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REAL ESTATE ISSUES

Published by THE COUNSELORS OF REAL ESTATE

Volume 31, Number 1   Winter 2006 – 2007

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Published by The Counselors of Real Estate, a not-for-profit organization of the National Association of REALTORS®, 430 N. Michigan Ave., Chicago, IL 60611.

Third class postage paid in Chicago. *Real Estate Issues* publishes three times annually. Subscription rates are: $48 for one year (3 issues); $80 for two years; $96 for three years; $42 per year to students and faculty; $54 foreign rate, submit in U.S. currency; single copy $15. Remittances may be made by credit card or personal check, payable to The Counselors of Real Estate. Remittances, change of address notices, undeliverable copies, orders for subscriptions and editorial material should be sent to *Real Estate Issues*, The Counselors of Real Estate, 430 N. Michigan Ave., Chicago, IL 60611. Phone: 312.329.8427; Fax: 312.329.8881; E-mail: info@cre.org; Web site: www.cre.org

Library of Congress card number LC 76-55075

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Editor's Statement

BY MAURA M. COCHRAN, CRE

OK, I'LL MAKE AN EMBARRASSING confession. Two months ago my firm, Bartram & Cochran, was working on a typical (for us) assignment on the economic impact of a proposed big box development to a small community. We kept asking the developer for his ongoing costs to place in the economic multiplier model. After a few weeks he got back to us and said that the information could be found at a publication called *Real Estate Issues* in an article titled "The Economic Impact Study for a Big Box Retailer," by Joseph S. Rabianski, Ph.D., CRE. At least I wasn't editor in chief at the time or I really would have been taken to task. Lesson learned!

From now on, we'll check the *REI* section of the CRE Web site for past articles anytime we're researching a topic. This process is now easier thanks to an improved search mechanism that allows browsers to quickly and easily scour more than 30 years of *Real Estate Issues.* To take advantage of this new tool, visit www.cre.org and click on Publications, then Real Estate Issues, and Articles and Abstracts.

This edition of *REI* is the second to be delivered in print as well as electronic versions. The response to the electronic version has been wonderful, with visits to *REI* Web pages increasing 300 percent since the first electronic version hit in-boxes in early March. The REI Editorial Board is working on sending the electronic *REI* to professors at leading colleges and universities whose students will be able to access not only *REI*, but also other case studies and research on the CRE Web site. Other professional organizations, including the Society of Industrial and Office REALTORS®, have agreed to send a copy of the electronic *REI* to members and post it online as a resource.

To keep up the flow of top-level articles, the REI Editorial Board is always proactively searching for new authors and ideas. We encourage readers who see articles of interest to send authors' names to info@cre.org. Board members will locate authors and inquire whether they have articles that are appropriate for *REI*. In this edition, the roundtable on U.S. demographics and development models was envisioned after I read an article about immigration in the Kennedy School alumni magazine.

The spring 2007 issue of *REI* has 10 articles divided into two general sections: International Issues, and Law and Land.

Marc Louargand, Ph.D., CRE, FRICS, did double duty for us by moderating the roundtable titled "Shifting U.S. Demographics and Development Models: Immigration, Economy and the Workforce" and writing "The Global REIT Revolution." Marc has been behind the creation of a global REIT for Cornerstone Advisers LLC, and shares his comprehensive insight and research into this market. The roundtable panel included Counselors from the full range of the political spectrum, from very liberal to more than tad conservative. Readers should find the perspectives of CREs Hugh Kelly, David Lynn and Francis Parker entertaining and educational.

David Wilkes, CRE, FRICS, looks at the management of an international portfolio in his article "Who's Running the Show? Implementing Centralized Management of Property Taxes for a Global Portfolio." Anyone who has tried to get information from markets that are less than transparent will certainly relate to this article.

Barry Gilbertson, CRE, PPRICS, continues his series on international issues in his article titled "Residential Property—Do You Own Enough?" Though based on the UK market, the article's key points are relevant to all nations and regions where housing prices are soaring.

The international section is rounded out by a review written by Brent Palmer, CRE, FRICS, of Bowen H. "Buzz" McCoy's book *The Dynamics of Real Estate Capital Markets—A Practitioner's Perspective*. After reading the review, many professionals will likely decide to buy the book.

Cheryl Pavic Henner addresses loan issues in the article "Negotiating Defeasement Provisions at Origination Can Materially Impact the Bottom Line." Her points should be included in many future contracts to avoid costly contract disputes. The article "FIRREA and Its Effect on the

Investment Community," by Bradley Carter, CRE, and Dori D'Esposito Bower, is particularly important reading for those who are not appraisers, but use their reports on a regular basis.

Maureen Mastroieni, CRE, expands the discussion about the aftermath of *Kelo vs. New London* in "Collaborative and Market-Driven Approaches to Economic Development and Revitalization." Her points are well taken as most states continue to pass legislation to correct or clarify eminent domain issues.

In "Going Green Pays Off for Two Leading Businesses," Mark Golan points out that green building is more than just a feel-good proposition. In reality, the tactic results in significant energy savings and overall financial rewards.

My new best friend, Joseph Rabianski, Ph.D., CRE—the author of the big box retailer article mentioned previously—presents alternatives to the current understanding of effective land use in "Comments on the Concept and Definition of Highest and Best Use." The article offers new views into making better and more financially feasible recommendations to clients. Readers may want to circulate this article to the office.

Being editor-in-chief has caused me to read (and re-read) articles about topics that have no direct relation to my practice; it is a real education. Though certain articles in *REI* might not have a real take-home value for all of us, overall the journal strives to present a clearer understanding of big picture issues for all in the industry. And as I learned, *REI* also provides a resource for research that can validate project assumptions.

Send your ideas and comments to info@cre.org. In addition to article recommendations, the board welcomes letters to the editor from readers who wish to air their opinions about issues presented. ■

Maura M. Cochran

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EDITOR IN CHIEF

REAL ESTATE ISSUES

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CRE

FOCUS ON INVESTMENTS

The Global REIT Revolution

BY MARC A. LOUARGAND, Ph.D., CRE, FRICS

INSTITUTIONAL INVESTORS LIKE TO POINT to the so-called Modern REIT Era to distinguish between the sleepy world of passive real estate investment trusts that drew modest amounts of capital between 1960 and 1991, the year Kimco Realty Corp. came public and adopted the REIT format. Following Kimco, the capitalization of U.S. REITs took off, growing from less than $9 billion equity capitalization in 1991 to more than $400 billion at the end of 2006. Along with that growth came a shift in business focus.

Before Kimco and other trusts formed in the 1990s, REITs had been passive investment portfolios typically run by external advisers who often held them captive. A series of regulatory changes between the mid-1970s and late 1980s made it possible by the 1990s to use REITs to recapitalize entrepreneurial portfolios. That event gave rise to today's REIT in the U.S.; a modern vehicle in the business of owning and operating real estate. REITs now routinely engage in the development, repositioning, management and sale of assets. This ability to play across all lifecycle stages is a vital part of the REIT success story.

Today there is a parallel evolution taking place in many countries as REITs are adapted to meet the needs of European and Asian property capital markets.

RISE OF THE J-REIT

The Japanese REIT market launched in 2001 and has grown to more than ¥5 trillion in capitalization. J-REITs follow an early model and are externally advised. The self-managed REIT may make its appearance in Japan within the next few years as the regulatory and capital market players become comfortable with the concept. J-REIT performance since inception has been nearly double the broad Japanese equity market returns: 19 percent vs. 10 percent, according to the STB Research Institute.

CREATION OF THE SIIC

More than 10 years after the introduction of the J-REIT, France weighed in with the SIIC, or *Societes*

About the Author

Marc A. Louargand, Ph.D., CRE, FRICS, *is managing director and chief investment strategist for Cornerstone Real Estate Advisers LLC, based in Hartford, Conn. Previously, he was a professor of real estate finance at Massachusetts Institute of Technology and a consultant to institutional portfolios, industrial and financial corporations, and domestic and foreign governments. Louargand is co-editor of the* Journal of Real Estate Portfolio Management, *associate editor of the* Journal of Real Estate Literature, *and a member of the editorial boards of the* Journal of Corporate Real Estate, Briefings in Real Estate Finance, *and the* Journal of Real Estate Research. *He is the founding director of the Pension Real Estate Association Institute, president of the American Real Estate Society, a fellow of the Homer Hoyt Institute and has served as chair of the Portfolio Strategy Committee of the National Council of Real Estate Investment Fiduciaries.*

d'Investissements Immobiliers Cotees. Introduction of a REIT-like instrument helped France through the resolution of its own property market recapitalization. In just four years, SIICs have grown to €50 billion in capitalization spread across about 45 firms. Recent regulatory proposals in France appear to be designed to encourage broader ownership and greater transparency in the SIIC market.

UK PROPERTY TRUSTS

Listed Property Trusts are not a new thing in the UK, which has a well-developed public real estate market. In January 2007, however, seven firms announced their intention to convert to the newly approved REIT status. Observers have been handicapping the REIT conversion race in the UK and Germany for the past 18 months or so and though Germany has announced its plans, it appears that the UK will be the first of the two to make the change.

In all, 26 countries have REITs or REIT-like vehicles listed on public exchanges today. More are expected to follow in the near future as global capital markets become increasingly integrated.

GERMAN REITS

The German property market may be most in need of new vehicles and fresh capital. The introduction of the G-REIT in 2007 will be a major force for resolution of the country's issues. The German property market has not seen meaningful value increases in the past 15 years, according to one observer in early 2006.[1] Since that time, the residential market has shown signs of revival and opportunistic buyers have entered the general property market. Despite some reluctance on the part of the current government, Germany has committed to the introduction of REITs in 2007 and we may see the equivalent of the mid-1990s REIT boom in the U.S.[2]

A TRUE GLOBAL MOVEMENT

Capital will flow to tax-advantaged opportunities wherever possible, so expect the marketplace to apply firm pressure on reluctant governments.

SOME EVOLUTIONARY THEMES

Having lived through the entire U.S. REIT era as a real estate investor, I can accept that things have truly changed in the Modern REIT Era contrary to the appropriate cynicism that greets most Wall Street announcements of a new paradigm. The global REIT movement likely will follow parallel or similar paths of change as it grows and matures. Changes could include:

- Diversification—The U.S. REIT has proven to be a successful vehicle for capitalizing portfolios of virtually every property type. Outside the U.S., a more limited range of sector bets are available. Figures 1 and 2 illustrate the difference and another key disparity between the two groups. Early on in the U.S., the investor and analyst community's actions showed that it valued single-sector firms more highly than diversified ones, and the industry evolved in that direction. The diversified category in the U.S. is primarily a blend of office and industrial park investors and developers. In Europe and Asia, numerous firms operate across a broad range of property types, lifecycle stages and national boundaries. Several also engage in property services of one type or another.

  It will be interesting to watch this market mature and see whether it goes with the single-sector model, the diversified model or can maintain a rationale for applying two standards at once. If forced to hazard a guess, I would predict the single-sector model will hold sway but may be suboptimal in jurisdictions where every project is perforce mixed use, as in much of urban Europe and Asia.

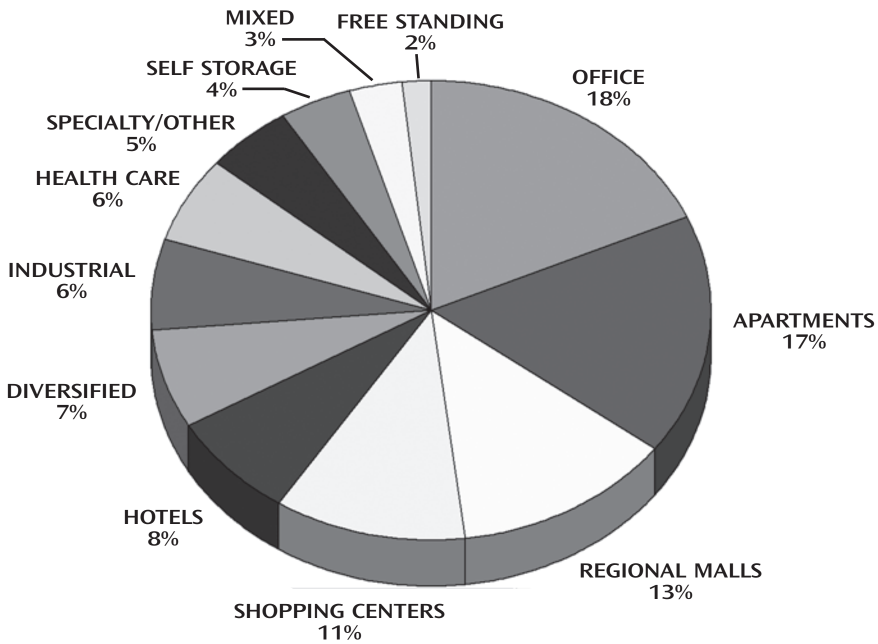
- Self-management—Where REITs are structured only as passive, externally managed investment portfolios, they probably will evolve into actively managed operating companies. This step is necessary to achieve parity across national and regional boundaries. Absent self-management, a permanent risk premium penalty will apply to those markets.

- Rationalization—Some companies that will convert or subsequently become public will represent suboptimal collections of assets, ill-conceived strategies or will be the product of weak management. Expect these firms to be rationalized by merger or acquisition, or privatized as a result of disinterest.

- Globalization—The spread of the REIT concept is itself a good example of globalization. Capital markets have become porous. Funds flow around the world at will. Nations with a tax-advantaged

Figure 1

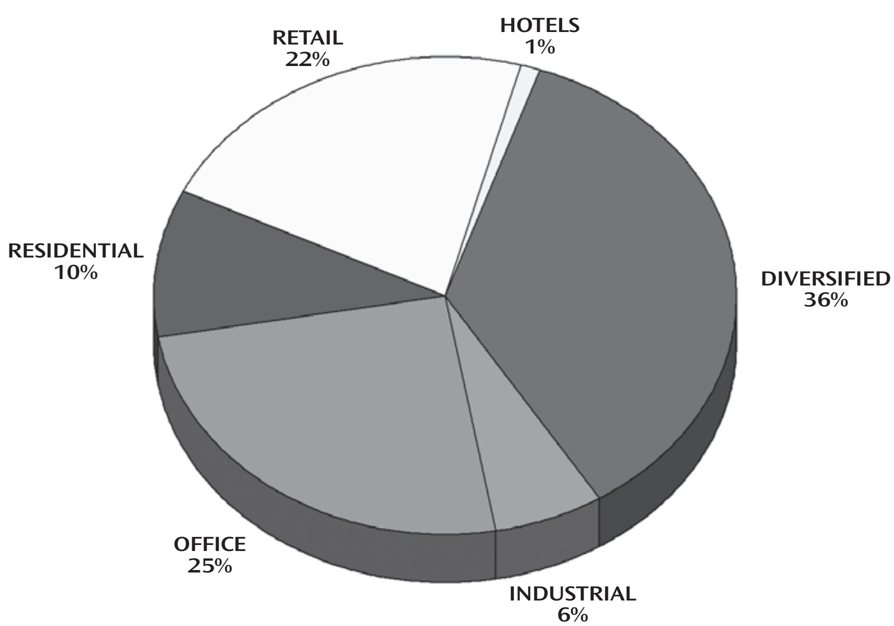
U.S. REITs by Property Sector



Source: EPRA/NAREIT; Cornerstone Real Estate Advisers LLC

Figure 2

Global REITs by Property Sector



Source: EPRA/NAREIT; Cornerstone Real Estate Advisers LLC

REIT structure will draw capital away from those that do not have one. This fact alone will serve to spread the REIT presence through the world. More important, the rise of REITs with multinational interests such as ProLogis and AMB foretell the likely path of the sector.

Firms domiciled in one country will acquire or form joint ventures with firms in another, and global operating companies will emerge. If Procter & Gamble can make the world's toiletries, why can't one firm operate office buildings around the world, as some already do?

> *Firms domiciled in one country will acquire or form joint ventures with firms in another, and global operating companies will emerge. If Procter & Gamble can make the world's toiletries, why can't one firm operate office buildings around the world, as some already do?*

- Integration—Globalization in real estate will bring integration in many areas, just as it has in consumer behavior, styles and products. How might it affect the REIT business?
- Tenants—Thousands of firms maintain multi-national locations today. Large transnationals like P&G, United Technologies, General Motors and others have highly sophisticated and integrated property strategies. Those competencies have filtered down the size scale in the past decade as outsourcing corporate real estate services to third-party providers made them available to smaller firms. Today's economy allows nearly every firm to pursue business across borders so these services should become available on an even wider basis. Will the tenant-rep broker go global to survive as well?
- Developers—Hines and others have shown the way for many years in this area. It is quite possible and logical for the providers of buildings to go global in service of their clients. U.S. REITs with in-house development capacity and good development pipelines tend to enjoy higher valuations than their peers who lack these capabilities. If this metric spreads around the globe, it may bring a swift end to the passive, externally advised structure. Follow the acquisition news to see which competencies are valued most highly.
- Information—The 1970s advent of institutional real estate investment in the U.S. brought the development of benchmarks and reliable information resources that supported the onset of fundamental economic analysis in real estate with consistent data. Most Counselors whose careers go back to the 1970s or beyond can identify with the comment that "20 years ago I was begging for data, now I'm begging for mercy."[3] In the U.S., investors are awash in data. This situation does not yet exist in Europe and Asia, but it will. Early movers in the information business will prosper and grow along with the REIT movement, and the capital markets will have increased transparency as a result.
- Professionals—Observing the rapid evolution of this investment sector, it becomes clear that we are witnessing a massive technology transfer between and among the investor and analyst communities around the world. Firms that had been national or regional property firms are adopting a new legal and operating format. There is a saying in the investment community: "Deal guys don't make good asset managers." Deal guys (inclusive of both genders) will counter that asset managers don't do good deals. We are witnessing a second showing of the evolution that occurred in the U.S. in the past decade. Deal guys were forced to become competent operators and good operators were forced to make good deals. We will see this play out again.

  In the first showing, some adapted, some sold out and some simply became irrelevant. We probably will see more of the same in Europe and Asia in the coming decade. The primary beneficiaries of this evolution will be practicing property professionals of all stripes as the world of opportunity becomes truly global. At first, this business environment will provide a much enhanced set of lifestyle choices for Counselors and others. As the sector grows, true labor shortages will develop in markets as industry capitalization grows, introducing global labor mobility for real estate professionals. Individuals will benefit, of course, but whole societies will as well. The mature societies of the developed world will benefit immensely from the creation of a pool of human capital elsewhere as their own professional cadres age into full retirement.

