REAL ESTATE ISSUES®

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WEB REVIEW

The New American FactFinder (or *http://factfinder2.census.gov/main.html*)

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Editor's Note

BY PETER C. BURLEY, CRE

"Little Darling, I see the ice is slowly melting.
Little Darling, it seems like years since it's been clear…."

—George Harrison

The truth is the winter of 2011–2012 didn't amount to much. It was pretty mild, relatively dry, and, in some quarters, downright disappointing. At my little apartment in Washington, we had two mornings with just the slightest dusting of snow. February was among the warmest on record at both Reagan National and Dulles, according to the National Weather Service. In Colorado, my wife reported just a single blizzard at the old homestead (lucky for me, because I would have heard shoveling horror stories to be sure).

I am thinking that, perhaps, the weather serves as an apt metaphor for our lives and our businesses. Perhaps, things aren't as dismal, cold and barren as we had thought. Maybe that stupid bird, singing in the courtyard outside my little apartment all day and all night long for the past six weeks, has it right: The ice is melting. It has been for a while. We just haven't been paying attention. Or, perhaps we have just been afraid to think that things might be getting...well, better.

So far, in 2012, the economy appears to be (ever so slowly) improving. Employment figures are on the mend. Consumer spending is stable. Housing markets, according to a number of analysts, have finally found a bottom. Stocks have had a wild, if largely upside, ride, hitting levels not seen since before the crisis.

Of course, there are hazards aplenty. And, there is still a heap of uncertainty out there. As of this writing, considerable turbulence continues in the EU, with future bailouts and austerity measures—even a whole currency—in some doubt. Tensions have increased across a large swath of the Mideast, and oil prices have responded with a volatile climb to some of the highest levels we have seen in late winter. Dodd-Frank is still coming as new regulations slowly make their way onto the books in ways that will have sweeping implications across the financial and investment landscapes. Debt issues—personal, corporate and governmental—continue. Those distressed properties are still out there. And, of course, election-year antics in the U.S. have pushed political and policy agendas to and fro across this town and the rest of the country, as the Republicans seek a single voice behind which to rally and as the Democrats seek simply to be heard.

It does seem like years since we've been here. And, maybe that's why we're not fully confident about the strength or stability of the recovery. But, according to the Conference Board's Index of Consumer Confidence, while the Index dipped a tad in March, people feel marginally better about current conditions and slightly better about future conditions, including jobs and incomes. On the business side, *Moody's Analytics* reports that businesses are slightly more confident so far this year, while expressing some caution in hiring and investment. Maybe, we've just been beaten up with so much bad news that we refuse to see the smiles returning to the faces.

Real Estate Issues is pleased to offer a number of articles to ease our colleagues into spring, to stimulate the mind, to get the sap running, as it were.

While winter was a fairly mild affair across much of the country, my wife reports that it has been unusually windy in Colorado, with the month of March one of the driest but windiest on record there (she is learning to retrieve and stow susceptible outdoor items). Ironically, just as I heard that report from home, which is one of the hot spots for the wind energy industry, **Barton DeLacy, CRE,** submitted his article "Renewable Energy: Headwinds Ahead?," which focuses on the interrelationship of fuel, power generation and real estate. DeLacy asserts that the relatively mature wind energy industry is in crisis mode in 2012, as government subsidies expire. Without those subsidies, he notes, large scale wind energy projects will no longer be feasible. He tells us "In the end, energy is a commodity whose availability and cost can dramatically affect facility location and overall economic growth." He reviews the fundamentals of power generation to illustrate the real estate implications for energy markets—which "involve locations, connections and space." Renewable portfolio standards (RPS), which require power suppliers to purchase a minimum quantity of renewable energy (wind, solar) along with federal tax policies and maturing technologies, may promise to realize the ambitions of the environmental movement for a "greener" America. But, not without roadblocks and limitations, which DeLacy discusses further in the article.

Much has been written about the ramifications of the Kelo decision by the Supreme Court 2005 [*Kelo v. City of New London*, 125 S. Ct. 2655; 162 L.Ed. 2d 439 (2005) (Kelo)]. In "The Evolution and Consequences of *Kelo v. City of New London*," **Jeffrey D. Eicher**, **J.D.**; **Jerry D. Belloit**, **Ph.D.**; and **C. Frank Shepard**, **Jr.**, **J.D.**, give us a comprehensive review of the decision, discussing the background, the action, the consequences and responses to the now infamous decision. But, Kelo paved the way for jurisdictions to take private property if there were a *belief* that future development might generate a public benefit (i.e. new tax revenues), without necessarily demonstrating the *need* for the property or the benefit of its condemnation for public use. As they put it, "The purpose of the Bill of Rights is to protect the individual from the power of government, and in theory, from the will of the majority by protecting individual liberty." The New London Development Corporation had taken private properties based on a concept of "public purpose" that was not fully articulated and that was predicated on the development of a facility that never came to fruition. The Supreme Court determined that "public use" could be interpreted as "public purpose" and that the concept of "public purpose" refers to *perceived* public needs in justifying the use of the takings power of the Fifth Amendment. Reaction has been mixed over the past several years, with a number of states and other jurisdictions considering—and some implementing—legislation that limits 'takings' to very specific purposes.

In "An Analysis of New Markets Tax Credits," authors **J. Russell Hardin** and **Thomas Nolan** offer us a detailed picture of the program that is designed to "encourage investors to make investments in impoverished, low-income communities that traditionally lack access to capital." The New Market Tax Credit (NMTC) program, which was established as part of the Community Renewal Tax Relief Act of 2000, has financed a wide range of projects, from urban supermarkets to schools, health centers, solar companies, and a number of revitalization projects. An extensive review of projects at the local and the state level provide examples of the program's broad array of projects, most of which are focused on extremely disadvantaged communities. Variations on the theme at the state level are also explored. According to the authors, demand for NMTC far exceeds availability, and Community Development Entities have requested more than seven times credit availability. With successes in bringing additional funding into distressed communities, in bridging funding gaps and in achieving strong returns to investors, extension of the NMTC program at the federal level has been requested for 2012 by both the Administration and members of Congress.

"Inflation is among the worst nightmares depriving investors of peaceful sleep," says **Martha Peyton**, **CRE**, as she examines the inflation protection offered by commercial real estate in her article, "Is Commercial Real Estate an Inflation Hedge?" Peyton's article reviews recent inflation trends along with the risks that monetary or fiscal policies might stimulate in an overheated economy, resulting in inflationary conditions. She then looks at commercial real estate performance relative to inflation and the elements of real estate that offer protection from inflation. While a simple correlation analysis between commercial real estate returns and inflation is "rather low compared with a perfect inflation hedge, it beats the correlations between inflation and every other asset type." And, by simulating portfolios of commercial real estate, Treasurys, stocks and bonds over five-year investment horizons, Peyton finds that commercial real estate returns beat inflation in 84 percent of the cases. The exception is during periods with excessive supply or a collapse in demand. While Treasurys and corporate bond portfolios might beat inflation more frequently than commercial real estate, they do so with smaller degrees of outperformance. Stock portfolios beat inflation less frequently, but when they do beat inflation, they do so by a larger degree.

Back in my early days of economic and demographic analysis, census data came in print (books!) or on large tape reels that were stored at a few data centers scattered around the country. To inquire into the data in any detail, one needed to write a program (in FORTRAN or PL/1 or SAS or SPSS—on punch cards, no less!) and then wait for the data to spill out onto sheaves of wide, green barred paper. OK, OK, so the Web has changed a lot of things and, yes, now one can access census data on *American FactFinder*, the U.S. Census Bureau's website for tracking down just about any data series the agency produces. The latest version of *AFF*, which officially replaced the previous version in January, is now where one goes to access U.S. Census data, and **Mary Bujold**, **CRE**, our esteemed associate editor, offers us her review of the new site in her Web Review, "The New American Factfinder." Bujold tells us, "When first faced with the daunting task of trying to navigate the new *AFF*, I, a seasoned customer of the old website, tried valiantly to get into the head of the individual(s) who designed it so I could figure out how this new website was supposed to be so much "easier to navigate." In fact, she continues, "The interface of the old *AFF* was definitely more user friendly." *AFF2* has its advantages, including a "Quick Search" feature, and easy retrieval of basic data for most geographies. But, Bujold advises, "if you want to aggregate different geographies or search on multiple topics, it becomes very complicated from this point on." After spending "almost an entire afternoon figuring out how to obtain a modest amount of data, which under the old *AFF*, took only a few minutes," Bujold offers her suggestions for accessing needed data.

Our many thanks to our contributors for this issue; and, thanks to Carol Scherf, our managing editor, who continues to do the work of many; and, to The Counselors, thanks for letting me continue working on this journal. ■

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EDITOR IN CHIEF

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Peyton joined TIAA-CREF in 1993 and has 30 years of financial industry experience. Her prior experience includes financial executive positions with Marine Midland Bank's Credit Policy division and Domestic Economics group. Peyton also formerly taught economics at Fordham University and Manhattanville College. She is a Counselor of Real Estate and a member of the American Real Estate Society, the Urban Land Institute and the International Council of Shopping Centers. Peyton earned a doctorate degree in economics from Fordham University, as well as a bachelor of arts and a master's degree.

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FEATURE

Renewable Energy: Headwinds Ahead?

BY P. BARTON DeLACY, CRE

INTRODUCTION

Energy touches every aspect of life. However, search engines, when queried for the terms "energy" and "corporate real estate," will return countless references to conservation and sustainability. Missing in the discussion of clean, green and renewable is information on how energy is generated.

The focus of this article is on the interrelationship of fuel, power generation and real estate. Beyond these factors public policy provides incentives, often favoring one form of energy delivery over another. Such policies, informed by science and global politics, strive to override what are considered short-term consumer preferences. For instance, American consumers long favored low-mileage sports utility vehicles (SUVs) when gas was relatively cheap.

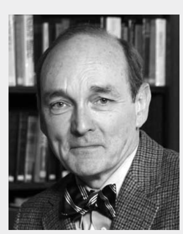
MUST RENEWABLE ENERGY BE SUBSIDIZED?

Why does utility-scale renewable energy power generation, as represented by the proliferation of wind and solar farms, require such heavy subsidy? Could such governmental "investment" inflate a bubble, or are the superseding public policy goals sufficient to assure the prudent expenditure of capital and a wise use of the land? So the question becomes, is there sufficient demand in the marketplace to support the scale of renewable power development envisioned by U.S. policymakers or is the stimulus excessive and likely to encourage speculation and over-building? Speculative bubbles have plagued national, if not world, economies ever since trade was globalized—at least since the tulip craze of the late seventeenth century. Most readers of this journal are well aware of the perils of real estate speculation and the current plight of our new-construction-driven housing economy. Yet any commodity, be it tangible (tulip bulbs and oil) or intangible (dot-com and broadband) can spike in price before collapsing in ruin. As we should have learned in the late subprime housing bust, external stimulus can be the catalyst for irrational enthusiasm.

In a tumultuous political year, how we finance and incentivize development of green power has forced the renewable energy industry to confront its economic fundamentals. The bankruptcy of Solyndra, the solar panel manufacturer, brought to light the relative high cost of production components. In the case of California-based Solyndra, heavy taxpayer-financed subsidies were necessary for the company's products to be competitive with Chinese imports (which themselves were heavily subsidized by the Chinese government).

The relatively mature wind industry finds itself in crisis in 2012. Two critical subsidies are, or will be, gone. Without those subsidies, we have learned, most large utility-scale wind projects will no longer be feasible. The soon-to-expire production tax credits (PTC) have been around for a couple decades with periodic extensions. A PTC now

About the Author



P. Barton DeLacy, CRE, MAI, FRICS, *based in Chicago, is National Energy Practice director in Valuation and Advisory Services for CBRE. His consulting experience includes wind farm property value impact studies, land lease analyses, and valuations of both renewable and thermal energy power plants. DeLacy previously has been published in* The Appraisal Journal, Real Estate Issues *and the* Journal of the American Planning Association. *He holds a master's degree in urban planning from Portland State University and a bachelor of arts degree from Willamette University.*

pays about 2.2 cents per kilowatt-hour of power produced over a ten-year span. When modeling the impact of this subsidy, developers typically showed it returned up to a third of installed project costs.

However, the success of a PTC, or any tax credit, is contingent on having healthy banks that have the income to justify the credit. During the recession of 2008–2009, the number of eligible tax credit investors evaporated. Thus, as part of the Recovery Act,[1] Treasury Grant 1603 provided an outright cash subsidy to renewable energy projects for up to one-third of their construction costs. The grant paid out once a project was put into service. The 1603 grant program expired at the end of 2011 and the PTC is set to expire at the end of 2012.

The American Wind Energy Association (AWEA) has orchestrated a broad-based lobbying effort on behalf of its member developers and component manufacturers to extend the PTC. Without the credit, AWEA claims pending projects will be delayed or abandoned, with thousands of jobs lost. While construction jobs are temporary, and only skeletal staff is needed to maintain operating wind farms, project curtailments threaten widespread layoffs throughout the domestic supply chain.

On one hand, this clamor for continual subsidy may sound like funding the next financial bubble; yet most innovations in energy technology have required significant federal assistance for many years. For instance, the tax code still recognizes depletion allowances and other incentives to aid oil and gas exploration. However, some argue, including Pulitzer Prize-winning author Daniel Yergin, that improvements in the technology for extracting and conveying natural gas to industry and consumers[2] have served to disrupt the narrative that so-called fossil fuels are in danger of being depleted at all.

Understanding the economics of renewables will help real estate advisors support appropriate public policies. In the end, energy is a commodity whose availability and cost can dramatically affect facility location and overall economic growth. Focus on the wind industry brings these observations into high relief, beginning with a review of the fundamentals of power generation.

POWER GENERATION

Power plants include any facility housing a turbine connected to a generator that converts kinetic energy into electricity. Examples range from hydroelectric dams to wind turbines to steam-powered generators. Photovoltaic solar panels and fuel cells create electricity through chemical reactions.

How can real estate professionals participate in the energy marketplace and its growing appetite for property? As a start, lenders and investors need to appreciate there is a financeable asset once these capital intensive projects are built.

Energy markets can be defined as those enterprises that bring together all factors necessary to generate the power needed to operate within our urban landscape where so-called "peak loads," i.e. demand for electricity, are generated. Today these markets may include:

Fuel:

- non-renewable from fossils (natural gas, coal and oil);
- renewables: wind, water and sun; also geothermal and biomass (synthetic gas).

Generation:

- power to spin an axle (water wheels to jet engines);
- kinetic energy from spinning electro-magnets (creates electricity);
- fuel cell chemistry.

Transmission (collect, transform, upload and send the power):

- switching stations to collect and transform electricity for conveyance;
- overhead transmission corridors;
- subterranean pipelines.

Distribution (download power and connect to users):

- substations;
- local overhead lines/cable distribution;
- local distribution (i.e., roof-mounted panels).

Historically the industry has been segmented to concentrate, say, on the oil market and the price of gasoline, or utility stocks and consumer electricity rates. Today, all these submarkets have converged and the impact of one or another can no longer be understood in isolation. The economics of energy creation, distribution and use are influenced not only by fuel supply and consumer demand, but by public policy, science, the environment, technology and global events.

The real estate implications for the energy markets are inevitable because all of these factors involve locations, connections and space.

