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FEATURE AND PERSPECTIVES

LEADERSHIP Q&A

RESOURCE REVIEW

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REAL ESTATE ISSUES®

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Editor's Note

BY MARY C. BUJOLD, CRE

"This issue continues with our commitment to bring additional perspective to the Top Ten Issues as identified by The Counselors."

Once again, I am pleased to present what I consider to be an interesting and varied set of articles for this volume of *Real Estate Issues*. Features and perspectives lead the way with domestic and international viewpoints and information, including a strong analysis of the relationship between real estate values and the stock market in Poland, hindsight and foresight regarding real estate trends in the U.S. and globally, a timely article on the eminent domain question for underwater mortgages, primarily focused on the California market and others. This issue is a full one, and we are delighted that contributions to *Real Estate Issues* have been responsive to requests for material that is timely and interesting.

This issue continues with our commitment to bring additional perspective to the Top Ten Issues as identified by The Counselors with a Q & A on Global Real Estate Investment and Risk, featuring David Lynn, Ph.D, and CRE. Each issue will carry an article, perspective or other format to expand on these topics.

As K.C. Conway, CRE, mentions in his article on "Bright Spots and Blind Spots," this is an exciting yet somewhat cautious time for real estate investment domestically and internationally. While real estate continues to be in many ways a solid financial investment, global financial markets and economic realities also bring questions as to sustainable recovery over the long term.

I want to thank those who contributed articles to this issue. We welcome your comments and feedback in order to continue to enhance this esteemed journal and make it pertinent to the membership and the real estate community.

Mary C. Bujold

MARY C. BUJOLD, CRE
EDITOR IN CHIEF

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The Relationships Between the Real Estate and Stock Markets in Poland

BY JOSEPH A. FARINELLA, PH.D.; J. EDWARD GRAHAM, PH.D.; JACEK MARKOWSKI; AND PETER W. SCHUHMANN, PH.D.

INTRODUCTION

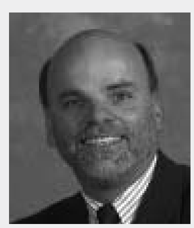
Poland's economy has been one of the most successful in Europe, and the world, since the early 1990s. In 2009, during the Great Recession, Poland actually had a positive (albeit small) increase in GDP. In light of the success of Poland's economy, it is noteworthy that no widely circulating research examines the relationship between its real estate and stock markets. This is likely because Poland has been a free market for a relatively short time and usable data, particularly on the real estate market, is limited.

Given this limitation, the authors assembled a proprietary real estate data set covering Warsaw residential property values between 1995 and 2009. Using that data to examine the relationships between the real estate and stock markets in Poland, they discovered a small positive correlation between those markets. The data shows that positive stock market returns anticipate increases in real estate values. These findings contrast with the results of similar studies of relationships in more developed countries; those tend to show a low or negative relationship between these markets.

The results of our study of Polish real and capital markets are similar to the findings of earlier research on developing markets around the world; Poland's economy actually seems to emulate behavior that can be described as being between a developing and a fully developed nation. As it emerged from behind the Iron Curtain, starting its exit earlier than many with social upheaval such as at the Gdańsk shipyard in the early 1980s, Poland moved more quickly than most, if not all, Soviet-era countries to join the community of nations.

About the Authors

Joseph A. Farinella, Ph.D., *is an associate professor of Finance at the University of North Carolina/Wilmington, where he teaches courses at the graduate and undergraduate level in the areas of investments and corporate finance. Farinella earned his doctorate degree in Finance from the University of South Carolina in 1994. He earned a master's degree in Business Administration from DePaul University in 1989. Farinella completed a bachelor of science degree in Finance from Illinois State University in 1987. His research interests include real estate, market efficiency and forensic economics. Farinella also earned the Chartered Financial Analyst (CFA) designation in 1999, and consults in the areas of valuation and forensic economics.*



J. Edward Graham, Ph.D., *earned his doctorate degree in Finance at the University of South Carolina in 1998, and has been a professor of Finance and Real Estate at the University of North Carolina/Wilmington since the fall of that year. He graduated with a bachelor of science degree in Commerce from Washington and Lee University in 1978, and received a master's degree in Business Administration from the University of North Florida in 1979. At the University of North Carolina/Wilmington, he teaches Corporate, International and Real Estate Finance at the graduate and undergraduate levels. Graham's research has been published in a number of journals, covering real estate, investments and other financial and educational topics. Prior to earning his doctorate, he founded a small investment firm in Jacksonville, Florida. He retains interests there in residential and commercial real estate. Graham also is a founding member of the Wilmington Investor's Network, an officer of the Academy of Economics and Finance, and an advisor to a number of non-profits.*

The Relationships Between the Real Estate and Stock Markets in Poland

This article provides a brief historical background on Poland's exit from Soviet rule and entry to the free world. This is followed by a review of extant literature on relationships between the real estate and capital markets. Following the literature review, the authors describe the data collection, methodology, and report the findings.

About the Authors

Jacek Markowski, *earned a master's degree in Business Administration from the University of North Carolina/Wilmington (UNCW), and a master of science degree in Computer Engineering from Warsaw University of Technology. His studies at UNCW focused on international finance and his thesis was presented at the American Real Estate Society's meeting in 2011. He is currently working for one of the largest investment banks in the FX markets.*

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SOME HISTORICAL BACKGROUND

The aftermath of World War II led to decades of Communist rule in Poland and a centrally planned economy. The country's exit from this dogma brought about rapid change, with shockwaves felt across the country; real estate markets in particular were affected.[1]

In 1990 a new political environment, including the election of Solidarity candidate Lech Walesa to the re-established office of president, served as a catalyst for economic change. Walesa's election was preceded by the adoption of the Balcerowicz Plan in December 1989; that edict aimed to rapidly transform the centrally planned economy to a market system.

In relation to other countries in the region that did not introduce reforms—such as the Ukraine, Slovakia, Romania and Bulgaria—Poland's economy is a clear success. Over the past couple of decades, Poland has been able to lower inflation, lower interest rates, stabilize its currency (the zloty) and privatize state-owned enterprises. A more stable legal infrastructure has likewise contributed to private sector growth.[2]

Poland became a full member of the European Union in May 2004. And, depending on the period examined since 1995, the International Monetary Fund [3] reports that the economic growth in Poland is among the highest, if not the highest, of all the nations in Europe. More recently, Poland has considered adopting the euro, but the current euro zone crisis will likely delay that adoption.[4]

LITERATURE REVIEW

Various authors have examined the relationship between real estate and stock returns in the United States. In early work, they find a small negative correlation between U.S. real estate and the S&P 500®.[5] This inverse relationship is confirmed in later research using different real estate data.[6]

While the authors found no widely circulating study considering the relationships between the real estate and stock markets in Poland, this relationship in other countries has been examined by many authors. The evidence regarding the relationships between real estate and stock returns varies across countries. The Asia–Pacific region, along with a few European countries, has a significant positive relationship.[7] Accordingly, diversification across asset classes in these countries may be less beneficial than would be the case with assets more poorly correlated.[8]

Several methodologies have been used to examine the relationship between real estate and stock returns in the U. S. Studies reveal that U.S. commercial real estate and stock returns are significantly integrated. A similar and expansive research examines relationships between international real estate and financial markets.[9]

Numerous studies illustrate the benefits of including real estate as an investment.[10] In general, the results show that investors would benefit by adding real estate to their portfolios. However, the extent of the benefit varies across countries.

The authors' study extends the existing literature in several areas. Using a proprietary Polish real estate data set covering a fifteen-year period, the study explores the correlation between real estate and stock returns in Poland, and tests whether stock returns have an impact on changes in real estate prices and rentals. In addition, the study measures Polish residential real estate and capital market changes, and contrasts those changes to movements in U.S. markets. This article considers the implications of the findings for varied stakeholders.

DATA AND METHODOLOGY

Data for this study were compiled by estimating the average monthly asking price in the Polish currency (PLN or zloty) per square meter based on real estate listings in *The Gazeta-Wyborcza,* the largest newspaper in Warsaw. The estimate of the average monthly asking price is calculated using ten listings per month from January 1995 through December 2009. To account for variation in prices across different regions, listings were randomly selected from each of the five geographic regions in Warsaw. A total of ten listings were selected from those regions each month.

The study begins with samples from 1995 because it took several years for Poland's economy to stabilize after the transition to a market-based system. Property availabilities and real estate listings were far more sporadic prior to 1995. Advertised real estate prices and monthly rentals in Warsaw were used as proxies for changing home prices and rents across Poland, although it should be noted that Warsaw is among the most attractive real estate markets in all of Northern Europe, and values there are likely higher than in most of Poland.

According to the National Bank of Poland, about 30 percent of the real estate in Poland is rented, but average rental rates are not widely available. Given this, the study follows the same methodology as for selling prices—using advertisements in The *Gazeta-Wyborcza* to collect data on average monthly rents per square meter.

Polish stock market data was more easily accessible. The return on stocks in Poland is published by the Warsaw Stock Exchange (WSE). Of the various WSE indexes, WIG was the first exchange index and has been calculated since April of 1991. The value of it was obtained from *Trading Economics*. The WIG is based on all companies listed on the WSE that meet base eligibility criteria. The WIG is a total return index; thus it accounts for price changes, dividends and subscription rights income.

The S&P 500 represents U.S. stocks. The S&P/Case-Shiller Home Price Index Series is the leading measure for the U.S. residential housing market, and the study employed the 10-City Composite Home Price Index as the U.S. real estate proxy. As Warsaw is far and away the largest real estate market in Poland, the purpose was to contrast it with the ten largest (but not the single largest) markets in the U.S.

Figure 1 provides a summary of the annual returns on the WIG and the S&P 500 from 1995 to 2009. The higher returns and greater risk (standard deviation) of the Polish stock market, relative to the U. S., is observed. Data in Figure 1 may help explain why private equity firms and investors are attracted to opportunities in Poland.

Figure 1
Annual Return on the S&P 500, and the Warsaw Stock Index (WIG)

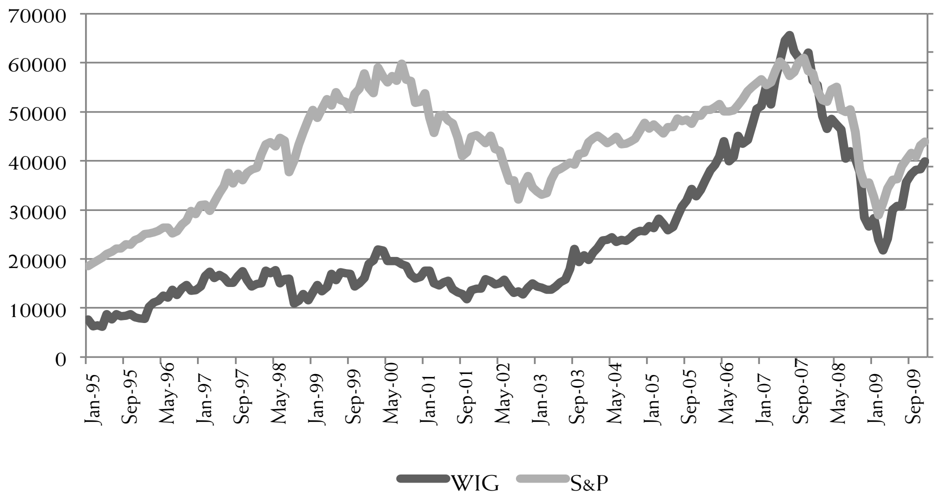
Year	S&P 500 Annual Return (in $)	WIG Annual Return (in zł)	WIG Annual Return (in $)
1995	35.20%	-2.42%	0.66%
1996	23.61%	60.16%	86.71%
1997	24.69%	-14.45%	3.21%
1998	30.54%	-11.46%	-11.21%
1999	8.97%	23.94%	43.60%
2000	-2.04%	-7.06%	-6.90%
2001	-17.26%	-19.92%	-20.81%
2002	-24.29%	8.98%	2.74%
2003	32.19%	51.99%	48.14%
2004	4.43%	50.92%	25.40%
2005	8.36%	32.54%	34.96%
2006	12.36%	50.44%	42.05%
2007	-4.15%	31.86%	8.43%
2008	-40.09%	-60.52%	-48.97%
2009	35.02%	61.00%	43.92%
Arithmetic Average	8.50%	17.07%	16.80%
Geometric Average	5.92%	10.65%	11.78%
Standard Deviation	22.14%	34.64%	32.82%

Sources: S & P Dow Jones Indices and *Trading Economics*
January 1995–December 2009

Like Figure 1, Figure 2 reveals that the WIG outperformed the S&P 500 over the fifteen-year period ending in December of 2009. That figure provides a graph of the WIG index and S&P 500 from 1995 to 2009, in local currencies. The WIG is plotted on the left axis and the S&P 500 is plotted on the right axis. The WIG index ended with a value of 39,906 in December 2009, evidence of a 419 percent increase from January of 1995 to December

Figure 2

The Warsaw Stock Index and S&P 500



Sources: S&P Dow Jones Indices, *Gazeta-Wyborcza* and *Trading Economics*
January 1995–December 2009

Figure 3

Annual Changes: Case-Shiller Index, Polish Real Estate Values and Rentals in Poland

Year	S&P/Case-Shiller 10-City Composite Home Price Index (U.S. index, in $)	Polish Real Estate Values Annual Change (in zł)	Polish Real Estate Rentals Annual Change
1995	-0.34%	20.68%	25.23%
1996	1.99%	28.27%	12.72%
1997	5.92%	21.08%	-1.62%
1998	8.90%	4.75%	10.78%
1999	11.04%	15.33%	-2.46%
2000	14.58%	2.38%	-11.97%
2001	8.16%	-17.27%	-4.25%
2002	15.27%	9.34%	-16.03%
2003	14.03%	2.46%	-1.60%
2004	18.69%	11.64%	4.62%
2005	15.06%	55.22%	11.64%
2006	-0.52%	53.78%	63.98%
2007	-11.40%	10.51%	2.77%
2008	-19.44%	-4.41%	-4.13%
2009	-0.06%	-0.90%	14.80%
Arithmetic Average	5.46%	14.86%	6.97%
Geometric Average	4.92%	13.38%	5.6%
Standard Deviation	10.28%	18.92%	18.46%

Sources: S & P Dow Jones Indices, *Gazeta-Wyborcza* and *Trading Economics*
January 1995–December 2009

of 2009. The S&P 500 closed at 1,115 in December 2009, representing a 137 percent increase since January of 1995, far less than the non-risk-adjusted return of the WIG.

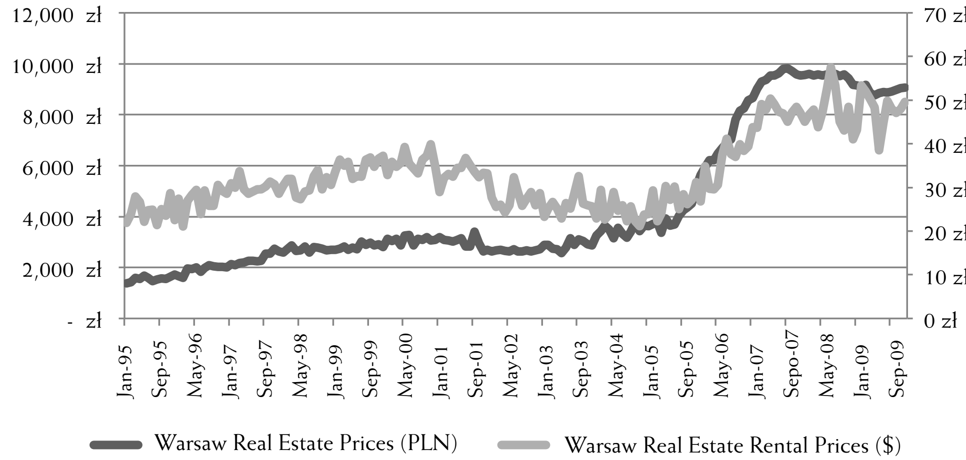
Figure 3 provides a summary of the annual changes in the property values and rental rates in Poland and property values in the U.S. The data are expressed in local currencies. An initial review of the table suggests greater returns and greater risk in Warsaw, but the data need to be employed with care. They do not reflect actual annual returns and are not directly comparable to stock returns or each other. The U.S. figure is an index of home values and the Polish data represent changes in asking prices. For Poland's figures, if the relative difference between the asking price and selling price remains constant over the period then this would be a measure of annual return. However, this relationship likely varies over time; the "bid-ask spread" certainly varies.

The data in Figure 3 support the idea that the real estate downturn did not impact Poland as severely as in the U.S. in 2007 and 2008. The difference between the U.S. and Polish real estate markets is stark. U.S. home values, on average, decreased by 11.4 percent and 19.4 percent during those years, while Poland's real estate increased by 10.5 percent in 2007 and decreased by only 4.4 percent in 2008.

The annual data do not reveal the extent of the volatility occurring during the sample period. Figure 4 illustrates

Figure 4

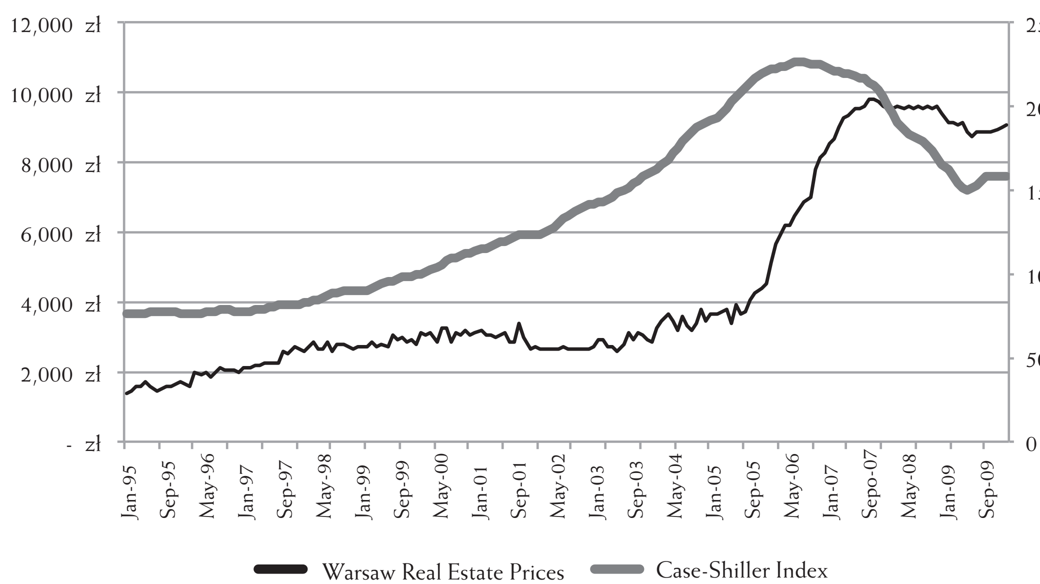
Poland Real Estate and Rental Prices Per Square Meter (PLN)



Sources: *Gazeta-Wyborcza* and *Trading Economics*
January 1995–December 2009

Figure 5

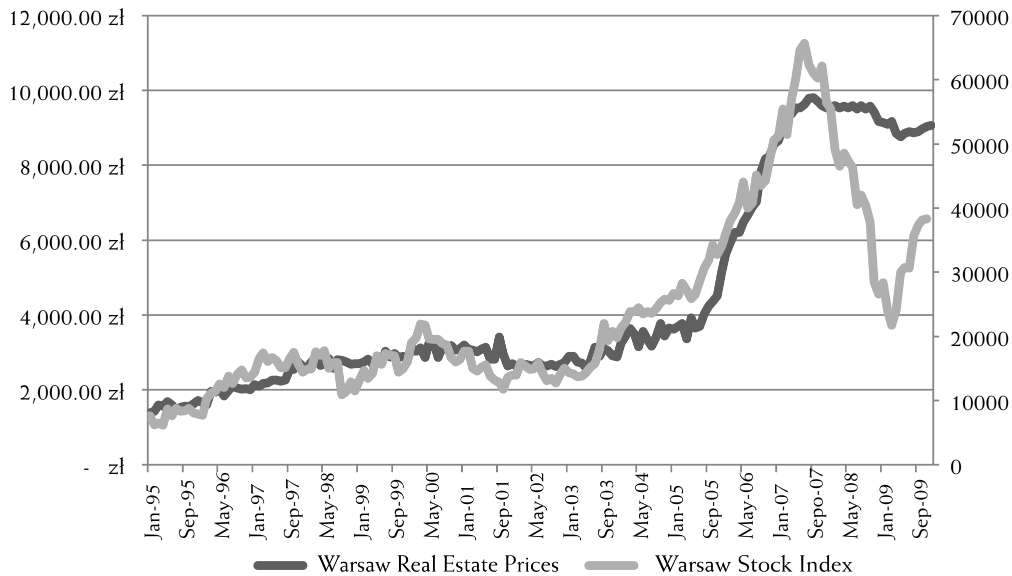
Poland and U.S. Real Estate Prices



Sources: S & P Dow Jones Indices, *Gazeta-Wyborcza* and *Trading Economics*
January 1995–December 2009

Figure 6

Poland Real Estate Prices and Stock Index



Sources: *Gazeta-Wyborcza* and *Trading Economics*
January 1995–December 2009

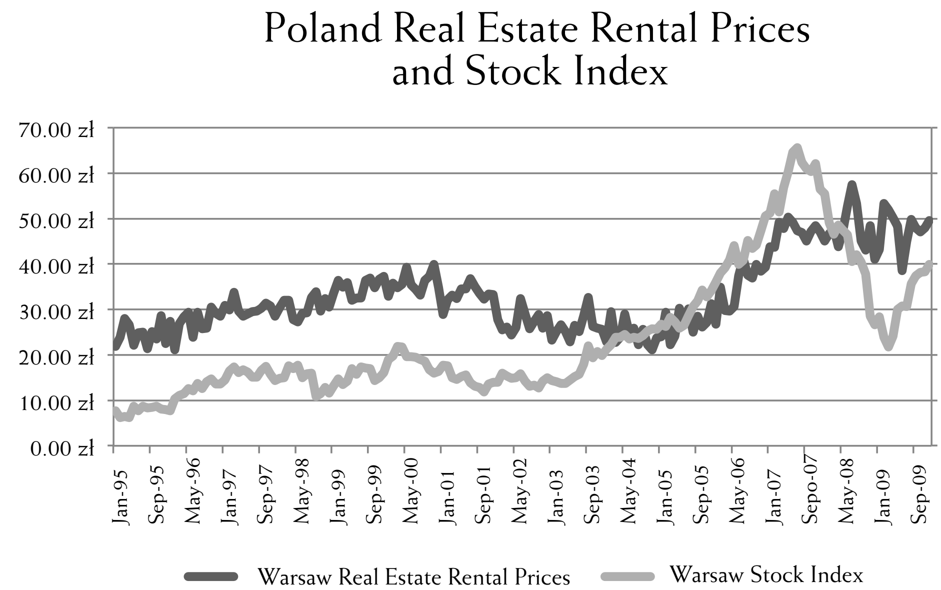
average monthly measures of the asking purchase prices of real estate in Poland (per square meter) on the left axis and the asking rental price (per square meter per month) on the right axis. The values are expressed in zloty. Over the same period, the asking price of rental property in Warsaw, Poland, increased by 126 percent.

