Adversaries to Allies: Creating Wealth for the Republic of Serbia from Surplus Military Property

BY JOHN J. HENTSCHEL, CRE, MAI, FRICS

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BACKGROUND

The U.S. Agency for International Development (USAID) had contracted with the Urban Institute to implement the Municipal Economic Growth Activity (MEGA) in the Republic of Serbia, part of the former Yugoslavia. The initiative sought to develop the skills of local governments to foster economic growth and employment by creating a business environment where the local private sector could flourish. I was recommended for the assignment by a fellow Counselor of Real Estate (Olga Kaganova, a senior associate at the Urban Institute) and was engaged to serve as a special advisor and consultant in conjunction with the Municipal Capacity Building component of MEGA, in particular a project involving the Conversion and Commercialization of Surplus Serbian Military Property for Local Economic Development. Although initially I was engaged to merely develop a manual and some training in valuation principles and practices for use by Serbian officials, subsequent critical inquiry and thoughtful analysis revealed a more profound underlying problem as well as an opportunity to resolve it.

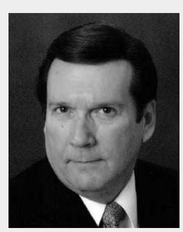
In addition to valuation, the assignment ultimately required the application of a host of other interdisciplinary skills including organizational dynamics, public policy, economic development, public sector asset and portfolio management, market analysis, property marketing, finance, educational course development and instruction, together with an ample dose of diplomacy in a foreign country with an emerging economy where the market framework and the rules of the game all were in transition and evolving.

Seldom is one presented with the opportunity to not only study a problem, devise a solution and guide the implementation of recommendations to resolution, but also be afforded the chance to help resolve a situation of national significance with the potential to influence the well-being of the general population.

THE ISSUE

The government of the Republic of Serbia had adopted a master plan for the sale, conversion and commercialization of surplus military immovable property which envisioned that the military would fund reforms, including housing for military personnel and pensioners, from the proceeds of surplus military property sales. At the same time, the national government had enacted legislation that granted provincial

About the Author



John J. Hentschel, CRE, MAI, FRICS, *is founder and CEO of Hentschel Real Estate Services, a real estate valuation, consulting and advisory firm that, for 40 years, has provided expert advice and guidance to assist leaders in business, government, law and finance make complex decisions, solve difficult problems, and seize strategic opportunities. A contributing author to Urban Institute's book,* Managing Government Property Assets-International Experiences, *he is an internationally recognized adviser, expert, speaker and author on real estate valuation and public sector asset management practices. A former member of the University of Baltimore Real Estate faculty, he was a trusted adviser to three mayors of the City of Baltimore and a former head of Baltimore's Department of Real Estate.*

governments known as Municipalities a pre-emptive right to negotiate purchases of the properties from the military.

The existing property disposal process was arcane, cumbersome and fragmented with roles and responsibilities divided among the Ministry of Defense (MOD); the Republic Property Directorate, the agency responsible for documenting and conducting property transfers; the Republic Tax Administration, the agency responsible for establishing property value; and the Municipalities. The process was not only inordinately complex and time-consuming, but was not administered in an efficient or uniform manner, thereby causing incessant delays and frustration resulting in tension between the MOD and the Municipalities.

These conflicting policies resulted in a paradigm that inadvertently pitted the MOD and the Municipalities in the role of virtual adversaries in a zero-sum rivalry that required both to commit considerable resources, yet yielded neither the immediate desired outcome. Despite a successful property conveyance, not only would MOD's goal of obtaining new housing remain unfulfilled, but the opportunity for MOD to harness or leverage private capital sources to accomplish its housing objectives was foregone. A Municipality that was able to accomplish an acquisition still faced sizeable risks, considerable time, and a daunting commitment of even more scarce capital resources before the property could yield any significant economic development benefits or revenues. As depicted in Figure 1, the paradigm merely transferred scarce capital resources between levels of government without creating any incremental benefits.

