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CRE

Editor's Statement

BY MAURA M. COCHRAN, CRE

IN MY ROOKIE YEAR, now more than 30 years ago, an industry leader whose name I have long forgotten said that to succeed in real estate you needed either a background in finance or law and had to learn architecture, engineering and planning; or a background in architecture, engineering and planning and had to learn finance and law.

He theorized that many a bad portfolio decision was made by those with MBAs who had never taken a course in urban planning and, therefore, did not understand the dynamics of a community; or those who had never taken a basic construction course and didn't know what they were looking at when they did a site inspection. On the flip side, there are architects who don't understand that buildings need to be leased at market rates with an efficient floor plate.

When the downturn happened in the early 1990s, his observations were prophetic. As buildings went back to lenders in foreclosure, it became evident that many of the projects never should have been built in the first place.

His words have been a focal point of my career. Because my background is in architecture and urban planning, I have consciously affiliated with team members who bring the missing pieces of the puzzle to the solution. The CRE organization is a major part of that knowledge base—through Counselors sharing their experiences and life work and, in more than a few occasions, partnering with my firm to win and complete assignments. Overall, CREs have an intellectual curiosity that makes even casual encounters educational.

Real Estate Issues mirrors the Counselor community. Three times a year, it presents current thinking and research from our members and other industry leaders. This issue has four main sections:

- Land Use
- International Issues
- Tax and Regulation
- Economy

LAND USE

The issue leads off with a synopsis of Steve Rushmore's presentation from the recent CRE Annual Convention, held October 2006 in Maui, Hawaii. As one the leaders in the hospitality and hotel industry, his insights gave a great perspective to a complex topic.

Next is the first installment of a new *REI* feature: a roundtable discussion. The panel, led by CRE Marilee Utter, delved into the characteristics of great cities and how to encourage smart, sensitive development that is contextually appropriate in cities across the U.S. Panelists James Curtis, CRE, Richard Hanson, CRE, and Lynn Sedway, CRE, all have distinct views about issues such as mass transit and zoning. I'm sure readers will follow their discussion with interest.

After having seen the film "An Inconvenient Truth," CRE Richard Ward's article about floodplain development strikes home. He makes a strong case for changing land-use policies to avoid more disasters such as the Hurricane Katrina aftermath and the Great Flood of 1993, which decimated scores of communities along the Mississippi and Missouri rivers.

INTERNATIONAL ISSUES

This ongoing department includes three articles focusing on global matters. David Lynn, Ph.D., CRE, discusses the pros and cons of investing in property markets outside the United States. He points out that "investors … could potentially enjoy higher returns, increased portfolio diversification, greater variety of investment vehicles and the opportunity to benefit from the growth of the global economy."

Barry Gilberston, CRE, FRICS, presents the second of a four-part series encapsulating his perspective on the state of the property market in the United Kingdom. (Visit the online *REI* archives at www.cre.org/publications/rei_abs.cfm to read the first article, which was published in the Fall 2006 edition of *REI*.) Though he concentrates on the UK, the issue of ever-rising values in the commercial property sector affects markets worldwide.

Mary Bujold, CRE, has written a resource review of *The Right to Buy: Analysis & Evaluation of a Housing Policy*. The book, written by Colin Jones and Alan Murie, details the background and policies of council housing in the United Kingdom. Similar to affordable housing in the United States, council housing has gone through numerous phases with varying degrees of success. The review provides insights that consultants who deal with housing in many parts of the world will find valuable.

TAX AND REGULATION

These articles are a must read because they cover new regulatory issues. Dianne Crocker's article about environmental due diligence addresses the changes in requirements that took effect Nov. 1, 2006. The U.S. Environmental Protection Agency's new All Appropriate Inquiry rule has created a great deal of uncertainty in the market as practitioners try to interpret and implement the guidelines.

Mike Cannon, CRE, offers his review of *USPAP in Plain English*, written by John Leary, CRE, FRICS, and Albert Franke III. Though I am not an appraiser, I am glad to know of a resource I can turn to—and CREs I can call—that address an issue that touches so many real estate transactions.

ECONOMY

Kenneth Riggs, CRE, is a regular contributor to *REI.* Many know Riggs from the many reports that his company, Real Estate Research Corp., produces. His perspective pieces about the economy provide a great continuity for those of us who need to track leading performance criteria and explain the market to clients.

CRE Dick Maine's firm, Madison Harbor, develops real estate investment strategies organized as multi-manager funds. In other words, it is a fund of funds. He presents a viewpoint on market conditions from that of the dealmaker and provides an interesting bookend to Ken Riggs' research.

REI UPDATES

For the past year, the REI Editorial Board has been working with CRE staff to develop an electronic delivery medium for *REI.* This issue marks the successful completion of that effort. Counselors and subscribers will begin receiving via e-mail the electronic *REI*, which includes article summaries and links to the full version of each article. This tool gives readers the ability to review articles online and easily forward topics of interest to colleagues and clients—a great way to share the wealth of knowledge in each issue. Of course, Counselors and subscribers will continue to receive *REI* in print format as well.

In other news, the REI Editorial Board agreed recently to review and potentially publish limited-circulation articles; for example, those that have appeared in a company newsletter. If you or your firm has a timely article relevant to the field of real estate counseling, feel free to submit it to *REI* Managing Editor Marcie Valerio. Likewise, we encourage individuals who would like to recommend topics and panelists for future roundtable discussions to share their thoughts. Forward all submissions and suggestions to mcochran@bartramandcochran.com and mvalerio@cre.org.

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CRE

FOCUS ON HOSPITALITY

Despite Age-Old Risks, Opportunities Abound in the Hotel Industry

BY STEVE RUSHMORE

Editor's note: This article is excerpted from the presentation Steve Rushmore delivered during the 2006 CRE Annual Convention, Oct. 23 – 26 in Maui, Hawaii. Read more conference coverage in most recent issue of The Counselor *newsletter (published January 2007) and at www.cre.org/programs_and_events/annual_convention.cfm.*

GENERALLY IT'S A GREAT TIME TO BE IN THE HOTEL BUSINESS—and a great time to be consulting in hotels—because everything you say is upbeat and good. No matter where you are in the world, it's almost universal that the hotel industry is doing well, particularly in the United States.

But there's always risk. Some of the major risks of investing in hotels are over-building, economic lifespan and natural disasters. We'll touch upon each of these issues briefly.

The first risk is over-building. People say the best thing for a hotel is location, location, location. I say it's barriers to entry, barriers to entry, barriers to entry. You want to be in a location where the competition isn't going to build another hotel. In the United States this could be anyplace on the coast, especially in California and the Northeast. The Southeast is not as good—it's very easy to get things built down there.

If you look at any of the downturns in the hotel industry, they're because of over-supply. The reason the hotel industry is doing so well now is because the supply has been in check for about the last five years. It doesn't look like we're going to get a whole lot of new hotel supply coming in on a macro basis in the United States. Some markets will get over-built, but for the most part it's pretty well under control.

A number of factors have led to this situation. First, it's very difficult to finance new construction in the hotel industry today. The cost of building a hotel, particularly a five-star hotel, is another barrier to entry because the chances are good that the developer could end up with a hotel that costs more than its economic value.

THE BATTLE AGAINST OBSOLESCENCE

Then we have economic lifespan, or the fact that hotels suffer from physical deterioration, external obsolescence and functional obsolescence. Take, for example, the original Waldorf-Astoria Hotel built at Fifth Avenue and

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34th Street just before the turn of the 19th century. It was torn down to build the Empire State Building only 34 years later. So the original Waldorf-Astoria in New York lasted less than four decades. It was moved over to Park Avenue and has been there ever since, but what's interesting is the concept of economic life.

My company verified a study that found the economic life of most hotels is about 41 years. That sounds fairly reasonable, but consider the standard deviation. That is the risk of investing in hotels (see Table 1). You don't know within one standard deviation whether your life is going to be 20 years or 60 years. Therein lies the problem.

Table 1

Economic Lifespan

	LIFE IN YEARS	STANDARD DEVIATION
Hotels	40.91	20.63
Motels	31.00	6.87

Other significant problems are external and functional obsolescence. Motel-type properties built through the decades are rather obvious. The exteriors really date the properties, which means hotels that are more than 20 to 30 years old need major external renovation.

When you go inside the hotel you can also date it by what the décor looks like. When you really think about it, has the interior of a typical hotel room changed? You walk in, you have a bathroom on the left, a closet on the right. You walk in a little bit farther and have a bedroom with a bed and dresser and table and so forth. Things haven't really changed; what changes is the décor. Maybe it's a conspiracy of interior designers to constantly change the style of hotels, but this is the reality that hoteliers face so they have to constantly put money back into their properties.

NATURAL DISASTERS CAN BE A BOON TO BUSINESS

The industry has experienced many hotel disasters recently. In New York City, the Sept. 11 terrorist attacks damaged numerous properties, but HVS studies show that a hotel disaster can actually be good for a local area from the hotel point of view. The research also indicated that travelers are very resilient. The New York City attacks made an impact on the city for about three months. After that the city went through a huge recession, but it had nothing to do with the attacks.

Other hotel disasters had only a two- or three-week impact. Certainly the December 2005 tsunami decimated that part of the world, but most of the hotels have been rebuilt and they're all doing well. Once the SARS virus was under control in Hong Kong, the hotels filled up again. So things happen and turn around very quickly after a hotel disaster.

Another example is Hurricane Katrina, which hit New Orleans in September 2005. By the end of 2005, the value of a typical hotel on a per-room basis went up about $11,000. Why? Because the hotels were filled; not with travelers, but with FEMA employees and insurance adjusters.

Luckily, the French Quarter is still vibrant, and the future is very bright for the hotel business in New Orleans because almost every group in the United States is saying: "We have to go and support New Orleans." In the next five to 10 years, tourism should increase, so it's an excellent place to invest in hotels. The same is true in other hurricane-ravaged cities around the United States. Hotels that are still standing after a hurricane do extremely well. Owners just have to get them up and operating to benefit from everyone who's coming in to help recover.

VALUES INCREASING IN MOST U.S. MARKETS

Now for the numbers (see Table 2). These figures are somewhat U.S.-centric—HVS tracks the values of a typical hotel in 65 U.S. markets—but show the value change on a per-room basis, a percentage change and a change per room for a typical U.S. hotel starting in 1987.

We saw a slow increase, then a recession and over-building had an impact in the early '90s. We had a period of very good growth from 1992 to 2000, with some years such as 1995 going up about 22 percent. The events of Sept. 11 coupled with a recession caused a decrease in typical hotel value of about 25 percent by the end of 2001. The year 2002 was flat and 2003 saw another slight decrease. In 2004, a typical hotel went up 27 percent; 2005 values increased about 26 percent.

So the hotel industry is definitely on the rebound because the economy is strong, people are traveling and the number of international travelers to the United States is growing. The most important factor, though, is that we've

Table 2

Value Change—United States

	1987	1988	1989	1990	1991	1992	1993
Value Per Room	$37,000	$37,000	$38,000	$32,000	$27,000	$30,000	$33,000
Percentage Change		0%	3%	-16%	-16%	11%	10%
Change Per Room		$0	$1,000	($6,000)	($5,000)	$3,000	$3,000

	1994	1995	1996	1997	1998	1999	2000
Value Per Room	$37,000	$45,000	$50,000	$59,000	$60,000	$61,000	$69,000
Percentage Change	12%	22%	11%	18%	2%	2%	13%
Change Per Room	$4,000	$8,000	$5,000	$9,000	$1,000	$1,000	$8,000

	2001	2002	2003	2004	2005	2006	2007
Value Per Room	$52,000	$52,000	$51,000	$65,000	$82,000	$94,000	$102,000
Percentage Change	-25%	0%	-2%	27%	26%	15%	9%
Change Per Room	($17,000)	$0	($1,000)	$14,000	$17,000	$12,000	$8,000

	2008	2009	2010	2011	2012	2013
Value Per Room	$107,000	$107,000	$102,000	$98,000	$94,000	$94,000
Percentage Change	5%	0%	-5%	-4%	-4%	0%
Change Per Room	$5,000	$0	($5,000)	($4,000)	($4,000)	$0

had very few new hotels constructed. As a result, occupancies go up and rates go up.

Looking to the future, the big questions are: When will the downturn hit, the supply increase or the demand slow down? HVS is projecting that will occur somewhere between 2010 and 2012. But compared with some of the 25 percent downturns, it should be a soft landing. Values will go down fairly slowly because supply shouldn't increase rapidly. Nevertheless, increases should grow faster than demand, and occupancy will go down.

Overall, the average value of hotels in U.S. cities should increase about $21,000, with more significant increases in top 10 cities (see Tables 3 and 4.) Value in only one market—Norfolk—is projected to decline.

VOLATILITY INDEX HINTS AT GOOD INVESTMENT MARKETS

Another thing to consider is what HVS calls the index of volatility: the standard deviation of value over a 20-year period of time. To calculate this index, we take the standard deviation of value change for a property or market and divide it by the average value in that market. Right now, the average index of volatility for a typical hotel in the United States is 16 percent (see Tables 5 and 6). So in stock market terms, that's the beta. If you assume volatility is a reflection of risk, the less risky markets are below 16 percent, and the more risky markets are in the 25 percent to 55 percent range.

HVS also tracks major transactions—single-asset sales of more than $10 million. The peak was in 1997 with 280 major transactions. As of September, 2006 has seen about 160. About 180 major transactions had taken place

Table 3

Change in Value per Room: 2005 – 2010

RANK — TOP CITIES			RANK — BOTTOM CITIES		
1	New York	$272,000	57	St. Louis	$17,000
2	Oahu	$168,000	58	Albuquerque	$15,000
3	San Francisco	$161,000	59	Syracuse	$12,000
4	Miami	$137,000	60	Pittsburgh	$12,000
5	Washington, DC	$136,000	61	Indianapolis	$11,000
6	West Palm Beach	$129,000	62	Sacramento	$11,000
7	Long Island	$128,000	63	Houston	$10,000
8	Boston	$125,000	64	Tallahassee	$8,000
9	Los Angeles	$105,000	65	Rochester	$7,000
10	Chicago	$94,000	66	Norfolk	($3,000)
54	USA AVERAGE	$21,000			

Table 4

Percentage Change Value: 2005 – 2010

RANK — TOP CITIES			RANK — BOTTOM CITIES		
1	Cleveland	180%	57	Las Vegas	26%
2	Denver	102%	58	USA	25%
3	Austin	93%	59	Pittsburgh	20%
4	Tucson	92%	60	Syracuse	19%%
5	New York	86%	61	Indianapolis	14%
6	Charlotte	85%	62	Rochester	13%
7	Dallas	83%	63	Sacramento	12%
8	San Jose	81%	64	Houston	12%
9	Long Island	81%	65	Tallahassee	10%
10	San Francisco	79%	66	Norfolk	-4%
58	USA AVERAGE	25%			

through September 2005 so we're a little bit below where we were last year. In all, 237 major transactions occurred in 2005. Per-room values also increased each year. Last year, the average price per room was about $160,000; this year the average transaction is about $204,000 per room (see Table 7).

Major transactions this year include the Four Seasons Resort on Hawaii's Big Island, which sold for more than $2 million a room; the Drake Swissotel in New York—sold as a tear-down to be rebuilt as condominiums—which went for $888,000 a room; and the Mark Hotel in New

Table 5

Index of Volatility: Relative Risk

RANK — TOP CITIES			RANK — BOTTOM CITIES		
1	New Orleans	11%	57	Wilmington, DE	25%
2	Albuquerque	12%	58	Boston	25%
3	Buffalo	12%	59	Oahu	27%
4	San Antonio	12%	60	Los Angeles	27%
5	Pittsburgh	12%	61	Austin	27%
6	St. Louis	12%	62	Oakland	29%
7	Sacramento	13%	63	San Francisco	31%
8	Syracuse	13%	64	Miami	37%
9	Cincinnati	13%	65	San Jose	40%
10	Indianapolis	13%	66	New York	55%
20	USA AVERAGE	16%			

Table 6

Low Volatility Index, High Change in Value, 2005 – 2010

VOLATILITY INDEX		CHANGE IN VALUE PER ROOM
11%	New Orleans	$61,000
12%	San Antonio	$55,000
13%	San Diego	$76,000
14%	Seattle	$52,000
14%	Baltimore	$52,000
14%	Santa Fe	$49,000
15%	Jacksonville	$57,000
16%	Tucson	$87,000
16%	Tampa	$54,000

York, which sold for $847,000 a room and is going to be converted to condominiums (see Table 8).

Markets where I would buy hotels: New Orleans, San Francisco, Boston, San Diego, Washington, D.C., Santa Fe, San Antonio. All of these areas have low supply, high barriers to entry and will do well over the next five to six years. I would sell if I had hotels in Norfolk, Houston or Tallahassee. Values either will go down, or they won't go up very fast. I would be cautious if I had hotels in Phoenix, Portland, Indianapolis or Sacramento.

I would build in Oahu and any location where market value is 10 percent to 20 percent higher than construction costs. Markets with that difference between market value and construction costs are rare.

BOUTIQUE AND CONDO HOTELS GAIN POPULARITY

A recent trend in the industry is the boutique hotel, where the rooms have large beds, plenty of comforters and pillows, stylish décor, and the lobby has a trendy lounge and restaurant with a celebrity chef. One of the most famous chain boutique hotels is the W Hotel. That company does a lot of conversions of regular hotels into W hotels and their properties tend to be larger than typical boutique hotels, which have about 150 rooms, but they do extremely well.

