

REAL ESTATE ISSUES

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THE COUNSELORS OF REAL ESTATE™



- \$ **Special Edition:**
CAPITAL FORMATION IN REAL ESTATE
- \$ *Western Real Estate Advisors Case Study:*
REIT Roll-up
John McMahan, CRE
- \$ *The Impact of the Taxpayer Relief Act of 1997*
on Real Estate Investors
J. Russell Hardin & Jack R. Fay
- \$ *Real Estate Capital Flows: The Money Trail*
Kenneth P. Riggs, Jr., CRE, & Angela G. Thornton
- \$ *Real Estate Capital Markets: A New Paradigm?*
Bowen H. "Buzz" McCoy, CRE
- \$ *Real Estate Capital Market Trends & Applications*
Scott R. Muldavin, CRE
- \$ *Exploring Capitalization Rate Differentials*
Across Property Types
Petros S. Sivitanides & Rena C. Sivitanidou
- \$ **CRE PERSPECTIVE**
How Real Estate Debt Affects Asset Allocation
John K. Rutledge, CRE
- \$ **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.^{REI}

WILL THE VOLATILITY OF THE REAL ESTATE CYCLE CONTINUE?

At this time, certain economists and financial reporters are predicting the end of the business cycle as we have known it. As real estate practitioners, most of us would probably disagree with that premise. In my opinion, one of the fundamental factors which causes real estate to become overbuilt toward the end of each cycle is the lack of "perfect" data and information. "Irrational exuberance" is undoubtedly a factor as well.



Real estate disclosure has benefited greatly in recent years from broader access to the public markets. Informational requirements of the Securities and Exchange Commission, the rating agencies, security analysts, market makers, and investors have brought forth a much greater database for real estate assets held in real estate investment trusts or in commercial mortgage-backed securities portfolios. As more and more assets are captured in the public market, it may become possible to construct national and local indexes of rental rates and vacancies which are more reliable than what has previously existed. The existence of such data may eventually mitigate the volatility of the real estate cycle.

As more and more reliable data enters the public marketplace, one might even envisage the construction of property indices

which could be traded, much as one trades the *Standard and Poors 500 Index*. If such indices were to exist for both the national and local markets, and by different property types, an investor could go long or short any particular property type or location. A prospective large office tenant, for example, could hedge the possibility of rising rents by purchasing an index to hedge the risk.

The increased appeal of real estate to the public markets becomes a self-fulfilling prophecy. As more and more real estate is subject to the rigorous reporting standards of the public markets, more and more confidence will grow in real estate as an investment asset class, and the more demand there will be for real estate in the public markets. We may see a day when "perfect" information will be available on-line for each significant market and property type.

When that day arrives, and we are swamped with information and data, Counselors of Real Estate will be in even greater demand to apply their wisdom and judgment to make sense out of it all.

A handwritten signature in black ink that reads "Bowen H. McCoy".

Bowen H. "Buzz" McCoy, CRE

1997 President

The Counselors of Real Estate

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WESTERN REAL ESTATE ADVISORS

CASE STUDY: REIT ROLL-UP

John McMahan, CRE

This case is based on a series of roll-up proposals that have been offered institutional investors over the last year. As with most good cases, there is no single, preferred solution to Western's quandary. Western clearly has opened a Pandora's Box by announcing the roll-up and must now move quickly to prevent the loss of assets to competitors and perhaps the destruction of the organization they have worked so hard to assemble. The pressure for "action" inherent in the roll-up situation creates a crucible in which assets, careers, and fortunes may be made or lost in a relatively short period of time.

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THE IMPACT OF THE TAXPAYER RELIEF ACT OF 1997 ON REAL ESTATE INVESTORS

J. Russell Hardin & Jack R. Fay

If real estate investors are to maximize after-tax profits and maintain appropriate levels of capital investment, they must have a working knowledge of the latest legislative changes enacted by the United States Congress that pertain to real estate. On August 5, 1997, President Clinton signed into law the Taxpayer Relief Act of 1997. This sweeping piece of legislation contains over 800 amendments to the Internal Revenue Code and approximately 300 new tax provisions. Investors in real estate are urged to look closely at this new tax legislation to seek ways in which they can significantly diminish their future income taxes. Significant changes include a lower tax rate for capital gains, the tax-free treatment of lessee construction allowances, the tax treatment of real estate investment trusts, and more.

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REAL ESTATE CAPITAL FLOWS: THE MONEY TRAIL

Kenneth P. Riggs, Jr., CRE, & Angela G. Thornton

The real estate industry continues to mature after one of the most secular market corrections of this century. This correction forced us to adjust the way we approach real estate investments and therefore gain a more astute understanding of capital flows into the industry. The traditional sources of capital are still active in the market; however, the impact of the public markets and role of the debt and equity players can only fully be appreciated by understanding their capital market positions and the property types they are invested in. In this article, previous research on capital is presented and analyzed to determine which methodologies provide the best understanding of the various sources of capital and their impact on the debt and equity markets.

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REAL ESTATE CAPITAL MARKETS: A NEW PARADIGM?

Bowen H. "Buzz" McCoy, CRE

Has there been a fundamental change in the real estate capital cycle? The author thinks not, but only after analyzing the impact of securitization, consolidation, technology, globalization, and the like. After surveying the state of the real estate capital markets, the author concludes that the trend toward public markets for real estate capital will continue. Along with such growth in public markets comes a requirement for much greater information about real estate. This enhanced flow of information could fundamentally change the private nature of real estate finance. Those who control such information databases will be the big winners in the next real estate cycle.

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REAL ESTATE CAPITAL MARKET TRENDS & APPLICATIONS

Scott R. Muldavin, CRE

Despite the explosion in the availability of real estate capital markets information, the real estate capital markets are poorly defined, and few standard definitions and measurement techniques have been introduced. This manuscript identifies the types of real estate capital markets information available and introduces strategic-based frameworks that link specific information needs to specific decisions. A forecast of capital market conditions based on newly created historical real estate capital markets indices is presented as well.

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EXPLORING CAPITALIZATION RATE DIFFERENTIALS ACROSS PROPERTY TYPES

Petros S. Sivitanides & Rena C. Sivitanidou

This manuscript presents the results of analytical work intended to empirically identify differences in transaction-based capitalization rates across office, warehouse, retail, and apartment properties during the period 1986-1996. The analysis indicates that capitalization rates differ across these property types along three dimensions: in the magnitude of their fixed, time-invariant component; in the pattern of their time trends; and in the persistence of these time trends. Potential explanations on the sources of such differences are advanced.

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:

Halbert C. Smith, CRE, editor in chief, *Real Estate Issues*, The Counselors of Real Estate, 430 North Michigan, Chicago, IL 60611. All manuscripts are reviewed by three members of the editorial board with the author's name(s) kept anonymous. When accepted, the manuscript and any recommended changes is returned to the author for revision. If the manuscript is not accepted, the author is notified by letter.

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 58 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 1998 William S. Ballard Award. All articles published in *REI* during the 1998 calendar year will be eligible for consideration, including member and non-member authors. The \$500 cash award and plaque is presented annually each spring, during The Counselors' Midyear Meetings 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. (The 1997 recipient will be honored at The Counselors Midyear Meetings in Boston, May 1998.)

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EDITOR'S STATEMENT

Capital formation in real estate is occurring at a more rapid pace than at any other time in our history. Most of the market mechanisms to enable this cadence of growth have been developed only in the last several years, and the shift in real estate finance can only be described as revolutionary. The re-emergence of REITs in a more viable format than existed in the 1970s and the development of commercial mortgage-backed securities (CMBS) in the mid-1990s have, in large measure, converted the "property" market into a segment of the securities markets. What was formerly only a dream of real estate developers and investors of being able to tap into the capital markets has truly been realized.



These financial developments came at a propitious time, following the great real estate depression of the late 1980s and early 1990s. With the oversupply of properties and the dearth of development activity during that period having run its course, the increasing demand of the mid-1990s required enormous sources of capital. This year, for example, the total market capitalization of CMBS may reach \$150 billion—triple the \$50 billion of just four years earlier. REITs, of course, have had an equally dramatic growth story, and it is now these forms of securitized real estate that dominate the real estate investment activities of institutional investors.

Institutional investors are replacing substantial portions of the equity real estate investments with real estate securities. For example, the percentage of pension fund assets in equity real estate is now between 2 percent and 3 percent, down from almost 4 percent in the early 1990s, with the slack being taken up by both CMBS and REIT shares. Other institutional investors have followed the same trends, with banks and life insurance companies continuing to make the vast majority of direct loans for real estate financing.

In this Special Edition of *Real Estate Issues* some excellent articles address these changes and their effects on the market. A case study of a REIT roll-up by John McMahan highlights the important issues facing an adviser and clients in determining whether to combine real estate assets in the REIT form. Buzz McCoy presents the "big picture" of market shifts and terms it "a new paradigm." Ken Riggs takes a capital flows approach to measuring and explaining the market revolution, while Scott Muldavin links information needs to specific applications for various user groups.

An article by Hardin and Fay discusses some of the most important changes in the 1997 Taxpayer Relief Act affecting real estate investors, while Sivitanides and Sivitanidou document differentials in capitalization rates across property types. Finally, John Rutledge presents a viewpoint that is somewhat different from the traditional viewpoint about how real estate debt affects asset allocation.

Enjoy and profit!


Halbert C. Smith, CRE
Editor in chief

WESTERN REAL ESTATE ADVISORS¹ CASE STUDY: REIT ROLL-UP

by John McMahan, CRE

This case is based on a series of roll-up proposals offered to institutional investors over the last year. The pressure for "action" inherent in the roll-up situation creates a crucible in which assets, careers, and fortunes may be made or lost in a relatively short period of time.

Camiella Concilatore raced into the management meeting 25 minutes late, her heart pounding, and largely out of breath. Just before the meeting, she had placed a call to Tom Razier to ascertain his receptivity to a "roll-up" of Western's clients' assets into a Real Estate Investment Trust (REIT). Tom was the head of real estate investments for the Bloomfield Urban Retirement Plan (BURP), one of Western's largest clients.

Cami had started at Western in 1991 as a real estate acquisition officer and now served as the firm's director of portfolio management. The management meeting was called to finalize strategy for the proposed roll-up, tentatively scheduled for closing on October 15, 1997, just three months away. Unfortunately, the news she brought would not be well received.

BACKGROUND

Firm's Beginnings: Western was founded in Los Angeles in 1987 as an investment advisor for pension investor clients. The firm was registered

under the Advisor's Act of 1940 and was a fiduciary under ERISA. Western specialized in suburban office and industrial properties located primarily in the western United States.

Western's founders, Jim Aires and Serge Leosky, were 1981 classmates from a well-known western business school. They later worked together as mortgagebrokers specializing in loans for office and industrial properties. As a result of their mortgage activities, they became acquainted with several major pension funds and believed that they could develop an investment niche that would provide attractive equity returns to pension investors. To raise the initial \$200,000 in equity capital for their new firm, they invested their life savings as well as proceeds from second mortgages on their homes.

