REAL ESTATE ISSUES®

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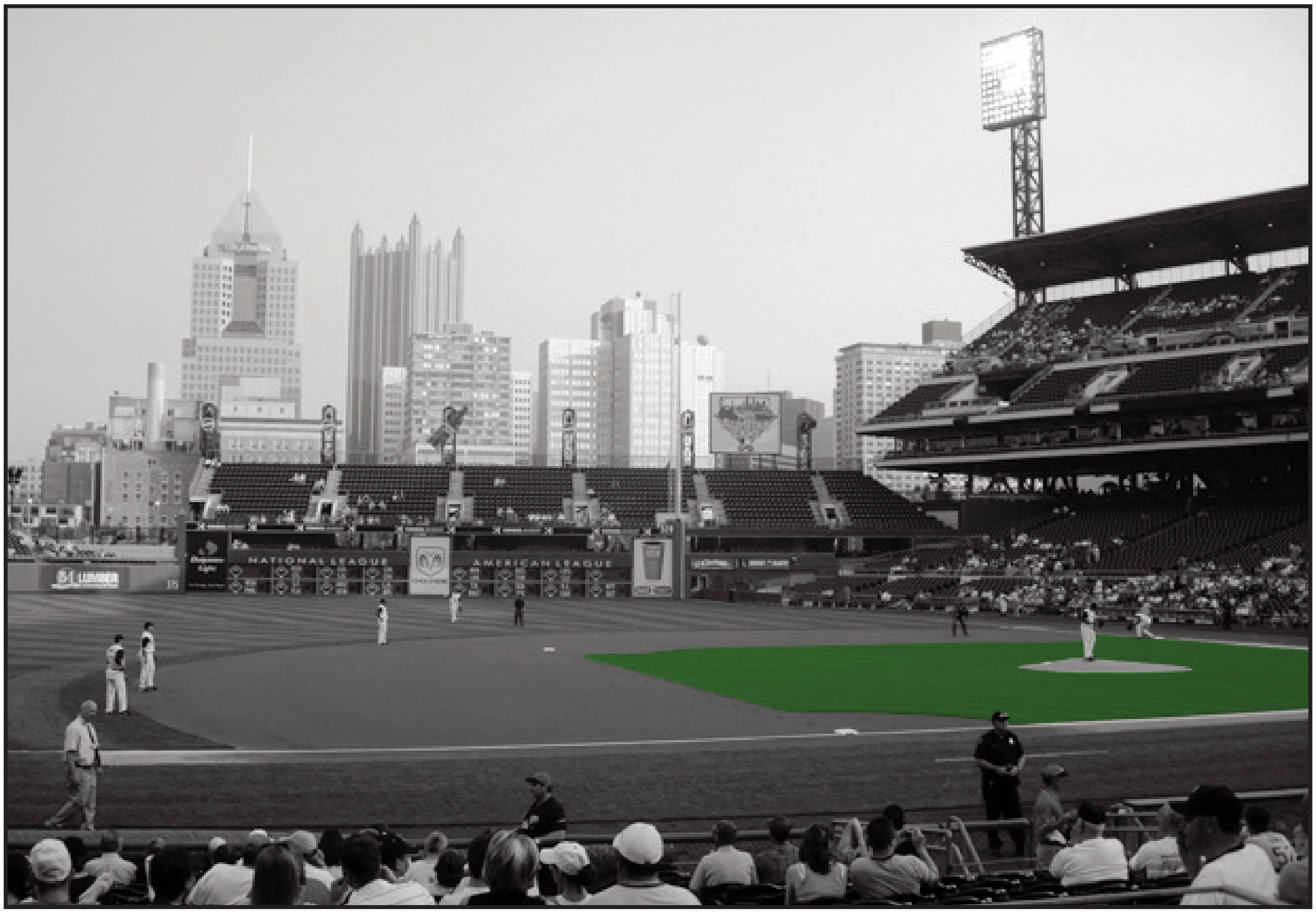

FEATURES AND PERSPECTIVES

RESOURCE REVIEWS

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RESOURCE REVIEWS

Editor's Note

BY PETER C. BURLEY, CRE

"My motto was always to keep swinging. Whether I was in a slump or feeling badly… the only thing to do was keep swinging."

–Hank Aaron

My daughter Katy was three when we lived in St. Louis. I was working briefly at Washington University, helping to run a research and computing facility for the social sciences. One weekend, a group of faculty and students got hold of a block of tickets to a Saturday afternoon Cardinals-Pirates game at Busch Stadium. I got two—one for me and one for Katy.

We often watched the game on television, and Katy played three-year-old T-Ball, but this was her first-ever Major League Baseball game in a real Major League Baseball stadium.

We sat high in the right field stands, but not so high that we couldn't see the game well enough. And we watched as the Pirates creamed the Cards, with a score that was something like 8–1.

It was disappointing to see the home team lose so badly. But, the game was fun with good friends, peanuts and popcorn and sodas.

Katy was unusually quiet as we walked to the car after the game.

After I had strapped her into her car seat and started up the car, I looked at her in the rearview mirror.

"So," I asked her, "how did you like the game? Sorry the Cards lost."

"OK," she answered, looking wistfully out the window.

"Just OK?" I asked. "Wasn't it fun to see a real game in person, right here at the stadium, even though we lost?"

"I never got my turn," Katy grumbled.

"You... never...got...your...turn?" I asked quizzically.

"I didn't get my turn to hit the ball," she mumbled, almost in tears.

I was speechless for a moment, then struggled to explain, without laughing. "But, this was….It isn't…They don't..." I stopped. I really had no answer for her. I did my best to choke back a chuckle.

All I could say was, "Well, maybe next time."

The good news late last month was that U.S. Gross Domestic Product (GDP) rose at an annualized 3.2 percent during the first quarter of 2010. The bad news was that U.S. GDP rose 3.2 percent in the first quarter of 2010. There are, I suppose, as many reasons to sneer at the news of growth in the U.S. economy as there are to celebrate. It was less than the consensus expected (3.4%). It was largely the result of heavy inventory investment. Final sales were good, but not good enough. Demand cannot recover until employment picks up. Employment can't pick up until demand picks up. Plenty of reasons to sneer…

On the other, more celebratory, hand, GDP rose for the third consecutive quarter, indicating that the Great Recession likely ended sometime late last year. And, businesses have begun to spend again, on equipment and software at least, if not on structures. When added to the last couple of employment reports, for March and April, during which a few hundred thousand new jobs were created, the GDP report conveys news that, to me, is good. It is real, measurable improvement. And, it is worth a toast, if not riotous partying in the streets. It may be early in the season, but those green shoots of spring have begun not only to finally emerge, but to flourish, to take root, even to spread.

It has been a struggle for many of us, especially in this business, to get through the aches and pains of the last couple of seasons. It's been hard enough just to get out of bed in the mornings, much less to throw ourselves into the game and keep swinging. Still, we *have* kept at it, despite the slump, the dismal news and lousy stats. As the stats—the GDP numbers, the employment numbers, the demand and sales figures, the NOIs, rents and vacancies—all continue to improve, the game starts to get good again. The stands start to fill up again. We may even see a few home runs in the early innings, who knows?

That so many have stayed in the game and kept on swinging is evident in the selection of articles in this edition of *Real Estate Issues*. Our contributors have been toning their game, looking at the field from new angles, testing new and better strategies, and swinging where others could have been caught looking. Reading these articles has made it quite clear to me that it isn't that we are in a new game. It's that we just need to become better, stronger, savvier players with a keener eye, faster out of the box and more agile on the field.

We lead off this issue with Ken Riggs, CRE, who surveys the current economic and investment landscape in **"Emerging from the Rubble"** to give us a clear view of the playing field. While there have been enormous pressures on the industry over the last two years, and many obstacles remain, there are signs that opportunities are, indeed, beginning to emerge. "This will be the year for resilient investors to resume the challenges of investing, managing and adding value to commercial real estate" Riggs tells us, "as we continue on the path to recovery." And buyers "…should be preparing to make their move soon so that they can take advantage of the value and price increases that will follow." He concludes, "…investors seeking to seize market opportunities will find 2010 to be the best time in some years to buy high quality, well-priced, long-term investments in commercial real estate." Sounds like solid pregame advice to me.

Tony Colavolpe, CRE, takes a look at Corporate Real Estate from a retailer's perspective in **"Demystifying the Corporate Real Estate Process: The Retailer's Perspective."** While corporate retail real estate is a difficult proposition in the current environment, he tells us, "opportunities still exist" for skilled, savvy practitioners. Evaluating retail opportunities is partly science, he says, and partly art. Experienced and knowledgeable practitioners will use both the art and the science, although "…seasoned merchants and operators often have a "sixth sense" when it comes to picking the right location for a store…" which will, at times, "…override the scientific analyses." In his carefully crafted discussion, Colavolpe offers advice and insight into the organizational and practical decision-making aspects of retail real estate and how one might build a successful retail real estate business in today's environment.

Don Epley, Ph.D., of the University of South Alabama at Mobile, offers advice on using depreciation as an operating expense in **"Value is Lower when Depreciation is an Operating Expense: A Current Issue."** Epley contends that the "…use of the non-cash deduction of depreciation as a real property operating expense lowers net operating income…" and causes any resulting estimate of value to decline. Using the depreciation figure inaccurately will lower the property's overall capitalization rate, he tells us, and the lower value and cap rate estimates end up sending incorrect transaction figures to the marketplace. He suggests, instead, that depreciation not be included when computing a property's income stream, and offers a practical guide to methodologies through which NOIs and capitalization rates are left largely unaffected.

Nicholas Ordway, J.D., Ph.D., of the University of Hawaii, and Jack Friedman, Ph.D., CRE, propose new definitions for real estate synergy in **"Five Levels of Synergy Potential to Create Real Estate Value."** Further, they suggest some new ways to recognize how synergies that can be applied in a connected world require new thinking about new linkages in the real estate industry. Ordway and Friedman suggest that "…many real estate projects are affected by changes in a set of networked externalities that affect the internal economics of the project itself." Real estate is, after all, more than just the physical property, they tell us, and recent innovations on the Internet, in globalization, securitization and other changes require new thinking about how those innovations affect the use of real estate and its value. The authors offer five levels of linkages that can affect the use of a property, the risks involved and, ultimately, the value of real estate.

"Despite the recent downturn in the commercial real estate market, the demand for green building space in office, retail and mixed-use projects continues to increase throughout the U.S." In fact, as attorneys Katherine Oberle and Monica Sloboda point out in **"The Importance of 'Greening Your Commercial Lease,"** the market for "green" space in office and mixed-use real estate has grown from two percent of nonresidential construction in 2005 to 10–12 percent in 2008, and is expected to rise upwards of 25 percent of the market by 2013. In addition to the environmental benefits, the authors note that tenants often seek to attract investors and customers with a "green" reputation with the space they occupy. Oberle and Sloboda offer some practical guidelines for developing "green leases" that can outline a variety of sustainable practices in the use of green space in tenant-landlord agreements, including specifications on the use of water and energy conservation, the use of alternative energy resources, the maintenance of indoor air quality, and the allocations of costs and benefits involved.

"… it isn't that we are in a new game. It's that we just need to become better, stronger, savvier players, with a keener eye, faster out of the box and more agile on the field."

While the First-Time Homebuyer Tax Credit expired at 11:59 P.M. on April 30, 2010, there is, and will be, considerable discussion as to its ultimate impact on U.S. housing markets. There is not much disagreement that the Act helped to boost home sales, slowed the rate of defaults on existing mortgages and likely lifted sales in housing-related services. But, the tax implications for homebuyers will continue well beyond the Act's expiration date. In their article, **"Tax Credit for Principal Residence: Clearing the Housing Glut,"** Drs. Mark Levine, CRE, and Libbi Levine Segev offer a brief rundown of some of the lingering details. "Because of the credit's various time extensions, qualifier expansions, assorted requirements and computations, the details related to claiming the credit can be difficult to assemble," they note, and the list of requirements will be daunting to homebuyers, even long after the Act expired. The question remains: will the pace of home sales, much improved under the Act, continue now that it's gone?

David Lynn, Ph.D., CRE, offers his review of *The Next Hundred Million: America in 2050*, by Joel Kotkin. "By 2050 the population will have increased to approximately four hundred million—roughly 100 million more than today. Along the way, the U.S. will become a much more crowded and complex place. The composition of the population will change…". Lynn gives credit to Kotkin's lively reporting style for an interesting and readable discussion of the implications of population growth in the U.S. on the urban, rural and suburban landscapes over the next 40 years. Personally, I am intrigued.

Finally, Maura Cochran, CRE, reviews the much-anticipated *Value Beyond Cost Savings: How to Underwrite Sustainable Properties*, by our own Scott Muldavin, CRE, FRICS, the Green Building Finance Consortium and the efforts of a number of Counselors. Scott's long history in underwriting and his prominence as an expert in "green" finance offer incredible detail and insight into the process of underwriting green properties effectively. Cochran concludes, "Muldavin's book deserves a place on your bookshelf; the electronic version should be bookmarked on your computer." I call it a home run.

This issue of *Real Estate Issues* demonstrates to me that a lot of people have been preparing smartly for the upcoming recovery, getting ready for the next several innings. There is, indeed, plenty of debris left on the field from the last disastrous season. But, as Ken Riggs says, "…most signs indicate that we have entered the recovery phase of this cycle, and while there will be more struggles ahead, economic activity continues to strengthen." The efforts that The Counselors and others have put into understanding the implications of the last couple of years, sizing up the field, as it were, and practicing their swing, will benefit the entire industry.

The Counselors of Real Estate are at the top of the League. We are ready for the next season, well-toned, and well-equipped.

The game's on. Bring your glove.

PETER C. BURLEY, CRE
EDITOR IN CHIEF

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KENNETH P. RIGGS, JR., CRE, FRICS, has served as president and CEO of Real Estate Research Corporation (RERC) since 1991. Under his leadership, RERC provides research services, valuation management, strategic consulting, independent fiduciary services, litigation support, and Web-based management services for property portfolios. Riggs also serves as publisher of the *RERC Real Estate Report*, the *RERC/CCIM Investment Trends Quarterly*, and as co-publisher of the annual forecast report *Expectations & Market Realities in Real Estate*. Riggs holds a master's degree with a concentration in finance and statistics from the University of Chicago Graduate School of Business.

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Emerging from the Rubble

BY KENNETH P. RIGGS, JR., CRE, FRICS

As we emerge from the most severe financial crisis and economic recession in more than 70 years, we are only beginning to unravel the devastation and debris left in its wake. There are deficits as far as the eye can see—a record $1.6 trillion deficit is expected for fiscal 2010 and more than $9 trillion projected for the coming decade, according to the Congressional Budget Office. The unemployment rate is expected to decline to only 9.3 percent by year's end, according to the Labor Department and the *Wall Street Journal* economists' survey. In addition, hundreds of regional banks are at risk of failing this year, due in great part to the commercial real estate loans on their books. Still, most signs indicate that we have entered the recovery phase of this cycle, and while there will be more struggles ahead, economic activity continues to strengthen.

Commercial real estate activity, which lags the rest of the investment market, remains tepid but growing. Although the fundamentals for this important asset class will see little, if any, improvement in 2010, this will be the year for resilient investors to resume the challenges of investing, managing and adding value to commercial real estate as we continue on the path to recovery.

THE STATE OF THE MARKET

Real Estate Research Corporation (RERC) routinely surveys many of the industry's most knowledgeable institutional investors each quarter and tracks their views on commercial real estate, the economy and other related issues. These views are reported quarterly in the *RERC Real Estate Report*, and annually in *Expectations & Market Realities in Real Estate*.[1]

As shown in Figure 1, up until first quarter 2008, commercial real estate's attractiveness held firm relative to expectations for alternative investments (stocks, bonds and cash), but as the credit crisis overpowered market confidence, there was a mad rush to cash. Commercial real estate bounced around at its 2009 lows, and ended fourth quarter 2009 slightly down from the previous quarter but up from 2008 results. Despite the loss in commercial real estate value, decline in returns and difficulties still ahead for this important asset class, we expect these ratings to remain generally stable through 2010. Investors are hoarding cash and formulating strategies to jump into a beleaguered industry in 2010.

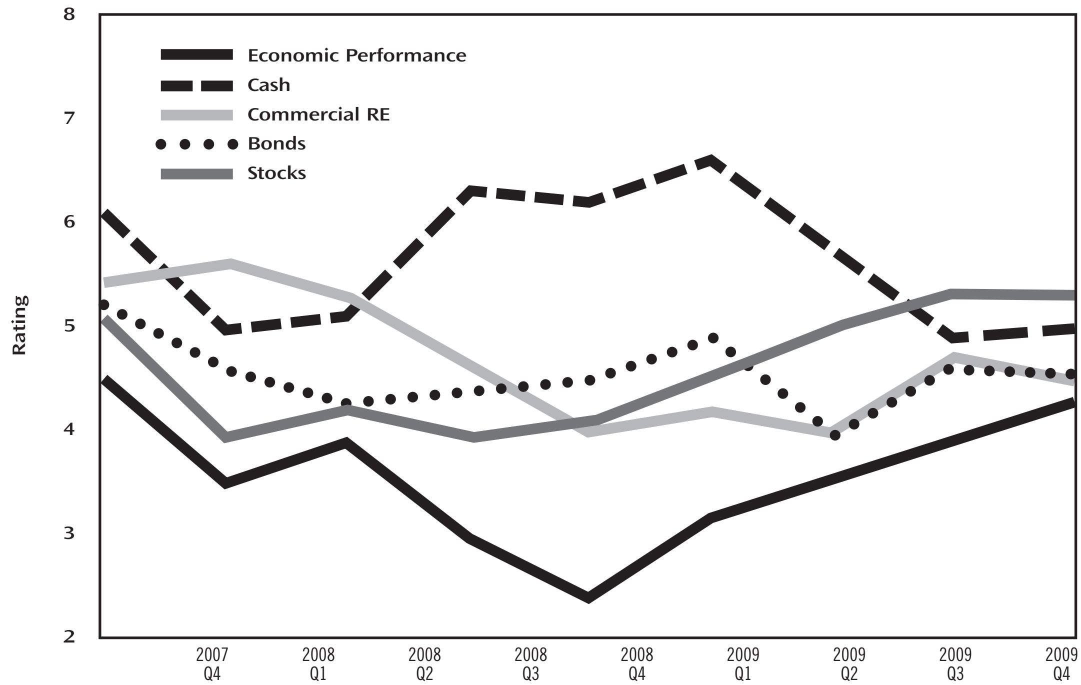
About the Author

Kenneth P. Riggs, Jr., CRE, FRICS, *has served as president and CEO of Real Estate Research Corporation (RERC) since 1991. Under his leadership, RERC provides research services, valuation management, strategic consulting, independent fiduciary services, litigation support, and Web-based management services for property portfolios. In addition to leading the firm's business ventures, Riggs serves as publisher of the* RERC Real Estate Report, *the* RERC/CCIM Investment Trends Quarterly, *and as co-publisher of the annual forecast report* Expectations & Market Realities in Real Estate.

