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# Editor's Note

**BY PETER C. BURLEY, CRE**

*"To build may have to be the slow and laborious task of years. To destroy can be the … act of a single day."*
—Sir Winston Churchill

People build things. It's what we do. Skyscrapers, supermarkets, strip malls, movie theaters, stadiums, highways, bridges. Homes, streets, neighborhoods. Fences, gardens, barns, and sheds. We build to serve a purpose—or multiple purposes. We build to improve our lives and our society. We build things to last beyond our own short existence. We build to leave a legacy.

I have been thinking a lot about how we build things, how long it takes to build them, and how long things last. In particular, as I prepare to move this household and this office to Washington, I have been thinking about what was left by those who lived here before me and about what I will leave to those who come after.

My house was built in 1910. It is a solid structure, set on a foundation of hand-formed concrete that was mixed on-site with water and sand from the creek nearby. It was built for family life, with four bedrooms upstairs, and a parlor, kitchen, and pantry downstairs. Originally, it had no indoor plumbing or electrical wiring or heat (other than a large fireplace and a wood-burning stove in the kitchen). Years later, bathrooms were added, as were electrical wires and light fixtures. Many years after that, a garage was added to house several cars. The driveway was paved in the 1980s.

Residents here have added and subtracted to accommodate various changes in situation and lifestyle. Some of the remodeling that has taken place here still leaves us wondering: "what on earth were they thinking?" For the most part, though, the changes over the years have been for the better. I am not sure if I would have bought the place if the kitchen, for instance, had not been updated to include a gas range or dishwasher. And, I certainly don't think we would have moved out here if our bath time had required a walk down to Cook Creek once every other week.

*The Legacy of a Solid Structure* *Photo courtesy of Tallant Burley*

A hundred years ago, when the house was first built, the original residents here also constructed a small stable where the horses likely spent the night and where various equine supplies were kept. It was well built, like the house, with hand-crafted concrete and heavy timber studs and rafters. But, over the years, particularly after the new garage was built, it fell into neglect, slowly falling into disrepair. In the fall of 2008, a fierce canyon wind pushed a very large willow tree onto the structure, bringing whatever remained of its useful life to an end. The tree and the outbuilding lie, just as they fell, at this very moment. We have not addressed the situation (for which I feel some personal guilt) as neither the old shed nor the the tree have been priorities in our life in the country—we keep no horses, we require no tack, and eventually the tree will provide a cord or two of firewood.

Back behind the house is another old outbuilding that was originally built, we believe, as a chicken coop. The family that built the chicken coop likely shuffled "out back" every day to gather eggs for breakfast or a hen for dinner. Later, there is evidence that the chicken coop was converted into a smokehouse, where a steer or hog was prepared as winter meat. The building is also in a state of slow decline, having fallen into disuse over these past many decades. We don't keep chickens (few people do these days), and we don't smoke our own livestock.

The things we build—and the things we change in the things we build—reflect purpose, our sense of what is important in our lives.

Stuff happens. Sometimes that stuff changes our lives or, at least, changes our perceptions of what is important. Sometimes, structures are threatened. Sometimes, structures collapse or are crushed by very big events, or trees, and circumstance. That the tree fell on an old stable that we don't use enabled me to build and to improve other, more important structures on this property. If the tree had fallen on the house, I would have hurriedly repaired the damage in order to keep the house—and our lifestyle—intact.

That ill wind, the one that brought down the old willow and flattened the stable, blew in about the same time that the financial markets and our economy were nearly brought down by a devastating windstorm of their own. A number of the financial and economic structures that we, as a society, had built over the years (some more sturdy than others) were heavily damaged. This time, the storm damaged the very house in which we live and do business, and it became imperative that we repair the damage, and shore up the foundation and the structural supports, in order to keep the house intact. Other structures were severely threatened. And, the questions we have asked ourselves since the storm have rightly focused on what we should rebuild, where we might remodel, what we should simply let lie as perhaps no longer useful.

This edition of *Real Estate Issues* focuses on where some of the damage was done and what is being done—as well as what yet needs to be done—to restore our financial and economic house and to keep it intact.

Historically, real estate has been one of the stronger and more reliable components in restoring and rebuilding after damaging economic storms. This time around, that has not been the case, as **Tony Downs, CRE**, suggests in his Insider's Perspective, **"The Outlook for Recovery in U.S. Real Estate Markets."** In fact, Downs points out that real estate has been largely responsible for most of the damage we have experienced in the recent downturn. We set our expectations too high, in believing that real estate values would simply continue to rise, leading us to forget that "what goes up, must come down." In fact, the damage that was done was done largely as a result of a poorly constructed foundation, as it were—we crafted much of our financial and economic structure on those expectations, weakening the structure itself.

But, what kind of damage has been suffered, and what kind of structural repair might be undertaken to gird against subsequent economic windstorms? In a special *Real Estate Issues* **Leadership Roundtable**, Downs engages three experts, **CREs Marc Thompson** and **K.C. Conway**, and CNLBank President **Sandy Hostetter**, in a conversation that runs through some of the issues that have emerged in the financial sector during and after the recent crisis. They offer a look at the structures and regulations that have been put in place as well as a glance at some of the implications for the banking industry and for real estate going forward. We may need some new approaches this time around. As Conway suggests, "…we need to begin to think about how different this situation is and what kind of policies need to be different rather than finding the same old tools of the old recession."

New tools. **William "Bill" Pittenger** points out in **"A Brief Look at the Dodd-Frank Act"** that: "The financial crisis that began in 2008 was largely a product of outdated regulation and supervision" along with innovations in technology and credit markets that were "advancing faster than regulatory and risk management controls." Pittenger reviews the Dodd-Frank Act, which creates new agencies and oversight for various financial institutions, with an eye on the Act's possible unintended consequences and some of the difficulties in implementing many of its provisions. Not addressing the future of the GSEs in the Act, he points out, leaves a very big hole. Additionally, Pittenger says, "… the Act's many provisions and those that will follow with creation of numerous regulations will increase regulatory and legal risk and the cost of doing business for virtually all financial service institutions."

Dodd-Frank may be, as Pittenger says, "the most sweeping piece of financial legislation enacted in the U.S. since The Great Depression." In addition to the new structures and regulations put in place by that legislation, Congress has also passed, and the President has signed into law, the Patient Protection and Affordable Care Act, followed closely (March 30, 2010) by the Health Care and Education Reconciliation Act. A look at the tax implications of health care reforms for small businesses and real estate investors is provided in **"The Income Tax Effects of Health Care Reform on Small Businesses and Real Estate Investors,"** by **J. Russell Hardin, Ph.D**. Hardin offers tips and advice for businesses trying to navigate their way through the new law. He concludes that "…a law as complicated as this Act commands a great deal of study by investors and small business owners who desire to maximize returns and minimize the tax burden."

Government assets, including real estate, are the subject of an article, **"Government Property Assets in the Wake of the Dual Crisis in Public Finance and Real Estate: An Opportunity to Do Better Going Forward?"** by **Olga Kaganova, CRE**, of the Urban Institute. Kaganova reminds us that "… government property assets constitute a very substantial share of public wealth in most countries… these assets often make up the lion's share of public wealth." Good data on "on the size and composition of government property and business holdings is still lacking," however. In fact, even in the United States, she points out that nearly half of the states do not have even basic property or asset data. This can have important financial implications, she tells us, since creditworthiness ratings of governments issued by credit agencies usually do not depend on assets owned by the government." That can "prevent implementation of rational financial solutions." And, government assets can be part of the solution to current fiscal crises at many levels. Given how large and complex property portfolios can be, Kaganova suggests that governments enlist the expertise available through such organizations as The Counselors and RICS to make the best use of those assets in the future.

In their article, **"Timing the Market: You Don't Have to be Perfect," Randy Anderson**, **CRE**, and **Joshua Harris** ask the question: "Is there an optimal strategy to time purchases and dispositions based on changes in the real estate or macroeconomic cycle?" Through a simulation of macroeconomic cycles and real estate cycles, as represented in the NCREIF Index, Anderson and Harris develop a perspective of real estate asset performance during and after recessions and a view of active market timing. Buying at or near a market low, for instance, clearly benefits an investor by producing returns higher than a simple buy-hold strategy. There is also benefit in exiting an investment before a downturn hits. They conclude: "…do not fear recessions and downturns, but do plan on worst-case scenarios and be prepared."

In addition to the recent changes brought by the Dodd-Frank bill and Healthcare Reform, the Small Business Jobs Act of 2010, which was signed by President Obama in September 2010, provides additional tax relief for small businesses and promises additional support in the economic recovery. **Mark L. Levine**, **CRE**, and **Libbi Levine Segev** outline some of the provisions and discuss some of the legal ramifications of the Act in **"Small Business Jobs Act of 2010: Impact on the Real Estate Market."**

Finally, *Real Estate Issues*' Associate Editor **Mary Bujold**, **CRE**, reviews *Emerging Market Real Estate Investment: Investing in China, Brazil and India*, by **David Lynn**, **CRE,** and **Tim Wang, Ph.D**. With China, Brazil and India comprising a combined GDP of roughly $12.4 trillion, and with each country moving rapidly up the economic scale, these countries represent significant opportunity for real estate investment. But, investment in these, or any emerging market, can prove a daunting task. The book's authors outline a systematic framework for evaluating emerging markets and measure the desirability of investing in those markets based on locational factors, the competitive environment and growth factors.

There has been a lot of repair and rebuilding in our financial and economic house since the last violent storm. Hopefully, the work that has been done will prove sturdy enough to withstand the next storm. Just like my old house, of course, as the times and challenges change, we may be required to rebuild yet again, or to remodel or, in some cases, to simply let lie. But, with the experience and insights we have gained, particularly with the expertise represented in this edition of *Real Estate Issues*, we will be better prepared to do so.

I would like to extend my heartfelt thanks to all of our contributors, especially to Tony Downs for assembling the Roundtable discussion and to K.C. Conway, Marc Thompson and Sandy Hostetter for agreeing to take time out to participate. Also, a special thanks to Carol Scherf, our managing editor, for her continued efforts in producing, once again, another fine edition of *Real Estate Issues*.

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EDITOR IN CHIEF

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# The Outlook for Recovery in U.S. Real Estate Markets

**BY ANTHONY DOWNS, CRE**

***Editor's note:*** *The views in this article are solely those of the author, and not necessarily the view of the Brookings Institution, its trustees, or its other staff members.*

IN THE PAST, REAL ESTATE MARKETS HAVE NEARLY ALWAYS been a positive force, helping the U.S. economy recover from a recession, especially through rising activity in housing markets. But in this economy, real estate of all types has instead become a drag on our recovery. In fact, current housing market conditions in particular are notably slowing our progress in getting out of trouble.

Real estate was the major force that threw us into this rather deep recession—as compared with most others since World War II. Hence it should not be so surprising that it is not now leading us out. The upshot is that our recovery is proceeding only very slowly, and is likely to remain moving at a snail's pace for several more years to come.

### HOW IT ALL STARTED

In reality, Americans are now being forced to adjust their standard of living downward—I believe for a long time—because they had been living far beyond their true ability to sustain their high levels of consumption. From about the mid-1990s through 2007, Americans were consuming far more than they were able to pay for through either savings or investment in productive capacity. Instead, we borrowed tons of money from other nations who were more than eager to support our irrational behavior by exporting to us without getting comparable imports from us in return—only I.O.U.s in the form of U.S. Treasury securities.

So, in this economic boom and bust period, real estate has been the villain both coming and going. It is still


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*Downs has served as a consultant to many of the nation's largest corporations, major developers, government agencies at local, state, and national levels, and to many private foundations. President Johnson appointed him to the National Commission on Urban Problems in 1967, and HUD Secretary Jack Kemp appointed him to the Advisory Commission on Regulatory Barriers to Affordable Housing in 1989. He has been a director or trustee of General Growth Properties and the NAACP Legal and Educational Defense Fund. He also has served as a past director of the MassMutual Life Insurance Company, Bedford Property Investors, the Urban Land Institute, Essex Property Trust, the National Housing Partnership Foundation, Penton Media, and The Counselors of Real Estate.*

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behaving villainously by impeding our progress back to prosperity. The whole adventure started after housing prices, as a national average, kept rising continuously for 32 years from 1968–2006, though they occasionally declined for awhile in specific areas. That generated a widespread American belief that housing prices would always keep rising, no matter what else was happening in the economy.

The second stimulator of over-emphasis on real estate was the collapse in the U.S. stock market in 2000, when the "Internet bubble" suddenly burst and stock prices plunged. That drove investors the world over away from stocks and toward better investments. For most cash-laden investors, the best alternative in sight was real estate, even though it too had crashed in 1990, at least as far as commercial properties were concerned.

So, capital flooded into real estate markets both in the U.S. and worldwide. It came from inside the nation and from investors the world over. That massive excess of capital created such intense competition among investors looking for "good deals" that their bidding against each other drove property prices up—thus, cap rates down. Such bidding also motivated eager investors to gradually weaken, and eventually, abandon altogether carrying out proper due diligence before committing their funds to specific deals. The old rule that "everything that goes up must come down" was abandoned. But it was still true, as most clearly evident in the behavior of homebuilders. As usual, they kept building as many homes as they could, as fast as they could. They completely ignored the fact that such behavior since World War II had always led to eventual overbuilding and a subsequent fall-off in housing starts and markets. When new housing starts (including manufactured homes) exceeded two million units in both 2004 and 2005, there were not enough buyers to keep the market going, and home prices began to fall. That fall was accelerated by the greedy behavior of the mortgage loan industry. Many of its members, including many banks, had urged and enabled millions of low-income households to buy new homes, by breaking all the normal rules of prudence and legality. They designed, sold and then securitized mortgages for millions of households that would never be able to repay. So, when home prices started to fall in 2006, the entire structure of home lending fell apart. This spread panic among real estate investors around the world, many of whom had bought securitized bonds because they had triple-A ratings from American rating agencies that had also abandoned careful due diligence. The resulting fear of the quality of American real estate securities led to a lending freeze on all types of properties that caused the major crash in 2008 and 2009.

That crash was the worst in the U.S. economy since before World War II—especially in housing markets. New housing starts plunged from a peak of just over two million in 2005 to a low of about 554,000 in 2009—a drop of 73 percent in just four years. That was by far the biggest fall-off in home building since records on starts began to be collected. Moreover, that collapse threw millions of construction workers, mortgage brokers, bank tellers, furniture makers, and other people out of work, leading the way to the largest increase in unemployment in the post-World War II period. Of course, that fall in employed workers spread to other industries as consumer spending took a nosedive, further weakening the possible forces of recovery. Now, with unemployment over nine percent, where are the engines of recovery?

### WHY COMMERCIAL REAL ESTATE WILL NOT BE AN ENGINE OF RECOVERY VERY SOON

Commercial real estate is not likely to become one of those engines. More than one trillion dollars in loans on commercial properties will become due in the next few years, but many of the borrowers concerned will be unable to repay them or even just roll them over. Commercial property values have fallen from 25–40 percent since the crash of 2008. Many loans made from 2000–2007 at high loan-to-value ratios of 70–90 percent are now tied to properties worth much less than the mortgage amounts on them alone. In the eight years from 2000–2007, 5.8 times as much commercial property lending was done, as measured in dollars, as in the preceding eight years, mainly because borrowing money was so cheap from 2000–2006. Reckless lenders used securitization to leverage their loans vastly beyond prudent ratios to their reserves. When such loans come due in the next few years, borrowers will discover that their lenders now value the properties concerned at 25–40 percent less than they did when those loans were made. Moreover, lenders no longer accept loan-to-value ratios of much more than 60 percent. Assume you bought a property worth $100 million in 2002 and you borrowed $75 million on a mortgage to get it. When it comes due, the lender will say it is now worth only, say, $70 million, but they will not lend you more than 60 percent of that, or $42 million. So you have to come up with the difference between $70 million and $42 million, or another $28 million, to roll over the loan. Where will you get that amount? What lenders will make such a deal on such a devalued property? Are you willing to add $28 million to the $25 million in presumed equity you already had, for a total of $53 million in equity on a property worth $70 million, at best? In more and more cases, commercial borrowers and owners are choosing to hand the keys back to the lender, if it is a non-recourse loan, and just walk away.

Even considered from the lender's side, the deal is not very attractive. If the borrower cannot come up with the necessary capital, do most lenders want to foreclose and then have to operate such properties? Many lenders today prefer to extend the loan into the future at the same interest rate and monthly payments in hopes that property prices will rise between now and when the loan comes due again. Moreover, until very recently, rent levels and vacancy rates were deteriorating in most commercial property markets. So, foreclosing would stick the lender with a weakening property in a tough market. Conditions have been getting better in some office markets, but there is still not a lot of dynamism anywhere. The upshot is that commercial property markets are not likely to lead to a surging recovery in real estate in the near future.

### WHY THE OUTLOOK IN HOUSING MARKETS IS EVEN WORSE

Because of high unemployment, many homeowners who thought they had incomes adequate for carrying their mortgages now find those mortgages under water—that is, with a greater face value than the current market values of their homes—and their incomes falling towards zero. Some mortgage experts estimate that one out of every four homeowners with a mortgage now has a mortgage that is under water. Since about 32.8 percent of homeowners do not have mortgages, the implication is that 16.8 percent of all homeowners—or 12.8 million households—have mortgages under water. Millions have become delinquent in making payments or have simply stopped paying. As a result, foreclosure filings have soared to record levels. RealtyTrac®, a firm that tracks foreclosures, states that the number of foreclosure filings has risen from about 1.0 million in 2006 to 3.9 million in 2009, and will reach about 3.9 million again in 2010. Only about 20–30 percent of filings in any given year result in takeovers or sales by lenders in the same year. But that means approximately 975,000 takeovers or sales will occur in both 2009, 2010 and well into 2011. The present owners of the homes concerned will not soon be in the market to buy other homes, so many will rent.

Overall, sales of existing homes peaked at just over seven million per year in 2005, and have fallen to about five million in 2010, a drop of 29 percent. As of 2008, more than 4.2 million homes were for sale in all of the U.S., according to the National Association of REALTORS® (NAR).

However, the already bad situation in housing markets actually worsened in October 2010. Several major lending banks discovered that many of their mortgages in foreclosure had not been carefully read by their own personnel or by the originators, and could be marred by fraudulent aspects not yet uncovered. Hence those banks have frozen their own foreclosures nationwide while they review millions of documents in those cases. This has caused a semi-paralysis in many housing markets, since many buyers do not know whether the deals they are engaged in will proceed to closure soon.

Another negative factor is the continued declines in home prices in some markets. The Federal Housing Finance Agency (FHFA) seasonally adjusted price index (1991 Q1 = 100) was 136.87 in Q1 2000, and peaked at 220.04 in Q2 2007. That indicates a rise of 60.7 percent in seven years. Since then, it fell to 194.28 in Q2 2010, a decline of 11.8 percent in three years; it was then still 41.9 percent above the 2000 level. The Case-Shiller Home Price Index for 20 metropolitan areas rose from 100 in 2000 to 206.43 in May 2006, a gain of 106.43 percent. It then declined to 147.55 in July 2010, a drop of 28.6 percent in four years. It was still 47.6 percent above its 2000 level. NAR median home price peaked at $221,900 in 2006 and then declined to $178,600 in August 2010, a fall of 19.6 percent in four years. If we average the declines from the peak of the three indices, the result is almost exactly 20 percent. However, home prices are still falling in many regions, though at slower rates than in the last few years. But these data are somewhat distorted because they are based on sales of both foreclosed homes and "normal" homes, and the share of foreclosed homes—which have lower prices than "normal" ones of similar character—has been higher recently than in the past. That has pushed the overall average prices downward significantly.

Another factor of importance is that population growth rates have slowed over the past two years, according to preliminary data developed by William Frey from the 2010 Census. In the period from 2000–2007, population grew by two percent or slightly more per year in the exurban portions of metropolitan areas; by approximately 1.8–1.96 percent per year in the suburban portions; and by approximately 0.8 percent in urban areas (central cities). But in 2009, growth rates fell to 0.45 percent in urban areas, 1.4 percent in suburbs, and only 1.15 percent in exurbs. It appears that we cannot count on a backlog of unsatisfied home seekers to expand the demand for new housing—at least not in the immediate future.

