

# REAL ESTATE ISSUES®

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## LEADERSHIP ROUNDTABLE

Stepping Up the Game to Bring More Sophistication  
to Counseling in an Expanding, Shifting Market

## FEATURES AND PERSPECTIVES

Dispute Resolution for All Counselors?  
A New Way of Looking at Our Business

Creative Counseling:  
Preserving the Hawaii Opera Theatre

Information Overload:  
Emerging Academic Challenges and Their Implications

Reverse Mortgages:  
Should the Elderly and U.S. Taxpayers Beware?

Demand for Warehouse and Distribution Center Space

Monasteries, Mutuals  
and Investment Banks

The Value Proposition of Sustainability:  
It's in the Eye of the Beholder

## RESOURCE REVIEW

*The Big Short: Inside the Doomsday Machine*



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# REAL ESTATE ISSUES®

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# REAL ESTATE ISSUES®

Published by THE COUNSELORS OF REAL ESTATE®

## CONTENTS

4

### Editor's Note

*Peter C. Burley, CRE*

7

### Contributors

60

### About *Real Estate Issues*®

61

### About The Counselors of Real Estate®

## LEADERSHIP ROUNDTABLE

8

### Stepping Up the Game to Bring More Sophistication to Counseling in an Expanding, Shifting Market

*Moderator: Peter C. Burley, CRE; Panelists: John J. Leary, CRE, 2011 Board Chair; Arthur P. Pasquarella, CRE, 2010 Board Chair; Kenneth P. Riggs, Jr., CRE, 2011 First Vice Chair; and Howard C. Gelbtuch, CRE, 2011 Second Vice Chair*

Having survived the meltdown, and having started on a path to recovery, we at *Real Estate Issues* were curious as to how various members of the Leadership team of The Counselors of Real Estate® view the world; how they approach the issues of the day; what they hear and think about with respect to the state of the real estate markets and the industry in general. During the months of March and April this year, we invited CRE leaders to answer a few very broad questions online. This Q&A is the resulting conversation with *Real Estate Issues* CRE Editor in Chief Peter Burley.

14

### Dispute Resolution for All Counselors? A New Way of Looking at Our Business

*John M. Duncum, CRE, and Joe L. (Joey) Cope, J.D.*

As American business is faced with a more litigious environment and the cost of litigation has soared, more interest is being shown in Alternative Dispute Resolution and mediation. In this article, the authors discuss how the counselor may add this component to the practice of real estate consulting or may find the skills learned in mediation training to be of great value in many real estate consultations.

19

### Information Overload: Emerging Academic Challenges and Their Implications

*James D. Ray, M.S.*

Like the real estate profession it serves, today's real estate educational environment has responded to the information age, and students face a new basket of related challenges. In this article, an adjunct professor discusses common classroom pitfalls and their relevance outside of academia.

24

### Demand for Warehouse and Distribution Center Space

*Joseph S. Rabianski, Ph.D., and Philip A. Seagraves, MSRE*

From 1990–1995, the analysis of warehouse and distribution center space came into its own in real estate literature. Previously, warehouse space was considered a component of industrial demand, along with production facilities. In this article, the authors present a review of the literature by focusing on the demand determinants as well as current thinking about the demand for this space and its market. The authors hint at potential new developments that may cause the current models to come into question, and conclude with suggestions for further research into warehouse and distribution center space demand and market activity.

35

### The Value Proposition of Sustainability: It's in the Eye of the Beholder

*Linda G. Tresslar, CRE*

With the continued advancement of sustainability initiatives, both mandated and voluntary, has come the rise of differing sustainability priorities and measures of success attributed to the same asset by various stakeholders. The quandary for an asset owner then becomes how best to address these varying value propositions for maximized long-term asset value. In this article, the author discusses the necessity of understanding the sustainability value propositions of others, including the broader community, represented by government agencies and users of an asset. Without that, says the author, asset owners can wind up spending on measures that carry less weight or even worse, falling behind other assets by not spending in essential areas, resulting in an asset's economic obsolescence over time.

## CASE STUDY

41

Creative Counseling:  
Preserving the Hawaii Opera Theatre

*Karen Char, CRE, MAI*

In May 2010, Karen Char, CRE, president, John Child & Company, Inc. and Christine Camp, CRE, president and CEO of Avalon Group, LLC, both of Honolulu, were honored by The Counselors of Real Estate® with the 2010 James Felt Creative Counseling Award for their work developing and implementing a long-term real estate strategy for the Hawaii Opera Theatre (HOT) in Honolulu. This case study shows how their work enabled HOT, which was faced with making crippling cost cuts, to continue to produce outstanding opera performances and nationally recognized educational programs in Hawaii. The following article describes the process through which HOT was able to turn a liability into an asset.

46

Reverse Mortgages:  
Should the Elderly and U.S. Taxpayers Beware?

*J. Douglas Timmons, Ph.D., and Austra Naujokaite, M.A.*

Reverse mortgages are becoming popular in America, and although they are only a small niche in the multi-trillion dollar banking industry, they have begun to attract the interest of banks, mortgage brokers, insurance companies, and Wall Street investors who are looking for new profit centers in the wake of the subprime mortgage meltdown. Here, the authors discuss why seniors who might be considering these loans, and U.S. taxpayers who have suffered from the subprime meltdown, should carefully evaluate how the reverse mortgage market is developing. Reverse mortgages are complex financial transactions that have considerable closing costs, but when used correctly and under the right circumstances, have the potential to greatly enhance the lives of the senior borrowers who obtain them. This article introduces the reader to the reverse mortgage market, providing information about its growth, characteristics of these loans and issues of concern.

56

Monasteries, Mutuals and Investment Banks

*Albert J. Brenner, CFA*

Henry VIII's dissolution of the English monasteries in the early 16th century and the expropriation of their wealth has odd parallels to some modern developments in American banking and finance. In this article, the author looks at how the large-scale conversions of mutual savings institutions to publicly owned companies and the conversion of American investment banks from private partnerships to public corporations gives management and partners the opportunity to get rich—without really trying.

## RESOURCE REVIEW

58

*The Big Short: Inside the Doomsday Machine*

*Reviewed by William P.J. McCarthy, CRE*

In this review of *The Big Short: Inside the Doomsday Machine* (which remains a best seller) by Michael Lewis, CRE William P.J. McCarthy gives a big thumbs up to the author, referring to him as a “brilliant chronicler of business affairs,” in his story about what occurred on Wall Street and beyond during the global financial meltdown and subprime mortgage fiasco that peaked in 2008. McCarthy says those in the real estate and finance industries will read in amazement how widespread and deep the greed, corruption and incompetence of some of the supposedly best minds and most privileged leaders in business led to the loss of \$1.75 trillion in wealth in the subprime mortgage markets, shamed capitalism and ruined thousands of lives in the process.

# Editor's Note

BY PETER C. BURLEY, CRE



*“Observe constantly that all things take place by change, and accustom thyself to consider that the nature of the Universe loves nothing so much as to change the things which are ...”*

—MARCUS AURELIUS

## Here Comes the Sun (...and Change...)

IT WAS AN UNUSUALLY LONG, COLD WINTER FOR THIS PART OF the country, and it seemed to take forever for the sun to warm the air, for the trees to bring forth their famous floral display, and for the tourists to arrive.

But, like all winters (and recessions), it eventually came to an end. The days grew warmer, the cherry trees finally blossomed, and the tourists arrived (I know this because I have noticed a statistically significant increase in the number of “duck boats” loading up at Union Station). There has been a marked, if seasonal, improvement in the emotional tenor of the town. It is nice to see smiles on at least a few faces and to sense that we have, indeed, survived yet another long, cold, dreary winter.

Much goes on in this town, a lot of it important. This is the place where ideas, advocacy, politics, and policy converge—sometimes in the light of day. It is the place where decisions, many of which have the potential to truly change our lives and livelihoods, are made. In recent months and years, much has come out of this town to engage us, change us and (often) enrage us. There is likely to be more in coming months—Washington is, after all, a place where many things are set in motion, largely for the good, though often with unintended consequences that must later be addressed.

We chose the cover photo for this issue for what it says about where I now reside, about the environment in which I work, and about the changes that we are experiencing or that we will experience as we continue our slow passage from the depths of recession to recovery and (one hopes)

into renewed expansion. The photo is my everyday workplace view of the REALTOR® Building where I work (right foreground) as it stands on its wedge-shaped lot on New Jersey Avenue, a former Brownfield site, just three blocks from the Capitol. Our building was the first green building (LEED Silver) constructed in the District of Columbia, by the way, and it has a remarkable terrace on the roof that offers amazing views of the surrounding area, including the Capitol and many of the familiar monuments, offices and museums for which Washington is known.

At the end of the street is the Capitol itself where, as I write this, there is much a-clatter about budgets and deficits, raising the debt limit, entitlement reform, spending reductions, and a host of other issues, many of which directly affect the real estate industry, like the future of the GSEs and the how Dodd-Frank will affect banks, investors and homebuyers. For me, whether I agree or disagree with Congressional action (or inaction), it is a hallowed hall deserving of considerable pride and honor. I often wander the grounds contemplating the significance of this place that affects so much of the globe. As the budget and deficit battles wear on, discussions have turned to what can and cannot be done to get the nation's fiscal house in order. Much of that will, no doubt, either ease or add pressure on the real estate industry. Will the honorable members down the street make changes to real estate friendly policies affecting everything from housing to retail to office space? I have no idea. There are many ongoing discussions—not a

few of which will affect each and every one of us as practitioners and counselors in this industry.

Our approach to the business we do will undoubtedly evolve as our environment evolves. The economy is, as most economists will testify, in recovery. Not particularly robust, but recovery nonetheless. And, depending on one's perspective, property markets are either in the early stages of their own recovery or languishing along a 'floppy bottom' awaiting a surge of demand to drive them forward. Alluding once again to the cover photo, it seems appropriate that the traffic lights on New Jersey Avenue are flashing yellow. Proceed with caution. Despite recovery, which most economists maintain is sustainable, there is still considerable cross traffic ahead, not to mention road construction, lane closures and more than a few potholes lying in wait to flatten our tires.

It is the recovery, or impending recovery, that prompted us to contact our distinguished Leadership team for its sense of the current and future state of the industry. We were curious how various members of this team of The Counselors of Real Estate® view the world, how they approach the issues of the day, and what they hear and think about with respect to the state of the real estate markets and about the industry in general. So, I asked CREs **John Leary**, **Art Pasquarella**, **Ken Riggs** and **Howie Gelbtuch** to offer their views for the journal. The upshot, I would conclude from our **Roundtable** discussion, is that we need to be well-grounded in the basics but more sophisticated in our approach. Clearly, even as we take tentative steps back toward a more active market, uncertainties remain—many of which challenge us to find innovative solutions to guide our businesses and our clients forward.

Innovative solutions should well include our approach to disputes, as **John Duncum**, CRE, and **Joe Cope** point out in **"Dispute Resolution for All Counselors? A New Way of Looking at Our Business."** As they point out: "Conflict and its manifestation—disputes—will happen at some point in most groups, whether business, political, charitable or religious in function." Settling disputes through mediation can be critical to the counseling practice and can represent an avenue to collaborative success. Duncum and Cope conclude: "The counselor, by employing the proven skills and processes of interest-based negotiation and mediation, can assist the parties in the discovery of underlying interests. The understanding that results is often the key to the creation of solutions previously unavailable." Looking down the street, I

wonder if my neighbors on the Hill have ever considered such an approach to *their* "business."

Innovation in our industry grows out of creative, forward thinking with a dash of flexibility and resourcefulness to respond to changes and challenges in the landscape. Additionally, and importantly, we need to be able to pass what we have learned on to those who choose to follow us into this business so they can better respond to the challenges of the future. How best to pass our knowledge and experience along presents a whole new set of challenges which, according to **James D. Ray** in **"Information Overload: Emerging Academic Challenges and Their Implications,"** require new approaches to teaching in real estate and business schools. From focusing on real estate basics to information delivery to mentoring and building problem-solving skills, Ray discusses his experience and suggestions for improvement in the modern real estate curriculum.

Our approach to real estate evolves. We learn more through experience and by taking new approaches to the challenges we face. An example of how our understanding has changed in certain segments in the industry might be found in **"Demand for Warehouse and Distribution Center Space"** by **Joe Rabianski** and **Philip Seagraves**. The authors discuss the evolution of the measurement in demand for warehouse and distribution center space, describing the shift from strictly industrial employment-based models to those that encompass "a function of employment, investment and technology." Rabianski and Seagraves offer a comprehensive view of historic and modern approaches to measuring warehouse and distribution center demand, including a glimpse of changes that are likely to occur after the expansion of the Panama Canal (the coming Post-Panamax era).

I have noted considerable dialogue surrounding the long-term value of sustainability in commercial real estate in recent months, as the topic and the application of sustainability initiatives expands and evolves. **Linda Tresslar**, CRE, contributes to the dialogue with her piece, **"The Value Proposition of Sustainability: It's in the Eye of the Beholder."** As the adoption of sustainability initiatives evolves, she tells us: "The extent and rapidity of adoption depends upon what is mandated, what is voluntary and the perceived extent of positive impact on value." Exploring areas of potential value enhancement for stakeholders requires well-defined sustainability goals and measures of the benefits and performance, Tresslar tells

us. Otherwise, an asset is “vulnerable to perpetual economic obsolescence.”

In May 2010, **Karen Char**, CRE, of the John Child & Company, Inc. and **Christine Camp**, CRE, of Avalon Group, LLC, were awarded the 2010 James Felt Creative Counseling Award for their efforts in developing a long-term real estate strategy for the Hawaii Opera Theatre (HOT) in Honolulu. Their work enabled HOT to continue to produce outstanding opera performances and nationally recognized educational programs in Hawaii. HOT owned fee simple interest in two struggling properties approximately two blocks from the NBC Concert Hall in Honolulu, both of which were in need of substantial renovation. In her article, “**Creative Counseling: Preserving the Hawaii Opera Theatre**,” Char gives us a fascinating account of the process undertaken to upgrade HOT facilities by moving its administrative and box offices from dilapidated warehouse space in an industrial district to healthy and safe offices in a commercial office building, and to ensure the viability of the HOT program well into the future.

With an aging population, it is interesting to note that a substantial proportion of seniors—even those with very small incomes—have considerable equity in their homes, despite the recent contraction in home prices. Recent changes in reverse mortgage products and growing interest in reverse mortgage products on the part of lenders and Wall Street increases the likelihood that seniors will begin to draw on the equity in their homes. Going beyond Robert Wagner’s late-night television advertisements and CD offers, **J. Douglas Timmons** and **Ausra Naujokaite** offer a detailed history and discussion of the reverse mortgage concept, including positive and negative aspects and areas of potential concern, in their article “**Reverse Mortgages: Should the Elderly and U.S. Taxpayers Beware?**”

“The surest way to individual wealth,” says **Albert Brenner** in “**Monasteries, Mutuals and Investment Banks**,” “is to locate a store of accumulated wealth and find a way to expropriate it. Whether it be centuries of gifts, decades of retained earnings or inflated housing values, if we can just find a way to tap the wealth, we can get rich without really trying.” Brenner, having just read an account of the dissolution of the monasteries of England by Henry VIII, describes an interesting parallel with the conversion of mutual savings institutions in New England to publicly owned stock institu-

tions. The monasteries in the 16th century had accumulated considerable wealth, and by their dissolution, it should come as no surprise that wealth flowed to the Crown and its supporters. Brenner suggests that the conversion from mutual savings companies to stock companies “essentially cashed out the accumulated capital of the institutions.” In addition, he points out: “so much capital flowed into the region, and banks were so eager to put the capital to work, that a boom in commercial real estate followed as project after project got funded without anyone asking how all of the projects could be supported.” Another parallel, according to Brenner, is “the conversion of the investment banks from private partnerships to publicly owned stock institutions.” An unorthodox view, to be sure, but thought-provoking and worthy of discussion.

Finally, **William P.J. McCarthy**, CRE, offers a review of last year’s headliner (but still relevant and still oft-discussed) *The Big Short: Inside the Doomsday Machine* by Michael Lewis. As McCarthy says: “For those of us in the real estate and finance industries, you will read in amazement how widespread and deep the greed, corruption and incompetence of some of the supposedly best minds and most privileged leaders in business led to the loss of \$1.75 trillion in wealth in the subprime mortgage markets, shamed capitalism and ruined thousands of lives in the process.”

My hope is that the honorable members down the street from my office are able to navigate the future well and that they make wise decisions to minimize any hazards that remain along our road to recovery. I hope that all of the constituencies represented in my new hometown can work together (*please*) to smooth the pavement for future generations. Lastly, it is my own sincere hope that Ken Riggs is right—I think he is—when he says in our **Roundtable**: “the U.S. will be stronger for the lessons learned during this Great Recession.” ■



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EDITOR IN CHIEF

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# Stepping Up the Game to Bring More Sophistication to Counseling in an Expanding, Shifting Market

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*Having survived the meltdown, and having started on a path to recovery, we at Real Estate Issues were curious how various members of the Leadership team of The Counselors of Real Estate® view the world; how they approach the issues of the day; what they hear and think about with respect to the state of the real estate markets and about the industry in general. During the months of March and April this year, we invited CREs Art Pasquarella, 2010 Chair, John Leary, 2011 Chair, Ken Riggs, 2011 First Vice Chair, and Howard Gelbtuch, 2011 Second Vice Chair, to answer a few very broad questions online. The resulting conversation, with Editor in Chief Peter Burley, is below.*

**BURLEY:** In your business, in your travels and your conversations with CREs and other real estate professionals, what have been the two or three prevailing issues/stories/concerns that you are hearing, seeing, experiencing out there?

**LEARY:** As I look at the marketplace, it is fairly clear that a two-tier market is developing. Just as the gap between haves and have-nots has grown in our population over the last 30-plus years, we are starting to see a gap between first-tier property and other real estate. As a result, those who deal in the upper end of the real estate markets are expressing positive views about recovery, while those who deal in the more mundane properties are not. We are all the prisoners of headline fever. The real estate market is painted with a broad brush, and we all know that just does not work. Each location differs. A perfect example is the

## About the Moderator



*Peter C. Burley, CRE, is a real estate market and economics research professional with more than 20 years experience tracking, analyzing and making sense of national and regional economic conditions and trends in the real estate industry. Presently, he serves as director of the REALTOR® University Research Center at the National Association of REALTORS® in Washington, D.C. Burley formerly served as vice president of market research at Simpson Housing LLLP in Colorado. Previously, he was director of research at Amstar Group Ltd., where he developed regional and metropolitan area investment strategies. Burley holds a lifetime college teaching credential and taught urban economic geography and spatial analysis at the University of California for several years before entering the private sector. He is a Counselor of Real Estate, a Fellow of the Homer Hoyt Institute and a national policy panelist for the National Association for Business Economics. Burley currently serves as editor in chief of the professional journal Real Estate Issues.*

## Stepping Up the Game to Bring More Sophistication to Counseling in an Expanding, Shifting Market

S&P/Case-Shiller Index. The headline is the overall change in prices indicated by the index. The fact is that each of the markets in the 10-City and 20-City indices has very differing results...but who reads the third page of the press release to find this out? And who points out that you most likely cannot measure the health of the real estate markets in the entire U.S. based on a 10-City or 20-City set of studies? The budget-cutting mania that has gripped the country is the end result of many years of reduced federal dollars going to states and reduced state dollars going to counties and/or municipalities. Municipal finance and real estate are tied together through the property tax, and one of the underlying pieces of the current debate is a push-back from owners of real estate that they just cannot afford further increases in property taxes.

**PASQUARELLA:** I see an increasing focus among real estate participants regarding the importance of job creation as the primary catalyst for improving demand for all real estate space. Increasing amounts of debt capital and favorable interest rates now available are enhancing property values. Real estate investors and brokers remain surprised by the relative low levels of distressed property selling in the market. I think we *were* in a bifurcated market for the past 18 months but I feel that is already changing. Toward the end of 2010, and certainly through the first third of 2011, I have seen evidence that the “edges” of what were recently considered the “only places” where buyers would invest start to fray. It has been simply a case of more capital than investment product in a small niche. As a result, investors are starting to make exceptions as to what is acceptable risk. Likewise, I think most capital providers, both debt and equity, are getting more comfortable with risk because we are now in the midst of an economic recovery as opposed to being in a free-falling jobs market which existed for most of 2009 and 2010.

**GELBTUCH:** First, I see a dichotomy between asset pricing and investor interest in major markets such as New York City and Washington, D.C. versus secondary and tertiary cities like Hendersonville, N.C. Second is the large volume of capital trying to buy real estate: either the highest quality product such as retail on Manhattan’s Fifth Avenue or real bottom fishers looking for oceanfront condominiums in Florida. Properties in the middle are not attracting as much investor interest. Third is the unknown impact of global events, ranging from the impact on energy costs resulting from political turmoil in Northern Africa and the Middle East to the potential environmental consequences of the disaster in Japan.

**RIGGS:** We are returning to core principles whereby all decisions throughout the process affect value, and at the end of the day, all you have is what the asset is worth. Commercial real estate is proving to be a very attractive investment from a risk and return perspective relative to stocks, bonds and cash in an era of uncertainty. Beyond bifurcation in the values of properties, there is a bifurcation in the market between high-level consulting/valuation services and run-of-the-mill services. Depth of experience and a dedication to quality matter. Offices focusing on valuation are getting fewer valuation assignments, lower fees and smaller litigation assignments. It is a value-centric world where understanding value under any circumstance (advisory, consulting, leasing, property management, etc.) is critical.

