

REAL ESTATE ISSUES

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Focus Edition:

GLOBAL REAL ESTATE MARKETS & INTERNATIONAL COUNSELING

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EXPERTS' & CONSULTANTS' GUIDE

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 organization's **CRE Designation** (The 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 valued at over \$41.5 billion. 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 Networking, Education & Publications

Networking 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' tri-annual 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 on a non-contingent fee basis or a performance fee under certain prescribed conditions. The counseling fee is rendered for advice given rather than for achievement or outcome of the transaction. 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 1,000 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.

THE STATE OF FOREIGN INVESTMENT IN REAL ESTATE

It is a special pleasure to write the introductory letter to this international edition, as I have had the privilege of engaging in international finance for 35 years. It is interesting to me that, while we pride ourselves on the large amount of international finance which has taken place over these years, in percentage terms, the relative portion of international



trade and finance is probably less today than it was in the 19th century, when foreign capital flows supported the growth of nations such as the United States, Australia, India, and the African colonies. Indeed, if one goes back even further in time, the great French economic historian, Fernand Braudel, reports that the silver mines of New Spain (Central America) created such inflation levels in Spain that they literally bankrupted the nation.

Nonetheless, the nominal level of international capital flows is much higher than ever before. In my own experience, I have noted that, from time to time, various parts of the world have found themselves afloat in dollars for particular reasons, and their financial institutions seek ways to invest such surplus flows. This was a part of the "Italian miracle" in the early 1960s. The central bank in Italy dealt privately with a couple of New York investment banks to recycle roughly a billion dollars of such funds. The same situation occurred, on a larger scale, in the Middle East in the early 1970s and in Japan, on an even larger scale, throughout the 1980s. Typically, such capital flows are invested first in U.S. Government securities; then in high-grade

corporate bonds; and, late in the cycle, in equities, joint-ventures, and real estate.

It is difficult to predict where or when such surplus flows will occur in the future. Japan and Eastern Europe at present are dealing with internal deficits and capital problems—with the exception of the Dutch, who continue to invest in U.S. real estate, particularly REITs. At the moment, mainland China is the largest beneficiary of surplus cash flows, about a third of which are coming in from overseas Chinese. Large amounts of investment capital will be required in Eastern Europe and the former Soviet Union, as well in developing market economies such as Southeast Asia, Indonesia, and India.

It seems to me less likely that the United States will benefit from foreign capital flows in real estate over the next five years to the extent that it did in the 1970s and 1980s. Real estate seems to come late in the foreign investment cycle, because of the lack of available data, lack of trusted third-party advisers, lack of liquidity, and possible lack of an investment return that compensates for all the above factors, as well as currency risk. The two areas most likely to attract foreign investment are REITs and Commercial Mortgage Backed Securities, because of relatively better price discovery and relatively better perceived liquidity.

As always, the best source for unbiased, expert advice in all these areas is your friendly CRE.

A handwritten signature in cursive script that reads "Bowen H. McCoy".

Bowen H. "Buzz" McCoy, CRE
1997 President
The Counselors of Real Estate

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REAL ESTATE SECURITIZATION

GAINING FAVOR IN FRANCE & JAPAN

Howard C. Gelbtuch, CRE, & Takashi Kataoka

With real estate markets showing signs of recovery in France and Japan, and the shift in institutional investment away from single assets and into securitized offerings, astute investors now have an opportunity to reap large rewards. As the United States real estate market has recovered, value-oriented investors have had an increasingly difficult time acquiring domestic properties at attractive prices. At the same time, the growing global focus of all investors, not just those focused on real estate, has made investing overseas more commonplace.

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REAL PROPERTY & LAND LEGISLATION

IN THE RUSSIAN FEDERATION

Sheila O'Leary & Olga Kaganova, CRE

Until recently, the legal basis for private property was nonexistent in Russia. However, beginning with the legalization of private property and privatization of the public housing stock, a number of major legal developments in Russia during the past five years have been catalysts to spur development of the private real estate market. This article reports on the current legal framework governing real estate transactions in four areas: property rights, registration, taxation, and land use regulation.

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CZECH REPUBLIC & HUNGARY: TWO GOLDEN REAL ESTATE OPPORTUNITIES OR TWO ECONOMIC QUAGMIRES?

Mark Lee Levine, CRE

When investigating real estate opportunities in the Czech Republic and Hungary, consideration must be given to the unknown economic downside present because of the accelerated growth and development underway in these evolving marketplaces. The information in the article is based on the author's recent trips to these countries, where he observed first-hand the opportunities and pitfalls of real estate investment in these Eastern European nations.

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APPRAISAL PRACTICE IN CENTRAL & EASTERN EUROPE

Lincoln W. North, CRE

In the five years that have followed the demise of the Soviet era, extraordinary progress has been made in developing valuation and counseling associations in the Central and Eastern Europe Countries (CEECs). When

compared to the length of time it took these professional services to develop in North America, the progress in Central and Eastern Europe is extra-ordinary. However, the author predicts it will take another five years to reach full maturity, as the evolving professional associations in the CEECs grapple with the tremendous social problems related to the transition process.

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CLOSING BERMUDA'S NAVAL BASES

Frank J. Parker, CRE

In 1995, the United States of America, after 54 years of presence in Bermuda terminated its leases on the 1000+ acre naval bases which it had leased until 2040. This article discusses the strategy of conciliation employed by the Bermuda Government in negotiating closure and contrasts it with the likely results if it had chosen instead to bring a lawsuit against the U.S. Government for breach of contract.

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FUZZY LOGIC: THE NEW PARADIGM FOR DECISION-MAKING

Carlo Bagnoli & Halbert C. Smith, CRE

Fuzzy logic is a system for decision making that is relatively new, particularly in terms of applications in the social sciences. While it has been studied and applied for some 20 years in the physical sciences, its applicability to the social sciences—and real estate analysis, in particular—has been recognized only recently. The goal of fuzzy logic is to enable analysts to quantify the imprecision inherent in estimates and evaluations. Derived from the classical set theory of mathematics, in which an observation either belongs or does not belong to a set, fuzzy logic employs fuzzy sets that allow membership in a set to vary from 0 to 1. This article describes the general nature of fuzzy logic and presents an example to illustrate a simple application to real estate. Finally, a conceptual framework for a more complex fuzzy system is developed.

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INVESTOR & LENDER REACTIONS TO ALTERNATIVE SOURCES OF CONTAMINATION

Elaine M. Worzala & William N. Kinnard, Jr., CRE

This paper reports the findings of a 1996 survey of investors and lenders and their reaction to alternative sources of contamination of real estate. A hierarchy has been constructed from the survey results of those contaminants that investors and lenders are willing to ignore or discount in making investments and loans and others which are genuinely feared. Although lenders have been surveyed on this issue in the past, this is the first survey to specifically examine the equity investor and to compare their attitudes and perceptions with professionals in the real estate lending community.

CONTRIBUTOR INFORMATION

The journal currently publishes three times annually (April, August, and December), and reaches a lucrative segment of the real estate industry as well as a representative cross section of professionals in related industries. In 1998, a fourth edition will be added.

Subscribers to *Real Estate Issues* (REI) are primarily the owners, chairmen, presidents and vice presidents of real estate companies, financial corporations, property companies, banks, management companies, libraries and REALTOR® boards throughout the country; professors and university personnel; and professionals in S&Ls, insurance companies and law firms.

Real Estate Issues is published for the benefit of the CRE (Counselor of Real Estate) and other real estate professionals, planners, architects, developers, economists, government personnel, lawyers, and accountants. It focuses on providing up-to-date information on problems and topics in the field of real estate.

REVIEW PROCESS

Readers are encouraged to submit their manuscripts to:

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The policy of *Real Estate Issues* is not to accept articles that directly and blatantly advertise, publicize or promote the author or the author's firm or products. This policy is not intended to exclude any mention of the author, his/her firm or their activities. Any such presentations however, should be as general as possible, modest in tone, and interesting to a wide variety of readers. Potential conflicts of interest between the publication of an article and its advertising value should also be avoided.

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DEADLINES

See Editorial Calendar on page 64 for deadlines.

MANUSCRIPT/ILLUSTRATIONS PREPARATION

1. Manuscripts **must be submitted on disk** (along with hard copy) in **IBM or PC format only—Mac files cannot be accommodated**: ASCII file format or Word for Windows 6.0. All submitted materials, including abstract, text and notes, are to be **double-spaced** on one side only per sheet, with wide margins. Number of manuscript pages is not to exceed 15. **Submit five copies of the manuscript accompanied by a 50- to 100-word abstract and a brief biographical statement. Computer-created charts/tables should be in separate files from article text.**

2. All notes, both citations and explanatory, are to be numbered consecutively in the text and placed at the **end** of the manuscript.

3. Illustrations are to be considered as figures, numbered consecutively and submitted in a form suitable for reproduction. (Camera-ready form, line screen not to exceed 80 dots per inch-DPI.) If higher DPI is warranted to show greater image blends or contrast, illustrations must be computer-generated on a Macintosh or PC compatible using the following formats: QuarkXPress, PageMaker, Illustrator, Photoshop, Corel Draw. Any other formats will not be accepted.

4. Number all tables consecutively. All tables are to have titles.

5. Whenever possible, include glossy photographs to clarify and enhance the content in your article.

6. Article title should contain no more than six words including an active verb.

7. For uniformity and accuracy consistent with our editorial policy, refer to the style rules in *The Chicago Manual of Style*.

THE BALLARD AWARD MANUSCRIPT SUBMISSION INFORMATION

The REI Editorial Board is accepting manuscripts in competition for the 1997 William S. Ballard Award. The competition is open to members of The Counselors of Real Estate and other real estate professionals. The \$500 cash award and plaque is presented in November during The Counselor's annual convention to the author(s) whose manuscript best exemplifies the high standards of content maintained in the journal. The recipient is selected by a three-person subcommittee comprised of members of The Counselors of Real Estate. Any articles published in REI during the 1997 calendar year are eligible for consideration and must be submitted by **September 1, 1997**.

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This edition represents a first for *Real Estate Issues*—co-sponsorship of the edition by The Counselors of Real Estate with a private counseling organization, Landauer Associates, Inc. We are grateful for the support provided by Landauer, and we are happy to provide some advertising and publicity for the company. Co-sponsorship, however, has no effect on our editorial policies. If your firm would like to consider co-sponsoring a coming edition of *Real Estate Issues*, please let us know.

I am particularly pleased to be writing this column for an edition of *Real Estate Issues* in which the focus is on "Global Real Estate Markets and International Counseling." As you may recall, a "focus edition" is one in which at least one-half of the articles are on a particular topic. I believe this is a very timely and important topic, given the extent to which real estate activities are occurring internationally, the increasing number of members invited to CRE membership from countries other than the United States, and the number of individual CREs who are participating in assignments outside of their own countries.

What are some of the trends that are causing this increasing internationalization of markets and Counselors' activities? First, of course, has been the tremendous increase in the technology of information processing and dispersal. Computers tied to networks and the internet allow the almost instant exchange of data. Analysts anywhere in the U.S. can have data transmitted from other locations around the world almost instantly and vice versa.

Also not to be overlooked is the technology of moving people. While the speed of jet airplanes has not increased since the late 1950s (with the exception of the relatively small supersonic transports), the increased availability of international flights, improved facilities for international travelers, and the improvement of ground transportation systems in major cities around the world make international face-to-face contacts possible.

The most important trend, however, is the integration of real estate markets into the general capital markets. As real estate markets have become "securitized" both on the equity and debt sides, investors far away from properties can bid for and own interests in them. The availability of REIT shares, GNMA securities, MBSs, CMBs, and other forms of securities backed by real estate or financial interests in real estate allows investors around the world to invest in and provide capital for real estate in the U.S. Similarly, U.S. investors can buy REIT shares in many foreign countries, although other types of financial instruments for real estate investment are not widely available.

It is clear that the globalization of real estate markets is closely tied to the integration of real estate markets with the capital markets. It is equally clear that the trend of integration of the markets will continue and therefore, that globalization will also continue. Thus, the opportunities for real estate counseling on an international level will undoubtedly increase at an exponential rate for those with an interest and some expertise.

For those CREs and other real estate professionals who wish to participate in this exciting and challenging field, it is important to learn about other countries—their histories, cultures, and institutions. Speaking one or more foreign languages will become increasingly desirable, although perhaps not a prerequisite to international counseling for native English speaking CREs, since English is recognized as the international language of business. Nevertheless, some knowledge of a foreign language, if not total fluency, can reveal insights into the culture and modes of thinking that cannot be obtained in any other way. After all, it is always helpful for a Counselor to understand a client's background when attempting to solve a problem.

The articles in this issue will provide interesting insights into several different countries. Another article, while not on an international topic, is the fruit of co-operation between an Italian researcher and an American researcher. Finally, an article on investor and lender reactions to various sources of contamination completes this issue.



Halbert C. Smith, CRE

Editor in chief



REAL ESTATE SECURITIZATION GAINING FAVOR IN FRANCE & JAPAN

by Howard C. Gelbtuch, CRE, & Takashi Kataoka

*"Those who cannot
remember the past
are condemned
to repeat it."*

George Santayana,
1863-1952, American
philosopher & poet

Just a few short years ago, the United States real estate market was characterized as overbuilt, illiquid, and even under-demolished. Steadily increasing loan delinquency rates at traditional institutional lenders such as commercial banks and life insurance companies contributed to a liquidity crisis, making new mortgage financing difficult if not impossible. The Resolution Trust Corporation ("the RTC") was formed to step in and dispose of the unwanted real estate assets of failed lending institutions, many of which had to be bailed out by the federal government because of their excessive amount of under- or non-performing mortgages. In February 1992, the RTC concluded its first commercial property-backed securitized offering.

A few brave souls formed "vulture funds" to buy real estate and mortgages at depressed prices. Who can forget the infamous March 1993, Salomon Brothers report titled, "It's 50 Cents on the Dollar, Stupid"¹? Mimicking the, "It's the Economy Stupid,"

it proved to be the undoing of re-election efforts for President George Bush. In the early 1990s, when a lack of transactions made real estate values largely conjectural, these contrarian investors made a fortune buying real estate assets at 50 percent of their previously reported value, later selling them at a substantial profit when the property markets and the national economy recovered a few short years later.

Now many domestic real estate markets are so strong that there is talk of renewed speculative construction ("although it will be different this time"), and from time to time, there are even isolated instances of purchases in excess of replacement costs. As a result, value-oriented investors are having a difficult time securing domestic properties at attractive prices. Fortunately, history has once again repeated itself, and there is now a golden opportunity for forward thinking investors who view the market globally: acquiring bulk real estate assets overseas in countries where

prices have declined significantly, but whose economies can be expected to recover, specifically France and Japan.

FRANCE

Since the mid-1980s, France's economic growth has been modest. In the 10-year period from 1983 to 1994, Gross Domestic Product (GDP) grew by an average of only 2 percent annually. Starting with unemployment of 8 percent in 1983, the unemployment rate increased in seven of the following 10 years, exceeding 12 percent by the end of 1993. France had succumbed to the worldwide recession of the early 1990s.

A weakened economy, coupled with a series of internal corruption scandals, skyrocketing unemployment, and a budget deficit were the principal causes of the Socialist's downfall in 1993. A new political regime led by former Paris Mayor Jacques Chirac took office, one of whose first priorities was to create jobs and stimulate the economy. A loosening of monetary policy in 1995 has finally begun to reverberate throughout the French economy. Although unemployment remains high, currently approaching 13 percent, annual inflation is under 2 percent, and interest rates remain low. While anticipated GDP growth remains in the 2 percent to 2.5 percent range, consumer confidence is increasing. The reason that unemployment remains high is because of a strong increase in the French workforce, rather than a lack of jobs. Furthermore, President Chirac pledged to reduce the budget deficit from 4.2 percent of GDP in 1996 to 2 percent, a move that would allow the government to gradually reduce taxes.

If the French economy was sluggish during the last dozen years, the office market was on a roller coaster ride characterized by booms and busts. Until the 1970s, office facilities in France were largely constructed (and owned) by industrial companies for their own use. Service companies in need of accommodations sufficed by converting centrally-located residential apartment buildings into suites by altering their interiors.

During the 1970s, strong tenant demand for office space, coupled with the onset of a speculative construction market fueled by foreign investors, led to the construction of the first generation of buildings designed specifically for office use. The 1980s witnessed an explosion of office development including buildings with varying levels of quality, ranging from superficial conversions of residential properties to new construction of top quality buildings.

Fortunately, history has once again repeated itself, and there is now a golden opportunity for forward thinking investors who view the market globally: acquiring bulk real estate assets overseas in countries where prices have declined significantly, but whose economies can be expected to recover, specifically France and Japan.

The Paris office market enjoyed a spectacular boom during the latter half of the decade, with property prices and office rentals often doubling in value. Developers responded vigorously to the run-up in prices and rents, and new office construction surged to record levels. The office market peaked at the end of 1990, following a decade during which office rents soared in the face of little availability. This lack of suitable accommodations forced many space users to the suburbs, furthering a building boom in the suburban areas as well.

By late 1990/early 1991, the booming office market began to sputter, a result of over-building and a weakened global economy, and both rental and capital values began to decline precipitously. Rentals for the best, most modern accommodations in Paris peaked at about 4,500 FF/m² or U.S.\$84 PSF (and occasionally higher), compared to about 3,000 FF/m² (U.S.\$56 PSF) in 1995. Similarly, some buildings that were sold to overseas investors at capital values as high as 125,000 FF/m² (U.S.\$2,300 PSF), declined to maximum attainable prices of 50,000 to 75,000 FF/m² (about U.S.\$1,150 PSF) by 1995. Like those in the U.S., French banks and insurance companies found themselves awash in bad loans secured by real estate that had greatly declined in value.

Similar to the United States years earlier, the combination of a gradually recovering economy and depressed real estate prices presented an opportunity for astute real estate investors. This opening became apparent to forward thinking United States investors and investment bankers during 1995, as the French wrote down the value of their assets to market levels, permitting bulk sales of assets. Although this occurred almost two years ago, it has recently received an increasing amount of press coverage in the United States.

In a watershed event akin to the first RTC portfolio sale, in late 1994 Comptoir des Entrepreneurs

securitized U.S.\$1.8 billion of non-performing loans, one of the first securitizations in Europe. Sensing that French institutions were motivated sellers (Credit Lyonnais announced in 1995 that it would dispose of 10 percent of its U.S.\$8.6 billion problem real estate portfolio), overseas investors rushed to France, led by investors, investment bankers, and consultants from the United States. Gerald Hines entered into negotiations to acquire U.S.\$1 billion of shopping centers in France, Italy, and Spain from Macif, a French insurance company; and J.E. Roberts Cos. formed a joint venture with Finestate, a French property company, to facilitate American investment in French real estate.

Then in January 1996, the French subsidiary of Barclays Bank plc concluded the first French bulk sale of distressed real estate, selling U.S.\$175 million of loans backed by office and residential properties to a consortium of U.S. investors led by Cargill Financial Services, Lehman Brothers, and LaSalle Partners.

Also in early 1996, Goldman, Sachs & Co. acquired U.S.\$550 million of real estate loans from Cie. De Suez, one of the largest, single real estate transactions in French history. The purchase price was widely reported to have occurred at about 30 percent of book value. In fact, Goldman's Whitehall Street LP has become one of the most active of the U.S.-based value oriented or vulture real estate funds, acquiring at least two other similar portfolios overseas.

In France, some other parallels to the United States included:

- many banks began setting up "good bank"/"bad bank" structures, turning over their problem real estate assets to the bad bank to remove them from the good bank's books;
- the job of the bad bank is to restructure and/or dispose of these loans, just as U.S. institutions accomplished their workouts during the early 1990s;
- equity investors have generally reacted favorably to the French restructurings, pushing up share prices as problem real estate is removed from a company's books.

Now that U.S. investors have paved the way, locally-based French investors have begun to follow suit. In March of this year, local French investor Walter Butler Capital Partners acquired a portfolio of 12 city-center buildings from insurer Union des Assurances de Paris for U.S.\$60 million. Although financially a much smaller transaction than many

of the bulk sales described above, this transaction is significant in that 1). it was the first portfolio sale to a local investor; and 2). it was the first institutional portfolio sale of buildings, rather than loans. The reported price was about 13,000 FF/m² (U.S.\$240 PSF), about one-third of the 40,000 FF/m² these properties would have commanded five short years ago. Updating the mantra of the previous round of value-oriented investors in the United States, so far in France, *"It's 30 Cents on the Dollar, Stupid."*

JAPAN

While many opportunities remain in France, the same buying opportunities are just beginning to emerge in Japan.

The Japanese economy grew throughout the 1970s and 1980s at an average of about 4 percent per year in terms of real GNP (Gross National Product) growth. The Japanese government had adopted a low-interest rate policy, and with the economy booming and prices stable, the official discount rate was a record low 2.5 percent in February 1987. Between 1987 and 1989 however, the increase in the nation's money supply was greater than the growth in GNP, creating an excess of liquidity.

As a result, significant sums were invested in securities and real estate. Stock prices reached their highest level in December 1989, and real estate prices, particularly land, increased by even more than equities. In the six largest cities, urban land prices increased nearly fourfold between 1985 and 1991. The increase in urban land prices escalated in 1986 and 1987, and spread to Japan's rural areas as well. Nationwide, urban land prices increased by about 60 percent between 1985 and 1991. This abnormal increase in asset prices was termed the "bubble economy," and Japan's economic boom continued until asset prices finally collapsed during the Summer of 1991.

The downturn in Japan's economy, more severe than any other post-war recession in terms of duration and depth, officially lasted until March 1993. However, its aftershocks can still be felt today, particularly in the real estate market which now has an oversupply of office space brought about by a combination of over-building during the boom years and the collapse of the bubble economy with its associated economic downturn.

Although the Japanese economy has slowly recovered since 1994, one of its most important

Table 1

**Urban Land Price Index of Commercial Land
Six Largest Cities in Japan**
(Tokyo 23 wards, Yokohama, Nagoya,
Kyoto, Osaka, and Kobe)

1990 = 100

Year	Index
1985	25.6
1986	33.0
1987	44.2
1988	62.6
1989	78.3
1990	100.0
1991	103.3
1992	87.5
1993	67.9
1994	55.3
1995	41.9
1996	30.3

Source: Japan Real Estate Institute

aftereffects, the bad loan problem caused by overly optimistic financing for land acquisition and construction of office buildings, remains to be solved. It will continue to have a significant negative impact on the Japanese economy. According to the Ministry of Finance, the amount of bad loans at banks and other financial institutions was more than 85 trillion yen as of March 31, 1996.

To solve the bad loan problem, non-performing real estate will have to be liquidated. Whereas investment properties in France are frequently valued using the French version of the Income and Sales Comparison approaches, the high proportion of value attributable to land in Japan presents some unusual problems for American investors wishing to capitalize on that country's presently depressed real estate market. For example, land and improvements are legally severable properties in Japan, and their ownership is recorded separately, even if owned by the same entity. In addition, the land component typically accounts for such a disproportionately large percentage of property value that, during the bubble period, appraisers were frequently asked to ignore any existing improvements, and value the site as if vacant. Now appraisers more commonly take the existing improvements into consideration, whether the value of the improvements is positive or negative.

To illustrate the severity of the real estate crisis in Japan, one needs to look no further than the Urban Land Price Index published by the Japan Real Estate Institute (see Table 1).

Note that after increasing by fourfold from 1985 to 1990, the price of commercial land in Japan's six largest cities has declined since then by nearly 70 percent, to about "30 cents on the dollar." (This is getting easy!)