### WHAT DOES IT ALL MEAN?

Looking at all of these characteristics of the home market together, we are forced to conclude that a return to "normal" housing markets not dominated by foreclosures is still several years away. The key factor is the speed at which unemployment is replaced by jobs that will enable more households to afford to buy homes. In the meantime, rental housing seems to be more favored than ownership housing because of the limited ability of households to amass enough money to buy a home. That is undoubtedly why apartments are doing better than single-family homes in today's markets.

True, some other parts of the U.S. economy are doing much better than real estate. Farming is booming because of a sharp rise around the world in food prices. The high-tech world is showing some signs of recovery. And ironically, banks—especially big ones—are making enough money these days to return to paying high salaries and bonuses, though smaller payoffs than earlier in this decade. So the failure of real estate to carry much of the load of a strong recovery does not mean the economy is doomed.

But it does mean that people in the real estate business had better prepare for at least a few more years of sub-optimal prosperity. And perhaps conditions in real estate will never return to "normal"—if that word means "conditions that prevailed in 2007." The nation was living beyond its means then, especially in real estate. We need to become reconciled to achieving a more sustainable balance between what we consume and what we produce. This is most obvious in our federal and state budgets, but applies to our own production and consumption in the private sector as well. ■

# Different Perspectives: Banking and the Outlook for Recovery in U.S. Real Estate Markets

Panelists:
**K.C. Conway, CRE**
*Executive Managing Director, Market Analytics*
*Colliers International Valuation and Advisory Services*
*Lilburn, Georgia*

**Sandy G. Hostetter**
*President, CNLBank, Central Florida*
*Orlando, Florida*

**Marc R. Thompson, CRE, FRICS**
*Senior Vice President*
*Healthcare Unit Manager, Bank of the West*
*San Ramon, California*

Moderator:
**Anthony Downs, CRE**
*Senior Fellow, Brookings Institution*
*Washington, D.C.*

**DOWNS:** IT'S A PLEASURE TO GET THE VIEWPOINTS of our three panelists: **CRE K.C. Conway**, executive managing director, Market Analytics, Colliers International Valuation and Advisory Services, and formerly an officer of the Federal Reserve banks in Atlanta and New York; **Marc Thompson** of the Bank of the West in San Ramon, Calif., also a CRE; and **Sandy Hostetter**, president of CNLBank in Orlando, Florida. Our general topic is: what important issues do you think are facing the nation's banks as we try to move ahead in this weak recovery? Go ahead and give us your thoughts to start, K.C.

**CONWAY:** Thank you Tony. Let me say first that the views I express in this discussion are my personal views and not necessarily the views of the Federal Reserve.

The three issues that I believe we have been trying to come to grips with in the bank regulatory world are: first, the size of the real estate problem; second, the concentra-

## About the Moderator

**Anthony Downs** *is a Senior Fellow at the Brookings Institution in Washington D.C. He also was a Visiting Fellow at the Public Policy Institute of California in San Francisco from July 2004 until February 2005. Downs served for 18 years as a member and then chairman of Real Estate Research Corporation, a nationwide consulting firm advising private and public decision-makers on real estate investment, housing policies, and urban affairs.*

*Downs has served as a consultant to many of the nation's largest corporations, major developers, government agencies at local, state, and national levels, and to many private foundations. President Johnson appointed him to the National Commission on Urban Problems in 1967, and HUD Secretary Jack Kemp appointed him to the Advisory Commission on Regulatory Barriers to Affordable Housing in 1989. He has been a director or trustee of General Growth Properties and the NAACP Legal and Educational Defense Fund. He also has served as a past director of the MassMutual Life Insurance Company, Bedford Property Investors, the Urban Land Institute, Essex Property Trust, the National Housing Partnership Foundation, Penton Media, and The Counselors of Real Estate.*

*Downs received a Ph.D. in economics from Stanford University. He is the author or co-author of 24 books and more than 500 articles. His books include* An Economic Theory of Democracy *(1957), translated into several foreign languages, and* Inside Bureaucracy *(1967)—both still in print. His latest books are* Real Estate and the Financial Crisis *(2009) and* The Niagara of Capital *(2007). Downs is a frequent speaker on real estate economics, housing, transportation, smart growth, urban policies, and other topics, having made more than 1,000 speeches to hundreds of organizations. He is a member of The Counselors of Real Estate, American Academy of Arts and Sciences, American Economic Association, Anglo-American Real Property Institute, National Academy of Public Administration, American Real Estate, Urban Affairs Association, and Urban Land Institute.*

tion of real estate in the banks compared to any other time in U.S. history; and third, how to refinance all the maturing commercial real estate debt when there is such a refinance gap?

Let's start with an examination of the size of the problem. According to the U.S. Federal Reserve, we have a record $3.3 trillion of outstanding commercial real estate debt in the U.S. The largest shareholder of that debt is the U.S. banks with $1.4 trillion, or 42.4 percent of the total debt.

The next largest shareholder is commercial mortgage-backed securities, or CMBS, as I'll refer to it. Outstanding CMBS commercial real estate debt is just shy of $700 billion. This amount of commercial real estate debt is unprecedented. Total outstanding commercial real estate debt was just $800 billion in 1998, or 25 percent of today's amount of $3.3 trillion. We did not quadruple the amount of commercial real estate space in the U.S. between 1998 and 2008. Thus, one can clearly see that this real estate crisis is an over-leverage event, and less an oversupply event. The U.S. Central Bank has virtually no experience with over-leverage of this magnitude. That's why policy-makers are struggling with a response. Are "extend strategies" such as the "Commercial Real Estate Loan Workout Guidance" issued in October 2009 the right policy response? Japan's experience would tell us "no."

The second major issue is the concentration of this commercial real estate debt in banks. Until this recession, U.S. banks had never exceeded a commercial real estate concentration ratio close to 50 percent of their Tier 1 capital, even during the savings and loan crisis from 1987 to 1991. Today we have institutions with ratios that reach into the 300–600 percent of Tier 1 capital range, and the average for all U.S. financial institutions exceeds 100 percent. In other words, not only do we have an unprecedented level of commercial real estate debt in the U.S. compared to any other time in our history; we also have it concentrated in our banks more than any other time in our financial system. How to unwind that concentration in commercial real estate debt when other options, CMBS for example, have yet to get back on their feet, is a huge challenge. The net effect that borrowers and developers are experiencing is a massive contraction in credit to refinance maturing real estate loans. If a solution is not developed soon, a large amount of commercial real estate debt will mature, default, and drive values down as it is foreclosed and liquidated. It's a serious problem that the regulatory community does not yet fully understand or approach with a real sense of urgency. If this commercial real estate debt is not refinanced and reconciled by 2012 to 2013, the amount of other U.S. debt (corporate, municipal, etc.) that comes due and will compete for the same capital is staggering. In excess of $10 trillion in total U.S. debt (commercial real estate, corporate, municipal, state government, etc.) comes due in the 2012 to 2015 period. The U.S. is facing a serious refinance hurdle that will likely be met with much higher interest rates.

I'll also comment by property type. Maybe some things that we're seeing are on the "good news" side: I analyzed 180 markets for the Federal Reserve Bank examiners every quarter, and there was some encouraging news. We've definitely seen correction and recovery come back in the multi-family class. We're seeing what we saw earlier in this recession two years ago; concessions come into the market which precede the rise in vacancy—we saw those rise in the 8 to 12 percent range in most markets—and vacancy rise to about 10 percent in most markets across the country, although worse than that in some markets. We've now seen national vacancy fall to about 8 percent; we're about 92 percent occupied across the board. And we've seen concessions cut in half and in many markets, even overbuilt markets where there was a lot of condo development, we've seen concessions come down to really nominal two to four percent numbers. So we're seeing real improvement in operating cash flow and occupancy, and we think part of the reason is that we didn't have the overbuilding in multi-family as we did in other classes. Overbuilding was greater in a condo or single-family housing size.

Also, the condo market is primarily concentrated in about 25 MSAs in the country, not in all 360 MSAs. What we're finding in markets like Chicago and Atlanta and others that have the bulk of the condo overbuilding is that the very expensive high-end condos are not being returned to the market for rental. If you look at, for example, the portfolio that was sold in a joint venture with the FDIC in Starwood—the good majority of that inventory has been taken off the market. They're not going to rent million-dollar rentals for $1,000 a month. So that's not going to produce a pocket of inventory or a shadow inventory that we thought was going to come to market. And so, what we're seeing now, because of the search for yield by investors, is five, and in some cases, four percent cap rates for quality apartment properties in growth-restricted markets like Austin, Texas or Baltimore. My concern is we could actually begin to see a lot of mothballed planned projects come back into the pipeline. That would restart the whole problem on multi-family, with underwriting at five percent cap rates and 95 percent occupancy.

**DOWNS:** Now let's turn to Marc Thompson.

**THOMPSON:** Hi Tony. First of all, I want the readers to know that I am speaking as a counselor of real estate professional. My views stated in this interview are not to be construed in any way as the views of Bank of the West or its senior management.

I'm Marc Thompson, a Counselor of Real Estate, and I've published four articles in *Real Estate Issues* on the risks to the economy of high aggregate commercial real estate debt growth. I work for Bank of the West in San Ramon, California, managing a senior housing lending group for its balance sheet.

One of the big observations I see in the financial markets is that the banks are being squeezed on their capital externally by the FDIC and government-sponsored entities—or GSEs, Fannie Mae, Freddie Mac, Housing and Urban Development, and internally by delinquent borrowers. What I'm finding is that all of them are managing their loss reserve capital against potential real estate losses. The FDIC, Fannie Mae, Freddie Mac, HUD, and the banks' borrowers are trying to make sure they, respectively, don't have a loss hit on capital. So banks are caught in between, trying to preserve their minimum capital requirements from claims from both sides. The FDIC, in 2009, had charged its annual fees for the following three years to shore up its FDIC loss reserve capital in preparation of future losses. GSEs are pushing back on losses on loans that were originated by the banks by having the banks buy back these faulty underwritten loans, and rightfully so in some cases. Also impacting banks' loss reserve capital are borrowers who are trying to shift as much responsibility of a loss to the bank as they can get away with. So, who's taking all the losses and who's taking all the risk of this financial crisis is the banks, and they're getting hit hard trying to meet minimum regulatory capital requirements. I just want to make sure that everyone understands that I'm seeing a continuing pattern that appears to be weakening banks' loss reserve capital levels.

My second observation is the shrinking of banks' real estate loans on their balance sheets. Banks' balance sheets are shrinking because of loan foreclosures, re-margining at loan modification, or loan payoffs due to a sale or refinance. With construction loans, I observed single-family development loans go through the foreclosure

## About the Panelists

**K.C. Conway, CRE, MAI**, *recently joined Colliers International Valuation and Advisory Services as executive managing director, Market Analytics, in Lilburn, Ga. From 2005–2010, Conway worked in the Federal Reserve System in multiple capacities, ranging from the commercial real estate subject matter expert for the Atlanta District Bank to the commercial real estate risk specialty officer designee to the New York District Bank. In these roles, he briefed Federal Reserve Board Chairman Ben Bernanke, the Board of Governors, Federal Reserve District Bank presidents, and real estate industry groups on market conditions and burgeoning issues during the 2008–2009 financial crisis. Conway has also served in various capacities for Cushman & Wakefield, the former Equitable Real Estate, Deloitte & Touche, Wells Fargo, Prudential, and SouthTrust Bank.*

*Conway is a frequent lecturer to real industry groups such as the Appraisal Institute, the American Institute of Certified Public Accountants, The Counselors of Real Estate®, CCIM Institute, and the Risk Management Association. He also teaches and lectures extensively to various state banking and finance agencies, as well as some of the nation's leading real estate centers, including the University of Colorado, DePaul University, University of Connecticut, Georgia Tech and New York University. He is a graduate of Emory University's School of Business.*

**Sandy Hostetter**, *president of CNLBank, Central Florida, Orlando, has more 29 years of experience in the financial services industry. Prior to joining CNLBank in January 2002, she spent seven years as the chief executive officer of Florida Community Partners, a not-for-profit bank lending consortium that specialized in financing for affordable housing communities. From 1982 until 1992, Hostetter was vice president of Corporate Banking for Barnett Bank of Central Florida.*

*Hostetter also has served in various capacities for The Community Playground for the City of Winter Park, Central Florida Housing and Neighborhood Development Services (HANDS), Florida Coalition for Housing, City of Orlando Mayor's Affordable AD Hoc Housing Task Force, the Association of Reinvestment Consortia for Housing, the Central Florida Not For Profit Housing Roundtable, and the Orlando Housing Authority. She holds a bachelor's degree in business administration from the University of Florida and a master's degree in business administration from the Crummer School of Business, Rollins College.*

**Marc R. Thompson, CRE, FRICS**, *has been a member of The Counselors of Real Estate®, headquartered in Chicago, for 12 years, and is a Fellow of the Institution of Chartered Surveyors, headquartered in London, since 2003. He currently serves as senior vice president of Bank of the West, San Ramon, Calif., (a BNP Paribas subsidiary), where he manages a lending operations unit that provides both construction and term financing on senior housing and care properties. Thompson is a real estate investment professional with mortgage risk assessment expertise. He has served on many industry association boards, is an active writer, and studies complexity science to enhance his understanding of complex systems, social networks and economics. He holds a master's degree in business administration, and has served as an adjunct professor of financial management studies at California State University, East Bay.*

process early in 2008 and 2009, so I don't see much single-family development portfolios in banks anymore. What I am seeing is that the income property loan portfolios are weakening in retail, office, warehouse, and industrial loans. Multi-family loans are holding up, but I did see some multi-family loan loss hits in '08 and '09 in some markets throughout the country. I am only seeing banks' real estate loan portfolios increase through distressed bank acquisitions together with loss-sharing agreements with the FDIC. So if you're seeing bank balance sheets in real estate loans increasing, it's because of bank acquisitions. It's not so much organic growth through new loan originations.

The third point I want to make is that banks are in a hyper-risk assessment period in the economic cycle after incurring two years of high regulatory scrutiny and high realized loan losses on their commercial real estate loan portfolios. There's a lot of "analysis paralysis" on every commercial real estate loan that bankers review. Commercial real estate loan originations are highly analyzed, so it takes banks twice as much effort to get a loan approved to put on its books. Frankly, I'm doing construction financing, and my group just closed one yesterday, so we are trying to do business to grow our earning loan portfolio within the bank. Commercial real estate loans have historically been the best way to get earning assets on the bank balance sheet, together with sales of bank-related products, and so that's certainly something banks want to push for, but it continues to be very, very challenging.

My fourth and last point is that organic growth is possibly a positive bank growth strategy, but is limited by the low number of good credit quality opportunities. That's really the debate—what is good enough? And that's why banks have analysis paralysis, and why it takes us so long to get credit approved; because we're still trying to figure out what is good enough internally within banks' credit administration, and externally, with FDIC and other bank regulators.

One of the things I share with K.C. is that we did have just a tremendous amount of aggregate debt growth from 2004 to 2007. I measured it via a model that I developed and published in *Real Estate Issues* last year. That illustrates about a 50 percent higher probability of loss risk than what was experienced in the savings and loan industry. If you take what we experienced in income property losses in the savings and loan industry, and take that loss rate against the outstanding at that time, then double that against aggregate debt, you get approximately a trillion in commercial real estate loan loss exposure. I observed that commercial real estate aggregate debt levels actually shrank 10 percent in the savings and loan crisis from the peak of aggregate debt in 1990, with aggregate de-leveraging ending in 1995. It decreased by 10 percent then. I calculated, based on my aggregate debt growth risk model, that commercial real estate aggregate debt levels will drop by 15 percent through 2014 and then begin to rise again over the following five to ten years. Single-family, I'm forecasting about two to three trillion dollars in losses over the next ten years, applying my aggregate debt growth model analysis. On commercial real estate loans, I'm forecasting debt losses anywhere from $600 billion to a $1 trillion. This is a forecast I've been holding since 2007, based on a previous analysis and my aggregate debt growth risk model that helps define loss risk more accurately.

**DOWNS:** Thank you very much, Marc. Sandy, do you have some thoughts?

**HOSTETTER:** Sure, I thought it might help a little bit if I give some quick background. I am the president of CNLBank, and we're on the smaller side of things compared to my co-panelists, but not all that small. When we started this downturn, our bank was about a $1.7 billion institution and the tenth largest, independent, Florida-based bank. We cover the Florida market: Orlando, Jacksonville, St. Augustine, Fort Lauderdale, Fort Meyers, Sarasota, Naples, and Coral Gables. We put a team in place that we thought could grow our bank to a five billion dollar-plus franchise, so a lot of people refer to us as a community bank, but I would say our goal is to become more of a regional player. We're in a pretty strong capital position, and the reason I'm setting it up this way is that I think both K.C. and Marc touched on some really good points here. One of the problems is that lending has just stalled. There are not a lot of deals that look that strong, number one, but number two, there is a capital crisis. As Marc said, unless your bank has the benefit of the FDIC absorbing some of the losses, or you've opened within the last two years, chances are good that you are battling a struggling portfolio. Banks cannot afford to drive lending, and by that I mean they need to protect the capital of the bank because they need to meet the more stringent capital ratios. They don't want to be growing the bank at the same time because that puts more stress on capital, and if they're working through their real estate portfolio they're probably taking some losses. Most investors are hesitant to invest in banks now unless they have already failed and are an acquisition target. Raising capital is dilutive otherwise, so I think a lot of banks are taking the position that they are going to work through their legacy real estate portfolios and not put any additional strain on capital in the meantime. And I do want to point out that we have $140 million in capital, we are in compliance with the elevated Tier 1 capital ratio of 8 percent; we're just slightly shy of the elevated Total Risk-Based Capital ratio, at 11.81 percent. So we are well-capitalized. I'm not coming to you from the position where I think we're weak.

The second issue is that most banks also have a concentration of real estate loans that they are trying to reduce to lower their risk profile. Bank examiners like to see what we refer to as the "100 to 300 buckets," whereby no more than 100 percent of your capital is invested in land and construction loans, and no more than 300 percent in all real estate lending combined, including owner-occupied loans. Those numbers just got out of control, particularly in Florida where there was a lot of speculation, and now we're trying to get back in compliance with the normal ratios. When you're looking at growing a bank with real estate loans or growing a bank with commercial loans, it is certainly faster to grow it with real estate. Real estate lending was once a substantial part of our growth. A large commercial loan is in the neighborhood of $2 million, where a large real estate loan for us could be $15 million. We aren't even replacing our runoff right now. My theory is, part of that is because the banks don't want the strain on their capital and they also don't want any more real estate exposure.

**CONWAY:** Tony, I'd like to proffer two additional observations at this point. I think the other panelists are exactly correct. What I am hearing them say is, first: bank capital is under siege on a lot of fronts. Banks have been vilified, and everyone in Washington wants a piece of their capital—whether it's in the form of holding more capital for losses, adding regulatory burden and costs in a one-size-fits-all structure that hurts community banks who were not the egregious parties, or higher taxes and fees.

Second: how can banks lend with such an unclear picture of the economy, capital and loan loss reserves? Banks are not going to lend in an uncertain climate. Incentives need to be developed to restore credit. Washington and the regulatory community need to be clear on policy and new legislation—especially Dodd-Frank. Otherwise, banks will hold onto their capital and earnings for fear they will be needed to address future losses and the cost of higher regulatory burdens. If the U.S. is not careful, it may see its banking industry move offshore. Banking in the U.S. could go the way of the auto, steel and textile industries in the 1970s and 1980s.

**DOWNS:** OK, now I'm going to take a turn. I'd like to discuss why real estate is acting like such a drag on the nation's overall economy, with an equal drag on bank prosperity. And I'm going to repeat some things that the others have said.

The first reason is one K.C. emphasized, that most banks have a very high fraction of their loans based upon real property. I used a different fraction than he did, but in the third quarter, real estate loans were 44 percent of all bank lending. By 2009, that had risen to 60.7 percent. That's more than one-third of all the assets in the banks.

The second reason, which he also mentioned, was that almost all real estate properties have fallen sharply in value, leaving many loans larger in face value than the current market values on the properties on which they are based. Today, about 25 percent of all homes with mortgages are underwater. That is, the mortgages on them are larger than the current market values of those homes. But, 31.7 percent of homes have no mortgages. Thus, considering the entire housing stock, about 17.8 percent of owner-occupied units are "underwater." From 2004 to 2006, commercial real estate loan-to-value ratios were 72 to 73 percent based on the value of the property at that time. Since then, falling prices of those values have increased the loan-to-value ratios of those loans to 94 to100 percent. That has put many of those homes underwater.

