REAL ESTATE ISSUES®

Published by THE COUNSELORS OF REAL ESTATE *Volume 34, Number 1, 2009*

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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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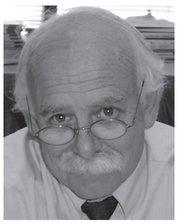
Editor's Note

BY PETER C. BURLEY, CRE

"And finally, start at the beginning!"



THIS VERY PUBLICATION WAS MY FIRST exposure to The Counselors of Real Estate. I have been citing and referencing its authors and articles in my own work for years. OK, make that decades…but, long before I was honored with the distinction of becoming a Counselor, I was more than impressed with the range of expertise represented in this organization, with the breadth of experience, the depth of knowledge and with the keen talent that exists within this incredible assembly. I may have dreamt it, but I never expected to be editor in chief of this prestigious journal, much less even to participate in assembling the thoughts, observations, experiences, applied skills—the professional leadership—that Counselors represent. But, here I am. Honored. Humbled. Exhausted. Thrilled.

This is a particularly interesting time to be presiding over *Real Estate Issues*. With the economy and financial markets in continued turmoil, and with that turmoil nipping aggressively at the heels of the commercial real estate industry, this organization is uniquely qualified to show us not only where we have been (and the troubles we've seen) but also to show us a number of routes to safety (or redemption). *Real Estate Issues* is a most suitable forum from which to refine standard viewpoints, to rethink long held assumptions, to offer up new and different perspectives and new approaches to the issues we face. Right here, in these pages, is where Counselors do some of their best work and lead the industry to new, better, higher ground.

This issue of *Real Estate Issues* begins with Peter Holland's Roundtable conversation with CREs Buck Moody, Michele Flynn, Martha O'Mara and consultant Barbara Hampton on the role of corporate real estate and the challenges confronting corporate real estate executives in today's uncertain environment. As Buck Moody says, "A lot of strategic thinking and assumptions and policies…have completely changed" when it comes to managing the corporate real estate portfolio. There are important roles for Counselors to play in this arena.

We note, with deep sorrow, the passing of Roland Dean Nelson in March. He did not leave us without passing along his wisdom and expertise, however. "And finally," he says in discussing how we might pin down the Business Enterprise Value (BEV) of a property, "start at the beginning!" While appraisers "have spent considerable time and effort on various thoughts and methods…more than one method can be applicable." Nelson covers the topic and offers an approach to the process—a creative and innovative approach—as only a CRE could do. Goodbye, Dean, and thank you.

Assessing the market and the financial environment are undertaken with particular skill by Counselors on a regular basis. Professors Joseph Rabianski, CRE, and Karen Gibler, along with doctoral students J. Sherwood Clements and O. Alan Tidwell, offer a comprehensive review of the literature covering factors that influence the success of mixed-use development. While mixed-use development has enjoyed growing popularity in recent years, and the "…synergy and appeal…" of various uses "…can increase office and retail prices, rents and occupancy rates," not all locations are particularly well-suited, and the financial feasibility of a project should be carefully considered. As the authors put it, "Mixed-use development generally moves the industry away from specialization in a property type to a more sophisticated consortium of planning and development." The authors offer some new ideas and insights to a complex arena.

Just in case it has slipped our minds, the current economic/financial/credit crisis is not confined to the U.S. The whole mess has spread across the rest of the globe. As Simon Rubinsohn tells us, "No longer is there any hiding place, even if a country's banks have been largely untouched." Rubinsohn tells us that developments in global commercial real estate markets are clearly reflecting the wider macroeconomic forces at work and no part of the property market, apparently, is immune. Rubinsohn cites the latest *RICS Global Commercial Property Survey*. But, look for opportunities in some international markets as repricing begins to attract capital.

Could we have averted the current financial crisis? I don't know. Sometimes, I wonder how things could have been different. Marc Thompson, CRE, suggests there may be a way to avert it in the future. Thompson proposes new Basel II regulations that he says will "significantly reduce the risk of another real estate boom-bust cycle threatening the viability of the U.S. financial system." He identifies speculation risk and ways to manage portfolio risk within regulated financial institutions. He further suggests that his methodology could be applied to Commercial Mortgage-Backed Securities.

Illustrating the depth and breadth of interests represented in *Real Estate Issues*, Keith Varian and Jennifer Rockwell offer a very different view of property finance in their discussion of Islamic Financing and Foreclosure. The United States has seen considerable growth in financing according to *Shari'ah*, yet few of us understand the underlying principles or its relationship with federal, state or local laws. The authors discuss common forms of Islamic financings and compare them to traditional (U.S.) mortgages to help us understand some of the issues facing the legal community, particularly with respect to foreclosure actions.

With the economy taking a huge toll on the banking system, and visa versa, it was probably only a matter of time before we began to face an interesting question: What happens to all of those bank branches out there? Bradley Carter, CRE, J. Tyler Leard, and Matthew H. Jackson offer a study intended to help those among us who counsel the banks as they struggle with the acquisition and disposition of bank branches in an evolving market. While the number of financial institutions has decreased, they tell us, the number of bank branches has continued to increase. The demise of some banks (and the absorption of others into larger institutions) leaves us with a number of questions, including: What bank branches will sell? Who is most likely to buy them? How will they be valued? What other options are out there for former branch properties? Given the volatility in the banking industry, they tell us, "good advice has never been in greater demand." We concur.

Legislation designed to assist economic recovery, in the form of the Housing and Economic Recovery Act of 2008, may indeed help us recover from the recession. But the new law, passed last July, and other government actions, including the Emergency Economic Stabilization of 2008, the American Recovery and Reinvestment Tax Act of 2009, change certain tax provisions for homeowners and investors. J. Russell Hardin, Ph.D., offers a look at some of those implications. Hardin also spells out some of the latest tax effects for REITs and REIT investors.

To many analysts, the Miami condominium market has been ground zero for overdevelopment and the foreclosure crisis. From their up-close vantage point, Miami CREs Richard Langhorne and John Blazejack offer commentary on past and current circumstance, as well as a possible outcome. As Langhorne and Blazejack say, "the ebb and flow of the public-private struggle for saving or developing pristine waterfront parcels is emblematic of each real estate cycle, whether it be a frenzied run of overbuilding or the aftermath of a complete market collapse." As Counselors, we are often in the middle of the struggle, as we should be, hoping to bring about the best possible solutions.

In my view, that is where we all are. We struggle at times, but we continue to learn and to apply our experience and our knowledge to increasingly complex situations. And we hope, in the end, to bring about the best possible solutions. Examples of our continuing effort to learn and to apply what we have learned are three resource reviews. Mary Bujold, CRE, reviews *Navigating the Redevelopment Maze*, by Brian Blaesser and Thomas Cody, while Daniel Swango, CRE, looks at *A Practical Guide to Commercial Real Estate Transactions* by Gregory Stein, Morton Fisher and Marjorie Fisher. And Buzz McCoy gives us his unique—and sage—CRE view of *Enough. True Measures of Money, Business and Life* by John C Bogle.

I'd like to take a moment to thank Maura Cochran for her several years of skillful, expert editorial leadership of *Real Estate Issues*. Maura's careful hand steered this journal to an honored place within The Counselors of Real Estate and beyond. Thank you, Maura. I hope I don't wreck it.

Also, I am honored to have Marc Louargand as associate editor. Marc's experience and expertise in putting together a journal like *Real Estate Issues* is indispensable. He's really smart, too, and great to work with. We are thrilled that Carol Scherf continues with us as managing editor, keeping us honest and, mostly, on track and on time.

As Dean Nelson said, "And finally, start at the beginning!" I continue to read *Real Estate Issues* as I always have. I continue to learn from it. And, I continue to reference the authors and articles. That I am a part of it makes me more than a little proud. ■

PETER C. BURLEY, CRE
EDITOR IN CHIEF

To send any article and/or the complete issue of REI electronically, please visit www.cre.org and go to the Real Estate Issues web page.

REAL ESTATE ISSUES

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Editor's Note: In the Volume 33, Number 3, 2008 issue of Real Estate Issues, *the biography of author Daniel Lemieux identified his firm, Wiss, Janney, Elstner Associates, Inc., as a law firm. His firm is an A/E firm. Lemieux authored* "Trust, but Verify: Building Enclosure Commissioning in Sustainable Design."

Corporate Real Estate: An Interview With Experts

Panelists:
Michele Flynn, **CRE**
President, Expense Management Solutions, Inc., Southborough, Massachusetts
Barbara Hampton
Consultant, Providence, Rhode Island
Von W. Moody, III, **CRE**
Senior Vice President, Corporate Real Estate, Wachovia Corporation, Denver, North Carolina
Martha A. O'Mara, **CRE**
Managing Director, Corporate Portfolio Analytics, Boston, Massachusetts

Moderator:
Peter L. Holland, **CRE**
Partner, Bartram & Cochran, Inc., Hartford, Connecticut

INTRODUCTION

IT'S ALWAYS BEST TO START AT THE BEGINNING. AND BEFORE real estate can be discussed as an asset class or as something to be valued, leveraged, traded or securitized, it must first be seen as a place for the conduct of work. Put simply, the real estate industry begins with a tenant's demand for space to house its products, production or employees. All that follows in the real estate industry is the result of tenant demand. Accordingly, The Counselors of Real Estate does convene a standing committee on corporate real estate, and the topic is featured in a dedicated session on the program at each of our annual and mid-year meetings.

Recently, roundtable moderator **Peter Holland**, **CRE**, had the opportunity to speak with an exceptional group of thought leaders and practitioners in corporate real estate. In a discussion with CREs Martha O'Mara, Michele Flynn, Von W. "Buck" Moody, III, and also with Barbara Hampton, who has served in several corporate positions, most recently as vice president, Workplace Resources at Hartford Financial Services Group. Holland explored current corporate real estate practices and some of the ways in which Counselors could better engage with those charged with the responsibility of managing corporate portfolios.

HOLLAND: Let's talk about the role of the corporate real estate function within an enterprise—what it does and how it fits into the rest of the organization. Where should it report, for example?

HAMPTON: A real estate organization, or as I would prefer to describe it, a workplace organization, is responsible for housing a corporation's most cherished asset, namely its people. Employees are, after all, what creates a company's competitive advantage.

O'MARA: True, and I have observed that notwithstanding this importance of real estate, while it is not necessarily badly managed, real estate may be too often undermanaged. It has less to do with where it reports than with what it does. Clearly, being close to the CFO or close to power is helpful, but that is not the point.

HAMPTON: Correct—real estate needs to reside where it can do its best work, reporting to someone who under-

About the Moderator

Peter Holland, **CRE**, *is a principal with the Hartford, Connecticut-based real estate advisory firm of Bartram & Cochran, Inc. Previously, he served as COO and CFO of CoreNet Global, where he formed part of the thought leadership of the profession and had day-to-day responsibility for the strategic direction, finances and operations of the organization. Before joining CoreNet , Holland served as senior vice president for Hartford Financial Services. He has more than 25 years of consulting Fortune 100 and not-for-profit experience in the field of real estate.*

About the Panelists

Michele Flynn, **CRE**, *is founder and president of Expense Management Solutions, Inc., a Southborough, Massachusetts-based global advisory firm recently recognized as a Top Outsourcing Advisor by* The Black Book of Outsourcing. *Flynn has written and presented extensively on the subjects of procurement and sourcing strategy, supplier relationship management, global sourcing, administrative systems reengineering, real estate finance, shared service organizational issues and corporate real estate management. She holds a master's degree in business administration from Southern Methodist University, and is certified by the Costa Institute of Real Estate Finance.*

Barbara Hampton *is a consultant based in Providence, Rhode Island. Previously, she served as vice president of Workplace Resources at The Hartford, Hartford, Connecticut. From 2004-2005, she served as program manager for Corporate Real Estate 2010, a research and leadership development initiative for CoreNet Global, the professional association for corporate real estate and infrastructure executives. Prior to CoreNet Global, Hampton served as senior vice president of corporate strategy for Spaulding & Slye Colliers, working on strategy for both internal and external corporate clients. Hampton earned a bachelor's degree in economics and mathematics, magna cum laude, from Vanderbilt University in Nashville, Tennessee.*

Von W. "Buck" Moody, III, **CRE**, *is senior vice president of corporate real estate for Wachovia Bank (now a part of Wells Fargo). In his more than 30 years of real estate experience, Moody has been involved in counseling, valuation, distressed property, due diligence, tax assessments and asset management, among other areas. In addition to the CRE designation, he holds the FRICS, MAI, CCIM, CAE, SRA designations, and a North Carolina broker's license. Moody also is a past regional chair and board member of the Appraisal Institute. His community service has included serving on the boards of various organizations including Rotary, and service with Habitat for Humanity, United Way and Wachovia's Diversity Counsel.*

Martha O'Mara, **Ph.D.**, **CRE**, *is a leading authority on the integration of corporate real estate planning with business strategic planning. She is co-founder and co-managing director of Corporate Portfolio Analytics, Boston, which applies portfolio planning processes, real estate market intelligence, and forecasting tools to corporate portfolios. O'Mara also lectures in real estate executive development at the Harvard University Graduate School of Design, and serves on the Harvard Alumni Board for Real Estate. She earned a bachelor's degree in social ecology is from the University of California, Irvine; a master's degree in both sociology and business administration from Harvard; and a doctorate degree in organizational behavior, jointly awarded by the Harvard Business School and Harvard's Graduate School of Arts and Sciences.*

stands the imperative of integrating human resources, information technology and real estate. This is no longer about bricks and mortar or even deals. It is about the conduct of work and the ability of a business to recruit and retain first-rate employees and to enable those employees to be as productive as possible.

FLYNN: Real estate may well report to a CFO, or perhaps to a COO in an industrial company—where it reports really depends upon the business of the organization itself. As companies begin to recognize how critical it is to integrate the functions needed to support their employee base, we are seeing the creation of an integrated shared services organization. In fact, the real estate or "box" is key, but so too are technology, human resources, food service, procurement, fleet, travel etc. They all enable work. We ask clients to think, and to think hard about the mechanisms and structures that make integration among these functions as seamless as possible.

MOODY: I, too, see corporate real estate's role as a facilitator of the core business. Real estate directors must ensure that they are fluent in the language of the business and that the real estate strategy is closely aligned with the corporate strategy.

HOLLAND: It strikes me that real estate directors are generally anxious about meeting corporate expectations. In particular, some of this angst would appear to be associated with a changing role for real estate within large organizations.

HAMPTON: Corporate real estate executives may well be nervous, and they are often at risk, but that is primarily in the event that they have failed to think and act strategically. But, directors of real estate really do need to make better decisions about their own roles, particularly considering the responsibilities they may have delegated to their outsourced service providers.

FLYNN: Both internal and external corporate resources must clearly understand what is required of themselves and of each other. The standard of performance is indeed very high, requiring excellent functional skills, an ability to enable technology, and flawless execution. The number of service providers who can manage the complexity—the depth and breadth—of a global real estate portfolio is, in fact, very limited. As more and more companies have outsourced, real estate directors now need to manage those outsourced relationships effectively. Given the tightening of the supplier market, we may see a return to "point" solutions utilizing multiple vendors. This has become more viable for corporations, as collaboration software tools now make it easier for companies to effectively manage multiple vendors.

MOODY: In my view, large-scale M&A activity has created a new set of demands on the corporate real estate executive. Such events generally result in redundancy of facilities and accelerate the functional obsolescence of certain properties within a corporate portfolio.

HOLLAND: Does the current economic recession create an opportunity for corporate real estate professionals to display leadership and to accomplish heretofore unrealized goals?

MOODY: The unprecedented challenges in the financial services industry have elevated the role of the corporate real estate function. Again, the wave of M&A activity is just one example. A lot of strategic thinking and assumptions and policies about matters such as lease versus buy have completely changed. There are still companies that don't maintain an accurate database of their portfolios. I would advise anyone with portfolio-wide responsibility to understand and actively manage that portfolio and to identify consolidation and expense reduction opportunities, not to mention for valuation purposes during the due diligence process. In our M&A experience, integration needs to happen fast for both operational and expense reasons. Integration requires a well-oiled real estate function.

HAMPTON: We have always known that we need to minimize costs and maximize flexibility through strong contract language in lease documents and purchase and sales agreements. This is even truer today.

O'MARA: Just knowing the impact of real estate on financial statements reveals that real estate can influence overall corporate performance. As Buck indicated, real estate needs to revisit how it analyzes alternatives such as lease versus buy decisions. Some answers given in the past are simply wrong. It is possible, for example, for a long-term lease to be less flexible and beneficial to the corporation than an ownership position. To a large extent, these are also decisions that properly reside in treasury or finance and not solely in real estate. Maintaining a predetermined ratio of owned and leased property is not a portfolio strategy.

MOODY: An acquisition, merger or any "life-as-we-know-it" event creates an opportunity to advance alternative office techniques such as hoteling, mobile work force or what we call "touch down" space for employees who no longer have a fixed office. We need to increase the efficiency of our space utilization. We now have 10 percent of our corporate real estate employees working remotely, at least to some degree. Technology will make it possible to work more and more in non-traditional space.

FLYNN: It would be unacceptable for an industrial concern to operate at 50 or 60 percent efficiency in a manufacturing plant, but corporations do this all the time with their office space. There is a trade-off, however. The cost per square foot may increase due to more expensive collaboration space, technology and building systems, but the number of square feet can drop dramatically. I see less space, but better space, and space that is used for longer hours to accommodate businesses that span the globe and every time zone. We find that the math works on this exchange.

O'MARA: The economy, as difficult as it is, does provide a "bully pulpit" for the real estate director. If a company is in survival mode, it will likely be willing to more closely heed a real estate department's advice. Companies are starting to recognize that office space is no longer used in the ways that it once was. Michele and Buck are correct about efficiency levels, but even dramatic changes may not require significant capital. One can, for example, go from assigned space to unassigned space without a lot of expense. It does require attention to thoughtful change management.

MOODY: The economy has provided the incentive, but the availability of technology such as VOIP and the widespread use of PDAs has sure helped to make it possible.

HAMPTON: In addition to the economy, corporations are also now looking to real estate for leadership on sustainability. Who can better calculate an enterprise-wide carbon footprint than corporate real estate? This of course also links to people working at home—it reduces traffic and the need to heat and cool office space. You asked earlier about organization, and in order to do these things, I should add that the real estate function must be centralized. Carbon tracking requires accurate and complete portfolio data.

O'MARA: The public accounting of a company's carbon footprint will drive change, but in order to really accelerate change there has to be some turnover in a portfolio. The default position was always simply to renew. We all know what it is like to try and consolidate space from head count reductions in small increments across departments and across a portfolio. Yesterday's "Swiss cheese" of vacant office space will now likely aggregate into meaningful blocks of space whereby material overall reductions of office space will be possible.

FLYNN: There have been a lot of good comments and observations here, but I want to add that people can no longer protect the old ways of doing business. There need to be some radical decisions to deliver efficiency and effectiveness. Good companies are seeing the human resources and real estate or workplace areas designing and implementing overall corporate workforce strategies. Given this strategic focus, outsourcing of many traditional real estate functions continues as a trend.

HOLLAND: We have touched on outsourcing already, but let's discuss the topic further.

FLYNN: Many functions can clearly be successfully outsourced, and there is a proven track record of corporations and service providers structuring excellent arrangements. In no small measure, successful engagements result from the alignment of objectives by the two parties. Such tasks as project management and lease administration, for example, can work well. In other areas, however, the persistence of a brokerage commission-based compensation structure can be problematic as it can serve to misalign objectives. And commissions simply may not be able to support all of the work. Whereas corporations have expected to receive real estate strategy services for "free" as part of a larger deal, I would suggest that such services might be better delivered with direct compensation. A weak economy will further exacerbate the commission-driven model.

HAMPTON: I agree that the process of developing a meaningful strategy is a great example of something that has value and, as such, merits compensation to a vendor. I want to add that the "whole package" of compensation needs to be fixed.

MOODY: The size of a deal or the rate per square foot may be unrelated to the strategic value of a deal to a business. ATM locations are a good example of something that could have strategic significance to a bank, but that yield very little income to a service provider in a commission-based contract. The working interactions between corporations and service providers need to result in solutions that provide adequate incentives for such non-conventional service.

FLYNN: We are recommending a number of alternative compensation structures, such as a fixed price per square foot per annum, variable unit cost models whether a deal is done or not, or some other fixed or flat rate management fee. In addition, we'd like to see service providers put some of their fees at risk, based on performance.

HOLLAND: You have provided some wonderful observations on the corporate real estate industry today. How can members of The Counselors of Real Estate help?

O'MARA: The visibility of the corporate real estate industry needs to be raised in general, and within The Counselors of Real Estate in particular. It is not a backwater, but as you pointed out, tenant demand drives the entire real estate industry. I also believe that corporate real estate as an industry requires stronger and better thought leadership.

FLYNN: There is a need for more competition among the integrated service provider firms, particularly from firms with true global capability. There are yet unmet opportunities and some of these opportunities can be met by Counselors.

MOODY: There will be opportunities for Counselors from among mid-cap companies, banks, and special asset groups in banks of all sizes. Obviously, the distressed properties work right now is an example of a tremendous opportunity for Counselors to provide guidance for the financial services companies. And, Counselors should think about providing assistance to corporations with a presence in smaller second- or even third-tier cities.

HAMPTON: There are also opportunities to make productive business connections in other organizations, such as IAMC or CoreNet Global. I know that many Counselors also participate fully in those organizations. I agree with Marti that Counselors need to continue and even elevate the presence of corporate real estate on their meeting agendas and within this publication. Counselors who wish to expand their practice areas into corporate real estate may wish to consider the organizations I just mentioned.

Corporate real estate organizations need internal and external talent to undertake their work. They need broad-based business skills, great communicators and people with technical expertise. I submit that The Counselors of Real Estate is a great place for corporate real estate executives to source this talent. ■

Enterprise Component Allocation: Methodology Discussion

BY ROLAND D. NELSON, CRE

Editor's Note: *Roland D. Nelson, a CRE for 30 years, passed away in March 2009.*

BUSINESS ENTERPRISE VALUE (BEV) HAS FOR MANY YEARS eluded a universally accepted method of appraisal. It has been the subject of much discussion, writing and even litigation. By definition intangible, BEV is difficult to pin down. This article reviews various methodologies for estimating BEV, and discusses how it relates to various types of real estate.

Business enterprise value is a component of going-concern value, which is defined in *The Dictionary of Real Estate Appraisal, Fourth Edition,* as:

1. The market value of all the tangible and intangible assets of an established and operating business with an indefinite life, as if sold in aggregate; also called *value of the going concern*;
2. Tangible and intangible elements of value in a business enterprise resulting from factors such as having a trained work force, an operational plant, and the necessary licenses, systems, and procedures in place;
3. The value of an operating business enterprise. Goodwill may be separately measured but is an integral component of going-concern value.

Going-concern value was originally defined by the United States Supreme Court in a 1933 case involving a public utility (Los Angeles Gas & Elec. Corp. v. Railroad Com'n, 289 U.S. 287), as follows: "This court has declared it to be self evident that there is an element of value in an assembled and established plant, doing business and earning money, over one not thus advanced, and that this element of value is a property right which should be considered in determining the value of the property on which the owner has a right to make a fair return."

A counselor or appraiser may be requested to isolate the BEV, which is defined in *The Dictionary of Real Estate Appraisal, Fourth Edition,* as follows: "A term applied to the concept of the value contribution of the total intangible assets of a continuing business enterprise such as marketing and management skill, an assembled work force, working capital, trade names, franchises, patents, trademarks, contracts, leases, and operating agreements." Reasons to separate BEV components of a going concern include: 1) benefits to the ownership of the after-income-tax cash flow; 2) property tax purposes; 3) mortgage lending allocations; and 4) general property analysis. Identifiable real estate entities that have basic earmarks of enterprise components include: restaurants, gasoline service stations, hotels, marinas, shopping centers, bowling alleys and nursing homes.