Clients: Raising pension capital turned out to be harder than they had anticipated. It took over two years to secure their first pension client, who invested \$25 million in a separate account.

Exhibit 1

WESTERN REAL ESTATE ADVISORS, INC.
 PROFIT & LOSS STATEMENT (Unaudited) - (000's)

	1996 (actual)	1997 (estimated)	1998 (forecasted)
Assets Under Management			
BOP	\$688	\$725	\$835
Acquisition/Development	55	116	165
Dispositions	<u>18</u>	<u>6</u>	<u>0</u>
EOP	725	835	1,000
Revenue¹			
Asset Management	4.713	5.226	6.675
Acquisition/Development	0.930	1.346	1.980
Dispositions	<u>0.179</u>	<u>0.113</u>	<u>0.000</u>
Total	5.82	6.69	7.80
Expense			
Salaries	1.88	2.01	2.20
Fringe Benefits	0.413	0.442	0.440
Rent	0.120	0.125	0.125
Insurance	0.028	0.030	0.050
Travel	0.541	0.615	0.800
Promotion	0.433	0.492	0.600
Legal	0.057	0.044	0.100
Accounting	0.036	0.042	0.060
Research	<u>0.103</u>	<u>0.305</u>	<u>0.300</u>
Total	3.61	4.10	4.68
EBITDA	2.21	2.59	3.13

¹ Western's standard fee structure was .70% annually for asset management; 1.0% for acquisitions; 2.0% for development; and 1.0% for dispositions. Disposition fees sometimes had a portion of cost recovery reflected in them.

Although from time-to-time they considered sponsoring pooled funds, they continued to focus on separate accounts and by mid-1997, had attracted 14 pension clients allocating \$835 million to the firm for investment purposes. Six of the clients were public pension plans; five were corporate; two were Taft-Hartley; and one was a college endowment fund.

Investment Strategy: Western's investment strategy was to concentrate on the rapidly growing suburbs of metropolitan areas in the western United States where they believed they could secure superior investment returns. They focused on new, modern, suburban office buildings leased to local (27.3 percent); regional (39.2 percent); and national business firms (33.5 percent).

Assets: As of December 31, 1996, the firm had approximately \$725 million in assets under

management comprising 43 properties located in California (48.3 percent); Washington (27.1 percent); Arizona (17.6 percent); Oregon (5.2 percent); and Colorado (1.8 percent). Ninety-three percent (93.0 percent) of the portfolio's value was in office and R&D buildings, with the remainder in industrial warehouse facilities. The average length of leases in the portfolio was 4.2 years. Approximately 20 percent of the investments had been developed by Western's staff.

Investment Performance: Despite the recession of 1991-1993, and the problems besetting the office sector, the properties had performed relatively well over the past seven years, with a 10.3 percent total annual return—of which 8.2 percent represented net operating income (NOI).

And things were getting much better. As a result of asset value write-downs in the early 1990s and rapidly improving property markets in the West, Western's NOI return for 1996 was 10.3 percent, and was expected to be 11.3 percent for 1997. Management believed

that NOI returns would reach 12 percent by 1998. Tenant improvements and leasing commissions typically reduced NOI returns by approximately 15 percent annually.

Organization: Western was organized as a corporation, with a functional/matrix organizational structure. Jim was President and CEO with Serge serving as the chief operating officer. Besides Cami, other officers included Mary Ishade, chief financial officer; Bill Closdeale, director of acquisitions; and John Leascom, director of asset management. Property management was performed by independent contractors. Non-founding officers owned 37 percent of the company.

Profitability: During its early years, Western had lost money, but began to enter the black in 1990. Profitability then turned down in 1993, as new

capital dried up and clients demanded higher levels of reporting and other services. With new capital flows in late 1995, however, profitability had returned. EBITDA for 1996 was \$2.2 million and was expected to increase to \$2.6 million in 1997 and \$3.1 million in 1998 (*Exhibit 1*).

PENSION INVESTORS

Poor Performance: Although Western had faced problems, they paled in comparison with those experienced by older, larger investment advisory firms. And not without reason—pension investors were upset with real estate returns consistently lower than their securities portfolio, largely as a result of losses of up to 40 percent in real estate portfolio value. Also a concern, was the incredible amount of staff time that real estate investing seemed to require.

"Agency" Problem: Many investors believed that a large part of the poor performance record was an inevitable result of the investment advisory delivery system, in which the advisor not only initiated the investment, but managed it as well. Investors perceived a conflict of interest in this arrangement, as no one knew who the investment advisor really worked for. The fact that most advisors did not invest in the properties meant that advisory firms could be making money while their clients, the pension investors, were losing theirs.

Search for Solutions: In order to resolve these concerns, pension investors began exploring alternatives. About 30 percent, mostly smaller plans, decided to get out of real estate altogether. Not wishing to leave real estate, other plans sold their private market assets and invested the proceeds in securitized real estate, primarily REITs. Some of the larger public plans attempted to modify the private market investment process by requiring changes in their investment advisory contracts. They believed that by making certain requirements of their advisors (e.g. dedicated advisor staffs, dedicated reporting, advisor co-investment, etc.), they could capture the major benefits of securitized investing and still enjoy the greater portfolio diversification benefits provided by private market assets.

REAL ESTATE INVESTMENT TRUSTS

Legislation: The REIT Act of 1960 envisioned a conservative investment vehicle with certain tax avoidance features that would encourage long-term investment in real estate by individual, taxable investors.

Although regulations have loosened considerably over the years, REITs still must meet fairly stringent rules if they are to annually maintain their REIT status:

- Have at least 100 shareholders. Five individuals cannot not own more than 50 percent of the stock (5/50 rule);
- Seventy-five percent of assets must be in real estate equity, mortgages, REIT shares, or cash;
- Seventy-five percent of income must come from rents or mortgage interest;
- No more than 30 percent of operating income can come from properties held less than four years;²
- Ninety-five percent of taxable income must be paid out annually.

In terms of organization, all REITs must be a corporation or a trust and be managed by a board of directors or trustees. The majority of trustees must be independent of REIT management.

Early History: Less than half of the REITs operating in the 1960s were self-advised (internally managed, no external advisor) and, even in these cases, management did not participate extensively in stock ownership. There was little market activity and not much coverage from the financial community.

In the late 60s, Wall Street began shifting the emphasis of REIT Initial Placement Offerings (IPO) from long-term equity investment to short-term mortgage investment, largely in the form of construction loans. Mortgage REITs were the largest single source of capital funding for the 1971-1975 real estate "boom," largely borrowing short and lending long in order to arbitrage the yield curve. This bubble collapsed in the mid-70s and REITs became tarred with a negative image that they would not overcome for 20 years. Not all of this was investor perception—*REIT market values had declined almost 75 percent from their 1972 highs.*

Largely as a result of the debacle of the 1970s, REITs missed the real estate "bubble" of the 80s. In the subsequent collapse of the real estate markets at the end of the decade, all forms of capital for real estate evaporated. Developers and other owners of real estate found themselves with highly leveraged properties, often built with short-term financing and no source of refinancing. With interest rates falling and real estate yields rising, Wall Street saw an opportunity to arbitrage the private and public markets.

Birth of the "Modern REIT:" The Kimco offering in late 1991 was the first sign that REITs could play a

Exhibit 2

"OLD" vs. "NEW" REITs

<u>Old REITs</u>	<u>New REITs</u>
1960 - 1962	1992 - 1997
Passive investments	Operating company
Externally administered	Self-administered
Institutional sponsors	Entrepreneur sponsors
Small mgt. ownership	Large mgt. ownership
Diversified portfolio	Focused portfolio
Small capital base	Larger capital base
Little analyst coverage	More analyst coverage

major role in financing real estate and, more importantly, real estate operating companies. During 1991, eight IPOs involving REITs raised \$808 million. A similar number were completed in 1992, raising \$919 million.

While this was meaningful investment activity, particularly in a capital-starved real estate market, 1993 proved to be a real turning point — 75 equity IPOs raised \$11.1 billion. Excluding placements of less than \$50 million, 39 IPOs were completed raising \$8.2 billion—approximately 14 percent of total IPO activity in the entire securities market for the year. This represented more real estate capital than from any other source.

New REITs Were Different: Perhaps more significantly, the character of the 1993 IPOs was dramatically different. Virtually all represented real estate operating companies, specializing by property type. The new REITs were also significantly larger—10 equity REITs had market capitalization of over \$500 million (versus two at the end of 1991), and 40 had capitalization exceeding \$200 million (versus 10 in 1991). Almost two-thirds of new and proposed REITs were structured as UPREITs, in which the REIT owns an interest in one or more existing partnerships, an approach utilized to reduce the tax impact on selling partners.

Most of the 1993 IPOs were self-administered and, in many cases, management had significant equity positions, minimizing conflicts and enhancing congruency with investors. Most of the management groups had spent their careers specializing in the particular property type and had effectively worked together as a team for many years, (including at least one full real estate cycle). (*Exhibit 2*).

At year-end 1993, the REIT market reflected many of the changes occurring at the individual

firm level. Total market capitalization of all REITs increased to \$31.6 billion. The 30 largest REITs measured \$15.1 billion vs. \$8.6 billion at the beginning of the year.

Over the next three years, REITs would grow exponentially. The 1993 IPO calendar had focused on retail; 1994 saw the emergence of investor interest in multi-family and office/industrial; 1995 was the year of hotel IPOs; and 1996 was dominated by office/industrial (*Exhibit 3*). In 1995 and 1996, secondary offerings also became an important source in REIT equity financing, overshadowing IPO activity (*Exhibit 4*).

By the end of 1996, there were 302 REITs with a total market capitalization of \$126 billion. Approximately two-thirds of these were equity REITs with a total market capitalization of \$95 million (*Exhibit 5*).