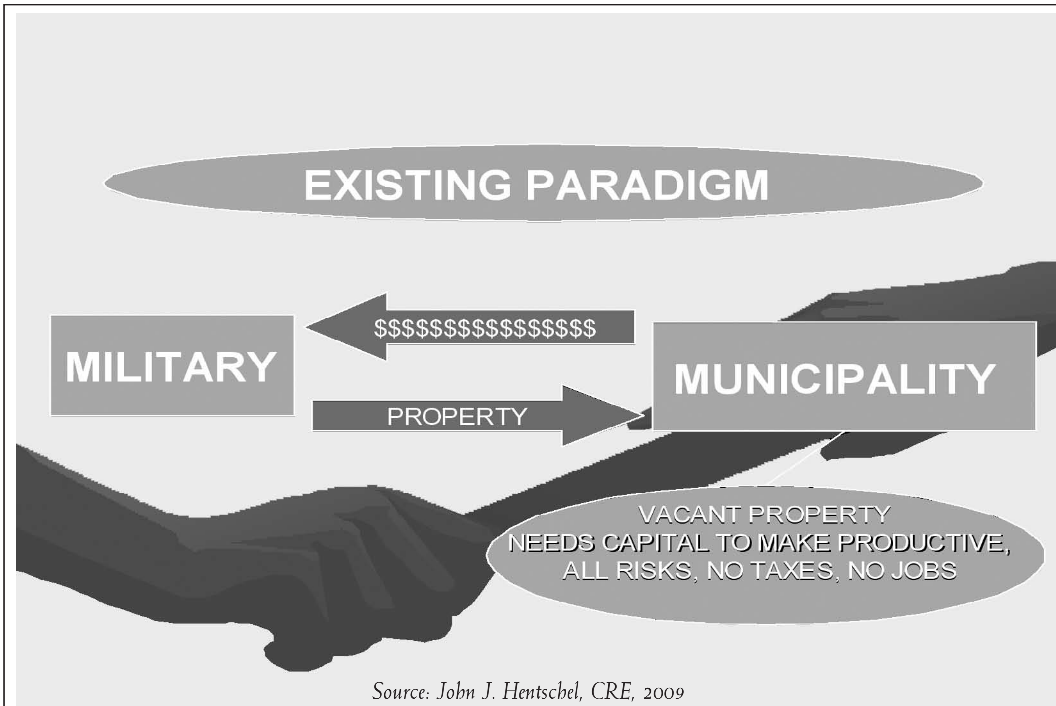
Under the existing paradigm:

- MOD sought to maximize the price to be paid by a Municipality;
- Municipalities sought to minimize the price to be paid to the MOD for properties;
- The diametrically opposed objectives, visions and viewpoints held by MOD and the Municipalities created an environment of mutual mistrust and frustration resulting in an impass, as well as missed opportunities to achieve reciprocal success. Indeed, many of the properties that the Municipalities now were being asked to buy originally had been conveyed at no cost to the MOD at the time of Yugoslavia's formation.

To further complicate the problem, Serbia was in transition from a centrally planned to a free market

Figure 1

Existing Paradigm



Source: John J. Hentschel, CRE, 2009

Figure 2
Republic of Serbia

economy. Many state-owned enterprises were yet to be privatized, a primary mechanism through which significant properties were acquired by private investors. Although emerging and evolving, the Serbian real estate market was immature and unorganized, with little transparency or transactional data available to corroborate value. All land within the country was still owned by the government with investors only able to acquire a right to use or a long-term lease with all rent payable in advance.

Notwithstanding its statutory role and responsibility, the Republic Tax Administration acknowledged that it lacked the knowledge, expertise, resources and capacity to accurately determine the value of the complex properties in the military portfolio. Although in some instances it engaged the services of local independent court experts (civil engineers with little or no training in market-based valuation techniques) to establish sale prices, their legacy bureaucratic valuation techniques based solely on replacement cost were insufficient for the task, seldom uniformly applied, and often skeptically viewed by Municipalities as overstating value. This further exacerbated the rancor between the MOD and the Municipalities.

Despite Serbia's high unemployment and need for economic growth, the adversarial nature of the relationship between the MOD and the Municipalities, together with the crisis of confidence regarding property valuation, resulted in stalled negotiations and few properties being transferred to induce much needed economic development.

THE ENVIRONMENT

Located in Eastern Europe, the Republic of Serbia is physically about the size of the state of Maine with a total population of 7.365 million, similar to that of the state of Washington.