Despite the decline, land prices in Japan remain expensive by U.S. standards. According to a survey by the Japanese government released this year, the price of commercial land in Tokyo averaged U.S.\$79,568 per square meter, or U.S.\$7,392 per square foot; a decline of 45 percent since January 1995. Needless to say, many of Japan's lending institutions have become saddled with bad real estate loans. At least 13 Japanese banks closed their New York offices between March 1993 and April 1997.

For example, an affiliate of Nippon Credit Bank, Crown Leasing, had lent money to real estate developer Sueno Kosan. Sueno Kosan was forced into

bankruptcy in 1996 by Japan's Housing Loan Debt Administration Organization. This forced Nippon Credit to immediately write off U.S.\$968 million owed to it by Crown Leasing, starting a chain reaction that ultimately lead to Nippon Credit's restructuring. In a move that would have been unthinkable just five years ago, in April of this year, Bankers Trust announced an agreement with Nippon Credit Bank Ltd. to take over U.S.\$18 billion of the latter's overseas assets. Nippon Credit is Japan's 17th largest bank, with about U.S.\$125 billion in assets. (Bankers Trust has also been a key player in the sale of French assets, having advised the French Barclays subsidiary in its 1996 sale of distressed real estate to a U.S. group.)

In effect, Bankers Trust will be helping to "bail out" Nippon Credit, much as the United States Federal Deposit Insurance Corporation bailed out Continental Illinois National Bank in 1984. In addition to being required to liquidate its foreign assets, Nippon Credit's plight has necessitated the sale of its corporate headquarters. Several of Japan's other banks may also have to collectively contribute up

to U.S.\$1.3 billion to Nippon Credit as well, raising investor's fears that bailouts will become a precedent that could weaken healthy banks too.

The importance of this agreement should not be underestimated in terms of the opportunities it creates for U.S. real estate investors. First, Japan's important Ministry of Finance had to approve, if not recommend the Bankers Trust agreement. (This event speaks volumes about the weakness of Japan's domestic banking system, as normally Japanese banks would have only been permitted to seek help from their domestic partners.) Secondly, the magnitude of Japan's non-performing loan problem has created a psychological shift in the way that Japanese institutions have begun doing business, opening their doors to foreign investors for the first time. One unidentified senior Japanese banking regulator was recently quoted in *The Wall Street Journal* as saying, "The markets are proving better at forcing change than the authorities." Perhaps most importantly, the arrangement between Bankers Trust and Nippon Credit could result in many of Nippon Credit's loans being repackaged into securities and offered to investors. Nippon Credit has approximately U.S.\$40 billion of real estate and loans, of which approximately U.S.\$12 billion are estimated to be under-performing real estate loans.

And just as in the United States, the problem has spread from Japan's banks to its insurance companies. In June 1990, Salomon Brothers presciently forecast the spread of the impact of bad real estate loans from financial institutions to insurance companies.² The Japanese insurance industry accounts for about 12 percent of total savings in Japan and a significant amount of pension money as well. Just days after word of the Nippon Credit/Bankers Trust agreement was announced, and insolvent banks and credit unions were threatened with closure, Wall Street analysts began making predictions of consolidation in Japan's U.S.\$935 billion insurance industry, brought about by the industry's exposure to bad loans. These predictions proved accurate, as later that same month, the Ministry of Finance shuttered Nissan Life, the country's 16th largest life insurer, and the first Japanese insurance company to be closed in 50 years. Nissan Life had invested heavily in real estate and securities, promising high returns to its investors. When the bubble burst and land and equity prices fell precipitously, Nissan Life was left with an insurmountable gap between its investment income and the returns it had promised investors.

Although Japan's securitization market (as we know it) has been slow to develop thus far, the country has a long history of quasi-securitization structures. In fact, Japanese securitization began with mortgage loans, and these securitizations have since evolved into three distinct types:

- *Teito Shoken (Mortgage Securities)*

This first quasi-securitization appeared in 1931 and was revised in 1987. Under this arrangement, mortgage companies provide housing loans to borrowers, and obtain approvals from the borrowers to sell the loans. As mortgage companies guarantee payment to investors, the credit risk associated with the mortgage securities reflects the credit of the mortgage company, rather than that of the borrowers.

- *Jutaku Teito Shosho (Housing Mortgage Certificate)*

Began in 1974, financial institutions such as banks and housing loan companies offer a pool of common housing mortgage certificates to other financial institution investors. Further transfer of these certificates is prohibited.

- *Jutaku Loan Saiken Shintaku (Housing Loan Receivables Certificate)*

Started in 1972, financial institutions and housing loan companies pool their housing loans with trust banks, which in turn issue trust certificates backed by pools of housing loans. Although the credit quality should reflect the quality of the underlying assets, most securitized offerings are supplemented with guarantees from the loan originators.

Note that in each instance above, the securitizations are structured to reflect a guarantee from the originator, rather than relying exclusively upon the credit quality of the underlying assets. This is a function of the long-held belief in Japan that corporate credit is the most cost-effective means of financing an investment. The acquisition of most real estate has historically been arranged through corporate finance means, based on an entity's creditworthiness, rather than by valuing the underlying real estate. Non-recourse loans that ascribe value to specific assets such as real property have not been widely used in Japan. In fact, specific project financing has been practically non-existent. More importantly, until now the necessity to liquidate specific assets or properties has rarely, if ever, arisen.

Secondly, the nature of "secured credit" is different in Japan than in the U.S. In the case of a default, a

claim on secured property cannot be transferred to other creditors because the security consists of all the assets owned by the debtor, not just the secured asset.

In July 1995, Tokyo Mitsubishi Bank issued U.S.\$10 million in zero coupon bonds by skirting Japanese regulations and establishing a special purpose corporation overseas. They were the first offering to securitize mortgages on non-performing real estate in Japan. In August 1996, Fuji Bank issued JAF No.1, an interest-bearing Euro-yen bond that became the second securitized product based on non-performing loans held by a bank.

Spurred by a weakening economy, there has been increasing talk in Japan over the past three years of expanding the securitization process further. Many government officials hold the view that the real estate market will have to become more liquid to assist in solving their banks' bad debt problems. They believe that a fresh round of investment in securitized real estate, like we experienced in the United States during the early part of this decade, is necessary to stimulate the market.

In March of this year, the Ministry of Finance announced its real estate asset securitization plan, known as the "General Strategy for Liquidation of Mortgaged Real Estate." The plan outlined four methods of developing a securitization market. The goal of the plan is to implement policies and procedures that will allow Japan to establish a liquid market for real estate asset-backed securities. As outlined in *Grant's Asia Observer*, the plan will work like this:

"Real estate held as collateral on defaulted loans will be purchased from creditors by special purpose corporations (SPCs). The SPCs will then sell trust certificates or bonds to investors who will be paid with the income from the properties or the proceeds from their sale. Tax breaks are being considered to exempt SPCs from punitive real estate transaction taxes. In addition, casualty insurance companies will be allowed to issue financial guarantees against the underlying properties to protect investors against a loss of principal."³

In addition, Japan's Big Bang, the country's plan to reform its financial system, is scheduled to take effect by the year 2001. The name comes from the deregulation of the London securities market on October 27, 1986, also known as the Big Bang. It is comparable to May Day in the U.S. when brokerage

commissions were deregulated. Besides deregulating the securities transaction tax and liberalizing brokerage commissions, the Japanese Big Bang will offer substantial tax advantages to healthy banks that take control of weaker institutions. This should result in the liquidation of numerous non-performing real estate loans, either by the present holders of the loans in an attempt to clean up their balance sheets, or by the acquiring institution. Whatever form of securitization ultimately proves most prevalent, one thing appears certain: we can expect to see a large volume of securitized real estate offerings based on prices far lower than these assets commanded just a few short years ago.

OUTLOOK

Several trends are at work that will affect the globalization of securitization. Among them are:

- the recovery of the domestic real estate market that has made it increasingly difficult to buy U.S. assets at attractive prices;
- the increasingly global focus of all investors, (not just those that focus on real estate), that has made investing overseas more commonplace;
- the earlier stage that many overseas real estate markets are in, (in terms of their recovery from the world-wide recession of the early 1990s);
- the shift in institutional investment away from single-asset investing and into more liquid securitized offerings such as pools of loans, real estate investment trusts, and value-oriented funds; and
- the historical success that U.S. contrarian real estate investors experienced during the early 1990s.

If the returns are commensurate with the rewards, as they now are in several corners of the globe, the globalization of securitization will continue to spread.^{REI}

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REAL PROPERTY & LAND LEGISLATION IN THE RUSSIAN FEDERATION

by Sheila O'Leary & Olga Kaganova, CRE

The Russian Federation has made significant progress in establishing the legal basis for private property ownership and moving a great deal of property into private hands, thus creating the environment for a private real estate market to develop.

By many accounts the Russian real estate market is beginning to thrive. This is true at least in cities like Moscow, St. Petersburg, and Nizhni Novgorod that are hubs for domestic and foreign business. Several major legal developments in the past five years have been catalysts to spur development of the private real estate industry. The legalization of private property, housing, and enterprise privatization, and the establishment of the rudimentary systems for mortgage lending and property registration all contributed to improving the climate for real estate activity in Russia.

One of the last major areas to be reformed is land ownership. Currently, the majority of urban land in Russia is government-owned. A lack of political consensus on whether and how to privatize land is probably the single most significant obstacle to land reform today. The 1993 Russian Federation Constitution established the right of private land ownership. However, numerous efforts by national legislators and policy makers to implement the

language of the Constitution have resulted in a body of law that is incomplete, unclear, and sometimes ambiguous. Some progress has been made—several Presidential decrees on land reform and the 1994 Civil Code helped establish a workable legal framework for land relations. However, the national legislature has yet to pass the Land Code, the major piece of legislation that would provide the fundamental legal basis for land relations.

The current version of the Code was enacted in 1991. Between 1994 and 1997, the national legislature (Duma) considered and rejected several drafts of the Land Code. The most current draft Code, sponsored by Communist factions within the Duma, passed the upper house of the legislature in June and the lower house in July 1997, with huge majorities. It prohibits the privatization of agricultural land and ownership of land by foreigners. Although President Yeltsin is certain to veto the law, some analysts predict that there is sufficient support within the legislature to override the Presidential veto.

Establishing the legal and regulatory basis for real property relations is mainly the task of the national government. However, local governments, through their interpretations of federal law and the pace at which they implement new legislation, have a fair amount of control over the shape of real estate reform within their jurisdictions. For example, St. Petersburg and Nizhni Novgorod allow legal entities to buy and sell land. Moscow prohibits legal entities from owning land and allows only land leases up to 49 years. Some cities are using their new authority over legal and economic matters to attract investors and encourage development. These cities are attempting to create comprehensive and streamlined procedures to foster real estate investment. Other cities force developers to comply with a maze of confusing and inconsistently applied local regulations that ultimately stymie the goals of modernization and development.

This article¹ reports on the current legal framework of real property relations in Russia in four areas: property rights, registration, taxation, and land use regulation. We attempt to offer a concise overview of the relevant federal laws affecting urban real property. We do not discuss in detail any local legislation. However, the role of local government is discussed in those cases where federal legislation designates primary responsibility for a given area to local officials.

REAL PROPERTY RIGHTS

Previously a state where all property was government-owned, Russia now recognizes and constitutionally protects all major forms of private property ownership. During the early 1990s, government-sponsored programs of housing and enterprise privatization moved a great deal of property into private hands, creating the basis for a private real estate market. Other than the restrictions imposed by land use and environmental regulations, there are few limits on the ownership rights of legal entities and natural persons (Russian or foreign) to real property, exclusive of land. As discussed below, the issue of land ownership is more complicated, although the legal basis for national and foreign individuals and legal entities to own land is established in Russian law. Although problematic, lack of clarity on the land ownership issue has not been a complete impediment to acquiring secure land rights. Even where government allocation of land in fee-simple ownership is not the practice, land consumers may acquire long or short term lease or use rights.

This section briefly discusses several attributes of Russian law related to property rights in land and structures: 1). the separate legal systems regulating land and structures; 2). land privatization; 3). property transfers; and 4). termination of private property rights.

Regulation of Land and Structures

Although the concept of real property as land and improvements attached to it exists in Russian law, Russian legislation regulates land rights and rights to buildings and individual units separately. The basic body of law governing property rights in land consists of the 1993 Russian Federation Constitution; the 1991 Land Code; Parts I and II of the Civil Code (enacted in 1994 and 1995, respectively); the 1994 enterprise privatization law; and a host of Presidential decrees and Government laws. Rights to buildings and individual units are regulated by the Constitution, Civil Code, 1992 Fundamentals of Federal Housing Policy, the Law on Property, Law on Housing Privatization, the 1984 Housing Code (in the process of being revised), and numerous other laws and decrees.

The most important practical implications of this bifurcated system are the separation of the tax and registration systems (as discussed in sections below) and the necessity to complete two separate processes to transfer land and structures. Formerly, Russian law separated land rights to a parcel from rights in the occupying structures. However, policy-makers have come to recognize the necessity for property owners to have secure property rights in both buildings and the underlying land. The law is now clear that when buildings are privatized or transferred, the entity taking ownership (natural person or legal entity) has a right to acquire ownership of the underlying land. According to a May 1997, Presidential decree, this right also extends to those with lease, permanent use, or lifetime inheritable tenure rights. The relevant law on mortgage lending provides that buildings may be mortgaged only if the owner has secured fee-simple, lease, or use rights to the underlying land. Likewise, the national condominium law recognizes that the land under condominium buildings is part of the common property and requires that local governments give to condominium associations property rights in the underlying land.

Land Privatization

Land ownership is the last major area related to real estate in need of reform. Land rights are determined by the legal status of the entity possessing rights to

the land and the designated use of the land. Natural persons who own land for individual housing construction, "dachas" (vacation homes), garages, and gardening, essentially possess fee-simple ownership rights as understood in market economies. The land rights of owners in multi-family apartment buildings are not as developed, although the law makes no clear distinction between single and multi-family structures in cases where the land use is residential. Currently, owners in multi-family buildings have permanent use rights to the land under the building. However, a recent law on condominium associations states that land is part of the common elements and local governments should transfer underlying land free of charge to unit owners (up to some normative limit). The establishment of condominium associations has proceeded slowly in Russia. More widespread development of condominiums and implementation of the new condominium law will clarify the land rights of owners in multi-family buildings.

The rights of legal entities to own land for residential or commercial purposes is an unclear area of the law that has resulted in varying practices in cities across Russia. There is no outright ban on private ownership of land by legal entities. In fact, the Constitution states that owners may "possess, utilize, and dispose" of land as long as they do not damage the environment or infringe on the rights of others. In language echoing the Constitution, a general provision in the Civil Code states that land owners may freely possess, use, and dispose of land to the extent permitted by law as long as the owner does not damage the environment or violate the rights of others. The 1994 enterprise privatization law is clear that privatizing enterprises have the right to purchase underlying and adjacent land. There is a detailed, market-oriented chapter of the Civil Code (Chapter 17) which goes a long way toward clarifying the rights of land owners and regulating land transactions. However, this chapter does not become effective until passage of a new Land Code. Meanwhile, with much of the Land Code nullified by a 1994 Presidential decree and Chapter 17 in existence only on paper, there is a large vacuum in Russian land law.

Only the current draft Land Code makes a distinction between foreigners and non-foreigners regarding land ownership and permits lease as the sole form of property rights in land foreigners may have. This provision is clearly unconstitutional.

The aforementioned May 1997, Presidential decree attempts to fill in this void. In some provisions

it reiterates existing law and adds several new principles. The decree provides that land ownership rights may be exercised at the time of or subsequent to privatization of existing or uncompleted structures. Additionally, owners of structures that have lease, use, or inheritable lifetime possession rights in the underlying land have the option to purchase the land. In all circumstances, the selling price of the land is fixed at five times the land tax rate.

Property Transfers

Once owners establish their property rights in land and buildings, Russian law presents a new set of challenges to transfer those rights. Transferring real property rights between parties may be a complicated process depending upon the legal status of the property owner. The processes for transferring land and real property without land are separate. Transfer of residential or commercial property (without land) between private parties is governed by contract law as contained in the Civil Code. The process is similar to that found in market economies and is fairly straightforward. The sales contract must be notarized and registered with the appropriate government authorities. The registration office is usually the Bureau of Technical Inventory (BTI), a Soviet-era bureaucracy that has detailed technical information on all buildings. Failure to notarize or register the transaction renders the transaction null.

Natural persons may transfer land they own that is used for residential and gardening purposes. The process is governed by a series of Presidential decrees that require notarization of the sales contract, attachment of the plot layout to the sales contract (to compensate for the fact that most cities do not have complete land cadastres), and registration of the contract. In most cities the government office registering land transactions is the local land committee (komzem), not BTI.

The Constitution provides general language stating that legal entities may own land. The interpretation of this language among many in the legal community is that this necessarily includes the right to sell the land. However, there is no federal law in force which contains a comprehensive procedure for private legal entities that are owners of land parcels to sell their parcels. Provisions of the Land Code that provide some guidance on this point are nullified; similar provisions of the Civil Code are not yet in force.

Despite the shortcoming in the law, as previously mentioned, transactions of this type do occur. A 1994 Presidential decree on enterprise privatization provides a procedure for transferring to privatized enterprises the land on which their facilities are located and any adjacent land. However, the law does not deal with transactions in the second stage where those enterprises sell the land to another legal entity. In some cities, a great deal of land has been privatized through the enterprise privatization process and is beginning to enter the secondary land market. Purchasing land from privatized enterprises appears to be a legitimate way for legal entities (including real estate developers) to acquire fee-simple ownership of land. However, the privatization law states that its provisions must conform to the new Land Code. Therefore, any legal entity acquiring land through this process must be very careful to secure its ownership rights to the maximum degree the law currently allows to survive any property rights challenges that the Land Code may present, once enacted.

As an alternative to acquiring real property through private owners, interested parties may purchase, lease, or acquire other property rights to government-owned buildings and land. In cities where many residential, commercial, or industrial occupants did not exercise their option to privatize, the government continues to own a large share of the buildings and land. Federal law guides the process of disposing of federal and municipal government property, and in all cities, the federal Property Management Committee plays a major role in the process. In addition, cities have created their own bureaucracies and procedures that may differ from city to city.

Government Termination of Private Property Rights

Russian law provides for several circumstances under which a property owner's rights to residential premises or land may be terminated. According to the Civil Code, a local government may terminate the ownership rights of a residential owner if the property is used for non-residential purposes, the owner violates neighbors' rights, or destroys the property. If the owner fails to correct the problem after adequate notice from the local government, the local government may sell the property at public auction and give the sales proceeds to the owner.

According to provisions of the Civil Code not yet in force, the government may withdraw a property owner's rights to land under several conditions: the plot is withdrawn for state or municipal needs;

According to the Civil Code, a local government may terminate the ownership rights of a residential owner if the property is used for non-residential purposes, the owner violates neighbors' rights, or destroys the property. If the owner fails to correct the problem after adequate notice from the local government, the local government may sell the property at public auction and give the sales proceeds to the owner.

the plot is not used for its designated purpose; or the owner's use of the land violates land use or environmental regulations. If the government expropriates land for state or municipal needs it must compensate the owner for: the market value of the land (as determined by contract with the owner); immovable property located on the land; and all other losses associated with withdrawal of the plot. Land withdrawn from private ownership because of the owner's improper use of the land is sold at public auction. In these circumstances, local law governs the procedure for withdrawal of the land and compensation to the owner.

REAL PROPERTY REGISTRATION

For several years, Russian policy makers have been working on establishing a comprehensive law for real property registration. For a variety of primarily political reasons the law is still making its way through the legislative process, although passage is expected in late 1997. Meanwhile, the law governing real property registration in Russia consists of general provisions in the Civil Code and a number of other laws on land, mortgage, and privatization that contain select provisions on registration.

The Civil Code mandates that all transactions involving land and immovable property be registered. The following property rights must be registered: ownership, inheritable lifetime possession, permanent use, mortgage, servitude, economic jurisdiction, operative management, and other rights as required by law. Failure to comply with this provision renders a transaction legally nullified. The Code also requires notarization of certain types of transactions, including real estate sales. Notaries in Russia are attorneys and the notarization process requires the notary to certify the authenticity of the documents and their contents.

Most locations in Russia maintain separate registration agencies for buildings and individual units (usually the Bureau of Technical Inventory) and land (usually the Land Committee). The quality of the records varies between locations. It is safe to say there are few registration agencies that can boast sufficiently detailed and accurate records for a potential property owner to rely on when performing a title search. Historically, public access to the records has been non-existent. The Civil Code states that any person who requests information from the records is entitled to receive it from any registry location, regardless of where the transaction in question was registered. However, the draft registration law discussed below circumscribes the rights granted in the Code.

Russian policy makers recognize the importance of establishing a single registry for all transactions. Part I of the 1994 Civil Code calls upon the Ministry of Justice to establish a unified state registry. Although the Ministry has established an office for this purpose and is proceeding with the Civil Code mandate, no demonstrable progress has been made to date. The Ministry's job is especially difficult, given that it has little experience in the mechanics of registration (unlike BTI and the Land Committees). Currently there is no detailed law on registration to guide the Ministry in the process of establishing a registry.

In the absence of a national comprehensive law on property registration, laws on land allocation and privatization, housing privatization, and mortgage contain some guidance on the procedures to follow in registering the types of transactions these laws address. For example, according to a 1991 Presidential decree, land plots privatized for residential use should be registered with the local Land Committee, which in turn issues the owner a certificate of title. Similar laws govern the process for registering privatized apartments and privatized enterprise land.

Another shortcoming of the present framework governing property registration is that none of the relevant laws contain clear language on the legal implications of registration. The Civil Code contains general language that failure to register transactions for which registration is mandatory renders the transaction null. However, this Code does not address fundamental questions of what guarantees the state provides to those who register (particularly

The federal government has primary control for establishing and regulating the tax system. Federal law stipulates which taxes are federal, regional, and local, meaning that revenue from the tax is earmarked for the respective government budget.

in cases where the state errs in entering information into the record) or how competing claims to the same property will be resolved.

Many of the gaps in the current law on registration will be filled in when the Duma passes a comprehensive law on real property registration. According to the Civil Code, the details of the registration system and the legal implications of registration are to be worked out in a separate law on registration of rights to immovable property. A draft law currently under consideration contains mandatory registration of property rights (as stipulated in the Civil Code); creation of a countrywide, single, unified registration system (i.e. land and structures) to be implemented by local registries under the supervision of the Ministry of Justice; a registration case organized by cadastre number containing basic physical and legal information on each object of real property (land, building, or portion of a building); a requirement that registration is effective from the date the application is accepted (although registration itself may take up to 30 days); and title reports for a fee. Passage of this law will go a long way toward clarifying property rights, streamlining transaction procedures, and making the process more transparent.

REAL PROPERTY TAXATION

Just as the law treats land and buildings separately regarding property rights and registration, they are taxed separately as well. The main real estate tax laws affecting natural persons are the land tax and tax on personal property. Legal entities must comply with the land tax and enterprise assets tax.

The main tax law in Russia is the 1991 Fundamentals of Taxation. Although this law was considered comprehensive when enacted, lawmakers generally accept that a new "Fundamentals" is necessary to consolidate and simplify the mass of tax legislation enacted since 1991. A new law is in the drafting stages, but has not been introduced in the Duma as

of this writing. Among other provisions, the Fundamentals defines the general principles for the formation of the tax system; lists which taxes are federal, regional, and local; and outlines the rights and obligations of taxpayers, including the right to appeal Tax Inspectorate decisions regarding tax liability.

The federal government has primary control for establishing and regulating the tax system. Federal law stipulates which taxes are federal, regional, and local, meaning that revenue from the tax is earmarked for the respective government budget. Regional and local governments do not have the authority to levy taxes beyond those enumerated in the Fundamentals. In many cases, such as the land tax, a portion of the revenue is earmarked for the federal budget and a portion goes to the regional and local government coffers.