One of the bothersome aspects of revolutions, apart from the guns and barricade type, is that we generally don't know we are in them until after they're over or nearly over. We are in a global revolution in the property world today, driven by the Global REIT Revolution. Let's all enlist and enjoy the ride. ■

ENDNOTES

1 Sven Lorenz, "How to Buy into Germany's Coming Property Boom," *MoneyWeek* (MoneyWeek Ltd., Feb. 2, 2006).

2 Karl-Werner Schulte, CRE, was instrumental in the design and creation of the G-REIT.

3 Marc A. Louargand, "Information and Real Estate Markets," *Journal of Real Estate Portfolio Management, Volume 4, Number 1* (American Real Estate Society, 1998).

Shifting U.S. Demographics and Development Models: Immigration, Economy and the Workforce

Panelists:
HUGH KELLY, CRE
DAVID J. LYNN, PH.D., MBA, CRE
FRANCIS PARKER, CRE

Moderator:
MARC A. LOUARGAND, PH.D. CRE, FRICS

LABOR ISSUES: Is there a role for immigration in offsetting workforce shortages predicted to begin within the next 10 years?

LOUARGAND: When I think about immigration, I think about the potential growth in the labor force in the United States given the current composition of the population. I typically rely on the U.S. Census Bureau's middle series to do conservative forecasting, and the agency reports that the 20 to 65 age group has been growing at 110 basis points a year for the last decade. Looking forward, it predicts that age group will grow 40 basis points in the next decade and 20 in the decade after that.

KELLY: That's right, and some work I've completed indicates that around 2015 to 2016 we'll get to the point where the number of people entering the labor force offsets the number of people retiring by less than a million workers. For now, we have significant natural increase in the labor force but in about eight years, that goes away. You're absolutely right to say there are some real implications on the immigration side.

PARKER: I think workforce trends will be more stable after 2010 than we might suspect at this point. Medical improvements leading to significantly longer life cycles will encourage many to keep working significantly longer. A number of psychiatrists can attest that among their most difficult patients are those in their mid-60s who retired too soon. After five years of leisure, they are sick of golf, and their business contacts and acumen have diminished. In addition, mounting problems with Social

About the Roundtable Participants

Hugh Kelly, CRE, *is the principal of an independent counseling practice specializing in applied real estate economics for clients with domestic and international commercial property interests. Based in Brooklyn, N.Y., he also is a well-known writer and public speaker.*

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Security and private pension shortfalls will force reassessment of overly optimistic retirement plans for more people than we might think.

LOUARGAND: I also find it troubling that analysts expect Baby Boomers to continue working beyond their traditional retirement age. Though actual retirement age is still falling, if you look at that data and assume that half the people between 65 and 84 will work, you still have a radically reduced growth rate.

KELLY: And that has very serious implications for gross domestic product. So I think it's a serious problem that's really offset only by a productivity increase on the GDP side and immigration on the labor-force side.

LYNN: However, the U.S. is fortunate in that immigration is a possible solution. Immigrants generally integrate fairly quickly; there aren't as many cultural or institutional barriers in this country as, say, in Europe where the same, if not worse, workforce problems exist. So immigration even now is probably about half the population increase in the U.S. That's a faucet that we can turn off or on—one of the saving graces for our demographic and labor force picture.

In terms of retirement, it's a difficult problem looming for the United States. Retirement age has been hovering around 60 and Baby Boomers are the wealthiest population group of all time in terms of household wealth. So many in this group don't have to work until they're 65. But contracting agreements that have become popular over the past 15 years are giving these older, highly skilled workers employment flexibility. They may not join staff as full-time employees, but they can add to productivity and create value.

LOUARGAND: I agree, and I think there's no question that you'll see a lot of the Boomer generation working full or part-time in retirement, or what would have been their retirement years.

HOT-BUTTON POLITICS: Are current immigration policies affecting the workforce balance?

LOUARGAND: Let's discuss this point in the context of the current political debate about immigration, which has a jingoistic tone and doesn't address workforce shortages.

KELLY: It's a very wide divide. Probably no other issue creates such a division of opinion as immigration.

LYNN: The U.S. is fortunate to be able to attract immigrants from all over the skills and wealth spectrum.

LOUARGAND: Well there's no question about that, but at the same time we are restricting the number of people who can come in on H1B Visas. So we're making it tough to bring highly skilled workers in.

At the same time, if you look around the world a lot of other economies that U.S. immigrants come from are growing solid middle-class infrastructures of their own. I'm a little concerned about whether we're going to be able to draw in as many of the high-caliber, high-skill, high-talent workers as we have in the past.

KELLY: Are you thinking about the Chinese and South Asian economies?

LOUARGAND: China, India, Singapore, Indonesia, Philippines.

KELLY: The demography there is so huge that even as the middle classes grow, the ability to absorb that population capacity is going to be really stretched. Another thing is that they have very sharp imbalances in their male-female ratios so I think people will say: "If I stay here, I'm going to be unmatched for a prospective spouse." That is a strong motivation to pick yourself up and move.

LYNN: India and China are good examples. There is great human capital there, robust economies right now and they should continue to grow higher than the world average.

But there's great income inequality in these countries so the main issue isn't the lack of a growing economy, it is access to economic opportunity.

In India and especially China there are an increasing number of millionaires, but you have a great deal of poor people who see what it's like to live in the middle class, but are essentially locked out of the system. I think the U.S. will still continue to be a gateway for those individuals.

PARKER: Another thing to keep in mind is that workforce balance in the United States is tied intricately to the nation's ability to continue its dominating role in high-tech innovation and cutting-edge entrepreneurship. We should not be terrified by the ascendance of China and India. With the severe downsizing of the former Soviet

Union, the U.S. is the third most populous nation in the world. There still is massive space for intellectual advancement and increased prosperity.

POLICY AND HISTORY: What are the public policy implications given the fact that the U.S. has a political debate that seems to be stifling immigration?

PARKER: I welcome the public policy debate on immigration. We can't drift forever toward a two-class society, and assimilation takes a long time. At present, 80 percent of the U.S. Hispanic population is in seven states: California, Texas, Florida, New York, New Jersey, Illinois and New Mexico. Populations also are increasing in North Carolina, Georgia and Nevada. Continuing diversification will be a positive event.

LYNN: I think U.S. institutions and values really do stand for equal opportunity and the country has embraced immigrants. Still, there's always been this initial period of adjustment with new groups.

Each wave of immigrants has faced its challenges and backlash from the U.S. mainstream opinion at that time, but they've all successfully assimilated.

LOUARGAND: Another example is St. Louis in the 1800s and early 1900s, when there were all-German neighborhoods where the children were schooled only in German.

KELLY: That's true in New York, too.

LOUARGAND: It's similar to the way Latinos are accused today of not joining the general U.S. culture. I thought the most compelling part of Joel Kotkin's presentation at the 2006 CRE High Level Conference (see www.cre.org/programs_and_events/high_level_conference.cfm for more information) was the statistic—which has been vetted by several sources—that by the third generation most immigrants don't speak their native language and have married outside their ethnic group.

LYNN: Yes, and so wave after wave, very diverse peoples from around the world have integrated very successfully in this country. A good litmus test, I think, is Arabic peoples, many of whom are well educated and have above-average income levels. You can see a great counterpoint in Europe where they tend not to assimilate as successfully. So I'm very optimistic that immigrants from across the skill spectrum will continue coming to the U.S. and adding to our productivity as a nation.

POPULATION IMPACT: What are the implications for the business environment and the real estate industry?

LYNN: Typically, immigrants go to where the jobs are. Today the jobs tend to be on the coasts: the East, South and West coasts. These jobs focus primarily on economy, finance and high-tech, and are in places where established ethnic communities can offer a support network to new immigrants.

Typically, immigrants go to where the jobs are. Today the jobs tend to be on the coasts: the East, South and West coasts.

LOUARGAND: And it's not just urban areas like New York, San Francisco, Boston and L.A. It's also places like Waterbury, Connecticut with its steel mill, and the Carolinas, where hundreds of people come from Central America and Mexico to work at Christmas tree farms.

KELLY: Yes, but it's worth thinking about the urban issue, the major coastal cities issue. It's something that New York City is really focusing on. The city planning department is figuring out how to deal with a population increase of nearly 1 million people by 2030.

PARKER: I worry about the decreasing quality of life, especially along the coastlines and in large cities. New York City has experienced an 11.3 percent population increase between 1990 and 2005. Los Angeles has increased 10.3 percent in the same period. Nothing can match the 111.1 percent increase in Las Vegas during these years—taking it from No. 63 to No. 29 in population size—and significant growth also has occurred in Austin, Texas; Mesa, Arizona; Phoenix; and Charlotte, North Carolina, to name a few.

KELLY: But New York City, for example, is doing some really interesting things in terms of rezoning the city—up-zoning and down-zoning. The Bloomberg administration is also talking about infrastructure needs and the implications of absorbing this population surge. This would be more than a 10 percent population increase in less than 15 years without adding any land. They're struggling with how to cope with density, services and so on. Some people would see that level of growth as a fundamental problem, but the city planners aren't shying away from it.

LOUARGAND: The density in New York City is very low, though, compared with what it has been historically. Other than midtown and downtown, the city is embracing pretty low-density development; it's mostly low- and mid-rise. There's plenty of opportunity to increase density, I think.

LYNN: There certainly is, and I think that's a message for cities all over the country: You can either see this as a problem or you can take an objective, look at it and say:

> *The next generation is even more committed to urban dwelling. Their parents have sophisticated tastes and are highly educated, and urban life is what these people identify with.*

"Okay, now how are we going to do the best planning for the future?"

URBAN AND SUBURBAN DENSITY: Will the shifting population affect development and real estate practices?

LOUARGAND: I want to talk a bit about what could happen to the real estate business, industry and products. One of the things I find interesting is the data indicates that people assimilate in a 40- to 50-year span, yet others say the answer is to build housing comparable to housing in the countries these groups come from. Is that the right thing to do, or is it a mistake?

LYNN: I think there's a density trend that started in the early 1990s. Many cities that were highly concentrated a hundred years ago are densifying again, and even new satellite cities are becoming dense. It's basic demographic and economic forces at work because it's much less expensive to increase density in established cities than it is to build new roads and bridges and infrastructure to new suburban communities.

An urban lifestyle might be appealing in terms of cultural offerings, shopping, services and socializing. As the children of Baby Boomers leave the nest, there should be less demand for suburban housing.

LOUARGAND: Except for the fact that I see empty nesters and Baby Boomers around the country adding 2,000 feet to their suburban houses.

LYNN: Yes, that trend also is continuing. Suburbia is certainly expanding but it's not one or the other, it's both. So suburbia is expanding, mainly in warm climates where income levels are high. Urban areas are densifying or redensifying as well; you're seeing that in the form of multifamily projects such as condominiums, condo hotels and a range of things.

LOUARGAND: How much of that is really a change in people's behavior and how much is just replacing obsolete stock?

LYNN: A recent study of replacement stock that's needed found that a fair amount of it is becoming functionally obsolete. But it's also demographic. As a country, the U.S. looks like an emerging market nation in terms of population increase. And most of those people are coming to the coasts, not the Midwest.

GATEWAY CITIES: Will global trade, economic growth and education levels change the urban landscape?

KELLY: Global gateway cities are growing disproportionately to the country. We should study these areas because they're connected not only with a high-growth economy but also with world growth and global trade. These phenomena are working in concert; it's not one or the other.

I also think the next generation is even more committed to urban dwelling. Their parents have sophisticated tastes and are highly educated, and urban life is what these people identify with.

LOUARGAND: But how much of what you're describing is lifecycle? These are people in their 20s, and there's a much higher proportion of professionals in that generation than in ours—almost twice as many college graduates. So if you're in your 20s and you're single and you're working at an accounting firm or a law firm, aren't you likely to be attracted to that urban experience?

KELLY: Yes, there's a whole body of research that looks at places like Austin, Texas, where many young professionals are relocating to. I think that influx could penetrate at least some places along the lines of an Austin or a Madison, Wisconsin, for example.

LYNN: I think economic growth isn't coming from the industrial sector. It's coming from the more creative aspects of the service sector—not call centers, but chip design, architecture design and biotech. It's coming from intellectual capital and those people generally want to live in an urban area. They could be in the suburban part of that urban area but they want a large MSA for their careers, social interaction and lifestyle.

LOUARGAND: That group also is a tremendous component of the high labor mobility in the U.S.

KELLY: Another issue, to some degree, is whether there are differences between young cities and old cities across the country. Are there different opportunities and different issues in each? You're right in saying New York has some housing obsolescence and replacement needs. But building on vacant land isn't an option, so it becomes a question of adaptive reuse.

Similar situations exist in places like the San Francisco Bay Area, Los Angeles and even Las Vegas. Many cities are reaching limits—physical limits such as mountains or water. And commuters are reaching driving limits. Once you get into commute times exceeding an hour and a half, you see development really start to drop off. I think we're reaching that limit in many cities around the county.

LYNN: Right, so where there's room for growth not too far from the city centers—places like Phoenix, for example—suburbs will expand tremendously. But there also will be denser projects and mixed-use construction in city centers in the Bay Area, downtown Austin and even Phoenix.

But massive suburban development also is occurring along with job formation not just in city centers but in places such as Tempe and surrounding cities. So I think suburbs will continue to expand but urban core areas will become more important and dense.

LOUARGAND: I would expect to see Phoenix grow much like Los Angeles has, with central business districts spread all over the place. The question is how does that relate to immigration? If you look at Phoenix, it has a heavy Latino population component and I can't see any difference in the way that community lives compared with how the Anglo community lives.

LYNN: Qualitatively you're right.

XENOPHOBIA AND GLOBALIZATION: So why do we have this passionate immigration debate going on in the U.S.?

LYNN: I think part of it is xenophobia, and part of it is that the rate of globalization has ratcheted up tremendously in the last few years. People are seeing their jobs get outsourced; that's an important part of this discussion. The situation used to be common in heavy industry jobs, but now it could be any job. It could be a call center, a medical technician position and certainly heavy industry.

LOUARGAND: Xenophobia definitely is an issue. The level of fear has escalated in the past several years and has exacerbated the immigration issue. We are in more fearful times; people are more cautious.

Some people in the debate are speaking out of fear. We could spend hours discussing what constitutes rationality and irrationality, but I don't think there's any argument that the level of fear is higher now than it was 10 years ago.

KELLY: Yes, and because terrorism is certainly part of that, there been a huge movement to strengthen U.S. borders.

LOUARGAND: That's an interesting point. I think a key question is what are people concerned about? Is it immigration or weak borders?

LYNN: I think the two have been deliberately morphed into a single issue.

LOUARGAND: I would agree.

KELLY: I think it has to do with jobs, too. We're in a good jobs environment right now but jobs are moving to other countries. Globalization is a fear that every country in the world has, even China.

The U.S., however, has had a very insular economy. Its level of global trade has always been low, and the number of U.S. citizens who hold passports is ridiculously low—something like 14 percent.

PARKER: For the first time, perhaps with some reason, some in the U.S. are feeling crowded as a nation. It took until 1915 for our nation to reach 100 million inhabitants, but we hit 200 million just 52 years later in 1967 and last year reached 300 million. Demographics point to the U.S. having 400 million inhabitants by 2043 and 420 million by 2050. The average growth now is 2.85 million inhabitants per year. I am not so certain the cause of this immigration debate is xenophobia.

Another thing to consider is the infrastructure development this growth spurs. An additional 20 percent of U.S. land is occupied by structures such as houses, schools, shopping centers and roads compared with 20 years ago. The U.S. consumption appetite is massive. The nation deposits twice as much rubbish and expends five times more carbon monoxide than the worldwide average. The population makes up 5 percent of the world's total but consumes 23 percent of its energy and 15 percent of its meat. These trends cannot continue indefinitely.

THE IMMIGRATION POOL: Can the U.S. stay competitive in attracting highly skilled professionals from other countries?

LOUARGAND: Virtually every manufactured good U.S. consumers buy is made somewhere else. Given the U.S. economy and productivity in the context of a globalizing economy, do you believe that the United States will continue to be the destination of choice for migrants around the world?

LYNN: I do. The U.S. occupies a very unique position in the world. It's not just the economy that is attractive; the U.S. really is a much freer country than most in the world. Citizen's rights are protected, it has a variety of established cultures and support structures that make it easy to assimilate. It has a variety of geographies and climates that people can identify with and be comfortable in.

Because of its openness, I think the U.S. economy will always be a player on the world stage. It probably will be eclipsed by China, in terms of GDP size, in about 20 years, but I think it will always be fairly productive because of the free markets and labor mobility. So immigrants should always see it as a leading destination.

LOUARGAND: And to underscore a previous point: If you look at the history of immigrants in other countries, they haven't been treated with the same degree of openness and freedom as they have in the U.S.

LYNN: I think people celebrate cultural and racial diversity in this country. U.S. Sen. Barack Obama is a great example. He has a shot of being president and the debate isn't about his race or culture, it's about his ideas and qualifications. That's not to say there are no barriers or prejudices, but in general I think it's easier to reach goals here than in most countries.

KELLY: One of the persistent economic strengths in the U.S. is the fact that population pyramids are pretty well balanced. Immigrants come as families and their children have an even greater impact on the workforce than the first generation. It's an advantage that most other countries don't have.

LOUARGAND: When you look at it, we've gone through a series of ethnocentric outcries in this country ever since the late 1600s, and governments have periodically engaged in some inappropriate lawmaking around it.

LYNN: Yes, then they've always reversed it. So I think it's history's indication of what we'll see. I think this is just a temporary period, a fad. I'll put my chips on the U.S. welcoming immigration in response to the labor-shortage problem. The focus won't just be the number of bodies, though; it'll be the quality of the people. ■

Frank Parker, CRE, extends thanks to Boston College senior Jessica Bennett for providing demographic research on which Parker based some of his remarks.

FEATURE

Who's Running the Show? Implementing Centralized Management of Property Taxes for a Global Portfolio

BY DAVID C. WILKES, CRE, FRICS

MANY PROPERTY TAX AND ASSET MANAGERS who oversee a global portfolio of real estate would be hard pressed to answer the seemingly simple question: "How much does our company pay in annual property taxes?" This reality may come as a surprise to many senior finance and facilities executives. Global property tax managers frequently don't know the answer to this and an array of more particular questions concerning tax liability for the company's overseas facilities, and it's not because they lack intelligence, competence or initiative.