Figure 1

Photo by P. Barton DeLacy

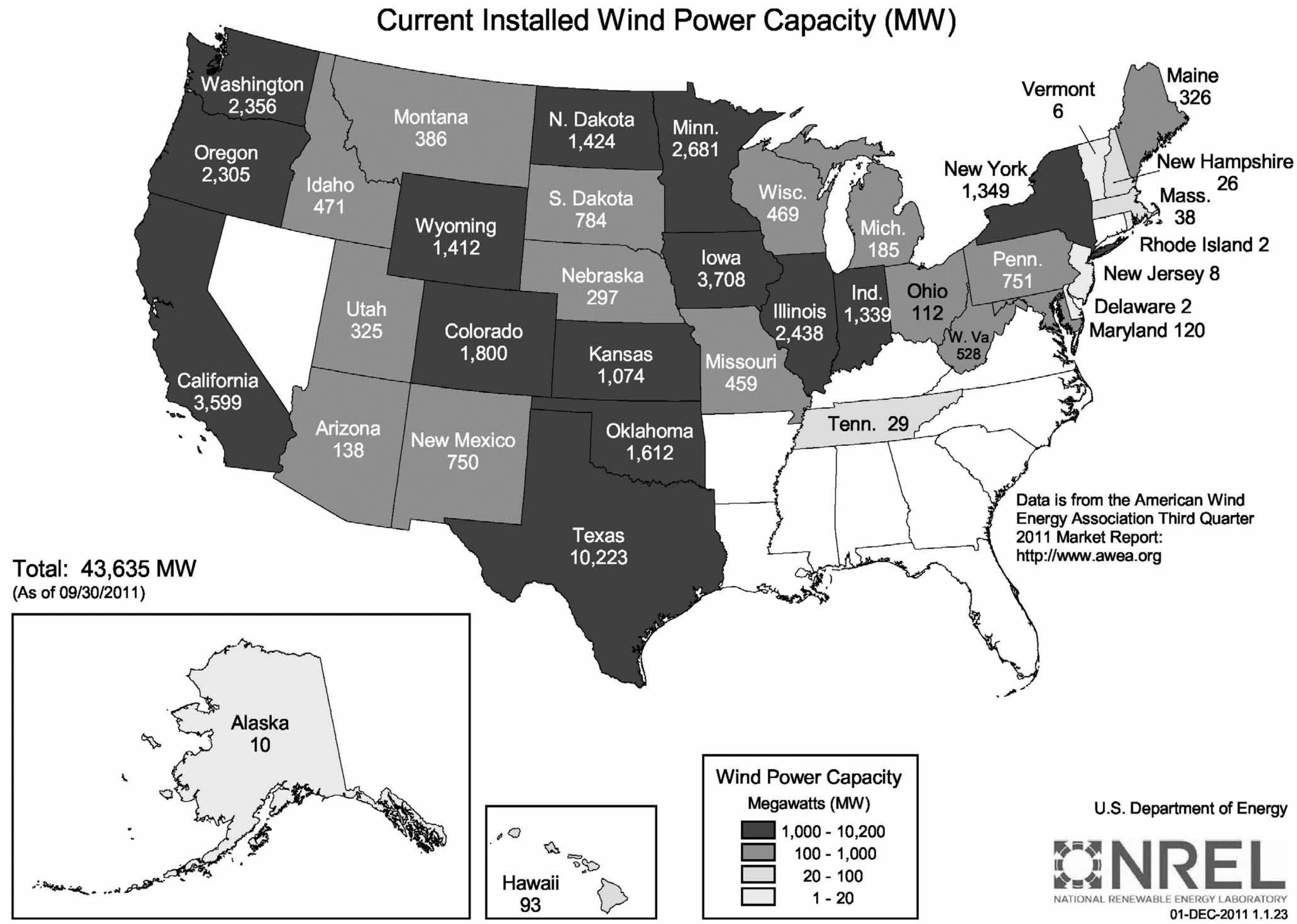
A row of wind turbines dominate the landscape of Wasco County, Oregon. Power generated here is typically sold into California.

Figure 2

Photo by P. Barton DeLacy

Traditional thermal power has long been generated by oil-, gas- or coal-fired plants. This one-time 1000-plus MW natural gas-fired plant has been relegated to use as a peaker [3] station on the California coast—its future may be backing up nearby solar projects in San Luis Obispo County.

Figure 3



THE ECONOMICS OF THE U.S. WIND INDUSTRY: AN OVERVIEW

In many parts of the country, the iconic wind turbine—an elegant, if outsized, sculpture—has come to populate gusty prairies and high desert expanses. The history of wind farm development in the U.S. cannot be understood without recognizing the role of public policy in shaping demand.

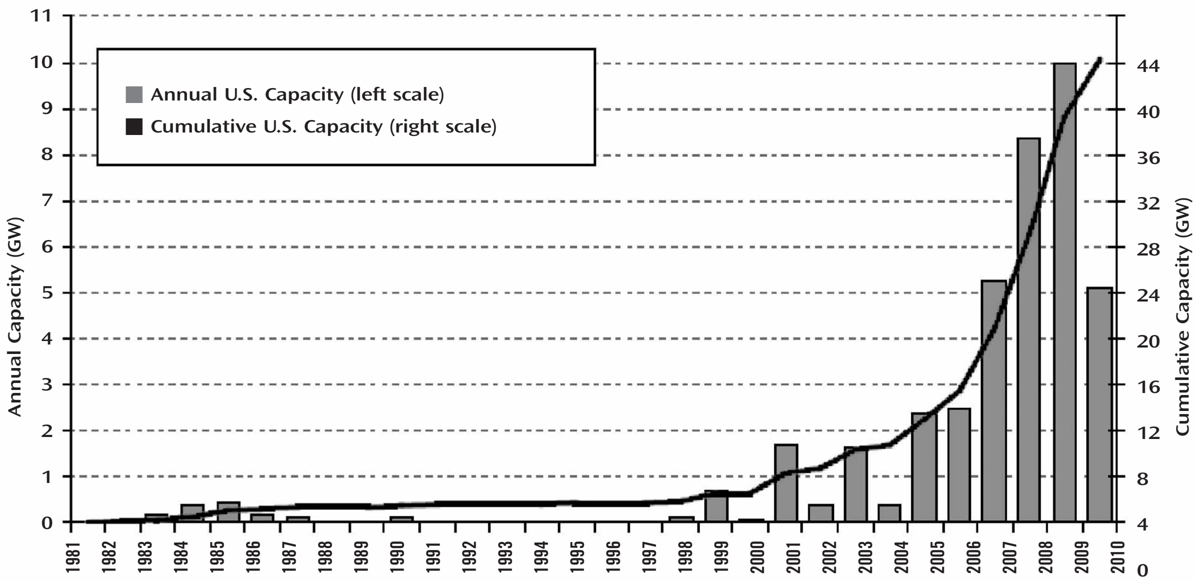
The U.S. wind energy business got its start in California during the 1970s when spikes in oil prices forced policymakers to look for alternative fuel sources. In the intervening 40 years, the wind industry has continued to be driven by federal policies that offer significant financial incentives for its development. This public policy is supported by national goals to achieve energy independence, coupled with environmental goals to reduce the U.S. carbon footprint in a time of concern over climate change. However, growth is very much contingent on government funding.

The U.S. Wind Limited wind farm development proceeded apace (thanks in part to tax credits) beginning in the 1980s, but was stalled through the 1990s when electric utility restructuring disrupted energy pricing and tax credit programs began to expire.[4] Since 1999, installed wind capacity has grown every year. The AWEA provides a graphic snapshot (Figure 3) of installed wind power over the past three decades.

Yet, absent significant tax credits (investment tax credits or production tax credits), it is unclear to what extent pure market forces would have propelled "big wind" to compete with fossil fuels. In essence, while the fuel, i.e., wind, is free and without harmful externalities, the capital costs to build wind power are significant. Most industry observers now agree that absent a change of heart by

Figure 4

Annual Installed Wind Capacity in the U.S. 1999–2011



Source: American Wind Energy Association project database

Congress, the tax credits will not be renewed beyond 2012. If history is any indicator, big wind projects will drop precipitately. The impact has already been seen in Illinois where, according to the *Chicago Tribune,* more than 150 companies that either develop or supply wind power are now based. As of February 2012, nearly 14,000 megawatts of capacity, now permitted, may be abandoned or postponed absent the tax credit.

The PTC is awarded once a project is completed and its power has been offloaded to a utility. The second component to financially model a wind project is a power purchase agreement (PPA). A PPA is a long-term, fixed-price off-take contract. It funds operations and a return on investment to the developer. This funding vehicle can be used for any power generating project where the power producer is independent of the utility. The PPA is typically negotiated on a price per kilowatt-hour basis. That rate will vary depending on the avoided cost of local electricity.

An alternative financing mechanism, so-called feed-in tariffs (FIT), are used in parts of Canada. Under a FIT system, regional or national electricity companies are obligated by governments to buy renewable electricity (electricity generated from renewable sources such as solar photovoltaics, wind power, biomass and geothermal power) at above-market rates. These rates differ among the different forms of power generation, depending on the capital cost and commercial maturity of each technology. At this date and given the weak post-recessionary economy, surcharging electricity rates to pay for renewables is a tough sell to the consumer lobby.

Capital costs to build utility-scale wind, on a dollar per megawatt of electrical power produced, still exceed capital costs for conventional thermal power plants (burning coal or natural gas).[5] Offshore wind may come on line in the U.S. as early as 2012, but its costs are significantly higher still, compared with onshore farms.

The relative ranges of cost per kilowatt-hour for different power sources still favor thermal sources, i.e., coal- or gas-fired generators. Today, the installed cost of a typical 2.0 megawatt turbine in a utility-scale project (generally more than 20 megawatts, so at least 10 turbines) can run between $2.5 and $3.0 million per turbine or $1.25–$1.5 million per megawatt of installed capacity. A state-of-the-art combined cycle gas turbine rated at 100 megawatts could likely be installed for well under $1.0 million per megawatt.

However, the Department of Energy last reported that cost ranges from 2003–2004 compared with costs for similar facilities in 2008 showed wind power declining on a dollar-per-megawatt basis, compared with thermal alternatives. This trend may have continued through 2011 as the U.S. domestic supply chain was built out, reducing costs for component parts. However, the expected expiration of the PTC may throw this trend in reverse. Less big wind may get built and at a higher per-megawatt cost. Utility-scale solar installation costs are higher still (at more than $3.0 million per megawatt) but are more likely to be reduced over time because the science may be more open to further technological improvement.

However, as noted earlier, almost all forms of energy production are supported by some type of federal incentive or special government regulation (from oil-depletion allowances to the monopsony status of many public utilities). Thus, as federal tax credits are designed to support the supply of renewable energy projects such as utility-scale wind, renewable portfolio standards (also referred to as renewable energy standards) were intended to assure demand, even in the face of consumer resistance to cost.

CAN RENEWABLE PORTFOLIO STANDARDS ASSURE LONG-TERM DEMAND?

Renewable portfolio standards (RPS) contribute a third leg of government support for utility-scale wind and solar projects (along with tax credits and power purchase agreements, in essence enabled in a quasi-regulated arena). While the goals of the RPS may vary from state to state, an RPS requires retail electricity suppliers and load-serving entities to purchase a minimum quantity of eligible renewable energy. These load serving entities, technically referred to as independent service providers are, in lay terms, local and regional utility companies. These standards are intended to stabilize the industry.

Of the 35 states that have adopted mandatory RPS, performance goals (as a percentage of electricity sales) vary from 10 percent by 2015 (Michigan and North Dakota) to Maine's 40 percent by 2017. California now has a 33 percent goal by 2020 and is struggling to expand its transmission capacity amidst a state government fiscal crisis. Most states that have adopted RPS have set a 20–25 percent goal within a 10–15 year time frame.

Compliance with RPS entails owning a facility or its output generation, purchasing a renewable energy certificate, or purchasing bundled renewable electricity. RPS requirements are most commonly applied to investor-owned utilities and electric service providers. It is unusual for mandatory RPS requirements to extend to municipal utilities and cooperatives, as these entities are predominately self-regulated. However, some states have included provisions for municipal utilities and cooperatives to voluntarily join the RPS program or to "self certify."

What qualifies as "renewable energy" at utility-scale project size?

Wind – electricity generated by "farms" or clusters of wind machines referred to as turbines;

Solar – technology varies and is maturing, typically relies on photovoltaic devices, often arrayed as ground- or roof-mounted panels;

Geothermal – relies on hydrothermal resources, concentrated in California, Alaska and Hawaii;

Biomass – wood, corn, landfill gases, garbage and ethyl-alcohol fuels; still a nascent technology and not necessarily energy efficient;

Water – hydropower, or wave action offshore (latter still experimental).

THE REAL ESTATE COMPONENT OF RENEWABLE ENERGY

Wind and solar power account for only a fraction of renewable energy produced in the U.S. today (compared to hydropower). Yet wind and solar farms encompass a significant amount of real estate. Figure 5 below shows the relative amount of land consumed by different power plants:

Figure 5

Renewables vs. Thermal: Some Comparisons

THERMAL:	FUEL	NAMEPLATE CAPACITY	NCF	LAND
Steam turbines	coal	100-500 MW	95%	fractional
Combined cycle peaker	gas	up to 150 MW	97%	fractional
RENEWABLE:				
Utility-scale wind	wind	1.5-3.0 MW	25-35%	40-50 ac/MW
Utility-scale solar (PV)	sun	arrays up to 10 MW	10-12%	10-12 ac/MW

Source: P. Barton DeLacy

Solar panels, arrayed on rooftops or ground-mounted, consume six to ten acres of land per megawatt of potential or nameplate power generated. The wind developer may need 50–100 acres per megawatt, depending on topography and how the wind blows, although a wind turbine platform and its network of access roads will actually displace less than one percent of the land taken up for staging.

Thus, solar photovoltaic projects will consume hundreds of acres to achieve utility-scale efficiencies, whereas wind farms encompass acreage by the thousands. Nevertheless, building photovoltaic projects costs three to five million dollars per megawatt of installed power[7] compared with installed costs of one to two million dollars for wind.

Today, the Department of Energy reports that wind power represents the second largest new source of electric capacity additions to the U.S. It trails new natural gas plants, but is ahead of coal.

ENTITLEMENT: LAND USE AND SITING CHALLENGES FOR BIG WIND VERSUS UTILITY-SCALE SOLAR

The successful entitlement of land for wind farm development requires a lengthy and collaborative process in which real estate consultants, if not appraisers, may play an important—albeit peripheral—role. Appraisers often are asked to participate in the permitting process when expert opinion is necessary to advise siting authorities on local property value impacts.

Three geographic characteristics will dictate placement of utility-scale renewable energy projects:

- availability of the resource (wind, sun, geothermal vents);
- availability of land;
- proximity to the power grid.

Given the near 40-story height of most wind turbines, opposition to so-called big wind is grounded in fears of diminished property values and increasing concern over loss of raptors (hawks, eagles, etc.) and, in the Midwest, bats!

Offshore wind has been successfully developed in Europe but poses significant environmental concerns that have yet to be resolved in the U.S. The big challenge in deploying more wind across the central U.S. is transmission capacity, a topic beyond the scope of this article.