About the Author

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Real property is sometimes valued and subtracted from the going-concern value to isolate the BEV. Conversely, one can value each non-real estate component, separate these items from the value of the going concern, and thus isolate the value of the real estate. Also, BEV components could be identified by employing a discounted cash flow (DCF) analysis. The difference between the value of the property as currently in operation and the same property if vacant and available could well be the business enterprise value.

In any type of analysis, the appraiser should first research the market for items that are the easiest to identify and isolate. By elimination, the components of the BEV can be narrowed down to the more difficult items to value.

Generally, when the market declines on volatile, relatively short-lived enterprises, the last item of value remaining is the BEV, including licenses, operational expertise, supplies, etc. An operation that no longer supports the land and/or improvements will finally be closed, at which time the highest and best use of the real estate is greater than the current non-performing use; hence there is no BEV.

This author is in general agreement with most articles and valuation analyses regarding valuations of BEV, but concludes that there are no perfect or superior methods. Appraisers have spent considerable time and effort on various thoughts and methods, and most agree that more than one method can be applicable.

There is another component of real estate enterprise and BEV that needs to be defined, that being goodwill, defined in *The Dictionary of Real Estate Appraisal, Fourth Edition* as:

1. An intangible asset category usually composed of elements such as name or franchise reputation, customer patronage, location, products and similar factors;
2. The intangible asset that arises as the result of name, customer patronage, location, products, and similar factors that have not been separately identified or valued but that generate economic benefits.

Under IRS Section 197, goodwill is to be amortized over a 15-year period for income tax purposes.

The aim of many investors is to seek "tax shelters" in real estate-oriented properties for after-tax cash flow returns. Historically (prior to 1992), when enterprises were sold, the general tendency was to minimize land value, allocate everything possible to depreciable tangible improvements, and ignore business value. Currently, for income tax purposes, the depreciable real estate improvements are amortized over 39 years.

Is it appropriate to depreciate old, worn-out real estate improvements in economically depressed locations that may have a ten-year remaining economic life, but for income tax purposes, the investor is required to depreciate the improvements over the next 20 years remaining of the 39 years of depreciation? (If built after May 1993, or a 31.5-year period of depreciation is applicable if put in service after 1986 and before 1993.)

Today, many lenders are looking for the vacant-and-available value of property being mortgaged, as these institutions are basing loans on collateral value of the real property, whether an owner-occupied office building, industrial plant, commercial building, etc. What would mortgage loan terms be on commercial property without personal liability on the mortgage indebtedness? Could the difference be something other than real estate value, and/or could the difference be depreciated for IRS purposes as a business value? These interesting concepts are based on common logic and valuation procedures.

The assessor should be looking at the vacant-and-available status of all property for tax assessment purposes in states that assess on a fee simple, market value basis (as required, e.g., by the Michigan Constitution). Generally, value of recently leased commercial buildings could be greater than that of similar vacant buildings, which could take time to lease up and incur expenses during vacancy, including rent loss, leasing fees, management, insurance, debt service, property taxes, maintenance, security, utilities, etc. An assessor should not penalize a landlord of a vacant building by placing an assessed value equal to that of a similar occupied building; and the owner of leased property should not be required to pay taxes on property subject to existing occupancy (BEV). This analysis is applicable to the real estate investor's maximizing his/her after-tax cash flow position.

For some time, counselors and appraisers have used the DCF method to analyze and value property, including enterprises (BEV), that have not achieved market stabilization, as well as for properties that have contracted variable income streams. Investors/lenders often require various value estimates for a project, i.e., as is, as if complete and as if stabilized. These indicate a possible—

and very probable—BEV allocation. Assume there are two physically and functionally similar apartment buildings in similar economic locations. Assume one is vacant and one is in a stabilized operating condition. In good times it is easier and less time-consuming to fill up the vacant building, than in economic down times. This is indicative of a possible greater BEV in some properties that are in poor economic areas versus in good economic areas. The lease-up costs are generally not considered real estate and could reasonably be depreciable for income tax purposes.

These old residual techniques for land and buildings were developed in the mid- to late-1930s. Some articles analyze successful enterprises by applying residual techniques to the stabilized net income, and reasonably suggest that the difference between the net income necessary to justify the improvements and the projected pro-forma net income is the net income (value) that accrues to the non-realty components.

There are allocation methods based upon various formulas involving franchise value percentages and business portion allocations. An overall capitalization rate applicable to business-oriented real estate, such as a hotel, should be higher than a capitalization rate that is appropriate for a leased, high-profile fast food franchise.

In general, these approaches are reasonable. However, can these approaches be applicable to an economically marginal BEV property? A marginal BEV property could be any business-type of property located in an area where new competition or changing economics have limited the property's economic future. In a marginal operation, an interest rate on the land alone might require all of the net income from the enterprise to satisfy the demands of the land.

However, a marginal enterprise could have some BEV. The BEV could be the last component of value remaining, short of salvage value (furniture, carpeting, elevator cables, etc.). Not every BEV will represent enough net operating income to cover the depreciated value of all of the improvements, including land. This author's article, "Valuation of a Pari-Mutuel Race Track," *Appraisal Journal*, April 1989, states that in the valuation of a successful operation:

> "The depreciated value of the improvements (cost less physical, functional and economic obsolescence) plus land must be less than the capitalized value of the Enterprise because the difference has to be related to start-up and organizational costs, FF&E, the licenses and working capital, etc. These types of items, along with inventories, are always part of the operating enterprise.
>
> If the capitalized value is less than the depreciated cost, the Practitioner must rethink the valuation. The value of the Real and Personal Property should be less than the value of the enterprise because the business components of value are generally always present in an operating business and exist to a point at which perhaps they are the only components of value. When this occurs, it is most likely that the appraiser has not calculated all of the functional obsolescence and physical deterioration and, most importantly, has not recognized all of the existent external obsolescence. If present, external obsolescence must be properly calculated and addressed. External obsolescence is basically the difference between the amount allocated to Real Property as obtained by use of the Income Capitalization Approach and the amount obtained by the Cost Approach based upon physical deterioration and functional obsolescence provided that both approaches have been properly executed."

The valuator should always go to the market when valuing the components of a BEV. If one can't find it in the market, one probably should not use it in an analysis. Find out how enterprises are put together, i.e., identify their components. The net operating income produced in an income approach must support all aspects within a going concern by providing a return on all components, such as land, building, licenses, inventories, start-up/organizational costs, etc.

A cost approach involves adding the land value and hard and soft building costs, including developer's profit, interest and taxes during construction, costs of licenses, fixtures, working capital, etc., including cost required to bring the going concern into a stabilized operating condition at the date of valuation.

This author is suggesting that in the allocation of improved real estate, one should look to the underlying land value. Vacant comparable land sales are appropriate for the valuation of a new property. When improvements are economically worn out, demolition costs would be deducted from the land value. There are generally no arm's-length vacant land sales in the marketplace to reflect the value of land as-if-vacant that is under normal operating improved properties. Hence, one could consider amortizing demolition costs to the as-if-vacant value over the remaining life expectancy of the improvements, which would allocate a higher appreciable valuation to the improvements for IRS after-tax cash flows.

At this point it is appropriate to address the subject of entrepreneurial profit. *The Dictionary of Real Estate Appraisal, Fourth Edition* defines entrepreneurial incentive as: "A market-derived figure that represents the amount an entrepreneur expects to receive for his or her contribution to a project and risk."

Reviewing a cost manual, or an architect's cost breakdown, indicates that there are many components of entrepreneurship that must be taken into account within the calculation described above. Consider the following: someone had to originate the idea. Idea people get paid for their good ideas; some even get paid for bad ideas. Regarding a hotel: someone created the idea; found an economically viable area for development; located a site and negotiated a sale for the site; selected a builder and architect; decided on elevations, floor plans, franchises; conducted investigations; and so on. Someone has to be paid, or an allowance made to compensate for these ideas, financial backing and courage. Normally, informed investors do not build something to have it worth, upon construction, only what it cost. There has to be a profit incentive (entrepreneurship) that is typically added to the improvement costs and reasonably allocated for income tax purposes.

It is not as simple as acquiring a McDonald's franchise and constructing a build-to-suit building. The more speculative and development-intensive, the greater the entrepreneurship needed to get the deal started. Entrepreneurship is not tangible real and/or personal property.

Shopping centers present their own unique challenge to determining BEV. Several articles written about potential BEV in shopping centers relate a BEV to percentage rent, and/or rent in excess of market rent. None of the articles seems to have developed the vacant and available approach to discovering the BEV. Placing a new shopping center on the open market and using a DCF analysis derives a value that could be based on market rent, or could be based on vacant-and-available subject to costs associated with obtaining occupancy. The costs required to bring a shopping center into stabilized operating condition (including entrepreneurship) can be subtracted from the DCF value to determine the value of the real property. The difference between this value and the value-in-operation is often attributable to the value of the intangible, non-realty components of the BEV.

Along with reference to percentage rents, numerous shopping center valuation articles cite management contracts in place, and various rental rates based on dollars per square foot of building area, depending on a unit's location, size and the center's tenant mix. This accounts for the fact that not every tenant in a major shopping center makes an equal financial contribution to the total income.

In any developed and reasonably well-managed shopping center, the calculation of a BEV using contract rent versus market rent and existing management contracts seems only to be a guessing game. A well-managed center does not necessarily mean a center that is financially successful, as it could also be past its prime or in financial difficulty. Good property managers attempt to maximize income over the remaining economic life of a property. Percentage rents, typically based on gross sales, are based on a tenant's business. Management fees are not the BEV of a property. After deducting a percentage of gross income for management fees, including any incentive fees, generally there still is BEV.

In most business-oriented operations, there are departments that are necessary for the total business to operate well, and these departments do not all contribute equally to the bottom line. In a typical full-service hotel, rooms generate the money and management hopes food and beverage components break even. Similarly, golf courses have pro shops and cart rentals; marinas have gas docks, boat repairs and/or boat sales.

Let's look at a typical enclosed shopping mall with a 2,000-square-foot store on each side of a corridor. One store is rented for $25 per square foot by a jeweler and the other rents to a coffee shop at $8 per square foot. What is the market rent for each store?

Appraisal literature reiterates that if market rent is more than contract rent, then a leasehold interest exists, and not a BEV. When contract rent is more than market rent, it is income to the going concern. Economics can and do change, sometimes overnight, and remember, excess profits often breed ruinous competition.

As appraisers press on with the challenge of analyzing going concerns and, within reason, calculating the BEV, we should continue trying various approaches for improvement. Often this is a matter of keeping in mind some of the basic principles and methodology discussed in this article. In good economic times and in good locations for a particular property, there is less risk achieving stabilized occupancy. In economic downturns, the property in good operating condition could have a greater BEV, as it is more difficult for a business-related property to reach stabilized operating condition. A DCF analysis allows changes to the allocation of non-realty items occasioned by economic times, conforming to the Uniform Standards of Professional Appraisal Practice, and further identifies non-realty items, which can be depreciated faster for after-tax cash flows.

And finally, start at the beginning! In a BEV property analysis, it is generally judged most wise and educational to consider starting from scratch, such as with a vacant-and-available allocation approach to value. How would a developer look at a property? What are the steps and costs needed to get the enterprise into its current condition as of a specific date? Get data and information from the market, if possible.

It is our responsibility as appraisers/counselors to advise clients of various possibilities for allocating non-realty items, which could dramatically affect after-tax cash flow that a property can offer. The real estate appraiser/counselor has the ability to be much more qualified than CPAs and others who often perform the required allocation of an enterprise transaction for the after-tax cash flow concerned investor. We appraisers are able to take a more in-depth look at the market and a wide variety factors—and thus offer a more creative and innovative approach. ■

Contributing to the ideas and editing of this article were Coleen Handlon-Shaull, general real estate appraiser, who has been associated with Integra Realty Resources in Detroit for more than 20 years, and Ken Blondell, MAI, president of Integra Realty Resources–Detroit, and Nelson's partner.

Mixed-Use Development and Financial Feasibility:

Part I - Economic and Financial Factors

BY JOSEPH S. RABIANSKI, PH.D., CRE; KAREN M. GIBLER, PH.D.; J. SHERWOOD CLEMENTS, III; AND O. ALAN TIDWELL

INTRODUCTION

MIXED-USE DEVELOPMENTS ARE GROWING IN POPULARITY AS they reportedly can create additional value and outperform standard single-use real estate developments. The synergy and appeal of a quality mixed-use development can increase office and retail prices, rents and occupancy rates as well as accelerate absorption rates. Retail tenants may be willing to pay higher rents because of the increased customer traffic generated by the compatible and complementary uses. Residents and hotel guests are attracted by the convenient location of dining, retail and entertainment venues on the site. However, some locations are not well suited for mixed-used developments, and careful consideration must be given to the financial feasibility of each specific project.[1]

Financial feasibility of mixed-use development occurs when the return on the investment meets or exceeds the required return of the developer and/or the investor. Evaluating financial return on a mixed-use project is more complex than with a single-use development. While some economies of scale may be achieved, the complexity of multiple uses may raise development and operating costs. On the other hand, the synergy of complementary uses may increase cash flows. Financing development is complex and can be more costly than for single-use developments. Measurement tools for such financial success are expressed in different ways. Discounted cash flow analysis generating an internal rate of return is one important tool. Debt service cover and cash-on-cash are also considered useful tools.[2]

Some developers believe that a mixed-use project diversifies risk across the multiple uses.[3] Other developers believe that the added financial and physical complexity of a mixed-use development, in addition to longer development timelines, heightens the uncertainty associated with the project and thereby increases the level of risk.

Factors influencing the financial success of a mixed-use development can be grouped in the categories of economic and market, financial, physical and public issues.[4] This article will focus on economic and financial factors in the professional literature.

ECONOMIC AND MARKET FACTORS

The Local Economy

A general economic precondition for the financial success of a mixed-use project is a strong local economy. Employment, population and consumer disposable income should be growing. This growth benefits both tenants and customers for the uses on the site. A mixed-use project developed in a stagnant or declining local economy can have problems attracting quality tenants, an adequate number of customers and rent levels high enough to ensure financial success. A stagnant or declining local economy can be perplexing for a community that wants a mixed-use development to serve as a catalyst for urban regeneration. However, it may be possible for a certain geographic market area to grow within a larger stagnant local economy. A possible scenario is a high-income geographic market area within a stagnant local economy. The population base of high-income consumers could be underserved (excess demand) for high quality retail goods and convenient personal services such as medical and dental services, accountants, insurance agents and attorneys. In addition, the "empty-nester" portion of the population base desires

FEATURE

Mixed-Use Development and Financial Feasibility: Part I - Economic and Financial Factors

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to remain in the area but also wants to downsize to luxury apartments or condo units. This situation could support a mixed-use development of retail, office and residential units. Another possibility is that a strong tourist component could offset some lack of local economic vitality, especially if hotels and entertainment venues were incorporated into the development.

If the geographic market area is depressed or distressed, whether in a stagnant or declining local economy, public sector assistance, incentives and/or participation need to be considered. Because of the positive externalities that such projects are expected to generate and the risk that developers are taking by investing in a depressed area, these projects will rely heavily on public/private partnerships and financial support. Examples include tax abatement for reimbursement of infrastructure costs,[5] tax increment financing for parking structure construction,[6] and acquisition of land that is then leased to the developer.[7]

Market Analysis

Market analysis for a mixed-use development is important in determining the demand and supply of each use on the site. It should be used in the same manner as in analyzing a single-use project. The analysis should demonstrate sufficient net demand from both on-site and off-site consumers for each use that comprises the development. This is because "… many tenants' businesses will depend on demand from the surrounding area."[8] In addition there are other matters that the mixed-use market analysis should consider.

Market factors are not static; they change with time and other influences."[9] A market analysis should examine trends and forecasts to capture the influence of changing economic, demographic and psychographic factors of demand. "Two keys to success are to do your homework upfront, and to revisit it regularly at every phase and after build-out. These market analyses need to be fine-grained and tailored enough to your locale for you to identify both shifts in preferences and niches that aren't served. This requires a dual-pronged approach to evaluate the market at that point in time and the other to assess how well you're meeting it. As the market changes, so should your project."[10] Market research should be performed early in the developmental process and in some cases, depending on the timing and absorption, updated throughout.[11] These statements apply to single-use as well as mixed-use developments, but the complexity of the analysis increases when the number of uses increases.

A word of caution appears in the following statement: "Just because you have high-end retail doesn't mean you have a high-end condo market."[12] Each use needs to be analyzed with regard to its own demand and supply situation and its relationship to the other on-site uses. Each use on the site must attract sufficient market demand to make it financially feasible. The financial success of one use should not be expected to carry a weak market performance by another use. The contributory value of one use should not subsidize the other uses on the property. The denotation in these statements is clear but connotations are also present. First, while the development is planned and evaluated as a whole, the analyst must also consider the risks of all phases of a multi-phased project not being completed as planned, and some anticipated uses not opening. For example, the project could have retail with residential on top planned for phase one, and offices in a separate building planned as phase two. Over time, the office market could weaken and phase two is either scrapped or changed to more retail and residential.

Second, the completed phases and the active uses should be financially viable. In some situations these phases and the active uses may be financially feasible but not attain the return that was anticipated from the mixed-use project that was planned. The problem/solution partially depends on which use is curtailed or lost. The key retail tenants are those that draw strongly from the traditional retail trade areas but also draw customers from outside traditional trade area boundaries; these tenants cannot be lost. The key residential units must match the demand from the market. If the development plan calls for equal numbers of one-, two- and three-bedroom units in each phase of the project while the market demands only one- and two-bedroom units, vacancy in phase one will be high, making that mix of residential units financially unsuccessful. The planned units must change if phase two is to be built.

The geographic extent of the retail trade areas of each of the anchor tenants and the majority of the non-anchor tenants needs to be considered.[13] Several points to recognize are:

- The retail trade area for each retail tenant is not the same. Some of the shops will attract customers from a greater distance than other shops. Therefore, a three- or five-mile ring could be too much geography for some stores and not enough for other stores.
- The retail trade area for the most prestigious retail store or the major anchor store is not the retail trade area for the project.[14] The anchor store might draw customers from five miles away but the non-anchor tenants may only draw from a two-mile radius because of competition in other retail facilities.
- A properly developed mixed-use property has the potential of attracting customers from outside conventional trade area boundaries. Adding components such as parks, walking trails, playgrounds, ball fields, community centers, and even municipal buildings can create habitual or repetitive traffic flow from outside the traditional boundaries. These elements will give customers more than one reason to come to the development and can ensure that they visit the development on a regular basis. Boutique shops and soft goods retailers, which make mixed-use developments more enjoyable and not just functional, rely on regular visitors from greater distances who are likely to patronize these shops.
- Entertainment venues may draw customers from a geographic market area beyond the market area for the retail uses.

The residential market area for the mixed-use project will more than likely not be the same geographic area as the retail market or trade area, and the office market area may differ from both the retail and the residential areas. The market analysis for a mixed-use development may need to consider a different geography for each specific on-site use.

On-site Synergy

On-site uses need to be compatible, complementary and mutually supportive for synergy to exist. If synergy is achieved, it increases customer patronage, rent levels, sales volumes, and both the investment value and the market value of the project; thus, the mixed-use project has the potential for creating greater total value than if each of the uses were developed in separate locations. Generating synergy in a mixed-use development requires that each on-site use serve as an amenity for the other uses and the tenants add to the revenue the uses would otherwise generate from the surrounding neighborhood. Occupants of the office space can generate additional sales for the retail facilities and restaurants beyond what would be expected from area residents. Office tenants are likely to use hotels located in close proximity to service their clients. Office and retail workers may speed lease-up of the residential units. To encourage this synergy, the price mix of residential units should provide options for the categories of workers expected in and near the project.

Some of the financial benefits of mixed-use development emanate from the close proximity of a variety of uses with different peak demand times, increasing the hours that facilities are generating income. The development needs to balance night and day activities so that everything on the site does not shut down at the end of the workday.[15] With a "24/7" vitality as an ideal goal, bringing together users who will use facilities at different times of the day or days of the week increases the potential revenue tenants can generate. While office workers might dominate the weekday luncheon crowd at restaurants, residents and hotel guests could form the majority of the dinner and weekend trade.

A clear relationship exists between the prospect of synergy and the size of the mixed-use project. This is a definite direct or positive relationship but it is not known whether the relationship is a straight line, a curve that increases at a decreasing rate, or a curve that increases at an increasing rate. At the low end of the spectrum there is very little or no synergy in a mixed-use development consisting of a single residential unit, a single small-scale retail store and a small-scale office structure located adjacent to each other on a single site. However, as the number of residential units increases, a synergistic effect can benefit the retail store. Then, if the most desired tenant mix in the retail space is achieved, it can benefit the residential units by generating higher rents.

Relationships with the Surrounding Market

A successful mixed-use project must be compatible with its neighbors and integrated into the community to maximize its economic effect. Strong linkages among on-site and off-site land users are important. Off-site residential growth leads to an increased demand for on-site commercial activity such as retail stores, restaurants and personal service establishments. The on-site users such as restaurants need to serve potential customers (residential users and office space users) living or working in close proximity to the project.

Competition with existing single-use developments must be considered. For example, building retail space in a mixed-use project near a highly successful super-regional mall surrounded by power centers, community centers and a lifestyle center may lead to high on-site retail space vacancy and a lower rent schedule, while the office and residential components of the project are financially successful. This same reasoning carries over to the on-site housing option. Building more condo units in a saturated local condo market is not a good plan but building apartments could be. Similarly, building a hotel on site could be a problem if the existing market has excess hotel space. Financial success depends on "being able to maximize and mix the uses in a way that responds to market conditions, opportunities and economics…"[16]

FINANCIAL FACTORS AND ISSUES[17]

A multitude of financial factors can contribute to the success or failure of a mixed-use development. From the planning stage through construction, to lease-up and sale, the developer must maintain focus on the integrated finished living and working environment that the development promises. The complications of multiple ownerships, loans and leases, as well as the possible increased cost of construction and time for development make financial planning and oversight essential.

Financial success depends on minimizing the requirement for initial equity funds. Try to find lenders who are willing to provide high loan-to-value ratios, and try to obtain development incentives from the local jurisdiction.

Lending Issues

Financing construction is a critical element of the deal. Most developers will want to minimize their initial equity in the property, trying to find lenders willing to provide high loan-to-value ratios; however, equity requirements may be higher than for single-use projects. Larger capital requirements limit the number of development firms and financial institutions that have the resources to undertake a mixed-use project. Development incentives are often available from the local jurisdiction if the government is trying to attract development into a blighted area or encourage denser development in urban rather than rural areas or at transit hubs.

Even though mixed-use developments have complicating aspects that make them more difficult for which to structure financing, efficiently priced capital is available for well-conceived mixed-use developments. Lenders' willingness to provide funds may be primarily attributable to:

- Financial success of completed mixed-use developments across the nation;
- Increased lender sophistication;
- Profusion of mezzanine capital and other unsecured debt;
- Municipalities providing cash subsidies, property tax abatements or tax increment financing.

Although capital is available for developers, lenders thoroughly analyze the proposed development as well as the developer. The primary lending criteria used are:

- Adequacy of the developer or the financial partner to deal with any cost overruns;[18]
- Unleveraged yield on cost;
- Economic environment of the location—adequacy of consumers' and the project's ability to achieve market thresholds;
- Risk profile of the development—preleasing, sales and absorption time;
- Developer's history and track record—ability to complete the job on time and according to budget.

Lenders have difficulty determining how well the land uses work synergistically as a single development and estimating the varied sources of the components of income. They tend to evaluate the overall mixed-use project as a weighted average of the individual property types, as collateral that could be sold off separately.[19] Underwriting each land use separately adds to the complexity and cost of the deal.

How the financing is structured will influence the ownership structure. If a single lender is financing the construction, then that lender would prefer a single borrower entity that owns all of the project's components. However, if the project is structured such that each of the land uses is in separate ownership with one asset per special purpose entity, the developer has a more flexible exit strategy with the ability to sell pieces at different points in the development cycle and repay each construction loan. Exit strategies are being emphasized more by lenders as the investment cycles are different for different uses.[20] Creative solutions include individual financing of multiple land parcels, each with a separate use, or allowing early partial releases of parcels.[21]

When mixed uses are vertical in a single building, staging/phasing and financing issues are more complex.[22] Also, because many mixed-use projects take longer to develop, phasing takes place over a longer period of time.