For some taxes, although the Fundamentals controls the objects a regional and local government may tax, local legislation defines the tax rate and method of collection. This is not true for the taxes related to land and real property. For example, although the enterprise assets tax is a regional tax and the personal property and land taxes are local taxes, their rates and methods for assessment and collection are regulated by federal law.

Land Tax

The land tax is regulated by federal legislation, collected by local authorities, and revenue is shared among the federal, regional, and local governments. The main land tax law is the Law on Payment for Land and accompanying regulations on assessment and collection. Land taxes are imposed under a system which centralizes control of rates in the Duma and classifies rates based on land use and location.

The Law on Payment for Land establishes the basic procedures for calculating and collecting land taxes which are elaborated upon in supplemental Tax Inspectorate regulations. The land tax is not an ad valorem tax. Average tax rates are set by hectare on a scale that differentiates rates based on region and population. In some cases, the law further modifies the calculation by considering primary land use. Localities are permitted some flexibility in assessing land taxes by dividing the city into various tax zones, provided that the zones correspond to the economic value of the territory and Master Plan and collectively do not exceed the average tax rate for the region. For certain types of land, localities may increase the tax rate not

more than twofold if the land is situated in a desirable location. The tax on residential land is lower than land for other uses (3 percent of tax liability), reflecting the long-standing public policy of protecting homeowners and tenants.

Property Tax

Russian law taxes the personal property of natural persons and the assets of legal entities. The personal property tax is regulated by federal law, but is a local tax—revenue from the tax is allocated to the local budget where the property is registered. The tax rate is set by federal authorities and the tax is paid annually. This tax has an ad valorem structure, but the assessment used to calculate the property's value does not reflect the current market value of the property. Inventory value is essentially the depreciated replacement cost of the property. Currently the rate is 1 percent of inventory value. This value is calculated based on the Soviet-era cost of the building at the time of construction. Inflation indexes periodically adjust this value, but the indexes do not realistically reflect replacement costs or real depreciation. BTI maintains records on the inventory value of all property. The local office of the federal Tax Inspectorate is not responsible for assessing or verifying property values, but always relies on information from BTI.

Legal entities must pay an assets tax on any real property owned by the company. The tax is regulated by federal law, but revenue from the tax goes to the regional and local government budgets. The maximum tax rate is currently 2 percent of the assets' value and is paid quarterly. Regional governments may set different tax rates for a company based on the enterprise's activity. The tax base is calculated as the assets' value as recorded on the company's balance sheet minus the value of certain assets used for production. Value is the depreciated replacement cost as calculated by the company. Alternatively, the company may request an independent appraisal of the property's market value. In either case, the Tax Inspectorate generally accepts the company's assessment of the value of its assets without outside verification.

LAND USE REGULATION

During the Soviet period the central government controlled land use and planning through detailed regulations that designated particular land uses for each plot of urban land, often designating a use for each building occupying the plot. Elaborate Master Plans contained blueprints for controlling land use and urban development. Public participation in the

development process was essentially nonexistent and the contents of Master Plans were accessible only to a limited number of government employees. The law of land use and planning is currently in flux in Russia, but moving in the direction of a more market-oriented, flexible system that gives most decision-making authority to local governments and encourages public participation.

The 1995 Law on Local Self-Government established that local governments have authority for regulating zoning and development and monitoring use of municipal land. However, these provisions are primarily hortatory and require supplementary laws to give them meaning. The most important federal land use law is the Urban Planning Codex. The Codex is close to passage in the Duma and is expected to be enacted into law before the end of 1997. According to the Codex, the federal government is responsible for determining the general policy goals of land use and planning and controlling federal lands, but the Codex grants most authority over land control and development to local governments. Local governments will design Master Plans, more flexible than the plans of the past, that will serve as guidelines for urban development. Legally enforceable zoning regulations will set the parameters for permissible uses. Local administrations may create local zoning commissions which draft regulations, handle disputes, and grant variances. The Codex also directs local governments to ensure that land use regulations and decisions are accessible to the public and to allow the public to participate in the decision-making process.

Although land use and planning is destined to become an area primarily controlled by local governments, the federal government is expected to continue playing a role. The federal government will control land use decisions regarding federal land. In addition, federal Ministry of Construction (Minstroï) regulations direct local governments to develop certain types of planning documents, including a Master Plan and more detailed regional plans for land use zones within a city. However, local governments are responsible for the substance of these documents. Minstroï also publishes suggested development guidelines for height and density, building materials, infrastructure networks, and related areas that local governments may choose to adopt.

CONCLUSION

The Russian Federation has made significant progress in establishing the legal basis for private property ownership and moving a great deal of

property into private hands, thus creating the environment for a private real estate market to develop. The law governing transactions in land and housing between natural persons for residential purposes is well established, and these types of transactions have become commonplace.

More complicated are the property rights of legal entities, particularly in land for commercial use, and the procedures for acquiring, using, and registering land rights. The Civil Code made an important contribution to clarifying the process of real property transfers minus land and the enterprise privatization law is the comprehensive law on the topics it addresses. However, until the Land Code is passed (also activating Chapter 17 of the Civil Code on land transactions), and the law on property registration and the Urban Planning Codex are enacted, there will be major holes in Russian real estate and land legislation.

Meanwhile, some local governments that are eager to foster real estate activity within their jurisdictions are working within the existing legal framework to attract real estate investment. It is in these cities, and in other cities aspiring to the same goals, that interested parties should explore investment opportunities.^{REI}

NOTES

1. Sheila O'Leary is an attorney at the Urban Institute who has worked on housing and land reform issues in Russia since 1992. Olga Kaganova, Ph.D. is a researcher at the Urban Institute with extensive international experience in urban real estate reform. This report was produced in connection with the Urban Real Estate Reform Indicators Project funded by the United States Agency for International Development (USAID). The opinions expressed in this article are the authors' opinions and do not necessarily reflect the views of the Urban Institute or USAID.

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CZECH REPUBLIC & HUNGARY: TWO GOLDEN REAL ESTATE OPPORTUNITIES OR TWO ECONOMIC QUAGMIRES?

by Mark Lee Levine, CRE

Given that historical events are often repeated if not properly studied and avoided, this certainly needs consideration when examining Eastern Europe and its historical postures during this century.

Recently during a visit to the Czech Republic (previously Czechoslovakia) and Hungary, I was fortunate to travel with two companions¹ who were native to these countries and whose input and background on the current economies proved valuable. They provided information on the development and destruction that occurred in Czechoslovakia and Hungary preceding and during World War II and how this formed the backdrop for today's economic status in these countries, including the recent proposal for these countries to be admitted to NATO.

Real estate opportunities clearly exist within Hungary and the Czech Republic. However, historical events support concern for the potential risks which would accompany any real estate investment. Given that historical events are often repeated if not properly studied and avoided, this certainly needs consideration when examining Eastern Europe and its historical postures during this century. Germany's occupancy and its

sociological and economic impact, including the utter destruction of populations (Jewish and others), continues to influence the development of these areas, as does the subsequent control by the former Soviet Union after World War II. Only recently did Hungary and the Czech Republic remove themselves from communistic control,² and, subsequently, become two separate countries.³

This article examines the resulting paradigms from communism, which, for the most part, ended in 1989, and the development of capitalism and a more democratic role of government which followed. Any background for successful implementation of real estate and related investment opportunities in these countries remains uncertain when their history is considered.

OVERVIEW OF HUNGARY

The land area in Hungary is about the size of Indiana (approximately 93,000 square kilometers or 36,000 square miles). The Hungarian population consists of 10 million people, including

an estimated 92 percent of Hungarians (Magyars). Other ethnic groups include (approximately) Romanians (3 percent), Germans (1 percent), Slovaks (1 percent), Jews (1 percent), and others (estimated at 2 percent).⁴

Budapest, the capital city of Hungary, has a population of about 2 million people, according to the most recent census. Having visited Budapest and many of its historical buildings, I saw first-hand the potential for residential and business opportunities within Hungary.

Religious denomination in Hungary is around 70 percent Roman Catholic, 20 percent Calvinists, and 10 percent divided among Lutherans, Jews, Baptists, and others. The dominant language is Hungarian (Magyar). However, Hungarian history, geographic location, (see Figure 1) and control by the Germans and communists have resulted in other languages being spoken, especially German and Russian.

Government & Economy

Hungary's governmental structure, important to consider when evaluating real estate opportunities, is framed as a parliamentary democracy. The Hungarian constitution was substantially revised in 1991, following the 1989 Communist withdrawal.

The Hungarian economy is growing; its current Gross Domestic Product is at approximately \$40 billion. Currency is the forints, which, on our visit, had an exchange rate of approximately 151 forints to the U.S. dollar. Inflation and economic concerns continue to be major issues, especially with the ongoing political changes. The Hungarian Communist Party was in power until about November 1945. From 1948 to 1953, the economy was controlled by the Soviet Union. In one form or another, this control continued until March 11, 1989, when an agreement between Hungary and the Soviet Union resulted in the final withdrawal of the Soviet Union and its troops in 1991. In 1990, the Hungarian Democratic Forum won 43 percent of the vote, and the democratic viewpoint continues today.

This transition remains encouraging. The apparent support of the Hungarian government toward private business and the privatization of many state enterprises could lead to more investment within the country from both national and international interests. However, this transition should also raise a flag of caution for investments. There should be concern with the government's lack of stability.

In support of greater political and economic permanence, the United States and Hungary established full diplomatic relations in 1945; however, with the advent of communism, these relations were strained. In 1991, with the political changes already discussed, the United States and Hungary undertook a more cordial relationship, and the result has been additional U.S. assistance for Hungary and its development.

Investment

Investment opportunities in Hungary are very appealing. This was reported in a recent article by Linda Liston,⁵ where she emphasized that the 1989 political change brought many investors to Hungary. According to Ms. Liston's data, Hungary had \$9.5 billion in foreign investments from 1989 to 1995. Hungary attracted over one-half the total investments in Eastern Europe, along with the possibility for direct investments of a shareholder-type, including 100 percent ownership. (Many countries limit foreign investments and/or limit investments only to the country's citizenry.) Hungary prides itself in allowing investors to remove their capital and profits from the country without a great deal of red tape. On the downside, notwithstanding the comments noted, Hungary is a developing country. It suffers from inflation which now languishes between 20 percent to 30 percent.

Unemployment

Hungary suffers from an unemployment rate of between 12 percent to 15 percent. While this could have a negative impact on the country's development, it also means that labor is available for development of real estate and other projects. Labor works for a much lower wage; the average earnings of a worker in Hungary are about U.S.\$300 per month.

Tax Rates

Tax rates and other costs of doing business in Hungary also appear very favorable for the investor. In approaching the 21st century, Hungary has proven to be very aggressive and innovative as an economic base in Eastern Europe. It has reduced some tax burdens, liberalized regulations for trade relations, made favorable rules for investors, and is attempting to stabilize its unemployment position and its currency. Fast food operations such as Pizza Hut, Kentucky Fried Chicken, and McDonalds, already have key locations within Hungary and, specifically, within Budapest. There are many attractive real estate opportunities regarding location, pricing, and early stage development. However,

Figure 1



caution must also be exercised by the investor, considering the country's inflation and its evolving transition from communism to democracy.

Infrastructure

A favorable rail network already exists, additional transportation systems are being developed, and plans are underway to develop infrastructure and other support requirements for the cities. The benefit of the Danube River, especially flowing through Budapest,⁶ enhances economic development and attracts new residents and visitors.

An excellent source for information on Hungary is the Hungarian Real Estate Association (HREA).⁷ This organization can be reached through its Web-page, via the CEREAN (Central and Eastern European Real Estate Association Network) home-page, found at <http://www.arkcms.cz/CEREAN>. Zoltan Szekeres is the secretary general of HREA. Another resource is the U.S.-based Eastern

European Real Property Foundation (EERPF), an association partner of HREA. The EERPF works with independent institutions and professional associations to support training in real estate professions and the development of professional associations.⁸

OVERVIEW OF THE CZECH REPUBLIC

The Czech Republic is located in Central Europe, southeast of Germany (see Figure 1). The land area of the Czech Republic is approximately 78,700 square kilometers, a land area somewhat smaller than South Carolina. Bordering Austria, Germany, Poland, and the Republic of Slovakia, the Czech Republic is landlocked. Prague is the capital.

Similar to Hungary, the Czech Republic also was occupied by Germany during World War II and, subsequently, dominated by communism and the Soviet Union. Czechoslovakia had a democratic history in the mid-1900s. In 1993, Czechoslovakia was divided into the Czech Republic and the

Slovakia Republic. The Czech Republic returned to a parliamentary democracy, and its constitution was ratified.

Following the withdrawal of Soviet Union troops from the Czech Republic, the government is struggling with numerous requirements to develop laws and positions on issues that need to be addressed, including general taxation, property taxes, and control of governmental functions. After the political and geographic divisions, the Czech Republic seems to have the better economic position over that of the Republic of Slovakia.

Sociological Profile

The population of the Czech Republic, similar to Hungary, is approximately 10.5 million, based on July 1995 estimates.⁹ The resulting ethnic divisions are approximately 95 percent Czech, 3 percent Slovak, and the balance consists of Poles, Germans, Hungarians, and others. The dominant language is Czech.

As a result of the German occupation followed by the Soviet Union, approximately 40 percent of the people are atheists. However, there is a strong presence of Roman Catholics (approximately 39 percent) and other religious influences. The large Jewish population, present in both Hungary and Czechoslovakia before World War II, was all but destroyed by Hitler's actions and that of the other governments in power (including communism via the Soviet Union). Now only a small percentage of the former Jewish population remains in Hungary and Czechoslovakia. This sociological and political history impacted the development of the legal system in the Czech Republic, which currently is based on a unique civil law system and Austro-Hungarian codes.

Economic Position & Real Estate

From an economic and investment standpoint, along with the move to democracy, inflation has been substantial, similar to that of Hungary. Current inflation estimates are between 20 percent to 30 percent. The 1994 estimated Gross Domestic Product approached \$80 billion.

At the same time, the Czech Republic has been attempting to restructure its government toward democratic ideals by encouraging private ownership and privatization of what were previously governmentally-controlled properties and businesses. In Prague, the opportunities are enormous

to revitalize the beautiful buildings and other structures for real estate investment. Overall, there has been an increase in tourism and the development of a business community. The Czech Republic has a developed railway system and is working to provide more infrastructure to support various business developments.

All the while, the per capita earnings for citizens remain low. Like Hungary, individual earnings are approximately U.S.\$300 to \$400 per month. Inflation was reduced during 1995; more recent estimates indicate that inflation may be in the 10 percent to 20 percent range, although these figures may be unreliable.

An interesting point raised in the *Czech Republic Law Digest* is that foreign investment enjoys a comfortable position in the country. The digest stated, "Foreign persons may develop business activity in territory of the Czech Republic under same conditions and to same extent as Czech persons if law does not stipulate otherwise."¹⁰

In summary, the Czech Republic seems to be facilitating opportunities for investments. The U.S. Department of State issued a report stating that the economy of the Czech Republic is strongly emerging as a leader in Eastern Europe, and a well-educated population and strongly-developed infrastructure is underway. Given the favorable activity and development to a stable investment climate, the Czech Republic was the first post-communist country to receive an investment grade credit rating by the International Credit Institution, as reported by the U.S. State Department.¹¹

Millions of Americans can trace their ancestry back to Bohemia and Moravia, which once were part of Czechoslovakia. Also, with the large number of Czechs currently living in the United States, it appears that many U.S. investors have personal ties to the Czech Republic. The United States recognizes both the Czech Republic and the Republic of Slovakia; recently U.S. and Czech Republic relations have become economically and politically positive.

As stated in the U.S. Department of State report: "The government (Czech Republic) has an ambitious plan to privatize state industries in all sectors of the economy. It hopes to create a private sector . . ."¹² To investors, this means that there are many opportunities to acquire real estate and other businesses from the Czech Republic. Its

government desires to raise funds, privatize various businesses, and encourage investments.

OPPORTUNITIES VS. PITFALLS:

Is It In The Eyes (Pockets) of The Beholder?

Pros and cons exist regarding the exposure and the real estate investment opportunities in Hungary and the Czech Republic. It is clear that both countries support democratic ideals and foreign investments. Their residents and citizens want to attain the economic opportunities they see prevalent in Western Europe and other free democratic societies. To achieve this they are receptive to embracing western culture and enterprises, such as fast food businesses. On the other hand, the size of the populations in these countries (approximately 10 million in each) are not attractive to investment opportunities when compared with other larger populated countries, e.g., India with over 900 million people and China with 1.2 billion people.

A majority of the population in Hungary and the Czech Republic has earnings which are substantially lower than those in the United States. To name a few elements at issue, one must consider the limited per capita income in Hungary and the Czech Republic, the population, and the potential instability present when countries are in transition from a communistic state to a democratic society. The instability that exists in the former Soviet Union is evidence of these concerns. Other issues also must be considered, such as the need to develop infrastructure and capital funds, and curb inflation.

CONCLUSION

Typically investors are attracted to business opportunities in countries with populations the size of India or China. However, I witnessed first-hand the receptiveness of investors for real estate developments in these evolving markets. Hungary, the Czech Republic, and other Eastern European countries are becoming extremely attractive for investment opportunities.

As is true with any investment, risk vis-à-vis reward must be in balance. Given reasonable controls and judicious consideration of various investment criteria that are necessary to maintain any investment setting, it appears, on a macro basis, that the rewards clearly outweigh the risks for real estate investments in Hungary and the Czech Republic.^{REI}

NOTES

1. The two individuals, Rabbi Israel Rosenfeld and Eric (Tova) Rosenfeld, were foreshadowed in part by the devastating

losses that they suffered, personally and to their families and friends, as a result of the Nazi occupation of Eastern Europe. The Rosenfelds, who now reside in Denver, Colorado, have a history that spanned not only the countries noted, but also Austria, Israel and numerous other locations throughout the world. Their visions of what existed during their childhoods at locations in Hungary and Czechoslovakia and other countries, lent further insight to this author regarding concern for economic and real estate development.

2. In February, 1989, Hungary developed a multi-party political system. In March, 1989, Hungary and the Soviet Union agreed to the withdrawal of the Soviet Union troops. This withdrawal took place in June, 1991. The independence of Czechoslovakia, relative to the Soviet Union, followed a similar approach. The formal separation of Czechoslovakia into the Czech Republic and the Republic of Slovakia was effective January 1, 1993.
3. The effective date of the breakup of Czechoslovakia into two states was January 1, 1993.
4. Much of the data for the profile of the Czech Republic as well as Hungary have been drawn from several major sources, viz.: *Global Real Estate*, edited by Dr. Mark Lee Levine and assisted by Jeffrey L. Engelstad. This work, to be published at the UNIVERSITY OF DENVER, Daniels College of Business, Burns School of Real Estate and Construction Management, provides profiles for comparison of 65 countries throughout the world, including Hungary and the Czech Republic. For more details, contact the book's editor (Dr. Levine) at UNIVERSITY OF DENVER, Daniels College of Business, Burns School of Real Estate and Construction Management, 2020 South Race Street, Denver, Colorado 80208-3432 (fax: 303/871-2971) (e-mail: mlevine@du.edu). This work was published in 1996. See also the publications on Hungary and the Czech Republic by the United States Department of State, Bureau of Public Affairs and the Office of Public Communications.
5. See the article by Liston, Linda, "Hungary - the Competitive Edge," *Site Selection* 1 (December, 1995).
6. See the Map, attached hereto.
7. I had the privilege of visiting with the General Secretary of HREA, Voltan Szekeres. The EERPF sponsored the creation of the CEREAN home-page, as well as sites for its other association partners. When complete, the home-page will contain contact information on real estate opportunities and markets in each member country.
8. Id.
9. See the *CIA World Fact Book* and *supra*, footnote 4.
10. See *Czech Republic Law Digest*, Ziner Golan Nair & Partners, in cooperation with Professor Jud r. Zdenek Kucera of the Faculty of the Charles University, Prague, Czech Republic (1994).
11. See U.S. Department of State, Bureau of Public Affairs, Office of Public Communication, "Czech Republic" (July, 1994).
12. See Id.

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APPRAISAL PRACTICE IN CENTRAL & EASTERN EUROPE

by Lincoln W. North, CRE

*The sweet flavour of
democracy in the
CEECs is here to stay.*

*It is within this
framework that the
market economy will
become successful. As
their market economy
strengthens, so too
will a market-based
professional appraisal
practice. As we know
all too well, valuation
activity is directly
proportionate to
economic growth.*

Nearly 20 years ago, about half way through my career as a real estate appraiser, (or valuer, as we are more commonly known outside of North America), I had my first exposure to the international scene. As President of our Institute, I attended the 7th Annual Pan Pacific Congress of Real Estate Appraisers, Valuers, & Counselors in Rotorua, New Zealand. Afterwards, I delivered a paper in Brussels, Belgium, on the subject of foreign investment in Canadian Real Estate. In sharp contrast to what I found in Europe, the experience in New Zealand at the time, and subsequent visits to Australia and other countries in Southeast Asia, revealed that the practices and procedures of valuing property in these latter regions were very similar to those in North America. Thus, I was left with the impression that the profession had a very common and uniform functional basis; i.e., very few differences existed in the ways and means of practicing in this field—at least westward from Canada.

Europe, on the other hand, was another matter. It soon became apparent that the professional appraisal practice in Western Europe was more of a science than an art. Market values were commonly formulated through application of the cost approach, as we know it. The majority of valuers were educated and trained in the technical professions, particularly engineering, surveying, and other sciences. A professional appraiser was a professional engineer; not unlike the situation in Central and South America (even today), and not unlike the situation in Quebec prior to the 1950s. These technical practitioners were assisted by estate agents, or real estate brokers. Such persons were held in high esteem since they usually operated with impeccable integrity, honesty, and forthrightness. Being a civil engineer myself, and having been exposed extensively to cost approach applications early in my career, I was able to relate to Western European practices. They were however, unusual when compared to North

American methods. My exposure to appraisal practices in Central and Eastern Europe¹ came after the break-up of the Soviet Union.

Of course to fully understand and appreciate appraisal practices and procedures in Central and Eastern Europe today, a reflection upon the entire evolution of the profession is suggested. Since it had its modern origins in the late-1800s, it calls for an introspective look at the political structure of these Republics during the past 50 years, in contrast to events that have transpired during the past five years. However, due to space limitations, this manuscript will discuss the appraisal profession as it was reborn, or reignited in 1991. In my view, the appraisal profession in the CEECs (Central and Eastern European Countries) will be on a par with the status of our institutes and societies by the end of this decade. To date, the resurrection has been nothing short of extraordinary.

THE RETURN TO INDEPENDENCE

The collapse of the Berlin Wall in 1989 signalled the "beginning of the end" of controlled economies in Central and Eastern Europe. As joyous as the thoughts and events of independence were to become in the ensuing years, the Republics lacked the initial internal wherewithal to engineer the reformation. The first day of each Republic's independence totally shocked and shook the entire political, social, economic, and legal infrastructure to its foundations.

Independence and reformation began in earnest in 1991, with the act that effectively dissolved the USSR and released 28 Republics from state control. Thus, the gradual and very painful transformation to a market-based economy began; occasionally with shocking velocity (as in Poland), but very gradually in the Republics of Southeastern Europe that lacked the financial and economic infrastructure needed to kick-start the transition.

Prior to discussing the rebirth of valuation activity within the former Soviet Republics, it is significant to have an appreciation of political events that have transpired during the past five years. These events have governed both the depth and velocity of the growth in professional valuation activity within the emerging 16-nation group of CEECs.