A third reason is that the prospects for rapid recovery in housing markets are very poor. Yet housing recoveries have been major positive forces in past recoveries. Existing housing sales have plunged to a record low level of about five million total sales in 2010. Banks in 2010 are down 19 percent from their peak in 2005. Homebuilding is even worse. Homebuilding starts in 2009 were 550,000 units; that is, a 71 percent drop from their peak of more than two million units in 2005. That drop from 2005 to 2009 was the biggest drop in the history of such records. Yet in 2010, new housing starts were only 529,000, actually fewer than in 2009. The number of housing foreclosure filings went from a million in 2006 to 3.9 million in 2009. There will probably be another 3.9 million again in 2010. And recently, as you know, several major banks have stopped filing foreclosures because they discovered fraudulent or inaccurate documents. So the whole foreclosure situation is a mess. Yet the already huge amount of foreclosures—72 percent of which were concentrated in just nine states—has created a large number of housing units available at relatively low prices.

That further reduces the willingness of homebuilders to start new housing.

The fourth reason is that commercial real estate, as K.C. mentioned, is about to be hit by the rolling over of huge numbers of highly leveraged loans made from 2000 to 2007, at very high property values and high loan-to-value ratios. This will create an acute shortage of borrower equity with which to pay off those loans when they roll over. In those eight years from 2000 to 2007, six times as many dollars were lent in commercial property as were lent in the preceding eight years. Most loans made in that second period of great lending were highly leveraged with cheap debt that was then available. But no such debt is now available or will be soon. If banks deleverage by reducing their huge debts, they will be unable to refinance these loans made from 2000 to 2007 without gaining more capital for reserves. In fact, the lending capacity of the entire U.S. banking system will be much smaller in the future, and is much smaller today than it was in the recent past.

The fifth reason, and one that underlies all the others, is that high rates of unemployment are likely to continue for several more years. As a result, consumers will not have the funds to return to heavy spending on goods and services, thereby stimulating small businesses. So, small businesses will have little reason to expand their resources.

The last reason I'll mention is that no sudden change in conditions is likely to radically increase the demand for workers and for new production. But such a sudden change is what World War II did to bring the Great Depression in the 1930s to a sudden end. It caused a huge influx of government spending, and the government drafted eight million people, many of whom were previously unemployed, into the armed forces. We don't have any comparable force to turn around the economy now.

**THOMPSON:** One of the things that I would like to say is that in the CMBS market, REMIC, or Real Estate Mortgage Investment Conduit laws were changed, and this is what I understand to have happened to actually provide the CMBS special servicers the ability to extend matured loans up to two years. Extensions are done so in a manner, in an "extend and pretend" kind of fashion, to provide more time for the CMBS loan to meet refinancing qualifications and not incur a tax consequence for the REMIC. So there's been some enabling of this extending of credit once those commercial loans mature in this CMBS market. Similarly, I've observed within banks this same kind of pattern of trying to provide more time for borrowers to become successful and put the loan in a position to be either refinanced or provide the property enough time to put it in a position for a sale to pay off the loan. Those things I think are definitely happening on the income property side but they're also happening to a large extent on the single-family mortgage side. What I'm observing is a stretching out of the consequence of loss, which appears to be very similar to what we saw as a pattern in Japan. Though, others are saying: "Hey, there's no way the U.S. will ever follow what Japan has gone through in the last decade." But it seems as though we're following that same pattern because the probability of real estate loss hits are too high, and that's why I threw out some numbers—to give people some perspective as to what kinds of losses will be, or potentially be, sustained by the economy. There are just so few people who can understand how big this real estate debt problem really is and why it's going take a long time and why it can't be solved quickly.

**DOWNS:** K.C., you said at one point that properties had fallen, both residential and commercial. What were your estimates of how far property values had fallen, say from their peak around 2007?

**CONWAY:** When we look at where we have come from and gone to in property values, it's easy to sum it up for both residential and commercial real estate, as follows: we have returned to 2002–2003 levels. Commercial real estate values have fallen 45 percent from their peak in 2007 to their trough in 2010. Nationwide, home prices have fallen for the first time in since 1968. They have declined more in coastal and higher priced markets like California, Florida, Washington, D.C., northern Virginia, New York, Atlanta, Chicago, Phoenix, Las Vegas, etc. We've experienced an unprecedented decline in home prices since 2007, but it is not as great as the unprecedented rise in home prices we experienced from 2000 to 2007. Double-digit annual home price appreciation and sub-6 percent cap rates were never sustainable and have simply unwound.

The real question is, where were the bank credit and risk staff and the regulators during the unprecedented rise in values in terms of intervening and challenging the sustainability of what was going on in that time period? The answer is that they were AWOL because no one wanted to be the one to stop a great party prematurely. Congress wanted higher rates of homeownership. To accomplish this, it forced the GSEs to take on a new risk profile of subprime mortgages without building up their capital base from a nominal 1 percent to, say, four to six percent, where losses have actually developed. Banks wanted more earnings, and they simply followed the herd of cattle over the cliff because "it was what everyone was doing."

The attitude that permeated the bank and regulatory environment was: "until I have losses, why should I be concerned, reserve for more losses, etc.?" It takes courage to pull away from the spiked punch bowl late in a party, but it means the difference between gain and pain. The regulatory and banking community failed. Bank regulators failed to update things like the *Interagency Appraisal and Evaluation Guidelines* to address securitization, subprime mortgage products, drive-by appraisals, etc. The last update to those guidelines was enacted in 1994 in accordance with the Financial Institutions Reform Recovery and Enforcement Act. The banks failed to adhere to a 3M approach to risk management, which means continuously measuring what is happening in markets; continuously monitoring the results; and then continuously managing the business lines in response to the risk that is building. What the banks did was essentially say: "Let's invest more in earthquake-prone areas because there has not been an earthquake in a long time, and let's just assume then that no more earthquakes will occur going forward." Until we have an earthquake, let's not plan for one.

The banking and regulatory communities alike now act very indignant and shocked that there is such destruction from an earthquake. This was not an unforeseen real estate and banking crisis. It was a failure by banks and regulators alike to manage risk. Now, Americans deal with the destruction in their wealth and the economy. We seem doomed to repeat this cycle nearly every 20 years. We deregulated the savings and loans and then changed the tax codes to drive real estate in the early 1980s, and then acted surprised at the aftermath from 1987 to 1991. Twenty years later, we essentially deregulate the mortgage industry and financially engineer residential and mortgage products to accelerate real estate without understanding their structures and risks, and once again act surprised at the financial wreckage. Directors of bank boards, regulators and legislators are all the principal tour guides down this economic path of destruction.

My concern going forward is how do we dig our way back out? The FED has spent most of its ammunition and is now engaged in supervisory policy that undermines prudent monetary policy. Printing money to capitalize on the excesses of banks devalues our currency and will lead to commodity inflation and more hardship to the American taxpayer that could rival what we experienced from 1977 to1981 when the prime interest rate rose to 21 percent. The rest of the world now holds more than half of our total debt, and I don't think those holders are going to continue to extend us credit at Triple-A borrower ratings when we don't deserve it. Really smart analysts like Meredith Whitney (Meredith Whitney Advisory Group LLC) are already out there warning about the next shoe to drop—state and municipal bond debt. We'd better learn to manage risk proactively—not reactively—if we want stable property values going forward.

**DOWNS:** Let me ask a question of Marc Thompson. You seem to imply that the number of banks may actually shrink because of the pressure on their balance sheets and the difficulties they're facing from the FDIC and other forces that are reducing their effectiveness. We have about 8,000 banks today, although we once had 14,000—not too long ago. How many more banks do you think will have to disappear before stability in their numbers is established again?

**THOMPSON:** That's a tough question to answer. The number 5,000 has been thrown around a couple of times in some discussions and what I hear in listening to other bank regulators in various states. They have their forecasts and they think that it might go down to as low as 5,000, but it's very difficult to predict what that number would be.

**DOWNS:** Let me ask Sandy a question. Your bank, you said, is very well capitalized, so you are apparently not under any pressure to disappear at this point, but are there other small banks in Florida and around you that are having trouble staying afloat?

**HOSTETTER:** Definitely. The numbers, I think, through the second week in September, showed that 127 banks had failed, and I think we're predominantly seeing that in Florida and Georgia. Banks are struggling. If you were open for business in 2004 through 2007, and had any appetite for real estate lending, you're probably dealing with the problems that those projects are experiencing.

One of the comments I was going to make is when this downturn started, I remember distinctly about a year into it thinking I'd seen this movie. I came out of Barnett Bank, and in the late '80s early '90s, Barnett Bank of Central Florida had the largest real estate portfolio in the

Barnett system. We had a floor filled with bank examiners when this downturn hit a full-blown recession. But some of the solutions that helped us get back on our feet as a nation and as a bank at that time are not available. The government gradually lowered both interest and taxes. Well, the rates can't go much lower than where they are today, and some would argue the same is true with taxes in light of our country's debt position. We've talked about the cap rates, and we've talked about the value of keeping a project going by just having more favorable interest rates, but the truth is, they can't get any better than where they are right now. I'm very concerned about raising taxes at a time when most people are struggling to get back on their feet. That could be devastating. And because we have already used one of the tools that helps us get back on track—dropping interest rates—I don't think this recovery is going to be anywhere near as swift as the one that resulted when we made those two moves back in the early '90s. And we haven't even touched on unemployment.

**DOWNS:** You think that these banks are going to go out of business? You said some of them around you are really in tough shape. Are they actually disappearing?

**HOSTETTER:** It's already happened. Several of the banks here already have been acquired. It's going to depend on how long this economy stays down. Tony, I want to be honest with you—we lucked out a little bit because we had just done a capital raise to double our footprint in Florida. Sometimes, you're lucky, and we were. We went into this with more capital than we normally have and fortunately, did not commit to the real estate investments that expanding in branches and leasing normally require. Fortunately, at the time, we realized the economy was weakening, and we were able to hold onto our capital.

**DOWNS:** Let me ask Marc a question again: you once said in a conversation with me that the FDIC was not following its own policy of assuming 80 percent of the losses of banks that closed. Where could it get the funds to follow that policy other than forcing banks to use their capital?

**THOMPSON:** As I said in my first opening point, the FDIC is managing its loss reserve capital. I've spoken to other banks that have loss-sharing agreements with the FDIC, and they're indicating to me that they're managing their loss reserve capital. In other words, if there's a loss that the bank has to get approved by the FDIC to share in, FDIC will say, on occasion, "We're not going to do that." And then the FDIC is not promoting it will not, according to these bankers that I've talked to, approve loan sales, because it doesn't want to realize those losses. It's managing the rate in which it's taking loan losses against its loss reserve capital. I believe it's as fearful of the same things that all banks are—that there are going to be further losses down the road. The FDIC has to manage its balance sheet for those losses, and so it's postponing losses on loss-sharing agreements and managing the rate—the best it can—of closing troubled banks. Everybody who's participating in the U.S. economy can't take directly or indirectly all these real estate loan losses at the same time, for fear of having nothing left to maintain minimum capital adequacy requirements or solvency on their respective balance sheets. So, what's happening out there is that even in the loss-sharing agreements, the FDIC is managing losses as anybody should be in this economy. It's managing its balance sheet to conserve loss reserve capital for future probable real estate loan losses.

**DOWNS:** To K.C.: it seems that the small banks are having difficulty raising capital, but the biggest banks have been quite successful in raising capital. We've heard a lot about banks being too big to fail, but what about small banks being too small to survive? Is that something that seems to be emerging?

**CONWAY:** It's a very legitimate concern. We recently had Meredith Whitney, who's a pretty well known bank analyst, especially on the community bank side, speak with us at the Federal Reserve, and that was a point that she did make. Her assessment was that if you're not at least a billion dollars in size, it's almost impossible for you to raise capital. And, if you're a billion in size or smaller, it's very difficult if you've got a concentration of real estate and you've got to deal with more losses. Where do you go for earnings? So, where do the earnings come from to deal with the problems of working out or extending these assets if you don't have other lending? So you're seeing a kind of feeding frenzy among the community and smaller banks who are trying to refocus into other areas such as C & R lending, or small business. But what we've heard from the small businesses is that it's not so much that credit isn't available, but that their businesses don't see the demand to go out and take the capital risk. We see, even in medium- and large-sized institutions, very low utilization of the credit by businesses. The National Federation of Independent Businesses has a real good chart and some stuff on its public Web site that shows the survey "What is the

Number One Problem of Small Businesses?" And it's not different regulation, it's not absence of credit; it's poor sales. They don't see the demand to go out and extend capital to hire employees or invest in plant equipment or additional space. And so I think what you're hearing from Sandy and the smaller banks is you're exactly right. They are at a disadvantage, and when you look at Dodd-Frank; smaller banks are going to have to comply similarly with the large banks, and that creates another kind of cost burden on them. So I think it's a legitimate concern that the smaller and community banks are raising that may have to be addressed if we want to preserve a community and smaller bank situation in this country.

**DOWNS:** Let me ask you, K.C., another question, and also Marc, maybe you could answer this, and Sandy too. What if you are looking for some way to cope with the fact that a commercial real estate loan is coming due, and the borrower does not have the equity to meet your current terms or you have lower loan-to-value ratios, lower prices and higher interest rates. Where can you go for capital and how can you respond to that situation? Are you going to lend, are you going to extend the loan forever? Are you going foreclose it and sell it quickly? What are the reactions to that situation, which is going to become much worse? Any of you can answer.

**CONWAY:** I'll start real quick, because I think the first thing the banks need to ask themselves when they're in that situation is: "what are the prospects for this loan to be taken off, be paid off and go away?" So if you look at the primary source of recent adds to the banks pre-2007, it was securitization of CMBS referral, and in 2007, CMBS was a $234 billion annual market that would basically take these assets off the banks' balance sheets and enable them to recapitalize and go back and lend and do construction and development. This year we may be lucky to see somewhere between five and ten billion in these securitizations. Every one of the new issuances that have been done since the TALF program was made available to restart securitization are essentially 60 percent or lower loan-to-value—180 to two times debt service coverage, single-borrower, not multi-borrower situations. They don't want any major leases to expire during the life of the loan. The most recent deal was a retail deal by Vornado, in which only five percent of the leases had any market rollover risk in the next ten years. That is not the profile of what's in the bank. So, if securitization is going to stay in that mode—very conservative—and they're in that mode because now the commercial borrowers and the CMBS borrowers have said: "we're going to adopt the same behavior that homeowners and mortgage folks have," which is strategic foreclosure. If the refinance gap is just too big to ever meet, we'll strategically walk away.

There was a recent *Wall Street Journal* article that interviewed Vornado Realty Trust and some others in which they openly advocated that they're incentivized to strategically default on these non-recourse CMBS deals. And that's why we're seeing this sharp rise in CMBS delinquencies that just reached 9 percent, a new record, and overall 11 percent of all CMBS entering special servicing. So the capital markets in CMBS are not crawling or walking back to life; they're barely even in existence compared to where they were. That source isn't going to be there. So if it's not there, and there aren't other sources for other sectors of real estate like multi-family, and you don't have that same equivalent for retail, or office or subdivision land, there really is no other option but an extend strategy. And I think that's why you saw the respective regulatory agencies reintroduce the "Commercial Real Estate Loan Workout Guidance" last fall, which said: "If it makes more sense, if it's prudent, to work and extend the loan rather than foreclose." In other words, if your market value is better for working it out than liquidation value and foreclosure, "by all means, do that and focus on debt service coverage rather than collateral value." So really what's being said to the banks right now is: "If you can find a way to restructure the loan into a sort of A/B note restructure and get some kind of debt service coverage of one better, we'll work with you in an extend strategy as long as you get some sort of cash flow." But that still means, in many cases, when you write and sign that loan into an A/B restructure, the charge-off of the B note is such a hit to capital that financial institutions can't even do that. The thing we're really confronted with is, as both Marc and Sandy have said, the only option in place in the banks right now is an extend strategy, because the capital markets have not opened back up to really deal with it. And if you're an under $20 million commercial real estate asset, outside of one of the top ten or 20 markets in the country, there is not refinance capital for you.

**DOWNS:** Let me ask Marc and Sandy whether you have had any of your clients decide that they didn't want to cope with their mortgage. They just walk away and hand you the keys. Has that happened to you?

**HOSTETTER:** Yes. We've have several law firms here in Central Florida advertising their services relating to strategic defaults, which is only exacerbating the problem. But I will tell you the reality is exactly what K.C. said. What we've been trying to do is to work with our borrowers to come up with a solution that works for both the borrower and the bank. We don't just let people walk away from a deal, particularly not if they have personally guaranteed our loan. And we have very, very few deals that do not carry personal guarantees, so unlike a CMBS market whereby you put it to bed in a permanent market and there's no personal liability, our loans, by and large, hold the sponsor personally liable. So I can't say we're seeing very many people go through that strategy, Tony. What we're doing instead is that we either ask for additional collateral, and if they can't right-size from a collateral standpoint, which happens in probably 20 percent of the cases, then we do our best to begin amortizing so that we can demonstrate repayment ability. Most borrowers at this point don't have a lot of liquidity left, but every deal is different. We drop the interest rate if we have to and extend for a 20- or 25-year payoff and just amortize it right on out unless they can make the debt service coverage on a more aggressive schedule.

**DOWNS:** Marc, I'm going to ask you the same question. Do you have many people walking away from their properties? Now, California is the state in which if you are in a house, I don't think they can go after you if you walk away from it.

**THOMPSON:** Yes, if your home is your primary residence, that is correct. But if you walk away and you incur a loss through a foreclosure or even a lender-approved short-sale, you have tax consequences if some of the leverage put on the house didn't increase the basis in the home; that is, paid off consumer debt with cash-out home mortgage proceeds. So there are certainly financial incentives to stay in a house to discourage strategic defaults on homes, especially if the homeowner isn't insolvent and has a net worth.

But, looking back at the savings and loan crisis, this is a perfect example of why recourse loans to the investor are very important for banks. In the savings and loans crisis, we had an "S and L" portfolio where I worked at the time consisting of recourse and non-recourse commercial real estate term debt. What I observed at the beginning of that de-leverage cycle was that a large amount of the non-recourse debt went first into strategic default. At the beginning of 1992 to 1993, we had some recourse borrowers ask for loan modifications early on, but we chose not to provide them because it was recourse debt. Frankly, we had such a high volume of distressed non-recourse commercial real estate debt for workout or foreclosure that we just didn't have any capacity to handle the recourse modification requests at the time, even though it may have been beneficial to them and the bank.

But the point is that recourse signers of the debt are responsible for that debt's full repayment. Unless the guarantor became financially exhausted, recourse commercial real estate debt has proven to be a very stable portfolio of loans. I did not see recourse debt go into foreclosure or into some kind of workout until much later in the de-leveraging cycle in 1994 and 1995. And so there is a case to have recourse debt in banks because it provides for a much more stable portfolio in difficult economic periods. When you have non-recourse debt, it's a strict economic decision to walk away or keep paying debt service out-of-pocket. "OK, I've invested my maximum equity in this commercial real estate investment. I'm not going to put in anymore equity. Here are the keys." This position was taken by many non-recourse investors during this period. I heard the same back in the S and L crisis days. Whereas if you have recourse debt, the guarantor would be served a judicial foreclosure action and go through a whole negative legal process, facing a deficiency judgment between the fair value of the property and the higher loan amount. Recourse debt discourages guarantors from going through a loan default, especially if they have a net worth to protect. So, I really believe that non-recourse debt is not to be originated for banks' balance sheets. It's just too volatile for a bank's balance sheet to manage its minimum capital requirements in challenging economic times. In a financial crisis, we're now seeing that non-recourse real estate debt creates and accelerates a systemic financial market problem in MBS portfolios—residential and commercial securitized loans—and in banks. It's too easy for an investor with a non-recourse loan to walk away from the responsibility of fully repaying it.

**DOWNS:** Let me ask this: what signs of optimism do the three of you see? Is there any way out of this? We've all been talking about how it's going to get worse or it's going to get better, only very, very slowly. Are there any optimistic signs that anyone can speak of?

**THOMPSON:** We closed a construction loan in the bank I work for with one of my group's customers yesterday. Some banks are still lending. We're doing the best we can, and it's just a harder environment to do it in. The bank I work for is well-capitalized. Bank of the West is owned by a French bank called BNP Paribas. Banks are seeing more opportunities for providing credit to credit-worthy borrowers. What I'm finding is more competition for the high-credit quality commercial real estate loan deals. I'm seeing some good competition come back to the market with three to four well-capitalized banks bidding on high-credit quality real estate projects, either on a term loan or on a construction loan opportunity. So I am seeing lending activity on commercial real estate and residential development projects in the stronger markets in California. Even with California experiencing tough economic challenges as a state, banks are making good commercial real estate loans. I would say that's a positive sign.