When a single construction loan has separate take-outs for the project components, the construction lender is dependent upon each of the permanent lenders to accomplish full take-out of the loan. A large permanent loan on the entire property may be more attractive to many lenders; however, individual loans on each property type parcel will give the owner greater flexibility in exit strategies.[23]

In addition to private financing, a variety of public financing tools may be available for mixed-use developments. Tax abatement may be available for reimbursement of infrastructure costs.[24] Parking structure construction may quality for tax increment financing.[25]

Costs

Several features of mixed-use projects can lead to higher development costs. Initial planning costs are much larger for mixed-use developments because of the complexity and need to integrate varied uses. In addition, the project may require multiple approvals from local regulators under a variety of zoning, conditional use permits and variance requirements.

Then the builder may be required to comply with different building codes for each use, adding to the complications, costs, and the time required to build the project.[26] Residential uses in mixed-use buildings often have to be designed and constructed to meet commercial standards for handicapped accessibility, fire safety and mechanical requirements. In addition, special design and construction features may be required to reduce incompatibilities between uses.[27] If the development features a pedestrian-friendly design with automobiles relegated to parking structures, then those structures increase cost beyond that of surface parking lots. Alternatively, integration in horizontal mixed-use developments may provide efficiencies in terms of infrastructure, utilities and zoning changes.[28]

The cost of land that is suitable to serve a range of uses is generally higher than sites suitable for just one land use. Land carrying costs could be higher or lower than for single-use properties. The larger site requirements and longer construction period add to development and construction costs.[29] The costs could be less for a mixed-use development than those for a very large single-use project (like an office park or a residential subdivision) because the uses are developed earlier. This can avoid cost increases for subsequent phases in the single-use office park.

Owners hope to reduce operating costs through shared services and facilities, such as common area maintenance, parking, building management and marketing.[30] Separate and duplicate technical systems minimize tenants' impact on each other and make operating expense recovery easier for the manager, but add to construction cost.[31]

Another cost consideration for mixed-use developers is the issue of sustainability. By integrating uses and higher density, developments may be able to achieve the same amount of usable space in a smaller footprint. Some sustainable design elements may require additional cost in terms of materials, but they are expected to pay for themselves in increased rents and lower operating expenses. Estimates are that cost premiums that have been at 5–10 percent may have dropped to 2 percent with the steep learning curve that comes with new construction methods. One study showed no significant difference in average costs for green buildings versus non-green buildings.[32] Another study found that an upfront investment of about 2 percent can yield a life cycle savings of ten times that investment if savings through productivity and worker retention are considered in addition to costs of energy, maintenance and repair, but such estimates are subject to considerable debate.[33] In markets where green buildings are available, there is evidence of rental and purchase premiums in both the U.S. and Australia. These buildings use 32 percent less electricity and 26 percent less natural gas, according to analysis of CoStar data.[34]

Risk

Generally, both lenders and investors have attached a risk premium to mixed-use developments because of the complexity of meshing multiple uses, the increased construction costs, and the longer development horizon.[35] The skill, experience and investment required to develop all components of a master planned mixed-use project may be beyond most firms, but a skilled developer can organize a team of investors, designers, builders and operators who are interested in each component of the project, allowing the developer to transfer risk during the development and operational stages. Investment in a variety of land uses should provide diversification, and thereby reduce risk. A mixed-use development reduces reliance on a single market sector and the amount of space of a single type that must be absorbed by the market.[36]

Decision-Making Process

Lenders, investors and developers have asked if mixed-use project development changes the decision-making process. Mixed-use development is much more complex and complicated than single-use development. The development model has changed from the situation in which one person was the expert on all facets of the single-use development to the need for a committee, group or organization of experts to plan and execute the project. Mixed-use development generally moves the industry away from specialization in a property type to a more sophisticated consortium of planning and development.

CONCLUSION

The professional literature discussing mixed-use development is full of learned opinion about the factors and features that lead to financial success. Much can be learned from these expert opinions. This literature review and its organizational scheme should have revealed some new ideas and perspectives even for the very experienced developer or consultant dealing in mixed-use development. A significant point to realize is that more empirical information is needed. Real estate academics need to determine if there is a statistically significant combination of the factors presented in this article that is strongly associated with financial success of mixed-use developments. ■

Editor's Note: *Part II of this article will be published in the next issue of* Real Estate Issues.

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Credit Crisis Has Weakened Global Property Fundamentals

BY SIMON RUBINSOHN

A STRIKING FEATURE OF THE RECENT FLOW OF MACRO DATA IS how the downturn in those economies most directly affected by the credit crunch has spread across the rest of the globe. No longer is there any hiding place, even if a country's banks have been largely untouched by the whole subprime debacle. As consumers rein in their spending and importers seek to reduce inventories, economies that rely heavily on trade to drive growth have experienced a dramatic shock. This impact has been felt most heavily in Asia, with Indonesia seeing exports cut in half over the past twelve months, and Taiwan and South Korea suffering almost as badly. It has, however, also been visible elsewhere with Germany, in particular, taking a big hit as sales of high-end capital goods have ground to a halt.

The worsening global economic picture has, not surprisingly, also been increasingly visible in the real estate market. For much of 2008, while commercial property values were sliding in large parts of the advanced world, real estate in many emerging economies seemed to be largely immune from these problems. Prices were continuing to rise, investors still had the appetite to invest, and rents were being underpinned by healthy tenant demand. That, however, all changed in the latter part of last year.

Market developments in global commercial real estate markets are now clearly reflecting wider macroeconomic forces. In those countries where consumption is the main driver of economic growth, supported in the past by easy access to credit and rising equity and house prices, consumer confidence has been shot and spending is falling. Given the collapse in final demand, manufacturing output is falling in those counties where exports are the main driver of growth. Falling consumption and industrial production is now resulting in a global labour market adjustment. Rising unemployment is feeding back in each country's domestic sphere, in turn impacting on its service sector, and prompting further job losses. As the vicious cycle continues, no part of the commercial property market has remained immune. Falling consumption is hitting the retail sector, falling manufacturing output is hitting the industrial market—and weakness in both of these areas, combined with the fact that the global financial sector is virtually on life support—is now weighing on the office market.

The latest *RICS Global Commercial Property Survey* has just been released, and it predictably makes for fairly grim reading. What it clearly shows is that the synchronised nature of the downturn in the global economy has resulted in a synchronised downturn in global real estate markets. On the occupier side, the survey shows that rents now are falling, even in those parts of the world

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Simon Rubinsohn *is chief economist for the Royal Institution of Chartered Surveyors (RICS), and is responsible for leading RICS' economics and research team in providing timely analysis of developments in both the commercial and residential property markets, as well as in the construction industry. Previously, Rubinsohn was senior strategist for Barclays Wealth, where he played a key role in setting and managing the asset allocation for client portfolios focusing on a broad range of asset classes. He entered the financial services industry in 1985 when he joined ANZ Merchant Bank as a UK economist.*

which previously were seen to be showing a fair degree of resilience, including the Middle East, Emerging Asia and Emerging Europe. Rents fell across more than 90 percent of the countries surveyed, with the greatest downward pressure occurring across parts of Asia. Taiwan, Hong Kong, Singapore and India were ranked in the bottom five for rental performance, as the collapse in world trade has damaged export earnings and business confidence. In the previously resilient Eastern European markets, the collapse in lettings activity and worries over financial instability have raised fears that income streams to landlords are likely to come under significant pressure, creating a rise in bankruptcies, prompting growing voids and tenant default.

In the four largest economies that make up 80 percent of the Euro-area economy—Germany, France, Italy and Spain—unemployment is now rising. This is depressing consumer confidence, private consumption and ultimately, retail rents. In Spain, where the labour market adjustment is at a more advanced stage than in the other major economies (unemployment is 14.8 percent), retail rents are falling the furthest. Meanwhile, in Germany, where the labour adjustment has only just begun (unemployment is 7.3 percent), retail rents were still rising in the latest quarter. That said, even in Germany, rental expectations in the retail sector have now turned negative.

As a result of the sinking occupier market, rental expectations are now negative across all world regions, with weaker occupier demand likely to lead to further rises in available space and looser market conditions across all emerging and developed markets. In Western Europe, rental pessimism is bleakest in Ireland, Portugal, Spain, Belgium and the UK. Germany remains a relative outperformer, with less negativity towards both rents and tenant demand as available space continues to decline.

On the investment side, price declines continue at a record pace in Western Europe, driven by steeper drops in the retail and industrial markets, which have overtaken the office sector in terms of weakness. The sharpest falls were registered in Ireland, Luxembourg and the Scandinavian countries. Cyprus was the only European market to resist the negative trend. In the United States and Japan, sharp declines in economic activity have taken their toll across all three sectors of the commercial property market. The U.S. retail market and Japanese office sectors are expected to see the largest downward price adjustment in the coming months as rising unemployment and declining output growth weigh further on investor sentiment. The tide also has now turned in China, with respondents reporting declining capital values despite recent announcements of a huge fiscal stimulus plan to the tune of 10 percent of Chinese GDP (the largest fiscal plan of any individual country as a share of GDP).

Hungary, Poland, Ukraine and Turkey reported price declines at almost double the pace of the preceding quarter. Recession and tough financial conditions are knocking at the door across many Eastern European countries with worries over a systemic crisis across the region gaining traction in recent weeks. No early recovery is expected in terms of deal activity, with transactions expected to fall further from an already anemic level. In Russia, a country also reeling from the oil declines and a plummeting currency, worries over macro stability have weighed further on investment sentiment, sending capital values lower for the second consecutive period.

Whilst the commercial property industry will remain in the eye of the storm during 2009, opportunities now are emerging for those with capital to invest. The correction in developed markets is well underway, pushing yields up sharply in relation to some less mature and transparent property markets. Relative pricing may start to attract interest in the developed economies, with transaction activity expected to slowly pick up, although pricing will continue to slip amid declines in achievable rents. Furthermore, the opportunity to acquire prime performing assets should increase as companies come under pressure to raise cash quickly to repair over-leveraged balance sheets.

In the coming months, expect to see the downturn in emerging markets gather pace, as a result of the withdrawal of capital from higher risk markets and renewed instability. Countries with a high level of external financing needs will be in the spotlight amid signs that many banks will be focusing on domestic concerns as a priority. As such, a refinancing shortfall across the industry will see a greater numbers of distressed assets hitting the market during 2009. Whilst this may stimulate deal activity from recent lows, inevitable declines in pricing will continue. ■

Managing Risk in Income Property Loan Portfolios

Relative Index Methodology: A Proposal to Enhance Basel II Regulations on Income Property Lending and Assess Risk Positions in Income Property Loan Portfolios

BY MARC THOMPSON, CRE, FRICS, CCIM

Note: *The views expressed herein are those of the author. They are not to be construed in any way as the views of Bank of the West or its senior management. This article was prepared by a practicing real estate finance banking professional for consideration by regulators, academics and real estate researchers to further develop, debate and possibly amend Basel II regulations to hedge speculation risk from real estate mortgage portfolios.*

INTRODUCTION

The purpose of this article is to propose Basel II regulation to significantly reduce the risk of another real estate boom-bust cycle threatening the viability of the U.S. financial system. This proposed Basel II regulation identifies speculation risk and better manages portfolio risk using a relative index methodology within regulated financial institutions. The methodology could also be applied to Commercial Mortgage-Backed Securities (CMBS). The author contends that the recent boom-bust cycle could have been prevented through appropriate regulation and risk management.

BASEL II: CORE COMMERCIAL BANK CAPITAL ADEQUACY REGULATION

Basel II is a worldwide regulation framework describing a comprehensive measure and minimum standard for capital adequacy that national supervisory authorities are now working to implement through domestic rulemaking and adoption procedures. Core banks (the biggest multinational banks, e.g., BNP Paribas) must adhere to the highest standards and already began implementation as early as 2006. The U.S. officially adopted the framework into its regulation policy in April 2008, although banks have the option to adopt a less stringent standardized approach approved by U.S. regulators. The Basel II implementation submittal deadline for review by U.S. bank boards of directors was Oct. 1, 2008. The approved Basel II implementation plan is to be implemented in a three-stage process over a three-year period, utilizing a parallel approach to the bank's existing risk management and capital adequacy measurements.

All multi-national banks are in the process of implementing the highly complex and advanced measurements of the Basel II regulations. However, Basel II may have a flaw that can be mitigated by U.S. banks and all banks governed under the Bank of International Settlements—using the CPI-adjusted TBI price value methodology. A similar type of price value index that tracks changes in prices on a quarterly basis could be created for all other countries. William M. Isaac,

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chairman of the Federal Deposit Insurance Corp. from 1981–1985, explains its potential negative impact in an opinion piece published in the *Wall Street Journal* on Sept. 19, 2008, as follows: "Basel II requires the use of very complex mathematical models to set capital levels in banks. The models use historical data to project future losses. If banks have a period of low losses (such as in the mid-1990s to the mid-2000s), the models require relatively little capital and encourage even more heated growth. When we go into a period like today where losses are enormous (on paper at least), the models require more capital when none is available, forcing banks to cut back lending."

Mr. Isaac certainly understands regulatory changes and its impact on lending markets. Once the probability of loss and loss severity estimates are set for income property in all institutions, the Basel II regulated financial institutions will pursue those lending opportunities that best fit its credit risk profile. Most likely, a herd mentality will cause bank officers to seek those opportunities identified as lower risk. Such behavior would lead banks to overshoot the market, creating market speculation risk leading to higher realized loan defaults and losses than would otherwise be projected, based on historical loan default and loss data. If the credit decision process becomes more systematic and complex, the system will create its own systemic credit related losses—perhaps with a worse outcome than exists today.

At HSH Nordbank, a Basel II Risk Adjusted Return of Capital (RAROC) system was implemented between 2005 and 2007. As RAROC was applied in practice at the field level, it may have been manipulated to meet loan underwriting and management goals. In addition, RAROC did not factor into its system a relative index methodology to determine how much market speculation risk it was taking on the collateral for its loans at the high market price levels. This version of RAROC did not manage risk but proliferated the taking of more risk since it applied a system-dependent risk management evaluation as opposed to a more simplistic inflation-adjusted relative index methodology. What financial institutions do not need today is more complex regulatory processes and procedures that may result in less control over their destiny. If the president of the bank does not understand how the capital allocation system works within his/her own bank, this regulation policy is prone to engender systemic losses, loss of control over its performance and increase the probability of bank failure.

Another major potential issue related to Basel II is that capital will be allocated within banks on the probability of loss and loss severity on a specific asset class as experienced by the entire industry. It does not reward those financial institutions that, due perhaps to conservative underwriting standards, experienced a better default and credit loss recovery than the average financial institution.

A commercial bank's incurring a high probability of loss and loss severity on real estate loans is not a sustainable and viable function of its business model. One enhancement of Basel II policy would identify market speculation risk in new loan applications and existing income property loan portfolios via a relative index methodology. This relative index methodology would create a lending system that identifies all lending risk simply and transparently enough to be relatively easy to implement and regulate. Such a methodology should provide a higher degree of confidence to the marketplace by reducing the probability of loss and loss severity on loans originated by worldwide regulated institutions.

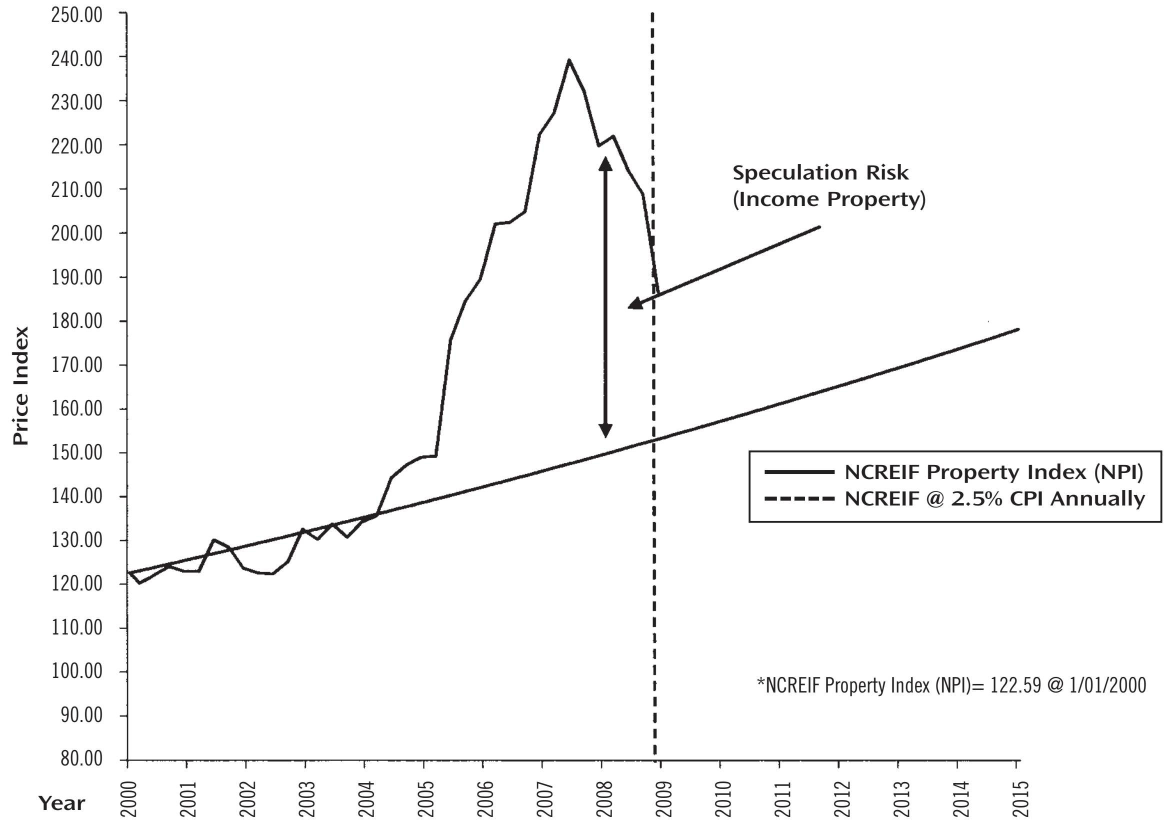
A major advantage of the spirit of Basel II is that this worldwide commercial banking regulation proposed by the Bank of International Settlements is adaptive to product and system innovations. Basel II has introduced the use of Advanced Measurements Approaches for capital adequacy regulation and risk management. The relative index methodology proposed for incorporation with Basel II regulation was developed to appropriately assess the probability of loss and loss severity in existing income property loan portfolios. This relative index methodology also will help investors and credit rating agencies to correctly determine risk ratings within tranches of CMBS issuances for each vintage year.

DEFINING MARKET SPECULATIVE RISK AND RELATIVE INDEX RISK

This article defines "market speculative risk" and "relative index risk" on income property real estate investments. A previous article by this author in *Real Estate Issues*[1] explored why the credit rating agencies, conduit underwriters, investment banks, commercial banks and investors "did not know what they did not know" in assessing probability of loss and loss severity to determine the appropriate amount of leverage and tranche amounts in CMBS loans from 2004–2007. The objective of this article is to restore confidence in both commercial banks and CMBS investors, and thus restore the non-functioning banking and CMBS markets to healthy and growing lending markets.

Figure 1

TBI Income Property Price Index



Source: NCREIF Property Index (NPI). Graph provided by Marc Thompson and Mike Halliday.

The U.S. has gone through an interesting period in which investors purchased a variety of "innovative" types of debt securities. Income property investors were caught up and benefited from it, as did commercial banks and other financial intermediaries. Although the CMBS system has its flaws, including missed risk assessments by credit rating agencies, conduit loan underwriters, investment banks and investors, it can be fixed with the appropriate use of the proposed CPI-adjusted relative index approach. This methodology combines an index, such as the MIT Center for Real Estate Transactions-Based Index (TBI),[2] proposed underwriting policies, five-year minimum time scales and an oversight board. Adding a relative debt service constant index to assess market speculation risk provides stability to the country's financial system. Within the next three to five years, CMBS issuances in the 2005, 2006 and 2007 vintages will be subject to probability of loss risks in the 23–34 percent range. It is possible to hedge risks that are well identified.

It is expected that the thesis, recommendations and probable loss estimates described here will be controversial to many credit rating agencies, investors, lenders and bank regulators. It is important to be aware of the potential ramifications of implementing this relative index methodology in CMBS pricing and, for that matter, the estimated value of most debt secured by income property on the balance sheets of commercial banks. The bubble, or over-leverage, can be estimated to be $750 billion to $1.1 trillion on the loan underwriting amount on income property debt held by all financial intermediaries and investors. If this relative index methodology were applied to single-family mortgage portfolios, the impact would be much higher, given that the scale of that debt bubble is $3.5–$5 trillion.

Although the implementation of a relative index methodology would be negative to the economy, if fully integrated as a regulation today, it would best be integrated gradually and phased into Basel II regulation for U.S. banks over a three-year period. At the end of this period (Jan. 1, 2012), the negative impact should not be as severe and would provide a discipline for lending from that time forward. Although the over-leverage bubble estimates stated here may be high, the estimates of probability of loss and loss severity using a relative index methodology on real estate secured portfolios are sound and will stand the test of time.

RELATIVITY TO INDEX VALUE METHODOLOGY DEFINED

One of the critical reasons for error in assessing probability of loss and loss severity by the credit rating agencies is that the agencies are conditioned by the U.S. capital markets to assess all types of risk on varying investment classes on both a quarter-over-quarter and year-over-year time scale. But, the overall risk in providing debt on income property real estate can be assessed only in longer time scales. As a consequence of not incorporating a longer time scale in CMBS overall risk assessment models, the probability of loss and loss severity on income property portfolios is likely far greater than credit rating agencies have concluded. This has serious consequences for the U.S. and world economies for years to come. Real estate cycles are much longer than other investment cycles, such as those for the more liquid stock and bond investment segments. Because of this time issue and the enormous amount of over-leveraged real estate in the U.S., in a best-case scenario, U.S. income property real estate prices, in aggregate, will begin to appreciate in 2015. It will take at least that long to clear the market of over-leveraged real estate; for loan foreclosures that depress prices to cease from occurring; and for lenders to once again become confident about lending in mass. This assumes collateral deflation risk has dissipated from the markets. If inflation rapidly increases within this period, recovery could come sooner than 2015.

In the meantime, the U.S. and world economies must develop a Basel II regulation that mitigates the likelihood of another real estate bubble and bust. The following sets forth the case for a CPI-adjusted TBI price value methodology regulation to be phased into Basel II regulations from Jan. 1, 2009 through Dec. 31, 2011, and to be fully implemented beginning Jan. 1, 2012.

THE MISSED ASSESSMENT OF MARKET SPECULATIVE RISK

In the context of this article, speculation risk can generally be defined as the type of risk in a market segment taken by participants in anticipation of pricing above the CPI inflation rate. Generally, speculative risk was taken by investors in first lien mortgages without their knowledge since credit rating agencies had not uncovered it. If prudent underwriting criteria using a CPI-adjusted TBI price value methodology had been followed to uncover such exposure, the risk of owning first lien mortgages would had been mitigated. Speculation risk should be taken only by equity investors or by unregulated debt providers.

With this general description of speculation risk in mind, the biggest threat to the CMBS market is the missed assessment of speculation risk on CMBS issuances over a six-year time period (2002–2007) by the credit rating agencies, conduit underwriters, investment banks and investors. Using the TBI as a basis for analysis, it appears there was a significant error rate in risk models used to assess probability and severity of loss, with the most severe error rates beginning in the CMBS origination years of 2005–2007, when CMBS issuance reached unprecedented levels.