The principle political objective, of course, was and remains to be, independence. However, political independence carries a hefty price, as the economy

of a Republic cannot be transformed overnight. Fortunately, for some of the Republics, such as Poland and the Czech Republic, the process of transformation from a planned, central economy to a market economy, came quickly; aided and abetted by the entrepreneurship indigenous of their citizens and those who had the courage and resources to form new private enterprises. Yet, even Czechoslovakia had to pass through an interim "velvet revolution" in the process, resulting in the partition of the country into two independent States. For other Republics that were more dependent on trade and commerce with Mother-Russia than the West, the transformation process was almost devastating from an economic point of view, since the structural economy of Russia itself nearly collapsed; it still remains in a precarious position.

As a result of the tremendous economic hardships imposed on the former Republics, they have, both individually and as a loose alliance, directed their political efforts at becoming full members of the European Union. This is in an effort to arrest trade barriers and nurture new markets for their exports. The thrust for this "economic security" is all-prevailing among these nations today; they cannot function as independent, national economic units. Various western European countries cannot continue to operate in economic isolation either, which is the founding reason for the creation of the European Union.

The second focus of political activity in Central and Eastern Europe has a military connotation. Membership in NATO is the security blanket being sought in this regard. Naturally, the United States has an interest in expanding NATO. Naturally, Russia opposes such expansion, particularly into countries that are bordering States and that connect central Russia to the high seas. Protection of one's flanks is paramount to any country's security and independence. Fortunately, the compromise evident on the horizon today appears to be the mutual acceptance of all parties to what is now termed "political membership" in NATO, in contrast to "military membership." The entire issue is extremely sensitive and significant. In the wake of growing nostalgia within Russia for a rebirth of some form of a new Soviet Union, the CEECs desire protection of their borders. All the while, Russia itself is left to feel increasingly defenseless as its "super power" status has dissolved.

It is within this fabric of emerging political and economic circumstances that the transformation

process must be viewed. The transition to a market economy is now irreversible, even in Mother-Russia itself. This holds true even if the political structure of Russia or any of its former member Republics transcends another era of socialist leadership. The sweet flavour of democracy is here to stay, and it is within this framework that the market economy will become successful. As the market economy strengthens, so too will a market-based professional appraisal practice. As we know all too well, valuation activity is directly proportionate to economic growth.

With this overview of the political events associated with the transformation process, more specific attention can now be focused on the re-emergence of the property market and professional appraisal activity.

THE REBIRTH OF THE PROPERTY MARKET & APPRAISAL ACTIVITY

Part and parcel of the change from a state controlled political, economic, and social system, to one which is commonly called a market economy, involves the privatization of real estate. Here, the essence of privatization is the transfer of ownership interests previously held by the state to individual citizens, joint-venture corporations, and domestic business enterprises and manufacturing companies. The privatization process does not necessarily result in the complete transfer of property ownership, or the complete bundle of ownership rights. Freehold title may be obtained in certain instances, such as for single family dwellings and rural property. However, the privatization of commercial and industrial property usually is restricted to the creation of a leasehold interest: the state maintaining ownership of the underlying land.

During the initial stages of the privatization process, the first test of valuers was the formidable task of seeking a market-based price for the conveyance of state owned property to private ownership, (conveyance in this instance being an act of transferring clouded rights of ownership rather than clear title.) Initially, it was difficult to characterize supposed market-based prices as market value, beyond the concept of having a willing seller and a willing buyer. This is because open market comparison data was non-existent, having been non-existent for 50 years. No sales data was available to consider, other than occasional evidence of administrative prices. Rentals, where they existed, were also prescribed sums, established by sworn valuers. Consequently,

In the wake of growing nostalgia within Russia for a rebirth of some form of a new Soviet Union, the CEECs desire protection of their borders. All the while, Russia itself is left to feel increasingly defenseless as its "super power" status has dissolved.

the new breed of valuers had a choice of: 1). applying an artificial multiplier to previously determined administrative prices; or 2). establishing arbitrary unit prices; or, in the alternative, 3). employing some form of replacement cost methodology.

Generally, application of these arbitrary valuation methods produced a fairly nominal expression of value, particularly for multiple-family residential units. For commercial and industrial properties, initial values were seldom of meaningful or rational significance. Valuers simply had no objective means of estimating or otherwise determining a fair market price. Even today, the market value of commercial and industrial assets is better established by an auction process.

Aside from the problems associated with fixing a price or value for the initial conveyance of ownership from the State, the appraiser's endeavours were seriously encumbered by the inability to identify what legal and other rights of ownership were actually being sold by, or leased from the State.

The process of valuing real property in the West² is usually based on the fact, or a definitive assumption, that: 1). proper title to the property rights being valued exists in the public records; and that 2). either a real or notional transfer of title can be accomplished with a minimum of time and effort. In Central and Eastern Europe there can be no assumption that a valid title exists or that a transfer of ownership can take place without undue delay.

As far as a physical description is concerned, the boundaries of a parcel of land may have ceased to exist in a legal context at the end of World War II, with the implementation of public or state ownership. In instances where private ownership of certain types of property was permitted to continue, the ravages of war often destroyed either the property or the public records that defined ownership. Thus the initial stages of privatization, (which

usually relate to granting the original land owner the right of first refusal), may be frustrated by the inability of the State to be able to provide a proper survey or similar technical description of the boundaries of a site.

The right of first refusal is a process that was created to permit persons who had possessed title to real property prior to the advent of the State's acquisition of ownership, to reclaim ownership of assets collectivized after the War. Unfortunately, valid documents attesting to previous ownership may no longer exist, having been lost with the passage of generations. However, some claims have been processed and titles actually restored based on the presentation of very scant family records that would otherwise have no legal weight.

The initial stages of the privatization process related primarily to apartments and other non-single family residential properties that were either constructed or confiscated during the Soviet era. Occupants generally had, and still have, the first right to acquire ownership of their living quarters, and title is conveyed at times simply through documents, vouchers and other declarations produced by the housing ministries. In some instances, no money exchanges hands and usually the costs to acquire ownership represent a nominal sum at best.

Technically, the privatization of apartments and flats within buildings owned by the State has only resulted in the conveyance of the actual amount of living space privately occupied by the residents. This represents the portion of the building over which the occupant enjoys physical control and privacy; the occupant's "personal property." Over the years, maintenance of common areas, if and when it took place, was the responsibility of the State. For flats occupied by pensioners and others requiring social assistance, the State will undoubtedly have to retain this obligation. Further, conveyance of a prorata segment of the underlying land to the occupant in such transactions seldom occurs. If it does take place, the description of the premises conveyed is generally absent of reference to the land. The State frequently takes the attitude that privatization should not be otherwise. And for the occupants of multiple-unit properties, seldom it is of any significance. Further, the state was always responsible for the upkeep and maintenance of what we generally consider to be the common areas of residential properties and, in all likelihood, economic and social

factors will command that the State continue to provide these services in the foreseeable future.

When one considers the massive economic hardship that the CEECs experience during the transition period, it is fairly easy to understand why the privatization of apartments and similar residential dwellings has to take place at little or no cost to the occupant-purchaser. Further, when one considers the ongoing need of State support, it is equally understandable why conveyances to the occupants or others in waiting are undertaken simply by saying "it's your key," with a minimum of associated paperwork.

Perhaps if a secondary market, characterized by resales by the original occupants, was envisaged by State authorities, the conveyance system might have been more formal. However, when one views the physical condition of most of the public housing constructed during the Soviet era, it is unlikely that much of it will remain habitable for more than another few decades. Also, it is equally unlikely that an active secondary market will be found for such housing units; even if they do begin to trade, the level of market prices achieved may be too illusive to identify reliable market values.

THE EMERGENCE OF OPEN MARKET VALUES

Within a year of the commencement of economic reform in the early-1990s, privatization of property and the rebirth of the property valuation profession in a market-based economy had begun. The property market began to function once again, fostered by the combined efforts of: State agencies; seasoned or re-trained sworn valuers; persons who were members of the learned professions; and the first wave of Western professionals (usually personnel from the Big Six international accounting firms) and Western-based property companies (usually UK-based). As local sales evidence was still in short supply, market data from Western Europe was transferred, translated, messaged, and otherwise tested to determine if this data could be relied upon as a surrogate representation of reasonable rental or capital values for local properties.

Eventually, a rental market began to emerge. Rental values could then be translated into capital values. Transactions soon began to take place. The process had begun and the first evidence of open market behavior was available to domestic appraisers for their consideration. It was a start. Unfortunately, the rental and sales markets did not flourish,

because the Great Recession of the early-1990s in the West began to arrest the availability of sorely needed investment capital, especially for joint-venture developments. So overwhelming were the effects of the recession throughout the whole of Europe, that the newly emerging market economics nearly collapsed. To this day, they remain in a precarious state of affairs.

The significance of appraisal activity during the initial stages of the transition period is manifested in the methods and procedures that became operative. The tools of the trade and the techniques of those who had to use them tended to be a function of the physical make-up of real property, thus leading to the necessity to over-rely on the replacement cost method of estimating market value. As such, the concept of market value during the initial years of reform only reflected the cost of reproducing or replacing the physical assets—namely, the buildings constructed on the leasehold lands.

EMERGING NEEDS OF THE PROFESSION

The demand for high quality real estate appraisal services in the CEECs is driven by a combination of government requirements, as well as by the needs of the private sector. In order to achieve the best professional practice, the newly formed independent, non-governmental, and non-profit professional appraisal associations are now focusing their efforts on advanced and continuing education; practical training and hands-on experience for their members; development of operative valuation standards and performance guidance; State and public recognition of their associations and their membership through a vehicle of licensing and/or self-regulation; creation of professional indemnity programs; and, generally speaking, achievement of the same goals and objectives sought by professional valuation associations in the West.

Education & Training

The original thrust of the educational process in the early years of the transformation period focused on the re-training of sworn valuers and other persons responsible for property-related, decision-making services, generally related to the privatization process. In the initial absence of qualified instructors familiar with market-based valuations, the State, acting through newly created privatization departments, turned to the professions traditionally engaged in real estate, namely: surveyors, engineers, architects, developers, economists, and lawyers.

Soon private and semi-private schools entered the training and education process. These schools were created and operated by Western-based property companies and consulting firms, by international accountancy bodies, and by external foundations in the West that were financially well-endowed. Universities and academics were relatively late in entering the field of education and training of property valuers, as institutional changes and operational flexibility were very difficult during the initial years of reform.

Presently, while the three aforementioned sources continue to be relied upon in providing the education, training, and research functions, the newly formed professional associations are increasingly involved in the process. Through their membership in, and their affiliation with domestic valuation associations like the International Valuation Standards Committee (IVSC) and The European Group of Valuers of Fixed Assets (TEGOVOFA), they have been able to access vitally needed educational material and, in some instances, financial assistance to support their aims and objectives. In the process, they have also been able to establish contacts with valuation practitioners in the West to assist in the presentation of training courses and other educational seminars. The assistance of market-experienced colleagues from the West is considered crucial to bridging the gap between theoretical training and the harsh reality of putting the education and technical training to practice.

To this day, an acute need remains to develop better basic education, improve advanced education and training, and to move into the field of continuing education. There is also a vital need to establish a continuing relationship with Western-based valuation associations, in terms of sourcing educational material, and Western-based, multi-lingual practicing appraisers to serve as lecturers.

Before closing on the subject of education and training, it should be re-emphasized that the valuation associations in the CEECs are striving to find the ways and means to facilitate on-the-job training for their members. This is a major obstacle, particularly due to the lack of financial resources. Although arrangements to have their young members work abroad in Western-based appraisal companies would serve as a good route to follow, the costs of doing so make such considerations impractical except in isolated instances. In the alternative, the creation of case-study courses, taught by external

appraisers possessing the expertise and experience of dealing with the practical side of such valuations, may be the best alternative.

Professional Recognition

Virtually all of the former East Block Republics have one or more professional valuation societies or associations. Where only one association exists, it is usually multi-disciplined; encompassing property valuers, business valuers, plant and machinery appraisers, etc. Several Republics have multiple associations, generally defined by discipline specialties, but occasionally identified by geographic location within the country. In the case of Poland, the number of professional groups engaged in appraisal activity and related practices of land economics is so extensive that the Polish Federation of Valuers' Associations was created.

Aside from education and training, the principle thrust of these associations in recent years has been the need to obtain professional recognition. The speed of the transformation process and the demand for professional valuations has obliged these associations to seek professional recognition by the most expedient means possible, both to amplify their status as a disciplined profession and to preserve the identity they have worked so hard to achieve.

The need to obtain formal recognition by the public at large is driven by anxieties related to untoward competition. In the early days of privatization, government ministries created valuation departments, and in some instances these public sector agencies continue to exercise a commanding influence in both public and private sector valuation activities. Within the emerging private sector, profit-motivated valuation associations were formed. These, in some cases, resemble business syndicates attempting to monopolize valuation services, rather than to develop a better and more respectable profession. As a consequence, the truly professional valuation associations have justified anxieties.

State recognition of these newly emerging private professional associations and societies is essential. The State needs to be aware not only of the existence of these associations, but most importantly, aware of the services their members can provide. Association members can provide services to assist both the public at large and the various levels of government who will be responsible for

There has always been a secondary market in Central and Eastern Europe, even if it functioned basically on the barter system.

Communism never closed the economy: at best it only controlled it. Each and every individual knew everything there was to know about the haggling process and the fundamentals that govern the price of what one has and what one wants.

establishing property assessment systems for taxation, land management programs, and social assistance projects (especially for housing). Recognition of professional service providers is important for any programs and processes that the State will have to remain involved with to provide needed financial and social assistance; especially in housing elderly and less fortunate citizens.

In order to foster domestic professional recognition, these new associations first sought membership in international and Western European valuation standards organizations. Aided by achievement of international recognition as being the most prominent valuation society in their respective State, these associations were then able to put their case to internal government agencies for formal recognition as being the most predominant domestic group of valuers. In most instances, recognition by the international valuation community gave them the means of obtaining formal recognition by the State. State recognition is important not only for political reasons, but also for financial assistance where possible. Thus they have to convince the State that they not only have sound practical objectives, but are capable of playing a vital role in the privatization process, as well as in the provision of best appraisal practice to the general public.

The method of obtaining formal recognition by the State and the private sector, is via the licensing process. But to avoid becoming regulated by the State, the best arrangement calls for self-regulation, with member licenses to be granted by a board consisting of representatives from both the government and the professional association.

Having just emerged from central administration and a planned economy, the last thing in the world these associations want is direct or indirect

involvement by the State in the valuation field or in its related administrative procedures. Rather, the associations consider licensing as simply a form of professional recognition and as part of the process of becoming an independent self-regulating body—without State involvement. Considering the long-term intentions of their objectives, the entire process is both complex and extremely interesting, especially because it is actually founded on the principles of self-regulation. As such, the expression "licensing" does not have the same meaning as it does in the West, where such endeavours frequently are designed primarily as a source of income for the State and/or for the association.

Part and parcel of the licensing or self-regulation process is the structure thereof. State licensing can be either vertical or horizontal, or both. Vertical structuring reflects plateaus of education and expertise, ranging from a fully-qualified and experienced practitioner, as we know the meaning in the West, to students of the subject. Horizontal structuring refers to the field of expertise, be it urban or rural, be it residential, commercial, or agricultural. It is in this perspective that we will observe the structural evolution of the valuation profession in Central and Eastern Europe in the years ahead, under licensing or otherwise.

CHALLENGES

Two areas of appraisal practice are particularly challenging in the CEECs: 1). the valuation of property to be secured as collateral for mortgage financing, and 2). the development of mass appraisal techniques pursuant to establishing an assessment system for property taxation. In regard to the financing of real estate, the mortgage banking system is still in its infancy. In fact, to date, only a few Republics have an operational mortgage banking system which permits borrowers to obtain credit by pledging real estate as collateral security. The problem is not related so much to the valuation of real estate, but rather to the structure of the banking system itself.

Where credit is available for real estate development or acquisitions, the terms and conditions associated with such loans are extremely onerous by Western standards. Interest rates may range from 25 percent to well over 100 percent. The maximum term of a loan seldom exceeds five years. Both of these conditions reflect the extraordinary degree of inflation which has beset the Republics, as well as the high incidence of bank insolvencies brought on

by the inability of new banks to handle depositors' funds in a proper commercial perspective.

Mortgage banks, where they exist, are only beginning to have a rudimentary understanding of real estate and the meaning of market value. To a great degree, the loan-to-value ratio reflects their lack of understanding. More seasoned bankers not only want to know the value of the property today, but desire to have the appraiser express an opinion of what the value will most likely be during the full term of the loan. Aside from the aspect of property values, is the question of title. While no problem exists with having the property surveyed in order to define the physical limits of the security, the capability of providing clear title is frustrated by the absence of historical records and the inability of the legal system to create proper title if the assets to be pledged were previously owned by the State. It will probably take the remainder of this decade before an effective and efficient mortgage banking system comes into operational existence and longer in the less developed Republics.

Titular problems are also the root of the difficulties associated with the development of an operative property assessment system for municipal taxation. Massive changes have to occur in the legal system and government regulations before the question of valuation comes into focus. But it must come quickly, as the value of real estate is one of the vitally needed sources of potential tax revenue for the State. Once these obstacles are overcome, there will be an extraordinary need for valuation services to establish an assessment base; so extraordinary that it is almost incomprehensible.

SUMMARY

It is remarkable how well educated valuers are in the CEECs; further, how well experienced they are in the basic concepts of a free market. It is said that since they have had a closed economy for 50 years, they do not, or should not, have an understanding of how a market economy functions. To the contrary, citizens and professional people alike, not only have an intimate and well-founded understanding of markets but are much more cognizant of how markets function than many of us in the West are led to believe. There has always been a secondary market in Central and Eastern Europe, even if it functioned basically on the barter system. Communism never closed the economy: at best it only controlled it. Each and every individual knew everything there was to know about the haggling

process and the fundamentals that govern the price of what one has and what one wants.

Private ownership of single family residential properties remained a fact of life in most of the countries that became a part of the USSR following World War II. Farmers markets for excess or surplus agricultural production continued unabated, driven not by political forces, but rather by human desire and necessity. So it is easy to understand how Eastern Europeans were well prepared to adjust to a market economy in terms of understanding the process and in implementing the procedures. Unfortunately, the cost of the transition is extremely painful. It is too much, too soon. Their economies cannot cope with the rigours of massive transition overnight. All economies need to have some process of assisting the needy and less fortunate. All economies represent a blend of public and private initiatives and functions. It is the balance of what is best at a particular moment in time that will bring the combined optimal benefits to the individual, both separately and collectively.

We in the West have much to offer. We also have much to learn about our own systems. We cannot impose our concepts of free enterprise on Central and Eastern Europeans, as necessarily being the best way to do things. Somewhere in between lies the answer that will best serve their markets and provide the greatest benefit to the population at large, not only in the broad economic and political perspective, but as it applies to their professional activities.^{REI}

NOTES

1. Central and Eastern Europe encompasses the following States or Republics: Albania, Bosnia, Bulgaria, Croatia, the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Macedonia, Monte-Negro, Poland, Romania, Serbia, the Republic of Slovakia, and Slovenia.
2. References throughout the article to "the West" refer to all countries outside of Central and Eastern Europe.

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CLOSING BERMUDA'S U.S. NAVAL BASES

by Frank J. Parker, CRE

When the main American base plan for St. David's is approved and offered for bid, the same types of disputes and criticisms undoubtedly will occur at a higher level, given the significant dollar amounts involved. This will be true whether a base closing agreement has been signed with the U.S. or not.

HISTORY OF LEND LEASE IN BERMUDA

By the summer of 1940, the British Empire stood virtually alone in resisting the military strength of Germany (except for such help as could be given by the benevolently neutral United States of America). Britain's most pressing naval need was for well-armed, small craft for convoy duty on the North Atlantic shipping lanes. America's great concern was the defense of its continent, whether it was drawn into the war in Europe, or not.

The United States felt it needed extra bases to consolidate its defense in the Caribbean. As a result, the governments of the United States and Great Britain entered into negotiations, culminating in the "Destroyers for Bases" Agreement, signed on September 2, 1940.¹ By its terms, Britain received 50 over-age destroyers and the U.S. received the right, under terms of a 99-year lease, to construct bases in eight British possessions. All fell within the broadly-defined Caribbean defense area, except one in Canada, Newfoundland (Arguenta), which became

part of the North Atlantic defense area. The southern group consisted of Bermuda, Jamaica, the Bahamas, Antigua, St. Lucia, Trinidad, and British Guiana.

Bermuda is a small group of islands connected by bridges and causeways, stretching 21 miles from end to end. It is located in the Atlantic Ocean and is the most northerly group of coral forming islands in the world. The nearest land mass is Cape Hatteras, North Carolina, which is 650 miles to the west; New York 774 miles to the Northwest; and London 3460 miles to the Northeast.

During the fall of 1944, U.S. Military and Naval activities at American bases in Bermuda gradually diminished in importance, as the progress of the war in Europe became increasingly favorable to the Allies. The original 1941 agreement was updated fundamentally in 1978. Effective on December 6, 1978, the United States declared its intention to abandon certain leased areas on Bermuda. These areas included parts of the Naval Air Station Annex, Her Majesty's Dockyard,

Daniel's Head, Mount Hill, Cemetery Hill, and Skinner's Hill (see Figure 1). They were to be given to the Government of Bermuda for purposes that are outlined in the re-negotiated lease document. Basically, the United States decided to sublet to Bermuda part of the lands that the U.S. had originally leased from Great Britain in 1941. As part of the agreement, Bermuda was also expected to assume responsibility of these and other areas.

Until President Clinton announced the closing of the U.S. Naval Base on Bermuda as of September 1, 1995, there had been approximately 1,350 active-duty United States military personnel, some 440 Department of Defense civilian employees, and 1,100 military and civilian dependents. However, at the time the agreements was updated in 1978, provision was included for U.S. base rights on Bermuda until the year 2040.

BERMUDA YESTERDAY & TODAY

Bermuda has a long and fascinating history. Discovered by the Spanish navigator Juan de Bermudez in 1505, Bermuda was first settled and claimed by the British Virginia Company following a shipwreck in 1609. The representative assembly, which the Islands have had since 1620, makes it the third oldest parliament in the world. The Crown assumed direct responsibility for Bermuda in 1684 when the Bermuda Company, which had acquired the rights to the Islands in 1615, was dissolved.

Until the mid-nineteenth century, Bermudians were seafarers involved in trading, whaling, and shipbuilding. Agriculture developed from the 1840s on. Tourism took root during the last quarter of the century, and by the 1920s, the Islands were a highly-popular resort for North Americans. The volume of visitors increased dramatically after World War II with the development of commercial air travel. Bermuda is now a favored destination for many affluent travelers, as well as a base for many international businesses.²

Bermuda is a self-governing British Colony (Overseas Independent Territory). A 1968 constitution gave Bermuda even greater self-determination than was present under The Crown. This is why Bermuda is now treated as the landlord to the base lands and not a sub-tenant. The Government of Bermuda controls its own affairs and maintains a militia, the Bermuda Regiment. In a 1995 referendum, Bermudians voted to retain the existing constitutional position. According to Bermuda's Chief



Pictured above is an aerial shot of former United States naval base properties in Bermuda.

photo courtesy of the Royal Gazette

Statistician, the 1996 resident population stood at approximately 60,140. The population density is high at an estimated 1,200 people per square km. The racial composition of Bermuda is about 60 percent black and 40 percent white.

Once almost entirely dependent on tourism for foreign exchange earnings, Bermuda has developed its position as a premier international business center since World War II. Together, tourism and international business account for over half of the gross domestic product (GDP), thus consistently generating high levels of foreign exchange earnings. Residents of Bermuda enjoy a high standard of living. At current prices, its GDP per capita is one of the highest in the world at \$32,000 per person.