Solar takes less land and is seen as less obtrusive than wind, yet siting objections tend to do more with taking farmland out of production. As distinguished from wind, solar energy systems are smaller, modular and can be deployed at the retail or household level, as in roof-mounted panels to heat domestic hot water. However, the focus of this discussion is on utility-scale projects of at least 10 megawatts—the threshold for a solar development.

So real estate professionals may expect to find important roles in the brokering, entitlement and valuation of renewable energy projects, certainly at the local or "micro-economic" level. But why should the real estate counselor bother being conversant in the parlance of energy or power generation? Why should we learn to speak "megawatt?"

It goes back to the three things that count most in real estate: location, location and location.

CONCLUSIONS

The biggest drawback to renewable power is that the resource is intermittent. It can be unpredictable, contingent either on the wind blowing or the sun shining. Neither solar nor wind power can be turned on or off at will. Hence, to integrate such "renewables" into a regional utility grid requires back-up "peaker" capacity, typically provided by gas-powered generators. The integration of renewable with conventional thermal power probably poses the most intriguing challenge to energy sufficiency in the U.S.

Utility-scale wind and solar energy developments will encompass more of the U.S. rural landscape as renewable portfolio standards proliferate. RPS mandate that retail electricity suppliers procure minimum quantities of eligible renewable energy. State by state passage of RPS, converging federal tax policies and maturing technologies promise to realize the ambitions of the environmental movement for a "greener" America. However, does the market really support this proliferation and the pipeline of product? Are there signs that incentives and public policy alone feed demand so that unforeseen price changes in alternate fuels could create a bubble? Could such a bubble trigger contagion into other markets, real estate and otherwise, as the housing bubble did this past decade?

While those questions identify potential future roadblocks, significant current challenges may yet further limit the proliferation of renewable power generation. These include:

U.S. ELECTRIC GRID:

- Power transmission is fragmented throughout U.S.—there is no equivalent to the interstate highway system;
- Existing transmission lines are approaching capacity in the West;
- further investment is needed to connect the resource with the load (think: conveying North Dakota wind power to Chicago demand);

SUPPLY CHAIN:

- tax credit availability has been inconsistent;
- the U.S. has been slow to develop component manufacturers.

INTEGRATION:

- wind and solar are intermittent resources and require thermal backup to assure peak performance and load balance;
- wind and hydro integration is complicated and expensive.

STORAGE:

- there is no way to efficiently store wind power;
- battery technology has a long way to go.

The one component, the factor of production that may bring together divergent energy interests across industries, may be land—getting power to the load and bringing wind from the plains to the demand in the cities. What about the real estate implications of repurposing obsolete thermal (i.e., coal or even nuclear) plants? Many of those obsolete facilities enjoy truly irreplaceable locations adjacent to switching yards and transmission corridors. All of them involve geography and the land that links locations. Maybe it is time for real estate counselors to speak and think in megawatts. ■

ENDNOTES

1. American Recovery and Reinvestment Act of 2009.
2. The technology is subterranean fracturing of shale rock. See Yergin, Daniel, *The Quest: Energy, Security and the Remaking of the Modern World,* Penguin Press, 2011.
3. A “peaker” power station, also known as peaker plants, and occasionally just “peakers,” are power plants that generally run only when there is a high demand, known as peak demand, for electricity. Today, peaker plants are often fueled by natural gas and are frequently needed to help balance the intermittent power generated by wind and solar plants.
4. Herzog, Steven J., “Wind Energy: Power and Policy,” *The Appraisal Journal*, January 1999, pp. 24–28.
5. Ibid.
6. U.S. Environmental Protection Agency, Renewable Portfolio Standards Fact Sheet *http://www.epa.gov/chp/state-policy/renewable_fs.html.*
7. Costs cited were provided by Paul Wormser, senior director, Engineering, SHARP Electronics Corp.

FEATURE

The Evolution and Consequences of *Kelo v. City of New London*

BY JEFFREY D. EICHER, J.D.; JERRY D. BELLOIT, PH.D.; AND C. FRANK SHEPARD, JR., J.D.

INTRODUCTION

THE FIRST TEN AMENDMENTS TO THE UNITED STATES Constitution, the Bill of Rights, were created to save us from what John Stuart Mill called tyranny by the majority. The purpose of the Bill of Rights is to protect the individual from the power of government, and in theory, from the will of the majority by protecting individual liberty. For example, the First Amendment protects the dissemination of unpopular ideas, protects the press, provides for religious freedom, and gives people the right to collectively assemble and complain to and about the government. Each one of these protections has been given specific legal meaning.

At least since *Marbury v. Madison*, 5 U.S. (1 Cranch) 137 (1803), courts have been charged with determining the constitutionality of governmental action. By this process courts have protected the individual from the government, and therefore from tyranny by the majority. Never has a court said that the phrase “Congress shall make no law…abridging the freedom of speech…” was not subject to judicial interpretation. Obviously, if liberty of free speech, as provided by the First Amendment to the Constitution, extends only as far as Congress says it extends, then we have no free speech. Since the Bill of Rights was established to protect the individual from the majority, it would defeat its purpose to have the majority determine what freedom of speech meant. Therefore, time and again, courts have given specific meaning to the phrase “freedom of speech” and have continually risen to the occasion by defeating the legislative will and protecting the individual.[1]

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The Fifth Amendment to the Constitution states, in part, "…nor shall private property be taken for public use, without just compensation." That clause originally applied only to the federal government, but was made applicable to the states by the Fourteenth Amendment.[2] It is hard to imagine that the drafters of the Bill of Rights envisioned that some of the language they were debating would simply have no meaning. However, the United States Supreme Court made exactly that determination in the case of *Kelo v. City of New London,* 125 S. Ct. 2655; 162 L. Ed. 2d 439 (2005) (*Kelo*).

KELO VS. NEW LONDON

The issue presented to the Supreme Court in *Kelo* was the specific meaning of the phrase "public use" as it is used in the Fifth Amendment. In *Kelo* the Court was presented with exactly the situation that the Bill of Rights was meant to prevent. A few families were seeking the protection of law from the power of the majority. The families involved lived in the Fort Trumbull neighborhood in New London, Connecticut. The economic base of New London had weakened considerably in preceding years. The Naval Undersea Warfare Center had closed down in 1996 and many of New London's jobs left with it. The population in and around New London dropped to its lowest level since the 1920s. The most blighted area of New London was its Fort Trumbull area. This area is located on a peninsula in the Thames River.

In the New London area there existed a private, nonprofit entity called the New London Development Corporation (NLDC). This organization was reactivated in January 1998 with the idea of assisting the city with economic development. At about the same time as the group's reactivation, the city of New London received news that Pfizer Pharmaceuticals was planning to build a $3 million research center in the Fort Trumbull area which would, presumably, rejuvenate the area and bring in needed employment.

The NLDC crafted a redevelopment plan which it hoped would complement the new Pfizer facility and revitalize this area of New London. In January of 2000 the New London City Council approved the plan and designated the NLDC as being in charge of implementation. The council further delegated to this private corporation its power to purchase property pursuant to the plan, and to exercise eminent domain in the name of the city of New London if necessary.

The Fort Trumbull area was composed of approximately 115 privately owned properties and 32 acres of a former naval facility. The NLDC's development plan encompassed approximately 90 acres, divided into seven parcels, with a different use contemplated for each parcel. These uses included a waterfront conference hotel, retail shops and restaurants, a pedestrian river walk, a residential neighborhood, marinas and a new U.S. Coast Guard museum.

The majority of landowners in this 90-acre area of interest agreed to sell their property to the NLDC. Nine families, owning 15 properties, could not come to terms and had their properties condemned by the NLDC via the power granted to them by the New London City Council. Eleven of these properties were in Parcel 4A and four were in Parcel 3. As stated in the *Kelo* opinion: "Petitioner Susette Kelo had lived in the Fort Trumbull area since 1997. She had made extensive improvements to her house, which she prized for its water view. Petitioner Wilhelmina Dery was born in her Fort Trumbull house in 1918 and had lived there her entire life. Her husband Charles (also a petitioner) had lived in the house since they married some 60 years ago."

Interestingly, the NLDC had no firm plans for the use of Parcel 4A, a site composed of only 2.4 acres which included eleven of the properties at issue. In fact, the Supreme Court rendered its decision in *Kelo* before any specific plans had been made for the site's use. All the NLDC could tell the Court was that the subject property might be used to support a local marina or as a parking lot for a nearby state park. Parcel 3, which contained the other properties at issue, was to be used as office space for research and development. This area was located immediately north of the newly planned Pfizer facility.

The Supreme Court held that the city's proposed disposition of petitioners' property qualified as a "public use" within the meaning of the Fifth Amendment. In so doing they cited *Fallbrook Irrigation Dist*. v. *Bradley*, 164 U.S. 112, 158–164 as standing for the position that "public use" should be interpreted as "public purpose." They went on to state that the Court has defined the concept of "public purpose" broadly, in deference to legislative judgments as to what public needs justify the use of the takings power of the Fifth Amendment. In other words, the Court was saying that the use of eminent domain is limited only to showings of "public purpose," and local governments are the appropriate parties to determine when "public purpose" is best served by the use of that power. So long as the local governmental body has satisfied its duty of due diligence by "carefully formulating its plan" and "thoroughly deliberating its (the plan's) adoption," the Court will defer to that judgment.

The Court specifically rejected a request that economic development should not qualify as a public use. It also rejected petitioners' argument that for takings of this kind, the Court should require a "reasonable certainty" that the expected public benefits will actually accrue. The Court did recognize that "…the city could not take petitioners' land simply to confer a private benefit on a particular private party. …" However, it dismissed this important limitation in *Kelo* merely by stating that "…the takings at issue here would be executed pursuant to a carefully considered development plan, which was not adopted 'to benefit a particular class of identifiable individuals.' …"

In its opinion, the Court cited its decision in *Berman v. Parker*, 348 U.S. 26 (1954) (*Berman)* in which it held that eminent domain could be properly used for the elimination of slums or blight. Interestingly, neither the city of New London nor the NLDC made any allegation that the subject properties in *Kelo* were blighted in any way. Rather, the Court expressly noted that they were condemned only because they happened to be located in the development area. Many of the properties were located on valuable beach front and were being transferred to a private developer by the NLDC. The Court found no problem with this and left the definition of the phrase "public use" completely to the whim of local government—in this case the unelected officials of a development corporation.

How has the interpretation of "public use" evolved into such a broad application that it has supported taking private property to give to another private individual? The Supreme Court in 1798 stated: "[A] law that takes property from A and gives it to B: It is against all reason and justice, for a people to entrust a Legislature with SUCH powers; and, therefore, it cannot be presumed that they have done it. The genius, the nature, and the spirit of our State Governments, amount to a prohibition of such acts of legislation; and the general principles of law and reason forbid them. … "[3] Today, pursuant to the decision in *Kelo,* "such powers" are an acceptable power of state and local governments. The determination as to what is a public use or a public purpose is now wholly a local government determination, and further, it essentially matters not that the land is taken by the governmental entity and given to another private owner, so long as the government's plan is carefully considered and does not identify a particular individual or group of individuals to be benefited. This dramatic reversal of constitutional determination was arrived at through a slow and incremental process which began in the nineteenth century.

THE EVOLUTION OF A DECISION

In some ways, things have come a long way since the Supreme Court in *Calder* described what was to eventually happen in the *Kelo* case as being "against all reason and justice." In other ways, things are right back where they started. Initially, the Takings Clause, that section in the Fifth Amendment stating the government can take property only for public use and with just compensation, applied to actions of only the federal government. In *Baron v. City of Baltimore*, 32 U.S. 243 (1833), the Supreme Court was confronted with the question of whether the Takings Clause could prevent the destruction of harbor property by the City of Baltimore without just compensation. The Court said it could not, that the states were not subject to the restrictions of the U.S. Constitution. It stated, "The constitution was ordained and established by the people of the United States for themselves, for their own government, and not for the government of the individual states." Therefore, as regarded state action, the definition of public use was left to the states.

History teaches us what happened when the states were given this power. Beginning with the discovery of the Comstock Lode in 1859, mining and mining companies controlled Nevada politics. Thus it was not a surprise when mining interests were able to get the Nevada legislature to declare that any land needed for the mining industry was serving a "public use." Specifically Nevada's statute stated that, "the production and reduction of ores are of vital necessity to the people of this state; are pursuits in which all are interested and from which all derive a benefit; so the mining, milling, smelting, or other reduction of ores are hereby declared to be for the public use, and the right of eminent domain may be exercised therefore."[4] A challenge to this law was brought to the Nevada Supreme Court in the autumn of 1876. A mining corporation decided that it would be easier to transport lumber and other materials to its mining operation if it could take land belonging to James Waddell. Since Waddell had no desire to part with his land, the mining company simply had the local government take his property by eminent domain and deed it to the company. The Nevada Supreme Court found no problem with taking land from a relatively powerless individual and giving it to one of the most powerful interests in Nevada at the time— a mining corporation. The Court obviously did not base its decision on any theory supported by the Bill of Rights, such as protection of individual liberty. As the Court succinctly stated, "…that mining is the paramount interest of the state is not questioned; that anything which tends directly to encourage mineral developments and increase the mineral resources of the state is for the benefit of the public and is calculated to advance the general welfare and prosperity of the people of this state, is a self-evident proposition."[5]

Nevada was not alone in its view of the broad applicability of eminent domain and the broad definition of public use and purpose. As mining interests controlled Nevada, steel companies and railroads controlled Pennsylvania during this era. In 1858, a coal company decided that it wanted to shorten its route to the Monongahela River by building a railroad through the farm of James H. Hays. Since Hays preferred not to lose productive farm land, nor have his peace and solitude destroyed by a noisy and smelly coal fired train, he refused to sell an easement to the corporation. The coal company contacted the local government who took the right-of-way by eminent domain and gave it the company.[6]

Hays brought his argument to the Supreme Court of Pennsylvania. He argued that this taking was not for a public use. The Court rejected this argument, finding that the mining of coal was a financial benefit to the state. James Hays also argued that the company should take a shorter and more direct route to the river that would not damage his land as severely. The Court reasoned that the coal company was best able to determine its own most appropriate route. However the Court did not stop with taking the land of this private citizen to give to a private corporation. It also found it necessary to disparage Hays for his rudeness in thinking that his land should not be made available for taking by a powerful corporation. The Court called him the "unneighbourly owner." It also found that the actions of a private corporation and the actions of the government were one and the same since the government granted the right to take private lands through the *Lateral Railroad Act* 67 P.S. § 781. The Court further chastised Hays for arguing the outlandish idea that private lands should be taken only for a "public purpose." It stated: "The Constitution was not made to prevent or hinder the government from improving the country and promoting the general welfare of the citizens; and when the selfish passions of individuals attempt to set up the instrument for such purposes they misapply it, and cannot expect the courts to help them." At this point in our history, while state and local governments, without the restrictions of the Fifth Amendment, were running roughshod over private landowners at the behest of the powerful, the federal courts, constrained by the Fifth Amendment, were following a different route.

