restricted. Using the left hand for any public purpose usually is unacceptable in many Middle Eastern countries. And tipping or removing a hat, meanwhile, may be a respectable action in many countries, but inappropriate in Jewish and Muslim cultures, for example, which require head coverings.

Eating and Etiquette

The choice of foods and manner of eating foods is another important consideration. For example, it is quite acceptable in Indonesia to eat with knives and forks or chopsticks, but eating meals with the fingers also is common. In Asian countries, proper etiquette calls for diners to lift the rice bowl toward the face when eating, whereas Western cultures may consider moving plates rather than utensils uncouth.

Placing chopsticks to the side of the bowl is proper; do not leave chopsticks sticking up or out of the food. Eating with one end of the chopsticks and using the other end for picking up food from a central dish is often considered proper in Japan and other countries where chopsticks are the main eating tools. On the other hand, in Singapore and many other countries, taking food from a central plate without turning the chopsticks is quite common and acceptable.

The order and method of the consuming foods also is important. Some cultures forbid mixing certain foods, such as milk and meat in a traditional orthodox Jewish setting. Other cultures limit or prohibit alcohol. In addition, formal or ceremonial meals must not be rushed; they often take several hours.

Be sure to know what topics of discussion are inappropriate. In Central and South America as well as Asia, talking about some business topics during meals is rude. Instead, some cultures discuss business only after the meal is finished; others limit such discussion to formal business meetings.

Timing for Business Discussions

The timing of business discussions should consider numerous issues. For example, in most Muslim settings, Friday is not a day for conducting business. Many other cultures do not discuss business on Saturdays or Sundays. Thus, setting the meeting date is crucial.

Proper Dress at Meetings

General dress codes in many societies dictate proper attire for general business meetings, meals or other situations. Yet in many Asian and Middle Eastern countries where the temperature is quite hot for a majority of the year, omitting a coat and tie is common.

Topics of Discussion

Be cognizant of proper topics to discuss. For example, the recent conflict between Pakistan and India would be a topic to avoid in those two countries. Be aware of sensitive political and social issues; do not bring them up in formal, and even informal, business settings.

It would normally be impolite in the United States to ask someone his or her age. But asking someone's age in most Asian countries is usually acceptable and often important to determine the individual's status and degree of respect he or she expects.

It would normally be impolite in the United States to ask someone his or her age. But asking someone's age in most Asian countries is usually acceptable and often important to determine the individual's status and degree of respect he or she expects.

The status of the family is an acceptable topic in many societies. However, asking about personal information may not be acceptable until one reaches a greater state of comfort in business dealings. This situation is especially true in a several African nations, where inquiring about a colleague's wife would often be considered forward. In most Asian countries, discussing the family isn't considered small talk, as it is in United States; it is part of getting to know the person, before undertaking business transactions.

Timeliness

In many jurisdictions, timeliness is not of great concern; in other settings, it is an insult to be late. In Germany, for example, one normally schedules a meeting for a specific time. Arriving late would be an insult. But in some situations in Central and South America, Thailand, Indonesia and elsewhere, some degree of tardiness is typical. Because of adverse traffic conditions—such as those in Jakarta, Indonesia; Bangkok, Thailand; Cairo, Egypt; Dubai, United Arab Emirates; Mexico City; and many other cities—some delay is almost expected.

Accepting or Rejecting an Offer

During a meeting, the process of requesting an immediate answer to determine whether a position is acceptable—if the price is acceptable when discussing a property sale, for example—is common in the United States. Yet this practice would be poor etiquette in many Asian countries. It not only could compromise the purchaser's standing among peers, but it also fails to recognize that a group or high-level executive must often make the decision. Attempting to "force" a decision frequently is an affront and is unacceptable behavior.

Saying No

In many western societies tactfully saying "no thank you" to a business proposition is usually acceptable. In other societies—such as most Asian societies, especially Japan and Korea—saying "no" outright, is unacceptable. Instead, other approaches to avoid the absolute "no," such as using body language or postponing the decision, show sensitivity to the society's typical practices.

Negotiations

The method of negotiating is substantially different in many countries. For example, people in the United States often attempt to present a win-win situation that shows how all parties benefit from the transaction. But this practice may be considered a sign of weakness elsewhere. Similarly, giving in on a point and expecting a reciprocal good faith position by the other side is an acceptable practice in many cultures, but don't expect this tactic to work in settings such as Russia, Eastern Europe and many Asian countries.

Calm, non-threatening, friendly negotiations are the common approach in Asia. Patience is necessary because the time needed to structure an undertaking in places such as in Japan and Korea—as well as many South American countries—is relatively long when compared to transactions undertaken in the U.S. and Western Europe. Another key difference is that directly involving professionals other than the principals in business meetings often is inappropriate. Lawyers, accountants and other specialists often provide support, but shouldn't be mentioned in the early stages of negotiation. They can consult with the parties outside of business meetings, then prepare documents only after the parties have reached a final agreement.

LEARN FROM MISTAKES TO ENSURE FUTURE SUCCESS

If one is not aware of the cultural nuances and differences, it is entirely possible that the transaction will not bear fruit and will not conclude positively. Even more unfortunate, the parties may lack an understanding about what caused the relationship to deteriorate.

Many U.S. brokers and principals are not aware of cultural elements that can effectively terminate a transaction with a buyer or seller from outside the United States. Failing to acknowledge cultural requirements or unknowingly insulting a potential colleague can spell doom for a business transaction. Losing the transaction is a disappointment; but even more important, the broker, principal or investor may not realize that it was his or her actions that ruined the deal.

Individuals who are unaware or unconcerned about other parties' cultural concerns will likely not complete many international business transactions. Learning what caused the affront, however, and adopting culturally sensitive communication methods could lead the way to future success.

When examining the overall issues, the knowledge and personal interaction of those involved in the transaction often are just as important as the financial aspects. Both are necessary for a successful transaction to take place. As a respected colleague said: "People don't care how much you know—until they know how much you care." Showing an understanding of the lifestyle, culture and social norms of people across the global market is part of that caring. ■

FOCUS ON THE UNITED KINGDOM

The State of the UK Property Market: Key Drivers

BY BARRY GILBERTSON, CRE, FRICS

THIS IS THE FIRST OF A SHORT SERIES of four articles with my personal perspective on the state of the property market in the United Kingdom. Initially, I will focus on some of the key drivers and the macro-to-micro picture, then look at the commercial and residential property markets before mopping up the remains of the marketplace, with some clues for lenders and investors (the seeds of doubt) in the final article. Things will inevitably change over the course of the year between the start and finish of the publication of these articles, but I hope they will be of interest to the international readership especially if you, as reader, are able to compare and contrast my views with your own thoughts about the marketplace in which you ply your trade.

It was, interestingly, a CRE who kick-started my current thought processes. My chum, Ken Riggs, said in the winter of 2005: "Something has to give; or does it?" Many other experienced commentators and players keep saying, privately and in the media, that we must be approaching the peak of the market's values. The key word is *must*. Seeing it written down does not show the emphasis that, when said aloud, implies we *must*, *mustn't we?* Note that they do not say *are* at the peak. Is this a fear that they might not be asked again if they get it wrong, or a concern that they do not want to be seen to be merchants of doom?

A long time ago, a very experienced property player said to me that one should always "leave something in the deal for the next owner." What a wise and pragmatic phrase that has turned out to be. His thinking was that we operate in a very small world, and that treating people well on the way up will pay dividends on the way down, when paths inevitably cross again. Squeezing the pips from a deal generally leaves a bad taste in the mouth of the other party.

However, I feel that the same maxim also applies to the actions of market players who successfully navigate the peaks and troughs of our usually volatile market environment. After all, if there is a good profit to be taken from a deal now, why wait until the market has moved along, maybe up or maybe down. In the past, very few have called the market exactly to the moment. One or two superstars got it right last time round; sold all their property and went liquid until the storm abated sufficiently to wash up fresh opportunities on their shore. Alternatively, perhaps they were lucky.

About the Columnist

Barry Gilbertson, CRE, FRICS, *a partner at PricewaterhouseCoopers, is past chair of the United Nations Real Estate Advisory Group's International Valuation Forum, a member of the Bank of England's Property Committee and Visiting Professor of the Built Environment at the University of Northumbria, England. He earned the CRE designation in 2000. Gilbertson also is a past president of the Royal Institution of Chartered Surveyors, a standards and membership organization for property professionals with whom The Counselors of Real Estate has a formal alliance to promote information exchange and foster an internatonal network of like-minded professionals. Read more about RICS at www.rics.org.*

BANKS SEEM EAGER TO FINANCE SPECULATIVE DEVELOPMENT

For a year or more, I have been saying to those who ask me what I think about the market, that "if you can't make money when interest rates are at this (historically) low base, when will you ever make a profit?" Milan Khatri, the chief economist at the Royal Institution of Chartered Surveyors said earlier this year: "Low interest rates have been the primary fuel for a surge in property demand, though by the end of 2006 these will rise."

So, what will we do if interest rates do rise? By how much will the rates have to rise for demand to slow, or even stop? These are difficult questions to answer. Each reader will have his or her own view, but I am influenced by the growth in speculative development over the last few years, driven not only by developers' desire, but also by an increasing willingness by banks and other funders to be more aggressive in their lending terms.

So, what will we do if interest rates do rise? By how much will the rates have to rise for demand to slow, or even stop? These are difficult questions to answer.

A survey by de Montfort University, in Leicester, England, has shown that in 2005 there was £23 billion of development finance out of a total market size of property lending in the UK thought to be between £164 billion and £175 billion. Six years earlier, though, at the turn of the millennium, there was only £9 billion of development finance. In that year, £3 billion was for residential development for sale, and £6 billion was for fully pre-let commercial real estate development. There was nothing for speculative commercial real estate development. Though this category hovered between zero and £3 billion for the five years up to 2004, it shot forward to £5 billion in 2005. What will it be in 2006, I wonder?

In May 2006, *The Times* newspaper of London said of this news that "banks have rapidly stepped up their exposure to speculative development finance, from virtually nothing five years ago to £5 billion at the end of 2005." The respected journalist, Jenny Davey, continued: "Lending to speculative commercial developments, where no business tenants have been signed up in advance to rent the building, is regarded as risky. In the early 1990s, excessive bank lending to speculative projects came unstuck when the economy crashed and developers could not repay their loans."

INTEREST RATE HEDGING REDUCES RISK

The £5 billion of lending to speculative development projects represents only some 5 percent of the total value of outstanding debt secured on commercial real estate. Nonetheless, Davey comments that "the rapid increase in lending to these (speculative) projects is beginning to cause concern among some property analysts, who fear that banks should be more careful not to repeat past mistakes."

If interest rates do rise in the short term, will it matter? Yes, of course it will. Many people—individuals and corporations—will be affected. They may not be able to afford their monthly repayments, though that does not necessarily predicate a crash. After such a long bull run, many borrowers should be able to refinance by extending their length of term, or by infilling the loan to value ratio.

A significant number of borrowers, though, will be less affected than most for one good reason—in fact, for one single word: hedging. In 2005, some 71 percent of new commercial real estate loans in the United Kingdom had interest rate hedging in place.

DEARTH OF OFFICE SPACE COULD FORCE LARGE FIRMS TO BECOME PSEUDO-DEVELOPERS

One more observation about developments before discussing some of the macro-economic issues driving or reacting to the market shifts. The latest research from DTZ shows a dramatic leap in the city office development pipeline from less than 1 million square feet in 2006 to some 4 million in 2007 and a further 4 million in 2008.

When these startling statistics are combined with the knowledge that there are 13 occupiers in the city who currently occupy 1 million square feet or more, one can only wonder what may happen as they grow their need for space. Hotelling and hot-desking can only be taken so far. If some of these occupiers fulfill their stated aims to grow their businesses at 5 percent per annum, they will each need a further 200,000 square feet of space within a few short years—that is another 2.5 million square feet of extra office space.

At this time only one building (a new, rather than second-hand one) is available at more than 100,000 square feet. There is nothing currently available, new or second-hand, at more than 200,000 square feet, and there will not be any building available to let at this size for at least another year.

What this means, of course, is that any large firm looking for space in the City will have to identify a location, and probably fuel a site assembly plan, together with a commissioned architect design before pre-letting the accommodation from a friendly partner developer. Essentially, the firm will be forced to become property developers to generate the most efficient deal in the search for new real estate.

INVESTOR CONFIDENCE IS KEY TO DRAMATIC GROWTH RATE

So what are some of the macro-economic factors driving this predicted growth in business space requirements, especially at the top end? Observations from the Bank of England have recently highlighted that, with rates unchanged, inflation below target has been achieved. Worldwide oil price pressures continue to exert influence, and now non-oil commodity prices are also on the rise. The United Kingdom's gross domestic product growth remains robust, and the general international outlook remains positive, despite some of the war-torn traumas around the globe several thousand miles from home.

Asset price growth has been rising over the past two years. As an example, though things obviously fluctuate and change, the FTSE All Share index showed an annual growth rate of 26 percent in April this year. Investor confidence is key to this growth, dramatic by most standards. The renewed number of corporate mergers has reinforced this view. United Kingdom real—or "safe"—rates reaching a 10-year low earlier in 2006 has encouraged the search for yield that many players, commentators and advisers have seen across world markets rather than just here in the United Kingdom.