Figure 5 shows the S&P/Case-Shiller 10-City Composite Home Price Index and the monthly data for property values in Poland from January 1995 to December 2009. The 10-City index reached its high in June 2006 at 226.29; this represented a 195 percent increase since January of 1995 when the index was at 76.82. The index was "pegged" at around 100 in January of 2000, the base year. It was at 158.16 in December 2009, representing a 106 percent increase since January of 1995. Average real estate prices in Poland had a significantly larger increase over this period (558 percent) than was the case in the U.S. And prices in Poland did not drop as significantly from their highs as did prices in the U.S. The relationship between Poland's real estate and stock markets is framed by these outsized returns.

Figure 6 shows monthly data for Poland's real estate and stock markets from January 1995 to December 2009. The asking price of real estate per square meter in Poland is on the left axis and the WIG is on the right axis. These variables generally move in concert until the beginning of 2007, when the stock market spikes and then plummets, divorcing itself from the closer relationship with housing prices that existed until up to 2007. At its peak, the WIG increased by 755 percent and at the end of the period still had a 419 percent total return. This compares to real estate prices which at their peak had a 612 percent increase and closed with a 558 percent increase over the period. The graver correction and pronounced recovery of the WIG between 2007 and 2009 is noteworthy. Overall, real estate outperformed stocks in Poland from 1995 to 2009; annual returns for real estate were about 13.4 percent, and stock returns in the same period were less than 11.8 percent. Even given that these results derive from advertised asking prices for Polish real estate, and not closed sales or rental data (which was unavailable in Poland over the period examined), the findings are significant, and are borne out with the study's last sets of tests.

Figure 7 shows the relationship between monthly real estate *rental* prices and stocks in Poland over the sample period. Results similar to those for (sales) asking prices

Figure 7



Sources: *Gazeta-Wyborcza* and *Trading Economics*
January 1995–December 2009

in Figure 6 are observed. Rental rates are far more stable since 2007 than is the case for the Polish stock market. This is especially true since 2005 or 2006.

The study employs simple linear regression analyses to discover relationships between stock prices and residential property values and rents in Poland. This approach is appealing in its ease of interpretation and has precedence in the literature.[11] The dependent variables are real estate prices and rents in Poland, and the independent variables are current and lagged stock returns in Poland. The lagged specification allows for the slow adjustment that may occur in the less efficient real estate market. The basic models are:

$$\text{D RE Price}_t = \beta_o + \beta_1 \,\%\text{DWIG}_t + \beta_2 \,\%\text{DWIG}_{t-1}$$

$$\text{D RE Rent}_t = \beta_0 + \beta_1 \,\%\text{DWIG}_t + \beta_2 \,\%\text{DWIG}_{t-1}$$

where t = Jan 1995-Dec 2009

The dependent variables are the change in Polish real estate prices in month i (Δ RE Price_i) and the change in monthly rentals in month i (Δ RE Rent_i). The independent variables are the stock return (% Δ WIG_i) and lagged stock return in Poland (% Δ WIG_{i-1}). A priori, one expects the coefficient on WIG to be positive. It is reasonable to assume that an increase in stock values would be driven by the same economic factors that influence real estate prices. Those factors might also be expected to increase the amount of capital flowing into Poland from foreign investors. This would increase wealth and personal income, lower unemployment, and increase residential real estate asking prices. The correlation coefficients between the variables were also calculated.

RESULTS

Correlation coefficients between these variables are reported in Figures 8 and 9. Figure 10 provides a summary of the models used to measure the strength and direction of the relationships between the WIG and real estate asking prices and rental rates.

In Figure 8, real estate prices in Poland are found to be significantly correlated with rental costs (0.64) and Polish stock prices (0.55); a weaker correlation with U.S. stock prices (0.326) and U.S. real estate (0.126) is observed. The lower correlation with U.S. stock prices suggests some diversification benefit for the U.S. investor buying Polish real estate, or the Polish investor buying U.S. stocks. Advertised rental rates in Warsaw are not significantly correlated with Polish or U.S. stock indexes, or the U.S.

Figure 8
Correlation Coefficient for the Annual Percentage Change in each Variable

Variable	Poland Real Estate Values	Poland Real Estate Rentals	U.S. Real Estate Values (C-S index)	Poland Stock Price (WIG)
Poland Real Estate Rentals	0.640***			
U.S.Real Estate Values (C-S index)	0.126	-0.244		
Poland Stock Price (WIG)	0.550**	0.360	0.291	
U.S. Stock Prices (S&P 500)	0.326	0.421	0.232	0.578**

A ***, and ** indicate significance at the 1%, and 5% levels, respectively.

Sources: S & P Dow Jones Indices, *Gazeta-Wyborcza* and *Trading Economics* January 1995–December 2009

Figure 9
Correlation Coefficient for the Monthly Percentage Change in each Variable

Variable	Poland Real Estate Values	Poland Real Estate Rentals	U.S. Real Estate Values (C-S index)	Poland Stock Price (WIG)
Poland Real Estate Rentals	0.096			
U.S. Real Estate Values (C-S index)	0.021	-0.004		
Poland Stock Price (WIG)	0.114	-0.085	0.138*	
U.S. Stock Prices (S&P 500)	0.032	-0.091	0.128*	0.079

A ***, and ** indicate significance at the 1%, and 5% levels, respectively.

Sources: S & P Dow Jones Indices, *Gazeta-Wyborcza* and *Trading Economics* January 1995–December 2009

housing index. Polish and U.S. stock markets are highly and positively correlated (0.578), suggesting only modest diversification benefits to the investor spreading his or her portfolio over those two stock markets.

Because annual returns do not capture the true volatility in the underlying data, Figure 9 examines the correlations between the monthly percentage changes in the variables. All of the correlations are significantly lower using monthly returns. Polish real estate prices have relatively low correlation with Polish stocks (0.114), Polish rental values (0.096), U.S. real estate prices (0.021) and U.S. stocks (-0.032). Polish rents are negatively correlated with Polish stocks (-0.085), U.S. stocks (-0.091) and U.S. property values (-0.004). The correlation between the two countries' stock indexes is 0.079. The lower correlation measures in Figure 9, versus Figure 8, imply potentially greater diversification benefits for the investor crossing the Polish or U.S. border assembling a portfolio for the U.S. or Polish investor, respectively.

Figure 10 provides the results from the time series regression models. In Panel A, the dependent variable is the change in real estate prices. The coefficient for stock returns is not significant, indicating the stock market does not immediately impact real estate prices. Real estate prices may be slow to adjust to stock returns so a one-period lagged variable is examined in Model 2. The lagged variable is significant at the 10 percent level, indicating that real estate prices react slowly to movements in stock

Figure 10
Time Series Regression Results

Panel A: Dependent Variable: $\triangle$ *RE Price*$_i$

	Model 1	Model 2
Intercept	40.18 (0.005)***	35.87 (0.015)***
% $\triangle$ WIG_i	210.27 (0.178)	233.53 (0.079)*
% $\triangle WIG_{i-1}$		274.71 (0.079)*
R^2	0.01	0.03

Panel B: Dependent Variable: $\triangle$ *RE Rent*$_i$

	Model 1	Model 2
Intercept	0.210 (0.803)	0.165 (0.618)
% $\triangle$ WIG_i	-4.12 (0.1478)	-3.81 (0.186)
% $\triangle WIG_{i-1}$		2.65 (0.934)
R^2	0.01	0.02

A ***, and * indicate significance at the 1%,and 10% level, respectively.

Sources: S & P Dow Jones Indices, *Gazeta-Wyborcza* and *Trading Economics* January 1995–December 2009 prices. The R-squared in both models is low, indicating that stock returns are not the primary factors driving real estate prices. Panel B shows the results from the same two models using the change in rents as the dependent variable. The stock return variable and the lagged stock return variable are not significant in either model. These results indicate that the changes in rents in Poland are not significantly influenced by stock returns. These findings drive the concluding remarks below.

CONCLUSION

No circulating study considers the relationships between Polish real estate and stock returns in the manner conducted here, as no data platform such as the one offered in this article has been available. The data presented here, prosaically assembled using advertisements in the local newspaper, leads to several discoveries: first, alongside Poland's robust economy, real estate values in Warsaw increased dramatically in the fifteen years ending in 2009. Second, stock returns appear to have a positive impact on real estate prices but stock returns do not seem to directly impact rents. Third, the correlation between real estate and stocks in Poland is low and provides evidence in favor of diversification opportunities for investors. The data also provide evidence illustrating the high returns in Poland's real estate and stock markets over the period examined.

These findings are important to the international investor contemplating opportunities in Poland, in both the real and capital markets. The discoveries reported here are also clearly important to the Polish investor placing funds domestically. Like many markets, real estate in Poland, as measured by advertised asking prices on residential rentals and sales in Warsaw, can serve as an important diversification objective for the Polish investor. Likewise, U.S. or other foreign investors can use this data, and discoveries, in refining their own international and real estate investment strategies. Additionally, the policymaker, across Europe and in other countries, might wish to discover and emulate those Polish protocols that influenced that country's favorable macro-economic environment; this is particularly meaningful in the midst of the economic malaise that populates much of the policymaker discussions at present across Southern Europe. And finally, the results are important to the academic in the U.S. and Poland, as that Eastern European country enters the Western fold, and measures develop to gauge the behavior of Polish markets within the realm of traditional financial and economic theory.

Later work will build on this study's preliminary findings. As real estate transaction recordation at the local level becomes more standardized in Poland, opportunities will develop for more exacting research—with more thorough and accurate real estate transaction data. ■

ENDNOTES

1. See Kaliński, J., Zarys *historii gospodarczej XIX i XX w.* Efekt, 2000. Kaliński reports that a shortage of homes developed in the 1980s; in 1988 there were more than 30 percent fewer homes completed than ten years earlier. Nearly 600,000 married couples were waiting at that time for their own homes. See also Czarnecka, K., "Real Estate Market Trends in Poland," *Integrating Generations FIG Working Week,* Stockholm, Sweden, 2008. He reported on macroeconomic matters plaguing Poland as it transitioned to a market economy.
2. Private equity firms have recognized the success of Poland and have increased investments there. For some recent comments on this, see Klonowski, D., "The Evolution of Private Equity in Emerging Markets: The Case of Poland," *Journal of Applied Corporate Finance,* Vol. 23, No. 4, 2011, pp. 60–69. And, acording to the European Private Equity and Venture Capital Association, as of 2011, there were 40 private equity firms that had invested in Poland.
3. See International Monetary Fund: Dissemination Standards Bulletin Board: *http://dsbb.imf.org/Pages/SDDS/CtyCtgList.aspx?ctycode=POL.*
4. Sobczyk, Marcin, "Euro's Popularity Hits Record Low in Poland," *The Wall Street Journal,* June 5, 2012. Sobczyk notes that Poland has met two of the "convergence criteria" that would allow it to adopt the euro.
5. Ibbotson, R., and L. Siegel, "Real Estate Returns: A Comparison with Other Investments," *AREUEA Journal,* Vol. 12, No. 3, pp. 219–241, 1984. They use annual data from 1947 to 1982 and construct a market-value weighted index based on commercial, residential and rural real estate values.
6. Diversification benefits of real estate are considered by Hartzell, D., "Real Estate in the Portfolio," *The Institutional Investor: Focus on Investment Management,* edited by F.J. Fabozzi, Cambridge, Ma., Ballinger, 1986. He uses quarterly data from 1977 to 1986 and finds a -0.25 correlation between U.S. real estate and the S&P 500.
7. See, for example, Barkham, R., and D. Geltner, "Unsmoothing British Valuation-Based Returns without Assuming an Efficient Market," *Journal of Property Research,* Vol. 11, No. 2, pp. 81–95, 1994. They correct for serial correlation and find a correlation of 0.38 between real estate and stock returns in the UK. A study of the relationships between real estate and stock returns in the international markets is provided by Quan, D. and S. Titman, "Commercial Real Estate Prices and Stock Market Returns: An International Analysis," *Financial Analyst Journal,* Vol. 53, No. 3, pp. 21–34, 1997. They find that the correlation between real estate and stocks varies across countries. In the aggregate, they find the relationship between real estate and stock markets to be statistically significant and positive.
8. Quan, D. and S. Titman, "Do Real Estate Prices and Stock Prices Move Together? An International Analysis," *Real Estate Economics,*

Vol. 27, No. 2, pp. 183–207, 1999. They use data from 17 countries and find that over long periods, changes in GDP and stock prices are positively associated with real estate prices.

9. An extensive literature on the international real estate markets is represented first by Liu and Mei in three articles: Liu, C. and J. Mei, 1992, "The predictability of Returns on Equity REITS and their Co-Movements with Other Assets," *Journal of Real Estate Finance and Economics,* Vol. 5, No. 4, pp. 401–418; Liu, C. and J. Mei, 1994, "An Analysis of Real Estate Risk Using the Present Value Model," *Journal of Real Estate Finance and Economics,* Vol. 8, No. 1, pp. 5–20; and in 1998, "The Predictability of International Real Estate Markets, Exchange Risks and Diversification Consequences," *Real Estate Economics,* Vol. 26, No. 1, pp. 3–40. Successively, the authors report that T-bills and long-term yield spreads impact stock and real estate markets and these markets tend to move together. In the 1998 study they examine international real estate and stock markets and find that short-term interest rates, maturity spreads and dividend yields are relevant in some countries but not others. Two articles by Ling and Naranjo pursue similar international real estate objectives: See Ling, D. and A Naranjo, 1997, "Economic Risk Factors and Commercial Real Estate Returns," *Journal of Real Estate Finance and Economics,* Vol. 14, No. 3, pp. 283–307; see also their 1999 study "The Integration of Commercial Real Estate Markets and Stock Markets," *Real Estate Economics,* Vol. 27, No. 3, pp. 483–516. In those two papers, the authors employ non-linear estimation techniques and securitized real estate data and find that common factors impact commercial real estate and stock market returns. The key factors were T-bill rates and per capita consumption. Their results support the hypothesis that the market for exchange-traded real estate companies (including REITs) is integrated with the market for exchange-traded non-real estate stocks. Their results show that the degree of integration increased significantly during the 1990s.

10. Worzala, E. and C. F. Sirmans, "Investing in International Real Estate Stocks: A Review of the Literature," *Urban Studies,* Vol. 40, Nos. 5–6, 2003, pp. 1115–1149.

11. Op. cit. at 7.

Economic Rationale, Highest and Best Use, and Market Valuation Issues for Appraising Inextricably Intertwined Assets

BY THOMAS W. HAMILTON, PH.D., CRE, FRICS

INTRODUCTION

Classifying Property Rights and Interests in the Valuation Process

WHEN SPECIAL PURPOSE PROPERTIES SUCH AS PIPELINES, bulk oil storage terminals, truck terminals, railroads, etc., are sold, these transactions *may* include going-concern (non-realty) items such as long-term contracts, an assembled workforce and even goodwill. Although these special purpose properties are relatively few in any individual market area, such a property can be investigated and researched just like any other income-producing asset. And, the special purpose property can be analyzed by an appraiser to determine the property's value through a properly conducted appraisal process which includes: defining a scope of work; conducting a site analysis; conducting a market analysis; developing a highest and best use (HBU) determination; developing valuation estimates from multiple approaches to value; reconciling the approaches to value and concluding a value estimate. This article will use bulk oil storage terminals as an example property, but the process can be applied to any special purpose property. A glossary of terms used in the article appears at the end.

SCOPE OF WORK

All real estate appraisers, when developing their scope of work for an appraisal assignment, must first identify whether any potential non-realty items exist in the transaction; and if any non-realty items do exist, the appraiser must determine how to account for and allocate any potential value to them. The process of identifying potential non-realty items is required by the Uniform Standards of Professional Appraisal Practice (USPAP).[1]

This identification process is also mandated according to state regulatory agencies. For example, the *Wisconsin Property Assessment Manual* states:

> *The law requires that the assessor assess all property not exempt by law, which has any marketable value. To make an assessment the assessor must first identify the property and be able to distinguish it from other property. The assessor must understand the difference between real and*

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personal property and be thoroughly familiar with the different classes of property.[2]

Wisconsin statutes are also clear on the issue of differentiating between real and personal property in the valuation process. Wisconsin Statutes (specifically s. 70.03 and s. 70.04) differentiate real property and personal property for assessment purposes. Section 70.03 defines real property as:

> *"Real property," "real estate" and "land," when used in chs. 70 to 76, 78 and 79, include not only the land itself but all buildings and improvements thereon, and all fixtures and rights and privileges appertaining thereto, except that for the purpose of time-share property, as defined in s. 707.02 (32), real property does not include recurrent exclusive use and occupancy on a periodic basis or other rights, including, but not limited to, membership rights, vacation services and club memberships.*

Section 70.03 further explains:

> *Income that is attributable to land, rather than personal to the owner, is inextricably intertwined with the land and is transferable to future owners. This income may be included in the land's assessment because it appertains to the land. Income from managing separate off-site property may be inextricably intertwined with land and subject to assessment if the income is generated primarily on the assessed property itself. ABKA Ltd. v. Fontana-On-Geneva-Lake,* 231 Wis. 2d 328, 603 N.W.2d 217 (1999), 98-0851.

Section 70.04 defines personal property as:

> *The term 'personal property,' as used in chs. 70 to 79, shall include all goods, wares, merchandise, chattels, and effects, of any nature or description, having any real or marketable value, and not included in the term 'real property,' as defined in s. 70.03.*

Most states have similar statutes relating to definitions of real versus personal property for property assessment purposes because economic and appraisal theories regarding the valuation of non-realty components included in special purpose property transactions range from "little to no value should be allocated to the non-realty components" to "nearly all of the value of the transaction is due to the non-realty components." This division of real and personal property is also important for lenders in that the underlying collateral for the loan could be a mix of real and personal, tangible and intangible property. The correct economic answer to this question must therefore be based solely on the allocable net income stream from each right (or obligation) in the property and whether that particular net income stream is dependent on the right's (or obligation's) current situs; and the correct economic answer will result in the proper allocation of assets for property tax purposes, for income tax purposes and for lending purposes.