In 1897, a case reached the U.S. Supreme Court involving the Gettysburg Battlefield. Congress had decided to preserve the battlefield and erect tablets and statues at various places on the site. On June 5, 1894, by joint resolution of Congress, and with approval of the President, the federal government was further authorized to take any necessary land by eminent domain. The Court determined that a taking could only occur if its purpose was both a public one and within the powers granted to government by the U.S. Constitution.[7] "It [the government] has authority to do so [take property] whenever it is necessary or appropriate to use the land in the execution of any of the powers granted to it by the Constitution. Is the proposed use, to which this land is to be put, a public use within this limitation?"[8] After an exhaustive analysis of the public benefits of preserving the battlefield, the Court determined that "…when the legislature has declared the use or purpose to be a public one, its judgment will be respected by the courts, unless the use be palpably without reasonable foundation." Thus a two-pronged test emerged for the use of eminent domain by the federal government. First, was the goal within the powers granted by the U.S. Constitution, and second, was there a public use to which the land was going to be put?

Therefore, as we approached the end of the nineteenth century, the United States had two distinct legal approaches regarding eminent domain. One, followed by the states, allowed the taking of private property and subsequent transfer to another private individual so long as the taking indirectly, or even arguably, advanced the economic welfare of the state or its citizens. The other approach required that the federal government, operating under the restraints of the Fifth Amendment's Takings Clause, act only within its constitutional authority and exercise the right of eminent domain only for a truly public use.

It was not until the adoption of the 14th Amendment in 1868 that people began to contemplate the application of the Bill of Rights to state and local actions. Even though Congressman John Bingham, the drafter of the 14th Amendment, argued that he was proposing the amendment specifically to make the first eight amendments to the Constitution applicable to state and local action; the courts did not agree. It was not until 1897 that the first section of the Bill of Rights was incorporated into the 14th Amendment and made applicable to the states.[9]

The decision in *Cincinnati v. Vestor*, 281 U.S. 439 (1930) (*Cincinnati*) is telling on the issue of public use under the new standard of federal liberty guarantees being made applicable to state and local actions. In this case the city of Cincinnati decided to take property via eminent domain for the widening of Fifth Street. No one contested the expansion as being for a public use. However, the city attempted to condemn an area wider than was necessary for the public use. In its decision the U.S. Supreme Court began by laying out what it viewed as current precedent.

> *It is well established that in considering the application of the Fourteenth Amendment to cases of expropriation of private property, the question what is a public use is a judicial one. In deciding such a question, the Court has appropriate regard to the diversity of local conditions and considers with great respect legislative declarations and in particular the judgments of state courts as to the uses considered to be public in the light of local exigencies. But the question remains a judicial one which this Court must decide in performing its duty of enforcing the provisions of the Federal Constitution.*[10]

This is a statement of the law that gives due regard to the Bill of Rights and the Court's responsibilities to use it to insure our freedoms. In the end, the U.S. Supreme Court did not allow the city of Cincinnati to take the excess property because it could not delineate a public use for it that was specific enough to pass Fifth Amendment or Ohio statutory law scrutiny.

The Court's decision in *Kelo* discounted the earlier case of *Cincinnati v. Vestor* and instead turned to two cases that were decided in the latter half of the twentieth century: *Berman* (above) and *Hawaii v. Midkiff.*[11] Justice Stevens, writing the majority opinion in *Kelo,* relied heavily on these two cases for the proposition that the Court must "…decline to second-guess the city's considered judgments about the efficacy of its development plan." The Court's reliance on these cases is arguably misplaced.

Rather than simply deferring to the opinion of a locally appointed corporation, the U.S. Supreme Court in *Berman* took a hard look at the public purpose involved in the taking. *Berman* concerned a redevelopment project in Washington, D.C. The Court was persuaded to allow the exercise of eminent domain by the fact that the areas being condemned were slums that adversely affected the health and welfare of the inhabitants of Washington, D.C. The Court in *Berman* stated:

> *In 1950 the Planning Commission prepared and published a comprehensive plan for the District. Surveys revealed that in Area B, 64.3% of the dwellings were beyond repair, 18.4% needed major repairs, only 17.3% were satisfactory; 57.8% of the dwellings had outside toilets, 60.3% had no baths, 29.3% lacked electricity, 82.2% had no wash basins or laundry tubs, 83.8% lacked central heating. In the judgment of the District's Director of Health it was necessary to redevelop Area B in the interests of public health. The population of Area B amounted to 5,012 persons, of whom 97.5% were Negroes.*

It is extremely hard to argue that the eradication of such conditions does not serve a public purpose. Rather than displacing the affected persons. the plan required the construction of low-cost housing that was clean and sanitary. It is extremely easy to see the public use here, and a unanimous Court had no difficulty in finding the eradication of squalor to be a public purpose.

In 1984 the U.S. Supreme Court revisited the issue of public use in deciding an appeal in the case of *Hawaii v. Midkiff.* Hawaii had been settled by Polynesian peoples from the western Pacific. When they arrived they established a feudal system whereby the land was owned by the king. The peasants worked land they did not own, and never could own. By the mid 1960s Hawaii was still owned by only a few people. On Oahu, 72 percent of the land was owned by 22 landowners. Overall, 49 percent of all the Hawaiian Islands was owned by the state and federal government, while 47 percent was owned by 72 private landowners. Hawaii attempted to end the remnants of its feudal system by having the government purchase all land in excess of five acres that was leased to a private individual. It paid the owners just compensation.

Justice O'Connor, who would later dissent in *Kelo*, wrote the Court's opinion in *Midkiff*. She determined that the ages-old Hawaiian land system had "…created artificial deterrents to the normal functioning of the State's residential land market and forced thousands of individual homeowners to lease, rather than buy, the land underneath their homes. Regulating oligopoly and the evils associated with it is a classic exercise of a State's police powers."[12]

In the case of *Kelo*, however, there was no such limitation concerning a public use or a public purpose. In *Berman* and *Midkiff* there was an evil that had been perceived by the state and the state acted to eradicate that evil, e.g., the existence of unsafe, blighted properties and an antiquated feudal system of land ownership. These cases dealt with an easily recognizable public use or purpose in eradicating these recognized evils. Neither problem existed in the *Kelo* case.

In *Kelo,* the City of New London simply made a determination that one private citizen could provide more economic benefit to the community than another private citizen. Perhaps there is some public purpose in attempting to create a better economic climate or to collect more tax revenue. However, as a result of the *Kelo* decision, there is now no distinction between a public purpose and a private purpose. The Court specifically addressed the instance of a "one-to-one transfer, executed outside the confines of an integrated development plan," but found that such a transfer was not present in the instant case, presumably because the beneficiary of the transfer was not specifically identified at the time of the trial. Therefore, the definition of a public purpose is left to the local government so long as its planned use for the property is considered and does not name a specific person or group to be benefited thereby. The logic of this decision would allow a city to condemn a church to build a retail store because it would provide jobs or to condemn modest housing because an expensive high rise would yield higher tax revenue. As Justice O'Connor stated in her dissenting opinion: "The specter of condemnation hangs over all property. Nothing is to prevent the State from replacing any Motel 6 with a Ritz-Carlton, any home with a shopping mall, or any farm with a factory."

Justice Stevens, writing for the majority in *Kelo*, did not provide a standard by which to interpret the phrase "public use;" he simply explained why one standard after another could not work and left the determination to local government. In other words, the Court declined to address the issue. This is more than a little troubling as the question at hand was a fundamental right guaranteed by the Bill of Rights. As stated by the Court in *Cincinnati* (above) "…the question remains a judicial one which this Court must decide in performing its duty of enforcing the provisions of the Federal Constitution." Unfortunately, the Court in *Kelo* abandoned its responsibility to develop standards by which to interpret the Bill of Rights in a way that protects the citizenry from tyranny by the majority. It failed its fundamental task.

The result of the *Kelo* decision has been to return us to the days prior to the Incorporation Doctrine which made the Takings Clause applicable to state action. The protection of individual liberty is essentially now left to the whim of local government.

POST-KELO

As mentioned above, the petitioners in *Kelo* maintained that for takings of the kind present in the instant case the Court should require a "reasonable certainty" that the expected public benefits would actually accrue. The majority rejected this argument, stating: "Such a rule, however, would represent an even greater departure from our precedent. 'When the legislature's purpose is legitimate and its means are not irrational, our cases make clear that empirical debates over the wisdom of takings—no less than debates over the wisdom of other kinds of socioeconomic legislation—are not to be carried out in the federal courts.'"

Three years after the Supreme Court case was decided, Susette Kelo's house was relocated to another site. The city's redevelopment plan, which figured so prominently in the Supreme Court opinion as justification for the taking, failed. The redeveloper was unable to obtain financing and the redevelopment project was abandoned. The promised new jobs and increased tax revenues did not materialize. In September 2009, four years after the *Kelo* decision, Pfizer completed a merger with Wyeth and in late 2010 chose to close its New London facility prior to the expiration of its tax breaks on the New London site.[13] The land was never deeded back to the original homeowners, most of whom left New London for nearby communities.[14] As of early 2011, the original Kelo property was a vacant lot, generating no tax revenue for the city. The cost to the city and state for the purchase and bulldozing of the formerly privately held property, as of 2009, was $78 million. [15]

Prior to *Kelo* only eight states specifically prohibited the use of eminent domain for economic development (except to eliminate blight). These states were Arkansas, Florida, Illinois, Kentucky, Maine, Montana, South Carolina and Washington. By July 2009, 43 states had enacted some type of reform legislation in response to the *Kelo* decision. Of those 43 states, 22 enacted laws that substantially inhibited the takings allowed by the *Kelo* decision, while 21 states enacted laws that placed some limits on the power of municipalities to invoke eminent domain for economic development.[16]

CONCLUSION

The Supreme Court Building in Washington, D.C., has a statue of Lady Justice, as do many courthouses in this country. She is a woman, often blindfolded, holding a set of scales and a sword. The sword represents reason and justice, and may be used for or against either party. The blindfold represents her lack of concern for the social status of the individuals before her. The scales hold all of the many items that must be weighed to achieve justice and promise that the evidence will be weighed fairly and objectively. The statue has been prominent since the ancient Greek civilization and adorns courthouses throughout Europe and the Americas. She does not depict law. She depicts justice. The goal of our legal system is not the enforcement of laws, but rather the pursuit of the elusive goal of justice. Justice is made up of many things of which law itself is but one small part. The laws created by our legislature attempt to create justice for the majority. The Bill of Rights in our Constitution protects the minority from the majority, thereby ensuring individual justice.

The U.S. Supreme Court ignored individual justice with its decision in *Kelo*, returning to the days when local government is free to select winners and losers without the constitutional restraint of the Fifth Amendment. Unfortunately, local government is not equipped to balance liberty interests; that can be done only by an independent judiciary.

The *Kelo* decision raises several disturbing issues. First, in light of the lack of standards defining public use, are there any private property rights left in this country? Ownership and future control of property is potentially subject to the whim of local government to favor one owner over another for some possibly nebulous reason such as the desire to collect more tax revenue from the property. It does not seem difficult for a local governmental entity to satisfy Justice Stevens' requirements of a "carefully considered development plan … not adopted to benefit a particular class of identifiable individuals." Even more disturbing, as pointed out by Justice Thomas in his dissent, is the possibility that local governments might use eminent domain to rid themselves of housing opportunities for the economically disadvantaged, thus driving the poor from the community.

Ironically, in response to the *Kelo* decision, a proposal was made to take Justice Souter's home in Weare, New Hampshire, through eminent domain and give it to another individual to make a bed-and-breakfast. While the irony of this situation is humorous, it highlights the possibility that local governments might choose to take properties from private citizens for any number of reasons—to create tourist attractions, to advance business interests, to increase tax revenues—merely by arguing that such takings would benefit the local economy.

Following the *Kelo* decision, Riviera Beach, a community in Florida, made plans to condemn much of its waterfront property, potentially displacing thousands of people. On May 4, 2006, the state of Florida passed legislation that prohibited the taking of properties through the use of eminent domain where the properties were to be used for private development. Florida's Governor Jeb Bush signed this legislation on May 11, 2006, but the Riviera Beach City Council voted on the night of May 10, 2006, to authorize signing an agreement with developer Viking Harbor Inlet Properties that the city would use eminent domain to take property for the project. As a result, an 800-acre area full of homes and businesses, including as many as 5,100 residents, was to be replaced with a yachting complex, luxury housing and other private commercial uses.

Riviera Beach's mayor announced that the city believed Florida's new law did not apply to Riviera Beach. Riviera Beach's home and business owners filed suit to stop the use of eminent domain for this private development. Shortly thereafter, the mayor was voted out of office, and new city council members were elected. Responding to public outcry, they made clear that plans to use eminent domain for this project were off the table. An editorial by the *St. Augustine Record*, May 14, 2006, stated:

> *That decision [Kelo] paved the way for cities and counties to take private homes or businesses if they 'believed' the development 'might' generate more tax revenue. And according to the Virginia-based Institute for Justice, hundreds used the ruling to prepare or begin condemnation proceedings across the land. And because of the wording of the Supreme Court opinion, governments did not need to demonstrate any need for the property in the foreseeable future. Some simply began to condemn property with the intent of shopping for a developer down the road.*
>
> *The Justices did, however, say in the ruling that individual states could enact their own laws to provide more protection to owners than did the court.*
>
> *Thursday, Florida became one of the first. The legislation signed by Bush prohibits transferring property from one owner to another by use of eminent domain. It forbids the use of eminent domain to eliminate "blight." It does still allow government to take private property, but in the much narrower description written*

in the state constitution. By contrast, Connecticut's statutes allow eminent domain for developments used for 'any commercial, financial or retail enterprise.'

The Florida law has been heralded by property rights groups as a model for other states, although some commentators argue that it goes too far in forbidding takings to eliminate blight. Unfortunately, in light of the U.S. Supreme Court's ruling in *Kelo,* individual state legislative action may be the only avenue remaining to protect individuals from this particular form of "tyranny by the majority." ■

ENDNOTES

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3. Calder v. Bull, 3 U.S. 386, 388–89 (1798).
4. Nevada Statute (1875), 111.
5. *Dayton Gold and Silver Mining Co. v. Seawell,* 11 Nev 394 (1876).
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7. *United States v. Gettysburg R.R.*, 160 U.S. 668; 16 S. Ct. 427; 40 L. Ed. 576 (1897).
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An Analysis of New Markets Tax Credits

BY J. RUSSELL HARDIN, PH.D., CPA; AND THOMAS G. NOLAND, PH.D., CPA

INTRODUCTION

CONGRESS ESTABLISHED THE NEW MARKETS TAX CREDIT (NMTC) Program as part of the Community Renewal Tax Relief Act of 2000 to encourage investors to make investments in impoverished, low-income communities that traditionally lack access to capital. Conventional access to credit and investment capital for developing small businesses, creating and retaining jobs, and revitalizing neighborhoods is often limited in economically distressed communities or in communities with large low-income populations. The NMTC provides investors (individuals, financial institutions, other corporations, etc.) with a tax credit for investing in communities that are economically distressed or consist of low-income populations.[1]

OVERVIEW OF THE FEDERAL PROCESS

The NMTC Program is intended to spur the investment of private sector capital into low-income areas by permitting taxpayers to receive a credit against federal income taxes for making qualified equity investments (QEIs) in designated Community Development Entities (CDEs).

The credit provided to the investor totals 39 percent of the investment in a CDE and is claimed over a seven-year credit allowance period. In each of the first three years, the investor receives a credit equal to five percent of the total amount paid for the stock or capital interest at the time of purchase. For the final four years, the value of the credit is six percent annually. Investors may not redeem their investments in CDEs prior to the conclusion of the seven-year period.