Money supply, often referenced at least here in the UK as M4, has seen a consequential rapid growth to reach a 12-year high. It is likely, of course, that increases in the quantity of money are also likely to be contributing to asset price growth.

As with equity prices, commercial real estate prices have also been rising rapidly. For example, in the year to March they rose 14 percent. Put simply, an investment worth £1 million rose £140,000 in that period—a good return, and one that is far better than can be found by putting the money in the bank or under a mattress. This sort of rise is also consistent with the worldwide search for yield and the growth in money supply. Consequently, and you probably have observed it in your marketplace, the rapid growth in commercial real estate pricing is not a UK-specific phenomenon.

IS STABILIZATION ON THE HORIZON?

Having said all that, some of the latest data suggests that real rates and money supply growth are apparently stabilizing. Might this suggest, I wonder, that asset price growth might also begin to stabilize? With the arbitrage between, for example, Eurozone interest rates and UK interest rates, small though it may be, there are opportunities for the Eurozone borrowers to outbid UK or U.S. borrowers.

During the past 10 or 12 years, rental income cover has been increasingly under pressure, leading to a situation where projected capital growth may have become the only reason to buy. However, this theory is threatened by the current anomaly of the retail sector, where many retailers are finding trading conditions difficult, yet the property from which they trade is becoming increasingly expensive in rental and yield terms.

At a recent cocktail party, in a summery marquee in one of London's great and historic garden squares, I was chatting to a real estate investor who specializes in retail property. I asked him what he thought about the current trend of sub-4 percent yields. "Sub-4" he said. "I am currently paying sub-3 for the best!" Just to remind you, a sub-4 percent yield is, in simple terms, 25 years purchase—or, without rental growth it will take 25 years to get your money back. Extend that to sub-3 and it becomes more than 33 years. The chances are that I will not still be in the market in 33 years' time.

All that said, these are exciting times to be in the real estate market, whether as player, commentator or adviser. Would you want to do anything else?

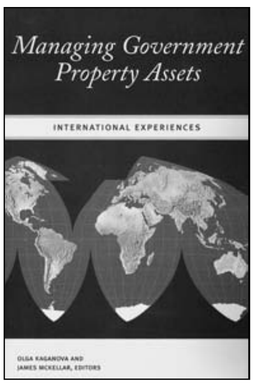
Why not e-mail your views to me at barry.gilbertson@uk.pwc.com? ■

RECOMMENDED READING

Managing Government Property Assets: International Experiences

Edited by Olga Kaganova, CRE, FRICS; and James McKellar (2006, Urban Institute Press, Washington, D.C., 238 pages)

REVIEWED BY MARK LEE LEVINE, PH.D., CRE, FRICS, CIPS



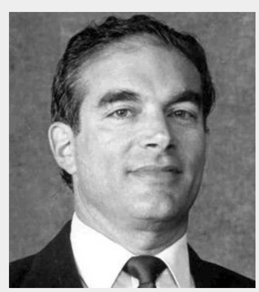
MANAGING GOVERNMENT PROPERTY ASSETS, edited by Olga Kaganova, CRE, and James McKellar, allows input from a number of authors who are practitioners as well as researchers. The objective of the book, the editors write, is to establish "a framework for more intensive debate and discussion on the topic of managing real property assets in the public domain from an international perspective."

The book offers perspectives from Australia, Canada, New Zealand, France, Switzerland, Germany, the United States and several emerging markets, including countries in Europe and Asia. "A key objective is to identify potentially transferable approaches and practices that might be applicable in countries that are just beginning to wrestle with the problem of devising a coherent management strategy for their real property assets," editors write.

The book is not a comprehensive compendium of best practices or asset management approaches across nations, the editors state. Instead, it features authors from seven countries who provide a sampling of considerations that are important when considering public property asset management on an international basis. Because governments own huge amounts of extremely diversified properties, myriad issues and difficulties arise when categorizing and handling those assets. The book focuses primarily on "common rules, institutional arrangements and management incentives to improve the efficiency and public usefulness of government owned property," editors write.

Though the issue is daunting and enormous—and a single book cannot cover it in detail—*Managing Government Property Assets* is certainly a worthwhile tool to address many essential issues in property management when dealing with public assets. However, "what this book cannot directly address is the political context for decision-making that inevitably affects how governments make the decisions that they do," editors write. They further explain that practitioners should research additional subjects related to national and local governmental practices.

At local governmental levels, for example, vastly different legal positions and accounting principles could have a



About the Columnist

Mark Lee Levine, Ph.D., CRE, FRICS, CIPS, *is the director of and a professor at the Burns School of Real Estate and Construction Management at the University of Denver. He has taught in international real estate for more than 20 years and is the author of many books and updates including* International Real Estate, a Comparative Approach *and* Real Estate Transactions: Tax Planning and Consequences.

significant impact on property management positions. And in developing countries with emerging real estate markets, officials often focus primarily on building new properties instead of caring properly for existing assets.

Most real estate professionals and government officials who deal with property management recognize the need for proper property management. This practice includes consistently updating property management techniques and tools as well as reviewing examination and accounting procedures to provide for transparency. Authors also examine issues related to pre-reform asset management such as the lack of a central policy framework, fragmented management of public property assets, economic inefficiencies associated with properties, incomplete or inaccurate information about properties, and the absence of transparency and accountability.

The book attempts to present a "unified framework" of practices in the countries that authors cover, including:

- Process and key drivers of state real property asset management reform
- Legal and regulatory framework
- Institutional framework
- Inventory of state real property assets
- System of accounting and fiscal management
- Cycle for real property asset management
- Strengths and weaknesses of the current system

Authors covered many of these issues; however, it is difficult to readily see a suggested unified framework as the guideline of each chapter. For future editions, if any, it would be helpful for the authors to employ a standard template for comparing data from various countries. And though many chapters contain some tables, adding maps, charts and other visual aids also would assist with making comparisons among countries.

By raising the issues mentioned above, though, the work takes a valuable step toward providing a tool for properly managing public assets. Government officials should find this work helpful when managing the public assets of their governments—and especially when examining practices and considering refinements.

The editors are real estate researchers who offer detailed analysis in this important book. Kaganova, a senior associate at the Urban Institute in Washington, D.C., has conducted a great deal of analysis of numerous countries in eastern and central Europe, as well as the Middle East and Asia. Before joining the Urban Institute, she was a founder and managing director of a consulting company in St. Petersburg, Russia. She has lectured at numerous universities and holds a number of professional designations. James McKellar is a professor and academic director of a real estate program at York University in Toronto. He also is a principal in McKellar and Associates Ltd., a firm that undertakes strategic advisory work. He has an impressive background in teaching and lecturing, holds a number of certifications, and is an honorary and life member of the Society of Industrial and Office Realtors.

The highly qualified authors who contributed to various chapters include myriad professors and professionals involved with strategic real estate research. Chapters cover subjects such as Management of Property in Australia, Framework for Management of Real Property in Canada, Asset Management in New Zealand; State Asset Management of Property in France; Asset Management Reforms; Balance Sheet Issues as to Asset Management; Examination of U.S. Cities and Management Issues; Real Property Management in Switzerland; Real Property Management in Germany; Guidance Issues for Management in Emerging Markets; Municipal Asset Management in Emerging Markets; Information Systems in Public Property in Canada; and several other topics relating to planning for and management of government assets.

This book will prove valuable for real estate professionals and other practitioners covering international real estate issues with a focus on property management. Governmental employees who deal with property management of public assets and strategic planners involved in governmental positions also will benefit from reading it. ■

FEATURE

Real Estate Bubbles:

Evidence in the Lender-Borrower Relationship

BY ROGER J. BROWN, PH.D., AND BEATE KLINGENBERG, PH.D.

In the typical real estate acquisition, the lender often has more money in the property than the borrower; hence, lenders influence transactions through the loan terms they offer. Indeed, buyer interest in a property at any given price is dependent on certain loan terms. When the loan terms change, the buyer's interest in purchasing the property changes, which can lead to a price change. This paper develops a bubble theory based on the connection among the loan-to-value ratio, or LTV; debt coverage ratio, or DCR; interest; and capitalization rate. It explores how data on capitalization rate trends can guide lenders and borrowers to better decisions.

Several definitions of bubbles[1] exist. This paper builds on the position that the market exhibits rational behavior; however, underlying market factors change over time, making it difficult for market participants to correctly interpret the information—in this case information garnered through loan underwriting.

Loan underwriting employs one of two risk management tools: LTV or DCR.[2] Understanding how they relate to each other and what happens in the market as the lender moves from one rule to the other is an important part of conducting business effectively despite ever-changing variables.

Borrowing money to purchase investment realty has the potential to confer two benefits on the buyer. First, if the interest rate on the loan is less than the capitalization rate, the borrower enjoys positive financial leverage in the form of cash flow that is higher than debt service. Second, if the

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borrower experiences a period of inflation that the lender hasn't anticipated—especially if the loan is granted at a fixed rate of interest—leveraged equity growth follows because the appreciation of the entire property value is credited to the borrower's equity.

The choice of how much debt to use can vary with the difference of opinion between borrowers and lenders about inflation expectations. This introduces the issues of risk and return and opportunity costs for both parties. This situation, given fixed net operating income, leads to borrower capitalization rates that differ from lender capitalization rates.[3] The connection between LTV and DCR reveals that market value may be represented as either of the two identities in Equation 1 where "constant" is the ratio of monthly installment payments required on the loan to the loan balance.[4]

$$\frac{noi}{cr} = \text{market value} = \frac{noi}{12 \times \text{constant} \times dcr \times ltv}$$

Equation 1

Setting the two expressions for market value equal to each other and solving for the capitalization rate produces Equation 2.[5]

$$cr = 12 \times \text{constant} \times dcr \times ltv$$

Equation 2

Lenders have some influence on interest rates, but because of competition and the influence of the U.S. Federal Reserve System, the lender's discretion is across such a narrow range that it is inconsequential for this article. Thus, assuming an amortization period of 360 months and exogenously determined interest rates, the choice of constant is essentially out of the control of the parties to the loan contract.[6]

A central value of discounted cash flow analysis and its appraisal analog, called the mortgage-equity method, is that these procedures provide the benefit of varying future cash flows as part of arriving at value—an advantage lacking in the older capitalization rate approach. The lender who fixes the loan to value ratio and the debt coverage ratio is, in effect, dictating the capitalization rate to the buyer. An important secondary consequence is to require the buyer to use capitalization rate as the valuation tool and to implicitly force the buyer to accept the lender's inflation expectations.

Toward the end of markets where prices rise much faster than income, the cautious lender begins to view investor bids as over-valuing the property. The lender intent on imposing both LTV and DCR requirements faces a fatal choice: Decline the loan or relax one of the underwriting standards to acquire the loan. In the former case, if other, less restrictive lenders in the market can attract this loan, the borrower is likely to go elsewhere. If the lender considers it a desirable loan to a qualified borrower, the second alternative is preferable because over time the quality of borrowers influences the quality of the lender's portfolio. Highly qualified borrowers use modern valuation techniques that attempt to forecast changing income over time. The converse, if one believes that low-quality borrowers use outmoded valuation techniques, is that the lender who fixes LTV and DCR will suffer from adverse selection because overly restrictive loan underwriting standards will attract weaker borrowers.

To use the mortgage-equity appraisal method for lending decisions that align with the borrower's use of discounted cash flow analysis for purchasing decisions, either LTV or DCR must vary. One question remains: Is the borrower better qualified to make a forecast, or simply a better forecaster than the lender?

LITERATURE REVIEW: EXAMINING NUMEROUS ASPECTS OF BUBBLES

A substantial body of literature discusses the topic of residential housing bubbles, but fewer publications cover commercial property bubbles.[7] Researchers concur that the existence of real estate cycles is accepted fact, with peaks sometimes exhibiting speculative behavior.

Using option pricing, author Steve Grenadier attempts to answer why some property types are more susceptible to bubbles than others in the article "The Persistence of Real Estate Cycles." Researchers also have considered the theoretical framework of bubbles and empirical observation of bubbles. For the latter, see "Bubbles in Metropolitan Housing Markets," by Jesse M. Abraham and Patric H.

Hendershott. In addition, "House Price Dynamics: An International Empirical Perspective," by Peter Englund and Yannis M. Ioannides, covers bubbles in several countries outside the U.S.; and "How Long Can Real Estate Investments Defy Weak Supply/Demand Conditions?," by Hessam Nadji, discusses the sustainability of current market conditions in commercial real estate.

Kyung-Hwan Kim and Seoung Hwan Shu present an empirical analysis of bubbles in Korea and Japan in the article "Speculation and Price Bubbles in the Korean and Japanese Real Estate Markets." They find that the level of interest rates have a significant impact on the existence of a bubble. In "Forecasting Prices and Excess Returns in the Housing Market," authors Karl E. Case and Robert J. Shiller develop a forecasting model based on empirical data for single-family homes. They conclude that price changes continue in the same direction for several years and are positively related to real per capita income growth, increase in adult population and the ratio of construction costs to prices. Through the article "Speculative Prices and Popular Models," Shiller also explains the results of an empirical study on the applicability of popular models to the understanding of speculative bubbles in residential housing and other markets.