Riggs holds an MBA with a concentration in finance and statistics from the University of Chicago Graduate School of Business. He received the CRE designation from The Counselors of Real Estate in 1995, and was elected second vice chair of The Counselors of Real Estate for 2010. In addition, he has earned the CFA® designation from the Association for Investment Management and Research, the FRICS designation as a Fellow of The Royal Institution of Chartered Surveyors, the CCIM designation from the CCIM Institute, and the MAI designation from the Appraisal Institute. Several years ago, the National Association of REALTORS® named him as one of real estate's 25 most influential thought leaders.

Figure 1

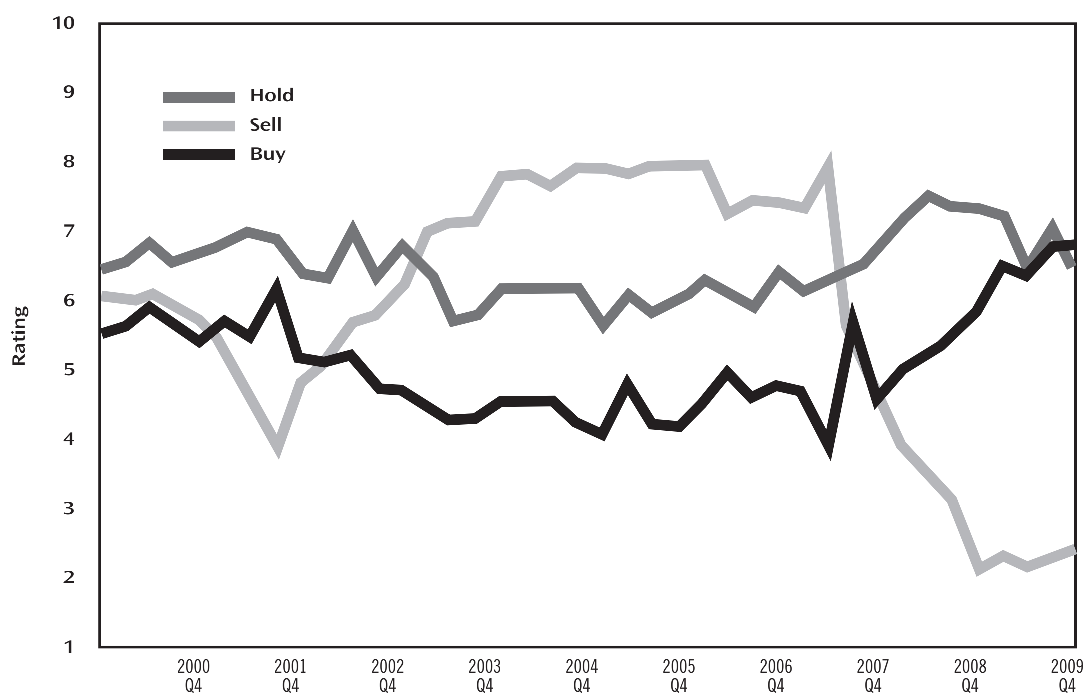
Institutional Investors Rate Investment Alternatives



Source: RERC, 4Q 2009

Figure 2

Buy, Sell and Hold Recommendations



Source: RERC, 4Q 2009

RESEARCH SHOWS COMMERCIAL REAL ESTATE INVESTMENT A 'BUY'

As illustrated in Figure 2, today's market is filled with high buy and hold (versus sell) recommendations for those investors looking for quality properties. Properties offered for sale have been marked down on a gross asset level by approximately 30 percent, and in some cases, 50–60 percent. Even with such markdowns, there is still a divide between price and value, but that gap is expected to narrow over the next several quarters and the number of transactions will increase in 2010.

The distress in the market means that pricing and yields are coming much more in line with buyer expectations. Buyers, already in the driver's seat, can afford to wait until property prices hit bottom, but they should be preparing to make their move soon so that they can take advantage of the value and price increases that will follow. As we examine the recent evidence, and with fourth quarter 2009 recommendations remaining unchanged from those of third quarter (and up significantly from 2008 results), note that the buy period began taking shape during first quarter 2010. Further, capital is still scarce, and while there is an uptick in availability, it is a time to buy and not to sell (if one can avoid doing so). RERC believes that the bottom is forming on commercial real estate prices, but values have not yet matched that reality.

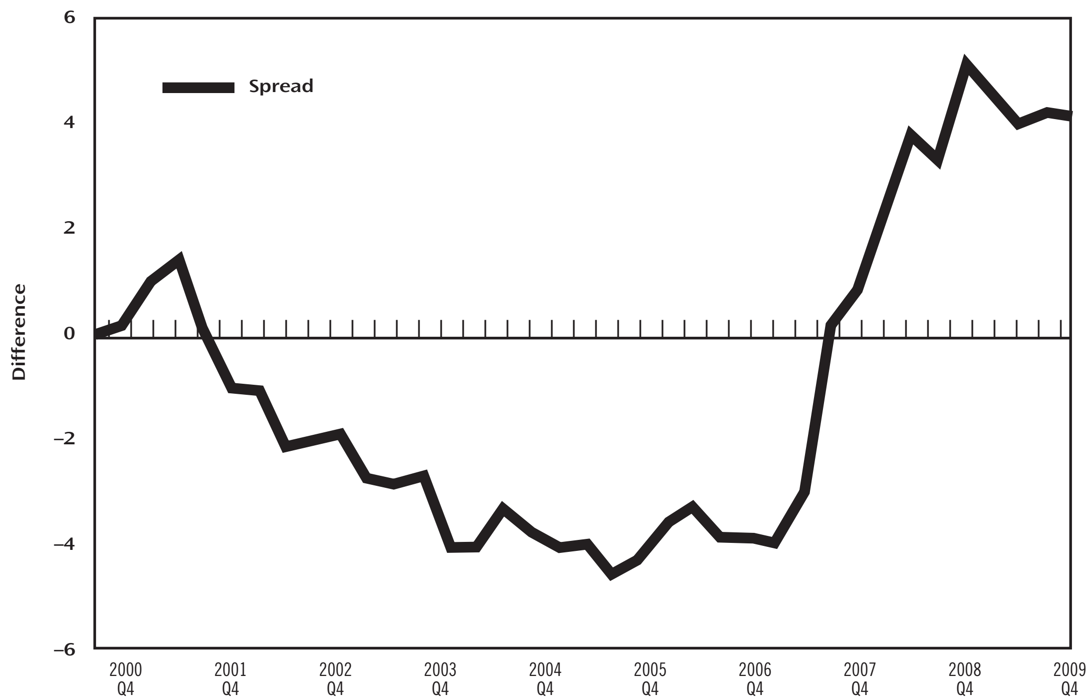
Looking back, and as noted by RERC's institutional investment survey respondents, capital availability reached a peak—almost 9 on a scale of one to 10, with 10 being high, with the discipline of capital being average—in first quarter 2007. However, that dynamic of excess capital yielded a spread of -4 between the discipline of capital versus the availability of capital, as illustrated in Figure 3. (Zero would suggest that there is a good balance.)

BID-ASK SPREAD NARROWS

In 2009, the bid-ask spread narrowed significantly as sellers began accepting and reflecting the realities of dramatic market change within their valuation assumptions. But until fourth quarter 2009, the bid-ask spread resulted in a nearly non-existent transaction market, with 2008 and 2009 sales volume, according to Real Capital Analytics, down from 2007 levels by approximately 72 percent and 90 percent, respectively. (That drop,

Figure 3

Spread Between Capital Availability vs. Discipline



Source: RERC, 4Q 2009

however, is from 2007 transaction levels that were unsustainable, given the euphoric state of the investment market.) A more relevant statistic is a comparison of 2009 sales volume to 2003 sales volume (the previous post-recessionary environment), with 2009 activity approximately 60 percent off 2003 levels. But regardless of the year of comparison, transactions have been few and far between, although it appears that the tide turned in fourth quarter 2009.

With commercial real estate re-priced downward by between 30–40 percent, according to various index calculations, investment capital is beginning to re-emerge. It is clear that we do not have the liquidity problem experienced in the 1990s when sellers could not find buyers at any price. Instead, today's challenge is in bridging market pricing to market values amid the uncertainty that surrounds forecasting cash flow under stressful economic conditions. Although commercial real estate investors perceive a market opportunity, most institutional real estate funds are held back from taking advantage of the favorable buying dynamics due to fund investment limitations. Values and pricing are expected to achieve greater equilibrium by year-end 2010, resulting in a more active and fluid transaction market.

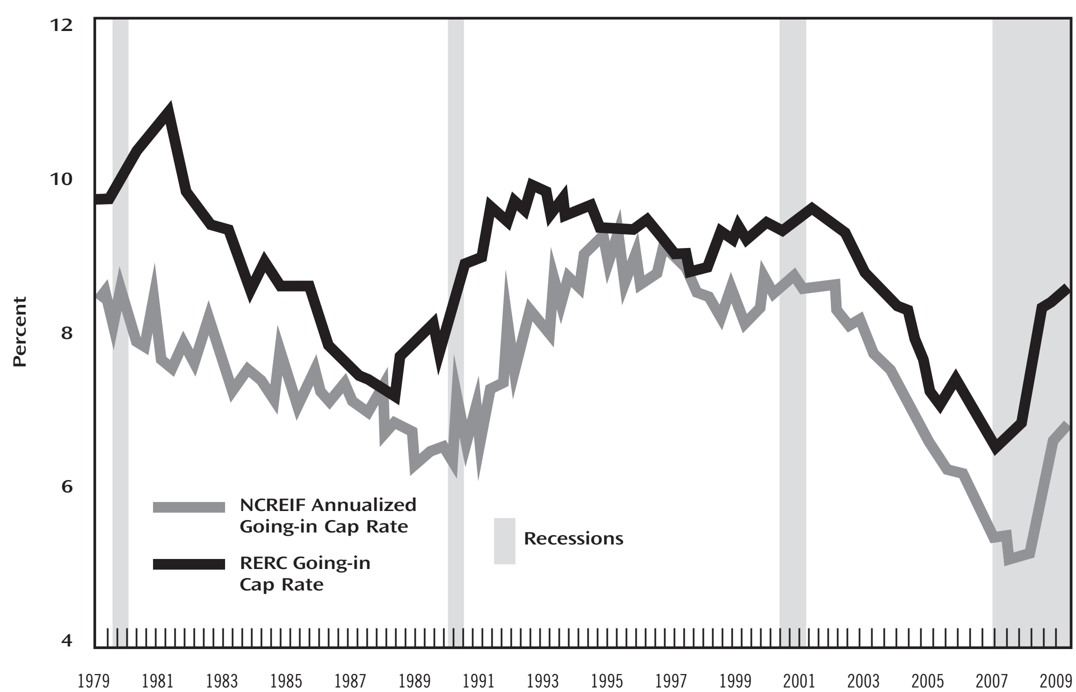
MORE VALUE-PRICE ADJUSTMENTS TO COME

RERC's required going-in capitalization rates (all property types average) last peaked at 9.6 percent in first quarter 2002. In comparison, the lowest cap rate average occurred in third quarter 2007 and was 6.5 percent (the lowest cap rate average since RERC started tracking rates in 1979). Since this all-time low, RERC's required going-in cap rates have increased 210 basis points, although they remained relatively stable during 2009 and have returned to fourth quarter 2003 levels, which was prior to the period of cap rate compression.

As shown in Figure 4, the spread between RERC's required (forward-looking) going-in cap rates versus the realized cap rates reported by the National Council of Real Estate Investment Fiduciaries (NCREIF) was 180 basis points (8.6 percent versus 6.8 percent) in fourth quarter 2009. For NCREIF's reported cap rates to realign with RERC's required cap rates, NCREIF cap rates would need to rise another 90 basis points, indicating that there

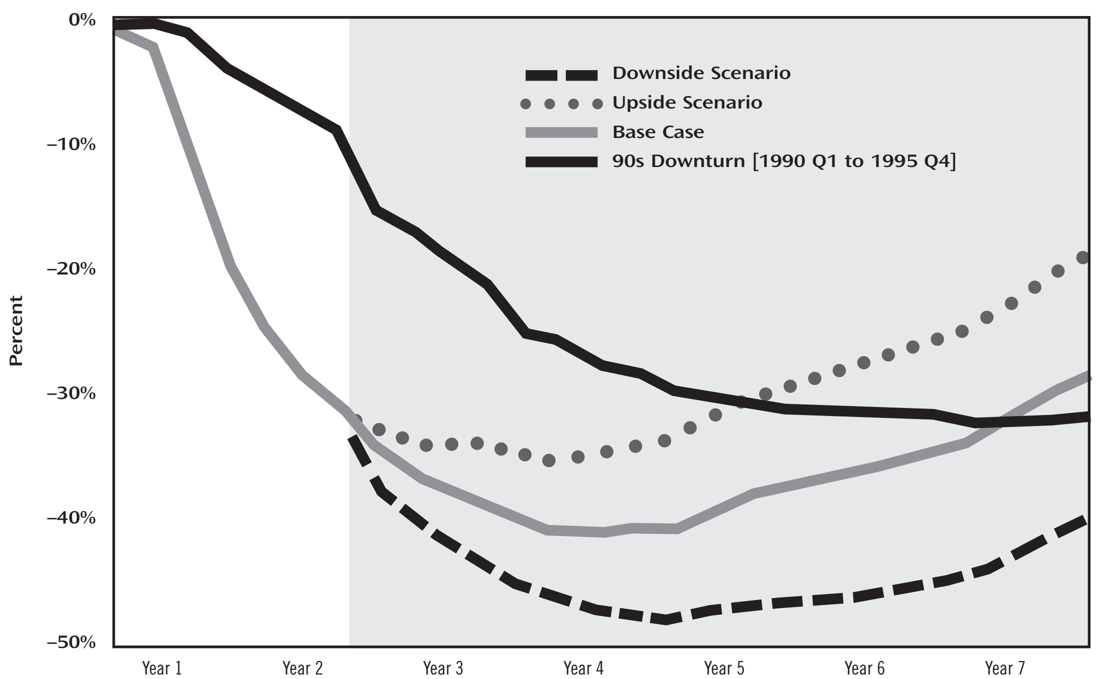
Figure 4

RERC Cap Rates vs. NCREIF Cap Rates



Sources: NCREIF, NBER, RERC, 4Q 2009.

Figure 5
Value Peak-to-Trough Estimates



Source: NCREIF, RERC, 4Q 2009
NOTE: Shaded area reflects RERC's outlook for the Base, Upside and Downside Scenarios from 1Q2010 to 1Q2014.

are still value adjustments to come that will be reflected in higher NCREIF reported cap rates. RERC's required or "expected" rates have already priced-in the full correction, as the market sees it today. This is essential for institutional properties that are unleveraged, and is important because investors dealing with Class B or Class C assets with 60-percent leverage will likely see their equity wiped out from a value perspective. However, this also encourages lenders to continue to "blend and extend" as they work with investors.

NCREIF net and gross value declines since second quarter 2008 were roughly 31 percent and 29 percent, respectively. (The 200-basis-point spread is attributable to the loss in capital improvement, as owners are putting very little money into properties today.) Figure 5 reflects RERC's view of values in this current down cycle versus value declines in the 1990s down cycle.

REAL ESTATE VALUE OUTLOOK

Following the relatively minor value correction that took place early in the decade, real estate values experienced an unprecedented (and clearly unsustainable) value increase of approximately 48 percent before coming to a dramatic halt in 2008. NCREIF reported a current peak-to-fourth-quarter 2009 value decline of approximately 31 percent, which compares to RERC's projected peak-to-trough value loss projection of approximately 40 percent for the same period. That is also on track with the recorded price decline of 41 percent reported last fall by Moody's/Real Commercial Property Price Index (CPPI) for all property types; that index showed its first faint upward move (one percent) late last year.

Going forward for the near and medium term, commercial real estate investment returns will focus on the income (dividend) component, as opposed to chasing value appreciation. This cyclical re-evaluation is inherent in the boom-to-bust mentality. Commercial real estate was, at its basis, a bond-like investment with some equity (appreciation) upside, and we are witnessing a return to investment basics. Understanding this renewed focus on income provides guidance on investor expectations and what investors find attractive in the asset class. Further consideration of the return-to-basics investment strategies can be found by examining the historical NCREIF capital (value) index. NCRIEF, in combination with

RERC's value projection going forward, indicates that value "appreciation" would have been almost non-existent over the 32-year reporting history of NCREIF if capital expenditures for value maintenance were excluded.

As presented in RERC's base case scenario provided in Figure 5, our forecast is for aggregate NCREIF values to decline at a relatively steady pace through mid-2011 to an anticipated aggregate value decline of approximately 41 percent—in line with the decline recorded by the Moody's/Real CPPI. RERC's overall range for the peak-to-trough values is 35–48 percent. It is important to note that the NCREIF Index is unleveraged, and the use of leverage (even prudent levels exhibited by core funds) has a compounding impact on the value decline of a fund.