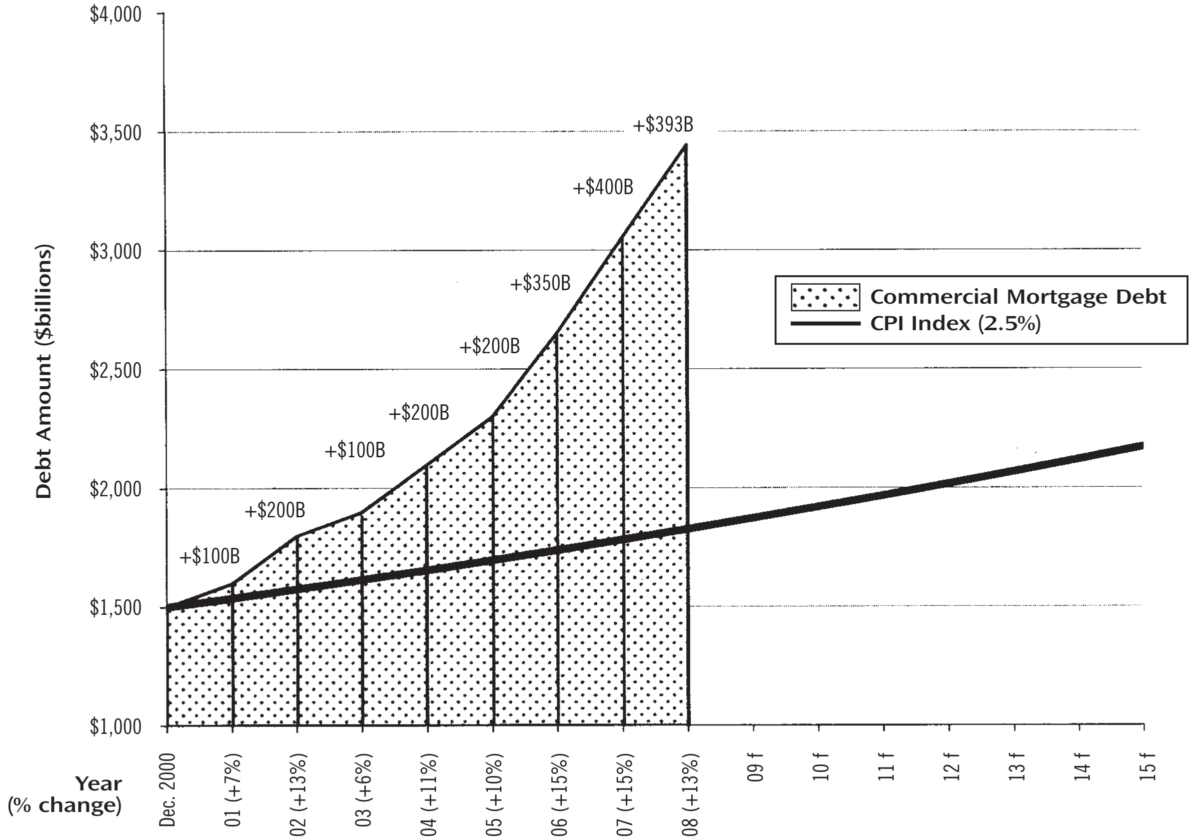
There were a number of factors contributing to growth of high speculation risk in income property loans, with the most prevalent being systemic “hustle and flow” CMBS conduit loan production processes. The result was easy and low-cost loans that artificially increased income property values in the high CMBS issuance years of 2004–2007. This artificial increase in income property values created high speculation risk positions on permanent loan portfolios. CMBS debt increased an average of 28 percent after 2002. Given this CMBS growth, banks also inflated lending amounts for income properties on their balance sheets. Speculation risk should be appropriately recognized and removed from non-recourse permanent long-term income property lending with an equivalent AAA probability of loss and loss severity credit rating.

MIT CENTER FOR REAL ESTATE TRANSACTIONS-BASED INDEX (TBI) PRICE INDEX

The TBI is a quarterly measure of private market transactions—mainly by private and public pension funds—on income property real estate, and is based on data received by MIT on a quarterly basis from the National Council of Real Estate Investment Fiduciaries (NCREIF). NCREIF requires members to contribute transaction information (for various income property types, bought or sold) and valuations prepared either internally or externally, on a quarterly basis. The TBI is based only on the transactions

Figure 2

Commercial Mortgage Debt Outstanding



Source: Flow of Funds Accounts, Federal Reserve Board of Governors. Graph provided by Marc Thompson and Mike Halliday.

data supplied by the NCREIF members. However: "The TBI is a hedonic price index that uses the recent appraised values of the properties as a composite hedonic variable. Appraisals are used only to control for cross-sectional differences in properties, not to influence the longitudinal price changes tracked by the index. The TBI price index represents movements in transaction prices in closed deals in the market."[3] MIT Center for Real Estate (MIT/CRE) indicates that the TBI can often provide a more up-to-date or precise picture of movements in the real estate market than other types of commercial real estate indices, and is being provided for research purposes by MIT/CRE as a service to the industry and academic research communities. For these reasons, the TBI price index is applied to determine relative TBI price values against a CPI-adjusted TBI price value on a quarterly basis. The product types included in the TBI index are office, retail, hotel, warehouse/industrial and multi-family.

The formation of the NCREIF index was begun in January 1977 by pension consultant Frank Russell Company, and reached its current form on Jan. 1, 1995. NCREIF's data contributing members are among the nation's largest public and private pension funds. They report combined portfolio assets of nearly $1.0 trillion.

For our purposes, TBI price value changes begin after January 2000 and are relative to the CPI-adjusted TBI price value of 120 as of that date. The TBI price value of 120 is inflated by an average estimate of CPI of 2.5 percent from January 2000 through Q3 2008. For example: if the TBI price value is 219 for office buildings in the San Francisco MSA in December 2007, the prices for similar office buildings in this MSA increased 99 percent since January 2000. On a quarterly basis, MIT/CRE provides a TBI report indicating the changes in various income property prices from the previous quarterly reporting date. For example: the MIT/CRE Web site reported 4Q 2008 results that show a 10.6 percent decline in prices compared to the previous quarter for properties sold from the NCREIF database, placing the price index 21.9 percent below its 2Q 2007 peak. MIT/CRE advises users to consult the Moody's/REAL Commercial Property Price Index for quarterly sectoral index updates based on a larger property population since the NCREIF database limits its data gathering to only institutional owners of income property.

Note: The Moody's/REAL index was not available for review for consideration as a primary source of data in the proposed relative index methodology for lending regulation purposes. Given this index's broader scope, including the NCREIF database and other transaction databases, it might prove to be an index more reflective of price changes in various product types within more MSAs. However, like Standard & Poor's SPCREX index which possessed these broader database qualities, Moody's may choose to no longer support its income property price index. NCREIF appears to be the only income property database that stands the test of time, independent from commercial interests, and independent from ownership interests that may influence quality and sustainability over time.

CPI-ADJUSTED TBI RELATIVE INDEX VALUE DEFINED

An "advanced measurement risk management" approach in Basel II regulation monitors the CPI-adjusted TBI relative price value against actual sales prices to help determine speculation risk in the market. It provides a basis to lend on a specific property based on its value given the CPI-adjusted TBI relative price value on January 2000. The value of a specific property can be adjusted to the date of the loan risk assessment date or lending date.

The variance between these two value measurements of actual price relative to CPI-adjusted TBI relative price value can be considered speculation risk. This risk can be shifted to investors buying at prices above the CPI-adjusted TBI relative price value for the property type calibrated for quality, location and amenities from 2000, adjusted to the date of the loan application. In the proposed regulation, the buyer would be required to invest more equity capital into the price above the appropriate CPI-adjusted TBI relative price value, as determined by a trained appraiser using this methodology. The value of the property may be higher than the CPI-adjusted TBI relative price value, but the U.S. financial system would not incur significant additional market speculation risk or the negative consequences of a bubble in prices and leverage such as that observed in the income property markets. By applying this CPI-adjusted TBI relative price value methodology, the amount of debt on income properties would not rise to potentially high bubble market levels. Debt levels would only increase at the CPI-adjusted TBI relative price value levels beginning from the base of Jan. 1, 2000. In times of excess demand for property and prices above the CPI-adjusted TBI relative price value, the loan amounts available for purchase financing would be only those at the CPI-adjusted TBI relative price value amount. For example, if CPI is 2.5 percent and the property value has increased 10 percent per year for the past three years, the price above the CPI-adjusted TBI relative price value would be contributed by an income property investor as cash equity or possibly by debt provided by a non-regulated financial intermediary.

TBI PRICE VALUE OBSERVATIONS

Extensive examination of the probability of loss and loss severity risk on specific income property loans suggests that CMBS loans were erroneously underwritten above the CPI-adjusted TBI relative price value of 120 beginning in January 2000 through 2007. This has led to the following:

1. Values of commercial real estate from 1996 (when the market improved for virtually all parts of the sector) through March 2001 (when the dot-com boom ended) experienced a significant run-up in year-over-year relative prices. Most income properties peaked in price level in January 2001. Therefore, the base Jan. 1, 2000 CPI-adjusted TBI price value of 120 included most of these already historically high income property prices. Paradoxically, national TBI price values relative to income property prices continued to remain stable through 2003 and began aggressively increasing beginning in 2004 through 2007, even though rents had not yet reached the previous TBI price value peak of January 2002.
2. In 2006, income property rents had only begun to approach the highs of January 2002 in some MSAs, and in many other MSAs and product types, rents continued to remain below 2000 and 2001 levels, yet net operating income available for debt service had declined because of rising expenses at or above the CPI.
3. Among all property types from 2002–2007, CMBS loans were being underwritten more aggressively, with a high reliance on the market comparable approach to value. This valuation methodology utilized capitalization rates that dropped 280 basis

points on average on all product types from 2002–2006. In addition, CMBS loan underwriting reflected the lowest interest rates in 40 years.

4. CMBS conduit loan production grew rapidly during this time, increasing from $94 billion in 2004 to $202 billion in 2006. In 2007, prior to the collapse of the CMBS market beginning in August, CMBS issuances were more than $230 billion.
5. With high CMBS growth rates and increased competition among CMBS conduit lenders and commercial banks, underwriting standards deteriorated. This continued a "hustle and flow" loan production process driven by fee generation. An example of lower underwriting standards is the high (57%) interest-only composition of all outstanding CMBS loans as of June 30, 2008. These interest-only loans have no amortization for the entire term, or amortization begins to occur at a future date prior to the maturity date of the loan. In 2007, 86 percent of all loans originated in CMBS had interest-only payment features.

These systemic income property inflation patterns indicate significant price deflation risk in almost all property types in almost all MSAs beginning in 2008, and likely continuing for many years. Had not interest rates dipped to a 40-year low and aggressive loan underwriting not taken place, income property values would have increased much more in line with CPI-adjusted TBI price values during the period beginning in January 2002.

If the index methodology described below had been used by credit rating agencies, conduit loan underwriters, investment bankers and investors in their modeling to hedge year-over-year systemic market speculation risk, the existing high leverage in CMBS 2004–2007 vintages would not have occurred. In fact, the real estate debt bubble and consequent worldwide financial system risks might not have occurred.

THESIS: CPI-ADJUSTED TBI PRICE VALUES

Income property TBI price values since January 2000 is referenced to begin at 120. The TBI price values rose to a high of 239 as of June 30, 2007, or 119 percent in a nearly eight-year period. By comparison, the TBI price value in 1Q 1984 was 103. It wasn't until 2Q 1997 that the TBI price value again reached 103—a 13-year span. Based on the above observations of the market, there is significant risk of deflation or reversion to the TBI price value of 120, adjusted by the CPI year-over-year rate from the January 2000 start date. However, this does not necessarily indicate the reversion will naturally go back to the CPI-adjusted TBI price value line. Depending on the rate of inflation, the vacancy rate in a market, the unemployment rate and amount of devaluation of the dollar, the TBI price value could be higher for a specific property if the optimal conditions for each of these factors occur at the same time.

It is difficult to predict the future. However, in reflecting upon the past, and given the conditions in the market since January 1984 and the data available for review from the MIT Center for Real Estate Web site, it makes sense, for risk analysis purposes, to inflate the TBI price value at CPI, given that all long-term leases are also inflated at CPI. Thus, the 1Q 2000 TBI price value of 120 is inflated at a 2.5 percent annual rate through the end of 2008, resulting in a CPI-adjusted TBI price value of 146.

TWO EXAMPLES OF HOW SPECULATION RISK IN INCOME PROPERTY LOAN PORTFOLIOS ARE PROPOSED TO BE ASSESSED

ONE: RELATIVE INDEX METHODOLOGY

To determine the market speculation risk and the resulting probability of loss and loss severity embedded in specific CMBS loan vintages or within bank portfolio origination years, the TBI price value on the collateral for the income property loan originated at the peak of prices in June 2007 can be adjusted as follows:

1. The inflation-adjusted index value from the base year of 2000–2008 is 146.
2. Reducing the TBI price value of 239 in December 2008 from the CPI-adjusted TBI price value of 146 for Jan. 1, 2009, results in a preliminary estimate on a TBI price value basis of market speculation risk of 93.
3. Reduce the estimated inflation-adjusted index value of the property by 20–25 percent to account for the investors' equity contribution.

Example: More simply put, think of the TBI price value as a square foot value in the following example:

1. A retail property was financed in June 2007, based on a purchase price at a TBI price value of 239.
2. The CMBS loan was underwritten at 80 percent loan-to-value, indicating a loan-to-TBI price value of 191 in June 2007.
3. The market speculation risk assessed for this property is calculated as follows:
   a. The CPI-adjusted TBI price value for retail as of

June 2007 is 146, less 20 percent equity contributed by an investor, resulting in a CPI-adjusted TBI lending value for the retail property of 117.

b. The difference between the TBI June 2007 TBI price value of 239 and the CPI-adjusted TBI price value of 144 is 95, or 40 percent lower than at origination, which is classified as the market speculation risk.

c. The difference in the amount of TBI leverage value financed in June 2007 at 191 and the amount proposed to be financed at 117 is 74, or 39 percent of the debt amount, is also subject to being classified as market speculation risk and carries a high probability of loss risk at this time.

Figure 3

Speculation Risk Calculation

TBI Index Value Retail June 2007	239
Leverage Ratio	80%
TBI Leverage Amount	191
CPI-Adjusted TBI Retail Price Value (TBI base at 2.5% annual inflation rate from 2000 through June 2007)	144
Leverage Ratio	80%
Inflation-Adjusted Retail Index Value Leverage Amount	117
Estimated CMBS Loan Speculation Risk Assessment	74 (38%)

TWO: CMBS FINANCING USING AN INFLATION-ADJUSTED INDEX APPROACH

The borrower wants to buy an office building in San Francisco in December 2008 for $600 per square foot. The base period for the index is 1Q 2000 for a high quality office building sold, at that time, for $334 per square foot. The aggregate mean inflation rate for office buildings as provided in the specific referenced index is 2.5 percent annually. Taking $334 per square foot and compounding at a 2.5 percent annual inflation rate indicates a 2008 inflation-adjusted index value of $406 per square foot. The CMBS loan originator would underwrite out the top 20 percent as equity and recommend financing the balance of $325 per square foot. The credit rating agency would then rate the CMBS issuance on a risk tranche level, determining the amount of the total debt that qualifies as AAA up to the 80 percent debt to index level.

Figure 4

Basel II Debt Calculation

San Francisco Office Purchase Price Per Sq. Ft.	$600
Inflation-Adjusted TBI Office Price Value (TBI base at 2.5% annual inflation rate from 2000 through 2008)	$406
Leverage Ratio	80%
Inflation-Adjusted Office Index Value Leverage Amount	$325
Speculation Risk Assessment Example:	$275

Cash flow from the property would also need to be incorporated into the loan underwriting at the same 80 percent debt to CPI-adjusted TBI price value. Debt service coverage is based on the debt service coverage index constant of 6.5 percent using a 30-year amortization. The debt service coverage based on this index constant is required to be, at a minimum, 1.15x on a trailing twelve months basis with an outlook of stable cash flow income to pay debt service over the next three years. (Please note: lenders would have the discretion to set debt service coverages in alignment with their specific interest rates.) The outlook would be based on existing leases assessed in good standing. BBB- or lower credit rated subordination levels or tranches within the CMBS issuance would be required to be assessed on the certainty of receiving future cash flows. For example, if there is high occupancy by high credit quality tenants (over 85 percent) with long-term leases, there is a high certainty of property cash flows to support the loan's lower subordination levels of non-investment grade debt. The difference between the debt that would qualify—under an inflation-adjusted index approach—as the CMBS loan underwriting amount and the purchase price of the income property is assessed as market speculative risk. The market speculative risk debt and equity that would not be financed through a CMBS issuance under this approach would be $275 per square foot. Only $325 per square foot, or 54 percent of the proposed purchase, would be financed in this example.

In the event an investor believed rents were going to spike or the value would appreciate, the investor would buy the office building at $600 per square foot. In addition, the investor would be willing to take the market speculation risk on the $275 per square foot of equity not financed in the first lien position loan, anticipating compensation for taking this risk. This inflation-adjusted relative index methodology removes market speculation risk from the financial system and shifts it back to the equity income property speculator/investor in a fashion similar to equity investors in the stock and bond markets.

CONCLUSIONS DRAWN FROM THE RELATIVE INDEX APPROACH

As indicated above, if the CPI-adjusted TBI price value methodology were used to assess the amount of market dependent speculative risk (risk to be taken by second lien, mezzanine or equity investors), 38 percent of that CMBS issuance in 2007 could have been financed as speculative risk in the CMBS first lien loan. CMBS loans in the peak production year and peak TBI price value in 2007 are subject to a high probability of loss and high loss severity in the event of a recession. When the outlook for positive outcomes in a property turns negative, the market speculative risk component of the existing debt is most at risk since the speculation risk assumed, for example, higher occupancy or higher rental rates in a higher percentage of space than existed when the loan was originated. This speculation risk exposes this portion of the loan to a high probability of loss.

INCOME PROPERTY CMBS DEBT TRENDS

The average loan to appraised value on CMBS loans increased from 65.9 percent in 2002 to 69 percent in 2007. The most problematic aspect of this is that credit rating agencies continued to reduce subordination levels of AAA tranches (from 21 percent in 2002 to 12 percent in 2007) when market speculation risk was increasing in income property. During this same period, underwriting standards were deteriorating. This is evidenced by the alarming increase in interest-only loans as a percentage of the total volume of CMBS issuances (from 23 percent in 2002 to 86 percent in 2007).

QUANTIFYING THE PROBABILITY OF LOSS ON INCOME PROPERTY LOAN PORTFOLIOS

To determine market speculation risk in specific CMBS years or "vintages," the average loan to appraised value on CMBS in 2007 of 69 percent can be reduced by the average subordination level of 12 percent. This results in a 57 percent loan-to-value of average AAA tranches originated in year 2007. If the relative CPI-adjusted TBI price value is used to determine the amount of market speculation risk, the AAA tranche rises to an average loan to a relative CPI-adjusted TBI price value exposure of 70 percent. Taking this concept one step further, CMBS issuances in 2007 comprising a higher loan to CPI-adjusted TBI index value than the 70 percent average will have AAA tranche levels exposed to higher market speculation risk or probability of loss and loss severity in a recession than will CMBS issuances in 2007 with an average loan to relative CPI-adjusted TBI price value of less than 70 percent. In assessing CMBS issuance risk, start with issuances in 2005–2007 that have loan to appraised values in excess of 69 percent together with highly market speculative risk property mixes held as collateral and with properties located in depressed markets. By determining the highest market speculation risk in CMBS issuances, one can determine the probability of loss and loss severity exposures in holdings under varying economic scenarios.

This same relative index methodology using CPI-adjusted TBI price values can be applied to bank loan portfolios, and is recommended for the same issuance years of 2004 through 2007 or 2008, if applicable. This method can be applied to property types that are non-recourse, that have significant lease turnover, below-projected stabilized occupancy levels or located in depressed markets. The same relative index methodology can also be applied to recourse loans with high lease turnover, below-projected stabilized occupancy levels, located in depressed markets. Benchmarking the market speculative performance of the property together with the bank underwriting at the inception of the loan would help to determine how much market speculation risk was taken by the bank during the year of issuance. Comparing this standard bank portfolio performance benchmark with the projection of variance to the relative index methodology, it is likely that the bank's risk management officers would conclude that a difference in probability of loss exists *vis-a-vis* this relative index methodology values. This relative index methodology will help manage the bank's overall lending risk on real estate collateralized loans.

PROPOSED RELATIVE DEBT SERVICE CONSTANT INDEX MONITORING REGULATION

For each commercial product type, a Relative Debt Service Constant Index (RDSCI) could be developed and compared against operating performance over time for each property type. It is feasible to obtain operating statements on each property type in the various CMBS loan pools and within commercial banks' balance sheets to fulfill this monitoring regulation proposal. It is possible to assume that regulators would be in a good position to request operating performance data from the entities they regulate to create an operating performance index for each product type. If this data could be collected and pooled to increase the reliability and usefulness of this RDSCI analysis, the probability of a significant variance would be severely reduced, especially when applied to smaller markets throughout the country.

An RDSCI could be set on each product type at the same date as the TBI price values on Jan. 1, 2000. Property performance data could be derived from NAREIT for each product type from Jan. 1, 2000 through to a date on which collected operating performance reporting for a property type can be relied upon to provide integrity to RDSCI. The RDSCI comparison would monitor operating results over time relative to a constant interest rate and amortization schedule to insure that a reduction in interest rate does not create a speculative increase in leverage and, as a result, a speculative increase in real estate values. It seems reasonable that one constant be used (such as 6.5 percent using a 30-year amortization). This is simple and can be easily monitored. It would also preclude any arguments made by various investors who believe they are being discriminated against by the use of a higher constant.

STANDARDIZED INFLATION ADJUSTED INDEX BOARD

In addition, an independent Standardized Inflation Adjusted Index Board (SIAIB) should be created with the assistance of others at the credit rating agencies. This board could be modeled after the NCREIF Index Oversight Committee (IOC). SIAIB would arbitrate proposed changes in the TBI price values and S&P/Case-Shiller indices and settle disputes regarding specific property leverage relative to a specific index recalibration claim. As the NCREIF website states, "IOC responsibilities include reviewing and recommending changes to the Board of Directors in index policies and procedures, requiring data elements, qualifying properties, quarterly index production review and the taking of any other actions deemed necessary to assure index statistical integrity."[4] SIAIB would be affiliated with the Bank for International Settlements or some other international organization with authority to implement international adoption of the relative index methodology within all countries. SIAIB would have the same discretion to differentiate among the quality and index values of various product types so that speculation risk will be virtually eliminated within the worldwide financial system. SIAIB also would be charged with training lenders, appraisers and investors to use the indices appropriately and consistently throughout the world. The mission of the SIAIB governing board would be, on a worldwide basis, to eliminate speculation risk associated with leveraging real estate assets.

CONCLUSION: MARKET SPECULATION RISK AND RELATIVE INDEX RISK

Loss and loss severity in income property loan portfolios has been incorrectly determined, creating an over-leveraged income property market that will create further losses on CMBS issuances or within banks beginning in 2008 and over the next five to seven years. This was partly due to time scale issues being too short for Wall Street analysts' and credit rating agencies' orientation to evaluating quarter-over-quarter and year-over-year patterns instead of longer cycle periods relative to a CPI-adjusted TBI price value. The price paid, or the value of the property, is not the only factor in making a loan. The price must be measured against something that makes sense to prevent the uncontrolled growth in real estate prices relative to CPI inflation rates. A CPI-adjusted TBI price value index methodology from January 2000 to the period of the loan origination is recommended to be added to Basel II regulations. The purpose is to moderate speculation growth and prevent its creating a worldwide financial collapse such as was recently averted with severe and unprecedented Federal Reserve and federal government intervention in the financial markets. ■

ENDNOTES

1. Thompson, Marc, 2008. "Deflation Risk in Income Property Investments and Permanent Loan Portfolios: a 2008 Update," *Real Estate Issues*, Vol. 33, No. 1.