The country is strategically located. The Pan European Highway Corridor 10, which runs from Austria to Greece, bisects the country at its approximate center. Principal Serbian cities of Novi Sad, Nis, and the capital, Belgrade, which is located in the center of the country at the confluence of the Sava and Danube rivers, abut Highway Corridor 10 and have attracted development of major industrial distribution centers. However, similar to other countries with emerging economies, substandard transportation infrastructure has hindered the expansion of economic activity, especially in the more remote regions of the country.

At the time of this assignment, Serbia was seeking candidacy in the European Union. With a parliamentary form of government, power was centralized and concentrated at the national level. The public sector was cumbersome and inefficient with considerable redundancy and overlapping authority among government ministries. Although politicians were quick to adopt reforms, the bureaucracy was resistant to change and slow to implement the reforms enacted.

The northern plateau sector of the country is more intensely developed and populated and accounts for a greater proportion of economic activity than the mountainous region in the south and west. With a population of approximately 1.6 million, the capital of Belgrade accounts for 22 percent of the country's total population, 30 percent of its employed population, and generates 30 percent of Serbia's Gross Domestic Product (GDP).

Agricultural production accounts for 9 percent of the Serbian economy, while manufacturing represents 15 percent. Principal industries include the manufacture of agricultural and transportation equipment; electronics and communications equipment; and the processing and production of pulp and paper. More than 25 percent of the workforce is employed by the government or state-owned enterprises.

The Serbian economy is highly dependent upon foreign direct investment which had declined from $2.2 billion in 2008 to $1.0 billion in 2010. Italy, Germany, Russia and Bosnia/Herzegovina comprise Serbia's principal trading partners. Major investors include Fiat (Italy), Gazprom (Russia) and Telenor (Norway). U.S. companies Phillip Morris, U.S. Steel and Coca Cola also had major stakes in Serbia. Most, if not all, of the foregoing investments were the result of acquisitions of formerly state-owned enterprises.

At the time of this assignment, the Serbian economy was slowing. Annual GDP growth had declined from 6.9 percent in 2007 to 1.8 percent in 2010, rebounding slightly to 3 percent in 2011. Nationwide unemployment, meanwhile, remained chronically high at 19 percent with a 30 percent rate prevailing in the more remote provinces. A 12.6 percent inflation rate and a corresponding 12.25 percent interest rate inhibited domestic growth and investment.

Serbia's population, according to its Census, had remained relatively static. During the previous decade, the population had declined slightly (2.5 percent) from 7.552 million in 1999 to 7.365 million in 2008. Housing production, however, had increased from 1.45 dwelling units per 1,000 people in 2000 to 2.5 dwelling units per 1,000 people in 2008, occurring mostly in the principal cities to replace historically substandard housing. The price of a typical 550–600-square-foot flat in Belgrade averaged approximately $75,000. The typical $521 monthly salary for a Belgrade worker yielded take-home pay of $440 after taxes, medical insurance and pension contribution.

Although a number of contemporary retail malls had been created in Belgrade and some other major cities, Serbia lagged the European Union in retail development (25 square meters per 1,000 people in Serbia versus 270 square meters per 1,000 people in the EU).

In Serbia, properties owned by the MOD often occupied the best and most strategic locations and thereby represented the foremost opportunities to create employment and promote economic development.

THE CHALLENGES

While each and every counseling assignment poses unique and sometimes difficult circumstances, this assignment was particularly challenging. The assignment addressed issues involving 447 disparate military facilities that included unimproved land; airports; barracks and housing structures; storage facilities; fortifications; training centers; army clubs; and sport, recreation, and tourist centers located throughout the Republic of Serbia. Some were located in major cities while others were situated in remote areas. Many of the structures improving the properties were antiquated, obsolete and poorly maintained.

PHOTOS DEPICTING EXAMPLES OF SURPLUS MILITARY PROPERTY

Military facilities are the classic special purpose property. They pose significant challenges for reuse and valuation, even in developed countries like the U.S. The perceived utility and corresponding value of such property to a military user may differ substantially from that of a private sector user/buyer. This assignment, therefore, required that I first educate government officials about the function and dynamics of a free market and the concept of economic utility and its influence on the contributory value of buildings, and thereafter devise measures that could be simply and uniformly applied in a limited data environment.