Based on the value outlook presented in Figure 5, RERC expects commercial real estate to begin recording positive total returns (income and capital changes) once again in 2011. It is important to note that this is an average view for the entire industry, and is not a projection for a specific fund. As often written and cited, the NCRIEF Index tends to lag the realities of the marketplace relative to value changes.

LOOKING AHEAD

The commercial real estate industry will continue to experience challenges and obstacles in its path to recovery, and RERC expects commercial real estate values to continue to decline at a measured pace throughout 2010. Going forward, the commercial real estate market's focus will be on how far values and eventually prices will decline from their peaks recorded in early 2007. We believe that most structural issues in the commercial real estate marketplace, including capitalization rate expansion, have been priced in, but valuations are still catching up and will not converge with prices until end-of-year 2010. When this occurs, we estimate that institutional commercial real estate will see a peak-to-trough average loss of 35–45 percent on an unlevered basis by year-end 2010.

Although institutional real estate has already taken many of its lumps, smaller investors and borrowers present a looming crisis because they have not yet marked their investments to market, and many regional banks are less able to continue to "extend and pretend." As such, investors seeking to seize market opportunities will find 2010 to be the best time in some years to buy high-quality, well-priced, long-term investments in commercial real estate. ■

ENDNOTE

1. The *RERC Real Estate Report* is published quarterly by Real Estate Research Corporation (RERC). "Expectations & Market Realities in Real Estate 2010: Crossing the Divide—The Passage to Recovery," was co-published by RERC, Holliday Fenoglio Fowler (HFF), and Real Capital Analytics. Both reports are available at *www.rerc.com.*

Demystifying the Corporate Real Estate Process: The Retailer's Perspective

BY ANTHONY A. COLAVOLPE, CRE, FRICS

INTRODUCTION

ALTHOUGH IN MANY CIRCLES RETAIL REAL ESTATE HAS LOST its luster, opportunities for knowledgeable practitioners still exist. This article is intended to inform the reader as to how to review real estate opportunities from the retailer's perspective and use this insight to become a more effective practitioner. In order to convey this in a useful manner, the following items are discussed: the typical corporate real estate organization; understanding the decision-making process; site selection methodology; the real estate committee approval process; and building a corporate retail real estate business.

THE CORPORATE REAL ESTATE ORGANIZATION

The structure of a corporate retail real estate organization varies from company to company and is dependent upon the importance of real estate to senior management. For example, if selecting the right location and making the "best" real estate deal is considered a core competency of the company and is paramount to its financial existence, real estate will be given much attention and have a significant position in the corporate hierarchy. If, on the other hand, real estate is more of an administrative function within an organization, it is given less weight and carries less influence. Most corporate retail real estate organizations fall somewhere in between these two types. Consequently, the first order of business for the real estate practitioner is to determine the importance of real estate within an organization. No point spending considerable time, energy and resources on real estate opportunities with a company that does not consider real estate a priority.

For obvious reasons, retailers usually consider real estate a very important element of their survival and success. Therefore they will organize their business around identifying, selecting and finalizing the best real estate transactions. Typically, the better operators or merchants integrate the real estate function with operations or sales forecasts to accomplish the overall objectives of the company and get everyone on the same page. This approach will often require the input and approval of multiple disciplines within a company. The real estate practitioner is advised to learn how this structure operates to avoid submitting sites or locations destined for unsuccessful results. The following organizational chart is common to retail real estate organizations (see Figure 1).

Location research, financial planning and asset management functions may be separate or incorporated into

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Figure 1. Some organizations combine real estate, planning and construction functions within one group, thereby vertically integrating the entire process. This often leads to a more expedited decision-making process. Other organizations will separate real estate from construction and planning. Depending upon the company's objectives, the latter type of structure could extend the internal timeline for company approvals. As a general rule, the more people involved in the process, the longer it takes to move things through the pipeline.

Figure 1

President or CEO
|
CFO or EVP of Real Estate.
|
SVP of Real Estate and/or Construction/Facilities
|
VP of Real Estate and/or Construction/Facilities
|
Real Estate and/or Construction Representatives

UNDERSTANDING THE DECISION-MAKING PROCESS

Understanding the decision-making process in corporate real estate can often mean the difference between success and failure. In order for a developer, investor, financial institution or real estate practitioner to spend time and resources on a potential retail project, they need an understanding of potential tenants. The terms, conditions, income stream and development costs relating to these tenants frame the overall financial results for the project. If the expectation is that a particular tenant will anchor a project, pay a certain rent and accept a pre-determined site plan, and then many months later these factors change, the project may no longer be viable. This is likely to happen when the person submitting an opportunity to a retailer is a novice or simply does not understand the corporate decision-making process. Of course the process differs among organizations. Depending on such factors as company size, level of senior management involvement, the marketplace in which a property is located ("barriers to entry"), the company's storing strategy and capital expenditure budget, it could take anywhere from 30 days to several years or more to receive a firm decision. If it's the shorter time frame, you are in good shape. If, however, you cannot get a decision for several years, you may want to think about finding another prospect. In an era where the world of retail and finance changes almost daily, a quick "No" is better than waiting a long time to be told "we are no longer interested."

Most corporate retail organizations make their decisions based upon some common elements. The first element of the decision process is typically centered on the company's storing objectives. Companies regularly need to forecast sales whether those sales are from their existing fleet, future stores or acquisitions. This is often accomplished by developing a one-, three- and five-year storing strategy for the company. Storing strategies are modified regularly to reflect overall market conditions, entitlement impediments, competitive influences, consumer trends and any other changes affecting buying power. The amount of capital a company has budgeted for store development will influence how many units, and within what time frame, stores will be delivered and opened. Retailers commonly allocate a percentage of sales to capital expenditures. Companies, especially those listed on a stock exchange, will include this type of information in their annual report.

Once the retailer has vetted its storing strategy, the real estate department within the organization is empowered to achieve the required results. Locations falling within the approved strategy will receive priority treatment. Those that do not are either rejected outright or receive much less attention. Although the strategy itself would, in all probability, be considered proprietary in nature, certain milestones will be shared with the real estate community, and it is incumbent upon the real estate practitioner to gain some insight on the parameters driving the strategy. Why is this important? For example, if a retailer has already reached its approved allocation of stores or capital expenditure budget for a given year and your project needs a decision now, you are probably out of luck. If, on the other hand, timing is not necessarily an issue, getting a firm commitment for another fiscal year might work for your project.

Once you have a handle on the strategy, you need to understand the retailer's other important considerations: the amount of sales a retailer can generate within a trade area, whether the prototype can be accommodated, and the financial metrics—sometimes referred to as hurdle rates—needed for a positive decision. Forecasting sales volumes is discussed under the heading of the Site Selection Methodology. Likewise, financial metrics are reviewed briefly under the heading of The Real Estate Committee Approval Process.

The retailer's prototype often changes with the ebb and flow of the market. The best advice in this regard is to regularly ask the retailer for its prototypical guidelines. Sending a retailer a half-acre site for consideration when the prototype requires five or six acres to complete a store development not only is a waste of time, but negatively impacts the credibility of the person submitting the location. It demonstrates a lack of knowledge, or worse, the impression that the retailer's needs are not important.

To recap:

- Determine the length of time needed to obtain a firm decision from the retailer;
- Determine the number of stores a retailer intends to complete within a given fiscal year. General rule: a company needs approximately 50 percent more projects in the pipeline than the stated objective in order to accomplish its strategy. Permitting requirements, financial conditions and property control may influence this number;
- Determine a company's capital improvement budget. Dividing that number by the typical investment to be made by the retailer on a per-store basis should line up with the number of stores the retailer intends to open in a given year;
- Keep abreast of the retailer's current prototypical building or space requirement standards. Do not waste time submitting locations that differ significantly from the stated criteria.

SITE SELECTION METHODOLOGY

Site selection can be viewed both as a science and an art. Critical to selecting the right site is forecasting the amount of sales volume a retailer will generate from a particular location. The sales volume estimate is a major factor in the corporate decision-making process. Two recognized approaches used in formulating a sales volume forecast are analogs and gravity models. The latter is a form of regression analysis. The analog approach mimics the characteristics of similar operating locations. This assumes if one or more sites with reasonably similar characteristics produce a particular result, the subject location, if comparable, can or will experience a similar level of activity and profitability. Gravity models are more sophisticated and therefore require a higher level of expertise and knowledge in order to arrive at a creditable conclusion. The gravity model also measures the retail tenant's ability to draw customers over distance. Each of the foregoing approaches is best left up to professionals well-versed in forecasting methodologies.

The real estate practitioner, however, can provide critical support and information to the forecast professional. The first step in developing a sales volume forecast is the delineation of the trade area. Unlike the common approach of simply drawing one-, two- and five-mile rings around a site, determining the demographics for each of these areas and submitting the "package" to a retailer, the trade area as defined by a retailer will encompass many variables. The end product resembles more of an amoeba than a circle. It takes into consideration natural barriers, traveled routes and the location of nearby competition or "sister" stores. A well-defined trade area is that area from which a retailer expects to draw 80 percent or more of its business. In the case of locations where a retailer already may have a presence, the customers' origins are often known. When dealing with a virgin location, however, the practitioner's assistance is always welcomed. Within these trade areas, demographics specific to the retailer's preferred or target customer are generated, analyzed and then compared to a set of predetermined criteria.

This section began by saying site selection methodology can be viewed both as a science and an art. The scientific elements have been briefly described above. The art takes the form of a "gut" reaction to a location. Occasionally, notwithstanding the results generated by analogs or gravity models, a retailer will either accept or reject a site based upon intuition. Seasoned merchants and operators often have a "sixth sense" when it comes to picking the right location for a store. This intuition can sometimes override the scientific analyses.

Once the trade area has been defined and a sales volume forecast estimated, it is not uncommon for a retailer to visit a location and its environs before making a final site selection decision. Assuming economics and other details need refining, this decision, although important, gets someone only to the next level. Decisions of this nature will often involve members of the retailer's real estate team or senior management driving the defined trade area in order to understand how customers will get to and from a site. The time it takes to drive to a location and determine the amount of "friction" encountered will weigh on the retailer's ultimate decision. The quality and quantity of the retailer's competition will also be a factor. The competitors' store size, age, condition, sales volume, offering and price points are generally given consideration when evaluating a site. A retailer's own stores within a given market or trade area will also affect the decision. For example, if a new store in a market already occupied by a retailer will not generate sufficient new or incremental sales dollars to justify another store, in all probability the retailer will reject the site. Building too many stores in one trade area is known as cannibalization and is not a popular business strategy in today's financial climate.

The real estate practitioner can assist the retailer and/or the sales forecasting expert by being extremely knowledgeable about the physical and locational characteristics of a site or location. Knowing a competitor's sales volume is also helpful but not mandatory. Having this information and product knowledge at one's fingertips is one of the hallmarks of a successful investor, developer or real estate practitioner. Relationships between the retailer and the real estate community often begin by nurturing these fundamentals. Lastly, the real estate practitioner can assist in formulating a well-conceived site visit for the retailer. In this regard, drive the market or trade area first and make sure you know the details as well as, if not better than, the retailer.

Suggested reading:

- *Site Selection* by John S. Thompson;
- *Market Research for Shopping Centers,* edited by Ruben A. Roca.

THE REAL ESTATE COMMITTEE APPROVAL PROCESS

In all probability, when all is said and done, without the approval of the retailer's real estate committee or satisfaction of other company requirements, the site, location or potential transaction submitted to the retailer will not move forward. Once the sales volume has been forecasted, a site visit has been conducted and the retailer's prototypical facility can be accommodated, the last step involves the determination of economics, as well as the terms and conditions of a proposed transaction. Most corporate retail real estate operations have an internal set of financial guidelines or policies used in making a decision. Each company relies on some benchmark rate of return, the time it takes to receive back its investment, the projected profitability of the opportunity and its impact on a balance sheet or profit-and-loss statement, as well as accounting, capital and human resources. The complexity of this process, the time it takes to assemble the right information, put it on an agenda and get an approval, varies from company to company. If the retailer is owned by an absentee international owner, the process may be extended by the parent company's own approval process.

In many organizations, a member of the real estate department or senior management will present the submission to the real estate committee and answer questions about the property, location or transaction. The submission often will include the following:

- An executive summary, including a comparison of the target criteria against the indicated results of the proposed transaction;
- Background information;
- An overview of the proposed transaction and its relationship, if any, to the company's storing objectives;
- A financial analysis, which may also include a store-related pro forma;
- Sales volume forecast and rationale generated from the location research analysis;
- A conceptual site plan;
- Other visual or factual items needed to assist in making a decision;
- A recommendation.

Assuming the opportunity has received the necessary internal approvals, and depending upon the protocol of a company, someone from the retailer's organization is usually empowered to go forth and negotiate the transaction. The real estate committee approvals and the economics or conditions specified therein will be used as a guideline for these negotiations. While the specifics may not be readily known to the real estate practitioner, understanding the financial criteria used by the retailer, its position in similar transactions and knowing the "deal-breakers" are helpful. In this regard, reading through documents related to similar transactions executed by the retailer, as well as speaking with developers, investors and financial institutions can generate some valuable insight.

To recap and add a few details:

- Determine what internal approvals are needed and the timing associated therewith;
- If possible, determine the financial criteria used by the retailer and how it fits within the economic parameters of the proposed transaction;
- Understand the accounting treatment or rules for retail transactions and the submission itself;

- Understand the body of information needed by a retailer and assist in the compilation of this material;
- Determine who, within an organization, will be making a presentation to the real estate committee or senior management;
- Read leases, contracts and other transaction documents to gain a better understanding of what a retailer will or will not do to complete a transaction. Speak with other informed individuals about the same things, particularly those who have consummated a transaction with the retailer.

BUILDING A CORPORATE RETAIL BUSINESS

For the real estate practitioner, there are three main factors in the building of a corporate retail business. Networking is probably a fourth, but the three other factors are much more important. The first is product knowledge, the second is credibility and the third is control of the product.

Knowing the marketplace "cold" is one of the things that separates a true professional from the "wannabes." Someone who knows every piece of real estate within a market or trade area, including those occupied by a competitor, as well as the strengths and weaknesses associated therewith, can save a retailer valuable time and resources. Sharing this kind of information with a retailer's real estate representatives helps them look good—a sure-fire way to build relationships. Help them also to know in advance the likelihood of getting requisite land use permits, and to understand transaction-related pricing levels and similar data. Retailers depend upon receiving quality information. This gets to the next point—credibility. If the information supplied by the practitioner is wrong, misleading or less than complete, the relationship will suffer. Instead of helping the retailer's real estate representatives look good, the opposite may occur. Not a good thing for building a business. Therefore, make certain whatever information or material you are disseminating is reliable, current and reflective of the marketplace.

Lastly, controlling the product typically means you have some influence over the end result. If you as a practitioner do not have some form of ball control and either another retailer or developer does, not only is your credibility negatively affected, so is your remuneration. Simply put: no deal, no money. Therefore, make sure you have secured a binding contractual relationship before submitting a site or location to a retailer. Under the broad banner of control is also confidentiality. One way to lose a deal is to tell the world about it prematurely. Retailers do not want to telegraph their moves; neither should you.

It is also advisable to quantify on some basis the likelihood of success, particularly if entitlements or permitting issues are prevalent. Some suggested reading in this regard is offered below. If expectations are not properly managed, the retailer may make costly decisions based upon the wrong set of assumptions.

Suggested reading:

- *The Complete Guide to Zoning* by Dwight Merriam, Esquire, CRE, ACIP;
- *Nimby Wars, The Politics of Land U*se, co-authored by P. Michael Saint, Robert J. Flavell and Patrick F. Fox.

CONCLUSION

Corporate retail real estate in today's economic environment is a difficult proposition. Notwithstanding these difficulties, opportunities still exist for seasoned and competent professionals. The often discussed future wave of toxic

Figure 2

Corporate Retail Real Estate Decision-Making

Create a Real Estate Storing Strategy
Empower Real Estate Team to Implement Strategy
Identify Real Estate Opportunities
Compile Site/Location Specific Information
Develop Concept Site Plan
Define Trade Area
Forecast Sales Volume
Conduct Site Visitation with Decision Makers
Complete Financial Analyses
Prepare Real Estate Commission Submission
Present to Real Estate Committee
Obtain Requisite Internal Approvals
Empower Real Estate Team to Negotiate Transaction
Secure Site/Location and Place in Queue

commercial real estate loans may, or may not, materialize. If it does, investors and developers will compete aggressively for these assets. However, other situations such as corporate downsizing, expense reduction initiatives and limited internal resources favor real estate practitioners with proven track records in asset management or advisory services. Financial institutions, investors or developers with limited or flawed expertise may also be a source of business for real estate practitioners.

Being on top of your game and constantly searching for good opportunities will give you an edge over your counterparts. Figure 2 outlines in summary form each of the steps discussed in this article. This illustration reflects the corporate decision-making process in many retail organizations. Understanding this sequence of events and the associated timing can be a beneficial tool to the real estate practitioner. ■

FEATURE

Value is Lower when Depreciation is an Operating Expense: A Current Issue

BY DONALD R. EPLEY, PH.D., CCIM, MAI

INTRODUCTION

STANDARD ACCOUNTING PROCEDURE DEDUCTS DEPRECIATION as an operating expense when computing the NOI for real property.[1] When the resulting NOI is incorporated in an estimate of value using NOI/R, the final estimate is lowered due to the deduction. In contrast, standard procedure used by the real estate profession, including appraisers, counselors and financial analysts, uses the depreciation amount only as a deduction in the calculation of taxable income from the property.[2] The NOI is unchanged and, consequently, the final value estimate is unaffected.

