

REAL ESTATE ISSUES[®]

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Peter D. Bowes, MAI, CRE; Douglas C. Brown, MAI, CRE; Albert R. Wilson, CRE

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(or Capitalized Economic Profit) in Sales to REITs:
A Practical Framework for Analysis
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into Profitable Historic Rehabilitation Projects
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BY PETER D. BOWES, MAI, CRE; DOUGLAS C. BROWN, MAI, CRE; ALBERT R. WILSON, CRE

In the real estate literature of the past decade or so confusion has arisen between the concepts of a damage to the market value of a property and a locational premium. Many articles discuss the influence of some alleged negative condition (disamenity) such as powerlines, landfills, railroad tracks, superfund sites, or industrial facilities on the value of nearby properties by comparing their value to the values of similar properties not nearby as if this differential were a damage. This differential, assuming it exists, is properly a locational premium, i.e. the difference a market participant is willing to pay to be further from the alleged disamenity (or alternatively, closer to an amenity). Damage to market value is specific to the ownership of the property and can occur only when a condition negatively influences the market value after purchase. This paper will clarify these concepts and provide concrete definitions for them. It also seeks to explain how damage to market value resulting from a condition such as an alleged disamenity may be identified and measured.

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Detecting Intangible Asset Value (or Capitalized Economic Profit) in Sales to REITs: A Practical Framework for Analysis

DAVID C. WILKES AND STEVEN A. SHAPIRO, CRE

Asset Management can be defined as the process of overseeing property performance with the goal of enhancing value and maximizing return to the owner. Asset management does not consist of a single activity that takes place at a discrete moment in time. It takes place over the life cycle of a property (from acquisition to disposition). It is a process. Asset Management is about maintaining and creating value consistent with ownership objectives. It blends both a "big picture perspective" and a "hands-on" approach to day-to-day operational issues and decision-making. This is done through an efficient balance of landlord and tenant relations, budgeting, operating expense analysis & control, real estate tax & insurance reviews, capital improvements, energy management programs, lease analysis and market awareness. Based on these various factors, Asset Managers determine ways to increase the profitability of the various properties under their stewardship.

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Since 1976, resourceful developers have taken advantage of significant tax incentives to rehabilitate historic properties into profitable development projects. Such incentives have sparked renewed interest in reviving forgotten local landmarks and have enabled developers to successfully tap into an emerging market of commercial and residential tenants who are looking for unique space.

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About THE COUNSELORS OF REAL ESTATE

THE COUNSELORS OF REAL ESTATE, established in 1953, is an international group of high profile professionals including members of prominent real estate, financial, legal and accounting firms as well as leaders of government and academia who provide expert, objective advice on complex real property situations and land-related matters.

Membership is selective, extended by invitation only on either a sponsored or self-initiated basis. The CRE Designation (Counselor of Real Estate) is awarded to all members in recognition of superior problem solving ability in various areas of specialization such as litigation support, asset management, valuation, feasibility studies, acquisitions/dispositions and general analysis.

CREs achieve results, acting in key roles in annual transactions and/or real estate decisions worth billions of dollars annually. Over 300 of the Fortune 500 companies retain CREs for advice on real estate holdings and investments. CRE clients include public and private property owners, investors, attorneys, accountants, financial institutions, pension funds and advisors, government institutions, health care facilities, and developers.

ENRICHMENT THROUGH PEER ASSOCIATION, COLLABORATION, EDUCATION & PUBLICATIONS

Knowledge sharing continues as the hallmark of The Counselor organization. Throughout the year, programs provide cutting-edge educational opportunities for CREs including seminars, workshops, technology sessions, and business issues forums that keep members abreast of leading industry trends. Meetings on both the local and national levels also promote interaction between CREs and members from key user groups including those specializing in financial, legal, corporate, and government issues.

CRE members benefit from a wealth of information published in The Counselors' quarterly award-winning journal *Real Estate Issues* which offers decisive reporting on today's changing real estate industry. Recognized leaders contribute critical analyses not otherwise available on important

topics such as institutional investment, sports and the community, real estate ethics, tenant representation, break-even analysis, the environment, cap rates/yields, REITs, and capital formation. Members also benefit from the bi-monthly member newsletter, *The Counselor*, and a wide range of books and monographs published by The Counselor organization. A major player in the technological revolution, the CRE regularly accesses the most advanced methodologies, techniques and computer-generated evaluation procedures available.

WHAT IS A COUNSELOR OF REAL ESTATE (CRE)?

A Counselor of Real Estate is a real estate professional whose primary business is providing expert advisory services to clients. Compensation is often on an hourly or total fixed fee basis, although partial or total contingent fee arrangements are sometimes used. Any possibility of actual or perceived conflict of interest is resolved before acceptance of an assignment. In any event, the Counselor places the interests of the client first and foremost in any advice provided, regardless of the method of compensation. CREs have acquired a broad range of experience in the real estate field and possess technical competency in more than one real estate discipline.

The client relies on the Counselor for skilled and objective advice in assessing the client's real estate needs, implying both trust on the part of the client and trustworthiness on the part of the counselor.

Whether sole practitioners, CEOs of consulting firms, or real estate department heads for major corporations, CREs are seriously committed to applying their extensive knowledge and resources to craft real estate solutions of measurable economic value to clients' businesses. CREs assess the real estate situation by gathering the facts behind the issue, thoroughly analyzing the collected data, and then recommending key courses of action that best fit the client's goals and objectives. These real estate professionals honor the confidentiality and fiduciary

responsibility of the client-counselor relationship.

The extensive CRE network stays a step ahead of the ever-changing real estate industry by reflecting the diversity of all providers of counseling services. The membership includes industry experts from the corporate, legal, financial, institutional, appraisal, academic, government, Wall Street, management, and brokerage sectors. Once invited into membership, CREs must adhere to a strict Code of Ethics and Standards of Professional Practice.

USERS OF COUNSELING SERVICES

The demand continues to increase for expert counseling services in real estate matters worldwide. Institutions, estates, individuals, corporations, and federal, state and local governments have recognized the necessity and value of a CRE's objectivity in providing advice.

CREs service both domestic and foreign clients. Assignments have been accepted in Africa, Asia, the United Kingdom, the Caribbean, Central and South America, Europe and the Middle East. CREs have been instrumental in assisting the Eastern European Real Property Foundation create and develop private sector, market-oriented real estate institutions in Central and Eastern Europe and the Newly Independent States. As a member of The Counselor organization, CREs have the opportunity to travel and share their expertise with real estate practitioners from several developing countries including Poland, Hungary, Bulgaria, Ukraine, Czech Republic, Slovak Republic, and Russia as they build their real estate businesses and develop standards of professional practice.

Only 1,100 practitioners throughout the world carry the CRE Designation, denoting the highest recognition in the real estate industry. With CRE members averaging 20 years of experience in the real estate industry, individuals, institutions, corporations, or government entities should consider consulting with a CRE to define and solve their complex real estate problems or matters. ■

Editor's Statement

BY HUGH F. KELLY, CRE



IN OUR PREVIOUS ISSUE, we mused about the possibility of using a variety of opportunities for readers of *Real Estate Issues* to interact with us, with the objective of probing more deeply the topics raised by our authors and tapping into the experience and judgment that are the professional hallmarks of real estate counselors. Letters to the editor, feedback on articles, or a readers' forum can all be helpful vehicles for promoting two-way communication in our journal.

It is our intention to introduce such features over the course of the coming year. We invite both your participation and your observations on the concept of increasing reader input into *Real Estate Issues*.

Over the past decade, publications like the *Harvard Business Review* have successfully engaged their readership and contributors in the back-and-forth of ideas. For example, Harvard has long been known for its insightful use of case studies as a teaching tool. *HBR* has taken the case study approach onto its pages, with a twist. The *Review* invites a panel of commentators to reflect on the case, to explore its implications in greater depth. Such a format seems a natural for Counselors. And we have a pool of topics that seem ripe for this approach, drawing from the challenging assignments undertaken by the Counseling Corps, the projects

funded by the James E. Gibbons Educational Trust Fund, and the submissions made for the James Felt Creative Counseling Award.

In the past we have relied upon formally written articles as the almost-exclusive style of presentation. There is a sense that the busiest of our top executives would be pleased to share their insights and knowledge, but have little appetite for penning extended essays. On the other hand, a cogent and incisive interview could be as thought-provoking as a more traditional article—and perhaps even livelier reading.

Real estate is a fast-evolving industry, and one in which change is likely to be accelerating, as a recent article by M. Gordon Brown and Stephen E. Roulac explained. As such, we will be looking to explore more intensively the business of real estate and seeking articles that examine "best practices." This is a continuation of one of the great traditions of the Counselors' organization, a sense of collegiality whereby we share what works in this service profession so that CREs can provide the highest level of assistance to our clients.

And, of course, we can do more to make the actual presentation of *Real Estate Issues'* content more attractive and accessible to readers. Re-design is an ongoing challenge and

one that can be addressed simultaneously with new approaches to our subject matter.

None of this means that we want to abandon the serious research article or reflective essay that has been the mainstay of REI over the years. We intend to build upon our now nearly thirty years of publication experience. Within the real estate industry, *Real Estate Issues* already enjoys a huge advantage in the quality and diversity of its readership. It can be the ideal forum where the top executives in all areas of real estate explore and exchange ideas. But we need to do some work to make that happen. And we need to hear from our readers with suggestions for features, topics, and formats that you want to see on our pages. So, as we did in our last Editor's Statement, we issue an invitation to all our readers to share ideas with us. Listening skills are a vital communication tool—and we are all ears! ■

HUGH F. KELLY, CRE
EDITOR IN CHIEF

Damage to Market Value and Locational Premiums

BY PETER D. BOWES, MAI, CRE; DOUGLAS C. BROWN, MAI, CRE; ALBERT R. WILSON, CRE

INTRODUCTION

IN THE REAL ESTATE LITERATURE OF THE PAST DECADE or so confusion has arisen between the concepts of a damage to the market value of a property and a locational premium. Many articles discuss the influence of some alleged negative condition (disamenity) such as powerlines, landfills, railroad tracks, superfund sites, or industrial facilities on the value of nearby properties by comparing their value to the values of similar properties not nearby as if this differential were a damage. This differential, assuming it exists, is properly a locational premium, i.e. the difference a market participant is willing to pay to be further from the alleged disamenity (or alternatively, closer to an amenity). Damage to market value is specific to the ownership of the property and can occur only when a condition negatively influences the market value after purchase.

This paper will clarify these concepts and provide concrete definitions for them. It also seeks to explain how damage to market value resulting from a condition such as an alleged disamenity may be identified and measured.

THE FUNDAMENTALS

The fundamental definition of real estate value is:

"The present worth of the future benefits that accrue to real property ownership."

and from it is derived the concept of market value, defined as:

"The most probable price, as of a specified date, in cash, or in terms equivalent to cash, or in other precisely revealed terms, for which the specified property rights should sell after reasonable exposure in a competitive market under all conditions requisite to a fair

*sale, with the buyer and seller each acting prudently, knowledgeably, and for self-interest, and assuming that neither is under undue duress."*²

Note that:

"A market value appraisal is also based on whatever the 'normal' or 'typical' conditions are in the marketplace for the property appraised in a time frame that is consistent with the date of value in the appraisal."^{3,4}

Damage is defined as:

*"Loss or harm due to injury to persons, property, or reputation."*⁵

Damage to Market Value may then be defined as:

About the Author

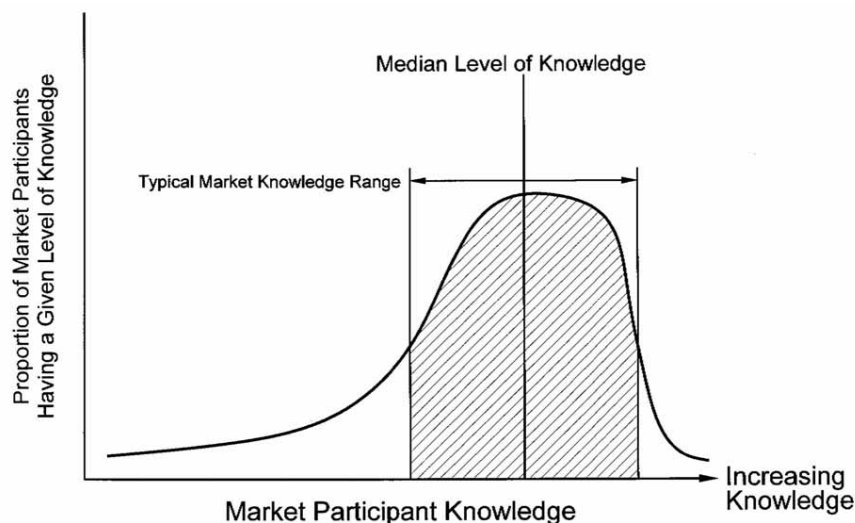
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Damage to Market Value and Locational Premiums

Figure 1—Typical Market Participant Level of Knowledge



A diminution in the market value of an owner's property resulting from an injury recognized by the market post-purchase. Damage may be measured by the difference between the market value at the date of purchase less the market value at the date of market recognition of the injury adjusted to the date of purchase.

A Location Premium may be defined as:

The incremental difference between the market value of a property in one location compared to the market value of a comparable property in a location judged by the market to be superior to the first location.

Note that in the definition of locational premium there is no tie to the ownership of a property or to any changes in the market value during a period of time. The point is that a locational premium is not a damage to market value, only a measure of the impact of location on market value. Further, it is the market that determines a damage or locational premium, not the individual opinion of an owner of a property.

MARKET VALUE AND PRICE

This discussion must begin with a clear understanding of the basis of the Market Value concept and in particular the role of the knowledge of the "typical" market participant, something rarely discussed in the literature. The typical

market participant is neither perfectly ignorant nor perfectly knowledgeable concerning all of the factors and issues surrounding a real property in the market, but is somewhere between these two extremes of knowledge. An understanding of the typical participant's level of knowledge must be developed by careful analysis of what actual participants

knew at the time of their participation. Normally this approximation is developed by the professional valuer's knowledge of the market and the confirmation of sales process. It may also be more formally developed through the conduct of properly structured, tested and validated surveys of actual participants in transactions contemporaneous to the time period(s) of interest.

Note that surveys, if conducted, must be of the population of parties who actually participated in the market, not of parties who are asked to pretend that they participated. Market Value is based on what has happened in the market, not on what someone is asked to imagine might happen under some hypothetical set of circumstances with no

The typical market participant is neither perfectly ignorant nor perfectly knowledgeable concerning all of the factors and issues surrounding a real property in the market.

Damage to Market Value and Locational Premiums

Table 1—Damage to Market Value

Year	Property A Market Value (Appreciation Rate of 5% per year, Original purchase price \$100,000)	Property A' Market Value (New Long-term Condition in Year three.)	Difference A' - A	PV of Difference @ 10% Discount Rate	Proof (\$100,000 for A - \$6,908 = \$93,092 at appreciation rate of 5% per year)
0	\$100,000	\$100,000	0	0	\$93,092
1	105,000	105,000	0	0	97,746
2	110,250	110,250	0	0	102,623
3	115,763	104,186	(11,576)	(9,567)	107,766
4	121,551	109,396	(12,155)	(9,132)	113,154
5	127,628	114,865	(12,763)	(8,717)	118,811
6	134,010	120,609	(13,401)	(8,321)	124,752
7	140,710	126,639	(14,071)	(7,943)	130,990
8	147,746	132,971	(14,775)	(7,582)	137,539
9	155,133	139,620	(15,513)	(7,237)	144,416
10	\$162,889	\$146,601	(16,289)	(6,908)	\$151,637
Gain	62.89%	46.60%			62.89%

monetary penalty or price extracted for the hypothetical answer.

Damage to value is clearly an owner-specific issue that depends on the state of market knowledge at two points in time, the date of purchase and the date of alleged damage. For each owner in a given location a different set of conditions—at least with respect to purchase date, may apply and therefore a different damage to value analysis will be appropriate.