**BURLEY:** What I am hearing here is that there appears to be a shift back to “the basics” in terms of how we view property markets; that is, looking closely at employment as a demand driver, as Art says, and in terms of how we conduct our respective businesses, as Ken alludes. At the same time, we are being asked to step up our game (i.e., deepening our understanding of the implications of a variety of circumstances, including global events), to broaden our perspective in order to cover all the bases for our clients. I am also hearing quite often, here and elsewhere, the notion of a bifurcated, two-tier marketplace, in terms of the geography (i.e., New York versus Hendersonville), the specific property sectors, (as John and Howie point out) and in terms of how we approach our practices. So, what are the big issues you, specifically, are dealing with today?

**LEARY:** One thing I am seeing is an increase of what I would call tax appeals as opposed to assessment appeals. In my markets, revaluations for assessment purposes occur periodically (three to five years, depending on jurisdiction). Property owners who did not originally challenge the valuation at the time it took place now are experiencing the impact of increased taxes and, in many instances, increased vacancy and lower rents. The only way to obtain relief is to try and claim that the valuation they once thought was reasonable is now excessive. The other big problem is how to measure current value in the absence of a significant volume of sales and in the context of many distressed sales.

**PASQUARELLA:** Being an owner of a large diversified property portfolio, the big issue for our firm over the past few years was maintaining adequate liquidity during a

## Stepping Up the Game to Bring More Sophistication to Counseling in an Expanding, Shifting Market

capital market freeze. Having weathered that storm together with the reemergence of the capital markets has now enabled us to return to focusing on building value through occupancy improvements, loan refinancing and timely property sales and loan refinancing. We have returned to the equity market ourselves with the raising of capital for our 11th discretionary investment fund.

**GELBTUCH:** I'm hearing mixed signals about the future of the economy and their impact on real estate valuation trends. On a positive note, municipalities are finally dealing with looming deficits, the stock market has doubled over the past two years, interest rates remain near historic lows, corporate profits are strong, and the

jobless recovery seems like it will eventually segue into a job-generating expansion. On the other hand, oil is hovering above \$100 per barrel and gas prices are rising as well, the Middle East is rife with political turmoil, state and local government jobs are rapidly declining, and several million unemployed persons have simply stopped looking for work. The litigation support aspect of our business has increased exponentially over the past few years. Lenders that have foreclosed on failed projects are going back and suing all of the parties involved, not just the developers but the appraisers as well. There is also the matter of dealing with Wall Street clients, which have taken an increasing interest in the underappreciated real

### About the Panelists



**Howard C. Gelbtuch, CRE, FRICS, MAI,** is a principal with Greenwich Realty Advisors Incorporated, New York City, an internationally oriented valuation and consulting firm. Gelbtuch has 37 years of real estate experience. Prior to founding Greenwich in 1994, he was a senior vice president at Landauer Associates, director of research for Morgan Stanley Realty, and oversaw the real estate valuation practice for North and South

America at Jones Lang LaSalle, among other work experiences. He has worked or taught real estate courses throughout the Americas, eastern and western Europe, Asia, the Middle East, Russia, and Africa. A prolific author, Gelbtuch supervised the writing of the tenth edition of the Appraisal Institute's textbook *The Appraisal of Real Estate*, and authored two textbooks on global valuation techniques. Gelbtuch chaired *The Counselors' Consulting Corps* for many years, and currently serves as second vice chair of *The Counselors of Real Estate*®.



**John J. Leary, CRE, MAI, FRICS, 2011** Board Chair of *The Counselors of Real Estate*®, is president of Leary Counseling and Valuation, Inc., New Haven, Conn. He specializes in real estate dispute resolution and litigation support, appraisal review services, major and complex property appraisals in the northeastern United States, and commercial real estate mass appraisal services. Leary also serves on the faculty of the Risk

Management Association as a valuation subject expert for its "Real Estate Lending Seminar," which is presented to the Federal Reserve and bank examiners twice annually. Leary graduated from Boston College in 1970, and is trained in appraisal, arbitration and mediation. From 1989–1994, he was one of the five original members of the Appraisal Standards Board (ASB) of the Appraisal Foundation, serving as vice chair in 1989, and chair from 1990–1992. The ASB is responsible for the development and promulgation of the Uniform Standards of Professional Appraisal Practice (USPAP). Leary is co-author of USPAP in plain English, a guidebook to the 2006 Uniform Standards of Professional Appraisal Practice for real estate appraisers and clients, and USPAP in plain English... 2008–2009.



**Arthur P. Pasquarella, CRE,** is a principal of BPG Properties, Ltd., Philadelphia, serving as the firm's executive vice president and COO. In this capacity, he oversees all of the real estate investment decisions and property operations of BPG. Prior to joining BPG in 1987, Pasquarella was a vice president of the Investment Sales Division of Helmsley-Greenfield, Inc. for five years where he negotiated major real estate investment transactions throughout

the eastern United States on behalf of institutional investors. He began his career at Strouse, Greenberg Financial Corporation in the income property mortgage banking business. Pasquarella holds a master of science degree in Real Estate Appraisal and Investment Analysis from the University of Wisconsin-Madison (1980) and a bachelor's degree in Finance from The Pennsylvania State University (1979). He is a member of *The Counselors of Real Estate*®, serving as the 2010 Chair of both its Board of Directors and its Executive Committee. He is also a Fellow of the Royal Institution of Chartered Surveyors.



**Kenneth P. Riggs, Jr., CRE, FRICS, MAI,** has served as president and CEO of Real Estate Research Corporation (RERC) since 1991. Under his leadership, RERC provides research services, valuation management, strategic consulting, independent fiduciary services, litigation support, and Web-based management services for property portfolios. In addition to leading the firm's business ventures, Riggs serves as publisher of the RERC

Real Estate Report and the RERC/CCIM Investment Trends Quarterly, and as co-publisher of the annual forecast report, *Expectations & Market Realities in Real Estate*. Riggs holds an M.B.A. with a concentration in finance and statistics from the University of Chicago Graduate School of Business. He received the CRE designation from *The Counselors of Real Estate*® in 1995, and was elected first vice chair of *The Counselors of Real Estate* for 2011. In addition, he has earned the CFA® designation from the Association for Investment Management and Research, the FRICS designation as a Fellow of The Royal Institution of Chartered Surveyors, the CCIM designation from the CCIM Institute, and the MAI designation from the Appraisal Institute. Several years ago, the National Association of REALTORS® named him as one of real estate's 25 most influential thought leaders.

## Stepping Up the Game to Bring More Sophistication to Counseling in an Expanding, Shifting Market

estate holdings of publicly traded companies. This is a continuation of a trend started nearly a decade ago when a hedge fund took control of Kmart in 2002, recognizing that while it couldn't compete with WalMart as a retailer, its long-term, below-market leases had significant real estate value. Today, hedge funds and private equity funds make up the largest segment of our client base.

**RIGGS:** The primary thing I am focused on is leveraging my time, talent and expertise to truly provide innovative solutions to clients as they finalize their strategy in a world that has changed in Draconian ways given the experiences of the Great Recession, the housing bubble, the worldwide geopolitical risks, and the strong cloud of terrorism over the past 10 years. I am also providing leadership to a new generation of thinkers, doers and individuals who have an entrepreneurial spirit. On a more personal level, my goal is to balance life between family, friends and spiritual interests.

**BURLEY:** So, the marketplace has changed, and there is some adjustment going on as we emerge from the past few years of "difficulty." We are re-evaluating properties, the marketplace and our own approaches to counseling. Even as we take tentative steps back toward a more active (and hopefully, "normal") market, uncertainties remain—many of which present daunting potential hazards. These challenge us to find, as Ken says, more innovative solutions to guide our businesses and clients through. How have you approached those issues? Are you doing things differently now than you would have a year or two ago?

**LEARY:** With regard to subsequent year assessment appeals, the important issue is to carefully address and analyze the market conditions that existed on the effective date of the revaluation and apply those to the property in question, even though the property owner and counsel for the property owner want to introduce all types of subsequent evidence into the debate. I work for both municipal clients and property owner clients in my litigation practice, and it is important to deliver a consistent message even though that often requires attempting to educate the client. With regard to measuring current value, the impact of listings and interviews of market participants has greater import in the absence of sales volume. Income valuation methods also take on greater import, and the selection of rates of return is critical in the context of the developing two-tiered market. Classifying the property risk is a significant part of the task.

**PASQUARELLA:** As various regional markets and property type sectors have improved, we have changed our emphasis from primarily focusing on occupancy levels to being able to increase rental rates again. Likewise the reemergence of the capital markets has enabled us to shop financing and property sales.

**GELBTUCH:** Our analyses have become, and will continue to become, more sophisticated. I recently saw a chart comparing average residential rents in Manhattan with private sector employment for the past 20 years. The correlation was amazing! In the past, we would have just plugged in an estimate of inflation rather than look to employment figures as support for anticipated changes in rents.

**RIGGS:** From a practical standpoint, one thing I am trying to do for our firm is to leverage technology and, at the same time, draw boundaries to ensure that technology does not dictate my focus and use of time. I find that I am able to gain additional productivity by identifying segments of the day that suit and optimize specific requirements of: responding to emails, conducting meetings/conferences, thinking creatively, spending time with family, and carving out time to recharge. Finally, I find that it is essential to surround myself with great individuals who share my vision, feel my passion and understand what enterprise effort is committed to achieving.

**BURLEY:** So, we *are* changing our approach, by employing new or different elements—technology, as Ken points out, and a heightened level of sophistication, as Howie says—to inform our analyses in addressing our clients' needs. I recently heard a practitioner suggest that his practice has evolved from 80 percent data gathering and 20 percent analysis to 20 percent data gathering and 80 percent analysis, because the data are available and we can employ new technology to enhance our analyses and our understanding of the critical forces in the marketplace. Perhaps some of that is actually driving the ability of the capital markets to "reemerge," as Art suggests, by making a market assessment—our understanding of valuation and risk—better. Staying on this theme of change, do any of you notice any emerging positive or negative trends?

**LEARY:** One of the negatives in the current market is the lack of trends. Every projection ends with a list of caveats because of the seesaw nature of market indices. To my way of thinking, this is not unexpected. We have just experienced the greatest market downturn of our professional

## Stepping Up the Game to Bring More Sophistication to Counseling in an Expanding, Shifting Market

lives that earned the name the Great Recession. Is it not logical to think that the recovery from a recession like no one had ever seen may well be a recovery like no one has ever seen? The problem is that we are trying to use the traditional measures of recovery to evaluate our current position. Now add in a natural disaster and a war or two or three, and where are we? Another negative from my perspective is the concept that we must measure recovery to the previous high-water mark. Most of us would admit that the real estate market behavior in 2006 up to mid-year 2007 was indeed an aberration on the high side. We are not better off if we return from one extreme to the other. Wouldn't our perspective on the current market be much better if we were measuring recovery in relation to more normative 2003–2004 market conditions?

**PASQUARELLA:** The operating and capital markets are generally improving across the country across most property types. Vacancy rates are declining and rental rates in specific submarkets are being increased. Values have generally stabilized and, in certain sectors and locations, are increasing substantially.

**GELBTUCH:** There is so much more information available now than there has been in the past. This is clearly a positive. Knowledge is power! Globalization is continuing. I can see that in our own practice. Several years ago we were active in western Europe, then eastern Europe, followed by the Soviet Union, Latin America, the Middle East and, most recently, Africa. When the Appraisal Institute published my first global valuation book a dozen years ago, it covered only about 21 countries and we had to fax chapters around the world for review and editing. Last year's book covered 47 countries. At one time, I think we had a fairly significant share of this market; now it's become much more common for U.S. appraisers and counselors to work overseas.

**RIGGS:** I've noticed change in the usage of some property types. Businesses and individuals are truly embracing the fact that you can work from anywhere (the concept that "the world is flat"), but you still need that human interaction. This has resulted in individuals using less traditional office space but carving up the use of space differently (more video conferencing rooms, open and flexible spaces, intensive wiring at home, and more complete home offices). This is both positive and negative, depending on what side you stand. Given the advances in technology and lower costs in just the past 2–3 years and the increase in the number of people working from home, certain office property locations are not likely to recover

for some time. On the other hand, demand for self-storage, particularly with the aging population and with so many people having lost and continuing to lose homes, is growing. An increase in online retailing/return to catalog sales, partly because stores cannot afford to stock everything people want in their stores, will reduce retail property demand but will likely increase warehouse demand. We also need to recognize that a new demographic is gaining stride in the work force. Generations X and Y, or echo boomers, are highly skilled and have a different view, an independent view, and an intelligent perspective on life, work and the world. Just like those in our generation, they will make a mark on society for the better, but they will also face unforeseen challenges in life and in the workplace. As those in each generation have done in the past, they will address its challenges, and in so doing, the world will be better and the human touch will never be lost.

**BURLEY:** I hear Art saying that property markets and values are stabilizing and, *in some sectors and locations*, improving substantially. And, as John points out, perhaps the norms against which we are measuring performance might be—or perhaps *should be*—somewhat different from what we used to expect. As Howie says, there does seem to be a lot of interest and movement overseas, and, as Ken points out, some of the traditional views of property demand and the use of space, have, indeed, begun to shift. All of which appears to suggest to me that our understanding of the market, as well as of those who follow us in subsequent generations of practitioners will, out of necessity, require increasingly sophisticated, global and, perhaps unorthodox, approaches to analyzing and evaluating property markets going forward. What do you think or expect will be different in the business a year or a few years down the road?

**LEARY:** I was tempted to punt on this question because of all the "what-ifs" out there. I do think a reckoning and readjustment in our thinking about certain property types will (or should) occur as we emerge. Let's think about fundamental issues that we have been discussing but have not really addressed that may impact the office space market and the retail space market.

**PASQUARELLA:** Job creation appears to be strengthening and with that I expect that occupancy and rental rates will increase faster over the next few years than most people expect. I also expect that capital transaction activity (both debt and equity placement levels) will increase by 50 percent per year over the next two years.

## Stepping Up the Game to Bring More Sophistication to Counseling in an Expanding, Shifting Market

**GELBTUCH:** Clients will demand more sophisticated analyses. The desire of people in emerging markets, particularly the former command economies such as Russia, China, Africa, and eventually Cuba, to learn from their U.S. counterparts will continue to grow. There are many otherwise intelligent citizens around the globe that have never been adequately exposed to capitalism who are now eager to learn how to measure supply and demand, begin land title registration systems and form joint ventures with their more experienced counterparts.

**RIGGS:** A new world of regulatory oversight, an aversion to risk, and the U.S. will be stronger for the lessons learned during this Great Recession (akin to the period after the Depression). The stronger firms will get stronger, the larger firms will get larger, and by the middle of the decade we will be back to a normal state of being, although different in many ways from the past, but equally the same in many ways. Human instincts and animal spirits will remain, and there will be another bubble in 10 years; we will repeat the nature of being human, imperfect and with shorter memories than we would like to admit.

**BURLEY:** So, real risks remain, despite the rapid improvement that Art sees in an expanding marketplace. We are becoming a more globally oriented industry, with huge interest and massive volumes of capital waiting (and learning how) to enter the market. John suggests that we may face a “reckoning” in our approach to certain property types and Ken echoes it in suggesting that we could face another bubble in ten years. That leads me to my final question: Do you see anything looming on the horizon that may not be readily apparent that might affect the business in coming months or years?

**LEARY:** Are office market norms in for an adjustment? For years we have talked about shadow space, the leased but otherwise underutilized space often found in the low-rise floors of downtown office buildings. Many of those leases are coming due this decade and will not be renewed. I can see a world where we no longer talk about Class A buildings and Class B buildings, but instead talk about the Class A and Class B space in the same building. I can also see a world where 20 percent starts to look like a more normative vacancy statistic for the office market than the old saw of 10 percent that we keep hanging onto. We know that online retailing is growing and the price of gasoline is on an upward trend. What will be the effect of these two conditions on the market for retail real estate? Will stores as we know them today become repositories for returns of two of the three similar items ordered

online once the consumer has made the final selection in the comfort of their own space? Will retail powered by vendors of necessities (the grocery-anchored center) have more appeal going forward than specialized retail? No answers here, but lots of questions.

**PASQUARELLA:** While our industry needs to be very careful about the risk of rapidly increasing interest rates (and the corresponding effect on capitalization rates) we need to remind ourselves that over the long term, interest rates should only move in tandem with the major price indices, and with real estate, having inherent inflation protection characteristics, we should remember that property values should not be as adversely affected as other investment asset classes.

**GELBTUCH:** There are pending accounting rule changes which could impact the way companies account for operating leases.

**RIGGS:** There also is a greater level of capital availability than anticipated, and that is weighing down returns for all asset classes. Specifically, there will be an influx of capital from foreign investors bidding up property prices and competing for returns against domestic sources of capital. There will be high prices paid for assets that carry a low level of risk. Expect a shift in demographic considerations to accommodate the millions of baby boomers, followed by the echo boomers. This will be fully realized in the employment base, the housing industry, infrastructure (including government, transportation, healthcare, etc.), monetary policy, political and business leadership, throughout the U.S. and the world. I also look for an era of return requirements and expectations that will focus on risk management and prudent oversight.

**BURLEY:** So, to sum all of this up—and, this is purely my interpretation—I guess we could say that there are, indeed, some new realities that appear to be emerging, along with the economic, demographic and policy changes and many, many uncertainties coming down the road—from the demand for and use of commercial space to the probabilities of rising interest rates to new accounting rules for the use of space. And, from reading these responses, I hear a requirement for us as counselors to provide ever-more sophisticated analyses for our clients with an increasingly close eye on evaluating risk from an ever-wider (even global) perspective.

John, Art, Ken, Howie: I want to thank each of you for taking the time to consider these questions and to respond as thoughtfully as you have. Your leadership will help us all approach the horizon better prepared. ■

# Dispute Resolution for All Counselors? A New Way of Looking at Our Business

BY JOHN M. DUNCUM, CRE; AND JOE L. (JOEY) COPE, J.D.

SOME OF YOU CAN REMEMBER when there was no television. It was a theory yet to be perfected and commercialized. Younger generations cannot visualize a time when television didn't dominate almost every room of our homes and offices. Similarly, students of law in the next couple of decades may be surprised to find that "dispute resolution" clauses—both mediation and arbitration—were not always included in contracts.

With dispute resolution emerging as a "new frontier" real estate-related practice, The Counselors of Real Estate® is providing assistance and information to counselors who have an interest in establishing mediation as an offering of their professional services. Some have asked if mediation or the other skilled techniques of dispute resolution fit in the practices of counselors. Perhaps there is another twist to this question. Can a practitioner of real estate-related disciplines benefit from using the techniques and skills of dispute resolution and yet never practice formal mediation?

As our society has become more litigious and litigation costs have risen dramatically, American business has sought ways to reduce that cost of doing business. In the last couple of decades "alternative dispute resolution" and "mediation" have become familiar terms in the boardroom and in the executive suite. American business has embraced this concept in handling disputes between the company and its customers, the company and its vendors, employees and management, and between employees. Conflict and its manifestation—disputes—will happen at some point in most groups, whether business, political, charitable or religious in function. Conflict occurs because people have different ideas, values, interests or accepted

behavior patterns. Conflict may have several different causes: poor communication, evil intent on the part of one or more parties, selfishness, personality disorders or scarce resources. Yet conflict is not the real problem. *Unresolved* conflict is. The resulting costs, hidden and obvious, of unresolved conflict can be seen in the expenses of litigation, damaged relationships or loss of customers.<sup>1</sup> While there are several alternatives in dealing with conflict, mediation is a less costly approach and one in which maintaining or reestablishing relationships is most likely.

## About the Authors



**John M. Duncum, CRE, MAI, FRICS**, is a practicing mediator, real estate developer and business investor in Bryan/College Station, Texas. Duncum earned a Master of Arts degree in Conflict Resolution and Reconciliation from Abilene Christian University in Abilene, Texas, where he also now serves as mediator/consultant.

Duncum serves as chair of the board, mediator trainer and pro bono mediator for the Dispute Resolution Center, Brazos County, Texas, a non-profit mediation center processing public and court appointed mediations.



**Joe L. Cope, J.D.**, is the executive director and associate professor at the Duncum Center for Conflict Resolution at Abilene Christian University in Abilene, Texas. The Duncum Center provides dispute resolution services and training to individuals and organizations, as well as offering graduate programs in conflict resolution. Cope earned his graduate certificate in dispute resolution from the

Pepperdine University School of Law where he is presently a visiting professor in the Straus Institute for Dispute Resolution, Malibu, Calif. He is also a visiting professor teaching mediation at the William H. Bowen School of Law, Little Rock, Ark.

## Dispute Resolution for All Counselors? A New Way of Looking at Our Business

Although Americans in the 20th and 21st centuries would like to take credit for the development of this creative process, recognition should be given to societies of centuries ago in China and Asia, Phoenicia, ancient Greece and Rome that employed the principles of dispute resolution in similar matters within their cultures.<sup>2</sup> Confucius believed that the best way to resolve a dispute was through moral persuasion and agreement rather than coercion.<sup>3</sup>

Further acknowledgment goes to the United Kingdom where, in the 20th century, mediation became institutionalized in the secular arena and was recognized as having a role in and of itself. The Conciliation Act relating to the conduct of industrial relations was enacted in the U.K. as early as 1896.