**DOWNS:** Sandy, do you have any optimistic thoughts?

**HOSTETTER:** Yes. We're still working through our real estate portfolio, but we are seeing some properties move. We've had a couple of large homebuilders come to us looking for large parcels of land. They're not knocking the doors down, but we feel like we're going to make a big dent in our problem assets by June of next year. And, hopefully, Tony, one of the things I would really like to communicate in this conversation, is that the banks WANT to lend. We don't make as much money not lending, nor do we have as much fun. We make a lot more money when we're out there lending, and we do want to lend. I think there are a lot of articles written that lead you to believe that the banks don't want to help people recover, and that's just not the case.

Personally, we feel like we'll be able to get back on track probably by June or July. We are currently making commercial loans. We're just trying to hold off on the real estate market to get our concentration down and work through what we have. But we're hopeful we'll be back in play by June/July of 2011.

**DOWNS:** K.C., how about you? What do you think? Anything optimistic?

**CONWAY:** There are some great finds out there. I mentioned at the beginning, multi-family is recovering, and there is some good news on the hotel side. We're seeing business travel come back, and revenue per available rooms up—RevPAR—that's the best metric to measure hotels. Essentially, of the 180 markets we're looking at, only ten of them still have RevPAR declining, so we've gone from 15 to 25 percent decline in RevPAR a year, with an overall 50 percent decline. Now we're actually seeing it grow. There are signs of progress. We're also seeing some surprise markets that were hard hit and overbuilt actually returning to positive job growth. Good examples are Charlotte, North Carolina, and Cleveland, Ohio. Those are pretty, kind of, surprise markets. Chattanooga and Knoxville, Tennessee. These are all markets that were negative in job growth for the past almost two years and are now positive.

I think the optimism is, if we can get the employment engine going again, we can fix a lot of things. That would rebuild capital, rebuild confidence, although I think we have to recognize there are still a lot of hurdles ahead of us. This isn't a quick fix this time. It's not going to be over within a year. Americans tend to like a tried-and-true convenient solution, and I think this is a recession where there is not a convenient solution. There's been a lot of damage, and the things that consumers and business and banks are doing, which are dealing with their over-leverage and trying to get their house in order, is the opposite of what's occurring in government. We can't continue the deficit structure at a national level and at municipal budget levels. Again Meredith Whitney recently released a 600-page report last week, with two years of research on how to view this problem. In the underfunding of things like pension plans by the state, we have a whole other shoe to drop out there. So I think that we need to keep trying to recognize what's good, we have to quit vilifying the banking industry. There were maybe ten, 12 institutions that were bad apples but the other 7,900-plus weren't egregious in executive compensation and doing insane things. A lot of them were doing basic blocking and tackling. We limited banks in many ways over the past decade as to what they could do to make money. A lot of things were commoditized or moved to Wall Street, such as credit cards and auto loans, and I think we need to look holistically at that and the products and lending opportunities that we can rebuild in our banking system so that we have a broad one. But the thing that concerns me the most is the deficit spending at the government level, which is going to potentially undermine what the consumer and businesses and banks are doing to get their houses in order. So, my optimism is the consumers and businesses and banks, I think, are doing the right things, but we could undermine that through our just out-of-control deficit behavior at state, local and federal levels.

**DOWNS:** Thank all three of you for taking part in this discussion. I found it very enlightening. ■

# A Brief Look at the Dodd-Frank Act

BY WILLIAM L. PITTENGER, MAI

THE DODD-FRANK WALL STREET REFORM AND CONSUMER Protection Act, as it is formally known, is the most sweeping piece of financial legislation enacted in the U.S. since The Great Depression of the 1930s. It was created to enhance the stability of the U.S. financial system and address many of the things that led to its near collapse in late 2008. The stated purpose of the act is to *"promote the financial stability of the United States by improving accountability and transparency in the financial system, to end too big to fail, to protect consumers from abusive financial services practices and for other purposes."* The Act was first proposed in December 2009 and was signed into law by the President on July 21, 2010.

The act contains some 2,000 pages of text, 16 titles and appears to require agencies to conduct at least 40 studies and perhaps as many as 67 to determine how to proceed putting regulatory flesh on the legislative bones. It requires regulators to create some 243 rules and to periodically issue 22 reports. It creates new agencies, merges some, eliminates others and creates new oversight for *specific* institutions deemed to be systemically important and whose failure could put the nation's economy at risk. The act affects the entire financial services industry including financial institutions, their regulators and even consumers.

The financial crisis that began in 2008 was largely a product of outdated regulation and supervision combined with credit innovation and technology that were advancing faster than regulatory and risk management controls. One gaping hole in the prior regulatory system was that no one had clear responsibility for monitoring the financial system as a whole. While financial innovation was hailed as a positive, the mismatch between that and risk management was an unintended consequence that led to near disastrous results.

While protecting consumers through new agencies, proposed efficiencies, enhanced enforcement, greater transparency and more are lofty goals, legislation as far reaching as Dodd-Frank will certainly have unintended consequences not yet even envisioned. With the holes in the law intended to be filled by further study and regulation, agencies, attorneys, advocates, and others will likely parse the language for years as they argue intent, try to clarify the law's ambiguities and debate such things as *does the law really mean "and" or was it intended to be "or."*

The law sets forth timelines for certain implementation steps. Moreover, each implementation step creates additional timelines and deadlines, many of which seem impossible to meet given their complexities and political


## About the Author

**William "Bill" Pittenger** *is a consulting economist and professionally designated (MAI) real estate appraiser with four decades of diverse experience in real estate, economic analysis, forecasting and valuation. He has held senior positions at a $44 billion super-regional bank (corporate chief appraiser), a $2.2 billion community bank (chief real estate economist and risk advisor), as well as at two of the nation's federal banking agencies. Pittenger is the author of* The Bankers' Guide to Federal Appraisal Regulation *and several other books, monographs and more than 200 articles. His research interests include housing, commercial real estate, land economics and financial economics. Recent research includes use of economic information in real estate credit underwriting, economic feasibility analysis and real estate lending risk analytics.*

realities surrounding them. Creation of the Consumer Financial Protection Bureau (CFPB), for example, is among the biggest and most complex endeavors. While the bureau's duties look clear on paper, implementation of regulation together with how the new agency draws resources from or delegates examination authority to existing agencies is currently a tangled web.

Its director, when appointed, is subject to Senate confirmation which, if recent history is a guide, will be a lengthy and politically charged process. The leading candidate for the position was widely thought to be Harvard Law Professor and Presidential assistant, Elizabeth Warren. As of this writing, however, she serves as a "special advisor" to the CFPB, under appointment by the Treasury Secretary, and has not yet been nominated to be the permanent head. That adds uncertainty and will almost certainly create delays in implementing the bureau's mission.

Perhaps the biggest hole left unplugged in the act is the future of Fannie Mae and Freddie Mac. The two government sponsored entities were placed into conservatorship in late 2008 but for reasons that are not clear, Congress chose not to address their future as part of the Dodd-Frank Act.

What is clear is that the Act's many provisions and those that will follow with creation of numerous regulations will increase regulatory and legal risk and the cost of doing business for virtually all financial service institutions. With that broad backdrop, let's explore several of the key provisions of the Dodd-Frank Act.

The Dodd-Frank Act covers nearly all aspects of consumer and mortgage lending from origination through packaging and sale as securities. While there are 16 titles in the Dodd-Frank Act, we will briefly summarize a few pertaining directly to commercial and mortgage banking and their regulation. For now, we'll skip several of the titles dealing with securities, rating agencies, insurance and transparency.

Title I, also known as the ***Financial Stability Act of 2010***, creates two agencies and clarifies the comprehensive supervision authority which are charged with monitoring systemic risk, researching the state of the economy and generally looking out for the next big problem. It also clarifies the comprehensive supervision of bank holding companies by the Federal Reserve.

The Financial Stability Oversight Council and the Office of Financial Research are two new agencies that are part of the Treasury Department. The chairman of the Council is the Treasury Secretary, and the head of the research office is a Presidential appointee who will have Senate confirmation. The Council is charged with identifying risks to the financial stability of the United States from both financial and non-financial companies., It is also charged with promoting market discipline and maintaining investor confidence.

As part of its duties, the Council will monitor the financial services marketplace and make general recommendations to affiliated agencies. It can also compel the Federal Reserve to assume direct oversight of certain institutions deemed to pose systemic risk to the economy.

The Council has two very broad authorities designed to help it monitor and assess risk. It may collect information from *any* state or federal financial regulatory agency. It can also direct the Office of Financial Research to collect information from bank holding companies as well as non-bank financial companies.

The executive director of the Council will also be the director of the Office of Financial Research. The Council and the affiliated Office of Financial Research are responsible for facilitating information-sharing among the Council's member agencies as well as other federal and state agencies with responsibility for financial services, rule-making, policy development, examinations, reporting, and enforcement. In the previous regulatory scheme, which was often disjointed and operated in a parochial fashion, there was very limited information-sharing, particularly between federal and state banking agencies. Indeed, federal agencies often exercised their pre-emption authority over state agencies, and that may have contributed to both worsening and prolonging the financial crisis.

Importantly, the director of the Office of Financial Research will have subpoena powers which will compel any bank or non-bank financial services company to produce data the agency deems necessary to carry out its functions.

The law will specifically end *too big to fail bailouts* by prohibiting use of tax payer dollars to fund bailouts of individual companies.

Title II sets forth ***Orderly Liquidation Authority*** and describes how and under what circumstances financial service companies can be liquidated. In addition to companies already covered by the liquidation authority of the FDIC and SIPC (Securities Investor Protection Corporation), the Act expands authority to include liquidation of insurance companies and creates an *Orderly Liquidation Fund.*

Title III is also known as the ***Enhancing Financial Institution Safety and Soundness Act of 2010.*** It streamlines banking regulation and permanently increases FDIC and NCUSIF (National Credit Union Savings Insurance Fund) insurance coverage from $100,000 to $250,000.

One of the most significant and far-reaching provisions of the Dodd-Frank Act is Title X which creates the Bureau of Consumer Financial Protection. It is more formally known as the ***Consumer Financial Protection Act of 2010***.

The CFPB has been charged with a wide range of consumer protection duties and has been given unprecedented authority and independence. The new bureau will be housed at the Federal Reserve with a dedicated budget funded by the Federal Reserve, yet the bureau will be independent of the Fed. The bureau will have an independent director appointed by the President and confirmed by the Senate. The bureau will contain five major units including Research, Community Affairs, Complaint Tracking and Collection, Office of Fair Lending and Equal Opportunity, and Office of Financial Literacy.

The CFPB will have rule-making authority and will be able to autonomously write rules for consumer protections governing all bank and non-bank financial institutions. The bureau will have authority to examine and enforce regulations for banks and credit unions with assets over $10 billion. Those institutions $10 billion or less will continue to be supervised by their primary regulator, such as the Office of Comptroller of the Currency and others. The CFPB will supervise and examine all mortgage-related businesses including lenders, servicers and mortgage brokers. The bureau will also take on supervision of payday lenders and student lenders.

One of the more significant but little noticed provisions is the ability to act quickly. The bureau will constantly watch for bad or predatory business practices and has been granted authority to act quickly to stop them without waiting for Congress to pass enabling legislation.

Title XIV is more formally known as ***Mortgage Reform and Anti-Predatory Lending Act.*** Its subtitles A, B, C, and E will be administered by the new CFPB. These four subtitles cover residential loan origination standards, minimum standards for mortgages, high-cost and reverse mortgage products, as well as escrow and settlement procedures for consumers who are having difficulty repaying their mortgages. It also makes changes to RESPA, The Real Estate Settlement and Procedures Act of 1974, specifically in matters relating to how servicers interact with borrowers.

Title XIV addresses a variety of appraisal and valuation issues. For example, it prohibits a broker price opinion as the primary valuation tool in connection with valuation of a primary residence. It allows use of an automated valuation model but requires bank regulators in concert with the Appraisal Standards Board of the Appraisal Foundation to establish quality control standards. The Act also addresses appraisal management companies which are widely used by financial service institutions. It requires that the fee paid to the appraiser and the administration fee charged by the management company both be set forth on the closing statement, commonly referred to as the HUD-1.

Within one year, the Government Accountability Office is required to conduct a study of the effectiveness and impact of various appraisal methods, valuation models and distribution channels as well the HVCC and the Appraisal Subcommittee. ■

***Editor's note:*** *This article can also be accessed at William Pittenger's Web site at http://billpittenger.com/real-estate-economic-commentary/.*

FEATURE

# The Income Tax Effects of Health Care Reform on Small Businesses and Real Estate Investors

BY J. RUSSELL HARDIN, PH.D.

## INTRODUCTION

If real estate investors and small business owners intend to maximize after-tax profits and maintain appropriate levels of capital investment, they must have a working knowledge of the latest legislative changes enacted by the United States Congress that pertain to real estate and to small businesses. On March 23, 2010, President Barack Obama signed into law the Patient Protection and Affordable Care Act, followed closely (March 30, 2010) by the Health Care and Education Reconciliation Act which amended the Affordable Care Act (hereafter collectively called the Act). These major pieces of legislation contain (in addition to many non-tax items) several new or modified tax provisions and amendments to the Internal Revenue Code. Several of the provisions of these new laws have implications for real estate investors and/or real estate transactions, as well as small businesses

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

## PENALTY ON EMPLOYERS THAT DON'T PROVIDE HEALTH CARE INSURANCE

Beginning in 2014, for employers with 50 or more full-time employees, the Act imposes a penalty on employers that don't offer coverage or offer coverage that pays less than 60 percent of health-related expenses. In determining whether a firm has 50 or more full-time employees, persons who work 30 or more hours per week are counted as full-time. In addition, the hours of part-time employees (for a month) are aggregated and divided by 120 to determine full-time equivalent employees. This computation is solely for purposes of assessing the penalty.

If an employer with 50 or more equivalent full-time employees fails to offer health insurance coverage to its full-time employees and their dependents, a penalty is imposed if at least one full-time employee is certified to the employer as having enrolled in health insurance coverage purchased through a state exchange for which a premium tax credit or cost-sharing reduction is allowed or paid to such employee. The penalty for having one


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employee enrolled in a subsidized program is $167 per month for every full-time equivalent employee beyond 30. The maximum penalty per year is $2,000 per full-time equivalent employee beyond 30. For example, if a firm employs 60 full-time equivalent employees and offers no health insurance coverage at all for the year, the penalty would be $60,000 (60 employees minus the 30 employee threshold times $2,000). Further, this penalty is not tax-deductible by the employer as an expense.

If an employer with 50 or more equivalent full-time employees offers health insurance coverage but the coverage offered pays less than 60 percent of health care costs, the employer is subject to a penalty if any full-time employee is certified to the employer as having enrolled in health insurance coverage purchased through a state exchange for which a premium tax credit or cost-sharing reduction is allowed or paid to such employee. In this case the penalty is not based on all employees, but it is imposed based on all employees who qualify for subsidized health insurance coverage and actually receive the credit or cost-sharing reduction mentioned above. The penalty is $250 per month for each subsidized employee up to a maximum of $3,000 per employee. The annual penalty is capped at the number of full-time employees above 30 times $3,000. Again, the penalty is not deductible as an expense on the business tax return. Finally, the penalties discussed above are adjusted for inflation each year.

*Tax Planning Tips:* Since the above change is not effective until 2014, employers have some time to engage in tax reduction strategies. For example, the 50-employee number discussed above does not include seasonal workers. Therefore, a company that uses 49 workers most of the year but uses seasonal workers (those who work 120 or fewer days per year) will not be subject to the above penalties. Also, employers that are only at or above the threshold level by a few workers may consider reducing their workforce below 50 to avoid the penalties either by a reduction in force or by switching some of the work, when appropriate, from full-time workers to seasonal workers.

## EXCISE TAX ON HIGH-COST EMPLOYER PLANS

Section 4980I of the Internal Revenue Code of 1986 is amended to add this new excise tax. The excise tax applies when an employee is covered under any applicable employer-sponsored coverage at any time during the taxable year and there is any excess benefit with respect to the coverage. The tax is calculated by using the total cost of insurance and insurance-related coverage, whether paid by the employee or the employer. This means that the insurance premiums paid by the employer, the insurance premiums paid by the employee, the money paid into flexible spending accounts, the money paid into health savings accounts, and the money paid into medical savings accounts are all aggregated. If the aggregate amount exceeds $10,200 for self-only coverage or exceeds $27,500 for other than self-only coverage, the excess benefit is subject to an excise tax of 40 percent of the excess benefit. The threshold amounts are increased by $1,650 for certain older employees and by $3,450 for employees in high-risk occupations (i.e., mining, law enforcement, etc.). This excise tax must be computed by employers but it may be levied on the employer directly or on the insurance provider depending on the circumstances and the insurance policy. The excise tax applies to tax years beginning in 2018 and thereafter with the threshold amounts indexed for inflation beginning in 2019.

*Tax Planning Tips:* This excise tax does not take effect for several more years. Currently most employers should not be affected by this tax due to the threshold levels. This tax is designed to penalize the so-called "Cadillac plans." No one knows what will happen to health care costs over the next several years, but it is sure to rise above current levels; so employers should proceed with caution into the future as they select health care plans for their employees.

## SIMPLE CAFETERIA PLANS FOR SMALL BUSINESSES

Section 9022 of the Act amends Section 125 of the Internal Revenue Code of 1986 to add a new section "(j)" which is entitled "Simple Cafeteria Plans for Small Businesses." These "simple" plans are available for "eligible employers." An "eligible employer" is defined as a business that employed an average of 100 or fewer employees on business days during either of the two preceding years. If a business did not exist in prior years, the business must estimate how many employees it will use during the current year. All employees who work 1,000 hours or more per year must be allowed to participate in the simple cafeteria plan and be eligible for any benefits available under the plan. In addition, a growing small business that establishes a simple cafeteria plan is allowed to continue to participate until the number of employees reaches 200. When a company employs 200 or more eligible employees, the cafeteria plan must meet all of the usual requirements for cafeteria plans.

Simple cafeteria plans do not have to meet the non-discrimination requirements of Internal Revenue Code Section 125. One of the major restrictions on cafeteria plans under Code Section 125 that made these plans unavailable to small business in the past is the 25 percent concentration rule under paragraph 125(b). Paragraph 125(b) states that "key employee" benefits cannot exceed 25 percent of the non-taxable benefits received by all employees under the plan. The 25 percent rule is essentially waived for these new simple cafeteria plans. For example, if a business has 10 employees with four being "key employees" and six being non-key employees and all 10 employees receive the same benefits; the plan would fail the 25 percent concentration test because 40 percent of the benefits (more than 25 percent) are being received by key employees. Under the new rules, the 25 percent rule is waived or considered to be met for eligible small employers. Generally, a more than five-percent owner, an officer earning more than $160,000, and a one-percent owner receiving more than $150,000 in compensation are defined as key employees. The new rules that establish simple cafeteria plans go into effect on Jan. 1, 2011.

*Tax Planning Tip:* Since the new simple cafeteria plan is for small employers and covers all "eligible employees," this law will primarily benefit C corporations. Sole proprietors, partners and limited liability company owners appear to have been neglected by this new law since they are not "employees." Therefore, some small businesses may consider changing the form of ownership to a C corporation based on advice of their attorneys and or accountants.

## CODIFICATION OF ECONOMIC SUBSTANCE DOCTRINE

The Economic Substance Doctrine (sometimes referred to as the Business Purpose Doctrine) is a judicially created common law rule that generally provides that a business transaction whose sole purpose is to reduce federal income tax will be disallowed for federal tax purposes. In other words, business transactions must be entered into for a business reason or a profit motive, not just to reduce federal income tax. This Doctrine has been used in the past primarily to deal with tax shelters.

Since the various courts in the United States have applied this Doctrine using different tests and standards (which led to uncertainty), the Act codifies the Doctrine in new Internal Revenue Code paragraph 7701(o). The new rules are effective for transactions entered into after March 31, 2010. A transaction is considered to have economic substance if it changes in a meaningful way the taxpayer's economic position and the taxpayer has a substantial purpose (other than to reduce federal income tax) for entering into the transaction. Transactions involving forming a new business and choosing debt versus equity in financing a business should not be affected by the new law.[1]

*Tax Planning Tip*: The new law imposes a penalty of 40 percent on business transactions that lack economic substance. Therefore, taxpayers should make sure that questionable transactions are entered into for economic reasons as well as tax reasons.