Literature to date does not agree about the exact definition of a real estate bubble or how to determine if a specific market is in a bubble. Jonathan McCarthy and Richard W. Peach argue in "Are Home Prices the Next 'Bubble'?" that increases in the U.S. housing market price are attributable to strong market fundamentals—not irrational exuberance expected from a bubble market. Damir Tokic concludes in "Is There A Real Estate Bubble?" that housing bubbles are a result of a speculator-driven, demand-supply imbalance that is corrected only when interest rates rise, a potential trigger for housing bubbles to burst.

"Bubble, Bubble, Where Is the Housing Bubble?" explains a recent study conducted by Margaret Hwang Smith and Gary Smith that indicates most U.S. housing markets are not actually in a bubble, and movements of housing price indexes are inappropriately interpreted. The authors suggest a different housing-valuation model that shows many bubbles in this market are perceived, not real. In "Corporate Equity and Commercial Property Market 'Bubbles,' " Patric H. Hendershott, Robert J. Hendershott and Charles R.W. Ward discuss alternative definitions of an asset bubble and identify two main positions: that irrational market behavior cause bubbles; and that underlying factors in a rational market change over time, making it difficult for market participants to correctly interpret the information.

The authors express views that are closer to the second group, but advance a new hypothesis based on the idea that lenders and borrowers have a difference of opinion about the future of the three-way relationship among capitalization rates, interest rates and inflation.[8] The role of lenders is essential in this analysis, at the outset providing inexpensive financing to inflate the bubble and, later, withdrawing that financing and causing the bubble to deflate.

Papers that try to explain how market prices adjust to an equilibrium level need to provide a logical explanation about why market prices adjust. Property appreciation is insufficient; rather, underlying fundamentals are key. Abraham and Hendershott argue that forecasts of real house price appreciation depend on two factors: forecasts of changes in fundamentals such as real income and real after-tax interest rates, and forecasts of initial gaps between actual and equilibrium prices. And in "Further Evidence on the Existence of Housing Market Bubbles," Steven Bourassa, Patric H. Hendershott and James Murphy introduce changes in real construction costs, employment and population owing to external migration, finding that real, after-tax interest rates matter. Finally, a number of papers including one by Stephen Malpezzi titled "A Simple Error-Correction Model of Housing Prices" look at the role of the regulatory environment and local market constraints.

"Property Asset Bubbles: Evidence from the Sydney Office Market," also by Patric H. Hendershott, considers commercial real estate and includes the investors' expectations about future cash flows, comparing them with equilibrium rental income to discuss the existence of a bubble. This paper, though also interested in expected cash flows, focuses on how lenders adjust the provision of capital to borrowers by using either LTV or DCR as the risk-management tool in loan underwriting to influence price dynamics. The following model extends the work that Patric H. Hendershott presented by including additional variables.

DEVELOPMENT OF THE MODEL—POSITIVE LEVERAGE AND GROWTH EXPECTATION

Lenders operate as a sort of governor at the market's party, monitoring the punchbowl and adding just enough juice in the form of easy credit to keep the market well lubricated, but not enough to allow the situation to get out of hand. Operationally, this restrictive behavior manifests itself as loan underwriting that moves between the two risk management tools, LTV and DCR.

Simplifying the discussion requires participants to make two assumptions. First, they should ignore tax consequences, which is justified for a variety of reasons. Investors purchasing even moderately sized real estate usually must have substantial financial resources that place them in the higher—and flat—income tax brackets. Investors presumably have similar after-tax motives. Also, because tax returns are confidential, tax benefits are not observable so empirical verification of after-tax results is essentially unavailable. The second assumption is that interest rates, at least for the first year, are fixed.

Equation 3 expresses cash-on-cash return, or cc, for an investment using 30-year amortizing debt in terms of capitalization rate, denoted as cr, interest rate, shown as i, and loan-to-value ratio, or ltv.

$$cc = \frac{cr\left[1 - \dfrac{12 \times i \times ltv}{cr\left[1 - \dfrac{1}{(1+i)^{360}}\right]}\right]}{1 - ltv}$$

Equation 3

DCR measures whether and by how much the property income exceeds the loan payments. The dollar amount of DCR in excess of unity is the same as the borrower's before-tax cash-on-cash return.

Previous empirical studies such as the analysis by Bourassa, Hendershott and Murphy indicate that changes in the real after-tax interest rate have an impact on the development of a bubble. However, those studies did not consider the role of the lender and the response to changes in the capitalization rate.

Assume that lenders' opinions of value lag behind borrowers' opinions.[9] As the difference widens, borrowers find that they apply for a loan that is 75 percent of the purchase price and get a loan that is 75 percent of the lenders' appraised value, a loan amount that is perhaps only 70 percent of the purchase price.[10] If buyers still want to buy and sellers remain inflexible on price, demanding cash, buyers must increase down payments to make up the difference. Lagging appraised values indicate a de facto change in the lenders' risk management strategy from LTV to DCR.

Why does the buyer make the concession of placing more money in the deal despite the absence of a current-year reward in the form of positive cash flow? What is it that the buyer is willing to pay for that the lender is unwilling to finance? Why does a buyer accept breakeven leverage? Buyers give up the current-year override in the expectation of future growth, shown as g, in rent and value. Introducing monotonic growth to the multiperiod discounted cash flow method of valuation converges in the limit to Equation 4.[11]

$$v = \frac{noi}{d - g}$$

Equation 4

In Equation 4, capitalization rate becomes the difference between the discount rate, or d, the investor demands and the growth rate the investor expects will produce part of the return that the discount rate represents.[12]

The expectation of future growth explains why investors increase down payments as cash-on-cash returns fall. The introduction of future growth into the capitalization rate equation essentially impounds those out-year rewards into the computation of first year return. One might argue that making return dependent on higher cash flows to be received in the future looks more like speculation than investing. Lenders agree with this assessment and begin refusing to finance buyers' speculative behavior. Their reaction, as governors of the market, is to constrain loan amounts—the loan-to-sale price ratio—to those values supported by actual past sales, not sales that may happen based on projected higher income that may be collected. Imperfect a restraint that it might be, this behavior represents the lenders' refusal to fully participate in a bubble economy.

The term "fully participate" is chosen carefully. It may be that the immediate previous sales that the lender can observe, and does base the present loan on, were part of the bubble. Also, the pressure of deposit cost and the competition for loans carries some portion of the lender's portfolio into at least the early stages of price euphoria. However, if sanity is to prevail, lenders can lower LTVs to avoid participating in the last expansion of the bubble. Equation 5 shows the cash-on-cash with growth assumption, or ccg, which after rearrangement and simplification bears considerable similarity to Equation 3.

$$ccg = \frac{(d-g)\left[1 - \dfrac{12 \times i \times ltv}{(d-g)\left(1 - \dfrac{1}{(1+i)^{360}}\right)}\right]}{1 - ltv}$$

Equation 5

Declining LTVs continue, adjusting DCRs upward as disagreement about what the future holds widens between lenders and borrowers. The lender's shift from LTV to DCR as an underwriting tool affects how risk is distributed between the lenders' senior claim and the borrowers' subordinate claim. The borrower is in the first loss position and if the bubble deflates, the lender wants the borrower to take the loss.

It is not news that borrowers are more optimistic than lenders. Adopting 1.0 as the least stringent DCR—meaning that the property has exactly enough income to make its loan payments—the lender's margin of safety, or the extent to which NOI exceeds loan payments, is defined as excess DCR, or xdcr, in Equation 6.

$$excess\ dcr = xdcr = dcr - 1 = \frac{noi}{ds} - 1 \geq 0$$

Equation 6

When excess DCR is zero, cash-on-cash return is also zero. At this point investors partially concur, though reluctantly, with lenders and accept zero as the minimum cash-on-cash return.[13] Again the words "partially concur" are chosen intentionally. Borrowers express their disagreement with lenders by increasing equity investment. This action is exactly what the lenders had in mind. If borrowers are to reap the benefit of higher future cash flows, borrowers should finance that risk. If the loan is at a fixed rate, the lender receives none of the higher future income and, even with variable interest rates, the lender usually does not capture the full benefit.

When cash-on-cash return and excess DCR reach zero, the buyer must finance 100 percent of any price increase. With prices rising and the acquisition NOI constant, all that keeps excess DCR at zero is the reduction of the percentage of sales price that the loan amount represents. At the top of the bubble lies the question: How much additional buyer equity investment is too much to support the sellers' promise of future growth in income?

At this point, an uptick in interest rates, given the delicate balance of excess DCR and cash-on-cash return at zero, deflates the bubble.[14] At low interest rates, buyers feel that the expected growth portion of the discount rate is sufficient to justify additional investment. If interest rates remain low and buyers actually increase income following their purchase, they may find yet another buyer with even more optimism and cash, given lender constraints on LTV. This continues through the moment that interest rates increase, at which time the bubble deflates.

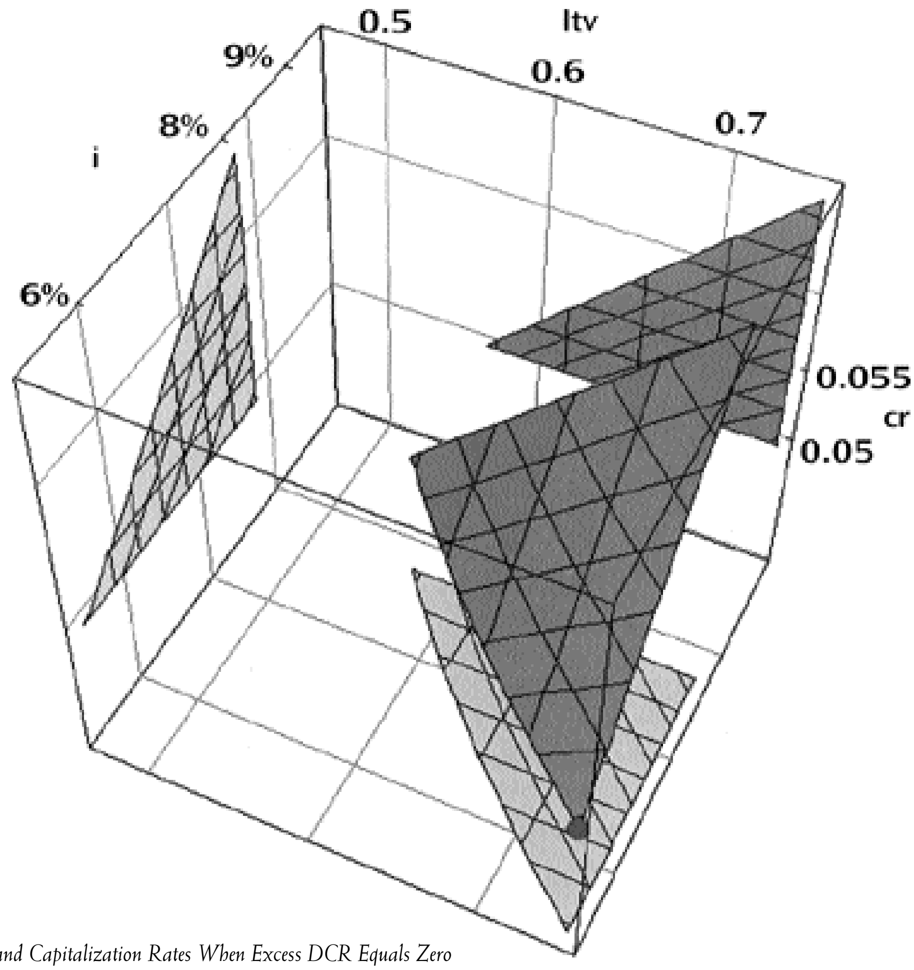


Figure 1: LTV, Interest and Capitalization Rates When Excess DCR Equals Zero

DISCUSSION OF FIGURE 1

The projected shadow on the west wall shows the range of the values of interest and capitalization rates as LTV moves through its specified range, all while excess DCR equals zero. There is one and only one point in the west wall shadow for each possible value of LTV. No transactions are possible in the white areas, given the constraint that excess DCR equals zero and the specified limits of interest, LTV and cap rates. Of course, lenders are always happy to allow transactions to take place when excess DCR is greater than zero, but in a bubble market it is assumed that buyers have pushed prices to the point where those transactions do not occur. To keep down payments to a minimum while paying high prices, borrowers apply for the maximum loan allowed, one with a payment that fully exhausts NOI. The smaller area of the shadow nearer the floor shows lenders phasing themselves out of deals as interest rates increase and capitalization rates fall because fewer values of LTV are possible in those ranges of interest and capitalization rates.

The same applies to the north wall where the shadow plot shows all combinations of LTV and cap rates, as interest moves over its specified range. As the triangle narrows traveling west the number of possible transactions shrink with higher interest rates.

Finally, the floor shows all possible values of interest and LTV as cap rates move through the specified range. Though the same effect is happening in the westward direction, the smaller end of the triangle on the floor takes on additional meaning when one recalls that the cap rate is the difference between the discount rate and growth rate.

ILLUSTRATING AND INTERPRETING THE MODEL

Recall that the difference between the discount rate and growth rate is the capitalization rate. Equation 7 combines two named variables into one.

$$xdcr = \frac{cr\left[1 - \frac{1}{(1+i)^{360}}\right]}{12 \times i \times ltv} - 1$$

Equation 7

Figure 1 depicts a three-dimensional plot of Equation 7, showing reasonable ranges of the variables. The figure depicts the bubble market balanced at a point where the three critical variables cannot move without a price reduction.