The current common knowledge and procedure practiced by the accounting profession and used by finance practitioners should be of concern to the real estate professional.[3] The use of depreciation as an operating expense is found in accounting texts and taught to finance students and professionals. It affects the real property professional in two important areas. The first is the estimate of value because of the decline in NOI. The second is the estimate of the overall capitalization rate, R=NOI/Value, which is the most commonly used real property financial ratio. This ratio often is used to send market signals on profitable/non-profitable properties and buy/sell in individual transactions, which could be incorrect because of this deduction.

This article examines the depreciation deduction in more detail. The purpose is to identify an issue that should be addressed. One recommendation is for the counselor to request and review the financial analysis supporting a value or rate estimate. Neither should be accepted and used without a preliminary scrutiny.

Source material to support this discussion must originate with several groups. The Appraisal Institute text provides insight on the procedure taught to professional appraisers interested in the market value of the property. The CCIM Institute course materials contain the concepts and procedure taught and used by a large group of commercial brokers and investment specialists. A third option is the textbooks used in higher education accounting, finance and real estate curriculums to illustrate the material taught to higher education students who enter the real estate business.

It is probable that when Congress established the asset classes for the depreciation deduction, it was devoting all of its attention to creating a lower tax liability on property as a means of providing a lower tax income stream back

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to the owner. The objective was to return the initial cost of the property prior to the end of its useful life. The issues of potentially lowering the NOI and the overall cap rate were not on the agenda or even a priority at the time this legislation was enacted. These results became important when the income accounts, such as NOI, became increasing important to real estate professionals in the current marketplace.

THE ISSUE

The traditional procedure used to calculate NOI is shown in the second column of Figure 1 without a depreciation deduction. The overall capitalization rate of 8 percent can be compared to the 6 percent estimate using the typical accounting and finance procedure.

Figure 1

	Benchmark	Accounting
Potential Revenue	$100,000	$100,000
–*Vacancy*	10,000	10,000
Effective Revenue	90,000	90,000
–*Operate Expense*	45,000	45,000
–*Depreciation*		11,250
NOI	45,000	33,750
R with no Depreciation	8%	—
R with Depreciation	—	6%
Value (NOI /R)	562,500	562,500
Land Value	123,750	123,750
Building Value	438,750	438,750
Depreciation per Year	—	11,250
Depreciation % of Value	—	2%
Cap w/o Depreciation	8%	—
Cap with Depreciation	—	6%

Source: Epley, 2010

The real estate analyst must make an immediate decision on which procedure to incorporate into an estimate of value.

The recommendation is to rely on the traditional procedure using the original property revenue and income numbers generated by the property in the current market, and use the subsequent calculations that produce the value estimate. In this manner, the traditional method is the point of focus, which can be justified in the common real estate body of knowledge represented by the references. For this reason, the traditional method has been labeled the "benchmark" because the resulting overall capitalization rate relies on the revenue number to be the market justified benchmark.

Cost of capital: The capitalization rate is composed of two elements that are combined to represent the total cost of capital. Each has a right to claim a portion of the NOI from the investment as return to its interest in this investment.[4]

The first is a claim by all equity contributors to receive a return on their equity in the property. The second is a claim by all debt contributors to receive a return on their loan of debt funds. A unique feature of these two contributors in a typical real estate investment is that each may also claim a regular return of the amount contributed. For example, the debt contributor may want the debt funds returned concurrently with the interest payment. The total regular payment is known as amortization and can be calculated easily with a financial calculator.

In sum, the total NOI is available for distribution to the two groups of investors who combined their funds to pay the purchase price. This arrangement can be illustrated in the band of investment that is used sometimes to derive Ro.[5]

$$Ro = Re\,(E/V) + Rm(M/V)$$

where Ro = overall capitalization rate

Re = equity capitalization rate, or the initial before tax cash flow/initial equity funds

Rm = mortgage capitalization rate, or the annual debt service/original debt

E = initial equity

M = initial debt

V = initial property value, which is purchase price or appraised value

Note that both contributors have a right to claim a share of the NOI relative to the proportion of funds contributed to the property. ***Both have a right to claim a portion of the amount shown for the*** **depreciation** ***deduction because it is not a cash account.*** This is explained below.

Adjusting the Ro: An analyst may receive a recommendation that a simple adjustment to the capitalization rate is acceptable when depreciation follows the accounting method. The result will produce the correct 8 percent in the illustration above, which is quick and straightforward.

The recommendation here is not to make this adjustment. A better method is to use always the benchmark revenue and expense numbers and allow the resulting Ro to be calculated from the original figures. In this manner, every reader and user will know exactly how this number was produced.

WHAT DO WE KNOW ABOUT REAL PROPERTY OPERATING EXPENSES?

Operating expenses may be defined as all cash expenses necessary each year to maintain the collection of rents and revenue.[6] Examples of such expenses include utilities, property insurance, property taxes, accounting and legal fees, management and personnel, and normal maintenance. Excluded are items that are not cash expenses such as the following:

Annual debt service: Loan payments do not maintain the collection of rent and revenue. They can continue when income stops.

Reserves for replacement: Cash set aside for replacing fixtures over the long term does not affect the annual operation of the property. An appraiser may present an argument that the maintenance account must be substantial, should the reserves account be missing. The reason is that expenses to repair and replace features and fixtures are necessary on a regular schedule to maintain the revenue stream and remain competitive in the market.

Agent leasing fees: Charges for negotiating lease space and rates for the sale of the property are special non-operating expenses.

Tenant improvements: Special one-time expenses for changes within a tenant's rented space are not included.

Capital expenditures: Anticipated major repairs that extend the useful life of the property are not charged in total in the year the expenditure is made. Normally, these are expensed in a separate category.

Depreciation: It is not a cash expense.

WHAT DO WE KNOW ABOUT DEPRECIATION?

The actual depreciation charge is determined by Congressional tax legislation that places assets in classes and assigns the write-off to each class.[7] Charging of depreciation is purely an accounting entry and does not directly involve the movement of funds. It is not viewed as a new source of funds although it reduces tax liability by protecting income from taxes. It is an attempt to allocate initial cost of asset over the useful life of the asset.[8]

During an asset's useful life, its revenue-producing capability declines because of wear and tear. The depreciation deduction is an attempt to match expenses with revenues in a systematic manner.[9]

The depreciation deduction has been used as an attempt to allocate the initial basis, or cost, of the real property over its useful life and return this amount to the owner. The total amount charged to depreciation represents the amount allocated to expense, although a cash payment is not actually made. It is not an accumulation of cash and should not be viewed as a source of cash. In effect, it lowers the final net operating income and creates a lower tax liability.[10]

Weygandt, Kieso and Kimmel summarize the essential issue in their statement that,

"No attempt is made to measure the change in an asset's value during the ownership. Therefore, the book value (initial basis minus depreciation) may be different from the asset's market value."[11]

FIRST YEAR ESTIMATE OF NOI BY THE REAL ESTATE PROFESSIONAL

The real property First Year Financial Statement should be assembled with a well-known procedure:

Potential Gross Income from All Sources

– Lost income from vacancy and collection

= Potential rental income

+ Other income

= **Gross** operating income

– Operating expenses

= **Net** operating income

– Agent fees for leasing and negotiating space

– Reserves for replacement

– Annual debt service

– Capital expenditures (expensed)

= **Before** tax cash flow

– Annual income taxes owed on property taxable income

= **Cash** flow after **taxes**

When Is the Annual Depreciation Deduction Used?

The depreciation deduction is used as a reduction in the taxable income calculation in the following procedure:

Net operating income for year "X" only

– Interest paid on eligible debt for year "X" only

– Depreciation deduction for year "X" only

= Taxable income

× Investor's tax rate

= Annual income taxes owed on property taxable income

Consider the following multi-family property as an example of the typical method used by a real estate analyst to deduct depreciation:

Asking price	$950,000
Initial basis:	15 percent allocated to site
	85% to bldg;
	27.5 yrs. useful life; straight-line
First year rental revenue	$159,600
Projected annual growth rate:	4%
Projected additional annual revenue	$4,920
Vacancy and bad debt	3.5%
First year operating expenses	$46,000
Projected annual growth rate:	2%
First year debt service	$66,919
First year interest:	$60,571.
Individual owner's tax bracket	28%

The first-year NOI would be:

(gross revenues) - (vacancy and bad debt) + (additional revenue) - (operating expenses),

$159,600 - ($159,600 x .035) + $4,920 = $158,934 gross operating income

$158,934 - $46,000 = $112,934 NOI

The annual income tax liability would be:

(NOI) minus (annual interest) minus (depreciation) times (owner's tax bracket),

$112,934 - $60,571 - the depreciation amount.

The depreciation amount is found by:

.85 × (initial basis) × 1/27.5,

.85 (950000) × 1/27.5,

$807,500 × .036364,

= $29,364 depreciation deduction [12]

Substituting above,

$112,934 - $60,571 - $29,364 = $22,999 .taxable income,

and,

$22,999 × .28= $6,440 income tax liability on this property

In this illustration, depreciation of $29,364 was used to lower the taxable income to $22,999.

RECOMMENDATION

Several recommendations can be made to any analyst or user of real estate income accounts and the overall capitalization rate. First, always use the ***benchmark*** method shown earlier. It is supported by the professional real estate literature. Second, try not to apply adjustments to the overall cap rate when depreciation is included. Always rely on the benchmark approach that all real estate professionals will understand. Third, always examine the revenue and expense accounts to confirm the correct use of the depreciation deduction. Never rely on or use a Ro without conducting the preliminary due diligence. Fourth, encourage the appropriate trade group such as counselors, appraisers, brokers and managers to emphasize the benchmark approach to other accounting and finance trade groups when valuing real estate. Fifth, recommend to all text authors that the benchmark approach shown here be included as a traditional technique that incorporates this account in a different manner.

CONCLUSION

The common use of the non-cash deduction of depreciation as a real property operating expense will lower net operating income and cause the resulting estimate of value to decline. In addition, use of this NOI figure will lower the property's overall capitalization rate. The lower value and cap rate estimates will send incorrect transaction signals into the marketplace.

Real estate professionals view depreciation as a deduction against taxable income when the property's income taxes are computed. It is not an operating expense as it does not represent a true cost of maintaining the property's revenue stream.

The conclusion is that all users of property and cap rates should request the financial analysis worksheet to review the depreciation deduction. ■

ENDNOTES

1. Illustrations representative of the common knowledge taught to accounting students are shown in Jerry J. Weygandt, Donald E. Kieso and D. Kimmel, *Accounting Principles, 8th Edition,* John Wiley (New Jersey 2008), pp. 728–729.

2. Illustrations representative of real estate trade groups and academia include: Appraisal Institute, *The Appraisal of Real Estate 13th Edition*, 2009, Chapter 21; William B. Brueggeman and Jeffrey Fisher, 2001, *Real Estate Finance and Investments*, McGraw-Hill, Chapter 9; CCIM Institute, 2007, *Financial Analysis for Commercial Investment Real Estate,* CI1, one of a series of professional courses offered by the CCIM Institute; Donald R. Epley, *Common Real Estate Principles and Practices,* 2008, *www.universityreaders.com,* Chapters 8–9.

3. Examples can be found in Richard A. Brealey, Stewart C. Myers and Alan J. Marcus, *Fundamentals of Corporate Finance*, McGraw Hill, 1995, Chapter 17; and Stephen A. Ross, Randolph W. Westerfield and Jeffrey Jaffe, *Corporate Finance*, McGraw Hill, 2005, Chapter 2; Stanley B. Block and Geoffrey A. Hitt, *Fundamentals of Financial Management, 8th Edition,* 1997, Richard Irwin, pp. 37–40, 356.

4. Appraisal Institute, op. cit., pp. 460–461. Also, Shannon Pratt has a good discussion of a similar calculation for combined corporate equity and debt called the weighted average cost of capital in *Cost of Capital: Estimation and Applications*, John Wiley, 2008, Chapter 7.

5. Ibid., pp. 505–507.

6. CCIM Institute, op. cit., pp. 2.10–2.12.

7. IRS Publication 946, "A Brief Overview of Depreciation," Aug. 8, 2008, *www.irs.gov*.

8. Weygandt, Kieso and Kimmel, op. cit., Chapter 10.

9. Ibid.

10. Ibid.

11. Ibid.

12. The depreciation deduction for the first and last years of ownership would require an adjustment for the mid-month convention that is not shown here.

FEATURE

Five Levels of Synergy Potential to Create Real Estate Value

BY NICHOLAS ORDWAY, J.D., PH.D.; AND JACK P. FRIEDMAN, PH.D., CRE, FRICS

PROFESSIONALS IN THE REAL ESTATE INDUSTRY FREQUENTLY use the word "synergy." An Internet search in early 2010 using the search string "real estate synergy" resulted in 980,000 hits on Google and 1,130,000 hits on Bing. Downloading a sample of these sites indicated that "synergy" is used primarily as a marketing concept.[1] The concept of synergy is commonly used by industry groups such as property developers and shopping center operators. There is, however, little explicit discussion on how synergy creates new value. Standard real estate valuation textbooks indicate little coverage of the concept and its applications.[2]

The objective of this article is to propose a definition for real estate synergy; further, to identify how synergy may be applied to real estate assets on five separate levels. Because of such innovations as the Internet, globalization, securitization of mortgage markets and other changes, real estate analysis requires thinking more about linkages that can create synergy. Many real estate projects are affected by changes in a set of networked externalities that affect the internal economics of the project itself. Synergy is a useful analytical concept for considering value potential for linkages to externalities.

SYNERGY AND REAL ESTATE

The root of the word "synergy" is the Greek word *synergia*, which is defined as joint working, working together, collaboration or cooperation. It may be useful to rethink the real estate value in the context of the General Systems Theory. The biologist Ludwig von Bertalanffy is credited with articulating this theory in 1936. It was quickly adopted and extended by others in many fields. Systems theory describes connection, organization and interdependence of relationships. The advantage of a systems

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approach is that the decision maker can better understand how small changes in one part of the environment can produce unexpected effects on components of the real estate project or deal.

Dean Schwanke, writing for the Urban Land Institute, has touted synergy as one of the key benefits of mixed-use development.[3] Synergy benefits developers of these products with "premium prices or rents or faster sales or leasing." Another area in which synergy concepts apply is vacation timeshares. Timeshare developers and operators have found many ways to create synergy by building projects as part of hotels, by marketing to hotel customer lists for hotel-sponsored projects, by tying timeshares to vacation clubs, and/or by using a point system or "right to use" for a set period of years instead of fractional fee simple ownership.

A search of journals published by the American Real Estate Society produced one hit using the search word "synergy." This was an article on real estate joint ventures.[4] Even though the synergy vocabulary has not been explicitly used by real estate scholars, the synergy and systems theory concepts are implicitly understood. For example, Roulac applies to the real estate value chain concepts similar to synergy.[5] James R. DeLisle has summarized many scholarly studies that evaluated synergy in the context of shopping centers.[6]

A PROPOSED DEFINITION OF REAL ESTATE SYNERGY

Following is a proposed definition for real estate synergy:

A process of recombining, adding, subtracting or otherwise affecting relationships of internal or external factors associated with a real estate asset that results in increased overall value at a specific point in time.

This definition is related to the appraisal concept of highest and best use. A conventional definition of highest and best use has been developed by the Appraisal Institute: "The reasonably probable and legal use of vacant land or an improved property that is physically possible, appropriately supported and financially feasible, and that results in the highest value."[7] The Appraisal Institute's flagship textbook requires appraisal professionals to answer this question as part of their highest and best use analysis: "Should the existing improvements on the property be maintained in their current state, or should they be altered in some manner to make them more valuable, or should they be demolished to create a vacant site for a different use?"[8]

Also influencing the definition is the work on feasibility analysis by James A. Graaskamp. He noted that a real estate client who is putting together a deal has the ability to design or change variables but must work within a set of constraints. Graaskamp wrote: "He can give form to these variables, but this form must be compatible with the context of all those factors which he cannot change and which place demands on the solution or form which he selects."[9]

Classical appraisal theory has always understood that real estate includes connections to non-realty factors. For example, Frederick M. Babcock, in the seven valuation approaches described in his treatise, contemplated income distributed to chattels and income distributed to business.[10]

ECONOMIC ELEMENTS HAVING SYNERGY POTENTIAL

Real estate is more than just the physical property and its improvements. This article suggests that real estate assets may be evaluated for synergy potential on five separate but interconnected levels (see Figure 1).

Figure 1

Economic Elements	Explanation and Examples
Level 1: Physical	Tangible elements fitting within the conventional definition of real estate such as land, improvements, utilities, water, minerals, etc.
Level 2: Activity	Elements that encompass the economic uses or internalities of the real estate such as going concern values incorporating tangible and intangible elements contributing to the overall project.
Level 3: Relational	Physical and economic linkages between the real estate and the rest of the world. These include situs (location and access), leasing lock-ins, branding, market power, etc.
Level 4: Financial	Deal structuring, influencing access to capital, tax subsidies, leverage and investor base, all of which create financial synergy possibilities.
Level 5: Intangible	Various tools provided by the legal system: contracts, intellectual property and public entitlements.

Source: Ordway and Friedman, 2010

LEVEL 1

Level 1 consists of the physical, on-site elements of real property. Most real estate professionals have significant experience analyzing and describing existing or planned real estate assets. The traditional elements that are typically evaluated in the standard appraisal methodology under the Uniform Standards of Professional Appraisal Practice (USPAP) are the basis of Level 1 analysis. USPAP Standards Rules 1–2 require an appraiser to:

- identify the characteristics of the property that are relevant to the purpose and intended use of the appraisal, including:
    - its location and physical, legal and economic attributes;
    - the real property interest to be valued;
    - any personal property, trade fixtures or intangible items that are not real property but are included in the appraisal;
    - any personal property, trade fixtures or intangible items that are not real property but are included in the appraisal;
    - any known easements, restrictions, encumbrances, leases, reservations, covenants, contracts, declarations, special assessments, ordinances or other items of a similar nature;
    - whether the subject property is a fractional interest, physical segment or partial holding.