While we Americans neither invented nor perfected it, we have successfully borrowed the process and are using it with our own modifications. In the United States, alternative dispute resolution (ADR) processes were formalized as an alternative to litigation early on, with the U.S. Department of Labor (established in 1913) appointing a panel, the “commissioners of conciliation,” to deal with labor-management disputes. These commissioners later became the U.S. Conciliation Service and, in 1947, that entity became the Federal Mediation and Conciliation Service. Some of the early writings in ADR drew on the experiences of labor and industrial dispute resolution and adapted them to the resolution of interpersonal conflict.<sup>4</sup> Late in the 20th century, American giants such as Halliburton, Shell Oil Company and General Electric incorporated internal processes in their companies that allowed for collaboration before litigation could be pursued, especially in employee-related matters.<sup>5</sup> In addition, many states have now encouraged this alternative to parties’ settling disputes in court by allowing for the establishment of local centers for dispute resolution. These public centers are partially supported by fees collected by the court.

While the authors incorporate dispute resolution techniques generally in this article, specific attention is addressed to the skills used in mediation. Mediation should not be confused with arbitration. In arbitration, a decision or “award” is made regarding the dispute by an arbitrator or a panel of arbitrators based on the evidence provided to the decision maker(s). In mediation, the parties in dispute are encouraged or led to an agreement to resolve the conflict themselves, with the mediator

assisting as facilitator, analyst, referee, and proposer of creative ideas for solutions. The styles of mediators can vary from one who simply carries messages to the disputing sides to one who becomes very involved in analysis and recommending points of solution.

Mediation as an alternative to resolving disputes by litigation or other costly solutions of conflict has become increasingly accepted and praised. In fact, in his article about the “vanishing jury trial,”<sup>6</sup> Joseph Ryan notes: “According to statistics kept by the administrative office of the United States Courts, in 1962 there were 5,800 civil trials—about 11 percent of all dispositions. In 2004, although there were eight times as many cases filed, there were only 3,900 federal civil trials, or 1.7 percent of case dispositions.”

What does this mean for the practice of counselors of real estate? Is the establishment of a mediation practice just another added partition of the practice of real estate consulting? But what about those counselors who have neither the time nor the desire to enter the practice of mediation? The authors suggest that all counselors would benefit from learning and applying more of the principles upon which mediation practice is based. Mediation is, in fact, more of an art than a science.

An old adage says: “Under all is the land.” And that is the notion upon which our profession advises, brokers, develops, finances, buys, sells, and from which it enjoys monetary benefits. The preamble to the code of ethics and standards of practice of the National Association of REALTORS® recognizes the importance of land in our profession:

*Under all is the land. Upon its wise utilization and widely allocated ownership depend the survival and growth of free institutions and of our civilization. REALTORS® should recognize that the interests of the nation and its citizens require the highest and best use of the land and the widest distribution of land ownership. They require the creation of adequate housing, the building of functioning cities, the development of productive industries and farms, and the preservation of a healthful environment.*<sup>7</sup>

Beginning in the 18th and 19th centuries, an economic theory developed that considered land as one of the agents of production along with capital, labor and coordination, and therefore, a contributor to value. While economic theorists debated and modified this basic



## Dispute Resolution for All Counselors? A New Way of Looking at Our Business

premise, land continued to be a foundational element in the theories of value.<sup>8</sup> Thus, “Under all is the land” implies more than its physical reality. It is the surface of the earth, the source of all minerals, the source of our food supply, and the foundation of our social and economic life as well as the source of wealth.<sup>9</sup>

Alfred Marshall (1842–1924) contributed greatly to the contemporary value theory and the basis of the techniques of the appraisal of real estate. Marshall’s focus on supply and demand theories included what he called “market forces” and a perfect “economic market” that would bring equilibrium to supply and demand. Marshall’s vision of market forces was, without saying it, the identification of the “human element” involved in all real estate transactions.<sup>10</sup>

Marshall’s analysis was that supply and demand could ultimately be perfectly balanced, yet seldom does a market exist in perfect balance or “equilibrium.” It is the human element that deciphers and perceives why the transaction should be at one price level or another. The supply and demand is real, but its impact on price is a perception driven by vision, desire and analysis of human beings.

Since “equilibrium” is only theoretical, the interpretation of it in the market produces differences of opinion, and a difference of opinion produces conflict in regard to valuation and other transaction terms. Seldom do buyers and sellers agree on a price or a lease amount without having some difference of opinion. The buyer wants to buy for less and the seller would like to sell for more. So, barring identical expectations on the part of the buyer and seller at the onset, every real estate transaction is a conflict and thus, a potential dispute. These conflicts do not often nor necessarily result in a dispute—particularly one that requires some action, such as litigation, to resolve. Generally, most are resolved in peaceful negotiations or in impasse where the potential transaction fails to materialize. Accordingly, if the conflicts are mostly settled by continued negotiation (collaboration), what interest does the counselor serving as consultant have in the application of mediation principles to those transactions?

Let’s see how that is important to the counselor. Land does nothing without the human element causing something to happen. Yet, often in our real estate transactions, the human element is obscured. The human element creates demand. One of the appraisal principles (estimating value) is anticipation. We believe anticipation to be the most significant of the influences on market movement. Anticipation develops and fosters a human

decision. In real estate investment, an individual or individuals, not an electronic device, sees the opportunity or risk singularly, makes decisions based on all input data and takes action thereupon. Many influences may cause the individual(s) to have a certain anticipation, but the individual or collective decision usually has unseen and unknown elements of thought. A person must be *motivated* to desire a piece of real estate or to sell. That motive may be obvious, or thought to be obvious, or may be obscured. If it is obscured or masked, the underlying interest of the party in the transaction remains unrealized and the desired maximum benefits of a potential transaction may also be unrealized.

As counselors, perhaps another aspect, then, of our service to a client should be to look for the motives of the players in the transaction. This article is based on that concept and proposes that the skills used in interest-based mediation can be applied to hasten successful agreements. To the broker, the analyst, the appraiser, the buyer and seller, this principle of going to the underlying interest—the motive—is the key to discovering why the transaction takes place or should take place at all. And, it is the lack of understanding “why” that may cause one party to have an advantage in a negotiation over another. That same lack of understanding may bring the parties to impasse.

Motives or unseen, underlying interests may have the most significant impact upon the decisions being made in any transaction.

An actual case in a mid-size southwestern U.S. city demonstrates how the techniques of dispute resolution (specifically, mediation) can serve the counselor and the counselor’s client well.

A counselor’s client was approached by a political entity that wanted to purchase a closed entertainment property owned by the client family, with the intention of opening the facility for public use. An opening offer was made by the political entity. The counselor was asked by the family to review the offer and assist them in the transaction. The value estimate exceeded the offer substantially and precipitated a meeting with the political entity to discuss the offer. The offer was increased to about half the estimated value and the political entity would not budge on the offer. The mediation-trained counselor perceived there was more to the situation than mere differences of opinion as to valuation. The counselor asked the client’s permission to meet privately (and without attorneys) with the head administrator of the political entity. In that meeting, the counselor learned that promises had been

## Dispute Resolution for All Counselors? A New Way of Looking at Our Business

made to the entity's budget approval group that precluded the administrator from going back to ask for more money. The "why" or the underlying interest was now known. The counselor's next step was to seek a creative solution—the collaboration. With a firm view of the interests or motives operating, an agreement was structured whereby the family would make a gift to the political entity for the full value over the offered amount (a tax benefit to the client) and the political entity agreed that the patriarch of the family would be honored by naming the public facility for him. The collaborative approach to the deadlocked transaction resulted in all parties being rewarded satisfactorily in the final arrangement.

In mediation it is extremely important to identify motives, the "whys" of the parties' taking "positions" in the conflict. It may be just as important to the counselor to seek the "whys" of any transaction in which the counselor is an advisor. Often, an understanding of the underlying interests, the "whys" of the offers of the participants, can be useful in structuring a compromise that "makes the deal." As a result, the deal may not lead to one side winning and one side losing.

In many negotiations there need not be winners and losers. In integrative bargaining—also known as interest-based, collaborative or problem-solving negotiation—the goal is for all to win to the extent their interest is best served. The quest for mutual benefit often produces substantial common ground as a foundation for agreement. It becomes the counselor's objective to manage the negotiation context and process to gain the willing cooperation and commitment of all parties to bring about a successful conclusion.<sup>11</sup> Often the parties in a transaction see the possibility of the results as a fixed pie. As such, parties are in competition to "claim value." Only so much can be distributed from that pie. In truth, there may be elements of the transaction that are worth more to one party and less to the other.

Consider this scenario: Two children, a boy and a girl, were arguing over the last apple in the bowl. The mother, wanting to end the fight, cut the apple in two and gave each child half. The boy took the apple and ate his half, throwing the uneaten core with its seeds in the trash. Meanwhile, the girl carefully lifted the seeds from the middle of her half and threw the leftover apple in the trash. The mother never sought "why" the apple was wanted. The boy wanted to eat the apple while his sister wanted the seeds for an experiment at school. In frustration, the mother had ended the fight by dividing the

apple equally (distributive negotiation). As a result, neither of the children received the maximum benefit in the process. Integrative negotiation would have given each more than they eventually received. It was a matter of discovering their interests or their "whys" in wanting the apple. It was a matter of motive.

Collaborative-success results are not limited to simple real estate transactions, but are seen in many types of transactions. The principles of interest-based mediation are applicable in every deal from the simple to the complex deliberations of major world decision makers.

Therefore, we ask the question again: "Is dispute resolution for all counselors?" Perhaps a better question is: "Are the techniques of dispute resolution of benefit to all counselors whether or not they intend to add mediation to their practice?" We believe the answer is "Yes." counselors interested in providing mediation services or in using dispute resolution skills and techniques to enhance their consulting practices should consider a quality training regimen that includes specific training in interest-based negotiation and mediation.

### SUMMARY

"Under all is the land."

Yet real estate, in and of itself, is inanimate and has no value without the use that humans intend for it. This "motive" for acquiring land is often obscured. The counselor, by employing the proven skills and processes of interest-based negotiation and mediation, can assist the parties in the discovery of underlying interests. The understanding that results is often the key to the creation of solutions previously unavailable.

Thus, the utilization of mediation skills can be important for all counselors, regardless of their intention or desire to actively practice as a mediator.

*The mediation profession needs qualified individuals, and counselors who are trained and prepared to serve can meet a vital need in settling real estate transaction disputes. Every jurisdiction in the United States has unique requirements regarding mediation training and credentialing. However, at this time, those requirements are applicable only to mediators choosing to participate in court-annexed mediation. Counselors interested in providing mediation services or in using dispute resolution skills and techniques to enhance their consulting practices should consider a quality training regimen that includes specific training in interest-based negotiation and mediation. ■*

# Dispute Resolution for All Counselors? A New Way of Looking at Our Business

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# Information Overload:

## Emerging Academic Challenges and Their Implications

BY JAMES D. RAY, M.S.

### INTRODUCTION

THE FIRST DECADE OF THE INFORMATION AGE should have been a boon for commercial real estate, and no other segment of the industry could have benefited more than the next generation. Undergraduate and graduate students enrolled in real estate programs have more tools and opportunities than previous generations, but classroom observations and employer sentiment suggest that current students increasingly struggle with an emerging set of information age problems.<sup>1</sup>

These challenges threaten long-term achievement and extend well beyond the classroom, but unlike generation-defining problems from previous eras, remedies to these challenges are more likely to be generated from awareness and experience than academic study. Consequently, working practitioners have more to add to the current academic environment than ever before.

### PROBLEM 1. KEEPING UP

Just as typewriters and carbon copies have been replaced by computers and email, formal real estate training in the information age is a distant relative of the program that educated most working professionals. The current educational environment is increasingly defined by the following traits:

- **Options.** Previous generations of students interested in commercial real estate careers generally majored in business administration, finance or accounting and had the singular option of obtaining a generic Master of Business Administration degree. Today's students, on the other hand, have dozens of degree options at the undergraduate and graduate level. Degree and course options go far beyond "introduction to

commercial real estate" and include topics such as hotel investment management, financial engineering and real estate development.<sup>2</sup>

- **Competition.** Domestic business schools have a far larger pool of applicants than in previous eras, which is driving a nationwide trend toward increased specialization and selectivity. Today's top students need standardized test scores in the 95th percentile range to have a fighting chance of getting into the highest-ranked schools, a stark contrast from 30 years ago when standardized test scores were rarely required. Additionally, competition does not abate after acceptance, as a tenth of a grade point frequently separates 20 percent or more of graduating classes.
- **Delivery.** Although campuses were unaffected by the Internet prior to the 1990s, the information age is rapidly expanding educational options. Transient education platforms (such as online, night and weekend offerings) are some of the fastest-growing academic segments and provide a wider range of students with access to higher education. Students in cities nationwide can get a Cornell University Master



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## Information Overload: Emerging Academic Challenges and Their Implications

of Business Administration degree, for example, without spending more than a week on campus,<sup>3</sup> and traditional business schools are expanding beyond their home cities, offering specialized night and weekend degrees to working professionals in nearby locales.<sup>4</sup>

- **Expense.** Tuition has increased over the last 30 years by approximately 10 percent per year,<sup>5</sup> and several other factors exacerbate the financial burden of higher education. Graduate degrees have become the norm for breaking into the industry, and many of the nation's top real estate programs are located in New York, San Francisco, Los Angeles and Cambridge, where housing costs add at least \$10,000 per year to the total education bill.
- **Institutional goals.** Academic institutions have been forced to adapt to an evolving landscape and, in an effort to maintain financial viability within a highly competitive environment, universities are targeting high value-added platforms such as specialized graduate programs (particularly for working professionals) focused on alternate delivery.

Overall, the current educational landscape is defined by technology, competition and specialization, and faculty observations suggest that students are responding in ways that expose them to costly mistakes. More specifically, students are migrating toward a “fast surfing” approach to information seeking (think Google-based research instead of textbook reading), which leaves them lacking conceptual understanding.<sup>6</sup>

### PROBLEM 2. MASTERING THE BASICS

Commercial real estate students face a myriad of academic options. From courses on “Mixed-income Housing Development” at MIT to “Urban Fiscal Policy” at Wharton to “Strategic Real Estate Management” at New York University, students have a range of exciting topics to choose from but, unfortunately, countless options divert attention away from core real estate principles. Consequently, many students complete real estate programs without mastering basic industry concepts.

Intelligent and ambitious students zip through complex analytical problems with amazing efficiency, but dozens of these same students struggle when asked to interpret and critique a property appraisal. They dive into data-slicing exercises with ease but stumble when asked, “Is

this cap rate too high, too low or about right?” or “Are you a buyer or a seller at this appraised value?”

Similarly, many students dazzle professors and classmates with presentation graphics, but they stumble when asked to explain differences between a positive financial leverage situation and a negative financial leverage situation, or when asked to predict the relative performance of Property A (a full-service hotel with a 65 percent fixed-cost ratio) versus Property B (a downtown office building with long-term leases and a 50 percent fixed-cost ratio).

This increasingly common breakdown is complemented by institutional migration away from the original purpose of higher education. Colleges and universities traditionally sought to impart conceptual understanding of fundamentals, or what researchers call “propositional knowledge,” which is critical to problem solving in a constantly evolving world.<sup>7</sup>

However, academia increasingly responds to lightning-fast flows of information and daily doses of new data by promoting procedural knowledge, the understanding of memorable processes such as applying formulas and creating charts. This institutionalized focus on procedural knowledge hinders achievement by limiting students' ability to solve problems but, more importantly, it limits the generation of new knowledge. As a result, identifying the shrinking minority of students primed for problem solving apart from those with procedural memories has grown into a primary and costly challenge for employers.

### PROBLEM 3. COMMUNICATION DEFICIENCIES

Effective written and spoken communication skills are vital in the contemporary work force<sup>8</sup> and are threatened by the migration toward reactive (and often thoughtless) conveyance of ideas. Handwritten letters and formal reports have been replaced by quick email notes, interactive chats and text messages. And although new media limits wait times, information age technology frequently undermines student communication skills.

For example, student essays and presentations often lack clarity and style, and undeveloped communication skills bleed into the work force. In fact, nearly one-third of employers report that college graduate writing skills are deficient.<sup>9</sup> Additionally, classroom observations suggest that students particularly struggle with effective writing in real-world situations. Given an essay topic, a two-thousand-word limit and six months to complete an assignment, student writing excels and is generally

# Information Overload: Emerging Academic Challenges and Their Implications

readable and compelling, but even exceptionally bright students struggle when given 30 minutes to explain, for example, the differences between publicly traded real estate (REITs) and privately held properties, without the benefit of notes, classmates, books or the Internet.

Student presentations also often lack clarity, but unlike their writing, which is commonly threatened by a lack of organization, their presentations tend to be plagued by rigidity and an aversion to diverting from bullet points on slides. It is certainly true that professional writing and presentation skills improve over the course of a career, but students stand to benefit from targeted feedback, clear expectations and peer review when it comes to writing and presenting.

## PROBLEM 4. BEHAVIORAL PITFALLS

Coverage of the most relevant problem area is largely absent from contemporary real estate curricula. Behavioral finance, an emerging body of academic work that combines psychology and traditional economics, explains why “wealth maximizers” consistently make irrational decisions, and the field arguably provides real estate investors with more useful information than any other area of study, as it explains industry phenomena.

The transaction environment of 2007, for example, highlights the real estate sector’s structural propensity for booms and busts. Investors purchased nearly \$450 billion of commercial properties immediately before valuations fell by 30–40 percent, and lenders provided the bulk of acquisition capital (about \$300 billion) at record low rates.

Behavioral economists explain the sector’s excessive swings by diving into irrational behavior and highlighting tendencies such as investor overconfidence. Investors often seek information that confirms assertions about the real estate world while dismissing contrary evidence (confirmation bias), tend to think that past events were more predictable than they actually were (hindsight bias) and struggle with the alignment of economic interests.

Cyclical ebbs and flows are natural components of investing, but behavioral finance attempts to differentiate irrational behavior and provides flags for investors (and students) looking to avoid costly mistakes. Due to natural overlap with real estate investment activity, behavioral finance topics deserve a place in contemporary classrooms and increased understanding among practitioners.

## REMEDIES

Information age challenges have increased the disparity between the “best” and “worst” students, and classroom observations of each group can impart value to students and practitioners alike.

- **Increase Awareness.** Most of the emerging problems outlined above are unintentional by-products of reactive tendencies, and the best defense comes with awareness. Students or practitioners looking to better understand these increasingly common pitfalls will find value in reading related texts (e.g., *Nudge: Improving Decisions about Health, Wealth and Happiness* by Thaler and Sunstein), by completing a journalism writing class (journalism methods are applicable because they focus on quick, digestible writing, which anchors contemporary business communication; e.g., Gotham Writers’ Workshop sponsors online and day classes in article writing that start at \$150), or by enrolling in a public speaking program (e.g., Toastmasters).
- **Focus on individual problem-solving skills.** Information overload and a rapidly evolving landscape result in fast surfing, which often leaves students with a working memory of superficial topics but lacking in the area of ad hoc problem-solving skills. Discerning problem solvers from “fast surfers” is difficult, particularly in a forum such as a job interview where applicants seek to illicit a positive reception. However, some tricks of the trade prove to be very helpful in this regard. Interviewers should rely on interactive discussions about complex situations instead of asking “yes” or “no” questions. Providing a job applicant with a case study situation that includes more information than necessary to solve the problem will highlight problem-solving skills (or the lack of), because “fast surfers” try to fit all information into a response while problem-solvers tend to focus only on valuable information. Brain teasers are also effective in fleshing out problem-solving skills (e.g., “how many golf balls can fit into a Boeing 747?” or “how many movie theaters are in the United States?”). The key with brain teasers is to carefully observe a responder’s problem-solving approach instead of debating correct answers.
- **Find quality mentors.** Another distinction between academic high performers and underperformers relates to the presence (or absence) of an effective mentor.

## Information Overload: Emerging Academic Challenges and Their Implications

Good mentors take on one or two young professionals and get actively involved in their development in the field for at least one to two years. They build relatively deep working relationships and provide invaluable support as students progress over the career learning curve. The least effective mentors, on the other hand, tend to take on too many students and rarely get beyond informal pleasantries.

One effective way of sparking such a relationship is to begin by sharing reading lists. A rapidly growing body of plain English texts gives mentors and students an informal basis for conversationally exploring real world problems. Student favorites include: *Fooled by Randomness* and *The Black Swan: The Impact of the Highly Improbable* (Nassim N. Taleb); *Liar's Poker*, *Moneyball* and *The Big Short* (Michael Lewis); *When Genius Failed: The Rise and Fall of Long-Term Capital Management* (Roger Lowenstein); and *Nudge: Improving Decisions about Health, Wealth and Happiness* (Richard M. Thaler and Cass R. Sunstein). In addition, the PricewaterhouseCoopers and Urban Land Institute annual publication *Emerging Trends in Real Estate* is filled with anecdotes and useful information.

- **Increase practitioner involvement.** Working professionals bring much needed experience to the increasingly specialized nature of commercial real estate academia. Reach out to faculty members at local universities and offer to provide resources such as teaching material, mentoring or guest visits. Students and institutions benefit from experience, and professionals gain a frontline view of emerging talent.

The key to successful practitioner involvement rests in the use of realistic material and the value of professional experience.<sup>10</sup> The most effective adjunct professors and class visitors bring examples, case studies, experiments and distilled industry information into the academic environment. Authentic material engages students and prepares them for situations they will likely see in the future. Integrate actual real estate documents such as leases, contracts, mortgages and appraisals into class material. Hide names and locations for anonymity when needed, but use care not to delete transaction-defining details.

### CONCLUSION

Today's commercial real estate educational environment is significantly different from the 20th century version experienced by most working professionals. Current

students benefit from many different options and flexibility, but a handful of emerging challenges threaten student development and future productivity.