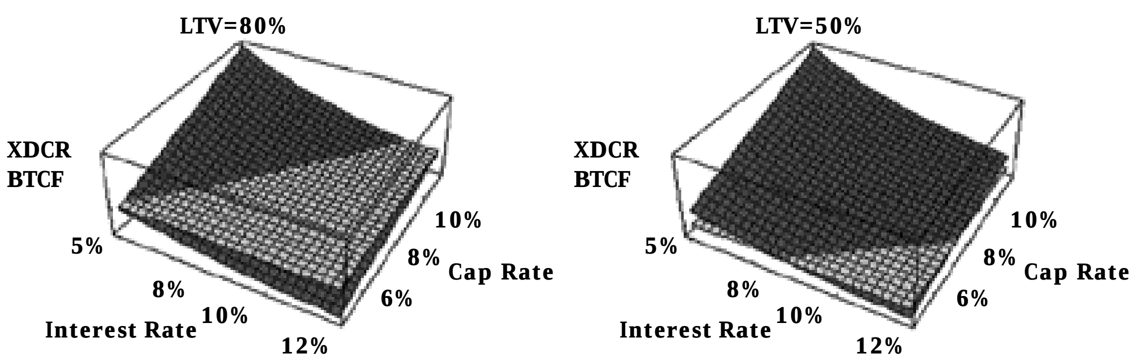
Returning to the earlier question of how much added equity is too much, the companion question is whether the last permissible capitalization rate is weighted too much toward the discount rate or growth. Though analysis cannot precisely determine the answer, common sense suggests that the growth expectations have reached the limit. There is an upper limit to how high buyers believe the market will go, how high they will project future rent increases and how little they will discount those projections. The cost of capital influences those limits. Therefore, during the last expansion of a bubble, buyer expectations are maintained solely by low interest rates.

Finally, the bubble reaches its maximum expansion when the combination of LTVs, capitalization and interest rates result in the only one permissible point where excess DCR equals zero—the balance point at the lower right corner of the center triangle in Figure 1. An increase in interest rates produces an impermissible drop in excess DCR below zero that can be avoided only by an increase in capitalization rate. If net income does not change, prices must fall.

Smaller LTVs may offset additional negative leverage. The consequence is that buyers put more of their own money into the acquisition, and depend even more on rising values to offset negative leverage and provide a long-term positive overall return. By adding cash, buyers neutralize lender funding restraint. The farthest extension of this practice is that buyers abandon debt financing altogether, purchasing property for all cash at values that do not relate to current income in any way. Before that time comes, buyers refuse to finance higher prices that implicitly require more speculative growth to justify them.

With any increase in capitalization rate, higher LTVs again become permissible at higher interest rates. As prices fall, the lender continues to rely on the DCR as the primary loan underwriting tool. Only when net income actually increases and buyers return to income-based valuation do lenders return to LTV. The rational lender uses LTV when increasing values offer the most protection; and uses DCR when net income offers the most protection. The lender's dilemma is twofold: knowing how the selection of risk management tool affects the portfolio quality, and knowing when to change from one to the other.

Figure 2: Excess DCR Against Interest and Capitalization Rates at Two LTVs



To provide another perspective, plots in Figure 2 illustrate the effect of changing LTV. Each image shows excess DCR against the same range of interest and capitalization rates. Both show a plane where excess DCR is zero; and that higher positive before tax cash flow, or btcf, rises to the rear where the highest capitalization rates and lowest interest rates are combined. Transactions may only occur where the curved plane is above the flat plane where excess DCR equals zero. Those combinations below cannot take place.

Of particular interest is the line at the intersection of the two planes. On the left, when lenders offer relatively high LTVs over a broad range of capitalization rates, the line constituting the intersection of the two planes is fairly long, indicating many transactions may occur.

On the right, because more of the curved plane is above the plane where excess DCR equals zero, it appears that more transactions can take place. However, the combination of lower LTVs and capitalization rates make the intersection line, where bubble market transactions do take place, much shorter. The lower LTV on the right provides a range of transactions at lower interest rates, generally showing up only along the west portion of the front edge of the curved plot.[15]

The investor who buys in a normal market with positive leverage—meaning the cap rate is greater than the loan constant—and positive cash flow is compensated in the acquisition year for committing down payment funds. Increases in prices and speculative fever push cash flows to zero. The only thing justifying investment is future

EMPIRICAL EVIDENCE

Table 1 reflects mean annual observations for capitalization rate and LTV on the leveraged sale of 5,331 U.S. office buildings that took place between January 1997 and February 2003.[16]

YEAR	LTV	CAP RATE
1997	73.47%	10.000%
1998	72.86%	9.325%
1999	72.66%	9.546%
2000	71.83%	9.523%
2001	71.57%	9.278%
2002	71.55%	8.909%
2003	70.20%	8.320%

Table 1: Mean Capitalization Rate and LTV

Figure 3 plots Table 1 to show that lenders do lower LTVs when capitalization rates fall. This time period was one of strong recovery for real estate in general following the recession of the mid-1990s and the stock market decline of the late 1990s.

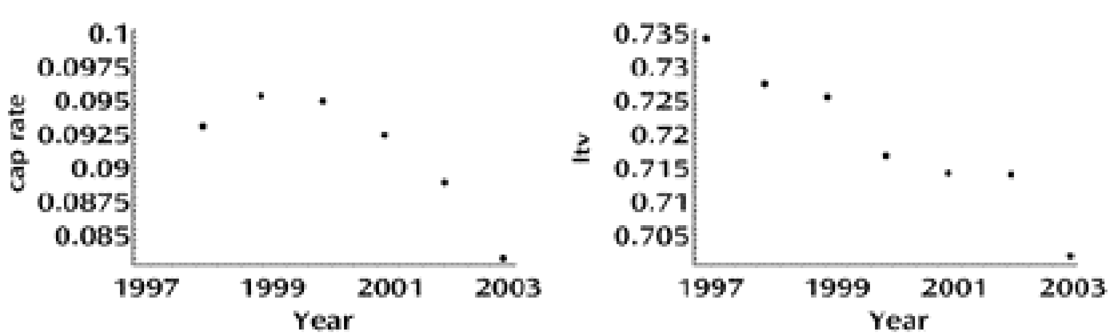


Figure 3: Office Building LTVs and Capitalization Rates

increased income with its associated increase in value. Such compensation is delayed and, therefore, subject to a discount that considers the cost of waiting and the risk. The bubble reaches its maximum size when demand stops. This occurs when there are no more dollars to chase property. The money dries up in two stages. First, lenders refuse to finance the speculative aspect of price. Second, investors refuse to discount future rents further, and will not risk larger down payments.

SUMMARY

Institutional lenders can conclude two things from this paper. One is that they should be alert to changes in the direction of capitalization rates when setting loan underwriting policy. The other is that changes in underwriting standards affect both the quality of the loan portfolio and market transaction prices.

Investors should recognize the best entry and exit points, noting how the direction of capitalization rates affects the final results. Perhaps the most astute investors in any market are those who refuse to be carried along with the crowd, sit out bubble markets and avoid auction environments. Wise real estate entrepreneurs know that they make profits on the purchase of a property; they merely collect these profits at the time of sale.

A more ambitious claim is that real estate bubble activity predicts a wave of inflation. Investors consider real estate—like other hard assets such as gold, rare coins and art—to be safe harbors when financial markets are weak. Evidence shows that hard assets tend to perform well in inflationary environments as well. If real estate investors are particularly sensitive to these potential precursors, they might be the canary in the mine shaft for inflation expectations.[17] ■

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ENDNOTES

1 The authors distinguish, by using the word "bubble," a situation of unsustainable increases in property prices not supported by a commensurate increase in income. A bubble differs in this way from cyclical price movements. (For more information, see Literature Review: Examining Numerous Aspects of Bubbles, page 38).

2 Emphasis on using *either* LTV or DCR arises from the improvidence of fixing both variables. Doing so precludes the use of the mortgage equity technique for valuation.

3 For a further analysis and discussion of capitalization rates and their relation to holding periods, see "Private Investor Holding Period" (details in References).

4 The constant is also the factor from Elwood Table No. 6—the payment to amortize $1.

5 The presence of the constant "12" in Equation 2 indicates that the loan is amortizing monthly and that the constant in use is the monthly constant. The use of the annual constant is not the same as 12 times the monthly constant. Such unfortunate complications arise from the convention of lenders requiring monthly payments while investors use annual capitalization rates.

6 This is not to preclude the borrower from electing a shorter amortization term to retire debt faster, which can occur without agreeing to a shorter loan provided prepayment is permissible.

7 See References for details about all articles mentioned in this paper. Only three papers deal explicitly with commercial real estate: "Property Asset Bubbles: Evidence from the Sydney Office Market," "Corporate Equity and Commercial Property Market 'Bubbles'" and "How Long Can Real Estate Investments Defy Weak Supply/Demand Conditions?"

8 This three-way relationship presents an anomaly. If capitalization rates are partially composed of interest rates and interest rates rise with inflation, capitalization rates should rise with inflation. In bubble markets the opposite occurs: capitalization rates fall as buyers bid up prices in anticipation of higher rents expected with inflation.

9 Some market participants question whether the issue of appraisals typically lagging transaction prices plays a role in this matter. Though this view could be argued, the model is based on a difference in opinion between the lender and borrower regarding value. How they arrived at that value is beyond the scope of the model presented in this paper.

10 This points to another subject, long discussed but never resolved: the price-value dichotomy. It is not the goal of this paper to resolve that question.

11 This is equivalent to the Gordon Growth Model in finance.

12 Clearly, d and g must be different and d must be larger than g.

13 It is possible to accept the negative cash flow that comes with negative leverage but that is beyond the scope of this paper. Borrowers otherwise willing are often restrained from doing so by lenders who prohibit it as a condition of granting the loan.

14 Author Damir Tokic anticipated this outcome, but he did so by analyzing the economic aspects of the demand-supply imbalance.

15 An animated and interactive version of this figure is at www.mathestate.com using Tutorial Tool No. 7, Real Estate Price Bubbles. The direct link is mathestate.com/tutorials/bubble1.html.

16 The authors can provide the complete dataset upon request.

17 At the time of the final draft of this paper, oil prices reached a record-high price and gold prices reached a 20-year high.

FOCUS ON COMMERCIAL REAL ESTATE

Navigating the Complex World of Business Property Leasing—The Tenant's Side

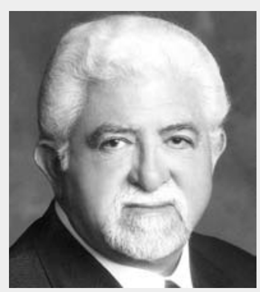
BY ARTHUR MAZIROW, ESQ., CRE

NO CONSULTANT, REAL ESTATE BROKER OR LAWYER likes a client to accuse him or her of over-lawyering a lease. This is particularly true when one is acting on behalf of a prospective tenant in a lease that has been prepared by the landlord. A lease is a very complex document; a fact that clients who do not deal with leases on a regular basis fail to recognize. The lease is only a "simple" document for those who are not knowledgeable.

The leasing of real estate for business use has been a part of the business scene since time immemorial. Originally, the courts viewed a lease as a sale of the real estate for the term of the lease. That concept resulted in the tenant taking the property with all its defects and inadequacies, and the lessor having no responsibility for the condition, repair or maintenance of the property during the lease term. The tenant also was required to continue paying rent under any circumstance. Even if the building burned down, the tenant was obligated to pay the rent.

When the subject of the lease is residential property, all states have changed that rule by court decision or legislative action. But when it's a business lease—whether the property is commercial, office or industrial property—the rule has been changing very slowly. In fact, states' rules vary widely when it comes to identifying parties' obligations and rights when nonresidential property leases fail to address key issues.

However, in one respect, all U.S. courts are in agreement: To a substantial extent, parties can change the rules by signing a written lease that contains different rules than the law would otherwise impose. In effect, the law permits the parties to make up their own rules if they wish to, so long as they do not violate applicable law or public policy.



About the Columnist

Arthur Mazirow, Esq., CRE, FRICS, *is a full-time arbitrator of real estate disputes and expert witness whose practice is based in Southern California. For many years he was a transactional real estate attorney representing clients in several thousand industrial and commercial real estate transactions involving purchases, sales, space leases, ground leases, financing, brokerage, joint ventures and real estate development. He has also lectured extensively for the UCLA Extension and the California Continuing Education of the Bar. He is the 2007 chair of the CRE Dispute Resolution Program Committee and a member of the State Bar of California, Los Angeles County Bar Association, American Bar Association and an arbitrator for the American Arbitration Association.*

Navigating the Complex World of Business Property Leasing

Leases concerning business property, whether typed or printed, are, for the most part, heavily biased in favor of the lessor. The tenant and the tenant's representative must examine this one-sided document closely to determine whether it contains the business points the parties agreed to and ensure nothing has been added or deleted since they reached the informal agreement. However, the lease form will contain a great number of provisions that no one ever spoke about and the tenant didn't think about, and it likely will fail to mention concepts that the tenant has raised with the lessor's representative. So the negotiation process begins.