## NEW MEDICARE TAXES

The Act imposes two new Medicare taxes on various taxpayers. The first new Medicare tax affects "high-income" taxpayers with wages received from employment. Any wages received in excess of $250,000 in the case of a joint return, $125,000 in the case of married filing separately, or $200,000 in the case of other taxpayers is subject to an additional Medicare tax of .9 percent. The additional tax is also imposed on self-employment income from all self-employed taxpayers other than corporations, estates and trusts. This high-income Medicare tax takes effect on income earned after Dec. 31, 2012.

The Act also imposes a new Medicare tax on unearned income. The tax on individuals is imposed at 3.8 percent on the lesser of the individual's net investment income for the year or the amount of the individual's modified adjusted gross income that exceeds a threshold amount. The threshold amount is $250,000 for a married taxpayer filing a joint return, $125,000 for a married taxpayer filing a separate return, and $200,000 for all other individuals. The new Medicare tax is also imposed on estates and trusts on the lesser of their undistributed net investment income or their adjusted gross income that exceeds the threshold amounts discussed above. This provision will particularly penalize real estate investors.

Net investment income is defined as the sum of gross income from rents, royalties, interest, dividends and annuities, minus deductions properly allocable to that income. Net investment income also includes a trade or business that is a passive activity and a trade or business involving the buying and selling of financial instruments or commodities. Finally, net investment income includes net gains from the disposition of property other than property held in a trade or business (i.e., net capital gains). Exempt from this tax is interest on tax-exempt bonds, veterans' benefits, and gain on sale of principal residence. This additional tax applies to income from transactions occurring after Dec. 31, 2012.[2]

*Tax Planning Tips*: These taxes must be included in a taxpayer's estimated tax payments, and the taxes are not deductible for federal income tax purposes. Taxpayers who have businesses that are passive but almost meet the appropriate threshold to be reclassified as active should consider altering income-producing activities to make the trade or business become classified as active. Taxpayers should also consider investing in tax-exempt bonds. Individuals who can shelter taxable income through retirement contributions should consider making maximum allowable tax-sheltered contributions to their retirement accounts to lower their taxable income levels and their adjusted gross income.[3]

## SMALL BUSINESS TAX CREDIT

New Section 45R is inserted into the Internal Revenue Code of 1986 where other business-related tax credits are discussed. Section 45R adds a credit for "employee health insurance expenses of small employers." An eligible small employer is defined for this Section as an employer with 25 or fewer employees and average annual wages of $50,000 or less. These small businesses would be eligible for a credit of up to 50 percent of the contributions the businesses make on behalf of their employees for health insurance premiums. From 2010–2013, the maximum credit is 35 percent of the employer's eligible health insurance premium expense. Beginning in 2014, the full 50 percent credit will be available. Employers will not be allowed to take both an expense deduction and the credit for the same dollars.[4]

Employers with 10 or fewer employees and average annual wages of $25,000 or less will receive the full credit. For employers with more than 10 employees or average annual wages of more than $25,000, the credit will be phased out so that employers with more than 25 employees or average annual wages higher than $50,000 will lose the credit completely. The amount of the credit is reduced (but not below zero) by the sum of the following amounts: (1) the amount of the credit multiplied by a fraction where the numerator is the total number of full-time equivalent employees of the employer in excess of 10 and the denominator is 15 plus; (2) the amount of the credit multiplied by a fraction where the numerator is the average annual wages of the employer in excess of $25,000 and the denominator is $25,000. For example, an employer with 16 employees would lose 40 percent of the available credit (16-10/15). Also, an employer with average annual wages of $30,000 would lose 20 percent of the available credit ($30,000-$25,000/$25,000). Lastly, an employer with 16 employees and average annual wages of $30,000 would lose 60 percent of the available credit (40 percent + 20 percent).

## OTHER PROVISIONS OF HEALTH CARE REFORM

### Business Information Reporting

Congress expanded the form 1099-MISC reporting requirements as part of the Act. Under the Act, all payments totaling $600 or more in a calendar year to a corporation (other than a tax-exempt corporation) must be reported to the Internal Revenue Service using form 1099-MISC. Under prior law, taxpayers were not required to provide 1099s when they paid for property or services purchased from a corporation. This new law requires reporting all payments totaling $600 or more except for payment for securities and brokerage transactions.[5] An exception is made for payments made by credit cards and debit cards. This information reporting provision could prove very burdensome for small businesses. This provision is effective for tax years beginning after Dec. 31, 2011.

### Modification of Itemized Deduction for Medical Expenses

Subsection (a) of section 213 of the Internal Revenue Code of 1986 is amended by striking "7.5 percent" and inserting "10 percent" as the new deductible threshold for medical expenses on Schedule A for itemized deductions. In other words, only medical expenses that exceed 10 percent of adjusted gross income will be deductible on Schedule A. The amendments to this subsection apply to tax years beginning after Dec. 31, 2012. The Act does give a tax break to seniors (taxpayers 65 or older) by allowing the deductible threshold to remain at 7.5 percent for tax years from 2013 through 2016.

### Limitation on Health Flexible Spending Arrangements

The Act established a new uniform standard that, effective Jan. 1, 2011, applies to Flexible Spending Arrangements (FSAs) and Health Reimbursement Arrangements. Under the new standard, the cost of an over-the-counter medicine or drug cannot be reimbursed from the account unless a prescription is obtained. The change does not affect insulin, even if purchased without a prescription, or other health care expenses such as medical devices, eyeglasses, contact lenses, co-pays and deductibles. The new standard applies only to purchases made on or after Jan. 1, 2011, so claims for medicines or drugs purchased without a prescription in 2010 can still be reimbursed in 2011, if allowed by the employer's plan. In addition, the Act lowered the maximum contribution to an FSA from the current $5,000 per year to a maximum of $2,500 per year. This $2,500 maximum is effective for tax years beginning in 2013. The maximum amount is adjusted for inflation in 2014 and later years.

### W-2 Reporting

The Act requires an employer to report on each employee's W-2 form the value of the employee's health insurance coverage provided by the employer. The employer must include not only health insurance, but also must include dental coverage and vision plan coverage. To calculate the value of the health care coverage, the employer would use the value of equivalent COBRA coverage. This provision is effective beginning in 2011.[6]

### Implementation Schedule of Selected Tax Changes:

**2010** Small business tax credit
Economic substance doctrine codified

**2011** W-2 reporting of health insurance coverage
Simple cafeteria plans

**2012** 1099s for payments to corporations
Adoption credit expires

**2013** 3.8 percent Medicare tax on unearned income
.9 percent Medicare tax on high-income taxpayers
Decrease in flexible spending arrangement maximum

**2014** Excise tax on uninsured individuals
Employer health coverage penalties

**2018** Tax on high-cost employer plans

## CONCLUSION

This article summarizes some of the changes in the Patient Protection and Affordable Care Act of 2010 and the Health Care and Education Reconciliation Act of 2010. The focus is on the changes that would directly or indirectly affect real estate investors and/or small businesses. The author sees no movement toward tax simplification by the U.S. Congress and the president. These new laws create greater tax burdens and greater reporting burdens on numerous taxpayers. Real estate investors and small business owners should review the new laws to determine how the new rules will affect their tax burdens and business operations. In fact, a law as complicated as this Act commands a great deal of study by investors and small business owners who desire to maximize returns and minimize the tax burden while being mindful of the Economic Substance Doctrine discussed above. Taxpayers should consult with appropriate tax professionals to assure proper application and maximum benefit from this new tax Act. ■

## ENDNOTES

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FEATURE

# Government Property Assets in the Wake of the Dual Crisis in Public Finance and Real Estate: An Opportunity to Do Better Going Forward?

BY OLGA KAGANOVA, PH.D., CRE, FRICS

## INTRODUCTION

It is well established that governments of all levels, including state and local governments in the United States and European Union countries, control large and diverse portfolios of real estate, infrastructure, movable property, and business interests. Unfortunately, any systematic data on the size and composition of government property and business holdings is still lacking or not disclosed to the public in most countries, and the holdings can be strikingly large. Occasional data assembled over the past decade confirms that government property assets constitute a very substantial share of public wealth in most countries, and in former centrally planned economies, these assets often make up the lion's share of public wealth (for illustrative examples of typical cases see Table I).

*Table I*

Examples of Capital Assets Value on the Balance Sheet of Local Governments

| Asset Type | Los Angeles County (U.S.) | Warsaw (Poland) |
|---|---|---|
| Total assets (financial and capital) | 100% | 100% |
| Capital assets, total | 67% | 94% |
| *Including:* | | |
| Land and easements | 28% | 80% |
| Building, improvements | 15% | 8% |
| Infrastructure | 20% | |
| Equipment | 2% | Not available |

*Source: County of L.A. Comprehensive Annual Financial Report, 2009; Prospectus, City of Warsaw, March 2009; Report Municipal Assets of City of Warsaw, 2009.*

It is also clear that government land and property assets can be very important for many public management objectives, including spatial development of cities, infrastructure finance, local economic development, local housing policies, and efforts to curb corruption. Moreover, recent research identified multiple risks associated with a lack of proper asset management, along with the negative implications of these risks—from substantial financial losses to public budgets to non-sustainable housing policies.[1] In practice, many municipal and regional governments are moving to better management of property assets, in particular, by consolidating this function within a specialized department or assigning some functions to a specialized corporate-type subsidiary.[2]


About the Author

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However, in many governments, there is still a persisting and substantial discrepancy between the multiple benefits that good asset management can generate and the insufficient attention it receives. One of the acute problems, even in developed countries, is that asset managers, being under constant pressure to cater to immediate needs of their governments (reaching revenue targets for a city annual budget), cannot focus on introducing a strategic, long-term approach. Even in the United Kingdom, where systematic nationwide efforts to improve asset management in local governments have been made since the early 2000s, including incentives for developing strategic asset management plans, the Audit Commission found in 2009 that *only one in 14 councils is an exemplary manager of its assets.*[3] This article focuses on property of sub-national governments, though most problems are similar for central (federal) governments as well.

## WHERE ARE GOVERNMENT ASSETS WITHIN THE PUBLIC MANAGEMENT LANDSCAPE?

### Invisible Treasure, Unknown Liability

Governments own property and infrastructure for performing their functions (such as delivering public and social services or being guardians of property that is preserved for future generations), and for a whole host of other reasons. For example, governments can hold properties accumulated historically "by default" (tax foreclosed properties), as symbols of power and prestige, or for income generation. The latter often implies holding not only real estate, but business interests as well (liquor wholesale and retail in several states in the U.S., lotteries, real estate companies owned by cities in Eastern Europe, etc.).

Paradoxically for public management as a whole, property assets, despite being the major part of public wealth, often are the least visible and recognizable in government systems. Indeed, not all governments, even in developed countries, have reasonably accurate, complete and available (for decision-making) information on the amount and value of real estate they control and on transactions with these properties. For instance, in the U.S., *nearly half of the states and Washington, D.C. do not have the basic property and asset data*.[4] Moreover, transparency in this area is often lacking; the public does not have access to such information even when it exists. This is quite different from, for example, budgetary information, which is easily available in developed countries.

Lack of transparency is a symptom of a deeper problem: management of government property assets is often associated with lack of explicit policies and with insufficient regulatory frameworks, which opens the gate for short-sighted and often unqualified, if not corrupt, government practices. This lack of basic good governance also leads to encumbrances on assets and government liabilities that are neither recorded nor disclosed properly. The fact that governments are much less regulated in what they may do with property assets than in their borrowing activities can be illustrated by the following comparison: practically all developed countries have debt ceilings for sub-national (i.e., state and local in the U.S. context) borrowing prescribed by law, while restrictions on "excessive" sales of government property assets usually do not exist (except in some European countries).

Further, recognition of economic value[5] of government property remains a conflicted issue. On the accounting side, only a few countries such as New Zealand, Australia and the U.K. have moved consistently towards recognizing the market (or similar) values of government assets within accrual accounting. Sub-national governments in most countries, including Canada and the U.S., continue recording land at historic costs, which often leads to a major underestimation of what governments own. Furthermore, even in transactions (sales, transfer to subsidiaries), land can be transferred without acknowledgement of its economic value, especially in transactions with other public entities or public/private partnerships (PPPs). At the same time, the economic value of property assets is often utilized in complex off-balance sheet transactions such as sale-leaseback. Finally, in many countries (most of Eastern Europe), government business interests in companies are accounted for by the companies' capital and shown at this value on the government balance sheets as long-term investments, while land and property holdings by these companies are not presented in government financial reporting at all.

Moreover, not only economic value but liabilities as well cannot be fully recognized or quantified. For example, in Canada, government-owned land sites are often contaminated and, if so, they usually cannot be disposed of without spending on cleanup. Meanwhile, the amount of this liability for each particular government cannot be exactly known.

How deeply the ignorance of government assets is ingrained in financial systems is illustrated by the fact that creditworthiness ratings of governments issued by credit agencies usually do not depend on assets owned by the government.

On the policy side, governments in many countries have been giving land for private uses for free or with discounts, for fulfilling various government strategies, policies or informal ambitions. This translates into explicit or hidden public subsidies for such projects. It would be a mistake to claim that this happens only in emerging markets and just because of a lack of recognition of property values. There are many examples that clearly illustrate that this can be a result of conscious public policy. For instance: contribution of government-owned land for building stadiums for private sport teams in the U.S.; multi-criteria performance management at governmental land corporations in Canada, which combines profit and social goals or contribution of municipal land to some land development corporations at historic cost; and land price discounts given to certain types of buyers of municipal land in South Africa.

A legitimate concern about such policies is that their full costs to taxpayers often remain unknown. For example, municipal land sites can be contributed to a municipal land corporation tasked with redeveloping derelict urban areas, including new transportation infrastructure and affordable housing. This land is transferred to the corporation at its historic cost and should be later repaid to the city at this cost. In such a case, the recognized costs of this redevelopment project and the repayment to the city (i.e., to general taxpayers) omit and forgo the economic value of the land.

### Fiscal Implications

Government property assets are directly linked to public finance in many ways, some of them obvious. For example, an acquisition of a property asset implies, on the public finance side, such elements as capital investment planning, capital financing and capital budgeting. Despite this, traditional public sector financial and budgeting systems are not well suited to reflect these links.[6] Moreover, there are documented cases (examples follow later in this article) illustrating that the existing budgeting systems and related regulations sometimes prevent implementation of rational financial solutions related to government real estate.

For financial decision making, governmental assets should be considered from two viewpoints. First, there are potential budgetary gains that can be obtained through better asset management. The four-quadrant scheme presented in Table II shows sources of some revenues and savings that public budgets often forgo.

*Table II*

## A Budgetary Viewpoint: Main Revenue and Saving Opportunities Related to Property Assets

| Sources of Forgone Revenues | Potential Savings on Expenses |
|---|---|
| **Operating**<br>■ Hidden price subsidies to private lessees / users of municipal property (land tenants, retail tenants, non-governmental organizations)<br>■ Rent collection below the private sector benchmarks | **Operating**<br>■ Maintenance and operation of municipal real estate and infrastructure is one of the main expense items of municipal operating expenses (in Germany, it's second only to salaries; in Warsaw, it's about 12-20% of city's total operating expenses). Optimization of management can save 10-15% of this cost (or 1-2% of the operating budget, without even reducing the property holdings or outsourcing maintenance and operations to the private sector)<br>■ Further savings through rationalizing property portfolios<br>■ Moving to own buildings instead of leasing space at private properties can be justified, in the long term, in some cases |
| **Capital**<br>■ Losses due to land / property sales at the bottom of the real estate market<br>■ Undisposed surplus properties | **Capital**<br>■ Higher efficiency of capital project implementation and replacement of public expenses by private investment and finance, through PPPs<br>*Example: A public garage delivered by a private developer in exchange for the right to use a government land site for mixed-use development* |

Besides potential budgetary gains such as illustrated in Table II, it is critical to point out that national and sub-national capital assets often suffer, on a grand scale, from chronic budget underspending. This happens through deferred maintenance and, more broadly, deferred investment—just because these expenses have been sacrificed regularly, as a response to pressures on public budgets. Aggregate data for municipal- and state-deferred investment in the U.S. was not found, but the authoritative Canadian report on the subject, symptomatically entitled "Danger Ahead: The Coming Collapse of Canada's Municipal Infrastructure,"[7] estimates the deferred investment in the *municipal* infrastructure alone (i.e., water / wastewater, local transportation, transit systems, and local government, cultural, social and recreational facilities only) as $123 billion by 2007, and constantly increasing. The report indicates that conditions and age of infrastructure are similar across all of North America. Reports regarding state-level infrastructure in New York and California convey similar concerns.[8]

In addition to budgetary considerations, the second viewpoint from which government property should be considered is that of the balance sheet. In particular, rebalancing the asset portfolio—for example, through disposing of surplus land and reinvesting in public infrastructure—can be a prudent and often overlooked way of funding infrastructure, replacing, at least partly, borrowed funds.[9] Further, property assets can be directly related to government liabilities. Thus, in many countries—from Norway and Denmark to Poland and China—government property is used as collateral for municipal borrowing. Less explicit government liabilities associated with properties are often linked with some other forms of public borrowing, in particular in the U.S. For instance, certificates of participation (COPs) are a type of financial scheme based on complex leasing agreements used for issuing off-balance sheet revenue bonds.[10] However, COPs usually establish governments' long-term lease payment obligations, similar to sale-leaseback deals, and early termination could result in a government's large financial loss. Neither a number nor value of government properties tied into such borrowing schemes is usually known to policymakers or the public. Further, the economic value of some other, also unknown, portion of government buildings and facilities is already utilized through sale-leaseback deals or simply long-term leases to private lessees, both for one-time, upfront payments. Obviously, in exchange for generating these one-time revenues, the properties are encumbered by contractual (i.e., binding) long-term payment obligations for government agencies involved.

### Intrinsic Uncertainties

Usually, there are no hard rules or legally binding requirements for the quantities of many governmental services or public goods that require property. Therefore, the composition, size and quality of property holdings that governments have depend, to a very large extent, on traditions and values of the society and sheer historic accidents. Moreover, these services and related property portfolios obviously depend on fiscal conditions in a particular jurisdiction, as discussed below. Hence, the services and portfolios can change. Indeed, how many parks, playgrounds, libraries, golf courses, etc.—and which ones—should a local government have and maintain?

## THE CURRENT INTERNATIONAL CRISIS OF PUBLIC FINANCE: ITS IMPACT ON GOVERNMENT CAPITAL ASSETS

### Key Features of the Fiscal Crisis at Sub-national Governments

Typical, often interrelated, elements of the crisis are as follows:

**Deficit of current (operating) budgets**. The deficit is caused by a decline of tax-based revenues (due to either the economic downturn or the reduction of real estate values underlying the property tax, or both), on one hand, and increased demand for certain social programs (unemployment benefits) on the other. For instance, in the U.S., the estimated deficit of state and local operating budgets is about $39 billion in 2010, and $124 billion in 2011.[11] Obviously, the situation varies across jurisdictions.

**Loss of investment capital.** Sub-national governments that can invest in financial instruments lost capital in the financial market crash in 2008–2009. In the U.S., even the most prudent investments lost, by late 2009, from 20–25 percent of their value. In the U.K., the estimated loss of local governments is about 1 billion euro.[12]

**Breakdown of the U.S. and European systems of sub-national lending and borrowing.** Simple systems of fixed-rate long-term municipal bonds (U.S.) or loans (Europe) gave way to complex financial instruments such as financial derivatives known as municipal interest-rate swaps, which promised—and delivered for awhile—a lower cost of borrowing compared with the traditional fixed-rate instruments.[13] Governments were not qualified to estimate risks of using these potentially "toxic" instruments, and as a result of the global financial crisis, sub-national governments in the U.S., France, Germany, Belgium, Poland and Italy face accelerated payment schedules associated with their debt or contingent liabilities they never expected to materialize. In Italy alone, approximately 500 cities and towns face losses of nearly $1.4 billion on derivative contracts, outstripping gains by 11 times.[14] In the U.S., it is expected that the number of defaults on municipal bonds will increase,[15] but in the meantime, hundreds of government and non-profit borrowers have bought themselves out of their swap deals since 2008, at the total cost of more than $4 billion of taxpayers' and clients' money paid to lenders for swap termination.[16] The cost of borrowing for sub-national governments increased in most countries.