Bureaucratic institutions are highly resistant to change. In this instance decades of operating under a centralized authority within a centrally planned economy had narrowed their focus to the effect of existing laws, bureaucratic rules and procedures. Such shortsightedness was undermining opportunities to successfully redeploy assets to produce desperately needed economic development. Challenging and encouraging public officials at the local and national levels to think "outside the box" and consider not only what was permissible, but also what was possible, enabled the MOD and the Municipalities to discern and acknowledge a commonality of interest as well as muster the will to achieve it.

The assignment was in an unfamiliar foreign country with a transitional economy containing nascent, unorganized real estate markets, the framework and rules of which were in flux and evolving with few accessible or reliable sources of data.

THE PROCESS AND RECOMMENDATION

Beginning in January 2009, this assignment spanned approximately two years and was accomplished in a number of successive phases with the assistance and support of Urban Institute employees and contractors in Belgrade and Washington, D.C.

The first phase was focused on fact-finding—to gain an understanding of the current Serbian paradigm for valuation, disposition and reuse of surplus military properties to facilitate identification of problems and opportunities inherent in the existing model. Information was gathered indirectly through research and review of published data, and thereafter directly by traveling throughout Serbia to view representative military properties and to become acquainted with the country's business practices, economic and geographic linkages; the structure of the national and local economies; as well as the organization and framework of the real estate market. Interviews also were conducted with leaders of the Defense Ministry and local and national governments.

The second phase was devoted to analysis in order to develop recommendations that could resolve the problems inherent in the existing process and identify opportunities that could mutually benefit the military and Municipalities.

Money, people and property are the resources that all organizations use to attain a vision, accomplish a mission, and achieve goals and objectives. Their deft deployment enables businesses and investors throughout the world to create and accumulate wealth.

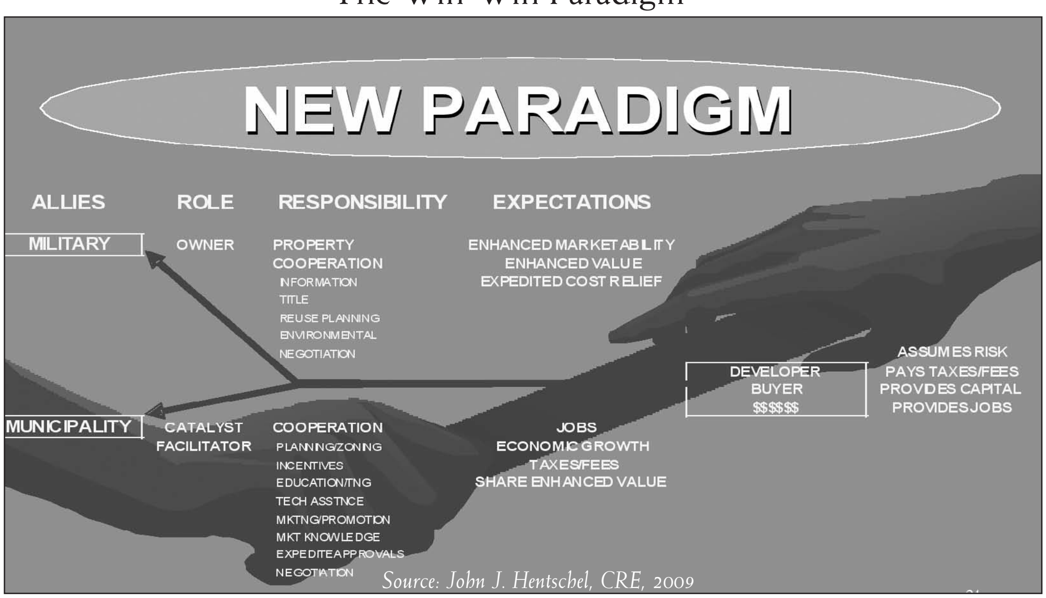
The wealth of a nation encompasses the sum of the collective resources of its towns, cities, provinces and regions. When local economies prosper, regions are healthy; when regions are healthy, a nation is strong. Economic development is a bottom-up process. Hence, when making resource deployment decisions, governmental entities at all levels—national, regional and local—need to coordinate their efforts and aim to create and expand the nation's wealth.