Because leases are extraordinarily difficult to read and understand (surpassed only by insurance policies) and contradictions almost always exist, the negotiation process rarely comes to a speedy conclusion. When the tenant gets the lease form from the lessor, it is a heavy, thick and forbidding document. The tenant usually doesn't have enough technical knowledge to understand all its implications and must decide whether to sign it as is, read and negotiate it without help or retain a knowledgeable and experienced representative to conduct a review.

No single lease form is correct for all types of property, lessors and tenants. All leases have similarities but there is no single form that fits all transactions. Like it or not, all lease forms must be negotiated. It's the nature of the beast.

Depending upon the degree of sophistication of the tenant and the tenant's representative, they may or may not deal with important issues in the lease—not the least of which is clauses the lessor did not put into the lease, but the tenant should insist upon being included in the lease.

ISSUE NO. 1: DRAFTING THE LEASE

The question of who will prepare the lease form is a very important one. The side that has drafting rights has the opportunity to make sure everything it wants is in the lease and slant the transaction to its favor. That favoritism—which can be expressed in writing or can occur by omitting critical terms, conditions or concepts—can be heavy-handed, medium or slight.

Typically, the lessor will draft the lease and present it to the tenant. An exception to his general rule is when the tenant is a Fortune 500 company. Then, the tenant presents the lease form to the lessor. In that event, the lessor will have all the problems with the lease form that the tenant normally experiences. If the bargaining position of the lessor and the tenant are equal, then every clause and term is subject to negotiation and every term can become more onerous or fair.

Whoever drafts the lease, whether the lessor or the tenant, has some basic decisions to make about the lease. The lease can be a one-way document that attempts to give 100 percent protection to the side that is paying for the lease to be prepared. This lease is so tough that merely reading it makes one angry. Taking that approach means a long, drawn-out negotiating process that can be very expensive to both sides and can result in the lease falling apart if either party has other options.

Another approach to lease preparation is to write a lease that, in the very first draft, gives to the other side the protections they would get if represented by someone knowledgeable in real estate leases. A lease transaction that starts from this type of document will result in a faster process, have less legal expense for all parties and be a much more pleasant experience.

Frankly, it is easy to prepare a lease that no one will sign. The trick is to have a lease that people will sign quickly, with a minimum of acrimony and expense. Unfortunately, in many cases the lessor initially presents the prospective tenant with the toughest lease possible, and the tenant must start the negotiation process to eliminate the most unreasonable provisions of the lease.

NEXT: THE NEGOTIATION PROCESS

The number of changes that a tenant can reasonably expect to negotiate will vary with the facts of each lease. And that number commonly has less to do with the negotiating skill and knowledge of the tenant and the tenant's representative than the amount of space available for rent in the marketplace. If a great deal of space is available for rent, the lessor will be willing to consider any and all suggested changes. If there is little available space that is suitable for the tenant, the lessor probably will not do a lot of negotiating.

No single lease form is correct for all types of property, lessors and tenants. All leases have similarities but there is no single form that fits all transactions. Like it or not, all lease forms must be negotiated. It's the nature of the beast.

The problems that a tenant will experience with a lease are rarely apparent at the beginning of the lease term. As problems arise, though, the tenant could discover that a poorly negotiated lease does not provide the protection the tenant thought it did.

Most legal and practical problems that tenants experience with leases are omissions in the lease document. That is, the lease doesn't cover issues at all, or the lessor covers issues in his favor and the tenant doesn't pick up on it before signing the lease. Most omissions are easily addressed and will come to mind if the tenant approaches the transaction as if it were a purchase of the property. If the tenant looks at the lease like a purchase—and considers what would be desirable if this were a sale agreement—then deals with the transaction from that point of view, the tenant will be able to avoid many future problems.

Addressing those considerations and including them in the lease will give the tenant a great deal of protection.

MAKE A POINT TO ADDRESS KEY ISSUES

When reviewing leases, tenants and their representatives should be careful to:

Ensure the lease incorporates representations the lessor made to induce the tenant to enter into the lease

If the lessor or the lessor's broker made specific representations during the negotiating process that certain matters of extreme importance to the tenant will occur in the future or have occurred, those matters should appear in the lease as a representation and warranty by the lessor. These representations and warranties are colloquially called the "but for" rule, meaning that but for those oral representations the tenant would have not entered into the lease.

Obviously, what is important will vary from tenant to tenant, taking into account the nature of the business to be conducted in the leased premises as well as the nature of the property itself and the availability of other suitable locations. The tenant's representative must learn from the tenant what those "but for" representations are or they will not be in the lease. The tenant's representative should be aware, however, that the typical lessor-drafted lease states that the lessor is not making and has not made any representation of any type or nature to the lessee that is not contained in the lease.

Ascertain authority of lessor to sign the lease

In a real estate purchase transaction, a title insurance company insures the buyer that the grantor of the deed has the authority to execute the deed and deliver good title to the property to the buyer subject to only specified items. Rarely does the leasing tenant obtain title insurance, but the same issue exists.

Is the person or entity signing the lease the owner of the property? In most circumstances, the same person or entity who has to sign a deed to sell the property also has to sign the lease. If a lessor is an individual and that individual is married, both spouses usually have to sign the lease. If an agent of the owner or a trustee of the trust that owns the property is signing the lease, it is up to the tenant to determine whether the person or entity signing on behalf of the owner has the authority to enter into the lease. If there is no such authority or if person required to sign the lease did not, the lease may be either void or voidable. This circumstance can be particularly disturbing to a tenant who has invested large sums of money in the property in the form of tenant improvements or similar activities.

The tenant's representative also must find out if the tenant wants a policy of title insurance, which insures leasehold interest in the property.

Determine the nature of encumbrances against the property

Rarely will a commercial property buyer make a purchase without a preliminary title report and a title insurance policy insuring that no liens—or only known liens—are recorded against the property. The buyer is concerned because if an encumbrance on the property is not paid, a foreclosure could occur and wipe out the interest of the buyer. The same concern exists for the tenant. If a trust deed, mortgage or other encumbrance on the property is superior to the lease of the tenant and that encumbrance or trust deed or mortgage goes into default, a foreclosure by that superior encumbrance will wipe out the interest of the tenant.

Though most representatives think of encumbrances as constituting deeds of trust or mortgages to secure monetary obligations, the word "encumbrances" is a much broader term. It could mean that some other tenant has an option to purchase the property or some litigation concerning the property that is disclosed by a *lis pendens* or notice of litigation affecting title or possession could interfere with the tenant's leasehold rights. Those other encumbrances could include not only options to purchase, but also options to extend another tenant's lease, which could affect his property or, in a retail context, that someone has an exclusive right to sell certain merchandise in the location.

No matter how innocuous, options are a disadvantage to the lessor because they restrict the lessor's ability to deal with the property. For that reason, lessors are very reluctant to grant options of any type to the tenant; the tenant should ask for options because options often give the tenant some leverage in future negotiation.

The way to avoid or learn about these problems is for the tenant to obtain a title report and a policy of title insurance for the leased property. The tenant also should consider obtaining a boundary line survey. The sophisticated tenant will obtain a policy of title insuring leasehold rights and a boundary line survey that shows all easements, parking and the location of the building on the property.

Obtain a warranty from the lessor regarding the amount of square footage in the leased premises

During lease negotiations it is customary for the rent to be quoted in terms of price per square foot either on a monthly or yearly basis. When parties reach agreement on economic terms the lease is prepared and presents a number that was calculated, but frequently does not state the price per square foot or number of square feet in the leased premises. There are a number of ways to measure the amount of space being leased. For obvious reasons, the lessor wants the premises to contain as much space as possible whereas the tenant wants the space to be the least amount possible.

The agreement should always include the number of square feet comprising the leased premises and how it was calculated. It also should have a provision for resolving disputes about the amount of square footage and the method the parties will use to determine the square footage. The tenant also should decide whether to require a measurement of the space before signing the lease.

Ensure the lease includes restrictions that limit the lessor's ability to lease space to certain types operations that would conflict with co-tenants' businesses or have negative impact on the operation of a multi-tenanted property

Many businesses, particularly retail businesses, should require restrictions on the lessor's ability to rent space to other types of tenants that might interfere or conflict with the tenant's use. Even in office buildings, the tenant should address this point because, for example, if an office building is not designated initially as a medical office building but subsequently is turned into a medical office building, the elevator service likely will be inadequate and result in long delays and very unhappy tenants and customers.

Provide that tenant can make repairs, if needed, and deduct costs from rent

The lease always spells out some obligations for the lessor. If the lessor does not perform those obligations, the tenant, in most states, doesn't have the right to use the all or some portion of the rent to perform the lessor's obligation—unless the lease gives the tenant that right. The Lessor rarely offers the tenant the right to repair and deduct. The tenant will have to request and insist on that right.

In most states, the obligation of the tenant in nonresidential leases to pay rent is an unconditional promise unless the lease provides otherwise. If there is no "otherwise provision" in the lease, the tenant must continue to pay rent even if the lessor is in default of performing obligations outlined in the lease.

Address any free-rent issues

Depending on market conditions, a tenant may obtain free rent for some period of time. Normally, free rent to the tenant means freedom not only from base rent, but also common area and operating expense charges. Odds are, however, the lessor will have a different view.

Separate improvement rent from base rent
The term "improvement rent" means the amount of money added to the base rent to cover the lessor's cost to make additional improvements to the leased premises. This cost typically is amortized over the term of the lease. The improvement rent should be separated from the base rent because once the improvement rent is paid, the tenant should pay only base rent. In the event of consumer price index increases, those increases should be based only on the original base rent, not on the improvement rent.

In addition, if there is to be a fair market re-evaluation of the base rent, the lease should provide that the re-evaluation shall not take into account improvements made by the tenant, or any improvements that were paid for by improvement rent or by the tenant directly.

Leases often provide for midterm increases in rent to fair market rental value as well as options to extend the length of the lease. If a midterm revaluation occurs, will the tenant be treated as a "new incoming tenant" with all the concessions given to a new incoming tenant? The same issue exists when the tenant considers exercising the option to extend.

The tenant should request a specific agreement on the process used to make determinations of fair market rental value as well as the process used in the event of a disagreement. Frequently, the process for dealing with disputes concerning fair market rent is binding arbitration. However, often it is difficult to tell from the lease whether the parties intended the method of determining fair market rental value to be binding. The best practice is to clearly state whether the determination is binding; failing to do so will result in litigation concerning the process and not the substantive issue.

Limit amount of time lessor can delay in delivering possession of the leased premises to the tenant
This issue regards how long the tenant will wait for the lessor to deliver possession of the premises. The lessor's inability to deliver the space may arise because of a number of problems; however, whether those problems are within or outside the control of the lessor, the tenant should have a limit on how long the tenant will have to wait. At some point, the tenant must have the right to walk away from the lease without penalty.

Obtain warranties from the lessor concerning the leased premises
The tenant will want to require the lessor to warranty that the leased premises, as of the time the lease commences, will be in compliance with all applicable building codes; and if it is not, the lessor will promptly make repairs at the lessor's cost. In addition, the tenant probably will want the lessor to warranty that the mechanical equipment in the leased premises are in good working order and condition, and if not, the lessor will make repairs at the lessor's cost.

In addition, the tenant will want a warranty from the lessor that no hazardous contamination is affecting the leased property. This is very important for the tenant because it is possible for a tenant to be legally liable to clean up hazardous contamination even if the tenant did not cause it to occur or if it were a preexisting condition.

Ask for options
Many types of options could apply to a lease including options to extend the term of the lease, purchase the real estate, terminate the lease early, the right of first refusal to lease additional space and the right of first refusal to purchase the property if the lessor ever decides to sell.

No matter how innocuous, options are a disadvantage to the lessor because they restrict the lessor's ability to deal with the property. For that reason, lessors are very reluctant to grant options of any type to the tenant; the tenant should ask for options because options often give the tenant some leverage in future negotiation.

Exclude inappropriate operating expenses or common area charges
The concept of the tenant paying some portion of the operating expenses or common area charges, also called CAM, is that the lessor is obligated to maintain the property in good and proper order, condition and state of repair for the benefit of all tenants and that each tenant, or some of them, shares proportionately in the cost of the CAM. Expenses that the lessor cannot include within CAM have a negative value on the property because it is a cost that the lessor must absorb, which results in a lower net operating income from the property. Therefore, it is to a lessor's benefit to include within CAM as much

expense as legally permitted, and to the tenant's advantage to keep the list as short as possible.