In 1994, international company-related expenditures generated about \$545 million in foreign currency earnings for Bermuda, approximately 44 percent of the total revenues for the country's government. Bermuda is regarded as a premier off-shore financial center because of its long-established and highly-developed commercial and social infrastructure. Its success as an international business center also includes: its proximity by air to the U.S.; ease of access to Europe; modern business facilities; excellent living conditions; and well-educated labor force. In addition, there is the absence of direct taxation and exchange controls for international business. Bermuda also has a long established legal system and an extensive, well-qualified support system of auditors, attorneys, and investment professionals. Equally important is Bermuda's stable economic and political history and the high standards of financial integrity set by its business community.

Bermuda is one of the world's leading specialty insurance markets. It is the world's largest domicile for captive insurers and it has developed a large and growing market for excess liability and property catastrophe reinsurance. In 1994, total assets in the Bermuda insurance market totaled \$76.1 billion. Total capital and surplus stood at about \$30 billion. At the end of 1994, 1400 international insurance companies were registered in Bermuda, generating \$228.4 million in earnings. Of these earnings, 90 percent were generated by companies with a physical presence in Bermuda.

When President Clinton decided that Bermuda should be among the U.S. Naval Bases scheduled to be closed during his administrations, he was motivated by two major reasons. First, the ending of the internal Soviet-U.S. rivalry lessened the strategic importance of Bermuda as a staging base for protecting the North Atlantic. Second, the constantly spiraling budget deficits strangling the U.S. taxpayer had reached a point that significant savings needed to be found. The obvious target . . . a foreign base that increasingly had become a rest and relaxation oasis for senior naval officers and their families.³

Bermuda was faced with a number of major decisions. Suddenly, there was the possibility of receiving back 10 percent of its land mass; this included some of the most beautiful, underdeveloped land on this overcrowded island. This massive disruption of the status quo came as the previously high-flying Bermuda economy (that had sailed through the 80s with scarcely a hiccup) had suddenly and decidedly gone into the tank. Failing tourism revenues were the main culprit.

For the year ending September 30, 1996, the eight major hotels lost \$5.6 million. The overall occupancy rate was stated to be 58.8 percent, and in two years, nightly room sales had fallen by \$39,000. Cumulative losses for the past nine years exceeded \$47.5 million. Overconfidence and outrageously priced food, room, tax, and taxi charges, and a failure to modernize existing facilities or construct new ones, all clearly took their toll. To make matters worse, it was estimated that Bermuda would also lose at least \$6 million a year in local direct purchases by base employees and dependents once the main U.S. Base was closed.

If it had not been for the strong performance of the international business sector, the economic situation in Bermuda would have been extremely

serious. The perceived political stability and financial integrity of Bermuda that has attracted international corporations in record numbers (especially in the reinsurance and private banking areas) seems to be slowing, especially with the turnover of power in Hong Kong to The Peoples' Republic of China. For one reason, the benefits to Bermuda from the Hong Kong takeover undoubtedly have peaked. In addition, a number of Caribbean Islands and countries throughout the world are adapting their own laws, seeking to entice these companies and others to leave or to incorporate and/or locate outside of Bermuda. Finally, there is fear that Cuba will be welcomed back into the free world which will pose significant business and tourism challenges to Bermuda.

Taken together, the weakening of tourism and the uncertainty of continued business growth make it essential that the American base lands and a far smaller Canadian base be integrated into the local economy in the most productive manner possible. Of course what business people would define as being the most productive manner possible, would likely differ significantly from the way environmentalists and domestic and foreign leisure seekers would define it.

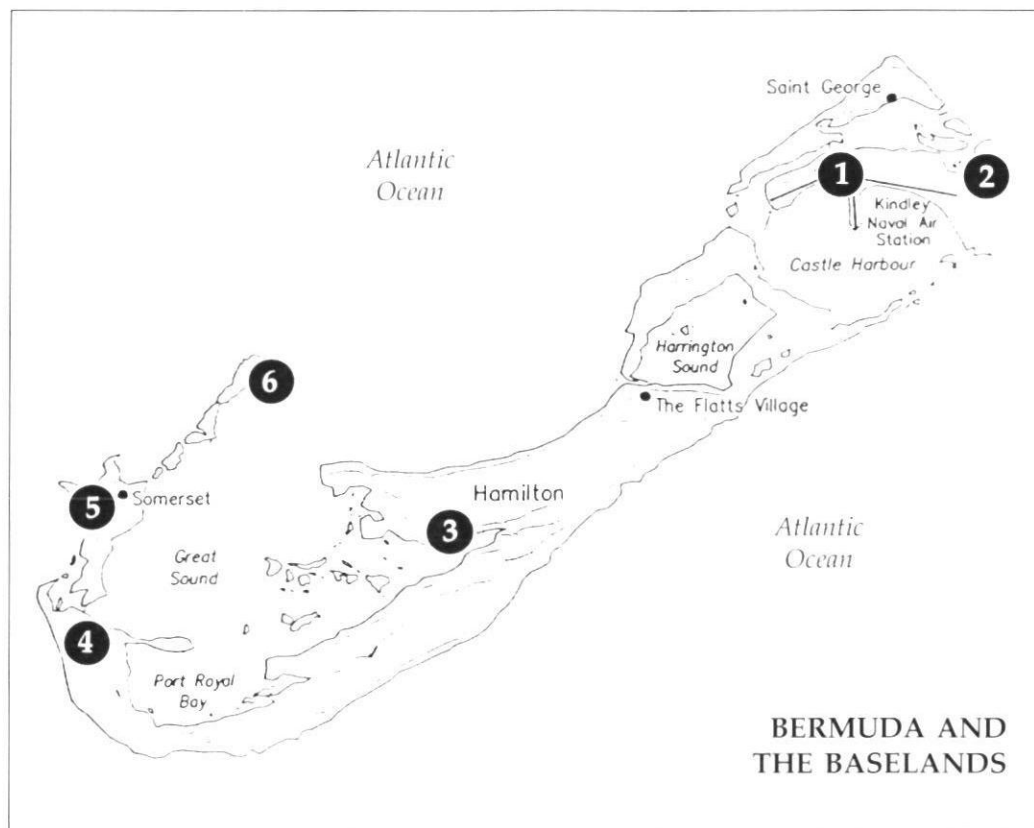
CONCILIATION OR CONFRONTATION?

Before significant development could take place on the abandoned base lands it would be necessary for Bermuda to negotiate a settlement with the United States. Four major questions are involved:

1. Does Bermuda owe compensation to the U.S. for improvements left behind as President Clinton claimed,⁴ or, in reverse, does the U.S. owe compensation to Bermuda for breaking a 99-year lease, 40 years ahead of time?
2. Is the U.S. liable for the early deterioration in the buildings that were faultily* constructed at the start of the 1940s? (*There is salt water in the concrete and mortar. Many buildings either will have to be taken down or, at the very least, substantially renovated.)
3. Should the U.S. pay for the hundreds-of-millions-of dollars worth of environmental cleanup that would be needed until this land could be safely used for commercial or recreational purposes?
4. By continuing to pay \$1.00 a year in rent could the U.S. return to the base at its discretion up until lease term? If so, could Bermuda assure an investor of "clean title?"

Key

1. Kindley Naval Air Station - Main Airport
2. U.S. Naval Base at St. David's
3. Hamilton, The Capital
4. The U.S. Naval Annex at Morgan's Point
5. The Canadian Base at Daniel's Head
6. The former British Base at Dockyard



During strategic planning, two diametrically opposite viewpoints emerged early on as to proper negotiating tactics for Bermuda's government to use in dealing with the U.S. Government.⁵ The choice was to be either:

1. conciliatory, recognizing the vastly superior strength of the United States and hope that the departing tenant would be beneficent while leaving; or
2. take the confrontational position that the departing tenant, the U.S., had broken its lease and if satisfactory compensation could not be agreed upon, request that the American Federal Courts enforce the contractual rights of the landlord in fact, if not in law — the Government of Bermuda.

Position of Conciliatory Approach Supporters

The conciliatory approach supporters advanced five major arguments on behalf of their position. First and foremost, they recalled the long history of warm relations between the United States and Bermuda. That history begins in Bermuda's earliest days when Captain John Smith sailed from there to save the starving colony at Jamestown. Second, they mentioned this good feeling was enhanced by the outstanding performance of Bermudian Armed Forces who served and died in World War II as part

of the British Armed Forces alongside their American compatriots. Third, the United States is far and away the economic and tourist engine that keeps Bermuda's "money earning train" on track. Any intense, American, bitter, feelings toward Bermuda could quietly turn the current island-wide recession into a depression. Fourth, the U.S. Government, through its myriad of executive departments and administrative agencies, provides regional technical and financial assistance to Bermuda, in a range of areas from drug interdiction and endangered fish, plant, and tree species preservation, to agricultural disease prevention, to name but three. If diplomatic relations with the United States deteriorated over base closing terms, it was feared that cutbacks in support services could occur across the board.

Fifth, these supporters took literally the terms of the original agreement that allowed the United States Government to almost totally leave the island anytime it wished; taking any improvements it desired with it.⁶ (It must be remembered that with the fall of the Channel Islands of Jersey and Guernsey off the French Coast to Germany on June 30, 1940, Great Britain was so panicked Germany would use these occupied plots of British soil as a naval jumping off-spot for an invasion of Great Britain

proper. As a result, they were willing to turn over ownership of Bermuda to the United States Government if it would carry out the lend-lease program that was the supply lifeline to keep Great Britain in the war.) The offer of "giving away" Bermuda was never seriously pursued by the United States Government. However, the fact that "giving away" was even suggested by Great Britain, demonstrated just how strong the bargaining position of the reluctant ally, the U.S., was at the time.

Position of Confrontational Approach Supporters

Those advocating the confrontational approach in base closing negotiations doubted that during 1993-1995, the U.S. was in any mood to be magnanimous. In addition, it was their belief that both law and equity favored the case of the Government of Bermuda. Five major counter arguments were advanced for this position. First, it was asserted that once the U.S. Government left the island on September 1, 1995, Bermuda's bargaining position would be significantly weakened. The failure of Premier John Swan's Government to obtain a negotiating session with the U.S. Defense Department in Washington before this date, let alone with President Clinton, was taken to be a bad omen.

Second, it was argued that the Bermuda Government should rely heavily on a lawsuit in a U.S. District Court on the precedent-setting, U.S. Supreme court case, *Vermilya-Brown Co. vs. Cornell*,⁷ dealing as it had done, most fortuitously, with Bermuda. This case stated that the United States Government must follow its own laws overseas, including: landlord tenancy laws of fixture removal, environmental damage caused by a tenant, and constructive termination of a leasehold interest. All of these issues in this case clearly favored the landlord—the Government of Bermuda.⁸

Third, again using the precedent of *Vermilya-Brown Co. vs. Cornell*, the provision in the base closing law prohibiting Federal funds to be spent on environmental damage at foreign U.S. bases should be challenged in United States courts on the grounds that the U.S. Government must follow its own laws. For unlike in the United States, where the Federal Government owns the land on which its bases are located, it does not do so elsewhere, as in Bermuda. As a tenant then, the U.S. must observe the host country's laws, as well as its own.

Fourth, the original lend lease agreement arguably was quasi-political in scope and thus, in international law, it is to be construed strictly against

Taken together, the weakening of tourism and the uncertainty of continued business growth make it essential that the American base lands and a far smaller Canadian base be integrated into the local economy in the most productive manner possible. Of course what business people would define as being the most productive manner possible, would likely differ significantly from the way environmentalists and domestic and foreign leisure seekers would define it.

the nation which benefited the most from it. In 1940-1941, this arguably was Great Britain and, by extension, Bermuda. However, once the United States entered the war, protecting its own shores became a priority, and the benefit quotient changed. With the 1978 extension of the original agreement, the United States Government became the clear beneficiary. All-in-all, international law principles would seem to be a wash item. At the very least, Bermuda did not need to adopt a totally supine position in negotiations with the U.S. Government because of the terms of the original agreement.⁹

Fifth and finally, the continuing legal debate concerning the eventual constitutional status of Bermuda kept throwing uncertainty upon its bargaining position. Should its citizens ever vote for Independence from Great Britain, Bermuda would become just one more North Atlantic, Caribbean-area, micro-nation, presumably, with far less negotiating support than it receives today when Great Britain gives it full assistance as one of its overseas independent territories. At the time when the conciliatory or confrontational decision was being made in the Spring of 1995, Bermuda was headed toward a referendum on Independence¹⁰ in which then Premier John Swan strongly supported an affirmative position. Nevertheless, independence was voted down soundly and he resigned from the Premiership and later from Parliament.

Inspection Precedes Decision

A 1981 inspection of the facilities in Bermuda by a U.S. Congressional delegation showed that many buildings were in need of renovation.¹¹ Many of the facilities, including some barracks, offices, and

recreational facilities were built in the 1940s, using saltwater mixed with concrete or mortar. Consequently, the inspection revealed extensive leaching, blistering, and chipping taking place. With the exception of the bowling facility and child care center, the welfare and recreational facilities in operation at the time were considered to be substandard. For example, at the marina, wood structural members and decking had deteriorated to such a degree that the facility had become hazardous. Softball fields were not playable due to poor drainage and holes in the ground. The annex gymnasium had no shower facilities for women and the showers available for men were inoperable due to pipe ruptures. Tennis courts had deteriorated to such conditions that play was unsatisfactory or hazardous. The annex chapel was in need of repair and painting.¹²

After fully hearing and considering both the conciliatory and confrontational approaches the Government of Bermuda chose the conciliatory approach. The United States Navy left Bermuda as originally scheduled, September 1, 1995. The highest level of negotiations that took place by that time were conducted by the U.S. Consul on the island and the departing U.S. Naval Captain in charge of the island base. These talks were preliminary and inconclusive.

A NEGOTIATIONS UPDATE

The writing of this article comes two years after the conciliatory approach was adopted. As of publication, no agreement has been reached between the two governments. The Bermuda Government's successor to Premier John Swan, Premier David Saul, met with members of the U.S. Defense Department and with President Clinton. No agreement was reached and a follow-up visit by U.S. Naval Officials to assess environmental damage in Bermuda was criticized by the Bermuda Government as being perfunctory in nature.

Most surprisingly, Premier Saul resigned in March 1997. He was replaced by Pamela Gordon who has made reaching an agreement over the naval base closing a priority. Within two months her government held talks with the U.S. Defense Department and hoped to meet with President Clinton. Her government publicly stated it was encouraged, that after five years of negotiating with the Canadian government over environmental damage left behind at four abandoned U.S. bases in Canada, (one of them a lend lease base), the U.S. Government recently announced it intends to grant a \$100 million arms credit to the Canadian military,

as compensation. Bermuda is hoping that this agreement will be a precedent for them to also receive compensation.

Bermuda is seeking compensation to dispose of asbestos discovered in former U.S. buildings on the island and to remove underground storage tanks leaking petroleum products on former U.S. base lands. In addition, the U.S. is being asked to live up to its ongoing constructional responsibility to repair or rebuild Longbird Bridge leading to the island's airport, Kindley Field. Unbeknownst to most Bermuda tourists, until the 1995 turnover, Kindley had been operated by the U.S. Navy.

Despite the optimistic appraisal of its compensation chances, the Bermuda Government is not at all certain that the Canadian Base settlement agreement will be particularly helpful in its own negotiations with the United States Government. First, the settlement with Canada must be approved by the U.S. Congress. Substantial budget cuts across the board in the U.S. these days are in severe conflict with the plans of the U.S. Defense Department to preserve a military presence at current levels until at least the year 2000. As a result, there seems little room for substantial funding to rehabilitate an abandoned foreign base in Bermuda. Second, the Canadian bases are still being used by a NATO military partner of the U.S. and the money involved will be used to purchase sophisticated military weapons from American manufacturers, (a situation not applicable to Bermuda). Third, the U.S. Defense Department has made it clear that the Canadian deal is an exception to the general rule of not cleaning up environmental waste at foreign bases, unless the environmental damage constitutes a substantial endangerment to human safety and health. Even then, this exception only applies to active military installations, which Bermuda no longer is. Fourth, even a freely-offered cash payment of \$100 million would not begin to deal with all of the problems left behind by the U.S. military and naval presence in Bermuda.

The Bermuda Government has pushed ahead with commercial development plans, even without a base closing agreement.¹³ Two smaller bases, the American Naval Annex at Morgan's Point and the minuscule Canadian Base at Daniel's Head, have been offered for commercial development as a prelude to a major offering of the main American base at Saint David's. At best, the dress rehearsals have received mixed reviews. Virtually all of the bidders

on both projects expressed doubts as to whether they could make a profit due to Bermuda's high cost structure, floundering economy, and declining tourist trade. In addition, local environmental and recreational enthusiasts questioned the soundness of virtually each proposal. As of now, no plan has been selected for Daniel's Head. The one selected for Morgan's Point has not yet been approved by Parliament. It has been heavily-criticized by the average Bermudian for emphasizing up-scale housing, while at the same time, designing a less than state-of-the-art golf course.

When the main American base plan for St. David's is approved and offered for bid, the same types of disputes and criticisms undoubtedly will occur at a higher level, given the significant dollar amounts involved. This will be true whether a base closing agreement has been signed with the U.S. or not. All-in-all, the jury is definitely still out as to whether Bermuda will eventually rejoice or regret the September 1, 1995, closing of the U.S. Naval Bases in Bermuda.^{REI}

NOTES

1. Material on the History of Lend Lease is drawn largely from Department of the Navy, Bureau of Yards and Docks, *Building the Navy's Bases in the World War II* (Washington, D.C.: U.S. Government Printing Office, 1947), 2 Volumes. Also helpful was Edward R. Stettinius, Jr., *Lend Lease* (New York: The MacMillan Company, 1944) and Warren F. Kimball, *The Most Unsordid Act: Lend Lease, 1939-1941* (Baltimore: The Johns Hopkins Press, 1969).
2. Lynda Milligan-Whyte, *Doing Business in Bermuda* (Hamilton: The Bank of Bermuda, 1994).
3. See, Defense Base Closure and Realignment Commission: 1993 Report to the President, United States Defense Base Closure and Realignment Commission (Washington D.C.: U.S. Government Printing Office, 1993).
4. The figure of \$138 million was cited by President Clinton. Heaven only knows that sum was arrived at but this threat seemed to paralyze the Bermuda Government.
5. The current author served as a consultant on this project to the Government of Bermuda from July 1994 until May, 1995. All views expressed in this article are his alone-and should not be attributed to the Government of Bermuda.
6. See, Thomas C. Suter, "Base Rights Agreements," *University Review*, Vol. 34, pp. 32-41, July-August 1983; Arie E. David, *The Strategy of Treaty Termination* (New Haven: Yale University Press, 1975).
7. *Vemilya-Brown Co. vs. Cornell*. 335 U.S. 377, (1948). In this regard, see also, *United States vs. Spelar*, Administrativ, 338 U.S. 217 (1949) which is distinguished from *Vermilya-Brown Co. vs. Cornell*.
8. Further to footnote 7, see also, among other real estate principles texts, Frank J. Parker and Norman P. Schoenfeld, *Modern Real Estate* (Lexington, Massachusetts: D.C. Heath Co., 1979).
9. See, Maria Teresa M. Lim, "Removal Provisions of the Philippine-United States Military Bases Agreement: Can the United States Take It All?," *Loyola-Marymount Law Review*, Vol. 20, pp. 375-453, January 1987; Rafael A. Porrata Doria,

Jr., "The Philippine Bases and Status of Forces Agreement: Lessons for the Future," *Military Law Review*, Vol. 137, pp. 76-102, Summer 1992.

10. See, Elizabeth W. Davies, "The Legal Status of British Independent Territories"; "The West Indies and North Atlantic Region," Grotius Publications, (Cambridge: Cambridge University Press, 1995).
11. See, Committee on Armed Services of the U.S. House of Representatives, *Report on the Inspection of Military Facilities in Panama and Bermuda* (Washington D.C.: U.S. Government Printing Office, 1981).
12. Upon personal inspection, the author believes it fair to state that by 1995, the facilities involved were in far worse shape than they had been in 1981. Again, where did President Clinton find evidence that the U.S. was owed \$138 million?
13. See Jeffrey Simon, "U.S. Bases Abroad: Prime Opportunities for Developers," *Urban Land*, Vol. 56, No. 3, pp. 31-35, March 1997.
14. The author acknowledges financial support for this article from the Boston College Faculty Support Fund, The Boston College Jesuit Community Academic Support Fund and The Arthur Anderson Consulting Group Academic Support Fund.

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FUZZY LOGIC: THE NEW PARADIGM FOR DECISION MAKING

by Carlo Bagnoli & Halbert C. Smith, CRE

A fairly new method of dealing with imprecision (called Fuzzy Logic) has been developed. So far its principal applications have been in the physical sciences, but some researchers are beginning to recognize its potential applicability to the social sciences—specifically real estate decision making.

Does an estimated rate of return on a real estate investment of 10.5 percent mean a return of 10.5 percent? Perhaps in a sense yes, but in reality, no. We all know that even a return calculated after disposition of a property is an estimate, and that an internal rate of return (IRR) of 10.5 percent means a return that could vary from perhaps 9.5 percent to 11.5 percent. The number, 10.5, is really a "best approximation" based on similarly imprecise estimates of the numbers used to calculate the IRR.

Does this lack of precision render the estimate useless? Certainly not. It can be compared with other, similarly imprecise estimates for decision-making purposes. For example, if we compare a forecast IRR of 10.5 with another forecast IRR of 9.5, and we believe that both forecasts are subject to the same degree of imprecision, we would (other things being equal) choose the investment yielding 10.5 percent. It does mean, however, that decisions based on the estimate may

be incorrect because the degree of imprecision may produce incorrect numbers for decision-making purposes (for example, the 10.5 percent may in reality be 9.8 percent, while the 9.5 percent may in reality be 10.2 percent).

Even historic estimates of some numbers are imprecise. For example, can we say with precision that a building depreciated by 10.0 percent over the preceding five years? Obviously, the 10.0 percent is also an imprecise estimate. Similarly, the estimated future net operating income (NOI), terminal capitalization rate, and tax liability are imprecise estimates. So, even in retrospect, an IRR is an imprecise number.

Other types of estimates are even more obviously imprecise. For example, access to a shopping center may be rated as convenient, inconvenient, or somewhere in-between. Or, we may rate the attractiveness of a shopping center as high, medium, or low. Similar imprecise ratings may be

required for a shopping center's layout, convenience of parking, adequacy of parking, ease of maintenance, energy efficiency, and signage. Such ratings will probably be required when either 1). estimating the value of the shopping center or 2). evaluating the performance of the shopping center. Analogous ratings would be required for other property types.

We live with imprecision in most aspects of life, and real estate decision making is no exception; the examples cited above are but a few illustrations of the imprecision that pervades all types of decisions. The question then becomes, how do we deal with imprecision? We could:

1. Ignore it. We base our decisions on numbers and ratings that we pretend are precise. The problem with this approach is that in effect we are gamblers, and we either win or lose. There is no protection against the possibility that our estimates are incorrect on the unfavorable side.
2. Recognize it implicitly. We hedge our bets and keep our options open, even when some hedges and some options cost more than their value. In other words, we know that our estimates are imprecise, but we have no estimates of how imprecise or in which direction.

Therefore, the ways in which we often deal with the imprecision of today are not satisfactory for making truly informed decisions. However, a fairly new method of dealing with imprecision (called Fuzzy Logic) has been developed. So far its principal applications have been in the physical sciences, but some researchers are beginning to recognize its potential applicability to the social sciences—specifically real estate decision making. The purpose of this article is to describe generally what fuzzy logic is, to show a simple example of its application to real estate, and to illustrate how a more complex fuzzy system might be constructed to deal with imprecision in real estate decision making.