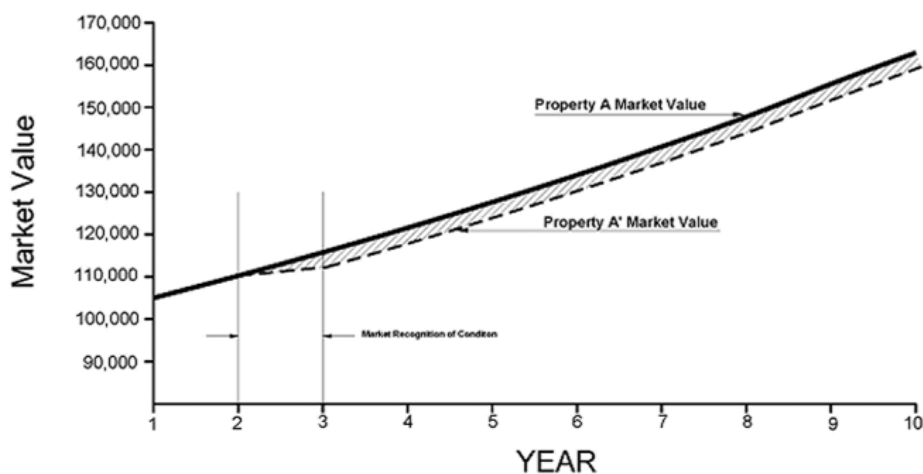
The level of knowledge of the typical market participant may be represented as in Exhibit 1 and will fall somewhere in the shaded "typical market knowledge range." The median level of knowledge indicates that 50% of the participants will have a lesser level of knowledge than the median, and 50% have a greater level of knowledge. The key point is that perfect knowledge—like perfect ignorance—is highly unlikely and not an appropriate criterion for market value.

There have recently appeared in the literature several analyses wherein the proposition has been put forth that Market Value should properly relate only to a "fully informed" market participant. Clearly this is not appropriate as may be seen by consulting USPAP Advisory Opinion 22 quoted above. A "fully informed" participant would be on the outer edge of the distribution and would not be any more appropriate for analytical purposes as a "typical" market participant than a market participant who acted with little or no relevant knowledge.

It is not the prerogative of the analyst to hypothesize that a greater level of knowledge should exist and then attempt to develop an opinion of market value based on that hypothetical condition. It is the analyst's charge to understand the extent of knowledge satisfactory to the typical market participant in order to evaluate how knowledge of a condition may have impacted value, if it did.⁶ A valuer reflects the market, he/she does not—should not—first attempt to alter the market knowledge and then solicit a

Damage to Market Value and Locational Premiums

Exhibit 2—Damage to Market Value



response from a market participant in seeking to determine the market value of a property.

The knowledge possessed and acted upon by the typical market participant is critical to the determination of damage to value. A typical participant purchases/sells a property in anticipation of the benefits to be received from the transaction. Those anticipated benefits are based on a level of knowledge satisfactory to each participant—satisfactory in the sense that the participant is willing to make a commitment based on that level of knowledge. Market Value presumes no special or advantageous knowledge on the part of either buyer or seller. Once the transaction has been concluded the buyer expects to receive the anticipated benefits barring an unanticipated change in the general economy or a catastrophe, general risks applicable to all transactions.

If the typical market participant at the time of the purchase did not know of, or was unconcerned by, the condition that would give rise to a diminution in market value, then the market value would be unaffected by that condition. If then at a later point in time the typical market participant becomes knowledgeable about the condition and that knowledge results in the typical market participant reducing their anticipated net benefits, then the market value has been diminished and a damage may result.

It is important to note that Market Value is not "price." Price is defined as:

*"The term price represents the amount a particular purchaser agrees to pay and a particular seller agrees to accept under the circumstances surrounding their transaction. A price, once finalized, refers to a sale or transaction price and implies an exchange; a price is an accomplished fact."*⁷

Market Value is an idealization of the price that would have been paid if the strengths, weaknesses, and interests of the actual parties to a transaction are adjusted out. Price may be more or less than a competently developed opinion of market value, but the difference, if any, should reflect only the strengths, weaknesses and interests of the specific parties involved in the transaction.

DAMAGE TO MARKET VALUE

Damage to market value was defined above as a post-purchase reduction in the anticipated benefits assumed by the typical market participant when the transaction took place. As an example consider a transaction where the buyer assumes that he/she will receive the benefits of a stream of net rental income for a period of years plus the reversion of the market value of the property from a sale

Damage to Market Value and Locational Premiums

Table 2—Locational Premium Rate of Return

Year	Property A Market Value (Appreciation Rate of 5% per year, Original purchase price \$100,000)	Property B Market Value (Same Property as A but in a "superior" location)
0	\$100,000	\$110,000
1	105,000	115,500
2	110,250	121,275
3	115,763	127,339
4	121,551	133,706
5	127,628	140,391
6	134,010	147,441
7	140,710	154,781
8	147,746	162,520
9	155,133	170,646
10	\$162,889	\$179,178
Gain	62.89%	62.89%

at the end of the holding period. These were some of the elements resulting in the consummation of the transaction at a price. Suppose that a few years later a street leading to the property is closed off, an unanticipated event, making access to the property more difficult and the property therefore less desirable for its original highest and best use. If the stream of future benefits has been compromised a damage to market value will have occurred.

Damage to market value is fundamentally different from the locational premium that might result if the market value of this property (after the street closure) was compared to that of a similar property absent the street closure. This locational premium may be used to help establish the amount of the damage to the owner, but if a new buyer appears and takes the property at the reduced market value after the street closure, the difference between the market value of the property with the street closure

and without is then just a locational premium to the new owner, not a damage.

The damage is essentially the difference between the unimpaired market value at the date of purchase, less the impaired market value as if the purchaser had known of the influence of the condition, evaluated at the date of the original purchase. Table 1 and Exhibit 2 illustrate this point. This procedure, a comparison of the unimpaired versus the impaired (by the condition) values has been widely recognized and well accepted.

In Table 1 the purchaser bought at a market value of \$100,000 in year zero. A five percent appreciation rate in market value for each year thereafter is assumed. Sometime in year three a condition was recognized by the marketplace that reduced the market value of the property by five percent. The evaluation takes place in year ten.

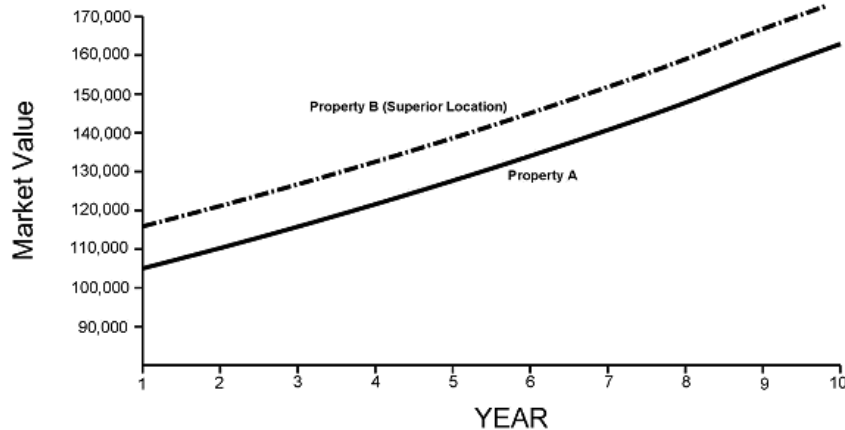
The damage is then the amount less than the original unimpaired market price that the purchaser should have paid in year zero to achieve the same gain in value as was reasonably anticipated at the time of the original transaction. In this way the present worth of the future benefits of the original bargain is preserved. The amount of damage is shown in the column PV of Difference for year ten, or \$6,908. If this amount is subtracted from the original purchase price of \$100,000 the amount that originally should have been paid for the property would have been \$93,092. Given the 5% market value appreciation rate this would have given the purchaser the originally anticipated 62.89% gain in market value, restoring the benefit of the bargain as shown in the column labeled "Proof" (Exhibit 2).

Because value is defined as the present worth of future benefits and the original market value is critical to the analysis we chose to perform the evaluation in terms of the original purchase date. Great care must be exercised to insure that all damage values are stated in the correct present value terms if another date is chosen. Further, there may be legal issues such as interest on damages that may become involved that argue for the use of the date of original purchase as the basic date for evaluation of damage to market value, but such issues are beyond the scope of this paper.

The methodology of computing a damage may be stated as follows:

Damage to Market Value and Locational Premiums

Exhibit 3—Locational Premium



*Potential Damage = Present Worth (of benefits)
at Purchase Date*

LESS

*Present Worth at Date of Evaluation evaluated
at the Purchase Date*

OR

Potential Damage = Market value at Purchase Date

LESS

*Market value at Date of Evaluation evaluated
at the Purchase Date*

We have identified this as a Potential Damage because it may be transitory. If the Date of Evaluation is also a date of sale then the Potential Damage may become an actual damage. If the Date of Evaluation is not at a date of sale then it is entirely possible that the passage of time may lead to an entirely different Potential Damage at a different date of evaluation. Damage, like all real estate valuation concepts, is as of a specific date and valid for that date only. Subsequent conditions can and will change value.

A question that may be asked here is "Why market value?" The answer lies in the difference between price and market value noted above. A price includes all types of considerations specific to the individuals involved in the transac-

tion, considerations that can only rarely be identified and quantified post-transaction, particularly those associated with the very human interaction of the parties at the bargaining table. Market value is a standard widely recognized and accepted by the courts and others as being a value stripped of those specific considerations.

CONCLUSIONS REGARDING DAMAGE TO MARKET VALUE

A damage to market value is specific to the ownership of the property. For a damage to occur the market value of the property at the date of purchase by the owner must not include an offset to the benefits resulting from the condition believed to diminish market value. That is, the typical market participant does not know of—or does not recognize a value influence associated with—a condition. At a later date—post-purchase—the typical market participant recognizes a diminution in value associated with a condition resulting in a decrease in the market value of the specific owner's property. This decrease is then a damage for that specific owner because the originally anticipated stream of benefits has been compromised.

LOCATIONAL PREMIUMS

A difference in the market values of similar properties at different locations, if the location is the only difference, is a locational premium to the property having the higher

Damage to Market Value and Locational Premiums

market value. This locational premium is simply the amount that a typical market participant is willing to pay to be in the "superior" location and is not a damage to the market value of the "inferior" location.

As an illustration of this fact consider Table 2 and Exhibit 3. In Table 2 Property B is a property in a superior (from the market's point of view) location compared to Property A which is otherwise identical to Property B.

Property B enjoys a 10% locational premium. Note that the owner of this property, although having a higher market value, had to make a greater investment to achieve the higher market value and still obtains the same rate of return as the

first property owner, therefore receiving the same present worth of future benefits. Since the rate of return on the investments is identical, no damage can be said to have occurred as a result of the locational premium.

In a recent article in *The Appraisal Journal*, the situation of a landfill's impact on residential property values was examined in some detail.⁸ According to the information in the article the landfill had existed in its present location and under its current management (a private firm) and ownership (a governmental entity) for a period of more than 50 years.⁹ Based on the information provided in the article it is clear that at least a significant minority of individuals who had been active in the market in the recent past were aware of the presence of the landfill and acknowledged that it impacted residential real estate parameters of concern to them. Whether a significant minority of participants may define a "typical" buyer or seller is an issue not addressed here, but it can reasonably be expected that most of the market participants who purchased property close to the landfill were aware of its existence prior to purchase—although this is not directly addressed in the article.

Any study that has not examined the question of whether or not the individual property owner's present worth of future benefits has been diminished—a study requiring an examination of market value at at least two points in time for each property—would be incapable of demonstrating a potential damage to value.

It is reasonable to conclude that the landfill was a long-standing condition acknowledged by a significant minority of market participants, if not the typical market participant.

Paired sales and regression were two of the reported techniques used to quantify a differential although little supporting data on the application of these techniques was provided. The reported techniques were used to define a point-in-time differential in property values between those properties within the allegedly impacted area and those elsewhere.

According to the information provided in the article the residential properties close to the landfill were worth 8-10% less in market value compared to similar properties not located in proximity to any identified disamenity. Is the 8-10% differential in property values a damage resulting from the landfill, or simply a locational premium for properties not near the landfill?

For the differential to be a damage, a property owner close to the landfill must be receiving a diminished present worth of future benefits compared to the present worth that that owner would have reasonably anticipated at the date of the purchase. If the original purchase price contained the locational premium no damage would result.

There was no information in the article indicating that the locational premium had changed at any point in time, and given the landfill's circumstances of known existence and long-standing it is unlikely that any such change would have occurred.

Given the information the conclusion must be that a locational premium was identified but no damage was either identified or quantified.

Other reported analyses appear to have been subject to this same confusion of locational premium with damage to value. Damage is an issue directly related to the period of ownership of a specific property, and the advent of new conditions that may impose a penalty on that property after purchase. Airport noise studies, powerline impact studies, landfill impact studies and the like frequently report only a differential in value at a point in time with no evidence of a change in the market value that would support a notion of damage, or market data that would provide evidence of a post-purchase decrease in the "present worth of future benefits" for a property owner whose property may be said to have been influenced by the con-

Damage to Market Value and Locational Premiums

dition. In general, any study that has not examined the question of whether or not the individual property owner's present worth of future benefits has been diminished—a study requiring an examination of market value at least two points in time for each property—would be incapable of demonstrating a potential damage to value.

CONCLUSIONS REGARDING LOCATIONAL PREMIUMS

To argue that a property is worth more or less than a comparable property in a different location is to acknowledge the real estate adage of "location, location, location," but no damage to value is established. For damage to exist it is necessary to show that the original bargain of a specific purchaser has been compromised. This type of analysis has rarely been in evidence in the literature of detrimental conditions and much of that literature must be viewed as only having demonstrated that location is a critical factor in market value, not that a damage to value has occurred as the result of some new condition. ■

ENDNOTES

1. *The Dictionary of Real Estate Appraisal*, Fourth Edition, Appraisal Institute, Chicago, 2002.
2. *The Dictionary of Real Estate Appraisal*, Fourth Edition, Appraisal Institute, Chicago, 2002.
3. Advisory Opinion 22, Uniform Standards of Professional Appraisal Practice, 2002 Edition, The Appraisal Foundation, page 207, line 89 et seq.
4. AUTHORS NOTE: In the following discussion the individuals described as "...buyer and seller each acting prudently, knowledgeably and for self-interest, and assuming that neither is under undue duress" will be referred to as the "typical" market participants. A review of the professional literature, particularly *The Appraisal of Real Estate* for any recent edition will indicate that this descriptive language is well accepted in the profession.
5. *The Merriam-Webster Dictionary*, Merriam-Webster, Inc. Springfield, MA, 1998, p131.
6. See for example the discussion of this subject in *The Appraisal of Real Estate*, 12th Edition, Appraisal Institute, Chicago, 2001.
7. *The Appraisal of Real Estate*, Twelfth Edition, Appraisal Institute, Chicago, 2001, page 19.
8. "A Survey Approach for Demonstrating Stigma Effects in Property Value Litigation," James Flynn, PhD, Donald G. MacGregor, PhD; Wayne Hunsperger, MAI, SRA, C. K. Mertz and Stephen M. Johnson, PhD., *The Appraisal Journal*, Winter, 2004.
9. Ibid. Page 38.

Detecting Intangible Asset Value (or Capitalized Economic Profit) in Sales to REITs:

A Practical Framework for Analysis

BY DAVID C. WILKES AND STEVEN A. SHAPIRO, CRE

"To begin with there is no such thing as 'value,' except in the eyes of the beholder. And one must understand where the beholder is coming from."—Bertram Lewis, "Do Syndicators Overpay," *The Appraisal Journal*, April 1985.

MANY CONTEND THAT REAL ESTATE INVESTMENT TRUSTS (REITs) overpay on an individual asset basis. Whether this is true can be significant for tax assessment purposes. Previous commentary posited that intangible value existed (or did not) in such sales as a general rule. The industry is variegated. Some purchases are non-market due to factors common to REITs, while others represent market value. A fuller understanding of the factors that might lead to overpayment, and an analysis of the sale at hand on a case-by-case basis is needed. This article should assist in determining whether a REIT purchase price may have been influenced by non-market factors.

INTRODUCTION: THE NEED FOR AN ANALYTICAL TOOL

The real estate investment trust (REIT) is a dominant player in today's real estate marketplace. Following exponential growth over the course of the last decade, REIT-owned properties and sometimes entire REIT portfolios can now be found in every major central business district (CBD). Most suburban markets and even many rural areas are home to REIT-owned shopping centers, apartments, industrial/warehouse properties, offices, and golf courses, among many other property types.

REIT investing increased from a market capitalization in 1991 of \$8.78 billion held by 86 Equity REITs to \$151.2 billion held by 149 Equity REITs in 2002.² Sales of properties and entire private real estate portfolios to real estate investment trusts soared through the mid- to late-1990s. Today, despite a slowing of sales activity among REITs and a general change in the motivations related to raising capital through public offerings, REITs remain a powerful force in today's national real estate market.