The types of expenses that a tenant will want to *exclude* from CAM are:

- Leasing commissions, attorneys' fees, costs, disbursements and other expenses incurred in connection with negotiations or disputes with tenants or leasing, renovating or improving space for tenants or other occupants or prospective tenants or occupants of the project
- Costs, including permits, licenses and inspection fees incurred in renovating or otherwise improving, decorating, painting or redecorating vacant space or space for tenants or other occupants
- Lessor's costs of any service provided to tenants or other occupants for which lessor is entitled to be reimbursed as an additional charge or rental over and above the base rent payable under the lease with such tenant or other occupant
- Any depreciation or amortization on the project
- Cost of a capital nature including, but not limited to, capital improvements, capital repairs, capital equipment and capital tools as determined in accordance with generally accepted accounting principles
- Cost incurred in conjunction with the investigation, remediation and/or monitoring of hazardous substances, including asbestos
- Expenses in connection with services or other benefits that are not provided to tenant but are provided to other tenants or occupants
- Costs incurred because of lessor's violation of any terms and conditions of the lease or any other lease relating to the project
- Overhead and profit increments paid to subsidiaries or affiliates of lessor for management or other services provided to the project, or for supplies or other materials to the extent that the cost of such services, supplies or materials exceed the cost that would have been paid had the services, supplies or materials been provided by unaffiliated parties on a competitive basis
- Interest on debt or amortization payments or increases in interest or debt on any mortgages or changes in deeds of trust or any other debt for borrowed money
- Rent or other payments related to any ground lease or underlying lease
- Rentals or other related expenses incurred in leasing air conditioning systems, elevators or other equipment ordinarily considered to be a capital nature, except equipment used in providing janitorial services that are not affixed to any building in the project
- The cost of all items and services for which tenant reimburses lessor or buys from third persons, or that lessor provides selectively to one or more tenants without reimbursement
- Advertising and promotional expenditures for the project
- The cost of repairs and other work occasioned by fire, windstorm or other casualty of an insurable nature and other work to the extent of insurance or condemnation proceeds
- Any costs, fines or penalties incurred because the lessor or any other tenant violates a governmental rule or regulation
- Any costs for sculpture, paintings or other objects of art
- Wages, salaries or other compensation paid to any executive employees above the grade of building manager shall be included in lessor's general overhead
- The cost of correcting any code violations that were violations before the commencement of the term of the lease
- Any other expense that under generally accepted accounting principles or practices would not be considered normal maintenance or operating expenses
- The cost of liability insurance in excess of $5 million
- The cost of any earthquake insurance
- Any increases in real property taxes if the project is sold, exchanged or transferred, or if there is otherwise a change in ownership of the project

- Any costs or expenses attributable to any merchants' association or other association of tenants—or the shopping center, if tenant is signing a shopping center lease.
- The cost of repairing any part of common areas that was negligently designed or defectively constructed
- Cost and expenses incurred by lessor in performing lessor's obligations to maintain and repair the project, which are stated in the lease to be at the sole cost and expense of the lessor
- Excess premiums for insurance covering common areas of the project caused by extra-hazardous use or activity therein by other tenants or occupants

Address the following matters:

- Count parking spaces to make sure there is sufficient space for all vehicles, particularly if the parking is shared with other building tenants. Specify parking fees, if any, and if there are charges, whether the income is credited against CAM charges.
- Hire independent experts to check the condition of the mechanical, structural and electrical aspects of the property; research permitted uses under building and zoning laws and covenants; report conditions and restrictions against the property; conduct an environmental evaluation of the property and its surrounding area; and inspect the records of the EPA, fire department, building department and health department with jurisdiction over the property.
- Protect tenant against the inability to use the property for reasons related to health and safety caused by other tenants, loss of utilities, national and local emergencies, defects, problems and contamination of the property not caused by the tenant.
- Affirmatively state that tenant is not liable for the repair of structural defects in the property.
- Retain the services of an insurance risk manager to review the insurance provisions in the lease.
- Sit down with an attorney to review the lease, in person, paragraph by paragraph.

CONCLUSION

The commercial real estate lease is a very complex document—so much so that some consider it a miracle every time a lease is signed. Lease signings occur because of the tenant's need for space, the lessor's need to rent space and obtain a stream of income for debt service on loans on the real estate, and the real estate broker's need to earn a commission. Those various needs result in signed leases even though it is never easy and many potential problems remain for the future. ■

Note: Portions of this article have appeared in previously published articles written by the author.

Ground Rents From Maryland to Hawaii: Leasehold Interests in Residential Real Estate

BY BENJAMIN A. NEIL

MARYLAND AND HAWAII, THOUGH GEOGRAPHICALLY DISTANT, are burdened by the same historical remnants of an English feudal land system.[1] In both states, residential property frequently is conveyed by leasehold deeds that require residents to pay a ground rent.

Ground rent agreements require homeowners to rent the land on which their houses sit, often for a term of 99 years, and whoever pays the ground rent has an option to renew at the end of the term. This type of agreement allows the lessor to retain title to the property, meaning that ownership of the dwelling is separate and distinct from ownership of the land.

These systems in Maryland and Hawaii present numerous problems for the residential real estate market, including risks of extreme forfeiture and impairment of alienability. This paper discusses the systems, notes similarities and differences, and describes the impact of the states' peculiar systems on commerce, real estate development, mortgage finance and the right to alienate property rights.

THE LEASEHOLD SYSTEM OF MARYLAND

In Maryland, one of the 13 original states, leasehold deeds for residential property originated in colonial times.[2] These deeds recite and document the existence of an automatically renewing 99-year lease on the fee-simple interest—allowing unqualified power of disposition—for the residential property. The lease also specifies a set dollar amount of the ground rent, payable on an annual or semi-annual schedule.

Maryland residential ground rent leases do not provide for an escalation clause, which would increase the leaseholder's rent cost during the term of the lease. People who pay ground rents, also known as leaseholds, can determine the payoff amount by calculating the capitalized value of the ground rent. The state determines the rate of return on a ground rent. Most modern ground rents were created from 1889 to 1982, when the rate of

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return was 6 percent. So a ground rent that costs $90 a year typically would cost $1,500 to redeem.

Leasehold deeds in Baltimore and surrounding counties that came into existence since 1884 can be redeemed at any time. Lessees can convert the leases to fee-simple deeds after paying a multiple of the annual rent[3]—usually 16.66 times or 25 times the annual rent, depending on the amount of interest outlined in the leasehold deed.[4]

In effect, a Maryland leasehold deed is a hybrid instrument that allows a grantor or predecessor in title to retain an interest-only secured loan against land for a fixed interest rate of 4 percent or 6 percent. Security for the loan is the lessor's statutory right to eject a lessee who has defaulted. A ground rent redeemable at a definite future period has most of the same benefits as a mortgage when securing a principal sum, with interest expressed as annual rent.[5]

However, the lessor has no current or residual right to possess the land as long as the lessee pays the ground rent. Foreclosure and ejection can occur only if the lessee falls into arrears. The right to payment is defined as personal property if the rent is paid, and the reversion is defined as realty.[6] And though the lessee's interest has all the characteristics of realty, courts have traditionally treated it as personal property.[7]

Lessors and lessees freely convey their interests, but lessors typically do not file deeds of assignment that reference particular properties. In Baltimore, it is not unusual for lessees to have difficulty determining the exact identity of the lessor, especially in instances when the lessor dies and his or her heirs do not promptly submit an estate to probate. As a result, lessees cannot locate and pay the party to whom they owe the ground rent. Under such circumstances, the unpaid rent can create a situation where a fairly small indebtedness raises the risk of an extreme default.

THE LEASEHOLD SYSTEM OF HAWAII

In Hawaii, the second youngest state in the U.S., private ownership of land was controlled by the monarchy until 1848.[8] The concentration of ownership has continued in an altered form to this day. As late as 1984, 49 percent of Hawaii's land was owned by the federal and state governments, And 49 percent of Hawaii's privately owned land was controlled by 72 landowners. A mere 22 landowners held 72.5 percent of titles to the land on the well-developed island of Oahu.[9]

Historically, a handful of Hawaii's largest landowners used land leases—which did not have automatic rights of renewal—for a fixed term of years as a preferred method of developing dwellings. The law of fixtures governed residential improvements.[10] Hence, at the conclusion of the lease term, a residential lessee had three choices: renegotiate the lease, remove his or her dwelling or forfeit the value of improvements.

The Hawaii legislature, from time to time, attempted to provide protection for lessees. In 1968, the Hawaii legislature enacted the Land Reform Act,[11] which empowered the Hawaii Housing Authority to condemn land in developments of five acres or larger, but only upon petition of a fixed number or percentage of affected lessees. After condemnation, the housing authority would resell the fee-simple parcels to the petitioning lessees.[12]

The Land Reform Act also permitted lessees to extend the term of land lease to 55 years, if they did so within the first 20 years of the lease.[13] The extended leases are limited to a period of 30 years, and afterward can be extended by agreement or arbitration.[14] In theory, the mandatory extension of the lease term allows the residential property owner to obtain a 30-year mortgage without placing the investment—that is, the house—at risk because of the lease's expiration.

In 1975, the legislature amended the land reform act to allow lessees, under certain circumstances, to abandon improvements at the end of the term and to compel the lessor to pay the appraised fair market value of the improvements.[15] In 1988, however, the Supreme Court of Hawaii, in *Anthony v. Kualoa Ranch Inc.*,[16] limited application of the 1975 amendments to leases that were signed after enactment of law.

HAWAIIAN LEGISLATURE ADDRESSES DIFFICULTIES, BUT CONTROVERSY CONTINUES

Before the enactment of the Land Reform Act, Hawaii's legislature determined that concentrated land ownership was responsible for skewing the state's residential fee-simple market, inflating land prices and injuring the public tranquility and welfare.[17] In its legislative findings and declaration of necessity, Hawaii's legislature determined that the concentration of ownership led to a serious shortage of reasonably priced fee-simple property in urban areas, and that the shortage adversely affected the economy of the state and was contrary to public interest because it undermined health, welfare, security and happiness.[18]

Rent increases often are substantial, rising to several hundred times greater than the initial fixed rent.[19] In Hawaii, residential ground rents act almost identically to those in England or commercial ground rents, which exist everywhere. After the 99-year lease ends, the ground rent owner can reclaim the land and the buildings on it. The lease, as it is phrased in England, "falls in."

Given the numerous complications, it appears clear that these leasehold systems are contradictory to sound public policy and should be phased out.

At that point, the ground rent owner is free to tear down everything, build improvements and set up a new 99-year lease that reflects modern-day prices. And as these leases get closer to expiration, banks become increasingly reluctant to offer financing on the dwellings.

Controversy surrounding proposals to condemn leasehold ownership of condominium buildings in Hawaii and resell the fee-simple interests to individual unit owners continues.[20]

MARYLAND DEALING WITH MISSING OWNERS AND URBAN RENEWAL

Upon delivering a property, title companies frequently put the lessee ground rent in escrow because they cannot readily ascertain the identity of the lessor from public records.[21] Because the sale of lessors' leased-fee interests typically are not noted in public records, lessees who want to redeem and pay ground rents often can't find the owner.[22]

The Maryland legislature recognized this problem and in 2003 changed the laws to allow home purchasers to redeem or purchase lessors' interests in ground rents if those landowners couldn't be located. Under the new law, the entity that conveys the title must collect and deposit three years of ground rent into a state escrow fund, along with expenses. After posting notice, the entity either pays the funds to the owner of the leased fee title if that person is found, or arranges for the funds to be kept on deposit and escheated to the state after 20 years.[23]

Many ground leases date back to a pre-inflationary era. With fixed principal and interest amounts, the leases typically require payment of 6 percent interest on the stated value of the land.[24] In the current state of modern real estate transactions, a foreclosure on such a small amount brings a forfeiture that is grossly out of proportion to the value of a fee-simple interest.

An additional undocumented difficulty could arise from a burst of gentrification activity in Baltimore's waterfront community, which has spurred urban rehab developers to create numerous new leaseholds and ground rents.[25] The practice is as odds with the Truth in Lending Act and its corollary Regulation Z.[26] According to the regulations, any party who creates five credit instruments in a calendar year may be subject to disclosure requirements and borrowers' rights of rescission. So far, no one has filed a lawsuit, but one likely will come in due time.

LEASEHOLD SYSTEMS NO LONGER SERVE THE PUBLIC INTEREST

Given the numerous complications, it appears clear that these leasehold systems are contradictory to sound public policy and should be phased out.

The Hawaii system is a relic from the days of the island's historic monarchy. Though Hawaii's history deserves a great deal of respect, the U.S.'s founding principle when establishing ground rents was to avoid monarchical powers, which at the time owned vast amounts of land. The land reform act will gradually bring dissolution of the oligopoly of land ownership, and some argue that the government should expedite the transformation from concentrated ownership of land to a fragmented and individual ownership scheme.

The Hawaiian system of leases defies the national trend, adversely affects amortization of loans, and ultimately deprives ordinary citizens of the privileges of building equity and bequeathing wealth to subsequent generations. Others argue, however, that the only thing that would impede homeowners' ability to build equity would be if the ground rent escalates above the market norm because a leasehold sale basically constitutes a purchase and a rent for a definitive term.

The Maryland ground rent system is another anachronism that cries out for elimination. Historically, a $90 or $180 ground rent with a capitalized rate of $1,500 or

$3,000, respectively, reduced the price of residential property to encourage and facilitate home ownership. As the price of property has increased, however, the Maryland ground rents have become little more than forfeiture traps for the unwary.

The Maryland ground rents survive challenge under the rule against perpetuities,[27] but they nonetheless are perpetual encumbrances on clear title to property. The new statutory scheme of creating a state-operated escrow for escheat is unnecessarily cumbersome.[28] In many instances, it will require purchasers to forfeit funds at settlement—a time when most borrowers need as much cash as possible.

A more owner-friendly policy would be to require lessors to convert leasehold deeds into second mortgages, and grant purchasers the right to merge them into primary financing. The indebtedness caused by the ground rents then would be on record, eliminating the need to search for the lessor. The encumbrances would be phased out through payment of principal and over a period of years, the anachronism would disappear.

At the very least, Maryland should require owners of fee-simple titles to place transfers, succession, and other changes of ownership on the public record so owners are documented.