SITE ANALYSIS: PROPERTY RIGHTS AND OBLIGATIONS AND THE ALLOCATION PROCESS

What is important regarding any asset valuation allocation process is for the appraiser to properly determine the net income stream associated with the specific property rights and obligations inextricably intertwined with the real estate that must be capitalized into the value of income producing real estate. For example, all income streams from property rights and obligations associated with and dependent upon a terminal must be located on sites permitted as terminalling operations. This is consistent with the findings in the Adams Outdoor Advertising case. [3] Changing the word "billboard" to "terminal" and the phrase "billboard permits" to "terminal zoning rights or permits," the Adams findings (paragraph 80) would read as:

> *The income attributable to the permit is properly included in the real property tax assessment, not the personal property tax assessment of the "terminal." Any value attributable to the "terminal zoning rights or permits" is not inextricably intertwined with the structure of the "terminal." The primary value of the "terminal zoning rights or permits" is unrelated to the structures; rather, the primary value of the "terminal zoning rights or permits" appertains to the location of the underlying real estate.*

As such, all rights and permits are part of the land under the structure (the rights and permits are inextricably intertwined with the land). A property without terminal zoning rights or permits to operate as a pipeline or terminal cannot generate income as either a pipeline or a terminal—regardless of the proximity to a property that has such rights. Proximity to parcels with unique rights and permits is not sufficient evidence to assert proximate parcels have the same rights and permits as other parcels and are therefore comparable properties in the appraisal process. It is also insufficient to summarily assume that a comparable site can be permitted as a pipeline or terminal regardless of whether zoning allows for such a use because not all sites in a zone allowing pipelines and terminals will be permitted to operate as such. In fact, given the limited quantity of terminal facilities (or railways, pipelines, billboards, etc.) in any one marketplace, these properties act as an oligopoly in their markets, with very few competitors supplying the entire marketplace a relatively homogeneous product at a price structure that keeps competitors from entering the market. Therefore, in determining comparability, the price of a permit cannot simply be added to the cost of the unpermitted land—one must first determine whether a permit or right will be granted. Without the possibility of gaining the necessary permit or right, there is no comparability to consider between the parcels.

If a site is zoned and *permitted* (or is likely to be permitted) to operate as a terminal, the limiting condition affecting the value of the permitted site will then be the physical proximity and interdependence of the terminal real estate to the pipeline real estate (i.e., the linkage) that exists as a value-generating privilege appertaining to both properties. The strength of the linkage between the pipeline and the terminal is what determines whether a potential change in value exists for either or both as operating real estate assets; and it is not the owner's business skill and acumen that creates value.[4]

Therefore, permitted uses of a site are inextricably intertwined to the site and are not related to management skill, and these permitted uses are appurtenant intangible real property rights that yield incremental value for the property and must be included in the appraiser's valuation of the real property rights associated with the ownership of the physical real estate. As such, they are not intangible, independent personal property assets with their own marketability. Furthermore, these specific appurtenant permitted uses do not have independent market values since they are inextricably intertwined with the land and the improvements permanently attached thereto.

MARKET ANALYSIS: SPECIAL PURPOSE PROPERTIES—COMBINED REALTY AND NON-REALTY ITEMS

Special purpose property transactions can potentially include non-realty items in the transaction agreement. Obvious situations include the transfer of real estate along with tools, vehicles and other tangible personal property—assets that are not integral, functioning parts of the real estate and can be separated and transferred as individual assets with individual, marketable values. Other situations might include less obvious and clear delineations between realty and non-realty assets and the distinction as to whether the assets can be severed, marketed and sold (transferred) as individual, separable assets. An example of such a situation is the distinction between excess land and surplus land. Excess land can be separated from an existing parcel and sold into the competitive marketplace because the land has its own individual highest and best use. Surplus land cannot be separated and marketed as a unique parcel and does not have its own highest and best use.

Transferability of enforceable rights in a competitive marketplace is the primary basis that determines whether property rights can have an independent value in the marketplace. Vehicles, tools and other tangible personal property that are not functioning parts of the real estate can be sold and transferred to other locations, and the tangible personal property is valuable to the receiving party. It is also possible for intangible personal property rights to be severed and sold or exchanged separately from the real estate, just as intangible real property rights (e.g., transferable development rights) can potentially be severed and sold independently of the underlying real estate. This is consistent with the findings of the 1994 Waste Management Case in Wisconsin,[5] and it is of great importance to lenders who would otherwise require separate loans for business and intangible components and for tangible personal property. It is also an important consideration for income tax purposes as personal property depreciation schedules and intangible asset amortization schedules are not the same as real property depreciation schedules.[6]

It is when intangible rights cannot be severed from the balance of the rights and obligations appurtenant to tangible real estate that they become recognized as "inextricably intertwined" with the real estate since they cannot be separated and sold apart from the real estate. Expanding on the concept of potentially severing assets and rights, even though future owners of the real estate do not use and exploit these inextricably intertwined property rights, the rights remain with the real estate and have value because the right did not remain with the seller nor did the right dissipate upon sale of the property. The income contributions from these inextricably intertwined rights are expected to continue to flow to any future owner and contribute to the value of the real estate under ownership. This is consistent with the findings in the 1999 ABKA case in Wisconsin.[7]

MARKET ANALYSIS: LEGAL ENFORCEMENT AND ECONOMIC VALUE

"Under it all is the land." Although this is the first sentence in the preamble of the National Association of REALTORS® code of ethics, the concept applies to all disciplines that study real estate. The first issue that everyone studying real estate markets must understand is that land has no value without legally enforceable property rights attached to the land (e.g., "permanent" real property rights). In particular the right to convey any or all of the rights to land (including the rights to appurtenances to land) is necessary before economic real estate transaction markets can exist. Once transferable and enforceable property rights are attached to land, land can have value—but the actual value will be determined by the economic marketplace where the property is physically located.

Enforceability and transferability are essential concepts to understand because to properly value real estate, an appraiser must be able to determine the transferability of rights, privileges and obligations that are commensurate with the ownership of land. Any enforceable right, privilege or obligation that is legally and permanently attached to the land is a property right that "runs with the land." All rights that run with the land individually and collectively affect the value of that particular parcel of real estate because the individual rights raise or lower the value of the land relative to other parcels.[8] These same economic market forces exist for adding or removing "permanent" appurtenances to land (e.g., changes in zoning or density).

If a right from one parcel can be transferred to another parcel, then there exists potential for a change in value for both the sending parcel and the receiving parcel. It must be noted that any change in value due to the transferred right may be—but does not have to be—the same value amount for both the sending parcel and the receiving parcel. For example, if development rights (intangible real property rights) can be transferred from one parcel to another, the value change of the sending parcel may be relatively small, assuming the development rights on the sending parcel could not easily be exploited by land-owners or the cost to develop the parcel was excessive. Those same development rights that subsequently become part of the receiving parcel could create a significantly large and positive value gain for the receiving parcel. This is an example of an asymmetric value exchange.

What this simple example of an asymmetric value exchange of transferable development rights shows is that the owner of the receiving parcel would be willing to pay an amount for the development rights that actually exceed the value reduction of the sending parcel. This exchange in development rights will most often yield a positive net benefit to the owner of the sending parcel (value loss to the property is less than the price received for transferring the rights), and the owner of the receiving parcel also will yield a positive net benefit in that the value increase to the receiving parcel is greater than the price paid for the transferred rights. What makes this entire process of transferring rights possible is the ability for one parcel (the sending parcel) to sever and send certain rights for a profit, and for another parcel (the receiving parcel) to obtain and attach those same rights for a profit—a win-win for both parties to the transaction. At the same time, it must be recognized that for the rights to be economically transferred, economic trading markets for the transferred rights must exist.

From an appraisal perspective, the appraiser must first be able to ascertain whether a particular right transfer is portable into the future or if it became permanently attached to the receiving parcel. If the right transfer maintains its portable nature, the right is personal property; otherwise the right becomes appurtenant to the receiving parcel and is now an intangible real property right of that parcel. The second step in the appraisal process is for the appraiser to estimate the value of the property. In the first case where the right transfer maintains its portability, the appraiser will estimate a personal property value. In the latter case where the right becomes permanently attached, the real property value of the receiving parcel includes the newly received, appurtenant right. In either case, the appraiser must conduct a new market analysis for the property being appraised, including a new HBU analysis for the property after the property right has been transferred.

In the case of a petroleum terminal operation, the particular rights, privileges and physical improvements that are permanently attached to the land are part of the real property being appraised. Any asset or right that has its own HBU (and by default, its own marketability) apart from other parcels is a separate asset and must be valued as an individual asset, either as real property or as personal property.

HIGHEST AND BEST USE OF THE SITE

As the term suggests, HBU is the singular use of the property (including all physical components and legal attributes of the site) that yields the greatest value to the property in a market value context. This is not the same as defining what the greatest value of the property would be to any individual owner of that property—that would be a particular value from an investment value context. For a property to be considered in its HBU, it must meet three specific criteria: it must be legally permissible; it must be physically possible; and it must be financially feasible. The HBU exercise can result in many potential configurations for a particular site, but the final step, finding the one use that achieves maximum value, is singular—there is only one HBU of an improved property.

For all potential configurations of assets on the site that meet the first three criteria, the one configuration that yields the greatest net value to the site is considered the use that is highest and best. Most appraisers begin with determining either the legally permissible (usual case) or physically possible consideration. Once uses of the site have met those criteria, the financially feasible consideration is analyzed. It is at this point where economic and market data and information are analyzed to find that use, from those that met the legal and physical constraints, which yields the best financial possibility in the marketplace.

It is in the market and economic analysis where an appraiser will determine the individual component asset configuration combinations that will generate the greatest positive financial return to the site. It is also in this step of the HBU process where an appraiser must be able to identify and properly place individual component assets into their respective classes—tangible and intangible, real and personal. This matrix results in four potential categories of property:

Figure 1

	Real	Personal
Tangible	Real Tangible	Personal Tangible
Intangible	Real Intangible	Personal Intangible

Source: Thomas W. Hamilton, Ph.D., CRE

APPROACHES TO VALUE

The cost approach to value will be difficult for an appraiser to properly apply in the case of terminalling facilities, especially in obtaining reliable land values for the approach. Since the legal permissibility of a bulk oil terminal is site specific (because of permits and/or rights applicable to that land parcel), and since the time, risk and cost to obtain such a permit are difficult to directly estimate, the appraiser will either misapply adjacent industrial land as a directly comparable property (misidentified because of a lack of intangible real property rights to site an oil terminal), or the appraiser will misallocate improvement value from comparable, existing bulk oil terminals in an extraction method. Without a reliable market value of a "bulk oil terminal site," the balance of the cost approach will result in a value estimate that is typically much lower than its real market value. Also, unless the improvements to an existing oil terminal facility are very new, estimating depreciation is a difficult task given the varying economic lives of the numerous component structures in a bulk oil terminal facility. Taken together, the cost approach for highly regulated, permitted facilities is going to yield questionable results unless significant time is taken to ensure that the value of the land is correct and a comprehensive depreciation study for the numerous different asset classes comprising the facility is undertaken.

The income approach to value can be a valid measure for estimating the market value of a bulk oil terminal. Since there is an active marketplace for the sale and purchase of existing facilities, there is sufficient data in most markets to derive market value estimates, even though each facility is fairly unique in age, quality, condition, throughput and capacity. A proper adjustment grid model can be developed to estimate a market-derived net operating income (or income stream) that can be capitalized (discounted) into a market value estimate for the subject property. The appraiser must be aware of all income sources attributed to the facility and then properly allocate only that income which is attributed to the inextricably intertwined system of real property assets. This requires the appraiser to fully recognize all income that cannot be attributed to real property and allocate that income to the non-realty components—if any exist. Simple rules, or heuristics, can be used for the small amount of workforce and tangible personal property assets at the facility (such as three percent), but allocating income to intangible personal property will require the completion of a separate market analysis of those intangible personal property assets to determine whether a competitive marketplace exists whereby the intangible personal property assets have a separate market value (exchange value). Without such evidence of a separate intangible personal property market, there is no justification for allocating income to anything else other than intangible real property.

Another issue with the income approach pertains to the development of capitalization rates and discount rates. For property tax purposes, it is imperative that the appraiser develop rates that properly and adequately reflect the income stream being capitalized or discounted. Since for property tax purposes there is no property tax expense allowed in determining net operating income (before income taxes), the capitalization (or discount) rate must be adjusted to account for this "missing" expense. This is usually accomplished by adding the effective before-tax property tax rate to a market-derived capitalization rate that was based on comparable properties but after property taxes were subtracted from net operating income. If, however, the capitalization (or discount) rate was calculated by a build-up method (band of investment; weighted average cost of capital; or weighted average rate of return), there not only will need to be an adjustment for property taxes, but also for depreciation and amortization allocations. Since depreciation and allocation are non-cash expenses, the before-tax equivalent expense rate must be *subtracted* from the capitalization (discount) rate. The reason for subtracting the depreciation and allocation expense rate from the build-up rate is that since these are non-cash expenses, they effectively raise the rate of return to investors. Since the appraisal process does not use depreciation or amortization expenses in the development of net operating income, if one does not adjust the capitalization (or discount) rate accordingly, the appraiser is misapplying the capitalization function (discount process).

The market approach to value possibly can be applied to a bulk oil terminal provided that sufficient sales of similar properties exist in the marketplace. However, much like other industrial properties, these facilities are very heterogeneous and the adjustment process will be quite difficult to accomplish without significant assumptions regarding age, quality, condition, throughput and capacity or without having to obtain comparables from other markets that will add additional complexity to supply and demand differentials in the various property markets. A stock and debt approach could be applied as an indicator of the market approach to value, provided sufficient market information is available for "standalone" bulk oil terminal facilities—however, most are owned as part of a portfolio of terminal facilities on a parent firm's balance sheet. This would make allocation from within the parent firm's balance sheet difficult to partition.

Another option, should the property have sold in the recent past, is to use the sale price of the subject as an indicator of its market value—after making any necessary adjustments for condition of sale and date of sale. Some jurisdictions allow the most recent sale of the subject to be used as an indicator of market value. The State of Wisconsin actually requires this to be the de facto estimate of market value for property tax purposes unless there is sufficient market evidence from the recent sales of comparable properties to contradict the most recent sale of the subject. In a sophisticated, transparent marketplace, the most recent sale should be the best indicator of the property's market value *unless* some issue that can be attributed to the condition of sale can be identified.

RECONCILIATION AND CONCLUSION OF VALUE

The issue with reconciling special purpose properties, such as bulk oil terminal facilities, is no different than any other appraisal assignment. The approaches that yield the most reliable results should be given the greatest weight in the final reconciliation. Given the strengths and shortcomings of the various approaches, it would appear that in most cases the income approach to value should yield the greatest reliability as an estimate of market value. However, as in the case of properties sold in Wisconsin, recent sales of the subject are deemed to be the best indicator of market value for property tax purposes unless market evidence to the contrary can be proven to exist.

SUMMARY AND CONCLUSION

This article develops a reasonable approach to construct an economic valuation framework that results in a proper identification of the HBU of the property and the proper allocation of individual real and personal, tangible and intangible assets that can be applied in general valuation assignments and in property tax-based valuation assignments. This article also creates a framework for properly identifying property ownership rights and the values associated with those rights from the perspective of whether those rights are inextricably intertwined with the property. Without properly recognizing and then incorporating the relevant economic, financial and market considerations that affect the financial feasibility in the HBU process or the rights appurtenant to the property, an appraisal assignment is merely one's opinion of a number, and not necessarily an opinion of the market value of the property being appraised. In essence, a proper economic valuation framework and HBU analysis begins with a complete market analysis process and ends with a real estate appraisal report resulting from an accurate depiction of the value derived from the rights and obligations associated with tangible and intangible assets that are inextricably intertwined with the land. ■

Figure 2

Glossary of Terms

appurtenant	Related to, or belonging to, another.
appurtenant intangible real property right	Any property right or restriction that belongs to real estate. Some appurtenant intangible real property rights can potentially be transferred to other real estate, while those rights that are classified as site permits are immobile and cannot be transferred (inextricably intertwined).
effective before-tax property tax rate	The annual property taxes owed for a property divided by the market value of the property, stated as a percentage. If a $100,000 property (market value) owes $1,250 per year in property taxes, the effective before-tax property tax rate is 1.25% (1,250 divided by 100,000 = 0.0125 = 1.25%).
going-concern	The condition whereby an entity (e.g., a company) has sufficient resources to continue to operate indefinitely.
going-concern value	The value of a company that has sufficient resources to continue to operate indefinitely.
inextricably intertwined	To become joined together and incapable of being disentangled.
intertwined assets	Multiple, individual assets that function as a new, single asset. An example is when individual bricks are mortared together to create a brick wall.
pipeline	A conduit through which products are transported.
special purpose property	A property with a unique physical design, special construction materials, or a layout that restricts its utility to the use for which it was built without a large capital investment.
terminal	A facility connecting two or more distribution channels.
terminal zoning	The potentially legal use of land for a facility connecting two or more distribution channels. The legal use is possible, but not certain.
terminalling operations	A business establishment that operates a facility connecting two or more distribution channels.
terminalling permit	The certain and legal use of land for a facility connecting two or more distribution channels.

Source: Thomas W. Hamilton, Ph.D., CRE

ENDNOTES

1. See Standards Rule 1-2(e) (iii), Standards Rule 1-4(g) and Guide Note 5.
2. *Wisconsin Property Assessment Manual*, page 1.1.
3. *Adams Outdoor Advertising, Ltd. v. City of Madison*, 2006 WI 104, 294 Wis. 2d 441, 717 N.W.2d 803, 05-0508.
4. Ibid., paragraph 83.
5. *Waste Management v. Kenosha County Board of Review*, 184 Wis.2d at 565 (Wis. 1994).
6. See Internal Revenue Code (IRC) Section 1245 Property, IRC Section 197 Intangibles, and IRC Section 1250 Property.
7. *ABKA Ltd. Partnership vs. Board of Review of Village of Fontana-On-Geneva Lake* 231 Wis.2d 328 (Wis. 1999) at paragraphs 15 and 26.
8. This is not always a completely additive process. The particular combination of rights creates a separate value in and of itself due to the specific portfolio of rights that can synergistically raise or lower the overall, marginal value of the parcel due to the particular combination of individual rights in the portfolio. This is the same effect seen in a portfolio of uncorrelated stocks where the portfolio return has a greater risk-adjusted return than the sum of the individual stocks in that portfolio.

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FEATURE

The Consequences of Tax Exempt Debt for Private Real Estate Development: The Case of The Villages

BY OWEN M. BEITSCH, PH.D., CRE

INTRODUCTION

Several states, especially those where large master-planned communities are common, have legislation permitting the sale of tax exempt debt to support infrastructure development. Typically, the debt is issued by a special district that exercises many of the powers of a local government. While the particular legal structure may vary across the states, these special districts are often instrumentalities tied to a private real estate developer able to take advantage of the resources made available through bond financing.

California and other states have many of these special districts, but their use in Florida has been especially remarkable. In the case of Florida, where several hundred community development districts (CDD) now exist, the shared interests or actions of the developer and the district acting as a government unit are explicitly authorized. Florida's enabling legislation openly encourages use of these districts as cost-effective vehicles to provide needed public services for major projects. At the same time, the legislation envisions communities funded or financed in such a fashion would, over a prescribed time frame, shift from the developer's control to that of the project's residents.

Almost any public facility can be financed with the tools made available through these types of districts, including but not limited to roads, utilities, schools, recreational facilities, and even some off-site improvements. The common form of financing involves varying assessments levied against the underlying land as the primary means of payment for any bond debt.

Until the residential market slipped into chaos, the market for the debt of these communities was very active, and some of the country's most recognized real estate projects are special districts. The combination of well-capitalized projects, favored tax treatment, rapidly rising land values, and a continued stream of assessments typically on parity with local property taxes made the securities of these districts especially attractive to large classes of investors. To date, Florida's CDDs have, by themselves, issued almost $7 billion of tax exempt bonds for a variety of purposes.

Much of the activity enabled by these special districts will continue to set the quality standard for real estate development. The implemented projects tend to be large, rich in amenities, and favored by the residents over other kinds of communities. Where several projects fell short of

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market expectations in the recession, they still delivered significant infrastructure capacity that will support future development.

By most accounts, The Villages, north of Orlando, is one of Florida's most successful special district communities. Since the beginning, several hundred homes have been constructed and sold *annually* in the project. Centered on active retirement housing, The Villages is bringing unfavorable attention to its tax exempt activity and, by extension, to every bond issue directed toward the capitalization of certain facilities or real estate activities.

Once broadly accepted, these kinds of ventures now face further scrutiny. At the very least, this closer look will add unwelcome complexity to real estate financing matters, and it may widen the basis for litigation already being filed.

THE RULING

For some time, The Villages had been operating certain large recreational activities that are an important centerpiece of this and other large real estate projects. In May 2013, the Internal Revenue Service (IRS) reported debt associated with these facilities or activities may not be tax exempt because, when issued, the project or the specific entity that had been the sponsor of the debt was not actually a political subdivision of the state.[1] The ruling appears to say the specific Villages legal entity involved was not a public body or instrumentality and may not be entitled to take advantage of the powers often associated with the typical special district structure.