Level 1 is the traditional foundation of most real estate analysis. Synergy is created when the internal built product is combined with land that has important linkages (for example, a shopping center that is developed near an intersection with streets that connect with populated housing areas).

The synergy questions that must be addressed include: Is the land developed to its highest and best use? Is it the right-sized improvement on the right-sized land built at the right location at the right time and for the right price?

LEVEL 2

Level 2 addresses the issue of how activities on the site affect the overall project. Appraisal theory includes in its scope a broad definition of real estate assets that goes beyond land and its improvements. In recent years, the appraisal literature has added more consideration of going concern value, incorporating tangible and intangible elements that contribute to the land and improvements. For example, there was a discernible expansion of coverage and detail on this topic between the 11th (1996) edition of the Appraisal Institute's primary textbook and its 12th (2001) edition.

A classic example of activity-based synergy is the typical American shopping mall. The mall generates reciprocal synergy from the tenant mix of anchors, specialty stores, restaurants and entertainment venues. Synergy might be improved by a better relationship of stores, improvement of traffic flow patterns, and marketing and promotions. In recent years, some shopping centers have experienced increases in gang activity and a growing crime problem. This problem is the opposite of synergy, and is sometimes called antergy or dyssynergy. A synergistic solution that some of these centers have undertaken is to provide space in the center of the mall for city police substations.

Likewise, brownfields and superfund sites suffer from antergy. Because of strict liability issues for clean-up responsibilities, many stigmatized sites suffer a severe market discount. In some cases the problem is incurable, but in other cases some developers have found that remediation of the defects can result in a synergistic value gain.

Part of the valuation problem faced by the real estate professional is how to properly design the site to maximize its functionality and architectural appeal. Paradoxically, aesthetics can result in diminished value. For example, in a mixed-use project in Atlanta, the retail component was designed around an ice-skating rink. This amenity created noise and restricted customer access. By removing the rink, the freed space was used for dining areas and free flow of customers. It also allowed for an integration of a hotel that had been previously isolated. This resulted in enhanced value to the overall project.

LEVEL 3

Level 3 deals with how the real estate project relates to off-site, trade-area, regional relationships, and the real and virtual world. Synergy could be created by better management of the supply chain, physical access, and different types of human, structural, customer capital and brand capital.

- **Human capital** is employee and organizational know-how consisting of skills, tacit and explicit knowledge, and competence. Human capital depends on management policies and techniques that begin at the top of the organization and permeate throughout the entire structure of the organization, with particular emphasis on the point of sale and servicing levels. One area often overlooked is the proper maintenance and supervision of the property management and leasing team. To some extent, these assets can be kept intact with a carrot-and-stick policy. The carrot can include stock options, bonuses and positive feedback. The stick includes a well-maintained trade secret program including confidentiality agreements, non-solicitation contracts and non-compete contracts.

- **Structural capital** consists of assets such as information and databases, customer lists, internal manufacturing and management processes, and other organizational capabilities used to work with customers in the marketplace. External structure and processes consist of supply chain management, suppliers, other service providers and regulators, and brands and image.
- **Customer capital** consists of customer loyalty and satisfaction. Customers can lead to repeat business and referrals. Failure to understand the value of this intangible capital can ruin a company. Solid brand promotion and management can maintain this asset. Customer loyalty programs (such as hotel guest loyalty programs or supermarket discount cards) also can be used with some real estate products or services.
- **Brand capital** is created by the establishment and promotion of an image that is directed to a defined target market. Brand capital is enhanced by the legal tools described under Level 5. For image creation in a shopping center, care should be taken in attracting a tenant mix that is consistent with the expectations of the targeted customers. For example, including a Tiffany & Co. with a used-clothing store may create a discordant message.

Mastering Level 3 possibilities are such companies as Walmart, Disney and McDonald's. Walmart has been relentless in driving down prices by managing its supply chain and its just-in-time inventory system. The company also has been able to rationalize its real estate in the context of a global distribution system. One of Disney's strengths with respect to its theme parks is the close attention it pays to the customer experience. Its employees undergo continuous training to positively engage with the public. It is difficult to find any Disney person without a smile, with the possible exception of Grumpy on the Snow White ride. McDonald's has mastered the system of clean restaurants, excellent locations, and a system that delivers fast and dependable food on a global basis. It does so by managing its human and structural capital to constantly build a loyal customer base, starting with children in its play areas to retired customers with its discounted "senior coffee."

LEVEL 4

Level 4 recognizes the importance that financial capital plays in the capital structure of a real estate project or company. Timing and cash flow amounts associated with mortgage financing can create risk-and-return synergies. Playing into the mix are the covenants and conditions required by lenders and equity investors.

Financial synergies offered by real estate may be demonstrated by fractionating the property into various ownership components such that the value of the sum of its parts exceeds the whole.

In its simplest form of fractionating a property, a purchaser arranges mortgage financing at market rates and terms. The purchaser, who gains ownership of the equity, leverages the investment. Leverage magnifies returns, whether negative or positive.

The mortgage lender seeks a competitive rate of return on investment, through receipt of interest, and a recovery of investment through amortization receipts or repayment of principal in a lump sum. A mortgage at a higher-than-standard principal may be arranged in exchange for a below-market interest rate. A second or third mortgage might be arranged.

The ownership may be fractionated further, and often is, especially for commercial property. The land may be sold and leased back, releasing immediate cash to the seller, who becomes obligated for future payments as lessee. The rental rate to be paid will depend on the security of the land lease, depending on subordination (or its absence) to prior liens.

More complicated financing or ownership arrangements can be made by selling various tangible or intangible components of the property to those who appreciate the characteristics offered.

In addition, the equity itself may be fractionated by one of a variety of syndication forms including corporate, partnership, limited partnership, limited liability companies or tenancy in common. Each may have unique liability, income tax, control or other consequences.

Each possible partial interest, entity or variation may add value such that the aggregate value of the individual parts exceeds the whole.

The successful entrepreneur attempts to carve out various ownership interests, each of which is sold to a party with a special appetite for that component. Raising more money to purchase real estate by selling individual components demonstrates the power of financial synergy.

Complicating synergy possibilities are constraints put on the financing structure by lenders requiring certain covenants and conditions as consideration for their participation. This can limit management flexibility and put a ceiling on value growth potential.

LEVEL 5

Level 5 addresses intangible property associated with real estate ventures. Of particular importance are such issues as copyrights in the architectural designs, trade dress and branding. There may also be some issues associated with patents of business models.

Intangible assets and intellectual property (IP) can be a key element in modern real estate value. The nature and importance of IP has been transformed during the last decade. The rules have changed. Initially, the transformation began when IP laws in the United States and in other countries were a part of the World Trade Organization (WTO) process. As a consequence of legal reforms, IP owners were able to successfully bring forth court actions winning large awards for misappropriation and infringement. The message from the courts was heard, as companies were motivated to quickly negotiate licensing agreements.

Four primary weapons provide legal protection over an entire range of assets and activities, creating an edge for companies competing in the global market environment. The weapons are trade secrets, patents, copyrights and trademarks.

A trade secret is business information that has value because competitors do not know it; reasonable steps must have been taken to keep the information secret. Common law and state statutes protect trade secrets. Applicable definitions vary among the states. Some states will protect only technical information (e.g., computer source code, mechanical processes, etc.) as trade secrets. Nontechnical information (business information such as customer lists or pricing data) will require signing confidentiality agreements to provide protection. Criminal law protection is provided at both the state and federal levels. The U.S. federal government put sharp teeth into the protection of trade secrets in the Economic Espionage Act of 1996 (18 U.S.C. 1832), which was signed into law on Oct. 11, 1996. This law makes theft of trade secret information a federal criminal offense and gives the Department of Justice authority to prosecute trade secret violations. The Act is intended to supplement state trade secrets protection rather than to supplant it. Trade secrets can protect real estate data, customer lists and development plans, among other real estate-related assets.

A patent is a government grant of a property right to exclude others from making, using, selling, offering to sell or importing a claimed invention for a specific time period within the territory of the country. Patents encourage technological advancement and economic growth. An inventor has a monopoly for a specific period of time in exchange for a full public disclosure of how the invention works. The inventor is given the incentive to invent by being able to financially exploit the invention and exclude competitors. The patent holder is responsible for taking the initiative to enforce a patent. The holder has the economic incentive to maintain the legal monopoly. By rigorous enforcement of patent rights, it is possible to reap additional licensing fees, collect damages and maintain monopoly pricing to optimize total income under market demand conditions. Patents have limited application to most real estate assets, but some construction processes, materials and business processes (especially those linked to computer applications) potentially create synergy.

Copyright protects original works of authorship including literary, dramatic, musical, artistic and certain other intellectual expressions, covering both published and unpublished works. This protection may last for the lifetime of the author plus 70 years. For companies, the copyright for publications lasts for 95 years or 120 years from creation.

Some people may not be aware that as of Dec. 1, 1990, copyrights apply to architectural drawings and design features incorporated into buildings. Artistic works such as sculptures in a building come under The Visual Artists Rights Act of 1990 (VARA). Some states such as California give similar rights to artists. VARA allows, under some circumstances, for the artist to control the work even if it has been sold by retaining his "moral rights" to the work.[11] The artist can agree to give up these rights as in a "work for hire" contract or other waiver provisions in a contract.

A mark (trademark or service mark) is a name, symbol, combination of name and symbol, or other indication of source and quality that distinguishes a business or products from competitors in the same field. A mark protects a business from unfair competition by those who would pass off their products or services as being those of the mark owner. The most recognized mark, a trademark, is a territorial right and must meet registration and other requirements specified within each nation. The basis for protection in most countries is registration in the national trademark register. In the U.S., this would be the U.S. Patent and Trademark Office. It is also possible to register a trademark in a given state, but protection would then be limited to that state. National registration enables enforcement of trademark rights including activities that might dilute a trademark through the court system. It is also possible to defend under common law an unregistered trademark if prolonged usage has enabled the mark to attain a secondary meaning.

Marks are the underlying basis for protecting brands. Some real estate projects have had enhanced value due to branding. For example, Disney's Celebration in Florida has been able to command premiums for houses because of the Disney brand. Until recently, the Trump brand enhanced the values of luxury condominiums, hotels, golf courses and other properties.

Similar to marks is trade dress protection for real estate assets. Trade dress enables protections under Section 43(a)(1) of the Lanham Act. It can be protected with or without registration. Trade dress consists of a combination of shapes, colors, designs and other elements that create a unified image such as the combinations found in typical McDonald's restaurants and Starbucks coffee shops. The leading real estate case is *Two Pesos, Inc. v. Taco Cabana,* 505 U.S. 763 (1992). The U.S. Supreme Court upheld the general idea that to prevent confusion on the part of the public, one restaurant chain cannot copy the image already developed and promoted by another restaurant chain.

CONCLUSION

This article proposes a five-level framework for analyzing potential synergy in real estate projects. The first two levels deal with on-site aspects of the project. The first involves the physical real estate itself; the second level deals with the business activities that take place on the site—both the businesses and the customers who use the site.

The next three levels are concerned with the externalities associated with the site. Level 3 deals with relational externalities including four forms of capital: human, structural, customer and branding. These contribute to the efficiency and effectiveness that can enable the real estate asset to maximize its productivity. A key to achieving full potential is skillful management. The analyst can only recommend what should be done. The management team makes it happen. Level 4 addresses the issue of financial structuring. The decision maker must seek an optimal balance between risk and return, and what lenders and other equity investors will allow. Finally, Level 5 identifies synergies that can be achieved by rethinking how new laws involving intellectual property can enhance value. New doctrines by the U.S. Supreme Court and state courts, new trade secret legislation passed by Congress, strengthened federal and state trade secret enforcement, and the WTO international rules have created new synergy possibilities.

Most real estate professionals have probably implicitly considered each of the five levels of synergy potential at one time or another. Published research has lagged behind cutting-edge practice. Evaluation of real estate developments in the context of synergy principles provides a qualitative approach to better uncertainty/risk assessment. ■

ENDNOTES

1. Both searches indicate the word "synergy" was typically part of the name of a company or a promise that use of services would increase value to the client.
2. *The Appraisal of Real Estate, 11th Edition*, 1996, *12th Edition*, 2001, and *13th Edition*, 2008, Appraisal Institute, Chicago; Byrl N. Boyce and William N. Kinnard, Jr., *Appraising Real Property*, Lexington, Mass., Lexington Books, 1984; H. C. Smith, *Real Estate Appraisal*, 1977, Columbus, Ohio, Grid, Inc.; J. H. Boykin and A. A. Ring, *The Valuation of Real Estate*, *4th Edition*, 1993, Englewood Cliffs, N.J., Regents/Prentice-Hall; G. F. Bloom and H. S. Harrison, *Appraising the Single Family Residence*, 1978, Chicago, American Institute of Real Estate Appraisers; and J. P. Friedman and N. Ordway, *Income Property Appraisal and Analysis*, 1981, Englewood Cliffs, N.J., Prentice-Hall.
3. D. Schwanke, *Mixed-Use Development Handbook*, 1987, Washington, D.C., The Urban Land Institute.
4. F. A. Elayan, "The Announcement Effect of Real Estate Joint Ventures on Returns to Stockholders: An Empirical Investigation," *The Journal of Real Estate Research*, 1993, Vol. 8, n. 1.
5. S. E. Roulac, "Real Estate Value Chain Connections: Tangible and Transparent," *The Journal of Real Estate Research*, 1999, Vol. 17, n. 3.
6. J. R. DeLisle, "The Evolution of Shopping Center Research: A 12-Year Retrospective," *Journal of Shopping Center Research*, 2005, Vol. 12, n. 2.

7. *The Appraisal of Real Estate, 13th Edition*, op. cit., pp. 277–278.

8. Ibid., p. 278.

9. J. A. Graaskamp, *A Guide to Feasibility Analysis*, 1970, Society of Real Estate Appraisers, p. 3.

10. F. M. Babcock, *The Valuation of Real Estate*, 1932, New York, McGraw-Hill Company. Babcock's seven approaches or "methods" were: Income Method (commercial rentals); Income Method (business profits attributable to real estate); Income Method (business profits distributed between real estate and chattels); Income Method (business profits distributed between real estate and business); Replacement Cost Method (business profits); Market-Comparison Method (amenity returns); and Replacement Cost Method (amenity returns), pp. 165–180.

11. VARA attempts to narrowly pattern the international Berne Convention for the Protection of Literary and Artistic Works. It tries to protect creators of fine arts and photographs the right to control the use of their authorship, and limited rights to prevent modification of their works. The most significant real estate impact is the right to protect an artistic work that is part of a building. These so-called "moral rights" can be waived only by a specific signed agreement.

The Importance of 'Greening' Your Commercial Lease

BY KATHERINE OBERLE, ESQ.; AND MONICA SLOBODA, ESQ.

WHAT IS A "GREEN" LEASE?

With demand increasing for leasable space in green buildings, it may be surprising that there is no widely accepted definition of a "green" lease. There is, however, general agreement that the purpose of a green lease is to encourage the building owner and the tenants to adopt and maintain environmentally friendly, sustainable business practices in an effort to reduce energy and water use, reduce waste, and create a more comfortable and healthy environment for the building occupants.

Green buildings offer benefits for owners and tenants. The benefits of owning a green building can include the ability to attract and retain high-quality tenants who are willing to pay a premium for green space; realizing cost savings through lower energy use; minimizing the ongoing risk of dealing with ever-tightening environmental restrictions and regulations; and higher real estate values as a result of the foregoing factors. The benefits for tenants leasing space in a green building can include lower utility costs, improved employee health and increased productivity.[1] In addition, some tenants may want to send a message of corporate social and environmental responsibility to their investors, clients or customers by leasing green space. To those tenants, the benefits of enhancing their reputations may be more difficult to quantify than, for example, utility cost savings, but those benefits may be just as important, if not more so.

GREEN STANDARDS

There are numerous green building standards that are now being used in the commercial building industry, but the three most widely used and recognized in the U.S. are LEED®, Green Globes and ENERGY STAR®.

Of those, LEED, which stands for Leadership in Energy and Environmental Design (LEED) Green Building Rating System™, is the most prominent standard for leased space. LEED is an internationally recognized green building certification program that provides third-party verification that a commercial or residential building has been designed and built in a sustainable manner.[2] LEED was developed by the U.S. Green Building Council

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(USGBC),[3] a nonprofit organization, and is a voluntary, points-based program that measures the sustainability of a building by reviewing performance in key areas. Those areas include water efficiency, sustainability of the site, energy efficiency, reduction of waste, use of materials and resources in a manner that reduces environmental impacts, and improvement of indoor environmental quality. Points are awarded based on the type of building and the satisfaction of various sustainable construction and operations benchmarks, enabling a building to earn one of the four levels of certifications: Certified, Silver, Gold or Platinum.

Canada-based Green Globes is another points-based sustainable development rating system used in the U.S. and Canada. In the U.S., Green Globes is owned and operated by the Green Building Initiative,[4] a nonprofit organization whose mission is "to accelerate the adoption of building practices that result in energy efficient, healthier and environmentally sustainable buildings by promoting credible and practical green building approaches for residential and building construction."[5] Green Globes is an online assessment system that uses third-party verification and rates the environmental performance of new and existing buildings by reviewing certain factors including the project site, use of energy, water and other resources, emissions and indoor environmental quality. While Green Globes and LEED have similar goals, they offer different advantages and disadvantages. For example, Green Globes emphasizes its simpler methodology and user-friendly interactive guide as compared to the LEED certification process, which is more complex. In addition, the Green Globes certification process is usually less expensive than LEED's certification process.[6] However, LEED is far more widely acknowledged and used in the U.S. than Green Globes. For example, as discussed in more detail below, some jurisdictions have adopted LEED certification levels as minimum standards for certain types of development.[7] Further, as of January 2010 only 100 buildings in the U.S. had been certified by Green Globes[8] while more than 2,400 projects in the U.S. have been certified by LEED.[9]

ENERGY STAR is a joint program of the U.S. Environmental Protection Agency (EPA) and the U.S. Department of Energy that aims to protect the environment by promoting energy efficient products and practices.[10] While meeting ENERGY STAR standards can contribute to earning other certifications, such as LEED certification, ENERGY STAR also offers its own certification system. Commercial buildings may earn the ENERGY STAR label by meeting strict energy performance standards set by the EPA.[11] The first step in obtaining the ENERGY STAR label is to obtain the "Designed to Earn the ENERGY STAR" certification, which is awarded to building design projects that achieve a rating of 75 or higher on EPA's energy performance rating system and are designed to perform among the top 25 percent of buildings in the U.S.[12] The second step is to measure and verify that the building's actual performance meets the ENERGY STAR requirements.[13] Because ENERGY STAR focuses solely on energy conservation, its certification system differs from the LEED and Green Globes certification systems, which use more comprehensive sustainable building approaches by assessing other factors such as indoor environmental quality, efficient use of water, reduction of waste and sustainability of the site.