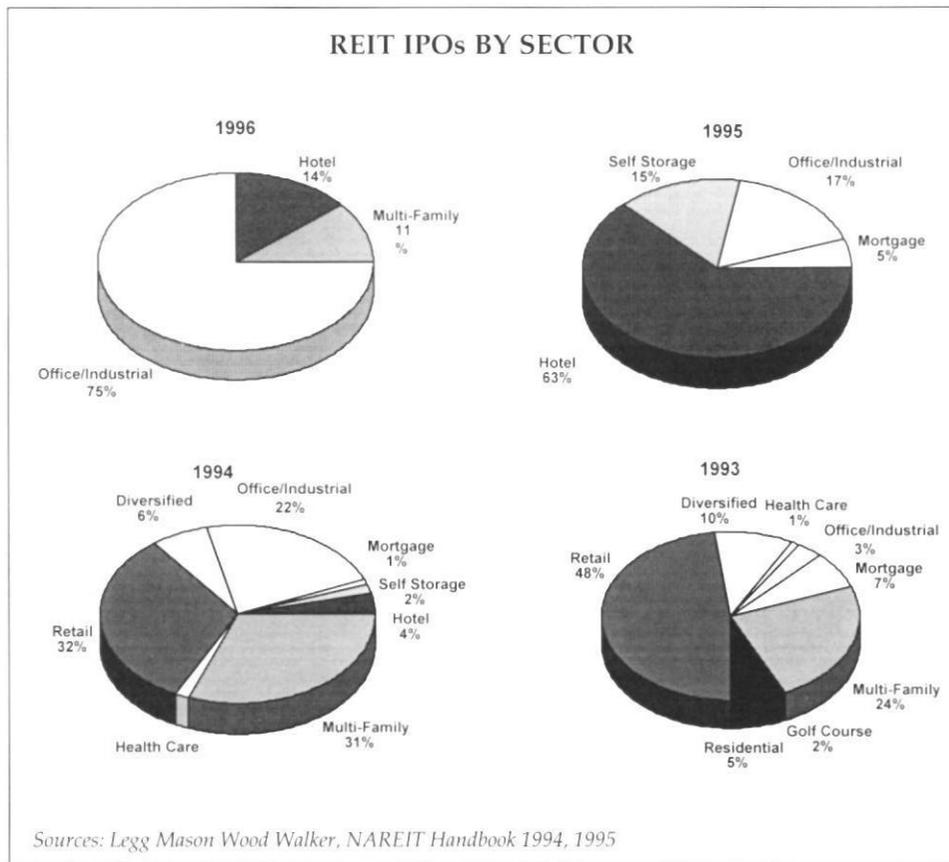
Today, most successful REITs are fully-integrated operating companies rather than the passive conduits envisioned by Congress 37 years earlier. Most are focused by property type and by geographical area, although this is changing as larger, national firms come onto the scene. Retail and apartments are still the dominant property type, although office, industrial, and hotels have grown in importance in recent years. Economic scale is also important as larger REITs reduce their cost of capital and spread operating costs over a larger base.

Market Valuation: REIT earnings are usually measured in terms of funds from operations (FFO), which is net income (GAAP); plus depreciation and amortization; less gain (loss) on sale of investments. Stock prices are generally compared to FFO flows, much the same as price/earnings ratios for non-real estate stocks. More recently, many analysts have begun adjusting FFO for capital expenditures and the impact of floating rate debt. This is termed Adjusted Funds From Operations (AFFO).

REITs are also valued in terms of their premium or discount to Net Asset Value (NAV). Better performing REITs are generally rewarded by premium pricing, reflecting the market's perception of greater enterprise value which should result in enhanced future FFO growth.

Other factors that analysts and investors track are "payout ratios" (percent of distributable income that will be paid out as dividends); "total debt to total capitalization" (the market does not like leverage exceeding 40 percent); the proportion

Exhibit 3



REITs, reflecting the belief in the market that they would experience higher levels of future growth.³

Pension Fund Interest: Despite the promise of the new REIT investment format, pension fund interest was slow to develop. Research on early REITs indicated that they performed in a manner similar to small cap stocks, not real estate. This implied that pension funds could not rely on a low or negative correlation with equities to reduce overall portfolio risk. More recent studies challenged this conclusion, maintaining that modern REITs had a higher level of real estate "effect" and could help to improve portfolio risk-adjusted returns, although not to the extent possible through private real estate investment.⁴

of floating debt in the capital structure; management compensation; and the alignment of management's interest with shareholders.

Recent Market Performance: 1996 turned out to be a good year for REITs with the average share price increasing 22.5 points, driving average total returns to over 35 percent. Office REITs produced the best investment performance, followed by industrial, hotel, apartments, and retail (*Exhibit 6*).

A large factor driving REIT investment performance was an increase in the price/FFO ratios, peaking in late 1996. Multiples declined after the first of the year and, as of June 30, 1997, averaged 12.4X 1997 FFO. The average dividend yield was 6.5 percent with an average total return of 15.7 percent over the prior 12 months. The average premium to NAV was 20.5 percent (*Exhibit 7*).

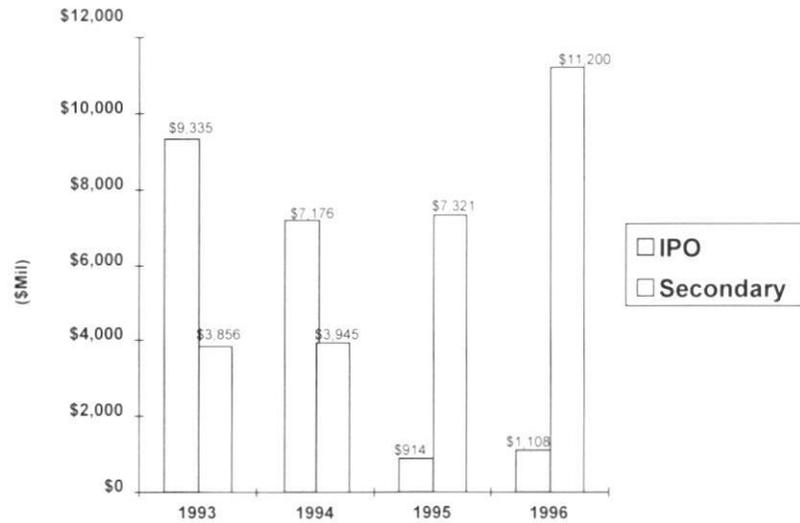
As indicated in *Exhibit 7*, office REITs traded at a premium of 26.0 percent over NAV in mid 1997, second only to industrial REITs (33.9 percent). The office price-to-earnings multiple of 13.3X was the highest in the industry. Office REITs also traded at a 7.3 percent premium to other equity

As a result of these studies, as well as continued growth in the REIT market, pension investment in securitized real estate went from virtually nothing in 1989 to approximately 25 percent of their portfolios in 1996 (*Exhibit 8*). A recent survey of pension investors indicated that they invest in REITs primarily through separate accounts and mutual funds. As with the broader REIT market, residential and retail are the major property types, followed by office, industrial, and hotels (*Exhibit 9*). Other characteristics of the pension securitized real estate portfolio are—debt ratio: 33.9 percent; dividend yield: 6.4 percent; P/E ratio: 14.2X; and portfolio turnover: 39.0 percent.⁵

Enterprise value: As a tax-avoidance vehicle, REITs should be expected to trade on the yield of underlying real estate assets, less a liquidity discount. Today, however, many successful REITs sell for more than their underlying real estate values, reflecting a premium for the "enterprise value" inherent in a "going concern."⁶ Such a premium reflects the market's belief in management's ability to grow future FFO through market and asset selection, development, refinancing, or restructuring investments (*Exhibit 10*).

Exhibit 4

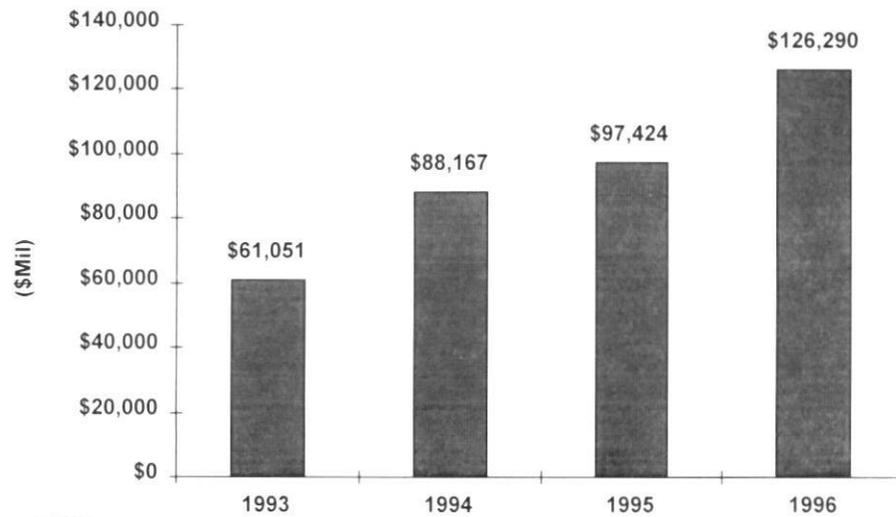
IPO & SECONDARY EQUITY OFFERINGS



Source: NAREIT

Exhibit 5

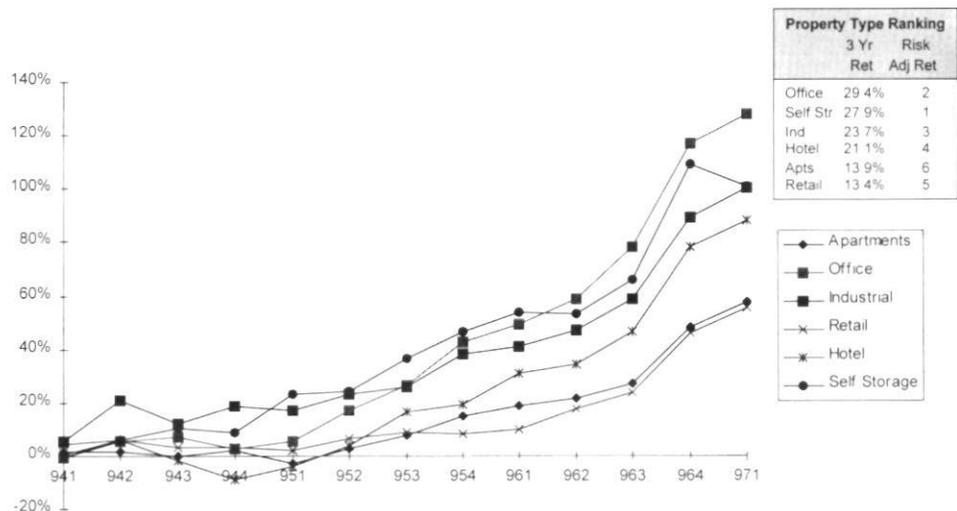
REIT TOTAL MARKET CAP



Source: NAREIT. Annual amounts as of 12/31.

Exhibit 6

REIT RETURNS BY PROPERTY TYPE



Note: Risk Adjusted Return ranking calculated using Sharpe ratio methodology.

Sources: NAREIT, Wall Street Journal. Analysis: The McMahan Group

Problem Areas: Despite the success of many REITs, the industry faced some formidable problems in mid-1997. The combination of analyst and shareholder pressure on short-term FFO growth and the high payout of annual cash flow forced most REITs to return to the capital markets frequently. With highly competitive property markets, the lack of attractive investment opportunities was leading some REITs into marginal investments, both in terms of physical quality and economic return. Many so-called "independent directors" were, in fact, very close to management and it was not always clear how good the vaunted REIT governance policies really were. Finally, many REIT boards and management lacked the vision and courage necessary to reposition their firms for future growth and profitability.

THE BOOM IN OFFICE MARKETS

The office sector had been devastated by the real estate depression of 1987-1994 and as a result, was one of the last areas to experience economic recovery. By early 1997, however, America's office building expansion was in high gear, driven by strong growth in office jobs and the lack of new construction over the prior 10 years. In July 1997, office construction was running at a rate of 23 million square feet annually, vs. 50 million square feet of annual absorption.⁷ Reflecting the strong nature of office demand, almost three-fourths of new construction involved build-to-suit facilities where a tenant was already in place.