The flurry of REIT activity over the last 10 years leaves a trail of purchase prices that may or may not be significant in the appraisal process for property tax valuation. These purchase prices, like any others, are of primary interest to assessors, many of whom presume them to be a fair reflection of ordinary market value. There has been extensive research on REITs generally over the last 15 years.³ Much of this research focused on issues of concern primarily to the investing public and REIT performance from a shareholder's point of view. Yet there remains only limited treatment of REITs at the asset level, which is the predominant concern of *ad valorem* professionals.

In most cases, a recent arm's length sale of real property provides high-quality evidence of value. Yet, many appraisers, investment analysts, and REIT property tax managers (and even some assessors) contend that REIT purchase prices are not indicators of market value because the prices REITs pay for property include value for items that are not "realty." In our experience, this contention is sometimes true, but not in every case.

Detecting Intangible Asset Value

Because of their ability to extract more value from a given parcel of real estate than conventional bidders while still obtaining the same or a better return on investment, the REIT will often be able to pay more and will pay more to get the property—or the portfolio—it wants. As Hardin and Wolverton observed in the context of apartment REITs,⁴ just as data supported the notion that properties obtained via foreclosure sold at a discount to market value, so too can it be hypothesized that REITs have in many cases either chosen, or been "forced into acquisition strategies that made over payment for individual properties more probable." It is also often true that a REIT may be buying much more than just the real estate, although this is often not reflected in portfolio purchases in which a total purchase price is allocated among many individual properties.

In the end, just as most individual properties have their own unique characteristics, so do the transactions involving them. As a result, some generalizations may be made but each sale requires careful analysis to determine whether, in fact, the price paid is above market value for *ad valorem* taxation. The purpose of this article is to provide a practical guide to several of the areas that would require examination in order to determine whether the price paid includes so-called intangible value.

DISTINGUISHING BETWEEN MARKET VALUE AND INVESTMENT VALUE

Because a REIT's corporate objectives are not usually the same as those of ordinary real estate investors, we begin by considering the difference between investment and market value. Investment value has been defined as "the value of an investment to a particular investor, based on his or her investment requirements, as distinguished from market value, which is impersonal and detached."⁵ The investment value of an asset is the amount a specific investor might pay for the asset, as opposed to the amount the unidentified, hypothetical market purchaser might pay. In determining investment value one must consider the unique motivations, opportunities, investment criteria, conditions of sale, risk tolerance, cost of capital, and other investment variables of an identifiable purchaser.

In determining market value, on the other hand, each such variable would be detached from specific investor identification, and would instead be determined by the

general characteristics of the market as a whole, the characteristics of the reasonable, prudent investor.

In every purchase there is investment value, because it is equal to the amount the successful purchaser believed the asset was worth. In many cases, this amount is also reasonably within the range of, or coincides with, the market value of the asset. One may find, for example, that two-thirds of all office buildings within a given market are sold within a price range of just 20 percent of each other. With the accumulation of many purchases by "typical" investors of fairly similar assets, purchasing patterns begin to take shape (particularly in an active market) and values will fall within

a normally distributed bell curve. Multiplied over many transactions, the investment value of a particular asset to one ordinary investor begins to also influence the investment value of a similar asset to another ordinary investor by shaping investment expectations. Then there are the outliers. The foreclosure sales, the bankruptcies, the sales between relatives, the business enterprise sales, the portfolio purchases. These all have an associated investment value, but each is, almost by definition, not necessarily market value.

For assessment purposes in most jurisdictions, property is to be assessed at market value and not investment value where investment value is different from market value. In most jurisdictions, a recent arm's length sale is legally considered strong evidence, and the sale is therefore considered indicative of market value. The key, then, is determining when a particular sale is not equal to market value.

In dealing with a sale of property to a REIT, the first order of business is to compare the purchase price with current local sales data. If the local market price range for office properties is predominantly between \$160 and \$200 per square foot and the subject sale is at \$180 per square foot

Because of their ability to extract more value from a given parcel of real estate than conventional bidders while still obtaining the same or a better return on investment, the REIT will often be able to pay more and will pay more to get the property

Detecting Intangible Asset Value

the investment value for the subject is fairly equivalent to the market value and a more probing analysis of the sale is not likely to reveal otherwise. In contrast, if the purchase is at \$300 per square foot, the analyst would be irresponsible in summarily concluding this to be the market value of the subject property. Though it may well turn out to be market value (for a variety of reasons one might imagine), closer analysis is still required.

Frequently, such pricing anomalies occur in sales to REITs.

This article is intended to provide a (non-exhaustive) overview of the specific factors one might consider in determining whether a seemingly above-market price was produced by investment variables unique to the REIT investor and unavailable to the ordinary market participant. Significant in this analysis is the identification of the characteristics

REITs prioritize cash flow and its growth ahead of asset appreciation in their acquisition strategy. A building with a strong cash flow projection will ultimately be more desirable to shareholders in the company than a building that may operate on a razor-thin margin but hold out the possibility of significant appreciation in 15 years

of the investors in the local market. To an extent, a large CBD may not only have a great number of REIT participants who enjoy similar investing advantages, it will likely have other institutional market participants such as pension funds and insurance companies that mimic many of the REIT advantages such as a lower cost of capital and reduced risk through diversification of assets and tenancies. A suburban or rural market may see greater contrast among the players and their respective abilities to pay a premium. Here too, one must be cautious in making distinctions, for with larger CBD properties, a seemingly minor difference between the profiles of two institutional purchasers may be greatly magnified, such as through cost-savings based on one company's ability to self-manage its buildings.

THE REIT ACQUISITION MINDSET

The *ad valorem* standard that governs taxation of real property requires the assessment professional to stand in the shoes of the hypothetical purchaser, make the assumptions of that purchaser, seek the return on investment of that purchaser, and assume the concerns of that purchaser relative to risk. Presumably, then, one arrives at a value that should roughly equate to the amount a typical market participant would pay for the asset. To the extent that a REIT purchaser may make different assumptions, anticipate a different return from a given set of rents, and anticipate risk differently from other purchasers, a value may be produced that is correspondingly different from what an appraiser might consider the fair market value of the asset.

Therefore, in addition to acknowledging the definitional distinction between market value and investment value, one must begin the analysis with an understanding of the factors a REIT acquisition team would be concerned with and contrast those factors with the approach taken by an ordinary investor.

Like any investor, each REIT is somewhat different in its approach to buying and operating real estate, so generalizations about how REITs do business are limited. Nevertheless, common threads run through a great many REIT acquisition and holding strategies, particularly as a result of their obligations to shareholders. This can be said to characterize a common REIT approach, or mindset, and that will often differentiate the amount a REIT will offer for a given asset from those of other investors.

Non-REIT real estate investors tend to buy property primarily in the hope of substantial asset appreciation over the holding period, anticipating much of the return on investment will accrue through the residual value of the property at the time of disposition or refinancing. Cash flow is primarily a concern to the extent that rents must cover operating expenses, reserves, and debt service so that there is no negative outlay of cash beyond the initial equity. A common example is the so-called "taxpayer" property, in which the property owner accepts the prospect of doing little better than breaking even (paying the taxes) during the holding period, which is offset by the build-up of wealth in the asset's appreciation over time.

In contrast, REITs prioritize cash flow and its growth ahead of asset appreciation in their acquisition strategy. A

Detecting Intangible Asset Value

building with a strong cash flow projection will ultimately be more desirable to shareholders in the company than a building that may operate on a razor-thin margin but hold out the possibility of significant appreciation in 15 years. Like virtually all public companies, a REIT's shareholders have little interest in the disposition value of the corporation's assets and are mainly focused on an assurance of positive and growing cash flow over a long period of time. In a REIT, the corporation's assets are its real estate holdings, which are a vehicle for the generation of income as opposed to the accumulation of personal wealth through net asset value. The same is true, for example, of the value of a railroad corporation, in which it is the ability of the railroad's assets—trains, rail lines, shipping contracts, and work-force—to generate income, and not in the physical assets themselves. As in any corporation, REIT shareholders would surely be outraged if the corporation in which they held stock decided one day that the company could generate more immediate and substantial cash by simply disposing of its assets.

So long as the REIT can predict that a property—or more often a portfolio as a whole—will produce the desired cash flow then it becomes irrelevant to the REIT what the market value of a particular property might be from the perspective of the ordinary investor.

In his examination of the reduction of unsystematic risk in lease portfolios through a so-called Monte Carlo Simulation, Colacino⁶ suggested the concept of "baskets" of commercial office leases being pooled and traded in a secondary market. To a great extent, it can be said that the REIT model does exactly this: the corporation is merely the securitizing entity that gathers together a vast volume of cash flows from its leases and sells securitized ownership rights in those cash flows to those purchasing stock in the company.

As a result of this cash flow-oriented approach to real estate investing, REITs tend to have longer holding periods for their assets than non-REIT real estate investors. To dispose of assets that generate a reliable source of cash

flow, even at an opportune time for sale, is often contrary to the corporate strategy of a REIT. As in most industries, the liquidation of a major revenue-generating asset is considered an "extraordinary" event under generally accepted accounting principles (GAAP) that could materially distort the depiction of a company's performance for forecasting purposes.

This approach is also aided by the REIT's lack of "below-the-line" expenses such as debt service (or at least less than typical) and income taxes. This means a REIT may produce a profit from the same cash flow that would have allowed the traditional investor to merely break even, and for which the traditional investor would probably have paid less for the asset.

So long as the REIT can predict that a property—or more often a portfolio as a whole—will produce the desired cash flow then it becomes irrelevant to the REIT what the market value of a particular property might be from the perspective of the ordinary investor. The following disclaimer from a REIT prospectus is typical of the industry approach to investing:

The company did not obtain appraisals of the fair market value of any of the original properties or related assets that the company will own immediately after consummation of the Offering. The public offering price of the shares and the related underlying valuation of the company have been determined primarily by capitalizing estimated cash flow of the company available for distribution, the enterprise value of the company as a going concern and other factors, rather than through a property by property valuation based upon historical cost or current market value. This methodology has been used because management believes it is appropriate to value the company as an ongoing business, rather than with a view to values that could be obtained from a liquidation of the company or of individual properties owned by the company.⁷

As discussed in detail below, it is also true that a REIT acquisition team may employ different assumptions in modeling potential returns than ordinary investors will. It is this very belief on the part of REIT managers as buyers of property that they can obtain efficiencies in operation—regardless of whether they are correct in their belief—that may make it more likely that the REIT will acquire its properties at a premium.⁸ Another major concern to the

Detecting Intangible Asset Value

Figure 1

	NON-REIT OWNERSHIP		REIT OWNERSHIP	
		PSF		PSF
INCOME				
Total Base Collected Rents				
320,000 SF Avg. Occupancy	\$7,840,000	\$24.50	\$7,840,000	\$24.50
Escalations & Recoveries (Actual)	\$396,800	\$1.24	\$396,800	\$1.24
Parking & Other Income (Actual)	\$35,200	\$0.11	\$35,200	\$0.11
Total Recoveries	\$432,000	\$1.35	\$432,000	\$1.35
POTENTIAL GROSS INCOME	\$8,272,000	\$25.85	\$8,272,000	\$25.85
Market Vacancy (Market - 97%)	\$8,023,840	\$25.07	\$8,023,840.00	\$25.07
EFFECTIVE GROSS INCOME	\$8,023,840	\$25.07	\$8,023,840	\$25.07
OPERATING EXPENSES				
Utilities (not recovered in base rent)	\$1,020,800	\$3.19	\$1,020,800	\$3.19
Operating Services	1,113,600	\$3.48	1,113,600	\$3.48
General & Administrative	12,800	\$0.04	12,800	\$0.04
Management	321,782	\$1.01	22,000	\$0.07
Reserves for Replacement (EGI)	0	\$0.00	0	\$0.00
Real Estate Taxes	1,024,000	\$3.20	1,024,000	\$3.20
Amortized Leasing Commissions	156,800	\$0.49	156,800	\$0.49
Amortized Tenant Improvements	326,400	\$1.02	326,400	\$1.02
Total Expenses	\$3,976,182	\$12.43	\$3,676,400	\$11.49
NET OPERATING INCOME	\$4,047,658	\$12.65	\$4,347,440	\$13.59
VALUATION ANALYSIS:				
Net Operating Income	\$4,047,658		\$4,347,440	
Capitalization Rate	0.09750		0.09750	
Fair Market Value	\$41,514,441	\$129.73	\$44,589,128	\$139.34

Capitalization of Management Savings:

Savings PSF: \$9.61
 x 320,000 SF:
 \$3,075,200

Total Value of REIT Self-Management:

\$3,075,200

Difference: \$9.61 PSF

acquisition team, particularly when assembling a multi-billion dollar portfolio purchase, is the passage of time. The acquisition team may often operate within a much larger corporation in which the concerns of other departments—such as the property tax director who must wrangle with the after-effects of a transaction—are of only moderate concern at the time of purchase. More significant is the goal of simply closing the deal—a mark of success or potential failure for the acquisition team, which is often characterized by a highly short-term outlook. The net asset value of the portfolio as a whole may be important, but haggling over individual property values rarely occurs. If the deal can be closed while paying what some might say was more than market value for an individual asset, the overpayment is of little significance compared to

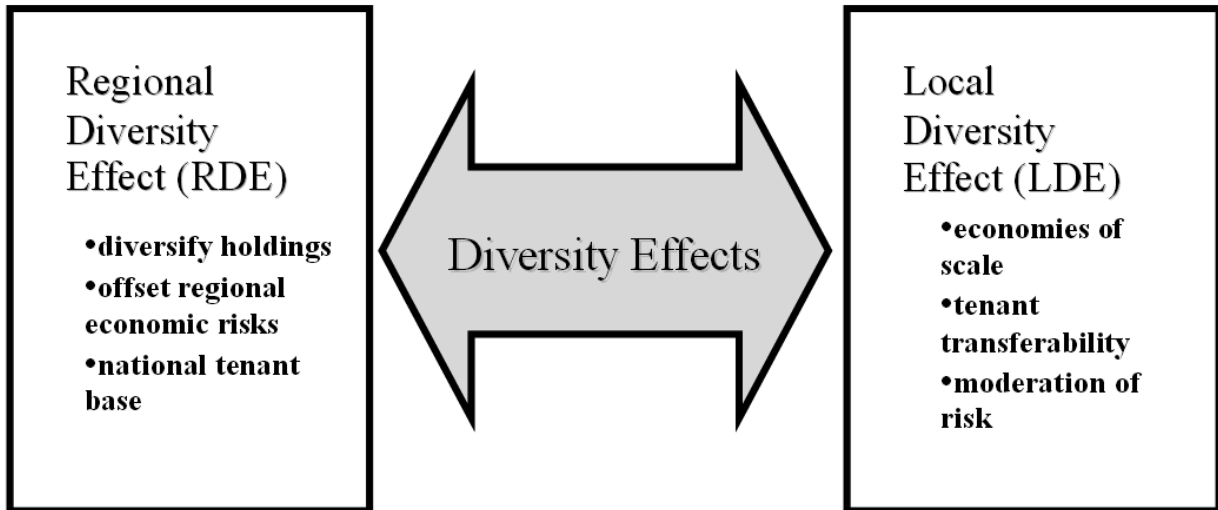
the costs of a failure to close the whole portfolio because another player jumped in at the last minute while the first was haggling.

The cost of an overpayment relative to net asset value may also pale in contrast to the increased transaction costs, such as accruing interest on a billion-dollar loan, that would be incurred if the parties were to dicker over individual asset values. In perspective, so long as the overall price relative to the overall cash flow obtained makes sense, the deal should go forward as quickly as possible.

With these concepts in mind, it quickly becomes apparent that our goal of determining market value for *ad valorem* taxation purposes may be a very different objective from

Detecting Intangible Asset Value

Figure 2



what the typical REIT is aiming for when it purchases property.

OPERATING EFFICIENCIES, SELF-MANAGEMENT, AND TENANT SERVICES MAY INCREASE REIT INVESTMENT VALUE

As noted, REITs may well purchase their properties in part on the belief that greater returns will be generated simply because of the REIT operation and the efficiencies the company brings as an owner and operator of a large portfolio of real estate.⁹ When analyzing a particular transaction price to determine whether it contains some component of intangible value paid by the REIT, one must consider the operations of the particular REIT involved. Often, itemized income and expense statements generated for the property a year or more after purchase, particularly as compared to operating statements from the previous owner, can reveal operational changes due solely to REIT ownership.