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CDE CERTIFICATION

To qualify as a CDE, an entity must be a domestic corporation or partnership that:

- has a mission of serving, or providing investment capital for low-income communities or low-income persons;
- maintains accountability to residents of low-income communities through their representation on a governing board of, or advisory board to, the entity;
- has been certified as a CDE by the Community Development Financial Institutions (CDFI) Fund.

Applicants may submit CDE certification applications to the CDFI Fund throughout the year.

A low-income community (LIC) is any population census tract that meets the following criteria (as reported in the most recently completed Decennial Census published by the U.S. Bureau of the Census):

a) the poverty rate for such census tract is at least 20 percent; or;

b) the Median Family Income (MFI) of such census tract does not exceed 80 percent of:

- the statewide MFI, if the tract is not located within a metropolitan area, or;
- the greater of statewide MFI or the metropolitan area MFI, if the tract is located within a metropolitan area.

ALLOCATION OF NMTCS

The CDFI Fund allocates NMTCs to CDEs through an annual competitive application process. Throughout the life of the NMTC Program, the CDFI Fund allocates tax credit authority to support investment in CDEs. See Figure 1 for a list of the largest 2010 allocatees. A complete list of allocatees and more details concerning each allocatee is available at *www.cdfifund.gov.*

USE OF QEI PROCEEDS

A CDE that is awarded an allocation of NMTCs by the CDFI Fund has five years from the date of notification of its allocation to close QEIs with its investors. The CDE has 12 months to place "substantially all" of the proceeds from the QEIs into Qualified Low Income Community Investments (QLICIs), which generally are:

- loans to, or investments in, qualifying businesses (including certain real estate projects);
- loans to, or investments in, other CDEs;

Figure 1

Largest Federal New Market Tax Credit Allocatees – 2010 *(in alphabetical order)*

Allocatee Name	Headquarters	Predominant Markets	Allocation Amount
Capital One Community Renewal Fund, LLC	McLean, VA	DC, LA, MD, NJ, NY, TX, VA	$63,000,000
City First New Markets Fund II, LLC	Washington, DC	DE, DC, MD, PA, VA	$70,000,000
Coastal Enterprises, Inc.	Wiscasset, ME	ME, MA, NH, NY, OR, VT, WV	$77,000,000
Community Hospitality Healthcare Services, LLC	Placida, FL	FL, KY, MD, NC, PA, VA, WV	$63,000,000
ESIC New Markets Partners LP	Columbia, MD	CA, DC, LA, MD, NY, OH, WA	$62,000,000
HEDC New Markets, Inc.	New York, NY	CT, IL, NY, OH, TN, TX, WA	$63,000,000
Local Initiatives Support Corporation	New York, NY	CA, DC, IL, LA, MA, MI NY	$70,000,000
MHIC NE New Markets CDE II, LLC	Boston, MA	CT, ME, MA, NH, RI, VT	$63,000,000
Midwest Minnesota Community Development Corporation	Detroit Lakes, MN	MN, ND, SD, WY	$74,000,000
National Community Fund I, LLC	Portland, OR	CT, IN, IA, MN, NY, OR, PA	$77,000,000
National New Markets Tax Credit Fund, Inc.	Minneapolis, MN	CA, CO, FL, MN, OR, TX, WI	$77,000,000
Rural Development Partners, LLC	Mason City, IA	IA, KS, MO, NM, ND, TX, WI	$77,000,000

Source: http://www.cdfifund.gov/docs/2010/nmtc/2010NMTCProgramAllocateeList.pdf

- the purchase of qualifying loans originated by other CDEs;
- counseling to low-income community businesses.

CDEs have used NMTC proceeds to finance a variety of activities in distressed urban and rural communities throughout the United States, including alternative energy companies, charter schools, health care facilities, affordable housing, timberlands, childcare providers, supermarkets, restaurants, museums, hotels, performing arts centers, manufacturers, processors, distributors, business incubators, office buildings, shopping centers, substance abuse treatment facilities and facilities for the homeless.

IMPACT OF FEDERAL NEW MARKETS TAX CREDITS

The following information was gathered by the NMTC Coalition through a Freedom of Information Act request filed with the CDFI Fund of the Department of the Treasury in September 2010. The NMTC Coalition issued its report in December 2010. The information was based on projects financed by federal NMTCs from 2003, when the first allocations were made, through 2009, the last full year of allocations. This information included data on more than 4,000 transactions that financed nearly 3,000 business enterprises.

From the *New Markets Tax Credit 10th Anniversary Report* Key Findings:[2]

- While the NMTC statute requires that projects be located in census tracts where the poverty rate is at least 20 percent or median family income does not exceed 80 percent of the area median, in fact, the preponderance of NMTC activity is in extremely disadvantaged communities with high distress factors far exceeding the minimum requirements in the law. Over 61 percent of investments are made in communities with unemployment rates exceeding 1.5 times the national average, 57 percent are in communities with poverty rates exceeding 30 percent and 60 percent of the investments are in places where median incomes are at or below 60 percent of the area median.
- Between 2003 and 2009 NMTC leveraged $8 in private investment for every $1 of cost to the government. The New Markets program generated almost $50 billion in financing to businesses in low-income communities. Of that amount $15.5 billion came from direct NMTC investments, which cost the federal government $6 billion in lost revenue (39 percent of $15.5 billion). The balance, totaling $34 billion, came from other public and private sources of capital.
- NMTC financed a wide range of projects, from the first supermarket in a generation in southeast Washington, D.C., to a loan for a school in Florida, a health center in rural Louisiana, a solar company in New Mexico, and a series of revitalization projects in Iowa, Michigan and Virginia. While a substantial portion of projects financed by the Credit were real estate—community facilities, industrial and commercial facilities, mixed-use buildings with affordable housing—many were non-real estate projects that provided financing to operating businesses for equipment and working capital.
- Demand for NMTC far exceeds availability. To date, CDEs have requested a total of $202 billion in allocation authority since 2003, a demand of more than seven times credit availability.
- Using federal Recovery Act standards, the NMTC Coalition estimates that NMTC-financed projects have created or retained up to 500,000 jobs, at a cost to the federal government of less than $12,000 per job.
- The vast majority of NMTC investments (89.5 percent, or $13.8 billion) have been made in communities with at least one factor of higher economic distress than required by law.

STATE-LEVEL NEW MARKETS TAX CREDITS—ACTIVE

As of January 2011, only four states have state-level NMTCs in place. Those states are Florida, Illinois, Mississippi and Ohio. Two states—Louisiana and Missouri—had NMTC programs but have defunded them. The state NMTC programs basically parallel the federal program and usually require the CDE to be federally certified before it can be certified by the state. Also, most of the same definitions contained in Internal Revenue Code Section 45 for NMTCs are applied at the state level.

Florida

Florida House Bill 485, which became effective July 1, 2009, authorizes tax credits for investments in low-income communities. The program is designed to encourage private investment in low-income communities in the state, and is modeled after the federal NMTC Program. Investors who make qualified investments are eligible to receive tax credit allocations to offset corporate income or insurance premium tax liabilities. The program is designed to make Florida more attractive to national investors who are deciding where to invest funds raised under the federal program.

A CDE needs to be a CDE for federal purposes and needs to be authorized to serve businesses in Florida. The state of Florida charges a $1,000 nonrefundable application fee. The annual state cap under this program is $20 million, and a qualified active low-income community business may not receive more than $10 million in qualified low-income community investments under this program. The credit is 39 percent of the purchase price of the qualified investment, making the total credit (federal plus state) 78 percent of the qualifying investment. The credit is taken against the state corporate tax or the state insurance tax. The state NMTC is claimed as follows: years one and two: zero percent; year three: seven percent; and years four through seven: eight percent.

A Qualified Active Low-Income Community Business (QALICB) in Florida is defined using federal requirements. Under the federal requirements, a QALICB is a business in a low-income community where:

- at least 50 percent of total gross income of such entity is derived from the active conduct of qualified business within any *Low-Income Community*;
- a substantial portion of the use of the tangible property of such entity (whether owned or leased) is within any *Low-Income Community*;
- a substantial portion of the services performed for such entity by its employees are performed in any *Low-Income Community*;
- less than five percent of the average of the aggregate unadjusted bases of the property of such entity is attributable to collectibles (as defined in IRC § 408 (m)(2)) other than collectibles that are held primarily for sale to customers in the ordinary course of such business;
- less than five percent of the average of the aggregate unadjusted bases of the property of such entity (as defined in IRC § 1397C (e)) is attributable to nonqualified financial property (e.g., debt instruments with a term of more than 18 months).

In addition to the federal requirements, Florida added the following requirements:

- Performs a substantial portion of its services through its employees in a low-income community for any taxable year;
- Does not derive or project to derive 15 percent or more of its annual revenue from the rental or sale of real estate;
- Will create or retain jobs that pay an average wage of at least 115 percent of the federal poverty income guidelines for a family of four;
- A qualified community development entity may not make a qualified low-income community investment in a business unless the principal activities of the business are within an eligible industry. (The Office of Tourism, Trade, and Economic Development, in consultation with Enterprise Florida, Inc., shall designate industries, using the North American Industry Classification System, that are eligible to receive low-income community investments.)

Illinois

Illinois Senate bill 2015, which established a NMTC for the state of Illinois, was signed by the governor on Dec. 31, 2008, and took effect in 2009. The bill established a new state incentive for investment entities that have been approved for the federal NMTC Program. The law supports small and developing businesses by making capital funds more easily available and makes the state more attractive to possible investors.

Only a CDE that is certified by the federal NMTC Program and has entered into an allocation agreement with the CDFI is eligible to apply for the Illinois NMTC Program. The CDE must apply to the Department of Commerce and Economic Opportunity (DCEO) on a first come, first served basis, with a non-refundable $5,000 application fee. Once eligibility is determined, DCEO will issue a preliminary letter of approval to the CDE which will include an allocated amount of Illinois NMTC contingent upon QEIs being made within 30 days of the date of the preliminary letter of approval.[3]

A person or entity that makes a QEI earns a vested right to tax credits. On each credit allowance date of the QEI, the purchaser of the QEI, or subsequent holder of the QEI, is entitled to a tax credit during the taxable year. The tax credit amount is equal to the applicable percentage of the purchase price paid to the issuer of the QEI and is claimed as follows: no credit for each of the first two credit allowance dates; seven percent for the third credit allowance date; and eight percent for the next four credit allowance dates (total credit is 39 percent). This credit is addition to the federal credit, so the credit is doubled to 78 percent of the qualifying investment.[4] The annual cap under this program is $10 million with no limit (other than the annual cap) on how much can be allocated to one transaction. A credit may be claimed against any income, franchise or insurance premium tax under Illinois law. A Qualified Active Low-Income Community Business (QALICB) is defined the same as federal requirements.

Mississippi

The state of Mississippi enacted a state-level credit called the Equity Investment Tax Credit [EITC] which is essentially a NMTC. The credit to Mississippi income or insurance premium tax is available for eligible investments made by CDEs in designated low-income census tracts in the state, as defined by the U.S. Census Bureau. These credits are state credits that act as companion credits to the NMTC Program. Mississippi allows a state credit equal to 24 percent of the QEI in addition to the credits awarded through the federal program.

Equity Investment Credits are calculated as eight percent of the QEI, and are available as of the Mississippi Credit Allowance Date, and annually for two additional years, so the credit is eight percent for the first three years of the investment. Credits are based on a Mississippi investment being maintained for a minimum of seven years, as required under the federal program. If all state and federal program requirements are not met, all credits may be recaptured by the State Tax Commission. Annual program reporting requirements must be met.

The maximum investment eligible for credits on any project cannot exceed $10 million. The total Mississippi EITCs that can be awarded is capped at $15 million per year. Credits can be used to offset up to 50 percent of the entity's income tax liability after all other credits have been taken, and unused investment tax credits can be carried forward up to five years. Mississippi EITCs must be awarded and certified by the Mississippi Development Authority prior to funding. Usage of credits is administered by the Mississippi State Tax Commission.[5]

Ohio

The Ohio New Markets Tax program is designed to leverage the highly successful and innovative federal NMTC Program by offering state tax credits to attract additional federal tax credits and private investments into Ohio businesses. The program will help finance business investments in low-income communities by providing investors with state tax credits in exchange for delivering below-market rate investment options to Ohio businesses. Ohio has already attracted more than $1.1 billion dollars in federal NMTCs. The state believes the Ohio program will give itself a significant competitive advantage nationally because very few states have a companion program to leverage and attract federal New Markets investments. As private credit markets have struggled, financial mechanisms like NMTCs have become increasingly important for businesses that need access to capital.

The Ohio NMTC program passed the legislature in 2009, with the first allocations made on or after October 2010. The tax credits are structured to be used for investments over the course of seven years. The total tax credit value will be 39 percent with the yearly percentage of tax credits as follows: zero percent for each of the first two years; seven percent for the third year; eight percent for the next four years. The amount of tax credit claimed shall not exceed the amount of the taxpayer's state tax liability for the tax year for which the tax credit is claimed. The maximum state tax credit impact in any fiscal year shall not exceed $10 million (state annual cap). There is a $4 million limit per CDE, and the maximum amount of state tax credits for one project shall not exceed $1 million. The state credit is in addition to any federal credits allowable.[6] The credit is allocated only to insurance companies and financial institutions.

A QALICB is defined similar to federal requirements. Excluded are businesses that derive or expect to derive 15 percent or more of their annual revenue from rental or sale of real property. An exception is made for Single Purpose Entities principally owned by a principal user of the property that is formed solely for the purpose of renting or selling the real property back to such principal.

STATE-LEVEL NEW MARKETS TAX CREDITS—INACTIVE

Louisiana

Louisiana had a state-level NMTC available from July 1, 2007, through the 2010 fiscal year. As of January 2011, the credit had not been extended. Under the Louisiana law, a CDE had to be federally certified and apply to the state of Louisiana. Investors were required to make application to the Louisiana Department of Revenue and the credits were allocated on a first come, first served basis. Investors were eligible for the tax credit if the CDE met federal guidelines, the CDE made qualified low-income community investments, and no more than 25 percent of its investments in low-income communities were in the form of loans.

The cap on the credit for initial investments made after July 1, 2007, was $50 million. The $25 million dollar cap for investments made in the 2008 fiscal year was reached. The $12.5 million dollar cap for investments made in the 2009 fiscal year was also reached. Finally, Act 463 of the 2009 Regular Legislative Session made the last $12.5 million in NMTCs available on or after Dec. 1, 2009.[7]

The maximum amount that could be issued by a single business could not exceed $7.5 million. The credit was 25 percent of the qualified equity investment as follows: five percent in year one and 10 percent in years two and three. The credit was in addition to the federal NMTC. The QALICB had to meet federal requirements and the credit had a seven-year compliance period similar to the federal NMTC law. The credit could be carried forward for up to 10 years and could be transferred. It was administered by the Louisiana Department of Revenue.

Missouri

The state of Missouri enacted a NMTC in 2007. The credit provided supplemental funding for investment entities that had been approved for the federal NMTC Program in order to direct more funding to Missouri projects. The Program provided state and federal tax credits to investors who made investments into approved funds that made investments in eligible projects located in low-income census tracts in Missouri. Eligible applicants were CDEs that had been allocated federal NMTCs for the state of Missouri.