This surging demand for office space helped to drive down vacancy rates for both downtown and suburban markets. As of March 31, 1997, downtown vacancy rates stood at 13.2 percent, down from 17.6 percent at the end of 1992; and suburban rates were 10.6 percent, down from 19.4 percent in 1992.⁸ With less space on the market, effective rental rates were steadily increasing—up 4.9 percent in 1995 and 6.8 percent in 1996.⁹

The nature of office space demand was also changing. As business firms downsized and outsourced their operations, office demand began shifting from larger companies to smaller companies, many of which worked for the larger companies. This trend has been accelerated by the application of new technologies which allowed many employees to operate from venues other than the traditional office (e.g. home, hotel, airplane, etc.). Many firms also have experimented with a variety of new ways to organize the work effort including open space design, "hoteling," and the widely reported "virtual"

office format. In all cases, the emphasis is on providing the firm with flexibility in dealing with its office requirements.

These shifts in demand have made many older office buildings functionally obsolete. They may be designed for the large company "footprint" where columns and other obstacles make it difficult to reformat space for smaller tenants. More commonly, many older buildings are not designed to adapt to the requirements of modern technology and retrofitting is expensive, if not impossible. Finally, the building may not be functionally obsolete, but it is an area where people do not wish to work.

The combination of these and other factors has contributed to suburban locations becoming more attractive to many office users. The suburbs offer lower land costs, facilitating new design and construction and are located where most people live. In many cities, (e.g. Dallas, Denver, San Diego, Tampa, etc.) suburban rents exceed downtown locations.¹⁰

OFFICE REITs SHARE IN THE BOOM

Consistent with their position in the real estate cycle, office REITs did not really get going until mid-1996. In the succeeding 12 months, six office REITs went public and a large number were poised in the pipeline, including Equity Office Properties Trust, a multi-billion national office REIT which went public shortly thereafter. The total equity raised by these REITs was \$2.2 billion. As of June 27, 1997, the average price had increased 13.7 percent over the issuing price (*Exhibit 11*).

In terms of operations, these new office REITs had a relatively low debt ratio (27.1 percent), although floating debt was quite high (22.8 percent). FFO is expected to increase 11.3 percent over the next 12 months. FFO multiples, however, were expected to decline in 1998 along with lower expectations for the market overall (*Exhibit 12*).

Interestingly, office REITs own only six percent of institutional grade office square footage in major metropolitan areas.¹¹ Many observers expect this relatively low penetration to lead to a large amount of consolidation activity as managers attempt to add economic scale to their operations through the acquisition of private market portfolios and companies. The improvement in office property values also makes it more attractive to sell companies than it did a few years ago.

The trend to larger economic units is consistent with and reinforcing of the need of office tenants for

Exhibit 7

REIT PERFORMANCE BY PROPERTY TYPE
30-JUN-97

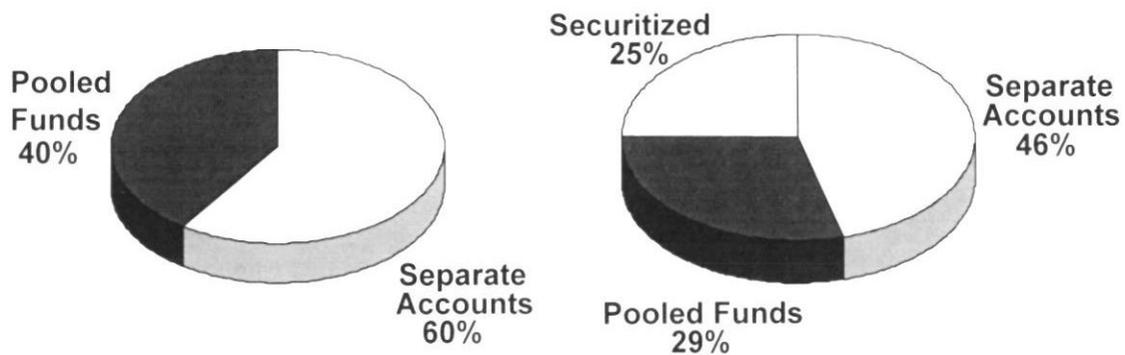
	Apartments	Regional Malls	Office	Industrial	Shopping Centers	Hotels	Totals/Average**
Equity Market Cap*	\$20,493.3	\$15,807.1	\$12,324.4	\$9,590.9	\$9,409.0	\$7,793.9	\$75,418.6
Dividend Yield	6.8%	6.7%	5.5%	5.8%	7.5%	6.8%	6.5%
Multiple	11.9	13.1	13.3	12.9	11.6	10.9	12.4
Premium to NAV	15.5%	16.2%	26.0%	33.9%	17.1%	21.2%	20.5%
12-Month Total Return	15.7%	14.0%	15.9%	18.0%	13.6%	19.0%	15.7%

* Billions ** Weighted by equity market capitalization

Source: Realty Stock Review; June 30, 1997

Exhibit 8

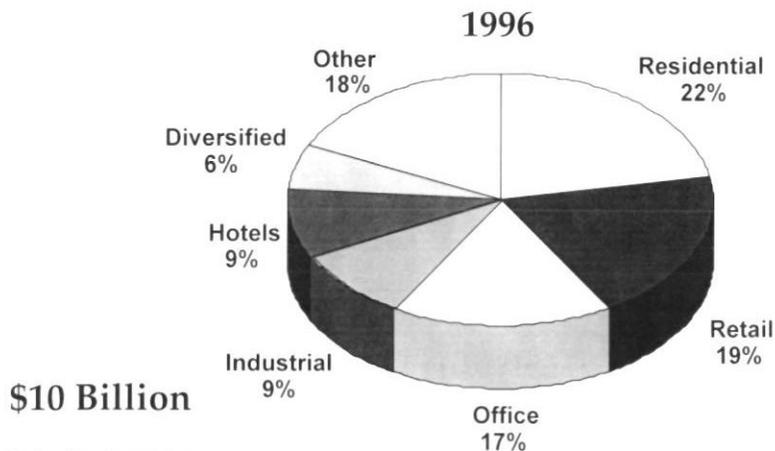
PENSION INVESTMENT IN EQUITY REAL ESTATE



Source: AEW

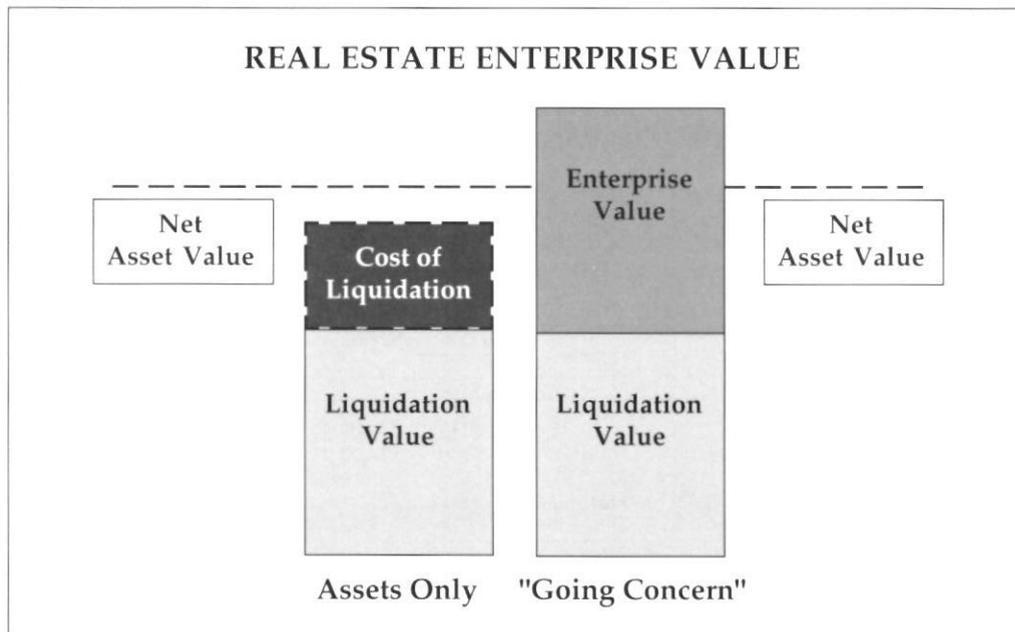
Exhibit 9

PENSION INVESTMENT BY PROPERTY TYPE



Sources: Data - Evaluation Associates
Analysis: The McMahan Group

Exhibit 10



more flexible operating environments and a greater menu of services as a result of downsizing. Many observers believe that ownership and rental of office space will provide a platform to market a wide variety of services to building tenants. Larger companies, the reasoning goes, will have the resources to launch and maintain such platforms and benefit from a broader array of income opportunities.

THE REIT ROLL-UP PHENOMENON

The exceptional market performance of REITs and the continuing strong IPO market has led many investment advisors and other private market managers to propose programs to "roll-up" their clients' assets into new REITs. To some extent, this is a response to client pressure to create new approaches to real estate investing. As of June 1997, as many as 18 roll-ups were under consideration, although one proposal had been withdrawn as a result of investor pressure (*Exhibit 13*).

The term "roll-up" was coined in the early 1990s to describe the process by which general partners of syndicated real estate limited partnerships forced limited partners to convert their partnership interests to stock ownership, often at a steep discount. Noting that the current REIT roll-ups were usually at a premium and that investors had a lot more influence over the roll-up process, many sponsors prefer to term them "consolidations" or "restructurings."

Sponsors believe that the new entities formed by the roll-up process will be attractive to investors for

several reasons. Most institutional real estate holdings reflect higher quality properties than those traditionally held by REITs. The size of the portfolios are often larger than most REITs, in some cases among the largest of their property type. This larger economic scale helps to lower the cost of capital and spread the cost of corporate infrastructure over a larger base, leading to higher investment returns. Some advisors also believe that these they can bring a better quality of management

than the public market has experienced to date.

Critics argue that larger economic scale can also create problems as the pressure to acquire large numbers of assets makes it more difficult to develop a "growth story" and have a significant impact on earnings. Furthermore, not everyone agrees that advisors are better managers of assets, as demonstrated by their disastrous performance in the 1980s. There is also concern that managing a public company is "different" and requires special skills most advisors have not utilized in the past. This becomes particularly important if the roll-up process awards a "value premium" to a management team before it has proven itself in the public marketplace.

THE WESTERN ROLL-UP PROPOSAL

In order to retain their clients, preserve Western as a viable firm, and monetize the value of their personal equity positions in the firm, Jim and Serge decided in early 1997 to explore the possibility of a roll-up of their clients' assets into a new public entity. They consulted several investment bankers experienced in REIT public offerings and began to develop a plan which was distributed to clients for comments in early July.