More specifically, students increasingly depend on Google-like research methods, and institutional focus has migrated toward procedural knowledge at the expense of conceptual understanding. Consequently, a growing number of graduates are well versed in industry slang but lack problem-solving skills and struggle with basic communication.

The observations outlined above are based on hundreds of interactions with students, and although they fairly summarize problem areas that consistently challenge today's students and young professionals, they certainly do not define all students. However, since these emerging classroom challenges result from reactions to information age changes, their solutions extend well beyond the classroom. ■

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Harvard Professor William Poorvu with Jeffrey L. Cruikshank authored a very useful real estate text that relies heavily on real world material: *The Real Estate Game: The Intelligent Guide to Decisionmaking and Investment*, 1999; Michael Mauboussin, an investment manager and adjunct professor at Columbia University, writes about behavioral finance and outlines experiments that help bring theory into the classroom: *Think Twice: Harnessing the Power of Counterintuition*, 2009; and *More Than You Know: Finding Financial Wisdom in Unconventional Places*, 2006. Many real estate research firms publish free newsletters that familiarize students and practitioners with industry issues. Examples include *About Real Estate* from Torto Wheaton Research, *CoStar Advisor* and *Real Estate Investment SmartBrief* from NAREIT.



# Demand for Warehouse and Distribution Center Space

BY JOSEPH S. RABIANSKI, PH.D.; AND PHILIP A. SEAGRAVES, MSRE

## INTRODUCTION

THE MARKET FOR WAREHOUSE AND DISTRIBUTION CENTER (W/DC) space is the least discussed property type in the academic and professional literature. Yet the demand for W/DC space is important for developers and investors to understand. The underlying determinants of W/DC demand are complex, have changed over time and show signs of continued change in the future.

Both the theory of and the investigation into the determinants of W/DC space demand evolved from office and retail space demand models that focus on employment and population. Prior to 1990, W/DC demand was the poor cousin to the other commercial property market studies. From 1990–1995, W/DC analysis came into its own. This article presents a brief review of this “industrial” space literature that, heretofore, included W/DC space as an undifferentiated property type. It also expresses current thinking, hints at potential new developments that may cause the current models to come into question, and concludes with suggestions for further research into W/DC demand.

To set the stage for a discussion of the demand for W/DC space, it is important to realize that W/DC space consists of different forms of warehousing. The general definition of a warehouse is “a structure or room for storage for merchandise or commodities.”<sup>1</sup> Also, “Warehouse applies to unrefrigerated or refrigerated buildings that are used to store goods, manufactured products, merchandise or raw materials.”<sup>2</sup>

However, within the real estate industry, storage space is used for different purposes:

- **Bulk:** Containers or pallets enter the structure in one truck and are routed to two or more trucks for distribution to users of the products (cross docking of pallet loads);
- **Fulfillment:** Containers or pallets enter the structure, the pallets are disassembled and routed by individual parcel to other trucks for distribution to users of the product (cross docking of disassembled parcels from incoming pallets);
- **Distribution:** Individual items enter the structure and are routed by individual parcel to other trucks for distribution to users of the product;

## About the Authors



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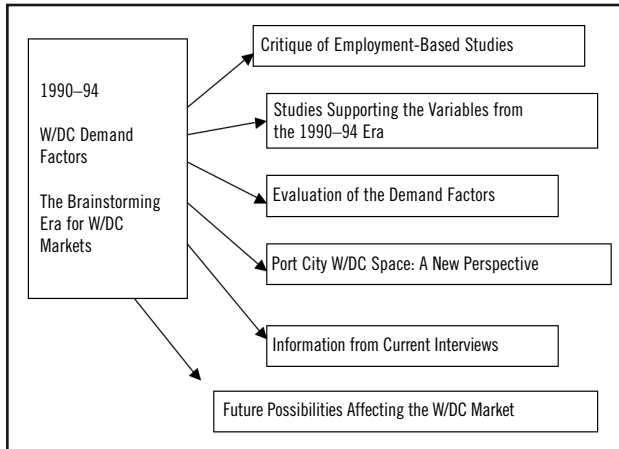


**Philip A. Seagraves, M.B.A., MSRE, Ph.D. candidate**, is a researcher and instructor in the Real Estate Department at Georgia State University. Seagraves' background also includes roles in several real estate firms and a variety of executive level corporate positions in strategic planning, marketing and product management.

# Demand for Warehouse and Distribution Center Space

- **Intermodal:** Shipments come to the facility by one transportation mode and depart via another. The transfer of containers from ship to truck or rail is an example of this activity. The transfer from rail to truck is another example.

A schematic of this article appears below:



## W/DC DEMAND FACTORS

The foundation of the W/DC demand determinant literature was laid from 1990–1994. During this time, most of the academic studies took a broad perspective, researching “industrial” demand that includes W/DC but also other property types such as manufacturing (both heavy and light), R&D and general flex space. The important demand factors we extracted from these studies are as follows:<sup>3</sup>

- Physical factors such as structural attributes are important determinants of demand. Age, condition, ceiling heights, structure size, column span, number of dock doors, number of drive-in doors, sprinklers, building age, parking area, truck service area, presence of a railroad siding and presence of office space in the structure are important factors.<sup>4,5</sup>
- Location variables such as access to thoroughfares and location in a city or metro area are important considerations in determining warehouse demand.<sup>6</sup>
- Factors that extend the scope beyond the physical characteristics of the structure include the revenue potential of the property, the per capita income of the market area, change in the population of the market area and access to major highways.<sup>7</sup>
- Demand for warehouse space is a function of physical features (size, percent of office space, ceiling height, dock doors, and age but not rail siding); financial factors (industrial cap rate and prime rate but not an index of local economic activity); location (county and distance to airport); and type of tenant (single or multi-tenant).<sup>8</sup>

- Demand for warehouse space is a function of the labor force and the population of the economy, public infrastructure and services, and international issues such as currency exchange rates and trade barriers/restrictions. Transportation is of particular note since it is the one factor most aligned with the demand for warehouse space. The author contends this to be the case when transportation access including highways, rail and deep water are advantages of a region.<sup>9</sup>
- Demand for W/DC space increases as firms relocate their operations from cheap office space (Class B and C space) to W/DC space in business and industrial parks typically in the suburbs.<sup>10</sup>
- Demand decreases as firms get better at managing inventories with modern computer systems and inventory handling equipment.<sup>11</sup>
- Increased warehouse technology (in the form of racking systems and forklifts) reduce demand for warehouse space property.<sup>12</sup>
- Industrial property demand (like other asset classes) is affected by lags related to the desire of organizations to purchase and deploy new capital and also in the risk mitigation approach of taking up only a portion of new capital in each of several successive years or investment periods.
- Warehouse employment is a cleaner proxy for warehouse demand as this figure tracks inventory levels very closely.<sup>13</sup>
- Changes in output (or employment) and movements in the after-tax cost of corporate capital are associated with industry property completions.<sup>14</sup>
- Increases in manufacturing output that result primarily from technological improvements and capital intensification rather than increased employment affect industrial space demand.<sup>15</sup>
- Considering employment as the major driver of commercial real estate demand, the author introduces economic development factors into the analysis. These additional factors are the employment growth rate, the instability of employment, the industry mix (the industrial structure of the local economy as revealed in one-digit SIC codes), a measure of industrial diversity (as measured by the Theil Entropy Index), educational attainment, percentage of young firms (five years old or less) and the percent of locally owned firms.<sup>16</sup>
- Location, even small geographic differences in location, can affect demand for warehouse facilities. Also, the land-to-building ratio can affect demand.<sup>17</sup>
- Replacement demand due to functional and locational (external) obsolescence of existing facilities affects total

# Demand for Warehouse and Distribution Center Space

demand for new W/DC space.<sup>18</sup> Properties suffering from obsolescence face a declining demand.

- Focusing on the price per square foot of industrial properties as the dependent variable, price per square foot in earlier periods, recent construction, a “monetary base” (undefined in the article) and a variable created as the difference between the long-term Treasury bond and the Moody’s Baa corporate bond rate.<sup>19</sup>
- The “path of goods movement” (POGM) theory proposes that land for warehouses gravitates to transportation corridors and hubs with favorable access to seaports, rail, air and truck transportation between major import sites and consumption centers throughout the nation. Figure 1 displays a map of the U.S. with the major highway transport routes. Rather than locating warehouses near the large manufacturing centers as had been the custom in past development cycles, warehouse space demand will more closely follow population centers where manufacturers and importers can position their product for quick consolidation, packing and distribution to the key retail and consumption markets in large population centers. Markets on this path of goods movement will see more warehouse space than other markets controlling for industrial and manufacturing activity.<sup>20</sup>

Summarizing the 1990–94 literature research into W/DC demand identified a wide array of substantive variables. They included physical attributes of the site and the structure; locational characteristics; inventory management techniques such as Just-in-Time inventory (JIT); technological improvements in W/DC equipment; the price of capital goods (W/DC space and equipment); the cost of capital; replacement demand due to functional and locational obsolescence; economies of scale; path of goods movement; and industrial employment level changes.

## CRITICISM OF INDUSTRIAL EMPLOYMENT-BASED MODELS

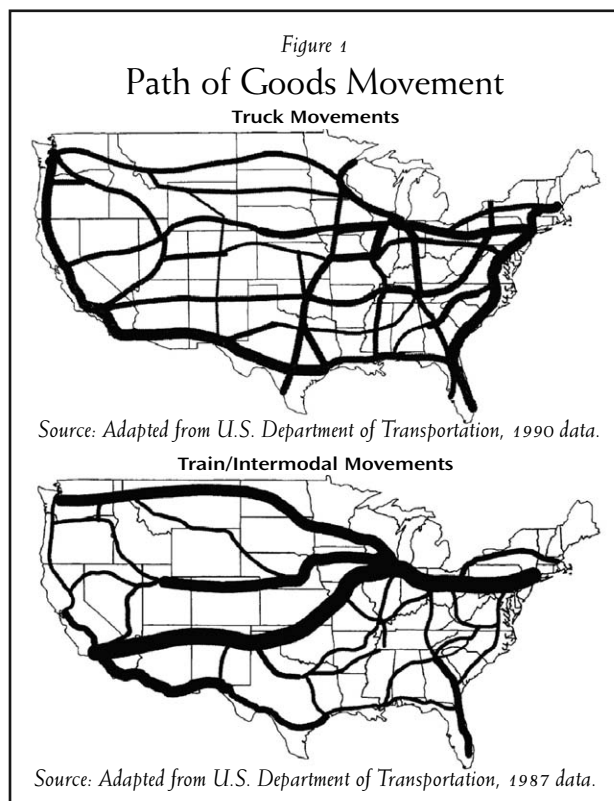
Starting in 1997 the “industrial space” demand literature branched in two directions from the 1990–94 literature. The first was the criticism of industrial employment-based demand models. The basic element of this criticism contends that the industrial space demand model and the analysis of the industrial space market are not variants of the office demand model and market analysis.<sup>21</sup> The determining factor in office demand models is employment with a more specific definition of office-based employment across SIC codes (NAICS codes today).<sup>22</sup> Some office studies used total employment in SIC codes that had a high percentage of office-based employment such as the finance, insurance and real estate SIC code (FIRE) and the services code.

The task of estimating office-based employment is difficult, but estimating “warehouse-based employment” is even more difficult. Manufacturing, wholesale and transportation sector employment are not easily segmented into employment in W/DC facilities. The manufacturing sector includes employment in both production and warehousing facilities, very often without specific distinction. Many workers in wholesale and transportation do not work in W/DC facilities. Many workers in the retail industry are W/DC employees but counted as retail workers; consider the big box retailers that use W/DC type facilities with high ceilings for their retail stores and use the upper racks for storage.<sup>23</sup>

“The demand for warehouse space originates more from the volume of inventories stored, rather than from the workers used to move this material around.”<sup>24</sup> The volume of freight shipments was used as a proxy for warehouse inventory.<sup>25</sup>

## SUPPORT FOR THE ORIGINAL DISCOVERIES

As stated above, starting in 1997 the “industrial space” demand literature took one of two branches from the



## Demand for Warehouse and Distribution Center Space

1990–94 literature. The second branch presents empirical support for the original discoveries made in the 1990–94 literature. The empirical results generated the following conclusions:

- Focusing on W/DC properties, ceiling height, age of the structure, number of ground level doors (not dock high doors), the change in net employment, and location in a metropolitan area (e.g., Dallas/Fort Worth) are statistically significant.<sup>26</sup>
- Focusing on W/DC properties and using a survey, a majority of respondents (62 percent) indicate that they expect their square footage needs to increase in five years; they are satisfied with the current number of doors and believe their future need for dock doors will remain unchanged (60 percent); their need for ceiling height will not change in five years (79 percent).<sup>27</sup> The survey was performed in 1998 and may not have current relevance.
- Focusing on “industrial” property, the demand for industrial space is a function of employment, investment and technology.<sup>28</sup>

### NEW DETERMINANTS

Focusing attention on the determinants of NOI in W/DC properties in three metropolitan markets, significant relationships for several different variables were discovered. In Chicago, the change in exports, the change in gross domestic product (GDP) and the W/DC vacancy rate were found to be significant. In Dallas, the change in exports and inventories as well as building “starts” (a ratio of new construction to the stock of W/DC space in the metro area) were found to be significant. In Los Angeles, the change in imports and manufacturing productivity were found to be significant. Previous period NOI was also found to be significant in each metro area.<sup>29</sup>

Focusing on the “industrial” property market, previous period rent, current period vacancy, current period GDP and the latest period change in GDP are statistically significant determinants of W/DC demand.<sup>30</sup>

### EVALUATION OF SUPPORTING VARIABLES

The previous sections of this article chronicle the W/DC market determinants discussed in the literature specifically starting with 1990. However, there are market factors not fully discussed in the literature.

#### Gross Domestic Product

The role of GDP in W/DC models focused on the U.S. needs examination. First, GDP numbers do not exist for

small geographic areas such as local market areas defined as counties or metropolitan areas. So, GDP-based models use national values in local market models; these GDP values are a proxy for local market vitality. The accuracy of this proxy relationship is questionable.

GDP is the total dollar value of all new goods and services produced in the U.S. in a specific year. Relating GDP to W/DC, consider the following ideas:

1. The newly produced goods may require W/DC space but the services do not. So, GDP measures more value than what goes into W/DC space.
2. Imports, which are not produced in the U.S., are a big factor in W/DC demand.<sup>31</sup>

#### Population or Employment

Population or employment: Which is the conceptually correct W/DC demand side variable? Population and employment numbers in a geographic area are related in the “labor force participation” rate. The rate is stated as the civilian labor force (employed plus unemployed workers) divided by the population in that area. For the majority of geographic areas, the labor force participation rate is typically in the 55–70 percent range. To develop the demand for W/DC space either of these concepts can be used. But which is most conceptually correct? It is population because retail expenditures are related to population more directly than to employment. Employment by NAICS codes in the study area is conceptually less appropriate because employment data does not include children or senior citizens who are retired. These are two large population groups.

#### Consumer Disposable Income

An author made the following statement: “... high levels of disposable income in the region... draw warehouse developers there.”<sup>32</sup> W/DC space holds inventories of retail goods distributed to retail stores for purchase by people who have disposable income. Two geographic areas with the same population but with different incomes will exhibit different demand levels for retail goods. The appropriate income measure to use with population figures is the per capita income of the population in the market area. If households are the measure of people in the area, the mean household income is the appropriate measure. However, many data sources provide only the median income figure of households in the market area.<sup>33</sup>

# Demand for Warehouse and Distribution Center Space

## Levels of Location

W/DC space is located on specific sites in the local economic area and this W/DC space serves at least two related but distinct geographic market areas. The local market area consists of the counties that comprise a metropolitan area. Some portion of the local W/DC space serves the needs of the local residents in the metro area, and it serves the needs of manufacturers that provide goods to both the local residents and to those residing outside of the local market area.

The regional market area that surrounds the metro area is the other geographic area. The other portion of the local W/DC space serves the needs of the consumers, manufacturers and the importers in this regional geographic area.

The geographic extent of these exurban areas reflects federal government regulation that sets restrictions on the truck transport industry. These restrictions are the topic of the next subsection.

## Drive Time Regulation

On the demand side, the important linkage for W/DC facilities is population. A key to the demand for W/DC space is “the percentage of population within one day’s drive of the port.”<sup>34</sup> A W/DC facility can serve at least two different population bases. It can serve the needs of the population in the local economic area, and it can serve the needs of a population external to the local economic area—the regional market area. The ability to serve these populations depends in large part on the regulations governing the truck drivers’ hours of service. The regulations are below:

*Commercial truckers transporting property* (the rules for passenger trucks are a bit different) *are subject to daily and weekly limits on the number of hours they are permitted to work. Generally, drivers are permitted to work no more than 14 consecutive hours. Of that time, only 11 hours may be devoted to driving. (The remaining time may be devoted to paperwork, loading and unloading, etc.). After exhausting these limits, drivers are required to spend a minimum of 10 consecutive hours off duty. (At this time a secondary source states that the 11 hours of driving time is being reduced to 10 hours but we have been unable to confirm this point.)*

Drivers are subject to weekly limits as well. Federal regulations prohibit driving after the driver has been on duty 60 hours in seven consecutive days, or 70 hours in

eight consecutive days. Drivers may restart the 60- or 70-hour clock by taking no less than 34 consecutive hours off duty.

The local population can be served by “short haul” truckers who leave a trucking facility, deliver the products and return to the facility within the 11-hour driving time and 14-hour maximum limits and generally confine the trips to the local economic market area—the metro area.

The population in the regional market can be served by “long haul trucking” which is also determined by these regulations. These long haul day trips involve a departure and return within the 11-hour driving time and 14-hour maximum limitation. On the condition that the truck can average 55 miles per hour, the total driving time sets out a total distance of 550 miles and a one-way distance of 275 miles.

## Points of Entry/Egress

The points of entry are the facilities along the three coasts of the U.S. (the East, West and the Gulf coasts) and the border crossings with Canada and Mexico. Figure 1 displays the 10 major ports and the 10 top border crossings with Canada and Mexico.

## Path of Goods Movement Theory

The POGM model is still theory; it suggests a strong association between truck traffic, W/DC locations and population. An inspection of the POGM routes reveals a strong relationship to the Interstate Highway System. Larger W/DC nodes tend to occur at major intersections in this system along routes to and near large population bases. A port is the end point of the POGM system. Over time, the container volume has grown at these major ports and the square footage of warehouse space per person in the major nodes of the POGM system has grown.<sup>35</sup>

## Logistics and Supply Chain Management

Logistics has many definitions that may be of interest to the reader. We provide the following from a Google search of the term. Notice that both of these definitions link a process to a warehouse.

- *The detailed coordination of a complex operation involving many people, facilities or supplies;*
- *The management and control of the flow of goods and services from the source of production to the market. It involves knowledge, communication, transport and warehousing.*

## Demand for Warehouse and Distribution Center Space

Supply chain management (SCM) is also defined as a process that is linked to a warehouse. Here is an appropriate definition taken from a Google search:

- *SCM is the organization of the overall business processes to enable the profitable transformation of raw materials or products (inputs) into finished goods and their timely distribution to meet customer demand.*

As logistics and SCM improve the efficiency of business operations within a company and between/among companies, the demand for W/DC space will decline. Here the efficiencies created would be quicker processing of products through a distribution center and the minimization of storage time in the facility. A point to remember is that technological change is not always technological improvement; resources could be reorganized in such a way that productivity declines. Logistical processes could also lead to a decrease in efficiency.

### PORT CITY W/DC: A NEW PERSPECTIVE

“Freight movements are an increasingly important determinant of warehousing/distribution space demand. In particular, the rising use of marine container terminals in the global movement of goods is a major contributor to demand (for W/DC space) in the United States.”<sup>36</sup> The growth of global trade volume and the demand for additional W/DC space will be determined by many factors, chief among them being the following factors that involve the accommodation of container ships of increasing size.<sup>37</sup>

### Panamax and Post-Panamax Ships

The size of oceangoing container ships is limited by the capacity of the Panama Canal. A Panamax ship can pass through the Panama Canal but it is at the upper limit for size. The Panamax ship cannot exceed 951 feet in length, 106 feet in width and a “draft” not exceeding 39.4 feet. The ship can carry a maximum of 4,500 containers known as TEUs (twenty-foot equivalent units). Each TEU is 20 feet long by eight feet wide and eight feet high. This limitation affects shipping between Southeast Asia (China, Japan, Taiwan, Korea, etc.) and the ports on the East Coast of the U.S.

These limitations do not affect shipping through the Suez Canal, which can handle larger ships (Post-Panamax) because it is wider. This extra width affects the shipping routes from Southeast Asia to the East Coast ports of the U.S. for the Post-Panamax ships. However, the transit time

for ships taking the Suez Canal route instead of the Pacific Ocean route grows from 11 days to 30 days. The Panama Canal Authority announced plans in 2006 to expand its facilities to handle larger ships. According to their plan,<sup>38</sup> the new facilities will be open in 2014 or 2015. As of 2003, ocean freight carriers were ordering ships of larger size—the Post-Panamax ships. These ships are longer (approximately 1,100 feet), wider (140 feet) and have a greater draft (48 feet); they also carry 8,000 to 12,000 TEUs.