There's a W in New York City's Union Square—not the best location—that's under contract and will sell for somewhere between $1.1 million and $1.4 million per room. The cap rate is about 6 percent, so if you figure 6 percent on $1.1 million per room, that's a lot of cash

Table 7

Major Transactions History

YEAR	NUMBER OF HOTELS	NUMBER OF ROOMS	AVG. PRICE PER ROOM	% CHANGE
1990	130	40,053	$136,000	—
1991	56	16,489	$96,000	-29.4
1992	70	26,751	$82,000	-14.6
1993	53	20,026	$93,000	13.4
1994	108	38,579	$81,000	-12.9
1995	147	48,619	$80,000	-1.2
1996	227	77,916	$106,000	32.5
1997	280	82,867	$117,000	10.4
1998	241	78,865	$136,000	16.2
1999	128	34,408	$148,000	8.8
2000	148	38,759	$125,000	-15.5
2001	117	29,608	$153,000	22.4
2002	105	31,626	$111,000	-27.5
2003	121	33,292	$138,000	24.3
2004	178	56,822	$141,000	2.2
2005	237	71,531	$160,000	11.9
2006 (January – September)	160	50,816	$204,583	38.6

flow to come out of what is considered probably a four-star hotel.

Another trend is the condo hotel, and there are three different types. Two are usually good investments and work well; one usually isn't. The most important element of a condo hotel is its ownership structure.

One type of condo hotel sells individual rooms of an ordinary hotel. The owners take an old hotel and fix it up, then sell each room as a guest room. They don't call it an investment because that would require registering it with the U.S. Securities and Exchange Commission, but they sell to people who want to rent their units and get an income. I wouldn't invest in this structure.

In another type, the condo is a primary residence. For example, the Ritz-Carlton in Boston sold condominiums as primary residences. The units don't go into a rental pool and residents benefit from the services of the hotel. These types of units are usually branded by the hotel and the synergy works quite well.

Branding these condominiums—calling them the Ritz-Carlton Residences or Four Seasons Residences or W Residences—causes sale prices to increase 10 percent to 30 percent. That extra selling price subsidizes the hotel portion of the property because of the fact that most Four Seasons or Ritz-Carltons are worth less than what they cost to build. It makes economic sense.

The third type of condo hotel is common in resort areas, where the residential component is sold to secondary home users. The Ritz-Carlton Key Biscayne Florida is a good example. There, condo owners buy a residential component, use it part-time and put it into a rental program so they can collect income when they're not there. This can be an excellent investment and has synergies similar to the primary-residence model.

Table 8

Largest Sales, Price per Room; January – September 2006

YEAR	INDIVIDUAL HOTEL	LOCATION	ROOMS	PRICE PER ROOM
1	Four Seasons Resort Hualalai	Ka'upulehu-Kona, HI	243	$2,069,959
2	Drake Swissotel	New York, NY	495	$888,889
3	The Mark Hotel	New York, NY	177	$847,458
4	Ritz-Carlton	Dana Point, CA	393	$839,695
5	Chatham Bars Inn on Cape Cod	Chatham, MA	205	$809,756
6	Four Seasons	Washington, DC	211	$800,474
7	Holiday Isle Resort	Islamorada, FL	151	$650,662
8	Hilton Times Square	New York, NY	444	$546,171
9	JW Marriott	Orlando, FL	998	$475,980
10	Ritz-Carlton	Orlando, FL	584	$475,980

But the picture isn't completely rosy; let me give you an example. The Plaza Hotel in New York City was appraised recently at about $550,000 per room. A condo converter bought it for $839,000 a room. He'll convert most of the hotel into primary residences, where he's getting somewhere between $3,000 and $4,000 per square foot. So these condos will sell for around $3 million, and will include the privilege of putting it into a rental pool.

It doesn't make sense to me. Why would people pay $3 million when they could have bought the whole hotel for $839,000 per room at the most? To me, that's not a good deal, and this is an example of a condo hotel that could create litigation down the road. These people will pay $3 million and get maybe a 1 percent return on investment because they overpaid by six times or so. So that's the problem I see with condo hotels these days.

CHALLENGES DON'T SLOW INDUSTRY GROWTH

Now let's consider future trends and challenges. Security is always an issue in hotels, particularly with increasing terrorism. Labor is an enormous headache in the hotel industry. A typical hotel will have complete turnover of lower-level employees every year. It's a huge problem, and nobody's figured out a solution yet.

Technology is always going to be an issue. Because of customer demand, expect to see faster, automated check-in with video monitors as well as Internet and all kinds of advanced communications in rooms. It's a very expensive upgrade for the hotel industry.

Building is going to increase for existing hotels and competitive properties. In Dubai, for example, condominiums are going up behind the Ritz-Carlton and surrounding construction is progressing at an amazing rate.

So what are some of the opportunities? On a global basis, most hotel companies are focusing on two markets: China and India. In these countries, particularly in India, a huge middle class has emerged and people want to travel, but there isn't infrastructure for traveling. So interstate highways and airports are under construction, and this huge middle class is starting to travel. It's just like the U.S. in the 1950s when the government built the Interstate highway system.

Motels are going to pop up at every intersection on the road from Delhi to Mumbai—a huge opportunity. Take that situation and multiply it by three, and you get a sense of what's happening in China. All the big players—the Marriotts, Hiltons, Hyatts, Starwoods—are looking at that part of the world.

In the United States, the big opportunity is the inbound traffic from China and India. The middle class of India and China are about 250 million people, and these people have enough money to start getting out and traveling. Compare this number with the total population of the United States, about 300 million, of which only 20 percent have passports. And the Indian and Chinese middle class will grow go to about 500 million through the next 10 years.

They're going to hit the road, and they're going to come to the United States, especially gateway cities such as New York, San Francisco, Las Vegas and Orlando. The opportunity to serve these people, with their unique needs, is enormous, and cutting-edge hotel companies recognize this. They're designing new hotels and hiring people who can cater to this huge market that's going to travel the world and definitely visit the United States.

LOOKING AHEAD

Some of my observations and predictions:

- We have five to 10 years of very favorable hotel trends in the United States and around the world. The hotel industry has a strong recovery after adversity, man-made or natural, so don't worry too much about the natural disasters. The industry will bounce back.
- Reinvest and upgrade during the good times. We're in good times now, so take care of external makeovers and upgrade guest rooms with décor and technology. Trendy designs in furnishings have short lives, so if you're emulating boutique hotels, be careful. Those designs may not be trendy five years from now.
- Unfortunately, the hotel industry will be the last industry to save the environment. Through the years the hotel industry has not adopted to environmental initiatives. The only thing hotels tend to do is ask if you don't want to have your towel washed, but that's a miniscule environmental initiative. Hopefully, the industry leaders will turn that around.
- If you sell a hotel room for more than its economic and intrinsic value, be prepared for litigation—a warning for all those condo hotels out there. If the room is not worth the economic value plus an intrinsic value, such as staying at a resort at your convenience, expect litigation.
- Finally, those who are prepared to welcome the middle class from around the world will reap great benefits. ■

FEATURE

Land Use and Master Planning: Flexibility, Vision and Effective Partnerships Make Great Cities

Panelists:
JAMES J. CURTIS III, CRE
RICHARD A. HANSON, CRE
LYNN M. SEDWAY, CRE

Moderator:
MARILEE A. UTTER, CRE

This edition of Real Estate Issues *includes the first of a series of roundtable conversations about hot topics in the field of real estate counseling. The following roundtable discusses issues related to land use and effective practices for building—or rebuilding—cities that strengthen community and are socially responsible. If you would like to participate in or suggest topics for an upcoming roundtable discussion, contact REI Managing Editor Marcie Valerio at mvalerio@cre.org or 312.329.8429.*

TRANSIT AND TRANSPORTATION: The saying goes, "Great cities must have great downtowns, and great downtowns must have great transit." Do you agree? Is it realistic in the United States?

LYNN SEDWAY: I agree that great cities need great mass transportation—I think that's what people are looking for in various demographic groups.

RICHARD HANSON: Interestingly, we're building large condominium buildings in downtown Chicago and the problem we have is not enough parking. Most people do not give up their cars. I think you could have a bus pull into the foyer of their condominium and many residents wouldn't use it. Unfortunately, I happen to be one of those people, and except for going to the airport in a snowstorm or a Cubs game, I never use public transportation.

About the Roundtable Participants

James J. Curtis III, CRE, *a principal at San Francisco-based Bristol Group LLC, specializes in industrial, mixed-use and commercial development and investment as well as identifying and turning around the underperforming assets of pension funds and private investors.*

Richard A. Hanson, CRE, *is a principal at Mesa Development LLC, headquartered in Chicago, with expertise in various aspects of corporate and governmental real estate including feasibility studies, investment analysis, land use, master planning and tenant representation.*

Lynn M. Sedway, CRE, *an executive managing director in CB Richard Ellis' San Francisco office, focuses on market and financial feasibility studies, corporate location and economic incentive work, public-private sector counseling and disposition of surplus public land.*

Marilee A. Utter, CRE, *president of Denver-based Citiventure Associates, has built her company on counseling clients about public-private, mixed-use, urban and transit-oriented project development with an eye toward strategic positioning and master planning.*

SEDWAY: They wouldn't use it or they also want their cars?

HANSON: Well, your choice. I didn't do a survey, but what I will tell you is that the city of Chicago attempted to reduce parking in these buildings to one parking spot for each condominium, and it didn't work. We're selling parking spots at 1.3–1.4 to one, which means that almost half the owners have two cars, not one. A long time ago the city also tried to limit the vehicular traffic in the city by experimenting with the idea that you couldn't drive a car downtown at certain times of the day and that didn't get any support.

It may be true that great cities can't work without great mass transportation, but people who actually live in the cities still want cars, and they want them nearby, and they want more than one of them. And I don't think that, at least at the condo level we see …

MARILEE UTTER: At the high level that you're at …

HANSON: Yes, at the level of luxury condominiums we sell I don't think people take any form of public transportation other than a taxi.

SEDWAY: They do in San Francisco, but they want a car as well.

JAMES CURTIS: They want to be able to go to the grocery store. They want to be able to go to Costco, wherever.

SEDWAY: Or to go away on the weekend.

UTTER: Maybe one of the key points here is that great cities need great transportation—and not just mass transit. Maybe by focusing on transit we're overlooking the fact that it has to be balanced and recognize autos as well.

CURTIS: I think it's got to fit the size. Consider a place like Madison, Wisconsin. Transit there may mean something totally different than it does in San Francisco or Denver or Chicago. And if you're in Bozeman, Montana, you may just need a downtown van service. The city could facilitate movement around the downtown, but residents aren't going to take a bus instead of their pickups into Bozeman.

SEDWAY: I guess I wasn't thinking of a place as small as Bozeman; I was thinking New York, Chicago or Los Angeles. But it's a good point. Well how small? When we talk about transit and the importance of transit for cities, we're at what size?

HANSON: The question is very interesting, but here's another example. Chicago does have great train transportation, but we're still the second-worst traffic city in the nation, surpassed only by New York. Our transportation is worse, at least according to the U.S. Census, than even Los Angeles. More people spend more time in their cars in Chicago than almost anywhere. We have this amazing train system that gets people in and out of the city if they want to use it, but the roads are still clogged.

There's another thing in the works, too: The city, the federal government and the state are spending $1 billion to connect the two airports—Midway and O'Hare—to downtown Chicago with a subway. That construction is underway, and the whole concept is that you'll be able to go to your airline in downtown Chicago, check your bag, get your boarding pass and send your bags along their way in a train that'll get them to the right airplane. All you've got to do is show up at the airport on time with your ticket to get on the plane. They're also going to have the arrival and departure screens downtown for both airports. It will be interesting to see when it's finished whether it works.

UTTER: That's amazing. That idea has been around for a while, but security has been an issue. I think it was the TSA (U.S. Transportation Security Administration) that put it on the back burner, so I'm delighted to hear it's moving forward again.

HANSON: Yes. Hopefully it will alleviate the 60- to 90-minute drive to the airport in the evening. The city definitely is thinking. This project comes after an attempt to do a light rail system that failed because planners couldn't come up with the money for it.

UTTER: You said earlier that you thought transit systems create density; I'd like to bring land use back into the equation. I think that transit lines are, in a way, organizing principles that guide what we ought to be doing anyway—building more compact communities. And as I think about the Chicago dilemma. You have such a huge area that people need to cover, it would be almost impossible for transit to address all of that. If you don't think about the land use, at least in parallel with the transportation, I don't think it has a chance of making a city great.

SEDWAY: I agree, but in a lot of cities—take New York, Boston or San Francisco—there would be no way to have the number of people living and working in our downtowns without transit.

UTTER: What about places like Cairo, for instance? Places that are great cities but are a disaster in terms of mobility. Lots of people close in. They don't have great transportation; you can barely get around, and look at the commerce that goes on.

SEDWAY: I'm assuming the living conditions are deplorable for most in the downtowns.

UTTER: Then you wouldn't call it a great city?

SEDWAY: No. Another thing I wonder about is the cost of transit. And to really make it effective it has to be comprehensive. What cities are really going to be able to afford it? Are we going to limit the definition of a great city to require transit? Can the Milwaukees of the world be a great city? Can any second-tier cities really have enough money to do this?

CURTIS: It's all a question of how you look at it. Las Vegas has a huge system with automated buses. San Francisco is looking at the system right now to go down Gary Street. It's very, very interesting, and it gives you a different experience than being on a bus. It gives you a sense like you're on a train. There's a bus driver, but it's all computer-operated.

Going back to the question of dealing with this huge human migration: With the demographic shift that's taking place, I think you're going to have a lot of cities and villages that are going to be different, they still need density. The scalability is different. I think the key is going to be for every village and second-, third- and first-tier city to visualize and plan for the community that they're going to be. They have to think about what's realistic. Roseville, California, is a great case study. City planners really thought about the layout of their infrastructure—how to combine uses, how to integrate hard and soft infrastructure.

Look at a city like Pittsburgh where Mayor Tom Murphy had to be realistic about what Pittsburgh was going to be, not what it was, and then how it positions itself. In both instances, they needed bold civic visions and buy-in from a number of community groups.

SEDWAY: And how are they doing?

CURTIS: When you look at Pittsburgh over the last 15 years, it's amazing. And Roseville is amazing how they've gone and planned for senior housing and their arterial. They also have combined their public parks and schools so that schools don't operate just 10 hours a day. They have these public athletic facilities 18 hours a day. There are some great examples of the use of the social capital being deployed in a much more multi-use perspective.

When we consider mixed-use we've totally missed it as an industry when we think we've got mixed-use if we put a hotel, residential and commercial together. I think if we integrate our parks, schools and athletic facilities into commercial and public projects, we can use capital in a much more effective manner.

When we consider mixed-use we've totally missed it as an industry when we think we've got mixed-use if we put a hotel, residential and commercial together. I think if we integrate our parks, schools and athletic facilities into commercial and public projects, we can use capital in a much more effective manner.

SEDWAY: I think those are great points.

UTTER: Yes, no question about it. And I'm interested in how we keep cities from becoming totally homogenized. How they do this planning, thinking about their infrastructure and the culture of the city. You talk about social capital as well as the physical building; how they think about who they are, where their values are and what they want to invest in. That takes a pretty sophisticated planning effort. It's interesting to talk about cities where we think they've been successful at that.

SEDWAY: And when we add—thinking, for example, of Denver's great art museums, and museums that represent different ethnic groups—that's important to making the city distinctive, as do historic renovations.

UTTER: Yes. The historic preservation is a key. I certainly think culture is. And in Chicago, look at the value of Millennium Park. It's a perfect example of integrating uses. It's a bit large scale, but could be done on a much different scale with schools and parks.

SEDWAY: This applies to Pittsburgh, I think. I was interested in Jim's comment because I had heard that

Pittsburgh was still suffering from major problems. So I'd like to hear more.

CURTIS: Well I'm not saying Pittsburgh doesn't still have challenges, but there's renewal. The reality is that it's going to be a much smaller city than what it was in the past, but if you're going to be that smaller city with limited resources, where are you going to allocate so that you can begin to regenerate? There are a number of examples in Pittsburgh relative to a downtown and neighborhood—how it reinvested in itself. They basically created a venture capital pool between public and philanthropic to create a VC pool to jump-start things in certain neighborhoods, then moved to different neighborhoods.

What's more important to a city—a great school system or a great transit system?

Chicago is probably the best ongoing example of staying ahead of the curve: bold civic vision, prioritizing infrastructure investments, redeploying its balance sheet by bringing in private money, redeploying the existing public assets and stabilized assets and, then, putting them into new initiatives.

I don't consider Denver an old city but presenters at the recent Urban Land Institute Fall Meeting in Denver really demonstrated how bold metropolitan vision really changed that metropolitan area in just five years.

HANSON: Just spending money doesn't fix schools, though. You do need a good educational environment. The city of Chicago has spent $4 billion on schools, but in addition you have to have family involvement and dedicated teachers who teach students that they go to school to learn. Students are improving their test scores, but we still have a huge portion of students below national averages. It's much more a motivational problem than a physical problem. By the way, something that's working well here in Chicago is charter schools.

Similar to what you were saying earlier: If you get personal involvement—you get people involved and the community involved—it makes a big difference. To just build buildings has very little effect.

UTTER: To pose the question: What's more important to a city—a great school system or a great transit system?

HANSON: Oh, a great school system.

CURTIS: I'd vote school system.

UTTER: I'd vote school system.

SEDWAY: Yes. Our whole nation needs a great school system. We're in such bad shape. I certainly think it has to be the top priority.

UTTER: And I feel sometimes that we revert to projects because they're so easy to do compared with solving that problem. It's so much easier to build a new building or a new hideaway or a new realign. Its fundable, it's tangible, it's limited and defined. We know how to do it and we do it, and we try to feel good about ourselves. But we're not solving that fundamental infrastructure question as a social problem.