CONCLUSION

These two systems may have different origins and histories, but they have the same effect. Hawaii's land leases and Maryland's ground rents fragment ownership of individual homes and complicate the American dream of home ownership. The same or similar problems exist in Florida, Arizona, Pennsylvania and the place where it all started: London.

To better serve the public interest, each of these U.S. states should find a way to gradually phase out its peculiar system in favor of a system that conclusively and permanently consolidates fee-simple title to land and the improvements located on the land into one instrument. ■

ENDNOTES

1 Its original purpose was an attempt by feudal tenants to put themselves in the role of lords over lower tenants.

2. *Banks v. Haskie*, 45 Maryland 207 (1876).

3 *Jones v. Magruder*, 42 Federal Supplement 193 (District of Maryland, 1941), *Kolker v. Biggs*, 203 MD. 137, 99 A2d 743 (1953)

4 Maryland Code, Real Property Section 8-110(b)(1)

5 *Posner v. Bayless*, 59 Maryland 56 (1882)

6 *Marburg v. Mercantile Building Co.*, 154 Maryland 438, 110A.836(1928)

7 *Jones v. Magruder*, *supra*.

8 *Hawaii Housing Authority v. Midkiff*, 467 U.S. 229 (1984). The Hawaiian Islands were originally settled by Polynesian immigrants from the western Pacific. These settlers developed an economy around a feudal land tenure system in which one island high chief, the ali'i nui, controlled the land and assigned it for development to certain subchiefs. The subchiefs would then reassign the land to other lower ranking chiefs, who would administer the land and govern the farmers and other tenants working it. All land was held at the will of the ali'i nui and eventually to be returned to his trust. There was no private ownership of land. See generally Brief for Office of Hawaiian Affairs as Amicus Curia3-5.

9 *id*, 32-33.

10 See Note "*Anthony v. Kualoa Ranch Inc.*: Statutory Requirements to Purchase Residential Leasehold Improvements Is Unconstitutional as Applied Retroactively," 10 University of Hawaii Law Review 419, 422. This case note provides an excellent history of the development of Hawaii's leasehold system.

11 Hawaii Revised Statutes 516, *et seq.*

12 The U.S. Supreme Court upheld the Constitutionality of the condemnation regimen in *Hawaii Housing Authority v. Midkiff.*

13 Hawaii Revised Statutes 516-65.

14 Hawaii Revised Statutes 526-66

15 Hawaii Revised Statutes 526-70

16 *Anthony v. Kualoa Ranch Inc.,* 69 Hawaii 112, 736 P.2d55 (1987)

17 *Hawaii Housing Authority v. Midkiff, supra*. at 233.

18 See note *Anthony v. Kualoa Ranch Inc.*, *supra*. 10 University of Hawaii Law Review 419, 422 citing Act effective June 24, 1967, N. 307 Hawaii Session Laws 488, 489 Hawaii Revised Statutes 526-83(a) 1985)

19 *Richardson v. City and County of Honolulu*, 124F3d 1150 (9th Circuit Court, 1997)

20 "The Constitutionality of a Naked Transfer: Mandatory Lease-to-Conversion's Failure to Satisfy a Requisite Public Purpose in Hawaii's Condominium," 25 University of Hawaii Law Review 561.

21 Eric Seigel, "Ground rent gives new owner headache," *The Baltimore Sun*, March 3, 2005.

22 Phillip McGowan, "Tradition: Ground rents are as much a part of Baltimore as steamed crabs, but not as simple," *The Baltimore Sun*, May 2, 2004.

23 Maryland Code Real Property Section 8-100(f)

24 *id.*

25 This is personal observation of the author, who owns and operates a title company active in the redevelopment areas in the city of Baltimore.

26 15. U.S.Code 1601, et seq.

27 The rule against perpetuities is one of the most complicated parts of estate planning to explain. Basically, common law disfavors and prevents property from being held perpetually in trust and, therefore, voids any agreement (varies from state to state) that does not end 21 years after a life in being, or one generation from lives presently in being plus 21 years.

28 Maryland Annotated Code, Real Property Article, Section 8-110.

RECOMMENDED READING

The Appraisal of Land

by Max Derbes Jr., CRE, MAI (2006, Mechling Books, Chicora, PA, 470 pages)

REVIEWED BY P. BARTON DELACY, CRE, MAI

FEW COUNSELORS HAVE BEEN MORE PROLIFIC in their writing and teaching than the late Max Derbes Jr., MAI, CRE, ASA, SR/WA. Max died last year at the age of 82, but not before writing his final magnum opus, *The Appraisal of Land*. The book is a virtual encyclopedia of theory and application, reflecting the author's half century in the field, which was punctuated with extensive writing and teaching experience.

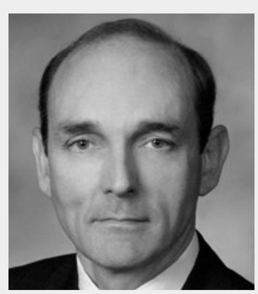
A veteran of World War II and second-generation MAI, Derbes joined his father's real estate firm in 1946 in New Orleans. During a nearly 60-year career, Derbes had significant industrial and right-of-way engagements including the then-proposed super-collider project near Dallas. He also wrote the industrial property valuation course for the former AIREA (the American Institute of Real Estate Appraisers), now the Appraisal Institute.

Privately published by Mechling Books, *The Appraisal of Land* has had only limited distribution to practicing appraisers. According to his son, Max J. Derbes III, CRE, the family would gladly donate the book rights to a real estate or appraisal professional organization that agreed to publish the work.

USE VALUE: LOGICAL OR UNORTHODOX?

Notwithstanding the book's staid presentation, some of the content is not without controversy. When Derbes first attempted to publish earlier in the decade, the Appraisal Institute and the International Right of Way Association both took a pass because of Derbes' discussion of the "use value" of land. Derbes explores at length the concept that, under some circumstances, land is not necessarily worth its highest and best use value but some other value related to its value in use and its logical contribution to the value of the property.

Derbes goes to great lengths to acknowledge where the Uniform Standards of Professional Appraisal Practice, or USPAP, call for a highest and best use valuation of land, and when they allow for some exception. He also quotes a number of legal cases in which judges make those distinctions. Nevertheless, his conclusion has been challenged as unorthodox by other leading practitioners active in the Appraisal Institute today.



About the Columnist

P. Barton DeLacy, CRE, MAI, *is managing director and national practice leader for corporate finance consulting at Cushman & Wakefield. He is based in Portland, Ore.*

This viewpoint is a shame because the book properly anticipates some of the scope of work challenges confronting appraisers today. Derbes concludes that it is up to the appraiser to determine the type of use that dictates the value of land. This is similar to the 2006 USPAP scope of work rule. Scope of work requires the appraiser to shoulder the burden to define the appropriate value and ensure that the results of such an analysis not be misleading or inappropriate.

Derbes' perspective may have evolved through his litigation practice, where he was often asked to value special purpose industrial properties for local assessors. His guiding definition was: "Use value relates to the value that results from that use deemed appropriate by the appraiser in light of the client's objectives" (see page 314).

As an example, he notes that the value of a farm under special assessment might be different for property tax purposes than for a mortgage loan.

BOOK COVERS TRADITIONAL TECHNIQUES AND TODAY'S CONTROVERSIES

Though *The Appraisal of Land* presentation is old school and gives one the feel of an Ellwood text, Derbes left few issues uncovered. He begins with defining the appraisal problem and discussing conventional valuation methodology, then moves to economic theories including use value. His section on right of way valuation encompasses traditional before-and-after techniques before extending to current controversies such as site contamination, corridor analysis and other complicated takings issues.

Perhaps it is appropriate for a professional body to sponsor a second edition of this thoughtful work as a legitimate contribution to the real estate profession. Indeed, with the real estate valuation profession dating back not much earlier than the depression era of the 1930s, it may be too soon for valuation theories to become so ossified and orthodox. Perhaps there is still time in the academy and in the field to debate the precepts and theories that compelled thoughtful practitioners such as Derbes to devote their lives.

> The Appraisal of Land *is a virtual encyclopedia of theory and application, reflecting the author's half century in the field, which was punctuated with extensive writing and teaching experience.*

On balance, the book is a worthy edition to anyone's real estate and valuation library. However a second edition might seek to consolidate some of the chapters and, more important, provide enhanced illustrations and diagrams to break up the text for an emerging generation of attention-deficit afflicted practitioners. ■

FOCUS ON INVESTMENT CONDITIONS

Capital Still Flows Into Commercial Sector as Investors Become More Discriminating

BY KENNETH P. RIGGS, CRE

COMMERCIAL REAL ESTATE continues to be an attractive investment relative to stocks and bonds for many reasons. Today, however, the appeal of commercial real estate is in its extremely high realized total returns in the absence of very little perceived downside risk.

The level of capital that continues to flow into the market indicates that commercial real estate is clearly coming of age. This sustained level of capital in the public and private real estate markets has created a very competitive environment for investment product. With this continued influx of retail and institutional capital, commercial real estate investments will push the envelope by taking on riskier investment strategies and, as a result, pricing parameters for commercial real estate continues at heightened levels.

Observers are seeing upward pricing pressure and extremely low cap-rate expectations for properties high on the list for institutional investors. However, it appears that investors are exerting upward pressure on cap rates for properties that are more interest-rate sensitive and in more marginal locations. The market is not fickle, but reflective of investors becoming more discriminating.

Commercial real estate performance has easily outpaced other investments and continues today to far exceed investor expectations. This success can be measured by a comparison of realized vs. expected returns, which has been a very good barometer of the relative strength of the market.

Institutional commercial real estate investors sense that they have had it too good for too long in the traditional core real estate arena. They realize it is an appropriate time to look outside the defined core property types and change their traditional views of real estate investments. As Table 1 shows, commercial real estate has been in an over-performance phase—with realized returns exceeding expected returns—since the second quarter of 2004.

Comparing these expected returns with realized returns shows a market that has been over-delivering—promises

About the Columnist

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made were promises kept. This performance is a contrast to the relationship observed in the past. The NCREIF Property Index, or NPI, exemplifies this phenomenon with annual total property returns of more than 19 percent for the 12 months ending second quarter 2006 and more than 15 percent over a three-year period for largely core-type investments. Investors have lowered overall return expectations as the sluggish stock market shows flat capital growth year-to-date, and low interest rates have permitted a high degree of positive leverage.

For much of the 1990s, strong returns for alternative investments, including stocks, led to the promise of overly aggressive acquisition returns. NPI returns were negative to 7.5 percent from 1990 through 1995, and did not exceed 9 percent from 2001 through 2003. As shown in Table 2, commercial real estate has done well and clearly has earned its rank among stocks and bonds.

The maturing of the industry and expanding view of what is considered an appropriate commercial real estate play is coming at a very challenging time in our world. Common concerns include inflation, increasing interest rates, geopolitical tensions in the Middle East, a slowing in the housing market, a reduction in discretionary consumer spending and higher commodity prices, especially oil. Despite continued strong consumer confidence, the lower end of the market is showing some signs of consumer stress.

Real estate investors are evaluating what the changing economic, financial and political environments mean to

Table 1

RERC All Properties Investment Performance Cycle

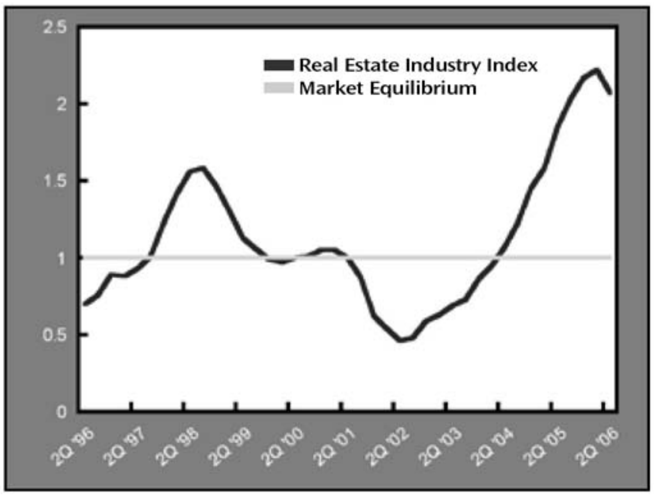

Table 2

What Do The Financial Markets Tell Us?

