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

Panelists:

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Moderator:

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

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

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

About the Moderator

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

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

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

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

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

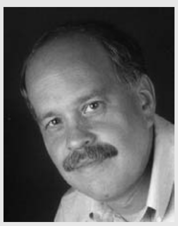
BURLEY: What I am hearing here is that there appears to be a shift back to "the basics" in terms of how we view property markets; that is, looking closely at employment as a demand driver, as Art says, and in terms of how we conduct our respective businesses, as Ken alludes. At the same time, we are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

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

PASQUARELLA: Being an owner of a large diversified property portfolio, the big issue for our firm over the past few years was maintaining adequate liquidity during a capital market freeze. Having weathered that storm together with the reemergence of the capital markets has now enabled us to return to focusing on building value through occupancy improvements, loan refinancing and timely property sales and loan refinancing. We have returned to the equity market ourselves with the raising of capital for our 11th discretionary investment fund.

GELBTUCH: I'm hearing mixed signals about the future of the economy and their impact on real estate valuation trends. On a positive note, municipalities are finally dealing with looming deficits, the stock market has doubled over the past two years, interest rates remain near historic lows, corporate profits are strong, and the jobless recovery seems like it will eventually segue into a job-generating expansion. On the other hand, oil is hovering above $100 per barrel and gas prices are rising as well, the Middle East is rife with political turmoil, state and local government jobs are rapidly declining, and several million unemployed persons have simply stopped looking for work. The litigation support aspect of our business has increased exponentially over the past few years. Lenders that have foreclosed on failed projects are going back and suing all of the parties involved, not just the developers but the appraisers as well. There is also the matter of dealing with Wall Street clients, which have taken an increasing interest in the underappreciated real

About the Panelists



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John J. Leary, CRE, MAI, FRICS, *2011 Board Chair of The Counselors of Real Estate®, is president of Leary Counseling and Valuation, Inc., New Haven, Conn. He specializes in real estate dispute resolution and litigation support; appraisal review services; major and complex property appraisals in the northeastern United States; and commercial real estate mass appraisal services. Leary also serves on the faculty of the Risk Management Association as a valuation subject expert for its "Real Estate Lending Seminar," which is presented to the Federal Reserve and bank examiners twice annually. Leary graduated from Boston College in 1970, and is trained in appraisal, arbitration and mediation. From 1989–1994, he was one of the five original members of the Appraisal Standards Board (ASB) of the Appraisal Foundation, serving as vice chair in 1989, and chair from 1990–1992. The ASB is responsible for the development and promulgation of the Uniform Standards of Professional Appraisal Practice (USPAP). Leary is co-author of* USPAP in plain English, *a guidebook to the 2006 Uniform Standards of Professional Appraisal Practice for real estate appraisers and clients, and* USPAP in plain English… 2008–2009.

Arthur P. Pasquarella, CRE, *is a principal of BPG Properties, Ltd., Philadelphia, serving as the firm's executive vice president and COO. In this capacity, he oversees all of the real estate investment decisions and property operations of BPG. Prior to joining BPG in 1987, Pasquarella was a vice president of the Investment Sales Division of Helmsley-Greenfield, Inc. for five years where he negotiated major real estate investment transactions throughout the eastern United States on behalf of institutional investors. He began his career at Strouse, Greenberg Financial Corporation in the income property mortgage banking business. Pasquarella holds a master of science degree in Real Estate Appraisal and Investment Analysis from the University of Wisconsin-Madison (1980) and a bachelor's degree in Finance from The Pennsylvania State University (1979). He is a member of The Counselors of Real Estate®, serving as the 2010 Chair of both its Board of Directors and its Executive Committee. He is also a Fellow of the Royal Institution of Chartered Surveyors.*

Kenneth P. Riggs, Jr., CRE, FRICS, MAI, *has served as president and CEO of Real Estate Research Corporation (RERC) since 1991. Under his leadership, RERC provides research services, valuation management, strategic consulting, independent fiduciary services, litigation support, and Web-based management services for property portfolios. In addition to leading the firm's business ventures, Riggs serves as publisher of the* RERC Real Estate Report *and the* RERC/CCIM Investment Trends Quarterly, *and as co-publisher of the annual forecast report,* Expectations & Market Realities in Real Estate. *Riggs holds an M.B.A. with a concentration in finance and statistics from the University of Chicago Graduate School of Business. He received the CRE designation from The Counselors of Real Estate® in 1995, and was elected first vice chair of The Counselors of Real Estate for 2011. In addition, he has earned the CFA® designation from the Association for Investment Management and Research, the FRICS designation as a Fellow of The Royal Institution of Chartered Surveyors, the CCIM designation from the CCIM Institute, and the MAI designation from the Appraisal Institute. Several years ago, the National Association of REALTORS® named him as one of real estate's 25 most influential thought leaders.*

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

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

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

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

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

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

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

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

LEARY: One of the negatives in the current market is the lack of trends. Every projection ends with a list of caveats because of the seesaw nature of market indices. To my way of thinking, this is not unexpected. We have just experienced the greatest market downturn of our professional lives that earned the name the Great Recession. Is it not logical to think that the recovery from a recession like no one had ever seen may well be a recovery like no one has ever seen? The problem is that we are trying to use the traditional measures of recovery to evaluate our current position. Now add in a natural disaster and a war or two or three, and where are we? Another negative from my perspective is the concept that we must measure recovery to the previous high-water mark. Most of us would admit that the real estate market behavior in 2006 up to mid-year 2007 was indeed an aberration on the high side. We are not better off if we return from one extreme to the other. Wouldn't our perspective on the current market be much better if we were measuring recovery in relation to more normative 2003–2004 market conditions?

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

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

RIGGS: I've noticed change in the usage of some property types. Businesses and individuals are truly embracing the fact that you can work from anywhere (the concept that "the world is flat"), but you still need that human interaction. This has resulted in individuals using less traditional office space but carving up the use of space differently (more video conferencing rooms, open and flexible spaces, intensive wiring at home, and more complete home offices). This is both positive and negative, depending on what side you stand. Given the advances in technology and lower costs in just the past 2–3 years and the increase in the number of people working from home, certain office property locations are not likely to recover for some time. On the other hand, demand for self-storage, particularly with the aging population and with so many people having lost and continuing to lose homes, is growing. An increase in online retailing/return to catalog sales, partly because stores cannot afford to stock everything people want in their stores, will reduce retail property demand but will likely increase warehouse demand. We also need to recognize that a new demographic is gaining stride in the work force. Generations X and Y, or echo boomers, are highly skilled and have a different view, an independent view, and an intelligent perspective on life, work and the world. Just like those in our generation, they will make a mark on society for the better, but they will also face unforeseen challenges in life and in the workplace. As those in each generation have done in the past, they will address its challenges, and in so doing, the world will be better and the human touch will never be lost.

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

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

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

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

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

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

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

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

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

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

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

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