It must be emphasized that fuzzy logic is not the same as probability theory; they are not substitutes for each other. Fuzzy logic is a system for managing imprecision of the present, while probability theory is a system for managing uncertainty about the future. This is an important distinction, because some decisions must be made about conditions in the present period (for example, whether to sell or buy a property at a given price), while other decisions must be based on probability estimates of future events (for example, the future income and expenses for inclusion in a cash flow forecast).

GENERAL NATURE OF FUZZY LOGIC

First, it must be emphasized that, as Gene Dillmore has said, "Fuzzy logic is not..."¹ That is, fuzzy logic is **not** fuzzy thinking. Rather, it is a method that recognizes the inherent "fuzziness" of many numbers and evaluations, such as those illustrated by the examples above. The method is based on mathematical set theory, in which an observation (*e.g.*, a person or an object) is either a member of a set or is not a member of the set. For example, in the set of even numbers, 2 is a member, while 3 is not. While some applications are well served by such a system (yes or no; 1 or 2; on or off)—such as computers which are built around a set of switches that can be turned on and off very rapidly in order to represent different numbers—many applications are not well served by this system. For example, we cannot rate the attractiveness or market acceptability of properties by categorizing them yes or no, or 1 or 2.

Fuzzy logic uses fuzzy sets, in which one may partially belong and partially not belong to the set. For example, a 6-foot tall man might partially belong and partially not belong to the set of tall men. The extent to which the man belongs to the set of tall men is termed the degree of membership, while the degrees of membership that men of various heights would have in the fuzzy set of tall men is termed the membership function. The degrees of membership within the function can vary from zero to one.

The membership function of the fuzzy set of tall men (called *A*) can be illustrated by *Figure 1* having the following values:

$$m_A(x) = 1 \text{ if } x \geq 74 \text{ inches}$$

$$m_A(x) = [(x - 68)/6] \text{ if } 68 \text{ inches} < x < 74 \text{ inches}$$

$$m_A(x) = 0 \text{ if } x \leq 68 \text{ inches}$$

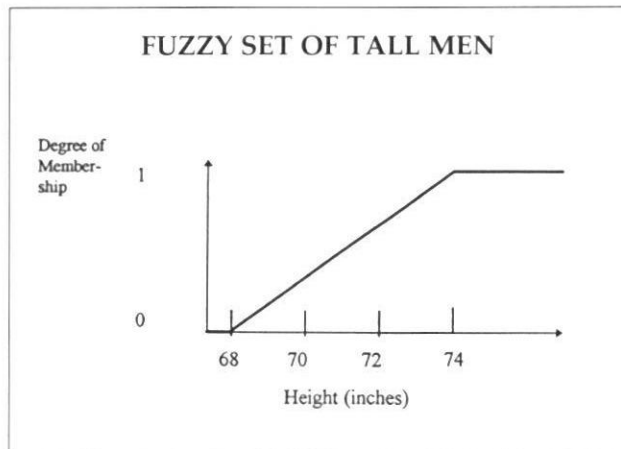
where: $m_A(x)$ = degree of membership of observation *x* to fuzzy set *A*

As can be seen from these specifications and in *Figure 1*, men who are equal to or taller than 74 inches have a degree of membership in the set of tall men of 1.0. Men who are taller than 68 inches but shorter than 74 inches have a degree of membership greater than zero but less than one, and men who are 68 inches or shorter in height have a degree of membership of zero.

Thus, the membership degree of a 6-foot (72 inches) tall man would be:

$$\begin{aligned} m_A(x) &= [(72 - 68)/6] \\ &= .6667 \end{aligned}$$

Figure 1



That is, a man who is 6 feet tall is considered to belong to the set of tall men 66.67 percent and not to belong to this set by 33.33 percent.

Similarly, a shopping center could belong to the set of "attractive" shopping centers by 66.67 percent and could not belong by 33.33 percent, and a property tax bill of \$50,000 could belong and not belong to the set of "reasonable" tax bills by 66.67 and 33.33 percent.

THE POTENTIAL ADVANTAGES OF FUZZY LOGIC

The primary benefit of fuzzy logic is that it provides us with a methodology of reflecting the experience and knowledge of people in making informed but imprecise evaluations and decisions. We all make evaluations and decisions such as, "I like that house pretty well"; "The service in that store is not very good"; "I like that shopping center; it is attractive"; or "The property has an expense ratio of around 35 percent." We recognize implicitly that these evaluations and estimates are not precise, but we have no formal way of quantifying the degree of imprecision. Fuzzy logic enables us to recognize and measure the imprecision of such evaluations and decisions.

Fuzzy logic also allows us to distinguish between evaluations in the present and predictions of future events. For example, the question of whether an appraiser *estimates* today's present value of a property, or whether the appraiser *predicts* a future selling price has been debated for many years. The definition of market value propounded by the Appraisal Foundation suggests that appraisers **predict** future prices because the definition is framed in terms of probabilities ("...the *most probable* price

for which a property should sell..."). Yet appraisers are also taught that the value estimate is applicable only for the date of appraisal—not in the future. Fuzzy logic enables us to deal with the imprecision of an estimate of market value without implying that a property should sell for this price weeks or months in the future.

SIMPLE EXAMPLE OF A FUZZY SYSTEM

Fuzzy logic is used most meaningfully when two or more fuzzy sets are combined to produce usable results. For example, if the value of a one-acre vacant parcel of land is believed to be primarily determined by its location, the relationship between fuzzy sets representing the desirability of the location and fuzzy sets representing values of similar one-acre parcels could provide a fuzzy estimate of the value of such sites.

The desirability (or quality) of locations could be based on precise measures of distance from principal destinations or origins (such as a major intersection or a major employment center). Suppose, for example, that locations of 0.25 mile or less from the important destination are considered to be "undesirable" (because of traffic, noise, etc.), and locations between 0.25 and 2.0 miles away are considered to be "good." These distances and rankings are shown in *Figure 2*.

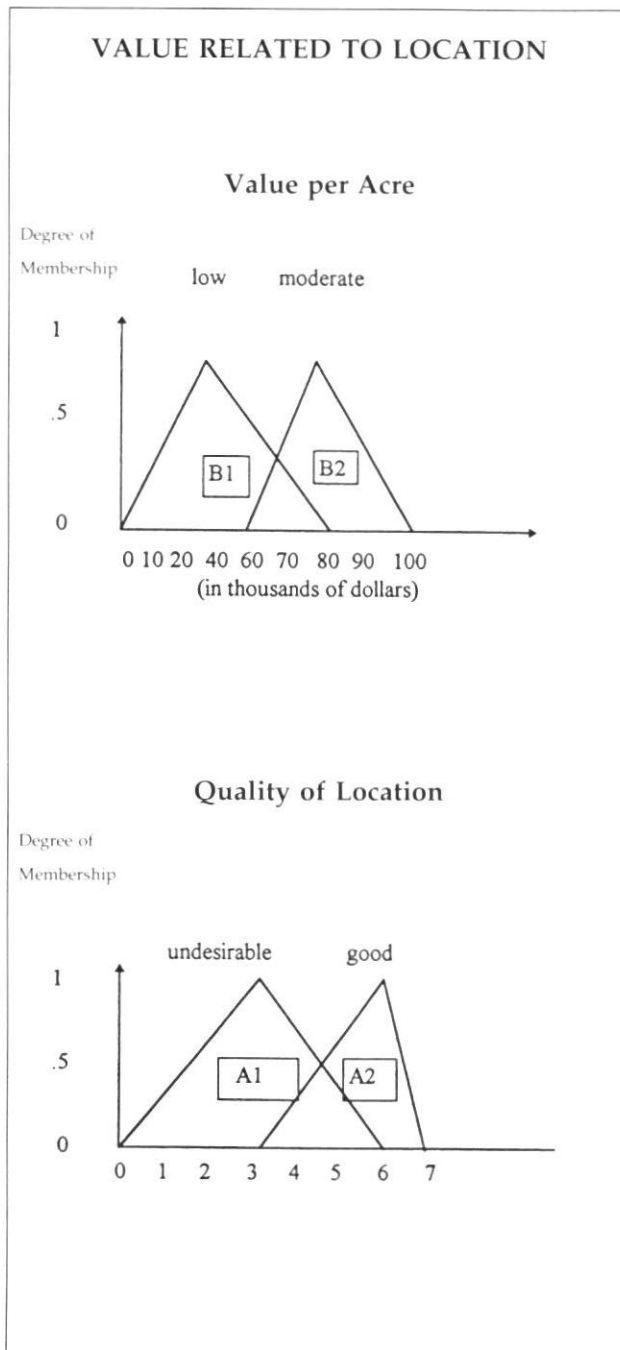
Figure 2

DISTANCE, RANKING, AND FUZZY SET FOR LOCATION		
<i>Distance from Major Intersection</i>	<i>Ranking</i>	<i>Fuzzy Set</i>
0 to 0.25 mile	Undesirable	A1
0.25 to 2.0 miles	Good	A2

We could also construct fuzzy sets of low- and moderate-value sites and combine them with the fuzzy sets of undesirable and good locations, as depicted in *Figure 3*.

If we label the fuzzy sets pertaining to location quality as A_1 and A_2 , and the fuzzy sets pertaining to per acre values as B_1 and B_2 , we can then make some rules about how these fuzzy sets interact. We will say that if the quality of location is undesirable, the value per acre must be low; and if the quality of location is good, the value per acre must

Figure 3



be moderate. These rules are expressed as:

If A_1 then B_1 , and if A_2 then B_2

Note that in both sets there is overlapping; that is, parts of A_1 and A_2 cover the same area, and parts of B_1 and B_2 cover the same area. Thus, some locations can be considered both undesirable and good, and some locations some locations have values that are considered both low and moderate. Similarly, some values can be considered both low and moderate. In other words, the overlapping locations or values

partially belong to two different sets. This is a key characteristic of fuzzy logic—that there can be overlapping relationships among input characteristics and among output results.

Next, we must employ a formal method for assigning the degrees of membership between the two fuzzy sets ($A \times B$). We use what is known as the Cartesian Product, which is represented by the following expression.

$$m_{A_1 \times B_1}(x,y) = m_{R_1}(x,y) = \min [m_{A_1}(x); m_{B_1}(y)]$$

where: $m_{A_1 \times B_1}(x,y)$ = degree of membership of each y in set B_1 , given the degree of membership of each x in set A_1

$m_{R_1}(x,y)$ = membership rule 1 for establishing the relationships between x and y

$\min [m_{A_1}(x); m_{B_1}(y)]$ = minimum membership degree between each x and y

In effect, the formula says that we must combine the two fuzzy sets in a spreadsheet, showing the degree of membership associated with each x or y . The lower of the two membership degrees is then put into each cell in the spreadsheet. Thus, for the first rule, if A_1 then B_1 , the following results are obtained as shown in Figure 4. Note that the membership degree for each x is given in parentheses in the top row, and the membership degree for each y is shown in parentheses in the first column. The lower of the two is put into each cell.

Figure 4

RELATIONSHIP OF FUZZY SET A_1 WITH FUZZY SET B_1							
$x [m_{A_1}(x)]$	0	1	2	3	4	5	6
Membership $y [m_{B_1}(y)]$	(0)	(.25)	(.75)	(1)	(.75)	(.25)	(0)
0 (0)	0	0	0	0	0	0	0
20 (.5)	0	.25	.5	.5	.5	.25	0
40 (1)	0	.25	.75	1	.75	.25	0
60 (.5)	0	.25	.5	.5	.5	.25	0
70 (.25)	0	.25	.25	.25	.25	.25	0
80 (0)	0	0	0	0	0	0	0

Next, we must construct a similar table representing the combination of fuzzy sets A_2 and B_2 . This operation is represented by the following formula, which is similar to the formula for combining fuzzy sets A_1 and B_1 :

$$m_{A_2 \times B_2}(x,y) = m_{R_2}(x,y) = \min[m_{A_2}(x); m_{B_2}(y)]$$

Again, it says that we must combine fuzzy sets A_2 and B_2 by constructing a spreadsheet and inserting into each cell the minimum degree of membership. The results are shown in Figure 5.

Figure 5

RELATIONSHIP OF FUZZY SET A_2 WITH FUZZY SET B_2						
X	3	4	5	6	7	
$m_{A_2}(x)$	(0)	(.25)	(.75)	(1)	(0)	
y	$m_{B_2}(y)$					
60	(0)	0	0	0	0	0
70	(.25)	0	.25	.25	.25	0
80	(1)	0	.25	.75	1	0
90	(.25)	0	.25	.25	.25	0
100	(0)	0	0	0	0	0

Next, we must formalize a union of all of the previous fuzzy rules: if A_1 then B_1 **or** if A_2 then B_2 . This is accomplished according to the following formula:

$$m_R(x,y) = \text{Max}[m_{A_1 \times B_1}(x,y); m_{A_2 \times B_2}(x,y)]$$

where: $m_R(x,y)$ = membership rule for the union of fuzzy sets

$\text{Max}[m_{A_1 \times B_1}(x,y); m_{A_2 \times B_2}(x,y)]$ = maximum membership degree when the results of two rules overlap

This is necessary to specify which rule governs when two or more rules act simultaneously—in other words when there is an overlap between rules. Overlapping occurs only for x 's of 3, 4, 5, and 6, and for y 's of 60, 70, and 80. The formula above requires that in these cases we choose the

maximum degree of membership. Note, for example, that for $x = 3$ and $y = 60$, Rule 1 produced a membership degree of 0.5, while Rule 2 produced a membership degree of 0.0. Thus, the higher of these two (0.5) is inserted in the cell $x = 3, y = 60$. The result obtained from this entire operation is shown in Figure 6.

Figure 6

UNION OF ALL FUZZY SETS								
X	0	1	2	3	4	5	6	7
Y								
0	0	0	0	0	0	0	0	0
20	0	.25	.5	.5	.5	.25	0	0
40	0	.25	.75	1	.75	.25	0	0
60	0	.25	.5	.5	.5	.25	0	0
70	0	.25	.25	.25	.25	.25	.25	0
80	0	0	0	0	.25	.75	1	0
90	0	0	0	0	.25	.25	.25	.25
100	0	0	0	0	0	0	0	.5

The final step is termed "formalizing the composition rule of inference," which results in an "output" of B , given an initial "input" of A . It is represented by the following formula:

$$m_{B\text{-output}}(y) = \max_x \min[m_{A\text{-input}}(x); m_R(x,y)]$$

where: $m_{B\text{-output}}(y)$ = resulting output of membership degrees for each y in set B

$\max_x \min[m_{A\text{-input}}(x); m_R(x,y)]$ = maximum membership degree for each y , i.e., across each row

According to this formula we must first decide on the input, which for demonstration purposes will be A_2 —the fuzzy set of "good" locations. The question is, therefore, given the fuzzy set of "good" locations, what is the membership degree of each per acre land value?

The first step in carrying out the formula is to compare the membership degree of each element (x) of fuzzy set A_2 with the membership degree

shown in the union of all fuzzy sets. If there is a difference, we must select the *lesser* degree of membership. Then, according to the formula we must select the maximum membership degree for each y value; in other words, we select the maximum number for each row of membership degrees. For example, note in Figure 5 that the membership degree for $x = 3$ and $y = 60$ is 0.0, while in the union of all fuzzy sets (Figure 6), the membership degree is 0.5. In Figure 7, therefore, the cell for $x = 3$, $y = 60$ contains a 0. Also, the maximum degree of membership across $y = 60$ is 0.25, and this value is shown in bold. These two operations for all combinations are shown in Figure 7 below.

Figure 7

FORMALIZATION OF THE COMPOSITION RULE OF INFERENCE								
X	0	1	2	3	4	5	6	7
Y								
0	0	0	0	0	0	0	0	0
20	0	0	0	0	.25	.25	0	0
40	0	0	0	0	.25	.25	0	0
60	0	0	0	0	.25	.25	0	0
70	0	0	0	0	.25	.25	.25	0
80	0	0	0	0	.25	.75	1	0
90	0	0	0	0	.25	.25	.25	0
100	0	0	0	0	0	0	0	0

Therefore, the final output shows the degree of membership for each y (e.g., when $y = 80$, the degree of membership is 1.0):

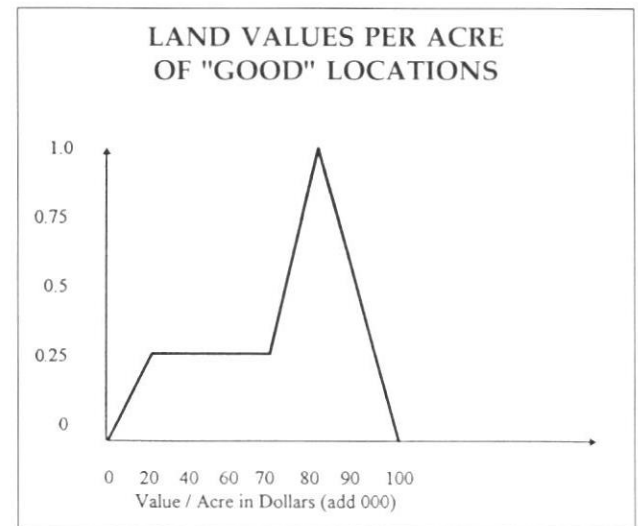
$$B_{\text{output}} = \{(0, 0); (20, .25); (40, .25); (60, .25); (70, .25); (80, 1.0); (90, .25); (100, 0)\}$$

Geometrically, the operation of the rule can be represented as shown in Figure 8.

The figure demonstrates that the output represents a union of fuzzy sets B_2 and B_1 . While B_2 is almost totally operational, however, B_1 is only partially operational, as indicated by the truncated figure

between 0 and 70. The shape of the figure is determined by the different weights assigned to the two sets by operation of the connecting rules.

Figure 8



INTERPRETING THE RESULTS OF THE COMPOSITION RULE OF INFERENCE

We can summarize the fuzzy results by saying that within the set of "good" locations ranked (3 to 7), we might find parcels of vacant land ranging in value from \$20,000 per acre to \$90,000 per acre. Those valued from \$20,000 to \$70,000 and around \$90,000, however, have a degree of membership of only 0.25, while those valued at \$80,000 per acre have a degree of membership of 1.0.

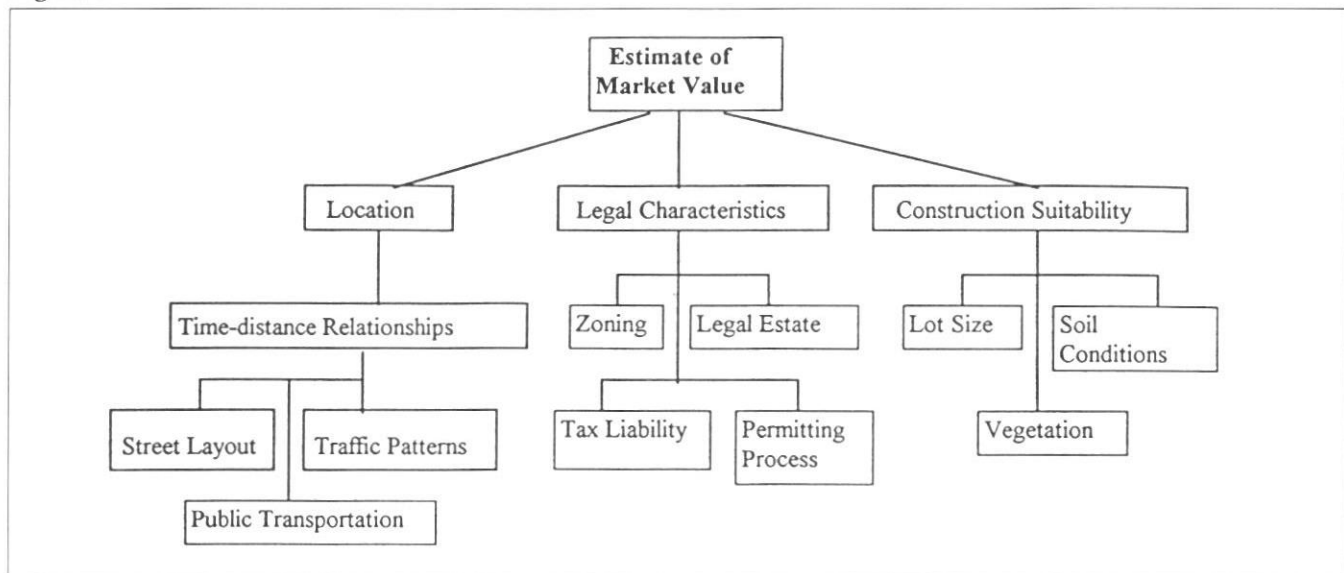
Thus, if we are seeking to find a "good" location for a client, he or she could spend from \$20,000 per acre to \$90,000 per acre. Sites priced around \$80,000 would definitely be considered "good," while sites having prices between \$20,000 and \$70,000 per acre might in reality be "undesirable," and sites having prices around \$90,000 might in reality be better than "desirable"—perhaps "excellent."

Obviously these results provide considerably more information to a client than the appraised value of a single site, or even appraised values or several sites. The use of fuzzy logic enables the analyst to quantify the degree of precision attached to the values of "good" locations.

EXTENDING THE FUZZY SYSTEM

A true fuzzy system is highly complex and requires a multi-step process in which each step is constructed similarly to the example above. For example, if location is regarded as the most general

Figure 9



criterion influencing the value of vacant land parcels, we would next have to determine what attributes determine the quality of location. There might be several criteria, each of which would have to be reduced to a fuzzy set. One such criterion might be the time-distance relationships between a parcel and the origins and destinations of likely customers of the most likely users of the site. These time-distance relationships would be ranked or categorized in some way, and a fuzzy system would be programmed to determine which locational rankings are produced by which time-distance relationships. Similarly, the time-distance relationships might be determined by such factors as layout of the streets, types of public transportation, and traffic patterns.

On the same level as location might also be factors such as the legal characteristics of the property and its suitability for the construction of improvements. Behind the legal criterion there could be zoning, the permitting process, property tax liability, the legal estate that would be conveyed in a sale, *et al.* Behind the construction suitability criterion might be size of lot, terrain, soil conditions, and vegetation. Thus, the system could be depicted as a tree diagram of fuzzy sets (see Figure 9).

CONCLUSION

True fuzzy systems for real estate analysis have not yet been developed, although the fuzzification of numbers within conventional analytical systems (e.g., discounted cash flow analysis) is now employed in several computer programs. While such applications are not true fuzzy systems, they represent a step toward fuzzy analysis.

Highly complex fuzzy systems have been developed for electronic applications such as controlling the subway in Sendai, Japan (which enables riders to have a much smoother ride than conventional systems), enabling computers to "learn" someone's handwriting, and controlling air conditioning systems and other electronic devices. Thus, it seems only a matter of time until true fuzzy systems that deal with the imprecision inherent in the evaluation of property performance and the estimation of market values are developed.^{REI}

NOTES

1. Dilmore, Gene, "Fuzzy Set Theory: An Introduction to its Application for Real Estate Analysts," paper given at the annual conference of the American Real Estate Society, Key West, Florida, 1993.

ABOUT THE AUTHORS

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INVESTOR & LENDER REACTIONS TO ALTERNATIVE SOURCES OF CONTAMINATION

Elaine M. Worzala & William N. Kinnard, Jr., CRE

For the marketplace, this study suggests that many of the environmental "problem" properties actually do have a market that is somewhat broader than has previously been believed.

During the 1980s, the prospect of finding an investor to buy or a lender to finance a piece of contaminated property was commonly considered daunting and sometimes virtually impossible. The "word on the street" was, if contamination was even remotely possible, then being on the chain of title to the property should be avoided like the plague. Results from recent research, however, have indicated that attitudes toward property with environmental problems have been evolving and there appear to be some types of contaminants which institutional investors and lenders, in particular, ignore or discount in making investments and loans (Healy and Healy 1991, Mundy 1992, Kinnard and Worzala 1996).