The existing property disposal process squandered the opportunity to use the nation's best-located properties to attract international investment that could spur job creation and economic development to augment the wealth of the nation. Although a Municipality might be induced to pay a price reflecting the MOD's unrealistic vision of value based on the replacement cost of the military structures, the Municipality's upside potential for the property would ultimately be capped and constrained by an entirely different perception of the property's value (which would be premised on its productive capacity) in the eyes of an international investor.

Over time, the MOD and the Municipalities had developed diametrically opposed, myopic visions and viewpoints that fostered an indifference to each other's needs, and engendered an environment of mutual mistrust which was only exacerbated by a property disposal process that lacked timeliness, transparency and uniformity. As a result, it became apparent that the parties were talking "at" each other instead of "to" each other.

Figure 3

The Win-Win Paradigm



Source: John J. Hentschel, CRE, 2009

The existing paradigm was inefficient, ineffective, and unproductive. Not only did resources merely transfer between layers of government without creating any new incremental wealth, but they were subject to further depletion from the insidious and sometimes imperceptible costs of inertia, as vacant deteriorating properties consumed even more of MOD's resources for the ongoing costs of maintenance, repairs, security and administration.

The solution seemed as clear as the problem was intractable—construct and implement a new paradigm, subsequently dubbed the WIN–WIN Paradigm, depicted in Figure 3, that would redefine the relationship, roles and responsibilities, and reposition the MOD and Municipalities as *allies* rather than *adversaries* who would mutually cooperate in the pursuit of common objectives to:

- leverage, enhance and maximize the value of surplus properties for the MOD;
- attract private investment and economic development to the Municipalities; and,
- create wealth for Serbia through mutual cooperation and a concerted effort to attract international investment capital.

The new paradigm re-cast the MOD and Municipalities as essential, albeit perhaps reluctant partners, each with singular vested interests, roles and responsibilities to entice and induce local and international developers and investors to acquire MOD properties. Whereas the MOD controlled large, significant properties in key locations with the capacity to contribute to local economic and community development, Municipalities had unparalleled local market knowledge and relationships as well as the ability to materially influence the utility and value of MOD properties through their regulatory authority. Although the MOD might have been exempt from local planning, zoning and permitting processes, any subsequent private buyer/user of MOD property would not be exempt.

The new paradigm envisioned a relationship that would be symbiotic, wherein the success, rewards and performance criteria of one would be linked to, dependent upon and measured by that of the other. In the new paradigm, the trust and confidence formerly absent in the relationship would transcend individuals and organizations in favor of a *process* wherein roles would be clearly defined, responsibilities clearly assigned, and value—whether contributed or created—would be measured uniformly, determined accurately and distributed equitably.

The third phase of the assignment focused on introducing, promoting and obtaining consensus for the new paradigm among senior policy makers from the Ministry Of Defense, the Office of the President, the Republic Property Directorate, the Republic Tax Administration, and the Municipalities to gain their support for the concept and achieve consensus for its adoption.

Although the Municipalities immediately embraced the concept, the leadership of the MOD, perceiving no apparent advantage or benefit, was initially, and understandably, wary of the idea. However, the MOD had acknowledged from the outset that it relied on and deferred to the Republic Tax Administration on issues of value. Perceiving the Tax Administration to be the critical linchpin to success, the focus turned to winning over Tax Administration officials to the merits of the new paradigm in hopes that the MOD would follow suit.

The fourth phase was devoted to swaying the Tax Administration to accept and adopt international valuation models and techniques founded on principles of productive capacity rather than on legacy administrative procedures based on reproduction cost. By adapting international valuation principles and techniques to the realities of the Serbian marketplace, the valuation process could thereafter be uniformly applied and understood by the MOD, the Municipalities, Republic Property Directorate and Republic Tax Administration when valuing military property.

The ensuing fifth phase of the assignment was focused on the development and delivery of training programs designed to aid personnel of the Defense Ministry, Republic Property Directorate, and the Municipalities understand, implement and execute the principles of the new Win–Win Paradigm. Another program was designed to provide technical advice and instruction in valuation techniques based on the productive capacity of property in a market with limited available or reliable data for Republic Tax Administration staff in support of the new Win–Win Paradigm.