> *We believe that an entity that is organized and operated in a manner intended to perpetuate private control, and to avoid indefinitely responsibility to a public electorate, cannot be a political subdivision of a State.* [2]

As one can observe from the proliferation of such projects in Florida especially, it has not been uncommon for other special districts using tax exempt debt to engage in at least similar initiatives, constructing and managing the large facilities expected in every major real estate development.

If the party concerned was not a qualified issuer of tax exempt bonds, an obvious interpretation of the IRS Technical Advice Memorandum is that any interest paid on bonds issued would become fully taxable income to those owning the bonds. Those bondholders would subsequently owe income taxes on the interest income that had been received, possibly penalties and interest as well.

Apparently, more than $400 million worth of tax exempt debt is linked to various recreational and utility facilities managed or constructed in this major community. Also obvious, those bondholders adversely affected by receiving unexpected taxable income will seek financial relief. Toward that end, they would likely look to the specific entity of The Villages involved as well as any related parties to defray the costs of additional taxation. As part of their effort to seek redress, bondholders or their agents also could act against residents in The Villages who pay various fees or charges to utilize the facilities in question. Even with a negotiated settlement, the expense realized would be enormous. The consequences, however, may reach well beyond this setting and any immediate costs or damages.

The specific actions or intent of The Villages notwithstanding, Florida's legislature inadvertently invited the project's problems when it intentionally blurred the line between the functions of government and private actors. Whatever similarities the legislature envisioned, the IRS is strongly arguing that government and private business have fundamentally different purposes and objectives.

As noted, Florida's community development districts, and a number of similarly created special districts elsewhere, are governed by appointed boards. Without regard to the nature of the larger project in terms of its residential or non-residential orientation, Florida's legislation very clearly allows the developer to name personal appointees to serve on these boards as they are initially created. But Florida law also prescribes governance will eventually pass to residents in the guise of their own duly elected board members. The change occurs once the concentration of residents and units has exceeded certain thresholds.

In those cases where a special district is comprised exclusively of commercial development, it has in effect few if any residents. Under those circumstances, landowners would continue to appoint the members to the regulating board. The Villages appears to have run afoul of the responsibility to distinguish commercial and residential functions that ultimately speak to the proper means of control.

The IRS memorandum focuses principally on the way The Villages acted to cede organizational power to others with the passage of time or a modification in the mix of activity. Or rather the way it *failed* to act. More specifically, the IRS claims the developer and The Villages performed in such a way that control of its own interests *would never* be diluted and worked to forestall a broader election of any non-aligned board members virtually forever. Indeed, despite the sale of more than 40,000 homes over two decades, the particular controlling entity in question had yet to transition to residents.

> *[Florida's legislation] contemplated that a board would be elected by the Qualified Electorate when a district acquired a sufficient number of residents. Even after over 20 years, this has not happened in the Issuer's case. Indeed, the facts indicate that Issuer was intentionally structured to ensure that this never could happen.*[3]

Among the observations made by the IRS, the developer structured the entity involved in the matter to avoid control by any persons other than its selected representatives or associates. As well, persons connected with The Villages used their position to induce Lady Lake—the superior local government in the region with comprehensive regulatory authority over district practices—to amend the boundaries of the special district in such a way that diminished or removed opportunities for future residential construction. The change in boundaries consequently also prohibited the occasion for future residents to engage in governmental activities.

> *… the Issuer was organized and operated in manner that insured continued effective control of the Board by A, rather than a general electorate or an existing governmental body. The Board was selected by majority vote of landowners, and, at all times, A was in a position, through entities under his control, to select all members of the Board…. The result was that during the relevant years, the Board was composed of individuals who, in all but one limited case, consisted of A, members of his family, directors, officers, or employees of the Developer, and the chief executive officer of Bank owned and controlled by A and his family.*[4]

Assuming such a negatively purposeful strategy, it would become almost impossible for residents to control board policies and practices at any point in time.

Perhaps it is a small comfort that the IRS does not systematically look to findings outlined in its memoranda as precedent to future rulings or actions. Even so, rational planning would suggest a need to embrace the agency's comments as basic principles when a special district underwrites what is primarily a real estate development program engaged in activities or programs that may be viewed as substantively *non-residential* in scope or emphasis. The IRS position could be construed as an admonishment to boards to oversee their existing non-residential projects or initiatives with discretion and to display greater care in the performance of their duties. Given the temporal dimension of The Villages case, strict behavioral standards become more critical over an extended period when there are questions about, or logical expectations of, change in policy or administrative practice.

> *Board members are subject to general laws relating to public officers and employees, including ethical standards requiring that public officials be independent and impartial, and that public office not be used for private gain other than the remuneration provided by law. Public officials must discharge their duties in the public interest and must act as agents of the people in holding their positions for the benefit of the public.*[5]

At the very same time, the seemingly non-residential focus of the IRS memorandum offers subtle implications for special districts largely of a *residential* character or focus. Like many rulings or judgments of this type, they can be instructive about things left *unsaid*.

By centering on the locus of control and the procedures to assure richer public engagement, the IRS tacitly appears to approve the predominantly residential special district where future control by residents on site seems a procedural certainty. The distinction between commercial and residential special districts (or the functions and components occurring therein) seems illusory, however, remembering that The Villages is itself substantively a residential community, and many of the criticized expenditures involve features broadly supportive of the residential objective. Fundamentally, these features were incorporated in the larger development precisely for that purpose.

OTHER IMPLICATIONS

How then to draw a distinction between residential initiatives and activities otherwise deemed primarily non-residential in scope or function? The obvious response leads to the self-evident strategy which discretely parses or isolates any suspect non-residential activities and related expenditures to avoid IRS curiosity in the first place. But disassembling tax exempt bond financing *already in place* is a substantially complex adventure and, to the extent there is a challenge, delinquent actions may mitigate, without undoing, the damage that already occurred. So, it is only practical to explore the separation of each activity at the initial stages of planning and financing, *before* debt is issued. Consequently, many *now-operating* special districts, generally considered residential in focus and form, may be exposed on several grounds. Because of the size of these residential projects, it is not unusual to see circumstances, markets and programs change, or to find residents demanding more services, many of which could be construed as essentially private. The level of required "publicness" intimated in the IRS memorandum may be only an initial test.

Special district litigation is pending or underway in many state court systems. Unlike the IRS ruling, which may not formally be the basis for precedent, both good and bad legal standards and tests will slowly emerge from these cases. Landowners, homeowners and banks are exploring options to recover substantial financial losses where these districts have not performed as planned. Without concluding that the circumstances at The Villages create new legal defenses or avenues in the state courts, several of the disputes involve claims about the proper interests of the controlling parties. In this context, the processes and sequence of actions by which the largely privatized behavior of a group may taint an otherwise public business becomes a compelling argument to reexamine the terms of unwanted or suspect agreements.

Particular to the circumstances posed by The Villages, strategic planning absolutely must consider the possibility that the community development district or a like unit of government implemented to support a largely non-residential project or activity *may not* be deemed qualified as an issuer of tax exempt debt. Although other special districts with a comparable commercial orientation may operate with fuller transparency and greater regard to public stewardship, the situation presented by The Villages does not seem subject to nuance. Such a possibility could curtail opportunities for some real estate projects to form special districts and to rely upon their tax exempt debt as a source of financial support, much in the same way private activity rules already limit such debt. The largest projects, involving a broad mix of uses or activity, seem the most vulnerable now.

For both existing and new real estate projects launched through a special district, it seems reasonable to posit that it will become more difficult to price or sell bonds intended for the tax exempt market. Where the vehicle is being questioned, the pricing advantage normally attached to tax exempt debt should begin to decline. Subtle evidence already points in this direction. As recently as July 14, 2013, Disney's powerful Reedy Creek Improvement District (government agent for Florida's Disney World and much of the development there) was obliged to distinguish its situation from that of The Villages in anticipation of a pending $360 million bond issue. By reflexively distancing itself from the unfortunate circumstances at The Villages, Reedy Creek acknowledges awareness about the exposure raised by the current IRS ruling. At a meeting of one CDD in Florida where The Villages matter was raised, an advisor commented, "I simply don't see how a bond or disclosure counsel could opine on the tax exempt status of *any* debt issue with characteristics like The Villages."

Then there are the bondholders—those who already have made investments, acquiring financial instruments from special districts anticipated to be tax exempt. These existing bond owners positioned in securities based on special district real estate projects, related activities or facilities of a comparable non-residential form, may find it more difficult to divest their holdings. Of course, steep discounts for these assets will affect the marketplace for future debt. The Reedy Creek offering scheduled for August may offer clues about the premiums, if any, that may burden these kinds of issues.

POSTSCRIPT

Irony weaves through what is really a dissent about the appropriateness of tax exempt debt for the varied purposes described. The more regulated states such as Florida demand the largest projects absorb their own costs, a challenge to the real estate community because of the financial requirements, but a logical nod to long-term community sustainability. Other states are calling for increased private participation in the provision of the most important infrastructure, especially the transportation network. However, the federal framework virtually precludes tax exempt debt from being channeled into privately controlled enterprises other than through the most elaborate legal schemes.

The special districts described here are, in the main, simple vehicles for promoting coveted public and private development. They could be a prototype of almost any instrumentality used to implement some form of public and private initiative. In the case of Florida, the enabling legislation for its special districts affirms as much. If the IRS ruling is remotely indicative, it hints the policies of the state and federal governments are very much apart on several key issues critical to bringing additional private capitalization to major development activities.

Any knowledgeable opinion is welcome at this point but it would be disingenuous to declare large master-planned communities like The Villages will no longer be constructed as the result of changes in tax code. The largest ones may be fewer in number. Those that are developed are likely to be increasingly expensive. However, their existence may be threatened more by a growing interest in the alternative urban experience. The larger planned projects will evolve, and in the absence of a debt structure provided by tax exempt financing, the market will force prices to move accordingly. In large part, the master-planned community always has been something of an elitist enclave. As prices rise, their costs will make them more prohibitive, exclusive, or segregationist, depending upon your social perspective.

Regardless of the way matters are resolved at The Villages, the disputed infrastructure *does exist* and apparently functions very well. Even with the accumulated debt experienced by many of the failing special districts, they have created valuable assets capable of supporting subsequent development.

What seems lost in the ruling is a cogent policy on the preferred form of ownership for the facilities in question and the best means of maintaining them over time. If local governments find it desirable to offload the costs of these facilities to a specific user, the shift is a financial burden removed from other members of the broader community and rationally a public benefit recognized as such by Florida case law, perhaps by case law in other states. Once the costs are shifted, they are removed from the public's balance sheet directly to the beneficiaries. The further public benefit is that limited public financial resources are released for purposes where private capital may be less inclined to stray, including upgrades to other infrastructure. Practically speaking, if the costs of constructing and maintaining infrastructure—all built to specific local government standards—can be passed to discrete users, it is worth reevaluating the measures and tests of "publicness." Alternatively if these costs can't be pushed back to the users, public bodies are left to examine their competing service and financial obligations. ■

ENDNOTES

1. Internal Revenue Service National Office Technical Advice Memorandum Index (UIL) No. 103.02-01 CASE-MIS No. TAM-127670-12.
2. Op. cit. p. 10.
3. Ibid.
4. Ibid.
5. Op. cit, p. 8.

Bright Spots and Blind Spots

BY K.C. CONWAY, CRE, MAI

What are the bright-spots and blind spots in the U.S. economy and real estate in the second half of 2013?

The year 2013 started off with the uncertainty of the "fiscal cliff" and a potential dockworkers strike against East Coast and Gulf Coast ports. However, despite sequestration and a lot of economic uncertainty during the winter, the spring did emerge. And, it brought forth a new six-year agreement with the dockworkers, as well as a plethora of good news on the housing front. Commercial real estate also continued its trek to improved fundamentals with vacancy falling across all property types. Even the capital markets seemed to shrug off Washington's dysfunctional nature with CMBS opening up its coffers the most since closing them down in 2009. Prognostications of $75–$80 billion in new private commercial mortgage-backed securitization activity were the buzz at the Commercial Real Estate Finance Council winter meetings in Miami. The following is a sampling of some of the headlines from First Quarter 2013 that set the tone for what most thought was gloom and doom for the year:

- ***Reuters* (January 2013): "Global jobless to hit record 200 million this year: ILO"[1]**
  The global jobless queue will stretch to more than 200 million people this year, the International Labour Organization said in its annual report on Tuesday, repeating a warning it has made at the start of each of the last six years. The U.N. jobs watchdog estimates unemployment will rise by 5.1 million this year to more than 202 million, and by another 3 million in 2014, following a rise of 4.2 million in 2012. If those predictions are right, global unemployment will hit a record.
- ***The Journal of Commerce* (Jan. 21, 2013): "ILA, New York Employers to Resume Talks"[2]**

  The International Longshoremen's Association and employers will resume bargaining Tuesday on New York-New Jersey port issues that may pose the toughest challenge to settlement of an East and Gulf Coast dockworker contract. This week's talks between the ILA and the New York Shipping Association follow a federal mediator's report of progress last week during three days of negotiations between the union and United States Maritime Alliance on a coast-wide master contract. The latest contract extension is set to expire February 6. The contract, originally scheduled to expire last September 30, has been extended twice.
- ***The Washington Post* (Feb. 17, 2013): "Automatic cuts are getting a big yawn from Washington"[3]**

  As deadlines go, the March 1 sequester lacked punch. Nobody's taxes went up; the U.S. Treasury won't run out of cash. Government offices won't

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K.C. Conway, CRE, MAI, *is executive managing director, Market Analytics, for Colliers International Valuation and Advisory Services, Atlanta. From 2005–2010, Conway worked in the Federal Reserve System in multiple capacities ranging from the commercial real estate "Subject Matter Expert" for the Atlanta District Bank to the "Commercial Real Estate Risk Specialty Officer" designee to the New York District Bank. In these roles, he briefed Chairman Bernanke, the Board of Governors, Federal Reserve District bank presidents and real estate industry groups on market conditions and burgeoning issues during the 2008–2009 financial crisis. Conway's work at the Federal Reserve was recognized with a Presidential Recognition Award by the Appraisal Institute in 2007, and "Key Player" and "Meritorious Service" awards by the Federal Reserve and the Federal Financial Institutions Examination Council in 2009 and 2010. Conway's career includes serving as an appraiser for Cushman & Wakefield and the former Equitable Real Estate, and in loan workout, portfolio management and asset advisory experience for Deloitte & Touche, Wells Fargo and Prudential. In 1997, Conway joined SouthTrust Bank where he developed a proprietary system to risk rate and manage its real estate portfolio across 28 states. Conway became a Counselor of Real Estate (CRE®) in 2009, and earned his MAI designation in 1989. He is a graduate of Emory University's School of Business.*

immediately turn out the lights and lock the doors. Most federal workers didn't face furlough for at least 30 days. So Washington felt little need to cancel the Presidents' Day holiday break. Instead, President Obama flew to Florida for a long weekend of golf. And Congress left town for nine days, with scant hope of averting deep cuts to the Pentagon and other agencies in the short time remaining when lawmakers return. Instead of negotiating, party leaders were busy issuing ultimatums and casting blame.

BUOYANCY OVERCOMES TURBULENCE

Despite the uncertainty of the U.S. fiscal situation, higher payroll taxes, and dire forecasts for consumer spending and retail sales, as well as a rise in the official unemployment rate to 7.9 percent following the controversial decline prior to the November 2012 elections, the U.S. economy remained buoyant in the first half of 2013, and the performance of both residential and commercial real estate continued its climb out of the 2009 abyss toward a new point of equilibrium. In other words, the buoyancy of the market overcame the fiscal, tax and political turbulence that spilled over from 2012. Housing inventory declined, home prices rose, manufacturing remained the "little engine that could" in this below-trend economic recovery, and capital remained optimistic about commercial real estate fundamentals. The following is a sampling of the headlines that prevailed in the second quarter that drove the stock markets to new record highs, and kept the "can reach equilibrium" momentum in commercial real estate:

- **Where Have All the Houses Gone?**

  March 3, 2013 – By DIANA OLICK, CNBC

  The first official day of spring may still be a few weeks away, but the spring housing market is already underway. Buyer traffic is rising along with home prices, but one traditional spring phenomenon is sorely absent: rising supply. The raw number of homes for sale is now at its lowest level in over 13 years, according to the National Association of REALTORS®. The numbers continue to fall.

- **U.S. Intermodal Volumes Rise for 10 Straight Week**s

  March 21, 2013 – JOC Staff

  U.S. intermodal *(http://www.joc.com/rail-intermodal/class-i-railroads/association-american-railroads/north-american-intermodal-traffic-continues-hit-new-highs_20130822.html)* rail volumes have risen for the 10th straight week over the same period in 2012, according to the Association of American Railroads *(http://www.joc.com/rail-intermodal/class-i-railroads/association-american-railroads/north-american-intermodal-traffic-continues-hit-new-highs_20130822.html)*. In the week ending March 16, combined North American carload volume, including all three North American Free Trade Agreement partners, rose 1.2 percent from the same week in 2012 to 376,243 carloads. North American intermodal volume grew 1.6 percent from the same week in 2012 to 287,285 trailers, and total intermodal volume for the first 11 weeks of 2013—3,281,456 units—is 6.6 percent higher than the amount in the same period in 2012.

- **U.S. Commercial Real Estate Forecast Reveals Optimism**

  May 21, 2013 –*Mortgage Orb.com*

  Industry executives currently have a "modestly optimistic" outlook on the U.S. commercial real estate market, as economic fundamentals show slow, yet steady, improvement according to the latest Sentiment Index from The Real Estate Roundtable. "Commercial real estate executives are seeing increased interest in transactions outside healthy core markets," says Jeffrey DeBoer, president and CEO of the Real Estate Roundtable. The company's survey for the second quarter of 2013 reveals an overall Sentiment Index of 69—unchanged from the previous quarter. The overall index score is based on the average of two indices: the Current Conditions Index (which stands at 71, up one point from the previous quarter) and the Future Conditions Index (67, unchanged since the first quarter). Figures above 50 indicate a positive market trajectory, the Real Estate Roundtable notes. This quarter's index indicates that senior commercial real estate executives continue to see favorable trends in both values and capital availability in major gateway markets, but remain nervous about how a potential rise in interest rates and political uncertainty could worsen market conditions.

- **Wells Fargo Securities: Structured Products Monthly, June 7, 2013 – Midyear Outlook**

  CMBS Overview: Credit trends in CMBS have been encouraging in 2013. Delinquency rates have been helped to some extent by the heavy issuance this year, but a significant factor is also the continued decline of newly delinquent loans. We expect the positive momentum to continue throughout the year given the limited pipeline of maturing loans and the steady decline of term defaults. We are now three years into the recovery in the property markets, and we are forecasting continued improvement through 2014. Strong property sales transaction volume has driven improved pricing across the major property types since the market trough in 2009. The slow growth economic environment will likely keep cap rates stable for the remainder of the year; further cap rate compression in the major markets appears unlikely as investors look beyond the major markets for value.

THE SECOND HALF 2013 BRIGHT SPOTS AND BLIND SPOTS OUTLOOK

Before forecasters can put forth any kind of outlook for the second half of 2013, they have to have some kind of view on what are the primary influences—or driving forces—behind the economy. As we enter the second half of 2013, four primary forces are at work that will determine the final "Bright Spot/Blind Spot" score at year-end. Those four forces are the:

- Federal Reserve and winding down of the Bernanke era;
- Sustainability of the housing recovery;
- Energy;
- Manufacturing activity fueled by a remaking of the domestic and global supply chains.

THE FEDERAL RESERVE AND WIND-DOWN OF BERNANKE ERA

On June 24, the President confirmed what this author had shared previously with many industry colleagues in the second half of 2012—that Chairman of the Federal Reserve Ben Bernanke would retire in January 2014—and we would have a new head of the U.S. Central Bank. Two days later, the Fed's June Federal Open Market Committee (FOMC) meeting concluded and Bernanke threw the market a curve ball. That curve ball was that maybe the Fed wasn't on a steroid-laced, accommodative monetary-policy trek through 2014—and that maybe it was time to at least pull back on its bond purchases program by $20 billion per month. The market reacted with an abrupt 70-basis point rise in the 10-Year Treasury bond's yield overnight. And, the market has been in volatility mode ever since. So what is Bernanke really doing, and what is the "Bright Spot" or "Blind Spot" in the second half of 2013 from Fed monetary policy?