I guess we also look around the country and say, "Where are the great cities?" I think a lot of the cities with significant racial problems are hurting themselves.

SEDWAY: And if anyone can figure the solution to that we can stop doing real estate.

UTTER: I know. Though one of the things I like about real estate is it can indirectly address some of those issues. That's why I get passionate about building diverse places—communities, villages or whatever name that you want to use—because I think when you bring people together and when they want to be there it really does make a difference.

And then my logic gets me back to transit as an organizing principle that makes people look at living in places they wouldn't otherwise. In Houston—and there's a city with social problems as well as physical problems—the transit system they're building is really bringing the city together for the first time.

The planning department, for the first time, is going out to the neighborhoods and saying: "Who do you want to be and what vision do you have for yourself? We'll figure out a way for the transit to further that vision." But it's a city that hasn't done the things you were talking about earlier, Jim. They haven't integrated and now they know they're not competitive. Houston is physically the sixth largest city in the U.S., but far behind in attracting people and jobs. And that's the other thing I think we often overlook in cities.

We've been talking a lot about residential entertainment and that's overlooked too much. I think that's one of the keys to Chicago's success, and the city has never lost track of jobs.

THE IMPACT OF KELO: Since the 2005 Kelo decision, America has passed legislation limiting eminent domain in more than 25 states. Even where such restrictive legislation has not been approved, eminent domain for any type of redevelopment is politically unfeasible. What do you see as the function impacts of this on community and economic development? On land values?

UTTER: The Kelo decision and eminent domain are linked to our discussion about regenerating and building cities. I think the U.S. Supreme Court's ruling has fundamentally eliminated that tool. What's your view?

SEDWAY: Well thank goodness Proposition 90 failed in California. What it would have done is eliminate any kind of planning and regulation, not just eminent domain. It's extremely serious and would have jeopardized the governor's infrastructure bond. So I think it cuts across party lines. And we're going to see the son or daughter of Proposition 90 rearing its head with the Howard Jarvis Taxpayers Association's plan to get another initiative on the 2008 ballot. I have yet to meet anybody in our planning or development circles who supported Proposition 90; it's one thing we've all come together on.

UTTER: It's interesting to me that there were several initiatives sort of like Proposition 90 on ballots across the country. And I'm wondering what's fueling that because, as you said, it isn't just anti-eminent domain, it's anti-planning.

CURTIS: I think it's in part that the core communication isn't as good as it could be. A lot of the hard feelings are because of stories like the guy in Oakland who runs an auto repair shop. He has to move and the government is going to pay him for his ground, but he can't duplicate his business.

I think it's my responsibility as a developer to come up with a win-win solution where I find him another space to move into, plus compensate him for moving. One of the problems with eminent domain is I just don't see where it comes up with win-win solutions. Too frequently it comes off like: "The city wants to build the project, and damn all the people in the way." The technique has been abused and, as a result, we're paying the price for it.

UTTER: The dilemma is it's not just a question of money. I've talked to people who said there's some consideration that they would change the evaluation process so that the appraised value isn't based on the value without the project, but on the value with the project. And I think that's probably appropriate and is coming. But it still doesn't solve the problem of people who are not motivated by economics. I think the conversation often shifts to the small-business owner and overlooks the many people who are going to benefit.

I also agree with Jim that eminent domain has been abused terribly, and we are paying the price. But I think it's a loss of a really important tool. Rich, where do you come down on this issue?

HANSON: I've never tried it, but I agree with Jim. I think it's interesting. You think about the classic situations where people have built things around the one guy who held out. Sometimes it's a downtown project where a 100-year-old restaurant decides it will never sell so you build the building around it. Other times you just decide that it's the person's property and it should remain the person's property.

UTTER: I also see this situation in the transit routing domain world. One of the keys to getting a transit village is getting a land assemblage. So you don't have the option to just build the project anyway; often, the holdout stops the project entirely.

CURTIS: I've experienced that problem in central California, and we may not build the project as a result. But I still respect the guy who has the land in the center of this 45–50 acre project and won't sell. I just said to the community: "That's for you guys to figure out." I said I'd talk with him and try to come up with solutions, but was very clear up front that if it didn't work I'd have no interest in being part of an eminent domain process.

UTTER: That's a good strategy. I think that's giving it back to the community to decide where the value is. Is it with this person or with a larger group? So I admire that. I'll be interested to hear how it comes out.

DEMOGRAPHICS: The profound changes in U.S. demographics favor communities with transit, infrastructure, a variety of housing choices, walkable neighborhoods and urban amenities. What role does zoning play in this transformation? Is it keeping up, helping or hurting the transition?

UTTER: As we try to create mixed-use developments, zoning laws, in my opinion, are working. On the other hand, Houston doesn't have zoning, and we usually criticize that. What it means, though, is that the city establishes design guidelines but doesn't dictate the use, which is actually where the thought process is going back to now with the form-based codes and so on. So it's quite liberating and much easier than having to go in and change zoning. Rich, what's your opinion?

HANSON: Zoning is used for many purposes in addition to supporting an existing city plan. I'll give you a personal example.

We're building a 72-story building in a historic district where the zoning was that no building could be any taller than the average in the district. But we proved that the benefit to the entire area was worth an exemption. We just did an analysis, and our two buildings near Millennium Park will create $350 million in real estate taxes in the next 23 years. That $350 million of real estate taxes will pay for a lot of city services including public works, parks, schools, etc.

The zoning that had been there forever didn't allow big buildings around Millennium Park, but the city took into account the overall benefit of building the park—and how to create revenues that would offset costs—and revisited those regulations. So I think zoning is very important but should be flexible if something that would improve the community at large comes along. And evaluating those opportunities is sometimes at odds with the underlying urban plan.

But you have to be prepared for some flak when new urban plans trump old ones. In the case of our 72-story building: It's in an area that at the turn of the century was all quaint six- and seven-story buildings, but the area changed and the city built a $450 million park complex, which naturally attracted new development. So now there's a high-rise where there used to be a six-story building and some residents are upset that the zoning changed. But the project is one of the reasons the city can keep making civic improvements like Millennium Park, so the city decided to approve it for the greater good.

CURTIS: You were part of the solution, Rich.

HANSON: What I'm saying is that you asked what zoning has to do with it, and I think very little. Chicago has a central-area plan—and it's a very interesting plan—but when any individual building goes for zoning approval, the central area plan and how one particular area is zoned at the moment will be balanced with a consideration of how the new building affects the community and the city.

CURTIS: The other way to look at it is that life is a multifactor equation; and zoning, in a lot of respects, ends up being a single factor. If you only take that one factor into account, you end up with too much of a silo effect. The great thing about Chicago is that you've had a mayor who's been there a while—who has experience and understands how things fit and move back and forth. And though he's not able to dictate like the rest of the world thinks, through his leadership he's able to facilitate change.

UTTER: The irony of that example, I think, is that when you put half a billion dollars into a park it deserves density around it.

HANSON: Absolutely. But we still had half a dozen people on a phone call and they were very upset.

UTTER: Saying you ruined the neighborhood and the property values are going to fall?

HANSON: Yes, and this density is terrible and this was a historic district and so on. It's all in the eyes of the beholder, but I think the economics will remain an important factor in any zoning decision.

INFRASTRUCTURE MAINTENANCE: American infrastructure, largely built shortly after World War II, is starting to age and crumble. Meanwhile, the country is enjoying a healthy growth rate and now requires new infrastructure as well as repair of the old. At the same time, government has less money than ever to address these needs. What are the prospects for public-private infrastructure funding to keep the economy healthy?

CURTIS: I think we're on the verge of being hit with a tsunami of capital for infrastructure in the United States. The cities that will thrive are the ones that can facilitate the movement of capital within major metropolitan areas.

When you look at pension fund allocations in Australia, Canada and Europe, real estate has 6 to 8 percent of allocations, maybe 10. Infrastructure investments are entirely separate with anywhere from 9 to 15 percent of the total assets for the pension fund. And in the United States, the U.S. pension funds have zero allocations to infrastructure. Most of these new infrastructure investments have been coming from foreign pension funds.

U.S. cities are going to have to start running themselves as enterprises. They're going to have to look at their balance sheets and sources and uses of money simultaneously to optimize their futures. And they're going to have to work much more to realize their vision through public-private projects. For example, Denver did a great job relative to Stapleton. There are a lot of other examples, but having public infrastructure totally funded by the public and used in only municipal bonds is, in my opinion, going to be old technology.

UTTER: And infrastructure is so important to the viability of cities. You've got to finance. We've done special district funding and have had some tools, but never at the scale I think we're facing now.

CURTIS: But it's an opportunity, especially considering the amount of money they've been able to raise.

UTTER: I'm a little worried that the public sector doesn't know how to negotiate these deals. When I ran the real estate for the city of Denver, I looked at our portfolio and in that old BCG model—the cash flow model of years ago with the dogs, the cash cows and the rising stars; and you're supposed to have a balanced portfolio of anything including real estate—the city, the public sector, had all the dogs.

I think the general opinion was that the private sector makes money, and the public sector doesn't. So if there's a positive cash flow piece of real estate—a parking lot or whatever—the private sector gets to take it. They've cherry-picked public portfolios for anything that makes money, then left the money-losers with the city or the public sector. The deal was, "You take the dogs and we'll pay taxes to fund it."

Then we started cutting back taxes, and now the public sector can't afford all those dogs and they need to have a more balanced portfolio to pay for their operations. So we're starting to see more innovative projects. But the question is: Can they sustain their long-term function? It's kind of like selling assets for short-term. What if the money goes into operating costs instead of long-term reinvestment and capital? You don't sell capital to fund operating shortages.

CURTIS: If they do that, it's not going to be politically viable and that's why the governor of Indiana basically got his head handed to him. Chicago's mayor, on the other hand, has continued to march on. He's done a much better job right up front selling the neighborhoods, selling the vision. He took the Chicago Skyway, which many would consider to be a public albatross, and improved it. Now the public is ecstatic. They've got better service. It's generating more money. They took those dollars and redeployed them. Most people would have considered the Skyway a dog, but it isn't.

UTTER: They probably had to raise tolls, right?

CURTIS: No, a lot of it was just throughput; they increased the throughput unbelievably. They're able to get money not just on the debt component; they're also able to get equity dollars.

UTTER: Well if there's real value-added through operations efficiency, then it makes sense. I don't know if that's true in a lot of situations.

CURTIS: Recent case studies show great, great promise.

UTTER: One of the other examples is Houston again. The Metropolitan Transit Authority is building five new quarters of transit, and four of them are going to be a bus rapid-transit technology. The agency is putting out one contract for designing, building, operating and maintaining. And transit has got to be a subsidized activity. So I started thinking: "What does the transit agency do? They've basically privatized the whole thing. How do they respond to service demands? How do they respond to what if they don't make their box? And how do you structure a deal like that?" It comes back to the question of what the role of the public sector is when working with the private sector.

I agree with you, Jim, on a lot of those points. I'm just worried that the public sector doesn't know how to negotiate the deals and isn't going to think long-term. There are so many cities that are broke right now that will be tempted to not be as thoughtful as Chicago has been.

CURTIS: And if they aren't, they won't be re-elected or have to face civic or political issues, similar to the governor of Indiana. The people are going to vote with their feet. ■

CRE

Floodplain Development—Learning From the Great Flood of 1993

BY RICHARD C. WARD, CRE

NEARLY 14 YEARS AGO, THE NATIONAL NEWS WAS DOMINATED by stories of levee breaks and flooding along the Mississippi and Missouri rivers and their tributaries. In 2005, the story of the year was destruction on the Gulf Coast caused by hurricanes Katrina and Rita, compounded by the massive impact of two levee breaks that devastated neighborhoods in New Orleans. A year later, we saw serious flash flooding across the Northeast as a result of heavy local rains—up to 14 inches in places—with the entire state of Pennsylvania declared a disaster area.

Numerous other instances of flooding in areas along inland rivers impacted by flooding also have been documented, as has the continuing devastation of shorelands affected by hurricanes. Added to these traditional concerns is the fear of rising ocean levels from global warming that will affect not only coastal properties, but also inland riverfronts.

As quickly as these crises arise, they tend to fade from the public consciousness. More disturbing is the fact that we have seen few gains in terms of knowledge and commitment to changing land-use policies and practices to avoid repeat disasters. Instead, we remain destined to relive the past, perhaps with even worse consequences, as ongoing development occurs in flood-prone areas.

CONSIDERING THE PHYSICS OF THE RIVER

Any assessment of the phenomenon of repeated flood-related catastrophes requires a brief review of the basics of floodplain development. A river system consists of two distinct components. The first and most obvious component is the water flowing within its banks. The area between the riverbanks is technically termed the "flood way," because it contains the runoff from the watershed—the area drained by the river—the vast majority of the time. When the volume of water coming downstream exceeds the capacity of the area between the riverbanks, floodwater overflows and spreads onto adjacent land.

Over the course of geologic time, hundreds and thousands of years, repeated flooding results in a build-up of alluvial soil—soil deposited by receding flood waters—on one or both sides of the normal river channel. This flat plain extends to the point where the land rises beyond the reach of the most severe flooding, often to a bluff where elevations increase steeply. This natural basin, the floodplain, is the second primary component of the river. However,

About the Author

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because actual flooding occurs in this basin only periodically, there is a tendency to forget, or perhaps overlook, that this area is an integral part of the river system.

As long as there have been human settlements, people have sought to put floodplain land into productive use in support of human endeavors. This land is particularly attractive because it is flat, fertile and close to water. Perhaps most notable, in an urban context it also is less expensive than land outside of the floodplain. Conversion of floodplain land typically begins with the removal of bottomland forests to create crop or grazing land, followed by urban uses in many cases. The net effect of these changes is often that the volume and rate of runoff increase tremendously because there is a loss of natural land cover—forests, prairie grasses and brush lands—that has been replaced first by agricultural crops and grazing, and later by impermeable areas of pavement and buildings.

Once people invest in an otherwise flood-prone area, there is a natural desire to protect their investments. This leads to the building of levees, also referred to as dikes, to wall off rising floodwaters. When only one relatively small area of a floodplain is walled off from flooding by a levee, there is little impact on the river itself or on properties otherwise not so protected. The problem occurs when a system of levees is repeated along a much broader reach of the river. Then, when a dramatic increase in the volume of water is not allowed to spread out, the river rises higher and runs faster in the channel created by the levees. This effect is then intensified by higher volumes and rates of runoff from lands in the watershed.

VICIOUS CYCLE

Once the first levees are built and the area is altered by the economics and politics of urban growth, a vicious cycle starts. The value of flood-protected land rises dramatically, causing other property owners to want to "get on the bandwagon." More investment is made in the protected floodplain, so more people, businesses and governments have more at risk should the levee fail—and a growing stake in ensuring that it doesn't fail. Eventually, steps are taken to raise the levee even higher to enhance the perceived level of protection.

As more and more areas along the river system are similarly treated, there is a dramatic and corresponding loss of capacity to store floodwaters. The result is a river channel much like a large ditch with high levees on both sides and nowhere for the floodwater to go but up. At that point, the areas of protected floodplain also act as a bathtub, capturing and holding runoff from local streams that normally would flow into the river but cannot when the level of the river is above that of the floodplain.

ONCE IN 100 YEARS

The current convention is that areas of a natural floodplain that have a 1 percent chance of being flooded in any one year are designated as being in the 100-year floodplain. To receive flood insurance, anything built in this area must either be raised above the level of the 100-year flood or protected by a levee that provides that level of protection.

Recalling the Great Flood of 1993, the Missouri River rose to breach levees and flood all but a few spots along its reach in central and eastern Missouri—the primary exceptions being the Riverport and Earth City business parks in suburban St. Louis County. The most dramatic levee failure was the Monarch levee, which provided nominal 100-year flood protection for an area on the Missouri River called Chesterfield Valley, located in the city of Chesterfield in west St. Louis County.

On July 30, an area of some 4,700 acres occupied by office and industrial parks, a large general aviation airport owned by St. Louis County government and a five-mile stretch of Interstate 64 disappeared under 10 feet of water. Because the levee break was in the upstream portion of the valley contained by the Monarch Levee, the floodwaters were very slow to drain out of that basin even as the level of the river dropped. Flood damage was estimated at more than $320 million in 2006 dollars. Though no precise determination was possible because of limitations of historic records and continual changes in run-off characteristics throughout the river basins, the U.S. Army Corps of Engineers estimated that the 1993 flood was of lower frequency than a 100-year flood but not nearly as extreme as a 500-year flood—perhaps a 250-year flood.

The recovery of Chesterfield Valley since 1993 is a dramatic and inspiring story. Nearly a half billion dollars in public and private funds have been invested, with nearly 20 percent of that directed toward providing improved access and a 500-year flood protection system—a levee rated to withstand a flood level with a probability of occurring once in 500 years, or 0.2 percent probability in any one year. Business is booming, and the city of Chesterfield, along with the private interests that took the risk and invested in the recovery, are reaping handsome fiscal and economic rewards.

The new construction and economic activity in Chesterfield Valley, however, obscures the memory of that summer of 1993 when the Missouri River extended from bluff to bluff along its entire 250-mile length across Missouri. The river filled its floodplain—a distance some 10,000 to 12,000 feet wide, compared with the normal distance between the river banks of 1,000 to 1,200 feet. Simple math would suggest that, with a roughly 10-to-1 ratio of the normal river width to the width of its floodplain basin, and assuming an average depth of the 1993 flood across the plain of perhaps five feet, any attempt to protect large, extensive sections of this land from flooding is a practical impossibility.

BUILDING AGAIN IN FLOODPLAINS

The recovery of Chesterfield Valley has certainly inspired major development activity in the other big floodplains that bracket the St. Louis region. A significant example is the emergence of a large planned residential community known as New Town in the city of St. Charles, which is across the Missouri River in St. Charles County.