GREEN LEASING IS ON THE RISE

Despite the recent downturn in the commercial real estate market, the demand for green building space in office, retail and mixed-use projects continues to increase throughout the U.S. According to information compiled by USGBC, in the U.S. the green market was two percent of nonresidential construction starts in 2005; 10–12 percent in 2008; and will grow to 20–25 percent by 2013.[14] This is evidenced by the growing number of LEED-certified buildings over the past five years: in 2005 only 404 buildings were LEED certified, but by 2008 more than 2,000 buildings were LEED certified.[15] This trend is consistent with the increase in ENERGY STAR-rated buildings. According to a study performed by the U.S. EPA, during the first six months of 2009 alone, the number of ENERGY STAR-rated buildings rose 17 percent.[16]

In the U.S., buildings account for 72 percent of electricity consumption, 39 percent of energy use, 38 percent of carbon dioxide emissions, 40 percent of raw materials use, 30 percent of waste output and 14 percent of potable water consumption.[17] The impact on the environment and the depletion of precious resources caused by traditional construction practices account for some of the increasing interest in buildings that have been sustainably designed and constructed. However, there are many other benefits associated with owning or leasing green space.

The most obvious benefits associated with sustainably designed and constructed buildings are environmental benefits. Such environmental benefits include the improvement of indoor air quality, reduction of waste, conservation of water and other natural resources, and protection of our ecosystems. According to a study of sustainably designed buildings conducted by the U.S. General Services Administration (GSA), green buildings consume 26 percent less energy and have 33 percent less greenhouse emissions than traditionally built commercial buildings.[18]

There are also numerous direct and indirect economic benefits associated with green building including lower operational costs. The GSA study revealed that its sustainably designed buildings had 13 percent lower maintenance costs compared to traditionally constructed buildings.[19] Another direct economic benefit is the availability of federal and state incentives for sustainable construction and operation practices that an owner might be able to obtain. For example, there is a federal tax deduction for the cost of installing certain qualifying energy-efficient improvements such as lighting, heating, cooling, ventilation or hot water systems that reduce a building's total energy power cost by 50 percent or more compared to a building meeting only the minimum requirements set by Standard 90.1–2001 of the American Society of Heating, Refrigerating and Air-Conditioning Engineers (ASHRAE).[20] This deduction is available primarily to building owners, although tenants may be eligible if they make qualifying construction expenditures. An example of a California state incentive is a property tax exclusion for certain types of solar energy systems installed in industrial, commercial and residential buildings.[21] Qualifying active solar energy systems are defined as those that "are thermally isolated from living space or any other area where the energy is used, to provide for the collection, storage or distribution of solar energy."[22] This includes solar space conditioning systems, solar water heating systems, active solar energy systems, solar process heating systems, photovoltaic systems and solar thermal electric systems.

There is a wide variety of indirect economic benefits as well. One such benefit is the improvement of occupant satisfaction which, in turn, increases employee productivity and helps to attract high-quality tenants. The GSA study revealed that its sustainably designed buildings had 27 percent higher occupant satisfaction rates compared to traditionally constructed buildings.[23] Also, a November 2009 report entitled "Why Do Companies Rent Green?" published by RICS Research found a less obvious reason for some tenants' interest in leasing space in green buildings: enhancement of the tenant's reputation as an environmentally and socially responsible company.[24] Certain tenants, the report found, strive for a "green" reputation to help attract investors as well as customers who are increasingly judging companies by their actions as well as their products. Other companies appear to be motivated more by the opportunity to avoid risk. They recognize that with the trend toward increasing environmental regulations, they can avoid the necessity of sharing in the cost of expensive modifications required to comply with such regulations, including stricter controls on energy use and waste emissions, by occupying buildings that are likely to conform with environmental regulations for some time.[25]

Incentives offered by many local jurisdictions for constructing or remodeling buildings in conformance with a particular green standard such as LEED also provide motivation for building sustainably. For example, Marin County, California, has a green building incentive program that offers fast-track permit processing, free green building technical assistance and waivers of certain fees for projects that meet certain sustainable-development requirements.[26] Some jurisdictions have gone beyond providing incentives to encourage green building, and have adopted ordinances that require that projects achieve certain minimum environmental standards. The City of San Francisco, for example, requires that all projects of more than 5,000 square feet must obtain a LEED rating of Silver or higher.[27] Additionally, the State of California has recently become the first state in the nation to adopt a mandatory green building standards code.[28] California's building standards code, known as CALGreen, previously only included voluntary standards. However, as of Jan. 1, 2011, certain components of those standards, including the following, will become mandatory for all new buildings: reduction of water consumption by 20 percent, diversion of 50 percent of construction waste from landfills and the installation of low pollutant-emitting materials, such as paints, carpet, vinyl and particle board.[29]

With the environmental benefits, marketing advantages, financial incentives and mandatory requirements associated with green building, the approach known as green building is no longer just a trend or an ideal to achieve. Rather, it is a necessary and inevitable evolution in our building processes. Since green building is the reality for future development, it is imperative that provisions within commercial leases related to the construction, operation, management and use of commercial buildings be revisited and revised accordingly.

THE NEED FOR SPECIFIC GREEN LEASING PROVISIONS

Typical commercial leases do a good job of allocating various obligations between the building owner and the tenants, but they seldom address environmental considerations beyond the basics of specifying which party is responsible for payment of utilities. Worse, typical commercial leases can even be a deterrent to adoption of sustainable practices and procedures. For example, if a lease requires the tenants to pay all utility costs, there is little incentive for the building owner to add environmentally friendly improvements such as low-flow water fixtures, lighting timers and climate controls because none of the energy cost savings would accrue to the building owner's benefit. A green lease, however, is likely to go into detail about water and energy conservation targets and methods, the use of alternative sources of energy such as solar or wind, the use of environmentally friendly products and maintenance of indoor air quality standards; and to allocate the costs and benefits of those practices and improvements between the building owner and the tenants in accordance with their negotiations. The lease should define and incorporate the applicable green standards with enough specificity that the landlord and tenant will know what is required of each party, but with enough flexibility that the lease can accommodate necessary or desired updates. An owner constructing a building with sustainability in mind should include the appropriate green provisions in its lease form. Obviously, owners of existing buildings seeking to adopt sustainability standards will have a more difficult time, at least with their existing tenants, in incorporating green provisions into leases. While leases for new tenants of the existing building should include green provisions, the owner would need to seek modifications of leases for existing tenants, which may not be possible unless those tenants are motivated by the advantages that the green building features might offer, such as lower operational costs passed on to them. Otherwise, as those existing tenants' lease terms expire, new leases would need to include the green provisions.

The absence of lease provisions drafted specifically for green buildings (including those that address the expectations and sustainability goals of the parties, the allocation of responsibilities and expenses for maintaining sustainability standards, and the penalties for failing to satisfy sustainability standards) will lead to ambiguity in the lease, resulting in disputes between the parties. If such a dispute is litigated, the court will have difficulty in assessing the parties' intent as to allocation of the responsibilities for paying for and maintaining the sustainability of the building because the lease is silent on such issues. In addition to the time and money spent on litigating such issues, the court will be left with no other option but to speculate as to the parties' intentions and to decide for the parties what the lease will provide regarding those absent provisions. To avoid these problems, parties to leases for new green buildings should specifically address sustainability issues in their leases, and landlords who are adopting sustainability practices for existing buildings should incorporate sustainability provisions in leases for new tenants and should seek to amend leases for existing tenants. Noted below are examples of some of these provisions that are, for the most part, unique to green leases.

USE OF AN ENVIRONMENTAL MANAGEMENT PLAN

An environmental management plan (EMP) is a document that describes the environmental standards, pollution control measures, performance criteria and practices that a building owner and its tenants will follow to reduce negative impact on the environment. The EMP may also set forth future sustainability goals. The EMP would include, for example, the specific requirements related to recycling and waste management, use of energy efficient equipment, use of lighting controls and implementation of water reduction measures. An owner of a building that has earned an environmental certification may be required to, or may desire to, adopt and implement an EMP to ensure that the building operations and maintenance practices remain consistent with that certification. If a building owner establishes an EMP, the lease should require the tenant to comply with the EMP, and a copy of it should be attached as an exhibit to the lease. From the owner's perspective, the lease would ideally include a provision that allows the owner to modify the EMP from time to time as new sustainability practices become available, since changes in green technologies continue to evolve and improve, and as certification requirements may be updated. The EMP should also specify how the costs of compliance will be allocated between the building owner and the tenant. Some of the types of items that should be addressed in an EMP include:

- **Utilities (Lighting and Climate Control).** An EMP would set forth the standard for operation of the building's heating, ventilation and air conditioning systems (specific ASHRAE standards, for example).

Either the EMP or the rules and regulations for the building that are incorporated into the lease should prohibit the tenant from using energy-intensive equipment (such as space heaters) without the prior written approval of the landlord, and the tenant should be required to keep window blinds closed during exceptionally warm or cold weather and during non-business hours. The tenant and landlord should both be required to use compact fluorescent lamps, high-intensity discharge lamps, light-emitting diodes and other devices that produce more visible light but use less energy than standard incandescent lamps.

- **Furnishings.** The use of low- or no-VOC paints, solvents, adhesives, furniture, carpeting and fabrics should be required in order to reduce emissions from the materials used in the construction and furnishing of the building. These emissions can substantially reduce the indoor air quality within a building.
- **Cleaning Products and Practices.** Cleaning and maintenance practices that reduce the impact on the environment and indoor air quality should be required. Such practices include the use of: 1) sustainable cleaning chemicals and carpet care products that meet the Green Seal GS-37 standard;[30] 2) micro-fiber wipes or dust cloths or paper products that contain a large percentage of recycled material; and 3) hand soaps that do not contain antimicrobial agents, except as required by health codes. The EMP should set forth the standard, such as Green Seal, that the cleaning products must adhere to, and tenants should be required to train their maintenance personnel about the proper use, maintenance and disposal of cleaning materials. The landlord and tenants should be required to maintain documentation, subject to audit rights of the other party, providing proof that the cleaning products and practices used by them are in conformance with the criteria specified in the EMP.

ENVIRONMENTAL REPRESENTATIONS AND WARRANTIES

A tenant who has specifically bargained for the lease of green premises should try to include in the lease a representation and warranty from the building owner that the building is, and will continue to be, certified by the applicable environmental standard, if any. If the building has not earned any particular certification, the representation and warranty should be for a certain minimum green standard. For example, if there is an EMP, the representation and warranty would provide that the landlord will, at minimum, satisfy the sustainability requirements set forth in the EMP. The building owner, on the other hand, will likely prefer to include a general statement of the intent to operate the building in compliance with the EMP, rather than including a specific representation or warranty to that effect.

RECYCLING AND DISPOSAL ACTIVITY

A typical commercial lease will require tenants to remove all of their personal property and certain tenant improvements and/or alterations at the end of the lease term. Green leases should further require tenants to dispose of such improvements in an environmentally sensitive manner in accordance with the landlord's sustainability practices as set forth in the EMP, and to reuse and/or recycle to the extent possible. The same should apply to any obsolete personal property, equipment and furnishings the tenants want to dispose of during or at the end of the lease term. Tenants should also be required to report their recycling/disposal activity to the landlord at reasonable intervals, such as quarterly or annually. Requiring these practices assists the building owner in verifying that the building's sustainability practices for the building are being followed. Some building owners have started scheduling regular recycling days to make it convenient for tenants to recycle or dispose of unwanted materials—from used batteries to computer components—in one place and at one time.

ALTERNATIVE TRANSPORTATION INCENTIVES

A standard commercial lease would not address issues related to transportation. However, depending on the project, a green lease may include provisions related to incentives for reducing automobile use and increasing the use of alternative transportation. For example, to encourage bicycle use, a building owner may include bike racks and shower facilities within the building to provide occupants the option of biking to work. If so, the tenant might want to include lease provisions that require the building owner to provide a minimum number of bike racks, shower facilities and lockers. Also, the owner of a sustainably built and operated building might want to encourage carpooling or the use of low-emission or alternative fuel vehicles by providing incentives such as preferred parking. If so, the details of such incentive programs should be clearly defined either in the body of the lease or in the rules and regulations attached to the lease.

STANDARD LEASE PROVISIONS

The lease of space within a green building, whether certified by any particular standard or not, requires incorporating certain green provisions. The following are examples of provisions found in virtually all commercial leases. These should be modified to address the sustainability practices applicable to the building.

PERMITTED USE

A standard commercial lease will include a permitted use provision that will specify the type of use allowed for the leased space and will prohibit the tenant from using the space in any manner that would be unlawful or would constitute waste or nuisance. In a green lease, that provision should be expanded to include a prohibition against using or operating the premises in any manner that would be inconsistent with the building owner's sustainability practices or the certification of the building, if applicable. From the tenant's perspective, the lease should include a representation and warranty from the building owner that no space within the building will be leased to any tenant whose use would be in violation of the building owner's sustainability practices or the building's green certification standards. Of course, the ability to obtain such representations and warranties depends on the parties' respective bargaining power in the transaction. However, it would not be an unusual request from a tenant who has specifically bargained for space in a green building or from a landlord who wants to be able to continue representing and marketing the building space as being green or meeting a particular standard.

OPERATING COSTS

A standard triple-net commercial lease will require the tenant to pay a proportional share of the operating costs of the building and any common areas of the project. For a full-service lease, the tenant will be required to pay a proportionate share of any increases in operating costs over a base year. In both cases, a well drafted lease will specify in detail which types of costs will be included and which will be excluded from those operating costs to be shared by the tenant. In a green lease, it is important to include an allocation of the following costs as well:

- The cost of insurance endorsements to repair, replace and recommission the building for recertification in accordance with the applicable certification system, if any, that the building has earned;
- Costs of applying, reporting and commissioning and recommissioning of the building to conform with certification, to the extent such costs are not covered by insurance;
- Costs associated with the building owner's sustainable operations policies for the property including the maintenance, repair and replacement of specific systems that are unique to the sustainability practices that the owner has adopted, such as particular types of water or energy reducing mechanical systems, and compliance with the EMP.

INSURANCE

Several commercial property insurers are now offering green coverage endorsements to enhance their standard all-risk property policies. The endorsements are intended to protect a building's green certification. These endorsements provide flexible coverage for the additional costs of repair or replacement of the energy-efficient materials and systems necessary to restore the LEED certification level (or other green rating standard) of the building or premises. The additional coverage should include the cost of retaining an accredited green consultant to assist in the green design and reconstruction, as well as the costs of removing, recycling, disposing of and replacing the damaged property using environmentally responsible methods and materials. Building owners should verify that their leases are structured to pass any additional green insurance costs on to their tenants (generally as part of the operating costs), and tenants may want their leases to require the owner to maintain green insurance necessary to restore the building's green rating after any rebuilding.

In addition, some insurers offer reduced property insurance rates for LEED-certified buildings based on the building systems being designed, installed and operated in conformance with LEED requirements and the ongoing monitoring generally required. Allocation of the savings in insurance premiums should be addressed in a green lease, as well as how any increased costs will be allocated if the building does not retain its certification.

MAINTENANCE AND REPAIRS

Typical maintenance and repair provisions in a commercial lease will specify which portions of the building the landlord and the tenant will each be required to maintain. The tenant is normally required to maintain the leased space, including the fixtures and equipment located within and serving the space. The landlord is typically required to maintain those areas of the building and portions of the property that are not used exclusively by a tenant, including mechanical systems serving the building. The costs of such maintenance, repair and replacement are charged back to the tenants in the form of operating costs. From the landlord's perspective, the maintenance and repair provision in a green lease should specify that the tenant must satisfy maintenance and repair obligations in a manner that is consistent with the building's sustainability practices as set forth in the EMP, and the environmental certification earned by the building, as applicable. For example, the tenant should be prohibited from replacing a dishwasher with one that does not meet the water reduction and energy reduction measures of the building. Similarly, the tenant should negotiate a provision within the lease requiring that the landlord's maintenance, repair and replacement obligations will be satisfied in a manner that is in conformance with the certification earned by the building.

COMPLIANCE WITH LAWS

Typical commercial leases require the tenant to comply with all present and future applicable laws, statutes, ordinances, codes, rules and regulations applicable to the property. The allocation of the responsibilities and costs of compliance, of course, depends on the respective bargaining power of the landlord and tenant. In a green lease, this provision should be expanded to require the tenant to comply with the landlord's sustainable building practices (which may be specified in an EMP) including the applicable requirements for any green certification earned (or sought to be earned). From the tenant's perspective, the green lease should also require the landlord to continue to comply with all certification requirements and the EMP, and should require the landlord to include in other tenants' lease agreements the obligation to comply with the certification requirements and sustainability practices of the building and EMP.

ASSIGNMENT/SUBLETTING

The assignment and subletting provision in a standard commercial lease will contain various terms permitting or prohibiting the tenant's ability to assign or sublet the leased premises, which terms may vary greatly depending on the bargaining strength of the parties. While some leases will allow the tenant to assign the lease or sublet the premises without the landlord's consent under certain, limited circumstances, most commercial leases require the landlord's reasonable consent before assignment or subletting. The assignment and subletting provision of a green lease should provide that it will be reasonable for the landlord to disapprove any assignment or sublease if, in the landlord's reasonable opinion, the proposed assignee's or sublessee's use would cause the premises or the building to be in violation of the building's sustainability practices or the requirements of the certification earned (or sought to be earned).