2. Massachusetts Institute of Technology Center for Real Estate (MIT/CRE) Transactions-Based Index (TBI) of Institutional Commercial Property Investment Performance. See Web site *www.mit.edu/cre/research/credl/tbi.html*.

3. Ibid. 2008 Quarter 4 Transactions-Based Index (TBI).

4. National Council of Real Estate Investment Fiduciaries, "Frequently Asked Questions About NCREIF And The NCREIF Property Index (NPI)," *www.ncreif.com/pdf/Users Guide to NPI.pdf*, p. 15.

Other Resources:

NCREIF information was sourced from the NCREIF Web site *www.ncreif.org*.

Commercial Real Estate/Multifamily Finance (CREF) Quarterly Data Books, Mortgage Bankers Association. Data from 4Q 2004 through 4Q 2008. Author has interpreted this data as it has changed over time as a basis for deflation risk concerns.

Databases obtained from MIT Center for Real Estate Web site indicating the Transactions-Based Index (TBI) price index for office, industrial, retail, hotel and apartments on a national basis. The periods covered are quarterly from 1984 through 4Q 2008. This database was used to create the two graphs submitted. The S&P/Case-Shiller data for single-family housing graph representation was obtained from the Standard & Poor's Web site.

Islamic Financing and Foreclosure

BY KEITH S. VARIAN, ESQ.; AND JENNIFER M. ROCKWELL, ESQ.

In the past several years, the United States has seen substantial growth in a subsection of international finance sometimes called "Islamic Finance." Although conclusive data is not yet available, *Forbes* magazine recently estimated that at least $500 billion in assets around the world are managed in accordance with Islamic principles—known in Arabic as *Shari'ah*—and the sector is growing at more than 10 percent per year. Management consultants McKinsey & Company predicted that the value of assets managed by Islamic banks will grow to $1 trillion by 2010 as more Muslims seek financial services that comply with their beliefs.

Islamic finance is, in many ways, similar to socially conscious investing and is based on the principles of *Shari'ah*, which typically prohibit investment into industries such as gambling, pornography, alcohol, tobacco, defense, banking and insurance. The most well-known aspects of Islamic finance are the prohibitions of: 1) interest (*riba*); 2) speculation, betting and gambling (*maisir*), including the trade or exchange of money for debt in the absence of an underlying asset transfer; and 3) preventable uncertainty (*gharar*) occurring, for instance, in certain financial derivative instruments and forward contracts.

As opposed to conventional finance, where interest represents the agreed-upon cost for funds, the central concept of Islamic financing is the prohibition of *riba*. Most Islamic scholars agree that *riba* covers not only usury but also the charging of interest and any predetermined rate of return that is guaranteed regardless of how an investment performs. Since Islamic finance permits only those forms of finance that are interest-free, financial relationships between banks and borrowers are governed by shared business risk (and returns) from investment in lawful activities. Profits must not be guaranteed in absolute terms but in specified ratios, and can only accrue if the investment itself yields income.

Shari'ah-compliant mortgage financing emulates key economic features of secured lending through (more) complex financial structures. We first discuss the common forms of Islamic financings and how they each compare to traditional mortgage financings to understand the foreclo-

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sure issues facing courts. There are three main types of Islamic financing structures available when purchasing and refinancing real estate to replace the traditional mortgage structure: 1) *Ijarah* is the rental of a property by the bank to the customer, combining aspects of a finance with an operating lease; 2) *Murabaha* is the acquiring of property first by the bank, as identified by the customer, then the selling of it to the customer at an agreed-upon markup; and 3) *Musharaka* is used now as a primary means of a diminishing partnership between a bank and the customer. For a longer list of terms commonly used in Islamic financing and their respective definitions, please see the Islamic Financial Services Board's Web site at *www.ifsb.org*.

IJARAH

Ijarah, or lease-based transactions, are becoming increasingly popular and are a significant portion of the current Islamic banking and finance market, particularly in the U.S. *Ijarah* is a form of leasing in which the bank acquires the asset, whether real estate or otherwise, and then immediately leases that asset to its customer for a determined period of time at the end of which the customer will own the asset, either by the terms of the lease or by purchasing it at an agreed-upon nominal sales price. Both the acquisition by the bank and the lease to the customer are intended to occur at a single closing. This form of financing is used for both acquisitions and refinancings.

Regulatory agencies have examined the question of whether U.S. banks may enter into *Ijarah* transactions. The Office of the Comptroller of the Currency, for instance, has issued a detailed advisory letter guiding U.S. banks so as to lawfully enter into *Ijarah* transactions.

In purchase financings, the customer identifies the real estate for which it seeks financing from the bank. As with traditional real estate purchases, the customer will have entered into a sale contract for the real estate with a seller prior to obtaining financing. Either prior to or at the closing of the purchase, the customer obtains the seller's written consent to designate the bank to purchase the real estate. Under this designation, the bank does not typically assume any other obligations or liabilities under the sale contract. Moreover, the seller is instructed to look only to the customer for any claims it may have under the sale contract.

In refinancing transactions, the customer will sell to the bank assets already owned by the customer. The bank will then lease those assets back to the customer. The transaction is in effect substantially similar to a sale-leaseback.

At the closing of either a purchase or refinancing transaction, the bank will purchase the assets for their specified purchase price less any advances already paid by the customer and any customary adjustments that may be appropriate. It should be noted that banks many times choose to take title to the real estate in each transaction through a special purpose company created specifically for that transaction. At this closing, the bank will lease the assets to the customer.

The price paid periodically by the customer under the lease includes a rental (or, for tax and the bank's bookkeeping purposes, an interest) component. It also includes an amount that goes toward the acquisition of the asset (or, for tax and the bank's bookkeeping purposes, a principal component). The bank may determine these periodic payments in the manner it deems appropriate (subject to applicable law). *Shari'ah* scholars reluctantly permit this calculation to be linked to interest rates such as LIBOR, although in residential mortgages they may seek to impose a floor and ceiling as a means of consumer protection. It is not uncommon in these types of transactions for the resale price determination to assume that a conventional loan was in fact being made by the bank to the customer and to incorporate the bank's usual credit evaluation processes. In fact, the customer typically signs an agreement stating that it not only agrees with tax treatment of the price but will similarly present it as such for its own tax reporting purposes.

As it would in a conventional loan financing, the customer grants the bank a security interest, whether in the form of a leasehold mortgage, security agreement, assignment of rents or otherwise, to secure its obligations to the bank.

As with conventional financings, a customer may be afforded a right to prepay, in whole or in part. However, because of certain Islamic principles, these concepts are set forth in a separate written instrument often labeled a call option. Furthermore, those instances in which the bank may seek to accelerate payment, such as situations of default or condemnation, are addressed in a written instrument often labeled a put option, where the bank has the right to put the assets to its customer for its purchase.

Banks are usually concerned with the nature and extent of their liability because of their ownership of the assets in *Ijarah* transactions. *Ijarah* transactions traditionally provide that the bank is making no representations and warranties regarding the assets, and places the burden of inspection and all maintenance, charges, taxes and other impositions and liabilities relating to the assets solely upon the customer. In addition, the customer indemnifies the bank for any claims made relating to the property, as well as any breaches by the customer of the *Ijarah* transaction.

MURABAHA

Murabaha is commonly translated as a "cost plus mark-up" sale and is the most popular and most common form of Islamic financing, and has been in use in New York State by HSBC to provide home financing. A *Murabaha* transaction is initiated by a customer applying to the bank through its normal credit application process, subject to the bank's usual criteria, but also to any further considerations the bank may deem appropriate. The bank may issue a pre-approval letter or commitment letter, as it deems appropriate.

Like the *Ijarah* transactions discussed above, regulatory agencies have examined the question of whether U.S. banks may enter into *Murabaha* transactions. For example, the Office of the Comptroller of the Currency similarly issued a detailed advisory letter for how U.S. banks may lawfully proceed in *Murabaha* transactions.

In a *Murabaha*, the customer identifies real estate for which it seeks financing from the bank and enters into a sale contract for the purchase of that property from the seller. Either prior to or at closing, the customer obtains the seller's written consent to designate the bank as purchaser of the real estate. Under this designation, the bank typically does not assume any other obligations or liabilities under the sale contract. Moreover, the customer agrees in writing not only to purchase from the bank the assets in question but also to indemnify the bank should it fail to do so.

At closing, the bank purchases the assets for the pre-specified purchase price pursuant to the sale contract, less any advances already paid by the customer, and any customary adjustments that may be appropriate. It should be noted that banks often choose to take title to the real estate in each transaction through a special purpose company created solely for that specific transaction. At this same closing, the bank then immediately resells the assets to the customer at a price marked up from that which the bank paid. As it would in a conventional loan financing, the customer grants a security interest to the bank, whether in the form of a mortgage, security agreement, assignment of rents or otherwise, in order to secure its obligations to the bank.

The resale price, agreed upon in advance by the customer and the bank, is paid in periodic installments by the customer. The bank may determine the period payments of this resale price in the manner it deems appropriate (subject to applicable law). As with an *Ijarah*, the periodic payments may be linked to interest rates such as LIBOR. It is not uncommon in these types of transactions for this price determination to assume that a conventional loan was, in fact, being made by the bank to the customer, and to incorporate the Bank's usual credit evaluation processes. Frequently, the *Murabaha* documentation divides the price into components of what are, for tax and the bank's bookkeeping purposes, principal and interest payments. In fact, the customer typically signs an agreement stating that it not only agrees with the bank's tax treatment of the price but will similarly present it as such for its own tax reporting purposes. As with conventional financings, a customer may be afforded a right to prepay, as the bank deems fit.

Banks are usually concerned with the nature and extent of their liability due to their ownership, however brief it may be, of the assets. *Murabaha* transactions traditionally provide that the bank is making no representations and warranties regarding the assets and places the burden of inspection solely upon the customer. The seller, according to the contractual documentation, agrees to look only to the customer in the event of a breach of the sale contract. In addition, the customer indemnifies the bank for any claims made relating to the property, as well as any breaches by the customer of the *Murabaha* transaction.

MUSHARAKA

Musharaka is a partnership contract—now being used as a financing mechanism—in the form of diminishing partnership, which ends with the complete ownership by the partner who purchases the share of another partner in the property by a redeeming mechanism agreed between both of them. The *Musharaka* form of financing is becoming more popular with customers and is increasingly being used for residential and, more recently, commercial, mortgage financings in the U.S.

The typical form of *Musharaka* used to purchase property is termed a diminishing partnership. In such a financing, the customer identifies real estate for which it seeks financing from the bank and enters into a sale contract for the purchase of that property from its seller. Then, the bank and the customer form a joint ownership of sorts, which will acquire title to the property or, in some cases, the customer alone is named on the deed. Either prior to or at closing, the customer obtains the seller's written consent to designate the "partnership," or both customer and bank, as purchaser of the real estate.

At the closing, the "partnership" then acquires the property in accordance with the sale contract. Simultaneously, the bank enters into an agreement with the customer whereby the bank agrees to lease its interest in the property to the customer for an agreed term of years, and the customer periodically buys the bank's interest in the property, usually in the form of a monthly payment. As with the *Ijarah* and *Murabaha* transactions described above, Shari'ah scholars tolerate these periodic payments' being linked to interest rates such as LIBOR. The customer's equity in the property increases with every payment made towards acquiring the bank's interest. Thus, the rent payments payable by the customer to the bank will be reduced as the customer's equity in the property increases. The customer also agrees to mortgage the lease and its share in the property to the bank to secure the rental payments.

Banks are similarly concerned with the nature and extent of their liability because of their ownership in the partnership; accordingly, *Musharaka* transactions traditionally contain the same limitations on liability that *Ijarah* and *Murabaha* transactions do, including an indemnification of the bank by the customer for any claims made relating to the property.

FORECLOSURE

Our attorneys have been involved in the creation of one of the first Islamic residential and commercial mortgage financing programs in the U.S., using *Murabaha* and *Musharaka* forms. In our practice, we also have structured numerous Islamic financing transactions using the *Ijarah* form. Devon Bank, a Chicago-based bank, is one of the top-providers of *Shari'ah*-compliant products in the U.S., and currently offers residential *Murabaha* and *Ijarah* products in the states shown on page 19 in a chart from Devon Bank's website (*www.devonbank.com*).

In review of dockets across the country, very few of these Islamic financing transactions have actually gone through to foreclosure; most of those coming before the courts have been withdrawn or dismissed. One apparent reason is that Islamic financing is in its early stages in this country and the ratio to conventional financing is proportionately smaller. A less obvious but equally likely reason is that the credit strength of the Islamic finance customer, typically a Muslim, is subject to more scrutiny, and is accordingly higher, than some of the customers targeted in the recent sub-prime conventional mortgage market. A recent study also has shown that American Muslims are well-educated and affluent and have strong credit scores, as compared to the average American. [1]

However, when so many other mortgage structures are now crumbling, it is difficult to pinpoint any specific reason for the seeming endurance of the Islamic finance structures. All the same, since some Islamic finance transactions have indeed gone into foreclosure, the question becomes how a court would handle a foreclosure proceeding where the structure is *Shari'ah*-compliant. One recent transaction that was an *Ijarah* structure—involving a mortgage on the property of a condominium conversion in Greenwich, Connecticut—almost became a test case. However, the parties were able to work out a deal where the customer was able to sell the property. Without written decisions of case law on these foreclosure proceedings, it is hard to predict whether the *Shari'ah*-compliant structure played any role in the foreclosure actions.

As described earlier, each of the *Ijarah*, *Murabaha* and *Musharaka* structures involves a mortgage that secures the Islamic financier's position. As such, it is unlikely that an Islamic financier would be less secure than a conventional bank in a foreclosure proceeding when it is secured by a mortgage, leasehold mortgage, or other security granted by the customer, such as guarantees, pledge agreements, assignments of rent and environmental indemnifications, since they are also conventional means of securing a bank's rights.

BANKING LAWS

As mentioned above, state and federal banking agencies already have examined the structures of Islamic financing transactions and established the importance of weighing the substance of the transaction over the form in determining whether the financing complies with state and federal banking law.[2]

More particularly, the Comptroller of Currency found that the Islamic financing transactions were functionally equivalent to the conventional financing transactions prevalent in the United States. The ownership of real or

STATE	RESIDENTIAL MURABAHA	RESIDENTIAL IJARA	COMMERCIAL MURABAHA	COMMERCIAL IJARA
Alabama	Yes	Not currently.	Not currently.	Not currently.
Alaska	Yes	Not currently.	Not currently.	Not currently.
Arizona	Yes	Not currently.	Not currently.	Not currently.
Arkansas	Yes	Not currently.	Not currently.	Not currently.
California	Yes	Not currently.	Not currently.	Not currently.
Colorado	Yes	Not currently.	Not currently.	Not currently.
Connecticut	Yes	Not currently.	Not currently.	Not currently.
Delaware	Not currently.	Not currently.	Not currently.	Not currently.
District of Columbia	Yes	Not currently.	Not currently.	Not currently.
Florida	Yes.	Not currently.	Not currently.	Not currently.
Georgia	Yes	Not currently.	Not currently.	Not currently.
Hawaii	Not currently.	Not currently.	Not currently.	Not currently.
Idaho	Yes	Not currently.	Not currently.	Not currently.
Illinois	Yes	Yes	Yes	Yes
Indiana	Yes	Not currently.	Not currently.	Not currently.
Iowa	Not currently.	Not currently.	Not currently.	Not currently.
Kansas	Yes	Not currently.	Not currently.	Not currently.
Kentucky	Yes	Not currently.	Not currently.	Not currently.
Louisiana	Yes	Not currently.	Not currently.	Not currently.
Maine	Not currently	Not currently.	Not currently.	Not currently.
Maryland	Pending	Not currently.	Not currently.	Not currently.
Massachusetts	Yes	Not currently.	Not currently.	Not currently.
Michigan	Yes	Pending	Not currently.	Not currently.
Minnesota	Yes	Not currently.	Not currently.	Not currently.
Mississippi	Not currently.	Not currently.	Not currently.	Not currently.
Missouri	Yes	Yes	Not currently.	Not currently.
Montana	Not currently.	Not currently.	Not currently.	Not currently.
Nebraska	Yes	Not currently.	Not currently	Not currently.
Nevada	Not currently.	Not currently.	Not currently.	Not currently.
New Hampshire	Yes	Not currently.	Not currently.	Not currently
New Jersey	Pending	Not currently.	Not currently.	Not currently.
New Mexico	Not currently.	Not currently.	Not currently.	Not currently.
New York	Yes	Not currently.	Not currently.	Not currently.
North Carolina	Yes	Not currently.	Not currently.	Not currently.
North Dakota	Yes	Not currently.	Not currently.	Not currently
Ohio	Yes	Not currently.	Not currently.	Not currently.
Oklahoma	Yes	Not currently.	Not currently.	Not currently.
Oregon	Yes	Not currently.	Not currently.	Not currently.
Pennsylvania	Yes	Not currently.	Not currently.	Not currently
Rhode Island	Pending	Not currently.	Not currently.	Not currently.
South Carolina	Yes	Not currently.	Not currently.	Not currently.
South Dakota	Yes	Not currently.	Not currently.	Not currently.
Tennessee	Yes	Not currently.	Not currently.	Not currently.
Texas	Yes	Not currently.	Not currently.	Not currently.
Utah	Yes	Not currently.	Not currently.	Not currently.
Vermont	Not currently.	Not currently.	Not currently.	Not currently.
Virginia	Yes	Not currently.	Not currently.	Not currently.
U.S. Virgin Islands	Pending	Not currently.	Not currently.	Not currently.
Washington (state)	Not currently.	Not currently.	Not currently.	Not currently.
West Virginia	Not currently.	Not currently.	Not currently.	Not currently.
Wisconsin	Yes	Yes	Not currently.	Not currently.
Wyoming	Yes	Not currently.	Not currently.	Not currently.

Source: www.devonbank.com

personal property by the bank is for the sole purpose of financing specific property, not to maintain an inventory of property to sell to customers. Additionally, the bank will be exposed to no greater risks than it would face in a conventional commercial financing transaction. The ownership of property was found to be merely incidental to the making of the loan to the customer. The bank does not operate the property, pay the taxes, insurance or other costs associated with the property, maintain or make repairs to the property, assume liability, or otherwise exercise control over the property. All those functions will be the obligations and responsibilities of the customers, or lessees. Fundamentally, a lease transfers substantially all the benefits and risks of ownership to the lessee or customer.[3] Therefore, a structure whereby the bank owns title to the real estate does not affect the bank's rights with respect to our banking laws, assuming it is structured correctly.

The United States Supreme Court has held that the National Banking Act provides a broad grant of power to engage in the business of banking.[4] The Ninth Circuit also has specifically recognized that banks structure leases so that they are functionally equivalent to lending secured by real or personal property.[5] Under the precedent set by these higher courts, the lower courts currently facing a foreclosure proceeding should look to the substance over form standard when reviewing the layers of documents in *Shari'ah*-compliant transactions and recognize the Islamic financier as a creditor with a valid security interest by the lease, or co-owner's agreement and mortgage, entered into for the purposes of financing the acquisition of the real or personal property.

Although no U.S. court has specifically addressed the structure involved in a typical U.S./*Musharaka* transaction, we believe a court would most likely enforce the documents as written. In these types of transactions, there is typically a mortgage granted by the customer to the bank or financier to secure the customer's obligations. We would not anticipate that this type of foreclosure would differ materially from that of a conventional mortgage foreclosure. The substance over form standard should likely apply in this situation, whereby the co-ownership and mortgage structure is deemed another vehicle to provide financing and not entered into for the purpose of owning and operating the real property. The "borrower" holds all the benefits and risks of ownership in a *Musharaka* transaction as well.

BANKRUPTCY COURTS

Since foreclosure proceedings can involve not just a standard default by the customer but also its insolvency or bankruptcy, it is also important to consider how the bankruptcy courts would sort through the creditors' rights in *Shari'ah*-compliant transactions. Bankruptcy courts have looked at sale-leaseback transactions and have set forth rules for analyzing creditor's rights in each circumstance, along with the issues of ownership of real property and whether the lease is a true lease or disguised financing. Although states vary in their real property laws, generally there is a presumption that a deed to real property, a lease and a repurchase agreement are what they purport to be.[6] To overcome the presumption, the evidence must be clear and convincing that the transaction is really a disguised financing.[7]

Bankruptcy courts "look through form to substance" in determining the nature of the transaction and whether a true lease exists as opposed to a disguised financing.[8] Some factors a court may use in determining the true nature of the transaction are whether: 1) the transaction actually transfers the normal risks and responsibilities of landlord to the lessor; 2) the payments under the lease are reasonably designed to compensate the lessor for the use of the property or simply reflect the repayment of the lessor's acquisition costs plus interest; and 3) the lessor retains an economically significant interest in the property.[9] Courts have noted a determinative factor is whether the effect of the transaction was to leave the debtor with all the risks and rewards of ownership of the real property.[10]

Most of the bankruptcy cases cited above found that the sale-leaseback transaction was really a disguised financing and therefore the "owner" of the real property was a creditor to the debtor and had a mortgage on the property instead of a lease.[11] One bankruptcy court found that the sale-leaseback transaction that included a "triple Net Lease" was not a disguised financing transaction, but in fact a true lease. This was because the underlying facts proved that the owner of the property had turned down a straight financing transaction and instead elected the sale-leaseback transaction.[12]

In our review of the analysis made by bankruptcy courts in determining whether a lease is a true lease or a disguised financing, it appears that most of those courts would find an Islamic financing transaction involving a purchase of real or personal property by the bank and a lease to the customer, or a sale-leaseback, not to be a true lease but rather a "disguised" financing. As noted above, Islamic financiers are looking to finance a transaction to comply with Islamic law. Therefore, if a certain transaction found its way to a bankruptcy court, it is unlikely there would be an argument over the ownership of the property; instead, the parties' intent for the lease to be only a financing mechanism would presumably predominate. The consequence is that the "owner" is truly a mortgagee, in the same position as a conventional bank in bankruptcy proceedings. It does not appear that banks in Islamic financing would be any less protected.

FORECLOSURE CASES

In an effort to see what arguments were made in a foreclosure of an Islamic financing, we reviewed the pleadings in the record of two cases where foreclosure had been ordered by the court. In each case, the structure involved a borrower and a limited liability company who co-owned a residential parcel of real property, i.e., a *Musharaka* structure. A mortgage was filed on the land records whereby the "borrower" was obligated to pay to the limited liability company for the acquisition payments and profit payments. There also was a co-ownership agreement obligating the borrower to pay the limited liability company. In both cases, the court issued a judgment for foreclosure and sale of the real estate. While there is no mention specifically of the Islamic financing structure in the pleadings, the court's judgment stated that the plaintiff had a valid subsisting lien on the property. Therefore, it does not appear that the Islamic financing structure played a role in the validity of the security interest of the lender, and the lender was treated no differently from conventional lenders in foreclosure proceedings.[13]

We expect that the commercial mortgages that are created as part of an Islamic financing structure would most likely be treated the same as commercial mortgages in conventional lending. We also expect that the layers of documents in a *Musharaka* transaction would most likely be enforced as they are written.