Located in the heart of the vast alluvial plain near the confluence of the Missouri and Mississippi rivers, the project takes advantage of a unique geologic condition. It is located slightly higher than the rest of the floodplain—a matter of inches in some places and up to a few feet in others. Therefore, it has a lower probability of flooding than the rest of the bottomland area. Though this difference is not discernable to the naked eye, it was during the 1993 flood, when this area sat as a dry peninsula, albeit barely.

The developer of New Town, Whittaker Homes, engaged the new urbanist architect/planner Andres Duany of Duany Plater-Zyberg to prepare a development plan that provides housing products for a variety of incomes and lifestyles. Most important, the plan incorporates a storm-water collection and detention system that enables the ground floors of buildings to be raised several additional feet to a level at or above the 500-year flood elevation. The storm-water detention basins are treated as water features and community amenities. The planning concept of a pedestrian-friendly village with diverse housing types in the manner of traditional neighborhood design has been eagerly accepted by the market, and additional phases are planned.

Despite its many positive attributes, there is good reason to be concerned that the New Town plan will become a catalyst for still more residential development in the St. Louis region's major protected floodplains. Similar areas planned and developed in the Missouri portion of the St. Louis region over the last 40 years have been reserved exclusively for nonresidential uses, thus avoiding placing residents and their homes and possessions at risk.

The new construction and economic activity in Chesterfield Valley, however, obscures the memory of that summer of 1993 when the Missouri River extended from bluff to bluff along its entire 250-mile length across Missouri.

For example, the city of Chesterfield's plan for its valley, completed in 1995, purposely excluded residential uses—even before the 1993 flood had excluded through zoning any new residential uses. (About a dozen original farm dwellings that predated zoning were inundated by the flood.) Likewise, the previously mentioned Earth City and Riverport business parks, which escaped damage from the 1993 flood in the Missouri River Valley, have excluded residential uses.

Now, however, the land-use plan for the area protected by the recently rebuilt Howard Bend Levee in the adjacent downriver city of Maryland Heights is being reconsidered. Chesterfield's market success with retail, office and service center uses in its floodplain district has yet to extend to Maryland Heights. Consequently, inspired by the success of New Town across the river in St. Charles County, the property owners who funded the construction of the new Howard Bend Levee in Maryland Heights have pressed the city to amend its land-use plan and development guidelines to enable residential uses within the flood-protected area.

LESSONS LEARNED: A GOOD NEWS, BAD NEWS STORY

The good news is that St. Louis developers and their host communities have clearly taken lemons and made lemonade with regard to floodplain developments since 1993.

The Chesterfield Valley and New Town developments are economic successes that are inspiring other communities and developers to follow suit.

The net result is a rapid and accelerating pace of conversion of agricultural uses of floodplain lands to urban uses. From a real estate development perspective, the clear lesson is that out of catastrophe can come highly rewarding development opportunities along with dramatic gains in land value. By investing public and private funds to create a level of protection that sounds almost perpetual to the average person—500 years, or six to seven times the lifetime of most people—the perceived risks of levee failure and the kinds of losses experienced in 1993 wane and are discounted to zero.

The bad news, however, is that the lessons of past river events appear to have been lost as perceptions of risk and potential inundation continue to fade with each year that has passed since the flood. Private developers and investors continue to anticipate windfall profits from developments in the floodplains as the perceptions of danger continue to decline. Yet no one is realistically accounting for the collective impacts of the continued walling off of vast areas of floodplain with higher and higher levees, thereby increasing the height and speed of floodwaters in future floods and eventually eroding or even negating the increased levels of protection made possible by those very same levees.

Neither the U. S. Army Corps of Engineers nor the regional planners with the East West Gateway Council of Governments, the region's Metropolitan Planning Organization, appear to have much, if any, influence on local land use policies and practices. Floodplain land is being provided additional protection and converted from agricultural to urban uses, including residential.

The inevitable result is significant further reduction in the capacity of the region's big river floodplains to detain and slow the floodwaters of the Mississippi and Missouri rivers at the point they converge and are most powerful. It even appears that the stage is being set for the development of hundreds, if not thousands, of new residential units in these nominally protected floodplain areas. Should this occur, the unwritten rules accepted by most local governments and developers in precursor developments over the past 40 years, which excluded new residential uses from these areas, will have been swept aside. With this, the level of potential human suffering and economic loss will grow substantially.

The concluding note is that enlightened members of the real estate community should join with public and civic interests to seek to impose limitations, if not exclude, the building of additional urban levees that will remove more land from natural floodplain areas. What has been done is done, and it would be unrealistic to call for removal or reversal of past commitments to floodplain development. Rather, efforts should be directed at not repeating these mistakes.

Certainly public floodplain insurance programs and corresponding public policies should be amended. And it should be clearly communicated that future development of urban levees and the investment in urban patterns of development fostered thereby will not be secured by government underwriting of the insurance or by direct payments for damages when those means of protection ultimately fail. ■

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FOCUS ON GLOBAL MARKETS

Looking Outside the U.S. for Real Estate Investment

BY DAVID J. LYNN, PH.D., MBA, CRE

THE REAL ESTATE INVESTMENT SECTOR has often been criticized for its lack of liquidity and high degree of lumpiness, transaction costs and geographic idiosyncrasies. Despite these characteristics, real estate remains one of the best risk-adjusted investments in recent years. In fact, real estate has produced solid returns—beating the U.S. domestic stock and bond markets in the last five years—is collateralized and, in the case of institutional-grade assets, typically yields a consistent income stream.

Over the past decade, a number of factors have made world markets more interesting and potentially highly profitable. These factors include deregulation, accelerating globalization, integration of financial markets, economic and political reforms, and high economic growth—especially in emerging-market countries, where growth rates typically exceed that of developed countries.

Investors who look outside the U.S. market could potentially enjoy higher returns, increased portfolio diversification, greater variety of investment vehicles and the opportunity to benefit from the growth of the global economy.

PERFORMANCE AND GLOBAL ECONOMICS CAN YIELD INCREASED RETURNS

International real estate can help boost returns by investing in international properties with prospects for better financial performance than domestic assets. For example, if U.S. investors had secured UK, Australian and Canadian office property assets between 1985 and1995, rather than domestic assets, they would have earned significantly higher returns. During this period, the U.S. office market's average annual return was zero, but the other markets averaged 12.4 percent, 8.1 percent and 4.5 percent, respectively. [1]

Investors also can realize potential gains though currency valuation movements. The U.S. dollar has depreciated significantly against other major world currencies since mid-2001. Though it has seen some recent improvement against the euro, the dollar remains depressed by historical standards. This dynamic has boosted the value of many U.S. companies' real estate assets abroad.

For example, an asset that was worth $200 million to its U.S.-based owner as recently as early 2003, when the dollar traded near 1-to-1 with the euro, would translate

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Table 1

Capitalization Rates

	NCREIF CURRENT VALUE CAP RATES (FOUR-QUARTER MOVING AVERAGE)			REAL CAPITAL ANALYTICS CAP RATES (SIX-MONTH AVERAGE)		
	1Q2002	1Q2005	CHANGE (bps)	1Q2002	1Q2005	CHANGE (bps)
Apartment	7.6%	5.3%	-230	8.5%	6.6%	-190
Industrial	8.8%	6.8%	-200	9.7%	8.1%	-160
Office	8.9%	7.0%	-190	9.7%	7.7%	-220
Retail	9.0%	6.8%	-220	9.5%	7.6%	-190
Average	8.6%	6.5%	-210	9.4%	7.5%	-190

Sources: National Council of Real Estate Investment Fiduciaries (NCREIF); Real Capital Analytics
The trend of cap rate compression reveals an increasing demand for real estate investments in the U.S., evident across all sectors.

to a value almost $240 million under current exchange rates. This increase in value occurs even without additional investment in the property.[2] Of course, the downside effect from foreign currency depreciation is a non-negligible risk.

Timing of transactions and knowledge of the macroeconomic situations of countries is essential. Using financial instruments such as futures, forwards and swaps can further hedge currency exposure in the short and longer term.

Investing in international real estate may be the best way in the long run to secure higher returns because of declining rates in the U.S. This decline is caused by the flood of capital in the U.S. market, which pushes up the cost of transactions, and declining net operating incomes in many markets. Growing liquidity is behind the decline of capitalization rates—a common way to measure real estate returns—across all property types, averaging some 200 basis points from first-quarter 2002 through first-quarter 2005 (see Table 1).[3]

MYRIAD GLOBAL INVESTMENT VEHICLES OFFER A RANGE OF CHOICES

More and more investment vehicles and products are now gaining ground across global markets, in public as well as private sectors. These investments include new real estate investment trusts and REIT-like vehicles, the global expansion of the commercial mortgage-backed securities market, and a growing number of private investment products such as funds and individual deal investments. With an ever-increasing array of products and strategies from which to choose, an investor is more likely to find a better fit for his particular return/risk tolerance (see Table 2).

There are an increasing number of sophisticated financial products beyond the domain of equity investments. Public debt investing, predominantly in the form of CMBS, has emerged as a strong global trend. Liquidity, as well as the ability to securitize large income streams and tranche loans into various risk profiles, has made this asset class increasingly attractive. CMBS and other investment products may have the potential to grow faster than the U.S. market because of country-specific factors.

The Japanese CMBS market emerged as a result of the steep decline in real estate prices during the 1990s. Financial institutions stressed increased securitization to repair balance sheets. Japan as well as mature markets of Australia and Europe also should see CMBS grow much faster than the U.S. market. In fact, CMBS issuance in 2006 far outpaced the previous year's volume (see Table 3).

Another key trend in the industry is the rapid expansion of global real estate investment options in terms of quantity and variety of nonlisted private investment vehicles. In addition to nonlisted property investment vehicles in U.S., there is a large number of established vehicles with various strategies, specialized sectors and return targets (i.e. core, value-add, opportunity, etc.) available to investors. According to INREV, the European Association for

Table 2

Summary Listing of Selected REIT Vehicles

	VEHICLES	YEAR INTRODUCED
ASIA-PACIFIC		
Australia	LPT	1971
Hong Kong	REIT	2003
Japan	J-REIT	2000
Korea	RETF, K-REIT, CR-REIT	2001
Malaysia	REIT	Late-1980s
Singapore	S-REIT	2002
Taiwan	REIT	2003
EUROPE		
Belgium	SICAFI	1995
France	SIIC	2003
Germany	N/A	2007
Italy	FII	1994
Luxembourg	FCP, SICAV, SICAF	1988
Netherlands	BI	1969
Spain	REIF, REIC	1994
United Kingdom	N/A	2007
LATIN AMERICA		
Brazil	FII	1993
Mexico	Fibras	2004
NORTH AMERICA		
Canada	REIT	1994
United States	REIT	1960

Sources: EPRA/NAREIT, UBS, Bloomberg, Pramerica Real Estate Investors

German and UK vehicles list the year they are expected to be introduced[4]

Investors in Nonlisted Real Estate Vehicles, the gross asset value, or GVA, of nonlisted real estate funds has grown from approximately €140 billion in 1995 to more than €320 billion in 2006 (see Table 4). This represents an increase of more than 200 percent in just over a decade. The number of real estate vehicles also grew substantially. A similar trend exists in Asia.

Table 3

Worldwide CMBS

	U.S. ASSETS	NON-U.S. ASSETS	TOTAL ISSUANCE
2001	67,149.9	22,713.8	89,863.7
2002	52,073.3	28,705.9	80,779.1
2003	77,848.1	20,802.9	98,651.0
2004	93,838.2	33,746.0	127,584.2
2005	169,169.5	69,376.1	238,545.6
2006	185,700.0	81,100.0	266,800.0

Source: Commercial Mortgage Alert, December 2006

As a result of the global growth—in quantity and diversity—of real estate investment vehicles and public and private markets, we have seen beneficial byproducts of increased transparency, credibility and liquidity, which in turn is attracting more real estate investment capital.

PORTFOLIO DIVERSIFICATION AND RISK REDUCTION

To benefit from diversification, investors must create a market portfolio consisting of many sectors and submarkets that exhibit low correlations. The U.S. is the largest and most diverse real estate market in the world. However, it still represents a minority share of the global investable universe of commercial real estate.

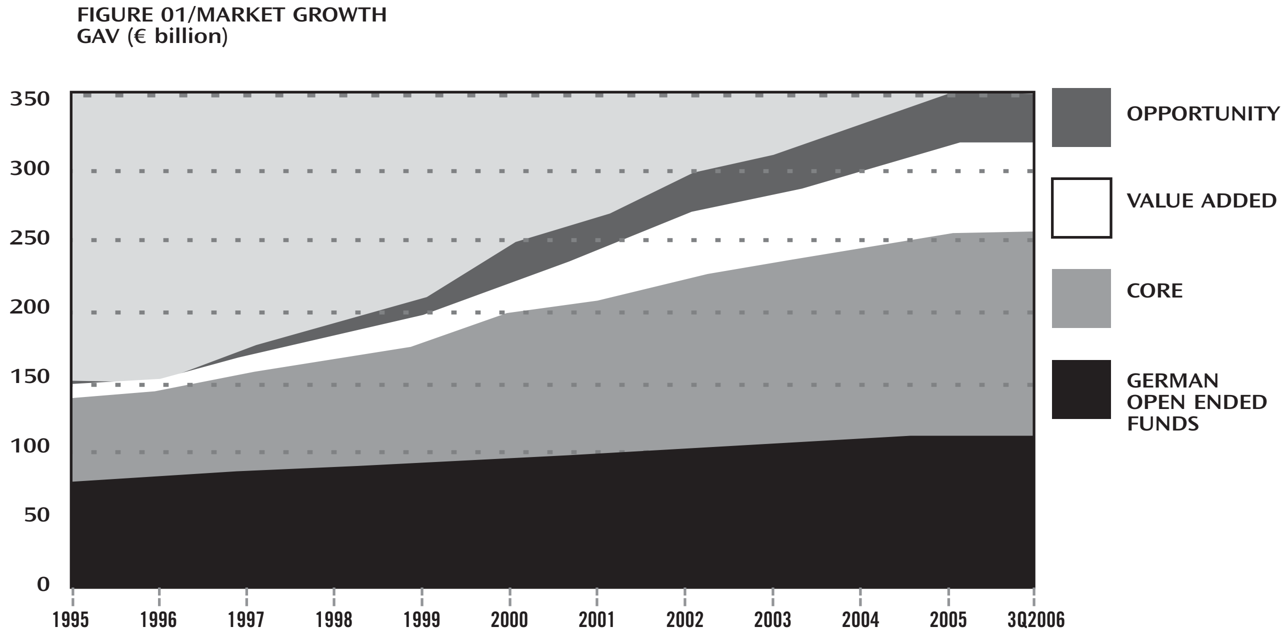
Since 1990, the U.S. share of gross domestic product relative to the world total hovered between 25 percent and 32.5 percent. In the longer term, the U.S. economy will likely command a trend share of about 30 percent.[5] According to estimates,[6] the global real estate investment universe was US$6.2 trillion at the end of 2005 (see Table 5).

The U.S. share of investment-grade commercial real estate is estimated at $2.4 trillion, which is less than half size of the global universe. These estimates clearly indicate an ample supply of investment-grade properties across different countries with different economic conditions and even varied sector performance.

Diversifying real estate investment from domestic to international, as with other asset classes, can reduce risk by reducing volatility. Some real estate markets—Canada, for

Table 4

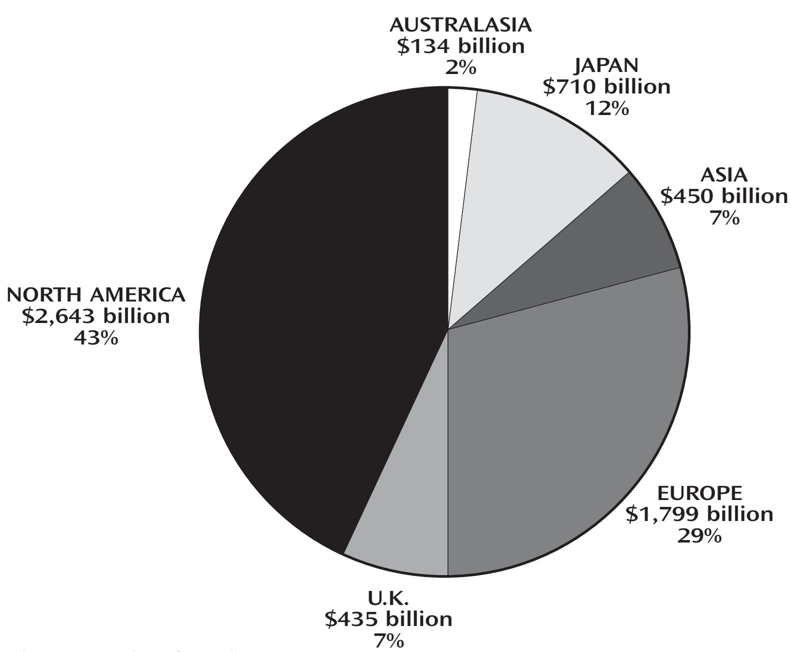
Value of Nonlisted Real Estate Funds in Europe



Source: INREV, Quarterly Research Report, November 2006

Table 5

Global Real Estate Market Capitalization



Source: UBS Real Estate Research as of December 31, 2005

Table 6

Growth Drivers in Emerging Markets Versus Developed Countries

	Average Annual Population Growth Rate (%)	Annual GDP Growth Rate (%)				Gross Capital Formation Average Annual Growth Rate (%)	Labor Force Average Annual Growth Rate (%)
	1990-2003	2001	2002	2003	2004	1990-2003	1990-2003
Argentina	1.3	-4	-11	9	9	1.6	1.8
Chad	2.8	10	10	11	31	20.0	2.8
Chile	1.0	3	2	3	6	5.4	2.2
China	0.6	8	8	9	10	10.9	1.1
Hong Kong, China	0.2	0	2	3	8	4.4	1.9
India	1.2	5	4	9	7	6.9	2.1
Jordan	2.1	5	5	4	7	0.4	6.0
Korea, Rep.	0.4	4	7	3	5	3.1	1.8
Malaysia	1.5	0	4	5	7	2.9	2.9
Philippines	1.6	3	3	5	6	3.6	2.8
Saudi Arabia	2.6	1	0	8	5	-	2.5
Singapore	1.1	-2	3	2	8	2.5	2.3
South Africa	0.3	3	4	3	4	3.3	2.6
Sri Lanka	0.9	-2	4	6	6	5.3	2.0
Turkey	1.2	-7	8	6	9	2.5	2.5
Uzbekistan	1.3	4	4	4	8	0.7	2.8
Vietnam	1.1	7	7	7	8	16.5	1.9
World	1.0	1	2	3	4	2.8	1.6
Low income	1.6	5	4	7	6	6.2	2.3
Middle income	0.8	3	3	5	7	2.9	1.4
Lower middle income	0.8	5	5	6	7	2.6	1.4
Upper middle income	1.1	0	1	4	7	4.1	1.9
Low & middle income	1.2	3	3	5	7	3.3	1.7
East Asia & Pacific	0.8	6	7	8	8	7.9	1.4
Europe & Central Asia	0.1	2	5	6	7	-4.0	0.5
Latin America & Carib.	1.3	0	-1	2	6	3.0	2.3
Middle East & N. Africa	1.7	4	4	5	5	-	3.1
South Asia	1.4	5	4	8	7	6.4	2.2
Sub-Saharan Africa	2.0	3	3	4	4	3.5	2.5
High income	0.3	1	1	2	3	2.7	0.9
United States	0.7	1	2	3	4	6.2	1.3
Europe EMU	-0.0	2	1	1	2	1.6	0.5

Source: World Bank, World Development Indicators Database example—demonstrate less volatility in the office sector than the U.S. To put it in the language of stocks, some global real estate markets exhibit lower betas. Investors can reduce risk simply by diversifying their portfolios with the inclusions of foreign assets whose performance is likely to be minimally correlated with the performance of domestic assets. Such low correlations are attributed to differences in behavior over time stemming from different market regimes, and idiosyncratic economic characteristics.