Often, large global portfolios are poorly understood because overseas properties and businesses may have been acquired with existing local managers in place, and sharing data with the home office can be a complicated task. Overseas facilities managers commonly store data in multiple formats, systems, languages and currencies, and those systems usually aren't designed for property tax and valuation analysis. Likewise, if the company has invested in property tax-specific technology at all, management is likely using a system designed for compliance purposes in the U.S., such as the completion and filing of tax forms required by the local jurisdiction—not for global management and valuation.

As a result, the home office may virtually ignore properties in other countries, leaving them to the attention—or lack thereof—of local regional managers over whom the so-called global tax manager may have little control. For example, most large U.S.-based multinational owners will have a fair or solid understanding of U.S.-based facilities and the local tax regimes that apply, even across many states that may include real and personal property taxes. But they will have little hands-on information about properties located outside the U.S., relying almost entirely on local site managers and external tax appeals providers to tell the home office what to do with regard to local taxes.

Data management is a key component in maintaining an effective ongoing strategy for managing taxes for a large, global portfolio of fixed assets. Unfortunately, even when a company uses anything more than a common

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spreadsheet-based program to track global tax data *ad hoc*, these tax-specific database systems typically are the product of consulting firms that specialize in tax-appeal services rather than management services.

Thus, the systems provide little in the way of analytical tools, such as valuation analysis, because those who offer the systems seek to perform the analysis—and consequently drive the determination of which properties to appeal, what the parameters for success are and whether the results are laudable. In short, most technology serving the industry is not created with the interests of the client, the property owner or tenant in mind.

Worse yet, in many instances these database systems are highly labor intensive and cumbersome to use, leaving tax managers to resort to copying the data back into jury-rigged Excel spreadsheets to perform the analyses and benchmarking they require to manage the portfolio rather than simply administer it.

BOTTOM-UP VS. TOP-DOWN

Much of this plays into the common perception that it is easier and more cost effective for a real estate owner to control property tax costs almost entirely through an appeals-based, bottom-up approach instead of a centralized tax management strategy from which the tax manager retains principle decision-making power. The bottom-up approach, which relies on outside providers to highlight and pursue problem areas, is based on the illusory premise that the owner incurs no costs unless he or she realizes a savings, mainly the result of the common contingency fee-based arrangement for services.

This fully decentralized approach delegates far too much decision-making power to external providers and compromises cost transparency and strategy at the home office. It also provides little ability at the top level of management to understand the costs of the portfolio as a whole, consider which and why properties to appeal and how aggressively and efficiently to pursue those appeals, and seek tax relief prospectively instead of retrospectively. Frequently, the interests of client and consultant are at odds, resulting in higher rather than lesser cost.

A common example illustrates the problem. A large proportion of major Global 2000 property owners are those that own a thousand or more relatively small facilities, each of which individually pays a small local tax, though collectively the portfolio may bear a substantial tax burden on its real and personal property. These operators include national coffee shop chains, brand name convenience and drug store owners, rental outlets and fast food franchises.

For a number of reasons, many tax appeal providers are eager to handle these household-name portfolios with a large volume of properties. But, common fee structures in the U.S. for these services often interfere with the goal of providing the most effective management. The so-called costless system of providing tax appeal services based on a percentage of the tax savings is a poor motivator if the taxes levied on each property, and thus the potential fee, are too insignificant to warrant the hours needed to properly value and analyze the property before deciding whether to file an appeal.

Yet, the local provider commonly supplies this part of the service, so management and strategy are effectively bottom-up procedures, and the tax manager becomes more administrator than corporate strategist. Managing the portfolio, and each property, involves far more than just ensuring tax appeals are filed each year. Someone in the home office must have a system they can use to analyze the portfolio *en masse* and make the proper comparisons among properties, then decide appropriate actions in consultation with local talent. This process also prevents the often overlooked, and substantial, costs that go into the pursuit of inefficient appeals—at least in the form of unnecessary valuations, filing fees, and the added burden on home office staff time and resources in monitoring and keeping abreast of these unnecessary efforts.

Moreover, a more centralized approach enables the company to immediately provide the local appeals firm with the data and analysis it needs, so it can invest its time more efficiently and focus purely on the assessment appeal to produce a better result.

GLOBAL MANAGEMENT STRATEGIES

The need to understand and manage local taxation in exotic parts of the globe was of little concern to the vast majority of businesses just a decade ago. But today, the relentless drive toward globalization has spurred U.S. companies to acquire assets ever farther afield, and tax managers are finding the decentralized appeals-based model of tax management an expensive and haphazard means of controlling costs.

FEATURE

Who's Running the Show? Implementing Centralized Management of Property Taxes for a Global Portfolio

Because this article is principally concerned with evaluating the optimal strategy for global tax management, in contrast to tax appeals, it first considers the various management approaches multinational corporations have taken in response to the need to run global businesses. And before that, readers should understand the attraction and motivation to go global.

A simple definition of the term "globalization" is: "localized activity driven by foreign interests." Globalization has never been so prevalent and vibrant among private, corporate interests as it is today; not only among large, familiar multinationals, but also among small and mid-size companies.

Interestingly, real estate, long considered one of the most local of assets in nature—immovable, locally built, locally governed—has proven to be eminently globalizable, and most major real estate owners have either taken the plunge into international ownership or are actively considering outright acquisitions or some form of joint venture that will yield foreign acquisitions.

Companies view globalization as a way of accessing new markets, getting themselves closer to customers, finding new customer bases and identifying cost efficiencies. At the same time, investors and shareholders may be seeking greater upside than they can find in their home countries, which may be more stable and present lower risks, with consequently lesser opportunity. This certainly has been the case with many top-tier U.S. real estate investors, who have grown tired of wading through over-picked deals in which pricing has lost all sense of rhyme and reason. These investors in many cases are looking to emerging markets, where the risks are greater but so are the rewards.

From an investment perspective, no matter the obstacles, globalization is a tonic that remains perennially alluring. Corporations that go global have access to increased deal flow, additional investment choices, access to global capital markets, the opportunity to achieve risk reduction through greater geographic diversification and smoother portfolio returns. At the same time, host countries are eager to see foreign investment because it spells employment opportunities, better access to foreign capital for growth and added technologies.

MANAGING BEYOND THE ACQUISITION

Despite all the lofty talk of global aspirations, companies frequently overlook middle and functional management, and the fundamental mechanics of how things get done—or don't—with regard to managing facilities in far-flung locations and controlling operating costs. Unfortunately, the ongoing asset management function usually faces hurdles that companies don't fully consider at the initial investment stage.

The ugly truth, in fact, is that much gets done without a plan, a strategy or the information necessary to make informed decisions.

The ugly truth, in fact, is that much gets done without a plan, a strategy or the information necessary to make informed decisions. Tax managers must figure out a host of seemingly basic questions for themselves: which properties are under their control (a turf war commonly exists between companies' real estate and tax departments); who the local in-country property managers are; what the local assessment regimes are; whether the local tax is significant enough to worry about; and, even if it is, whether there is any meaningful opportunity to challenge it. In addition, valuation and taxation concepts and approaches can differ substantially around the world. Compare, for example, the common application of an asset value standard with the rents-based standard applied in the United Kingdom and other locations.

Managers usually inherit in-house, onsite personnel who are accustomed to the status quo and may have established preferences for using local outside firms to provide appeals services—tax consultants and lawyers, for example—even though that tactic might not be the most effective. Existing systems and relationships require close and periodic examination. Otherwise, central managers may face something even worse than poor results: They may be unable to understand why the results occurred or implement a consistent corporate strategy portfolio-wide. Because these managers struggle day-to-day to put out fires—which frequently relate to more familiar issues and locations, often in the managers' home country—they might fail to adequately address many global issues.

As globalization presses forward and barriers to investment continually dissipate, local taxation continues to vex many owners, investors and tax specialists, even in the world's largest corporations. At a core level, local tax systems are not all that different from one part of the world to another, but every system has its subtle nuances, differing procedures and deadlines, unique standards and the all-important human, personal element required to get things done.

The globalization concept never completely removes the local component of facilities management, nor could it. Reliance on local players and local customs is essential, whether in the U.S. or abroad, even when employing a centralized approach to facilities cost control.

Effective management of local taxes from a central, corporate location requires substantial strategic planning and a commitment from senior management. In many cases, top management is not fully aware of the problem; those on the front line may need to educate them. Developing a command of the process also takes a great investment of time, though it is well worth the effort.

STRIKING THE RIGHT BALANCE

The globalization concept never completely removes the local component of facilities management, nor could it. Reliance on local players and local customs is essential, whether in the U.S. or abroad, even when employing a centralized approach to facilities cost control. And implementing a more centralized level of strategic management is virtually impossible without first investing in the appropriate data collection and global-oriented technology.

Unfortunately, even the brightest executives seem to stumble and fall prey to ambivalence about the best approach to running a global company. At the largest multinational corporations, those at the top of the organization often lack a strong conviction about the right way to manage on a global scale.

Studies show that the directional flow of corporate management—whether predominantly top-down or bottom-up—is often in flux, with one approach dominating for a period of time, then changing to the reverse approach when, for example, new executives come to power or a series of failures occurs that seemingly arises from the reliance of one approach instead of the other.

Consider the case of Coca Cola, which by the 1990s had become the prototype for global business. Coke's chief executive officer in 1996 declared: "The labels 'international' and 'domestic' no longer apply." His program of globalization became referred to as "think global, act global" and involved an unprecedented level of standardization. The company eventually came to generate 67 percent of revenues from outside North America.

But the strategy of complete standardization began to fail within just a few years. By 1999, the company had lost almost a third of stock value—some $70 billion U.S. dollars—so the company went in the opposite direction. The new mantra was "think local, act local," and top management opined that it was local people who got thirsty and bought locally made Coke. But that approach didn't work either. The focus shifted back to Coke's home city, and a more centralized style of management.

Property tax managers should expect that the waffling occurring at the senior-most level of the corporate hierarchy is likely to also prevail in facilities management—and particularly control of the companywide property tax—one of the most locally oriented functions of management. Managers would do well to consider this phenomenon in thinking about the best tactical way to advance the process in the field, and promote company goals and strategy for cost control.

A CENTRALIZED, STRATEGIC APPROACH TO COST SAVINGS

There are many persuasive arguments for keeping the property tax function decentralized and directed by local appeals providers. In a broad sense, when dealing with a highly nuanced local tax imposed by local authorities, municipal officials often resist requests for tax mitigation that come from a corporate home office located thousands of miles away and perhaps in a different country.

Interestingly, this resistance to the corporate trends is emerging because of globalization goes well beyond and much deeper than property tax or even corporate management. Franklin Foer, in his book titled *How Soccer Explains the World* (HarperCollins, 2004), writes of how tightly held local beliefs and culture frequently get in the way of visions of a "global way of doing things." The power of global mega-brands and businesses do not erase local attachments; he cites the intense hold of local football club ties in the face of globalization as an example when he writes:

> "By the logic of both its critics and proponents, the global culture should have wiped away these local institutions. Indeed, traveling the world, it's hard not to be awed by the power of mega-brands like the clubs Manchester United and Real Madrid, backed by Nike and Adidas, who have cultivated support across continents, prying fans away from their old allegiances. But that homogenization turned out to be more of an exception than I anticipated. Wandering among lunatic fans, gangster owners and crazed Bulgarian strikers, I kept noticing the ways that globalization had failed to diminish the game's local cultures, local blood feuds and even local corruption. In fact, I began to suspect that globalization had actually increased the power of these local entities—and not always in such a good way."

This view certainly supports the argument that in a global environment, the property tax function is best approached through a decentralized business strategy. A bottom-up approach that lets the local talent—whether it be local corporate management or local appeals providers—take the reins and simply report back up to the home office periodically.

In fact, property tax decentralization is a well-known concept in many parts of the world where government finance reform efforts are underway. Decentralization of the local tax, from the municipal side, typically occurs to improve local governments' fiscal control and autonomy, and to allow for improved management of local real property assets. Most experts agree that decentralization of the property tax works well in the government context, where the beneficiary of the property tax is the local population. The model calls for revenues collected locally to support local programs, which is starkly different from the way things worked in most former Soviet and command economy environments.

In contrast, the property tax objective in a corporate context is quite different from the government tax administration objective. Though local economic benefits might stem from multinational ownership, cost control is for the benefit of the corporate bottom line and the company's shareholders and investors, who are generally far removed from the assets under management. Therefore, a centralized approach is the best practice.

In property taxation, particularly for large portfolios, there will always be the need to rely on the services of local tax appeal providers, both consultants and lawyers. The often unstudied question, though, is who determines the need for these services and how? Most large companies notionally oversee the portfolio from the home office and seek out local services as needed, but in reality the process is driven by a bottom-up approach and with little true management or strategy. The goal is overly simple: Save money wherever possible. But oversimplification of this goal masks hidden costs and inefficiencies and, above all, a lack of full information at the home office.

Frequently, a non-specialist who relies entirely on the advice and direction of local service providers oversees property tax, and companies have no centralized management or strategy at all. They do little to spot trends in the taxation of the portfolio on a variety of levels that may be relevant: geographic region, property type, value and so on. This practice occurs in many companies' U.S.-based facilities, and to a far greater extent for the non-U.S. portion of their portfolios, where realty taxation remains a murky and poorly understood subject. The larger and more globally diverse the portfolio, the more significant these issues and the need for centralized control becomes.

The provider of tax appeal services is usually local to the individual asset and knows the local players and rules quite well, but has very little perspective on the company's global portfolio and corporationwide mandates. Nonetheless, the local provider has wide latitude to seek cost savings by whatever means he or she feels appropriate.

Likewise, owners of a large number of facilities that individually carry only a modest tax burden are particularly vulnerable to substandard service because there may be little incentive for the local provider to act in the most effective manner possible. Even large facilities may suffer where the incentives are not properly aligned between owner and local provider.

In the long run, it's far more costly to manage global taxes through a decentralized, appeals-based approach that starts and ends with the local provider. Permitting a multitude of third-party service providers in a range of markets to determine tax strategy is very much the tail wagging the dog. Instead, strategy and centralized management should come first, followed by an accounting for the local role and, finally, local players providing the skills, knowledge and relationships that are beyond the reach of the home office.

A BETTER MODEL

The better model—which a number of the world's Global 2000 companies have successfully implemented—puts strategy, direction and better oversight in the hands of the home office, while deferring to local know-how and respecting the talents of those with local expertise and relationships. The model provides far greater transparency in global operations, improves the level and quality of communications with local management and service providers, and permits the tax director to instantly collect performance results for the whole portfolio or any segment of it.

This three-step approach begins with the significant effort of consolidating property data from the full global portfolio into one system accessible by all levels of management in the company (see Figure 1). Managers first must collect data from company and municipal records as well as external sources such as satellite imaging and maps, Internet-based resources and market-based information.

Second, these experts conduct a portfolio-wide review and analysis, and detect anomalies. The analysis relies on principles of mass appraisal along with advanced technology that examines the portfolio more collectively than would be possible through the typical single-asset review process.

Having a portfolio with numerous but similar types of properties allows for the use of technology, automation and the application of mass management principles to more effectively and proactively manage the property tax expense. Achieving this objective requires managers to consolidate all data and information related to the process, then analyze it *en masse*. By applying statistical parameters—for example, average rent per square foot, median tax per square foot, etc.—across the entire portfolio and benchmarking specific values, anomalies will quickly appear. These findings become the basis for managerial decision-making to achieve fair and appropriate property assessment and taxation, wherever in the world facilities are located.

Step three is the tactic that most companies begin and end with, having skipped the first two steps: the pursuit of tax relief on a single-property basis through local providers.

IMPLEMENTATION

Though this process seems straightforward, tax managers at large multinational corporations will instantly recognize the many hurdles to adopting such a plan of action. These obstacles tend to arise from several sources, including:

- Getting high-level management to focus on and commit to finding a solution
- Persuading upper management to free the resources necessary for implementing the approach
- Navigating turf war hazards and local management personnel's resistance to change—and fear of job loss
- Collecting sufficient facility data to make meaningful strategic decisions

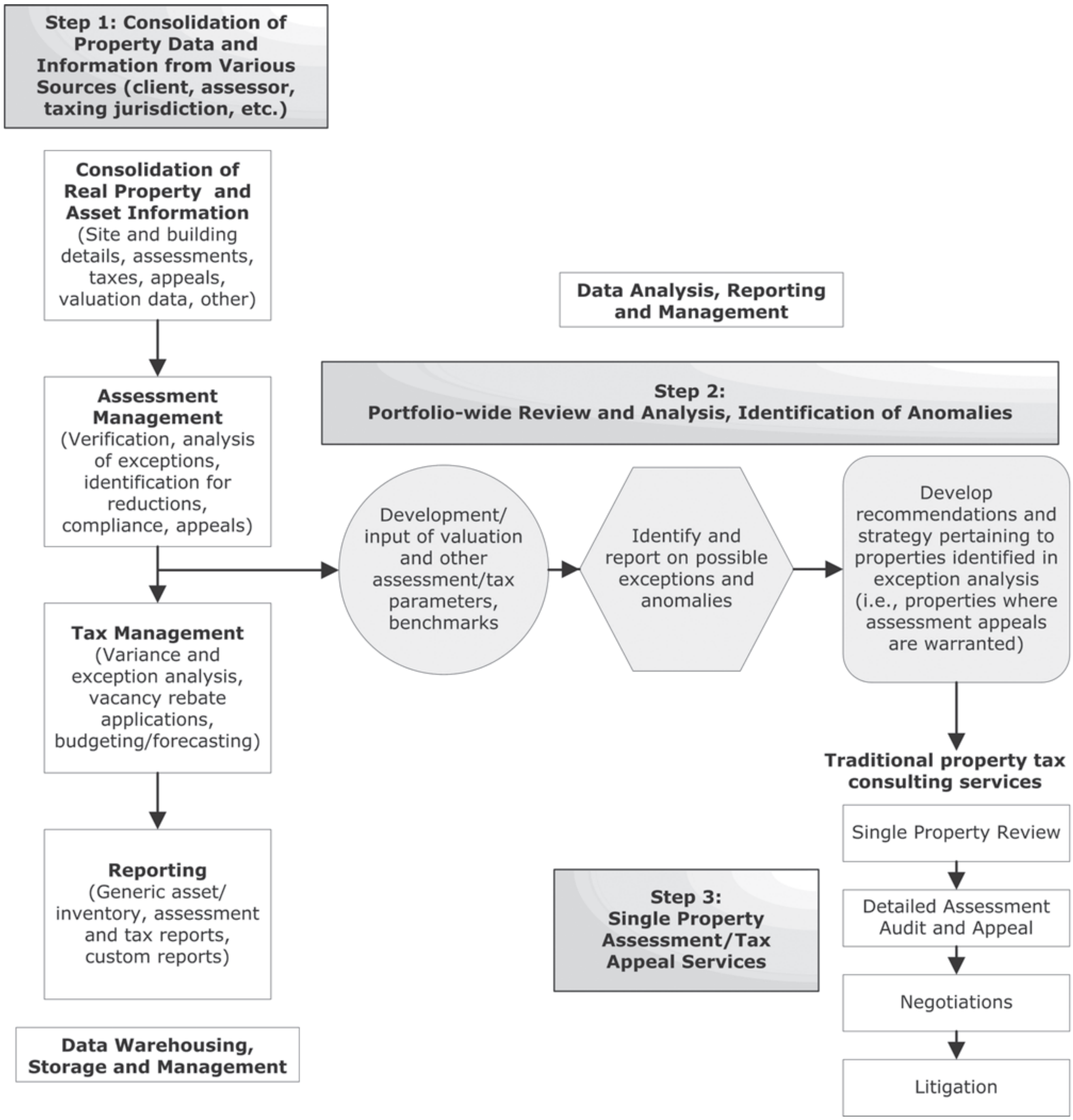
By far, the biggest challenge is the first issue: garnering corporate focus and commitment. Every other factor is far less daunting than it might seem and eminently achievable. But the ability to convince senior management to adopt the plan can be the place where an effective solution succeeds or dies quickly. In the case of real estate investment companies, it probably would be easier to get top management involved in this process. User companies might present more of a challenge because the real property tax is less directly tied to the product or service offered.