**Long before the crisis: overstretched spending and borrowing (U.S.).** Like many citizens, many sub-national governments in the U.S. have been spending beyond their means for a long time. Here is how the U.S. Government Accountability Office describes the situation:[17]

> *State and local government total general expenditures (capital and current) grew slightly faster than total general revenues—both own-source and federal grant revenues—in most states during the period from 1977 to 2007. In addition, state and local government current expenditures grew faster than own-source revenues in almost all states between 1977 and 2007. The state and local sector as a whole generally avoided operating deficits despite current spending growing faster than own-source revenues in part because the growth in federal grants for the purpose of funding current spending somewhat exceeded the growth in current spending. In addition, from 1995 to 2007, the sector increasingly financed capital purchases by issuing debt, rather than with revenues, which left more revenues available to pay for current expenditures.*

In particular, the outstanding debt of state and local governments, after being relatively stable during the 1990s, rose from $1.19 trillion in 2000 to $1.85 trillion in 2005, and $2.31 trillion in 2009. Roughly about 40 percent of this debt is in general obligation bonds that are usually subject to legal ceilings and require public approval. The other 60 percent are in revenue bonds, which are not subject to these restrictions and often constitute off-balance-sheet liabilities.[18] Besides, many states have unfunded obligations for the future, such as pensions of governmental retirees.

All the above, combined, put substantial fiscal pressure on many sub-national governments and limit their ability for continuing "business as usual," including the pre-crisis pace of borrowing for capital investment. In addition, in several countries including the U.S., uncertainty regarding the dynamics of future central (federal) government transfers to sub-national governments makes the sub-national public finance even more daunting.

### The Impact on Capital Assets: Now and in the Future

Government capital and intangible assets (companies) are getting pulled into attempts to address fiscal problems that many national and sub-national governments experience. Sales of property assets and business interests for paying off government debts have been used in the past. Similarly, they should be a part of the solution this time as well, given how much wealth is concentrated in them. However, the issue of concern is whether these assets will be tapped strategically and prudently—or wasted.

The unfolding impact of the crisis on government real estate, infrastructure and services associated with assets has two sides. On one hand, the fiscal crisis on all levels of government amplifies the risks to which the assets are subject even in better times, and converts some of the risks from possibilities into grim realities, as illustrated below. On the other hand, the crisis opens dormant opportunities, in particular, for capital assets to become better integrated in public financial management. Outcomes will depend on many factors and can potentially range from devastation of public wealth to healthier, in the long term, sub-national finance. Without doubt, the outcomes will vary from country to country and even among sub-national governments inside one country, including the U.S. They also will have an impact on the competitiveness of countries, regions and localities, and on the quality of life. In particular, on the public services side, it is likely that the crisis will accelerate reduction of some services—the process that has been quietly brewing even before this crisis.

A positive development is that the crisis sparked interest in government assets among organizations that can help promote good practices. For example, in 2010, the California Association for Local Economic Development developed and offered to its members—local governmental agencies—a workshop on asset management issues.

Here are the key elements and implications of the crisis' impact on government assets:

**A decline of planned land sale proceeds.** Those governments and agencies that perform regular planned land sales suffered from the combined effects of the financial and real estate crisis. For example, the Arizona State Land Department land sale revenues have been sharply declining after peaking in FY 2007, so that in FY 2010 they are expected at about eight percent of the 2007 amount.[19] Similarly, sales on municipal land auctions in 2009 in Warsaw, Poland, crashed compared with 2007, including both sales volume and prices.

**Spotlight on a mismatch between public budgetary systems and good asset management.** The crisis certainly shed more light on this structural problem within public management: public budgetary systems (more precisely, the regulations and practices) often do not support—or sometimes even directly obstruct—strategic and efficient asset management and lead to systematically unhealthy practices. For example, in March 2010, the General Service Administration (GSA) testified to the U.S. House of Representatives Committee about the accelerating non-sustainability of GSA's funding system.[20] The core problem is that the budgetary rules, coupled with chronic underfunding by congressional appropriations, force GSA into the use of long-term operating leases, while a more economically viable option would be lease-purchase. Since 2008, the size of space leased by GSA for governmental operations has exceeded the size of the space owned. This continuing decrease of the share of the owned space further erodes the ability of the Federal Building Fund, which accumulates payments of governmental tenants for space and is supposed to fund GSA capital investment, to fulfill its function. Resulting underinvestment in maintenance and repair makes GSA buildings unattractive to government tenants, and they move to leasing space on the private market. This, in turn, increases vacancies at GSA properties and further diminishes revenues of the Federal Building Fund, transforming the whole process into a vicious circle. The GSA testimony practically conveyed a message that GSA was approaching the breaking point of being not able to deliver on its mandate.

Another example, from Poland: municipal land managers in Warsaw have been under pressure to sell land in order to reach annual budget targets for land sale revenues, despite an obvious real estate market crash.

It may be useful to note that when land is managed by a specialized entity that has some degree of separation from government, this provides a certain level of protection for land assets from being disposed of without long-term planning, or at a wrong time.[21]

**Fire sales.** Under pressures of the fiscal crisis, governments attempt to generate some revenues by disposing of a wide range of assets, despite obviously bad timing for the disposition of most properties, given the real estate crisis. Assets slotted for sale vary from income-generating businesses to infrastructure to real estate, including sale-leaseback of government-occupied buildings. The process seems to be especially large-scale and visible in Europe. For example:[22]

- *Ireland*. In July 2010, the minister of finance appointed a commission tasked to examine and recommend by the end of the year possibilities for the disposal of: (1) 28 commercial companies fully or partly owned by government; and (2) intangible assets such as the radio spectrum allocated for broadcasting and telecommunications, carbon emissions permits, and mineral, hydrocarbon and other licenses issued by the state. The companies in question range from the country's transportation infrastructure (ports, airports, bus and rail) to energy infrastructure to horse breeding and greyhound racing.
- *The U.K.* The government indicates intentions to sell, over the next 10 years, a broad mix of assets including infrastructure and student housing.
- *France*. The budget minister has announced a plan to sell six percent of the government's total building stock over the next three years, or 1,700 of the government's 28,000 property assets. This includes 750 buildings from local and decentralized services.
- *Germany.* A specialized unit responsible for the disposal of state-owned properties intends to sell about half of its 6.8 billion euro portfolio within the next five to six years. The rest of the portfolio is considered generally less marketable According to CB Richard Ellis, the agency has had a notable presence on the real estate market in Europe during the past four years, making up from two percent to 2.5 percent of all European public sales, with its share of sales rising to four percent in 2010.

Obviously, attempts to sell quickly at the bottom of the real estate market lead to diminished revenues, as in the example with Warsaw land sales. Further, given their massive offers, governments quite realistically start to compete with one another and with the private sector.

Many transactions are becoming very politicized and subject to pre-election demagoguery, be this an intention to privatize the liquor wholesale and retail business in Virginia (currently the state monopoly) or sale-leaseback deals with government buildings in Arizona and California.[23] However, politicking aside, sale-leaseback deals may have an important public finance aspect that deserves an open and honest discussion. In many cases, these deals would lead to gaining cash now at the cost of losing on net present value in the long term. Consider the case of the "Golden State Portfolio" offered by California for a bid in spring of 2010. The portfolio had 11 state-owned and government-occupied buildings in Los Angeles, Sacramento and San Francisco, with 7.3 million square feet of office space. From information available, it appears that the deal, as the government offered it, would supply the state with up-front cash to pay off some construction bonds and invest in capital projects, but would cost more over the 20-year contract period compared with the option of continuing governmental ownership. Such situations with sale-leaseback deals are not always the case,[24] but when they emerge and if they become known to the public, they often stir up public controversy, despite the fact that in terms of long-term impact on taxpayers, these deals can be no worse than the alternative of continuing to own the buildings but also continuing standard municipal borrowing.

Further, some current sales indicate desperation. For example, the Italian town Recanati, caught in the unexpected pay-now liability resulting from its derivatives deals, rezoned for development and sold off park land and a public kindergarten—transactions it hardly would perform in normal circumstances and which normally would be considered asset-stripping.[25]

Furthermore, the sale rush increases the risk of governments' entering badly structured deals, especially in such complex cases as sale-leaseback for real estate, or PPPs for infrastructure and utility companies. For preparing a reasonable deal and good-quality procurement, about six to 12 months are needed along with specialized expertise representing government's interests. Attempts to move faster or cut costs will, most probably, lead to losses for taxpayers.

Last but not least, properties disposed of in fire sales are often (if not as a rule) selected haphazardly, without strategic planning and sufficient professional considerations. This unavoidably will lead to negative implications in the future, including the future public costs.

**How will sale proceeds be spent?** One of the biggest asset-related risks of this crisis is that the land and income-generating assets will be converted to a one-time cash injection without improving the long-term financial standing of government and without other assets (infrastructure) created. In practice, main uses of sale proceeds include: patching operating budget deficit; paying contingent liabilities; paying-as-you-go for capital investment projects; and paying off long-term debt. The first of these options would be *the worst* public outcome imaginable; worse, in general, than uncontrolled borrowing for capital investment. Public assets that should be passed on to the next generation are exchanged for current consumption. The second option seems to be not much better. However, in the current fiscal crisis, both options will be proposed and implemented in some jurisdictions (see the example with the town of Recanati above).

Spending sale proceeds for paying off long-term debt or for capital projects on the pay-as-you-go basis are the options that can and should be a part of a prudent fiscal policy. This assumes, of course, that paying off the long-term debt is a part of a broader fiscal and austerity policy that prevents government from falling into over-borrowing again.

**Reduction of operating, maintenance and recapitalization budgets associated with property and infrastructure assets**. There are countless examples of this crisis-induced process, from libraries and even schools operating on part-time schedules, to reduced or suspended maintenance and repair of public facilities—in addition to the chronic deferred maintenance discussed above. Obviously, this accelerates a decline of the aging facilities, which implies that more funding would be needed for their rehabilitation in the future.

On the positive side, the crisis forces governments to think creatively, and some constructive solutions are surfacing as a result. These include consolidation of services geographically and administratively, new ways to reduce operating expenses (use of inmates for cleaning public facilities), etc.

In the longer term, the current crisis may lead to certain redistribution of responsibilities for service provision between local governments and localized (sub-municipal) initiatives. This would imply further proliferation of instruments of sub-municipal services, through the mechanisms that are already used quite broadly, at least in the U.S: business improvement districts (BIDs), tax increment financing (TIF) districts, homeowners associations (HOAs) and community facility districts (CFDs).[26]

**Reduction of government property holdings in the longer term**. In some instances, the crisis and a grim outlook for public spending on property operation and maintenance in the foreseeable future will force politicians and decision-makers to recognize the fact that many government asset managers have been signaling for a long time: a chronic shortage of funding for operation, maintenance and recapitalization of some portfolios cannot be sustained any longer. The only available solution is a reduction of the portfolios through a combination of disposal of (sale or lease) and mothballing some properties in these portfolios.

Establishing targeted sectors/portfolios for these measures is a big issue for policy decisions, and one can expect that answers will vary among countries and sub-national governments. In general, this is the area where reduction of norms, formal and informal, regarding provision of public goods and services, along with governments' use of properties for their operations, can be expected. This, in turn, would lead to redefining what the core assets are and what should be declared surplus in each property class or under each managing agency. In the best case, such a shift of the norms for government property consumption, if needed, would be based on evidence-based careful strategic considerations of costs and benefits, after *unified, cross-agency* (and *cross-portfolio*) analysis. However, given how institutionally fragmented government asset management is, it would be overly optimistic generally to expect such a whole-of-government approach. Moreover, there is a risk that government bureaucracies would make some effort to shield the properties they use themselves from application of austerity and downsizing measures, while pushing the burden on public-use and fiduciary properties. In North America, one can suspect that after easy targets—like vacant school buildings in neighborhoods with changed demographics—are gone; government-owned parks and historic properties might be among the first portfolios to experience direct downsizing.

Where the whole-of-government optimization of the portfolios is not feasible, the next best option would be making rational decisions within each agency. Not all agencies are prepared to make such decisions. This makes dissemination of good methodologies for prioritizing properties in large portfolios developed by some agencies (e.g., by the U.S. National Park Service and Parks Canada) critical for preventing expensive or irreversible mistakes.

**Reduction of public capital investment in the short and middle terms.** Similar to reduction of property-related operating expenses, new capital investment has been postponed or canceled in countless instances, often through 2014 or so. It remains to be seen for how long this decline will persist.

### WHAT WOULD BE A PRUDENT ASSET MANAGEMENT POLICY IN THE WAKE OF THE CRISIS?

For exiting the current public sector fiscal crisis and once it is over, government capital assets should be incorporated in overall policy and solutions in a more systematic and substantial way than they have been in most countries so far. In particular, the governmental financial practices and regulations that conflict with good asset management must be modernized. However, no prudent decisions can be made if governments do not know what they own: "What cannot be measured cannot be managed." Therefore, starting from the basics is critical.

Furthermore, for stabilizing the public finance in the long term, governments need policies addressing the fundamentals that deal with sustainably balancing taxation, spending and borrowing, all of which is well beyond management of government property assets per se.

Nevertheless, there are some policy, regulatory and technical actions associated with assets that are reasonably realistic to implement and can contribute to exiting the crisis:

1. Review outdated laws and regulations and modernize them in a way that would allow for more effective and efficient management of government assets, including removal of obstacles for private sector participation. This need for modernization exists in most countries, including the U.S.
2. Introduce binding policy requirements/regulations that would limit bad practices at governments and would increase chances that the economic value of government assets is recognized and used properly. Many of these rules can be introduced by sub-national

legislators for their respective levels of government and for subordinated lower-level governments. In particular:

- Establish incentives (for example, through conditions attached to inter-government transfers from a higher level of government) for sub-national governments to inventory their assets and asset-related liabilities within some unified format and develop a strategic asset management plan.
- Make it obligatory to estimate the economic value of government land/property before *any* transaction with this land/property can be approved, even if the transaction is between two government agencies or the government and its subsidiary. This should be required for management purposes, even if accounting practices do not require market valuation of assets. Any disposition decisions should take the economic value of the asset into consideration, to better reflect the full cost of projects or activities in which government land/property is involved.
- For transactions that impose long-term obligations on a governmental partner (sale-leaseback deals), require preparation and presentation of a net present value or another form of cost-benefit analysis before the transaction is approved.
- Make mandatory the transparency of any deals with government-owned property assets, including complex transactions like sale-leaseback and borrowing schemes (e.g. OP), regardless of on-off-balance-sheet status. As an instrument of such transparency, establish centralized depositories of data—at the municipal or regional (state) level—on transactions with government property.
- Introduce the requirement that net revenues from disposing of capital and intangible assets (companies) be earmarked for capital expenses or paying off long-term debt.[27] Exclusions can be made, if needed, for a pre-defined period of exiting the crisis. Establish a "time-to-market" approach to disposition of government property. In particular, give asset managers flexibility to postpone or reduce sales when the real estate market (or any other relevant sector of the market) is down. Furthermore, for protecting the government capital budgets from these fluctuations, establish a special budgetary infrastructure fund, which will accumulate the earmarked disposition revenues on a multi-year basis and release them to the capital budget evenly, thus serving as a buffer between the market and the budget.

3. Require that property dispositions be planned and conducted within approved strategic asset management plans that take into consideration all capital and intangible assets of the particular sub-national government.
4. Modernize and deepen approaches to financial planning at governments. In particular, in the U.S., the Government Financial Officers Association promotes long-term financial planning, which "*combines financial forecasting with financial strategizing to identify future challenges and opportunities, causes of fiscal imbalances, and strategies to secure financial sustainability.*"[28] The strategies considered within this approach should incorporate deployment of government land assets (and other possible land financing instruments), in addition to traditional borrowing or instead of it.
5. As a subset of the previous item, it would be useful to expand existing models that simulate various scenarios of public revenues, expenses and borrowing by adding an explicit component related to capital assets.
6. Provide governments with more guidance on property asset management. In particular, exchange of knowledge and good practices needs to be facilitated and intensified substantially: internationally, regionally, across and within agencies.

## CONCLUSION

Government-owned property assets can be a part of long-term solutions for exiting the current fiscal crisis. Furthermore, the current crisis may stimulate better integration of government property assets with public financial management in the future. Absent the necessary improvement to asset management practices, one would foresee a loss for taxpayers of a substantial part of the public wealth accumulated in government property or, worse, creation of new liabilities for the future.

Good management of government property assets is a highly technical area and requires professional real estate expertise, along with knowledge of specific tools such as

PPPs. Given how large and complex government property portfolios are, it is impossible to overestimate a role that "elites" of the real estate profession could play in various countries. In the U.S., it would be worthy for The Counselors of Real Estate® (CRE®) and members of the Royal Institute of Chartered Surveyors (RICS)-Americas to consider what these and other professional organizations can do to help all three levels of government in the country—and colleagues working in governments—make the best use of government assets. The experiences of RICS in these matters in the U.K. can provide useful insights. One of the obvious elements would be facilitating professionalization and de-politicization of the public debate on this subject. Another domain of huge untapped potential is international knowledge exchange on the subject. Here, the cooperation of CRE and RICS with academic organizations such as the American Real Estate Society, its international offspring and international donor organizations could, perhaps, be productive. ■

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# Timing the Market: You Don't Have to be Perfect

BY RANDY I. ANDERSON, PH.D., CRE; AND JOSHUA A. HARRIS, MBA, CAIA

## INTRODUCTION

It is widely accepted and known that macroeconomic cycle conditions directly affect the returns and cycle conditions of commercial real estate (Pyhrr, Roulac and Born, 1999). As macroeconomic conditions improve or deteriorate, fundamental demand for commercial real estate will react, thus affecting returns, and often, prices. As such, investors should pay attention to the current state and expected states of the economy and underlying real estate markets when acquiring or disposing of real estate assets. Our analyses show that a bottom in real estate prices and returns can occur after the bottom of the macroeconomic cycle occurs;[1] as such, investors can profit by using all available economic and real estate information to make buy and sell decisions. Is there an optimal strategy to time purchases and dispositions based on changes in the real estate or macroeconomic cycle?[2] What is the real impact on returns by being invested during the different macroeconomic or real estate cycles? This article examines these questions by simulating the performance of a real estate investor who invests in the National Council of Real Estate Investment Fiduciaries (NCREIF) Property Index (referred to as the NPI) during various times and holds for various lengths during the past thirty years.[3] We run simulations using both time frames from the macroeconomic cycle and the real estate cycle. We do this for two reasons: one, comparing the results can give investors an honest perspective of how real estate performs during and after recessions, something that may have great value at present times; and two, we want to adequately show the potential benefit of actively timing the real estate market relative to a benchmark that is moving dynamically as well. In our analyses we first show that a simple buy and hold strategy produces an economically significant 8.18 percent annualized total return over the 30-year time span of 1980–2009. Second, we show that investing after recessions but liquidating at predetermined times (ten, seven and five years) can produce highly volatile[4] returns (as high as 13.38 percent to as low as 1.42 percent in annualized total returns) and thus, no discernable pattern emerges. Since the ability to refinance or sell a property is determined in part by macroeconomic and real estate cycles,[5] we strongly urge investors to cautiously take on leverage that can force exits or demand refinancing at such predetermined intervals; this can


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destroy returns even if the investment was made at a relatively low price. Finally, we simulate returns of various strategies based on the peaks and troughs of the real estate cycle that occur near the '91 and '01 recessions. Without need of exact timing, investors could have realized returns 200–300 basis points higher on average than with the simple buy and hold strategy. In fact, investors can be off by as much as a year from the bottom and a year from the top during acquisition and disposition. This is critical as actual tops and bottoms are not observed or recognized until long after they have come and gone. In fact, official announcements of macroeconomic peaks and troughs by the National Bureau of Economic Research (NBER) typically lags several quarters; thus, approximate timing is the best anyone can actually use.

In sum, investors should obviously spend a significant portion of their time and resources selecting the right properties in the right markets. However, our results indicate that timing entry and exits based on macroeconomic and real estate cycles can both enhance returns and reduce risk; thus, investors should also expand resources to monitor macroeconomic and real estate cycle metrics.