Despite increasing global integration of economies, significant country and continent divergence still exists in real estate market property performance. Though few markets have return series for private equity real estate with an adequate history to calculate the correlations directly, one of the few exceptions is the United Kingdom. Based on roughly 30 years of data from the UK and U.S. property markets, the correlation between returns in the UK and U.S. has been about 0.40.

Given the similarities and close relationships between the UK and U.S., it seems reasonable to assume the correlation between them should be among the highest. To put it another way, real estate markets in different countries have relatively low correlations compared with those for other asset types such as stocks.

RIDING THE GLOBAL GROWTH WAVE, ESPECIALLY IN EMERGING MARKETS

Economic growth rates tend to be higher in emerging markets than in developed economies. In other words, emerging markets are in the early phase of their growth cycles. High GDP growth rates are typically composed of population, employment and investment growth—all of which drive real estate returns. Countries in Asia, South America and even several countries in the Middle East and Africa are expected to show much higher rates of growth than developed countries over the next four years (see Table 6). As a result, real estate markets in these countries are expected to experience proportionate expansion in the real estate sector (new and renovated buildings of all types), to accommodate the growing demand for larger quantity and modern assets, at a faster pace than in developed countries.

Decreasing entry barriers in many countries has facilitated investment in emerging markets. For example, as recently as the late 1990s foreign investors could not invest directly in South Korea. The same was true for Taiwan as recently as a few years ago. India liberalized its foreign direct investment laws with respect to real estate only a year-and-a-half ago. Today, more real estate markets are open than ever, and the trend toward greater openness, transparency and increasing capital flows continues.

In short, there is more room for achieving alpha in the globalized real estate investment market. Because of the unique risks of international investing, attaining superior risk-adjusted returns is not always an easy task. ■

ENDNOTES

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FOCUS ON THE UNITED KINGDOM

Are Commercial Property Yields Fully Compressed?

BY BARRY GILBERTSON, CRE, FRICS

THIS IS THE SECOND IN A SERIES OF FOUR ARTICLES providing my personal perspective on the state of the property market in the United Kingdom. The first article, which appeared in the Fall 2006 edition of *Real Estate Issues*, focused on some of the more generic key drivers and the macro-to-micro picture. This article focuses on the phenomenon of seemingly ever-rising values in the commercial property sector. The third and fourth articles will review the residential property market and the seeds of doubt: key issues, words and phrases that trigger a response when they crop up in conversation, and cause property funders, lenders and investors to stop and think about their assets.

One of the reasons for writing these articles is to draw, in the mind of the reader, a similarity or contrast between the UK and the property market in which the reader operates. It seems to me that property markets function in very similar ways around the world, and we can all benefit by experienced practitioners and commentators sharing their opinions and expertise. There are exceptions, of course, and the United Nations is doing what it can to help to create and re-order property markets in some of the globe's transitioning economies, especially those that are moving from a state-owned asset base to the free- (or at least more free) market economy.

This task, of course, is not easy. However, drawing on the experiences of many individuals and governments, and synthesizing the ordinary from the extraordinary, the United Nations is beginning to make progress. One bonus of the change is starting with a clean slate, and the newly successful economies are leaping ahead of established real estate markets in the use of today's technology and transparency in information exchange. From satellite

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mapping to comparable evidence, knowledge management in many of these countries is better than in countries with mature economies.

SPECULATION, RECENT TRENDS MAKE UK MARKET A TOUGH READ

Meanwhile, back home in the UK, the commercial property market has emerged from the safe world of pre-let construction into the heady atmosphere of speculative development. Of the £152 billion lent to property-backed securities in 2005, about £5 billion is to property developments where no tenant has been identified or signed up before beginning construction. Another identifier of market growth and activity is the "crane survey."

There is a total of 9.7 million square feet under construction, with about one-third let and two-thirds available space. This statistic indicates more than 6 million square feet of speculative development.

Industry observers have long been aware of the correlation between the number of visible cranes over a property market and the prospects for the future of that market. One firm, London-headquartered Drivers Jonas, has captured this bellwether in a quarterly report. Extracts from third quarter 2006 show some 90 sites in central London where development is underway. An aerial view would show this activity in three distinct groupings: the West End, focused on Mayfair; Mid-town, centered on Holborn; and, naturally, central London, also known as the Square Mile. Looking at the statistics generated by this report, there is a total of 9.7 million square feet under construction, with about one-third let and two-thirds available space. This statistic indicates more than 6 million square feet of speculative development.

The previous article sought to demonstrate that the UK property market was extremely difficult to read at the moment. An analysis of the Drivers Jonas data bears out this sentiment. Though there remains a seemingly large volume of space unlet, the fact is that the past two years have seen dramatic increases in rental levels—up by about 26 percent in the West End alone—and the prediction for 2006 is strong growth of 25 percent or more.

The difficulty in reading the market is compounded by a growth of only 5 percent in the amount of available space under construction during fourth quarter 2006. One would have expected many more developers to bring forward their proposed schemes to capture this rental growth and thereby enhance their portfolios, or their profits. Perhaps this sluggishness points to an unwillingness among developers, who must undergo an arduous process to gain necessary planning permissions and comply with regulations. The struggle commonly delays the launch of construction by an average of two to three years.

At a recent meeting of the Bank of England's Property Forum, attendees were treated to an exposition of these difficulties by the chief executive officer of a development company trying to bring forward some 67 acres of urban regeneration in the London district of Kings Cross. He showed a chart of the statutes, regulations and bylaws that had to be satisfied before receiving permission to move forward. In all, there were 350—a huge number and one that guarantees compromise because many of the edicts are contradictory. This company has, so far, spent seven years and more than £25 million, and the CEO thinks they are still a short stroll from receiving the paperwork that will be the cause of considerable celebration. Almost there, but not quite.

SEVERAL FACTORS PROMPT SPIKE IN RENTAL RATES

So what is fuelling the surge in rental levels? The Mayfair district, for example, recently crested at £90 per square foot. Many consider this an astonishing rate, but if the financial markets are any indicator, it does not normally take long to gallop past a milestone once it is in sight. So how long before rates reach £100 per square foot? Of course, tenant demand is key. In this age of hot-desking and hotelled office schemes, why are firms expanding their space requirements? This dichotomy is yet another indicator of the difficulties of reading the market.

However, if a major investment bank decides to increase its staff by just 5 percent a year, and they occupy 1 million square feet, then over four years they will need more than 200,000 square feet of extra space. To put such a requirement into context, there are 22 schemes under construction in city of London's financial district, yet only five of those schemes would be able to accommodate our hypothetical bank's space requirement. Also, about 13 organizations in London lease more than 1 million square feet each. If one bank expands, the others will, too. The competition for space will continue to drive prices higher.

Yield compression is a buzz-word that is echoing around the world's real estate markets. What does it mean? Well, given that a yield is an inverse multiplier of the rent received, in simple terms it means that when the income from rents goes up, the yield-to-capital value goes down—or is compressed in today's jargon. So, what is compressing the yields? To compress something, one normally needs a heavy weight. In the world of real estate investment, pension funds and insurance companies are the heavyweights.

In recent years these strong investors in grade-A property have made a decision, individually or with a herd-like instinct, to increase the proportion of real estate in their portfolios. It used to sit at about 8 percent, but now their targets are to reach between 15 percent and 18 percent of funds invested. This objective could effectively double of their already massive property holdings. Apart from questioning whether there is enough grade-A property, with triple-A tenant covenants, available to slake this desire, it is not rocket science to recognize the effect that demand from wealthy, acquisitive buyers could have on market prices.

The consequential effect is that some non-institutional buyers cannot afford to stay in the heat of this particular kitchen, and move their sights to slightly lesser-quality property with slightly lesser tenant covenants, and so on down the food chain of the property market as normal secondary buyers shift their sights on to tertiary quality property investments. This fuels the market at all levels, but does not necessarily recognize the fundamental truth: as quality goes down, risk goes up. The risk of finding tenants, the risk of tenant default and the risk that a turn in the economy will leave the investor holding a particularly messy baby just when liquidating one's assets seems the most attractive option.

Normally, of course, the riskier the asset, the lower the price. Just as with the gold-rush, or south sea bubble, investors sometimes forget the basics when the feeding-frenzy of desire for quick profits sees the heart ruling the head.

IS RETAILER'S DEAL A PORTENT OF THINGS TO COME?

A sobering thought has just begun to percolate the minds of the astute. It was announced recently that B&Q, a massive home improvement store chain, had managed to negotiate for no rent increases on two of its largest out-of-town stores. In a report by Laura Chesters in the November 2006 issue of *Property Week*, the group argued that there was no demand from other retailers and, therefore, there should be no rise in rent.

Freezing rents in the retail property market should send a shiver down the spines of those working or investing in other real estate areas, too. The do-it-yourself market seems as strong as ever. With residential property continuing to increase in price across the country, many home owners are either improving their properties with a view to sell, adding personal touches after buying, or deciding to stay in their homes and enlarge or enhance them. On the strength of this enthusiasm, fuelled in part by the plethora of home improvement programs on television, B&Q embarked on an expansion drive, opening a scheduled 18 stores a year, as a defensive move against the potential entry into the UK of the U.S.-based Home Depot.

Still, even with these contrary indicators, the real estate market is a vibrant and challenging environment in which to earn a crust. Would you have it any other way? Why not email your views to me at barry.gilbertson@uk.pwc.com. ■

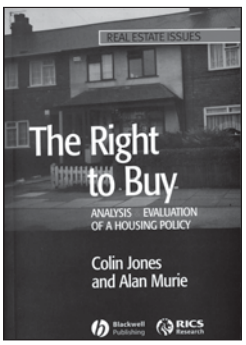
CRE

RECOMMENDED READING

The Right to Buy: Analysis & Evaluation of a Housing Policy

By Colin Jones and Alan Murie (2006, Blackwell Publishing Ltd., Oxford, UK, 254 pages)

REVIEWED BY MARY C. BUJOLD, CRE



COLIN JONES, PROFESSOR OF ESTATE MANAGEMENT at Edinburgh's Heriot-Watt University, and Alan Murie, professor of urban and regional studies at the University of Birmingham, have provided a detailed and thorough treatise on the history, operation and management of council housing in the UK.

It is obvious from the onset that council housing and its operation, though perhaps similar to what we consider affordable housing today in the United States, bears little resemblance to our historic public housing and, rather, was undertaken initially to address issues related to housing supply and demand, particularly after the devastation of two world wars.

The Right to Buy policy, established in the United Kingdom in 1980, allowed council tenants to purchase the homes they were renting. The policy was a segment of a much larger public policy agenda geared toward deregulation and privatization introduced by the conservative Margaret Thatcher government that came to office in 1979.

Since then, a constant and consistent debate about the appropriate level of state intervention in housing provision has existed in the UK, the authors state. They contend that the growth of public sector housing in the UK has always been contested, and that opponents have long suggested it was ineffective for the state to own, control or manage the housing it originally built. Examples of the sale of state housing exist through the war years and after 1945. By the mid-1960s and into the 1970s, those who proposed selling council housing became increasingly verbal and prominent.

POLICY AFFECTS NEIGHBORHOODS DIFFERENTLY

Enter the Right to Buy policy, which launched a significant sale of council housing to existing tenants. Studies however, found that purchasers most often were dual-income families and those whose heads of household were generally older than 45 or near retirement. These residents, logically, had greater financial wherewithal, and were more capable of purchasing and owning their homes compared with other segments—specifically, younger households, single-parent households and those with much lower incomes.

The book also delves into various social aspects, identifying how the sale of council housing in highly desirable

About the Reviewer

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areas had a stabilizing and enhancing effect but, conversely, estates considered less attractive and populated primarily by low-income households experienced higher turnover rates and less stable economic environments.

Much of council housing, however, was built to high standards in a traditional product type that offered single dwelling units rather than flats, and provided individual yards and small gardens. This policy is dissimilar to most public housing historically constructed in the United States, especially during the expansion period of the 1960s.

Dissimilar to the U.S., where public housing provides the bulk of assistance to low-income renters, council housing offers a broader range of housing and is, some would consider, less stigmatized.

SPECIFIC IMPACTS ON THE OWNER-OCCUPIED MARKET

Beginning in the 1980s, the public gradually accepted the idea that council houses were marketable investments. Resale markets have since matured, and resales have been integrated into the local housing market in all areas, accounting for at least 10 percent of the market.

One of the most significant arguments raised against Right to Buy deals is the "residualization of social and public rented housing." In general, housing privatization in the UK involved selling the most attractive homes and retaining the least attractive portions of the housing stock. Therefore, as affluent tenants converted to home owners, a less attractive housing stock typically catered to a uniformly low-income group of residents.

In general, this situation follows the U.S. model of public housing and is, according to the authors, a directional change occurring in the UK. Authors caution that this practice further reinforces the distinction between neighborhoods by adding a tenure label to certain estates and lowering the reputation of public sector housing.

In large measure, the consequence of the Right to Buy policy is a distressed housing system and severe affordability problems caused by growing numbers of residents, historically low vacancies in rental housing, record homelessness and high home prices. In the face of rising household formations, the private market is building few homes, especially at the lower end of the price spectrum or as replacement units for those converted to private ownership.

NEW PROGRAMS ADDRESS INEQUITIES

Government policies are now in the works to rectify some of these inconsistencies. Additional council homes scheduled for construction will include rental units as well as those up for sale through Right to Buy. Other proposed programs include:

- A new Homebuy program offering up to 300,000 council and housing association tenants the opportunity to buy part of their homes and increase their equity over time if they wish
- A first-time buyers program to help more than 15,000 first-time buyers who need financial help to make a purchase
- Strengthening existing home ownership programs, including the Key Working Living program and shared ownership

Through this detailed and highly interesting analysis of one of the most significant government policies and programs in the UK, the authors have presented a thorough evaluation of a complicated process. Though I found the book captured my attention, I sometimes felt somewhat lost in the myriad details and issues associated with the program. Undoubtedly, the book is detailed enough in its analysis to provide most readers with a complete background on this subject. ■

FEATURE

Environmental Due Diligence in the Wake of the EPA's New All Appropriate Inquiry Rule

BY DIANNE CROCKER

As any seasoned dealmaker knows, there are regulatory hurdles that need to be addressed before initiating any transaction. Now, we can add a new environmental regulation to the list. Purchasers of commercial property and those who receive site-specific brownfields grants must follow a new federal rule governing environmental due diligence if they wish to obtain federal liability protection.

The U.S. Environmental Protection Agency's All Appropriate Inquiry rule took effect Nov. 1, 2006, and lays out the type of research that dealmakers—and their environmental consultants—must conduct upfront to avoid paying for any past environmental contamination on a property. Still in the early stages of adoption, the AAI rule has generated a great deal of uncertainty in commercial real estate circles as dealmakers, their lenders, consultants and other stakeholders interpret and implement the new protocol for environmental due diligence.

Outside the environmental consulting world, awareness about what steps commercial real estate purchasers must take to avoid cleanup liability is far from widespread, and there seems to be more questions than answers. Following are the facts that every real estate investor should know about the EPA's new rule.

ENVIRONMENTAL CLEANUP LIABILITY: A BRIEF HISTORY

Enacted in 1980 to address the nation's most polluted sites, the Comprehensive Environmental Response, Compensation and Liability Act makes so-called potentially responsible parties liable for the cleanup of contaminated properties, even if they didn't contribute to—or know about—the contamination. Understandably, the act, also called Superfund, caused considerable alarm among real estate investors.