Other items of information will be available to the appraiser through researching the particular REIT's business operations, such as the particular types of ancillary services the company may provide which may include management, security, cleaning services, and other potential profit centers. Research may also reveal any economies of scale that may be realized through centralized property

management and suppliers, in-house designers and planners, and other portfolio-oriented cost advantages.

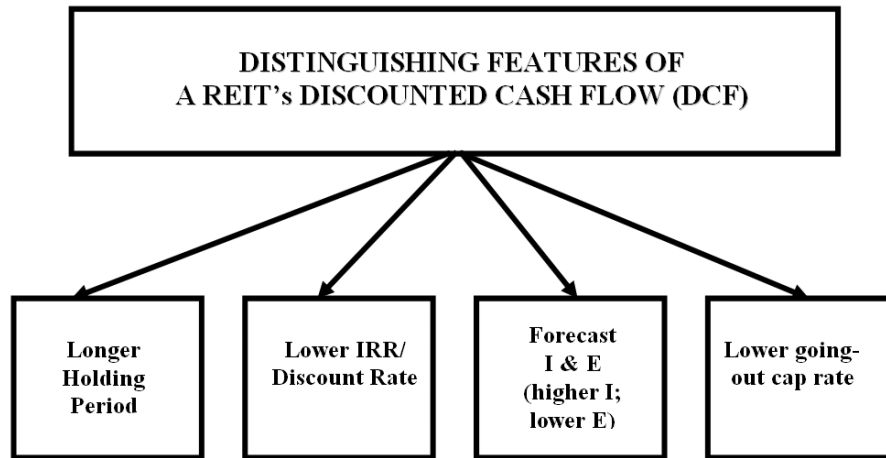
For example, in the context of office or warehouse properties, a portfolio of 50 buildings in a single market may require no more than two or three on-staff managers to oversee operations. Because the REIT can be an owner-operator (unlike, say, a pension fund owner), the REIT saves money in the first instance by avoiding the costs and fees associated with third-party management. Because many properties are concentrated in one area, the REIT further saves money through the economy of scale of a handful of staff covering multiple buildings.

The total salary expense for this management staff will be a small fraction of the fees that any other investor would pay for a third-party management company to oversee 50 buildings, or sometimes just a single large property. Depending on the type of properties in which the particular REIT specializes, this concentration of properties will have a similar effect on all manner of supplies and costs related to the operations of the real estate, such as insurance, repair and maintenance items.

This added premium value for management services is quantifiable, and often generates a greater "investment value" for a given property to the REIT than the general market value of the property. The hypothetical pro forma comparison below (Figure 1) demonstrates how the value of self-management can be isolated by adjusting only

Detecting Intangible Asset Value

Figure 3



management fees to derive an estimate of a portion of the intangible value that may be attributed to REIT-ownership.

Additionally, the economy of sale principle lends itself to the operation of the ancillary businesses that can be operated by the REIT mentioned above, all of which can turn an ordinary property with a limited cash flow into one with multiple profit centers not available to the ordinary investor. Such services may include a wide variety of items such as security, trash collection, providing heat and light, and cleaning services. Distilling the value of such profit centers and the "intangible" value of a major sophisticated management operation is not much different in methodology from that which is often employed in the valuation of regional and superregional shopping centers. Rent differentials and operating expense ratios among comparable properties may be helpful indicators of the degree of additional value attributable to non-market factors. These profit centers are considered in the REIT's determination of its investment value in a given property or portfolio.

DIVERSITY EFFECTS ON THE PORTFOLIO VALUE OF REAL PROPERTY

Generally a property valued in a portfolio is less risky than the same property valued alone.¹⁰ By combining one property with others the risk of the single asset is reduced, and

the portfolio effect is "the extent to which the variation in return on a combination of assets (a 'portfolio') is less than the sum of the variations of the individual assets."¹¹ REITs are a classic example of portfolio owners.

Even in a single property this principle can be achieved through lease term diversification: different termination dates would even out the cash flow of the portfolio compared with the cash flows of the individual properties. Viewed as a whole, the portfolio owner's properties contain a broad array of leases with differing terms.

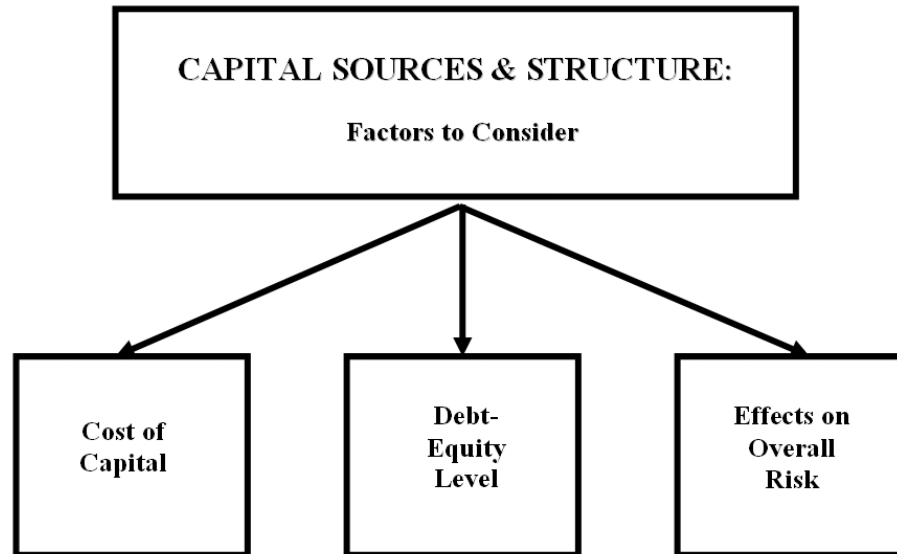
We term this concept generally as "Diversity Effects," which may be further divided into two distinct types of Diversity Effects: (1) the Regional Diversity Effect (RDE), and (2) the Local Diversity Effect (LDE) (Figure 2).

REGIONAL DIVERSITY EFFECT

Aside from overall growth of income from a portfolio, much of a REIT's core business strategy and objective is focused on the moderation of overall risk to the company and its total cash flow. A single-asset real estate investor faces a relatively greater level of risk, even in the ownership of a top-notch, fully-leased Class A building, when compared with the overall level of risk experienced by an investor who owns multiple properties, even if each of those properties are less than ideal.

Detecting Intangible Asset Value

Figure 4



By applying the RDE to their advantage, REITs typically own multiple properties in several distinct markets throughout the country, often owning properties thousands of miles apart, as opposed to owning multiple properties in only one area. Where an entire region may experience an economic downturn, perhaps due to a major local employer's decision to downsize, other portions of the REIT's portfolio may be situated in regions that continue to experience growth. The overall risk and performance level of the portfolio may remain virtually unchanged.

As a result of the RDE, the REIT may be able to employ a risk tolerance that is atypical of most other players in the particular real estate market. This is generally not a market factor but rather a question of investment value for the particular REIT, indicating that the purchase price is unnaturally skewed.

LOCAL DIVERSITY EFFECT

The Local Diversity Effect (LDE) has at least two major components, some of which has already been touched upon here:

ECONOMIES OF SCALE

As discussed above, in any one market a REIT may own many buildings of similar use within a relatively small radius. One office REIT that we examined owns over 50

properties with a radius of about four to five miles of each other. This high concentration of assets creates tremendous economies of scale in the operation and oversight of the real estate, as well as a significant impact on the local portfolio's risk level. The subsequent addition of a full office park or only one or two additional properties within the local market may not require any significant addition of staff to perform management functions. This local concentration of properties creates a variety of cost savings advantages for the REIT over other property owners and it also significantly reduces overall risk.

TENANT TRANSFERABILITY

The second major component of LDE is a reduction of local risk to the portfolio, which is a direct result of Tenant Transferability. In the example above in which an office REIT owns more than 50 properties within a small geographic area, the REIT holds leases with some 200 office and warehouse tenants renting space in blocks of anywhere from 500 square feet to 200,000 square feet. Buildings fall within a broad range of Class C to Class A space. Because of the close proximity of one building to another (many are adjacent to or across the street from others in the portfolio), the REIT has a major advantage over the single-building owner, because the REIT's tenants can be moved into other REIT-owned buildings as the tenants' space needs change over time. This reduces the overall vacancy rate of the portfolio, thereby reducing risk

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and maintaining cash flow, and is an attractive feature to incoming tenants who may be attracted by—and pay more for—the knowledge that they can be accommodated as their needs change. Furthermore, the costs of a leasing broker may often be omitted entirely or significantly reduced.

A COMPARISON OF DISCOUNTED CASH FLOW (DCF) FACTORS

It is important to consider and contrast the way in which REITs and non-REITs may formulate DCF models (in those cases in which appraisals are prepared).

Discounted cash flow analysis is a useful tool in the income approach because it makes explicit the factors and assumptions that go into the investment decision, whereas direct capitalization only implies these factors. As a result, DCF can often provide a revealing look at what an investor was thinking when it determined that a particular property met its investment criteria, would produce a desired return, and was worth bidding a particular purchase price. We provide below just a few points in which, in our experience, it appears that a typical REIT DCF analysis might differ from that of the non-REIT investor (Figure 3).

HOLDING PERIOD

REIT executives we interviewed indicate that REITs tend to project longer holding periods for particular properties than many other investors. The REIT is primarily interested in long-term cash flow rather than the return on sale. A longer holding period means that a REIT has a greater opportunity to meet its desired level of return while possibly accepting less-than-stellar performance in the early years of an investment. This type of approach would not be apparent if the appraiser were to look only at the sale

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price and first year's NOI. A long holding period also tends to smooth out overall risk caused by real estate cycles. For example, if an investor purchased a property in 1988 and held it for only five years, the investor would have sold it near the bottom of the market in 1993. In contrast, if an investor were to purchase the same property on the same date, and hold it for 10 years, the investor would have enjoyed the recovery of the market in the late 1990s, and owned a more valuable property in 1998 with higher rents.

INTERNAL RATE OF RETURN/DISCOUNT RATE

Anecdotal evidence indicates that REITs typically accept an apparently lower internal rate of return on a given investment for a given set of projected cash flows than ordinary real estate investors. A lower discount rate for a given set of cash flows will produce a higher initial investment, or purchase price. This appears to be acceptable to the REIT again due to the REIT's ability to maximize the profit potential of each below-the-line dollar in a way most others cannot duplicate. There are at least two ways in which the REIT accomplishes this:

- The REIT as a tax-favored entity: the REIT is a tax-favored entity for federal tax purposes. The REIT's taxable income is only taxed at the shareholder level, in contrast to other corporations, and therefore a dollar of before tax NOI carries greater value for a REIT than it would for an ordinary owner. The REIT can meet or exceed returns obtained by other property owners who might pay substantially less for the investment.

- The REIT enjoys a lower level of risk and favorable position in the capital markets: as will be discussed below, the level of risk enables many REITs to maintain a concomitantly lower debt level and cost of capital than typical real estate investors, which means that more cash flow accrues directly to the benefit of the REIT and its shareholders.

FORECAST INCOME AND EXPENSES

As a result of the Local Diversity Effect that produces a variety of economies of scale, discussed above, a REIT's DCF for a given property will likely indicate lower costs for many expense items than would be projected by non-REIT investors, again allowing the REIT to offer a higher price and still produce the desired return. Additionally, with its typically dominant local market position, a given

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REIT may be able to negotiate better rentals with tenants and derive additional income from some of the potential profit centers noted above, thus generating greater revenue out of a property than the ordinary investor would obtain. The average market participant will likely be more conservative in its forecasts of future income and expenses.

GOING-OUT OR TERMINAL CAPITALIZATION RATE

The remaining DCF factor that is worthy of attention is the terminal capitalization rate used by the REIT. This is the capitalization rate the investor estimates for the sale of the property at the end of the holding period. Because the REIT will tend to hold its assets for a longer holding period, as discussed above, this is a more remote consideration than the other DCF factors, but it nevertheless will impact the REIT's return on investment and the price the REIT will pay. With higher rents, lower expenses, and reduced overall risk, to a certain extent the REIT will have set in place the factors necessary to raise the terminal value of the property.

CAPITAL STRUCTURE AND CAPITAL SOURCES IN REIT TRANSACTIONS

In the 1990s, REITs had extreme flexibility in obtaining new equity for acquisitions through stock offerings. Today, REITs are often in stiff competition with other institutional purchasers and some of the ease with which REITs raised capital is gone. Foreign investors today enjoy significant advantages in their access to low-cost capital. However, REITs still enjoy significant advantages over many other real estate investors in cost of capital, access to capital markets, and capital structure. At least three issues related to the sources and use of capital are relevant to our discussion: (1) the cost of capital, (2) debt/equity level, and (3) effects on risk (Figure 4).

As a general investment principle, so long as an investor can access capital cheaper and on a less risky basis than other investors, that investor will be able to spend more while still achieving a desired return.

Like most publicly traded corporations, REITs access capital from a variety of sources not generally available to private real estate investors. Today's REITs may obtain capital from a combination of sources that may include commercial lenders, pension funds that are willing to lend money in a mortgage transaction, major lines of credit, and the issuance of debt in the public markets. A REIT may typically buy and sell multiple properties in a single transaction, perhaps accessing a billion or more dollars and,

depending on the credit of the REIT, enjoying preferred terms in comparison to other investors. At times, when REITs also enjoy a favorable reputation among stockholders, many REITs readily issue stock to raise large sums of cash with few strings attached. The transaction costs that REITs incur tend to be significantly lower than those charged to non-REIT investors.

The cost of capital in such transactions is frequently measured against LIBOR,

As a general investment principle, so long as an investor can access capital cheaper and on a less risky basis than other investors, that investor will be able to spend more while still achieving a desired return.

with preferred borrowers enjoying interest rates closer to LIBOR than other borrowers. As compared with other investors, large REITs will in many cases borrow capital at 150 to 200 basis points below more conventional real estate borrowers.

Another difference in the use of capital by many REITs is the debt-equity level in a REIT

transaction. Most conventional real estate loans today are in the range of 70 percent of value. A REIT, in contrast, will tend to borrow at the entity level rather than at the property level. Consequently, debt is often kept well below ordinary loan-to-value ratios, and the capital market and credit rating agencies typically require most REITs to operate at relatively low loan-to-value ratios. In addition to lowering overall risk, the result is also lower debt service payments that would reduce the below the line cash flow.

PURCHASES OFTEN INVOLVE MORE THAN JUST REAL ESTATE

The foregoing concentrates on a variety of factors that may affect the investment value of specific properties or an entire portfolio to a REIT, primarily as that value relates to the cash flow characteristics of those properties. An entirely different factor that has historically been found in many REIT purchases is the value paid for items having virtually no direct relationship to the real estate at all.

Currently, mergers and acquisitions involving REITs seem to have diminished from the levels seen in the late 1990s,

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with the exception of several sectors. However, when these transactions do occur, the acquiring REIT typically pays a lump sum to obtain the entire business operations and assets of the acquired real estate company. In short, the REIT is buying the assets of another REIT, and along with those assets are many intangibles typically associated with any large corporation.

The acquirer inherits many of the general and administrative expenses of the acquired company with the hope of a successful integration and resulting economies of scale. The amount paid often includes tens of millions of dollars relating to the immediate vesting of stock options, changing of control, payments under employment contracts, refinancing of debt, fees for investment bankers, auditors, attorneys, and a

host of other major transaction costs that may be buried within a multi-billion dollar deal. If, as is frequently the case, the total purchase price of the transaction is simply allocated among the buildings comprising the acquired portfolio based upon square footage, it is apparent such an allocated purchase price will not be equivalent to the market value of the individual properties; the stated price is composed of a significant amount of non-realty value.

This is perhaps one of the most straightforward examples capitalized economic profit forming a portion of the purchase price. In examining a particular sale for property tax assessment purposes, one must thoroughly investigate the circumstances of the sale before concluding that the sale is equivalent to market value. Where an acquisition of another company has occurred, the purchase is not necessarily viewed as simply the acquisition of real estate, but rather an ongoing business.

When reviewing a reported sale to a REIT, particularly where it is known that the sale involved a merger or acqui-

The investment value of a given property to a REIT may or may not be the same as for an ordinary investor and consequently may not always equate to market value. It should be apparent that these transactions often require far greater analysis and investigation than those involving more "ordinary" investors.

sition, a good place to start—what may also be referred to as a "sanity check"—is to compute the direct capitalization rate of the transaction. While there are many genuine realty-related factors that might skew this rate (such as a large vacancy that is anticipated to be absorbed quickly), an extraordinarily low first-year capitalization rate is often the first indication that the purchase money went to more than just the real estate value.