“A Post-Panamax container ship of 366 meters (1,200') length, 49 meters (160') width and maximum 15 meters (50') draft was used as the reference for establishing the ideal lock chamber sizes. This vessel has been identified as the largest type of vessel that carriers in the routes with the greatest frequency, volume and intensity would regularly deploy in transiting the Canal. It accommodates up to 19 container rows through its width and has a nominal cargo capacity of up to 12,000 TEU. The proposed lock dimensions will also allow handling of *Capesize* dry-bulk vessels and *Suezmax* tankers displacing 150,000 to 170,000 tons.”<sup>39</sup>

The obvious conclusion is the port cities that will experience an increase in demand for W/DC space will be the ports that can handle the Post-Panamax ships.

### Port Infrastructure

In order to accommodate the Post-Panamax ships, port cities must:

- Complete and maintain necessary dredging;
- Lengthen the dock facilities;
- Invest in new overhead cranes that can span up to 22 containers (existing cranes can span 18 containers);
- Provide land to expand the size of dock space;
- Provide land to expand the W/DC facilities;
- Provide skilled labor to expand the docks and build the new space;
- Redesign the dock facilities to efficiently handle the expanded volume of containers;
- Change time of operation of the docks. Many current docks operate only from 8 A.M.–5 P.M. In order to handle the expanded volume of containers, these hours will need to be expanded. 24/7 might be the ultimate time schedule for these expanded ports.

### Local Infrastructure

Even if the port facility significantly upgrades its infrastructure in order to handle the expanded container volume, it will not be successful if the containers cannot

## Demand for Warehouse and Distribution Center Space

be efficiently transported away from the docks. The local economy's infrastructure must facilitate this next leg of transportation. The local economy must:

- Provide streets and highways to facilitate the expanded shipments (expanding the number of lanes, dedicating truck lanes, etc.);
- Provide intermodal facilities to handle the expanded shipments;
- Eliminate impediments to traffic flows such as at grade rail crossings and street intersections that cause traffic backups.

### Transit Times

Both producers and retailers want to minimize transit time between the factory and the W/DC that ultimately serves the retailer and its consumers. Transit time has three components—ocean transport, transshipment and land transport. Transshipment involves the removal of the cargo from the ocean carrier and placing it on a land carrier, a process often requiring two to three days. Transshipment may also include the time it takes to cross dock the cargo in a port city W/DC to get the shipments on the road to the ultimate destinations. “The shorter the transit time, the more inventory turns can be accomplished and the greater the flexibility to meet changes in consumer demand or respond to other special circumstances.”<sup>40</sup>

### INFORMATION FROM CURRENT INTERVIEWS

As a point of interest for the authors, a convenience sample was generated and 10 designees from the SOCIETY OF INDUSTRIAL AND OFFICE REALTORS® were asked several questions. One question was: “Please list as many warehouse space requirements as possible from the point of view of a W/DC space tenant.” The items topping their lists largely coincided with the determinants identified in the 1990–94 studies. The rank order of their responses was: location, access to interstates, building size, access to good labor, and building characteristics. When building characteristics were listed, the respondents took the time to identify a series of the physical attributes studied in the academic literature. They also identified several characteristics that have not appeared in the literature. These include: floor flatness and load bearing capacity; insulation rating; electrical power capacity; air circulation; sprinkler system rating; and dock equipment.

In addition, the respondents identified several non-physical determinants not mentioned in the literature. These include: the ability of the facility to expand; the nature and extent of publicly provided infrastructure; the

provision of locational incentives; image of the facility; the nature and quality of neighborhood and the general area; and the safety/security aspects for the facility.

### WHAT THE FUTURE MAY HOLD

Future events and trends will have either a positive or a negative effect on W/DC space in the U.S. These “favorable” or “unfavorable” effects on W/DC space may emerge slowly over time or may not become evident until an unpredictable, critical threshold is reached.

### Energy Costs

A reasonable expectation is increasing energy costs. This increase in fuel cost will raise transportation costs on land, sea and air. Focusing on ocean transport and international air transit, as transport costs increase to a high enough level, they will reduce the advantage of overseas production that uses lower wage labor. This will reduce demand for W/DC in port cities and increase the need for W/DC space near inland metro areas as production of previously imported items shifts to lower wage areas in Mexico, Canada and the U.S.

### Foreign Wage Structure and Standard of Living

As the Asian and Indonesian economies grow, the result will be a rising wage structure and standard of living in that area of the world. To the extent these economies outpace the U.S., this will narrow the current wage gap between the U.S. and the Asian and Indonesian economies. Their costs of production will rise, reducing the current advantage of offshore production. Offshore wages will also increase as labor productivity in these countries increases.

### Terrorist Attacks

Terrorist attacks on the Panama Canal and Suez Canal facilities would result in canal closures. Such disruptions to shipping routes would greatly lengthen shipping days and increase transportation costs. Terrorist attacks on the major port facilities in China, India and Indonesia would stop a high percentage of ocean cargo, raise transport costs and create an environment of uncertainty regarding the economics of offshore production.

### Relative Wage Rates

A decline in the U.S. real wage structure relative to world wages will reduce our relative production costs and thereby increase our exports. At the same time, imports in general, and higher priced imports in particular, will become more expensive. The exact impact on the demand for W/DC space depends on the relative change in imports versus exports.

## Demand for Warehouse and Distribution Center Space

### Value of the Dollar

A decline in the value of the dollar, relative to other key currencies, will reduce our imports and increase our exports. Even if our exports increase, the combined effect of these two changes will be a reduction in the volume of traffic through U.S. ports.

### U.S. Government Regulation

Unproductive regulation that unduly limits transport options for the trucking industry will negatively affect procurement and distribution costs. Limiting driving time for drivers shrinks the travel zones and increases the need for overnight delivery patterns.

### Currency Exchange Rates

As the exchange rate of the U.S. dollar changes relative to foreign currencies, export and import levels in the U.S. will change. If the U.S. dollar falls relative to those foreign currencies, imports become more expensive and exports become cheaper. This situation will narrow the balance of trade deficit but more than likely will not turn it positive. The major effect could be a differential effect on the volume of traffic through specific ports. The ports nearest the export firms may experience an increase in the demand for W/DC space while most firms should experience a decrease in demand from a reduction in imports.

### Ship Size

The size of the fleet of transoceanic ships will continue to increase with more and bigger ships. This trend will not affect deep water ports but will affect the shallow harbor ports that will have to forgo servicing the big ships or incur greatly expanded costs of operation because of the need to dredge. Also, the Post-Panamax ships are wider, so the cranes will have to be upgraded as existing, narrower crane operations become functionally obsolete.

### INTERESTING STATISTICS

The demand for and regional structure of the W/DC space market are largely driven by the top ocean ports, border crossings and airports along the path of goods movement. Analysis of these factors presented in Figure 2 reveals several points of interest about export/import

truck traffic. First, the top border crossing is U.S./Mexico but the next three top crossing points are along the U.S./Canada border. Second, these border crossings are not in major metro areas but may require an extra amount of W/DC space—more than needed by their local population. Figure 3 reveals similar information about the top ten railroad crossings: Seven of the ten crossings are located at the U.S./Canada border.

*Figure 2*

**Top 10 Border Crossings By Truck**

State	Crossing	# Containers
Texas	Laredo	1,382,319
Michigan	Detroit	1,197,967
New York	Buffalo/Niagara Falls	846,114
California	Otay Mesa/San Ysidro	684,425
Texas	El Paso	644,272
Michigan	Port Huron	625,642
Texas	Hidalgo	419,426
Washington	Blaine	310,075
New York	Champlain/Rouses Point	294,970
Arizona	Nogales	276,877

*Source: U.S. Department of Transportation, Research and Innovative Technology Administration, Bureau of Transportation Statistics*

*Figure 3*

**Top 10 Border Crossings By Train**

State	Crossing	# Trains
Minnesota	International Falls	3286
Michigan	Port Huron	2846
Texas	Laredo	2479
New York	Buffalo/Niagara Falls	2120
Minnesota	Warroad	2097
Michigan	Detroit	1895
North Dakota	Portal	1739
Texas	Eagle Pass	1555
Texas	El Paso	1424
Washington	Blaine	1219

*Source: U.S. Department of Transportation, Research and Innovative Technology Administration, Bureau of Transportation Statistics*



# Demand for Warehouse and Distribution Center Space

Figure 4

## Top 15 Ports by Total Value in 2008

Port	Value (\$ millions)
Los Angeles, CA	\$243,910
New York/New Jersey	\$185,385
Houston, TX	\$147,695
Long Beach, CA	\$91,537
Charleston, SC	\$62,332
Savannah, GA	\$58,987
Norfolk, VA	\$53,950
New Orleans, LA	\$49,765
Baltimore, MD	\$45,312
Philadelphia, PA	\$43,176
Seattle, WA	\$39,989
Oakland, CA	\$38,698
Morgan City, LA	\$38,503
Tacoma, WA	\$35,322
Corpus Christi, TX	\$29,685

Source: U.S. Department of Transportation, Research and Innovative Technology Administration, Bureau of Transportation Statistics

Figure 5

## Top 10 Airports by Total Value in 2008

Airport	Value (\$ millions)
J. F. Kennedy, NY	\$167,966
Chicago, IL	\$97,180
Los Angeles, CA	\$78,292
San Francisco, CA	\$52,756
New Orleans, LA	\$49,585
Anchorage, AL	\$41,443
Miami, FL	\$40,036
Dallas/Ft. Worth, TX	\$39,488
Atlanta, GA	\$32,335
Cleveland, OH	\$30,812

Source: U.S. Department of Commerce, U.S. Census Bureau, Foreign Trade Division, 2009

Figure 4 displays the top fifteen ocean ports and Figure 5 displays the top ten U.S. airports for shipping products. Figure 6 shows a different data set for volume of cargo in the top 30 international airports. Notice that Memphis, the FedEx hub, shows up as number one in cargo followed by the airport in Louisville (UPS hub), number two in the U.S. These airport facilities have a significant impact on the W/DC space demand in their local market areas and on specific locations in those local market areas.

Figure 6

## Cargo Traffic 2009

Last update: August 5 2010

Rank	City (Airport)	Total Cargo	% Change
1	MEMPHIS TN, US (MEM)	3,697,054	0.0
2	HONG KONG, HK (HKG)	3,385,313	(7.5)
3	SHANGHAI, CN (PVG)	2,543,394	(2.3)
4	INCHEON, KR (ICN)	2,313,001	(4.6)
5	PARIS, FR (CDG)	2,054,515	(9.9)
6	ANCHORAGE AK, US (ANC)*	1,994,629	(15.0)
7	LOUISVILLE KY, US (SDF)	1,949,528	(1.3)
8	DUBAI, AE (DXB)	1,927,520	5.6
9	FRANKFURT, DE (FRA)	1,887,686	(10.6)
10	TOKYO, JP (NRT)	1,851,972	(11.8)
11	SINGAPORE, SG (SIN)	1,660,724	(11.9)
12	MIAMI FL, US (MIA)	1,557,401	(13.8)
13	LOS ANGELES CA, US (LAX)	1,509,236	(7.4)
14	BEIJING, CN (PEK)	1,475,649	8.1
15	TAIPEI, TW (TPE)	1,358,304	(9.0)
16	LONDON, GB (LHR)	1,349,571	(9.2)
17	AMSTERDAM, NL (AMS)	1,317,120	(17.8)
18	NEW YORK NY, US (JFK)	1,144,894	(21.2)
19	CHICAGO IL, US (ORD)	1,047,917	(17.1)
20	BANGKOK, TH (BKK)	1,045,194	(10.9)
21	GUANGZHOU, CN (CAN)	955,270	39.3
22	INDIANAPOLIS IN, US (IND)	944,805	(9.2)
23	NEWARK NJ, US (EWR)	779,642	(12.1)
24	TOKYO, JP (HND)	779,118	(8.3)
25	LUXEMBOURG, LU (LUX)	628,667	(20.2)
26	OSAKA, JP (KIX)	608,876	(28.0)
27	SHENZHEN, CN (SZX)	605,469	1.2
28	KUALA LUMPUR, MY (KUL)	601,620	(9.9)
29	DALLAS/FT WORTH TX, US (DFW)	578,906	(11.3)
30	MUMBAI, IN (BOM)	566,368	1.3

Airports participating in the ACI Annual Traffic Statistics Collection.  
Total Cargo: loaded and unloaded freight and mail in metric tonnes.

\*ANC data includes transit freight.

Source: Airports Council International (ACI) at [www.airports.org](http://www.airports.org)

# Demand for Warehouse and Distribution Center Space

## SUMMARY AND CONCLUSION

Today, research into the demand for W/DC space must investigate the flow of goods and technological factors for answers to the pressing questions concerning both industry and academia. Early research focusing on the flow or path of goods transport began when U.S. manufacturing shifted first to Mexico and later to Asia, and increasingly to China. In the years since the introduction of the path of goods model, China has emerged as the dominant source for consumer goods shipped via larger and larger container ships to ports on both the East and West coasts of the U.S.

As the need for W/DC space grew in port cities, the demand for W/DC space in general was reduced by concurrent shifts in retail distribution activity in the U.S. As large retailers such as Walmart, Target, Costco, etc. grew, they sought to reduce costs and improve the speed and flexibility with which they move product to their stores. This motivation led to the creation of large W/DC structures placed along the pathways—interstate highways—to key markets. This trend reduced the demand for W/DC space in many older geographic markets. So demand grew in port cities and key inland sites along major truck transport routes while demand fell in other market areas. In more recent years, the W/DC space placed in the key markets, port cities and metro areas with major interstate interchanges was large square footage under a single roof—750,000 or more square feet.

Real estate developers building W/DC space should now consider the projections of port growth, import/export activity, and the transport pathways to major markets rather than the traditional industrial or manufacturing employment projections when making decisions on the amount of space and the best locations for new construction of speculative W/DC projects.

W/DC demand literature presents an orderly progression from employment and population demand models to current analytical methods tailored to the dynamics in the W/DC economic activity and spatial markets. ■

## ENDNOTES

1. Webster's New Collegiate Dictionary.
2. Space Type Definitions – Warehouse at [http://www.energystar.gov/ia/business/tools\\_resources/target\\_finder/help/Space\\_Type\\_Definitions\\_-\\_Warehouse.htm](http://www.energystar.gov/ia/business/tools_resources/target_finder/help/Space_Type_Definitions_-_Warehouse.htm).
3. Many of the studies referenced in this article focus on “industrial” properties. W/DC space is combined with manufacturing (usually light manufacturing). Also, some of the studies focus on a single set

of factors such as structural items while other studies combine sets of factors such as structural and locational. For this reason the categories presented are the authors' choice; for other authors the categories could be specified differently. Finally, this literature search focused on concepts and ideas affecting the demand for W/DC space so statistical results appearing in the articles were ignored.

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# The Value Proposition of Sustainability: It's in the Eye of the Beholder

BY LINDA G. TRESSLAR, CRE

## INTRODUCTION

BEFORE THE FIRST DIME IS COMMITTED TO A SUSTAINABILITY initiative, the spender has already determined a priority lens through which “value” will be judged. Real estate is a dynamic asset with multiple stakeholders, investor/owners, tenants and employees as well as the communities in which the real estate is located. This means there will surely be multiple definitions of sustainability representing varied elements and prioritization of the value derived thereof. Sustainability, as an overarching concept, is easy enough to understand—keep the focus on boosting efficiency in the use of materials and operations that constitute a real estate asset. From this basic premise, however, have emerged a variety of views as to priority, necessity and value of certain sustainability actions.

With the continued advancement of sustainability initiatives, both mandated and voluntary, has come the rise of differing sustainability priorities and measures of success attributed to the same asset by various stakeholders. The minefield for an asset owner then becomes how best to address these varying value propositions for maximized long-term asset value. To do so, owners and investors must understand the sustainability value propositions of others, including the broader community, represented by government agencies and users of an asset. These stakeholders may have differing priorities for specific sustainability initiatives. Without understanding the measure of success through their “value lenses,” asset owners can wind up spending on measures that carry less weight or, even worse, falling behind other assets by not spending in

essential areas. This could result in economic obsolescence over time. The focus of examination in this article is on areas of common ground and variability when it comes to sustainability initiatives, their priority and perceived value from differing stakeholder perspectives.

## COMMON GROUND

Are there sustainability initiatives emerging that owner/investors ignore at their peril when it comes to government mandates and tenant/user expectations for sustainable business and operating practices? The expectations are becoming fairly settled in the world of new design and construction. The U.S. Green Building



## About the Author

**Linda G. Tresslar, CRE**, is managing principal of Johnston Craig LLC, a commercial real estate development and consulting firm providing services to both corporations and investors. With broad experience at the corporate and asset levels, Tresslar helps clients develop and execute real estate strategy for successful business and investment outcomes. During her twenty-plus year career, she has actively worked with national and international clients in addressing real estate challenges associated with changing business and investment conditions with a focus on strategic, operational and financial real estate considerations and attendant economic, demographic, regulatory, environmental and labor market dynamics. Before founding Johnston Craig LLC, Tresslar was co-leader for Grubb & Ellis Company's global Strategic Consulting practice. She has served on the editorial and advisory boards for Area Development magazine and is an active industry speaker on issues of corporate governance, business location, logistics and regulatory and environmental considerations impacting real estate.

## The Value Proposition of Sustainability: It's in the Eye of the Beholder

Council's LEED (Leadership in Energy and Environmental Design) system for establishing and measuring a project's level of sustainability has served to coalesce the focus and direction for those involved in the design, construction and operation of real estate assets. These initiatives historically focused predominantly on an owner or owner/user's perspective but are rapidly being adopted by the broader public as part of overall sustainability efforts.<sup>1</sup>

Research is now yielding evidence of the positive impact of adoption of certain sustainability initiatives as represented by a building meeting LEED® or ENERGY STAR certification requirements. There is a clear consensus among most asset stakeholders that LEED certification standards, measures and initiatives are the direction to follow when it comes to new building design and construction.<sup>2</sup> This is being adopted in both the public and private sectors. But what is occurring as attention is turned to non-LEED certified existing buildings that represent 99 percent of today's total existing building stock?<sup>3</sup> This is where variations in focus and priority of importance in sustainable operating practices begin to emerge as key value differentiators and potential costly stumbling blocks in the future. There are LEED certifications centered on the construction of interior space retrofits of existing buildings. Many tenants now are either requiring owners to obtain such certification for their space or they are pursuing these initiatives on their own. In either case, the standards and measurements are the same for all (new as well as existing buildings) because they are part of the same LEED certification process. Buildings will also have to obtain LEED recertification by presenting actual performance data documenting the actual results obtained.<sup>4</sup> This process provides industry data on the impact of sustainability actions taken.

### GOVERNMENT MANDATE AND REGULATION

The ultimate levelers of the playing field are federal mandates enacted through law and regulation. Governing bodies at all levels are promoting sustainability or green initiatives to varying degrees. The expectations of the federal government, as both owner and tenant/user of real estate, are emerging with clear implications. Executive Order 13514, signed by President Barack Obama on Oct. 5, 2009, establishes numerous sustainability requirements for federal government agencies to meet, including:

- 50 percent of construction, recycling and waste materials must be diverted from landfills by 2015;
- 95 percent of all applicable contracts will meet sustainability requirements;
- Implementation of the Department of Energy's 2030 net zero energy building requirement for new buildings;
- Implementation of the storm water provisions of the Energy Independence and Security Act of 2007, section 348; and
- Development of guidance for sustainable federal building locations in alignment with the Livability Principles proffered by the Department of Housing and Urban Development (HUD), the Department of Transportation (DOT) and the Environmental Protection Agency (EPA).

This order makes it clear that success will be measured through broader operational criteria, not building construction.<sup>5</sup> This should make building owners take note that the current and future government regulatory environment will encompass requirements well beyond enhancing asset efficiency. The last part of the executive order specifically addresses employee work force conditions, traditionally an area of tenant, not owner, concern except for maintaining asset desirability. The potential for conflict here could emerge when work force or customer requirements require added expense to the owner, either in design and construction or in operating cost. Leases will have to address who will bear the cost of these types of regulation as they are enacted.

The extent of government involvement continues to grow. With commercial and industrial buildings using at least 49 percent of all energy consumed in the U.S. annually, the Department of Energy and the current administration have announced continued focus on energy saving and resource saving sustainability practices in both the public and private sectors.<sup>6</sup> The focus goes beyond energy and water efficiency to lighting, indoor air quality, greenhouse gas and other emissions control and landfill use reduction. This focus involves all stakeholders of real estate assets, though the potential impact will not affect all equally. Thus, the value of pursuing one sustainable practice versus another will vary, depending on the magnitude of implications for a stakeholder, including cost to that stakeholder.

- 26 percent improvement in water efficiency by 2020;

## The Value Proposition of Sustainability: It's in the Eye of the Beholder

There are now a growing litany of LEED-mandating government agencies enacting LEED-compliant regulation and requirements, and not just at the federal level.<sup>7</sup> While LEED certification is not required, the results are the same. It is below the federal level, however, where variation in the extent of government requirement varies. For example, California was the first state to pursue a comprehensive green building standard. The California Green Building Standards Code (CALGreen) adopted Jan. 1, 2011, requires all new buildings to increase energy efficiency by: demonstrating a 20 percent reduction in water consumption; diversion of 50 percent of construction waste from local landfills; use of low VOC (volatile organic compound) materials; separate water meters to track usage; and mandatory inspection of HVAC and other building energy systems.<sup>8</sup> At first glance, these seem very aligned with Executive Order 13514, but CALGreen's specific requirements for use of low VOC materials, installment of separate water meters and mandatory inspections go well beyond the federal regulations. These federal and state mandates will all add cost to owners for sustainability actions they otherwise may not have chosen to pursue because they deliver much less accretive value than measures focused on lowering operating cost and boosting efficiency directly. This is a clear illustration of diverging value priority by stakeholders; however, governing bodies always hold the legal trump card, enforcing a common ground, if you will.