Bernanke's call to reduce the Fed's bond-buying program from $85 billion to $65 billion is merely a balancing of what is needed in response to our projected fiscal debt. It is not any real tightening of monetary policy at all. Until this fiscal year, the U.S. has been running approximately a $1.0 trillion annual deficit. Divide that $1.0 trillion by 12 months and you get approximately $85 billion ($83.3 billion to be exact). In essence, the Fed has been soaking up onto its balance sheet an amount equal to our annual deficit to stabilize long-term interest rates. In June of this year, we learned that the projected annual deficit for Fiscal Year 2013 is projected by the Government Accounting Office (GAO) to be only $780 to $800 billion, thanks to the "fiscal cliff" deal that raised taxes on almost everyone in 2013. Now divide the new forecast annual deficit of $780 billion by 12 months and one derives a figure of $65.0 billion. In essence, Bernanke is really just right-sizing the amount of monthly bond purchases from $85 billion to $65 billion to stabilize long-term interest rates in response to a smaller annual deficit. There is no retraction of quantitative easing (QE) occurring by the Fed or Chairman Bernanke, but now the market has been awakened to the reality that interest rates could rise, with a change in the leadership at the Fed eminent. The market now wants to be approximately 100 basis points (or the first four, 25-basis-point increases) ahead of this interest rate risk that it was not planning on until 2014 or 2015.

While this rise in the 10-Year Treasury from a 1.60 percent range to a 2.60 percent range has caused some indigestion for the commercial real estate debt markets, it has had virtually no impact on cap rates or values? Why?

The answer is two-fold:

- Commercial real estate offers a yield not matched by bonds or equities—and capital is fixated on yield more than it is value; and
- Investors and lenders have adopted a debt-yield (or simply stated, interest-only) underwriting over the past few years to address the interest rate risk from extending long-term mortgage debt at today's unprecedented low interest rates. As long as the NOI after capital reserves throws off a 9–10 percent yield to the gross debt amount ($900,000 NOI / $10,000,000 permanent debt loan), investors and lenders are comfortable with refinance risk in a higher interest rate environment 5–10 years out. In essence, debt-yield has replaced debt service coverage ratio as the interest rate underwriting protection mechanism. Since this new mechanism already was

in place prior to the June FOMC meeting, the Fed's self-created uncertainty of higher interest rates has been negligible thus far on commercial real estate. That is the "Bright Spot."

The "Blind Spot," though, is that it is not all that simple. If real interest rates rise materially in 2014–2015 (say, to a 3.5 percent 10-Year Treasury or 6 percent, 30–year home mortgage rates) under a new Federal Board of Governors, businesses may likely curtail their already anemic pace of hiring, unemployment could rise above the official employment rate of eight percent and the total actual unemployment rate could rise above 15 percent level, the housing recovery and manufacturing activity could stall, and GDP could collapse to near recession levels. That would disrupt the vacancy and rental rate recovery underway for commercial real estate and undermine the investor/lender protection from even a debt-yield underwriting mechanism. We have a glimpse of this risk already with the decline in mortgage applications and revisions to GDP (downward to 1.8 percent from 2.4 percent).

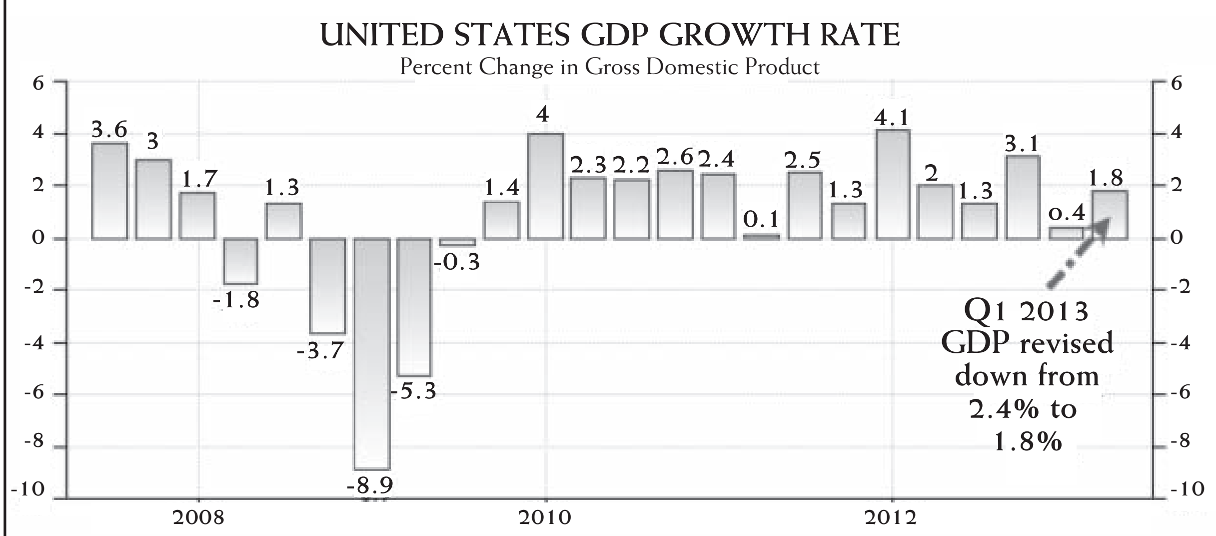
Fed monetary policy and the changing-of-the-guard from Bernanke to a new head of the U.S. Central Bank is the most material "Blind Spot" to be "at-bat" in the second half of 2013. How the Fed transitions from Bernanke, tempers QE, and eventually retrieves the approximate $4.0 trillion in excess liquidity in the system (25 percent of the U.S. annual $16.0 trillion GDP) will determine the fate of the macro-economy and commercial real estate performance over the next 6–24 months. With a second wave of CMBS maturities coming due 2015–2017 (more than double the volume of 5–7 year interest-only CMBS maturities 2010–2012 that blew up CMBS delinquencies to a record high of 10.5 percent), the Fed has a very fine needle to thread.

THE HOUSING RECOVERY

There have been many doubting Thomas' as to the nature of a housing recovery. After all, it has been seven years since home price appreciation fell from an annual rate of 14 percent to zero before then going negative for five consecutive years. Despite the glowing news on rising home prices from the likes of both Case-Shiller and the Federal Housing Finance Authority (FHFA), home builders lack the same enthusiastic outlook as the economists and media analysts because they continue to face the headwinds of:

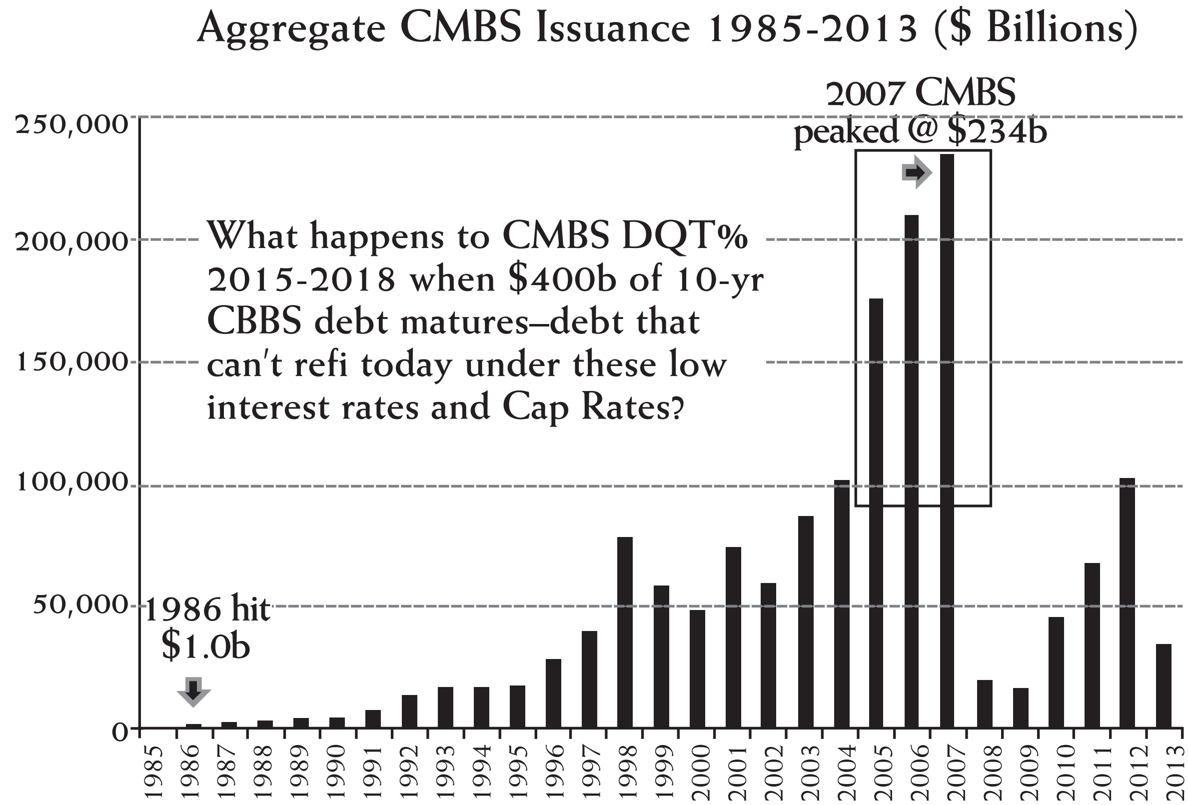
- lack of credit for land and construction loans;
- labor shortages in key trades;
- elevated construction costs that are up an astonishing 40 percent since 2007 (ENR/Dodge Construction indices show construction costs never declined during the 2007–2009 housing recession); and
- continued pricing pressure from a large inventory of foreclosure homes—especially in judicial foreclosure states like Florida where the backlog of foreclosures is greatest. This lack of builder confidence in housing is best reflected in the National Association of Home

Figure 1



Source: *www.tradingeconomics.com*, Bureau of Economic Analysis

Figure 2



Source: Real Estate Alert

Builders/Wells Fargo Housing Market Index (NHAB HMI) which has accurately forecasted every housing recession and recovery the past quarter century.

An examination of the NAHB HMI since 2001 reveals that:

- the all-time high in builder confidence was reached in June 2005 with a reading of 72;
- housing entered a recession in May 2006 (the NAHB was spot-on and ahead of the collapse that media and lenders didn't accept until mid- to late-2007), and remained in recession territory until June of this year (a record 85 months, or seven years); and
- the all-time low reading of home builder confidence occurred in January 2009 with a reading of just eight. Readings above 50 are considered conducive to housing growth and new construction activity. Looking forward into the second half of 2013 and 2014, monitoring the NAHB HMI is one of the two best leading indicators as to the vitality of the housing recovery. As the summer concludes, will the HMI dip back below 50 because of higher mortgage rates, or will builders shake off the higher rates as they have in the past by buying down the rate with an offsetting upgrade cut so buyers feel as though they are getting the same low rate as before June 26? This author is betting on the rate buy down and more sales growth.

The other key housing metric to monitor is a relatively new one introduced in 2008. It is the NAHB's Improving Markets Index (IMI). The NAHB IMI measures housing recovery on a MSA-by-MSA level via a weighting of several metrics that evaluate more than just home price appreciation (HPA). To follow is a snapshot of how this index has added MSAs that it considers as improving housing markets over the past 18–20 months, as well as a heat map of the breadth of the improving housing markets across the U.S. If you want just one metric to monitor to sort out the plethora of monthly and quarterly housing data (sales, starts, HPA, etc.), this is the one. The Web address is *www.NAHB.ORG/newsroom*, and is one of

Figure 3

NAHB/Wells Fargo National HMI - History

(Seasonally Adjusted)

	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec
2001	52	58	60	59	58	59	57	59	55	46	48	55
2002	58	58	62	61	61	61	61	55	63	61	62	63
2003	62	63	56	55	60	63	65	67	67	69	68	69
2004	68	66	66	69	69	68	67	70	67	69	70	71
2005	70	69	70	67	70	72	70	67	65	68	61	57
2006	57	56	54	51	46	42	39	33	30	31	33	33
2007	35	39	36	33	30	28	24	22	20	19	19	18
2008	19	20	20	20	19	18	16	16	17	14	9	9
2009	8	9	9	14	16	15	17	18	19	17	17	16
2010	15	17	15	19	22	16	14	13	13	15	16	16
2011	16	16	17	16	16	13	15	15	14	17	19	21
2012	25	28	28	24	28	29	35	37	40	41	45	47
2013	47	46	44	41	44	52						

Source: National Association of Home Builders/Wells Fargo

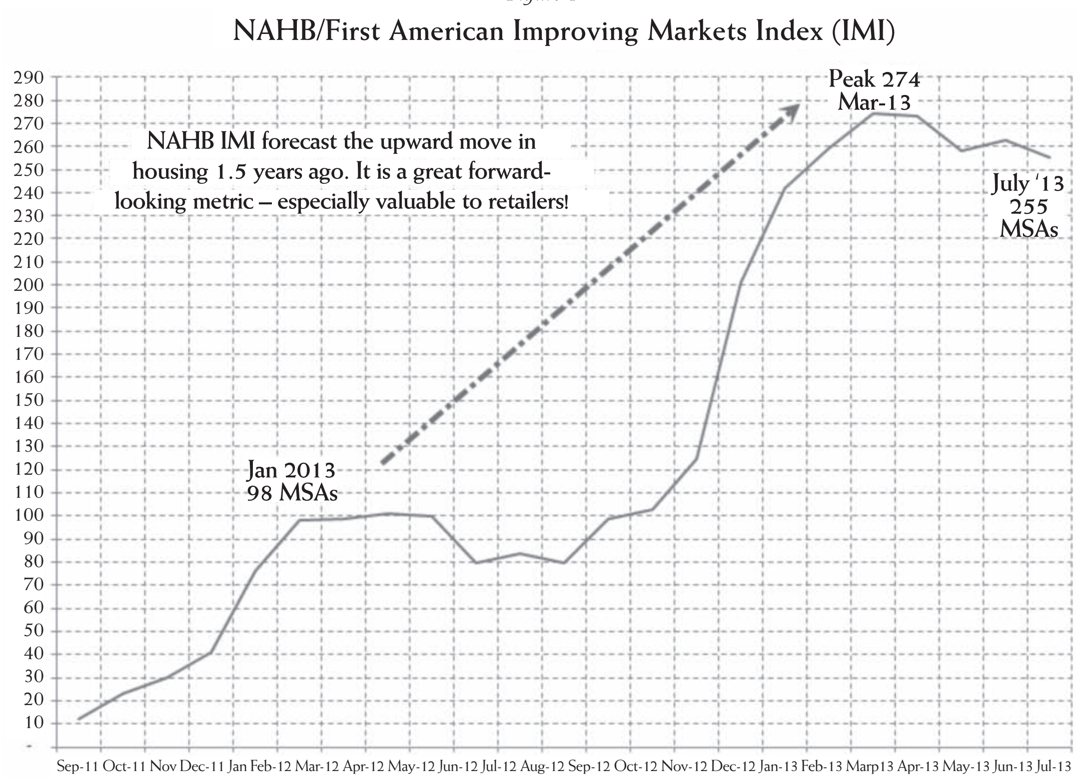
this author's top five picks for economic metrics to monitor the U.S. economy.

ENERGY, MANUFACTURING AND REMAKING OF SUPPLY CHAIN

These three items go hand in hand. They are perhaps more responsible for the progress in the U.S. economic recovery than even the Fed's QE. The Energy Information Association (EIA) projects that by the fall of this year, U.S. crude oil production will exceed crude oil imports by as much as two million barrels per day. That is an amazing turn of events in less than a decade—for the U.S. to go from energy dependence to energy independence.

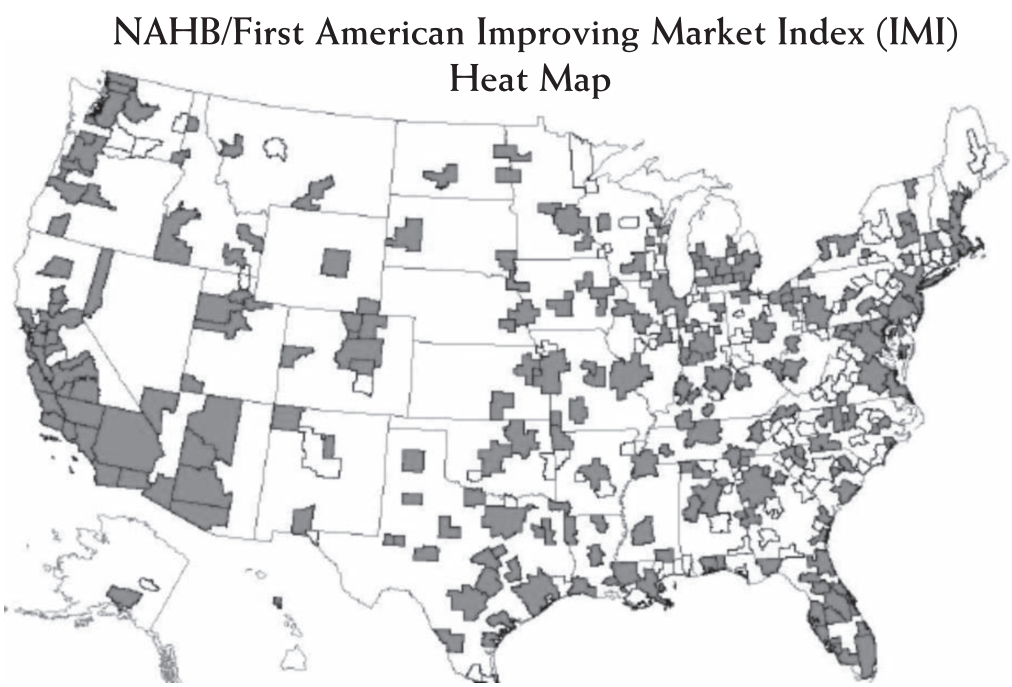
The abundance—and comparatively low cost of energy—in the U.S. is luring manufacturing from across the globe. Why? It is not just the cost of energy. It is the reliability of the energy infrastructure system (stable electric grid), and the redundancy of fuel options such as natural gas and coal. It is also a recognition by manufacturers that energy and transportation costs (50 percent) now surpass labor as the largest portion of their manufacturing costs. Real estate (plant and distribution centers/warehouses), represents less than five percent of a manufacturer's total costs. This shift in costs is because of technology and the automation of manufacturing processes that no longer force companies to chase cheap labor around the globe to unstable regions that are not so friendly to U.S. interests nor respectful of its patents and copyrights. Robots can travel anywhere, and demand no health care or retirement benefits. Today, manufacturers need cheap and abundant energy more than they need cheap human labor. Combine this reality with U.S. patent protection, and the U.S. is quite possibly the most attractive manufacturing center in the world again. The convergence of this manufacturing renaissance in the U.S.—along with the growth in e-commerce and the expansion of the Panama Canal lock system (scheduled for completion in 2015, and which will accommodate container vessels nearly three times today's Panamax-size container ships carrying a mere 3,000 to 5,000 containers)—is driving retailers, shippers and manufacturers to remake their supply chains. Connecting the "Post Panamax Ready" ports with intermodal rail to e-commerce fulfillment hubs (such as FedEx's in Memphis and UPS's in Louisville, Ky.) is the driving force behind manufacturing growth and the health in industrial real estate. Manufacturing continues to be 'the little engine that can" in this economic recovery thus far.

Figure 4



Source: National Association of Home Builders

Figure 5



Source: National Association of Home Builders

HOW CAN ONE MONITOR THIS TREND?

This author's best recommendation is to scrap the anecdotal respective Fed District Bank manufacturing surveys (such as the New York Fed's "Empire State Manufacturing Survey") and pay $100 per year to subscribe to the Association of American Railroad's "Rail Time Indicators." This robust monthly data series tracks everything that moves by rail in and out of North America, and is real-time, primary data produced by industry versus guessed-at and then heavily revised government data. A snapshot of a few of the best indicators in the "Rail Time Indicators" report is presented below, and includes metrics such as:

- volume of intermodal traffic;
- railroad employment;
- rail cars in storage, etc.

Anytime one can capture real-time, primary data produced by industry over government survey data, a more reliable forecast will result, yielding the true "Bright Spots and Blind Spots" ahead. Energy independence, manufacturing and remaking of the U.S. and global supply chains are all "Bright-Spots" for the second half of 2013 and on into 2015.

CONCLUSION

Going back to the opening question "What is the primary force fueling the U.S. economy?," one would have to conclude that all four options (Fed monetary policy, housing recovery, energy, and manufacturing) are quite material influences to propping up our anemic 1.8 percent GDP growth rate. Pulling the legs out from any one of these would likely pull the U.S. economy back into recession. With a total unemployment rate of 14.3 percent (none of the media pundits reported that June's real total unemployment rate actually increased 50 basis points from 13.8 percent to 14.3 percent), and job growth still running below 200,000 jobs per month, the U.S. economy needs fuel to all cylinders to even sputter forward.