From a 1996 survey of investors and lenders, we have identified some contaminants which will be tolerated and some which professional real estate market participants still consider "taboo." The hierarchy is based on responses to a mail questionnaire to which 78 equity investors and 69 lenders replied, for a total of 145 useable responses.¹

ATTITUDE TOWARDS SPECIFIC ON-SITE LOCALES OF CONTAMINATION

A series of questions focused on the investors' and lenders' attitudes toward property known to be contaminated with various kinds of contamination. Our intent was to identify the hierarchy of attitudes toward different types or sources of contamination which influence investor and lender decisions on whether to commit funds or to avoid doing so.

The first question covered three basic locales of on-site contamination. It read: *Do you/would you invest/lend on a property that had 1). groundwater contamination; 2). soil contamination; and 3). building contamination?* Results show clearly that building contamination is the least feared, followed by soil contamination and then groundwater contamination (most avoided). As illustrated in *Exhibit 1*, of the 115 respondents who answered the question, 77.6% indicated that either they would definitely or sometimes invest or lend on a property that had building contamination; 69.6% would possibly make the investment or loan if

Exhibit 1

Responses Toward the Question: *Do you/would you invest on a property with:*

Panel A: Aggregate Responses

Locale of Contamination	n*	"Yes" (%)	"Sometimes" (%)	"No" (%)
Groundwater contamination	115	7.8	48.7	43.5
Soil contamination	115	11.3	58.3	30.4
Building contamination	116	12.9	64.7	22.4

Panel B: Investors' Responses

Groundwater contamination	56	8.9	50.0	41.1
Soil contamination	56	16.1	58.9	25.0
Building contamination	57	17.5	61.4	21.1

Panel C: Lenders' Responses

Groundwater contamination	59	6.8	47.5	45.8
Soil contamination	59	6.8	57.6	35.6
Building contamination	59	8.5	67.8	23.7

* n equals number of respondents
Source: Survey Results

the soil was contaminated; and only 56.5% would possibly make the investment or loan if the contamination was in the groundwater. This was a similar result in the Healy and Healy survey (1991) where groundwater contamination was found to be of the greatest concern for lenders. Looking at absolute negative responses, 22.4% would not commit funds if the building were contaminated, 30.4% would not if the soil were contaminated, and close to half (43.5%) would not if the groundwater was known to be contaminated.

Comparing investor attitudes with those of lenders in all three cases, we found that investor respondents were less averse to investing, than were lenders, and more likely to answer "yes" rather than "sometimes." The hierarchy remained the same with groundwater contamination that most avoided (41.1% of the investors and 45.8% of the lenders would not consider these properties); soil contamination in the middle; and building contamination the most tolerable (78.9% of the investors and 76.3% of the lenders provided a positive response towards this type of contamination). Not surprisingly, lenders were more likely to answer "no" than investors.

ATTITUDE TOWARD PROPERTY KNOWN TO CONTAIN DIFFERENT SOURCES OF CONTAMINATION

The second question examined seven different sources of contamination or contaminants. It read: *Do you/would you invest/lend on a property known to be contaminated with 1). an underground storage tank; 2). volatile chemicals; 3). toxic chemicals; 4). petroleum products or derivatives; 5). radioactive materials; 6). asbestos; or 7). tenants that may contaminate the property?* Respondents were asked to indicate how they would react to these contaminants on the following 5-point scale: "yes," "probably," "maybe," "probably not," and "no." Our a priori judgement, based on earlier reports of similar surveys, was that few investors or lenders would be willing to work with any of the types of contamination, with the possible exception of asbestos, as previous surveys had identified some tolerance for this environmental problem. Therefore, the results shown in *Exhibit 2* were somewhat surprising.

Exhibit 2 indicates that both investors and lenders were willing to make investments in or loans on properties with different sources of contamination

Responses Toward the Question:
Do you/would you invest in property known to be contaminated with:

Panel A: Aggregate Responses

Type of Contamination	n*	"Yes" (%)	"Probably" (%)	"Maybe" (%)	"Probably Not" (%)	"No" (%)
Underground Storage Tank	115	13.0	15.7	40.9	15.7	14.8
Volatile Chemicals	115	2.6	2.6	23.5	34.8	36.5
Toxic Chemicals	115	2.6	1.7	26.1	31.3	38.3
Petroleum Products	115	3.5	13.9	42.6	20.0	20.0
Radioactive Materials	115	0.9	0.0	8.7	27.0	63.5
Asbestos	115	16.5	20.0	46.1	8.7	8.7
Tenants	116	8.6	6.0	44.8	16.4	24.1

Panel B: Investors' Responses

Underground Storage Tank	56	12.5	19.6	44.6	14.3	8.9
Volatile Chemicals	56	1.8	3.6	23.2	39.3	32.1
Toxic Chemicals	56	1.8	1.8	23.2	41.1	32.1
Petroleum Products	56	1.8	19.6	39.3	25.0	14.3
Radioactive Materials	56	0.0	0.0	5.4	23.2	71.4
Asbestos	56	19.6	23.2	37.5	8.9	10.7
Tenants	56	7.1	8.9	42.9	19.6	21.4

Panel C: Lenders' Responses

Underground Storage Tank	59	13.6	11.9	37.3	16.9	20.3
Volatile Chemicals	59	3.4	1.7	23.7	30.5	40.7
Toxic Chemicals	59	3.4	1.7	28.8	22.0	44.1
Petroleum Products	59	5.1	8.5	45.8	15.3	25.4
Radioactive Materials	59	1.7	0.0	11.9	30.5	55.9
Asbestos	59	13.6	16.9	54.2	8.5	6.8
Tenants	60	10.0	3.3	46.7	13.3	26.7

* n equals number of respondents
Source: Survey Results

in the following order:² properties with asbestos (not surprisingly, 36.5%); underground storage tank (28.7%); petroleum products or derivatives (17.4%); and tenants who might contaminate the property (14.6%). Quite a few also replied "maybe" with respect to these contaminants which could also be viewed as a positive response to the given source of contamination. When the "maybe" category is included, the order switches slightly with an additional 46.1% considering investing or lending when asbestos is present; 44.8% when a tenant might contaminate the property; 42.6% for petroleum products; and 40.9% if the source of contamination were an underground storage tank.

Respondents clearly indicated they would avoid commitments on properties contaminated with radioactive materials (63.5% explicitly said "no" and another 27% said "probably not," for a total of 90.5% responding negatively). Volatile chemicals and toxic chemicals were also viewed primarily negatively, with 71.3% and 69.6% respectively, responding with either a "no" or "probably not."

The responses by type of respondent basically mirrored the aggregate findings, although lenders seemed to reply "no" more frequently than the investors. Yet, for the most toxic of contaminants, the radioactive materials, 71.4% of the investors

Responses Toward the Question:
Do you/would you invest in property alleged to be contaminated with:

Panel A: Aggregate Responses

Type of Contamination	n*	"Yes" (%)	"Probably" (%)	"Maybe" (%)	"Probably Not" (%)	"No" (%)
Volatile Chemicals	107	1.9	4.7	20.6	29.9	43.0
Toxic Chemicals	107	3.7	1.9	21.5	29.0	43.9
Petroleum Products	106	2.8	17.0	29.2	21.7	29.2
Radioactive Materials	106	0.9	0.0	11.3	26.4	61.3
Asbestos	107	13.1	20.6	38.3	11.2	16.8

Panel B: Investor's Responses

Volatile Chemicals	52	1.9	7.7	19.2	32.7	38.5
Toxic Chemicals	52	3.8	1.9	19.2	36.5	38.5
Petroleum Products	51	2.0	21.6	25.5	29.4	21.6
Radioactive Materials	51	0.0	0.0	9.8	23.5	66.7
Asbestos	52	19.2	19.2	32.7	9.6	19.2

Panel C: Lender's Responses

Volatile Chemicals	55	1.8	1.8	21.8	27.3	47.3
Toxic Chemicals	55	3.6	1.8	23.6	21.8	49.1
Petroleum Products	55	3.6	12.7	32.7	14.5	36.4
Radioactive Materials	55	1.8	0.0	12.7	29.1	56.4
Asbestos	55	7.3	21.8	43.6	12.7	14.5

* n equals number of respondents

Source: Survey Results

answered "no," as opposed to only 55.9% of lenders. Lenders were also more likely to reply with a definite "yes" except in the case of asbestos contamination, where 19.6% of the investors and only 13.6% of the lenders would definitely advance funds.

ATTITUDE TOWARD PROPERTY ALLEGED TO CONTAIN SOURCES OF CONTAMINATION

After ascertaining the attitudes of investors and lenders toward known contamination and contaminants, we asked a similar question about properties *alleged* to be contaminated with the categories of contamination.³ Exhibit 3 summarizes the results for the five different types of contaminants: volatile chemicals, toxic chemicals, petroleum products, radioactive materials, and asbestos. (Underground storage tanks and contaminating tenants were omitted.)

As with the properties known to be contaminated, a hierarchy of willingness to invest or lend on properties with different types of contamination emerged. Asbestos was the least avoided, with 33.7% of the 107 respondents indicating a "yes" or "probably" for this source of contamination. Another 38.3% responded with a "maybe", suggesting that almost three-quarters of the respondents were somewhat positive (or at least not negative) toward properties containing asbestos. This was followed by petroleum products where 19.8% answered "yes" or "probably" and another 29.2% said "maybe."

As for highly-negative reactions, the order was similar to that found when contamination was stated to be "known." Radioactive materials had the greatest negative response: 61.3% said "no" and

Responses Toward the Question:
Do you/would you invest in property within 300 feet of:

Panel A: Aggregate Responses

Type of Contamination	n*	"Yes" (%)	"Probably" (%)	"Maybe" (%)	"Probably Not" (%)	"No" (%)
A contaminated groundwater plume	114	3.5	7.0	53.5	30.7	5.3
High-voltage electricity lines	115	15.7	27.0	33.0	18.3	6.1
An industrial landfill (hazardous, toxic)	116	0.9	2.6	22.4	43.1	31.0
A high-traffic street or highway	115	55.7	33.0	10.4	0.9	0.0
A high-pressure natural gas line	115	24.3	34.8	33.9	6.1	0.9
A radioactive materials handling facility	116	0.0	6.0	20.7	33.6	39.7
An oil refinery or petrochemical plant	115	3.5	10.4	30.4	30.4	25.2
A landfill (non-hazardous, non-toxic)	115	7.8	16.5	46.1	20.9	8.7
Land contaminated by radioactive materials	115	0.0	0.9	13.9	29.6	55.7

Panel B: Investors' Responses

A contaminated groundwater plume	57	5.3	7.0	49.1	36.8	1.8
High-voltage electricity lines	57	17.5	19.3	35.1	22.8	5.3
An industrial landfill (hazardous, toxic)	57	1.8	1.8	21.1	47.4	28.1
A high-traffic street or highway	57	61.4	26.3	12.3	0.0	0.0
A high-pressure natural gas line	57	28.1	29.8	36.8	5.3	0.0
A radioactive materials handling facility	57	0.0	5.3	12.3	29.8	52.6
An oil refinery or petrochemical plant	57	3.5	8.8	24.6	29.8	33.3
A landfill (non-hazardous, non-toxic)	57	14.0	17.5	43.9	19.3	5.3
Land contaminated by radioactive materials	57	0.0	1.8	8.8	24.6	64.9

Panel C: Lenders' Responses

A contaminated groundwater plume	57	1.8	7.0	57.9	24.6	8.8
High-voltage electricity lines	58	13.8	34.5	31.0	13.8	6.9
An industrial landfill (hazardous, toxic)	59	0.0	3.4	23.7	39.0	33.9
A high-traffic street or highway	58	50.0	39.7	8.6	1.7	0.0
A high-pressure natural gas line	58	20.7	39.7	31.0	6.9	1.7
A radioactive materials handling facility	59	0.0	6.8	28.8	37.3	27.1
An oil refinery or petrochemical plant	58	3.4	12.1	36.2	31.0	17.2
A landfill (non-hazardous, non-toxic)	58	1.7	15.5	48.3	22.4	12.1
Land contaminated by radioactive materials	58	0.0	0.0	19.0	34.5	46.6

* n equals number of respondents

Source: Survey Results

another 26.4% said "probably not." Toxic chemicals elicited a 43.9% "no" response with 29% who indicated, "probably not." Volatile chemicals were the third most negatively regarded source of alleged contamination: 43% said "no" and 29.9% said "probably not." It is interesting to note that "alleged" petroleum contamination produces more negative results than "known" contamination did, with over

50% indicating "no" or "probably not." By type of respondent, lenders were once again much more negative toward all sources of contamination, except radioactive materials. There, 68.7% of the investors responded with a definite "no" but only 56.4% of the lenders did. As for positive reactions, investors were more favorably inclined than lenders toward both asbestos and petroleum products.

ATTITUDES TOWARD PROPERTY LOCATED WITHIN 300 FEET OF CONTAMINATED PROPERTY

To test the judgment that investors and lenders are also concerned enough to limit their investing in and lending on properties located in close proximity to a source of contamination, the following question was asked: *Do you/would you invest in/lend on property within 300 feet [of 9 different contaminants]?* Again, the five response choices included "yes," "probably," "maybe," "probably not," and "no." Results are summarized in *Exhibit 4*, and the frequency of responses is ranked both for all of the respondents and by type of respondent: investor or lender.

A high traffic street or highway had the least negative impact. Over three quarters of all respondents (89.7%) indicated either that they would ("yes") or they might ("probably") invest/lend on property located within 300 feet of a piece of property. A high-pressure natural gas line was second most frequently cited as being no deterrent to investment (58.9%). Both high-voltage electricity lines (42.7%) and a non-toxic landfill (24.3%) were also not regarded as serious bars to investment. When the "maybe" responses were added in, a contaminated groundwater plume is included in the potential list with 64% indicating that "yes," "probably," or "maybe" they would lend or invest if it were within 300 feet of a site. This compares to a high-traffic street/highway (99.1%), high-pressure gas lines (93%), high-voltage electricity lines (75.7%), and non-hazardous landfills (70.4%).

When negative responses are considered, radioactive materials continue to rank highest on the list of contaminants that respondents would avoid ("no" or "probably not"). For a property located within 300 feet of land contaminated with radioactive materials, 55.7% of the respondents indicated they would not lend or invest. When the "probably not" responses are included, total negative reactions were 85.3%. A radioactive materials handling facility was the second most frequently listed "no" response (39.7%), followed by hazardous industrial landfill (31%). When the "probably not" responses are considered, these two contaminants have almost identical negative response ratings. Proximity to an oil refinery or petrochemical plant was the fourth most negatively mentioned contaminant, with 25.2% indicating "no" and another 30.4% responding "probably not."

When the most negatively regarded contaminants are examined, investors were more likely than

lenders to say "no" for property contaminated by radioactive materials (64.9% vs. 46.6%); a radioactive materials handling facility (52.6% vs. 27.1%); and an oil refinery or petrochemical plant (33.3% vs. 17.2%). On the other hand, the lenders were more likely to say "no" for the hazardous landfill (33.9% vs. 28.1%).

CONCLUSION

A major finding from this study is that there are some sources of contamination which investors and lenders are willing to tolerate. Building contaminants such as asbestos and underground storage tanks were more acceptable than many of the other sources of contamination. In particular, radioactive materials were high on the list of contaminants that investors and lenders alike avoid, and generally will not consider. For the most part, investors were more definite and pronounced about their aversion than lenders. While reactions to the different sources of contamination varied when the contamination problem was *alleged*, rather than *known*, the hierarchy of aversion remained basically the same. When investors and lenders were asked about contamination on properties in close proximity to a subject property, very strong negative reactions toward radioactive materials persist. Furthermore, investors were again much more concerned than lenders.

Although there is obviously a large degree of aversion to investor or lender liability from several types of both on-site and off-site (but proximate) contaminants, the results of this study provide some good news to owners and would-be purchasers of commercial and industrial property since a lot of institutional grade investment property is already known or suspected to be contaminated by asbestos or underground storage tanks, rather than by radioactive materials. Therefore, for the marketplace, these results suggest that many of the environmental "problem" properties actually do have a market that is somewhat broader than has previously been believed. Moreover, a not insignificant proportion of investors and lenders appear willing to invest or lend with some of the contaminants so the previous "word on the street" should be revised.^{REI}

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NOTES

1. To develop the hierarchy shown in this paper, we focused on only 4 questions in the survey. See Kinnard and Worzala (1996) for a complete description of the sample, response rate, and results of the survey.
2. Throughout our analysis, we judged a "yes" or "maybe" answer to be a positive response to the question. Each Exhibit indicates the actual number responding to each component of each question so the number of respondents for each question does vary.
3. In a few cases, respondents commented that they would verify to determine if the allegation were true and then skipped the question. We received 107 responses to this question, as compared with 116 replies when the contamination was *known* to exist.

ABOUT THE AUTHORS

Elaine M. Worzala, Ph.D., is assistant professor of finance and real estate at Colorado State University. She has published numerous articles on market studies in both the U.S. and Europe, in professional as well as academic journals. In 1995-96, she was a visiting assistant professor of real estate at the University of Connecticut. Dr. Worzala has worked as a commercial real estate appraiser and market analyst with firms in San Francisco and London, England.

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CRE PERSPECTIVE

SOUTH AFRICA, POST-APARTHEID

by J. R. Kimball, CRE

South Africa . . . a.k.a., "The Dark Continent." The name calls to mind safaris, wars, apartheid, violence, and mystery. Whether sought out or accidentally encountered, the public's image of South Africa has and continues to be shaped by what we have been exposed to by the media. Thus, when offered the opportunity to visit South Africa and experience first-hand what had heretofore always been a dream, I jumped at the chance. Following is a brief overview of a visit made in the Fall of 1996 as a team member of the Citizens Ambassador Real Estate Development Delegation of the People to People Program.¹

Background

Pre-trip, my delegation's knowledge included some recollections about South Africa's history; information that was soon to expand by volumes! We had recollections of frontier wars, (nine dating back to 1779); abuses associated with apartheid; international sanctions levied against South Africa for its human rights violations; and of course, the imprisonment of Nelson Mandela for his efforts to gain equal rights for all South Africans.

Discrimination was selectively applied under apartheid. Whites were the ruling minority class; the mixed races were called "colored"; and blacks were the majority class who had no political or social standing. Although not as numerous as Afrikaners, the English-speaking community has dominated industry and commerce.

Following is an attempt to relate some facts² and a observations on the real estate market as it is emerging under the new open society created post-apartheid.

The Government

Characterized as a multi-party democracy, South Africa achieved a transition from minority to majority rule in April of 1994, without upheaval. The African National Congress (ANC), obtained a large majority of the votes, with its candidate, Nelson Mandela, being elected President of the party. About 65 percent of the estimated potential electorate voted in a fully-democratic election; there was no formal census of eligible voters. In terms of the interim constitution, Mandela presides over what is termed the "Government of National Unity" (GNU). His cabinet includes representatives of two major rival parties: the National Party (NP), headed by Deputy President FW de Klerk; and the Inkatha Freedom Party (IFP), (the predominantly Zulu party), led by Chief Mangosuthu Buthelezi.

The current governing body consists of 400 Parliament members and 90 Senators. Most all are black, in contrast to the previous structure that was almost exclusively white. Critical issues facing the Government of National Unity, include: urbanization, which has created massive informal shanty towns surrounding established cities; legal and

illegal immigration; land reforms; job training; a Truth and Reconciliation Commission³; and the redistribution of wealth and resources.

The GNU has established a Reconstruction and Development Program (RDP). It is charged with correcting decades of racial discrimination, found especially in education, housing, job training, and welfare services. The RDP is also attempting to stimulate a weakened economy and generate jobs. Classified as a middle-income country, South Africa's per capita GDP is estimated at approximately \$2,900. Unemployment is generally estimated at 40 percent of the population eligible to work. Over 50 percent of the black population is classified as living in poverty.

Apartheid created inequities in ownership, employment, and skills, thus making for a very skewed economy in terms of individual income, skills, productivity, and employment. The low growth rate of the GDP, 3.4 percent, compared to a population growth rate of an estimated 2.4 percent, indicates little change in per capita income or employment.

The job of the RDP is to focus on: job skills; education; health care for all; housing for the backlog of an estimated 2.5 million people; access to clean water supplies and affordable sanitation facilities; a mass electrification program; and better transportation.

The RDP has not met its initial goal of providing 200,000 new housing units per year. Goals it has met include: free health care for some; annual mass electrification of 300,000 homes; approximately 600 programs upgrading municipal infrastructure; attempts to promote the small business sector; access to water for 3,000,000 people; and mass access to telecommunications.

Under apartheid, South Africa's economy had been geared toward satisfying the domestic consumption of an isolated country. This international isolation imposed by trade sanctions, left most industries with a decidedly domestic focus.

The post-apartheid lifting of trade sanctions put South Africa into global competition. This competition requires tremendous gains in productivity just to maintain status quo, let alone attempt to raise living standards and reduce economic divisions between the races. Gains in productivity can only be achieved by creating a skilled labor pool. Job training will provide the skills to be employed; employment will provide the income necessary to afford a mortgage; thus, together creating a demand for housing. The construction of houses will also stimulate economic growth by creating employment in related industries such as services, appliances, utensils, and furniture.

Foreign investment is treated the same as domestic investment. Incentives for foreign investors include: 100 percent ownership; no government approval required; substantial growth potential; access to African and Indian ocean markets; and few restrictions on exporting profits. Disincentives include: high crime rates, high interest rates, high taxes, low productivity, and restrictions on access to local credit by companies with more than 25 percent foreign control.

The Legal System

The South African legal system combines elements of Roman, Dutch, and English law. Procedures are similar to those in British courts. The jury system was abolished many years ago. In addition to the Constitutional Court

there are three other levels: Magistrate's courts, Supreme courts, and the Court of Appeal.

Many thousands of acres of land, either government or privately owned, have no land or parcel descriptions. Occupancy of some parcels has been by a tribal grant of a "Permission to Occupy" (PTO). These were for extended periods of time, (99 years), and are now being converted to fee ownership as part of the land reform program. Restitution, redistribution, and compensation are all problems being dealt with by the RDP. Having the potential to be the most divisive and controversial, land reform started with a policy paper issued in February 1996. Among other things, it called for expropriation at less than market value; a land tax; the release of parcels of land for urban squatter communities; and a legislative program giving security of tenure to people living on tribal land. Additionally, property owners were assured of a hard-line on land invasions.

Banking & Finance

Property finance is as diverse in South Africa as it is in the U.S. Many different programs are available, including: 1). bonds, traded in the stock market; 2). lease finance, where the payments of a credit tenant are discounted to their present worth and the proceeds used to purchase the property; 3). unsecured loans, where the borrower's name and standing are the main guarantees; 4). non-securitized mortgages, both short and long terms and at both fixed and variable rates; 5). stepped-rate lending, where the bank may require a bond for the original amount plus the anticipated total capitalized interest to be taken out; and 6). participation mortgage bonds, derived from the savings of the elderly. The criterion to obtain

appropriate financing is to have a property that is well-constructed, in a good location, and with a high quality income stream. Sound familiar?

Bank lending rates vary depending on the borrower, whether individual or corporate. There is a new venture in the parlance of South Africa called project finance. It does not have a great deal of security to offer, other than the fact that the development itself will borrow on the strength of the development.