Compounded Annual Rates of Return as of 6/30/2006

MARKET INDICES	1-YEAR	3-YEAR	5-YEAR	10-YEAR	15-YEAR
Consumer Price Index	3.18%	2.63%	2.70%	2.83%	2.92%
10-Year Treasury Bond*	4.59%	4.37%	4.41%	5.12%	5.65%
Dow Jones Industrial Average	8.52%	7.46%	1.20%	7.03%	9.38%
NASDAQ Composite	3.06%	9.42%	0.24%	5.90%	10.31%
NYSE Composite	10.31%	12.67%	3.66%	7.74%	9.00%
S&P 500	6.62%	9.24%	0.74%	6.60%	8.55%
NCREIF Index	18.68%	15.85%	12.13%	12.49%	9.01%
NAREIT Index	19.06%	26.14%	19.39%	15.13%	14.70%

*Based on Average End of Month T-Bond Rates
Sources: Economy.com, NCREIF, compiled by RERC

Table 3: RERC Investment Criteria Chart

RERC Required Return Expectations[1] by Property Type

	OFFICE		INDUSTRIAL		RETAIL						
	CBD	Suburban	Warehouse	R&D	Regional Mall	Power Center	Neigh/Comm	Apartment	Hotel	Avg. All Types	RERC Portfolio Index
PRE-TAX YIELD (IRR) (%)											
Range	7.5-11	7.3-11	7-12	7.5-12	7.5-11	7.3-10.5	7-10.5	7.3-10	9-12	7-12	7-12
Average[2]	8.8	9.1	8.7	9.4	9.2	8.6	8.5				
Weighted Average[3]	9		8.7			8.9		8.4	10.8	9.1	8.9
GOING-IN CAP RATE (%)											
Range	6-8.5	6.3-9	5.5-9.5	6.5-9.5	5.8-9	5.5-8.5	5.5-8.3	5-8.1	6.5-10.5	5-10.5	5-10.5
Average[2]	7.1	7.5	7.2	7.8	7.5	7.1	7				
Weighted Average[3]	7.3		7.2			7.3		6.5	8.9	7.4	7.2
TERMINAL CAP RATE (%)											
Range	6.3-9.3	6.8-9.5	6.5-10	6.8-10	6.3-10	6-9.5	6-9	5.5-8.6	7.2-11	5.5-11	5.5-11
Average[2]	7.7	8.1	7.9	8.5	8.2	7.7	7.6				
Weighted Average[3]	7.9		7.9			8		7.1	9.6	8.1	7.8
RENTAL GROWTH (%)											
Range	0-5	0-4	0-3.5	0-4	1-3.3	0-3.5	0-3.5	0-4.5	2-7	0-7	0-7
Average[2]	3	2.9	2.6	2.5	2.6	2.5	2.7	3.1	3.4	2.8	2.9
Expense Growth (%)											
Range	2-3.5	2-4	1.5-3.5	2-3.5	2-3.5	2-3.5	2-3.5	2-3.5	3-4	1.5-4	0.5-4
Average[2]	2.9	2.9	2.8	2.8	3	2.9	2.9	3	3.2	2.9	2.9

[1] **This survey was conducted in April, May and June 2006 and reflects expected returns for second quarter 2006 investments.**
[2] **Ranges and other data reflect the central tendencies of respondents: unusually high and low responses have been eliminated.**
[3] **Weighting based on 1Q06 NCREIF Portfolio market values.**
Source: RERC Investment Survey

returns. In some cases, the best option is investing in a different property sector. In other cases, it is evaluating demographic and industry changes and possibly selecting a different location in which to invest. In still other cases, it is taking a realistic look at costs such as insurance or other expenses, and determining whether it is possible to pass them on to tenants in the form of higher rental rates. We have enjoyed the benefits of a growing economy and will continue to do so. But as the rate of growth moderates, expect adjustments to the changing market.

A CLOSER LOOK AT THE MARKETS

Shifting from the previous two quarters, respondents to RERC's second quarter 2006 institutional survey rated commercial real estate slightly higher than stocks as an investment alternative (stocks were rated more favorably during the previous two quarters). The most recent respondents continue to prefer stocks over cash and bonds. These institutional survey respondents rated all commercial property types lower than in the previous quarter in terms of investment prospects.

On a scale of 1 to 10, with 1 being the lowest, the industrial warehouse and apartment sectors tied for the highest rating, at an average of 6.3. Of all the primary sectors, retail earned the lowest ratings, and the regional mall subsector received the lowest score—a 4.6 average—of all property types that RERC surveys each quarter.

OFFICE SECTOR

RERC's second quarter 2006 investment conditions ratings for the central business district and suburban office markets are slightly lower than those of the previous quarter. Office market fundamentals have improved slightly on a national basis. Decreasing vacancy rates and an increase in demand because of fewer completions have helped to increase rental rates slightly.

RERC's required going-in capitalization rates for the CBD and suburban office subsectors increased from last quarter by 10 and 20 basis points, respectively (see second quarter 2006 rates in Table 3), and the terminal capitalization rates for each property type increased as well. Survey responses indicate that expected rental growth, by percentage, in both types of office properties is likely to decline. However, vacancy rates continue to decline, and supply growth remains constrained.

INDUSTRIAL SECTOR

Respondents gave the industrial warehouse sector one of their highest investment conditions ratings—6.3 out of 10, with 10 being high—tying for the top spot with the apartment sector during second quarter 2006. However, the 6.3 rating was lower than last quarter's rating of 7.0. Respondents rated the industrial research and development sector at 5.5, down from 5.9 last quarter. Some respondents expect these numbers to improve because of increasing construction costs and land prices, which will limit the amount of development.

RERC's required going-in and terminal capitalization rates for industrial warehouse and R&D space each increased from the previous quarter, though expected rental growth was down for both property types. Expected expense growth for the industrial warehouse sector remained steady at 2.8 percent, and the industrial R&D sector increased slightly to 2.8 percent.

APARTMENT SECTOR

The investment conditions rating for the apartment sector has decreased slightly from the previous quarter, but is still tied, along with the industrial warehouse sector, for the highest rated sector. Second quarter 2006 apartment vacancy decreased to 5.6 percent from 5.8 percent, according to Reis Inc. The decline in occupancy is primarily because of increased absorption.

Some respondents suggest the apartment sector is on the upturn, and performance will improve as increasing interest rates make owning a home less affordable, thereby increasing demand, occupancy and rental rates. RERC's going-in capitalization rate for the apartment sector increased to 6.5 percent from 6.4 percent last quarter, and expected rental rate growth for apartments also is up.

RETAIL SECTOR

Institutional survey respondents placed the retail sector at the bottom of the scale with respect to investment conditions for second quarter 2006. On a scale of 1 to 10, with 1 being the lowest, neighborhood/community centers received a 5.6, power centers received a 5.0, and regional malls received a 4.6—the lowest of all of the property types that RERC surveys each quarter. All these ratings were between 40 and 90 basis points lower than first quarter results.

Respondents gave the industrial warehouse sector one of their highest investment conditions ratings—6.3 out of 10, with 10 being high—tying for the top spot with the apartment sector during second quarter 2006.

The rating is influenced by a number of issues, including increased caution in consumer spending, an already overpriced retail sector with no room for growth, overbuilding, and capitalization rates that are becoming much closer to interest rates. Retail sector availability rates are continuing to increase, with current availability at 8.5 percent, up from last quarter's 7.6 percent, according to Torto Wheaton Research.

In part, this increased availability rate is caused by the slowdown of retail sales in some areas, partially spurred on by increased housing and fuel costs. Because these factors probably won't improve greatly, the retail sector is likely to see continuing availability increases. Research shows that six of the top 10 areas with the lowest availability rates in the retail sector are in the state of California.

HOTEL SECTOR

RERC's investment conditions rating for hotels for second quarter 2006 is 5.6, slightly lower than the previous quarter's rating of 6. Several respondents to the RERC institutional investment survey stated that the hotel industry is facing high demand and will fare well because of limited supply.

According to Torto Wheaton Research, hotel occupancy rates have increased to nearly 72 percent from 66 percent last quarter. Revenue per available room, or RevPAR, is at $80, an increase of 8 percent since year-end 2005. Some areas with the highest RevPAR include New York City at

Table 4
RERC Expected Return Estimates

RISK CATEGORY	LEVERAGE	TOTAL EQUITY RETURN
Core (no or low leverage)	0 to 25%	7% to 8%
Core (moderate leverage)	25% to 50%	8% to 10%
Core-Plus	50% to 70%	10% to 13%
Value-Add	65% to 75%	13% to 16%
Opportunistic	70%+	16%+

just over $175; Washington, D.C., at $120; and Honolulu at nearly $120.

RERC's going-in and terminal capitalization rates for the hotel sector increased to 8.9 percent and 9.6 percent, respectively, and expected rental growth for hotels increased 30 basis points compared with last quarter. This increase is the first since third quarter 2005, indicating a possible upturn in the hotel sector. The development of mixed-use facilities that incorporate hotels with condominiums also is increasing, allowing new properties to enter the market while keeping the amount of new offerings in check.

CONCLUSION

Commercial real estate is coming of age in a global environment and, as such, is creating new investment frontiers and strategies. As the industry matures, it continues to take on elements of investment style and attitude like the stock and bond markets. In today's extremely capital competitive world, investors are willing to take on unexplored risk arenas in search of alpha, or higher returns with lower relative risk.

The challenge for the entire industry is to develop more rigorous models to approach risk classification and quantification relative to expected return. Commercial real estate is in a very solid position to get it right this time, and to continue to play a more significant role in the investment portfolios of both retail and institutional investors. Given the still local nature of commercial real estate, there is the opportunity for investment managers to add value and, thus, find true alpha strategies.

RISK AND RETURN INVESTMENT SPECTRUM

Based on RERC's extensive work in the industry, its conclusions, and the general consensus noted in forecasts for recent investment funds, the range of total equity return parameters expected by investors gives an indication of the risk profile of the classifications listed in Table 4.

The yield parameters have changed through the years, with steady declines in the past several years. Most new investment funds that target institutional capital, such as commingled funds sponsored by pension fund advisors, market themselves with monikers expressing their risk profile using the aforementioned labels. ■

FOCUS ON U.S. MARKET PRICING

Is U.S. Real Estate Priced Right Today?

BY RAYMOND G. TORTO, PH.D., CRE

AT TODAY'S RECORD PRICES, and with 20 percent total returns over the last year, many investors have found themselves asking: "Are real estate prices too high?"

Recent research shows capitalization rates in the low 6 percent range for office, industrial and retail properties, and less than 5 percent—yes sub-5s—for multihousing. Though interest rates have risen about 75 basis points since the first of the year, cap rates have barely moved. Higher borrowing rates have taken many debt-based investors out of the bidding, but evidence from the field shows that there are still large numbers of bidders on each offering, keeping prices high and cap rates low.

Analyzing pricing and cap rates means looking at their components. Cap rates form around the risk-free rate, the risk premium, capital expenditures and the expected appreciation in the net operating income and value of assets. The equation is:

Cap rate =	+	**Risk-free rate**
	+	**Risk premium**
	+	**Capital expenditures**
	–	**Expected appreciation**

The first three terms in the equation are additive and move positively with the cap rate. Higher interest rates, for instance, raise the cap rate—*ceteris paribus*. However, falling risk premiums or rising expectations for appreciation can offset higher interest rates and, if this happens, cap rates may not move in the face of increasing interest rates. This is clearly something that has happened in the past six months.

Analyzing cap rates by their components can help to set straight a terrible myth. Many analysts take the cap rate less the risk-free rate and erroneously call that the risk premium. But the difference really comprises several components:

Cap rate – Risk-free rate=	**+ Risk premium**
	+ Capital expenditures
	– Expected appreciation

Since 1988, this difference between the cap rate and the risk-free rate, using the 10-year U.S. treasury note as the benchmark, has ranged from a negative 275 basis points to a high of 500 basis points, depending on the property

About the Columnist

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type. The gap now is essentially 25 basis points for multifamily and about 125 to 150 basis points for office, industrial and retail property types.

But let's return to our question. Is real estate priced correctly today? Today's 10-year U.S. treasure note is about 500 basis points and most folks would agree that the risk premium and cap expenditures together range from about 200 basis points for multifamily to 300 or 350 basis points for office, industrial and retail. Analysts at Torto Wheaton Research believe that the 100 to 150 basis-point difference is because the market realizes capital expenditures for multifamily is much less than for other property types.

I know I'm not being exactly precise here but, for discussion sake, let's assume that the risk premium *plus* capital expenditures is 300 basis points. With the risk-free rate at 510 basis points, this would sum to 810 basis points. If expected appreciation were zero, the cap rate should be 8.1 percent today. If we thought that the U.S. Federal Reserve System was going to raise the 10-year U.S. treasure note to 5.5 percent in the near future, then with an expected appreciation of zero, cap rates would be 8.5 percent.

Torto Wheaton Research's fall 2006 forecasts for real estate fundamentals predict the market will improve nicely, even with a housing and consumer slowdown built into the forecasts. The markets in general are showing strong recovery in occupancy and some good rent traction. Gross income, sometimes called economic rent, is rising annually in the 3 percent to 5 percent range on average—and high singles or even double digits in some markets. Net operating income growth is the old-fashioned way of achieving appreciation.

Because expenses need to be subtracted from gross income, we could estimate that expected appreciation is 200 basis points. Doing the arithmetic, this equals a 6.5 percent cap rate. Operating on these assumptions, it strikes me that real estate is priced correctly; however, you should work out your own assumptions. This type of cap rate analysis can help you identify where you think the risk lies. If you predict, for instance, that the risk-free rate is going to 10, then you'll have a very different conclusion. However, I would argue that at that level, all investments today are priced incorrectly.

One last point: while research indicates that real estate is priced correctly today, economic and real estate forecasts show that pricing is very inefficient across markets. When we line up cap rates with estimates of market gross income growth, we do not see the relationship that ought to be there: a negative correlation that shows low cap rates in markets expected to do better in the future, and high cap rates in markets expected to do less well in the future. In other words, pricing is not efficient based on the outlook for markets and property types—at least based on the way some researchers see the outlook.

Of course, market inefficiency can translate into opportunities for those with the right insights—finding mispriced real estate assets can be fruitful investments for those who see the true value. ■

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