Figure 6

Rail Time Indicators

Policy & Economics Department
Association of American Railroads
July 8, 2013

Economic Indicator	Most Recent Data
U.S. Freight Rail Traffic (p. 1)	<u>Not Seasonally Adjusted</u>: Total carloads ↓**0.3%**, carloads excluding coal ↑**1.3%**, carloads excluding coal and grain ↑**3.8%**, and intermodal ↑**1.3%** in June 2013 compared with June 2012. Highest-volume intermodal month ever for U.S. railroads. <u>Seasonally Adjusted</u>: Carloads in June 2013 ↑**1.2%** over May 2013; intermodal in June 2013 ↑**1.4%** over May 2013.
Capacity Utilization (p. 29)	↓to **77.6%** in May 2013 from **77.7%** in April 2013. Manufacturing stable at **75.8%** in May 2013 compared with April 2013.
Railroad Employment (p. 34)	↑**474** in May 2013 over April 2013 to 164,249 employees. Fourth straight monthly increase, first time that's happened since Nov. 2011.
Rail Freight Car in Storage (p. 44)	↑to 303,547 on July 1, 2013, up 3,974 cars from June 1, 2013.

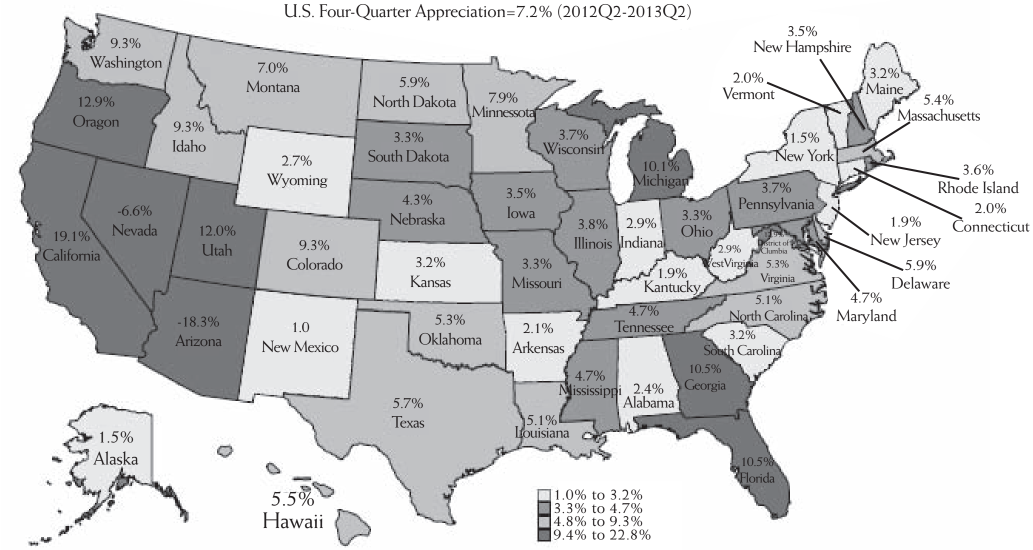
Source: Rail Time Indicators

Figure 7

Second Quarter 2013 Federal Housing Finance Agency Price Index

Four-Quarter Price Change by State: Purchase-Only Index (Seasonally Adjusted)

U.S. Four-Quarter Appreciation=7.2% (2012Q2-2013Q2)



Source: Federal Housing Finance Agency

Below are June unemployment rates reported by the Bureau of Labor Statistics: Note the official unemployment rate of 7.6 percent versus the actual unemployment rate of 14.3 percent (up 50 basis points).

Figure 8

Household Data June 2013

Alternative measures of labor underutilization

(Percent)

Measure	Not seasonally adjusted			Seasonally adjusted					
	June. 2012	May 2013	June. 2013	June. 2012	Feb. 2013	March 2013	April 2013	May 2013	June 2013
U-1 Persons unemployed 15 weeks or longer, as a percent of the civilian labor force....................	4.5	4.1	3.9	4.6	4.2	4.1	4.1	4.1	4.0
U-2 Job losers and persons who completed temporary jobs, as a percent of the civilian labor force..	4.4	3.7	3.8	4.6	4.2	4.1	4.1	3.9	3.9
U-3 Total unemployed, as a percent of the civilian labor force (official unemployment rate)	8.4	7.3	7.8	8.2	7.7	7.6	7.5	7.6	7.6
U-4 Total unemployed plus discouraged workers, as a percent of the civilian labor force plus discouraged workers...	8.9	7.7	8.4	8.7	8.3	8.1	8.0	8.0	8.2
U-5 Total unemployed, plus discouraged workers, plus all other persons marginally attached to the labor force, as a percent of the civilian labor force plus all persons marginally attached to the labor force..	9.9	8.5	9.3	9.6	9.2	8.9	8.9	8.8	9.1
U-5 Total unemployed, plus all persons marginally attached to the labor force, plus total employed part time for economic reasons, as a percent of the civilian labor force plus all persons marginally attached to the labor force...	15.1	13.4	14.6	14.8	14.3	13.8	13.9	13.8	14.3

Source: Bureau of Labor Statistics, U.S. Department of Labor, June 2013

Below is the latest actual table of unemployment rates from the Labor Dept for August.

Figure 9

Household Data August

Table A-15. Alternative measures of labor underutilization

(Percent)

Measure	Not seasonally adjusted			Seasonally adjusted					
	Aug. 2012	July 2013	Aug. 2013	Aug. 2012	Apr. 2013	May 2013	June 2013	July 2013	Aug. 2013
U-1 Persons unemployed 15 weeks or longer, as a percent of the civilian labor force	4.3	3.7	3.7	4.4	4.1	4.1	4.0	3.9	3.8
U-2 Job losers and persons who completed temporary jobs, as a percent of the civilian labor force	4.4	3.8	3.8	4.5	4.1	3.9	3.9	3.8	3.8
U-3 Total unemployed, as a percent of the civilian labor force (official unemployment rate)	8.2	7.7	7.3	8.1	7.5	7.6	7.6	7.4	7.3
U-4 Total unemployed plus discouraged workers, as a percent of the civilian labor force plus discouraged workers	8.7	8.3	7.9	8.6	8.0	8.0	8.2	8.0	7.8
U-5 Total unemployed, plus discouraged workers, plus all other persons marginally attached to the labor force, as a percent of the civilian labor force plus all persons marginally attached to the labor force	9.7	9.1	8.7	9.6	8.9	8.8	9.1	8.8	8.7
U-5 Total unemployed, plus all persons marginally attached to the labor force, plus total employed part time for economic reasons, as a percent of the civilian labor force plus all persons marginally attached to the labor force	14.6	14.3	13.6	14.7	13.6	13.8	14.3	14.0	13.7

Source: Bureau of Labor Statistics, U.S. Department of Labor, August 2013

Therefore, while the housing recovery is real, broad-based and a true "Bright-Spot," it can be derailed by the Fed getting monetary policy wrong. Today's home price appreciation map looks eerily similar to that of 2004.

Is the Fed's monetary policy creating a second housing bubble? That is the elephant in the Fed Second Half 2013 FOMC meetings—especially September's.

Manufacturing, while less dependent on the U.S. consumer today because of a shift in the U.S. becoming an exporting manufacturer, is heavily dependent on how global GDP is performing. Europe, the second-largest economy in the world behind the U.S.—and nearly double the size of China's $7.0 trillion GDP—matters a lot. Europe is a "Blind Spot" we can't forget or take for granted.

Energy is the "Bright Spot" that has cushioned the full impact of higher taxes, and is most responsible for the manufacturing renaissance underway. It is ironic that a president who takes credit for manufacturing job creation is also working against the one thing making that job growth possible—cheap and abundant domestic carbon.

The second half of 2013 is likely to see more rain delays because of volatility in the atmosphere than game play. The Fed has yet to learn how to be transparent and communicate what it is really doing. One day it has a date-specific interest rate policy that then changes to a metric-specific policy (6.5 percent unemployment and <2.5 percent inflation). However, the Fed has yet to tell us which unemployment rate it is targeting for a 6.5 percent rate—and below 2.5 percent inflation has only been possible because of falling housing prices and flat apartment rents. Neither is now true, and collectively, home price and rents influence as much as 40 percent of the CPI. The Fed is the "Blind Spot" ahead in the second half of 2013, and to infinity and beyond. Given its track record on knowing when to stop raising interest rates (last time it was during the summer of 2006 after the housing bubble had burst) or when to reduce (a 21 percent prime rate in 1981 was a little extreme), and that Bernanke is about to hand off his eight-year Pandora's Box, I suspect volatility is the economic forecast de jour for the balance of 2013. The other "Blind Spots" to keep on one's radar are:

- CMBS maturities 2015–2017 (Nightmare on Delinquency Drive—the sequel);
- inflation (rising home prices and apartment rents have yet to filter into the CPI);
- West Coast potential International Longshoreman's Association (ILA) port's strike in 2014 as the West Coast longshoreman have to renegotiate a long-term labor agreement as did the East and Gulf coasts in the second half of 2012 and the first quarter of 2103; and
- global risks from uncertainty and unrest in the Middle East that could materially impact the Suez Canal. Commercial real estate, though still offers the best yield opportunity for capital and a hedge against inflation. It has yet to fully recover its NOI, occupancy and value from pre-2007, and offers upside potential not so evident in the equities markets. Cap rates will remain stable despite interest rate risks because the investment interest in commercial real estate is yield, not value concentric. ■

ENDNOTES

1. Miles, Tom, "Global jobless to hit record 200 million this year: ILO," Reuters, Jan. 21, 2013.
2. Bonney, Joseph, "ILA, New York Employers to Resume Talks," *The Journal of Commerce,* Jan. 21, 2013.
3. Montgomery, Lori, "Automatic cuts are getting a big yawn from Washington," *The Washington Post,* Feb. 15, 2013.

Underwater Mortgages: Can Eminent Domain Bail Them Out?

BY ANTHONY F. DELLAPELLE, ESQ., CRE; AND CORY K. KESTNER, ESQ.

INTRODUCTION

The Genesis of the Concept

Discussion of the use of eminent domain to seize "underwater" residential mortgages began in mid-2012, when it was conceived as a potential way to improve the housing market and to assist homeowners who had outstanding mortgages exceeding the value of their respective homes. The movement was initiated by Mortgage Resolution Partners (MRP), a group of venture capitalists from San Francisco hoping to convince county and local officials in San Bernardino, California, to use the governmental power of eminent domain to seize control of private residential mortgage-backed securities with the intent of cutting the principal balances of negative-equity borrowers. This, of course, would be done for a fee.

As proposed by MRP, the group would work with local governments to find large institutional investors willing to finance the condemnation process. Under the plan, the local government would take title to the loans, without taking title to the actual homes, and pay the original mortgage owner the "fair value" with the money provided by institutional investors. MRP would then work to restructure or issue new loans to reduce homeowners' monthly mortgage payments while selling the restructured loans back to the private market, with the proceeds paying back the original financiers.

The plan was met with varying levels of approval, resistance and concerns. Objections were raised by both the Securities Industry and Financial Markets Association and the Federal Housing Finance Agency, who maintain that such seizures would represent an unconstitutional use of the sovereign's eminent domain power, and an unjustified interference of investors' rights.[1] Although several academics and MRP support the plan, an article from *The Wall Street Journal* notes that the White House rejected the idea when it was presented by a group of

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Anthony F. DellaPelle, Esq., CRE, *is a shareholder in the law firm of McKirdy & Riskin, P.A. in Morristown, New Jersey. DellaPelle is a Certified Civil Trial Attorney by the New Jersey Supreme Court. He has represented property owners in eminent domain, redevelopment and real estate tax appeal matters for more than 25 years, and also has experience in land use, zoning and planning matters. DellaPelle has served as special counsel to municipal agencies and public utilities in condemnation cases, real estate tax appeals, and in planning and zoning matters. He is the sole New Jersey representative for Owners Counsel of America, a national association of leading eminent domain lawyers across the country. DellaPelle is rated "AV/Preeminent" by the* Martindale Hubbell Law Directory, *and appears regularly on national television, where he provides commentary on eminent domain and property rights issues around the country. He served on Governor Chris Christie's transition team in 2009, and is the author of two blogs:* "New Jersey Condemnation Law" *and* "New Jersey Property Tax Law." *DellaPelle received a bachelor of arts degree in Economics and English from Franklin & Marshall College, and his juris doctor degree from the Seton Hall University School of Law.*

congressional Democrats two years ago.[2] Instead, the president has suggested his own plan to help property owners who own homes with underwater mortgages.[3] Legislation was also introduced in Congress to prohibit the four major government-sponsored mortgage providers from buying loans in any community that utilizes the eminent domain scheme.[4] The initial target areas of this scheme—San Bernardino and Sacramento, California, and the City of Chicago—analyzed the plan and declined to proceed, but the plan appears to have some new life, and is being mentioned as a possible option for smaller cities in different parts of the country. In particular, the City of Richmond, California, sent notices this summer to the holders of more than 600 underwater mortgages, asking them to sell the loans to the City. If they refuse to sell, Richmond has indicated that it will use its eminent domain powers to seize the mortgages, and will partner with MRP to finance the takings. These efforts quickly led an investor group—including institutions such as BlackRock and PIMCO—to file a federal lawsuit seeking an injunction to prevent Richmond from moving forward with its eminent domain plan. This lawsuit may end up being the first of many.

Does the government have the authority to acquire a mortgage by eminent domain? Is condemning a mortgage to reduce payments truly a "public use" under the Fifth Amendment to the U.S. Constitution? Will the plan really save people money and help the real estate market, or is it just a ploy that will reward and enrich the financiers? This article will seek to address those questions through looking at the legal theory underlying the plan, some of the practical considerations that will need to be addressed by the courts and the parties, and the current status of the plan.

LEGAL THEORY OF THE MRP PLAN

Legal Authority and 'Public Use'

Eminent domain has historically been used by governments to build roads, government buildings such as schools and municipal buildings, and more recently as a tool for municipal redevelopment, the latter use having given rise to increased public scrutiny of property rights since the U. S. Supreme Court decided the matter *Kelo v. City of New London* [5] in 2005, and allowed a local government agency to use eminent domain to take private property for "economic development" purposes. As areas have developed, the government's need to acquire property rights has generally increased, and so has the potential use—and abuse—of the sovereign power of eminent domain. Under the Fifth Amendment, private property may be taken only for a public use, and can be taken only if just compensation is paid to indemnify the owner for his or her loss. Bearing this constitutional limitation in mind, what is the public use that supports the MRP plan? The first possible suggested use is that the plan could prevent blight, keep local property taxes in line with the actual current value of the property, and thereby help to maintain vibrant communities. The second public use proffered, which is more national in scope, is that the removal of underwater loans from the marketplace would speed along the overall economic recovery by freeing up monies currently being applied to underwater mortgages, or perhaps by reducing the potential for foreclosures and limiting the foreclosure crisis that exists today. These possible "public" uses would, however, likely require an expansion of existing legal precedent which has extended only to the more traditional understanding of public uses.

The issue of using eminent domain as a tool to remove blight was addressed by the Supreme Court in Berman v. Parker.[6] In Berman, the Court upheld the District of Columbia's power to redevelop blighted areas and eliminate "blighting factors or causes of blight" through eminent domain, which specifically included the power to transfer condemned property from the original owner to a private redeveloper. The plaintiffs owned a department store that was not declared blighted, but was scheduled to be condemned to clear the surrounding blighted areas.

About the Author

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Plaintiffs argued that their property was not blighted and could therefore not be taken to merely make the community more attractive overall, and that taking land under eminent domain to give to a redeveloper violated the Fifth Amendment by taking "from one businessman for the benefit of another businessman." The Court unanimously decided in favor of the agency by holding that the issue of large-scale blight could be addressed only with a large-scale integrated redevelopment plan.

The *Kelo* decision noted earlier is one of the most reviled and denounced Supreme Court decisions in decades. It has been cited for the notion that the constitutional "use" mandate is expansive enough to include taking property "from one private party and giving it to another." In *Kelo*, the plaintiffs argued that economic development, the "public use" relied on for the taking and transfer of land to the New London Development Corporation, did not qualify as a public use under the Fifth Amendment. The Court held that once a legislative body finds a project will create new jobs, increase tax and other revenues, and revitalize a depressed area, then the project qualifies as a public use because it serves a public purpose. Further, the Court ruled that a government's delegation of its eminent domain power to a private entity was constitutional where permitted by law. Although the *Kelo* Court permitted action analogous to that relied on by proponents of the MRP scheme, the opinion also affirms that the states may limit government's power of eminent domain. *Kelo*, which relied on *Berman v. Parker* as authority for the passing of private property from one private owner to another private owner for a "public use," was the subject of a torrent of law journal articles and editorials, and the driving force behind 44 states passing legislation limiting the use of eminent domain, and specifically protecting citizens from having their property taken for the purpose of conveying it to another private party.

One proponent of the MRP plan suggests that the use of eminent domain to acquire underwater mortgages is supported by a decades-old Supreme Court decision, *Louisville Joint Stock Land Bank v. Radford*.[7] In that case, a federal appeals court ruled that the Frazier-Lemke Amendment, a subsection of the Bankruptcy Act,[8] was consistent with the Federal Constitution. The amendment prevented distribution of the mortgagor's property and allowed him to remain in possession despite defaulting on the terms of his mortgage. The Supreme Court invalidated the legislation at issue in that case on the ground that it failed to provide compensation for a right (the right of possession) that had been taken from the mortgagee. Important is that the Court did not reach the second issue—whether the taking was for a public use, and never specifically authorized taking a mortgage so long as compensation is provided, but simply stated that the property of a mortgagee *may* be taken for public use if compensation is provided.

IS A MORTGAGE "PROPERTY" THAT CAN BE TAKEN?

Assuming that the taking of mortgages is determined to satisfy the public use limitation, the next issue presented is whether a mortgage qualifies as "property" under the Fifth Amendment and state law. In New Jersey, as an example, the courts have broadly interpreted the language in relevant statutes such as the Local Redevelopment and Housing Law (LRHL) and Eminent Domain Act of 1971 that define "property." Citing to *Harrison Redev. Agency v. DeRose*,[9] the New Jersey Supreme Court determined that "the language the Legislature used to define 'real property' and 'property' in the LRHL and the Eminent Domain Act cross-reference each other and require cognate interpretations."[10] The LRHL defines "real property" as: "all lands, including improvements and fixtures thereon, and property of any nature appurtenant thereto or used in connection therewith, and every estate, interest and right, legal or equitable, therein, including terms for years and liens by way of judgment, mortgage or otherwise, and indebtedness secured by such liens,"[11] while the Eminent Domain Act defines "property" as "land, or any interest in land..."[12] The express mention of a mortgage, in addition to the catch-all "any interest in land" could potentially provide a government entity with support to condemn a mortgage interest.

Other states and federal appellate courts have historically held that a mortgagee has a property interest in a condemnation equal to the amount of the remaining balance on the loan in question.[13] As a simple example, a mortgagee who has a $100,000 remaining balance on a mortgage loan secured to the property would be entitled to collect only up to $100,000 in satisfaction of the mortgagee's interest.

PRACTICAL CONSIDERATIONS

Procedural Issues

If the condemnation of a mortgage is deemed to achieve a public use, and a mortgage is considered "property" that can be acquired via eminent domain, the procedural aspect of how the property is condemned would be addressed by each jurisdiction's statutes, codes and court rules. A typical condemnation action begins by having the condemning agency engage an appraiser to value the property to be taken. Depending on the jurisdiction, the parties would then engage in discussions in an attempt to settle at agreeable terms before any litigation costs would be incurred. Once the power of eminent domain is invoked by commencing the condemnation process, the litigation would likely be venued in a state court where the real property lies, but valid arguments may be made that could complicate the venue of the matter in several ways, including the following:

- If the condemned mortgage is federally owned or insured, should the matter be brought in the federal courts because of the federal government's interest?
- While most condemnation cases are litigated in the counties where the real property in question is located, since the "property" condemned is not the real estate, but rather the lien interest in the real estate, might a court need to determine if the venue should instead be in the locale where the loan was issued or is held?
- If the underwater loan in question was initiated or later assigned or sold to an investor along with a pool of other loans, should the taking of the loans be consolidated into one case in order to avoid piecemeal litigation?
- If the underwater loan(s) in question contain a clause that designates a choice of laws or venues for disputes, or some form of alternate dispute resolution such as arbitration, could those clauses be used by either party to attempt to litigate in non-traditional forums, and how could the power of eminent domain possibly be used in one state to take property in other states?

These and other procedural questions abound in what would represent unchartered waters for eminent domain litigation.

VALUATION

Perhaps more troubling than the concerns over the constitutionality of the plan and the possible procedural nightmares its implementation may create is the apparent assumption that the taking of an underwater mortgage will be inexpensive, merely because the value of the property to which the mortgage has been secured has dropped, and that "value" of the mortgage will therefore be reduced by the decline in value of the house. This is not necessarily so.

If the mortgage is performing (as many underwater mortgages apparently are), its "value" should be determined not by the value of the security interest—the realty—but rather by the potential income stream capitalized at an appropriate rate, one that may well be substantially lower than the original mortgage rate (because of lower current interest rates)—and the mortgage may therefore be worth *more, not less*, than its face value. (This is the same principle that explains why bonds increase in value when interest rates go down.)