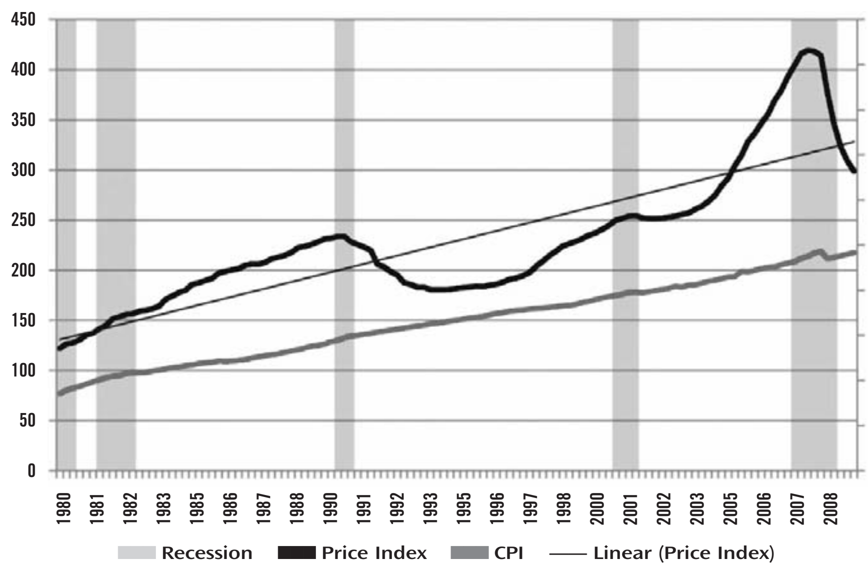
## DATA

The primary source of data used to measure returns on investment commercial real estate was the NPI as published by NCREIF. The NPI is constructed using the results of surveys of NCREIF members on the performance characteristics of their real estate holdings. The NPI is composed of data on office, industrial, retail, multifamily, and hotel properties and is generally considered to gauge the performance of "institutional investment grade" properties; meaning the NPI is generally representative of the holdings of institutional investors who typically purchase properties in large markets and of relatively high quality. The NPI is further broken into price and income return indices as well as the combined total return index; we will utilize the price and total return indices for this study. The dates and lengths of macroeconomic recessions are from the NBER's Web site. The NBER is the official organization charged with the duty of determining and dating peaks and troughs of the macroeconomic cycle in the United States. The time frame for all data and analyses in this article is from the beginning of 1980 to the end of 2009.

Figure 1 shows the NPI price return index values (along with its historical trend line) over time, along with shaded bars indicating recessionary periods. Additionally, we have charted the Consumer Price Index as reported by the U.S. Bureau of Labor Statistics, which is generally regarded as a good measure of inflation.

*Figure 1*

NPI Price Index




*Source: Anderson and Harris, NCREIF, NBER, and BLS 2010*

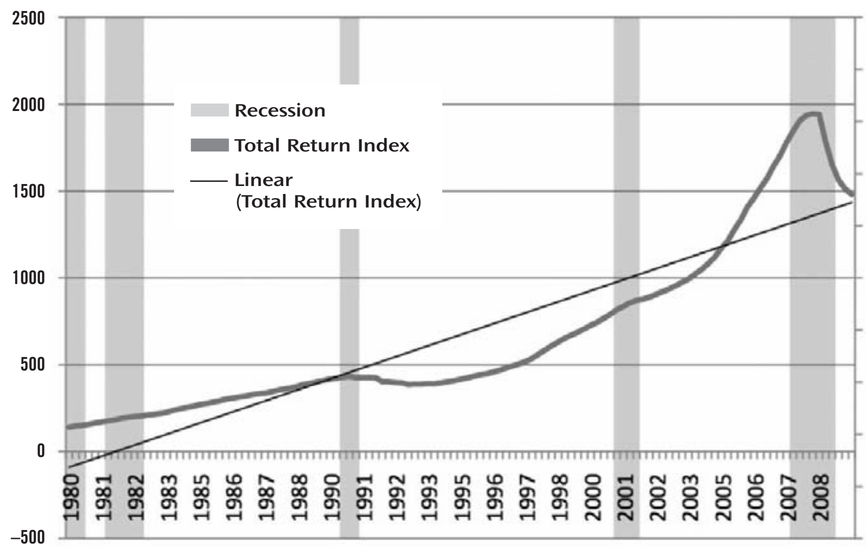
As can be seen from Figure 1, recessions are generally associated with declines, or at least plateaus, in the NPI price index. The recessions of the early '80s are the exception, where real estate prices rose due to catalysts such as high inflation and unique tax rules that favored investment in commercial real estate (many would be repealed by the Tax Reform Act of 1986). What is particularly compelling is that the price index shows mean-reversion in that there is an average long-term growth rate to which prices tend to revert. As a market begins to overheat, prices tend to move above the trend line and when markets decline, the decline is greater than that suggested by the trend. As such, simple guides such as this can be useful for investors in assessing pricing risk.

## SIMULATION ANALYSIS

To assess what an investor could have earned over various time periods during the last 30 years, we conduct simulation analyses using the NPI data for price and total returns. The NPI is reported quarterly and represents the unlevered rate of return on the underlying assets of the reporting NCREIF members. Because the NPI is unlevered, all our analyses also will represent unlevered returns. In practice many investors often employ varying degrees of leverage to enhance returns and acquire more real estate. Such actions would magnify, both to the upside and the downside, the returns presented herein. Accordingly, the risk of such investment would also be magnified and thus a levered investor may experience loan default and lose his or her entire investment, whereas an unlevered investor may only experience poor performance.

*Figure 2*

NPI Price Index




*Source: Anderson and Harris, NCREIF, NBER, and BLS 2010*

Additionally, when we graph the NPI total return index over time with the recessionary periods shaded (Figure 2), we see that total return (income plus price return) is generally more stable though all cycles than is price return. This is due to the natural characteristics of commercial real estate, including prevalence of long-term leases, often providing stable income even during turbulent economic cycles. Of course, the longer and more severe a recession is (such as the most recent), the stronger the eventual impact on income returns, and ultimately, total returns to be expected.

The following simulations assume that an investor purchases the NPI at the beginning of the quarter and sells at the end of the quarter for the relevant time period. The results are presented in Table I; each panel relates to a specific holding period and/or investment timing strategy. Holding period price return and holding period total return give the return by subtracting the beginning value of the index from the ending value and dividing by the beginning value. In this table we also compute an approximation of annual average price appreciation (Annual Price Change) and we approximate the internal rate of return of the unlevered investor (Annual Total Return) over the relevant time frames under each scenario.

*Table I*

## Simulated Holding Period Return Analysis

| Holding Period | Holding Period Price Return | Annual Price Change | Holding Period Total Return | Annual Total Return Total Return | Holding Period (Years) |
|---|---|---|---|---|---|
| | | | **Panel A** | | |
| Total Hold (1980 - 2009) | 145.02% | 3.03% | 958.23% | 8.18% | 30 |
| 10 yr Hold - (1980 - 1989) | 89.68% | 6.61% | 198.28% | 11.55% | 10 |
| 10 yr Hold - (1990 - 1999) | 1.67% | 0.17% | 74.40% | 5.72% | 10 |
| 10 yr Hold - (2000 - 2009) | 27.06% | 2.42% | 103.43% | 7.36% | 10 |
| | | | **Panel B** | | |
| Buy After '80 | 129.05% | 2.87% | 843.89% | 7.98% | 29.25 |
| Buy After '82 | 87.77% | 2.36% | 602.21% | 7.49% | 27 |
| Buy After '91 | 32.43% | 1.51% | 246.67% | 6.86% | 18.75 |
| Buy After '01 | 18.38% | 2.13% | 68.74% | 6.76% | 8 |
| | | | **Panel C** | | |
| 10 yr Hold - '80 | 79.15% | 6.00% | 176.11% | 10.69% | 10 |
| 10 yr Hold - '82 | 17.88% | 1.66% | 82.99% | 6.23% | 10 |
| 10 yr Hold - '91 | 11.59% | 1.10% | 95.94% | 6.96% | 10 |
| | | | **Panel D** | | |
| 7 yr Hold - '80 | 59.30% | 6.88% | 119.35% | 11.88% | 7 |
| 7 yr Hold - '82 | 45.35% | 5.49% | 97.93% | 10.25% | 7 |
| 7 yr Hold - '91 | -7.35% | -1.08% | 37.07% | 4.61% | 7 |
| 7 yr Hold - '01 | 49.26% | 5.89% | 103.00% | 10.64% | 7 |
| | | | **Panel E** | | |
| 5 yr Hold - '80 | 47.04% | 8.02% | 85.62% | 13.17% | 5 |
| 5 yr Hold - '82 | 32.82% | 5.84% | 67.54% | 10.87% | 5 |
| 5 yr Hold - '91 | -17.93% | -3.88% | 7.29% | 1.42% | 5 |
| 5 yr Hold - '01 | 46.29% | 7.91% | 87.37% | 13.38% | 5 |
| | | | **Panel F** | | |
| Trough to Peak - '91 | 40.90% | 4.38% | 122.77% | 10.53% | 8 |
| Buy Early - Sell Late - '91 | 34.35% | 3.00% | 138.84% | 9.10% | 10 |
| Buy Late - Sell Early - '91 | 34.46% | 5.06% | 90.06% | 11.30% | 6 |
| Buy Early - Sell Early - '91 | 30.43% | 3.38% | 105.00% | 9.39% | 8 |
| Buy Late - Sell Late - '91 | 38.50% | 4.16% | 121.44% | 10.45% | 8 |
| | | | **Panel G** | | |
| Trough to Peak - '01 | 66.68% | 8.89% | 113.84% | 13.50% | 6 |
| Buy Early - Sell Late - '01 | 35.94% | 3.91% | 92.53% | 8.53% | 8 |
| Buy Late - Sell Early - '01 | 48.33% | 10.36% | 74.69% | 14.97% | 4 |
| Buy Early - Sell Early - '01 | 49.23% | 6.90% | 98.67% | 12.12% | 6 |
| Buy Late - Sell Late - '01 | 35.12% | 5.14% | 69.30% | 9.17% | 6 |

*Source: Anderson and Harris, NCREIF and NBER*

We begin the analyses by looking at holding periods simply by decade and the entire 30-year span; this would represent a simple buy and hold strategy void of any timing decisions relative to the macroeconomic or real estate cycles. These results are presented in Table I, Panel A. The results are intuitive in that the average annualized return is slightly more than 8 percent. The decade-specific returns show a low total return of 5.72 percent for the '90s and 11.55 percent for a high during the '80s. The big difference in performance was the two large downturns in both the '90s and '00s. Nonetheless, an unlevered 5.72 percent return holding primarily core assets in core market is not dismal.

Next, we turn to Panel B. Since recessions are often associated with lows in the real estate pricing cycle, we assume an investor may choose to purchase near the trough in each macroeconomic cycle and then hold until the end of our data window, which is year-end 2009. These results are presented in Table I, Panel B. An investor would realize an annualized rate of return as high as 7.98 percent after the '80 recession and as low as 6.76 percent after the '01 recession. This is not markedly different from the 8.18 percent for the entire 30-year window, but occurs with much more stability than during the three-decade subsets.

We then consider an investor who purchases at the bottom of the macroeconomic cycle but liquidates at a predetermined time in the future; specifically ten, seven and five years, for the purpose of our study. These results are presented in Table I, Panels C, D and E respectively. This strategy set gives the most varied results in the entire set of analyses. The ten-year holders get a high of 10.69 percent from the '80 recession, but only 6.23 percent and 6.96 percent from the '82 and '91 recessions respectively (there have not been ten years of data since the '01 recession; thus, this could not be calculated). Seven-year holders get a high of 11.88 percent from '80 and a low 4.61 percent from '91. Five-year holders see the wildest variance from a high of 13.38 percent after the '01 recession and the lowest of any particular strategy of 1.42 percent (negative price return of -3.88 percent) after the '91 recession. It should be obvious that forced exits without regard to market conditions can be very risky; nonetheless many investors utilize financing on terms that require exactly that. Even though a "good" buy may have been achieved, a "poor" exit can eliminate the possibility of meaningful returns. Also, the need to refinance at a set time is equivalently risky if the property is highly leveraged; capital markets tend to tighten and even stop functioning around the same time as drops in real estate prices.

Finally, we consider the case of the most strategic investor, one who not only uses the macroeconomic and real estate cycles to time market entry but also to time market exit. Because the back-to-back recessions of the 1980s did not feature a resulting real estate price crash due to inflation and the now defunct tax advantages of real estate noted above, we exclude these recessions from this portion of the analysis. We believe that without some extenuating circumstances (as there were in the '80s), one can reasonably expect a macroeconomic recession to occur around the time of a similar fall in real estate prices and returns as seen with the '91 and '01 recessions. Since picking and executing deals at the exact top or bottom of the market seems highly impractical or improbable, we consider not only the exact trough-to-peak hold but also buying a full year too soon and selling a year too late (Buy Early – Sell Late), buying a year late and selling a year early (Buy Late – Sell Early), buying a year early and selling a year early (Buy Early – Sell Early), and buying a year late and selling a year late (Buy Late – Sell Late). The trough and peak dates are determined by finding the inflection points in the NPI data where total returns shift from positive to negative percentage change and vice versa. These results are presented in Table I, Panel F for the '91 downturn, and Table I, Panel G for the '01 downturn.

Buying in the trough and selling at the peak gives annualized total returns of 10.53 percent and 13.50 percent for the real estate troughs near '91 and '01 respectively. For the periods near the '91 downturn, we see that buying a year early and selling a year late returned 9.10 percent, only 143 basis points less than the exactly perfect strategy of buying at the trough and selling at the peak. Interestingly, buying a year late and selling a year early produced 11.30 percent annualized returns, which are 73 basis points better than supposed optimal timing. Similar findings exist for the periods around the '01 downturn; buy early and sell late generates 8.53 percent, which is close to the 9.10 percent for the '91 downturn but 497 basis points less than the peak to trough hold of the '01 downturn that generates 13.50 percent annualized returns. However, the buy late and sell early only generates returns 147 basis points better (14.97 percent) than the supposed optimal hold, which is more in line with the same strategy during the '91 downturn. In summation, being a year late or a year early on either side did not matter much; where there was increased variance (as with the '01 time periods) the risk was to the upside, and the worst strategy still beat the long-term buy and hold strategy. We thus conclude that attempting to time both entry and exit is optimal; but thankfully, one does not need to be perfect to generate better than simple buy and hold strategy returns. What is more critical is exiting before the peak and thus avoiding the fall of prices, which can occur rapidly.

What do all these returns and analyses actually mean? To simplify the analysis and make it more understandable, we present the averages across downturn windows of the various strategies in Table II. Simply holding for 30 years generated an annualized total return of 8.18 percent; the average of each decade was near the same at 8.21 percent; however, this occurred with much greater variance in terms of dispersion of the individual returns presented herein. This high degree of variance comes from the inherent variance of the economy over time. It may appear odd that buying and holding after recessions does worse than the simple buy and hold strategies: 7.27 percent versus 8.18 percent. This can be explained by the fact that the inflation-driven '80s produced solid returns despite macroeconomic turmoil; thus we do not expect this result to hold going forward. Holding for preset time frames (ten, seven and five years) following a recession produced the most varied set of returns. The seven- and five-year sets outperformed the simple buy and hold baseline of 8.18 percent by 116 basis points (9.34 percent) and 153 basis points (9.71 percent) respectively (ten-year is not discussed because of the lacking data point associated with the '01 recession). These results are a bit misleading, as the dispersion of results for these strategies was very high; thus, there really is no discernable pattern. Most important, the averages of the various strategic timing strategies around the '91 and '01 downturns beat the simple buy and hold return of 8.18 percent by 197 basis points (10.15 percent) and 348 basis points (11.66 percent) respectively. This occurred with a relatively low degree of variance; in fact, not a single strategy simulation of this variety fell below the 30-year benchmark of 8.18 percent.

*Table II*

## Holding Period Return Summary

| Holding Period | Average Annual Price Change | Average Annual Total Return |
|---|---|---|
| Total Time Frame | 3.03% | 8.18% |
| Hold For a Decade | 3.07% | 8.21% |
| Buy & Hold Post Recession | 2.22% | 7.27% |
| 10 yr Post Recession[7] | 2.92% | 7.96% |
| 7 yr Post Recession | 4.29% | 9.34% |
| 5 yr Post Recession | 4.47% | 9.71% |
| '91 Recession Strategies | 3.99% | 10.15% |
| '01 Recession Strategies | 7.04% | 11.66% |
| All Holding Scenarios | 3.88% | 9.06% |

*Source: Anderson and Harris, NCREIF and NBER*

What we surmise from these simulations is that exact timing largely does not matter; however, paying attention to the real cycles and acting accordingly near those time points does matter. The best strategies involved attempting to time both entry and exit based on the macroeconomic and real estate cycles; however, being a year late or early on either side of the real estate return peaks and troughs did not make much of a difference. Thus, results indicate that risk can be reduced by timing acquisitions and dispositions with the macroeconomic and real estate cycles.

Since investors are more likely to enter and exit real estate investments throughout the time frames discussed above, we examined the average quarterly returns during each of the timing strategies near the '91 and '01 downturns. The results are presented in Figures 3 and 4 respectively.

*Figure 3*

## '91 Downturn Average Returns


*Source: Anderson and Harris, NCREIF*

*Figure 4*

'01 Downturn Average Returns


*Source: Anderson and Harris, NCREIF*

This analysis shows that the strategies are more or less equivalent in price and total return measures with Buy Late – Sell Early being the best (2.79 percent for '91 and 3.69 percent for '01 average quarterly total returns) and Buy Early – Sell Late being worst (2.14 percent for '91 and 2.19 percent for '01), but the difference between the two is relatively small and not likely significant. We further divide the average quarterly returns for each strategy by its holding period standard deviation[6] to derive a measure of average risk-adjusted return for the timing strategies near the '91 and '01 downturns. These results are presented in Figures 5 and 6 respectively.

*Figure 5*

'91 Downturn Average Risk Adjusted Returns


*Source: Anderson and Harris, NCREIF*

*Figure 6*

'01 Downturn Average Risk Adjusted Returns


*Source: Anderson and Harris, NCREIF*

These results show that specific timing strategy may be more impactful, but not by a degree that we would consider highly relevant. Buy Late – Sell Early is still the dominant strategy (3.46 for '91 and 3.56 for '01 in risk adjusted quarterly returns). It is harder to discern any consistently inferior strategy that is stable between both downturn windows; still, even the worst one (Buy Early – Sell Late for '01) produced 0.74 risk-adjusted quarterly total returns versus the 0.88 measure for the simple long-term buy and hold strategy, a difference that is not likely to be significant.

## CONCLUSION

Should investors attempt to find troughs in real estate cycles by following macroeconomic trends? Yes, buying near-cycle bottoms produced annualized total returns in the neighborhood of 200–300 basis points higher than did a simple buy and hold strategy. However, is it important to buy only at the exact bottom of the trough? No, it is largely irrelevant, not to mention completely impractical, to exactly time the market. Simple strategies of buying after a recession but liquidating at a predetermined time in the future were shown to be the most risky of those analyzed; these produced good returns in the '00s but dismal returns in the '90s; thus, an investor using this methodology is relying on an element of chance to achieve significant returns. Therefore investors should conservatively utilize leverage when a forced sale or refinance is required at a predetermined date per the contractual terms of the financing, even if they are buying at the bottom of a cycle. Nonetheless, the simple buy and hold strategy produced unlevered annualized total returns of 8.18 percent, which is still highly economically valuable.

One important limit to this analysis is the lack of real estate data (NCREIF began data collection in the late '70s) along with recessions to measure their long-term impact with great precision. Thus, we do not advise anyone to view our results as some form of prediction as to what will occur following any recession including the most recent one that ended June 2009, according to the NBER. This raises another point: the NBER officially called the end of the most recent recession to be June 2009, but made this announcement in September 2010. Thus, if an investor is looking to the NBER press releases to call tops and bottoms at the moment they occur, they should forever give up this expectation. Still, we believe it is possible for investors to monitor data releases of key macroeconomic variables to gain insight into the future of the economy. Variables worth monitoring include Gross Domestic Product, inflation (the Consumer Price Index is a good proxy), retail sales, personal income, global trade balances, and others that relate to the specific property types and/or geographies of the individual investor. Also, measures of leading indicators, such as those produced by the Conference Board, have value as well.