The new entity would be organized as a private REIT, which would continue to acquire and develop properties and go public in six to 12 months when it reached approximately \$1 billion in assets. If the REIT did not go public within one year, investors could force a registration through a two-thirds affirmative vote. The new REIT would be

Exhibit 11

RECENT OFFICE REIT IPO'S

Ticker	Company	Market*	IPO Date	Capital Raised**	IPO Price	Price 6/27/97	Percentage Change
ARI	Arden Realty Corporation	CA	10/4/96	\$377	\$20.00	\$26.00	30.0%
PP	Prentiss Properties	TX/WI/CA/GA	10/18/96	323	20.00	25.00	25.0%
KRC	Kilroy Realty Corporation	CA/WA/AZ	1/29/97	331	23.00	25.50	10.9%
CPP	Cornerstone Properties, Inc.	NY/WA/MA/IL	4/15/97	225	14.00	15.00	7.1%
GL	Great Lakes REIT, Inc.	IL/WI/MI	5/7/97	88	15.50	16.00	3.2%
BXP	Boston Properties	MA/DC/CA	6/18/97	903	25.00	26.88	7.5%
Totals/Averages***				\$2,247	\$21.67	\$24.64	13.7%

In Registration

Equity Office Properties Trust	\$345	\$20.00
SL Green Realty	\$186	\$20.00

*States in order of number of properties; ** Millions; *** Weighted by capital raised

Sources: Montgomery Securities; The McMahan Group

Exhibit 12

OFFICE REIT OPERATING DATA

Ticker	Company	Debt/ Mkt. Cap.	Floating Debt	EBITDA/ Interest	FFO/Share		FFO Multiple	
					1997	1998	1997	1998
ARI	Arden Realty Corporation	23.0%	100.0%	5.3%	\$2.16	\$2.39	12.0	10.9
PP	Prentiss Properties	25.0%	3.0%	5.7%	\$2.25	\$2.45	11.1	10.2
KRC	Kilroy Realty Corporation	18.0%	13.0%	4.2%	\$1.97	\$2.26	12.9	11.3
CPP	Cornerstone Properties, Inc.	32.0%	4.0%	2.7%	\$1.26	\$1.37	11.9	10.9
GL	Great Lakes REIT, Inc.	4.0%	0.0%	N/A	\$1.49	\$1.69	10.7	9.5
BXP	Boston Properties	34.0%	8.0%	N/A	\$1.95	N/A	13.8	N/A
Average*		27.1%	22.8%	4.6%	\$1.94	\$2.16	12.7	10.7

* Weighted by capital raised.

Sources: Montgomery Securities; The McMahan Group

internally managed, including a new property management group which would be integrated into the overall operation.

In capitalizing the new entity, Western's pension clients would contribute the \$725 million in assets currently managed by Western. Western would contribute its management fees (e.g. acquisition; development; asset management; property management, and disposition). Jim and his team would execute three, three-year employment contracts filling similar roles as they had in the advisory firm. Both clients and Western would receive common shares with equal voting rights.

The new REIT would be valued at \$750 million, reflecting a value to the management company of approximately \$25 million. Both the property values and the value of Western would be confirmed

though independent appraisal. When the REIT went public, a fairness opinion would be obtained from the investment banking firm leading the underwriting. Total costs of the public issue were estimated to be approximately \$6 million, most of which ultimately would be paid by Western's clients.

The Western portfolio was largely unleveraged. While operating as a private REIT, however, up to 30 percent of the portfolio's value could be borrowed in order to provide funds to acquire and develop sufficient assets to reach the \$1 billion IPO threshold. At this point, a five million share IPO would raise an additional \$100 million to be utilized for new acquisitions and development projects. The pension investors would agree not to sell their shares for one year after the IPO (termed a "lock-out"). Management shares could not be sold for three years.

The new REIT would have a seven-person board: Jim, Serge, Bill, and four independent directors. Western clients could participate in the selection of independent directors, if they chose to do so.

A REIT subsidiary would be formed to own and manage assets which clients did not want to place in the new REIT or properties that Western did not choose to include. Up to 15 percent of Western's portfolio could be owned in the subsidiary, which would also have the right to add private market assets from shareholders in the REIT as well as manage assets for new clients who preferred to own assets directly.

In terms of pricing, most of the investment bankers felt that Western would command a multiple of 12 percent -13 percent since it was active in the suburban office markets in the Western U.S. where growth prospects continued to be very favorable. The offering would also be attractive since Western had quality assets and strong institutional backing. The management team was also seasoned having worked together for many years. Their development capabilities would also be attractive to investors in light of the dearth of new office construction.

Jim believed that the roll-up would be a "win-win" situation for Western's clients. The greater liquidity ultimately created by the daily pricing of a public market would provide greater control over investment programs. The stock value would be "accretive" to investors allowing them to essentially arbitrage the public and private markets and participate in the "enterprise value" of the new firm. Management's interests would be better aligned with investors with a large portion of personal compensation materializing only if investors made money. Finally, the public market process would establish higher levels of scrutiny, disclosure, and governance to help protect the plan sponsor's fiduciary interests.

CONVERSATION WITH TOM RAZIER

Cami had begun her client follow-up calls with some of Western's older, smaller clients who were generally pleased with the firm's performance and with whom they had long-standing relationships. Generally, all of these calls had gone well. She had put off talking with BURP and other large clients until she had a better understanding from the earlier calls as to the questions she might receive and the nature of possible client resistance.

Despite these precautions, she was not prepared for Tom's reaction.

He first reminded Cami that the reason BURP was in real estate was to reduce total portfolio risk by investing in an asset class that had low or negative correlation with its stock portfolio. Tom had seen research indicating that REITs had a high positive correlation to stocks and that he could expect little, if any, reduction in portfolio risk from adding REITs.

He also did not like the idea of the private REIT as an interim step. If he were to give up control over his portfolio, he wanted the right to sell his shares if he did not like the way things progressed. As presently contemplated, the private REIT would be largely illiquid and, when coupled with the one-year lock-out, he and other investors would not be able to trade their shares for at least 18 to 24 months. Even then, the size of their holdings would make it difficult to trade large blocks of stock.

Tom contrasted the illiquidity of the roll-up process with the private market where, as a result of intense demand for office properties and little new production, BURP's assets currently could be sold at relatively high prices. He did not know how long this market frenzy would continue and felt that perhaps the clients would be better served if Western began culling portfolios to capture appreciated values and enhance investor returns.

He also was concerned with the REIT subsidiary that Western was proposing to use to continue managing private assets. Although Tom realized that this proposal was to some degree a means of giving investors more choices, he was concerned with the potential conflict of interest between public and private investors and the way the arrangement might be viewed by security analysts and non-pension investors. "Isn't one of the attractions of REITs, their ability to reduce conflicts by better aligning management and investor interests?," asked Tom.

The valuation of Western also bothered him. He felt that \$25 million was too much for a company whose only assets were management contracts, the vast majority of which were cancelable on 30 days notice. As he put it, if he were going to trade hard assets (real estate) for "elevator assets" (people), he would at least expect to receive shares with some form of preferential interest. Besides, if he wanted to convert his interest to REIT shares, he could trade his assets for the shares of a seasoned REIT, well-regarded in the public marketplace. He had been approached by several existing office REITs and believed that a workable asset trade could be

arranged. Cami mentioned that such an approach would not provide the IPO "pop" in value inherent in the roll-up.

Tom countered that he was somewhat dubious about the true value of the IPO "pop" to the investors. He felt that much of the anticipated increase in value came from leveraging the portfolio and that the increased risk from leveraging had not been adequately considered by Western in its proposed plan. When asked by Cami if a lower level of portfolio leverage would ease his concerns, Tom did not think it would make much difference.

Finally, Tom was upset with the relatively short amount of time that he and his Board had been given to make a decision. BURP had been systematically considering its strategy for securitized real estate for some time, and the Western roll-up put them under pressure to make a decision much faster than they desired. Tom felt that they needed more time to analyze their overall portfolio strategy and suggested to Cami that the decision on participating in the roll-up be extended until after the first of the year. He also stated that he felt Western should pay for the major portion of the \$6 million in underwriting costs.

Cami finally gathered up her courage, and asked Tom if, despite his concerns he would vote for the roll-up. Tom said that if the proposal was the same as the package he received, he would vote "no" and, if asked, would encourage other investors to do the same. He did say, however, that he would consider a revised proposal which addressed his concerns.

In a state of shock, Cami thanked Tom for being candid and said she would get back to him in the next few days.

THE MANAGEMENT MEETING

Before Cami had a chance to catch her breath, Jim interrupted the management meeting to ask what had happened in her phone conversation with BURP. As Cami related her conversation, an enveloping cloud of gloom settled over the meeting. When she finished, the mood of the meeting changed abruptly to heated debate as the whole concept of the roll-up was back on the table and latent wounds reopened.

One group of managers led by Jim, wanted to proceed with the roll-up as it had been proposed. Western had generally good relations with its clients and, with the exception of BURP, all contacted

so far had indicated support. Western's investment banker believed that a successful public issue could be completed once Western had \$1 billion of assets in its portfolio.

Jim also expressed concern that Western's assets were "in play" and, if they did not proceed with the roll-up, many of the assets would be picked off by office REITs or other advisors undertaking roll-up programs. Jim was particularly concerned with the ability of REITs to trade assets for common shares or for Operating Partner (OP) units which could later be converted to REIT shares. Cami was aware of at least four of Western's clients that had been contacted by REIT representatives since news of their roll-up had leaked to the investment community.

In addition, Jim was concerned with the fall-off in private market commitments from pension investors. Western had been in many fewer RFP situations in the last 12 months and the \$110 in uninvested commitments may be all of the new funds they might receive if they did not take a dramatic step such as the roll-up program.

A second group of managers wanted to modify the roll-up proposal to make it more attractive to BURP. They argued that, since BURP was their largest client (\$135 million), its rejection of the roll-up most likely would be viewed as a negative by other investors and perhaps by Wall Street. This group wanted to drop the private REIT interim step and move immediately to a public issue to take advantage of the currently strong IPO market. "Who knows what the market will be like in six to 12 months," one of them argued. Several members of this group also were willing to modify management shares to make them subordinate to their clients' position, and extend management contracts and "lockout" provisions from three to five years.

The final and most vocal group wanted to drop the roll-up idea altogether and continue as a private market investment advisor. They believed that the "move" to securitization by pension investors was a more of a temporary "lurch" that would go away with any major drop in the stock market. They were also concerned that their personal compensation would be tied to stock options which could be worthless in the event of such a market downturn. In terms of operation, they also did not believe that property management should be internalized or that a REIT was a good vehicle for development activities.