On the other hand, corporate finance dictates that a larger and well-established company may be able to borrow on the strength of the company itself rather than its individual projects. In this instance, all cash flows are typically assigned to the bank. Loan to value ratios are 60 to 70 percent. With an annual increase in rental rates of 12 percent, an interest rate of 18 percent, and a capitalization rate of 11 percent, the rental income on a R10,000,000 (U.S. \$2,250,000) property, for example, would not cover debt service. Thus, the bank keeps all proceeds from the rental income, and loans the shortfall as an overdraft. This scheme will retire the original R6,000,000 (U.S. \$1,333,000) loan in nine years. Unfortunately, equity has had no return during this period. With a 10-year lease, equity will receive all of the tenth year's income that, with the 12 percent annual increase, now amounts to R1,711,159.00 (U.S. \$380,000). This is the preferred lending scheme of the bank. The risk factors of investing/purchasing are tenant retention, the sustainability of rental increases, IRR returns and inflation, the crime rate, and of course a stable political environment.

The Housing Market

Housing is the most critical

problem facing South Africa. Residential developments fall into two classes; formal and informal. Formal are platted, serviced subdivisions not unlike those found in this country. Informal developments, usually inhabited by squatters, are unplatted, unserviced, and have no utilities whatsoever. These settlements house the enormous numbers immigrating from other parts of South Africa to Cape Town and Jo'berg. Reports placed this number at 20,000 per month, although no accurate census has been taken. Under apartheid, blacks were not counted. However, the number seems to fairly represent the problem (judging from the number of informal settlements observed). Efforts were made to not show our delegation all of these settlements. Households with an average size of five members are being moved from informal to formal settlements as rapidly as product is made available.

The government has a subsidy program that allows first-time home buyers whose earnings do not exceed R3,500, (U.S. \$775.00), to receive R15,000 (U.S. \$3,333.00) towards purchase of a house not exceeding R65,000 (U.S. \$14,450) in a formal settlement. The problem however, is one of capacity. The houses cannot be built fast enough, and personnel cannot be trained for jobs that do not yet exist.

Over 60 percent of the SA population is urbanized. In the last four decades, apartheid restrictions on home ownership in urban areas has resulted in a housing backlog estimated at 2.5 million units. Demand is estimated to be growing by 200,000 units each year. Approximately seven million people are living in informal settlements throughout SA on land occupied legally or otherwise. The country's 240 government-built hostels have over 600,000 beds,

many often occupied by three people to a bed space. With unemployment rates of around 40 percent, four out of five households are not able to afford a mortgage.

Housing support centers are being established around South Africa for "self-build" programs. Existing housing units owned by the government are being sold to occupants, and hostels are being converted to family dwellings. Originally constructed as dormitories for miners, these hostels have outdoor communal toilets and cold water spigots. The rehab program converts these to one and two room apartments having shared, central living and cooking areas. Assignments are made with four people in a one-room unit and eight people in a two-room unit. Indoor plumbing is provided under the rehab program.

A mortgage indemnity program has been introduced to provide insurance to recognized lenders who have been deterred from lending in many areas by fear of violence, unrest, theft from building sites, and /or the culture of payment boycotts (carried over from the apartheid era). Instances of occupants unable to meet the mortgage payments are noted by the roof, roof framing, and windows being carted off and used to build a shelter in an informal settlement.

The emphasis on creating employment and job training is so strong that a recent offer by Japan to ship manufactured housing units was rejected. The importation of product would not provide the training in the trades and enable black residents to improve their situations, thus becoming more productive citizens.

Surprisingly, developers seem disinclined to attempt multi-family housing projects. This may be traceable to the native desire to own rather than rent, in an effort

not to create additional dense population centers. The informal settlements are quite dense enough. Some efforts are underway in Jo'berg to upgrade some very old multi-story apartments in the CBD. These structures were originally designed and constructed for a bachelor miners. Under the rehab program, these units will still share a common dormitory-style restroom located off the stairwell, offering little in the way of privacy. Given the average family size, the one and two room units will provide little more than a dry place with indoor plumbing.

Contractors are required to train individuals in each step of the building process so they will be able to find employment and even bid on similar work in the future. Under apartheid, a black person could not pick up a hammer, much less possess the knowledge of its use. The training is not limited to the trade skills, but includes learning the business of running a construction company. The individual is thus empowered to become a contractor.

The Commercial Market

The resulting increases in population and housing have had beneficial side effects. Existing retail centers are doing well, and more are in the planning stages. The vast majority of the black population does not own automobiles, so they rely on taxis or walk to stores. The daily pattern of purchases, (largely dictated by lack of refrigeration, uncertainty of cash flow, and mode of transport), is to buy only what can be carried in two bags. Thus, developers plan their locations and retailer's stock according to the "two bag" shoppers.

When whites and blacks partner in the development of retail

outlets, it is preferred that the black party be the "front" partner. Negotiations with all special interest groups are paramount, including prospective tenants as well as the sidewalk vendors and taxi cab companies. Each has a say in the arrangement of space and location of essential services. Additionally, the developer conducts training programs in inventory control, cash management, and marketing. Overall, blacks are distrustful of developers and they tend to remain loyal to their own people or tribe and to their own brands. They lack trading competency and remain fearful of exploitation. Cultural practices dictate the acceptance or rejection of merchants. A reputation goes a long way in the success or failure of any enterprise dealing with the black public. Almost tribal loyalties to one merchant may spell doom for another that does not enjoy the community's acceptance.

A peculiarity of the shopping center rental market is the payment of "key money," whereby an existing tenant who has a five-year lease will turn the key over (subletting) to another tenant for a fee (about R25,000; U.S. \$5,500). Thus, the landlord does not always have the desired control over the tenant mix.

Shopping center rentals average R90.00/square meter per month (approximately U.S. \$20.00/SF per annum); office park rentals are R35.00/square meter per month (approximately U.S. \$7.75/SF per annum); warehouse's rent for R21.50/square meter per month (approximately U.S. \$4.75/SF per annum). Rentals are exclusive of electricity, but do include: janitorial service, security, maintenance, management, insurance, taxes, and heating, ventilation, and air conditioning. All commercial lease structures are subject to a 14 percent Value Added Tax (VAT). The VAT

is recoverable through trading, except for the end-user.

Rental or lease rates on commercial/office/industrial space carry an annual increase of 10 to 12 percent. Leases are reviewed on a five-year basis with adjustments of the base rent to market levels. This is in addition to the annual percentage increase mentioned above.

Land for office park use sells for R180.00/square meter (approximately U.S. \$3.70/SF); industrial park land sells for R165.00/square meter (approximately U.S. \$3.40/SF).

National inflation has been estimated to be only 7 percent. Interest rates are 15 to 19 percent. Yields on prime office space in the CBD are 9.5 percent; long-term industrial leases yield 10 percent; secondary industrial yields are 12 percent; and IRRs range from 18 to 22 percent. The annual rental increase obviously contributes to this rate of inflation. After all, everyone uses real estate and must pay for its use. Tenants just pass the increases to customers in the form of higher prices.

Office occupancy and construction is currently focused on the suburbs. The CBD in Jo'berg has a high vacancy rate. This is brought on by the influx of street vendors that occupy the sidewalks in front of every major building. New office parks have developed along the major arterials. Judging from the "to let" signs, they are not yet fully occupied.

Conclusion

The attitude reflected by both black and white developers was one of total commitment to cooperation. There was no bitterness or resentment expressed by anyone. All are doing their best to bring success to the post-apartheid era, stimulate investment, promote

growth and job training, solve the housing problem, and bring South Africa into the world economic community.

The numbers immigrating into South Africa, the lack of employment opportunities, tribal frictions, and the overcrowded living conditions have all contributed to a rise in crime. Efforts have been made to reduce the visibility of the police force due to their history of brutality and crimes against citizens. Security features are still very evident with fencing, guards, and gated entrances. One does not have to guess about the mind set of tenants requiring this level of protection.

Counseling opportunities abound. Every action, policy, and procedure has to be re-examined. Yesterday's solutions are today's problems. Innovative thinking in providing solutions to the housing problem, the crime rate, and employment is critical. This is not to imply that South Africans are not sophisticated in their real estate practice or in their approach to their problems' solutions. Clearly, South Africans are top-notch. The opportunities exist in assisting with programs that will facilitate the movement from a segregated population in an isolated nation to an equal trading partner in the global economy.

Real estate finance, primarily in the area of affordable housing, is a critical problem. Land reform measures and the principles of land economics provide another area where Counselor's can participate. Adequate housing will alleviate overcrowding, which in turn, will help lower the crime rate. Training, resulting in marketable job skills, will reduce the unemployment rate and enable movement from informal to formal settlements.

From an outsider's viewpoint

South Africa's urban areas are analogous to a developed nation located in a third world country. So much needs to be done and in such a short time that the task seems staggering. Fortunately, English is a common language. Communication is not difficult once one gets past the differences in pronunciation and certain choices of words that a U.S. citizen may construe to mean a less than savory operation; i.e., "schemes" vs. development or project!^{REI}

NOTES

1. President Dwight D. Eisenhower founded The Citizen Ambassador

Program in 1956, believing that private citizens reaching out in friendship to the people of other nations could make a significant contribution to world peace. In carrying out citizen exchanges, under the auspices and direction of People to People International, The Citizen Ambassador Program promotes friendly relations among all countries through scientific, professional, and technical exchanges. Projects are developed around specific professional objectives and major discussion topics and delegates are invited to participate based on their professional backgrounds. The intent of each delegation is the cross-cultural sharing of information, ideas, and experiences.

2. SA 96-97, *South Africa At a Glance*
3. The Truth and Reconciliation Commission was established to probe human rights abuses committed in the

course of political struggle. Its purpose is not to punish but rather to seek the truth in an effort to facilitate healing.

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J.R. Kimball, CRE, is executive vice president of J.R. Kimball, Inc., Fort Worth, Texas, where he has been a practicing counselor and appraiser for over 30 years. He has extensive experience in all classes of real property. A licensed general appraiser in Texas, Mr. Kimball was a member of the original Texas licensing and Certification Board. He also holds the MAI designation of the Appraisal Institute and has published several articles for the Appraisal Journal.

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CRE PERSPECTIVE

DOING BUSINESS DOWN UNDER

by Theddi Wright Chappell, CRE

"Relationships and Performance", two of the key buzz-words for doing business in the 1990s, did indeed, create the opportunity for my company to capitalize on the globalization of real estate services in 1990. Acting on a perceived time window of opportunity and leveraging off of an existing relationship with a truly visionary client, Landauer Associates, Inc., was given the option of either opening an off-shore office halfway around the world, or losing a substantial chunk of revenue and the opportunity to enter the global foray. We chose the former, and I was the individual selected to open and manage our first off-shore office in Sydney, Australia.

The relationship developed because of long-term advisory services provided by one of Landauer's senior professionals, Helen Jones, CRE. Ms. Jones, who was actively involved in valuing and counseling services for various properties in which a major Australian corporation had an interest, was engaged to review more than 40 properties throughout Australia on the basis of what our clients termed "international best practice". Our initial brief was to ascertain the level of consistency between the U.S. and Australian marketplaces with respect to: valuation methodology, asset management practices, physical facilities, and a focus on maximizing returns. With the United States being perceived as the leader in global real estate trends, the practices embraced in our marketplace were seen to provide the best benchmark for evaluation.

We embarked on this assignment in the fall of 1990, when we were asked to review two of the largest properties under our client's management: a suburban regional retail center and a mixed-use office development in downtown Sydney. We were off-shore for a month, trying to assess a distinctly unique marketplace with dramatically different lease parameters, recovery provisions, and market benchmarks. Availability of data was a critical issue; there were virtually no independent, non-brokerage related sources for population, demographic, or market data. Consequently, our best resources consisted of a few specialized service providers, the Australian census, and an abundance of direct primary research.

After our original reports were favorably received, we then transitioned to a quarterly format of two to three week visitations. During these visits we performed property inspections and primary research in various Australian markets and then returned to the U.S. to complete our analyses. This modus operandi continued throughout 1991 and into the first quarter of 1992. At this time communication was primarily via facsimile, and enormous amounts of tenant and market data were transferred across the Pacific on a 24-hour basis. Computer disks were also utilized, but there was always the potential of compromising the data during shipment.

During our visits it became apparent that the analytical and valuation procedures, as well as the standard of reporting employed in the U.S., were far more stringent than had historically been the case in

Australia. In addition, our work contacts indicated a number of other leading institutions and major corporations also wanted to explore the possibility of working with Landauer. Seizing this window of opportunity, we identified our capabilities and the decision was made to open our first off-shore office. Ms. Jones made the decision to remain in the U.S. in a supervisory capacity, and I took on the responsibility of establishing the Landauer operation overseas.

Differences Abound

I suppose it is impossible to foresee all the challenges that would arise in a new marketplace, and we certainly encountered a number we had not anticipated. Overall, our own market research and the assistance of our clients enabled us to overcome the major hurdles. There are some very basic differences in work attitudes between Australia and the U.S., and anyone operating there should be cognizant of, and very sensitive to, these differentials. Depending upon the profession, Australians are not inclined to work overtime without direct, commensurate rewards. For the most part, salaried professionals are expected to be able to work within the defined parameters of a traditional "9-to-5" workday. If you did encounter individuals working late, it was typically the senior, not the junior professionals, unlike many workplaces in the U.S.

Two other areas in which a degree of attitudinal dissimilarity existed between the Australian and U.S. workforces were the basis of pay raises and the responsibilities of employers/employees to one another. Non-salaried Australian workers are paid on a scale, much like the American minimum wage scale. However, increases in wages

are automatic, given increases in age and time on the job. Therefore, in most instances there is very little, if any, correlation between a higher level of performance and commensurate increases in remuneration. From a typical American perspective, this situation creates a stumbling block in motivating individuals on a performance basis. It also basically dictates salaried positions, versus pay based on wage rate scales. Though potentially more expensive initially, overtime costs are eliminated using salaried positions, and over time, I believe flexibility with comp time serves to offset and better control employee costs.

From an employee perspective, Australian employers appear more socially responsible in the treatment of their employees than typical large, U.S.-based corporations. In general, Australian employers allow more latitude in employee performance and skill levels, and make more of an effort to place employees in alternative positions within the company, rather than to dismiss them. In the first quarter of 1995, legislation was enacted to further protect employees from employer injustices and basically reaffirm the ever-prevalent Australian belief that, "the more fortunate members of society have an irrefutable responsibility to the less fortunate." This is further exemplified by the presence of socialized medicine and the long-term strength of the labor movement in that country.

Doing business as an American in a very small marketplace also proved a challenge, considering there were a number of statutory requirements. The Australian valuation profession was regulated when I arrived and therefore, I had to meet its various requirements to practice. Given the rather hostile resistance to competition,

particularly from a foreigner (not to mention a female foreigner), their processes proved more of an obstacle than we had initially anticipated. However, with the guidance of a few (very few) supporters within the industry, a lot of personal interaction, and a healthy respect for the values of both Australian professionals and their credos, I was successful in obtaining formal registration. According to research done by the Institute of office in New South Wales, I was also the first American to simultaneously both hold the MAI designation and become a member of the Australian Institute of Valuers and Land Economists.

America/Australia . . . The Cultural Subtleties

Given the general stereotypical expectations that many ex-patriots encounter while working abroad, I had a lot of work to do to dispel the myths that: Americans thought they had all the answers; knew more than their counterparts in other areas of the world; and were basically incapable of adapting business practices to accommodate foreign cultural subtleties. I had never been a "foreigner" before, and the experience was an incredibly humbling one. Americans are viewed as being a bit "over the top" with their overt patriotism, and in general, there is a definitive, though subtle, love/hate relationship between the Australian people and the U.S. They view us as quite insular and wonder why we do not travel more. In many cases, they assume we consider ourselves above needing to be familiarized with other parts of the world. Though these comments are certainly generalizations, and do not pertain to the more well-traveled Australian professionals (who made up the core of our clientele), it was surprising how many times my family and I

heard similar remarks.

I found that as a foreigner, one is always an ambassador, whether you want to be or not. If you are in a position of authority, or chose to participate in your industry on a larger scale, you are automatically charged with the responsibility to represent both your company/profession and your country accordingly. During the three years that I was in Australia, I was asked to speak at several national conventions; I was interviewed a number of times by different magazines; I was asked to prepare and present papers for the Securities Institute of Australia for their graduate diploma program; and was invited to a variety of Boardroom lunches, among other activities. In every instance it was essential I remained cognizant of the fact that I was an ambassador for: 1). Landauer; 2). the counseling profession; and 3). the United States.

Soliciting Business Down Under

My CRE colleagues at Landauer had taught me that in conducting business overseas, you always have to *ask* for the business; so in Australia, I wasn't shy. Every new business tap dance was followed by a request to give Landauer just one chance to show a potential client what value we could add for them. To get our foot in the door, I would initially suggest giving us a small assignment, though I would stress our ability to handle complicated property types and would mention my special love of large retail. As it turns out, I converted each of these opportunities to additional work! Over 90 percent of the time, I ended up with their largest, most difficult regional shopping center to evaluate. It appeared that if they were going to use us, they were really going to put us to the test.

The Marketplace

There were differentials in market timing that we were able to use to our advantage. With some variation, trends in the Australian property market have historically lagged the U.S. by two to three years. We entered their marketplace at the bottom of the first major recession in quite a few years. Our experience had been to make forecasts that incorporated a consideration of downturns in various property sectors. Interestingly, the majority of younger professionals in the Australian real estate market had never experienced a downturn, nor consequently how to deal with projections that considered anything other than continual upward trends. In fact, most had dealt only with forward projections of 12 to 24 months, although our clients were utilizing cash flow forecasts of at least 10 years; sometimes longer. This was in a market where actual holding periods for major properties were generally 15 years or more.

The cap rate was still king in the valuation community when we opened our office and this posed some obstacles to finding individuals with minds open and progressive enough to be willing to incorporate cash flow analysis in their work. There were proponents of cash flow analysis in some of the larger practices within the industry, but they were in the minority. Our work product was enhanced by utilizing both cap rate and discounted cash flow (DCF) analyses and by going through those analyses independently. The Australian practice was to select a cap rate, then use the DCF as a check. This procedure involved inserting the selected cap rate as both the going-in and terminal rates, and then imputing an IRR, as opposed to relating the discount rate to a market-required rate of return. Despite

the commonality of this practice, I must re-emphasize that there are, extremely technically-savvy and forward-thinking professionals in the Australian real estate industry; there are just very few of them. This is easily understood, given the country's total population of only 17 million, thereby offering a commensurately small pool of highly-skilled professionals.

Property Analyses

While working in Australia, Landauer adopted a national and international, perspective regarding property analyses. We primarily dealt with major regional shopping centers and mixed-use office developments, which were definitely traded nationally or internationally, and very seldom "locally". We covered the entire continent and had first-hand knowledge of all the major properties, their competition, and competing marketplaces. This gave us a definitive advantage over reliance on local agents who were almost solely familiar with their own specific markets. This is not to say we did not rely heavily upon the local practitioners: we could not have completed our assignments without their assistance. At the same time, we were able to raise their local knowledge to a higher plateau of comparability, use it to enhance our own analyses, and provide a wider property perspective.

Technical Difficulties

Two of the major technical difficulties we encountered were: a dearth in research resources, and no formal or publicized tracking of demand for any of the real estate sectors. Often in the U.S., we take for granted the availability of research services and data. I am sure those of you who have done foreign assignments can commiserate with the fact that the rest of the

world has not yet "come to the party" regarding the provision of data. As noted previously, we relied heavily on primary research, as well as our own confidential data bases built from information provided in our various assignments.

We found a number of instances in which clients felt they owned enough properties to accurately assess market practice, only to find that the market they were assessing was specifically theirs - and did not necessarily compare favorably to the open marketplace. In one instance, a review of operating expenses at a major suburban property revealed that the owner, a service provider for one of the variable expense categories, was costing its services at levels above those typically charged in the wider marketplace. No one was more surprised than they were.

As previously noted, at that point in time there were no groups tracking demand for different property sectors. When I was recalled to the U.S. in mid-1995, BOMA* had just begun discussions on how the tracking of demand for CBD office space could be implemented. By now this has most likely been accomplished; however, at that time, it posed a continual challenge in forecasting absorption with virtually no market data. **(Note: BOMA in Australia is a much more politically-active property group than the informational organization that exists in the U.S. It has now been transformed into the Property Council of Australia).*

All-in-All . . .

From a personal perspective, challenges arose in coordinating the logistics of moving a family half-way around the world; adjusting to primarily single-sex schools with required uniforms; dealing with differentials in cost of living

and tax equalization, (which incidentally requires a true specialist if you and your company are to survive). However, at the end of the day, all proved to be challenges well worth the undertaking. The insight gained through this international experience by both my family and me could never have been accomplished without actually "living the dream." In retrospect, the difficulties and obstacles we overcame now seem minor compared to the professional growth and greater global perspective derived from the experience.

As a result of this assignment, I am convinced that we must address property and all its issues on a global basis, and almost every professional publication I read seems to support this premise. I

am equally convinced that the role of Counselor is absolutely the one we must serve in the future. Landauer's Australian practice, which began primarily as a valuation exercise, evolved into a counseling and consultancy that spanned almost all property types and incorporated everything from strategic lease analyses and assessing redevelopment alternatives, to maximizing tenant mixes and cash flows. I hate clichés, but "adding value" and international best practice was definitely what it was all about. I do not expect that to change.

One last observation is that as CREs, we have the capability to transcend the geographic and organizational limitations of other professional organizations, and

position ourselves successfully as global advisers. Based on the skill-sets and expertise within The Counselors, we should be able to identify and capitalize on opportunities across borders and professional designations. Our primary goal is the provision of the best and most advanced services for our clients, and as such, the synergistic potential for our group, on a worldwide basis, is unsurpassed. I hope we will meet this challenge.^{REI}

Theddi Wright Chappell, CRE, is Managing Director of International Advisory Services for Landauer Associates, Inc. She is responsible for the firm's development and implementation of international advisory services for both U.S.-based and foreign clients.

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INTERNATIONAL ACTIVITIES AT THE COUNSELORS OF REAL ESTATE

CRE International Relations Committee

At the recent CRE Midyear Meetings, The Counselors Board of Directors approved the formation of a full, permanent International Relations Committee. The new Committee will research the formation of bilateral co-operative agreements with other established real estate organizations abroad and work with the CRE Communications Committee to increase awareness of the CRE Designation outside the Continental United States.

CRE Executive Service Corps

Last summer, Counselor members were invited to participate in the *CRE Executive Service Corps*, an exciting pioneer-resource program sponsored by the Eastern European Real Property Foundation (EERPF). The response from members to the program has been overwhelming! Eight CREs have traveled abroad to share their seasoned expertise with real estate practitioners in 28 real estate associations in seven developing Eastern European countries. Additional CRE assignments are currently being scheduled for the Fall season.

Survey Says . . .

In December, a survey was sent to CRE membership inquiring about the level of real estate counseling they performed internationally. About 74 percent of the 160 respondents indicated they perform counseling outside the United States.

The most striking statistics, relate to the breadth of countries in which CREs have worked and the variation of activities in which they have participated. CREs have counseled clients in a total of 63 different countries! Overwhelmingly, the respondents indicated that their counseling activities outside the United States increased over the past five years. Approximately 41 percent of the members indicated that their assignment levels increased. The average increase was 83.4 percent.

To locate a CRE with international expertise, contact the national office of The Counselors of Real Estate at 312.329.8427, or visit its web site at <http://www.cre.org/>

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(deadline for manuscript submission - September 1)

March 1998

"Real Estate Issues Research Review"

Comprehensive Directory of Research Projects

June 1998

Articles on general real estate-related topics

(deadline for manuscript submission - March 15)

September 1998

Focus Edition

(deadline for manuscript submission - June 15)

December 1998

Special Edition

(deadline for manuscript submission - September 1)

See "Contributor Information" on page iii for information on submitting a manuscript or call Faye Porter at 312.329.8429.

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