In fact, three key levels of management should ideally engage in this process. Top management needs be involved with shaping the process as well as creating channels of engagement and a forum for interaction that facilitates the process. Most important, these individuals must keep the discussion going once a process is in place.

Global business managers, who can integrate worldwide strategy and implement efficiencies into the process, also should be involved. They can most easily see across borders, know where competition is tightest and how profits from one market can cross-subsidize losses in another. They can contend with country managers in the debate about how much localism gets its due in the process.

Figure 1

Tax Management Model



These individuals also can interact with functional managers who have worldwide responsibilities—tax managers in particular—who have the specialization and the expertise to know best practices and what may work in one location but not another. They will have the strongest network in their field and know the best means of achieving their objectives, including:

- The best technology for executing objectives
- Where to obtain the best data
- Industry resources available to solve problems
- The best consultants in a particular areas
- Specific problems that properties suffer related to valuation

First and foremost, the global tax manager needs to be a corporate strategist—someone who works proactively, not reactively. Once company leaders develop the strategy, local country offices must help determine how to best implement that strategy and use local consultants to best advantage. To get started, the manager must first assess the directional flow of decision making and what it really looks like. Next comes evaluation of the current process, ideally in a fairly detailed written paper that upper management reviews.

It's well worth the time and effort to create this working document. Ask questions that will provide better insight into the big picture:

- How do problem assessments on foreign properties come to the tax manager's attention?
- Does the tax manager have relevant data about every property at his or her fingertips, or is it necessary to go through intermediaries to get it?
- Who's really in control of property decisions?
- If certain properties seem high in comparison to others, is it possible to articulate the reasons why?
- If so, are they fixable or related to local factors beyond the company's control?
- How and when was each property acquired? Was it part of a portfolio purchase?
- Were portfolios purchased, then left at the helm of the same people who were making the decisions before?

After answering these questions, the data collection process for the global portfolio can begin. The data must include more than mere valuation and facilities statistics; it also should include qualitative information such as confirming who does what within the organization. This task can be particularly daunting, and require the efforts of a sufficient number of team members who each have a clear set of targets and due dates, along with appropriate follow-up procedures.

Unless the company is already well along the way in its ability to collect and manage facilities data, it may be best to set achievable goals such as the collection of data for certain regions or countries one-by-one. Among other things, tax departments need to:

- Identify key players in the organization—include job descriptions, or write them if necessary, even if only for team members' own purposes
- Determine each person's role in the process
- Identify properties and inventory
- Identify taxation systems and relevant legislation
- Determine the various standards of value that apply
- Identify the relevant assessing and taxation bodies
- Identify compliance and reporting requirements, not only those that are external to the corporation but also reports that may be helpful to management
- Determine relevant appeal procedures and deadlines
- Obtain and develop an efficient database
- Evaluate the role of technology

One of the most productive ways to accomplish these tasks is to look for strategic alliances within the company to get the job done. For example, developing a global tax management strategy goes hand-in-hand with developing broader asset-management strategies for total property management. A full asset management solution enables a global corporation to maximize its portfolio value and minimize costs in a wide range of areas including tax, insurance, tenant management, utilities, maintenance and many other aspects of property management.

And give extensive thought to local-side impacts. Local teams may agree with corporate plans on the surface, then undermine the goals of the plan through noncompliance. Very often the new strategy—because it seeks efficiencies and some level of standardization, and perhaps can result in cutting out or restructuring some long-term relationships—can be a real source of concern to the local team, which previously may have operated somewhat independently.

It's absolutely essential to actively involve local personnel in the new plan and its implementation. Even so, resistance, especially in the initial phases, is likely. Interpersonal skills are of greater value than any other when addressing this issue. It is often helpful to introduce new technology and systems gradually, phasing them in one country at a time and in a manner that suggests it will make it easier to handle local tasks.

If the new technology can consolidate several tasks—such as taxation, lease management and insurance—into one system, local managers may be relieved instead of repelled by the new approach. This approach may also bring managers from a wider range of company functions on board with the plan, and generate greater resources and companywide support.

The most important thing to remember in developing a centralized global tax management plan—so often the stumbling block of any organizational plan—is that it is just that: a plan on paper, no different from a map. It represents something but it is not that something. In a global environment, managers must avoid becoming rigidly tied to an operations plan to the point that they ignore common sense. It's essential that a global manager maintain a high level of sensitivity to cultural differences and local complexities, as well as jurisdictional norms that may at first seem illogical or a waste of time.

Additionally, keep in mind that the best managers continually seek opportunities to make the plan better, and find the corporate opportunities to increase competitive advantages and make a positive contribution to the company's bottom line. With the rise of the multinational corporation and available support systems and resource networks to help them do their job, tax managers have never before had so many opportunities to make a quantifiable impact on their organizations' success and achieve what may still, to some, seem impossible: centralized, strategic management of a global portfolio. ■

The author gratefully acknowledges the assistance of Marc Sances, vice president of real estate taxes for AMB Property Corp., who provided a wealth of insight and examples from his experience on the cutting edge of global property tax management.

FOCUS ON THE UNITED KINGDOM

Residential Property—Do You Own Enough?

BY BARRY GILBERTSON, CRE, PPRICS

THIS IS THE THIRD IN A SERIES OF FIVE 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. The second article discussed the phenomenon of seemingly ever-rising values in the commercial property sector. The third article reviews the residential property market in several of its guises, the fourth will focus on affordability and the final article will highlight 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 a freer market economy. From satellite mapping to comparable evidence, knowledge management in many of these developing countries is rapidly becoming more efficient than in countries with mature economies.

SOMEWHERE TO LIVE

So, how big is the UK residential housing market? How is it funded? What are the key components? Are there more apartments or houses? How does the government intervene? Have rapidly rising prices made the market

About the Author

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

unaffordable for first-time buyers? Where is the market going in the future? What about carbon-neutrality in housing design? This article addressees some of these questions; others will be addressed in the next edition of *Real Estate Issues.*

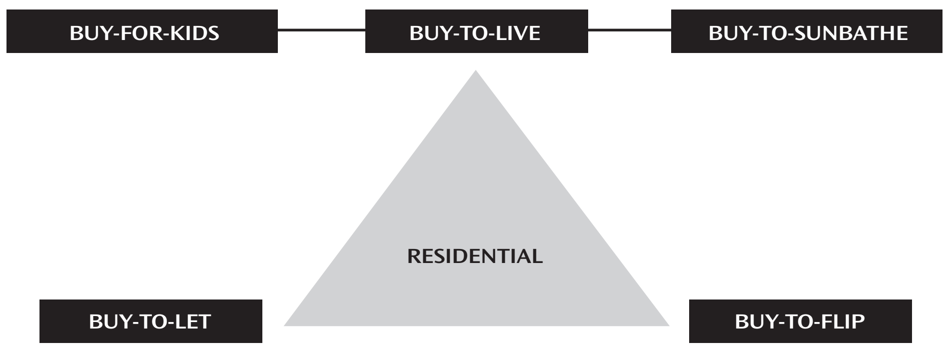
MILLIONS OF HOUSES

Recent estimates place the collective value of houses in the UK that are owned by the public at large—presumably excluding housing owned by national or local government, Housing Associations, etc.—at £3.8 trillion. In the past 12 months, that value has increased by more than £400 billion because of soaring prices. Among the United Kingdom's four countries—England, Northern Ireland, Scotland and Wales—the strongest rise in prices has occurred in Northern Ireland. Though values started from a base lower than the other three countries, housing stock is now worth 165 percent more than it was five years ago. Over the past 10 years, the average UK house price has increased 120 percent, according to research conducted by the Royal Institution of Chartered Surveyors. The number of properties bought and sold in 2006 was 1.15 million, UK-based property research firm Hometrack reports. The number of borrowers who use more than half their monthly income to repay their mortgage is about 1.12 million.

One way of defining the residential property market is by the purpose of the acquisition. *Buy-to-live* is obvious—it is where we call home. The two subsectors are *buy-for-kids,* used as a way to get one's children onto the first rung of the housing ladder, perhaps near their university, and *buy-to-sunbathe,* particularly overseas, in sunnier climes than the UK. About 9 percent of UK adults now own property outside the UK. *Buy-to-let* is when an investor buys property with the twin criteria of rental income and capital growth; whereas *buy-to-flip* is when the investor buys property before construction and hopes to sell, or flip, it at a higher price before the project finishes construction and before the balance of the purchase price falls due on legal completion.

Figure 1

UK Residential Property Market



Various data sources have tried to estimate the average house price. The Nationwide Building Society believes that in the last three months of 2006, the average price increased by 9.3 percent compared with the same period last year, to £172,065. However, government sources suggest that house prices in Britain—the UK excluding Northern Ireland—rose 8.9 percent to £199,467.

These figures are based on all types of housing, whereas the average price of a new-build home in Britain is now £260,924 and is 5.8 percent more expensive than at the start of 2006. The largest regional increase was in Greater London at 17 percent, followed by Scotland at 13 percent and East Anglia at 6.1 percent. The latter two increases started from a lower base, but given that London was already the market's highest average value, the gap is widening. Several areas saw small price decreases, when measured by asking prices rather than completed sales value.

In London, Hometrack indicates that prices rose by 12.1 percent, with the highest growth, at more than 20 percent, in Kensington and Chelsea. The borough was where Princess Diana lived and now is home to many celebrities from actors to footballers, some of the nation's highest earners. These figures will inflate further in 2007 amid rumors that more than 3,000 workers in London's financial district will take home annual bonuses of more than £1 million each. Many of these financial stars want to live in West London: Kensington, Chelsea and Notting Hill—home to the eponymous 1999 film starring Hugh Grant and Julia Roberts—are top choices.

HOUSE VS. FLAT

Though it has not been possible to track down statistics of the size, in square feet, of the average home, it is interesting to reflect on the different methods of pricing. Outside central London, the number of bedrooms has long been seen as a key driver of price, coupled with the fact that the dwelling was detached, semi-detached or terraced. Apartments, or flats as they are more usually called in the UK, have not entered into this general equation because there are relatively so few flats compared with houses. Whereas, in the very center of London, especially in the swanky areas of Kensington and Chelsea or Islington—where Prime Minister Tony Blair lived before his move to No. 10 Downing Street in Whitehall—it is much more typical to price properties per square foot of space, whether the home is a house or a flat.

In the past two years, prices have increased from about £800 per square foot to more than £1,000 per square foot. Imagine everyone's surprise when in February 2007 the developers of a new series of four blocks of flats overlooking Hyde Park announced that they were marketing four penthouses at a staggering £4,200 per square foot. The fact that these penthouses have all been pre-sold at around £84 million each suspends belief. In fact, it would be tempting to say that at these figures there is now ample proof that the very top end of the London residential property market has reached a level of unsustainable excess. It is now considerably higher than Shanghai or even New York.

Such are the vagaries of property development and ownership that nearly 300,000 dwellings in England, about 1.6 percent of all privately owned properties, have been empty for more than six months, the Halifax Building Society reports. Why is that? Could it be related to affordability? With houses continuing to rise inexorably in price, it is clear that many youngsters are being priced out of the market. However, this particular statistic might be more connected with a phenomenon of the buy-to-let market.

In the past two years, prices have increased from about £800 per square foot to more than £1,000 per square foot. Imagine everyone's surprise when in February 2007 the developers of a new series of four blocks of flats overlooking Hyde Park announced that they were marketing four penthouses at a staggering £4,200 per square foot.

Some private landlords prefer to leave their investments empty, rather than have them damaged by inconsiderate tenants. This tactic would be uneconomic in a more traditional market, but today's capital growth more than compensates for the lack of cashflow, which is diminished when the property requires refurbishment after each year of a tenancy.

Recent research shows that up to half the new flats in Leeds are empty: 40 percent in Salford, an improving suburb of Manchester close to the sporting arena that is home to Manchester United Football Club, and some 10 percent to 15 percent in London. A regional government, the Greater London Authority, is so concerned about this trend that it has commissioned its own major piece of work looking into this aspect of the buy-to-let market.

BECOMING FAMILY FRIENDLY

To conclude, following are a couple of observations about the flats vs. houses debate. The National House Building Council's latest statistics show that 47 percent of new homes started in the UK in the first 8 months of 2006 were flats and maisonettes, two-story flats often built over neighborhood shops or retail units. This is a dramatic increase from about 18 percent just 10 years ago. Is the trend a response to demand or some other phenomenon?

Certainly, some believe that the market does not want to buy studio flats or one bedroom apartments—or at least not as many as are under construction presumably because of the need to maximize, for profit, the number of dwellings on any development site. Perhaps the development is because of a desire to create more family-friendly homes. The UK government recently issued formal planning guidance—a document called PPS 3—designed to ensure access to gardens, playgrounds or parks. The guidelines mark the first time the government has put the needs of children ahead of granting planning permission or formal consent to build to a particular design, density or layout. It also creates kid-safe and pram-friendly environments for families.

In the past 10 years, the number of new three-bedroom homes has dropped from 54,100 per annum to just 44,000 each year, a 20 percent decrease. However, in London this movement toward housing with less room for children is even more dramatic. The Greater London Authority has calculated a 20,000 property shortfall of family-sized homes across the city. Stunningly, they have also calculated that 290,000 children live in overcrowded conditions in London.

"Under the new guidelines, developments will not be allowed to be just concrete jungles empty of trees, grass or any natural environment," a government spokesperson reports. Maybe, in future, it will be more about parks and less about parking.

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. ■

Sources: Halifax Building Society, Reed Business Information, The Times, The Sunday Times, *www.smartnewhomes.co.uk, Hometrack,* Inside Housing, *King Sturge, RICS, National House Building Council*

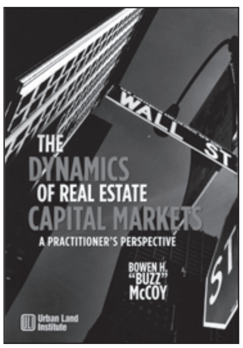
The author apologizes if any source believes that reference has been made to their material or data and, inadvertently, no credit has been given.

RECOMMENDED READING

The Dynamics of Real Estate Capital Markets—A Practioner's Perspective

By Bowen H. "Buzz" McCoy (2006, Urban Land Institute, Washington, D.C., 262 pages)

REVIEWED BY BRENT A. PALMER, CRE, FRICS



THIS UNIQUELY ORGANIZED TEXT comprises 36 of Bowen H. "Buzz" McCoy's articles and symposia summaries. McCoy is a "real estate icon" of the 20th century, according to *National Real Estate Investor* magazine, and this compilation of works provides tremendous insight into the evolution of transaction structure, market dynamics and analytical trends through the past 35 years.

During this time period, significant and critical changes occurred with regard to perception, perspective and practice for participants, counselors and investors as commercial real estate transformed into the much more transparent, liquid and sought-after asset class that it is today. And McCoy was one of the catalysts of this evolution. He worked at Morgan Stanley & Co. from 1962 to 1990 and held the roles of general partner, managing director and president of Morgan Stanley Realty. McCoy is "a pioneer and a legend in commercial real estate circles … one of the first people to bring Wall Street's mind-set into real estate," the Brookings Institution's Anthony Downs writes in the forward.

The first part of the book—An Overview and Thoughts on the Future—not only summarizes McCoy's extensive real estate experience, but also offers a detailed abstract of each article followed by his personal observations about the fundamental values essential to being a committed and successful practitioner.

Part two contains four articles focusing on the capital markets' evolving integration of real estate during the 1970s and 1980s, and the 15 articles comprising part three address the complex period of globalization in real estate markets concurrent with the turmoil and restructuring that affected the U.S. real estate capital markets in the 1990s. This section also highlights the progression of valuation methodologies, pricing and investment structure, and investment analysis. Part four, which contains nine articles, covers the years 2000–2005 and examines the issues of investment uncertainty, disconnected markets, demands for enhanced transparency and unrestrained capital flow.

Following the decade-by-decade story of real estate capital markets covered in parts two through four; the author

About the Reviewer

Brent Palmer, CRE, FRICS, *is senior vice president with NewTower Trust Co. in Bethesda, Md., as well as executive director of Seattle-based NewTower Valuation Services LLC. He provides consultation on numerous issues including pension fund investments, acquisitions, divestitures, market and asset performance metrics, lease analytics, risk assessment, adaptive re-use, infrastructure and sustainable development. His clients include commercial real estate investment, development, and capital placement professionals across North America.*

provides eight articles in the concluding fifth part that discuss values-based leadership. This last series of writings is timely and thought-provoking, covering several topics—including assessment of personal responsibility and character, public and private trust, global business ethics and social obligations—that are particularly applicable and essential to real estate practitioners today.