While REITs may often pay institutional investor capitalization rates for many of the reasons discussed earlier in this article, there is a point at which the indicated rate becomes so extraordinarily low that it cannot be considered indicative of the real estate market, at least not an indication of what ordinary local investors are paying in a particular market.

CONCLUSION

Though the REIT industry has changed, adapted, and matured in recent years with general economic trends, REITs continue to attract attention among property tax practitioners and to play a dominant role in many real estate markets. In some jurisdictions in which property tax appeals may remain unresolved for many years at a time, such as New York, REIT purchases made in the late 1990s are still directly at issue. Moreover, REITs remain distinguished from many other, more traditional real estate investors in their approach to buying and operating real estate. As such, the investment value of a given property to a REIT may or may not be the same as for an ordinary investor and consequently may not always equate to market value. It should be apparent that these transactions often require far greater analysis and investigation than those involving more "ordinary" investors. The analyst must inspect and understand the pro forma in far greater depth than with other transactions, research the characteristics of the REIT purchaser as a company, including the size, scope, and geographical location of its portfolio, its capital sources, and its general risk characteristics, among many other factors. One must also investigate thoroughly the components of the transaction itself to determine whether the REIT has paid for intangible and other assets of another business that are incorporated into the purchase price but which may have nothing to do with the underlying real estate for tax assessment purposes.

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Converting Tax Incentives into Profitable Historic Rehabilitation Projects

BY GORDON GOLDIE, CPA, AND TIMOTHY A. FRENS, CPA, MBA

SINCE 1976, RESOURCEFUL DEVELOPERS HAVE taken advantage of significant tax incentives to rehabilitate historic properties into profitable development projects. Such incentives have sparked renewed interest in reviving forgotten local landmarks and have enabled developers to successfully tap into an emerging market of commercial and residential tenants who are looking for unique space.

However, according to the National Trust for Historic Preservation, historic tax credits are widely underutilized. So, what tax incentives are available for historic rehabilitation projects and how can a developer take advantage of them? It depends upon the location of the property—in many cases a project may qualify for federal and state historic tax credits and New Markets Tax Credits.

FEDERAL REHABILITATION TAX CREDIT

The Internal Revenue Code (IRC) provides a federal tax credit of either 10 or 20 percent of qualified rehabilitation expenditures (QREs) incurred in connection with the rehabilitation of a qualified building. QREs represent all rehabilitation costs that are capitalized as part of the depreciable cost of the building and its structural components. QREs exclude acquisition costs, land improvements, and personal property. However, they may include capitalized interest and property taxes, as well as reasonable construction man-

agement fees and developer fees paid to related parties. Property owners may claim the credit in the year that the QREs incurred on a project are placed in service. Tax credits are extremely valuable, because they represent a dollar-for-dollar reduction in your federal income tax liability.

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ELIGIBILITY REQUIREMENTS FOR FEDERAL HISTORIC TAX CREDITS

To be eligible for the 20 percent credit, the following requirements must be met: (1) The building must be individually listed in the National Register of Historic Places or contribute to a historic district that is listed in the National Register, and (2) The rehabilitation must comply with the design and construction principles of the Secretary of Interior's Standards for Rehabilitation. These standards are designed to ensure that the architectural and historic significance of a property will be maintained during the rehabilitation process.

Nonresidential, nonhistoric buildings that were originally placed in service prior to 1936 are eligible for a 10 percent federal credit. The 10 percent credit can also be applied to a mixed-use project (e.g., first floor retail and upper floor loft apartments) as long as the revenue generated by the residential portion of the project is less than 80 percent of the project's total annual gross revenue.

In addition, there are some general restrictions that apply to both credits. For example, to qualify for either the 10 percent or the 20 percent credit, a building must be used in a trade or business. Therefore, personal residences are not eligible. In addition, the availability of the credit may be restricted if the property is owned or used by a tax-exempt entity. The property owner also must select either a 24- or 60-month rehabilitation period and the owner's QRE during that time must exceed the building's adjusted basis at the beginning of the period.

OBTAINING FEDERAL HISTORIC TAX CREDITS

To claim a 20 percent credit, the rehabilitation must be certified by the National Park Service. To obtain certification, taxpayer's must prepare and submit a three-part Historic Preservation Certification Application. The three-part application addresses the following: Part 1 of

the application provides information regarding the historical significance of the building and Part 2 includes a description of the proposed rehabilitation. Part 3 is submitted upon completion of the rehabilitation to request certification. Taxpayers must submit the application to the State Historic Preservation Office (SHPO). Applicants must pay a fee ranging from \$500 to \$2,500 with their application.

There is no certification process required for rehabilitations of buildings eligible for the 10 percent credit and the rehabilitation is not required to meet the Secretary of Interior's Standards for Rehabilitation.

NEW MARKETS TAX CREDITS

Another tax incentive that is quickly gaining favor in the historic rehabilitation area is the New Markets Tax Credit (NMTC). The NMTC program began with the passage of the Community Renewal Tax Relief Act in December of 2000. Under the NMTC program, through 2007, the CDFI (Community Development Financial Institutions) Fund of the Department of Treasury has authority to grant approximately \$6 billion of federal tax credits to taxpayers who make investments in or loans to qualified businesses located in low income communities. This federal tax credit is equal to 39 percent of the amount invested in or loaned to the qualified business. The investor is allowed to claim the credit over a seven year period, beginning with the date of the initial investment.

COMBINING THE HISTORIC TAX CREDIT AND THE NEW MARKETS TAX CREDIT

Not only can the NMTC be combined with the federal historic tax credit, but many of the properties that qualify for historic tax credits are also eligible for NMTCs. The National Trust for Historic Preservation estimates that 58 percent of buildings located in historic districts are located in census tracts that qualify for NMTCs. In addition, to date, a majority of the investments and loans made under the NMTC program have been used to finance real estate development projects, such as historic rehabilitation projects. However, it is important to note that, just like the 10 percent federal rehabilitation tax credit, NMTCs are not available for residential rental real estate. Residential rental real estate is defined as any building where 80 percent or more of the gross rental income from the building

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is rental income from dwelling units used as living accommodations. Consequently, a mixed use facility can qualify for NMTCs as long as the rental income from the residential portion of the building represents less than 80 percent of the building's gross rent revenue for the year.

OBTAINING NEW MARKETS TAX CREDITS

Access to the NMTC is only possible by routing an investment through a community development entity (CDE) that has directly or indirectly received an allocation of NMTCs from the CDFI Fund of the Department of Treasury. To date, the CDFI Fund has authorized approximately 130 CDEs to award \$2.34 billion of NMTCs. In May 2005, the CDFI Fund is expected to award an additional \$.78 billion of NMTC allocations to CDEs that submitted applications in October 2004. During the application process, each CDE identifies the geographic area where they will utilize their NMTC allocation. While some CDEs have geographic scopes as small as one city or county, many CDEs have a national scope which allows them to use their NMTC allocation in any low income community in the country. In addition, CDEs generally restrict the types of projects to which they are willing to allocate NMTCs (e.g., charter school facilities, nonprofit organizations, etc.). As a result of these restrictions, there may only be a few dozen CDEs that are allowed to allocate NMTCs to a particular historic rehabilitation project. However, many CDEs have specifically targeted historic rehabilitation projects. For example, a subsidiary of the National Trust for Historic Preservation has received an allocation of NMTCs with a national scope, which will be used primarily to benefit projects that are eligible for federal and state historic tax credits.

While historic tax credits can provide significant financial incentives for a rehabilitation project, they do not come without some costs. Failure to recognize such costs is a common pitfall that could easily be avoided.

POTENTIAL BENEFITS OF NEW MARKETS TAX CREDITS TO HISTORIC REHABILITATION PROJECTS

If the owner of a historic building is able to identify a CDE that is willing to assign part of its NTMC allocation to the project, the investor who "purchases" the historic tax credits will also receive NMTCs. Since the investor will receive two tax credits for making one investment, the investor is typically willing to make an investment that is approximately 25 percent higher than they would have made if they had only received historic tax credits. Historic rehabilitation projects can also benefit from the NMTC program by routing debt financing through a CDE. Since the lender's rate of return is essentially subsidized through the NMTCs generated by the CDE's loan to the historic project, the project can effectively borrow money at very favorable terms. For example, the interest rate could be as much as 2 percent to 3 percent below market or the project may not be required to repay the entire loan.

EXAMPLE: TWO SOURCES OF NMTC'S BENEFIT DETROIT HISTORIC REHABILITATION

In Detroit, a historic building was recently rehabilitated into a business incubator for high-tech companies with the help of two different sources of New Markets Tax Credits. The project benefited from a \$5.4 million New Markets Tax Credit enhanced loan which will save the project \$115,000 per year over the seven year term of the loan. In addition, the project's historic tax credit investor agreed to infuse the project with \$920,000 of additional capital after the transaction was restructured to enable the investor to receive New Markets Tax Credits upon making a \$3.6 million capital contribution to "purchase" the federal historic tax credits generated by the project.

STATE TAX INCENTIVES

While the federal government provides a significant financial incentive to encourage the rehabilitation of historic buildings and districts throughout the nation, individual states have also stepped up and formed unique programs involving tax credits, grants and loans to encourage the rehabilitation of historic properties. Such programs are typically coordinated by the SHPO. Twenty-four states currently offer some form of tax credit as an incentive to encourage rehabilitation of historic properties. In addition, twenty-nine states currently offer some form of

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property tax abatement for owners of historic properties. Many thousands of historic properties have benefited from state tax incentives such as these. The National Trust for Historic Preservation has compiled a list of these incentives. This list, which includes a brief description of each incentive, is available on the National Trust's website at <http://www.nationaltrust.org/help/taxincentives.pdf>.

OVERVIEW OF A TYPICAL STATE HISTORIC TAX CREDIT: MICHIGAN

The State of Michigan offers a state historic tax credit that is similar to credits offered by other states. Like many state historic tax credits, the Michigan credit has different eligibility requirements than that of the federal historic tax credit. For example, Michigan does not require the property to be used in a trade or business. Consequently, personal residences are eligible for Michigan historic tax credits. In addition, Michigan places fewer restrictions on property that is owned or used by tax-exempt entities. To qualify for the Michigan credit, the QREs must exceed 10 percent of the property's State Equalized Value. The process required to obtain the Michigan historic tax credit is essentially identical to that required to obtain the federal 20 percent credit.

The Michigan tax credit equals 25 percent of QREs. However, the Michigan credit must be reduced by the amount of any available federal historic tax credit (which may result in a 5 percent net state credit). The Michigan credit can be used to offset either the Michigan Single Business Tax (SBT) or the Michigan Individual Income Tax. It may be claimed during the year that the completed rehabilitation certificate is issued for the project. Any portion of the credit not used in a tax year may be carried forward for a maximum of 10 years. The credit may be assigned (but not reassigned) to owners of a pass-through entity or to tenants. The state allows developers to assign 100 percent of the credit to a single owner or tenant. An efficient market also exists for the "sale" of these credits. These state tax credits typically "sell" for approximately \$.60 per \$1 of credit. However, the price for these credits can range from \$.50 to over \$1 per dollar of credit, depending upon the federal and state tax position of the "purchaser."

DETAILED EXAMPLE:

The value of tax credits in financing a certified historic rehabilitation project is illustrated in the following exam-

Table 1—Uses and Sources of Funds

Uses of Funds:	
Building and land acquisition cost:	\$1,500,000
Rehabilitation expenditures:	
Qualified rehabilitation expenditures (QREs), includes related party development fee	8,000,000
Land improvements and personal property	<u>500,000</u>
Total uses of funds	<u>\$10,000,000</u>
Sources of Funds:	
Tax credit investor equity:	
Federal historic tax credits (QRE x 20 percent x \$.90)	\$1,440,000
New Markets Tax Credits (\$1,790,000 x 39% x \$.50)	350,000
State historic tax credits (QRE x 5 percent x \$.60)	240,000
Developer equity (including deferred developer fee)	1,000,000
Bank financing	<u>6,970,000</u>
Total sources of funds	<u>\$10,000,000</u>

ple, which assumes that the federal credits are "sold" for \$.90 per \$1 of credit. The example also assumes that the federal historic tax credit investor's capital contributions qualify for New Markets Tax Credits and that the tax credit investor is willing to pay \$.50 per \$1 for the NMTCs. Finally, the example assumes that the project qualifies for a 5 percent state credit that is "sold" for \$.60 per \$1 of credit (Table 1).

As this example demonstrates, tax credits can finance a substantial portion of a project's costs. By combining several incentives, such as New Markets Tax Credits and federal and state historic tax credits, 25 percent or 30 percent

Converting Tax Incentives into Profitable Historic Rehabilitation Projects

of the cost of a historic rehabilitation can be funded with tax incentives.

WHAT ARE THE COMMON PITFALLS OF A HISTORIC REHABILITATION PROJECT?

One of the most common mistakes a developer can make is to not adequately plan the project. The success of the project often depends upon the developer's ability to prepare a realistic time budget and financial projection and to obtain SHPO approval of the design plans before beginning construction. The financial projections will be critical in assisting the developer with obtaining financing and in negotiating the "sale" of historic tax credits to an investor.

While historic tax credits can provide significant financial incentives for a rehabilitation project, they do not come without some costs. Failure to recognize such costs is a common pitfall that could easily be avoided. When evaluating the potential benefits associated with historic tax credits, it is important to consider the following:

Construction Costs—Because the 20 percent federal credit requires that the rehabilitation meet the Secretary of Interior's Standards for Rehabilitation, the hard and soft construction costs associated with such projects will be higher. In addition, following these standards may constrain the developer's ability to design the rehabilitation to meet the optimal needs of the building's ultimate occupants. However, the developer may be able to mitigate such design restrictions by seeking input from the SHPO as early in the process as possible.

Reduced depreciation deductions—Taxpayers claiming a federal historic tax credit are required to reduce the depreciable basis of the rehabilitated property by the amount of the credit claimed.

Potential credit recapture—Taxpayers claiming a federal historic tax credit are required to recapture a pro rata portion of the credit if they dispose of their interest in the property within five years of the rehabilitated project being placed in service. Many states historic tax credit programs have similar recapture provisions. In projects that benefit from New Markets Tax Credits, a seven year recapture period applies to the New Markets Tax Credits.

Limitations on use of credits—A taxpayer's ability to use a federal historic tax credit is often limited (due to at-risk, passive activity and alternative minimum tax limitations). Consequently, taxpayers who generate such credits often "sell" the credits to investors who are able to utilize them quicker. Fortunately an efficient market exists that allows developers to "sell" historic tax credits for approximately \$.90 per \$1 of federal credit. The pricing of state credits differs from state to state depending upon the specific provisions applicable to the state's historic tax credit.

Transaction structuring costs—Unfortunately, "selling" tax credits is not as easy as it sounds. The IRS does not permit the direct sale of such credits. To accomplish such a "sale," developers typically enter into a partnership or LLC with the credit "purchaser." Extensive financial projections are typically required to properly structure the transaction. In addition, the tax credit "purchaser" often requires an attorney to issue a tax opinion to give them comfort that the transaction is properly structured. Such complexities obviously increase the cost of the project.

WHAT ARE THE KEYS TO A SUCCESSFUL HISTORIC REHABILITATION PROJECT?

The most important ingredient to a successful historic rehabilitation project is assembling a team of experienced professionals. An integral member of the team will be a historic consultant, whose primary job is to safeguard the tax credit (i.e., review plans and decisions as they are made, always with the credit in mind). It is also critical to the success of the project that the architect, CPA, and attorney all have experience with historic rehabilitation projects and the related tax credits. ■

Counseling Under Conditions of Uncertainty

Probability Analysis in Real Estate Practice

BY ROLAND DEAN NELSON, CRE

PLACE YOURSELF IN THIS POSITION. You are asked to counsel a client on a piece of vacant land currently zoned single-family residential, with all common municipal utilities, located on a paved two-way street. This site is also a corner location and was originally occupied with a single-family home built in the 1920s, which burned to the ground several years ago. Just one block north of the Subject rezoning took place one year ago for a small, new, neighborhood strip shopping center, which is in the process of being leased out. The Subject's neighborhood is seen to be in the process of revitalizing itself and becoming more commercially oriented.

A doctor has indicated that he would be most interested in occupying a small, new, neighborhood medical clinic on this site. An investor, who would build to suit, has asked you to provide him with a reasonable "current" value of this site. Your investigations with the local zoning board indicates a general reluctance by the community to rezone the property now, or in the near future.