The magnitude and length of each recession varied a great deal in this study. Nonetheless, there appears to be a benefit to "getting out early" before a downturn hits. To do this in practice, one will have to be willing to forgo lost short-term profits and even endure ridicule by fellow investors and real estate professionals. Why is this? Because one would be selling property as values and returns are still rising. In practice, it is far easier to justify buying at the bottom than selling at the top.

Finally, following the conditions of the broad U.S. economy should not be the only activity of a real estate investor. Instead, we believe an investor should also focus on analyzing local market trends and thoroughly examining the details of specific properties, as this is where excess profits can be generated. Further, the use of leverage should be balanced with the level of risk any particular property presents. Our analysis shows that if investors can hold long enough, they will likely see positive returns, meaning even if they are caught in a severe downturn, they can in fact wait it out if necessary. Investors who will not be able to wait it out are the ones with an over-leveraged property; they may be forced into default in the middle of the downturn. This could take their equity investment to zero and transfer the future benefits from the eventual recovery to a new buyer. Thus, we conclude with a simple thought: do not fear recessions and downturns, but do plan on worst-case scenarios and be prepared. Or more simply, pigs get fat, hogs get slaughtered. This implies buying near the bottom but selling before the market reaches the next top. ■

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## ENDNOTES

1. We do not attempt to assess the exact lead/lag relationship due to data constraints.
2. The macroeconomic cycle differs from real estate cycles; for a discussion on real estate cycles see Mueller and Laposa, 1994.
3. This index is generally not an "investable" index. However, it is a good proxy for returns on institutional quality core real estate.
4. The term "volatile" here refers to the dispersion of the returns using the stated holding periods for each simulation period and not a standard deviation metric.
5. The recent credit crisis that began in 2008 is a perfect example.
6. Standard deviation of the quarterly returns for each holding period scenario is used for this measure.
7. This is the average of returns from the ten years following the '80, '82 and '91 recessions only; there was insufficient time since the '01 recession to calculate the same.

FEATURE

# Small Business Jobs Act of 2010: Impact on the Real Estate Market

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

CONGRESS ACTED SWIFTLY IN SEPTEMBER 2010 to pass what is known as the Small Business Jobs Act of 2010 (hereafter called the Act). Signed by President Obama on Sept. 27, 2010, the Act means more business tax relief for small businesses and emphasizes the need to provide additional support in the process of economic recovery.

Summarized below are some key changes made by the Act that are important for small businesses and real estate owners. Much of the material for this article was drawn from and supported by comments made from the Joint Committee on Taxation, Technical Explanation (Sept. 16, 2010). The new tax rules apply beginning in 2010. Therefore, taxpayers may find they have additional deductions for 2010 and 2011 than anticipated.

## SUMMARY OF CHANGES MADE BY THE ACT

Some of the Act's changes are especially relevant to real estate practitioners, be they investors or representatives for clients. The changes provide for small business relief in various areas. For example, the Act allows for more capital, since less is paid in taxes. The theory is that tax relief from gains on small business stock will encourage investing more capital in small businesses.

Another change that can aid the real estate investor relates to a shorter time frame to obtain the benefits of business credits. There is now a 5-year carryback of general business credits. For example, a business that paid taxes last year but has tax credits in the current year can file, currently, for a refund of taxes by applying the current year's credits to the prior year's gain. As an example, if Business X has a credit of $100,000 for the year, an amended return for a prior year can be made resulting in using the $100,000 credit to reduce the taxes for a prior year. This would result in an immediate refund to Business X.

The Act allows business credits for eligible businesses without requiring payment of the Alternative Minimum Tax (AMT). The AMT subjects taxpayers to not only the regular tax calculation, but also to a potentially higher tax result by applying the AMT rules. In essence, these rules require a calculation of the current tax under what are the "normal rules" and a calculation under an alternative system. The AMT approach denies some deductions that are allowed for the normal tax rules. The taxpayer pays the greater of the two calculations. As an example of AMT, if the normal tax calculated was $200,000 due, but the AMT calculation denied certain deductions and resulted


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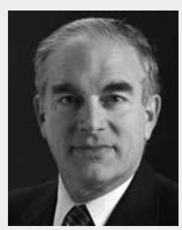

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in tax calculated of $220,000, the taxpayer would have to pay the additional $20,000.

To encourage more access to capital, the Act provides for avoiding a secondary or additional tax on S Corporations, which are entities that have the traditional corporate protection for shareholders, but normally are not taxed at the corporate level; thus it avoids the "double tax." That is, with an S Corporation, there is normally only a tax at the individual shareholder level. Congress created S Corporations to allow for an entity with corporate protection and with no corporate tax. However, in some instances, there could be a tax at the corporate level if the corporation sells property. To avoid this corporate tax, the Act allows for corporations that were C Corporations (regular corporations that pay corporate taxes), to elect to become S Corporations (corporate level and individual level) if the S Corporation can show it held the property being sold for at least five years. (Since a C Corporation pays corporate tax and an S Corporation normally pays no corporate tax, some C Corporations attempted to switch their status to S Corporations right before they sold property. To prevent such action, Congress provided that S Corporations would be taxed on the gain from the sale of such property, unless they showed a longer holding period, such as the five years noted.)

To encourage more investments in small businesses, the Act allows a more accelerated write-off of tangible personal property used in the trade or business. This write-off was generated by changes in a number of Internal Revenue Code sections. For example, Code §179 allows a current deduction for "qualified property," within certain dollar limits, to be expanded. This deduction was expanded to $500,000 of the cost for qualified, tangible personal property used in the trade or business.

In some instances, real estate leasehold improvements may qualify for additional current deductions. Also regarding tangible personal property, deductions for equipment used in business, cellular phones and other telecommunications equipment are allowed a current deduction, in most cases, under the new Act.

## DETAILS OF THE SBJ ACT OF 2010:

**The Small Business Stock rule:** This law allowed for the exclusion of 50 percent of the gain on the sale of small business stock, but such provision was scheduled to expire. As provided in the Act, this was changed to allow an exclusion of 100 percent. The exclusion applies to both the regular tax and the AMT.

**Tax Credits:** If a taxpayer qualifies for the general business credit, but does not have current taxable income to use all of the credits, the taxpayer is allowed, in certain instances, to carry back those credits to prior tax years, to receive a refund for taxes paid in a prior year. These credits include the investment credit, energy credit, low-income housing credit, etc. Qualifying or "eligible small businesses" are sole proprietorships, partnerships and non-publicly traded corporations with $50 million or less in average annual gross receipts for the preceding three years. The Act allows eligible businesses to carry back the credits to up to five prior years. If not consumed within the carryback period, the credits may be carried forward for use in future years. It is important to note that these small business credits can be used to reduce the AMT liability as well as the regular tax liability.

**S Corporations:** One issue with an S Corporation has been the potential of having to pay a corporate tax on the sale of assets by the corporation. Under the Code, S Corporations may have to pay tax on gain that is referred to as "built-in" gain. For example, if a regular C Corporation bought a building for its business and subsequently changed to an S Corporation, then sold the building five years later, the S Corporation would generally have to pay a tax on the gain. Under the new rule; the S Corporation is not taxed on the gain as long as it held the property for at least five years.

**Depreciation:** Generally speaking, the tax law, under Code §179, allows one to expense (take a current deduction) what is referred to as "qualified Code §179 property." Such property is personal property, not real estate, that is acquired for use in a trade or business. A cash register and furniture in a restaurant or brokerage office are examples of this Code §179 property.

Although Code §179 has existed for many years, the amount that one could deduct in a given year for qualified property has changed over the years. Under the new Act, the definition of "qualified Code §179 property" as explained under the Joint Committee on Taxation Explanation of Sept. 16, 2010, was expanded. This expansion includes real property that is referred to as "qualified leasehold improvement property." It also includes qualified restaurant property and other qualified retail improvement property.

There are limits on what can be expensed under Code §179. In general, the maximum amount that could be expensed was $250,000 of qualified Code §179 property.

The Act increases the amount to $500,000. Therefore, taxpayers have the flexibility of expensing that much more Code §179 property, which is qualified trade or business personal property. As an example, if a construction development company purchased $300,000 of equipment, the company can deduct this entire cost. Prior to the act the company would have to depreciate the property over many years.

Under a depreciation section of the Code, in addition to Code §179 deductions noted above and where applicable, taxpayers have been accustomed to claiming a bonus depreciation amount for the year in question. Thus, if a taxpayer claimed the Code §179 deduction and that did not use all of the potential deductions, the taxpayer might claim a *bonus deduction*, which allows for a 50 percent deduction or depreciation amount for the balance of the property.

As an example, if the taxpayer had acquired $1.2 million of personal business-use property (excluding passenger cars and trucks, in most cases), the taxpayer would calculate the current deduction as follows:

1. The taxpayer would claim $500,000 (the maximum noted above).
2. The balance of $700,000 would be eligible for a deduction of $350,000, (50 percent of $700,000). Thus the total deduction would be $850,000.
3. The taxpayer would then claim the balance of $350,000 over given years; this would be claimed by normal depreciation deductions.

As stated in the Joint Committee on Taxation Explanation, the property that qualifies for the 50 percent deduction must meet the following tests:

a. It must be property subject to the Modified Accelerated Cost Recovery System with a life of 20 years or less.

b. The taxpayer must show that the original use is with the taxpayer and that the property was acquired by purchase within the proper time periods, generally after 2007.

Because of the Act, the qualified 50 percent deduction continues to apply to qualified property placed in service during 2010.

The Act allows for a more generous depreciation amount for cars and trucks used in a business. This is important for all types of businesses, real estate or otherwise. In general, the Code limits the amount of depreciation write-off that a taxpayer might claim in a given tax year, even with the deduction rules noted above. However, under the Act, additional write-offs are allowed for business vehicles, such as passenger automobiles, with a potential write-off of an additional $8,000 in the year acquired and put into service.

For example, prior to the Act, the maximum deduction allowed under Code §280F for a passenger automobile was $3,060 in the year of acquisition; the Act increases this by $8,000, making the overall deduction limit $11,060. Thus a taxpayer claiming a business auto that cost $40,000 may deduct $11,060 in that tax year. The balance of $28,940 would be depreciated over future years.

For a van or truck, the general first-year allowance limit was $3,160; the same increase of $8,000 makes the overall total $11,160 maximum possible depreciation that could be allowed in the applicable tax year.

**Start-up Expenses:** Expenses to start a new business can generally be deducted. The Act increases the maximum deduction limit from $5,000 to $10,000. This rule change applies only for 2010. ■

RECOMMENDED READING

# Emerging Market Real Estate Investment: Investing in China, Brazil and India

*by David J. Lynn, Ph.D., CRE, with Tim Wang, Ph.D. (©2010, John Wiley & Sons, Inc., 236 pages)*

**REVIEWED BY MARY C. BUJOLD, CRE**


AS THE TITLE INDICATES, this book focuses primarily on the opportunities and potential risks of investing in what are projected to become the three of the four largest economies in the world, along with the United States, by 2050. As of 2008, China was the third largest economy and Brazil was the eighth largest. India was not on the list of the top 10 largest world economies as of 2008. Russia was excluded from the authors' analysis because of a much older demographic profile, a shrinking population, less diverse economy, and continued significant corruption.

The authors' approach uses what they refer to as the LCG Framework. The framework posits that the desirability of direct real estate investment in emerging markets is a function of three variables: locational factors; competitive environment factors; and growth factors.

Locational factors include geographic location, natural features, and institutional/legal factors such as natural endowments (i.e. in labor, raw materials). It can also mean controlling or owning specific locations within an urban market that confer special advantages (i.e. local monopolies). Real estate tends to be very site- and market-specific.

Competitive factors include core competencies of specific firms. Firms with advantages relative to domestic competitors may achieve higher returns or lower costs, thus leading to more total profit. These factors may include greatest access to investment capital, better practices and processes, better management, and superior technology. Branding and brand equity are also factors in this category.

Growth factors are related to locational factors, but are considered separately in the book. All other things being equal, local, regional and national markets that are characterized by sustainable growth are typically preferred over those with minimal or diminishing growth. In many mature countries, long-term growth prospects in terms of the economy and real estate markets appear to be limited.

According to the authors, China, India and Brazil encompass a significant percentage of the world's land, 30 percent of the world's population, and amount to a combined GDP of U.S. $12.4 trillion.

In selecting these economies as some of the most promising for real estate investment, the authors started with an examination of growth factors.

## About the Reviewer

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

Those factors include very large populations (numbers of people), generally young workforce, rapid urbanization, and rising per capita and household incomes. Although China is expected to experience some difficulties with an aging population, the sheer size of China's population and other factors are expected to override this demographic component. Both India and Brazil have significant and growing youth populations, each of which is expected to support its country's economic development for many years.

China already is the world's manufacturing powerhouse and is expected to continue to hold this status, although in order to sustain and secure its future, the authors believe that China will need to transition from such a significant exporter to more domestic-driven demand.

India already has reaped some of the rewards of its burgeoning IT sector, which is expected to continue to experience significant growth. India graduates some seven million college graduates annually including 350,000 engineers and IT professionals. Its human capital pool offers both quantity and quality.

Brazil is currently the world's fifth largest economy in terms of area and population. The country has considerable wealth in terms of its natural resources, and its ability to harness these resources for the benefit of its own population and for other world markets is expected to propel this country forward. In 2007 and 2008, oil accumulations were found in several exploratory blocks in the Santos Basin off the southeast coastline. The large oil fields found in this area could have as much as eight billion barrels of recoverable oil equivalent, according to Petrobras. The U.S. Energy Administration forecasts that Brazilian fuel production will grow steadily for the next two decades.

### CHINA

China offers a multitude of opportunities, primarily in the largest markets of Beijing, Shanghai and Guangzhou/Shenzhen, although growth is also occurring in several secondary markets. China's consumer class is growing rapidly. According to the authors, there are currently 64 million households earning more than the equivalent of U.S. $5,000 per year. This is the level at which discretionary consumption begins to grow. Underlying this growth is an increase in real income driven by new financial products and a change in consumer behavior.

Office, industrial and retail sectors in most of the primary markets have been booming. Although there has been significant supply added to the market recently, the significant growth projections suggest that the primary markets of Bejing, Shanghai and Guangzhou/Shenzhen will remain strong. Secondary markets, however, are not to be overlooked as they are significant in size, have not had the run up in price escalation of the primary markets and are experiencing strong growth from movement out of the primary markets to some of these secondary markets. Cities to watch include Chengdu, Wuhan and Dalian.

China's government is also closely managing the currency. Although there has been much discussion, especially with the U.S., about China keeping its currency artificially low, the authors expect that as China's economy moves forward and continues to strengthen, the government will permit the currency to become more widely used internationally and will pursue gradual liberalization of the capital account.

Downside risks include issues with property tenure, unpredictable government actions, a weak and ever-changing legal/regulatory framework, low transparency and high corruption. A recent law, however, now allows diverse pension funds to invest in real estate. This could mean billions of dollars of investment into the Chinese real estate sector.

### INDIA

India's property market differs significantly from many other markets in the world. It is very large, diverse, complex, fragmented, and experiencing rapid growth. The economy is growing rapidly, and demand for many types of real estate is strong, even though concentrated in only a few large cities.

There are relatively few major foreign players in the office, retail, hospitality, IT/business parks, and industrial sectors. There is also limited foreign presence in for-sale residential real estate. The fundamental growth factors driving demand are strong, including GDP growth, exports, foreign direct investment, urban growth, population growth, income growth (primarily the middle class), and increasing disposable incomes.

Markets have been artificially constrained because of significant regulatory barriers, although these have recently been significantly reduced or removed. There is estimated to be significant pent-up demand in several real estate sectors that resulted from the previous barriers.

The market is growing rapidly in all sectors, particularly residential and retail. There continues to be significant migration from the rural areas to the larger cities.

First-tier markets that are growing the most rapidly include: Mumbai, Kolkata, Delhi, Chennai, Bangalore, and Hyderabad. Bangalore, Chennai and Hyderabad are key IT destinations. Mumbai is the financial capital, headquarters of the media/entertainment industry and many corporate headquarters. Delhi is the political capital and a key tourist center.

Mumbai recorded the highest level of absorption of office space among all the Indian cities over the past several years. Developers are constructing a large supply of commercial space, catering to the needs of IT and computer companies. The IT and ITES and technology sectors have been the main drivers of demand for office space in Mumbai, especially in the secondary business districts of Malad and Powai.

Bangalore is the undisputed leader in software exports. The boom in the Indian IT industry has resulted in Bangalore being designated as the "Silicon Valley" of the Indian IT industry. Bangalore is one of the leading cities for high-paying, high-quality jobs. Despite significant supply of Class A office space in this city, rental values have remained stable and developers remain optimistic regarding growth.

In Delhi, established retail districts within the city are experiencing increased competition from shopping malls being constructed on the city's outskirts. The development authorities have taken a number of positive steps to develop large-format organized retailing areas. This has resulted in a number of malls being constructed in parts of the west and east of Delhi.

Downside risks include somewhat weak fiscal position, weather (monsoons still affect GDP), significant variations countrywide in terms of economic growth, economic policy, population, and human development. Other issues include low transparency, corruption and bureaucratic laws and governance.

## BRAZIL

Brazil is a much stronger economy relative to other South American countries and emerging countries elsewhere given its favorable rankings on all major indices of market attractiveness, such as market capitalization, economic size and growth rates, level of urbanization, and market risk.

Brazil has an estimated 191 million people, and 86 percent of Brazilians live in cities, a proportion that rose from 75 percent in 1990. Brazil has the fourth largest urban population in the world.

Brazil's real estate stock has not kept pace with the quality and quantity required by businesses and households given the rapid pace of economic growth, job expansion and significant consumer demand. According to the authors, there is significant demand for new housing, especially in the growth cities.

For a time, Brazil's currency remained unstable and there had been several periods of rampant inflation. With this recent government, the currency now has stabilized, and the real strengthened considerably against the dollar from 2007 through August 2008. The authors project that the real will remain stable or strengthen modestly against the dollar.

Major economies in Brazil are located in the state of Sao Paulo in the southeast and in Rio de Janeiro, although several other smaller cities also are growing rapidly, including Belo Horizonte, Curitiba and Porto Alegre. Brasilia is the nation's capital and home to significant public sector employment, as well as financial services employment. Suburban areas around Sao Paulo such as Barueri, Guarulhos, Sao Bernardo do Campo, and Osasco are all growing rapidly. Sao Paulo contributes one-third of the country's GDP.

Sao Paulo and Rio also are experiencing significant growth in industrial and office rents. The logistics industry is growing rapidly as well. Retail confidence and sales are strong and more robust in Brazil than in other South American markets.

Sao Paulo is the largest office market in Latin America with 8 million rentable square meters of office inventory, of which approximately 2.2 million square meters, or just about one-third, is defined as Class A/AA. Approximately 40 percent of the market is considered Class B, and the remainder is Class C. New stock continues to be developed at sustainable levels. Sao Paulo remains affordable by global standards with rents at about one-third of the most expensive rents in the world (found in Tokyo).

The office sector is expected to experience favorable conditions in several key submarkets of Sao Paulo and Rio de Janeiro in the medium and long terms. Value-added opportunities are expected to arise for the retrofit of lesser grade assets in low-vacancy submarkets.

In Brazil, foreign investment has entered the residential sector in joint venture with local developers/construction companies. There is the potential to finance homebuilders active in larger cities. The primary focus is on housing for the middle class since this segment possesses sufficient disposable income, is an expanding class and its income level is rising. Despite the recent slowdown, income levels are growing and the housing deficit is large in Brazil, so the downturn is not expected to change prospects for the housing sector in the medium and longer terms.

As with some of the other growing economies, Brazil is experiencing a significant shortage of housing, most acute in lower income groups, but there is also a significant need for owner-occupied housing.

Although the middle class in Brazil is growing rapidly, income inequality remains one of Brazil's most endemic economic issues.

Downside risks are limited. There is significant opportunity across all property sectors in many areas of the country. While periods of steep inflation in the past have hampered economic growth, the current government appears to have this under control. Infrastructure investments have increased.

## SUMMARY

Investing in emerging markets can be daunting. The authors have provided a strong and intelligent framework for examining the foreign investment potential of three of the most significant growth markets in the world. Their approach, focused on examining growth and development factors, along with the overall economic and political environments, and then applying these segments to various property sectors, provides a solid base from which to more fully explore the opportunities that exist.

While this book is directed toward real estate investors, I found that much of the information is pertinent to any investor desiring to capitalize on the growth potential of these three significant economies. ■

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