In another, albeit older, foreclosure case, the Supreme Court of Vermont did not permit the foreclosure of a first mortgage by the bank, as it did not secure lawful indebtedness.[14] It is important to note that the financing structure involved in this case is one not commonly used in Islamic financing. The plaintiff in that case was a subsidiary of a Saudi Arabian partnership and, therefore, the structure of the transaction complied with Islamic law by not charging interest on the loan to The Hilweh Enterprises Corp. (HEC), a New York corporation.[15]

The structure of this transaction included an agreement (the "Agreement"), a bond (the "Bond") and a mortgage (the "Mortgage").[16] In the Agreement, the plaintiff agreed to tender $1,617,000 to HEC in exchange for 231 shares of non-participatory preferred shares in HEC and a non-interest bearing Bond in the amount of $1,617,000, secured by a Mortgage on the real property in Vermont.[17] The shares entitled plaintiff to receive cumulative dividends at a rate of 14 percent out of the net profits of HEC.[18] The Bond obligated HEC to pay the plaintiff the full sum of $1,617,000 on or anytime prior to two days after the deadline for redemption of the preferred stock.[19] An acceleration of the full sum plus dividends would become due if HEC defaulted on any installment of principal or dividend due under the Agreement.[20] The Mortgage secured the payment of the principal and dividends, pursuant to the Agreement.[21]

Norstar Bank of Upstate New York, Inc., defendant, was the inferior mortgagee of the real property of HEC.[22] The defendant argued that, since HEC became insolvent, there was no obligation to pay plaintiff and therefore the Mortgage was not enforceable.[23] This argument was based on Section 513(a) of New York Corporation Law which does not permit the redemption of shares of the corporation when the corporation is insolvent or the redemption would make it insolvent.[24]

The Court relied on precedent to infer that "any security interest created to secure a stock repurchase agreement also becomes unenforceable once the corporation is insolvent."[25] The Court found the obligation created by the Agreement was not enforceable because of the insolvency of HEC.[26] The Court also found that the obligation in the Bond was conditional upon the breach of HEC's obligation under the Agreement.[27] Therefore, since the underlying obligation became invalid, the Mortgage itself could not create a new or different obligation by HEC.[28] The result was the dismissal of the plaintiff's foreclosure complaint and the award of a foreclosure judgment to the defendant.

Even though this case entails a structure that is not frequently used today by parties to Islamic financing, it is still important in two respects. First, it demonstrates how a court looks at the layers of documentation in a transaction that is *Shari'ah*-compliant. Second, it demonstrates that, when structuring a *Shari'ah*-compliant transaction, the parties must remain aware of the state law in which they are working. Due diligence must be performed to check the underlying grant of security interest in the real or personal property to ensure that the obligation of the customer does not become invalid or unenforceable for any reason. However, in the case the underlying security interest is deemed invalid, the remaining documents must be drafted in such as way as to provide a "back-up" obligation to ensure the validity of the lien by the bank.

CONCLUSION

Islamic financing is a fast-growing trend in America, and the different types of structures used for *Shari'ah* compliance should be studied closely by the parties entering into such transactions to determine which would serve them best. The *Ijarah, Murabaha* and *Musharaka* transactions are structured so as to secure the bank in virtually the same way as is done in conventional financing. However, there may be some nuances applicable to a specific part of a transaction, so it is important to carefully structure the transactions not only to be *Shari'ah*-compliant, but also to comply with all federal, state and local laws. As more Islamic financing transactions occur in the U.S., more courts will likely be looking at the layers of documents involved and making decisions on the bank's security interest. Accordingly, those involved in Islamic financing may need to tweak any structures currently in place in order to survive such scrutiny.

NOTE: The views expressed by Murtha Cullina LLP in this article should not be construed as legal advice or legal opinion on any specific facts or circumstances. The contents are intended for general information purposes only. ■

ENDNOTES

1. See "Marketing to Muslims Report" by JWT.
2. See Interpretive Letter #867 issued by the Comptroller of the Currency Administrator of National Banks dated June 1, 1999; Interpretive Letter #806 issued by the Comptroller of the Currency Administrator of National Banks dated Oct. 17, 1997; Staff Interpretations NYSBL 96(1) issued by the State of New York Banking Department dated April 12, 1999.
3. See Interpretive Letter #867 issued by the Comptroller of the Currency Administrator of National Banks dated June 1, 1999.
4. See *NationsBank of North Carolina, N.A. v. Variable Annuity Life Insurance Co.,* 513 U.S. 251, FN 2 (1995).
5. See *M&M Leasing Corp. v. Seattle First Nat'l Bank*, 563 F.2d 1377 (9th Cir. 1997).
6. See *Fox v. Peck Iron and Metal Co., Inc.*, 25 B.R. 674, 688 (Bankr. S.D.Cal. 1982); *contra In re Big Buck Brewery & Steakhouse, Inc.,* 2005 U.S. Dist. LEXIS 10754, at *30 (E.D. Mich. 2005).
7. *Fox*, 25 B.R. at 688; *In re Omne Partners II*, 67 Bankr. 793, 795 (Bankr. D.C.N.H. 1986); *contra In re Big Buck Brewery & Steakhouse, Inc.,* 2005 U.S. Dist. LEXIS 10754, at *30 (used a preponderance of the evidence standard).
8. *In re Omne Partners II,* 67 Bankr. at 795; *see also Fox*, 25 B.R. at 688.
9. See *In re Big Buck Brewery & Steakhouse, Inc.,* 2005 U.S. Dist. LEXIS 10754, at *20-21; *Fox*, 25 B.R. at 688.
10. See *In re Big Buck Brewery & Steakhouse, Inc.,* 2005 U.S. Dist. LEXIS 10754, at *18; *Fox*, 25 B.R. at 690.
11. See *In re Big Buck Brewery & Steakhouse, Inc.,* 2005 U.S. Dist. LEXIS 10754, at *18; *Fox*, 25 B.R. at 690, 693.
12. See *In re Omne Partners II*, 67 Bankr. at 795-797.
13. See *Guidance Residential, LLC v. Rabah,* Docket No. 07CH09021 (Cir. Ct. Cook County, Chancery Division May 30, 2007); *Guidance Residential, LLC v. Khaja,* Docket No. 08CH18407 (Cir. Ct. Cook County, Chancery Division May 20, 2008).
14. *Al Baraka Bancorp (Chicago), Inc. v. Hilweh*, 656 A. 2d 197, 202 (1994 Vermont).
15. *Id.* at 198, 200.
16. *Id.* at 198.
17. *Id.* at 198-199.
18. *Id.* at 199.
19. *Id.*
20. *Id.*
21. *Id.*
22. *Id.* at 198.
23. *Id.* at 199.
24. *Id.*
25. *Id.* at 201; citing *In re Dino & Artie's Automatic Transmission Co.,* 68 B.R. 264, 269 (Bankr. S.D.N.Y. 1986).
26. *Id.*
27. *Id.*
28. *Id.*

Counseling the Banks: What is the Market for Branches?

BY BRADLEY R. CARTER, CRE, MAI, CCIM; J. TYLER LEARD; AND MATTHEW H. JACKSON

INTRODUCTION

LOSSES ARE IN THE BILLIONS, CENTURY-OLD FINANCIAL institutions are failing, and those that formerly lent money to the rest of us now are on government assistance; these are the darkest days the banking industry has seen in generations. At the same time, the supply of branches has increased each year for more than a decade. It would seem that few saw the current financial crisis approaching, and many believed that e-commerce would never permeate mainstream society.

Uncertainty characterizes not only the future but also the present…and good advice on what to do with all these branches has never been in greater demand.

"*I believe a branch bank is the most obsolete form of U.S. retail real estate.*" –K.C. Conway, MAI, Federal Reserve Bank of Atlanta.

Following is a brief study intended to help those charged with the task of counseling banks as they re-define their strategy for the acquisition and disposition of branches in a market where changes continue to evolve.

A HISTORICAL PERSPECTIVE ON BANK EXPANSION

The number of financial institutions has decreased steadily over the past several years, which is a function of mergers outpacing new charters. However, as these financial institutions battled for market share, they executed aggressive strategies to rapidly expand into new markets. The result: Although the number of financial institutions decreased, the number of bank branches continued to increase from 1995 through 2007.

According to Conway, the S&L crisis of the early 1990s resulted in the number of banks declining from approximately 15,000 to about 11,000. As banks got bigger and stronger, mergers and acquisitions brought them down to our current level of about 7,600. Most agree that we are headed lower from here—but this time for a

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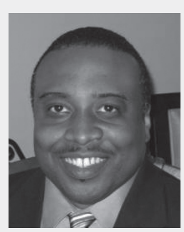

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different reason.

CURRENT STATE OF THE BANKING SECTOR

The mid-year 2007 decline of the commercial credit markets, a spike in foreclosure rates and a sector-wide downturn in residential mortgage origination combined to rock the banking business. Multi-billion dollar write-offs were announced, and institutions too big to fail are failing. The Office of Thrift Supervision said the nation's roughly 830 thrifts lost $1.7 billion in the second quarter of 2008. As slumps in the housing and credit markets worsened, the devastation continued. In the following quarter, a loss of $4.0 billion was posted. Troubled assets, which are defined as non-current loans and repossessed assets, rose 240 percent from a year ago (from 1.00 percent of all assets to 2.40 percent), and now stand at the highest level seen since the early-1990s.

According to the Financial Deposit Insurance Corporation (FDIC), there have been 23 FDIC-insured bank closures in 2008 (through Dec. 5, 2008). Nine of these closures were in the third quarter, representing the largest number of bank failures in a single quarter since 1993. Another 73 institutions were absorbed in mergers during the third quarter of 2008, with many of these mergers engineered to avoid imminent failures.

The list of recent bank failures includes giants Washington Mutual Bank and IndyMac Bank, F.S.B. Washington Mutual Bank, along with its subsidiary Washington Mutual FSB, had combined assets of $307 billion and total deposits of $188 billion, making it the largest financial institution to close in U.S. history. IndyMac Bank, F.S.B. had $32 billion in assets and $19 billion in deposits, and is also one of the largest financial institutions ever to close.

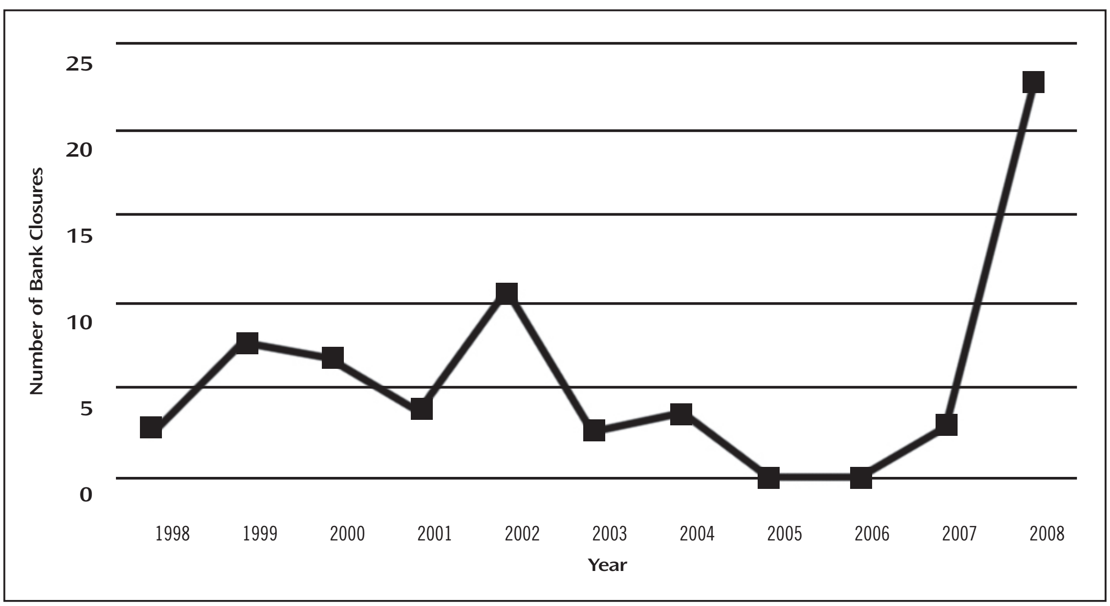
The rise in bank closures is depicted in Figure 1.

These bank failures have depleted the Deposit Insurance Fund—the FDIC's fund that insures deposits. During the third quarter of 2008, the Deposit Insurance Fund decreased by 23.5 percent from the previous quarter. The Sept. 30, 2008 reserve ratio of 0.76 percent for the combined bank and thrift insurance fund is at its lowest point since June 30, 1994. Considering the recent deterioration of economic fundamentals, and the resulting rise in delinquent loans, some industry experts warn that there are not enough reserves to cover future closures. To replenish the insurance fund, the FDIC announced plans to raise the premiums it charges banks, and banks with

Figure 1

Bank Closures (1998–Dec. 5, 2008)

United States (50 States and D.C.)



Source: FDIC 2008

the riskiest deposits may be charged the highest premiums. While that should strengthen the reserve, it would increase the financial strain on those banks already in most peril.

The FDIC had 90 banks and thrifts on its "Problem List" in the first quarter of 2008, which represented the highest number since 1995. By the second quarter of 2008, the tally of banks and thrifts designated as being in trouble grew to 117. According to the latest *Quarterly Banking Profile*, the situation has continued to worsen, and at an increasingly rapid rate of descent; an additional 54 institutions were posted to the list in the third quarter, bringing the total number of "Problem List" institutions to 171. The aggregate assets of these 171 troubled institutions total $115.6 billion. Worse, Conway believes that the FDIC list may understate the number of problem banks and potential failures.

In an effort to fix the problem, the government is intertwining itself with the banking system more deeply than anybody could have contemplated just a short while ago. But don't expect the fix to be either quick or easy.

WHERE ARE THINGS HEADED?

Craig DeMiranda, a former transaction manager for Comerica Bank who was in charge of evaluating transactions in four states, projects that there will be increased bank mergers and acquisitions. DeMiranda believes that fewer buyers of branches will mean less demand for this property type. The authors of this article interviewed several other experts that counsel banks on their acquisition and disposition strategies and found universal agreement on these points. Contraction in this industry seems self-evident, and a reduction in the number of branches needed seems inevitable. The severity of the contraction, however, and its specific impact on demand for branches are matters of opinion.

Von W. Moody, III, CRE, FRICS, MAI, CCIM, CAE, a senior vice president at Wachovia Corporation involved in branch acquisition and disposition strategies, predicts that up to one-third of all branch bank locations nationwide could become vacant or convert to an alternative use within the next three years, either because of bank failures or mergers and acquisitions. The resulting glut of branch banks will exert downward pressure on prices. Conway expressed a similar sentiment while noting that this is a process that is already underway, and should therefore be viewed as a situation that is more of a reality than an expectation. Conway added that, "2009 will likely see an acceleration in bank failures, which will exacerbate the inventory overhang of vacant branch banks across the U.S." Another source within the Federal Reserve believes the number of bank failures in this cycle could be as high as 2,000.

THE IMPACT ON BANK BRANCH DEMAND

Historically, branches becoming available was a function of redundant locations resulting from consolidations and mergers, and banks exiting weak or saturated markets. More recently, though, the instability of financial institutions and the questions regarding their continued viability have become increasingly important factors.

DeMiranda shared with the authors his experience at Comerica Bank as it relates to demand for new branches. He reports that there was demand for bank branches as recently as the beginning of the first quarter of 2008, although demand began to diminish by the end of the quarter. Comerica Bank is not the only institution to break the trend of perpetual expansion. Moody informed us that Wachovia Corporation had planned near-term construction of 50-100 branches in areas such as Texas and California, in addition to 300 LEED green branches with the "Gold" designation. However, new construction was halted when it was announced that Wachovia would be acquired by Wells Fargo.

OTHER CHANGES IN THE ROLE OF BRANCHES

The demand for branches is being impacted by something more fundamental than the ability of banks to operate them: People are changing the way they bank. "Online banking has significantly affected how bank branches are evaluated," reports Don Guarino, CRE, MAI, who was active in acquiring branch banks on behalf of an institutional investor. "Many people rarely step foot into a bank branch these days."

James "Tom" Coe, CRE, of Real Estate Asset Counseling, Inc., expressed similar thoughts. Coe notes that debit cards and online banking both reduce the amount of space that a bank needs. He estimates that while most small deposits are still made at branches, 70 percent of deposits, in terms of dollar volume, is now electronic.

A reflection of the changing role of branches is the way in which they are evaluated. Guarino suggests that deposit volume has become a key metric to identify the best locations; this challenges the conventional wisdom that highly prized branches are those that are successful at engaging in more high-profit activities such as lending, as opposed to simple day-to-day customer service transactions such as accepting deposits. Guarino explains his position quite simply: "How many loans do you think will be made in the next 24 to 36 months?" The authors advanced the idea to the other experts we interviewed that deposit volume has become the prime indicator for judging a branch's location. There was widespread agreement.

HIGHEST AND BEST USE AND THE DISPOSITION OF ALL THESE BRANCHES

Branches placed on the open market have historically yielded the highest prices from other banks who continue to operate them as branches. Community banks have shown particular interest in purchasing branches as they seek to expand their presence while avoiding the costs of new construction. Branches purchased for alternative uses were usually those with significant functional obsolescence and/or in declining markets; for the most part, though, banks paid the highest prices for even marginal branch properties.

Our research revealed a wealth of anecdotal evidence that banks will no longer necessarily be willing or able to outbid alternative users when branches come to market. This anecdotal evidence includes opinions expressed by several brokers marketing bank branch properties, as well as some of the largest purchasers of branches. We found empirical evidence to support that view as well, including examples of where branches purchased for continued bank use sold for less than similar branches purchased for an alternative use.

Guarino provided us with an inside view of why the numbers don't always work as they did previously when banks could and would outbid all competitors. A few years ago the metric used for the acquisition of a large group of branches for one of the nation's largest banks was tied to the return they could achieve for a safer alternative investment. A spread of fifty basis points above the return they would expect for this safer alternative investment was considered acceptable; however, Guarino expressed the opinion that in order to reflect the increased risk and volatility with bank branches, the current spread would likely be 300–400 basis points. This could easily depress the price they would pay below what others would pay, which demonstrates how pervasive shifts in highest and best use can occur.

Despite both anecdotal and empirical evidence showing that banks may not continue to outbid alternative users for available branches, most of the experts whose opinions we sought believe that the branches with the best locations remain the exceptions. According to James Culton, who handles acquisitions and dispositions of branches for SunTrust Bank, "For the properties located in high traffic areas with low availability of new sites, banks are still willing to pay full price for these closed branches." Moody expressed similar sentiments, indicating that banks consider some prime sites to be viewed as more than just real estate, adding that some banks have been known to purchase sites proximate to their existing locations and place deed restrictions prohibiting branch use as part of a competitive strategy.

WHAT DOES ALL THIS MEAN FOR YOUR BANK CLIENT?

Here are the key points that counselors need to remember in advising bank clients on their acquisition/disposition strategies for branches:

WHAT BRANCHES WILL SELL?

- Branches that will be easiest to dispose of are those near major employment centers and public transportation.
- Those with high deposit volumes are most likely to appeal to other banks.

WHO WILL BUY THEM?

- Healthy regional banks will be particularly good candidates to purchase excess branches from larger institutions that continue to consolidate. These regional banks can typically operate at a lower per branch deposit base than that of a larger bank.
- Community banks are also interested in purchasing branches as they seek to expand their presence while avoiding the costs of new construction. However, community banks are expected to lead the wave of near-term bank failures.

WHAT PRICE WILL THEY BRING?

- The sheer volume of branches expected to come on the market will depress prices.
- The "A+" locations will still command premiums from banks purchasing them for continued use as a branch. Otherwise, there is no clear reason to expect that a bank will pay more than an alternative user.

WHAT TO EXPECT WHEN MARKETING FOR ALTERNATIVE USE

- Properties designed as bank branches often appeal to a variety of commercial users because they typically have good commercial locations and abundant parking.
- The most common alternative uses have been restaurants and neighborhood services ranging from hair salons to small vet clinics. Check-cashing establishments and pawn shops also have been popular, particularly in declining neighborhoods.
- There is a wide pool of purchases for alternative uses, but they are often willing to pay just at 20–40 percent of replacement cost (over and above the value of the land).

WHEN TO BUY

- Any bank seeking additional branches should stay ready to act, as a glut of branches coming to market appears inevitable.
- Purchasing in bulk will result in a per unit discount, as large institutions with many branches to dispose of will be eager to solve their problem as quickly and in as few transactions as possible.
- If a branch becomes available in a market where your client is concerned about new competition, advise them to purchase it and place restrictions in the deed preventing continued bank use.

THE SALE-LEASEBACK OPTION

- Sale-leasebacks may be the best option for your bank client to generate cash, and perhaps even increase earnings.

CONCLUSION

We began with the observation that good advice has never been in greater demand. Given the volatility in this industry, that observation is one of the few things not expected to change anytime soon. ■

CRE

The Income Tax Effects of the Housing and Economic Recovery Act of 2008 on Real Estate Transactions

BY J. RUSSELL HARDIN, PH.D.

INTRODUCTION

If real estate investors are to maximize after-tax profits and maintain appropriate levels of capital investment, they must have a working knowledge of the latest legislative changes enacted by the United States Congress that pertain to real estate. On July 30, 2008, President George W. Bush signed into law the Housing and Economic Recovery Act of 2008 (hereinafter Act). This sweeping piece of legislation contains, among other things, numerous amendments to the Internal Revenue Code. Several of the provisions of the Act have implications for real estate investors and/or real estate transactions.

The purpose of this article is to summarize the provisions of several of the important changes to the Internal Revenue Code that are now the law or that will soon become the law and that pertain to real estate transactions. Investors in real estate are urged to look closely at this tax legislation to seek ways in which they can significantly diminish their future income taxes. The following discussions focus on the major provisions of the new bill which, directly or indirectly, affect real estate transactions. Some suggestions for tax planning are also included in the discussions. To determine the particular effect, if any, each of these provisions will have on a particular investment, each investor should consult with his/her CPA, tax attorney or other tax professional.

LOW-INCOME HOUSING TAX CREDIT

The Act states that the low-income housing tax credit for new buildings placed in service after the date of enactment of this change (July 30, 2008) and before Dec. 31, 2013, shall be subject to a tax credit rate of not less than nine percent. The nine percent rate applies only to new construction and substantial rehabilitation projects that are not subsidized by the federal government. The applicable rate for new buildings that are federally subsidized or are existing buildings is four percent. The appropriate credit may be taken for 10 consecutive years on the low-income housing project. A loan including federal funds is not considered to be subsidized if the loan bears an interest rate that is at or above the prevailing Treasury interest rate.

About the Author

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The basis that is available for the credit is determined in three basic steps and one additional step. In step one, the eligible basis is determined. Eligible basis includes all depreciable construction costs and all depreciable "soft" costs such as architectural fees and engineering costs. Non-depreciable costs such as the cost of the land are excluded from the eligible basis. In step two, the fraction of qualified low-income housing units is determined. The applicable fraction is the lower of the percentage of low-income units to total units or the square footage occupied by low-income units out of the total square footage for the project. In step three, the basis amount that qualifies for the low-income housing credit is determined. In the additional step, the credit may be increased up to an additional 30 percent. This extra credit is only available for areas that are designated as Qualified Census Tracts (QCTs) or Difficult Development Areas (DDAs) by the U.S. Department of Housing and Urban Development (HUD).[1]

SAMPLE COMPUTATION:

A local real estate developer is proposing to build 100 rental units in Boomtown, U.S.A. The developer will not use any additional federal funds. The development will not be located in a DDA or a QCT. Forty-five percent of the units and forty percent of the square footage will be set aside for low-income households. The total development costs for the project are estimated as follows:

Land Acquisition	**$2,000,000**
Dwelling Construction	**7,170,000**
Site Improvements	**700,000**
Architectural/Engineering	**80,000**
Other Eligible Soft Costs	**50,000**
Total Development Costs	**$10,000,000**

Generally, the value of the tax credit is calculated as follows:

- **Eligible Basis = $8,000,000 (Total Development Costs – Land Cost)**
- **Qualified Basis = $3,200,000 (Eligible Basis x Applicable Fraction: $8,000,000 x 40%)**
- **Annual Credit = $288,000 ($3,200,000 x 9% Credit Rate)**
- **Total Amount of Housing Tax Credits = $2,880,000 ($288,000 x 10 years)**

Tax Planning Tips: Since the above change is temporary and expires on Dec. 31, 2013, developers who wish to qualify for the low-income housing credit should make sure that construction projects are completed and the housing is placed in service prior to Jan. 1, 2014. Developers also should consider avoiding federally subsidized loans so that the projects qualify for the nine percent credit rather than the four percent credit.