RIGHT TO RELOCATE

Many leases will include the right of the landlord to relocate tenants to a different space within the building or the center. The typical provision will require the landlord to relocate the tenants to a similar space of approximately the same size. A green lease should include a provision that the landlord's relocation of the tenants will be to a space that meets or exceeds the applicable certification that the tenants bargained for pursuant to their lease. If the new space is within the same building, it would have the same certification, but if it is a multibuilding site, another building might not meet the standard. The relocation provision in a green lease should also require the landlord to use commercially reasonable efforts to relocate tenants in a manner that will minimize the waste of resources that typically occurs in connection with moving tenants from one space to another. For example, relocation to a space with similar layout and dimensions will minimize the need to build out or reconfigure the new space, thus minimizing consumption of materials and energy.

DEFAULT

A typical commercial lease will treat the tenant's failure to comply with a lease obligation as a default and then allow the tenant a certain period in which to cure the default after receiving notice from the landlord. But building owners may want to treat certain environmental obligations differently from general defaults because the consequences of a tenant default that prevents the owner from obtaining recertification under LEED-EBOM (LEED for Existing Buildings: Operation and Maintenance) could be significant, even causing the owner to lose other tenants whose leases are contingent upon the building maintaining LEED certification. In such a situation, the building owner may want to expand its self-help remedies. Such remedies enable the landlord to perform the tenant's obligations to allow it to comply with the tenant's environmental obligations on the tenant's behalf, and then bill the tenant for the resulting costs.

Even with single-tenant buildings, a default by the tenant under certain green provisions could cause serious problems for the property owner. For example, if a lease requires the tenant to use certain green cleaning materials throughout the building and to train its personnel in the use of those materials, the building owner may be concerned about potential liability if those requirements are not met and any health problems occur as a result. In such a case, the building owner may want to be able to require the tenant to use a landlord-approved cleaning service in order to ensure that its environmental practices are complied with on an ongoing basis.

On the other hand, if continuation of the environmental practices are as important to the tenant as to the building owner, the parties may want to have a lease provision that simply requires them to work together in good faith to remedy any breach of the environmental provisions of the lease.

BUILDING RULES AND REGULATIONS

Most commercial leases include a list of Rules and Regulations for the applicable building or project, which typically are attached to the lease as an exhibit. Generally speaking, unusual rules or those especially important to the landlord are better placed in the body of the lease where they may not be so easily overlooked during the tenant's lease review. Whether in the body of the lease or in the Rules and Regulations exhibit, a green lease should include a provision requiring the tenant to comply with the building owner's sustainability practices, as they may be modified from time to time by the building owner.

TENANT IMPROVEMENTS AND ALTERATIONS

Most office and retail space will require substantial improvements or alterations prior to a new tenant taking occupancy. How extensive the tenant improvements are and whether those improvements will be constructed by the landlord or the tenant, and the allocation of costs for those improvements between the parties, is obviously subject to negotiation. The more extensive the tenant improvements and the higher the building's certification (or targeted certification) level, the more important it is that the lease clearly specifies the green design and construction standards and practices to be followed. These requirements are best set forth in detail in the construction work letter that should be attached to the lease as an exhibit. Some of the more important green provisions to include in the work letter are noted below.

WORK LETTER

If there are substantial tenant improvements to be constructed, the work letter exhibit will be one of the most important parts of the lease. The work letter, like the body of the lease itself, should include a statement that the building is (or may be in the future) certified under LEED, ENERGY STAR, Green Globes, CALGreen or other relevant program. It should also contain a clear statement that all purchases of construction materials and all disposals of waste must comply with the construction and maintenance methods required by the relevant green program rating or certification for the building.

Here are several examples of green provisions and requirements that landlords should consider adding to their form work letters for green buildings:

- **Green Design and Implementation.** The tenant should be required to work with a LEED-Accredited Professional, or a similarly qualified professional if the landlord is not seeking LEED certification. That professional will coordinate and integrate all design and construction plans, material procurements and construction waste management plans, and oversee the entire project from design through occupancy to confirm that the project meets the building owner's sustainability requirements and practices.
- **Tenant Reports.** In order to gauge building performance, the landlord should require the tenant to provide specific information about all materials purchased for tenant improvements and alterations. The information should include data on cost, recycled content, salvaged content, rapidly renewable materials and geographic origin of the materials.
- **Soil Erosion Control.** If any exterior ground work is required, the construction management plan should address the methods to be used to prevent the loss of topsoil through wind or storm water erosion, and to prevent dust and particulate matter from escaping into the surrounding air during the construction process.
- **Indoor Air Quality/Volatile Organic Compounds.** The construction management plan must also address indoor air quality by establishing procedures to reduce emissions from the materials used in the construction and furnishing processes. This would include requirements for the use of low- or no-VOC paints, solvents, adhesives, furniture, carpeting and fabrics. When construction is complete, the building should be flushed out using 100 percent outside air for at least two weeks or until indoor air testing indicates that the concentration levels for chemical air contaminants are below specified levels, and then the filtration media should be replaced.[31]
- **Water Efficiency.** To reduce the use of potable water and the burden on the building's wastewater system, low-flow faucets, toilets and shower heads (if appli-

cable) should be required. Fire systems, domestic water systems and landscape irrigation systems should be maintained and metered separately.[32]

- **ENERGY STAR Equipment.** Installation of ENERGY STAR-rated equipment and appliances should be required including, but not limited to, lighting, electrical ballasts and controls, and kitchen equipment, if applicable. Such equipment and appliances must conform to the building's standards for energy management and connect into the building controls and monitoring systems. Daylight-responsive controls should also be required in all occupied spaces within 15 feet of windows and under skylights.
- **Construction Waste.** The tenant should provide documentation certifying the amount and types of construction waste that was recycled, salvaged or otherwise diverted from landfills and/or incineration.
- **Landlord-Constructed Improvements.** If the landlord, rather than the tenant, is the party responsible for constructing the tenant improvements, the costs associated with the green design and sustainability practices, documentation, registration and certification should be included in the definition of tenant improvement work to be reimbursed by the tenant or to which any applicable tenant improvement allowance would apply.

CONCLUSION

A confluence of factors over the past decade is leading to the inevitable conclusion that green building is not a mere trend or an idealized pursuit, but rather the new reality of commercial development. The reasons for the growth of green building include the desire of individuals and local governments to reduce energy use and other environmental impacts associated with the construction and operation of commercial buildings, and the financial incentives inherent in reducing operating costs and in attracting high-quality, long-term tenants.

Savvy tenants are passing over traditionally constructed buildings, choosing instead to lease space in buildings that are designed, built and operated using environmentally sustainable practices that reduce energy use and create a more healthy environment for the building occupants. Building owners want to take advantage of the targeted tax deductions, lower operating costs and higher rents attributable to green buildings. Unfortunately, most commercial lease forms in use today do not adequately address these new standards of building construction and operation, or fairly allocate the costs and benefits associated with such standards.

As a result, landlords and tenants should revise their lease forms to address the sustainability practices applicable to the building. Due to the many motivating factors promoting green building, voluntary and mandatory, this is a good time for landlords and tenants to discuss their needs and expectations for any future development or remodeling of the property and to document their agreements in an amendment to their lease. Landlords and tenants negotiating for new space in a green building should be sure to address the building sustainability practices up front in their lease negotiations. This will pave the way for a mutually beneficial, long-term relationship, the standards for which will be memorialized in a comprehensive, equitable green lease. ■

ENDNOTES

1. See report entitled "Why do Companies Rent Green?" by Piet Eichholtz, Nils Kok, and John Quigley, published by RICS Research, November 2009, available at *www.rics.org/site/scripts/download_info.aspx?fileID=5071.* Last visited April 7, 2010.
2. For more information on LEED®, visit *www.usgbc.org/DisplayPage.aspx?CMSPageID=1988*. Last visited Feb. 12, 2010.
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4. For more information on Green Globes, visit *www.greenglobes.com/about.asp*. Last visited April 27, 2010.
5. For information on the Green Building Initiative, visit *www.thegbi.org/about-gbi/*. Last visited April 27, 2010.
6. LEED® project registration and certification fees can be found at *www.gbci.org/main-nav/building-certification/resources.aspx* and typical cost estimates for Green Globes certification can be found at *www.greenglobes.com/about-faq.asp#cost*. Last visited April 27, 2010.
7. See, for example, San Francisco Environment Code, Chapter 7, Section 707(e).
8. See "Green Building Initiative Certifies 100th Green Globes Building," Jan. 14, 2010, on *www.thegbi.org/news/news/2010/news_201001_100th-GG-Building.asp*. Last visited March 25, 2010.
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16. ENERGY STAR® Snapshot, Fall 2009, at *www.energystar.gov/ia/business/downloads/ENERGY_STAR_Snapshot_Fall_2009.pdf*. Last visited April 27, 2010.

17. U.S. Green Building Council Web site *www.usgbc.org/DisplayPage.aspx?CMSPageID=1718*. Last visited Feb. 9, 2010.

18. "Assessing Green Building Performance, a Post Occupancy Evaluation of 12 GSA Buildings," *GSA Public Building Service Office of Applied Science*, June 2008, p. 4.

19. Ibid.

20. 26 USC § 179D. Landlords and tenants should seek the advice of their tax consultant to determine whether this, or other tax incentives, might be available for their specific project. (For a summary of federal tax and other governmental incentives, visit the Interstate Renewable Energy Council's Web site at *www.dsireusa.org/.)* Last visited April 27, 2010.

21. California Revenue & Tax Code §73.

22. California Revenue & Tax Code §73(b).

23. "Assessing Green Building Performance, a Post Occupancy Evaluation of 12 GSA Buildings," op. cit.

24. "Why do Companies Rent Green?" op. cit.

25. Ibid., p. 6.

26. Visit Marin County's Web site at *www.co.marin.ca.us/depts/CD/main/comdev/advance/Sustainability/greenbuilding/incentives/incentives.cfm* (last visited Feb. 6, 2009) for more information. For information regarding other incentive programs for jurisdictions within California, see the Database of State Incentives for Renewables & Efficiency prepared by the Interstate Renewable Energy Council's Web site available at *www.dsireusa.org/incentives/index.cfm?re=1&ee=1&spv=0&st=0&srp=1&state=CA*. Last visited April 27, 2010.

27. San Francisco Environment Code, Chapter 7, Section 707(e).

28. California Code of Regulations Title 24, Part 11.

29. For a more detailed summary of the CALGreen requirements, see the Office of the Governor Press Release dated Jan. 12, 2010, at *http://gov.ca.gov/PRESS-RELEASE/14186*. Last visited Feb. 10, 2010.

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31. See Sections 4–7 of ASHRAE Standard 62.1–2007, Ventilation for Acceptable Indoor Air Quality.

32. Among the requirements for LEED® 2009 for Commercial Interiors certification is that all available actual whole-project energy and water usage data be shared with USGBC and/or GBCI for at least five years. See the LEED 2009 for Commercial Interiors requirements at *www.usgbc.org/ShowFile.aspx?DocumentID=5543*. Last visited Feb. 12, 2010.

FEATURE

Tax Credit for Principal Residence: Clearing the Housing Glut

BY MARK LEE LEVINE, J.D., PH.D., CRE; AND LIBBI LEVINE SEGEV, MSRECM, J.D., LL.M.

IT IS OLD NEWS, TODAY, TO TALK ABOUT A SLOW HOUSING market. The discussion centers on when the housing market will gain new life, leading, it is hoped, to a strong uptick in the overall United States economy. In an attempt to provide a boost to the housing market and all its related services and industries, and to slow the number of defaults on existing mortgages, Congress passed legislation offering a federal income tax credit as a stimulus to home purchase.

The First-Time Homebuyer Credit (now expanded beyond first-time buyers) expired on April 30, 2010. That's the final date for a binding contract; the closing must be prior to July 1. The debate over its effect on the housing market will continue long past its expiration. Was it just a short-term stimulus or did it set in motion a long-term revival of residential sales? To be determined. What also lingers past its expiration is the need for qualifying buyers to determine how to take the credit on their tax filings. Because of the credit's various time extensions, qualifier expansions, assorted requirements and computations, the details related to claiming the credit can be difficult to assemble. This article lays out the pieces in an attempt to create a basic summary of the details.

A brief review of the initial legislation is needed because those who purchased homes under the first set of rules are still guided by those. The Housing and Economic Recovery Act passed by Congress in 2008 allowed a tax credit of up to $7,500 for first-time homebuyers. The term "credit" was a mislabeling, as it was actually an interest-free loan. The taxpayer was required to pay the $7,500 back to the government, at the rate of $500 per year, for 15 years. (If the home was sold during the payback period, the un-repaid credit was due in full in the year of the sale.) In 2009 Congress passed legislation making various changes to the credit, including an expanded time frame for eligibility and an increase to $8,000. Buried rather far down in a related Internal Revenue Service press release was that taxpayers "do not have to repay the credit, provided the home remains their main home for 36 months after the purchase date."

About the Authors

Mark Lee Levine, J.D., Ph.D., CRE, *is a full professor, and has been at the University of Denver since 1975. He is currently director of the Burns School of Real Estate and Construction Management, Daniels College of Business, University of Denver. Levine holds certifications, designations and licenses with various organizations including, CCIM and CIPS. He is extensively published (300-plus articles) in numerous fields such as accounting, real estate appraisal, law and taxation. Levine has been an active real estate broker, investor, consultant and attorney for more than 40 years, and is a frequent and highly regarded speaker at academic and professional forums throughout the world.*

Libbi Levine Segev, MSRECM, J.D., LL.M., *is a licensed real estate broker with Levine, Ltd. Realtors and a practicing attorney with the law firm of Levine Segev LLC, Denver. Segev's legal practice focuses on real estate acquisitions and sales, leasing matters, development and finance transactions, evictions, foreclosures, property tax assessments and appeals, business planning and formation, and estate and charitable planning. Segev also is an adjunct professor at the University of Denver, and has co-authored numerous publications.*

One might observe that while the Feds could be faulted for downplaying the initial repayment factor, they were equally low-key about the switch to a "real" credit.

As stated above, the credit initially allowed first-time homebuyers an amount of $7,500. At the end of 2009, the credit became the lesser of: 1) $8,000, with $4,000 allowed to a married couple filing separately; or 2) ten percent of the purchase price of the principal residence, assuming that the taxpayer otherwise qualified for the credit. In all cases related to the credit, only a principal residence qualifies. A first-time homebuyer is defined as having no home ownership in general, or no home ownership as a principal residence in the U.S., within a three-year period prior to the purchase for which the credit would be claimed.

The credit was due to expire Nov. 30, 2009, and thus there was concern that the stimulus for the market would be lost. Congress chose to extend the credit along with making other changes under the 2009 Worker, Home Ownership and Business Assistance Act (WHOBA), signed into law on Nov. 6, 2009.

This Act was explained by the Joint Committee on Taxation in its release entitled "Technical Explanation of Certain Revenue Provisions of the Worker, Home Ownership and Business Assistance Act of 2009" (JCX-44-09) dated Nov. 3, 2009. That release provides additional explanation about the home ownership credit as well as other matters. (See *www.jct.gov*.)

Under the new law, Congress amended Section 36 of the Internal Revenue Code with changes relating to qualifying for the credit, extension of the time frame allowed for home purchase, and repayment of the credit. The credit was expanded to include "repeat buyers" who purchased a different principal residence. Qualifying taxpayers who bought a home before Dec. 1, 2009, can claim the credit on either their 2008 or 2009 tax returns and are not required to repay the credit if the home remains their principal residence for 36 months after the purchase date.

Under the provisions of WHOBA 2009 the credit continues to be applicable only to the principal residence. The credit applies to those purchases that are qualified if a binding contract is entered before May 1, 2010; closing must be before July 1 (except as noted below).

For repeat homebuyers, if a taxpayer was a long-time resident of the principal residence the following applies: if the taxpayer is married and has maintained the principal residence for any five-consecutive-year period during the eight-year period that ended on the date the new home is purchased and the settlement date was after Nov. 6, 2009, the credit is $6,500.

There are other limitations. For example, the taxpayer will be eliminated from qualifying for the credit if the taxpayer's modified adjusted gross income (AGI) exceeds ceilings set by Congress. In general, the credit cannot be taken by married couples filing jointly if they have a modified AGI exceeding $245,000 in the year they purchase the residence. If one is single, the maximum modified AGI allowed is $145,000.

There are additional requirements to earn the credit as well as some special definitions and interpretations. For example, one must be at least 18 years of age as of the date the property is acquired to qualify for the credit. Couples qualify if one spouse is at least 18.

Other qualifications:

- There is an $800,000 maximum purchase price;
- The taxpayer cannot be claimed as a dependent by another taxpayer;
- The property cannot be acquired from one who is a disqualified related party, such as a parent;
- Some of the rules are relaxed or limited for those in extended-duty positions in the Armed Services or are outside the U.S. on official military duty;
- A copy of the settlement statement for the purchase of the property must be attached to the income tax return.

The new law does not affect those who purchased a home after April 8, 2008, and on or before Dec. 31, 2008. For these taxpayers who are claiming the credit on their 2008 tax returns, the maximum credit remains 10 percent of the purchase price, up to $7,500, or $3,750 for married individuals filing separately. In addition, the credit for these 2008 purchases must be repaid in 15 equal installments over 15 years, beginning with the 2010 tax year.

These new rules give many taxpayers the opportunity to buy a house with financial assistance from the federal government. This incentive may have motivated those hesitating on the purchase of a home, given the weakness in the marketplace, concern with employment, other debt issues and so forth. However, taxpayers need to carefully consider all of the requirements to qualify for the credit.