In summary, every real estate practitioner seeking greater perspective and increased understanding should consider *The Dynamics of Real Estate Capital Markets* to be required reading. The book reveals the myriad lessons learned and strategies created by the author through the past 35 years of real estate investment and capital markets integration. Readers will gain further insight about contemporary real estate issues as well as expected—and unexpected—market changes in the coming years.

This resource text is well-organized and includes abstracts that provide sufficient article summaries so readers who may not have time to delve into the entire book can efficiently navigate through pertinent topics. In addition, the scope and content of each article reflects the experiential authenticity of a true front-line thinker and leader in real estate finance and investment. ■

The Dynamics of Real Estate Capital Markets—A Practitioner's Perspective *is available for purchase through the Urban Land Institute. Order online at www.uli.org/bookstore or call 800.321.5011.*

FEATURE

Negotiating Defeasance Provisions at Origination Can Materially Impact the Bottom Line

BY CHERYL PAVIC HENNER

DEFEASANCE IS A PROCESS BY WHICH BORROWERS OBTAIN A release of their properties—typically for the purpose of selling or refinancing—from a mortgage that has been securitized. Once loans are securitized, lenders have little flexibility in changing the provisions established at origination. Because of this restriction, understanding and being able to negotiate defeasance provisions in the term sheet of a new loan go a long way in mitigating future defeasance costs.

UNDERSTANDING DEFEASANCE

Understanding defeasance provisions and their impact on the borrower's bottom line when negotiating the terms of a new loan can save money and prevent surprises when it is time to defease. Securitized commercial real estate loans are typically held in a structure called a real estate mortgage investment conduit, or REMIC. The Internal Revenue Code and Treasury Regulations promulgated under the code outline the governance of REMICs. After originating and securitizing the loan, lenders have little flexibility in changing the provisions negotiated at origination because of the restrictions these regulations place on lenders.

The concept of defeasance originated in the municipal bond market and in the 1990s was adapted to the commercial real estate market in response to the increasing securitization of fixed-rate loans. To make these securitizations attractive to investors, prepayment on loans was restricted, enabling predictable cash flows. Loan documents first included defeasance provisions in 1998 to create an avenue for borrowers to exit a securitized loan for a sale or refinance.

Often, defeasance is the only mechanism borrowers can use to release property from a securitized mortgage lien. The process allows borrowers to purchase a portfolio of high-quality government securities, commonly called defeasance collateral, to serve as a substitute for the property collateral identified at loan origination. But borrowers who pay attention to defeasance provisions and negotiate favorable terms at the onset of loan origination can avoid additional costs related to this sometime arduous process.

This article suggests that certain provisions provide borrowers with flexibility if and when they choose to defease a loan. In the suggested language, certain terms are bracketed to indicate that terms may differ by lender, though the substance should remain the same.

About the Author

Cheryl Pavic Henner *is a defeasance consultant for Chatham Financial, a Kennett Square, Pa.-based advisory firm that serves the capital markets. Chatham Financial was a participant in the largest real estate defeasance transaction—more than $1 billion—on record. Pavic Henner holds a bachelor's degree in architectural engineering from the Milwaukee School of Engineering and an MBA with a concentration in urban land development from California State University–Sacramento.*

AVOIDING LONG LOCKOUT PERIODS

Frequently, the first thing many borrowers notice in loan documents is a provision related to the earliest date—the lockout expiration date—that borrowers can defease the loan. Regulations mandate that securitized loans cannot be defeased until two years after the date of securitization. The period from origination to the date two years later is called the REMIC prohibition period. A defeasance provision in loan documents should allow borrowers to defease upon the expiration of this period. The lockout expiration date is the date a securitized loan first becomes eligible for defeasance. To ensure borrowers have the greatest flexibility in timing defeasance, it is important that the lockout expiration date immediately follows expiration of the REMIC prohibition period.

An example of desirable language is: *"Borrower may cause the release of the property from the lien of the security instrument at any time after the earlier of: (i) three (3) years from the date of the origination of this Note, or (ii) two (2) years from the "startup day," within the meaning of Section 860G(a)(9) of the Internal Revenue Code of 1986, as amended, of a "real estate mortgage investment conduit, that holds this Note."*

DEFEASING TO THE PREPAYMENT DATE VS. THE MATURITY DATE

Borrowers may have the option of prepaying a loan anytime from one month to six months before maturity of a loan without penalty or premium. The date on which borrowers may prepay the loan is the prepayment date, and the period from the prepayment date to matu-

Figure 1

Defeasing to Prepayment Date vs. Maturity Date

Sample Commercial Property Loan Terms

Original Principal	**$20 million**
Interest Rate	**6%**
Amortization Term	**30 years**
First Payment Date	**July 1, 2007**
Open Period Start Date	**Dec. 1, 2016**
Balloon (Maturity) Date	**June 1, 2017**
Defeasance Date	**July 1, 2010**

Estimated Cost of Defeasance Collateral That Provides for Payments Through Various Dates

BALLOON PAYMENT DATE	COLLATERAL COST[1]	TREASURE WITH CLOSEST MATURITY TO BALLOON DATE[2]
Dec. 1, 2016	$20.714 million	11/15/2016
Jan. 1, 2017	$20.780 million	11/15/2016
Feb. 1, 2017	$20.845 million	11/15/2016
March 1, 2017	$20.753 million	2/15/2017
April 1, 2017	$20.817 million	2/15/2017
May 1, 2017	$20.880 million	2/15/2017
June 1, 2017	$20.731 million	5/15/2017

[1] *Estimated costs are based on market rates as of May 1, 2007*

[2] *Denotes U.S. Treasury securities issued as of May 1, 2007*

rity is called the prepayment period or open period. A defeasance provision typically requires borrowers to purchase substitute collateral that provides for payments from the date of defeasance through the maturity date, without regard to whether a prepayment right exists in loan documents.

Savvy borrowers have been successful in negotiating terms that allow them to purchase defeasance collateral to provide for payments through the start of the open period. As a result, borrowers have a chance to realize substantial securities portfolio cost savings by eliminating the final months' interest payments.

Savvy borrowers have been successful in negotiating terms that allow them to purchase defeasance collateral to provide for payments through the start of the open period.

In some cases, however, purchasing defeasance collateral that provides for payments up to the start of the open period may actually be more expensive than purchasing defeasance collateral that provides for payments through any payment date within the open period. This scenario, typical for loans with several years remaining to maturity, is true if at the time of defeasance a U.S. government agency has not yet issued securities that will mature in time to cover the final loan payment on or close to the desired balloon payment date.

Figure 1 illustrates the costs of defeasance collateral for a sample loan that allows for payments to the start of the open period or on any payment date thereafter. Because the loan has several years remaining until maturity, it is particularly sensitive to this defeasance provision.

The following language gives borrowers maximum flexibility in selecting the most advantageous and cost-effective date for the final defeasance collateral payment: "*The Borrower shall purchase [Defeasance Collateral] that provides for payments on or prior to all successive [regularly scheduled payment dates] occurring after the [Release Date], including the outstanding principal balance of the Loan on, subject to the Borrower's sole and absolute discretion, a [regularly scheduled payment date] that falls within the Prepayment Period or on the Maturity Date.*"

MAXIMIZING THE BENEFITS OF PREPAYMENT RIGHTS

If borrowers must defease to the maturity date and cannot have the flexibility of purchasing defeasance collateral portfolios that make a final payment before the maturity date, loan documents should provide that any right to prepay the loan should survive the defeasance. Eliminate any loan document provisions that preclude the right to prepay the loan after a defeasance has occurred.

In many instances, the ability to prepay loans is especially valuable in the context of a defeasance if borrowers have the right to designate what entities will act as the successor borrowers upon defeasance. If borrowers have prepayment rights and can designate successor borrowers, they may be able to enter into an arrangement with successor borrowers' parent companies whereby borrowers have a right to a portion of the proceeds that successor borrowers receive if and when they prepay the loan. In this case, the original borrowers will realize all or a portion of the savings from the loan interest that otherwise would have accrued for the remaining months.

PROVIDING DEFEASANCE DEPOSIT VS. DEFEASANCE COLLATERAL

A defeasance deposit is the amount of money required to purchase the defeasance collateral portfolio that provides for monthly payments through the remaining life of the defeased loan. Some loan documents provide that borrowers must deliver defeasance deposits—not actual defeasance collateral—to lenders. If borrowers are required to deliver defeasance deposits, lenders have a right to play a role in various aspects of selecting the defeasance collateral including the structure and purchase of the portfolio. This right can result in potential embedded costs and inefficient pricing.

Conversely, if the defeasance provisions allow borrowers to provide the actual defeasance collateral to lenders and do not require defeasance deposits, the borrowers' defeasance consultant will be able to structure an optimized securities portfolio and hold a competitive auction to ensure best pricing. An example of desirable language is: "*Borrower shall deliver to Lender the [Defeasance Collateral].*" Further, borrowers should be careful that the defeasance provision does not mention a defeasance deposit.

AGENCIES VS. TREASURIES AS DEFEASANCE COLLATERAL

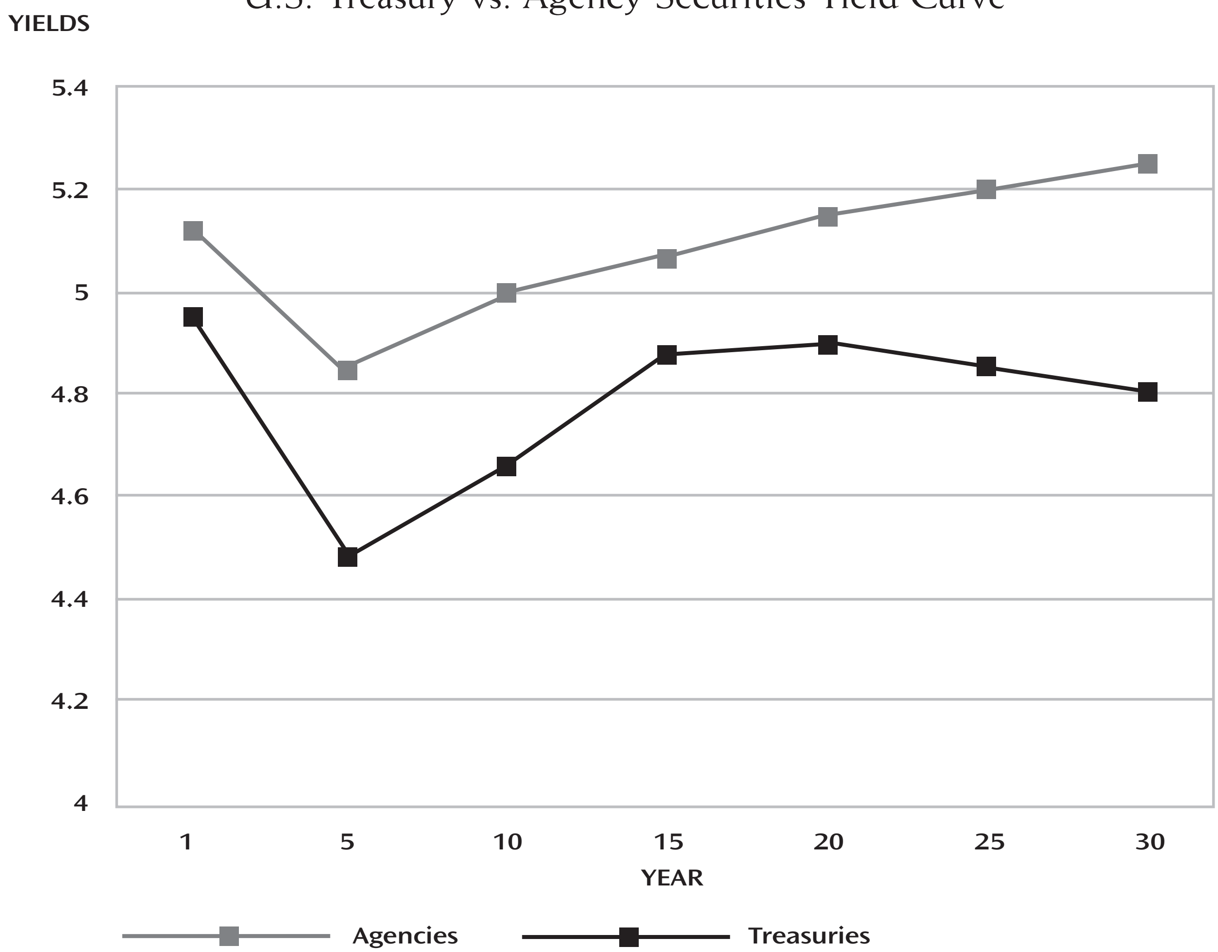
Perhaps the one provision that has the greatest impact on the overall cost of a defeasance is the type of securities that can serve as defeasance collateral. Generic language such as "U.S. obligations" or "government securities" limit these securities to direct U.S. government obligations such as bills, notes, and separate trading of registered interest and principal of securities, also called STRIPS. Though this type of portfolio is not fundamentally detrimental to the borrower, broadening the universe of possible securities will usually result in a more cost-effective portfolio.

Agencies of the U.S. government, or government sponsored entities—including the Federal National Mortgage Association, or Fannie Mae, and the Federal Home Loan Mortgage Corp., or Freddie Mac—issue fixed-rate bonds that offer higher yields (see Figure 2). These agency bonds also lend more liquidity to the universe of available securities. Because higher yields mean lower prices and increased liquidity creates greater efficiencies, using agency bonds will usually result in a cheaper securities portfolio (see Figure 3). With larger transactions, such as those greater than $50 million, government agencies may even be able to structure a customized bond where the cash flows on the bond identically match the payments required on the defeased loan.

Specific language is necessary in the defeasance provision of loan documents to ensure flexibility in selecting the

Figure 2

U.S. Treasury vs. Agency Securities Yield Curve



Source: Bloomberg. Market rates as of May 1, 2007

Figure 3

Agencies vs. Treasuries—Defeasance Collateral Comparison

Sample Commercial Property Loan Terms

Original Principal	**$20 million**
Interest Rate	**6%**
Amortization Term	**30 years**
First Payment Date	**July 1, 2007**
Balloon (Maturity) Date	**June 1, 2017**
Defeasance Date	**July 1, 2010**

Sample Commercial Property Loan Terms

TYPE OF PORTFOLIO[5]	COLLATERAL COST[2]
U.S. Treasury	**$20.731 million**
Agency	**$20.458 million**

[1]*Denotes securities issued as of May 1, 2007*

[2]*Estimated costs are based on payments through the maturity date, and market rates as of May 1, 2007*

Figure 4

Potential Residual Value of Defeased Loan

Sample Commercial Property Loan Terms

Original Principal	**$20 million**
Interest Rate	**6%**
Amortization Term	**30 years**
First Payment Date	**July 1, 2007**
Balloon (Maturity) Date	**June 1, 2017**
Defeasance Date	**July 1, 2010**

Potential Residual Value of U.S. Treasury Portfolio at Maturity

Treasury With Closest Maturity[1]	**May 15, 2017**
Balloon Date	**June 1, 2017**
Time Difference	**17 days**
Assumed Money Market Rate	**5.07%**
Balloon Payment Amount	**$17.085 million**
Future Value of Interest	**$40,883**

[1] *Denotes U.S. Treasury securities issued as of May 1, 2007*

most efficient, cost-effective defeasance collateral. Borrowers should use language similar to the following in the definition of defeasance collateral or in the provision that describes what type of substitute collateral borrowers can purchase: *"Obligations which are 'government securities' within the meaning of Section 2(a)(16) of the Investment Company Act of 1940."*

SELECTING THE SUCCESSOR BORROWER

Loan documents typically require that successor borrowers take the place of original borrowers upon defeasance. Successor borrowers are the entities that will assume responsibility for all payments remaining on loans after they are defeased, thereby releasing original borrowers from any financial obligations under the loan. It is most advantageous for borrowers to have the right to designate what entities will act as successor borrowers. If a defeasance provision gives lenders the right to form or designate successor borrowers, the borrowers may lose the opportunity to potentially benefit from residual value created by portfolio inefficiencies.

Unless a custom security is structured so that payments exactly match principal and interest payments due on the loan, a portfolio of defeasance collateral will have some inherent inefficiency. These inefficiencies are a result of mismatches in timing between cash receipts from the defeasance collateral—coupon payments or bond maturities—and the monthly payments of principal and interest due. The mismatches accrue interest at money market rates over the life of the defeased loan. Custom securities are not available in many cases and though defeasance collateral portfolios can be structured for high efficiency, some residual value is likely to accrue.

Rules governing the structuring of the defeasance collateral stipulate that the earned interest cannot be applied toward scheduled loan payments. However, all accrued interest can be realized when the loan matures. If successor borrowers offer a sharing arrangement, borrowers can receive a portion of this residual value (see Figure 4). For this reason, it is important for borrowers to be able to designate successor borrowers. As previously mentioned, this tactic also enables borrowers to benefit if the right to prepay the loan survives the defeasance. An example of language that secures this right is: "*Borrower shall, in its sole discretion, establish or designate a successor entity which is acceptable to the Rating Agencies.*"

THINKING ABOUT DEFEASANCE AT ORIGINATION

Defeasance provisions represent just one element of a loan—an element that does not necessarily influence upfront costs or monthly debt service payments. Thus, defeasance provisions are easy to overlook when negotiating the term sheet of a new loan. However, defeasance is typically the only way borrowers can release property for sale or refinance purposes. Because regulations preclude modifications to defeasance provisions after a loan is securitized, the best time to shape the destiny of a defeasance is at origination. Understanding the various defeasance provisions and requesting preferential language when negotiating the term sheet of a new loan will minimize future defeasance costs for borrowers. ■

FOCUS ON THE INVESTMENT LAW

FIRREA and Its Effect on the Investment Community

BY BRADLEY R. CARTER, CRE, AND DORI D'ESPOSITO BOWER

IN 1989, THE U.S. PRESIDENT SIGNED into law Title XI of the Federal Institutions Reform, Recovery and Enforcement Act, more commonly known as FIRREA. With it came fundamental changes in the way that federally regulated institutions must order appraisals as well as how professionals perform them.