In order to forge voluntary common ground between public mandate and private action, economic incentives are offered by governing bodies in order to improve the value proposition for asset owners and sometimes for tenant/users. The incentives are intended to mitigate some of the upfront or ongoing additional cost by providing some other value to the recipient. Green incentives are being used in the areas of energy efficiency, water conservation, use of green materials, reduction of landfill contribution and reduction of greenhouse emissions.<sup>9</sup>

When it comes to owners and users of real estate seeing eye-to-eye on sustainability, there are areas with proven data that illustrate the value enhancement for all. The adoption of LEED certification for buildings has produced a live laboratory to quantify the economic and value benefits of pursuing certain sustainable practices. A 2008 report, "Does Green Pay Off?" by Norm Miller, Jay Spivey and Andy Florance, documented the results of research on the value of LEED certification or ENERGY STAR certification for a building.<sup>10</sup> The study compared

LEED and ENERGY STAR buildings to non-LEED buildings of similar characteristics. Findings showed increased occupancy, increased rents, reduced operating expenses and increased sales per square foot values of up to 15 percent.

### LEED and ENERGY STAR vs. Non-LEED Buildings Comparative Performance

<b>Occupancy</b>	2.5% increase ENERGY STAR 5.4% increase LEED
<b>Rents</b>	\$4.73 psf increase ENERGY STAR \$9.06 psf increase LEED
<b>Expenses</b>	\$0.54 psf decrease in energy expense (30%)
<b>Sales Price</b>	15% premium on sale

Source:

*University of San Diego Burnham-Moores Center for Real Estate*

This data presents a compelling case for pursuing sustainable practices that comprise LEED compliance, especially when one considers that the added cost to achieve basic LEED certification is typically between zero and five percent of the upfront construction cost. These initiatives also provide direct and indirect benefit to tenants through lower occupancy costs and improved workplace environments.

### OWNER VERSUS USER

Where do you draw the spending line as an owner when it comes to satisfying tenant sustainability expectations? What should really be tenant expense versus owners—and for what? The answers will depend largely upon who perceives the most value for the action and who receives the economic benefit. There are sustainability initiatives that show up as major parts of corporate environmental responsibility platforms (e.g., recycling efforts, reduction of corporate carbon footprint or lowering greenhouse gas emissions) that may not carry the same importance for the asset owner as for the tenant. The tenant may see more value in such pursuits and in their extent as well.

It is hard to quibble with the ideas of improved efficiency and less waste. We all believe it is possible to do better. But determining at what cost and who should bear the cost is what begins to drive a wedge among owners, users and government agencies. It is obviously easier to avoid

## The Value Proposition of Sustainability: It's in the Eye of the Beholder

mistakes and achieve sustainability objectives on the design board than it is to change the operational direction of an existing asset. There will always be the constant tug of interests for an owner between maximizing asset value and spending in the right places and at the right times. The obvious action steps usually address low-hanging fruit and target areas for maximum goal achievement or “biggest bang for your buck” initiatives to help prioritize

*Even with varying priorities regarding sustainability initiatives, it is wise to explore future areas for value enhancement for all stakeholders.*

focus, but the most successful approaches begin with clearly defining sustainability and its value alongside clear performance measures thereof.

From a tenant/user's perspective, sustainability is most often viewed in the broader context of corporate social responsibility. This is the idea that companies have obligations not only to shareholders, but also to stakeholders, society and the environment. Green initiatives and requirements for the space a company occupies are tied to the larger goals of corporate social responsibility.<sup>11</sup>

As government regulation and shareholder accountability increase, American corporations are often turning to the International Organization for Standardization (ISO) for guidance with implementing green and corporate responsibility programs. ISO standards provide direction for establishing goals and compliance measurement. The ISO 140001 standard for environmental management systems (EMS) establishes best practices and benchmarks for

green initiatives but it is a compliance monitoring system, not a determiner of sustainable practices to adopt nor does it set performance expectations.<sup>12</sup> For many corporations that use measurement frameworks such as the Dow Jones Sustainability Assessment, sustainability has multiple components including, but not limited to, environmental responsibility.<sup>13</sup> Statements of corporate social responsibility can be found

on most large corporate Web sites, but the environmental components and how they measure success vary greatly. A list of most commonly addressed environmental sustainability practices are in the following chart along with the relative priority on behalf of tenants versus owners. Summary analysis indicates that areas of expense reduction and improved efficiency for the building show greatest alignment of priority. Practices that are important to users are recognized by owners in the context of enhancing a building's marketability, thus preserving or boosting asset value over the long term.

Sustainability: Degrees of Priority – Tenant Versus Owner

Sustainable Practice	Corporate Priority	Landlord Priority
Reduction in energy use	Yes	Yes
Reduction in water use	Yes	Yes
Reduced emissions	Yes	Only those practices mandated for the building
Enhanced lighting	Yes, improves workplace environment	Limited, if it enhances marketability and produces cost savings over time
Improved indoor air quality	Yes, improves workplace environment	Limited, if it enhances marketability
Pollution prevention	Yes	Only those practices mandated for the building
Green products and materials	Yes, improves workplace environment	Yes, provided additional cost is within reason
Waste reduction	Yes, recycling and reduction of landfill contribution	Limited, if cost-effective and enhances marketability
Use of renewable energy	Varies, where appropriate or if part of societal responsibility initiatives of company	Limited, if cost-effective or enhances redundancy
Reduced carbon footprint	Limited, if mandated or if it is perceived to boost societal responsibility initiatives of company	Limited, if enhances marketability
Improved transit patterns	Yes, reduces company impact on environment	Limited, mainly at the time of site selection or to add solution that enhances tenant accessibility, and to address a marketability issue

Source: Johnston Craig LLC

## The Value Proposition of Sustainability: It's in the Eye of the Beholder

When corporations operate in an environment of measuring sustainable practices, it can be reasonably expected that they will seek out real estate to occupy that which best helps them achieve their environmental sustainability goals. What are large credit tenants likely to demand in the way of sustainability requirements? How far will they push and in what areas? Where are government mandates also impacting them? What deal breakers are emerging? The answers to these questions reveal the priorities and relative value a tenant/user will ascribe to a sustainable initiative. In a 2010 article for *Commercial Real Estate Investment* magazine, Beth Young, CCIM, LEED AP, shares an anecdotal situation from a Grubb & Ellis broker in South Carolina who lost a 20,000-square-foot tenant to a silver LEED building with rent greater by \$2.12 because the landlord declined to implement a sustainable program at the behest of the tenant. The tenant actually preferred the building and its location but a sustainability program was the deal breaker. This is only one of numerous cases in which a landlord has incorrectly calculated the value ascribed to sustainability initiatives or particular practices by a potential tenant/user. The losing landlord in this instance has now instituted a rolling sustainability program as existing leases roll.<sup>14</sup> Had it not, a building such as this would surely decrease in economic viability over time as it slips in market competitiveness.

### FUTURE LANDSCAPE

What will be the likely confluence between government mandates, corporate responsibility initiatives and ownership operational initiatives? While the marketplace is gaining knowledge from data on actual performance improvements with which to gauge the cost/benefit of specific sustainability initiatives, there is ongoing need for vigilance as to what will be the next wave of green practices that may become mandated or could become tenant deal breakers.

#### What are governments going to mandate?

We can observe trends in sustainable practices that are being integrated into laws, regulations and codes. In this context, they will certainly have an impact on all stakeholders. It is helpful to look at outliers with respect to state and local mandates—who is pushing the envelope? A few examples of outliers include:

- The state of Hawaii mandated solar hot water heaters be installed in all new single-family homes beginning in 2010;<sup>15</sup>

- In May 2009, the city of Toronto adopted a green roof mandate of up to 50 percent coverage for multi-unit residential buildings over six stories, schools, non-profit housing, commercial and industrial buildings. Developers opposed the mandate, citing significant additional upfront cost and added maintenance costs which they argue will negatively impact property value.<sup>16</sup>

#### What are tenants and users going to expect?

We should continue to look at corporate responsibility initiatives. Where do tenants and asset owners share common ground on sustainability and green initiatives? What do tenants perceive to be the benefits to them from specific sustainability initiatives? How do tenants measure their own success? Are they expecting a lot more in certain categories than what LEED buildings and government mandated practices are achieving?

#### How best to preserve and maximize asset value?

For owners, what are the best sustainability initiatives to adopt to maximize long-term asset value? This speaks to the heart of a real estate asset remaining viable in an ever-changing world. It informs where and when to spend and what the measure of success or value should be.

### CONCLUSION

Adoption of sustainability initiatives with respect to commercial real estate is a continually evolving process. The extent and rapidity of adoption depends upon what is mandated, what is voluntary and the perceived extent of positive impact on value. While value has differing contexts depending on the stakeholder, there are key areas for thorough assessment that are important for all to consider. Vigilance in monitoring changes in mandates, corporate priorities and proven benefits derived from specific sustainability practices will ensure the ability to maintain market competitiveness, enhance value and prevent potentially fatal missteps or unnecessary expenditures.

Building upon proven areas for achieving valuable improvements in sustainability, stakeholders should consider the potential benefits of adopting new practices as they arise. Even with varying priorities regarding sustainability initiatives, it is wise to explore future areas for value enhancement for all stakeholders. This can be done effectively only in the context of well-defined sustainability goals and measures of benefit and performance. Without this value enhancement framework, an asset is perpetually vulnerable to economic obsolescence. ■



# The Value Proposition of Sustainability: It's in the Eye of the Beholder

## ENDNOTES

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# Creative Counseling: Preserving the Hawaii Opera Theatre

BY KAREN CHAR, CRE, MAI

## BACKGROUND

*IN MAY 2010, Karen Char, CRE, president, John Child & Company, Inc. and Christine Camp, CRE, president and CEO of Avalon Group, LLC, both of Honolulu, were honored by The Counselors of Real Estate® with the 2010 James Felt Creative Counseling Award for their work developing and implementing a long-term real estate strategy for the Hawaii Opera Theatre (HOT) in Honolulu. Their work enabled HOT to continue to produce outstanding opera performances and nationally recognized educational programs in Hawaii. The Felt Award recognizes credentialed members of The Counselors of Real Estate whose work most exemplifies excellence and ingenuity in real estate counseling resulting in far-reaching and long-term benefits to a community and its citizens. The following case study describes the process through which HOT was able to turn a liability into an asset.*

## INTRODUCTION

CHAR AND CAMP'S WORK FOR HOT spanned a four-year period that began in 2005 when Char joined HOT's board of directors. At the time, HOT was faced with making significant cost cuts in order to continue operating. Camp joined the board in 2008. Together, they were able to uncover assets belonging to the opera theatre and develop a plan that included moving its administrative and box offices to a safer, larger location along a major traffic artery and building a more appropriately sized rehearsal hall.

The full plan developed by Char and Camp involved relocating offices, renovating existing property, selling property and obtaining a line of credit. Today, the 51-year-old Hawaii Opera Theatre is maintaining its performance schedule as well as its educational programming.

## CASE STUDY:

### COUNSELING FOR HAWAII OPERA THEATRE

In 2005, at my first meeting as a new member on the board of directors of HOT, it was explained that financial exigencies required us to consider selling the medical office building that had been donated to HOT. At subsequent meetings, the likelihood of this sale was reaffirmed. HOT, like many performing arts organizations, faced significant challenges in its operating cash flow. However, HOT owned the fee simple interest in two properties:

- Waimanu property
- Beretania Medical Plaza (BMP)

HOT performs at the NBC Concert Hall in Honolulu. Both properties are about two blocks from the Concert Hall.

### WAIMANU PROPERTY

#### DESCRIPTION AND CHALLENGES

The Waimanu property was a consolidation of shabby industrial warehouse properties that housed HOT's administrative and box offices, rehearsal hall, shop and



### About the Author

Karen Char, CRE, MAI, ASA, president of John Child & Company, is responsible for developing and managing the company's professional practice that includes real estate consulting, appraisal, and business valuation. She specializes in complex real estate and business valuation assignments. Char also serves on the board of directors of two non-profits: Hawaii Opera Theatre and Hawaii Women's Legal Foundation (HWLF). The mission of HWLF is to help women and children in need in Hawaii.

## Creative Counseling: Preserving the Hawaii Opera Theatre



*HOT box office, administrative office street frontage, before...*

storage. The property had front parcels and a back parcel; no on-site parking. The buildings were originally constructed between 1936 and 1955.

In 2005, the Waimanu property was in disrepair. Despite significant repairs to the roofs twice in the preceding ten years, they leaked whenever it rained and mold was growing in the ceiling tiles and walls. The buildings were clearly in need of major repair, maintenance and renovation to comply with current building code requirements. The health and safety of the staff, volunteers and artists were a major concern.

Historically, HOT had been opposed to financing any capital improvements, repairs or maintenance of its real estate. Instead, HOT had solicited several major benefactors for donations to renovate the Waimanu property—without success. As a result, some board members believed the property was too expensive to renovate and maintain, and strongly advocated selling it and moving out.

As a result, no action was taken and no repairs were made to the Waimanu property. When it rained, furniture was moved, and buckets were strategically placed to catch the water.

#### **BERETANIA MEDICAL PLAZA DESCRIPTION AND CHALLENGES**

Beretania Medical Plaza (BMP) was a poorly maintained leasehold medical/dental office building. The leased fee interest in the land was donated to HOT in 1995. Initially the ground rent from the leasehold building was used to pay HOT's operating expenses. HOT became accustomed



*... and after*

to collecting ground rent without incurring expenses.

The building has 25,261 square feet of rentable area including a ground floor retail space, and medical/dental office spaces on the second, third and fourth floors. Parking is located on the ground and second levels.

In the early 2000s, the lessees were nearing retirement and not interested in maintaining the building, as required in the lease agreement. The building required capital improvements, repairs and maintenance. In 2003, the lessees gifted the leasehold interest in the building to HOT rather than make the required repairs and capital improvements.

Initially HOT had been collecting ground lease rent. Through the donation of the leasehold interest, HOT was now managing a medical office building and carrying the operating expense for the vacant spaces in the building.

In 2005, the leasing status of the building was as follows:

Lease term	Percent of building
Lease expires in 2014	22 %
Lease expires in 2006	20
Month-to-month	26
Vacant	32
<b>Total</b>	<b>100</b>

HOT could not lease the vacant space and was in jeopardy of losing existing tenants because of the building's condition. (After visiting the property, one board member exclaimed, "I wouldn't bring my dog to a vet in this building.")

## Creative Counseling: Preserving the Hawaii Opera Theatre



*Water damaged ceiling tiles, before...*

Many of the board members wanted to sell the property “as is” to fund HOT’s operations. Similar to its position on the Waimanu property, the board was opposed to financing repairs and maintenance.

#### COUNSELING PROCESS

In 2005, HOT had 66 board members. With the exception of four residential realtors, a retired real estate attorney and myself, the board members had limited commercial real estate expertise. Because of the experience and comfort level of several bankers and financial advisors (active and retired), the board had a strong preference for liquid investments. The board had seriously discussed selling its real estate.

The concept of a long-term real estate strategy began in 2005 when a task force was formed to study HOT’s financial needs and its real estate.

The task force requested pro bono services of a structural engineer. It obtained an analysis and bid from a roofing contractor. The structural engineer opined that the buildings were structurally sound; however, the spaces were not being used efficiently. The roofing contractor provided recommendations that would temporarily seal the roof leaks at a reasonable cost.

To educate the HOT decision makers, I made a series of presentations to the task force, steering committee and eventually, the board of directors.

1. With regard to BMP, I explained that the building must be repaired and maintained to attract new tenants, regardless of whether it was to be sold or retained.



*... and after*

The task force forwarded the recommendation to the steering committee. The steering committee forwarded the recommendation to the board for approval. The board approved the renovation of BMP to be funded by a short-term mortgage loan in February 2005.

2. With regard to the Waimanu property, I explained that HOT should consolidate and “right size” (downsize) its operations and sell a portion of the property (front parcels) to fund the renovations and repairs required for the smaller property (back parcel) and for operating losses.

HOT staff maintained that the current space was already too small. The task force and the steering committee did not recommend action. However, an informational presentation explaining the situation was made to the board in December 2005.

In December 2006, Joshua Dachs, an internationally known professional theatrical consultant, was visiting Hawaii. For a small fee, he visited the Waimanu property and met with HOT staff. He reported that HOT has very little room to “right size.” He said that other theatrical companies have larger shop areas and HOT must plan for long-term growth in staffing. He recommended rebuilding or renovating the entire Waimanu property to achieve a larger footprint and efficiency.

Dachs’ report was not helpful to the task force. HOT already had tried unsuccessfully to raise funds for capital improvements to the existing facility. Therefore, if nothing was sold, financing was the only option. A loan

## Creative Counseling: Preserving the Hawaii Opera Theatre

for rebuilding or renovation could only be repaid through excess operating income. There was no excess income.

In January 2007, I presented Dachs' report to the task force and steering committee. In addition, I presented worksheets showing that the cost of real estate in Hawaii was substantially higher than on the mainland and that HOT could not afford Dachs' recommendations.

The task force and steering committee were stumped. Rain continued to soak the ceiling tiles, grand piano, opera library and all of the interior spaces. Buckets of water were everywhere.

In 2008, CRE Christine Camp joined HOT's board of directors and the task force. As a new member and real estate counselor, she independently reviewed and analyzed HOT's financial needs and real estate situation. She saw the vacancies in BMP as an opportunity. She recommended moving HOT's offices to BMP and renaming the building.

Christine's company had an architect on staff. Under Christine's direction, the architect visited the property and interviewed the HOT staff to understand their operations and real estate requirements. The architect produced conceptual architectural studies and construction cost estimates. He designed alternative floor plans that fit HOT's administrative and production functions into the back parcel. He met with HOT staff and convinced them that the smaller spaces would function adequately. (Lesson learned: Have an architect prepare conceptual plans before attempting to downsize an organization's facilities!)

He also prepared cost estimates for alternative scenarios. Christine reviewed the cost of building administrative space into the existing building with the shop space (on the Waimanu property) and compared it to the cost of building tenant improvements in BMP. Christine determined that it was cost effective to build out and occupy space in the medical office building rather than build new office space in the shop building.

Christine presented her analysis, alternatives and recommendations to the task force, which approved and forwarded the recommendations to the steering committee.

### RECOMMENDATION

The composition of the steering committee and board, with limited real estate expertise and a strong preference toward liquid investments, made difficult our task of

advancing what we analyzed to be the logical and best course of action. It was critical that we collaborate toward a strategic initiative of educating the steering committee and board members with a comparative analysis in a format that could be easily understood.

In September 2008, the steering committee recommended the following long-term real estate strategy for approval by the board:

1. Permanently move the administrative offices to BMP;
2. Obtain a line of credit of \$500,000 to pay for the tenant improvements and move;
3. Sell Waimanu front parcels to pay for renovation of the back parcel;
4. Renovate the Waimanu back parcel to accommodate the rehearsal hall, shop and storage.

The strategy was presented in small group presentations to allow ample time for individual board members to understand the strategy and financing requirement.

In November 2008 the board unanimously voted to accept the task force recommendations.

### NEXT STEPS

Christine, who is a licensed broker, now had the task of selling the Waimanu front parcels. By November 2008, the real estate market had stagnated. However, with creative thinking and several months of negotiation, Christine sold the property by identifying the most motivated potential buyer—the property owner across the street who needed the property for long-term expansion.

In April 2009, HOT's staff moved into its new offices in the building now known as Hawaii Opera Plaza. Thus, the building that was to be sold to fund operations continues to provide investment income to fund operations, and the HOT staff and volunteers enjoy a healthy and safe work place from where they produce outstanding opera performances and nationally recognized educational programs.

A new task force was formed to complete the renovation of the back parcel. The task force included Christine, a structural engineer, architect, land planner, and other board members.

### COUNSELING SKILLS

To develop and implement a long-term real estate strategy for HOT, we undertook a careful and lengthy process of

## Creative Counseling: Preserving the Hawaii Opera Theatre

understanding the issues and facilities required to produce great opera in Hawaii. We used our combined expertise and experience related to:

- Real estate valuation;
- Feasibility studies;
- Highest and best use analysis;
- Management of office and industrial properties;
- Site selection;
- Development;
- Brokerage;
- Project management.

In addition, we used our counseling skills to communicate the real estate alternatives and recommendations in a manner that was understandable to a nonprofit board comprised of opera enthusiasts.

### RESULTS OF HOT'S LONG-TERM REAL ESTATE STRATEGY

An important measurement of the livability and vitality of a community is the prominence of its culture and arts. Opera is the most sophisticated and expensive performing art. In the United States, opera's dramatic stages and highly specialized artists require significant private funding and/or endowment. In Hawaii, the cost to produce opera is high because of the cost of construction and/or shipping of the stage sets, airfare and housing to bring in the artists, and costs associated with doing business (for example, union labor).

Without developing and implementing a long-term real estate strategy, HOT would have been required to make significant cost cuts, or worse.<sup>1</sup> Instead, in 2008 and 2009,

Charity Navigator gave HOT a four-star rating. Only four other opera companies in the United States have achieved Charity Navigator's highest rating. HOT was the highest rated opera company.