From researching current vacant land transactions, you are able to ascertain the indicated value "if" rezoning to office

use were permitted, and you can also estimate the indicated value "if" rezoning will not take place; a much lower value, as single-family would be the result.

Your client, the investor, wants a current indicated value. With this he will feel confident to make an offer to buy the property.

How would your valuation be effected by these factors?

You really cannot just say that it is worth so much without rezoning and is worth so much rezoned, and split the difference.

This situation offers the appraiser the opportunity to provide the client with a Probability Analysis.

It could require the counselor to question the local community planning department for an insight into their opinions.

About the Author

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Counseling Under Conditions of Uncertainty

It would be reasonable to explore other similar recent rezoning actions. It could also cause the counselor to consult with attorneys experienced in this field and cause you, as the counselor, to estimate the costs during the rezoning (taxes, insurance, and interest on the value) process.

With the current "as zoned" value (assuming a normal marketing period) and the present worth of the rezoned value in mind, the counselor can decide if indeed the probability is 75/25 or, say for illustration purposes, a 75% probability that the property would end up being rezoned and a 25% probability that it would not be rezoned. At this point the counselor could take 75% of the rezoned value and add to it 25% of the non-rezoned value with a time and expense allowance for a current "as is" value estimate. However, does this take into consideration the time value of money or cost(s) to rezone? If not, then deductions to account for them would be required.

This is a relatively simple probability analysis. Now let's look at another situation that is a little more complicated.

Let's hypothecate a high quality "headquarters" office building that you have been asked to analyze, assuming it is vacant and available in the current marketplace. Let's assume that your instructions are further stated that you are not to assume the present occupant is going to be available as a potential occupant/purchaser.

Typically, you find out that a headquarters office building is in the area of a +60% "efficiency" building. This "efficiency" rate means +60% is usable office space and 40% is interior atrium, or decorator lobby space, not typically rentable space. This fits the subject's description.

Usually, "headquarters" buildings of this type are show-off grandiose, prestige-type status symbols for the occupant.

Typically, modern office buildings have a +90% efficiency (usable building) ratio to total building area.

Your observations of the market quickly tell you that the typical office building investor usually pays for "usable" areas and this further means that the typical office building owner does not want the "carrying costs" of the non-usable building areas. These carrying costs can include property taxes, maintenance, insurance and utilities. These costs can and most often do, contribute to lower values as a typical income investment office building in the +90% efficiency area, with everything else from location to construction and condition being equal.

So now your investigation suggests that the highest value for this property would be as a headquarters office building, probably based upon a Cost Approach, and the lowest value as an investor office building with multi-tenant occupancy. Suppose you also find another niche in the marketplace to be a single user who is not a headquarters occupant and who is not an income-investor type of owner. This potential ego-driven occupant could be an owner-user or partial owner user and part income investor who would most probably pay much more than the net-income-driven investor and pay substantially less than the headquarters occupant.

This is where the counselor can effectively utilize a Probability Analysis.

For illustration purposes, let's say the counselor has come up with the following suggested values:

Suggested Value as Headquarters Building:
\$10,000,000

Suggested Value as an Owner-User Building:
\$7,000,000

Suggested Value as an Investor Building:
\$5,500,000

This scenario is not considered to be that unusual in the marketplace. Both the potential owner-user and the investor know that the excessive improvements required by many headquarters users are not recoverable in the market in the event of a sale.

Now, the counselor who has done his or her work and investigations carefully can apply a Probability Analysis. Let's say that the appraiser believes that there is only a 10% probability that "if" the property were offered on the open market, for a reasonable time period, a headquarters buyer could be found. Also suppose that the counselor feels that there is a 30% probability, or chance, that a partial owner-user can be obtained in the same general time period. This also means that there is a 60% probability that an investor will be the eventual purchaser if the property is offered on the open market.

Using the Probability Analysis Approach to value, we find the following:

Counseling Under Conditions of Uncertainty

Indicated Value as Headquarters Building:

$\$10,000,000 \times 10\% = \$1,000,000$

Indicated Value as an Owner-User Building:

$\$7,000,000 \times 30\% = \$2,100,000$

Indicated Value as an Investor Building:

$\$5,500,000 \times 60\% = \$3,300,000$

Total Indicated Value: \$6,400,000

Is the \$6,400,000 a valid indicator of Value?

The counselors cannot say for certain that the office building will be sold to any one of the three. If the counselor says the value is \$10,000,000 as a Headquarters building and it is put on the market and does not sell, the counselor has done his client a disservice. If the appraiser picks either of the other two possibilities as the Highest and Best Use, he has also not responded to the proper counseling assignment solution.

When the counselor is confronted with a counseling assignment where the property has more than one highest and best use, it is considered most reasonable by the authors to value each good possibility separately and, with reason and forethought, apply a Probability Analysis.

In general most commercial counselors are using Probability Analysis when they utilize a Discounted Cash Flow (DCF), whether it be for an office building, shopping center, etc.

Often times in counseling, utilizing the DCF approach different scenarios are used for rent or sale price projections, suggesting different values, and often a range in value is indicated by employing different yield rates.

The reader can easily see that a Probability Analysis is really nothing new. It has wide application possibilities and can be utilized very effectively. ■

FOCUS ON GLOBAL ISSUES

A Wave of Relief

BY BARRY GILBERTSON, FRICS, CRE



AS THE NEWS OF THE TSUNAMI STARTED TO COME IN, on the day after Christmas, I began to realise there was a situation unfolding that was potentially without precedent. The initial death toll gave way to ever more horrifying numbers of lives lost, of families displaced, homeless and, for some, seemingly, a life without immediate hope.

Why has the world taken this terrible natural disaster to its collective heart, and wallet, compared to other disasters? A difficult question, but the answer may lie in the scale of the wave—whilst in America, in January, I saw a silhouette of the United States superimposed on the Indian Ocean at the same scale, and it fell well within the distant shores. So many countries were affected, even Kenya and Somalia....more than the full width of America away from the epicentre. Also, of course, these were countries with holiday destinations and there were many international tourists and families involved or affected by the dramatic events.

I wondered what, if anything, RICS could do to show its global leadership in the face of a global disaster. Writing emails to our RICS leaders in Asia, in Sri Lanka, in Thailand, keeping our Governing Council and the wider membership informed—all good practical short term palliatives. Using my own contacts at the United Nations has raised their awareness of RICS and its members' capabilities. Hearing that Ranasinghe Silva, the chair of RICS Sri Lanka, was safe and that his family had survived the disaster, was good news. Hearing that they had no idea what help they really needed was less good.

Haydn Thomas, chair of RICS Thailand, told me that only 2% of Phuket is affected and the best thing we could all do to help, in his opinion, would be to visit his country on holiday to boost the inward cashflow and help to balance the economy.

Many RICS members were, and still are, just itching to help in some way. The Construction Faculty's new list of relevant member skills and the Building Control Forum's contacts with the Red Cross are two great examples for us all in getting initiatives under way. Getting an RICS-wide solution created and implemented is really very difficult. Surely the best idea to emanate from the Governing Council intranet forum is to recognise that disasters, both natural and terrorist, are part of our lives today and to work out now how to respond in the future.

Accordingly, I have set up a Presidential Commission to explore how RICS can be better prepared for the future, how we can evaluate the response needed, on whom we can call in an emergency, how we can interact with the world's leading aid and survival agencies, how much of our member's resources it would be right and proper to allocate to these tasks, how we can ensure that the skills that we have to offer—on a cross-faculty basis—can be made available at the right stage of redevelopment. Finally, what are the criteria for our involvement?

About our Featured Columnist

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INSIDER'S PERSPECTIVE

The next question must be "how can professional bodies, internationally, find a way to share their knowledge, and their experience, for the greater benefit of the global community?"

Having set the scene, I now pose this question to my fellow Counselors. It seems to me that one of the key differentiators for the CRE is the Consulting Corps concept. That very idea is founded on the same principles as my thesis...sharing knowledge and expertise for the benefit of those less privileged than ourselves.

So, what can CRE contribute to the RICS Presidential Commission? What skills can you bring to the party? What expertise do you have, individually, and corporately, that might alleviate suffering in the longer term?

Where we can bring our weight to bear is at the reconstruction phase, and before, in the strategic planning of the reconstruction, so that the lives, homes and businesses of those affected, in the vicinity of the disaster, are immeasurably improved for the longer term, not replicated

My sense tells me that our best contribution is not actually in the immediate aftermath of this disaster, or in fact any disaster, whether natural or terrorist (man-made). Our real opportunity to assist must come in the second or third phase, beyond humanitarian relief, beyond the provision of food and emergency shelter accommodation—there are plenty of international relief agencies to provide that help. Where we can bring our weight to bear is at the reconstruction phase, and before, in the strategic planning of the reconstruction, so that the lives, homes and businesses of those affected, in the vicinity of the disaster, are immeasurably improved for the longer term, not replicated (with all the attendant possibilities of a repeat performance).

Any help that we do offer needs to be cognisant of the diversity created by different nations, different religions and different traditions, rather than impose our own solutions in a "clash of cultures."

Here is a list of some of the things that we could do, together:

- master planning towns, villages and commercial environments
- construction cost advice
- tendering procedures and tender evaluation
- valuation of assets for bank lending and international grant application, both pre-build and after occupation
- capital fund raising for construction and investment including "private finance initiative" and special government funding schemes
- construction cost and project management
- building control regulations—creation, management and monitoring of regulations and strategic advice, to ensure that rebuild costs go into buildings constructed in accordance with relevant international best practice
- corporate occupier and multi-family housing advice and management
- real estate investment strategic advice
- eventual disposal advice beyond rental structuring and strategies to release capital value from real estate for further reinvestment

My guess is that there are plenty of other skills we could bring to bear, too.

What do you think ?

The Commission will have begun its work by the time that you read this column, but it is never to late to become a corresponding member. If it would interest you to participate, please email me on president@rics.org. ■

FOCUS ON THE ECONOMY

A Potpourri of Economic Issues Impacting Real Estate and the Rest of the World



BY DR. MARK LEE LEVINE, CRE

I. INTRODUCTION

THIS TIME OF THE YEAR, INTO THE FAST START of the first quarter of 2005, we are flooded with a potpourri of interacting economic, cultural, political and social issues.

Many of these issues are a "parry-and-thrust" position, arguing contrary positions which attempt to support diametrically opposed viewpoints.

In this short Note, it seems worthwhile to contrast several viewpoints which are often heard or seen in the media, especially around the first quarter of the year. When we reexamine such philosophical background, many issues previously thought as being on "solid ground" may cause one to revise thinking on important issues, as well as to laugh a bit, even at ourselves in the mirror. For the moment, consider some of the following issues and their implications as to whether the assumptions made are correct or incorrect.

II. POTPOURRI

The following areas are a collection of different positions that affect social, political and economic areas in which we often find ourselves in conflicting and/or disturbing positions. Each of the following areas is attributable to a

number of individuals, cited in the following work. Their insight often gives us a chance to reflect on some of the areas indicated.

A. WHAT IF?

In an interesting short note by Byron Wien, U.S. Senior Investment Strategist at Morgan Stanley, in the book *Surprises of the New Year: 2004* <http://www.morganstanley.com/ourviews>, Mr. Wien considered surprises that might impact our thinking if these circumstances came into fruition. These "surprises" included:

1. Osama bin Laden is found.
2. The Federal Reserve ends up not raising rates (any more than it already has).
3. The stock market is strong.

About our Featured Columnist

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4. Improper practices by mutual funds are no longer in the news.
5. The question is whether the European Union will unravel.
6. Pharmaceuticals and certain other large-cap companies perform very well.
7. The positions of Saudi Arabia result in overall deteriorated political developments, such as the price of oil moves above \$40 a barrel. (The \$60 amount has already been exceeded!)
8. Silver gains an attractive position; gold moves to \$500 per ounce. There is some question as to the value in the market for stocks, bonds and other currency.
9. The Japanese market picks up.
10. Republicans have important changes that take place, such as key folks in the Bush Administration resign, such as Secretary Rumsfeld.

Since this article was written, several events have taken place (eg, the upward movement on the price of oil). However, some projections and predictions are food for thought even though they may often be inconsistent with other positions.

B. IMPORTANCE OF CULTURE

In many of our classes, such as International Real Estate (at the Burns School of Real Estate and Construction Management, Daniels College of Business, University of Denver), we emphasize the importance of cultural aspects in making investments. Business and investment decisions are not normally made solely by examining financial issues. This is especially true when dealing on an international basis, as opposed to simply within the United States.

In an interesting article by Professor Dick Lamm, Executive Director at the Center for Public Policy and Contemporary Issues at the University of Denver, "The Elephant In the Room: How Culture Matters," *Head-First Colorado*, P. 47 (Fall 2003), Professor Lamm, three-term Governor in Colorado, emphasized the importance of cultural issues as to decision-making and life in general. Professor Lamm focused on what is important in educating our children.

Contrary to what many have learned in commercial real estate or other investment arenas, Internal Rates of Return (IRR) and Return On Investment (ROI) are not the only areas of focus. Many decisions are strongly influenced by non-financial considerations, such as the desire to own property, the desire to reside in a given location, ethical issues, safety of individuals (as opposed to simply safety of capital), and many other non-financial issues.

As the saying goes: "A starving man is not looking for gold." Some factors have more weight than the economic return.

C. ECONOMIC POSITION

One question raised in political circles, given the recent Federal Presidential election, is whether the "average" citizen in the United States is better off today as opposed to four (4) years ago—or eight (8) years ago.

In a study in September 2004, the Meyers Group Housing Market Key Indicator Alert (www.MeyersGroup.com), showed many factors which indicated that the U.S. economy is very strong. On the other hand, other reports have indicated that the economy is having a difficult time. Depending on the focus within the Study, comparing which of these factors is "correct" is sometimes difficult to determine. For example, in recent months, sales prices of some commercial properties have increased; yet, the Net Operating Incomes (NOI) have decreased. Financial indicators are "confused," to say the least. (The argument is that it is inconsistent to think that pricing would increase where the NOI is decreasing!)

There is confusion as to whether unemployment has decreased or increased, given questions as to types of jobs, seasonally adjusted issues, outsourcing of jobs (including to other countries), what is included in job levels and job descriptions, and so forth.

In grading what had performed well, the Meyers Study (noted above) showed that the real Gross Domestic Product Growth (GDP) would be rated, in their view, with a C+ grade. (Many politicians would disagree with this position.) On the other hand, that same Study showed that employment growth is at B-, indicating a not-so-favorable position. (However, politically, certainly, the Republican position would argue that is an incorrect assessment.)

Very few would argue that mortgage rates are at a level other than A or A+, given low interest rates for residential property today, when compared with the last 45 years, despite a recent slight rise in interest rates.

The Meyers Study also stated concern with affordability for housing, giving it a rating of B-, notwithstanding somewhat encouraging economic data, such as employment numbers.

D. MARKET TRENDS:

In "Notes," *Commercial Investment Real Estate Journal*, P. 6 (August, 2004), it was stated that, statistically, there has been a substantial increase in pricing for building materials, such as steel and lumber. Is this good or bad news? Obviously, to a supplier of such goods, this may be very favorable news. On the other hand, to a builder, this might be bad news.

The causes for differences in pricing are disputed within many circles. Arguments that much demand for goods has come from Asia, and, in particular, China and India, might be viewed as favorable or unfavorable, depending on one's economic position. If one supplies the goods and receives an economic benefit from increased pricing, obviously such increased prices would be favorable.

The lack of supply of raw materials, such as to the housing market which depends on such goods, was noted in the article by David Lereah, "Prices: Still About Supply," *Realtor Magazine* 20 (September, 2004).

E. INTEREST RATES:

What are implications of higher interest rates? Some might argue that higher interest rates are good news in that it preventing the economy from overheating and creating a larger "bubble." The practical point is that interest rates have been increasing, slightly, in recent months.

In an article by Anthony Downs, CRE, "Six Ramifications of Higher Interest Rates," *NREI* 56 (August 2004), Dr. Downs asserted six (6) key impacts from the increased interest rates. He noted:

1. Commercial property prices will probably not continue increasing, and in fact will begin to decline, in all likelihood.
2. Some capital will shift or be moved elsewhere, given changes in interest rates.

3. Home ownership will decline or slow; certainly sales of existing homes will also decline or slow. Appreciation will be slower; it may even stop, or drop in pricing of homes.

4. The amount of residential mortgage activity will certainly be reduced, as well as the activity in refinancing. Thus, the era of refinancing and "pulling" money by refinancing for tax-free, tax-deferred use may have seen its best days, at least for now.