One of Title XI's key objectives is to ensure that appraisals conducted for federally related transactions comply with uniform standards and are completed by individuals with proven competence. Another critical point is to ensure appraisals that banks order and review in no way involve employees responsible for loan production.

At face value, these rules would certainly seem to have merit. Eighteen years and multiple revisions later, opinions vary about how well they protect lenders, and how they affect the investment community these lenders serve.

Supporters of the Act would point out that the integrity of the lending process has improved because conflicts relating to loan producers overseeing the ordering of appraisals should no longer arise. A substantial body of evidence supports this view. Proponents might also cite that the rules have resulted in less pressure for appraisers to produce opinions of value that meet needs of the loan producer and the borrower. Though this statement might be true, it is a topic of vigorous debate.

This paper's objective is to take a look at some of the act's shortcomings and its unintended consequences as they relate to investors.

DOES ANYONE EVEN UNDERSTAND THE RULES?

Ask real estate professionals whether they personally have a grasp of FIRREA, and many will probably answer with a sheepish "yes," then hope the conversation doesn't go any farther. If pressed, many would admit that they understand it only at the most superficial level.

About the Authors

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A high-level review appraiser at a large national bank described FIRREA as, "a broad act subject to much interpretation. The OCC (U.S. Office of the Comptroller of the Currency) … FDIC (U.S. Federal Deposit Insurance Corp.) and other agencies try to provide clarity from time-to-time. In some cases, interpretations are allowed to develop by default at the local bank level in the absence of OCC guidance." This review appraiser may be on to something. Research shows that many lenders report violations of FIRREA are common, but they cite things that do not, in fact, violate FIRREA—at least not according to some experts' interpretation.

If lenders don't understand FIRREA, is it reasonable to assume that investors do? Probably not. And because these regulations pertain to lenders, does it even matter if investors understand them? That depends. Consider, however, that when investors do learn about FIRREA, it is often though an unpleasant and costly experience.

FIRREA RESTRICTS INVESTORS

One of the basic tenants of FIRREA is that a borrower cannot have any involvement in ordering an appraisal that a federally regulated institution will use for lending purposes. This rule comes as a surprise to many investors who typically order their own appraisals; it also shocks a few employees at investors' favorite federally regulated lending institutions.

"Borrowers often don't realize that they can't order an appraisal any more. When they do, they expect that a federally regulated lender will accept it," says Harris "Bo" Simpson, CRE, MAI, a principal at Greystone Valuation Services. "Sometimes their contact at the bank itself doesn't even know this. There have even been instances where bankers have actually encouraged their clients to order an appraisal, only to find that their bank will not accept it simply on the basis of by whom it was ordered."

In an effort to exceed perceived minimum compliance standards, many banks have policies that prohibit the borrower from having even indirect influence over who may or may not appraise their property. An example would be excluding appraisers simply because the borrower suggested they be considered. Simpson calls this the "tofu effect"—bankers who have the responsibility of ordering appraisals sometimes have the notion that appraisers retain the flavor of whoever speaks with them first.

It now is common to eliminate appraisers from consideration for a specific assignment because of their previous experience with the property. In a complex deal, it may be a time-consuming setback to eliminate the one appraiser who has some knowledge of the project.

DOES ALL THIS AFFECT THE COST TO BORROW MONEY?

It is difficult to imagine that setting up appraisal ordering and review departments, and hiring compliance officers to develop and enforce a long list of policies and procedures would reduce the cost to borrow money. A more direct affect on borrowing costs, however, is that the information a lender needs to analyze a particular deal may not be consistent with the rigid requirements of FIRREA.

For example, FIRREA requires every appraisal to provide an opinion of value for the property in its "as is" condition. Usually a good idea, but rules with no flexibility are rarely practical in all situations. Consider the very common scenario of an investor purchasing a tract of land subject to rezoning.

The sale will not close until rezoning is approved, and involved parties will not disburse funds until that time. What would seem to be the best option is an appraisal that reflects the collateral in the condition in which it will exist at of the time of closing—in this case, as if rezoned. The information that parties involved with the deal really need, though, is an appraisal that reflects two scenarios: as if rezoned and as is, or under the zoning that will no longer apply at the time of closing.

In this situation, the borrower typically pays the higher cost of the additional work. Some lenders have found a way around this higher cost—to allow, and sometimes even encourage, FIRREA violations. "Based on changes in community banking and the lack of experienced loan officers, I believe that FIRREA exceptions are becoming more common," says Brad Day, senior credit officer with Quantum National Bank.

Of course, some would say that citing reasons why costs could increase without any substantive analysis is supposition. Though these regulations could have changed the pricing that FIRREA lenders charge to finance these investments, "ultimately these FIRREA lenders need to compete with Wall Street and the Life Companies and other capital sources," says Ken Barnes, CRE, MAI, a principal in the appraisal and consulting firm McKee &

Schalka. "So the presence of FIRREA restrictions could not have had much of an impact on the cost of lending capital. If a FIRREA source is overly restricted in its lending, then other sources spring up," Barnes adds. "I might guess that the early '90s FIRREA accelerated the arrival of the conduits, given the bank's tightness during that period."

DOES FIRREA ENFORCEMENT RESULT IN A DISSERVICE TO INVESTORS?

"I think the enforcement of FIRREA has done a great disservice to the investment community," says fee appraiser Mike Hunter, MAI, principal of McColgan & Co. "It has cut off a line of service (appraisers) previously provided to developers. We would often have a developer come in to our office to go over a development plan, walk through the project with them, address feasibility and market issues, etc. Now if they do this before an appraisal assignment is given, we are required to disclose it to the bank and it very well may disqualify us from doing the appraisal" because it may be perceived to taint or violate the client/appraiser relationship with the lender.

Another service Hunter says he now rarely provides is speaking with loan officers to assist them with underwriting. Because the rules now place speaking with production people on the same level of skepticism and cynicism as speaking with the borrower, this type of guidance is another casualty in the wake of FIRREA enforcement.

Just as counseling options for investors have been compromised, so has the ability of many banks to respond to a borrower's need to move quickly. "Some of the larger banks have their hands tied so tightly in regulations that they can't always get things done fast enough when timing is critical," Simpson says. "The smaller banks have a competitive advantage in that they don't get scrutinized as closely or have not yet had to implement layers of insulation between loan officers and appraisers, and are therefore able to be more flexible to meet clients' needs."

RECOMMENDATIONS

Regardless of whether investors understand the intricacies of FIRREA, they are affected. We offer those in the investment community the following suggestions.

- Never order an appraisal that might be submitted to a federally-regulated lender. Similarly, don't discuss the terms of an appraisal engagement with an appraiser who the investor wants the bank to hire. Terms of an appraisal engagement include fee, timing and any special assumptions or hypothetical conditions.
- Lenders are particularly sensitive about borrowers trying to "pre-qualify" appraisers. Conversations of any type with an appraiser before their formal engagement lead to a precarious situation. Any question the investor poses regarding value will result in the appraiser disclosing that conversation to the bank, which will likely preclude the appraiser's future involvement. Appraisers must report even indirect questions such as: "Where do you see cap rates headed?" Realistically, this disclosure may or may not happen, depending on the circumstances and the parties involved.
- Be cautious regarding advice from bankers. Most banks have recently installed firewalls between appraisal review and loan production functions. Therefore, the people the investor interacts with may not have relevant knowledge or the control they represent; the deal could be delayed by people the investor will never meet.
- Though FIRREA affects all federally regulated lenders, the impact on their customers seems to come in varying degrees. Do some research beforehand about who will be able to respond to investor needs if the deal requires the lender to move quickly.
- Some real estate counselors are also appraisers. If using the services of a counselor/appraiser, understand that providing counseling services will probably preclude that person from appraising the project for a federally regulated lender.
- Related to the point above, if using the services of a real estate counselor, his or her expertise can still be of value in the appraisal process. Few lenders would prohibit the retained counselor from communicating with the hired appraiser. Similarly, providing a well-prepared market study to an appraiser unfamiliar with the deal can go a long way in heading off misunderstandings about the project. ■

FOCUS ON REAL ESTATE ANALYSIS

Comments on the Concept and Definition of Highest and Best Use

BY JOSEPH S. RABIANSKI, Ph.D., CRE

HIGHEST AND BEST USE ANALYSIS DOES NOT APPLY SOLELY to appraisals; it also relates directly to real property market analysis. Appraisal literature may contain the majority of discussion and presentation of HBU analysis to date, but it is imperative to valuation methods that all types of real estate practitioners rely on.

The 2001 edition of *The Appraisal of Real Estate* provides three definitions for HBU:[1]

- General definition—The reasonably probable and legal use of vacant land or an improved property that is physically possible, legally permissible, appropriately supported, financially feasible, and that results in the highest value.
- For vacant land—Among all reasonable, alternative uses, the use that yields the highest present value after payments are made for labor, capital and entrepreneurial coordination.
- For improved property—The use of a property, as improved, that will maximize its value.

This general HBU relationship among legally permissible, physically possible and financially feasible can be depicted as a simple Venn diagram (see Figure 1). Each circle represents one of the three elements.[2] In this context, financially feasible must be defined in some clear and definite context. It could be all properties that generate a positive net present value at the investor's anticipated or required rate of return; the discount rate that meets the investor's financial needs; or an internal rate of return that surpasses a predetermined hurdle reflecting the investor's perceptions of a safe rate, risk premium, illiquidity premium and administrative/management cost.

The intersection of the three elements can contain several different land uses for the property. To find the maximally productive option, the practitioner must identify the use in the intersecting area with the highest return—the use that has the best outcome when put to a financial test or guideline.

About the Author

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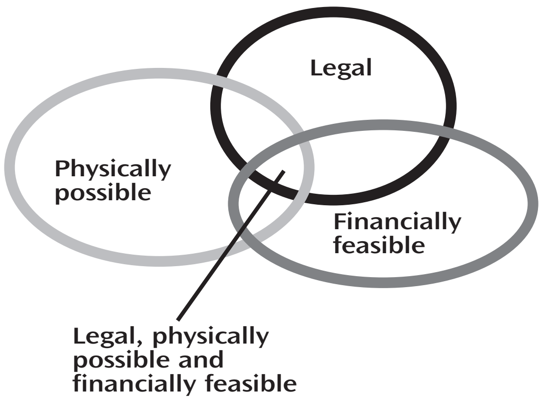
Figure 1

HBU Venn Diagram



THE LENNHOFF AND PARLI CRITICISM

Researchers have raised several concerns about the definition of HBU. One article by David C. Lennhoff and Richard L. Parli states the current HBU definition is "both ambiguous and redundant."[3] Their concerns refer to the phrase "reasonably probable and legal use." The phrase is ambiguous because it "suggests that only currently legal uses that are reasonably probable be considered." They continue: "Reasonable probability is both a tentative starting point and a conclusion if the use or uses that are ultimately deemed probable." The test, they say, is the use that is ultimately probable.

Lennhoff and Parli offer a new definition for highest and best use: "The probable use of land or improved property specific with respect to user and timing of the use that is adequately supported and results in the highest present value."

This article advances the Lennhoff-Parli critique. Their new definition moves in the right direction, but is also subject to evaluation, constructive criticism and reformulation.

First, the term "probable" should be replaced with a more explicit phrase such as "current or future" or "existing or prospective," which represent fact instead of conjecture. Second, the term "adequately supported" is too weak and vague. Practitioners can interpret it as "just scraped by" or "just made it over the hurdle." It also fails to answer the question: Adequately supported by what? Adding the adjective "financially" makes the nature of the support clear. Furthermore, if it is just adequately supported, why should it generate the highest present value?

The definition should use the term "financially feasible" because it is the basis of the HBU test. Thus, an alternative definition for vacant land and improved property is:

- HBU is the current or future use of vacant land specific with respect to the user and timing of the use that is financially feasible and results in the highest present value to the land.
- HBU is the current or future use of the improved property specific with respect to the user and timing of the use that is financially feasible and results in the highest present value to the property.

This recalibrated definition suggests a very important change. The issues of legal permissibility and physical possibility do not appear. Instead, the definition relegates legal permissibility and physical possibility requirements to inferior positions relative to financial feasibility. It places greater emphasis on the analyst's or appraiser's expert judgment about a use to be developed in the future.

FINANCIAL FEASIBILITY ISSUES

Financial feasibility involves two underlying issues. The first is specifying the phrase in an unambiguous manner. The second is ensuring a free market environment where no particular agent or entity is able to manipulate a property's financial feasibility.

The financial feasibility test is a critical element in HBU analysis. It needs to be clear, complete and as concise as possible. However, Lennhoff and Parli argue that ambiguity exists around the concept of financial feasibility. They make their point by considering two definitions found in Appraisal Institute publications:

- Financial feasibility is one of the four criteria the highest and best use of a property must meet: the ability of a property to generate sufficient income to support the use for which it was designed. See also economic feasibility. *(The Dictionary of Real Estate Appraisal)*
- As long as a potential use has value commensurate with its cost and conforms with the first two tests

(for HBU), the use is financially feasible. *(The Appraisal of Real Estate)*

Yet considering only current market conditions is ambiguous and incomplete. The Principal of Anticipation tells us that current market value comes from future benefits, not the present or past. Following are the other definitions related to financial feasibility that appear in the appraisal literature.

- Feasibility analysis is a study of the cost-benefit (cost-revenue) relationship of an economic endeavor. *(The Appraisal of Real Estate)*
- Economic feasibility is the ability of a project or an enterprise to meet defined investment objectives: an investment's ability to produce sufficient revenue to pay all expenses and charges and to provide a reasonable return on and recapture of the money invested. In reference to a service or residential property where revenue is not a fundamental consideration, economic soundness is based on the need for and desirability of the property for a particular purpose. An investment property is economically feasible if its prospective earning power is sufficient to pay a fair rate of return on its complete cost (including indirect costs), i.e., the estimated value at completion equals or exceeds the estimated cost. *(The Dictionary of Real Estate Appraisal)*
- Economic feasibility analysis is an analysis undertaken to investigate whether a project will fulfill the objectives of the investor. The probability of a specific real estate project is thus analyzed in terms of the criteria of a specific market or investor. *(The Appraisal of Real Estate)*
- Economic feasibility analysis may be defined as an investment's ability to produce sufficient revenue to pay all expenses and charges and to provide a reasonable return on and recapture of the money invested. *(The Appraisal of Real Estate)*
- Economic feasibility is indicated when the market value or gross sellout of a project upon achievement of a stabilized condition equals or exceeds all costs of production. Market value applies to a planned rental property: gross sellout applies to a project that will be developed as multiple units to be sold to multiple users. *(The Appraisal of Real Estate)*

After reading these definitions of financial and economic feasibility, the need for a clear, complete and concise definition for these two concepts is obvious. Practitioners might infer that "economic feasibility" and "financial feasibility" are synonyms. They also might get the impression two dimensions to feasibility analysis exist. One deals with costs (operating costs and debt service) and returns (investment analysis); the other concerns value (market valuation) vs. cost (development and construction costs).

Considering only current market conditions is ambiguous and incomplete. The Principal of Anticipation tells us that current market value comes from future benefits, not the present or past.

Appraisal literature needs to settle on one or the other phrase—financial or economic feasibility. Financial feasibility carries more weight because it is a test in HBU analysis. The term can cover two aspects in its definition:

- Financial feasibility analysis investigates the ability of a real property equity investment to produce sufficient periodic revenue (effective gross income) to pay all expenses (operating costs and debt service) and a future period reversion (sales price less selling costs and the loan balance), and to provide a return on investment that entices the investor to acquire the property and recapture the money invested.
- Financial feasibility analysis investigates the ability of a real property equity investment to generate a market value that equals or exceeds the full cost of construction and development (direct and indirect costs) of the property.

These two considerations of financial feasibility analysis are related: The yield capitalization of the net operating income using the appropriate terminal capitalization rate in the appropriate manner, and the appropriate discount rate establishing the current market value of the investment.

FREE MARKET OPERATIONS

Financial feasibility of a specific use for a specific property is a function of the property market in which that use competes. In other words, the financial feasibility of a shopping center is a function of the demand for and supply of retail space in a retail market that establishes the rent and occupancy levels. Financial feasibility analyzes revenues and costs for that use from the property market, combines this information with data from operating expense markets, and generates cash flows and a measure of the rate of return. The property market is depicted in rents and vacancies in effective gross income.

Have financially infeasible and currently illegal HBUs been made legal by rezoning? Have financially feasible and currently illegal HBUs been denied legal status by a rezoning refusal? The answer to both questions is yes.

The operating expense markets consist of several economic resource markets. Each operating expense is determined in its own specific market with its own market characteristics. The demand for public services and the local jurisdiction's ability to provide services determine property taxes. The insurance industry's estimates of various hazards determine insurance rates. Property owners must purchase repair services, materials and supplies in a specific market.

The major point is that use, for the most part, does not influence markets or prices in these markets. The property owner can negotiate costs and rates, but these financial factors in the property and operating expense markets are determined by market conditions; they are not subject to manipulation by the property owner or any other party such as the local jurisdiction. Though the local jurisdiction controls property taxes, special assessments and exactions, it does not control the financial feasibility of the use for a property. However, the local jurisdiction can affect the financial feasibility of the property.

PHYSICAL POSSIBILITY ISSUES

Most development and construction projects on vacant land are physically possible. The governing considerations are site development and improvement costs. These expenses enter the financial analysis by setting requirements for rent, vacancy and operating expenses to make the project financially feasible.

If the construction and development costs are too high, they raise the feasibility rent to a level higher than market rent and render the project financially infeasible. In the case of an improved property, rehabilitation, renovation and modernization costs also enter the financial feasibility analysis and the feasibility rent estimation. Many examples of these possibilities exist: old industrial space to residential, office space to apartments, small apartments to larger condo units, retail space to government office space and so on.

Analysts also must eliminate obvious physical inconsistencies in construction and development. For example, a one acre lot, which is 43,560 square feet, cannot hold a building with a 50,000-square-foot footprint. But at an additional cost a sloped site can become a flat site, a below-grade site can become an at-grade site and a load bearing wall can be modified or partially removed.