Because of its long-term real estate strategy, HOT has been able to:

1. Continue to produce great opera;
2. Continue to offer its nationally recognized educational program to Hawaii's school children;
3. Fund its operating losses for fiscal years ended May 31, 2009 and 2010;
4. Upgrade its facilities by moving its administrative and box offices from dilapidated warehouse space in an industrial district to healthy and safe offices in a commercial office building along a major traffic artery;
5. Celebrate its 50th anniversary in 2010;
6. Plan for 50 more years of grand opera in Hawaii. ■

### ENDNOTE

1. Since 2008, the following opera companies in the United States have closed, are in bankruptcy or have suspended operations:
  1. Orlando, Fla.
  2. Baltimore, Md.
  3. Hartford, Conn.
  4. Orange County, Calif.
  5. Western Massachusetts
  6. Augusta, Ga.
  7. Opera Pacific
  8. Florida Grand (cutbacks in productions)
  9. Connecticut Opera

# Reverse Mortgages: Should the Elderly and U.S. Taxpayers Beware?

BY J. DOUGLAS TIMMONS, PH.D.; AND AUSRA NAUJOKAITE, M.A.

REVERSE MORTGAGES ARE BECOMING POPULAR IN AMERICA, though it is only a small niche in the multi-trillion dollar banking industry. It has, however, begun to attract the interest of banks, mortgage brokers, insurance companies and Wall Street investors who are looking for new profit centers in the wake of the subprime mortgage meltdown. Seniors who might be considering these loans, and U.S. taxpayers who have suffered from the subprime mess, should carefully evaluate how the reverse mortgage market is developing. Reverse mortgages are complex financial transactions that have considerable closing costs, but when used correctly and under the right circumstances, have the potential to greatly enhance the lives of the senior borrowers who obtain them. This article will introduce the reader to the reverse mortgage market, provide information about the growth in reverse mortgages, describe the characteristics of these loans, and outline issues of concern.

## INTRODUCTION

The role of the reverse mortgage is to put money in the pockets of seniors by allowing equity depletion during the owners' lifetime. Seniors who are 62 or older and who have paid off their home mortgages (or owe only a small balance) are able to tap into their home equity to generate extra cash. These senior borrowers can take the money as a lump sum, a line of credit, monthly payments, or a combination of a credit line and regular payments. The borrowers, unlike with traditional mortgage or home equity loan, do not need to meet income or credit requirements to qualify, and don't have to repay the loan until they no longer use the home as their principal residence. These mortgages are called "reverse" because of the nature of payments. In this case, the homeowner is not the party who makes payments; the bank makes payments to the

homeowner. The loan is not repaid until the property is sold or upon the death of the borrower when repayment is settled through normal probate procedures.

Seniors are living longer, and the recent economic crisis has negatively affected their investment portfolios. Not only has the value of their investments dropped, fixed-income securities are providing low income yields. In addition, in many parts of the country home values have declined. Reverse mortgages can give older Americans greater financial security. Many seniors use the income from these loans to supplement social security, meet unexpected medical expenses, make home improvements, and cover other costs.

## About the Authors



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## Reverse Mortgages: Should the Elderly and U.S. Taxpayers Beware?

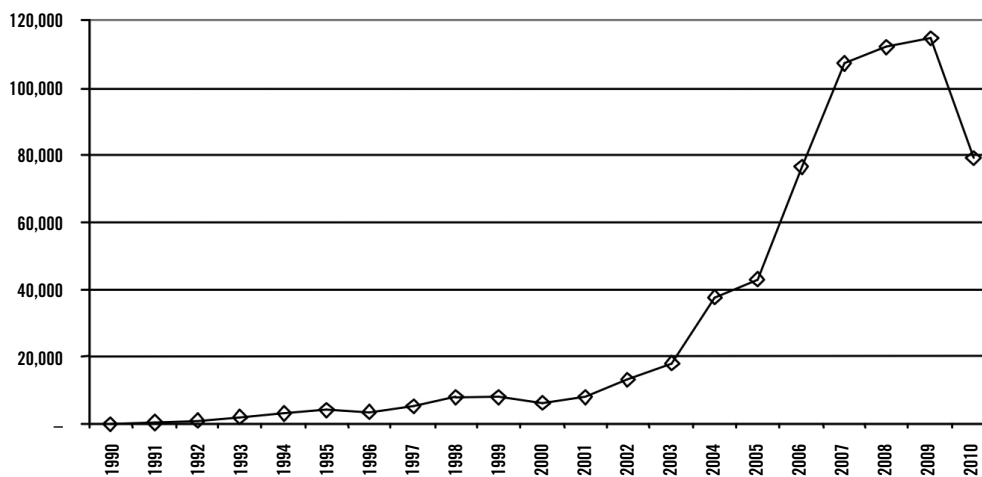
### ORIGINS AND EVOLUTION OF REVERSE MORTGAGES

As far back as the early 1960s, equity conversion loans were being offered by private financial institutions. These lenders introduced shared appreciation mortgages, reverse annuity mortgages, deferred payment loans, and sale/leaseback offerings that varied greatly and were largely unregulated. During the 1980s, financial institutions attempted to expand the reverse mortgage market to take advantage of increased home equity values among seniors. These early efforts to exploit new business opportunities with seniors did not prosper.

Senior advocates and academia thought there was a place for reverse mortgages as a way to remediate the impact of

very modest beginnings, the HECM program now insures more than 600,000 loans. Between 2000–2009, HECMs grew at a compound annual rate of approximately 40 percent. In 2009, 114,692 of these loans were made. In 1996, Fannie Mae developed a reverse mortgage of its own called the “Home Keeper,” but this product was discontinued in 2008. Just before the recent financial meltdown, a handful of private financial institutions offered a variety of equity conversion products. These private reverse mortgages were all securitized and when the private mortgage securities market collapsed, the relatively small part of it directed to reverse mortgages collapsed as well (Figure 1).

Figure 1  
Number of HECM RMs, 1990–2010



Source: created by the authors using HUD data for each fiscal year, (Oct. 1–Sept. 30), 2010

poverty on elderly homeowners. Congress was lobbied by these advocates to create an equity conversion product that was standardized and would be acceptable to the lending industry. In 1988, Congress authorized a prototype insured by the Federal Housing Administration (FHA), a branch of the U.S. Department of Housing and Urban Development (HUD). This initiative was the genesis of the government's Home Equity Conversion Mortgage (HECM) program.

The HECM is the federally insured reverse mortgage product. A commercial lender makes the HECM loan, and the government's primary role is to insure it. It is insured by the FHA. HECMs account for nearly all reverse mortgages originating in the U.S. today. From

Even though the housing market has been shaken by the subprime mess, and home values have dropped in most parts of the country, there is still a tremendous potential demand for reverse mortgages. The population of seniors in the U.S. is booming. In 2000, the senior population (65 and older) was 35 million, and projections indicate an increase to 64 million in this age group by 2025.<sup>1</sup> Today, the country's approximately 37 million seniors make up more than 12 percent of the population, and they are expected to represent around 18 percent of total U.S. population by 2025.<sup>2</sup>

Data from the American Housing Survey, conducted by the U.S. Census Bureau, suggests there is as much as \$2.8 trillion in home equity.<sup>3</sup> In 2008, the National Reverse



## Reverse Mortgages: Should the Elderly and U.S. Taxpayers Beware?

Figure 2

## HECM Borrower Statistics

Fiscal Year	Average Borrower Age	Borrower: Single Female	Single Male	Multiple
1990	76.75	57.32%	16.56%	26.11%
1991	76.54	56.04%	13.88%	30.08%
1992	76.57	57.66%	15.03%	27.31%
1993	75.64	54.97%	14.37%	30.66%
1994	75.13	54.75%	14.47%	30.77%
1995	76.00	56.46%	13.54%	30.00%
1996	75.88	56.40%	12.54%	31.06%
1997	75.90	56.59%	13.23%	30.18%
1998	75.66	55.98%	14.10%	29.92%
1999	75.26	54.78%	14.48%	30.75%
2000	75.96	56.79%	13.00%	30.21%
2001	75.54	54.46%	13.66%	31.88%
2002	75.13	51.36%	13.97%	34.67%
2003	74.30	48.61%	14.19%	37.20%
2004	74.26	48.62%	15.19%	36.20%
2005	73.78	46.01%	16.05%	37.94%
2006	73.75	44.49%	16.66%	38.85%
2007	73.54	44.60%	18.20%	37.21%
2008	73.06	43.83%	20.62%	35.55%
2009	72.91	41.18%	21.83%	36.99%
2010	72.93	42.71%	22.02%	35.27%

Source: summarized by the authors using HUD data, 2010

Mortgage Lenders Association estimated that seniors had perhaps \$4 trillion in home equity.<sup>4</sup> Whichever statistic is correct, there is a lot of senior home equity that could be tapped. Even many of the poorest seniors have built up home equity. The 2007 American Housing Survey found that more than 700,000 seniors with annual incomes below \$5,000 owned their houses, free and clear. The report showed that another 2.4 million seniors with annual incomes below \$15,000 had no mortgage debt.<sup>5</sup> Additionally, more than 7 million seniors with annual incomes below \$30,000 owned their home free of debt.<sup>6</sup>

#### BORROWER MOTIVATION

As a result of the housing and economic crises, reverse mortgages are being marketed to seniors with renewed vigor. Historically, retirees on fixed incomes sought reverse mortgages as a way to cope with the costs of health care, housing and other basic needs. Their one big asset, home equity, could provide much needed financial relief, and would enable them to stay in their home. The current

economic environment combines lowered home values and investment holding values with lowered interest rates, creating a reduction in seniors' incomes.

Today, however, lenders are using a sales pitch that tells seniors who are falling behind on their mortgage payments to use a reverse mortgage to avoid default. The reverse mortgage can save their home, but these borrowers need to bear in mind that the majority of the proceeds will probably be used to pay off their primary mortgage with little left over for other needs. Seniors who are contemplating a reverse mortgage must make sure that they have adequate savings to support themselves. Another sales pitch suggests using a reverse mortgage to cover everyday expenses, perhaps temporarily, during this time of economic hardship. This idea would appeal to seniors who are "house rich, cash poor." Some seniors, who previously would have sold their home and moved to a different type of housing, are finding mortgage relief in reverse mortgages. In today's economic environment, the

## Reverse Mortgages: Should the Elderly and U.S. Taxpayers Beware?

reverse mortgage can sustain these seniors until they can sell their house.

### LENDER MOTIVATION

The potential origination fees from reverse mortgages are enormous. The market for the reverse mortgages is far larger than the traditional mortgage market. Most people only buy or sell a home every 5–10 years, but there are millions of seniors sitting in homes with huge amounts of equity. With the collapse of the housing market, home values have declined, credit has dried up and fewer homes are being bought and sold. Mortgage departments have historically been a huge source of revenue for banks. The current housing market isn't generating nearly as much profit as in previous years. Enter the reverse mortgage. Here is a product with a huge borrower base. Here is a product that doesn't require any credit analysis. Here is a product that is government guaranteed so the bank doesn't have to worry about losing money in a foreclosure. The fees on reverse mortgages have been very high, which, in turn, creates higher profits for the lenders.

During the past couple of decades, mortgage market lenders' profits have been driven by loan volume. As in the forward mortgage business, most reverse mortgage loans have been sold to Fannie Mae (it stopped accepting new commitments after Oct. 4, 2010), Ginnie Mae or into the secondary market rather than being held by lenders. The sale of loans enables lenders to replenish their capital so that they can make more loans and, therefore, generate greater transaction fees.

The subprime debacle provides plenty of evidence that loan originators have been willing to sacrifice responsible lending practices to generate greater loan volume, higher fees and, ultimately, greater profits. Chasing volume and relaxing underwriting standards are often cited as the prime reasons for the subprime fiasco. In 2008 a report from the U.S. Government Accountability Office (GAO) showed that more than 1,500 lenders made their first reverse mortgage loans, and that 2,950 lenders offered HECMs.<sup>7</sup> However, a market consolidation trend has been taking place since 2008.<sup>8</sup> The number of reverse mortgage lenders has been decreasing, and the biggest lenders have been growing larger. There were only 1,883 lenders left by 2010. In 2010 the number of large lenders decreased by 3 percent, and the number of smaller lenders dropped by 47.7 percent, to 1,136 lenders.<sup>9</sup>

Mortgage brokers serve as intermediaries who bring mortgage lenders and borrowers together. Their compen-

sation depends on finding and originating loans. During the subprime mortgage boom this group was quite often responsible for pushing inappropriate mortgage loans on borrowers without any regard for whether the borrowers needed the loans or could afford the payments. Brokers don't get paid unless they close loans. Mortgage brokers who are originating reverse mortgages have a financial incentive to originate as many loans as possible.

There are some reverse mortgage products that are more profitable than others. Can we trust mortgage brokers to be more responsible this time? Seniors often assume that brokers are duty bound to look out for the borrower's best interest—they aren't. Mortgage loans are considered business transactions in which the parties are responsible for protecting their own best interest. In many states, brokers and lenders owe no fiduciary duty to borrowers.

As we saw with subprime mortgages, "push" marketing is being used extensively to sell reverse mortgages.

Advertising for reverse mortgages can be found on TV, the Internet, in the mailbox and over the telephone.

Celebrities are acting as spokespersons reassuring seniors that reverse mortgages are a good thing and can provide extra money to fund a better lifestyle. Most of the time the marketing promotes the reverse mortgage as a way to increase consumption of items that are not necessities.<sup>10</sup> Reverse mortgages are complicated financial transactions that should be considered carefully. Increased competition, loan volume and the vast number of potential reverse mortgage borrowers raises the question of whether this market will see the same abuses that were seen in the subprime market.

### REVERSE MORTGAGE CHARACTERISTICS

Virtually all reverse mortgages being originated today are FHA HECMs. The following outline highlights this particular type of reverse mortgage.<sup>11</sup>

#### Borrower Requirements

You Must:

- be 62 years of age or older;
- own the property outright or have a small mortgage balance;
- occupy the property as your principal residence;
- not be delinquent on any federal debt;
- participate in a consumer information session given by an approved HECM counselor.

Mortgage Amount Based On:

- age of the youngest borrower;

## Reverse Mortgages: Should the Elderly and U.S. Taxpayers Beware?

- current interest rate;
- lesser of appraised value or the HECM mortgage limit (currently \$625,000).

### Financial Requirements Include:

- no income or credit qualifications are required of the borrower;
- no repayment as long as the property is the borrower's principal residence;
- closing costs may be financed in the mortgage.

**Property Requirements**—The following eligible property types must meet all FHA property standards and flood requirements:

- single-family home, or one four-unit home with one unit occupied by the borrower;
- HUD-approved condominium;
- manufactured home that meets FHA requirements.

### Payment Plans:

- **Tenure**—equal monthly payments as long as at least one borrower lives and continues to occupy the property as a principal residence;
- **Term**—equal monthly payments for a fixed period of months selected;
- **Line of Credit**—unscheduled payments or in installments at times, and in an amount of the borrower's choosing until the line of credit is exhausted;
- **Modified Tenure**—combination of line of credit plus scheduled payments for as long as the borrower remains in the home;
- **Modified Term**—combination of line of credit plus monthly payments of a fixed period of months selected by the borrower.

The settlement charges on reverse mortgages cover basically the same costs that are involved on a forward mortgage, but there are some differences. The following types of costs will typically be associated with the HECM reverse mortgage:<sup>12</sup>

- mortgage insurance—2 percent of the lower of home value or maximum loan limit, and an annual premium of 1/2 percent of the loan balance;
- origination fee—set by regulation at 2 percent of the FHA loan limit, with a minimum fee of \$2,000 and a maximum of \$6,000;
- appraisal fee;
- title insurance;
- title, attorney and county recording fees;

- survey, if required;
- credit report fee, flood certification fee, pest inspection.

In addition, a monthly service charge of \$30–\$35 to cover the cost of servicing the loan will be added monthly to the balance of the loan. None of the upfront costs are necessarily out-of-pocket, and they can be included in the loan amount.

Reverse mortgages have long been considered one of the most expensive ways to extract cash from one's house. Declining property values and stricter lending limits imposed by the FHA in 2009 slowed the growth in the reverse mortgage market. From Oct. 1, 2009 to March 31, 2010, reverse mortgage origination volume dropped by 22 percent compared to the same period one year earlier.<sup>13</sup> As home values continued to fall, HUD cut the amount of equity that reverse mortgage borrowers could extract by 10 percent. In many cases, that meant homeowners no longer qualified for a reverse mortgage large enough to pay off their regular mortgage, and this is a basic requirement for getting loan approval. Lenders still saw this market as enormous and weren't willing to back away.

Recently, financial institutions such as Wells Fargo, Bank of America, MetLife Bank, and Financial Freedom have all waived their origination fees and other charges on certain reverse mortgages.<sup>14</sup> The reduced fees on reverse mortgages are a result of another important industry development: investor demand for mortgage-backed securities that include reverse mortgages. During the past two years, lenders have started securitizing reverse mortgage loans by converting them into Ginnie Mae-backed bonds. These are popular with investors because of their government guarantees and high yields relative to Treasury bonds. Investors are willing to pay a premium for that kind of safety with a higher yield and, therefore, lenders are passing on some of that premium to borrowers in the form of lower fees.

### PROCEEDS FROM THE REVERSE MORTGAGE

The amount of money a senior will receive from the reverse mortgage ultimately will depend on the following five factors:

- What is the appraised value of the property? What health and safety repairs must be considered? Are there any existing liens on the house?
- What are the prevailing interest rates on reverse mortgages?

## Reverse Mortgages: Should the Elderly and U.S. Taxpayers Beware?

- What is the age of the senior? Frequently, the older the borrower, the bigger the reverse mortgage payment.
- How will the payment be taken?
- Is the value of the property higher than the national loan limit set by HUD?

### EXAMPLE OF THE REVERSE MORTGAGE PAYOUT

There are numerous sites<sup>15</sup> devoted to calculating the proceeds that are possible from using a principal residence to enter into a reverse mortgage. Following are examples from a Reverse Mortgage (RM) calculator site using a home valued at \$200,000 with owners at three different ages (75, 70 and 65). We have used the RM calculator found on the Financial Freedom Web site.<sup>16</sup> Also, we have picked a zip code that would place the house in Davidson County, Tenn. This way, we are able to get a good general view of the RM output for a single person living in an average-priced home in Nashville, Tenn. and the surrounding area.

The actual outputs of the discussed reverse mortgage calculation results can be seen below.

### Sample Reverse Mortgage Payout

#### Parameters

75 years of age

Home Value	\$200,000
Zip Code	37211
Number of residents	1
Date of Birth	8/1/1935

	HECM Monthly LIBOR 175 Variable Rate	HECM Fixed*
<b>CASH AVAILABLE</b>		
Cash Available	\$115,425	\$121,297
<b>OR MONTHLY INCOME</b>		
Monthly Income Available	\$688	N/A
<b>OR LINE OF CREDIT</b>		
Credit Line Available	\$115,425	N/A
Annualized Growth Rate	2.59%	N/A

#### OR ANY COMBINATION OF THE ABOVE

For example: 1/2 Cash Available, 1/4 Monthly Income and 1/4 Line of Credit.

Source: <https://b2b.financialfreedom.com/calculator/>

### Sample Reverse Mortgage Payout

#### Parameters

70 years of age

Home Value	\$200,000
Zip Code	37211
Number of residents	1
Date of Birth	8/1/1940

	HECM Monthly LIBOR 175 Variable Rate	HECM Fixed*
<b>CASH AVAILABLE</b>		
Cash Available	\$107,324	\$113,697
<b>OR MONTHLY INCOME</b>		
Monthly Income Available	\$589	N/A
<b>OR LINE OF CREDIT</b>		
Credit Line Available	\$107,324	N/A
Annualized Growth Rate	2.59%	N/A

#### OR ANY COMBINATION OF THE ABOVE

For example: 1/2 Cash Available, 1/4 Monthly Income and 1/4 Line of Credit.

Source: <https://b2b.financialfreedom.com/calculator/>

### Sample Reverse Mortgage Payout

#### Parameters

65 years of age

Home Value	\$200,000
Zip Code	37211
Number of residents	1
Date of Birth	8/1/1945

	HECM Monthly LIBOR 175 Variable Rate	HECM Fixed*
<b>CASH AVAILABLE</b>		
Cash Available	\$99,738	\$106,497
<b>OR MONTHLY INCOME</b>		
Monthly Income Available	\$516	N/A
<b>OR LINE OF CREDIT</b>		
Credit Line Available	\$99,738	N/A
Annualized Growth Rate	2.59%	N/A

#### OR ANY COMBINATION OF THE ABOVE

For example: 1/2 Cash Available, 1/4 Monthly Income and 1/4 Line of Credit.

Source: <https://b2b.financialfreedom.com/calculator/>

*(All numbers listed above are estimates only. Computations for HECM Fixed Product have been done considering the rates available as of: 08/05/2010. The rate used is for the lump sum draw option.)*

## Reverse Mortgages: Should the Elderly and U.S. Taxpayers Beware?

HUD introduced a new reverse mortgage product as the second reverse mortgage option in October 2010.<sup>17</sup> The new HECM Saver is a reverse mortgage product insured by the FHA that has low up-front loan closing costs. Also, this product competes with regular home equity lines of credit because it has lower insurance premiums. The new product lowers the cost of entry for borrowers by charging only 0.01 percent (versus 2 percent for HECM Standard) of the maximum claim amount as an up-front mortgage insurance premium.

However, the loan limits are substantially lower than on the standard reverse mortgage. The HECM Saver has principal limit factors roughly 11–23 percent less than the standard product, and is offered in both a fixed and adjustable rate format.<sup>18</sup> Lower loan limits reduce default risk for the FHA and taxpayers of the country. The HECM Saver loans appeal more to those who only wish to pull a little cash out of their homes now, and expect to pay it back when possible.