Potential IPOs Involving Advisory Firms and/or Their Assets				
Sponsoring Firm	Potential REIT size	Property Type	Current Structure	Status
AMB Institutional Realty Advisors, Inc.	\$2.5 B	Industrial with some retail	Commingled funds; sep accts; private REIT	Studying roll-up as one of several options to present to clients. If approved, AMB would launch an IPO of \$200-\$300M as early as 4Q '97.
Cabot Partners	\$1 B	Industrial; R&D office	Primarily sep accts; 1 commingled fund	Expects to present plan for preliminary first step by June. Pending investor approval, Cabot would proceed with portfolio valuation this summer.
Heitman Capital Management Corporation	\$1.6 B (3 REITs)	Industrial; office	18 commingled funds; co-invested w/ sep accts	Withdrew proposal on May 15. Intends to go forward according to original business plan of each fund.
Koll/Bren Realty Advisors	\$1.1 B	Industrial; office	4 opportunistic funds; sep accts	In early June, tabled its plan to consolidate industrial and office properties. Intends to pursue original business plans.
MIG Realty Advisors	\$1.5 B	Multifamily	Sep accts; 2 priv trusts; priv REIT	Proposing to consolidate into a private REIT this summer that could go public as early as 4Q '97. Investors approved first stage: property appraisals.
The Retail Property Trust (RPT)	\$5 B	Retail	Private REIT advised by The O'Conner Group	RPT, Richard E. Jacobs Group, Inc., and New England Development may merge. Pending investor approval, the firm could file a REIT IPO by 4Q '97.
W.P. Carey & Co., Inc.	\$800 M (9 REITs)	Triple net lease; R&D office	9 investment partnerships	Hired third parties to evaluate exit strategies for the partnerships.
Zell/Merrill Lynch Real Estate Opportunity Funds	\$2.1 B	Office	Comm funds; private REITs	Filed an initial public offering with the SEC in May.

Sources: *Institutional Real Estate Securities*, June 1997

After two hours, Jim abruptly announced that they were not getting anywhere and that they all should go home and "cool off." The management meeting was rescheduled for 10:30 a.m. the next morning and asked each of the managers to prepare a memo recommending a course of action for Western with full supporting arguments.

As she left the meeting, Cami wondered what she would recommend and how it would be received by Tom and their other clients. She knew it would be another long night.

AUTHOR'S COMMENTS

This case is based on a series of roll-up proposals that have been offered investors over the last year. As such, it is a microcosm of many of the problems and issues confronting the various players in institutional real estate today. The pressure for "action" inherent in the roll-up situation creates a crucible in which assets, careers, and fortunes may be made or lost in a relatively short period of time.

Investment Advisor's Perspective

By most measures, Western would be considered

a successful advisory firm. The founders have created a strong management team which has generally delivered good performance to its clients.

The firm specializes in a product type, however, which was severely overbuilt in the 1980s and became subject to the greatest amount of investor scorn in the early 1990s. By 1997, however, this was rapidly changing, largely as a result of improving markets and the success of several office and industrial REITs.

On a longer term basis, the office sector is also facing major long-term problems in terms of functional obsolescence and changing customer needs. Neither Western nor its clients appear to be facing these issues and possible implications that more new capital may be required in the future to mitigate problems and possibly replace buildings.

Western also has been lucky. They did not enter the office market until late in the cycle so they did not have the property wipe-outs experienced by older firms. Because of the personal backgrounds of

the founders, Western also focused on suburban office investment rather than CBD office, where market recovery has been much slower and spot-tier. The firm operated in the Western United States which, when the real estate recovery gained steam, experienced a fabulous real estate boom, largely as a result of broader economic forces such as technology leadership and proximity to the then-booming Asian market.

As of the time of the case (mid-1997), Western's portfolio is in pretty good shape with broad regional diversification, relatively new buildings, and reasonably good lease tenures. The development capability allows them to access product in tight markets and better fulfill their tenants' growth requirements. They also have a diversified mix of clients with the largest client representing 19 percent of their portfolio.

Their fee structure appears to be competitive and sufficient to produce profitable levels of activity, given a sufficiently large asset base. Currently, the biggest operating question appears to be where new investment capital will come from in light of the reduced RFP calendar and the reluctance of many plan sponsors to add new managers.

Jim and Serge appear to have assembled a pretty good team, with broad management ownership of the firm and a good mix of skills. You also have the sense that the members of management seemed to work well together, at least until the roll-up was considered.

Plan Sponsor's Perspective

BURP is a large public pension plan and Western's largest client. There is little indication that Tom Razier is unhappy with Western's performance to date or that they plan to dump the firm in the near future as they consolidate managers.

What appears to be happening is that the roll-up proposal has caught Tom by surprise and forced him to react to securitization quicker than he had planned. His comments to Cami would also indicate that the industry has caught wind of the proposed transaction and that he is being contacted by advisors, REITs, and other real estate investment firms.

Regardless of the surprise element, the issues Tom raises are very legitimate and representative of the questions other plan sponsors are raising in this type of situation.

Western clearly has opened a Pandora's Box by announcing the roll-up and must now move quickly to prevent the loss of assets to competitors and perhaps the destruction of the organization they have all worked so hard to assemble.

REITs are not a good portfolio diversifier: Here Tom is simply out-of-date with the facts. Most new research indicates that REITs have a high real estate "effect" and, while not as good a diversifier as direct investment, are still better than straight securities. Cami has an education problem here.

Private REIT: A very valid concern. What if they went ahead with the private REIT and the IPO market fell apart? . . . Tom would be stuck without the flexibility to sell his separate account assets directly; a situation he presently enjoys. One could argue, if he wants securitized assets, why not sell his direct portfolio and invest the proceeds in a diversified portfolio of REITs? . . . The problem with this approach is that he misses the IPO "pop."

Lock-Out: Also a legitimate concern, which further reduces liquidity.

Management of Private Assets: This is potentially a high-conflict situation. Western appears to want it all ways and seems to be diffusing rather than focusing their activities, one of the major attractions of an operating company approach. They need to commit one way or the other.

Company Valuation: While the valuation may sound high to Tom, the numbers indicate that, at a 12.5 FFO multiple, Western's value is about 8X 1998 EBITDA, not too out of line with what Western could probably get if they sold the firm to a third party. Western's cash flow actually drops as a result of the transaction (\$3.1 million to \$2.6 million) and their IPO pop is a little over \$3 million. Considering they are tying their future to a public vehicle, the value seems reasonable.

The valuation is, of course, sensitive to changes in the public company multiple. At a 13.0X FFO multiple, the EBITDA multiple increases to 9.5X; at 12.0 it drops to 8.8X.

Assets for Shares: Tom makes a good point that Western does not have public market experience

and maybe BURP would be better-off trading assets for shares in an existing REIT with a seasoned public management team. Although much is discussed about this alternative, it is often a difficult transaction to execute, particularly under the tight time deadlines of a roll-up proposal. Also, Tom would not have the advantage of the IPO pop. Tom's argument that the pop comes largely from leveraging may be true, but it is still money in the bank and probably not too out of line with the leveraging risks.

There is, however, the post IPO stock trading level to consider. If an office REIT's multiples drop below 11.0X FFO, there is no enterprise premium.

Liquidity: Tom is also right on the liquidity issue. With only a few exceptions, REITs do not have extensive breadth or depth of public trading. This is compounded in the case of the proposed roll-up since only 10 percent of the proposed issue would be in "public" hands. The participants will have to wait for a much larger asset base before they will be able to trade any significant amounts of Western stock.

Alternative Courses of Action

Western is faced with at least three courses of action:

Proceed with the Roll-Up: An analysis of the proposed IPO indicates that it is a pretty reasonable offer, particularly when compared to some of the other office IPOs. At a 12.5 multiple, the enterprise premium is 13.9 percent, not too aggressive in today's market. The dividend yield of 6.5 percent is right in line with the market as is the 81.1 percent payout ratio. The 14.8 percent debt ratio is relatively conservative, by office REIT standards.

Tactically, Jim backs the original plan, even if it means proceeding without BURP's involvement. This strategy may work if BURP is the only holdout, but Western has six public plans and these people talk to each other. This is a high risk strategy, particularly since Tom Razier has raised some very good objections that could adversely affect the operation of the public company.

Jim is correct that timing is critical since Western's assets are truly "in play" and the future of the company is on the line. Any major time delays could be fatal. This is compounded by the recent fall-off in new capital raising in the private marketplace.

Cancel the Roll-Up and Continue as an Advisor:

This is perhaps an even riskier strategy in light of the rapid movement of the industry to securitization. If Western does not move to an operating company format, the firm not only will have a difficult time attracting new capital but also risks losing its existing assets through attrition to REITs and other advisors. This is compounded by the fact that the company's assets are already in play. To adopt this strategy, you would have really have to believe that securitization is merely a "lurch" on the road to prosperity and happiness.

Revise the Proposal: There is considerable merit in the notion that the roll-up is a joint effort with their pension investors and that legitimate concerns should be heard and revisions considered. The most obvious example is the continuation of private market activity which is not in the interests of either Western or the public company investors. Extension of the term of the management contracts also shows good faith and is a small concession for Western to make.

The concept of Western taking a subordinated ownership interest, while technically possible, seems to defeat the goal of achieving a congruence of interests between investors and managers.

The use of the private REIT, however, is a very difficult issue to resolve. The concept of the two-step process is to give Western an opportunity to "bulk up" to the \$1 billion level that the underwriters believe is necessary for a successful IPO. Unfortunately, no one can predict how long the current IPO market will last and Western may lose whatever "window" exists and have to operate as a private REIT for some time. This would put the investors in a much less liquid position than they currently enjoy as separate account direct asset owners.

One alternative would be to convince the investment bankers to go out at a lower threshold level, say the \$835 level the firm will have at by the end of 1997. Another would be to sell more than 10 percent to the public, although this has dilution problems. Still another is to ask the participating plans for additional commitments of capital to accelerate the bulking up process. Unfortunately, this takes time and further complicates the process.

The use of the private REIT interim step is clearly one of the toughest questions for everyone, regardless of how it is handled.

As with most good cases, there is no single, preferred solution to Western's quandary. Western clearly has opened a Pandora's Box by announcing the roll-up and must now move quickly to prevent the loss of assets to competitors and perhaps the destruction of the organization they have all worked so hard to assemble.

Whatever the final decision, it must be reached rapidly, unequivocally, and be understood by all.^{REI}

NOTES

1. This case was prepared by John McMahan, Adjunct Professor at the Haas School of Business at the University of California, Berkeley, as the basis for class discussion and does not necessarily illustrate either effective or ineffective handling of a business situation. Copyright: 1997 by The McMahan Group. All rights reserved. Revised October 2, 1997.
2. Current legislation was being considered by Congress which would liberalize or eliminate this provision.
3. Montgomery Securities
4. As an example, see S. Michael Giliberto and Anne Mengden "REITs and Real Estate: Two Markets Reexamined," *Real Estate Research*, December 1995.
5. Evaluation Associates
6. In 1997, the premium ranged from 15% to 35% of the value of the underlying assets.
7. Grubb & Ellis
8. CB Commercial
9. Grubb & Ellis
10. *National Real Estate Index*
11. Montgomery Securities

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THE IMPACT OF THE TAXPAYER RELIEF ACT OF 1997 ON REAL ESTATE INVESTORS

by J. Russell Hardin & Jack R. Fay

More than 1,100 tax changes became law on August 5, 1997. Several of the provisions of the Taxpayer Relief Act of 1997 have implications for real estate investors.