FIRST-TIME HOMEBUYER CREDIT

The Housing and Economic Recovery Act of 2008 offers a first-time homebuyer credit. This credit is available to a first-time homebuyer of a principal residence in the United States during a taxable year. The credit is refundable in a manner similar to the earned income credit. In other words, the taxpayer will receive the credit in the form of a refund even if the tax liability for the year is zero. The credit is an amount equal to 10 percent of the purchase price of the principal residence, up to a maximum of $7,500. This credit is equivalent to an interest-free loan because taxpayers receiving the credit must repay any amount received under this provision back to the federal government over 15 years in equal installments. The provision applies to homes purchased on or after April 9, 2008, and before July 1, 2009. This credit begins to phase out for taxpayers with an adjusted gross income in excess of $75,000 ($150,000 in the case of a joint return).

The repayment provision of the Act calls for repayment to begin in the second taxable year after the taxable year during which the home is purchased. For example, if the taxpayer purchases a home in 2008, the credit is allowed on the 2008 tax return, and repayment begins with the 2010 tax return. If the taxpayer sells the home prior to complete repayment of the credit, any remaining credit repayment amount is due on the tax return for the year during which the home is sold (or ceases to be used as the principal residence). No amount is recaptured after the death of a taxpayer. In the case of an involuntary conversion of the home, recapture is not accelerated if a new principal residence is acquired within a two-year period. In the case of a transfer of the residence to a spouse or to a former spouse because of divorce, the transferee spouse (and not the transferor spouse) will be responsible for any future recapture.[2]

Tax Planning Tips: An individual or married couple who has had no ownership interest in a principal residence during the three-year period ending on the date of the purchase of a principal residence will qualify as a first-time homebuyer. Also, a residence that is constructed by a taxpayer is treated as purchased by the taxpayer on the date the taxpayer first occupies the residence.

ALTERNATIVE MINIMUM TAX CHANGES

The alternative minimum tax (AMT) can increase the cost of implementing housing programs. Under current tax law, the interest on tax-exempt housing bonds is subject to the AMT. The potential taxability of this interest under the AMT limits the marketability and the incentive effect of these bonds. In addition, under current tax law, both the low-income housing tax credit and the rehabilitation tax credit (the rehabilitation credit applies to costs incurred for rehabilitation and reconstruction of historic structures and buildings built before 1936) cannot be taken as offsets against the AMT. Thus the incentive effects of these credits are limited.

The Housing and Economic Recovery Act of 2008 eliminates these impediments imposed by the AMT on housing programs. The bill would allow the low-income housing tax credit and the rehabilitation tax credit to be used to offset the AMT and would ensure that interest on tax-exempt housing bonds is not subject to the AMT. This portion of the Act applies to interest on tax-exempt housing bonds issued after the enactment date of the Act (July 30, 2008). The low-income housing credit amendment is effective for buildings placed in service after Dec. 31, 2007. The rehabilitation credit amendment is effective for qualified rehabilitation expenditures properly taken into account for periods after Dec. 31, 2007.[3]

Tax Planning Tip: Many parts of the Act are temporary and designed to help stimulate the real estate market in the short term. These AMT changes are an actual permanent repeal of the applicable provisions.

REAL ESTATE INVESTMENT TRUST REFORMS

The Housing and Economic Recovery Act of 2008 contains a number of provisions to liberalize the rules regulating real estate investment trusts (REITS). REITs are subject to several complex rules that can limit the ability of these businesses to adjust to changing market conditions and to properly manage risk. The Act relaxes these rules in several ways.[4] First, the Act shortens the prohibited transactions (i.e., a sale of property held primarily for sale to customers in the ordinary course of business, or "dealer property") safe harbor holding period from four years to two. A REIT is potentially subject to a tax equal to 100 percent of the net income derived from a prohibited transaction. Under prior law, the safe harbor rules applied to a sale of real property if, among other requirements, the REIT held the property for at least four years for the production of rental income, and the aggregate expenditures made by the REIT during the four-year period preceding the date of sale that were capital expenditures did not exceed 30 percent of the net selling price of the property. The Act shortens the minimum holding period under the safe harbor and the period during which the limit on capital expenditures applies from four years to two years. This gives REITs more flexibility to dispose of properties without risk of the 100 percent tax being imposed, provided the other requirements of the safe harbor are met.[5]

The Act also eases the rules concerning a REIT's foreign currency income associated with real estate activities. Under prior law, the definition of a REIT included the following provisions: 1) at least 95 percent of its gross income is derived from dividends, interest, rents from real property, gain from the sale or other disposition of stock, securities, real property, and several other items; 2) at least 75 percent of a REIT's gross income is derived from rents from real property, interest on obligations secured by mortgages on real property or on interests in real property; gain, from sale or disposition of real property, etc.[6] The prior 95 percent and 75 percent test included foreign currency gains as gross income in applying both tests. Foreign currency gains arise due to fluctuations in foreign currency between the time a REIT accrues rent or interest income, until the time it collects the income. Under the Housing and Economic Recovery Act of 2008, certain foreign currency gains are excluded from gross income in applying the 95 percent and 75 percent tests.

Tax Planning Tips: With the above changes in the rules for REITs, taxpayers may find that it is easier to qualify real estate investments as a REIT when engaging in foreign currency transactions. In addition, the new two-year safe harbor rule may allow real estate investors to sell their REIT investments sooner and realize the lower capital gains tax rates that are currently in effect.

MODIFICATION OF EXCLUSION OF GAIN ON SALE OF PRINCIPLE RESIDENCE

Generally, a gain on sale of most property is taxable. However, Internal Revenue Code Section 121 provides an exception to this general rule. Under Section 121, a homeowner selling a personal residence is permitted to exclude up to $250,000 ($500,000 if married filing jointly) of realized gain. To qualify for this favorable tax treatment, the residence must have been occupied for at least two years during the five-year period ending on the date of the sale. This five-year window allows a taxpayer to qualify for the Section 121 exclusion even though the property was not the taxpayer's principal residence at the date of the sale. Astute real estate investors have been taking advantage of this tax loophole for years. For example, an investor could purchase a home and use it as the principal residence for two years and then use it as rental property for the next couple of years. Or, alternatively, an investor could convert a rental house to a primary residence, live in it for two years, then sell it and qualify for the exclusion. In other words, in both of the above cases the investor could sell the house and take advantage of Section 121 and exclude up to $250,000 ($500,000 for joint filers) of his/her capital gain.

The Housing and Economic Recovery Act of 2008 amends Section 121 of the Internal Revenue Code so that if there were any non-qualified use of the real property prior to the property being used as the primary residence, the total tax-free exclusion is no longer available. Non-qualified use is defined as any use of the property other than as a primary residence. This includes use as a second home, a vacation property, a rental property or an investment property. It also includes use of the home in a trade or business.

The distinction between qualified and non-qualified use is important, and the timing of the qualified and non-qualified use is important. Homeowners/investors can no longer take the full tax-free exclusion under Section 121 when the property was held and used for non-qualified use prior to being held and used as a primary residence. When non-qualified use occurs prior to qualified use, the capital gain resulting from the sale of the property will be allocated between qualified and non-qualified use periods based upon the amount of time the property was held and used for qualified versus non-qualified use. The capital gain allocated to the non-qualified use period will no longer be excluded from the homeowner/investor's taxable income. The capital gain allocated to the qualified use period (personal primary residence) will still qualify for the Section 121 exclusion and will be excluded from the taxpayer's taxable income.

Homeowners will not have to determine when the property actually appreciated in value. Appraisals are not needed or required. The change or fluctuation in the fair market value of the property each year during the time the home is owned doesn't matter. The total capital gain recognized upon the actual sale of the property is all that matters. The capital gain recognized upon actual sale will be allocated between non-qualified and qualified use periods in order to determine the amount of gain to be excluded from taxable income under Section 121 due to qualified use, and the corresponding amount of capital gain that will be included in taxable income under Section 121 due to non-qualified use. The allocation of the gain between qualified and non-qualified use periods is very simple. Gain is allocated using a fraction based on the number of years the property was held for qualified use over the number of years of total use.

EXAMPLE:

A homeowner owned real property for eight years. The property was held as rental property for the first six years and then the property was converted to use as a primary residence. The use as a primary residence lasted for two years. The qualified use period is two years and the non-qualified use period is six years. Therefore, two-eighths, or one-fourth of the total actual capital gain is excluded from taxable income while six-eighths, or three-fourths of the capital gain is included in the taxpayer's taxable income. Remember that depreciation recapture cannot be excluded from taxable income under Section 121, and would be recognized and included as income in the year the property is actually sold.[7]

Tax Planning Tip: Property that is held as a primary residence first and then converted to investment or business property use will still qualify for the full Section 121 exclusion. The proration of the gain discussed above only occurs when investment property is converted to use as a primary residence. Therefore, real estate investors who know they will be converting property between investment and personal use should use the property as a primary residence first (for at least two years) and then convert it to investment use. This change in the Internal Revenue Code is expected to generate more than one billion dollars in new tax revenue for the federal government over the next ten years. The above changes are effective for sales or exchanges that occur after Dec. 31, 2008.

TAX-EXEMPT BONDS

Under current law, municipal bonds that are guaranteed by Federal Home Loan Banks do not qualify as tax-exempt unless the bonds are used to finance housing programs. The Act helps municipalities by temporarily allowing these bonds to be tax-exempt even when they are not used to finance housing programs. This temporary change will make it easier for local and state governments to obtain financing to build roads, repair bridges, build schools, etc. This change expires at the end of 2010.[8]

Tax Planning Tip: Investors looking for tax-exempt income should take advantage of the ability to purchase these newly exempted bonds between now and Dec. 31, 2010.

RECENT TAX CHANGES: UPDATE

In October 2008, Congress passed the Emergency Economic Stabilization of 2008. Some relevant provisions follow. Depreciation at a 50 percent rate is allowed in the year that reuse and recycling property is placed into service. Reuse and recycling property includes machinery and equipment that is used to collect, distribute or recycle materials such as plastic, glass, rubber, metal, etc. One provision allows the deduction of energy credits for solar, fuel cell and microturbine technology against the alternative minimum tax. Another provision allows a tax credit for residential energy-efficient property such as wind, solar or geothermal. Still another provision raised the alternative minimum tax exemption amount to $69,950 for married filing jointly ($46,200 for single) for 2008.[9]

On Dec. 29, 2008, the Internal Revenue Service issued Revenue Procedure (Rev. Proc.) 2008-68 to provide temporary relief to REITs. This relief will allow REITs to preserve cash by allowing the issuance of stock dividends. Under this new Rev. Proc., REITs are allowed to cap the cash portion of a dividend at 10 percent (the remaining 90 percent can be a stock dividend). This Rev. Proc. applies only to REITs that are publicly traded on an established securities market in the United States. The effective date of this Rev. Proc. is Jan. 1, 2008. Dividends declared with respect to a taxable year ending on or before Dec. 31, 2009 are covered by this Rev. Proc.[10]

On Feb. 17, 2009, the American Recovery and Reinvestment Tax Act of 2009 became law. This Act further increases the alternative tax exemption amount to $70,950 for married filing jointly ($46,700 for single) for tax years beginning after Dec. 31, 2008 (i.e., beginning in 2009). The 2009 Act extends from two to five years the carryback period for net operating losses incurred in 2008. This five-year carryback is for small businesses with $15 million or less in gross receipts. The bill also extends the 50 percent write-off of capital expenditures incurred to purchase depreciable property (e.g., equipment, tractors, wind turbines, solar panels and computers) acquired in 2009 for use in the United States.[11]

CONCLUSION

This article has attempted to summarize some of the tax changes in the Housing and Economic Recovery Act of 2008 (and some recent legislation). The focus has been on the changes that would directly or indirectly affect real estate investors and/or real estate transactions. The author sees no movement toward tax simplification by the U.S. Congress and the president, but the Housing and Economic Recovery Act of 2008, one hopes, will meet the objectives of improving the economy and providing some relief to taxpayers. Real estate investors have many opportunities created by the new tax rules to reduce their tax burdens. However, a law as complicated as this Act commands a great deal of study by investors who desire to maximize returns and minimize the tax burden. Real estate investors should consult with appropriate tax professionals to assure proper application and maximum benefit from this new tax Act. ■

ENDNOTES

1. *http://www.tnmha.net/untitled/Publication3.pdf.*
2. H.R. 3221.
3. *http://www.hud.gov/offices/cpd/about/conplan/foreclosure/senatefinancesummary.pdf.*
4. *http://www.hud.gov/offices/cpd/about/conplan/foreclosure/senatefinancesummary.pdf.*
5. *http://www.mondaq.com/article.asp?articleid=64256.*
6. Internal Revenue Code, Section 856.
7. *http://www.exeterco.com/article_changes_to_section_121.aspx.*
8. *http://www.icba.org/files/ICBASites/PDFs/hr3221summary.pdf.*
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When Will the Miami Condominium Market Recover?

Follow the Land, Man

BY RICHARD LANGHORNE, CRE, FRICS; AND JOHN BLAZEJACK, CRE, MAI, FRICS

Note: *The following is commentary. The opinions expressed belong solely to the authors.*

SINCE 2003, DEVELOPERS HAVE BEGUN CONSTRUCTION ON 22,000 condos in downtown Miami, which is more than double the number built over the last four decades. "For sale" condominium inventory has doubled. Residential vacancies have doubled in the past year. Prices have slipped downward dramatically.

As lenders have tightened restrictions on mortgages for condos, the closing rate on downtown condo sales has dropped from 18 per day in 3Q 2008 to five per day in 4Q 2008. Everglades on the Bay, for instance, an 848-unit condominium facing Bayfront Park and Biscayne Bay started closings in November. By December 31st, it had closed 18 units. Another project of more than 700 units in the Brickell market closed 106 units and stalled. In that project, one of the penthouse units currently is being rented for $2,000 a month, or just $1 per foot per month.[1]

BACKGROUND

In 2008, nearly 2.7 million square feet of condominiums, townhouses and single-family homes in coastal South Florida sold at an average discount of 43 percent. According to the Vultures Database™ (*CondoVultures.com*) that tracks residences where the price has dropped by at least 10 percent or $100,000, a total of 1,717 properties east of Interstate-95 in Miami-Dade, Broward and Palm Beach counties traded last year for a combined price of $775 million, down from a historical high of $1.33 billion. The overall price drop equates to a combined discount of more than $550 million off the historical high asking price for the properties. In each of the 12 months in 2008, an average of 143 residential properties in the Vultures Database sold at 57 cents on the dollar. For comparison, in 2007, there were 1,272 properties in the Vultures Database that sold at an average discount of 29 percent.

On Dec. 31, 2008, the Vultures Database was comprised of 4,301 condo units, townhouses and single-family houses in South Florida that had dropped in price by an average of 39 percent. Condos and townhouses, which account for 69.6 percent of the total, are down an average of 38.5 percent. Single-family houses, which represent the remaining 30.4 percent of the inventory, are down an average of 40.0 percent. According to the Vultures Database, the average price drop for condos in Greater Downtown Miami has been 41.8 percent, while across the causeway in Miami Beach, the average discount has been 34.3 percent.

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DOWNTOWN MIAMI

This article focuses on one submarket, downtown Miami, to show specific actions on the part of planners, city officials, developers, lenders and speculators that have led to overextension and overbuilding to the detriment of the market and the general public. In Miami, for instance, rental vacancy more than doubled from 2.6–5.8 percent from November 2007 to November 2008. For perspective, vacancy rate was 3 percent county wide in 2001 for buildings 18 months or older.[2]

We have seen the enemy. And the enemy is us.

The table and graph below indicate land prices from 2000 through the end of 2008.[3]

Figure A

Land Prices

PRICE	APPROVED	DATE	$/SF	$/UNIT
$9,000,000	560	12/1/2008	$150	$16,071
$45,000,000	2,424	10/1/2008	$183	$18,564
$18,100,000	560	2/1/2005	$302	$32,321
$18,700,000	554	3/1/2005	$401	$33,755
$19,475,000	560	6/1/2005	$359	$34,777
$31,750,000	924	4/1/2005	$358	$34,361
$190,000,000	3,000	3/1/2005	$470	$63,333
$94,000,000	1,705	12/1/2004	$443	$55,132
$38,948,537	1,276	8/1/2004	$283	$30,524
$15,000,000	633	4/1/2004	$200	$23,697
$14,600,000	516	1/1/2004	$201	$28,295
$30,228,000	1,424	11/1/2003	$56	$21,228
$14,700,000	516	11/1/2003	$196	$28,488
$6,000,000	200	6/1/2003	$192	$30,000
$25,000,000	866	5/1/2003	$204	$28,868
$6,300,000	142	12/1/2002	$223	$44,366
$8,750,000	343	12/1/2002	$104	$25,510
$19,000,000	667	4/1/2001	$170	$28,486
$12,500,000	360	4/1/2000	$87	$34,722

Source:
Blazejack & Company, Land Sales Research File, (2000–2008)

The land prices drop for high-density sites as the market becomes aware of the CMBS problems and financing availability diminishes. The new highest and best use for vacant sites today would include hotel, office and rental apartments, as well as retail. The big change will be a much smaller building envelope and lower FAR, all of which reduces the land value in a land residual model. This puts downward pressure on price points and elongates the recovery time frame. The two most recent sales are reflective of the 2002 prices prior to the run-up in values.

ON THE WATER, CIVIC OVERSIGHT IS FOGGY

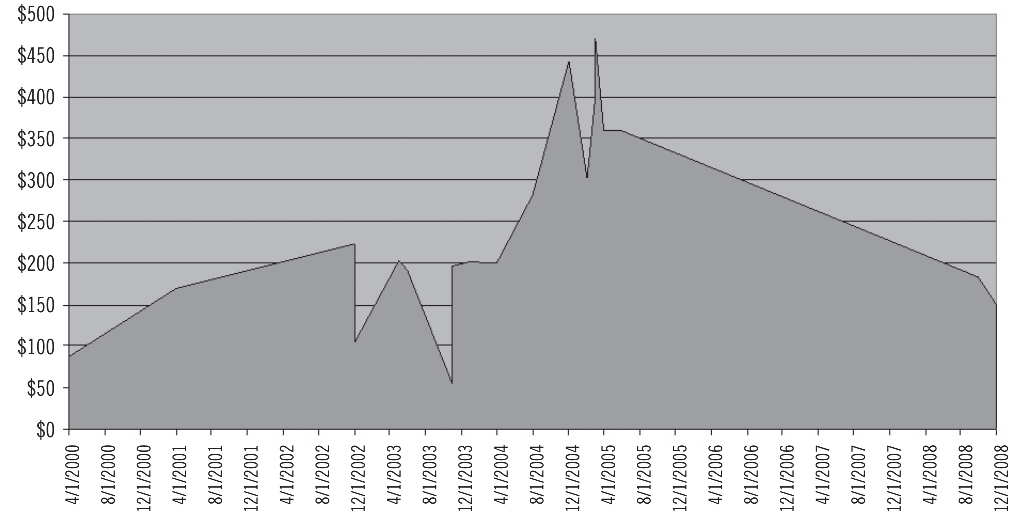
In every urban area that has access to a large body of water, whether it be a lake, river, ocean or back bay, there almost always comes an initiative for commercial real estate development on what are likely the most pristine of waterfront locations. Often these locations are those that the general public should enjoy and that government should actively protect for future generations. But when markets overheat, the development community seems to be unable to resist the opportunity to get at these locations. In the case of South Florida and, particularly Miami, there has always been a struggle between preservationists and developers. In the case of Miami-Dade County, the ebb and flow of the public-private struggle for saving or developing pristine waterfront parcels is emblematic of each real estate cycle, whether it be a frenzied run of overbuilding or the aftermath of a complete market collapse.

One longstanding example is the development of the Bayside Marketplace in the center of the City of Miami's downtown waterfront known as Bayside Park. The struggle for this 230,000-square-foot development with its accompanying 1,200 space parking garage went on for years. By the time the development commenced, the real estate cycle which prompted the fervor to create Bayside Marketplace had long passed, and most could not even remember how the idea had even been conceived. At one point, the developer negotiated the land lease (which had the City participating in net income) without defining the expenses, resulting in the elimination of any financial return to the City.

Another example is the Brickell Point Apartments which rested for many years in a decaying state on a river- and bay-front site of 99,000 square feet. A developer acquired the existing apartments, tore them down and commenced a luxury high rise development. In the process of excavating for the foundation, however, Indian artifacts were discovered, causing a delay. The developer then persuaded the City and State of Florida to pay a whopping $26,900,000, or $280 per square foot of land, to turn the site into a park that is now known as the Miami Circle site.[4] Later, the City allowed another developer to increase density for an adjacent project. The result was a very dense 1,700-unit

Figure B

Miami Condominium Land Sales 2000–2008



Source: Blazejack & Company, Land Sales Research File, (2000–2008)

project called ICON, constructed on 216,646 square feet of land, equating to 342 units per acre. The purchase price was $94 million, or $434 per square foot of land. The water and sewer infrastructure capacity for this massive development was greater than any previously built in the urban core. Despite the additional density granted by the city, no school or park contributions were made.

What is the possible nexus between the discussion of public-private land use on waterfront sites, and the recent cycle of overbuilding in the Miami-Dade County condominium market? A case in point is a 2.496 acre waterfront site in the prestigious Brickell Avenue submarket of downtown Miami, known as the Villa Magna site. This site received a Master Use Special Permit from the City of Miami in 2004 for a development that would contain 780 condominium units in a 45-story tower, equating to 313 units per acre. Subsequently, as the marketplace began to change and fears of overbuilding in the luxury condominium market grew, the plan for the site was altered to include hotel and condo-hotel use combined with office space. As of 1Q 2009, the same site is being leased to the City of Miami by the developer for $1.00 per year for use as a park since, due to the saturated condominium and office space markets, there is no other viable use for the site.

Now rented for just $1 per year, the Villa Magna site sold in 2001 for $15.5 million, or $142 per square foot of land. In 2004, the site was offered for sale for $87.0 million, or $806 per square foot, equating to $111,000 per unit—roughly double the per unit price of the ICON site. Today, the real estate tax assessed value is $38,054,100, or $350 per square foot, and the real estate taxes are $852,782.[5] Thus, in handing the site to the City for public purposes, the developer saves that amount each year, and the City looses that amount in tax revenue. The death walk has begun, and the unintended consequence of this change in land use is the first barrier to recovery of the marketplace.

How could this change in land use and "greening of the neighborhood" be a barrier to the recovery of the luxury condominium market? Tax assessments throughout the City in new condominium and existing projects are trending downward. Consequently, the City will be forced to contract for services in a market that needs such services as an amenity to facilitate recovery. It is reminiscent of an earlier decade when the City of Miami did not pay attention to the collapse of the office market. Values and tax collections retreated, and the City's bonds were put on watch, so much so that the State of Florida installed oversight on City financial activities.

The current inventory of new condominium units in this sub-market exceeds 22,000.[6] In the current marketplace in Miami-Dade County, using fundamental demand, and without making adjustments for the bulk sale of unsold condominium units, it is reasonable to assume that a 10-year supply of condominium units exists. Sales at prices less than the hard cost of construction would likely mean that the value of the land, the developers' initiative, design fees, soft costs, legal fees, marketing costs and interest expenses are burned to the ground and lost forever. This would be a scorched earth outcome.

RESET PRICING: ANOTHER STEP DOWN THE DEATH WALK

What does reset pricing mean for existing condominium housing stock where mortgages are at prices that are higher than bulk sale prices of new inventory? The reset pricing of formerly mature and stable projects is creating a disconnect throughout the urban condominium asset class in Miami. One project finished in 2003, known as Jade, was sold out prior to Certificate of Occupancy; 70 percent of its units were sold by October 2002.[7] There were 300 reservations within two weeks of releasing the first 30 units in August 2002.[8] Jade now has a significant number of its 340 units in foreclosure. There are now three mature buildings in the Brickell submarket with disproportionate numbers of foreclosures pending.[9] In 2008, The Vue at Brickell had 49 foreclosure actions pending, and The Club at Brickell had 54.[10] Combined, these three buildings in the same submarket (Jade, the Vu, and the Club) exceeded $100 million in mortgage foreclosures[11], which puts unforeseen financial pressure on the condominium associations, and would cause a good faith purchaser to take pause at any price because of the uncertainties with respect to the viability of the condominium association and its ability to maintain the asset. It is important to note that when lenders foreclose on condo units, they are not required to pay the monthly fees that accrue during the foreclosure process; those costs are borne by the association. Lenders often delay foreclosure sales to avoid paying association fees. Financial pressure on condominium associations is a second barrier to recovery of the luxury condominium market in Miami.