In response, the U.S. Congress passed amendments to CERLCA in 1986 that included the "innocent landowner" defense, a provision that exempts site owners from liability if they didn't know, or have reason to know, of contamination at the time of purchase. The defense can be raised, provided that the purchaser conducted environmental due diligence, or "all appropriate inquiry" on the property upfront. Until the AAI rule was passed, this step was accomplished with an ASTM E 1527-00-compliant Phase I environmental site assessment.

About the Author

Dianne Crocker *is senior economist and managing director of the Market Research Group at Environmental Data Resources Inc., a national environmental risk information provider. She is a member of the Air & Waste Management Association and the ASTM E 50.02.06 Phase I Task Group. Crocker also represented EDR as a resource participant on EPA's All Appropriate Inquiry Negotiated Rulemaking Committee.*

ENTER AAI

In 2002, Pres. George W. Bush signed into law the Small Business Liability Relief and Brownfields Revitalization Act. Also known as the Brownfields Amendments, the act sought to encourage the redevelopment of brownfields, which the federal government describes as "abandoned, idled or underused industrial and commercial properties where expansion or redevelopment is complicated by real or perceived environmental contamination."

To help meet its redevelopment goal and mitigate concerns developers had about being held liable for property contamination, Congress created two new CERCLA liability protections. The "bona fide prospective purchaser" defense provides protection for property owners who knowingly purchase contaminated property, provided they can demonstrate that any onsite contamination occurred before purchase; and the "contiguous property owner" defense provides liability protection for an owner from contamination caused by the migration of hazardous substances from an adjacent property, provided the owner demonstrates that he or she did not know of contamination on his or her property at the time of purchase.

Particularly noteworthy, the bona fide prospective purchaser protection marks the first time owners can take title to a property they know to be contaminated and still qualify for CERCLA liability protection down the road.

Within the Brownfields Amendments, Congress ordered the EPA to issue a federal regulation defining all appropriate inquiry; it then gave the EPA a 10-step framework to follow in drafting the rule. The Nov. 1, 2005, promulgation is a result of considerable effort by the agency's 25-member AAI stakeholder committee. The final rule, which includes a lengthy preamble, reflects changes made to the draft rule in response to more than 400 public comments solicited by the agency during a 90-day period in 2004.

WHAT DOES AAI ENTAIL?

The most pressing question facing commercial property purchasers is: "Just what do I need to do to protect myself?" Though the 2002 Brownfields amendments were designed to give prospective purchasers an incentive for new investment opportunities, particularly for sites with known contamination, they also impose new obligations under AAI—burdens for the user, i.e., the property purchaser, and the environmental professional chosen to conduct the inquiry (see Table 1).

Table 1

Distribution of Responsibilities for AAI Components

DUTIES OF ENVIRONMENTAL PROFESSIONAL

- Conduct an environmental inquiry that includes:
  - visual inspections of the facility and adjoining properties
  - interviews with past and present owners, operators and occupants
  - reviews of historical sources
  - reviews of federal, state, tribal and local government records

DUTIES OF USER

- Searches for recorded environmental cleanup liens
- Consideration of "specialized knowledge of the subject property and adjoining properties"
- Consideration of the relationship of the purchase price to the value of the property, if not contaminated

SHARED DUTIES OF ENVIRONMENTAL PROFESSIONAL AND USER

- Consideration of "commonly known or reasonably ascertainable" information about the property
- Consideration of the "degree of obviousness of the presence or likely presence of contamination at the property"

Before even getting started on AAI, property purchasers must choose a qualified environmental consultant. Under the AAI rule, environmental professionals must meet specific requirements for experience, education and certification as defined by the EPA (see Table 2). Individuals who do not meet these requirements may participate in

Table 2

AAI Rule's Final Definition of Environmental Professional

PROFESSIONAL AND EDUCATIONAL QUALIFICATIONS		RELEVANT FULL-TIME EXPERIENCE*
Hold a current professional engineer's or professional geologist's license or registration from a state, tribe or U.S. territory	**AND**	Three years
OR		
Be licensed or certified by the federal government, a state, tribe or U.S. territory to perform environmental inquiries	**AND**	Three years
OR		
Have a baccalaureate or higher degree from an accredited institution of higher education in science or engineering *(broadened from the proposed definition which was limited to "engineering, environmental science or earth science")*	**AND**	FIve years
OR		
None *(revised to delete baccalaureate degree requirement as of the date of the rule's promulgation)*	**AND**	10 years

**Relevant experience is defined as: participation in the performance of AAI investigations, environmental site assessments or other site investigations that may include environmental analyses, investigations and remediation that involve the understanding of surface and subsurface environmental conditions and the process used to evaluate these conditions, and for which professional judgment was used to develop opinions regarding conditions of releases or threatened releases to the subject property.*

an environmental inquiry, but only if they are under the supervision of someone who does.

An AAI-compliant Phase I report must carry the signature of the environmental professional who conducted or supervised the work, and that individual must attest that he or she meets the EPA's requirements. For their own protection, all individuals investing in commercial property should ensure that the firm they hire has at least one person on staff who meets AAI's definition of environmental professional.

RESPONSIBILITIES OF THE ENVIRONMENTAL PROFESSIONAL

Much of AAI's requirements go beyond its predecessor, ASTM standard E 1527-00, which until Nov. 1, 2006, satisfied the courts that all appropriate inquiry had been conducted. (EPA determined that ASTM's recently updated standard, E 1527-05, is sufficient protocol for conducting all appropriate inquiry. Both an AAI-compliant Phase I and an E 1527-05-compliant Phase I satisfy the AAI rule's requirements.) The revisions to the E 1527-00 standard to bring the practice in line with the requirements of the AAI rule were made under the guidance of EPA reviewers.

In the end, the EPA was satisfied that the new standard practice was at least as stringent as the federal rule and is, therefore, recognized as acceptable practice. This was a significant development because it would minimize any market impact of the AAI rule by allowing the market to adjust to a revised version of a practice that was already widely used. There are, however, a number of areas where the new AAI rule and E 1527-05 differ from the ASTM predecessor, in some cases significantly.

One of the most significant changes under AAI that commercial property investors should be aware of is the added scrutiny that must be placed on any gaps in the environmental investigations.

In terms of records review, the AAI rule expands the level of inquiry, requiring all previous ASTM-required records *plus* those from local government agencies and Native-American tribes. What's more, the environmental professional will have to search for engineering and institutional controls—i.e., restrictions on a property's use because of residual contamination on site—a function the environmental professional and the user share.

In terms of historical research, AAI's requirements are more loosely laid out than previous protocol, but not necessarily less strict. Research timeframes, data sources and search intervals are left to the judgment of the environmental professional, but research must go back as far as "it can be shown that the property contained structures or from the time the property was first used for residential, agricultural, commercial, industrial or governmental purposes."

One of the most significant changes under AAI that commercial property investors should be aware of is the added scrutiny that must be placed on any gaps in the environmental investigations. Unlike E 1527-00, under the AAI rule, the environmental professional must address, document and explain any data gaps—defined as "a lack of or an inability to obtain information required by the standards and practices listed in the (AAI rule) despite good faith efforts by the environmental professionals or (user) to gather such information."

Documentation should include a summary of the information the environmental professional had to work with, and a detailed account of what could not be obtained as well as documentation of the sources conducted to fill the gaps and, perhaps most important, a determination of the effect that said gaps have on the environmental professional's ability to draw conclusions about contamination at the subject property. This requirement to research, document and analyze the significance of data gaps will add considerable time and expense to the Phase I inquiry.

The AAI rule states that one way environmental professionals can address data gaps is to take soil and groundwater samples. Sampling is not required, however. Rather, the burden is on the environmental professional to determine the significance of gaps in information and recommend additional investigation including sampling, if necessary.

During the rule's public comment period, many environmental consultants objected to the idea of sampling, an activity traditionally seen as beyond the scope of a Phase I. Mark Fackler, president of Azland Risk Management LLC, an environmental engineering firm in Louisville, Ky., won't recommend sampling unless his clients request it. "The new standard specifically excludes Phase II sampling activities in its scope," he says.

Jane Mills, a senior environmental engineer based in the Redmond, Wash., office of Golder Associates, concurs. "Sampling of suspect hazardous materials should not be required as part of a preliminary site assessment. As a consultant, it is difficult to accurately predict the extent of sampling required at a site prior to the preliminary site assessment," she says.

Some environmental consultants, like Elizabeth Krol, a client program manager in Shaw Environmental & Infrastructure's Hopkinton, Mass., office, will sample in certain cases. "I will recommend sampling if it is warranted, but not as a routine practice without a trigger or issue that requires further investigation." Her colleague Gary Sirota, who is based in Scottsdale, Ariz., and serves as Shaw's national program manager of due diligence, agrees. "I would recommend sampling if it was necessary to fill a data gap."

When working with an environmental professional, commercial property purchasers should keep in mind that they will be held responsible for managing contamination responsibly. Like Krol, Kevin Billings, P.E., a senior vice president with Property Solutions Inc. in Moorestown, N.J., says he'd recommend sampling to fill data gaps, but adds: "Some clients will not like this, especially in the case of groundwater in urban areas where contamination may be picked up from off-site issues that do not really affect the utility of the property. In some states, you must notify the regulators that you found contamination on your property that you think is from someone else. Then you must prove your innocence. Eventually, the state may agree, but by that time, you have spent a good deal of money."

Real estate investors should weigh the question of whether to sample carefully. Though not required under the AAI rule, there is a business advantage to sampling in advance of purchase to identify all potential environmental concerns before taking title.

USER RESPONSIBILITIES

Like the environmental professional, the commercial property purchaser has obligations under AAI that go above and beyond previous requirements. Among these, the purchaser must inform the environmental professional about any environmental cleanup liens filed or recorded against the site, any activity and use limitations in place, any specialized knowledge or experience related to the property or nearby properties, the relationship of the purchase price of the property to its value if not contaminated, any commonly known or reasonably ascertainable information about the property and any obvious indications pointing to the presence or likely presence of contamination at the property.

Though this list of obligations sounds onerous enough, the user's duties don't stop on the date of purchase. The EPA makes it clear in the rule's preamble that to maintain CERCLA liability protection, the property owner must also keep up with so-called continuing obligations throughout the life of the property. These obligations include:

- Complying with land use restrictions and institutional controls
- Taking reasonable steps with respect to hazardous substances releases
- Providing full cooperation, assistance and access to persons authorized to conduct response action or natural resource restoration
- Complying with information requests and administrative subpoenas
- Providing all legal required notices

Though not required under the AAI rule, there is a business advantage to sampling in advance of purchase to identify all potential environmental concerns before taking title.

Property owners must comply with any land use restrictions on the property and must not impede the effectiveness or integrity of an institutional control at the property. (An institutional control, or IC, is a type of land-use control that is used when the presence of residual contamination on a property precludes its unlimited use.) Such a control might be in effect to prohibit the disturbance of contaminated soils in a particular portion of the property.

If the owner is unaware of the control and develops the restricted portion of the property, he or she could forfeit CERCLA liability protection, even if AAI was followed before purchase. Impeding the effectiveness or integrity of an IC does not necessarily require a physical disturbance or disruption of the land, though. A landowner could also harm the implementation of an IC through actions that are unrelated to land use restrictions, such as removing a notice conveying information about contamination on a site that was placed in the land records by the EPA or a state agency, or failing to give notice of any ICs to a subsequent purchaser, for example.

With regard to hazardous substance releases, if they occur, property owners must:

- Stop any continuing release
- Prevent any threatened future release

- Prevent or limit human, environmental or natural resource exposure to earlier hazardous substance releases

Commercial property owners are responsible for complying with any restrictions on the use of their properties *even if those restrictions were not identified in pre-purchase environmental due diligence*. CERCLA liability protection can be lost at any time if continuing obligations are not met.

> *Commercial property owners are responsible for complying with any restrictions on the use of their properties even if those restrictions were not identified in pre-purchase environmental due diligence.*

Just how difficult will it be for a property owner to follow these continuing obligations? From a practical standpoint, it could be fairly difficult, especially when owners and operators try to interpret what EPA considers acceptable. "Questions will be raised and different interpretations will be put forth. Unfortunately, it may take lawsuits to shake out the requirements," Billings says. Sirota agrees: "Many clients do not have a clear understanding of what the requirement actually means to them and what specific actions or responses they are required to make."

Krol has a similar belief. "I suspect that there is less awareness (among property purchasers) of the continuing obligation requirements. I think that if there is a significant enough issue that warrants ongoing activity—such as quarterly groundwater monitoring—this would be discovered during thorough due diligence, and the new owner would have both awareness and understanding that they must continue this work to remain in compliance. Alternatively, they may negotiate responsibility with the seller, who could continue to do the necessary work. In that case, I would advise my client to either be copied on submittals or do periodic state agency file reviews, etc., to ensure that the seller has met its obligation and that the owner is protected."

Because of the additional ongoing obligations required by the AAI rule, the Phase I report takes on new significance. It is crucial that the initial pre-purchase investigation uncover the information needed to determine an owner's obligations over time. It bears repeating: Missing issues during due diligence does not exempt the owner from obligation. Put another way, the landowner is not exempt from post-purchase compliance just because the site investigation failed to reveal an issue.

SHELF LIFE

Lastly, when considering the major changes that the AAI brings to bear on pre-transaction due diligence, it is important that property purchasers are aware that AAI-compliant reports have a one-year shelf life. The final rule allows for information in previous Phase I reports to be used, but all data must be collected or updated to within one year of the date that the owner takes title.

In addition, interviews with past and present owners, searches for recorded environmental cleanup liens, the review of government records, a visual inspection of the facility and adjoining properties, and the declaration by the environmental professional that AAI was followed must be current to within 180 days of the property's acquisition date. Information from past reports can be used, but EPA makes it clear that considerations of the following components must be updated to reflect the current transaction: "specialized knowledge" about the property, the relationship between the current purchase price and the value of the property if it was not contaminated, and any commonly known information about the property.

This stipulation is a significant change from former practice, when it was common for a purchaser to rely on an old Phase I conducted for the property from years past and just update certain components of the old report. The EPA's language is quite clear that all 10 steps of AAI must be followed, and they must be based on current information.

COMPLIANCE

Part of the uncertainty surrounding AAI relates to just how important CERCLA liability protection is to potential property purchasers. When ASTM released its first E 1527 standard in 1993, its purpose was for individuals seeking to qualify as innocent landowners to be exempt from CERCLA liability. Over time, the industry evolved and clients became savvier about the practicality of Phase I ESAs as a tool for measuring "business environmental risk," a concept introduced in the E 1527-00 standard.

Today, consultants report that the majority of Phase I inquiries are not conducted to qualify an owner as an innocent landowner but to protect the owner from the business risks of any environmental conditions at the property, including non-scope issues such as mold or lead-based paint. Other clients demand ASTM Phase I inquiries only in response to what lenders, attorneys or rating agencies require. This raises questions about the extent to which the market will embrace the AAI/ASTM E 1527-05 protocol. Prudent investors will make themselves aware of the new bona fide prospective purchaser and contiguous property owner protections and fully understand the additional labor required to satisfy the AAI rule—and the commensurate benefits of liability protection that go along with it—which, in certain cases, could be well worth the effort.

So how important is it to comply with the AAI rule? That depends, according to environmental attorney Barry Trilling, a partner with Wiggin and Dana in Stamford, Conn. "Parties undertaking diligence inquiries of routine commercial properties where they have no reason to anticipate site contamination and attendant liability may wish to consider ordering their environmental consultants to continue to follow the requirements of the less expensive and less onerous ASTM E1527-00 standard to screen properties for environmental issues. If, during the course of the E1527-00 examination, which would not provide a defense to CERCLA liability, the consultant discovers unanticipated liability concerns, he or she should have the flexibility to convert the examination into a broader AAI examination. In any event, prospective purchasers of commercial and industrial properties should consult with counsel as to the nature, extent, and quality of the diligence examination they will perform on subject properties."

Property purchasers should be aware that many lenders, especially large, national lenders, are already incorporating AAI-compliant Phase I ESAs in their CRE underwriting policies. Purchasers may have no choice but to follow AAI in certain cases.

IMPACT ON REAL ESTATE TRANSACTIONS

Because it is so new, there is, understandably, considerable confusion surrounding AAI. The Phase I industry is in a period of unprecedented transition. Also, no one is certain how Wall Street will react. Yet despite the confusion, environmental professionals are reporting that many clients will adopt the new AAI rule. "Most of our clients have adopted the new standard, or are in the process of modifying their existing scope of work to include reference to the new standard," Mills says.

Others are waiting to see how the market reacts. Krol says her key clients—attorneys or real estate investors who are advised by attorneys—are aware of AAI and are taking it seriously. "I also have a few clients—and these are more on the financial and lender side—who are taking a wait-and-see approach," she says.

The new law holds property owners to a higher standard of care in terms of responsibly managing contamination regardless of what was—or wasn't—found in the initial site assessment.

"Our client base basically falls into two camps," Sirota says. "those who are aware of AAI but may not have a depth of understanding, but who still want us to conduct ESAs under 1527-05, and those who are aware but request that we (use) one of the pre-AAI ASTM guidelines, most likely for cost savings."

"When we get a request for a Phase I, we ask, '00 or '05?'" says Pamela Pidge, a due diligence manager with URS Corp. in Fort Washington, Pa. "A lot of clients are not sure of the differences, so we explain them."