INTRODUCTION

If real estate investors are to maximize after-tax profits and maintain appropriate levels of capital investment, they must have a working knowledge of the latest legislative changes enacted by the United States Congress that pertain to real estate. On August 5, 1997, President Clinton signed into law the Taxpayer Relief Act (TRA) of 1997. This sweeping piece of legislation contains over 800 amendments to the Internal Revenue Code and approximately 300 new tax provisions. In other words, more than 1,100 tax changes became law on August 5, 1997. Several of the provisions of the Taxpayer Relief Act of 1997 have implications for real estate investors.

The purpose of this article is to summarize the provisions of several of the important changes to the Internal Revenue Code that are now or will soon become the law, as they pertain to real estate investments. Real estate investors are urged to look closely at this new tax legislation to seek ways in which they can significantly diminish

their future income taxes. The following discussions focus on the major provisions of the new bill which, directly or indirectly, affect real estate investments. Some suggestions for tax planning are also included in the discussions. To determine the particular effect, if any, each of these provisions will have on a particular investment, each investor should consult with his/her CPA, tax attorney, or other tax professional.

CAPITAL GAINS

Needless to say, this issue is one of the most important items on investors' minds. Unfortunately, Congress chose to give us some new complicated rules even though they provide some definite tax reductions. Eight different capital gain tax rates have been created; previously we had only two rates. The revised tax rates and holding periods for long-term capital gains apply to tax years ending after May 6, 1997.

The new, lower long-term capital gains rates apply to individuals,

estates, and trusts. Small business owners (sole proprietorships, partners in partnerships, and shareholders in S corporations) who have capital gain transactions through sales of stocks and other capital assets will also be subject to the new lower rates on sales or exchanges occurring after May 6, 1997. Capital gains on sales or exchanges made before May 7, 1997 will be taxed at the old rates. Generally, the new maximum capital gains tax rate is 20 percent rather than the old 28 percent maximum rate. Investors in the 15 percent tax bracket will have a capital tax rate of only 10 percent rather than the old 15 percent rate. For transactions after December 31, 2000, the maximum rates will drop from 20 percent to 18 percent and 10 percent to 8 percent for assets which have been held for more than five years—assuming Congress does not change the law before then!

To complicate matters, there is a new holding period for long-term capital assets. Generally, long-term status will apply to sales and exchanges made after July 28, 1997. The special low rates of 18 percent and 8 percent will apply for assets held more than five years for sales and exchanges made after December 31, 2000. To determine the long-term versus short-term status, the taxpayer begins the holding period on the date after the day the property was acquired. The same date of each following month is the beginning of a new month no matter how many days in each month. The date of disposal of the asset is included as part of the holding period.

Tax Planning Tip: If the taxpayer sold or exchanged a capital asset before May 7, 1997, there is nothing that can be done for tax planning—the old rates and holding period apply. If the taxpayer sold or exchanged a capital asset between May 7, 1997 and July 28, 1997, nothing can be done for tax planning—the old holding period applies but the new lower rates apply. If the taxpayer sells or exchanges a capital asset between July 28, 1997 and December 31, 1997, the new lower rates may or may not apply. The older, higher long-term capital gain rates will take effect if the asset has not been held for more than 18 months; the newer, lower long-term capital gain rates will apply only if the asset has been held for more than 18 months.

A couple of related new provisions for real estate investors to consider are: 1) long-term capital gains from the sale or exchange of depreciable real property that would be treated as ordinary income if the property were depreciable business personal

Real estate investors are urged to look closely at this new tax legislation to seek ways in which they can significantly diminish their future income taxes.

The focus here is on the major provisions of the new bill which, directly or indirectly, affect real estate investments.

property (Sec. 1245 property) are taxed at a maximum rate of 25 percent, and the remaining long-term capital gains are taxed at a maximum rate of 20 percent; and 2) a pass-through entity, such as an S corporation or partnership, must make the determination of when a long-term capital gain is taken into account on its books—a gain taken into account by a pass-through entity before May 7, 1997, is not eligible for the new lower capital gains rate.

REAL ESTATE INVESTMENT TRUSTS

Several changes were made to the legislation regulating real estate investment trusts. The requirements for qualification as a real estate investment trust (REIT) and the taxation of a REIT were both modified by the TRA of '97. The REIT must still have a beneficial ownership of at least 100 persons and not be a personal holding company as defined in the Internal Revenue Code and Treasury Regulations. According to the old rules, a REIT that fails to ascertain the actual ownership of its outstanding shares or to maintain necessary records of ownership could be disqualified as a REIT. Under the rules of TRA of '97, however, the REIT is levied a penalty of \$25,000 rather than being disqualified.

Another significant change is that a REIT may render a *de minimis* amount of impermissible tenant services and still treat amounts received with respect to that property as rent. Impermissible tenant services include amounts received or accrued for services provided to the property's tenants by the REIT or amounts received or accrued for managing or operating the property. The amount of impermissible income that may be received without causing all amounts received to fail to qualify as rent is one percent. Only if impermissible amounts received exceed one percent of all amounts received with respect to the property will all amounts fail to qualify as rent.

The 30 percent gross income test for qualification as a REIT has been repealed. A REIT no longer has to

derive less than 30 percent of its gross income from the sale or disposition of 1). stock or securities held for less than one year; 2). real property held for less than four years; and 3). property in a prohibited transaction. The House of Representatives felt that the 75 percent asset test provided a sufficient safeguard to ensure that the REIT is a pass-through entity for real estate investors. The 75 percent test requires that at least 75 percent of the value of the total assets owned by the REIT be comprised of real estate assets, cash and cash items, and government securities, and that no more than 25 percent of the value of the total assets be comprised of securities of any other single issuer.

Tax Planning Tip: The effective date for the above changes is August 5, 1997. Regarding the \$25,000 penalty, if the REIT's failure to comply was due to reasonable cause and not willful neglect, no penalty will be imposed. With respect to *de minimis* services, if an independent contractor provides the impermissible services and the REIT derives no income from the independent contractor, then the REIT is treated as not providing services and has not generated any impermissible services income. The changes discussed here are but three of more than a dozen changes to the rules regulating REITs. Consult with your tax professional for further information.

ENVIRONMENTAL CLEANUP COSTS

Expenditures paid or incurred after August 5, 1997, for certain environmental cleanup costs are now currently deductible. If the election to expense is not made, the costs must be classified as capital costs; the expense election is available for expenditures up to December 31, 2000.

To be eligible for a current deduction, the expense must be 1). an expense that would otherwise be charged to a capital account; and 2). paid or incurred in relation to the abatement or control of qualified hazardous substances at a qualified contaminated site. The taxpayer must obtain a statement from the state's environmental agency verifying the qualification of the "hazardous substance" and "contaminated area."

This cleanup deduction applies to trade and business property, property held as stock in trade or inventory, and property held for the production of income. Any cost expensed is subject to recapture as ordinary income when the property that was contaminated is sold or disposed.

Tax Planning Tip: Whether the cleanup costs are required or made voluntarily, an investor would normally desire to currently expense the costs rather than capitalizing them. These tax deductions should be taken whenever such costs are cost effective (or are required), but the rules for qualified cleanup costs are very complex and will necessitate some serious study and record keeping.

HOME OFFICE DEDUCTION

The TRA of '97 relaxes the home office deduction for tax years beginning after December 31, 1998. Under the new rules, a taxpayer may meet the "principal place of business" rule if the home office is used to conduct administrative or management activities of the taxpayer's trade or business and there is no other fixed location where the taxpayer conducts substantial administrative or management activities of the trade or business. This change would permit certain taxpayers (such as salespersons) to obtain the home office deduction even though substantial non-administrative and non-managerial activities are conducted elsewhere (such as real estate showings).

Tax Planning Tip: The expanded definition of a principal place of business will enable many taxpayers to deduct the cost of traveling to and from their home office to other locations where they conduct business. Under the old law, these costs would have been non-deductible as commuting expenses. Caution: The home office deduction is still not available to employees unless it for the convenience of the employer. Also, the home office area must be used exclusively and on a regular basis as a place of business.

LESSEE CONSTRUCTION ALLOWANCES

TRA of '97 provides that a lessee of retail space that receives rent reductions or cash from the lessor does not have to include that amount in gross income if the expenditure by the lessee is for qualified construction or improvement to the retail space. In order to qualify for the exclusion, the lessee must have a short-term lease for the retail space and the improvement or construction must be on the qualified long-term real property that is used in the lessee's trade or business at the retail space. A short-term lease is defined as a lease with a term of 15 years or less. Qualified long-term property is non-residential real property that is part of the retail space that reverts to the lessor at the end of the lease term. Retail space is defined as real property that is leased to the lessee to be used for the sale of tangible personal property or services to the public.

Tax Planning Tip: The amount that may be excluded from income under this provision must not exceed the amount actually spent by the lessee for the construction or improvement. As is the case with most tax provisions, detailed records must be kept by the lessor and the lessee. The Internal Revenue Service (IRS) may call on both or either to provide details concerning the amount of improvements and construction and the amount of the rent reduction or cash received by the lessee.

AMT EXEMPTION FOR SMALL CORPORATIONS

A "small corporation" will no longer be subject to the alternative minimum tax (AMT) as long as it qualifies as a "small corporation." A qualifying corporation is one that had average gross receipts of \$5,000,000 or less for the three tax years that ended with its first tax year beginning after December 31, 1996 (in other words, a corporation could first become eligible in 1998.) Once a corporation is recognized as a small corporation, it will still be exempt from the AMT as long as its average gross receipts for the prior three-year period do not exceed \$7,500,000 (the first year that it became eligible as a small corporation is not taken into consideration for this purpose.)

If a corporation was not in existence for the entire three-year period, the \$5,000,000 test will be applied on the basis of the period in which the corporation was in existence. When a corporation loses its small corporation eligibility because its average gross receipts for the prior three tax years exceeds \$7,500,000, it then becomes subject to the AMT. This AMT liability, however, will only be based upon certain preferences and adjustments that relate to transactions and investments that transpired after the corporation lost its status as a small corporation. These modifications must be determined for transactions and investments that were created on or after the change date (defined as the first day of the first tax year for which the corporation ceased to be a small corporation).

Tax Planning Tip: If a corporation becomes an ineligible "small corporation" and is subject to the AMT, it is important to study carefully the complex rules on the new modifications for AMT determination in order to make certain that the proper amount of AMT has been calculated.

Another new rule is a change in the AMT credit. Generally, taxpayers may be eligible to claim a tax credit based upon their AMT liability for the prior

tax year. Starting in 1998, the computation of the allowable AMT credit is modified for a "small corporation." The new allowable credit will be limited to the amount by which the corporation's regular tax liability (reduced by other credits) exceeds 25 percent of the excess, if any, of the corporation's regular tax (reduced by other credits) over \$25,000.