Still, financial feasibility should take precedence over physical possibility. As a cost factor in a cash flow format, construction and development costs are not subject to overt manipulation by the property owner or public officials. As always, differing estimates arise for the same construction or development task, but this is not manipulation. Contractors generate different bids for the project based on various methods of cost estimating, profit expectation, or construction quantity or quality.[4]

LEGAL PERMISSIBILITY

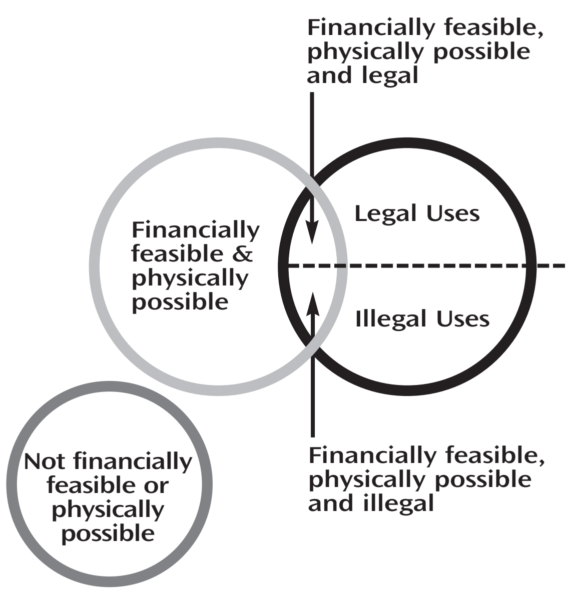
Legal permissibility encompasses many things but the most dominant is the land use restriction section of the zoning ordinance.[5] Land uses at a specific point in time are either legal or not. There is no "somewhat legal" or "almost legal."

The problem is that determining what is legal is subject to manipulation. A preordained process solely in the hands of local authorities determines the zoning ordinance. Have financially infeasible and currently illegal HBUs been made legal by rezoning? Have financially feasible and currently illegal HBUs been denied legal status by a rezoning refusal? The answer to both questions is yes. Two additional truisms are that the current use of the property may not be the HBU of the property, and the HBU of the property may not correspond to the existing land use allowance.

In a simplified form of the Venn diagram in which financial feasibility takes precedence over physical possibility, the diagram only has two circles: legal and the financial. But the legal circle should have two parts, one for legal and one for illegal uses (see Figure 2). Moreover, the illegal side should be partitioned according to the probability of rezoning or, stated differently, the probability of becoming a legal use. Financially feasible uses will appear on each side of the legal/illegal divide, but only one of these will be the maximally productive use, or the HBU.

Figure 2

Modified HBU Venn Diagram



MARKET MANIPULATION

In many rezoning cases, local authorities attempt to limit HBU analysis to land uses consistent with the existing comprehensive zoning map. In its noblest intent, this tactic seeks to eliminate an undesired land use that may be a financially feasible—or even the maximally productive—use but generates negative externalities to other properties.[6]

Property rights are in conflict with societal rights. This concern has always been an issue with zoning ordinance. However, authorities often make these legal permissibility decisions for less than the noblest reasons. Society's desirable land uses have often been denied, and society's undesirable land uses have often been permitted.

Manipulation of the legal permissibility criterion distorts the market, is a barrier to entry and, thus, a violation of the economist's competitive market concept. Remember that the current definition of market value is based on a competitive market. That definition is:

"The most probable price, as of a specified date, in cash or in terms equivalent to cash, or in other precisely revealed terms, for which the specified property rights should sell after reasonable exposure in a competitive market under all conditions requisite to a fair sale, with the buyer and seller each acting prudently, knowledgeably and for self-interest, and assuming that neither is under undue duress." *(The Appraisal of Real Estate)*

Economics discusses two forms of a competitive market. The first of these is the purely competitive market that requires two conditions:

- Large number of buyers and sellers such that no one buyer or seller can influence the price in the market
- Barriers to the entry of new firms or exit of existing firms do not exist

The perfectly competitive market adds two more conditions:

- All market participants have perfect knowledge and information
- Resources and products are perfectly mobile signifying costless transport over space

The legal permissibility activity of the local jurisdiction can be a barrier to entry of new or different land uses. If the barrier to entry is established, it is a deliberate act to affect the value of the land. In eminent domain cases, the requirement to conform to the existing zoning map could be a deliberate act to minimize the fair compensation offered to the property owner by limiting uses that are financially feasible in the future but not legal today.

In contract law, to have a competitive market the transaction must meet the reality of consent requirement: The agreement reached in the contract cannot be based on undue influence, menace, duress, mistakes of fact, misrepresentation or fraud.

Undue influence is the situation in which one party in a relationship uses that relationship to influence the other person to agree to the transaction. Menace is the threat of force. Duress is the use of force to influence the other person to agree to the transaction.[7] It is also defined as forcible restraint or restriction.[8] Some see the local jurisdiction's ability to determine legal permissibility as undue influence and, as such, a violation of the economist's competitive market conditions.

CONCLUSION

Analysts can estimate the financial feasibility of illegal uses for a property in the same way they estimate the financial feasibility of the property's legal uses. This process requires consideration of the property market as well as the various resource markets that affect operating expenses. As in perfect competition, no market participant can affect the outcome; manipulation does not occur, nor does it affect physical permissibility. However, legal permissibility is subject to manipulation because the local jurisdiction has sole control over it.

To avoid dealing with this market imperfection—this barrier to entry—the analyst and appraiser should focus on the financial feasibility of legal and illegal uses. If the HBU is an illegal use under current zoning, the analyst and the appraiser should report the most financially feasible legal use as well as the financially feasible illegal use. In other words, the appraiser should ignore legal permissibility and focus on financial feasibility of any and all land uses that can be supported by current and future market conditions.

A reworking of the existing definitions for HBU as vacant and HBU as improved could be:

- The HBU of vacant land is the most financially feasible use from all uses supported by freely competitive and (legally and physically) unobstructed current and future property market conditions generating the highest present value to the land.
- The HBU of an improved property is the most financially feasible use from all uses supported by freely competitive and (legally and physically) unobstructed current and future property market conditions generating the highest financial return to the property.

The definitions should be accompanied by a matrix that identifies the structure of the HBU analysis. For example, consider a vacant property zoned for single-family, apartment and retail uses. The HBU analysis matrix is:

Vacant Land HBU Analysis

Market	Legal Uses	Illegal Uses
Current	Vacant	**Office**
	Apartment	Industrial
	Retail	Hotel/Motel
	Single Family	
Future	Vacant	**Office**
	Apartment	Industrial

The appraiser would need to determine the most financially feasible use for the vacant site in each of four cells to determine the maximally productive use, the HBU. Assume that an analysis reveals that the uses in bold text are the most financially feasible uses in each cell, and that the maximally productive use turns out to be office space use in both the current and the future market.

Yet the property can become office space only if the local jurisdiction permits it. This monopolistic control is not the action of a free competitive market. If local authorities do not grant the rezoning request for office, the land likely will be used for a suboptimal retail use and the HBU will not be achieved.

Consider a property improved with an apartment structure and currently zoned for apartment and retail uses. The HBU analysis matrix is:

Improved Property HBU Analysis

Market	Legal Uses	Illegal Uses
	Legal Action	
Current	**As Is Apartment**	**Office**
	Retail	Industrial
	Demolish Apartment	Hotel/Motel
Future	Rehabilitated apartment	**Office**
	New Apartment	Industrial
	Retail	Hotel/Motel

In this example, the four cells can be created as they were for the "Vacant Land HBU Analysis" with the addition of a legal action inserted in the current market/legal use cell. As in the case of the vacant land, the appraiser would need to determine the most financially feasible use for the improved site in each of four cells. The resulting statement is that the appraiser would have to report an HBU in three of the cells, the current and legal as well as a future HBU that is legal or illegal.

The reworked definitions of HBU as vacant and HBU as improved bring in the issues of use and timing as suggested by Lennhoff and Parli. Practitioners should check all options—legal and illegal—to find the most financially feasible use in today's market as well as future markets.[9]

The discussion of legal permissibility presented in this article leads to a related topic: the probability of rezoning. An upcoming edition of will address this issue. ■

ENDNOTES

1 Appraisal Institute, *The Appraisal of Real Estate 12th edition* (Appraisal Institute, 2001).

2 Terry V. Grissom, "The Semantics Debate: Highest and Best Use vs. Most Probable Use," *The Appraisal Journal* (Appraisal Institute, January 1983).

3 David C. Lennhoff, MAI, and Richard L. Parli, MAI, "A Higher and Better Definition," *The Appraisal Journal* (Appraisal Institute, Winter 2004).

4 Construction companies can collude but only with great difficulty. The construction industry is not a pure monopoly or even an oligopoly. It can be best described as a monopolistic competitor, and collusion in this market situation is difficult because the number of firms on the supply side is large.

5 Other related restrictions include subdivision regulations and development standards, construction codes, ADA codes, etc.

6 These negative externalities could be such things as traffic congestion, over burdening public utility systems, high development densities, etc.

7 Donald Epley and Joseph Rabianski, *Principles of Real Estate Decisions* (Prentice Hall, 1986).

8 Webster's New Collegiate Dictionary.

9 HBU analysis now is exclusively a private property consideration. No consideration enters the analysis with regard to the costs a land use will inflict on adjacent and proximate properties or even on the community as a whole. The negative externalities a land use might generate are ignored in the present format of HBU analysis.

Collaborative and Market-Driven Approaches to Economic Development and Revitalization

BY MAUREEN MASTROIENI, CRE

RESPONSE TO THE 2005 U.S. SUPREME COURT DECISION IN *Kelo vs. New London* has been dramatic and polarizing. Overnight, eminent domain has become a topic for discussion in households, businesses and community forums. In the backlash from the decision, national and state legislators have proposed a number of bills aimed at limiting government's power to take private property for public use, and especially to take private property for economic development purposes.

Most of the discussion focuses on several issues:

1. Does the public-use clause of the Fifth Amendment permit condemnation of private property for transfer to other private parties solely for the purpose of promoting economic development?
2. Is the term "public use" synonymous with "public benefit," defined as the removal of blight, the reversal of economic decline, the creation of jobs and improvements to the tax base?
3. Assuming that eminent domain is here to stay—as the Kelo decision suggests—are there better ways to determine just compensation?

These are all good questions but they are shortsighted in that they fail to address the broader issues of how to define blight and best results, and how planners can undertake improvements in a manner that is sensitive to the needs of the people who are most directly affected. The question that remains unasked—and one that may be far more important than the technicalities of public use vs. public benefit—is benefit for whom?

EMINENT DOMAIN AND URBAN REVITALIZATION

One of the first eminent domain cases heard by the Supreme Court was the 1954 urban renewal case of *Berman v. Parker*,[1] in which the city of Washington, D.C., acquired large tracts of residential and commercial property in an attempt to eliminate slums. Following this decision—which upheld the government's authority to take property, regardless of condition, for the greater good and specifically for the elimination of blight—American cities undertook massive redevelopment projects that cleared large areas in and around central business districts.

About the Author

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The urban renewal process included designating an area as blighted, preparing a development plan, using eminent domain for land assembly, demolition and marketing the cleared land for redevelopment. In a variation on a questionable sentiment, cities essentially believed "if we demolish it, they—the developers—will come."

Unfortunately, the laws of supply and demand, and economic feasibility, became apparent only when the cleared land did not attract market-rate development and remained vacant. Blighted neighborhoods, by definition, were not the most attractive locations for market-rate development. And other problems occurred that officials probably should have anticipated. Once neighborhoods were declared blighted and targeted for redevelopment, individual properties became unmarketable and property owners stopped maintaining them. Without investment, deterioration accelerated and neighborhoods became more depressed, even in areas that were previously stable. Ironically, a program that intended to remove blight actually contributed to neighborhood decline in many cases.

Historically, officials have believed the only way to accomplish widespread improvement is to buy out existing property owners and relocate tenants—or not, depending on lease clauses and local policy.

Even proponents of eminent domain suggest that it should be used as a tool of last resort, because it is often more costly and time consuming than acquiring properties through voluntary exchange.[2] However, municipalities point out that it is often impossible to assemble large enough parcels to revitalize blighted communities without condemnation. Across the country, government officials and planning agencies point to any number of important projects that would not have been possible without eminent domain—projects like Times Square, the World Trade Center and Baltimore's Inner Harbor.

These types of successes usually come to fruition because of two reasons. First, revitalization in urban areas often involves infill development, and private developers do not have the ability to assemble the required parcels. Even if all property owners are willing to sell, the only way to obtain clear title typically is through the condemnation process. Second, many economic development projects are not, in fact, economic at all, at least not in the way that the private sector defines economic feasibility. Without the municipality's contribution of an assembled site, along with various tax incentives and below-market financing, the projects would not move forward.

ECONOMIC BENEFITS FOR WHOM?

Everyone wants safer neighborhoods without trash or abandoned buildings, better schools, successful businesses, an improved road network. In contrast, the current outcry against eminent domain is less concerned with long-term benefits than with the social impacts of demolition and relocation. Today, much of the discussion around eminent domain focuses on the best way to mitigate these impacts.

> What is the best way to relocate the existing residents, or how much can we pay them to truly compensate for their loss? But these still are not the pertinent questions. Rather, the questions should be: What is the best way to serve the existing residents, and must we completely move out the old before we can bring in the new?

Historically, officials have believed the only way to accomplish widespread improvement is to buy out existing property owners and relocate tenants—or not, depending on lease clauses and local policy. More often than not, the original residents are long gone by the time the new, improved neighborhood is ready for someone else to occupy. This is especially true of tenants, who generally have no legal claim on residence in the old or the new community.

The following case studies describe urban revitalization projects that are attempting to improve the situations of the residents, not just the real estate. All these projects have champions and detractors; many are works in progress. Readers who accept the premise that eminent domain may be a necessary evil can view these projects as a way to take a collaborative approach that builds neighborhoods without destroying lives.

DEMANDING A BETTER DEAL

In Baltimore, Md., the city has undertaken an ambitious revitalization effort to convert an 80-acre portion of East Baltimore into a new 22-acre biotechnology park for Johns Hopkins University, along with low-income, affordable and market-rate housing. As approved by the Baltimore City Council in December 2002, the 10-year project has the potential of acquiring, through eminent domain, as many as 3,000 properties, and the possibility of displacing as many as 800 households.

East Baltimore Development Inc., which is managing the $800 million project, has partnered with the Annie E. Casey Foundation to provide relocation assistance that is generous in terms of compensation but, more important, includes financial counseling, educational and employment training, and job placement. They connect families with resources including healthcare, social services, senior services, after school programs, credit counseling and substance abuse programs. "We want the families directly affected to end up better off as a result of this revitalization," says Douglas Nelson, president of the Casey Foundation. "Not just changed, not just moved, but really better off in all the common sense ways that we think about: better housing, more job opportunities, a healthier neighborhood, safer streets, better schools, more recreation opportunities."[3]

By early 2006, a total of 395 households had been moved, and Charles Cohen of the *Baltimore City Paper* reported that "Even some of the East Baltimore plan's most vigilant critics concede that the forces behind the project seem to be making a *bona fide* effort to improve the lives of the residents." [4] At the same time, Cohen quoted a number of residents, including long-time resident Lucille Gorham. "Whether it was a bad neighborhood and how it seemed to other people, it was my neighborhood and I lived there," Gorham told the newspaper. Lisa Williams, president of Save Middle East (Baltimore) Action Committee, pointed out that "...(some) residents were very happy living here. We were hoping for redevelopment, but renovating redevelopment, without displacement."

More than 60 percent of the East Baltimore redevelopment—the 50 acres of Phases II and III—is still on the drawing board in terms of what will be built and when. Though officials have given some indication that more renovations and less relocations in subsequent phases will take place, the development plan is not complete and Phase I is barely underway.

DEVELOPMENT WITHOUT DISPLACEMENT

The Dudley Street Neighborhood Initiative, or DSNI, is a resident-led community nonprofit dedicated to rebuilding the Dudley neighborhood of Roxbury/North Dorchester, Mass. Located less than two miles from downtown Boston, the DSNI neighborhood had been devastated by arson, disinvestment and dumping, with 1,300 vacant lots by the mid 1980s. At the heart of the neighborhood, the Dudley Triangle was a 64-acre tract that was home to about 2,000 people. The Triangle included approximately 15 acres of vacant land owned by the city of Boston and another 15 acres, or 181 lots, of privately owned vacant land.[5]

DSNI was formed in 1984 and has grown into a collaborative effort of more than 3,600 residents, businesses, nonprofits and religious institutions. In 1987, DSNI adopted a comprehensive revitalization plan focusing on development without displacement, and creating strategic partnerships with individuals and organizations in the private, government and nonprofit sectors. In 1988, they became the only community group in the nation to win eminent domain power, taking advantage of Chapter 121A of the Massachusetts State Statutes. To accomplish this, DSNI became an urban redevelopment corporation to acquire the properties, and a community land trust, Dudley Neighbors Inc., of DNI, to hold the properties. The community land trust will own the land in perpetuity and lease it under long-term ground leases. To preserve future affordability, the ground lease restricts the price at which owners can sell their units to a price increase that is set at 5 percent per year or the rate of inflation, whichever is lower.

Of the 131 individual owners identified for the 181 privately owned vacant parcels in the (Dudley Street) neighborhood, at least 81 lived outside the area and many could not be located.

DNI determined that no one would be displaced from a home or business; thus, the organization used eminent domain only to acquire vacant land, not land with structures on it. Though most of the private holdings were tax delinquent, foreclosing on them one by one would be complicated and time consuming. Of the 131 individual owners identified for the 181 privately owned vacant parcels in the neighborhood, at least 81 lived outside the area and many could not be located. Thus, eminent domain was essential to consolidating ownership. A $2 million loan from the Ford Foundation supported the purchase of the privately owned, vacant land. DNI acquired an additional 15 acres of vacant land from the city of Boston for $1.

Today, more than half the 1,300 abandoned parcels have been transformed into more than 400 new affordable houses, community centers, new schools, a community greenhouse, parks, playgrounds, gardens and an orchard. An additional 500 housing units have been rehabbed. DSNI takes a holistic approach to community development. The Dudley PRIDE (people and resources investing in Dudley's environment) Campaign focuses on health, safety and environmental concerns. DSNI also sponsors programs for college mentoring, parenting, home ownership, job skills, daycare providers, youth leadership, entrepreneurship, voter registration and more. DSNI reclaimed land for food production, constructed a community greenhouse and began a Farmers Market. In 1997, DSNI received an American Planning Association Award for housing planning. The Orchard Gardens K–8 pilot school opened in 2003. The Dudley Street Neighborhood Initiative celebrated "20 years of transformation" in 2004 and continues to move forward.[6]

The developers of Jefferson Square in Philadelphia dedicated themselves to answering the question: "How can we revitalize a community and serve existing homeowners, the majority of whom earn very low incomes, with as much care and respect as we seek to serve new buyers who earn higher incomes?"