5. There will be some decline in residential pricing, especially when supply is down in condominium markets, which were overheated. Dr. Downs specifically noted certain condominium markets, such as those in southern Florida and Las Vegas, where the condo "bubble" may burst.

6. In most cases, aside from the "bubble" bursting, as noted, many of the changes noted by Dr. Downs will probably occur on a gradual basis, as opposed to a sudden event.

What does this mean, relative to future planning? Some prognosticators would differ with Dr. Downs and argue that many bubbles will break, and there should be concern with refinancing and defaults, because of sudden changes in interest rates, as opposed to gradual changes as indicated by Dr. Downs.

F. WILL REAL ESTATE VALUES DECLINE?

With a bubble in some residential housing, if Dr. Downs is right, we may see a decline in housing values.

On the commercial side, in "Report," 5 *RCA* 3 (Realtors Commercial Alliance) (Summer 2004), a statement was made citing Torto Wheaton Research that office values will probably decline by 7.4%, and retail values will decline by 6.5% in 2005. This statement was made "even if interest rates only increase moderately."

Whether this statement would be agreed to by most real estate brokers and other real estate professionals is open to question. However, one could ask what the implications of such decline would be in the marketplace on not only specific buildings, but also on the commercial market and the general economic market in the U.S. This is an important issue, as several markets outside the U.S. follow U.S. positions.

G. WILL THE ECONOMY RECOVER? HAS IT RECOVERED?

At what rate would the economy recover? In the last few months, there have been many questions raised as to whether the general economy is in stages of recovery, whether this will be sustained, and the force and impact of such overall recovery on many markets.

In an article by Thomas, Craig, "A Modest Economic Recovery Will Be Sustainable, But Disappointing," *Real Estate Forum* 22 (August, 2004), Mr. Thomas argued that the economy is recovering at a slow recovery.

Mr. Thomas also argued that, although we are gaining some jobs and are seeing some improvement in the overall market, there are also unfavorable areas. He noted the pressure for more inflation, rising of interest rates and other negative economic signs which are now apparent in the marketplace and which will cause the recovery to be somewhat disappointing. Mr. Thomas said: "Moreover, expect higher borrowing costs to create a few new troubles of their own in the quarters ahead."

If Mr. Thomas is right, then other prognosticators projecting a favorable and immediate recovery, with strong impetus, are certainly wrong.

What implications there are to either view should be seriously examined. In *The Economist*, p. 90 (July 24, 2004), in summarizing their data, it was noted that Chairman Alan Greenspan, Chairman of the Federal Reserve, was very positive and upbeat in his assessment of the American economy during his 2004 testimony before Congress. Contrary to what Mr. Thomas seems to be saying, Mr. Greenspan said that the recovery was "broad based," and even with some offsets in consumer spending the recovery would be forthcoming and "broad" in its nature.

H. WHERE DO YOU WANT TO LIVE?

Many issues impact our daily activities. In this light, consider the review in *The Economist*, p.92 (July 24, 2004), that listed the most favorable places to live based on the "Human Development Index" (HDI).

Under this HDI, *The Economist* found that the top five (5) most favorable countries were: Norway, Sweden, Australia, Canada, and The Netherlands, in that order. The United States placed #8. Cuba was #52. Sierra Leone was #177, the lowest showing on the rankings. What, if

anything, does this say about the U.S. economy? It may provide some insight into how others view the U.S.

I. HEDGING TIME:

Most economists and prognosticators have a caveat, justifiably so, to qualify their comments. Whatever conclusion is reached (that the overall economy will do okay, be "great," have a "bubble," or face reasonable employment or rising unemployment), there are always qualifiers.

In projecting whether or not the economy will have strong improvement and recovery, Dr. James DeLisle, in his article "The Three Rs of Election Year Economics: Recovery, Rhetoric and 'Rithmetic,'" *The Appraisal Journal* 101 (Spring 2004), noted his qualifications or exceptions where the economy may be adversely affected. These risk factors included rising gas prices, terrorism and threats of terrorism, and concerns with consumer confidence.

There is little doubt that the items noted by Dr. DeLisle are very important. How strong an act of terrorism might need to be to have a strong impact on the economy remains an uncertainty. Certainly no one would doubt that 9/11/2001 had a strong impact on people and economies. More recently, the Tsunami in Asia continues to have devastating impacts on various world economies.

J. MIXED MESSAGES:

Probably one of the more favorable and honest views of the economy was captured in an article by Locke, Tom, "Hearing Mixed Messages? Deciphering the Economy," *Denver Business Journal* A9 (March 12-18, 2004). In this article, the caption discloses that there are mixed messages. There are increases and decreases in employment. Bankruptcies are up, yet some businesses are flourishing. Tourism may be up in some locales and down in other areas. Recent violent storms have caused major damage to housing, businesses and tourism in many areas. (Of course, the Tsunami in Asia has created a renewed appreciation of the tremendous power and impact on lives and economies via natural events.)

More home ownership opportunities have existed for potential home owners, given lower interest rates. However, increasing housing prices have limited the ability for some individuals to purchase homes. Thus, as indicated by Mr. Locke, we do have mixed messages. Which mes-

sages are correct will be the determining factor in many instances as to how the economy goes and how we all move in various directions.

K. IRRATIONAL EXUBERANCE AND RATIONAL EXUBERANCE:

"Irrational" exuberance language has been quoted subsequent to the comment made by Mr. Alan Greenspan when he previously asserted that possibly because the market was doing so well, there is an overconfidence level.

However, one might also argue that there is a "rational" exuberance. This term was utilized in the book by Thomas Friedman, *The Lexus and the Olive Tree: Understanding Globalization*, when Mr. Friedman commented on a number of settings in the economy and the global interaction of various countries.

One might argue that there is a little bit of both: rational and irrational exuberance as to our economy. This same point was made by DeLisle, James, "Real Estate and the Economy: The Train Has Left the Station," *The Appraisal Journal* 5 (Winter 2004). In that article, Dr. DeLisle concluded: "After struggling through 15-19 months of cyclical bottoming out, the commercial real estate market is finally showing signs of improvement. However, this improvement will not be a near-term phenomenon. It will be a lagged event that will depend on a continuation of the fledgling economic recovery."

L. FORECASTS: BUT "WHAT IF?":

Many forecasts have been made by economists and experts in financial markets. Another question might be to ask: "What will happen to some markets that are substantially impacted by a number of negative events?" Such events include terrorist activities referred to earlier, negative trade balances, oil considerations, occupation positions by the United States and others, wars, SARS and other medical dilemmas, consumer confidence (or lack thereof), inability to refinance because of prior refinancing and rising interest rates, financial scandals, increased energy costs, natural disasters (e.g., Tsunami), and many other issues.

Some of these points were noted in a recent article by John Fenoglio, "Capital Markets Overview, January, 2004." (jKirkpatrick@liveOakCapital.net).

It is not "if," but "when" the economy will change. As mentioned, many prognosticators on the economy agree that the economy is changing, mostly to the positive. However, how long it will take for these changes to take place, and the timing of those changes within various markets remain uncertain.

In an article by Brian Miller, "More Challenges Ahead," *Real Estate Forum* 30 (December 2003), Mr. Miller noted that the jobless recovery, the India factor (outsourcing jobs, etc.), and the growing presence of high net worth investors, are only a few issues addressed which will be impacted as to recovery.

M. BANKRUPTCIES ARE UP:

If the market is up so favorably, another question is: "Why are bankruptcies up so drastically?" For example, in the state of Colorado, bankruptcies are setting a record high. Some argue that bankruptcies are just a means of doing business or working out of business problems. (This has been well illustrated in the airlines industry, as well as other major industries.)

However, in a general sense, bankruptcies indicate a failure. Financially speaking, if bankruptcy indicates financial failure, then there is great concern that rising bankruptcies, though a lagging indicator, imply that the economy is not doing quite as well as some might predict.

Notwithstanding favorable statements made by economists that the economy is improving, there is continued concern with the clearly demonstrable number of increasing bankruptcies which belie the representation that the economy is greatly improving.

N. TAX RATES AND TAXES IN GENERAL:

If the economy is doing better, one argues that, therefore, there will be more monies available for the Treasury, and one need not increase tax revenues through increased taxed rates.

Vying positions as to tax rates indicate that the general Republican posture will attempt to hold Federal income tax rates to the current tax position. The general Democratic position on a national basis is that tax rates should be increased.

The broad economic question may be to ask what the implications will be on various economies as to raising

Federal tax rates, as well as state and local tax increases, in coming months and years.

The tax rate issue goes hand-in-hand with the tax deficit issue. This will continue to be of great concern in the U.S. economy. It will have implications on a global basis, too.

O. BUDGET DEFICITS:

The U.S. budget deficit is enormous. Many states also face great deficits. There are concerns as to how these deficits can be serviced, and how deficits can be reduced, assuming that is the desire by governmental leaders.

Numerous economists have raised questions as to implications of tax cuts regarding the existing Federal deficit. For example, in the article by David Lereah, "The Trillion-Dollar Question," *REALTOR* 18 (April, 2004), Mr. Lereah raised the issue as to what will happen now that tax cuts and Federal spending (which increased the budget deficit) wear off? What will be the price that the U.S. economy must pay for the positions taken by the Federal government as to tax cuts?

As Mr. Lereah indicated in his article, if the economy picks up speed and jobs continue to be generated, we might work our way out of some of these economic concerns. However, if the deficit continues to remain high, and we are not able to adequately service all of the needs of the deficit, as well as other needs to be met by the government, this means, as Mr. Lereah noted: "... prolonged joblessness, flattening profits and capital spending, and curtailed consumer spending."

P. DEBT: THE JOY OF SPENDING:

As mentioned, there is great concern with the various deficits in the U.S. economy, and great concern with the ability to service the debt, especially the Federal debt, based on a huge needs for increased Federal spending, tax cuts, and failure of the economy to generate a level of taxes to cover the Federal FISC.

Consumers have also kept the economy moving, as evidenced by many studies on the economy over the last year. One reason the economy has been buoyed is because of confidence that consumers have had, in large part, from the refinancing binge where homeowners, without paying income tax, have been able to withdraw part or all of their "equity" by refinancing, at very favorable interest rates, their principal residence.

Additionally, consumer spending from credit card activity has resulted in trillions of dollars of debt.

With the increased credit card debt, increasing mortgage debt, increases of debt in other areas, such as educational commitments for college, these lead to concern with the possible inability of consumers to service the debt, especially coupled with rising interest rates, where the amount of debt service on any of the above-noted items is also increased.

Even if one does not readily see the amount of leverage or debt that has been present in the marketplace, it takes only a momentary glance at the real estate market to see that are many opportunities for taxpayers and consumers to acquire home ownership or even automobiles with "nothing down." That is, the taxpayer has no equity in the property and is either financing it 100% through the lending institution, or through other entities or groups that facilitate such 100%, "no down" financing.

Congress has also played in this ballpark. Congress introduced House Bill 3755, which supported the position to allow FHA to provide for "no down payment" and also to support the position that closing costs can also be included within the financing for a single-family home.

Various programs exist within the marketplace to "lend" or "grant" the homeowner a down payment, emphasizing that there is no equity placed in the property by the homeowner.

Even if there is no visible "bubble" in the marketplace, and if the housing market simply declines by 5%, this may nevertheless be a sufficient decline to encourage the homeowner, who has no equity in the property, to simply consider leaving the property and going elsewhere. This might especially be true in a marketplace where the homeowner has found that his or her job was lost and a new opportunity exists in another state or location.

One argument for this favorable leverage is that as house prices increase, then equity is created. Historically, based on the past few years, this has been the case. However, this pattern may not continue for the near future. This point was made in a note entitled: "Cracks In the Brickwork?" *The Economist* 51 (January 3, 2004). The note indicated that, although pricing of housing has increased dramatically in many countries over the last few years, such increase is unlikely in the next few years, not only in the

U.S., but also in other countries, such as in Ireland, Britain and Spain.

There is a great deal of controversy as to whether there will be additional increased housing prices in the next few years. In an article addressing this issue, as to whether there will or will not be a crash in the housing market, see Jim Carlton, "Boom vs. Bust," *Wall Street Journal* 8 (Monday, June 14, 2004), Mr. Carlton stated that there were conflicting positions by experts. One argument was that inflated housing values will not last; this position was supported by John Talbott, the author of *The Coming Crash of the Housing Market*. The contrary position was also presented, which was supported by Mr. David Lereah, Chief Economist by the National Association of Realtors (NAR).

What is clear is that we are not clear. No one is quite certain of the ultimate position as to the housing market. The implications to a crash (or no crash) in the housing market are massive for the entire U.S. economy.

III. CONCLUSION:

What is certain is that many factors in a very complicated economy will influence the economy; and, the view remains cloudy. The economy, being bearish—and bullish—is much akin to the warning that has been given to patients by doctors: "Do not take a sleeping pill at the same time you take a stimulant! Sometimes the systems fight each other!"

Given such uncertainty, there is continued advice to consumers, the government acting for the public, and various economies, to be somewhat balanced or conservative. There is also the basic point of diversification, and to recognize that there is tremendous uncertainty within the marketplace today. The uncertainty caused by many factors listed (i.e., cost of medical care, terrorism, war, political instability, natural disasters, and much more), empha-

sizes that we have only a limited amount of "control" as to where the economy will go and when it will move to a given point. This should portend for all reasonable planners to allow for reasonable diversification and balance within the economic markets. ■

FOCUS ON MARKETS

Of "Boomers" and "Bubbles"



BY DALE ANNE REISS

THE CURRENT U.S. ECONOMY SHOULDN'T be appealing to real estate investors. After slow second and third quarters, economic growth projections were downgraded for the fourth quarter of the year and into 2005. The stock market is sluggish. Consumer spending could be slowing. Oil prices are at record levels. Yet capital continues to pour into real estate as investors seek higher returns, portfolio diversification, income-oriented investments, capital preservation, steady cash flows, potential capital gains, and opportunities to defer or shelter taxes.

The money is coming from a range of individual and institutional investors including retirees, baby boomers, Gen-Xers, partnerships, syndicators, pension funds, mutual funds, opportunity funds, public and private Real Estate Investment Trusts (REITs), foreign investors, corporations, and other investors. They are putting their capital into an array of direct and indirect property investments including vacation or retirement homes, direct property investments, public or private REITs or real estate operating companies, opportunity funds, real estate mutual funds, interests in partnerships, limited liability companies, or subchapter S corporations that own real estate; real estate timeshares, or hotel condominiums. One sign of real estate's popularity is the growth of the private REIT market. Investors put more than \$7 billion into shares of private REITs last year, or nearly double the 2002 figure.

Investors are taking advantage of near-term opportunities to acquire real estate while interest rates and financing

costs remain relatively low. But they also are investing for the long term.

Consider the baby boomers. As the largest and wealthiest generation in history, boomers have billions of dollars in capital to spend or invest. As the first boomers near the traditional retirement age, 60% or more of the economy's investment assets will be controlled by Americans older than 60. With longer life expectancies, boomers will need to put their investments to work for longer periods, and real estate can deliver consistent, annuity-type returns. This year boomers and other individual investors are expected to pump more than \$7 billion into direct commercial real estate investments.

U.S. pension funds and plan sponsors have growing pension obligations that real estate can help to meet. At the beginning of 2003, about 16% of corporate pension plans were less than 75% funded and 45% were less than 95% funded. U.S. pension fund assets invested in equity real estate jumped from \$175 billion in 2002 to \$192 billion in 2003—roughly 50% higher than investment levels of the late 1990s.

With more investors attracted to real estate, demand for properties should remain strong despite rising property

About our Featured Columnists

Dale Anne Reiss is Global Director of Real Estate, Hospitality and Construction, Ernst & Young LLP

prices and the likelihood of higher interest rates. Investors will continue to acquire real estate if they expect increases in property cash flows to offset higher interest rates and financing costs. While investment yields may decline as property prices increase, real estate will remain competitive with other investments, and investors may have more buying opportunities as some owners decide to cash out of mature investments.

The flood of capital into real estate has created challenges for developers, owners, and money managers to meet the return requirements and other investment goals of a broad range of investors. In response, developers are expanding beyond mainstream office, industrial, apartment or hotel investments and into niche markets such as infill development, condo-hotels, low-income housing development or rehab, preservation and adaptive reuse of historic properties, or mixed-use developments near transit stops. Investment advisors are seeking more opportunities in global markets. Of the \$100 billion in equity capital currently in the hands of major real estate private equity funds, about 40% of this capital is targeted at large commercial real estate assets in the United States, with the balance focused on a wide range of property-related opportunities abroad.