The tax credit amount was equal to the applicable percentage of the adjusted purchase price paid to the issuer of a qualified investment as follows: zero percent for each of the first two years; seven percent for the third year; eight percent for the next four years for a total credit of 39 percent. This credit was in addition to the 39 percent federal NMTC.

The amount of tax credit claimed could not exceed the amount of the taxpayer's state tax liability for the tax year in which the tax credit was claimed. The maximum state tax credit in any fiscal year for all CDEs (state cap) was $25 million. There was no limit per CDE, and state tax credits were allocated on a first-come basis. A QALICB was defined by federal law. The Missouri NMTC was administered by the Missouri Department of Economic Development.

SAMPLE SUCCESS STORIES RESULTING FROM FEDERAL NEW MARKETS TAX CREDITS

The following success stories are among the 50 detailed in *New Markets Tax Credit: 50 Projects—50 States.* A Report by the New Markets Tax Credit Coalition, December 2008. The full report can be found online at *http://newmarketstaxcreditcoalition.org/*.

Entrepreneurial Center, Inc.
Birmingham, Alabama

An old Sears store that lay vacant for more than 20 years is the new site of the Entrepreneurial Center located in the heart of Birmingham's Downtown West Urban Redevelopment District. The $17.8 million renovation project includes the redevelopment of an entire city block in a rundown section of downtown Birmingham. The Sears building has become the consolidated space for the Business Incubator for the Entrepreneurial Center (EC) and the University of Alabama at Birmingham's (UAB) Biotechnology / Life Sciences Incubator. The combined effort was renamed The Innovation Depot. The CDE, Wachovia Community Development Enterprises, offered NMTC financing of $14 million from its 2005 allocation.

The EC is a public/private, not-for-profit economic development organization and its purpose is to provide an environment in which emerging businesses can develop, grow and succeed. The EC received cash and multi-year funding commitments from the City of Birmingham, UAB and Jefferson County. The EC currently houses the Birmingham Business Resources Center and works closely with the UAB Research Foundation and various UAB departments. Some 60–80 prospective entrepreneurs who were located in the two previous facilities were consolidated and relocated to the new building. It is estimated that approximately 755 individuals will benefit from the EC, and the facilities will employ workers who are low-income residents in the community. Additionally, the project has provided a greater demand for local goods and services, resulting in indirect job creation for residents of the low-income community.

As a non-profit endeavor, the EC generated enough revenues to cover its cost of operation but could not attract private capital sufficient to accomplish the substantial $17.8 million acquisition and renovation project. Wachovia Community Development Enterprise's NMTC loan of $14 million was the key ingredient that made this project viable. It is having an enormous impact on revitalizing downtown Birmingham while fostering the growth of new entrepreneurs that, in turn, will provide new economic stimulus to the area.

Project Highlights

- Real estate: rehab mixed use;
- Total project cost: $17.8 million;

- NMTC: $14 million debt (amount available for 39 percent credit);
- Other Financing: City of Birmingham, Borrower;
- 100-plus companies have graduated from the two business incubation programs;
- $1 billion economic impact for the Birmingham region.

Decatur Street Project
Atlanta, Georgia

The Decatur Street project is located within an economically disadvantaged community in Atlanta's central business district, four blocks from the State Capitol. The site lies within a federal Empowerment Zone, Renewal Community, Enterprise Zone, and special "Tax Allocation District."

The CDE, Wachovia Community Development Enterprises, provided a $7.5 million NMTC loan that was used to fund construction of a 40,000-square-foot, three-story commercial office building and an additional 12,000-square-foot facility; replace existing construction financing; and reimburse the guarantor for equity infused into the project for direct construction costs. The property site consists of three commercial buildings: a three-story, brick, 100-year-old building renovated into "loft" style office space now occupied by the city of Atlanta; a factory building renovated for Excellatron, a start-up manufacturer of advanced multi-layer lithium ion batteries; and a third building, an 80,000-square-foot metal and brick building, renovated for telecom switching operations. Space will be made available to a regional nonprofit agency, the Georgia Alliance for Children.

The developer, as part of its business strategy, is committed to creating jobs for low-income citizens. With NMTC, the project was able to secure a significant portion of the funding with a substantial reduction in interest/financing costs. Wachovia served as both investor and lender for this $8.7 million project. The deal team has worked closely with the developers since 2001 to find an appropriate financing vehicle for this project. With the NMTC Program, Wachovia was able to provide creative solutions to make this project a reality.

Project Highlights

- Real estate: commercial rehab;
- Total project cost: $8.7 million;
- NMTC: $7.5 million (eligible for 39 percent credit);
- Other financing: developer;
- Jobs: 100 created/retained.

The Syndicate Building
St. Louis, Missouri

The Old Post Office historic district of downtown St. Louis is the site of revitalization projects including the Syndicate Building, considered a key historic building that was in a state of advanced deterioration. In fact, the condition of the building and potential threat it posed for the future of the surrounding buildings caused the city's Land Clearance for Redevelopment Authority to purchase the property in 2002.

Turning this problem into a revitalization opportunity, the CDE, Valued Advisor Fund (VAF), provided a one percent NMTC loan of $2.19 million in partnership with the local CDFI, the Central Bank of Kansas City, for the market-rate units and commercial space portion of this ambitious project.

The project produced considerable changes: redevelopment of a blighted cornerstone property; 28 affordable rental units, 42 market rate units; 102 for-sale condominiums; 19,600 square feet of commercial space; 125 new units of downtown parking; and an estimated $1.5 million of new tax base within the community.

The property included several energy-efficient and green features including a water loop and efficient HVAC and lighting systems. VAF assembled the financing package for the project that included a NMTC, low-income housing tax credits, tax increment financing, historic tax credits and private sector debt.

VAF worked directly with the city and also worked in coordination with the developers, investors, its local CDFI partner and other financial resources provided to help structure the complex layers of the transaction.

Project Highlights

- Real estate: historic rehab for mixed use;
- Total project cost: $70 million;
- NMTC: $2.19 million (eligible for 39 percent credit);
- Other financing: TIF, historic tax credits, low-income housing tax credits, private sector;
- Jobs: 207 construction, 133 permanent.

Golden Belt Complex
Durham, North Carolina

Throughout the late 19th and into the 20th century, downtown Durham was a vibrant manufacturing center engaged in the tobacco and textile industries. As these industries declined in the 1960s, so too did the vitality of downtown Durham. Steady disinvestment led to physical deterioration, made worse by the industrial waste left behind.

Golden Belt was a textile factory that produced pouches for Bull Durham loose leaf tobacco and then paper cigarette cartons. When tobacco moved out, the Golden Belt complex was donated to the Durham Housing Authority (DHA). DHA provided space for the Center for Employment Training's operations and sought partners to redevelop the larger facility. The DHA eventually sold a majority of the facility in 2006 to Scientific Properties, LLC, a North Carolina-based real estate and development company. Scientific Properties approached Self-Help with a plan to convert the historic site into a mixed-use commercial, arts and residential space.

Self-Help recognized the project's potential to anchor the area's revitalization, and worked with Wachovia to share the loan by borrowing a portion of Wachovia's NMTC allocation. Self-Help made an $8.15 million loan and secured $3.85 million from Wachovia's NMTC allocation to reach the $12 million necessary to make the project viable. The loan was a seven-year term, amortizing over 25 years with an initial 18-month interest-only period and a 5.4 percent fixed interest rate. The $12 million loan, combined with $10 million in state and federal historic tax credit equity, enabled the project developers to ensure affordable rents and leases for the community.

This project will put six warehouses back into use, has utilized environmentally friendly design features and is seeking silver LEED certification. The Golden Belt complex will provide affordable commercial and office space for local businesses and non-profits that serve community residents, including the Center for Employment Training. The project will provide 35 artist studios at below-market rents, an art gallery, 37 affordable loft apartments, office space, a live music venue and ground floor retail space.

Project Highlights
- Real estate: rehab for mixed use;
- Total project cost: $26.3 million;
- NMTC: $12 million (eligible for 39 percent credit);
- Other financing: federal and state historic tax credits;
- Jobs: 140 construction and 400 permanent.

SAMPLE SUCCESS STORIES USING STATE AND FEDERAL NEW MARKETS TAX CREDITS

Kress-Knox-Levy Project—GO Zone
Baton Rouge, Louisiana

The Kress-Knox-Levy Project is named after the three historic buildings being revitalized to accommodate the growing population in Baton Rouge's central downtown district, an area with a 27 percent poverty rate. Baton Rouge has been affected by a changing economy due in large part to an influx of residents from devastated coastal areas inland, including the more than 250,000 New Orleans residents that fled to the vicinity after Hurricane Katrina. This migration included individuals and families as well as commercial businesses. In the long run, Baton Rouge's population is expected to increase 20 percent or by 50,000 residents.

The Kress-Knox-Levy buildings are on the National Register of Historic Places and the renovation will rejuvenate 65,000 square feet as mixed-use development, including office and retail space, 16 rental apartments and three condominiums. The buildings lie on the edge of the city's primary entertainment and retail strip, but are surrounded by underutilized property. In addition to meeting the demand for high quality office space and housing brought on by the influx of New Orleans residents and businesses, it will also prompt the revitalization of the area.

Without the NMTC, the project would not have moved forward because rents in the area would not have supported the acquisition and renovation of the buildings without a below-market component. The NMTC is helping Baton Rouge address three important issues: a lack of high quality commercial and residential space; preservation of its architectural history; and revitalization of its central business district. Using Chase New Markets Corporation NMTC financing, it provided a $7.6 million construction and mini-perm loan with a seven-year interest-only period, a seven-year no amortization period, and an interest rate that was 300 basis points below JPMorgan Chase's conventional rate.

Once completed, the Kress-Knox-Levy Project will create 150 construction jobs, save three historic buildings from demolition and bring them back into use, and create 75 new permanent jobs in a growing community.

Project Highlights
- Real estate: historic rehab for mixed use;
- Total project cost: $21.7 million;
- NMTC: $7.6 million (eligible for federal and state credit);
- Other financing: Chase federal and state historic tax credits;
- Jobs: 150 construction, 75 permanent.

King Edward Hotel
Jackson, Mississippi

Built in 1923, the historic King Edward Hotel is an iconic building. Once the hub of social and political activity in the

Jackson downtown business district, the hotel sat vacant for 41 years, becoming severely blighted. Citizens of Jackson were divided between wanting to demolish or preserve the site, given the costs. The abandoned building has had a substantial negative impact for decades, contributing to the downturn in this section of Jackson.

Ultimately, preservation prevailed and NMTC financing came from several CDEs, including the National New Markets Fund (NNMF) for $15 million. All of the CDEs involved were committed to making the King Edwards Hotel renovation a reality.

The $89.5 million King Edward restoration has transformed the historic King Edward Hotel (313,000 square feet) into a 186-room hotel with restaurants and a state-of-the-art business conference center, with development of 64 apartment units and additional retail space. Sixteen one-bedroom units will be set aside for individuals earning less than 60 percent of the area median income, renting at a $200 per month market discount.

This project is regenerating the surrounding community and is a catalyst in bringing in necessary community and business amenities to support focused redevelopment of the area. The CDEs worked with the lead investors, the state of Mississippi, co-allocatees, and the developer to secure the necessary funding sources available for the project. This enabled the developer to utilize tax-exempt bonds, historic and NMTCs, grants and other below-market loans. NNMF worked to ensure that the developer would commit to reach out to local women- and minority-owned subcontractors and give priority to low-income employees for the hotel and its construction. The internal costs of capital and the required return on a traditional equity investment far outpaced the available return to investors, given the very high cost of reusing the historic building, and created a significant gap in the project's financing. The NMTC funding has enabled the redevelopment of the historic King Edward Hotel to become a reality.

Project Highlights

- Real estate: historic hotel rehab;
- Total project cost: $89.5 million;
- NMTC: $74.1 million (eligible for federal and state credit);
- Other financing: historic tax credits, GO Zone bonds, MS Development Authority, tax increment financing.

PROBLEMS WITH STATE NEW MARKETS TAX CREDITS

One of the problems with state new markets tax credit programs is that most of the states do not have any mechanism in place to track the effectiveness of the state-level programs. Two of the states included in this report were contacted by the authors, and the directors said they did not keep that kind of data because it was not required by the state law that authorized the state NMTC. This makes it difficult, if not impossible, to determine how many jobs were created or how much money was attracted for investment because of the state-level credits.

Another problem that makes it difficult, if not impossible, to determine the number of jobs that were created through a state NMTC program is the fact that the NMTC is often combined with numerous other incentives such as historic tax credits and Small Business Administration loans.

State legislatures should establish procedures that require state economic development offices to measure the effectiveness of state-level NMTCs in terms of jobs created, investment dollars attracted, square footage improved, property tax base increase or other appropriate measurement.

CONCLUSION AND RECOMMENDATIONS

Federal NMTCs help accomplish three objectives:

- bring additional funding into low-income communities;
- bridge funding gaps in projects;
- provide strong returns on investment to those willing to risk their capital.

The federal government benefits from NMTCs through jobs creation, while states benefit by having more taxpayers in the state pool and a higher property tax base from property improvements. An additional benefit is the reduction of urban sprawl and the improvement of living/working conditions in previously distressed communities. States such as Mississippi, Louisiana, Florida, Illinois, Missouri and Ohio that have leveraged state NMTCs with federal credits have seen much larger investments in their states than they would likely have had with only the federal NMTCs.

As noted above, most states do not track job creation and other economic impacts of the state-level NMTCs. This is an item that should be a component of any legislation that creates a state-level NMTC. The relevant state development office can be charged with this task and can report annually on the effectiveness of the program to the governor and the legislature.

Does the political will exist to continue offering the NMTC in the future and encourage investing in communities that are economically distressed or consist of low-income populations? It appears that there is political will for various governments to continue offering the NMTC. For example, President Obama's budget proposal released on Feb. 13, 2012, included a provision to extend and modify the NMTC. The budget proposal would extend the NMTC through 2013 with $5 billion allocated for the credit. In addition, U.S. senators Rockefeller (D-West Virginia), Snowe (R-Maine) and Menendez (D-New Jersey) added an amendment to a bill on Feb. 7, 2012, that would extend the NMTC through 2012. with $3.5 billion available for the credit. Also, several state legislatures have recently proposed bills to add or extend NMTC at the state level. These states include California (Jan. 6, 2012), Indiana (Jan. 16, 2012) and Hawaii (Jan. 27, 2012). ■

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Is Commercial Real Estate an Inflation Hedge?

BY MARTHA S. PEYTON, PH.D., CRE

INTRODUCTION AND FINDINGS

Inflation is among the worst nightmares depriving investors of peaceful sleep. Inflation erodes the value of corporate earnings and roils stock investors; inflation favors borrowers as debt repayments are made in lower value dollars, and inflation pummels consumers—especially those on fixed incomes—by depressing the purchasing power of their incomes. With the trough of the last recession now almost three years past and with the recovery characterized by a peculiar set of circumstances, inflation nightmares appear to be on the rise.