Fair market value has ordinarily been determined as the price a willing and able buyer would pay to a willing seller. In this setting, the "property" owner, the holder of the mortgage, would likely argue that the mortgage should be valued based on the existing obligation of the mortgagor to pay the agreed upon principal and interest. The condemning agency would likely argue a value based on the current reduced value of the land secured by the mortgage. As was discussed above, a third option for valuation is to value the mortgage as being the balance remaining (pay-off balance) as of the date of taking. Of the three scenarios, the condemning agency loses two out of the three, as discussed next.

In the first scenario, a condemning agency must pay the value based on the principal plus the projected interest income. As an example, a property is currently appraised at $70,000, but was purchased at $125,000 before the real estate market collapsed. The mortgage has a principal balance of $100,000, plus the mortgage company is collecting interest at a fixed rate that will provide $25,000 of revenue over the remaining life of the loan. If the mortgagee decided to sell the mortgage, it would obviously seek to collect some portion of the future revenue as its profit on the sale. That future revenue has a value that was determined for these types of transactions regularly before the market collapse. A condemning agency might argue that a performing mortgage must be valued as if it was *not* performing, merely because the property securing the mortgage is currently worth less than the mortgage. However, in this scenario, the condemning agency may lose, because it would be on the hook for a value greater than the value of the property securing the mortgage, and could not reduce the value of the mortgage without taking a financial loss on the transaction.

Under the second scenario, let us assume that the condemning agency is able to successfully argue that the mortgage's value is equal to the value of the real estate. It would then acquire the mortgage from the mortgagee for the determined value ($70,000 using the scenario above), and attempt to substitute a mortgage loan with a principal amount less or equal to the real estate's current market value, (e.g., 80 percent of $70,000). The catch here is that the new substituted mortgage rate is likely to be higher, because legal costs and transactional fees would all need to be recouped as part of the process. However, the mortgagor could still benefit by a reduced mortgage if the costs and fees are kept in check.

The third scenario could also present a losing proposition for the condemning agency because the mortgagee would need to be paid the principal balance still due on the mortgage. It is possible that the property owner could still benefit if the interest rate is high enough to permit a reduction in the portion of the mortgage payment attributed to the collection of interest, but the principal balance would remain the same unless the condemning agency was willing to operate at a loss. No proponent of the MRP plan has ever explained how a homeowner will be substantially helped if relieved of the burden of the mortgage, but still liable on the underlying debt as evidenced by the mortgage note, to which the original lender would presumably still have a monetary claim for any deficiency owed thereunder. Or does the plan envision taking the debt instrument as well? If that is the case, how does one measure the worth of that obligation? Is the debt of borrower Smith worth more than that of borrower Jones because Smith has a better job, better credit or more "skin in the game?"

Finally, the MRP plan's proponents totally understate the uncertainty and consequent chaos that the plan might introduce into the home finance industry. Which lenders and investors will become the condemnees, having their mortgage properties taken? Which will be the financiers? Will implementation of the plan actually tighten the credit market, making homes less affordable? And what will happen if it really does cost more than the proponents suggest, when the financiers realize that they may not be able to buy these mortgage interests at rock-bottom prices? If the plan is implemented, and the owners of the original loans are not made whole, they will sustain a series of losses from the write-offs which will cause them, and their investors, to likely litigate those issues and cause even further uncertainly and turmoil in the credit and housing markets. Mortgages are backed by bonds and their investors include the retirement savings of many middle-income Americans, and changes to those investment portfolios are likely to have far-reaching implications. So far, the answers to these or any related questions have been notably absent.

CONCLUSION

While few local governments have embraced the MRP plan so far, the concept of using eminent domain to take underwater mortgages is far from dead. Local government and community leaders have legitimate concerns about their constituents, many of whom are struggling with mortgage payments on inflated loans that have made their homes unaffordable, and nearly impossible for them to sell without sufficient equity to pay off the loans. However, the use of government's awesome power of eminent domain, at least at the present time, appears wrought with complications and does not appear likely to lead to any significant chance of furthering its stated "public" purpose—economic development. Instead, lengthy and expensive legal battles are all but certain to follow, as will disruptions to and changes in the credit industry, which may cause decreased access to capital for borrowers and to higher interest rates. With these legal uncertainties and potential economic ramifications, actions or options other than using eminent domain need to be considered.

Perhaps the Mayor of Elk Grove, California, Gary Davis, was on the money when he recently explained why the use of eminent domain to acquire underwater mortgages was rejected in his community: ■

> *It just seemed that the risks outweighed the benefits. You're taking a tool … designed for public works projects and using heavy-handed measures to weigh in on the free market.*[14]

Whether other government officials end up agreeing with Mayor Davis remains to be seen.

ENDNOTES

1. *http://www.sifma.org/news/news.aspx?id=8589940215.*
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3. *http://www.whitehouse.gov/refi.*
4. Swanson, Jann, "Congress Gets Bill Prohibiting Eminent Domain Mortgage Seizures," *Mortgage News Daily,* Sept. 13, 2012, *http://www.mortgagenewsdaily.com/09132012_eminent_domain_loan_mods.asp.*

5. *Kelo v. City of New London, 545 U.S. 469 (2005).*

6. *Berman v. Parker, 348 U.S. 26 (1954).*

7. *Louisville Joint Stock Land Bank v. Radford, 295 U.S. 555 (1935).*

8. *Frazier-Lemke Amendment, § 75(s) of the Bankruptcy Act, 48 U.S.C. 1289.*

9. *Harrison Redev. Agency v. DeRose, 398 N.J. Super. 361, 409-11 (App. Div. 2008).*

10. *Town of Kearny v. Discount City of Old Bridge, Inc., 205 N.J. 386, 405 (2011).*

11. *New Jersey Statutes Annotated 40A:12A-3.*

12. *New Jersey Statutes Annotated. 20:3-2(d).*

13. *It is a principle of equity that if a mortgage exists upon condemned premises, and it is necessary to the security of the mortgagee, the mortgagee is entitled to receive the condemnation money, to be applied to the mortgage debt, and is invested with appropriate remedies to enforce the right. Mary Lee C. & R. Co. v. Winn, 97 Ala. 495 (Ala. 1892).*

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FEATURE

Golf Courses and Tax Assessments: Just One Right Way?

BY LAURENCE A. HIRSH, CRE

INTRODUCTION

There is no "one size fits all" approach to appraising golf course properties for ad valorem tax assessments. While this is acknowledged, there is concern about methodologies being employed that do not reflect the actions of market participants. The real problem inherent in the valuation of golf course properties for tax assessment cases is that there is a lack of consistency between jurisdictions in golf property valuation methodology. The purpose of this article is to provide guidance to attorneys, judges, assessors, appraisers and other interested parties on current practices in golf property valuation, and how best to achieve fair assessments based on methodology consistent with buyer and seller behavior for the particular property being considered.

As clearly illustrated in "Segmentation of Golf Course Markets" by Stephen F. Fanning,[1] there are several distinct types of golf course properties, with the primary areas being private, public daily fee and resort. Each requires consideration of different data sets to understand and value accurately, though in some states, courts have dictated that all courses (even private clubs) be considered as daily fee, regardless of whether the property in question is a private, membership club with entirely different economics and operations, and may even be part of a gated, private community that is not open to the public. Taking such an approach not only distorts the actual property characteristics, but further ignores the fact that private clubs can be and are operated for profit, despite the sometimes present myth that they cannot.

About the Author

Laurence A. Hirsh, CRE, MAI, SGA, FRICS, *is the president of Golf Property Analysts, a golf and club property consulting, appraisal and brokerage firm based in Philadelphia. Hirsh has performed consulting and appraisal assignments on more than 2,500 golf and club properties in 45 U.S. states, Canada and the Caribbean, and has previously written two articles on golf and club property valuation in* The Appraisal Journal, *co-authored The Urban Land Institute's* Golf Course Development In Residential Communities, *and authored articles for a variety of industry publications. Hirsh also has lectured at seminars, meetings and universities, and is on the education faculty for the PGA of America. A founder and first president of the Society of Golf Appraisers, he has developed a golf course and brokered more than $100 million in golf course and club properties. Hirsh is a graduate of The Pennsylvania State University.*

Following are some facts about golf properties:

- Private clubs, though often operated as *not-for-profit* are also very frequently acquired by investors and operated for investment income and growth;
- Private clubs and daily fee courses have very different operating profiles and require considerably different management techniques;

- The value of golf course properties is almost exclusively driven by their income-generating potential;
- Golf course properties are typically bought and sold as going concerns and for ad valorem tax purposes; an allocation between real and personal property is required.

When considering a valuation assignment for a golf course property, like any other appraisal assignment, it is necessary to consider the three traditional approaches to value.

INCOME APPROACH

Without question, the income approach is the method preferred by market participants. The income approach reflects the fact that golf courses are going concerns and that they are typically purchased for income investment. However, in tax assessment cases in many jurisdictions, valuations of golf courses are often forced into one type of operating scenario rather than acknowledging that there are several different types of operations, some of which are so dramatically different the only thing in common is that they are golf course facilities. As clearly noted in Fanning, there are multiple (as many as 12) types of golf courses and even five types of private clubs, each serving a different market segment and each targeting different clientele, often from different geographies.

For instance, many private golf and country clubs are member-owned and operated as not-for-profits. As such, it is not uncommon to hear the comment from clubs that "it can't have much value because it doesn't make any money." Conversely, taxing authorities claim that the only way to value such a "special purpose property" is by use of the cost approach. Neither of these arguments is correct.

In addition to the many not-for-profit clubs, there are also many private clubs operated for-profit by companies and individuals in business specifically for the purpose of owning and managing private clubs for investment and income. Many not-for-profit clubs have been sold to these operators in recent years as member/owners have demonstrated limited ability to keep their clubs afloat financially. While some have become semi-private, or even daily fee facilities, many have simply become for-profit, private clubs that are now profitable or are on their way to becoming profitable through professional management. Since most member-owned private clubs have an economic value to for-profit buyers, and there is clear evidence of a market for these properties, it is logical to value these clubs based on their for-profit potential and assume the property is operated accordingly. The likely buyers are for-profit buyers and unless the club's highest and best use is for an alternative development, using the private, for-profit value model is the best way to develop an accurate and reliable value estimate. This assumes, of course, that the club has profit potential. If it does not and there is no economically feasible use, the appraisal problem becomes more complex, which is discussed later.

Laymen seem more comfortable with the idea of daily fee courses (as opposed to private clubs) being valued by the income approach. Since most daily fee courses are operated for profit, that *seems* easier to understand. This can be misleading since some golf facilities are ill-suited for conversion (in the valuation exercise) from one type to the other. "Shoe horning" a private club into a daily fee valuation model ignores the fact that private clubs have economic value and their own unique marketplace. The models for a private club are as different as are the facilities, and the appraiser should take care to and be able to synchronize the valuation exercise to the specific type of property and the characteristics of that club. In those jurisdictions where this practice is preferred, it is recommended to value as BOTH a private club and a daily fee facility in order to illustrate the differences and the difficulty in being accurate while trying to "fit a square peg into a round hole."

Depending on market dynamics, course characteristics, and the size and quality of infrastructure and buildings, a golf property may be more suited to either private or daily fee use, making use as the other unlikely, or at the very least challenging and costly to adapt. And, there is the potential issue of memberships, the rights of members and refund obligations with private clubs that can result in a variety of legal issues, and may or may not contribute to the value of the real property depending on the type of membership contract and in which theory one believes.[2, 3] Many clubs have the element of membership deposit or initiation fee refunds as a liability; in many cases, the potential liabilities are complex enough to discourage buyers from even considering the purchase of clubs with those obligations on their balance sheet.

The income approach requires a deft understanding of the subject property, its relevant market characteristics and the ability to develop a value model consistent with the property and market. This can be accomplished through taking the time to fully comprehend the club's business model, its competitive environment, and the strengths and weaknesses of the specific club.

SALES COMPARISON APPROACH

The sales comparison approach is often applied by inexperienced golf course appraisers utilizing a unit of comparison of sale price per hole (dollars/hole). The problem is that the vast majority of golf courses are 18 holes, and the rest are some multiple of nine holes. Using this approach, the other elements of a golf course or club, such as the clubhouse, other sports amenities, infrastructure and economic characteristics, are ignored. There is no *common denominator.* Since almost all courses are purchased for economic reasons, even in the sales comparison approach, an economic unit of comparison such as a market extracted overall capitalization rate is appropriate. In the current environment, with many courses having limited or no cash flow, many buyers rely on gross revenue multiples (GRM) and typically have either a particular investment requirement, a minimum level of gross revenues, or both. It is critical to understand that GRMs vary with the level of profit (or loss) experienced, and can be misleading on non-stabilized properties.

In today's market, many sales are distressed, or at the very least not *stabilized,*[4] and often to varying degrees. This makes analysis difficult and executing a classic sales adjustment grid virtually meaningless. If one has a sampling of stabilized sales considered adequate, the sales comparison approach is quite useful. Typically, it is the approach used to test the reasonableness of the income approach, and the sales comparison approach is done more subjectively than objectively.

Many jurisdictions rely exclusively on the sales comparison approach despite its inherent weaknesses, yet often ignore its strong point, which is based on comparing the sales of different income streams.

Most experienced and qualified golf course appraisal specialists advocate developing the sales comparison approach, even if the market data is fragmented and doesn't show strong trends. At the very least, it illustrates what is occurring in the marketplace and can often be used as a check on the income approach.

COST APPROACH

Some say the cost approach is a test of feasibility. Others say the cost approach provides an estimate of land value. Still others claim that the cost approach is the only appropriate method of valuation for "special purpose" properties such as golf courses. The short response to the last of these claims is "Nonsense."

Without question, assessors are at a considerable disadvantage because of the sheer number of properties they have to assess and the limited amount of information they are provided. The simple fact remains that if the golf course or club is the highest and best use, the land value is not of particular importance in most cases. Feasibility is not usually an issue once the course is developed, and golf courses are not so "special purpose" that the other approaches cannot be developed. Most important, market participants completely disregard the cost approach. There is often considerable economic and functional obsolescence, which is very difficult to accurately measure; costs are difficult to estimate accurately and are not relevant to the value of an existing course.

In assessment cases, the cost approach is often used by taxing authorities because:

- it can be completed with limited market data;
- assessors have computer models set up to do the cost approach; and
- it typically yields the highest resulting value.

A big challenge in the cost approach today is that few golf courses are being built, so cost comps are more difficult to find. If accurate costs can be estimated, depreciation can be estimated by the market extraction method, and this approach can be done with some degree of reliability, however reliant on the accuracy of the other approaches it might be.

HIGHEST AND BEST USE

What if the club has limited or no profit potential and alternative uses are limited or not economically feasible? As a club, the value may be *intrinsic* to the membership but have limited *value in exchange.* If there is no development potential, the club ceases to operate and there is no economic use for the property, the appraisal problem becomes more challenging. Because the value of "open space" can be a real challenge, the cost approach is often employed by assessors but really doesn't provide a market-based indication of value. Sometimes, there are sales of conservation parcels that could be analyzed, but the question as to the economic value remains unanswered. This is a challenging appraisal problem that could be the topic of another article. One thing is for sure: the procedures relating to the broader issue of highest and best use vary from state to state, and care must be employed to ensure that the appraiser understands those issues and how they are impacted by the Uniform Standards of Professional Appraisal Practice and by local jurisdictions.

ALLOCATION

The issue of allocation of real and personal property value is one that has been debated by appraisers for a long time. For golf course properties, several methodologies exist, but there are no conclusive methods that adequately answer all the questions. The text *Analysis and Valuation of Golf Courses and Country Clubs* [5] offers allocation methodology ranging from the "excess profits" technique to the "management fee" technique, and others. Another technique that has been used recently is the "market rent" method, which converts golf course revenue sources into a rental rate for real estate only, which is then capitalized into a value conclusion. There is also the recent (2011) Appraisal Institute course on allocation that promotes a technique utilizing balance sheet assets and the following equation:

$$TAB = RE + PP + BEV$$

TAB: Market value of Total Assets of the Business (i.e., market value of the going concern);

RE: Real Estate assets to include land, buildings and other improvements;

PP: Personal Property to include furniture, fixtures and equipment;

BEV: Business Enterprise Value to include all intangible assets owned by the business.

Each of these methods, however, has flaws. The excess profits and management fee techniques focus on the business value, but fall short on equipment. The market rent method, which is required in New York State by case law, suggests that even private clubs be considered as daily fee courses, and rental estimates are often derived from revenues for items not directly related to real property. The best way to estimate market rent is from comps, and the author's extensive research of golf course rental comps over the years shows that they are not as common as one would like and that those that exist often lack tight enough trends to conclusively support the rental estimates. The method derived from the Appraisal Institute course using the equation (***TAB = RE + PP + BEV***), though logical, utilizes balance sheet values rather than real-world market values of the personal property assets.

ALTERNATIVE USE

Conventional thinking by laymen is that golf course properties are worth more if put to another use. Many times that is the case. However, alternative uses often are not available or feasible, creating a more complex issue. Recently, golf courses have closed at a more rapid rate than new ones have been developed and opened. During the past two years, approximately 300 golf courses have closed and between 30 and 35 have opened for play in the United States, according to the National Golf Foundation. Considering that most states require assessment valuations to be based on the highest and best use, it is critical to consider the potential alternative uses for golf courses and whether or not they represent a "higher and better" use.

In many instances, and especially those where golf courses are an amenity to a residential development, alternative uses are limited either by zoning or restrictive covenants. Most of these will result in the golf course being the highest and best use. Where the golf course is not economically feasible, the use is usually restricted to open space or recreation and the economic value is often limited. In some states, such as New York, case law [6] dictates that value must be developed based on the property's current use, which effectively eliminates the highest and best use question, even when the highest and best use is for alternative development.

Even in those (most) states where property is to be valued based on highest and best use, during recent years, development slowed because of market and economic factors. The result is that some golf course properties with development potential still have a highest and best use for golf, at least for a period of time. As real estate markets improve, this could change or could be anticipated to change, resulting in the possibility of golf representing an *interim*[7] use.

Not only do decisions vary from one jurisdiction to another but, in Ohio, for example, several cases were found that contradict each other. In one, all three approaches to value were rejected. Some states disallow the income or sales comparison approaches, or both. Some states require the property be valued based on continued present use, and others based on highest and best use. Still other states require certain, specific methodology be used in order to satisfy the apparent direction of recent decisions. In New Jersey, the recent decision in one case (Bear Brook[8]) rejects the income approach as follows:

> *The income approach is seldom appropriate in appraising a private nonprofit club or a municipal course* <u>*Id. at 107;*</u> *this court finds no distinction with semi-private courses such as Bear Brook.*

The Bear Brook Club was, in fact a *for-profit,* semi-private club, and yet the judge found no difference between it and either a private not-for-profit club or a municipal course. Further, the court stated:

> *While it is clear to the court that the Cost Approach is the most appropriate valuation method for Bear Brook, Fredon's Cost Approach must nevertheless be rejected for the deficiencies delineated hereinabove.*

The appraisal deficiencies noted by the court related to comparable land sales that were judged to be inadequate and post-dated the valuation date. Of particular interest is that several golf course owners recently were awaiting a pending decision in New Jersey Tax Court that might have answered the question of whether the cost approach is judged to be the only acceptable way to value golf courses for assessment in that state, or if appraisers are encouraged to employ more market-based methods within the income and sales comparison approaches. After two years of waiting for a decision, the sides settled, mainly because of the onerous financial burden of continuing to pay the (excessive) taxes on the property. So the question—at least in New Jersey—is still unsettled.

SOLUTION

It is difficult to imagine that every judge, lawyer and assessor would have ample time to educate themselves on the unique issues of golf property valuation. However, when in litigation, a solution is to focus on the applicable theory both in the appraisal report and in the oral arguments before the judge. It is incumbent on the appraiser to be able to explain and justify his/her valuation theory and for counsel to present a concise and understandable case for proper valuation theory. As a state's rights issue on taxation, judges in each state vary on their decisions in tax court, so consistency nationwide on methodology is unlikely. However, working toward stipulations on methodology from both sides, or seeking guidance from the judge after presenting these issues relative to the specific property, can help clarify and lead to improved and consistent methodology.

As part of the solution to this problem, it is advisable to consider the definition of market value. As offered by *The Online Dictionary of Real Estate Appraisal,* [9] the most widely used definition is: "The most probable price that the specified property interest should sell for in a competitive market after a reasonable exposure time, as of a specified date, in cash, or in terms equivalent to cash, under all conditions requisite to a fair sale, with the buyer and seller each acting prudently, knowledgeably, for self-interest, and assuming that neither is under duress." Inherent in this definition is that any appraisal assumes a sale. While many states have different variations on the definition of market value, most are similar and (at least) imply that same assumption. Few, if any sales are based on a cost approach analysis. As such, it is incumbent on appraisers, assessors, attorneys and jurists to also consider value as if a sale were going to occur and analyze the property as market principals would.