THE TRIPLE BYPASS

The securitization of mortgage loans has fostered a complete abdication of prudent underwriting and has resulted in a new phenomenon which we will call "the triple bypass."

In the triple bypass, three important underwriting protocols were ignored. First, businesses were created with telephone boiler rooms to conduct "inspections"—actual site visits for property inspection did not occur. Second, due diligence modeling, such as a rental income analysis, was bypassed as part of construction loan underwriting. Third, the real structure in condominium purchase agreements, including meaningful deposits being placed at the time of execution of the contract, the time of commencement of the project and at a time certain during the construction phase, were ignored. Such contract provisions would have ensured a high degree of certainty that contracts would close.

In the triple bypass, everything that comes from the heart of a sturdy real estate model was abandoned for artificial and insider trading on land and development schemes, coupled with the ultimate artificial element, "the Buyers Club." Buyers Clubs were predominately groups of speculators who executed preconstruction purchase contracts that were fully assignable and were subsequently flipped to other speculators after the developer closed on construction loans.[12] Essentially, this was a fraud perpetrated on the lender, but the model allowed lenders to abandon prudence and discipline without prying into the number of contracts that each speculator held. In previous eras, purchasers were not allowed to have a half-dozen contracts in the same building. In the recent cycle, the only prudent actors in the game were the mezzanine lenders, who studied the credit scores of unit buyers and scanned buyer lists for active flippers.[13]

COMES NOW THE INTERNET

No one ever imagined that there would be trading of purchase and sale agreements for luxury condominiums across continents by virtue of the Internet and powerful Web sites. But, marketing Web sites of developers and real estate brokers have created an artificial perception of the depth, strength and durability of the condominium market.

This perception was enhanced through actual sales initiatives by developers in overseas markets. The result was implied demand that is irrational when compared to actual, fundamental demand.

IMPACTS FROM SEIZURE IN CREDIT MARKETS

Conventional lending for luxury condominium purchasers has become more stringent, with higher equity requirements and substantiation of income. The requirement for a higher equity contribution on the purchase of individual condominiums puts further downward pressure on price points and elongates the recovery timeframe.

NEW GUIDELINES FOR FANNIE MAE LOANS: A NEW BARRIER TO RECOVERY

Fannie Mae has issued new guidelines that Florida condos and condo conversions, and, in some cases, older condos, must meet before it will fund loans:

- At least 70 percent of the units in new condos must be presold.
- No more than 10 percent of units can be owned by a single entity.
- No more than 15 percent of units in *all* condos can be more than 30 days past due on association fees.

- No more than 20 percent of a condo can be devoted to commercial use.
- All condos, new and old, must have fidelity insurance, which protects association funds from fraud.
- The seller is not allowed to help with down payments or offer other perks, like deductions of association fees, unless they are disclosed.
- Condos must have hazard insurance.
- When investors buy in established projects, at least 51 percent of units must be owner-occupied.[14]

These are the sort of restrictions a successful project would require. People who are buying today should want these restrictions and, in some cases, even more restrictions. For instance, there is a growing consensus that renters do not "work" in luxury buildings for a variety of reasons, such as unit size, approval processes from associations and maintenance issues with non-resident owners, to name a few.

CONCLUSION

The economic recovery will be a painful recovery in every sector. Ultimately, Miami will have a phenomenal housing stock in its urban area, and will be extremely attractive for working professionals. The early part of getting there, though, will feel like a death walk. As we follow the land and condominium prices downward we can see where the point of illogical correction might occur. That is the point of logical correction amplified by fear. In this case, that will result in the elongation of the process to recovery.

The barriers or impediments to recovery are institutional in nature and include Fannie Mae rules; bank underwriting standards; lack of appropriate infrastructure for family occupancy of condo inventory, such as quality schools; destabilized condominium associations; the price disconnect between current sales price points and existing mortgage values; declining real estate tax assessments; and pressure on city services at a time when those services are a requisite to recovery.

Additionally, in 2010, the downtown Miami submarket will receive a four-year supply of Class "A" New Office space. Existing buildings will be cannibalized through aggressive leasing of new projects. The flight to quality that most always occurs in such an environment will most likely occur in 2010, leaving an array of quality buildings unable to make debt service payments. This will introduce another arena of financial instability to the submarket, and will lead appraisers and lenders to exercise further caution. This downward pressure on the urban office market is evidenced by the cancellation in February 2009 of a ten-year, $58 million lease on 115,000 square feet of office space at Brickell Financial Center, a project to be completed in 2010.[15] Because of the recent collapse of Stanford Financial, another 90,000 square feet of office space came back to the market.[16] Combined with the Bilzin Sumberg cancellation, the total is 205,000 square feet of office market space on the market.[17]

Mere bulk acquisition of unsold inventory will not resolve these issues. The bulk purchaser intends to resell at a price point that is attractive, and is at least $100 per foot more than the acquisition. Consider a bulk purchase at $200 per square foot and three-year subsidy of the asset of at least $15 per foot per year. That totals $45 per square foot over a three-year period, and $60 per foot over a four-year period without return of capital or risk-adjusted return.

There is no doubt that those who purchase from the supply of new condominiums at deep discounts will ultimately make serious profits. Our suggestion is that the big jackpot will be in the acquisition of drastically discounted urban land, because that is what will be in short supply. ■

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RECOMMENDED READING

Navigating the Redevelopment Maze

Redevelopment-Planning, Law and Project Implementation: A Guide for Practitioners

by Brian W. Blaesser and Thomas P. Cody, Editors (2008, American Bar Association, 329 pages)

REVIEWED BY MARY C. BUJOLD, CRE

EDITORS BLAESSER AND CODY HAVE put together a number of individual chapters, creating a primer on the redevelopment process. The book is targeted to attorneys acting on behalf of their developer clients or a government entity. As such, commentary in the book is often directed toward an individual or group that has a legal practice. Despite this direction, there are many components that are important to all practitioners of redevelopment, no matter if they are involved in government, public finance, private finance, urban planning, market research, appraisal or other occupations. There is virtually no component of the redevelopment process that is left out of the loop. Yet, the book is eminently readable and easy to understand.

While the first two chapters of the book discuss the various "stakeholders" in the process and the government regulations that have made redevelopment possible, the meat of the treatise includes information on market feasibility, the design process, land assembly, eminent domain and the often complicated process of public/private financing.

Simply put, the editors have compiled chapters from many authors and have nearly "covered it all." Features in many of the chapters, such as "practice tips" and a glossary of terms, assist the neophyte in better understanding the myriad details that comprise redevelopment.

Those who have already navigated these waters know that redevelopment is not for the faint of heart. However, the book provides clear and straightforward counsel about the key areas and issues associated with these complex projects.

Each redevelopment is unique and possesses its own characteristics and challenges. And, many times, the process does not proceed smoothly. Anyone intimately involved with redevelopment knows that the road twists and turns, starts and stops. Sometimes in reading the book you may have the feeling that "redevelopment" is much easier than it is, with each chapter succinctly moving you through the maze. The authors of each chapter often caution readers and practitioners about the pitfalls, what to watch out for, what concerns should be addressed early into the process. The land assembly chapter provides a six-step basic process for land assembly:

About the Columnist

Mary C. Bujold, CRE, *president, Maxfield Research Inc., Minneapolis, Minnesota, is considered a market expert in the field of residential real estate and in market analysis for financial institutions. As well as providing strategic direction for the firm, Bujold heads project assignments for large-scale land use and redevelopment studies, including downtown revitalization for private developers and municipalities in the Twin Cities and in the Upper Midwest. Her work spans public and private sector clients, including institutional clients. Bujold also regularly testifies as an expert witness for eminent domain, tax appeal and other types of real estate litigation. She holds a bachelor's degree in business administration from Marquette University and a master's degree in business administration from the University of Minnesota.*

STEP ONE: Stop and Assess the Process
STEP TWO: Secure Control of the Process
STEP THREE: Furnish Proper Tools
STEP FOUR: Instruct the Blind
STEP FIVE: Stay Organized
STEP SIX: Be Fully Involved

This six-step process is helpful, but only provides a very cursory analysis of the many challenges to land assembly.

The chapter on eminent domain is concise, but does not stress enough that the most recent changes in eminent domain laws have made developers and local governments exceptionally cautious when considering eminent domain. In many instances, local governments are so concerned about getting caught up in litigation that they will not venture forth with projects where they foresee that property owners will have any opposing claims. The chapter also discusses situations whereby the current State legislative changes have not sufficiently addressed "blight" statutes, placing a further cloud on the potential to utilize eminent domain. I perceive that local governments now often feel they are "hog-tied" when trying to proceed with even a legitimate case for eminent domain, simply because of the potential litigation that may ensue.

In the chapter on public-driven redevelopment projects, community involvement is mentioned in a short paragraph. In both public- and private-driven redevelopment projects, it has been my experience that community involvement is often critical to the success of the project and, at times, even to support the project being moved forward at all. While the book tries to cover a significant amount of information in a few pages, my experience with many redevelopment projects has shown that significant community involvement has often been necessary to secure full entitlement for these projects.

I was happy to see that the chapter on Market Feasibility stated that this was a crucial component to any redevelopment project. As my specialty, it was heartening to see a strong proponent of good market research prior to undertaking the redevelopment.

In today's world, the necessity of making appropriate use of land in urban areas and considering how to sustain and revitalize our communities so that their attributes effectively respond to the needs of residents and businesses today and in the future requires redevelopment. This book is a very good addition to most libraries, but if you have practiced in this area for a number of years, you have probably dealt with most, if not all of these issues many times. ■

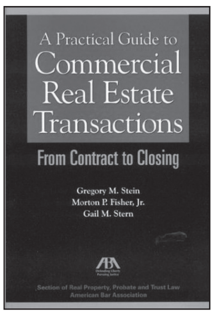
RECOMMENDED READING

A Practical Guide to Commercial Real Estate Transactions

From Contract to Closing, Second Edition

by Gregory M. Stein, Morton P. Fisher, Jr. and Marjorie P. Fisher
(American Bar Association Section of Real Property & Estate Law ©2008, 524 pages)

REVIEWED BY DANIEL L. SWANGO, PH.D., CRE, FRICS, MAI



"It was a dark and stormy night. Suddenly, a shot rang out! A door slammed. Someone screamed. Without warning, a…"

Well, this volume is not quite *all that* enticing—unless, of course, you find yourself involved in real estate transactions as counselor to one of the parties, real estate attorney, broker/agent, lender, partner or principal.

If you are ever in such a situation, then *this* book *is* for you.

You've read book reviews that say something like, "This book is a must for your bookshelf," or "No real estate library is complete without this book." Certainly not to fall in line or be trite, but this *is* indeed one of those special books, and here's why.

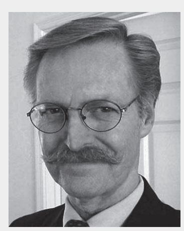
This 500-plus page remarkable paperback has valuable, very practical information useful to real estate attorneys, counselors of real estate, investors, commercial brokers and agents. It is complete with a detailed 10-page index and a very thorough, functional appendix with no less than 18 transaction-related forms on the included CD-ROM—so they are convenient, easy to access, use and modify.

A Practical Guide to Commercial Real Estate Transactions from Contract to Closing is packed with practical advice in property "conveyancing transactions," specific clauses and provisions to look for, specific items for your checklist, and things to do. There are countless first-rate ideas to consider for inclusion in sales contracts and other transaction related documents. This reference covers a variety of sophisticated complex matters in straightforward and quite readable fashion. Given the CD and model forms included, this reference is truly interactive.

Though the transaction is the focus, this book is extraordinarily useful in providing ideas to keep in mind during negotiations as well.

Readers and users will especially appreciate the many cautions and warnings about serious wording omissions, dangerous phrases and clauses, missteps and pitfalls. Thorny problems are brought to your attention and solutions suggested—the idea being, of course, to use transaction structure document content *to prevent problems* and *reduce risk* and *reduce the probability of future difficulties*.

About the Columnist



Dan Swango, Ph.D., CRE, MAI, FRICS, *is a real estate appraiser, counselor, broker and educator. In practice since the mid-1960s, Swango has been involved mainly with urban and suburban land, commercial improved and special purpose properties. He has worked and taught in all but two of the states of the U.S., and in China, Taiwan, Australia, Canada, Korea, Malaysia, Germany, Kazakhstan, Macedonia and elsewhere, with students from more 60 countries. Swango is past president of the Tucson Association of REALTORS®, Inc., and for many years, has served on the editorial boards of* Real Estate Issues *and* The Appraisal Journal *(editor in chief from 1995-2001), and serves on the faculty of the Appraisal Institute. He is the faculty coordinator for the appraisal program of the International Center for Land Policy Training and Studies in Taoyuan, Republic of China, and currently serves as a real estate tax hearing officer for the State of Arizona Board of Equalization.*

A Practical Guide to Commercial Real Estate Transactions

If you are involved in counseling buyers or sellers in transactions, reviewing transaction papers or preparing them, this is really one of those books that can make you and your professional services more valuable—*much more* valuable—to your clients.

This practical guide book focusing on "conveyancing transactions" is intended for real estate attorneys, whether new or seasoned. But it is also a professional-level book valuable (invaluable) for:

- counselors of real estate who review transaction documents and advise clients, buyers or sellers;
- counselors, brokers or agents who prepare or assist in the preparation of real estate contracts, loan commitment negotiations, and documents and other transaction-related documents;
- counselors who assist clients in their due diligence, post contract of sale or post loan commitment;
- counselors who assist clients preparing for closing;
- appraisers and market analysts who need to know more about what to look for in understanding specific sale terms, conditions and contract provisions;
- commercial real estate lenders reviewing transaction documents in their due diligence process.

A Practical Guide to Commercial Real Estate Transactions from Contract to Closing is not inexpensive, but it is filled with priceless ideas and specifics for transaction documents.

Major chapter topics give you an idea of content:

1. **Introduction:** bridging the gap between law school and practice, the mechanics of a transaction, gathering information and allocating risk;
2. **The Contract Of Sale:** buyers' and sellers' perspectives, parties and entities, personal property matters, sellers' representations, easements, access, certificates of occupancy and other permits, litigation, insurance and casualty, condemnation, and many more topics with specific suggestions and cautions;
3. **Post Contract Due Diligence:** what it is and addressing problems, checklists, allocating responsibility, title and survey matters, leases and liens, taxes, air and development and mineral rights, leases and estoppels, property condition and suitability, environmental matters, assignability of contracts and licenses to buyer, and legal entity matters;
4. **The Loan Commitment—**lender and borrower perspectives, terms and conditions;
5. **Post Loan Commitment Due Diligence:** title and survey matters, liens and leases, purchase options and others' rights, subordination, attornment agreements and other mortgages;
6. **Loan Documents**—notes and forms, special clauses and cautions, defaults, junior financing limitations, escrows, deed of trust, assignments of leases and rents, security agreements and guarantees, participation agreements, seller financing and subordinate lending;
7. **Preparing for Closing**—checklists provided with discussion of critical points and potential pitfalls;
8. **Running the Closing—**structure, checklists, title insurance, execution of documents, copies, delivery and distributions, funds transfer confirmations;
9. **Post Closing Matters**—recordings, distributions, follow-up, organization, records and files.

These topics, from the table of contents, provide a deceptively simple overview; because of space, the important details provided the reader are not included here. Each chapter topic treatment is in-depth and extensive.

The authors have obvious expertise, practical experience and an ability to communicate. They write from experience as well as their extensive education and research. It is indeed unusual to have such a readable book covering such potentially multifaceted, complex subjects.

RECOMMENDATION:
This is one of those reference books that actually can make you, as a counselor of real estate, more valuable to your clients involved in real estate transactions on either side of the table. When you read this well-written work, you'll no doubt think, "Wish I had had this resource when ..."

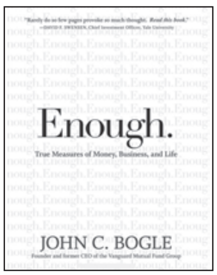
We've all been told, or thought to ourselves, "Do your homework!" This reference is one of your most important resources in that endeavor. If you are a counselor who advises clients involved in real estate transactions, you'll use this one—and it should help to avoid costly errors or omissions. The information in this book can give you an edge—reduce your risk, and enhance your value and position. ■

RECOMMENDED READING

Enough. True Measures of Money, Business and Life

by John C. Bogle (John Wiley & Sons, Inc., 2009)

REVIEWED BY BOWEN H. "BUZZ" McCOY, CRE



John Bogle is the founder and former CEO of the Vanguard Mutual Fund Group. He created Vanguard in 1974. *Fortune Magazine* rated him as one of four "Investment Giants" of the twentieth century. *Time Magazine* rated him one of the 100 most influential people in the world. Termed by some, "… the conscience of Wall Street," Bogle distills his half-century of observations of the capital markets, and on life in general, in this provocative and stimulating book.

Bogle sets the tone of the book with a quotation from David Brooks, *New York Times* columnist: "The country's moral guardians are forever looking for decadence out of Hollywood and reality TV. But the most rampant decadence today is financial decadence, the trampling of decent norms about how to use and harness money." He goes on to quote a party conversation between Kurt Vonnegut and his pal, Joseph Heller. Vonnegut states their host, a hedge fund manager, had made more money in a single day than Heller had earned from his wildly popular novel *Catch-22* during its entire history of sales. Heller responds, "Yes, but I have something he will never have … enough."

He reinforces this point with a quotation from Socrates made 2,500 years ago: "I honor and love you; but why do you who are citizens of this great and mighty nation care so much about laying up the greatest amount of money and honor and reputation, and so little about wisdom and truth and the greatest improvement of the soul? Are you not ashamed of this? I tell you that virtue is not given by money, but that from virtue comes money and every other good of man."

Bogle details a major premise that, on balance, the financial system subtracts value from our society. In 2006 the financial sector alone accounted for more than 30 per cent of the total earnings of the 500 companies that make up the Standard & Poor's stock index. Fees are excessive and, for example, in a fund of funds investment, are piled up one atop another. There has developed a disconnect between cost and value in our financial system. Money managers have shifted from long-term investment to short-term investment. Average annual portfolio turnover has increased from an average of 15 percent to more than 100 percent, further increasing costs.

Bogle passionately subscribes to three basic investment principles: balance, diversification and focus on the long term. John Maynard Keynes defined *investment* as "… forecasting the prospective yield of an asset over its entire life." He defined *speculation* as "…the activity of forecasting the market." Seventy years ago Keynes stated: "When the enterprise becomes a mere bubble on a whirlpool of speculation and the capital development of a country becomes a by-product of the activities of a casino, the job of capitalism is likely to be ill-done." Benjamin

About the Columnist

Buzz McCoy, CRE, *was responsible for the real estate finance unit at Morgan Stanley for many years. He is a past president of The Counselors of Real Estate and a Life Trustee of the Urban Land Institute. His recent two books are:* The Dynamics of Real Estate Capital Markets: A Practitioner's Perspective *(Urban Land Institute, 2006) and* Living Into Leadership: A Journey in Ethics *(Stanford University Press, 2007).*

Graham, Warren Buffet's mentor, once stated: "In the short run the stock market is a *voting* machine … but in the long run it is a *weighing* machine." When markets are driven by investors, volatility is low. When markets are driven by speculators, by hope, greed and fear, we have high volatility and turbulence. We live in the most speculative age in history. In the 1950s the annual rate of turnover of common stocks was 25 percent. Today it is almost 300 percent if we include exchange-traded funds.

Of particular interest to CREs, Bogle devotes a chapter to defining the characteristics of professional conduct. He quotes an article in *Daedalus*, the journal of the American Academy of Arts and Sciences, which lists the six identifying qualities of a profession and a professional:

1) **A commitment to clients and to society in general**. This resonates with me, as in the old Morgan Stanley partnership, the client always came first. Today investment banks have been known to trade against their clients
2) **A body of theory or special knowledge, presumably which adds value to the client**. Not just trading securities
3) **A specialized set of professional skills**
4) T**he capacity to render judgments with integrity and under conditions of ethical uncertainty**. We are always looking for rules to tell us the answer, when often the answer is not clear. I am reminded of Hannah Arendt's wonderful description of *New Yorker* editor, William Shaun: "He had perfect moral pitch."
5) **An organized approach to learning from experience, both individually and collectively, and thus of growing new knowledge from the context of practice**
6) **The development of a professional community responsible for oversight and quality control**. This is where most professions fail. It is difficult to enforce professional sanctions.

The article concludes that the primary feature of any profession is to establish an inherently ethical relationship between the professional and the general society. A profession should be seen to create value for society rather than to extract it. It should create wealth rather than redistribute wealth.

Bogle writes also of leadership, and he has ten rules for building a great organization:

1) **Make Caring the Soul of the Organization**. Everyone deserves to be treated with courtesy, candor, friendliness and respect for their honorable work.
2) **Forget About Employees**. Think instead of crew members, or team members, each linked together, each dependent on the other.
3) **Set High Standards and Values—and Stick to Them**. Do what's right. If you are not sure, ask your boss. Good ethics is good business.
4) **Talk the Talk. Repeat the Values Endlessly. Be inspiring**. Build an organization in which those who do the hard work of routine can take great pride.
5) **Walk the Walk. Actions Speak Louder Than Words**. Personal visibility, by everyone, is an attribute of leadership.
6) **Don't Over-manage. Manage by values, not by numbers**. Let spirit and spontaneity rise.
7) **Recognize Individual Achievement**. Validate the value of the individual through small human touches.
8) **A Reminder—Loyalty Is a Two-Way Street**. If you expect loyalty, give loyalty in return.
9) **Lead and Manage for the Long Term. Avoid layoffs in temporary downturns**. Never demand that some arbitrary percentage of the work force be unilaterally rated unsatisfactory. Character is the bedrock of the firm that lasts.
10) **Press On, Regardless**. Keep pressing forward, no matter the circumstances.

In answer to his question of how much is enough, Bogle quotes from *American Psychologist* magazine: "It is not money that determines our happiness, but the presence of some combination of three attributes:

1) **Autonomy**. The extent to which we have the ability to control our own lives;
2) **Maintaining "connectiveness" with other human beings** in the form of love of our families, our pleasure in friends and colleagues, and an openness with those we meet in all walks of life;
3) **Exercising competence.** Using our God-given and self-motivated talents, inspired and striving to learn."

Bogle quotes the Roman poet Horace: "Whoever cultivates the golden mean avoids both the poverty of a hovel and the envy of a palace."

In these days when trust has been destroyed in our financial institutions, it is a blessing to recognize that there are John Bogles as well, who have built businesses of lasting value on Wall Street while maintaining their integrity and their dreams. ■

REAL ESTATE ISSUES

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

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

MANUSCRIPTS

1. FEATURE ARTICLES

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

2. PERSPECTIVE COLUMNS

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

3. RESOURCE REVIEWS

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

4. CASE STUDIES

Case studies are actual counseling assignments that CREs have performed for clients. These studies should include: commentary on the decisions made regarding the approach to the problem, investigation and analysis; commentary as to why the work was needed; appraisal, brokerage, mediation, and related services; and visuals.

IMPORTANT NOTE: all case study submissions must include confirmation of the client's approval to share the details with a wider audience. Visit *www.cre.org/publications/rei2.cfm#Call* for a template, and more information.

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

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

REVIEW AND SELECTION PROCESS

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

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

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

WILLIAM S. BALLARD AWARD

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

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

CRE

THE COUNSELORS OF REAL ESTATE

THE CRE MISSION

To be the forum for leaders in real estate.

CRE CORE VALUES

■ integrity ■ competence ■ community ■ trust ■ selflessness

ORGANIZATIONAL OBJECTIVES

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

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

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

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