To be sure, some individual investors may move to the sidelines as the cost of acquiring assets increases, as could some REITs and other institutional investors. But other REITs as well as pension funds, opportunity funds, foreign investors and some individuals will stay in the game. The sources of capital may change, but capital will continue flowing into property.

ARE U.S. HOUSING MARKETS "ON THE BUBBLE?"

Historically low interest rates have fueled the housing boom, but now that the Fed has started to increase rates, concerns are being raised about the housing market's vulnerability to higher mortgage costs. Buyers traditionally have financed homes with fixed-rate mortgages that provided protection against higher rates, but recently adjustable rate mortgages (ARMs) have accounted for about a third of all new home loans nationally. More lenders are packaging ARMs with interest-only payments and up to 100% financing. To sustain home sales, some homebuilders are beginning to offer mortgage financing at lower rates than traditional lenders.

Cheap financing has fueled demand for housing and driven up prices, raising concerns about a housing bubble in red-hot markets from California to South Florida. (The multi-billion dollar price tag and impact of the recent hurricanes in the Southeast—Charley, Frances, Ivan and Jeanne—will result in re-evaluation of housing codes throughout the country particularly in those areas vulnerable to wind damage. Also, look for more efforts to deal with non-native vegetation, which has been proven more susceptible to storm damage by recent events.)

Further fueling housing demand, European buyers are taking advantage of the weak dollar to buy luxury condominiums and co-ops in Manhattan. In the second quarter 2004, the average price of such units topped \$1 million for the first time. More Latin American buyers are acquiring properties in Florida, despite the recent hurricanes. Signs of speculative investment in housing are evident in more markets such as Chicago and Las Vegas. To cool speculative fever, builders in markets such as California, Arizona, and Virginia are adopting such practices as requiring buyers to live in their homes for a year or refusing to sell homes to buyers who recently have purchased other homes.

Yet, the biggest potential concern in the residential sector is the ARMs market. The popular hybrid ARM typically converts from fixed to adjustable rates in three to seven years, and borrowers who use such financing could be squeezed if their mortgage payments increase faster than their incomes. (A September 20th cover story in Fortune magazine already puts prices in 28 major markets—including Portland, Ore., Sacramento, San Francisco, Los Angeles, San Diego, Miami, Washington, D.C., New York, and Boston, more than 15 percent ahead of incomes.)

Buyers are betting that the rapid appreciation in home prices of recent years will continue, enabling them to refinance on better terms, but if housing markets cool, prices may grow more slowly or even fall in some markets. Price declines could reduce or wipe out the equity of some highly leveraged owners, and if interest rates increase, they might walk away from their mortgages. The percentage of equity already held by U.S. homeowners has declined steadily over recent years, especially with the advent of home equity loan programs. Other owners, unable to make higher mortgage payments, could risk losing their homes in foreclosure. Higher defaults and foreclosures could have severe ripple effects in the secondary market.

Such a scenario suggests that borrowers and lenders should be cautious about financing home purchases. Loans that seem attractive today may not look as appealing in a higher interest rate environment.

many approaches to China, an embryonic but rapidly growing property investment market. No talk of a bubble there...yet. ■

CHINA'S HOUSING MARKET NOT AS BRITTLE

One housing market that doesn't seem to show potential for weakness is China. Construction activity in Beijing has to be seen to be believed. Just about anyone who wants to build there seems to have a project underway. Many of these projects are apartments or homes for China's rapidly growing middle class. Builders are selling projects to speculators or end buyers before construction is finished and using the money to start new projects. Some buyers are paying cash for their units, but if they require mortgage loans, up to 80% financing is available. In addition, the government is privatizing state-owned housing by selling apartment units to the occupants.

The government reportedly wants all construction in Beijing completed by the end of 2006, or about 18 months before the 2008 Olympics, to allow time for the dust to settle and projects to be cleaned up. This has added to developers' sense of urgency, and they are scouring Beijing as well as Shanghai and other major cities for new construction sites. Some are acquiring commercial properties in key locations and obtaining approvals to rezone the land for housing—a former factory site not far from Beijing's Forbidden City is being redeveloped for residential use.

Meanwhile, some international developers and investors are considering whether to try and participate in China's construction boom. This will require them to find local public or private partners with the relationships, market knowledge and acumen to take projects from start to finish, and to identify development and investment opportunities. In addition, the global investment banks and opportunity funds that have acquired assets in China's initial nonperforming loan sales are using their toehold in the market to expand into mainstream property markets. Some global companies are trying to enter the market through acquisitions of companies that have a presence in China. Following the example of U.S. real estate companies in India, some U.S. developers might try to get into China by working as merchant builders or providing property management, consulting, design or other services to Chinese companies. Developers and investors are trying

FOCUS ON GLOBAL ISSUES

Urban Institute Local Government Reform Project: Croatia



BY JOHN K. RUTLEDGE, CRE

IN MID 2001, I WAS ASKED TO ASSIST THE URBAN INSTITUTE with a technical assistance assignment in Croatia. The Urban Institute, a nonprofit policy research organization, has contracted with USAID to conduct the Local Government Reform Project there. Since January 2002, I have made seven trips for a total of twelve weeks.

This project has several components including Financial Management, Economic Development, Information Management, Citizen Participation, and Asset Management. Olga Kaganova, CRE, a technical leader for Asset Management, observed that most cities and municipalities in former socialist countries, including Croatia, own and control large portfolios of real estate and have not instituted modern asset management practices. She saw the need and developed a plan.

The project, primarily staffed by Croats but led by Americans in a Zagreb office of the Urban Institute and assisted by short-term consultants as myself, follows a pattern. For each component of the project, one or more cities volunteered to be a pilot site. In the pilot city, we studied their activities related to the component(s) in depth. We formulated recommendations for improvements and presented them to the Local Government. We observed the implementation and results of the recommendations. Based on this experience, we prepared a manual detailing the changes that need to be made along with a specific process for making the changes and the benefits that can be expected. We recruited a class of local Croatian professionals and presented a well prepared weeklong course with lectures, examples, group exercises, and summaries. Following their training, we partially subsidize the work of these new local consultants as they propagate the process to other cities and we provide ongoing

technical support to them. Meanwhile, we also continue to work directly with additional cities.

For Asset Management, Varazdin was the pilot city. It is an historic city of about 43,000 in northern Croatia that was the national capital from 1756 to 1776. Olga, with the assistance of very able local Urban Institute employees, conducted an initial assessment and identified key deficiencies and problems in asset management, and I was brought in to help find solutions using my practical experience. During my first visit to Varazdin, I conducted intensive interviews with city staff and elected officials as well as local professionals. Among many findings of our research, we discovered that the city owned or controlled about 230 properties classified as surplus (investments) that were not directly needed to conduct city business. A substantial number of these are subject to claims for restitution to families that owned them before the onset of communism. City staff manages these assets pending judicial determination of ownership.

Based on our research and assessment of options for improvements, we prepared a series of recommendations, and Olga and I, with local Urban Institute staff, presented them to the city council and senior officials in April 2002. We then observed their implementation.

During the summer and fall of 2002, we drafted an Asset Management manual of about 100 pages plus an extensive appendix, and it was translated to Croatian. The manual

About our Featured Columnist

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contains eleven chapters based on "activities" including the development of an inventory of assets; appraisal; financial statements; financial analysis; transitional issues; strategic planning; and other subjects. One very important activity is basic: classifying the assets as: a) mandatory (i.e., city hall); b) discretionary (beneficial for the city but not essential—museums, recreational facilities, space for NGOs, etc.); and c) surplus (rental/investment). This classification concept goes back to the 1980s work of Marilee Utter, CRE, in Denver, Colo.

We also prepared a course as noted above based on the manual, and a Croatian employee and I presented it to a class of fourteen students (attorneys, engineers, business people, etc.) in December 2002. The class participants then launched their consulting practices working with other local governments. They enter into paid contracts with cities and receive additional compensation from the Urban Institute for their consulting work that we monitor and support. Occasionally, we join with them in their work with local governments. In July 2004, I assisted two consultants in presenting the Financial Analysis module to officials of Karlovac.

Periodically, we meet with these newly minted local consultants to review their work, to encourage them to share experiences, and to provide continuing education. A goal is to see them create their own association of consultants, and I see the potential for future invitations to membership in The Counselors.

A few of these local consultants have dropped out of the program, but we do not consider this a loss. They are better informed as they work in their communities. The others are actively consulting, several collaborating as teams and one hiring another to join his organization.

During my visits in July and September/October 2004, I taught Financial Statements, Appraisal, and Financial Analysis to officials from clusters of villages centered near Dulovac and Vojnic. These are groups of small villages, each too small to justify direct assistance.

We are encouraging local governments to enter into Public-Private projects (PPPs) to bring private sector capital, experience, and risk assumption to the table in meeting city requirements. In October 2003, Olga and I presented the concept and Western examples to Varazdin, and in October 2004, I worked with both Varazdin and Rijeka in evaluating situations for the applicability of PPPs and made presentations to local officials on specific situations in their communities.

I am often asked if I see progress. I do, but it is slow. On the other hand, it would be pretty egotistical to think we could quickly instigate changes of this magnitude. In our pilot city, they did not have a complete inventory of assets. Now they do. They have classified them as to their importance to the city. They are separately accounting for assets, rather than running all the transactions through the general budget as before. They are moving NGOs, that were paying little or no rent, to smaller and less centrally located property so that rental income can be increased. They are estimating asset values and rates of return. They modified their leasing practices and improved their relations with operators of city sport facilities. They are thinking about capital expenditures on assets subject to claims for restitution. These are some of the signs of progress that I see.

It is easy to overlook the difficulty of reform. Most local officials had never known a private market. They are trying to change the entire fabric of their governing and management processes without the benefit of years of experience in a private market. I have been impressed with the enormous commitment, at some personal and professional risk, that so many local officials and government staff have displayed as they expose to us their current practices and seek our guidance in improving them.

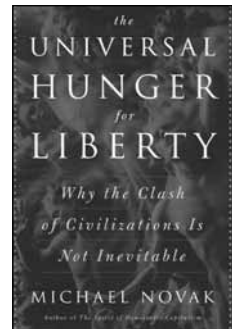
To me, the most important feature of this program is that local expertise is being developed so that we can eventually withdraw, as we have in other countries, and turn the reform process over to local consultants. It is much more important for us to teach them to solve their own problems than to try to do it for them.

As a personal note, I have seen a nation of 4.6 million people with a typical income of perhaps \$500 to \$600 per month and living space of about 200 square feet per person. I have seen areas where many homes have been destroyed by war, and many more seriously damaged, less than a decade ago. In some communities, there are many new roofs. The old ones were bombed off. It is not uncommon to come up behind carts being pulled by one or two horses or a homemade tractor. Travelers in some rural areas are warned about the danger of mines. In this difficult environment, I have found a warm, friendly, and generous people, eager to work on improving their circumstances. It is a privilege to join with them. ■

RECOMMENDED READING

The Universal Hunger for Liberty: Why the Clash of Civilizations Is Not Inevitable

by Michael Novak (2004, 281 pages)



REVIEWED BY BOWEN H. "BUZZ" MCCOY, CRE



This is an essentially hopeful book, from both an intellectual and a spiritual point of view, at a time when we need one. It counter-balances such works as Samuel Huntington's *The Clash of Civilizations and the Remaking of World Order* and Francis

Fukuyama's *The End of History and the Last Man*. It should be particularly useful to those CREs who are planning to attend the High Level conference in 2006, "Clash of Cultures: Understanding Life in the Global Village."

Michael Novak currently holds the George Frederick Jewett Chair in Religion, Philosophy and Public Policy at the American Enterprise Institute. He won the prestigious Templeton Prize for Progress in Religion in 1994, and he has received 23 honorary degrees in the U.S. or abroad. He has written 25 books, including *The Spirit of Democratic Capitalism*. He has served as Ambassador to the United Nations Commission on Human Rights and as head of the U.S. Delegation to the Conference on Security Cooperation in Europe, under both Democrat and Republican leaders. Political leaders from Margaret Thatcher to Vaclav Havel have recognized him for contributions to our further understanding of current religious, economic and political thought.

His thesis in the current volume is that the racial and religious differences that divide our world into clashing cultures are less important than the primary hunger for personal dignity, and for the personal liberty from which that dignity springs. He applies this cultural inclusiveness in particular to the Islam world.

He states that secularization no longer works and that a truly universal civilization will have to respect the world's great religions. According to the secularization thesis, advanced societies become ever less religious, ever more this-worldly, ever less in need of God. Yet religious fervor and ethnicity seem to be enjoying a vigorous revival. Secularism offers no answer to moral relativism. Novak goes on to state that, seeming to be non-judgmental, secularism applies no break to cultural and moral decline and offers little potential for cultural reawakening, conversion and renewal. Further, secularization has pitifully little to say about the most important things, such as death, suffering, weakness, and moral failure. It says even less about nobility of soul, the love of God, the nothingness and darkness in which God is found, the universal phenome-

About our Featured Columnist

Bowen H. "Buzz" McCoy is a retired investment banker and former President of the Counselors.

non of prayer, or any widespread sense of an inner human unity.

The Islamic question is at the center of the book. Can Islam come to terms with democracy? Novak answers with guarded optimism, rejecting the secularist models of Turkey and Egypt. He states that in not a few Islamic lands, during the past century, in the name of secularization, religion has also been brutally suppressed. This enforced secularism did much to turn devout Muslims away from the secular Arab state and to inspire political radicals to cling to religious Islam, which they then twisted to their own political purposes.

There are intellectual resources contained within Islam that may lead to a Muslim defense of several ideas crucial to democracy. These include the dignity of the individual, consultative government attuned to the common good, religious liberty and the fundamental equality of all human beings before God.

Bernard Lewis, the noted Islamic scholar whom Novak quotes, points to several elements in Islamic law and tradition that could assist the development of a form of democracy. Among these are five in particular: Islamic tradition strongly disapproves of arbitrary rule. There is need for continuing consent. There is no duty to obey a sinful law. Difference of opinion within a community is a sign of God's mercy. The tradition stresses the dignity and humility of all citizens.

Novak points out that recent polls in Iraq show a 40 percent belief that democracy will succeed. He concludes that this is not a chance to be missed.

Bringing his thesis back to home, he states that ours is one of the two or three most religious nations on the planet. He endorses de Tocqueville's claim that the first political institution of American democracy is religion, specifically Christian and Jewish. On any given weekend more Americans attend religious services than watch football on television both Saturday and Sunday together. Five times more American go to church each week than go to movies. The religious factor might be the single most important factor in American electoral politics. The American democracy is shaped upon beliefs of human dignity, equality and liberty formed out of a prior belief in the religion of the Hebrew and Christian Bible.

Even for those who do not believe in God, an ideal of universal friendship, or at least universal respect, as well as the

undeniable fact of reflection and choice among human beings everywhere, might well have trans-cultural validity.

Novak provides powerful insights into the interplay of religion, economics, culture, and democracy in the global world of the 21st century. We need three kinds of liberty: cultural, political, and economic. Cultural liberty is moral liberty, a personal liberty, a liberty of conscience, of ideas. We need to have a chance to reject or approve our rulers, and we need economic liberty, the right to pursue our initiative. An economy based on invention and discovery is a whole new idea in history. What makes capitalism is invention and discovery.

He utilizes the Catholic church as a proxy for Islam in the Catholic movement in the 20th century away from support of socialism to a recognition of the positive aspects of capitalism for a democratic society.

Novak stresses that business is a noble Christian vocation, a work of social justice, and the single greatest institutional hope of the poor of the world. If the poor are to move out of poverty, no other institution can help them as much as business, especially small business.

Business corporations themselves are important sources of moral teaching. They are schools of cross cultural cooperation, habits of teamwork and self discipline, prudence, modesty, and peaceful methods of persuasion.

Novak concludes that in trying to reach a global moral vision, it is not necessary to discover common principles, or a lowest common denominator, on which everyone can agree. Different traditions have different means of expressing common ideals. All the world's major religious bodies have significant insights to contribute.

I find it entirely plausible that religion is a key determinant in how societies choose to organize themselves. It is also plausible that there is, within the theology of Islam, ample wisdom as well as a sufficiency of laws and enduring principles which could sustain a democratic society. Some of the more enlightened Arabs with whom Novak met felt their religion must be brought up to date from the 9th century to the 21st century. Let us hope that such enlightenment succeeds in places like Afghanistan and Iraq. Novak's contribution is that within the seeds of their faith lies the promise of such a transformation. ■

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