There is no one "right way" to appraise all golf course properties. As stated earlier, there are at least 11 or 12 different *types* of golf courses and each operates with different revenue and expense profiles and trades with different motivations and economics. We can conclude that in almost all cases, exclusive use of the cost approach is rarely consistent with market behavior and that most golf course properties trade based on either their operating history or operating potential to generate cash flow. It's the appraiser's job to know and understand not only the applicable valuation methodologies, but also the jurisdictional specifics that sometimes complicate the valuation exercise. ■

ENDNOTES

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2. Benson, M.E., "Challenges in Appraisal of Private Clubs," *The Appraisal Journal,* October 1, 1998.
3. Hirsh, Laurence A., "Private Golf Club Memberships – Real or Personal Property," *Journal of Property Tax Assessment and Administration,* Vol. 4, Issue 3, 2009.
4. Income at that point in time when abnormalities in supply and demand or any additional transitory conditions cease to exist and the existing conditions are those expected to continue over the economic life of the property; projected income that is subject to change, but has been adjusted to reflect an equivalent, stable annual income.
5. Gimmy, Arthur and Buddie Johnson, *Analysis and Valuation of Golf Courses and Country Clubs,* The Appraisal Institute, 2003.
6. *New Country Club of Garden City v. Board of Assessors,* Supreme Court, Nassau County, Index No. 12696/88, June 4, 1991.
7. Interim use is the temporary use to which a site or improved property is put until it is ready to be put to its future highest and best use.
8. *Gale & Kitson Fredon Golf, LLC v. Township of Fredon,* 007359-2008; 004341, 2009, Tax Court of New Jersey, December 22, 2011.
9. *The Online Dictionary of Real Estate Appraisal,* 5th Edition, The Appraisal Institute, 2010.

Global Real Estate Investment and Risk:

An Interview with David J. Lynn, Ph.D., CRE

Interviewer:

Mary C. Bujold, **CRE**
Editor in Chief, Real Estate Issues®
President, Maxfield Research, Inc.
Minneapolis, Minnesota

Interviewee:

David J. Lynn, Ph.D., CRE
Executive Vice President, Chief Investment Strategist
Cole Real Estate Investments
Phoenix, Arizona

INTRODUCTION

One of the subjects on The Counselors of Real Estate's "Top Ten Issues Affecting Real Estate 2013" list is global real estate investing and risk. Foreign investors have been investing in real estate in the U.S. for many years, although recently, there seems to have been an increase in their activity. Investing in foreign markets has its rewards, but it also tends to come with a higher risk profile than investing in U. S. commercial markets. While foreign investors continue to invest in their own domestic markets, they may also seek to diversify their portfolios and spread risk by investing in other countries that could offer opportunities. The U.S. is one of those markets. **David J. Lynn, Ph.D., CRE,** chief investment strategist with Cole Real Estate Investments, and author of the book *Emerging Market Real Estate Investment: Investing in China, India and Brazil,* spoke with *Real Estate Issues*' Editor in Chief **Mary C. Bujold, CRE**, about global real estate investment and its risks.

BUJOLD: ***How would you characterize current commercial real estate markets in the U.S.?***

LYNN: The U.S. is one of the most attractive real estate markets globally. The economy is improving

About the Interviewer

Mary C. Bujold, CRE, *president, Maxfield Research Inc., Minneapolis, Minnesota, and Real Estate Issues® editor in chief, 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.*

About the Interviewee

David J. Lynn, Ph.D., CRE, *is executive vice president, chief investment strategist and a head of portfolio management at Cole Real Estate Investments, Phoenix. In this role, he is responsible for leading Cole's real estate investment strategy, and serving as the firm's economist. Lynn also serves as executive vice president and chief investment strategist of Cole Capital Advisors, Cole Capital Partners, CCPT I Advisors, CCPT II Advisors, CCPT III Advisors, CCI Advisors, and CCPT IV Advisors. Lynn previously was a partner and managing director at Clarion Partners, a commercial real estate investment firm. Prior to joining Clarion Partners, he was managing director, global head of strategy and portfolio manager with AIG Global Real Estate; senior director, investment and development with Avalonbay, Inc., a REIT; and vice president of GE Capital Real Estate/Bidcom.com JV, a real estate technology firm. Lynn earned doctoral and master's of science degrees from the London School of Economics, with a specialization in financial economics; a master's degree in business administration from the MIT Sloan School of Business; a master of arts degree in City and Regional Planning and Real Estate from Cornell University; and a bachelor of arts degree from the University of California at Berkeley.*

gradually, overall debt is decreasing, and households and corporations decreased debt during the recession. Improved real estate fundamentals, a low cost of debt, very low levels of new supply and positive returns during the past three years have all led to a strong domestic commercial real estate market in most sectors. Emerging markets notwithstanding, investors view the U.S. real estate market as one of the best in the world.

BUJOLD: ***Can you elaborate on that?***

LYNN: Since the economic slowdown, households and corporations have reduced their debt. Corporations significantly reduced payrolls and other business costs, and increased their use of technology in order to achieve higher levels of productivity. This resulted in corporations stockpiling cash—approximately two trillion dollars on the books—whereby their recovery phase was shortened, spurring production. Right now, manufacturing is making a comeback for the first time in many years, exports are up, agriculture is strong, energy development is very robust, medical is solid, as is education, although we still have an issue with student debt and some resistant unemployment. Higher unemployment rates are likely to stay with us for a while as we transition to the digital age where technology continues to play a larger role in worker productivity and production. We are feeling our way through this transition, but it is difficult to predict at this point how we will bring our workforce to a level where it has the skills necessary to implement new technologies. We are not doing enough to steer young people into the science, technology, engineering and mathematics disciplines to support our long-term business growth so that the U.S. can increase its competitiveness globally. Mexico currently graduates more engineers than does the U.S. We have acknowledged that there is a shortage in the U.S. of highly trained technical people, and companies are already lobbying to try to bring those workers into the U.S. The gap between skilled and unskilled labor is expected to widen before it gets better, and that is likely to have some long-term implications on the economy and real estate markets. Employment needs are shifting in the U.S. and elsewhere. In the book, *Race Against the Machine,* Erik Brynjolfsson and Andrew McAfee from MIT present a strong case for how the digital revolution is accelerating innovation, driving productivity and transforming employment and our economy. The U.S. business markets are relatively solid and gaining momentum. This spills over into real estate, potentially making our market even more attractive to foreign investors. In addition, the significant write-downs that occurred in the real estate market in the early part of the recession resulted in a much lower basis whereby when the market turned around, the ramp-up was more extreme, significantly improving fundamentals, which made real estate more attractive to investors over other types of investments.

Long term, as technology becomes more integrated into our economy, there may be some challenges as to how many workers we need, what types of positions are available, the education required for those positions and how that impacts office development in the future. Already there is discussion of declining space needs for office users moving forward.

BUJOLD: ***Which markets are seeing the highest levels of investment and why?***

LYNN: Of course, the global gateway markets have experienced the greatest inflows of capital (both domestic and foreign) over the past several years. This is primarily because these markets are considered to be "safer"—more liquid and with larger, more diversified economies underlying the real estate. Core markets are also easier to access and are more attractive to a wider array of buyers, including institutions. Risk aversion is typically greatest during a recession, making core gateway markets even more popular. As the recovery matures, investment capital, seeking higher returns, could migrate to secondary and tertiary markets. This is happening now to some degree. This trend is bolstered by the fact that many non-coastal states are seeing strong economic growth.

BUJOLD: ***Are investment-grade inventories in these major markets limited and are investors, in general, bidding up the price of commercial real estate?***

LYNN: Yes, there is, in general, a finite supply of high-quality properties in the global gateway markets, particularly Class A properties. These markets are generally more supply-constrained and are difficult to supply, accentuating the relative shortage and causing cap rates to fall, in some cases, below their 2007 lows. This has also been helped by a very low cost of capital.

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BUJOLD: ***What market conditions are prompting foreign investors to look to the U.S. for real estate?***

LYNN: There are a few very different reasons. First, the total and income returns for U.S. real estate have been very attractive. Second, prospects for future growth in many mature industrialized markets (Europe and Japan) are dismal. Capital is also coming into the U.S. from the Middle Eastern energy countries that have benefitted enormously from higher prices over the past five years, as well as high-growth emerging market countries that have amassed wealth (and real estate holdings) to the point where diversification makes sense. Many emerging market investors are also attracted to the transparency, liquidity and the rule of law found in the U.S.

In the U.S., we tend to take a lot of things for granted regarding our real estate markets that are not present in most other countries in the world such as strong private property rights and rules, enforceable contracts, a much higher level of transparency, and a very large and diverse economy. Also, we have a very stable government. Investors in other parts of the world may want to diversify into the U.S. not only for wealth building, but also as a protection for their own personal safety or that of their family in countries that are not as open and free as the U.S.

BUJOLD: ***In your opinion, do you believe that foreign investors are more likely to consider investment in U.S. markets than other population markets globally? If so, why? And which other foreign markets would tend to compete effectively again the U.S***?

LYNN: It is not an either/or proposition—foreign investors will continue to invest in their own countries, the U.S. and other foreign countries, both in mature and in emerging markets. Cross-border investment is becoming easier each year and is prudent from a portfolio diversification standpoint, as well as returns. Moreover, in certain countries such as China, India and Brazil, there is fear that the boom might turn into a bubble, and so investors are inclined to take some chips off the table and put money into more stable, liquid and mature markets such as the U.S.

BUJOLD: ***What types of fundamentals does the U.S. real estate market typically have that may not be present in other foreign markets?***

LYNN: We have a strong multifamily market that is virtually unknown outside of the U.S. Industrial is another sector which is not usually investable in many countries. The U.S. also has fairly developed niche markets in storage, student housing, seniors housing, digital storage and others, enabling more choice and diversification. In almost every case, the main and niche sectors in the U.S. are much larger and deeper than in most other countries.

BUJOLD: ***Are U.S. investors increasingly looking at opportunities overseas because they cannot get suitable returns here in the U.S., or is that not the case?***

LYNN: I believe that, if anything, there has been slightly less interest on the part of domestic investors to consider foreign markets because U.S. real estate returns and fundamentals have been so good. Also, emerging markets have been more volatile and have experienced some slowdown in recent years, so they are not quite as attractive as they appeared to be earlier. Also, during periods of economic difficulty, capital tends to be more conservative and investors are less eager to venture out on the risk curve. Some markets are highly opportunistic such as Brazil and India, but the risks are very high.

The U.S. has a very strong income-producing real estate sector which is very attractive to foreign investors and is generally limited in many other countries.

BUJOLD: ***In what ways do foreign investors approach buying real estate in the U.S. that would be different than U.S. investors?***

LYNN: They tend to use consultants and local partners to a greater degree. As mentioned earlier, they tend to stick to larger coastal markets and they usually, though not always, prefer larger, Class A assets. Examples of these coastal markets are Boston, Washington, D.C., Miami, Houston, Los Angeles, San Francisco, New York and Seattle.

Global Real Estate Investment and Risk:
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BUJOLD: ***Are foreign investors in China, Brazil and India investing just as heavily in their own markets as they might be in the U.S?***

LYNN: Yes, they certainly are. There have been great opportunities in these countries—high growth and strong returns, but they have been primarily in the form of opportunistic investment. As investors grow their portfolios, they want to diversify to different segments (core and income become more important) and not simply put all of their eggs in one basket, even if it has been a high-growth basket. There is also more concern among foreign investors' domestic markets of a greater potential for boom and bust. One way to hedge against that is to invest into a more stable and diverse real estate market such as the U.S.

BUJOLD: ***In the area of global risk, can you provide a risk ranking of the top five real estate markets in the world as related to their current level of risk in investing in commercial real estate?***

LYNN: Least risky markets:

1) U.S.
2) UK
3) Canada
4) Australia
5) Singapore

BUJOLD: ***How much do currency fluctuations or currency hedging play a role in commercial real estate investments here in the U.S. and abroad?***

LYNN: Currency fluctuations can affect returns dramatically and both positively and negatively. This has discouraged investment in places such as Argentina where rapid and dramatic currency devaluations happen regularly. Some countries in the past have tried to inflate their way out of their debt. Now, it is not that easy to do anymore. Carmen Reinhardt and Kenneth Rogoff, authors of *This Time is Different,* have written an excellent treatise on financial crises in history and how countries have produced financial crises that have devastated their economies.

One reason why emerging market countries have been investing in the U.S. is that their currencies, in general, have been appreciating against the U.S. dollar over the long-term. This has been true of the RMB (China), the Real (Brazil) and the Rupee (India), again, over the long term. Hedging is very expensive in real estate investment, and for that reason, is rarely done. The best way to hedge against currency fluctuations may be to receive rental and capital income in the form of dollars—if a U.S. investor.

Geopolitical stability is also more of a factor now with the rise in global investing. We are much more connected globally than ever before. There is a spillover and an interlinkage of events that can affect returns. Consider political disruptions in Egypt and Syria and how these affect the Suez Canal.

Also, the U.S. has one of the highest corporate tax rates in the world. This issue is likely to continue to be controversial as more companies take advantage of global opportunities. ■

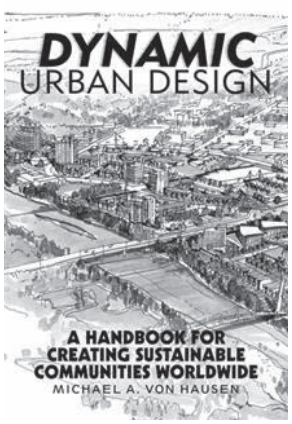
David Lynn, Ph.D., CRE, *serves as executive vice president and chief investment strategist at Cole Real Estate Investments, Inc. The views and opinions expressed in this commentary are those of the contributor as of the date of publication and are subject to change, and do not necessarily reflect the views of Cole Real Estate Investments and/or its affiliates.*

RECOMMENDED READING

Dynamic Urban Design: A Handbook for Creating Sustainable Communities Worldwide

by Michael A. Von Hausen, (© 2013, iUniverse, 505 pages)

REVIEWED BY JOE W. PARKER, CRE



It is all in the title: *Dynamic Urban Design*. Author Michael A. Von Hausen defines urban design as "the art and science of making places for people." So what makes urban design dynamic? The author believes that it is taking urban design to a more comprehensive level, essentially uniting urban design and sustainability "in a practical, measured way" and doing it on a global basis.

Von Hausen begins by presenting his case for more sustainable urban design, citing for support problems such as poor air quality in many of the world's largest cities, an increasing world population, increases in parking areas and roads at the expense of decreased agricultural acreage, debilitating traffic congestion, loss of tree cover and green areas, elevating health problems and increased use of personal automobiles. His proclaimed mission is *"to bring sustainable urban form to people around the world."*

The author believes that urban planners worldwide, empowered by significant government policy changes, are influencing ongoing shifts to more sustainable new communities. The result, he says, will be less waste, more jobs closer to home, more efficient buildings, and a better quality of life. He believes that a paradigm shift in sociopolitical forces, economic accountability and environmental responsibility are taking place now, and they are driving the new transformation in urban form and sustainable development worldwide. The shift, he says, is to include more compact, mixed-use communities with more energy-efficient buildings designed for that community.

About the Reviewer

Joe W. Parker, CRE, MAI, FRICS *is president of Appraisal Research Company and senior vice president of Equity Solutions USA. He first entered the real estate profession in 1974 and established Appraisal Research Company in 1978. In 2003, he co-founded Equity Solutions USA, an appraisal management company that provides appraisal services to regional and national banks.*

Parker has appraised commercial real estate throughout the South and Lower Midwest with appraisal experience in environmentally-contaminated properties, fiber optic corridors, cemeteries, golf courses and country clubs, colleges and schools, hospitals, wetlands, conservation easements and historic properties. As well as regularly advising clients on a variety of real estate matters, Parker also oversees all appraiser credentialing and reviewing processes at Equity Solutions USA.

Parker also serves as an expert witness on such issues as construction defects, mortgage fraud, title defects, environmental contamination and stigma. He was trained as a Mediator at the University of Houston's Bauer College of Business and at Harvard Law School.

Von Hausen presents his Dynamic Urban Design Model early in the book. It is a three-part model, with each part having three sub-parts:

- Framework, consisting of Place, Process and Plans;
- Components, consisting of Social, Ecological and Economic; and
- Measurements, consisting of Elements, Principles and Targets.

He argues for the urban design process to include not only the designer, but also the architects, landscape architects, planners, engineers, developers and economists in the design process from start to finish. The result, he writes, would be a more sustainable design. Without that interaction, the design process fails to properly address social, cultural, economic and diversity issues.

The book has four component parts. Part 1 provides a history of urban design and the framework and elements of sustainable community development. Part 2 discusses the comprehensive plan-making processes; essentially it is an extensive checklist of tasks that urban designers typically go through in their design processes. In Part 3 the author discusses the process of urban design evaluation, pointing out the application of some of those elements in notable suburban development processes. Part 4 of the book characterizes the pitfalls of the implementation of urban design and details the conditions that are required to include sustainability in urban designs.

Von Hausen provides a history of the evolution of the urban design process, beginning with early cities like ancient Rome and Mexico City. He explains the design components and logic that made those cities great, and even argues that the sustainable footprint of each is superior to that of many modern cities because each was based on walking distances, thus negating at least some of the requirement for personal automobiles, an element he strives to minimize in his urban design plans.

Von Hausen defines the four conceptual models of urban design (Organic, Cosmic, Practical and Car-oriented) and then incorporates illustrations of each, weighing in on their strengths and weaknesses. Nice, France, The Chicago Plan, L'Enfant's plan of Washington, D.C., and Frank Lloyd Wright's conceptual Broadacre City are among the many he analyzes.

In a section on "The Neighborhood Unit," the author examines how the invention of the automobile was a dominant factor in the development of neighborhoods, and how it solved what at that time was becoming a significant waste problem since horses were the primary unit of transportation. For many years thereafter, development in the U.S. and across the globe was automobile-oriented. Urban sprawl took place; its by-products in many cases included deterioration of the inner-cities, often followed by urban renewal. The author includes extensive commentary on each, then discusses downtown revitalization and what he terms "pedestrianization." It is essentially a return to the inner city, but without the horses and, preferably, without the cars. He includes several successful examples, all of which are accompanied by commentary on how those individual revitalizations were completed and accepted. He also discusses small town renewal, Smart Growth, New Urbanism and Transit-Oriented Development, along with the author's "Lessons for the Future," which is essentially his list of do's and don'ts for urban designers.

One section of the book discusses the elements that comprise "successful places." It describes the importance of the people who will live there, the heritage of those people and the community, other important design factors, and his opinion on how to integrate all of them into the final design plan.

Included in the author's comprehensive plan-making processes is an extensive checklist of tasks that urban designers typically go through in their design processes. The difference in *dynamic* urban design is that social, ecological and economic considerations (the SEE considerations) are incorporated into a logical and practical strategy, which the author labels "The Process Tree." Best Practices are also discussed, with emphasis on their relationship to sustainable design.

In this section, the author discusses and analyzes how various process thinking and problem-solving approaches from different designers can result in resoundingly different design plans, even though each designer goes through the same processes. The author includes a number of diagrams and illustrations as examples, along with discussion and explanation pertaining to each individual design. Those visuals are excellent aids to enable the reader to better understand the dialogue, and to envision what the designer "sees."

Von Hausen also includes details of the specific methods and procedures he uses in his practice, along with a case study of a design plan for the redevelopment of Lower Twelfth Street in New Westminster, British Columbia. The case study essentially enables the reader to follow the author's line of thinking, step by step, throughout the process. For a reader who is not an urban designer, the case study is both informative and important to help the reader understand and "see" the various elements as the author saw them, and to follow the author's reasoning through every one of the design steps.

Von Hausen cites several examples of successful *dynamic* urban design: Curitiba, Brazil; Seaside near Pensacola, Florida; Beacon Hill in Boston; and Mount Pleasant in Vancouver, Canada. Each has its own "signature," those significant things by which it is known or defined and that collectively shape what the author calls its "place." He includes an abundance of examples of various projects in which he has been involved, talks about the problems each presented, summarizes his analysis and decision processes, and then provides the reader with illustrations of the end design that was adopted. Many of these are written in textbook-like language, although I do not envision that the book was written with the intent of being a text.

Von Hausen concludes with a challenge: are we willing and ready to link sustainable urban design theory with practice? If so, hard choices have to be made and tradeoffs will have to take place, and according to the author, if those choices are made properly, they will result in communities that "will stand the test of time in terms of social, economic and ecological integrity."

This should be a must-read for urban planners, if only to assess whether the author's points of view are relevant and credible. It would be an interesting read for those practitioners who are involved in development projects and processes: architects, landscape architects, planners, engineers, developers and economists. For real estate professionals who are either involved in or curious about sustainability and the urban design process, I would recommend at a minimum a thorough reading of chapters one through nine, and 17, a familiarization with the "Case Studies" that follow in the subsequent chapters, and keeping it handy for future reference. After all, "sustainability" is here to stay. ■

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

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