ENVIRONMENTAL DUE DILIGENCE GOING FORWARD

It's understandable, and even predictable, that confusion is the norm as real estate investors and the consultants who advise them adjust to the new environmental regulations. Already, though, one thing *is* clear: The new law holds property owners to a higher standard of care in terms of responsibly managing contamination regardless of what was—or wasn't—found in the initial site assessment. Today, thorough environmental due diligence is more important than ever.

For more detail on the AAI rule, visit www.epa.gov.

What Environmental Professionals Say

ELIZABETH KROL: "I would always recommend thorough environmental due diligence. One of my colleagues has a client that now owns a site contaminated with PCBs because they did not perform adequate environmental due diligence prior to the acquisition. They were interested in the business that operated at the site and so it made sense for them in terms of manufacturing capacity, but they have expended well over $1 million cleaning up a small tributary, and will also be responsible for contributing to the cleanup of a significant watershed in eastern Massachusetts as one of the primary potentially responsible parties. The *caveat emptor* or buyer beware warning is one that really should be heeded, and now with the advent of AAI, a prospective purchaser really can't claim, 'I didn't know!'

"I think that AAI and the associated ASTM 1527-05 standard ensures a more thorough review for those who may not have thought it necessary before. In any case, a proactive, responsible buyer would want to know what concerns, if any, exist at the site. And I think that they should determine this prior to acquisition, whether they have specific development plans or not. Things change, and their plans may be revised after taking ownership, but if they haven't obtained indemnity or other appropriate negotiations/protections from the seller, it is too late and they would then be responsible for the full cost and regulatory compliance obligations. I would modify my recommendations based upon site conditions (for example, a site that already has a building onsite and would be renovated vs. vacant land or even a newly developed site). The recommendations should suit the client's risk tolerance and future plans as well as historic usage of the property."

JANE MILLS: "Prior to purchase, the developer should perform due diligence activities which include, but may not be limited to, an environmental assessment in accordance with E 1527-05, a preliminary geotechnical investigation (in locations where development is anticipated), a physical condition assessment of existing structures, and a hazardous materials survey of structures where renovation or demolition may be anticipated. Without this level of preliminary information, it would be difficult for a prospective purchaser to make an informed investment decision."

KEVIN BILLINGS: "There is a difference between an existing redevelopment and a property to be developed. Also, consider future use. There will be questions possibly of state regulators and their involvement with the redevelopment and AAI. Typically our clients have understood, or we have educated them about, the potential added construction costs and potential construction delays (and subsequent costs) of uncovering contamination during the construction phase vs. being able to underwrite the cost ahead of time and evaluating its impact on the overall project. Some clients have altered their construction design or development strategy based on the environmental conditions."

PAMELA PIDGE: "Conduct a Phase I. If we identify potential concerns, proceed with Phase II sampling activities." Pidge stresses the importance of being thorough. "In 2004, we conducted a Phase I on five acres of vacant agricultural property that was developed with a radio tower. The neighboring properties consisted of agricultural land, residences, a public park and the township public works department. Based on a review of aerial photos, topographic maps and historical fire insurance maps (none were available) plus current environmental database and township files, no evidence of environmental concerns were identified. However, in conversations with a township clerk, he recalled that the area might have been used as a dump in the 1960s. We recommended that our client install soil borings and collect soil samples to evaluate for environmental contamination. Arsenic exceeded cleanup criteria in two samples, lead in one. Based on this data, we then recommended delineating the impact. Long story short, this site ended up being cleaned up (soil excavation) under the direction of the EPA Superfund program to the tune of $750,000. It is important to interview the local people!"

MARK FACKLER: "One of my first recommendations would be to consult an environmental attorney. In addition, be aware that, as a purchaser, your liability exposure is different than a lender's exposure, since (purchasers) are not afforded lender liability protections. My recommendations are typically associated with a client's specific risk tolerance. A client purchasing an existing facility may be more willing to incur a higher level of business risk since the likelihood of new discovery of contamination may be diminished. However, the findings and conclusions would be identical in both scenarios, since the liability for property and facility is the same for both."

When asked whether he had experienced resistance from property purchasers, Fackler recalled one particular case. "I worked on a project in which the buyer was so set on purchasing the property because his lease was up for renewal at the end of the week that he pushed to the bank to conduct an environmental database review instead of a Phase I ESA. The bank stated that since the loan was likely going to be securitized, they had to have a Phase I performed. The historical aerial photos indicated that the property, which was only known to be vacant land, contained a lagoon in the late 1940s and early 1950s, with a gravel roadway leading to the lagoon from a nearby metal parts manufacturer. Soil samples taken from the area noted the presence of elevated chromium, cyanide and chlorinated solvents. The lagoon was declared a solid waste management unit and is still undergoing quarterly groundwater monitoring today."

GARY SIROTA: "If a prospective purchaser is interested in making changes to the property, I would recommend a staged assessment to determine if there are any ECs or ICs and what impact they might have. Since AAI became effective, we routinely obtain more information and ask more questions in the scoping stage." When asked whether environmental due diligence turned up anything surprising for his clients, Sirota says: "I recall one particularly interesting project where we were charged with conducting a due diligence assessment of a piece of abandoned property that had been leased from a transportation company years earlier. Records indicated that the previous tenant might have conducted some low end 'recycling' on the site. The majority of the site was covered with gravel with some open ground and our experienced assessor noted a rather large area of dead vegetation off to the rear of the property. Being a suspicious sort, he collected a 'grab sample' of soil and sent it to a lab for analysis. It came back showing that the soil had high levels of PCB. A subsequent Phase II assessment indicated extensive contamination of approximately 80 percent of the site by PCB and lead. Apparently, the previous tenant was conducting unlicensed collection of electrical transformers and lead batteries in contravention of regulations. The PCB oil was disposed of in the area where the dead vegetation was observed, and the batteries and transformer cases were broken up and buried on site." Sirota says the subsequent clean-up took about a year. ■

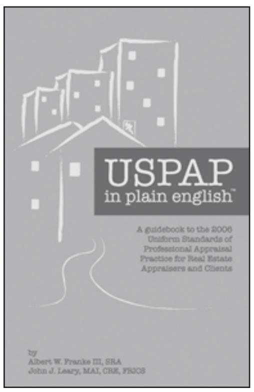
CRE

RECOMMENDED READING

USPAP in Plain English

By John J. Leary, CRE, FRICS, and Albert W. Franke III (2006, Elm City Clarion Associates LLC, New Haven, Conn., 65 pages)

REVIEWED BY MICHAEL Y. CANNON CRE



AUTHORS JOHN J. LEARY, CRE, FRICS, AND ALBERT W. FRANKE III are highly qualified to produce this resource, which is easy to read and summarizes, in outline format, the 2006 edition of the Uniform Standards of Professional Appraisal Practice as defined by the U.S.-based Appraisal Foundation.

Leary is an MAI designated member of the Appraisal Institute, and president of a firm that provides counseling and valuation services relating to dispute resolutions and appraisal reviews in the northeastern U.S. In addition, he served as vice chair and chair of the Appraisal Foundation's Appraisal Standards Board from 1989 to 1994.

Franke is an SRA designated member of the Appraisal Institute and past member of the Appraisal Institute's National Board of Directors. He is president of a firm that provides appraisal and litigation support services throughout Connecticut.

The authors state plainly what is expected by practicing appraisers' understanding and interpretation of USPAP rules and standards. This resource book clearly explains the intended use of an appraiser's assignment, but addresses only USPAP standards 1 and 2, which relate to real property appraisal, analysis and opinion. The authors did not address appraisal consulting (standard 3), mass appraisal (standards 4 and 5), personal property appraisals (standards 7 and 8) or business valuations (standards 9 and 10).

The book outlines new or changed definitions, addressing definitions for appraisal, appraiser's peers and scope of work, and identifies key areas of USPAP that changed, effective July 1, 2006, with emphasis geared toward residential appraisal work.

The major standard change in the "scope of work" rule shifts the responsibility back to the appraiser from the client or intended user, and benchmarks the appraiser's

About the Reviewer

Michael Y. Cannon, CRE, *is the managing director of Integra Realty Resources – South Florida. He is a practicing appraiser, market analyst and advisor with more than 40 years of experience. He has written several monograms and papers relating to appraisal theory and practice. Cannon provides consulting services for all facets of real estate analysis and investment, and has been qualified as an expert witness in various courts and mediation/arbitration disputes. His areas of expertise include ad valorem assessment analysis, land use, historic and fractional interests, and property valuation of urban and mixed-use developments. He holds MAI, SRA and ASA designations.*

value opinion to meet or exceed what other intended users would expect, and what would meet or exceed the level of work and credibility of the appraiser's peers for the type of appraisal assignment.

Leary and Franke stress very clearly that the appraisal process places the responsibility of appraisal with the appraiser. They also highlight that the appraiser is to obtain all relevant information from the client before the preparation of the appraisal in order to minimize hypothetical conditions and assumptions so that the intended user can rely on the appraiser's value opinion.

The authors identify 11 content items required for a credible report, and emphasize that the appraiser's work file should be well organized and contain all supporting information and data that the appraiser uses.

In summary, the USPAP 2006 edition re-emphasizes and cautions the appraiser to report and understand the intended use of an appraisal, and who the intended users are—and to use only appropriate scope of work and reporting formats; i.e., an appraisal form may not be the proper reporting format if the intended use differs from the intended use stated in the appraisal form.

USPAP in Plain English is an appropriate resource for not only the appraiser, but also for the user of residential appraisal services. ■

FOCUS ON THE INVESTMENT CONDITIONS

Economic Resilience Paves Way to Good Times for Commercial Real Estate

BY KENNETH P.RIGGS, CRE

THE FLEXIBILITY, CREATIVITY AND RESILIENCY OF THE CAPITAL markets and the economy all came into play during 2006 to place the economy in a better year-end position than most pundits had anticipated. With a decreased threat of inflation, substantially lower oil prices, strong employment, signs of improvement in the residential real estate market, huge levels of liquidity and low long-term interest rates in the capital markets, and the stock markets at near-record highs, the economy was in a very healthy condition as the year ended. As such, the economic and capital market landscape for 2007 is starting off with even more positives than 2006.

The economy is operating at a more efficient and effective level than in past cycles; business and consumers are holding strong and investment returns are continuing to gain. Look no further than the markets at year-end 2006: the Dow Jones Industrial Index surpassed the 16 percent mark, the NASDAQ Composite Index rose more than 10 percent, and the S&P 500 Index was up more than 14 percent. And for the seventh straight year, real estate funds were the year's top-performing U.S. stock sector, up more than 34 percent, according to the Lipper average, with 12-month trailing returns of approximately 18 percent as reported by the National Council of Real Estate Investment Fiduciaries Index.

This kind of performance, along with cheap debt and the amount of capital flooding the market, led to a record number of mergers and acquisitions in 2006. Thomson Financial reports a total of $3.79 trillion in M&A activity worldwide and 55 transactions valued at more than $10 billion each. Private equity firms were involved in five of the top 10 largest transactions in the U.S., including the planned sale of Equity Office Properties to Blackstone

About the Author

Kenneth P. Riggs, CRE, *is chief executive officer of Real Estate Research Corp. RERC offers research, valuation, independent fiduciary services, portfolio services, litigation support and other real estate-related consulting services. RERC also provides research, analysis and investment criteria—including cap rates, yield rates, expense and growth expectations and recommendations—for nine property types on a national and regional level and for 40 major U.S. markets through the quarterly* RERC Real Estate Report, the RERC/CCIM Investment Trends Quarterly, *the annual* Expectations & Market Realities in Real Estate, *and the RERC DataCenter.*

Group for a record-breaking $36 billion. With so much capital available and interest rates remaining relatively low, M&A should continue at this level into 2007 unless public market investors fight back.

Real Estate Research Corp. expects the M&A activity for control of commercial real estate assets to continue between the public and the private real estate markets. As you may recall, during the commercial real estate depression of the 1990s, just a little more than 10 years ago, there was a liquidity crisis with no debt or equity capital to be found, so big real estate companies sought relief in the public capital markets for debt and equity. As a result, most large private real estate holdings went public and formed real estate investment trusts to access capital.

Today, because of the deluge of domestic and global capital across all spectrums—and the inability of public companies to be hamstrung by the use of lower leverage and very watchful shareholders and regulators—private capital sources with huge pocketbooks are buying public companies and REITs. This scenario is especially true for investors who are willing to pay more for commercial real estate assets than the public REIT market is willing to price shares. Even Sam Zell is selling because of these capital market realities. The National Association of Real Estate Investment Trusts reports that REITs were involved in deals worth $117.8 billion in 2006, nearly four times as much as in the previous two years combined.

This backdrop brings a luster to private commercial real estate that hasn't existed in some time. In fact, 2006 may well have been the strongest year for real estate pricing in several decades. The question is, will this cycle of cheap money continue in 2007? Will real estate retain its attractiveness? Is the private market "right," and for how long?

Table 1

RERC Required Return Expectations[1] by Property Type

	Office		Industrial		Retail						
	CBD	Suburban	Warehouse	R&D	Regional Mall	Power Center	Neigh/ Comm	Apartment	Hotel	Average All Types	RER Portfolio Index
Pre-tax Yield (IRR) (%)											
Range	7-10.5	7.3-10.5	7-10.5	7.3-10.5	7-11	7.3-11	6.8-11	7.3-10	9-11.5	6.8-11.5	6.8-11.5
Average[2]	8.5	8.9	8.5	9.1	8.5	8.6	8.5	8.2	10.6	8.9	8.6
Weighted Average[3]	8.7		8.5			8.5					
Going-In Cap Rate (%)											
Range	5.5-8.5	6-8.8	5-8.5	6-8.8	6-9	6.3-9.5	6-9	5-8	6.5-10	5-10	5-10
Average[2]	6.8	7.2	7	7.5	7.1	7.1	7	6.3	8.6	7.2	6.9
Weighted Average[3]	7.0		7.0			7.1					
Terminal Cap Rate (%)											
Range	6-9.1	6.5-9.5	6.5-9	6.8-9.5	6.3-9.5	6.5-9.8	6.5-9.5	5.8-9	7-10.5	5.8-10.5	5.8-10.5
Average[2]	7.5	7.9	7.6	8.1	7.5	7.6	7.5	7	9.3	7.8	7.6
Weighted Average[3]	7.7		7.6			7.5					
Rental Growth (%)											
Range	0-5	0-5	0-4	0-4.5	0-3.5	0-3.5	0-3.5	0-5	0-4.5	0-5	0-5
Average[2]	3.2	3.1	2.7	2.7	2.6	2.7	2.7	3.3	2.8	2.8	3.0
Expense Growth (%)											
Range	0-3.5	0-3.5	0-3.5	0-3.5	0-3	0-3.5	0-3.5	0-3.5	0-3.5	0-3.5	0-3.5
Average[2]	2.8	2.8	2.7	2.7	2.7	2.7	2.8	2.8	2.6	2.7	2.8

[1]*This survey was conducted in July, August, and September 2006 and reflects expected returns for Third 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 upon 2Q06 NCREIF Portfolio market valuesSource: RERC Investment Survey*
Source: RERC, as published in the fall 2006 RERC Real Estate Report.

Table 2

National Transactions by Property Type

	OFFICE	INDUSTRIAL	RETAIL	APARTMENT	HOTEL	TOTAL
Volume ($ million)	$172,132	$44,414%	$65,618	$107,351	$35,866	$425,381
UNIT PRICE						
Average	$172	$84	$177	$109,193	$111,863	—
Median	$139	$67	$126	$87,500	$82,776	—
RERC ESTIMATED CAPITALIZATION RATE (%)						
Range	4.7-10.3	5-10.6	4.7-10.1	3.9-9.5	6.2-12	3.9-12
Average	7.2	7.4	7.0	6.3	8.8	7.4

Unit prices based on data derived from samples of commercial transactions on local, regional, and national levels.
Capitalization rates based upon available transaction information, survey respondents, and NCREIF Index Returns.
Source: RERC, as printed in the first quarter 2007 RERC/CCIM Investment Trends Quarterly *flash report. Content cannot be duplicated or reproduced without expressed written consent of RERC.*

RERC suggests that the private market is *right*—at least for the next few quarters and probably for a few years. Despite the risks—and there are risks, as with any investment—expect interest rates to remain low and capital/credit to be readily available. Employment should remain relatively strong, energy prices should remain reasonable and the residential real estate market should stabilize. Real estate fundamentals should continue to strengthen, and if new construction remains in check, real estate returns should be competitive on a risk-adjusted basis for 2007.

Investors continue to decrease their return requirements (see Table 1). Required pre-tax total yield rates are generally in the mid-8 percent range for the office, industrial, and retail sectors, with required pre-tax total yield rates slightly lower for apartments and 10.6 percent for hotels.

RERC's required capitalization rates inched slightly downward for nearly every property type, bringing investors' required capitalization rates more in line with transaction-based capitalization rates (see Table 2). Even so, these capitalization rates have moved little from the previous quarter, which is primarily a function of continued strong investor demand, availability of capital, and low risk-free rates.

RERC's institutional survey respondents expect office to remain one of the better-performing sectors in the commercial real estate market because of limited new construction and continued job growth. Apartments also are likely to perform well in the short term because of increasing rental rates and a slower housing market. Some survey respondents predict that retail could be the worst performer because of low consumer spending, overpricing and tenant risk. Others say hotels will be the worst-performing sector because of overbuilding and overpricing.

Opinions about the industrial market are mixed. Some respondents believe industrial properties have the best prospects, given that increasing land and construction prices limit building and put constraints on current supply. But others note the slowdown in manufacturing and predict industrial properties eventually will suffer.