### CONTROVERSIAL ISSUES AND CONSUMER PROTECTION

History has taught that where senior citizens and cash are involved, scammers are not far behind. An article in *The New York Times* states that hundreds of reverse mortgage applicants have complained about high-pressure or unethical sales tactics that steered them toward mortgages with high fees.<sup>19</sup> A 2009 report, “Subprime Revisited: How the Rise of the Reverse Mortgage Lending Industry Puts Older Homeowners at Risk,” by the National Consumer Law Center, suggests as much.<sup>20</sup> The report says the following:

“Many of the same players that fueled the subprime mortgage boom—ultimately with disastrous consequences—have turned their attention to the reverse market. Lenders, including some of the nation’s largest banks, view that market as a source of profits that have dried up elsewhere. Mortgage brokers see it as a new source of rich fees. Predators who once reaped profits from exotic loans have now focused on wresting more wealth from vulnerable seniors. And securitization, which allowed subprime loan originators to disassociate themselves from the downside risks of abusive lending, is becoming commonplace in the reverse mortgage industry.”<sup>21</sup>

The authors of this article also have concerns about protecting the elderly as well as U.S. taxpayers. The last thing the U.S. needs is a new scam that is harmful to mortgage borrowers and is detrimental to taxpayers.

There is no doubt that there will always be some unscrupulous characters who will try to take advantage of others, but we also feel that the reverse mortgage market is not likely to be a repeat of the subprime mess. Having said that, there are issues that need to be discussed and hopefully resolved with more consumer legislation to protect seniors.

During the subprime boom, the use of “yield spread premiums” provided mortgage brokers an incentive to increase the interest rates or add prepayment penalties to mortgage loans, thereby making those loans more profitable for lenders and investors. HUD has established caps on origination fees in an effort to curb profiteering in the reverse mortgage market.<sup>22</sup> Even though brokers are not permitted to collect any additional origination fees of any kind from borrowers, the regulations do not prohibit lenders from paying additional fees—yield spread premiums—to brokers. Yield spread premiums pose a serious threat to senior borrowers who are unlikely to understand the cost menu that brokers and loan originators use to generate increased benefits to themselves and potential investors.

Another area of concern is often called the “annuity trap.” Even though the Housing and Economic Recovery Act of 2008 included a prohibition on lenders’ ties to sellers of other financial products, we have concerns about enforcement.<sup>23</sup> There is no doubt that prior to this legislation, one of the greatest abuses of reverse mortgages came from originators who helped seniors cash out equity in their homes to buy expensive and complicated insurance policies, annuities or other financial products. Regrettably, HUD has yet to issue a final rule with respect to the cross-selling ban. It is imperative that it do so and, furthermore, it must strictly enforce the ban because in search of hefty commissions, there will be those who attempt to circumvent the prohibition.

A recent press release from the National Reverse Mortgage Lenders Association announced that it will soon be offering a Certified Reverse Mortgage Professional Loan Originator designation.<sup>24</sup> Applicants will be required to have a minimum of two years of service originating reverse mortgages, at least 50 closings, 12 hours of continuing education, and submission to a background check before they can sit for the exam. While this sounds like a better situation than prevailed for those selling subprime mortgages, there is still concern that seniors may take too much comfort in dealing with

## Reverse Mortgages: Should the Elderly and U.S. Taxpayers Beware?

someone with a fancy certification. Mortgage brokers get paid when they sell something.

Reverse mortgage applicants are required to participate in HUD-approved counseling sessions before the loan is approved. Counseling sessions are to be conducted by an independent third party who is neither directly nor indirectly associated with the mortgage originator.<sup>25</sup> Furthermore, lenders are required to provide borrowers with a list of at least ten HUD-approved counseling agencies.<sup>26</sup> Lenders are not permitted to pay for these counseling sessions, either directly or indirectly. Counselors are required to specifically discuss the following topics:<sup>27</sup>

- options other than reverse mortgages that are available to the homeowner, including other housing, social service, health and financial options;
- other home equity conversion options;
- reverse mortgage tax consequences, particularly the effect on eligibility for assistance under federal and state programs, and the impact on the estate and its heirs;
- the financial implications of reverse mortgages.

Counseling sessions are a good idea. Reverse mortgages are complicated financial instruments, and entering into such an arrangement is an important decision that impacts seniors for the rest of their lives. There are critics who say these counseling sessions are often brief and unhelpful. Some of the counseling sessions are actually done over the phone. According to a report by the U.S. GAO, counseling provides, at best, limited protection for senior borrowers. By participating undercover in reverse mortgage sessions the GAO found:<sup>28</sup>

- some counselors exaggerated how long the sessions lasted;
- almost half did not discuss alternatives to reverse mortgages (a requirement);
- none of the sessions covered all of the required topics;
- some counselors encouraged borrowers to use their proceeds to buy unneeded insurance or other products;
- occasionally, reverse mortgage materials included misleading claims.

Some senior borrowers report that their sessions lasted only 10 minutes rather than the 60–90 minutes that most counselors say is needed to fully explain the loans.<sup>29</sup> If counseling is required, and it should be, it is important that counseling be available and timely. This is important to the mortgage lenders, who complain that the counseling requirements create a bottleneck that reduces

loan volume. The government hasn't adequately funded counseling so many of the nonprofit groups that provide it have sought funding from reverse mortgage lenders. *The New York Times* reported that Money Management International, one of the largest reverse mortgage counseling companies, often asks lenders for funding. Money Management International received \$900,000 in 2007 from reverse mortgage lenders.<sup>30</sup> This sounds like a conflict of interest. We are fearful that the effectiveness of counseling has been undermined by inadequate funding and the limited availability of trained counselors. Counseling may help meet disclosure standards, but it doesn't seem totally effective in educating seniors about the complexities of a reverse mortgage.

### TAXPAYER RISK

Virtually all of the reverse mortgages written today are insured by FHA under the Home Equity Conversion Mortgage program. FHA insures the lender against loss in the event the loan balance at termination exceeds the value of the property. It also insures the borrower that any payments due from the lender will be made, even if the lender fails. HECM loans are nonrecourse loans, so the lender cannot seek restitution in excess of the value of the property at loan maturity. In order to fund the HECM insurance program, HUD charges an initial mortgage insurance premium of 2 percent of the value of the home (subject to lending limits) plus a recurring fee of 0.5 percent. Using this rate structure, HUD developed the principal limit factors that determine the amount of money borrowers are eligible to receive.

Until September 2009, the principal factors governing the money available to senior borrowers remained unchanged. In generating the principal limit factors HUD has postulated that home prices would appreciate at 4 percent annually, a figure that is consistent with historic data.<sup>31</sup> As we all know, home prices have fallen since the housing bubble burst in 2006. In response to falling home values, HUD, in October 2009, cut the amount of equity that reverse mortgage borrowers could extract by 10 percent. Because the HECM program is mandated to be a zero subsidy program, HUD was faced with the options of discontinuing the program or reshaping the program to comply with its original mission.

HUD asked for nearly \$800 million in 2010 in taxpayer money to boost its loan-loss reserves because of continuing home price declines.<sup>32</sup> This represents the first taxpayer subsidy in the 20-year history of the program. HUD has opted not to increase insurance premiums on

## Reverse Mortgages: Should the Elderly and U.S. Taxpayers Beware?

reverse mortgages, even though the subsidy is a sign that such an action might be called for. Looking forward, the amount of losses in the reverse mortgage market as a result of the decline in home prices won't be known for years. There may not even be losses if the housing market stages a decent price recovery, but what we thought we knew about the housing market has been turned upside down during the past five years. Prudent actions taken today might avert serious problems like those seen in the subprime market.

### CONCLUSIONS

The recent upheaval in the U.S. housing market provides an interesting opportunity to reevaluate our country's use of reverse mortgages. Our population is aging, and many seniors have seen their home equity erode along with their financial assets. Seniors, in growing numbers, may need to tap the equity in their homes. Recent changes in reverse mortgage products and the growing interest on the part of lenders and Wall Street to originate and securitize these mortgages has increased the likelihood that more and more seniors will draw upon the equity in their homes.

Reverse mortgage products have had a history of high closing costs. These costs appear to be falling. The industry also has some history of high pressure or unethical sales tactics. It now appears that some of the abuses have been remedied with legislation that better protects seniors. There is some evidence that even though seniors are required to participate in counseling sessions, the counseling may be inadequate.

It's fair to say that U.S. taxpayers don't want to experience another financial crisis that is rooted in another mortgage product. The subprime mess should provide a lesson about mortgage lending. Since reverse mortgage loans have nothing to do with the borrower's income, these loans don't face the same default risks as subprime lending. By cutting the amount of equity that reverse mortgage borrowers can extract from their homes, HUD has lessened the risk of problem loans. If the housing market, however, experiences further home value declines, the reverse mortgage program could cause trouble. If home prices start to appreciate, it's less likely there will be losses in this program. ■

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# Monasteries, Mutuals and Investment Banks

BY ALBERT J. BRENNER, CFA

I RECENTLY FINISHED READING C.J. SANSOM'S HISTORICAL mystery *Dissolution*. The book is set in England in the early years of the 16th century at the time of the dissolution of the monasteries. The monasteries were dissolved by Henry VIII as part of an ostensible reform of the English church. The motivations behind and the purposes of the dissolution were many, some noble and some not. The stated purpose was to root out the corruption and vice that—according to Henry and his advisers—had become endemic throughout the monasteries (a view subject to considerable disagreement among modern historians). The dissolution of the monasteries was also intended to eliminate the influence of Rome over the newly established English church with the king as its head.

A less noble motivation behind the dissolution was the expropriation by the Crown of the wealth of the monasteries—their lands and accumulated treasure. Even in the early 16th century, many of the monasteries were centuries old. Through generations of bequests, many of the monasteries had accumulated considerable wealth; and it was no inconvenient consequence of their dissolution that this wealth flowed to the Crown and its supporters.

While I was reading Sansom's historical postscript to the book, I was reminded of a much more recent phenomenon with odd parallels to the dissolution of the English monasteries five hundred years ago: the wholesale conversion of mutual savings institutions to publicly owned stock institutions. The mutual savings industry, a relatively small component of the American banking system but a larger component in certain areas such as New England, has been around since before the Civil

War. Many mutual savings banks in New England were established in the 1840s. These institutions, established to serve the small saver within their communities, provided banking services to the general public for more than a century and survived some of the most severe financial crises in American history. In the process, they made money, and their accumulated earnings were stockpiled as capital. By the late 20th century, many of the mutual banks had strong capital ratios—although some did not.

The mutual savings bank industry survived for more than a century until the management of the industry realized that they could tap into the accumulated capital of the mutual banks. Under the guise of raising capital to be more competitive, many mutual savings banks converted to stock ownership. Two things happened as a result.

## About the Author



Albert J. Brenner, CFA, is the executive managing director of Asset Allocation Parametrics, LLC, an investment research and advisory firm that specializes in providing asset allocation guidance for tax-exempt and tax-deferred investors. He is also the editor of the Asset Allocation Advisor.

Prior to founding Asset Allocation Parametrics, Brenner worked in the non-profit and banking sectors. He was the director of finance and operations of a non-profit organization in Connecticut for six years after working in banking for twenty years. His last position in banking was as executive vice president and treasurer of Northeast Savings, a multi-state thrift institution now part of Bank of America, and where he managed more than \$2 billion in assets.

Brenner is a graduate of the University of Notre Dame and holds master's degrees from Oxford and Yale. He earned the Chartered Financial Analyst designation in 1991.

## Monasteries, Mutuals and Investment Banks

Many people, and management in particular, made a lot of money. Through the grant of stock purchase rights (flowing ostensibly from being current “owners” of the bank by being current depositors or bank employees), bank managers essentially cashed out the accumulated capital of the institutions. One hundred years of stockpiled earnings were distributed in one fell swoop to the folks in the corner offices. The wealth of these community institutions, intended to serve the general public, was effectively expropriated by management. Unlike the dissolution of the monasteries, however, which led initially to a significant uprising, the conversion of the mutual savings banks had little opposition. Current depositors were able to join in the plundering, and few voices were left to speak out in opposition to the expropriation.

Ironically, the second consequence of the wholesale conversion of the mutual savings banks—at least in New England—was the ultimate failure of many of the institutions. So much capital flowed into the region, and banks were so eager to put the capital to work, that a boom in commercial real estate followed as project after project got funded without anyone asking how all of the projects could be supported. Just like the more recent national housing bubble, all of the building couldn't be supported. Commercial real estate prices dropped, buildings sat vacant, and banks failed—even those that hadn't raised new capital. Rather than buttressing the banks, the new capital resulting from mutual to public conversions precipitated a banking crisis.

As I was discussing these reflections with my intern, Jay Murray, he brought up another parallel: the conversion of the investment banks from private partnerships to publicly owned stock institutions.

Investment bankers have always been a rare breed in the world of American commerce. The traditional investment banking houses were elite institutions of moneyed individuals who put their wealth at risk to promote the growth of American commerce. Although investment bankers were wealthy individuals—or got to be wealthy individuals—their wealth was not particularly liquid. As anyone who has read Charles Ellis's history of Goldman Sachs (*The Partnership: the Making of Goldman Sachs*) knows, the accumulated wealth of the Goldman partners was typically locked up in the capital of the firm. The success of the partnership required that the pool of the partners' equity be maintained to support the underwriting and financing activities of the firm.

The conversion of the American investment banks from their traditional private partnership structure to publicly traded stock companies changed the entire dynamic of investment banking, as it gave the partners of the investment banks a means of getting more ready access to their accumulated wealth. The conversion to public companies did not constitute an expropriation of treasure accumulated over time—as in the case of the monasteries and the mutual banks—but it did change the dynamics of the investment banking world, and almost certainly for the worse. Investment banking partners were now playing with not just their own money, but also their shareholders' money. Rather than being just owners, they were now also agents.

The introduction of individuals acting as agents inevitably introduces agency problems, as they are known in the theory of corporate finance and management. Agency problems arise when the interests of owners or providers of capital are not perfectly aligned with the interests of those acting on their behalf. The private partnership structure of investment banking kept agency problems to a minimum. The partnership imposed discipline on those who acted in their own interests to the detriment of the firm. The conversion from private partnerships to public companies made thousands of investors silent partners with the in-house partners of the converted firms. The potential for significant agency problems came with the conversion. The failure of Lehman—and the near failure of several other investment banks during the latest financial crisis—is testimony to the elevated degree of risk that the banks were willing to take when playing with more than just the in-house partners' money. It would be extraordinarily disingenuous for us to imagine that the systemic risks associated with the subprime mortgage debacle would have escaped the notice of the major investment banks had they been private partnerships.

In the end, although the change in the structure and ownership of American investment banks did not constitute a direct expropriation of treasure accumulated over time, the financial crisis facilitated by the changes have amounted to the same thing—with the exception that, in the current case, a good deal of the expropriated wealth is coming from the future, not the past.

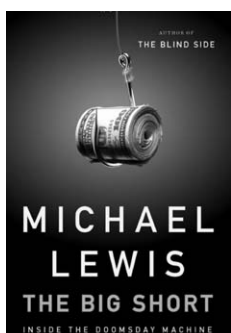
If there is a lesson to be learned from these stories, it is a cynical one. The surest way to individual wealth is to locate a store of accumulated wealth and find a way to expropriate it. Whether it be centuries of gifts, decades of retained earnings, or inflated housing values, if we can just find a way to tap the wealth, we can get rich without really trying. ■

RECOMMENDED READING

# The Big Short: Inside the Doomsday Machine

by Michael Lewis (©2010, W.W. Norton & Co., 266 pages)

REVIEWED BY WILLIAM P.J. MCCARTHY, CRE



THERE HAVE BEEN AS MANY BOOKS recently written about who and what caused the recent financial crisis as there are excuses for this debacle. If you are interested in a book that both reads like fiction due to its cast of characters, yet provides you with an insider's perspective of what occurred on Wall Street and beyond during the

global financial meltdown and subprime mortgage fiasco that peaked in 2008, then the book to read is *The Big Short: Inside the Doomsday Machine* by Michael Lewis. For those of us in the real estate and finance industries, you will read in amazement how widespread and deep the greed, corruption and incompetence of some of the supposedly best minds and most privileged leaders in business led to the loss of \$1.75 trillion in wealth in the subprime mortgage markets, shamed capitalism and ruined thousands of lives in the process.

Michael Lewis is a brilliant chronicler of business affairs, who by focusing on some of the more interesting and controversial characters, has the rare ability to also take complicated issues and subject matter and create fascinating vignettes. As a former Wall Street bond trader, Lewis knows where to look for information and what questions to ask, and whom to ask. Lewis first rose to prominence when at just twenty-four he released *Liar's Poker* in 1989, about his experiences with the then prominent Wall Street firm, Salomon Brothers—an intriguing, fast-paced look behind the scenes of the bond and capital markets. Lewis still can't seem to get over the fact that he was paid hundreds of thousands of dollars and bonuses

for advising clients on the purchase of stocks and bonds when he readily admits at his age, with no practical experience, he had no clue what he was doing. This sense of amazement about how fees are set and generated and what constitutes expertise and experience carries on in *The Big Short*. However, whereas his previous book, *Liar's Poker*, dealt with millions of dollars of transactions, *The Big Short* deals in the billions.

*The Big Short* is Lewis' eighth book. Several have been best sellers including his exposé on Silicon Valley entitled *The New New Thing*; the economics of big time sports, *Moneyball*; and perhaps his best known work, *The Blind Side*, which recently was made into an Academy Award-winning film about the unlikely life and career of football star Michael Oher. (*The Big Short* could also be made into a great movie). Lewis' style is to tell the story through the narrative of several prominent and obscure participants. He does this very effectively in *The Big Short*, which he considers a tale about systematic mass delusion.

## About the Reviewer



William McCarthy, CRE, FRICS, R.I., is a property developer and owner, and a real estate agent and consultant based in Burnaby, British Columbia. McCarthy is the immediate past president of the Real Estate Institute of Canada, and has served as a director and officer of several other professional and community organizations.

A Counselor of Real Estate since 1995, he duncumis a member of the CRE Consulting Corps and has participated in two major assignments for the Corps. McCarthy currently chairs the CRE Ethics Committee.

## The Big Short: Inside the Doomsday Machine

We are introduced to Steve Eisman, who tells Lewis of his journey from being a strident Republican to what he referred to as the financial markets' "first socialist," as he became increasingly concerned and outraged over how deceptive and corrupt the entire mortgage lending business was becoming. And then Eisman and his team discovered what Lewis refers to as the gold mine. Reviewing the first round of subprime mortgages in intimate detail, Eisman, a Harvard-trained lawyer, first became incensed, and then calculating, when he realized that realtors, appraisers, mortgage brokers, banks, regulators, governments—everyone who could take a cut of the action—were encouraging unqualified and delusional individuals to purchase residential real estate they could never afford. As traders Charlie Ledley and Jamie Mai told Lewis in the book: "The best way to make money on Wall Street was to seek out whatever Wall Street believed was least likely to happen, and bet on it happening," such as the greatest domestic economic crisis since the Great Depression.

Eisman was not the only individual to ponder or analyze the subprime and securitization boom. The Deutsche Bank bond salesman Greg Lippmann was also thinking about how to make money on top of the subprime loans. The key would be to buy credit default swaps and derivatives, those exotic and ultimately useless creations of Wall Street, impossible to qualify or quantify, or even explain. Wall Street simply invented artificial ways to generate fees and bonuses—without care or consideration for the consequences. First securitize junk mortgages, and then create dubious insurance schemes to capitalize on the defaults.

One of the first and most focused analysts to see the potential windfall of the credit default swaps, and the money to be made by betting on the collapse of the subprime market, is the most interesting character portrayed in the book, Dr. Michael Burry. Burry was an introverted loner who had lost an eye to cancer. Later

diagnosed with Asperger's Syndrome, he became a medical doctor and part-time stock analyst, whose research and attention to detail created a cult following in the industry. Requiring little sleep, and with both the fascination of and ability to study and chart massive and convoluted mortgage documentation and deal sheets, Burry knew the subprime was a farce, and that the bond rating agencies were willing participants in this scheme. Everything was rated a "buy." How could 80 percent of these extremely questionable and risky pooled mortgages be rated Triple-A, the same as U.S. Treasury debt? Burry noted there was an opportunity to essentially hedge against the collapse of some of these funds. Credit default swaps were the way. Lewis explains that while Wall Street firms were temporarily able to hide the risk by complicating it, a handful of proactive analysts and investors, such as Burry, knew that betting against these notes would pay off—massively. This was the Big Short.

(If you go onto the *60 Minutes* website, look for the March 14, 2010 edition where Michael Lewis talks about his book, and Michael Burry is profiled in a fascinating expose. In addition to reading *The Big Short*, you should also see the movie "Inside Job," which just recently won the Academy Award for Best Feature Length Documentary. The events and many of the personalities discussed in *The Big Short* are featured, and dealt with harshly).

*The Big Short* is an enjoyable read and an illuminating expose of one of the most shameful periods in American business. By 2009, the American taxpayer had assumed more than \$1 billion of bad debt and subprime losses. Homeownership is the noble dream of all hard-working families. Real estate is the foundation of a successful and flourishing economy. To see how these pillars of a free society were manipulated and abused for no purpose other than greed is difficult for us, the conscientious real estate professionals, to comprehend. *The Big Short* reveals the painful consequences that result when individual and corporate ethics and standards are allowed to free fall. ■

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

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