In an effort to quiet their uneasiness, investors are re-examining the capacity of various asset types to offer inflation protection, should inflation become problematic. Conventional wisdom and some solid historical research show that commercial real estate does indeed offer inflation protection, albeit imperfect. This article examines both inflation potential for the United States economy over the next few years and the capacity of commercial real estate to provide inflation protection.

FINDINGS

The findings presented in this article can be summarized in four main points:

- First, analysis of current economic conditions and of the drivers of inflation identified in up-to-date models does not justify inflation fears at this point in time, despite conventional wisdom's contrary view.
- Second, U.S. commercial real estate investment performance history is more strongly correlated with inflation history than is performance of Treasurys, stocks, bonds or REITs. Additionally and perhaps more important, commercial real estate performance for five-year holding periods has beaten inflation over those periods with 84 percent probability.
- Third, the average basis point outperformance of commercial real estate versus inflation has beaten Treasurys and bonds, but not stocks.
- Fourth, with inflation likely to cycle at approximately a two percent average, the absolute performance of investments is a more advantageous focus for investors than inflation protection, which is a low hurdle.

INFLATION OVERVIEW

Fear of inflation is a natural reflex in today's economy because the aggressive monetary ease, now underway to support economic recovery, has historically been difficult

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to unwind. In the past, when easy money remained in place too long, it contributed to inflation. Similarly, fiscal policy in the form of excessive deficit spending has also contributed to inflation at different times in the past. This history is the foundation of the famous "Phillips Curve" relationship, which shows higher inflation associated with lower unemployment rates. Within the context of the business cycle, those lower unemployment rates can be the result of either excessive easy money or deficit spending, or both. With the federal funds rate holding at essentially zero since December 2008, and with the federal deficit hitting a historically high 10.1 percent of GDP in fiscal year 2009, concern about inflation would appear to be rational. Conventional wisdom suggests that the combined fiscal and monetary stimulus eventually will boost demand beyond the economy's capacity and thereby ignite inflation.

History also shows that commercial real estate investment can offer protection from the ravages of inflation. This history is the foundation of the uptick in investor interest in commercial real estate when inflation fears flare up. Researchers have thoroughly examined the question of whether commercial real estate investment offers inflation protection; the unanimous conclusion is "it depends."

With these comments as a backdrop, the remainder of this article has the following goals:

- Review the path of recent inflation and the risk that current monetary and fiscal policies will over-stimulate the economy and ignite inflation;
- Update measures of the correlation between commercial real estate performance and inflation, explaining the underlying characteristics of the asset class that might be sources of inflation protection;
- Offer some analysis of the prospects that U.S. commercial real estate is currently positioned to offer inflation protection over the next several years.

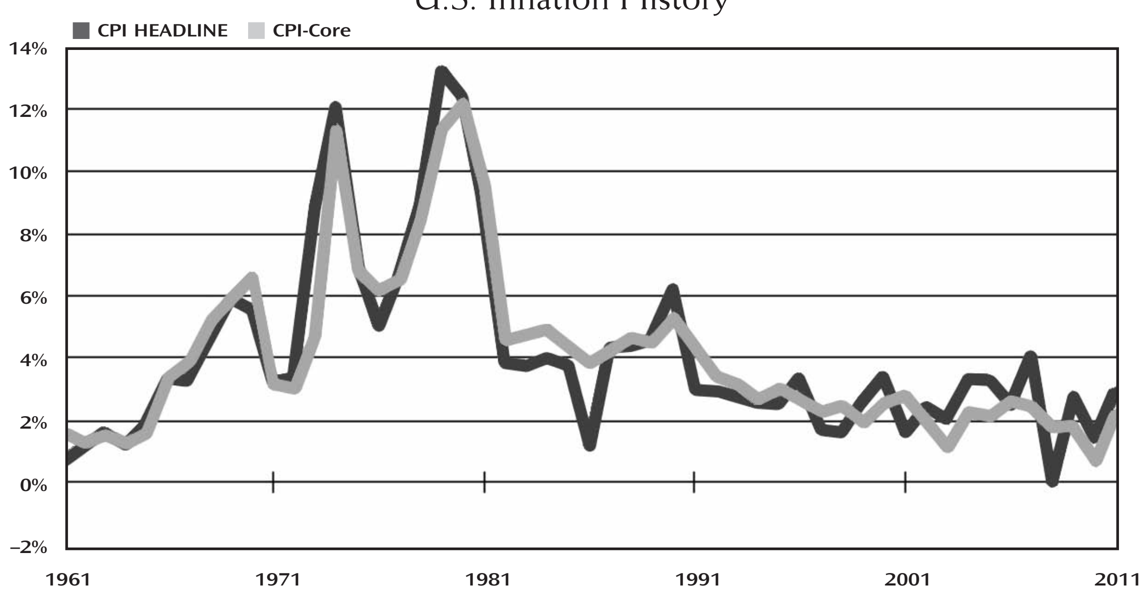
QUICK LOOK AT LONG-TERM INFLATION HISTORY

As shown in Figure 1, the U.S. inflation rate has been bouncing around two percent for more than a decade, both for the "headline" all-items consumer price index (CPI) and for the "core," which excludes food and energy prices. History shows similarly low inflation in the early 1960s, which accelerated in mid-decade through the early 1980s when it began a rocky path downward.

The story behind the history is well known. The uptick in inflation that began in the mid-1960s reflected strong economic growth, bolstered by the tax cuts of the Kennedy administration. Fiscal policy later in the sixties provided stimulation of a different kind through spending on the Vietnam War without raising taxes—a classic "guns and butter" story. In 1973, the first oil shock sent inflation up to almost nine percent for the year, with core inflation

Figure 1

U.S. Inflation History



Source: Bureau of Labor Statistics via Bloomberg rising less sharply but still a material 4.7 percent. The severe 1975 recession cooled inflation but only to a five percent rate in 1976, following the recession's trough. In 1979, the Iranian Revolution ignited another oil shock that sent both overall inflation and core inflation into double digits. That bout was followed by double-dip recessions in 1980 and 1982 that, again, pushed inflation back to more tolerable levels. The 1982 recession was the most severe post-WWII recession up to that time. Its severity was reflective of a new anti-inflation approach to monetary policy led by Federal Reserve Chairman Paul Volcker.

The Volcker era change in policy was accompanied by a strong uptrend in global trade and broadening and deepening in financial markets, both of which also contributed to the downward trend in inflation rates through the subsequent decade and to the present. Global trade has expanded both in absolute terms and also in its importance to the U.S. economy. In 1978, the nominal value of exports and imports were together equivalent to 17 percent of U.S. GDP. In 1999, they were equivalent to 24 percent, and in 2011, 32 percent. Imports have grown more strongly than exports, with imports equivalent to nine percent of GDP in 1978 and 18 percent in 2011, while exports were equivalent to eight percent of GDP in 1978 and 14 percent in 2011. Compositionally, imports of non-auto capital goods and non-auto consumer goods expanded the most vigorously; the former was 27 times larger in 2011 than in 1978, while the latter was 18 times larger. Nominal GDP was seven times larger in 2011 versus 1978. The increasing availability of imports over the period indicated a diminishing capacity for U.S. producers to control prices. At the same time, competition from imports also affected U.S. labor markets by constraining the scope of unions and diminishing their power to influence wages. In 1983, 23 percent of the U.S. labor force was covered by union collective bargaining; in 2011 the proportion was just under 12 percent.

Additional discipline affecting U.S. inflation has come from the operation of financial markets. The Federal Reserve manages short-term interest rates by targeting the federal funds rate, which represents the cost of overnight funds. The federal funds rate anchors the short end of the Treasury yield curve. Treasury security yields are determined by the "market" against the backdrop of the federal funds rate. Investors will calibrate yields on Treasurys to reflect their inflation expectations over the term to maturity. When investors judge inflation risk to be rising, they will push up Treasury yields which, in turn, serve to depress economic activity and send a message to the Fed that the market is worried. This discipline has served to reinforce the Fed's commitment to keeping inflation in check. It has evolved through improvements in trading technology and deepening in the stock of traded Treasury securities over the past few decades. In effect, bond market traders function as the inflation police force.

The two percent inflation trend that took hold in the latter part of the 1990s was the goal of monetary policymakers and it was achieved. The lesson learned from this period was that policymakers waited too long to tighten as core inflation took hold prior to both the 1975 and 1980–82 recessions. Because of this failure, the inflation cures were more painful than might have otherwise occurred.

RECENT INFLATION HISTORY

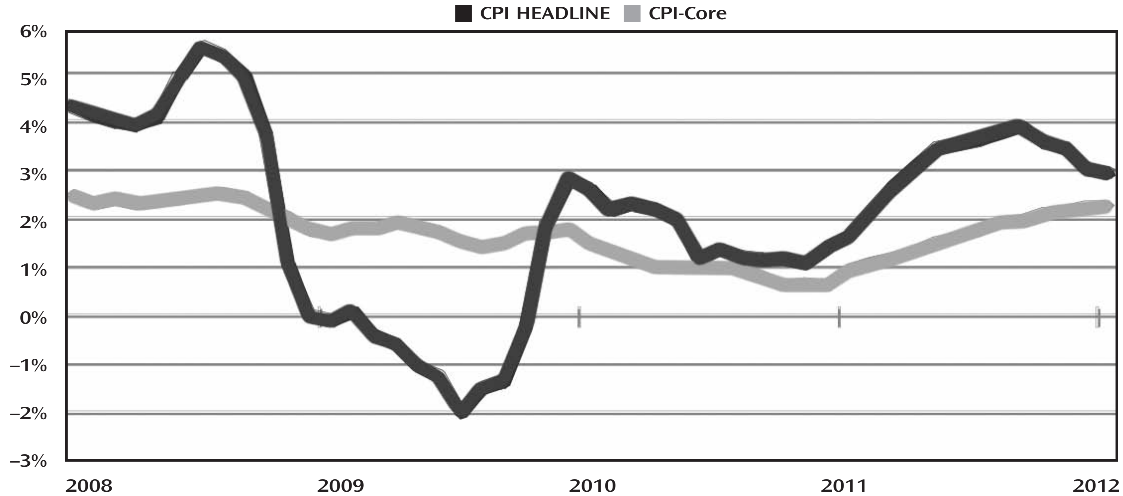
The recent history of inflation is shown in Figure 2. Since the peak of the last business cycle expansion in December 2007, core inflation has continued to hug the two percent trend line, though more often below two percent than above it. Headline inflation has been more volatile as expected because of ongoing volatility of food and energy prices.

The story behind inflation over this period is also well known. The 2008–2009 recession proved to be the most severe since the 1930s Great Depression. The financial crisis that erupted in the fall of 2008 pummeled the already weak economy and pushed headline CPI into negative territory while weakening core inflation. The weakening was serious enough to raise the risk of "deflation" wherein falling prices encourage buyers to postpone purchasers and wait for even lower prices in the future. The official trough of the recession was deemed to be June 2009 and the headline CPI did perk up after that, reflecting both the return of GDP growth in the U.S. along with strong economic growth in several developing countries including China, India and Brazil. Growth in those countries boosted demand and prices for natural resources which are reflected in the headline CPI.

Now, roughly three years after the recession's trough, inflation fears are building. First, the strong growth in developing countries and the impact on demand for food and energy is influencing headline CPI inflation. As the middle classes continue to grow in the developing world, this pressure only will get worse. Second, the monetary policy that helped to restore economic growth in the U.S.

Figure 2

U.S. Inflation – Past Five Years



Source: Bureau of Labor Statistics via Bloomberg

has kept the federal funds rate at essentially zero since December 2008. The historic link between "easy money" and inflation is a tenet of conventional wisdom; is the Fed again waiting too long to tighten? Third, the huge federal fiscal deficit is another risk reminiscent of the 1960s "guns and butter" budgets that contributed to the inflation of the 1970s.

Despite the reasonableness of these fears, current Federal Reserve Chairman Ben Bernanke espouses confidence that inflation is not an imminent threat and that tighter monetary policy is not warranted until the economy is stronger. Why?

A good foundation for the chairman's confidence is embodied in the change since the Volcker years in the economic mechanisms that govern inflation. Federal Reserve researchers along with other economists have updated the famous Phillips Curve relationships that many laymen still adhere to.[1] The new models show that the growth in the international trade component of the U.S. economy as described earlier has made the trade sector an influence on the path of U.S. inflation. The growing importance of trade means that the "supply and demand" that drives prices is now global supply and demand. As a result, fewer and fewer businesses have the power to raise prices without losing customers to cheaper alternatives produced elsewhere. It means that consumers must manage rising commodity prices within their budgets because they have no pricing power to negotiate higher wages. The functioning of these mechanisms explains why the $100-plus/barrel oil shocks of recent years did not feed through to core inflation as they did in the 1970s.

The January 2012 Federal Reserve Federal Open Market Committee forecast reflects these findings. The forecast shows expected inflation of no more than two percent through 2014 as the transitory effects of recent food and energy price spikes dissipate. Reviewing the history of these forecasts shows that the Fed's views on inflation retain a cyclical pattern with the range of core inflation from zero percent to 2.5 percent and headline inflation from 0.2 percent to 3.6 percent at various times over the past few years. In sum, the inflation cycle has not been eliminated but its peaks are unlikely to reach anywhere near the experience of the 1970s.

COMMERCIAL REAL ESTATE INVESTMENT PERFORMANCE AND INFLATION

Figure 3 shows the correlation between the National Council of Real Estate Investment Fiduciaries (NCREIF) National Property Index (NPI) that measures investment performance on U.S. institutional quality commercial real estate and CPI inflation. The correlations cover quarterly data for the period from 1978–2011; the NCREIF index data begins in 1978 and is available only on a quarterly basis, necessitating that the calculation be limited to this time period.

Figure 3

Asset Class Correlations With Inflation

NCREIF-NPI total return	0.38
NCREIF-NPI NOI growth	0.10
1-yr. Treasury total return	0.20
10-yr. Treasury total return	–0.29
S&P 500 total return	0.03
NAREIT total return	0.09
Corporate Bonds	–0.20

Source: NCREIF, Ibbotson, Bloomberg

A correlation of 1.00 would indicate that the asset class moves in lock step with inflation while a correlation of negative 1.00 would indicate the exact opposite; a perfect inflation hedge would have a correlation close to 1.00. The correlation between commercial real estate returns and inflation is 0.38. While it is rather low compared with a perfect inflation hedge, it beats correlations between inflation and every other asset type shown in the table. This very simple calculation is a basis for the conclusion that commercial real estate serves as an inflation hedge, albeit imperfect, relative to other investments.

A further analysis uses annual data for NCREIF-NPI total return, for its net operating income (NOI) growth and capital value components, and for individual property type total return and NOI growth components. NCREIF data is more accurate on an annual basis than on a quarterly basis because the distortions related to appraisal timing are greatly reduced. In addition, NOI data is particularly noisy on a quarterly basis with four-quarter growth rates greatly reducing the noise. Results are shown in Figure 4.[2] The correlation of total return with inflation is essentially unchanged at 0.40 using annual data, versus 0.38 using quarterly data. However, correlation between inflation and NOI growth is markedly higher at 0.49.

Figure 4 also shows that the correlations are not stable over time. If the high inflation period of the late 1970s and early 1980s is excluded, the correlations are very much lower. For the 1983–2011 period, the correlation between NCREIF-NPI total return and inflation is 0.12 while the correlation of NOI and inflation is 0.19, versus 0.40 and 0.49, respectively, for the period beginning in 1978.