To illustrate the principles of the new paradigm, I organized a study tour that brought 25 senior-level Serbian officials (representing the MOD, Tax Administration, Municipalities and the President of Serbia) to the United States to provide tangible examples of the cooperative principles advocated by the new Win–Win Paradigm and to demonstrate how inter-jurisdictional cooperation could leverage the benefits for each respective level of government when disposing and reusing surplus property assets.

The two-week fact-finding study tour included visits to surplus military properties that included presentations and discussions about:

- their potential for reuse and redevelopment;
- pertinent valuation issues;
- the roles and responsibilities of the respective parties; and,
- examples of conflict and cooperation that had transpired during the process of transferring the property from the military to the local government and/or a private developer.

The delegation also was introduced to the principles and practices of the military housing privatization process inherent in the U.S. Defense Department's Military Housing Initiative during a visit to Fort Meade.

Although fact-finding and education were the principal motives for the visit, an equally important mission was to build an operational team to foster communication and replace the mutual mistrust and tension with a sense of camaraderie and esprit de corps.

One example of this effort occurred during the group's stay in Baltimore, where I arranged for an evening crab feast at a waterfront restaurant. For the uninitiated, when presented with a whole, steamed Maryland blue crab in its shell, the inexperienced diner is confronted with the perplexing and daunting challenge of figuring out how to eat it, especially when the only utensils provided are a wooden hammer and a plastic knife. The experience can simultaneously be both humbling and hilarious. With seating intentionally and deliberately pre-assigned to ensure that the MOD, Tax Administration and Municipality officials were fully integrated, the former adversaries soon became steadfast allies in their quest to learn from each other how to navigate the nuances of eating a Maryland blue crab under the tutelage of my wife and adult children, thereby introducing a personal dimension to what had otherwise been an impersonal business relationship. By evening's end, an air of friendship and mutual cooperation would prevail and persist.

The study tour culminated with a day-long workshop at Urban Institute headquarters, during which each participant was guided in preparing an action plan for structuring and negotiating a transaction involving a specific military property in Serbia.

TEAMWORK
Serbian Delegation in Washington, D.C. During U.S.A. Study Tour

The final phase of the assignment focused on guiding the implementation of the principles of the Win–Win Paradigm and selecting a demonstration project to exemplify the application of the precepts of the new paradigm from which procedures, performance benchmarks and metrics could thereafter be developed for application in and monitoring of subsequent projects.

THE RESULTS

Oftentimes, clients discern and seek resolution for a symptom without first recognizing the larger underlying problem that was responsible for the symptom in the first place. In this instance, subsequent critical inquiry, thoughtful analysis of the situation, and a receptive and responsive client enabled me to refine and expand the Client's initially narrow perception of the problem and identify its true root source for which an appropriate and effective solution could thereafter be crafted to capture a strategic opportunity to advance Serbia's capacity for economic growth.

This assignment resulted in changes to the perspective, policies and procedures of national and local governmental institutions when disposing of surplus military property assets, replacing conflict with cooperation to create national wealth from idle and underutilized assets.

By agreeing to adopt the Win–Win Paradigm:

- The Republic Tax Administration committed to revise its procedures for the valuation of surplus military properties based on principles of productive capacity rather than administrative determination;
- MOD established a new real estate unit devoted to implementing the precepts of the Win–Win Paradigm and to serve as a liaison to communicate, coordinate and cooperate with Municipalities concerning the disposal of military properties;
- Municipalities, which control land use regulation, pledged to coordinate and cooperate with the military to enhance property value through planning, zoning and an expedited permitting process;
- MOD and Municipalities became better prepared to market surplus military properties to international buyers/financiers and promote sorely needed economic development and job creation since prices reflected the perceived productive capacity of property instead of bureaucratic formulae;
- Property transfers between the MOD and Municipalities began to transpire—the first transactions were consummated by the end of the assignment—with a firm model and framework in place to guide and expedite future transactions.

At the outset of this assignment, the level of mistrust and friction between representatives of the MOD and Municipalities was manifest and palpable. Relations were strained, communication was ineffective and, as a result, transactions languished. Two years later, at the conclusion of the assignment, representatives of the MOD and Municipalities were actively communicating and coordinating their efforts to maximize the benefits to be obtained from surplus military properties and to create wealth for Serbia. ■