SERVING EXISTING HOMEOWNERS

The developers of Jefferson Square in Philadelphia dedicated themselves to answering the question: "How can we revitalize a community and serve existing homeowners, the majority of whom earn very low incomes, with as much care and respect as we seek to serve new buyers who earn higher incomes?"[7] To acquire the 275 parcels of contiguous land needed to build 93 houses, Jefferson Square Community Development Corp, or JSCDC, also had to acquire 35 homes occupied by existing homeowners, many of whom were angered and disheartened by the lack of city support and services through the years that had caused their neighborhood to decline.

In six years, JSCDC acquired 57 properties through private purchase, 14 through conveyance of city-owned properties, 45 through institutional conveyance from a now-closed local hospital and 159 through urban renewal condemnation. The use of eminent domain was essential to the acquisition process because it was the only way that they could remove liens and acquire clear title. Jeremey Newberg of JSCDC and Capital Access Inc. calls it "condemnation with a conscience."[8] In fact, several homeowners attended a city council meeting and asked to have their homes condemned because eminent domain provided relocation benefits that they would not have received from a negotiated sale. These residents then reinvested the proceeds of the condemnation back into the project in the purchase of a new home in Jefferson Square. The development moved forward with 100 percent community support. In all, 22 residents chose to buy a new or rehabilitated Jefferson Square house under the relocation program.

Thirty of the 93 homes were targeted to buyers with low to moderate incomes. The remaining units were sold at market-rate sale prices ranging from $209,000 to $249,000—a price affordable to middle-income families earning $45,000 to $85,000, which is roughly 80 to 120 percent of median income. When the sales office opened May 3, 2004, some prospective buyers had camped out for two nights to buy a Jefferson Square home. All 93 units were sold out in four days.

Jefferson Square did not neglect the surrounding community. Organizers made funds available for the rehabilitation of 50 owner-occupied existing row homes, ranging from facade improvement grants to more substantial rehabilitation programs combining grants with loans based on the owner's income. Several existing row homes were purchased, rehabilitated and resold to first-time home buyers for between $110,000 and $145,000. A portion of the old Mt. Sinai Hospital was converted to 37 units of rental housing for seniors, using low-income housing tax credits.

The project managers, Capital Access Inc., served as consultants to the community and managed the construction process. The company attributes the success to its commitment to the community and the level of trust that evolved among community leaders and local residents, as well as to the strong support and sponsorship of state and local officials and municipal agencies. The total project cost was $25 million, and JSCDC raised $5.25 million from private lenders and $10.9 million in subsidies, including funding from the city's Community Development Block Grant program, state of Pennsylvania Housing Finance Agency, Federal Home Loan Bank and Wachovia Bank Regional Foundation.

Jefferson Square Homeowner Relocation Package

- No temporary relocations. No residents moved until their new house was ready.
- 100 percent of net proceeds from the condemnation of the existing house as well as any relocation benefits had to be reinvested in the new house.
- Relocated residents had to live in the new house. Rentals were not permitted.
- Monthly payments were maintained at the same level for the new house as the old house. Relocation buyers still had to pay real estate taxes and homeowners insurance; however, taxes on the new construction were abated for 10 years.
- Relocation buyers took a self-amortizing mortgage for the difference between the fair market value of the new house and the buyer's equity investment. In years one through five, the loan is deferred. In years six through 15, 10 percent of the loan is forgiven each year so that by year 15, 100 percent of the loan is forgiven. If the property is sold before 15 years, the balance of the mortgage must be paid out of the proceeds.

Source: Jefferson Square Neighborhood Revitalization Plan, August 2004

PIZZA WARS

Finding win-win solutions to commercial redevelopment is more difficult. Though most communities refer to the power of eminent domain as a tool of last resort, this situation often is not the case when it comes to commercial properties, but a local agency found an interesting solution for a redevelopment in Pittsburgh. In this instance, Home Depot acquired a closed Sears department store, vacant and owned by the city, to redevelop the property with a larger warehouse superstore. The company needed additional land—including properties occupied by a bar, dry cleaner, nail salon and the popular Vento's Pizzeria—to meet parking requirements. The Pittsburgh Urban Redevelopment Agency, or PURA, hoped to avoid using eminent domain, and apparently negotiated successfully with all of the businesses except Vento's.

This was the third time that Vento's would be forced to move to accommodate urban renewal, but the first time the company actually owned its building. The pizzeria's story was front-page news in the *Wall Street Journal.*[9] Pittsburgh Councilman Bob O'Connor intervened, setting up meetings between Al Vento Sr. and Home Depot officials. Eventually, they worked out an arrangement whereby Vento's property was transferred to Home Depot. Home Depot demolished the old building and built its superstore as well as a new corner restaurant for Vento's. The lease is 100 years and the rent, Vento says, is fairly minimal.

Everyone likes to hear a David and Goliath success story, and this is a good one. The owner of the pizza shop is happy, the neighborhood is happy, and, presumably, Home Depot is happy. Other small business owners—the bar, dry cleaner and nail salon—were displaced, but they were tenants, not owners. Reportedly, they were successfully relocated.

These projects show that a variety of private and public-private partnerships can accomplish redevelopment and revitalization either without eminent domain or with a kinder, gentler, more collaborative use of condemnation as a development tool. Cases also exist where the private sector made acquisitions for right-of-way improvements, and did so more quickly and efficiently than local municipalities, public utilities and transportation agencies could have accomplished. Perhaps they spent a little more money than it would have cost using eminent domain, but no one paid more than they could afford. And when timing is an important consideration, the private sector has the ability to move fast to resolve disputes and get the project underway.

PUBLIC SECTOR OR PRIVATE SECTOR

These successful developments involve a series of public-private partnerships that in most cases are fairly complex. These kinds of partnerships are essential to urban revitalization, despite the fact that many industry observers believe the private sector is more effective at driving real estate development than public agencies. A report by the Reason Foundation states: "Over the past two decades, economic development specialists have recognized that good projects almost always have a significant private sector component because entrepreneurs have a better grasp of market conditions and the long-term viability of certain kinds of projects. In short, the private sector does a better job of leading and managing projects and leveraging public dollars than does the public sector investing on its own."[10]

Private sector development bears with it the expectation of a reasonable return on investment. (In theory, public sector development is also done with the expectation of a

The power of eminent domain is part of the public sector's toolbox, though one hesitates to call it a skill because the term implies some proficiency and, more often than not, eminent domain has not been used well.

return; how reasonable it is, and whether it can be measured, is a topic for another paper.) Even nonprofit developers operating with a variety of grants and subsidies have to cover costs and pay back loans. Development in the private sector has the advantage of flexibility that the public sector does not have or is reluctant to use. Examples include the ability to move a projected right-of-way to accommodate a property owner, give property in exchange for property to be taken, pay more than fair market value, provide more flexible relocation alternatives, provide a replacement property—the list is almost limitless. A private developer also can offset excess costs, or a lower rate of return, from one portion of a project with a better outcome from another portion of the project. A private-sector developer understands the time value of money and the impact of changing market conditions.

Nevertheless, there is a limit to how much the private sector can do. The American Planning Association has written: "Many communities have observed through experience that the private sector is most often more nimble, more capable of making appropriate risk/reward decisions and, in general, more effective at being developers or redevelopers than is the public sector."[11] However, the organization notes that private developers and public agencies have "traditionally distinguishable skill sets," and that successful public-private partnerships take advantage of the best that both have to offer.

The power of eminent domain is part of the public sector's toolbox, though one hesitates to call it a skill because the term implies some proficiency and, more often than not, eminent domain has not been used well. "Development happens all the time nationwide through voluntary negotiation rather than by government force," says Dana Berliner, an attorney with the Institute for Justice. "There are also many tools that even the poorest of cities can use to promote development without resorting to eminent domain. Any city can encourage homesteading programs, where individuals who promise to develop can purchase abandoned or tax-delinquent property at a nominal amount. Cities can reduce bureaucratic barriers to permitting, zoning and entrepreneurship. Tax increment financing, tax incentives, Main Street programs, small loans, infrastructure improvements, and infill projects all can spur development without forcing someone to give up what is rightfully theirs."[12]

These are all good ideas for incremental improvements, but they disregard the fact that it is difficult to generate significant private investment in areas that are perceived as blighted, unsafe or deteriorating. Though it may be naive to assume large scale revitalization can occur ithout ever resorting to eminent domain, it is clear that a more socially responsible approach to redevelopment is necessary for creating neighborhoods that serve the city residents rather than relocate problems to less visible locations.

Equally important is that the social and economic instability that caused blighted neighborhoods is not a problem that has a real estate solution. Safe, affordable housing does help, but to be successful, a revitalization program must provide an opportunity for residents to break the cycle of poverty that has placed them in the neighborhood in the first place. Public agencies and private developers can work together to create the kind of structural changes that yield lasting solutions. ■

This paper was originally presented at the Pan Pacific Congress of Appraisers, Valuers and Counselors in September 2006.

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CRE

FOCUS ON THE ENVIRONMENT

Going Green Pays Off for Two Leading Businesses

BY MARK GOLAN

INCORPORATING BUILDING DESIGN ELEMENTS that are environmentally sensitive. Embarking on facility retrofits to conserve resources. These are no longer daring, radical concepts employed only by *avant-garde* thinkers with deep pockets. Today, going green isn't just a feel-good proposition that can get a company positive headlines and community applause.

Whether they are starting a building project from scratch or finding ways to retrofit existing facilities, companies that have committed to saving energy and resources are now enjoying national recognition—and significant financial rewards. Two examples:

- Bank of America—The financial giant is building a cutting-edge, $1 billion skyscraper in downtown New York that will generate 70 percent of its own electricity, cut water consumption in half, and rely on local and recycled materials for construction.
- Adobe Systems Inc.—The renowned developer of graphic design software has completed dozens of retrofit projects at its Silicon Valley headquarters that have had the aggregate effect of decreasing energy use by 35 percent, natural gas use by 41 percent, domestic water use by 22 percent and landscape irrigation by 76 percent.

Adobe has already earned the U.S. Green Building Council's LEED Platinum designation, the top rating that signifies meeting tough criteria for sustainable site development, water savings, energy efficiency, materials selection and indoor environmental quality. Bank of America is well on its way to becoming the first in the nation to receive this widely recognized certification for a high-rise building.

Both companies are also gaining from attractive fiscal benefits. Bank of America is receiving a Green Building tax credit from New York State worth $7.2 million over five years—enough to cover the cost of the building's environmental innovations. But there's more. In addition to anticipated operational cost savings over the life of the building, Bank of America has received a $1 million

About the Author

Mark Golan *is chairman of CoreNet Global, an Atlanta-based international association of corporate real estate and workplace executives, and a vice president for Cisco Systems Inc., where he oversees the Connected Real Estate Practice of the Cisco Internet Business Solutions Group. The team develops technologies and systems for real estate and multi-industry sectors to streamline and enhance the design/build process, reduce building lifecycle costs and foster environmental sustainability. Previously, he managed finance and engineering operations for Sun Microsystems and Hewlett-Packard, and was an investment banker at Smith Barney and Morgan Stanley. He is a member of the board of advisors for RealComm and the* Journal of Corporate Real Estate.

The Adobe Café in the West Tower of the headquarters building uses large windows to take advantage of natural light. The facility has earned the U.S. Green Building Council's LEED Platinum designation, the organization's top rating.

grant from the New York State Energy Research and Development Authority, an expedited permitting process from the New York City Department of Buildings—priceless, say many involved with construction projects—and a promised 25 percent discount from the New York City Department of Environmental Protection on future water bills.

Adobe found that going green pays off, too. The company, which has completed 72 projects at its three-towered headquarters building, spent $1.4 million, received rebates totaling $389,000, and is saving $1.2 million per year. Those who have led the Adobe retrofit effort calculate an average simple payback of 9.5 months and a return on investment of 121 percent.

A CLOSER LOOK AT BANK OF AMERICA'S SKYSCRAPER

When One Bryant Park—the name of Bank of America's 55-story high-rise in the heart of Manhattan—is finished in 2008, it will be among New York City's tallest, second in height only to the Empire State Building. It will house 1.1 million square feet of office space for Bank of America's New York operations, 1 million square feet for other commercial tenants and 50,000 square feet for the restored, historical Henry Miller Theater.

More important, it will set a new standard for high-rise construction, addressing a range of environmental concerns with cutting-edge innovations and already established environmental best practices. In many cases, strategies in one area cross over into other areas to provide benefits.

One example is the building's approach to water use. For most buildings, storm water is simply shed and dumped into the city's inadequate storm system, often causing sewage to overflow into the Hudson River. At One Bryant Park, captured storm water will combine with water from sinks, steam condensation and condensate from the air conditioning system. Treated slightly, this recycled water will be a resource for the building's cooling tower and for flushing toilets. In addition, waterless urinals will save about 3 million gallons of water annually. Together, these measures should cut water consumption by almost half.

Another water-related strategy affects heating and cooling energy costs. A pumping system will bring water from the bedrock on which the building stands into internal tanks. At a natural temperature of 58 degrees, this water will help cool the building's air in the summer and heat it in the winter.

Energy is another big savings area. The building's cogeneration power plant will provide more than two-thirds of the energy that occupants require and will operate at a higher efficiency level than utility-run electricity generation, which typically wastes 7 percent just transmitting the power over great distances. One Bryant Park's natural-gas-fired, 5.1 megawatt plant will recapture the heat energy that usually escapes from power plants, operating at 77 percent efficiency compared with the 27 percent achievement of most power plants. At night, when demand for electricity decreases substantially, the system will make ice in cellar tanks. During the day, building managers can melt the ice to supplement the air conditioning system—another way to reduce electricity demand.

Other innovations include:

- Relying on recycled content whenever possible. One example is using blast furnace slag, a waste product of steel manufacturing, in place of 45 percent of the cement needed for constructing the building. Normally, making a ton of cement releases a ton of carbon dioxide. Concrete made with slag not only sets up faster and is stronger, but also eliminates the release of about 56,000 tons of carbon dioxide at One Bryant Park.

- Providing an advanced air system that filters out 95 percent of particulate matter, ozone and all volatile organic compounds such as those found in carpet, paint and other materials. In comparison, the standard office building requirement is 35 percent filtration. An under-floor air displacement system also will provide personal ventilation rather than mixing and spreading dust, germs and pollutants through the building.
- Reducing future waste by placing wires and air conditioning in the floors so new tenants won't need to tear out ducts and ceilings when they reconfigure space to suit their needs.

Add to all this floor-to-ceiling insulating panels of glass, automatic daylight-sensing light dimmers and LED lighting. When finished, One Bryant Park should provide an inviting environment for workers as well as a standard-setting approach to new construction.

ADOBE'S TALE OF TOWERS

Adobe provides a different—but just as compelling—template for environmental sensitivity. Adobe's story begins with the summer 2001 California energy crisis. The state's governor called on large electricity users to reduce energy use by 10 percent. It was a tough challenge for a company like Adobe, whose three headquarter towers in San Jose, Calif., showed strong consideration for energy efficiency and won rebates for design even before the electricity crisis. Nonetheless, Adobe decided to see if it could do better.

The company partnered with a corporate real estate management firm to adopt a strategy of identifying multiple projects and proving the worth of each. In some instances, this strategy called for getting back to the basics of good conservation; in others, it meant employing best practices from other buildings and projects. For each initiative, the management firm completed an analysis that showed the costs, expected rebates, projected annual savings, projected return on investment and payback. By taking on one project at a time, the energy-saving team could demonstrate the value of each initiative and build credibility with each success story.

The cost to complete 72 projects at Adobe's three-towered headquarters was $1.4 million. The company received rebates totaling $389,000, and is saving $1.2 million per year. That translates to a payback of less than 10 months and a return on investment of 121 percent.

The first project was simple. Adobe launched a campaign to turn off lights, remove bulbs or reduce wattage by switching to more efficient bulbs and technology whenever possible. This provided a reduction of 337,020 kilowatt hours and a savings of about $100,000. Other projects ranged from simple steps to complex installations. Some examples:

- Modified tower cooling staging and sequencing to obtain roughly a 50 percent decrease in energy consumption. Cost: $575. Annual savings: $12,272.
- Installed Web-based, weather-station-automated irrigation controllers with a drip irrigation system

Adobe installed fluorescent bulbs in garages, and improved lighting efficiency in conference rooms and perimeter offices for annual savings of more than $110,000.

for east tower landscaping. Cost: $3,610. Annual savings: $9,001.

- Installed waterless urinals in all buildings. Cost: $35,374. Rebate: $5,396. Annual savings: $6,338.
- Converted east and west tower garage lighting to fluorescent bulbs. This project was expensive, but had the highest annual savings. Cost: $156,878. Annual savings: $86,198. PG&E rebate: $40,558. Payback period: one year, four months.
- Rewired conference rooms and perimeter offices for enhanced lighting zone control and reprogrammed relay controls for demand-response programs in east and west towers. Cost: $83,000. Rebate: $2,887. Annual savings: $28,000.

REAPING THE REWARDS OF GOOD CHOICES

Companies face increasing pressure to make environmentally sound choices, especially in a time of increasing consideration of global warming. Though most of the concern about greenhouse gases focuses on transportation and industry, the Pew Center on Global Climate Change issued a report in 2005 that estimates about 43 percent of carbon dioxide emissions result from energy services required by residential, commercial and industrial buildings. The Pew report found that using technology available today, between 30 and 40 percent of greenhouse gas emissions arising from such buildings can be reduced.

Of course, embracing an ecologically sound approach to facilities is about more than just reducing carbon dioxide, saving water or recycling materials. The examples that Bank of America and Adobe provide show that companies can respond to the environmental challenges that we all face and still pay attention to the bottom line.

The U.S. Green Building Council has pointed out that going green doesn't happen with a single decision or an individual change. It is the result of transforming the way buildings are constructed and operated so that environmentally and socially responsible policies become the default starting point for every company—with the end result being a safe, healthy and appealing work environment for occupants. ■

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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.