In addition to helping homeowners, the credit helps move inventory off the market. This of course benefits many groups in the home building and furnishing industries. Thus, the credit was clearly designed to stimulate the economy at a time when the market has been very slow in many areas of the country. ■

REFERENCE

The Code Section is Internal Revenue Code of 1986, as amended; Code Section 121 to define the principal residence; Code Section 36 for credit.

RECOMMENDED READING

The Next Hundred Million: America in 2050

by Joel Kotkin (©2010, The Penguin Press, Inc., 308 pages)

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

Based on extensive research, *The Next Hundred Million* analyzes in poignant detail how an additional 100 million people will affect the U.S. social and urban landscape by 2050. I found the book highly informative and readable at the same time, which I expect is atypical for a book on demographics. I think Mr. Kotkin's journalistic style of writing, with its many examples and sprinklings of reportage, adds to the liveliness of the text. The book covers a lot of ground and is more of a fascinating survey rather than a detailed scientific analysis.

The first chapter talks about the remarkable growth expected to occur in the U.S. over the next 40 years. By 2050 the population will have increased to approximately four hundred million—roughly 100 million more than today. Along the way, the U.S. will become a much more crowded and complex place. The composition of the population will change as the vast majority of new population growth will occur in its racial minorities, particularly Asian and Hispanic. He points out that our country is unique in its robust rate of growth as compared to other mature industrialized economies in Europe and Asia. Interestingly, he sees this growth as a positive trend for the ongoing health and success of the country—essentially growing our way out of some of the doom and gloom forecasts. Moreover, he sees robust immigration as a validation of our system of values and institutions, perennially attracting new citizens from both developed and developing countries alike. Nevertheless (and I certainly could not agree more), he cites one of the biggest challenges of the population today, and especially in the future, will be access to an improving standard of living and higher income growth for a broader swath of the population—not just the top echelons.

Chapter Two discusses the ramifications of growth and population diversity on cities. Unlike many other writers on urban change, he does not forecast one predominant future. For example, there is much talk in recent years about 24-hour global cities such as New York, Los Angeles and San Francisco, which he calls "luxury" cities. While he predicts growth of these cities, he also anticipates the

About the Reviewer

David J. Lynn, Ph.D., CRE, CPIM, CMA, AICP, *is an economist, institutional real estate investor and strategist with extensive experience in national and international markets. Currently serving as managing director of research and investment strategy, ING Clarion Partners, New York City, Lynn develops investment strategies for the private equity, public debt and public equity (REITs) platforms, and leads the firm's fund and product development initiatives. He is also responsible for tactical and strategic asset allocation and portfolio construction for more than $23 billion in private equity real estate assets. Lynn is the author of two books, the most recent entitled* Active Private Equity Real Estate Strategy, *and is the founder of* Colloqui, *an academic journal at Cornell University. He is a noted speaker and commentator, and writes a regular column on real estate capital markets called "Capital Trends" for the* National Real Estate Investor. *Lynn earned his doctorate degree in Financial Economics at the London School of Economics; a master's degree in business administration as a Sloan Fellow from the Sloan School of Management at MIT, where he specialized in finance and real estate; and a master's degree in city and regional planning from Cornell University.*

growth of other, less snazzy urban forms such as the exurbs and the dreaded suburbs. He points out that the suburb has been the preferred form of urban setting for many people, particularly families for much of the recent past, and predicts it will remain that way for the future of 2050. Moreover, the luxury cities are very expensive, with housing unaffordabilty and the general cost of living pushing many people to secondary cities, the suburbs and the exurbs. These trends, he predicts, will only continue with additional population growth. He discusses the changes in suburbia, from being more or less bedroom communities, to becoming "villages" with developed social infrastructure and amenities. He looks at the "greening" of some suburbs, as more residents seek natural, more sustainable environments.

Chapter Four makes, I think, a rather bold prediction that the heartland will experience a resurgence due in part to these many new Americans looking for room, particularly less expensive room, in which to grow. This view of the future contradicts many who, witnessing a century of decline of the country's heartland, see only more of the same in the future. He maintains the rising value of commodities and energy will also play a role in the region's rising prominence. The increasing flexibility of businesses and people to locate just about anywhere they desire will also fuel this growth. With technology and a service economy, firms and people can do business anywhere there is basic telecommunications infrastructure and high amenity locations. He points out that certain Midwestern states in the 1990s such as Iowa, North and South Dakota, and Kentucky had among the highest rates of immigration in the country, particularly among Asians and Latinos.

Chapter Five explores the increasing diversity of the U.S. population, particularly as it grows toward 400 million. The fact that the U.S. accepts and successfully integrates diverse peoples and cultures is a key strength of the country (with which I agree) and one of the main drivers of growth. He contrasts this with the mostly dismal record of many countries in Europe and Asia where greater homogeneity and less cultural flexibility are the norms. Americans of European decent will no longer be the majority of the population in 2050; instead there will be a mixture of peoples and an increasing hybridization of cultures.

Chapter Six explores the changes to the American family. He predicts a new localism with people preferring to be more settled and tied into their local communities. He sees a family-friendly shift in the coming decades. The Echo Boomers (the offspring of the Baby Boomers) seem to value family and traditional values more than their parents. Rural villages and small towns will see increased popularity not only among Baby Boomer retirees but also among younger families seeking a sense of family and community traditions. As a part of this he sees a resurgence of religion in the "new ecumenicalism" where faith is used as a means to create and extend local community and cultural bonds.

The last chapter reiterates the major points of the book. The U.S. stands in stark contrast to its peer countries in terms of its growth and increasing diversity. He believes the country will continue to promote growth, as it has been an intrinsic part of our culture and value system and a component of upward social mobility. In terms of urban form, the country will further decentralize as suburbs, small towns and exurbs continue to accommodate population growth. While luxury cities grow and attract population, they will be only one part of the new landscape. He advocates investments in infrastructure, technology, clean energy, and reviving manufacturing as ways to foster long-term economic growth.

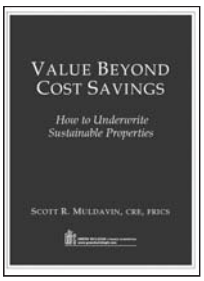
Overall the book was an informative, thought-provoking discussion of the anticipated growth and compositional change of the population. However, the great strength of the book—its journalistic and wide-ranging approach, is also its key weakness. The book is based not on rigorous analysis, but more on the collected reports, research and opinions from many different sources, some of which cannot be regarded as scientific. Therefore much of the forecasts and predictions come across as opinions and inadequately substantiated conjecture rather than convincing analysis. The book would have benefitted more from original and primary research. For example, there was no detailed or credible explanation as to methodology of how the population forecast was developed. This was a central concept of the book. Knowing just a little bit about population forecasting, I have learned that there can be huge inaccuracies in such predictions, particularly the farther out one goes. This left me feeling skeptical, when I generally believed in the author's thesis and major points. This is true with other key topics in the book. Greater attention to methodology, as well as more rigorous development of his many hypotheses, would have made for a more credible and cogent exposition. That said, I still believed in most of his rationale and predications and enjoyed the discussion. All in all, a great book and well worth the time to read it cover to cover. ■

RECOMMENDED READING

Value Beyond Cost Savings: How to Underwrite Sustainable Properties

by Scott R. Muldavin, CRE, FRICS (©March 2010, Green Building Finance Consortium, 306 pages)

REVIEWED BY MAURA M. COCHRAN, CRE



"The final key conclusion is that the biggest challenge to sustainable financial analysis is not the modeling, but the integration of sustainability considerations into the determination of the input assumptions." —SCOTT R. MULDAVIN

WHEN IS UNDERWRITING real estate different from underwriting sustainable real estate? Why is it different? What makes a building sustainable? What are the issues? In the new text, *Value Beyond Cost Savings: How to Underwrite Sustainable Properties*, Scott Muldavin, CRE, FRICS, leads readers through the quagmire of underwriting commercial and multifamily residential properties, and provides the logic to understand how to correctly modify old tools for "green" underwriting.

First, some background. Muldavin is a recognized expert in underwriting. In the early 1980s he developed the first commercial mortgage risk-rating system for Standard & Poor's. At Deloitte & Touche, and subsequently in his own practice, he worked with financial institutions and Fortune 500 companies to improve their underwriting and risk assessment. He has written more than 250 articles on financial topics and is in demand on the lecture circuit for his insights and commentary. Muldavin became intrigued with "going green" in its earliest years. Based on work with clients, he was increasingly hearing about concerns pertaining to investing in these new buildings or the retrofit of existing properties. He was fascinated with how to quantify the impact of these initiatives in a pro forma. This led to his creation in 2006 of the Green Building Finance Consortium (GBFC). GBFC's work is funded by the real estate industry, select government and non-governmental organizations, The Muldavin Company, and by the efforts of unpaid contributors. The Consortium's mission is "to enable private investors to underwrite sustainable property investment from a financial perspective."

To accomplish this mission, GBFC has developed the underwriting methods and practices required to independently assess sustainable property investment. This book is the result of the GBFC's efforts including CREs Theddi Wright Chappell, Tim Lowe and Andy Fusscas, who are on the Implementation Team; CREs Brent Palmer and Peter Korpacz, who are members of the Board of Advisors; and CREs Roy Schneiderman, Steve Grant, Steve Navarro, and Rick Tannenbaum, who have offered advice and assistance.

About the Reviewer

Maura M. Cochran, CRE, SIOR, *joined Bartram & Cochran in 1987 and has worked in the commercial real estate industry for more than thirty years. She practices both national and local consulting and project implementation, including due diligence analysis, adaptive reuse studies, marketing plans and corporate relocation assignments. Her active involvement with The Counselors of Real Estate (CRE) and the Society of Industrial and Office Realtors (SIOR) gives her excellent access to market information nationwide.*

In writing the review, I communicated with Muldavin to get more background on the creation of the book. He said: "The most interesting story about the book is its title. For nearly two years since I decided to write a book in 2008, it was called *Underwriting Sustainable Property Investment*. While completing a series of presentations in late 2009 about the findings of my book, just prior to its release, it became clear to me that besides being boring, the title failed to convey the key purpose and contribution of the book—to enable investors to calculate and consider the value of sustainable property investment beyond savings from energy costs. Despite a growing recognition of the health, productivity, recruiting, and related benefits of sustainable property investment, there was little guidance on how to assess these potential benefits and incorporate them into decision-making. Accordingly, the industry has been stuck, with most investment limited to that which can be justified by immediate cost savings over a short-payback period. With significant increases in the demand for sustainable properties by regulators, space users and investors, incorporating *Value Beyond Cost Savings* will not only enable substantially larger investments in energy efficiency and sustainability, but investors to maximize profitability from their investments."

I found myself fascinated with the Consortium's work. This book reviews the basics of underwriting: strategic decisions lead to tactical decisions, which lead to being property-specific, regardless of whether the property is "green." Once the basics are dealt with, the text provides data on the rent and sales premiums that tenants/investors will pay (or not pay) for a sustainable building. It notes that sales price premiums ranged from 5.8–31 percent for ENERGY STAR® properties and 9.9–35 percent for LEED®-certified properties. That is exciting, until clarified that "due to severe statistical, methodological and data problems in the sales price analysis, the Consortium places little confidence in these specific numerical results." What does a reader do with that information? We now know that there is a premium that purchasers will pay, but there is no absolute number. There is a range, and a sensitivity analysis is required. It also demonstrates that these buildings are viewed favorably, which is not an insignificant matter.

What is the demand for "green?" From March 2006–2008, 14 percent of law firms surveyed by CoStar Group® reported signing leases in sustainable buildings. At the low end of the spectrum, manufacturing and retailers/wholesales report one percent of leases being "green;" transportation came in at zero percent. How has that changed in the last three years? Lack of current data is part of the rub. With the financial world "on hold" for the past two years, there have been few building sales and a reduced volume in leasing transactions. Getting current data for underwriting is difficult in 2010, and "green" data is even more limited. The basics of underwriting come back to the forefront: understanding the tenants and the market in the context of the property.

The book cuts to the chase: discounted cash-flow analysis is well suited to address the financial implications of sustainability. The key to successful underwriting is in the logic and understanding of this new product or it will be easy to overshoot or undershoot the mark. This is where the book really hits its stride. The cost-benefit checklists are very helpful. But even more useful are some of the war stories and examples of what works and what doesn't. A bike rack helps get LEED points, but does it really add to the bottom line? Do waterless plumbing fixtures add or detract from the value because of maintenance issues? Understanding these issues provides confidence in knowing what to ask for in the due diligence process.

The book follows the axiom "Tell them what you are going to tell them. Tell them. Tell them what you told them." The topical index at the beginning of the text leads you through the 13 chapters. Each chapter outlines in more detail what is going to be covered, and the end of each chapter summarizes key points (a Cliff's Notes version for those in a hurry).

Muldavin related the following story in Chapter Four, which is interesting. "I began the research for Chapter Four because of my belief that real estate capital providers care less about the five cherry-picked "case studies" that describe successful outcomes, and are more interested in understanding investments that failed or underperformed. I initiated the "Failure and Underperformance in Sustainable Property Investment" study with high hopes, but quickly found that few of the people with substantial experience in the industry were interested in being associated with such a study. Accordingly, I renamed the study "Sustainable Property Performance" and got great response from the industry and a chapter that provides critical insights in translating performance information into financial analysis and valuation."

The entire book is really the tip of the iceberg, with more detail on each topic available online at *www.greenbuildingfc.com* which will be a great way of enabling the text to be continuously updated. The eight appendices are 130 pages long, with useful bibliographies, cost-benefit checklists and sample discounted cash-flow analyses.

The text concludes: "Underwriting properties with sustainable features does not involve a fundamental change in existing methods and practices. However, underwriters need to enhance their education of sustainability and learn some new techniques, and dust off some old ones, to effectively identify, price and mitigate sustainable property risks." Amen.

Muldavin's book deserves a place on your bookshelf; the electronic version should be bookmarked on your computer. The book, as well as complementary resources of the Consortium, can be downloaded from its Web site at *www.greenbuildingfc.com*; hardbound books are available for $35 from that same source. The author also has granted authority to include direct links to the book and other resources on your own Web site, and/or you can make the book's PDF directly available. ■

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

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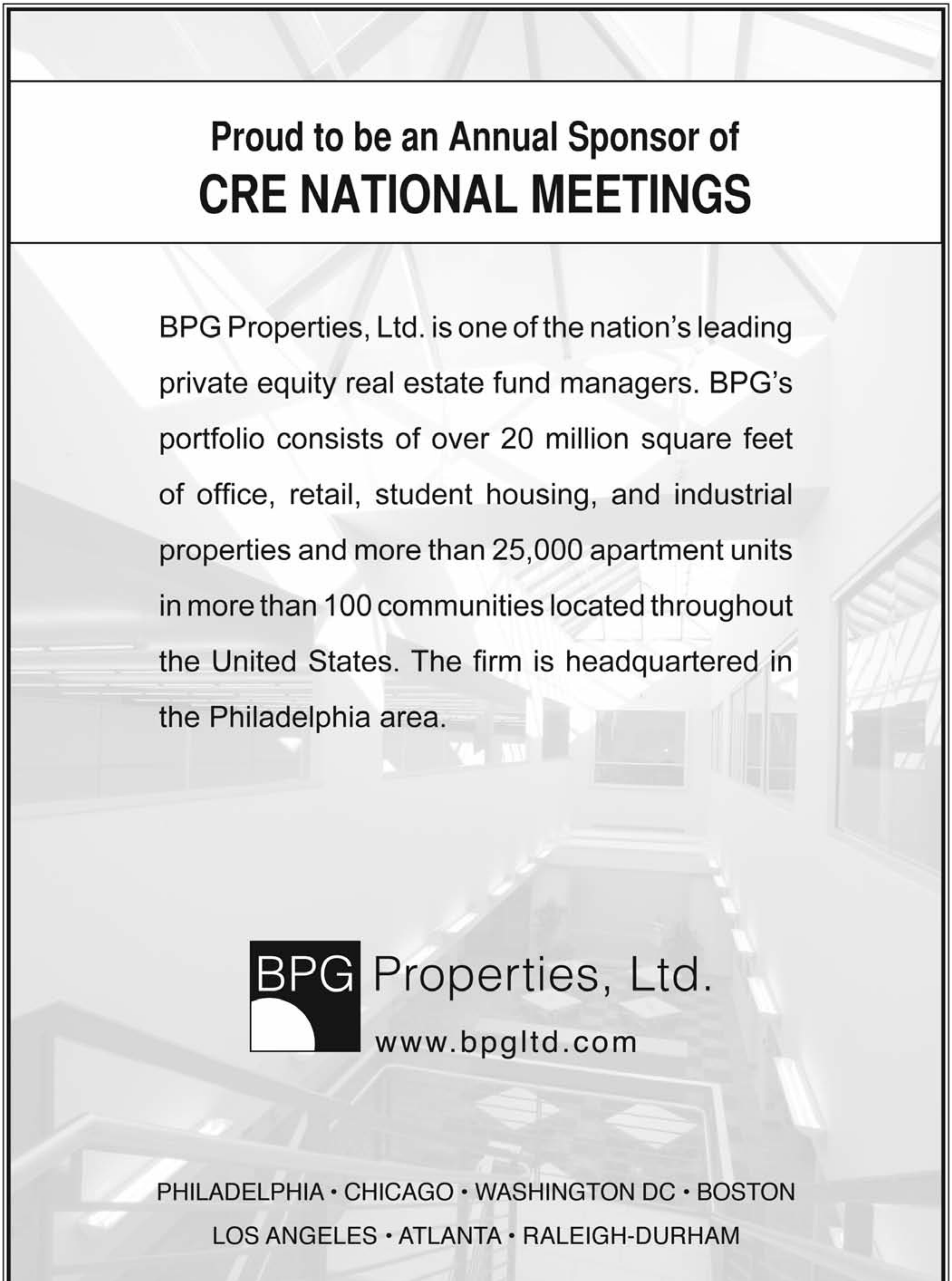
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