The year 2006 was a period when commercial real estate outstripped and exceeded all investor expectations with record deals and prices. 2007 will be another interesting time for commercial real estate, as we adjust to fundamental changes that occurred in the past year and will affect our industry for the foreseeable future. During the coming months, RERC anticipates that:

- Most economic threats related to high oil prices, inflation, a housing bust and the potential of a recession are behind us; 2007 should be balanced with less risk of recession.
- The economy will grow at a pace of around 2.5 to 2.75 percent, more than 1.5 million new jobs will be created and the inflation rate will be low.
- It is more likely that the Federal Reserve System will lower rates in 2007 compared with 2006.
- Capital markets will be flush and will continue to provide money at very favorable rates. Long-term rates should stay low or even fall somewhat in 2007.
- Commercial real estate markets will continue to strengthen, allowing office and industrial properties to gain some rental rate pricing power.
- Retail properties will face the greatest challenge in 2007 among the primary property types, given their spectacular run in rents, prices and transaction volume through the past several years.
- The private market's appetite and ability to leverage commercial real estate will continue to allow it to take assets from the public market.
- Realized or reported/transaction-based returns will come down from unsustainable levels and start to gravitate toward expected or required returns.
- Investors will continue to climb up the risk spectrum in search of higher real estate returns as they venture into smaller markets and broaden their definition of an acceptable real estate investment.

We all have been through cycles before, but somehow this one appears to be different. The outlook for commercial real estate is optimistic in the short- to medium-term because of the sustained period of favorable dynamics. This time we have highly skilled captains at the helm, and they have sophisticated investment tools at their deposal, watchful eyes overseeing their decisions and lifelines—if they need to use them.

There still is a chance that the market could cool because capital has gotten slightly ahead of itself, but we are nowhere near a major commercial real estate price correction. Pricing levels should stabilize, and cap rates should finally stop declining.

Overall, it will be a year for investors to count their booty and assess the strategic position of their real estate portfolios. However, 2007 is not a time to be greedy and, in the long run, the entire industry will be better off if investors

FOCUS ON THE ECONOMY

Inflation Moderates as Mid-Recovery Slowdown Surfaces

BY RICHARD W. MAINE, CRE

"SO FAR, SO GOOD!" This statement is a simple, yet accurate summary of what is unfolding in the U.S. economy and commercial property market. Neither recession nor stagflation is probable; instead, evidence that we are in the early stages of a Fed-induced mid-recovery slowdown is gathering. Inflationary pressures are subsiding and, most important, commercial real estate fundamentals remain solid and improving across all property sectors.

Through midyear, the U.S. economy ran stronger than industry observers had expected, but a slowdown has begun. Third-quarter real gross domestic product growth came in at 1.6 percent, down from 2.6 percent in the previous quarter and 5.6 percent in the first quarter. Housing, which kept the economic recovery going longer and stronger, is clearly in decline. Major domestic automakers have announced production declines stretching well into 2007. Oil has dropped more than $20 a barrel since August, largely because of reduced demand signaling a possible cyclical peak in the economy. The yield curve remains flat to slightly inverted, which points to a slowdown; and through late 2006, the U.S. Leading Economic Indicator also continued to point toward a slowdown.

The consumer, who has driven this five-year-old recovery, continues to do so, assisted by reduced energy costs and continued high levels of home equity withdrawals from single home refinancings, but at a decelerating rate of growth. Warning signs of future retail spending declines are flashing; examples include the recent numbers and projections from Wal-Mart—an important proxy for low- to middle-income retail spending trends.

EXPECT HAWKISH FED DESPITE ENCOURAGING TRENDS

Understanding that cyclical inflation lags and always peaks after GDP peaks, the recent news about inflation is mixed, with a growing bias toward moderating inflation. Importantly, there is no evidence that inflation is baking itself into higher wages and benefits. This series within the economy commands the U.S. Federal System's greatest scrutiny as it fights to prevent cyclical inflation flare-ups from becoming structurally embedded via payrolls.

About the Author

Richard W. Maine, CRE., *is managing partner for Madison Harbor Capital, an independent investment firm serving institutional and high net worth investors with timely and distinctive real estate investment strategies through primary investments into newly formed real estate partnerships and secondary acquisitions of existing interests in real estate. The firm focuses on providing investors with a proper balance of risk and return through a high level of diversification.*

The Fed, following 17 consecutive 25-basis-point rate increases, stood down and took no action since June 2006. This Fed pattern continues with key leading technical indicators prompting Fed pronouncements regarding "moderating inflation" tempered with language that reminds the market the Fed can and will hike rates further if moderating inflation fails to continue. Also, remember that despite encouraging trends, the core inflation rate has not yet returned to within the Fed's desired 1 to 2 percent safe harbor. For the foreseeable future, the Fed should feel good about the economy while maintaining a hawkish posture on inflation.

SINGLE FAMILY HOUSING UNWINDS

The single family housing sector has peaked and is in rapid decline, but hasn't yet bottomed out. Following five years where home prices had a compounded annual growth rate of approximately 15 percent, we can look back and say it was the highest national rate of house price appreciation ever. A phenomenon of that magnitude will not be corrected in a few quarters. Most observers feel the correction has to play out in terms of duration and magnitude.

Despite the slowing general economy, demand for rental space across all property types remains strong. At the same time, the pipeline for new supply of space remains constrained in most local markets by high costs for land, entitlements and building materials.

Nominal house prices are falling nationally for the first time in the post-World War II period. Though history shows the U.S. can unwind a housing bubble and avoid recession, the U.S. cannot avoid some meaningful consumer belt-tightening, which is still largely in the pipeline. This means the housing correction will be a significant contributor to below-trend GDP growth through at least 2007.

STOCKS FINALLY RESPOND

One very encouraging development has been recent stock market performance. It has overcome its stagflation obsession as demonstrated by the healthy year-to-date performances in the Dow Jones Industrial Average, S&P Indices, New York Stock Exchange, American Stock and Options Exchange and Russell 2000 Index—and even the NASDAQ Stock Market is now in positive territory.

The economy is downshifting, cyclical inflation fires are being dampened and, to date, the housing correction has proved manageable. However, the overall situation remains fragile with unforeseen accidents continuing to pose a threat to this scenario. Moving forward, it will be important to closely monitor job trends, the U.S. dollar and the continuing ramifications of the housing correction. If history is any guide and we continue on this mid-recovery slowdown path, the Fed should be in a position to consider reducing rates in late 2007, allowing the economy to return to trend-line GDP growth during 2008.

RENTS INCREASE IN U.S. COMMERCIAL PROPERTY MARKET

The picture for commercial real estate is very strong where it counts the most: the fundamentals. Despite the slowing general economy, demand for rental space across all property types remains strong. At the same time, the pipeline for new supply of space remains constrained in most local markets by high costs for land, entitlements and building materials.

The result is rising occupancies, increasing rents, sharp declines in the need for concessions, and improving net operating income to fund maintenance and replacements as well as investor cash distributions.

The 2006 year-end numbers included many firsts and records, but the most compelling story is about rent increases. According to third-quarter 2006 data compiled by Global Real Analytics, nationwide commercial rents have increased 6 percent on a trailing 12-month basis. Tracked by quarter over the previous year, each property type except retail achieved an accelerating rate of rental growth. Even retail properties maintained a steady and respectable 5.2 percent average rent increase.

Obviously, there was a broad range across regions led by the Pacific Coast states' 8.2 percent growth with even the lowest regions recording a positive 2 percent growth. By property type, rent growth experienced a tighter range spanned from retail's 5.2 percent, to 6.7 percent for Class A central business district office properties and class A apartments.

REAL ESTATE REMAINS WELL POSITIONED

Remembering that private real estate equity's historical returns are composed mainly of current income, the fundamentals indeed look solid—even going into a mid-recovery economic slowdown—given the equilibrium existing between demand and supply for space. With strong liquidity and ample capital for debt and especially already mobilized private equity, commercial real estate is well positioned for the next several years.

Total returns are likely to moderate as the rate of appreciation slows. Even if real estate reverts back to its historical unleveraged NCREIF 9.5 percent to 10 percent total returns, it still represents a solid diversification with attractive absolute and relative returns.

PUBLIC REITs ARE TOP PERFORMERS

The third iteration of public REITs that began in 1993 has enjoyed a strong performance run for its investors. REITs represent roughly 20 percent of U.S. commercial real estate equity capital, and the public REIT structure is now being replicated in other countries, with the UK being the latest to introduce public REITs on Jan. 1, 2007.

The REIT performance in the U.S. has been well chronicled and needs no repeating except to say that 2003 – 2005 produced continuous annual returns of more than 30 percent, with 2006 returning more than 34 percent—well ahead of major stock indices and the seventh consecutive year that REITs have outperformed the indices.

Yet behind the headline performance numbers are other important REIT trends that draw private real estate equity into play. At an accelerating pace over the past 12 to 18 months, REITs are experiencing consolidation as well as public-to-private conversions. According to Prudential Real Estate Investors, approximately $44 billion in REIT merger-and-acquisition transactions have closed through the first three quarters of 2006, including $24 billion in transactions first announced in 2005. At least $65 billion in additional deals were announced in 2006, but not yet closed.

Though some of the activity involves public-to-public mergers, the majority are privatizations of either the entities or the underlying asset portfolios. As share prices have appreciated, investors who were ostensibly drawn to REITs for their dividends have seen their yields cut in half. Many REITs that continue to be publicly owned are making ample use of private real estate equity capital to form joint ventures for the purpose of purchasing portfolios of core properties.

Capital market activity for the public REITs as of third quarter 2006 vs. full year 2005 is:

- Two IPOs totalling $267 million vs. 17 for $6.5 billion in 2005
- 61 Secondary Equity Offerings for $9.5 billion vs. 75 for $8.9 billion in 2005
- 31 Preferred Stock Offerings for $3.4 billion vs. 35 for $3.0 billion in 2005
- 66 Unsecured Debt Offerings for $19.4 billion* vs. 104 for $16 billion in 2005
  **Includes 34 deals for $8.4 billion completed in third quarter 2006*

There are some fascinating trends behind the headline performance numbers that are very different from what occurred with REITs between 1993 and 2004. Right now, despite the returns, REITs cannot be considered a growth market. Instead, REIT IPO issuance is nonexistent and the volume of unsecured leveraging is increasing as the entire sector is being rationalized through consolidation and public-to-private conversion.

SUMMARY

The investment environment remains fragile and risky. The Fed's preemptive move to tighten in mid-2004 seems to be working in engineering a mid-recovery slowdown to defuse an inflationary flare-up and prick the bubble in home prices. Implementation is proceeding in an orderly fashion but can still be sabotaged by the fallout from the housing correction or an unforeseen accident.

Threats of either a recession or a stagflation scenario have receded, and a resumption to trend-line GDP growth is probable within 12 to 24 months. Commercial real estate fundamentals are sound, still improving and positioned to perform well, albeit at somewhat lower appreciation rates as we move through the slowdown phase of this economic cycle.

So far, so good. But it's early, so stay tuned. ■

CRE

THE COUNSELORS OF REAL ESTATE

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To be the forum for leaders in real estate.

CRE CORE VALUES

- integrity
- competence
- community
- trust
- selflessness

ORGANIZATIONAL OBJECTIVES

CREATE: To provide a platform for professional relationships, insight and access to diverse experience.

PARTICIPATE: Through active participation, contribution, and camaraderie, members enhance the benefits of a diverse professional community.

COMMUNICATE: To communicate within the membership and marketplace that our members are the preeminent source of real estate knowledge and advice.

WHAT IS COUNSELING?
A unique specialty, counseling is not considered a specific discipline with a defined body of knowledge, such as brokerage, management or appraisal. Rather, real estate counseling is a process—one that requires technical competency, critical inquiry and objective analysis, all of which are directed toward achieving the best results for a client or employer. A Counselor of Real Estate serves as the link between defining the problem and devising a solution of measurable economic value. Essential to the counseling process is the trust and confidence that prevails in the CRE-client or CRE-employer relationship.

WHAT IS A COUNSELOR OF REAL ESTATE?
A Counselor of Real Estate, or CRE, is an advisor who brings a broad range of real estate experience and technical competency to assignments for clients or employers.

Only 1,100 real estate advisors worldwide belong to The Counselors of Real Estate organization and hold the CRE designation. Membership in the organization is by invitation only. To be invited, counselors must be recognized by their peers, clients and employers for their outstanding levels of accomplishment and impeccable judgment in counseling. They adhere to a strict Code of Ethics and Standards of Professional Practice that treasure the confidentiality of the CRE-client of CRE-employer relationship.

The CRE designation is a prestigious credential that serves as an identity and bond in the real estate marketplace. It declares individual professional achievement in the real estate counseling profession and acknowledges an advisor's status as one of the most trusted professionals in the field of real estate.

WHAT ARE THE BENEFITS OF MEMBERSHIP IN THE ORGANIZATION?
Access continues as the hallmark of The Counselor organization.

Those who belong to The Counselors of Real Estate have access to respected specialists in every market and in every field of real estate and access to a professional community that elevates their experience and expands their professional reach.

Counselors benefit not only from access to the collective knowledge of their fellow CREs, but also from an *esprit de corps* unmatched in any real estate association. CREs are linked to one another by their commitment to lifelong learning and inquiry, their appreciation of creative thinking and their pledge to community and service.

When CREs belong, they belong beyond the boundaries of a typical association environment. Membership provides access to a unique culture grounded in trust and camaraderie. ■

CRE

REAL ESTATE ISSUES

Real Estate Issues is a publication of the professional membership organization The Counselors of Real Estate. The publication is not an academic-oriented publication. Rather, it is a commercial real estate journal written for and by practitioners. Its focus, therefore, is on practical applications and applied theory.

Contributions from industry experts—from CRE members and nonmembers alike—have given *Real Estate Issues* a reputation in the real estate industry for offering substantive, timely content about key industry issues and trends. Members of The Counselors receive complimentary subscriptions. Nonmember subscribers include real estate and real estate-related professionals, organizations and institutions.

MANUSCRIPTS

1. FEATURE ARTICLES

Feature articles explore practical applications and applied theory addressing the diversified issues encountered in the broad field of real estate. *REI* accepts manuscript submissions that are no longer than 25 double-spaced pages (about 7,000 words) and no shorter than 10 double-spaced pages (about 2,800 words). Charts, graphs and photos are welcome, when appropriate, to enhance the article. CREs and nonmembers can contribute feature articles.

2. PERSPECTIVE COLUMNS

Perspective columns provide the author's viewpoint about a particular real estate practice, issue or assignment; a description of the author's involvement in a specific counseling assignment; or the author's opinion about a long-standing industry practice, theory or methodology. Perspective columns are about four to nine double-spaced pages (1,000–2,500 words). CREs and nonmembers can contribute perspective columns.

3. RESOURCE REVIEWS

Resource reviews provide commentary about real estate-related and business-related books, Web sites and other resources that would be beneficial to real estate practitioners. Reviews are two to five double-spaced pages (500–1,500 words). CREs and nonmembers can contribute resource reviews.

First-time authors may wish to submit a brief paragraph or outline about the intended focus/treatment of the topic to ensure the article's appropriateness for the publication.

RIGHTS

Upon publication, The Counselors of Real Estate holds copyright on original works. This practice allows CRE to post articles on its Web site and authorize their use for classrooms and other reprint requests. The Counselors will not refuse any reasonable request by the author for permission to reproduce his/her contributions to the journal.

WEB SITE

CRE posts a PDF file of each article on the association's Web site after the issue mails, allowing members and site visitors to access and circulate information.

REPRINTS

Reprints are available to authors; CRE will provide authors with the cost of reprints after publication.

MANUSCRIPT/GRAPHICS PREPARATION

Contributors should submit manuscripts via e-mail (info@cre.org). All information, including abstract, text and notes, should be double-spaced.

1. Manuscripts should follow page and word count as listed above. Each submission should also include a 50- to 100-word abstract and a brief biographical statement. Computer-created charts/tables should be in separate files from article text. If accepted, the author also is required to submit a headshot in EPS, tiff or jpeg format with a resolution of at least 300 dpi.
2. Graphics/illustrations are considered figures, and should be numbered consecutively and submitted in a form suitable for reproduction. Electronic forms are acceptable.
3. Number all graphics (tables/charts/graphs) consecutively. All graphics should have titles.
4. All notes, both citations and explanatory, must be numbered consecutively in the text and placed at the end of the manuscript.
5. For uniformity and accuracy consistent with *REI*'s editorial policy, refer to style rules in *The Associated Press Stylebook*. The *Real Estate Issues* managing editor will prepare the final manuscript in AP style.

REVIEW AND SELECTION PROCESS

All manuscripts are reviewed by at least three members of the REI Editorial Board: two members of the board and the editor in chief. Author names remain anonymous.

The managing editor makes every effort to notify authors about the status of manuscripts under review at the earliest possible date.

The policy of *Real Estate Issues* is not to accept articles that directly and blatantly advertise, publicize or promote the author or the author's firm or products. This policy is not intended to exclude any mention of the author, his/her firm, or their activities. Any such presentations however, should be as general as possible, modest in tone and interesting to a wide variety of readers. Authors also should avoid potential conflicts of interest between the publication of an article and its advertising value.

WILLIAM S. BALLARD AWARD

The William S. Ballard Award is presented annually to the author or authors whose work best exemplifies the high standards of William S. Ballard, CRE, and the high standards of content maintained in *Real Estate Issues*. The award-winning manuscript, selected by a three-person committee, is chosen from the published articles that appear in an annual volume of the journal. CRE and nonmember authors are eligible. The award, which is funded by the William S. Ballard Scholarship Fund, includes a $500 honorarium and is presented at a national meeting of The Counselors.

The award is named in honor of William S. Ballard, who was a leading real estate counselor in Boston in the 1950s and 1960s. He was best known for the creation of the "industrial park" concept and developing the HUD format for feasibility studies. He was an educator who broke new ground during his time in the real estate business, and whose life ended prematurely in 1971 at the age of 53.

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