Figure 4

Property Type Correlations With Inflation

	(1978 to 2011)	(1983 to 2011)
all property total return	0.40	0.12
all property NOI growth	0.49	0.19
all property capital return	0.38	0.14
apartment total return		0.14
apartment NOI growth		0.35
apartment capital return		0.14
industrial total return		0.12
industrial NOI growth		0.29
industrial capital return		0.13
office total return		0.04
office NOI growth		0.05
office capital return		0.07
retail total return		0.23
retail NOI growth		0.17
retail capital return		0.26

Source: NCREIF, Bloomberg

Yet, there is still some meaningful correlation with inflation for the shorter period shown in property type performance separately. As shaded in Figure 4, the 0.35 correlation between apartment NOI and inflation, the 0.29 correlation between industrial property NOI and inflation, and the 0.26 correlation between retail property capital return and inflation are all meaningful.

So far, correlation calculations do not seem to provide very strong evidence for the inflation hedging capacity of commercial real estate. In fact, the lower correlations for the later period could be easily misinterpreted to mean that commercial real estate became a less powerful hedge against inflation in more recent years. A more accurate conclusion is that the structural decline in inflation after 1983 has made correlation a rather ineffective tool for understanding the relationship between commercial real estate performance and inflation.

HOW COMMERCIAL REAL ESTATE INVESTMENT RESPONDS TO INFLATION

Leaving correlation aside, several characteristics of commercial real estate investments contribute to its capacity to provide inflation protection. They are well described in the Huang and Hudson-Wilson 2007 article cited above.[3] Most important is the structure of leases which often includes step-ups in rent over the term of the lease. The most inflation protective step-ups would call for explicit indexation to inflation. Even without step-ups, leases have a specified term calling for a new rent contract upon renewal. If the local property market does not have a supply glut at the time of renewal, the adjustment in rent is, at a minimum, likely to catch up to inflation. Shorter-term leases can catch up more quickly than longer-term ones.

The assignment of expenses can provide further inflation protection for commercial real estate investors. Some leases pass all expenses through to tenants, most commonly the "triple net" leases on industrial space, while others pass through only some specified expenses as in the common area maintenance charges for regional malls.

Property valuation is also affected by inflation through two avenues: NOI growth and capitalization rates, both components of property value that can be described roughly as "*NOI times the inverse of the cap rate.*" To the degree that inflation protection is embedded in the flow of net operating income, property value will be affected as well, without any change in cap rates. But, the market capitalization rate is itself affected by inflation through its link to longer-term interest rates.[4] Over the cycle, higher interest rates will materialize as economic growth heats up, creating negative pressure on property values. But at the same time, strengthening economic growth also will bolster NOI growth, creating a positive impact on property values. The stronger the response of NOI growth to inflation, the more likely it is that property values will be enhanced rather than depressed as interest rates rise with the maturing business cycle.

Cap rates also are affected by the risk appetite of investors. If investors expect commercial real estate to offer inflation protection, the spread between cap rates and longer-term Treasury rates will tighten compared with spreads on other asset types that offer weaker inflation protection, such as corporate bonds.

HOW COMMERCIAL REAL ESTATE PERFORMS OVER TIME AND VS. OTHER ASSET TYPES

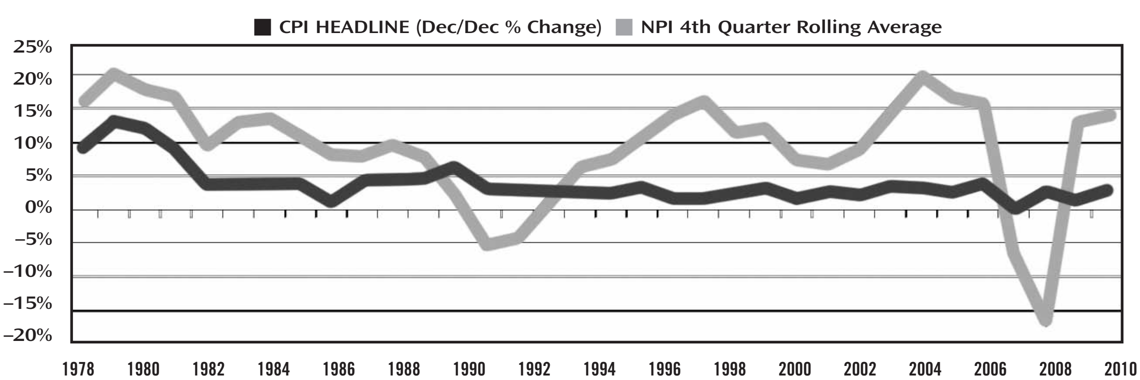
The traits of commercial real estate investments described above are most powerful when there is no supply overhang in commercial real estate markets. When local markets build more than their economies can absorb, power shifts to tenants who can negotiate very favorable terms no matter what the inflation environment might be. Local markets vary with regard to their susceptibility to supply excesses. These differences offer commercial real estate portfolio managers opportunity to construct portfolios that can be more inflation protective by virtue of selecting markets less vulnerable to supply excess.

There are times, however, when supply excess is geographically pervasive. The early 1990s was such a period and commercial property investment performance underperformed inflation by a substantial margin. Similarly, the recent recession hobbled U.S. economic growth, diminished the demand for space, and created a glut of vacant space. During this period as well, inflation exceeded NCREIF-NPI total return.

Even excluding these periods of property market imbalance, the correlation between inflation and commercial real estate returns also has been compromised by the structural changes in inflation. As described earlier, the path of inflation shifted materially after the 1982 recession and followed a downward trend through the late 1990s. Commercial real estate performance did not

Figure 5

U.S. Inflation vs. Commercial Real Estate Total Return



Source: Bureau of Labor Statistics (via Bloomberg) and NCREIF decline in lock step with the structural decline in inflation because it is independent of many of the factors that created the inflation shift. This has been to the benefit of investors.

Over the history covered in this research and shown in Figure 5, investors in commercial real estate benefited to the degree that commercial real estate returns ***beat*** inflation regardless of its correlation.

The benefit was measured by constructing portfolios of commercial real estate, Treasurys, stocks and bonds over five-year investment horizons. This time frame recognizes commercial real estate is a relatively illiquid asset class with high transactions costs that make frequent trading impractical. Portfolios were created by selecting 5,000 random *starting points* over the period 1978 to 2006; starting points end in 2006 to accommodate the five-year holding period ending in 2011. Results are shown in Figure 6.

Does commercial real estate investment offer inflation protection? According to the portfolio results for five-year holding periods, commercial real estate returns beat inflation in 84 percent of the 5,000 random portfolios created for the analysis. On average, the outperformance was 698 basis points. Short-term and long-term Treasurys as well as corporate bond portfolios beat inflation more frequently than commercial real estate but with smaller degrees of outperformance. Stock performance beat inflation slightly less frequently than commercial real estate but with a larger degree of outperformance on average. To compare these results, the probability of outperformance is multiplied by the average basis points of outperformance in the third column of the table. The probability-weighted outperformance of commercial real estate was 583 basis points, second only to stocks at 923 basis points.

But, of course, there are caveats associated with these results. Most important, the 1978–2011 performance history available to evaluate inflation protection was a period dominated by the structural decline in inflation that began in 1982. Because inflation was trending down, the inflation expectations embedded in long-term bonds was generally above the inflation that actually materialized. This explains why long-term bonds outperformed inflation for 93 percent of the 5,000 portfolio scenarios.

Looking ahead, it is not possible for inflation in the years ahead to repeat the path shown in the history examined here. Inflation is simply too low now to trend downward without igniting a deflation morass. As discussed above, inflation is currently inching up toward an expected two percent average with the potential to gyrate cyclically around that rough average. The upward trajectory is welcomed as an indication that deflation risk has diminished. At such low levels, investors can do better by targeting absolute performance in conjunction with downside risk tolerance rather than targeting inflation protection. With a two percent expected average, the latter is simply too low a hurdle.

CONCLUSIONS

The key to commercial real estate investment performance is to construct portfolios that are protected from supply excesses that impair the inflation protection otherwise associated with commercial real estate. Historically, commercial real estate has handily beaten inflation except during periods of severe supply gluts brought about by too much construction or a collapse in demand. Those

Figure 6

Asset Class Investment Performance vs. Inflation

(5-year holding periods, 5,000 random starting years; data drawn from 1978-2011 performance history)

	% of 5,000 that beat inflation	avg bps of outperformance	probability-wtd outperformance	% of 5,000 portfolios that don't beat inflation	avg bps of underperformance	probability-wtd underperformance
NCREIF-NPI total return	84%	698	583 bps	16%	(234)	(39) bps
Short-term Treasury total return	91%	320	290 bps	9%	(35)	(3) bps
Long-term Treasury total return	93%	617	572 bps	7%	(76)	(6) bps
S&P 500 total return	79%	1,167	923 bps	21%	(348)	(73) bps
Corporate Bonds	98%	543	535 bps	2%	(53)	(1) bps

Source: Ibbotson, Bloomberg, NCREIF, TIAA-CREF Global Real Estate periods have been infrequent on a national basis. For local markets, imbalances have been more prevalent, reflecting local market characteristics. Investors can benefit from focusing on these characteristics to build commercial real estate portfolios that promise stronger returns along with beating inflation. ■

Editor's note: This article updates information first presented in a paper published by the TIAA-CREF Global Real Estate Research Group.

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2. These calculations update similar calculations in Huang, H. and S. Hudson-Wilson, "Private Commercial Real Estate Equity Returns and Inflation," *The Journal of Portfolio Management,* Special Issue, 2007.

4. Ibid.

5. See author's article on capitalization rate models in *The Journal of Portfolio Management*, Special Issue, 2009.

The New American FactFinder

(or http://factfinder2.census.gov/main.html)

BY MARY C. BUJOLD, CRE

THOSE OF US WHO NEED TO USE U.S. CENSUS DATA ON A regular basis are no doubt already familiar with the *"New American FactFinder"* (*AFF*), the Census Bureau's website for all census data. Of course, anything "new" represents change and the new data website is a ***significant*** change from the previous one.

When first faced with the daunting task of trying to navigate the new *AFF*, I, a seasoned customer of the old website, tried valiantly to get into the head of the individual(s) who designed it so I could figure out how this new website was supposed to be so much "easier to navigate." I am willing to admit that I kept going to the old *FactFinder* website until it cut me off on Jan. 20, 2012, and I was forced to use the new one.

The interface of the old *AFF* was definitely more user-friendly. It led the user clearly through simple steps, beginning with identifying the level of geography desired, whether that be state, county, city, census tract or block group. From there, the user was to select the specific geographies in the state in which they wanted to search. Once all geographies were identified in a convenient, step-down manner, the user could select the types of data or tables for the geographies. The download feature worked relatively well, although there were some confusing but manageable issues with Zip files.

Enter, *AFF2!* The initial home page is relatively appealing with a "Quick Search" feature that enables the user to rapidly search for limited information such as the population of a particular county or city or the number of households in a specific metro area. Because this feature is easy and quick to use, I found myself using it many times, even when I should have been using the more robust tables feature. The quick search can provide you with a connection to a summary demographic profile for any level of geography. You can simply type in Population in the Topic or Table box and then type in the geography that you want in the other box, such as Minneapolis city, MN. You have to be somewhat careful to indicate that you want the city and the state because there may be other geographies with that same name in other locations in the country. Although they say that geography is "optional," if you do not select a "Geography," the list of population tables is seemingly endless and includes all types of tables with population as a category.

About the Reviewer

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

As an example, if you type in "population" and Fargo city, ND, you will find a list of tables from various census documents. If you are looking for recent census information, you can search for DP-1 which is a Profile of General Population and Housing Characteristics with data from the 2010 Demographic Profile SF. This summary offers the following information for any census geography:

- Total Population
- Age Distribution of the Population by Sex
- Race of the Population
- Relationships of the Population (i.e. spouse, children, householder, group quarters, etc.)
- Total Households
- Household Type
- Number of Housing Units
- Occupied Housing Units
- Vacant Housing Units
- Number of Owned and Rented Housing Units

This is a good start for some basic information about any community or geographic area.

If you want to aggregate different geographies or search on multiple topics, it becomes very complicated from this point on. You must use the "filters" section on the left-hand side of the website to define your selections.

It took me almost an entire afternoon to figure out how to obtain a modest amount of data, which under the old *AFF* took only a few minutes, even when I was new to the old *AFF* site. Some blogs are recommending that users try a new website interface called *Social Explorer*, which has census data back to the beginning of time in the U.S. The *Social Explorer* website is identified as having a much easier and friendly interface than *AFF2*, especially for Decennial Census data or interim estimates through the American Community Survey.

For those of us who choose to tackle *AFF2*, below are my suggestions for navigating its many options.

As with the old *AFF*, my recommendation is to:

1) CHOOSE YOUR GEOGRAPHY FIRST

- From the Geography section, select "Within State," then select "Within County" for multiple county subdivisions, or select "Within Place" if you are selecting cities, villages or census tracts. Once the list has filtered down to the level for which you are looking, place a check mark in each box beside the "Geography" that you want included. If the geographies are on multiple pages, you must click the "Add" key on that page before moving to a new page, which will save your selected geographies. Make certain you have selected to include all geographies below your geography filter.

Next:

2) CHOOSE YOUR TOPICS

- From the "Topics" section, you can select a general topic, such as population or housing or identify a specific topic such as "Age Distribution," "Household Type," "Household Tenure," "Household Income," etc. The website will present you with a myriad of tables that contain the information listed on your subject. On the right-hand side of the list of tables is the source data for the information such as 2010 Census STF 1, 2009 ACS estimates, etc. You may have to scroll through a number of pages to get to the specific tables that you want. Do not give up at this point!! You are halfway there. Once you have found the table with the information for which you are looking, you can click on the Web link to that table and it will open on the screen.

Next:

3) SELECT YOUR OPTIONS FOR RETRIEVING THE DATA VIA PRINT OR DOWNLOAD

- Once you have retrieved your data, *AFF2* provides multiple options for its presentation. You can modify the table, bookmark the table, view, download and print from the screen. There are several download options and, here, I must admit that *AFF2* has surpassed the old *AFF* in this regard. Once you select "Download," *AFF2* compiles the table for you and lets you know when it is complete. You can select Excel, PDF or Rich Text Format; you also can select paper size and landscape or portrait orientation. Usually, I select Excel so that I can also manipulate the data further on my own. If you download to an Excel file, all geographies are listed separately on the spreadsheet. If you choose "Print Version from the Screen," each geography typically is listed separately and not aggregated; however, I believe that is another option, if I could spend more time figuring it out.

I would also recommend the following references for further information beyond the brief and possibly still confusing summary that I have presented here:

1. *www.socialexplorer.com.*
2. *http://factfinder2.census.gov/faces/nav/jsf/pages/index.xhtml* Tutorial on Using *AFF2* on the website.
3. *http://www.lib.unc.edu/reference/data_services/census/newaffwkbk.pdf - The New American FactFinder Classroom Training Manual*—a brief, but generally effective document on how to navigate the primary features of *AFF2*.

I have to say that it will probably be 2020 before I can safely say that I have mastered the "New" *American FactFinder* and by then, it will have been replaced by something new and, dare I say it, more "user-friendly." Hope springs eternal! ■

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