AMT DEPRECIATION ADJUSTMENT

This new adjustment, which does not take effect until the beginning of 1999, will simplify one element of the AMT computation. The AMT adjustment for the Modified Accelerated Cost Recovery System (MACRS) depreciation allowance claimed on Section 1250 property (real property) and any other property depreciated under MACRS using the straight-line method will be eliminated. This provision will replace the existing rule, which requires an AMT adjustment for such property equal to the difference between the depreciation claimed for regular tax purposes and the depreciation that would have been claimed using the MACRS alternative depreciation system (ADS).

Also beginning in 1999, the MACRS recovery period that applies for regular tax purposes also applies for AMT purposes. This new provision will replace the requirement of the 150 percent declining balance method over the applicable ADS recovery period.

Tax Planning Tip: Taxpayers will no longer be required to compute a separate AMT adjustment for MACRS residential rental and non-residential real property or any other MACRS property depreciated using the straight-line or 150 percent declining balance method for regular tax purposes. An AMT depreciation adjustment will continue to be required for MACRS three-, five-, seven-, and 10-year property which is depreciated with the 200 percent declining balance method for regular tax purposes; but, the adjustment will be equal to the difference between the depreciation reported for regular tax purposes and the depreciation that would have been reported with the 150 percent declining balance method over the same recovery period.

SALE OF PRINCIPAL RESIDENCE

A major new tax law in the TRA of '97 concerns the exclusion of gain on the sale of a principal residence. For sales and exchanges of principal residences that occur after May 6, 1997, individuals may now exclude up to \$250,000 of gains realized if the ownership and use tests are met (the residence

used as a principal residence must have been owned and occupied by the taxpayer for a total of at least two of the five years before the sale or exchange). A married couple filing jointly may exclude up to \$500,000 if 1). either spouse meets the ownership test; 2). both spouses meet the use test; and 3). neither spouse is ineligible for the exclusion because of a sale or exchange of a residence within the last two years. If only one spouse meets the ownership and use tests, the couple will be eligible for a \$250,000 exclusion or a prorated exclusion. A prorated amount of the \$250,000 or \$500,000 exclusion may apply if a taxpayer (or married taxpayers) does not meet the ownership or use test when the sale or exchange is due to a change in place of employment, health, or unforeseen circumstances. The rules for the proration calculation are rather complex.

The exclusion applies to only one sale or exchange every two years, but, pre-May 7, 1997, sales are not considered for this time period. This new exclusion rule replaces the deferred Internal Revenue Code Section 1034 gain and the onetime \$125,000 exclusion for taxpayers age 55 or older. Taxpayers may elect to apply prior law to sales and exchanges made before August 5, 1997; or made after August 5, 1997 (pursuant to a binding contract in effect on August 5, 1997); or when the replacement residence was acquired on or before August 5, 1997, and the rollover or deferral rules would apply.

As further evidence that Congress is showing no signs of simplifying tax laws, the new provisions on the sale of a principal residence include special rules for 1). ownership and use of prior residences; 2). incapacitated taxpayers; 3). divorced or widowed taxpayers; 4). remainder interests; 5). expatriates; 6). involuntary conversions; and 7). co-ops. Also, the new law makes an exception to the real estate transaction reporting requirements in which it is no longer necessary to report the transaction to the Internal Revenue Service if a residence is sold for \$250,000 or less (\$500,000 or less if the seller is married) and the person or organization otherwise required to report the transaction receives written assurance on the following: 1). that the residence is the seller's principal residence; 2). that there is no federally subsidized mortgage on the residence; and 3). that the full amount of the gain on the sale or exchange is excludible from gross income.

Tax Planning Tip: Even though this is definitely a huge tax break for taxpayers who sell or exchange their personal residences and realize a gain, it will

Several changes were made to the legislation regulating real estate investment trusts. The requirements for qualification as a real estate investment trust (REIT) and the taxation of a REIT were both modified by the TRA of '97.

be very important for them (and their tax preparers) to study all of the ramifications of these new provisions.

MISCELLANEOUS ITEMS

Other new TRA of '97 provisions related to real estate include the following:

- 1). Qualified distributions from the Roth Individual Retirement Arrangement (established as a new type of IRA) are not included in the taxpayer's gross income and are not subject to the 10 percent early withdrawal penalty tax. In order to be a qualified distribution, the distribution must satisfy a five-year holding period and must meet one of four requirements. One of these four requirements is that the distribution is used to pay for "qualified first-time homebuyer expenses." This provision takes effect after December 31, 1997.
- 2). A business which rents tangible property to others can qualify as an enterprise zone business (and thus be eligible for various tax incentives) if at least 50 percent of the rental of such property is by residents of an empowerment zone or community or by an enterprise zone business. An enterprise zone business which leases commercial property to others is entitled to rely on the lessee's certification that the lessee is an enterprise zone. This new tax law relaxing the requirements for qualification as an enterprise zone business apply to tax years beginning on or after August 5, 1997.
- 3). Cash-method farmers may now use the installment method of accounting for the purpose of computing income from the disposition of farm property used in a trade or business of farming for the computation of the alternative minimum tax liability. This new provision is retroactive and applies to such farm property in tax years beginning after December 31, 1987.

CONCLUSION

This article has attempted to summarize some of the 1997 tax changes, many of which are unique to the real estate investment segment of our economy. TRA of '97 is a complicated piece of legislation that contains over 1,100 amendments

and new provisions. The proper application of many of these provisions can help real estate investors reduce their tax burdens, resulting in increased capital maintenance. A law as complicated as this commands a great deal of study by investors who desire to maximize returns, minimize the tax burden, and maintain appropriate capital structures. In addition, real estate investors should consult with appropriate tax professionals to assure proper application and maximum benefit from this new sweeping piece of legislation.^{REI}

NOTES

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REAL ESTATE CAPITAL FLOWS: THE MONEY TRAIL

by Kenneth P. Riggs, Jr., CRE, & Angela G. Thornton

The pulse is racing for real estate—especially as measured in the public markets. Investable real estate is profoundly being redefined, from both a source of capital and the type of property chosen.

One clear message resonates from the 1980s: real estate has to stay connected to the capital markets. The overbuilding of the 1980s sent the clear message that the capital markets (pricing of risk and the allocation of money) had become de-coupled from the spatial markets (fundamentals of supply and demand for space). For real estate to be classified as a mainstream investment in the aftermath of the deepest market corrections of the century, the asset class had to behave much more within the rules of other capital markets. However, it continues to struggle due to the lack of readily available information, as well as other arbitrage opportunities in the market, yet real estate will continue to access better information at a more rapid pace. Keep in mind however, that no investment market ever has perfect information. Developing a real estate strategy requires implementing investment models that are built on a mosaic of information regarding property types, market fundamentals, and capital flows. The purpose of this article is to provide an intellectual understanding of sizing

up capital flows and how following the money trail can improve the understanding of the past, present and future of the real estate market.

Real estate is here, there, and everywhere! Tell me there is not a problem with adding up the nation's sticks and bricks and applying a market value! Guess again. Even in today's information age, where companies know more about us than we know about ourselves—spending habits, car and phone usage, bank account balances, etc.—there is just too much real estate. Yet solid studies of the capital composition and size of the real estate market continue to be generated. These studies have dissected real estate into institutional and non-institutional, debt and equity, property type, and by type of investor. To satisfy the capital pie quest, the two perspectives have developed and focus on either: a). space and/or inventory, or on b). the source of investor capital.

For the most part, capital flow analyses have focused on the inventory side or space analyses instead of counting

up investors' equity and debt holdings of real estate. The market's ability to follow the money trail has only begun over the past decade and has had dramatic improvements; however, currently, no one can totally account for the ever-changing capital flows into the industry.

ESTIMATING THE SIZE OF THE U.S. REAL ESTATE MARKET PORTFOLIO

The first generation of real estate capital analyses dealt with the size of the investment real estate market, focusing on real estate type and location of investment grade real estate. Generally, the studies were not particularly concerned with the sources of capital by investor. Meg Parker Holden completed a synthesis of capital studies and provided further analysis of the real estate universe.¹ This 1993 article, entitled *The Nation's Portfolio of Institutional-Grade Real Estate*, attempted to determine the nation's investment universe for commercial real estate. This article appropriately points out that knowing the size of the real estate investment market provides one of the starting points in the process of portfolio decision-making. In order to make accurate judgments on what types of property and where to buy, one must know what is available and where. Knowing the 'size of the pie' also enables portfolio analysts to make more accurate comparisons and allows investors to adjust their portfolios to more accurately fit their investment desires. A more academic reason for determining the portfolio is that it allows testing of portfolio theories, such as modern portfolio theory and portfolio diversification, as they relate to real estate. As a backdrop in exploring the real estate universe, the following table (*Exhibit 1*), provides a summary of this study and others that have guided the industry insights into this world.

Since it is not feasible or practical, an all-inclusive survey of all U.S. real estate has never been completed. There have been, however, many methods used to attempt to estimate the 'size of the pie' for commercial real estate. Relevant and useful studies that have been undertaken to estimate the size of the U.S. real estate market portfolio. The values estimated by these surveys vary significantly. The variation stems from the parameters set forth during data collection: property categories used and basis of estimating the values in the surveys, such as a variance in the base year used. However, the key difference rests in value estimation applied against a subjective inventory. The authors fully recognize that there have been other rigorous analyses done by respected industry leaders and groups such as:

Exhibit 1

REAL ESTATE UNIVERSE ESTIMATES			
Study	Year of Estimates	Category of Real Estate	Estimated Value at Time of Study (\$ BILLIONS)
RREEF (Holden)	1990	Office	\$375.0
		Industrial	265.0
		Retail	<u>320.0</u>
		<i>Total Institutional-Grade Property</i>	960.0
Salomon Brothers ²	1988	Office	\$388.0
		Retail	231.0
		Warehouse	<u>142.0</u>
		<i>Total Business Real Estate</i>	\$761.0
Arthur Andersen/ IREM ³	1990	Office	\$1,009.0
		Retail	1,115.0
		Warehouse/ Distribution	223.0
		Manufacturing	<u>308.0</u>
		<i>Total Business Real Estate</i>	\$2,655.0
David J. Hartzell ⁴	1992	Retail	\$730.0
		Office	665.0
		Industrial	341.0
		Warehouse	143.2
		Manufacturing	<u>197.8</u>
<i>Total</i>	\$1,736.0		
ERE Yarmouth ⁵	1997	Non-Institutional	\$2,020.0
		Institutional	<u>1,450.0</u>
		<i>Total Flow of Funds</i>	\$3,470.0

M.E. Miles, Census of Government, Ibbotson, and Commerce Department/Federal Reserve. However, since this article's objective is not to estimate the nation's portfolio of real estate, the aforementioned analyses are not detailed for the reader.

Calculating the pie is particularly problematic once one separates the nation's real estate between institutional investment-grade properties and real estate that is not available for investment (for example, hospitals, small properties, universities, etc.). Additionally, the universe is rapidly changing its definition of what constitutes investment-grade properties. The old paradigm of a core investment portfolio consisting of primarily office and retail with some industrial and multi-family is obsolete. As will be presented later by analyzing Real Estate Investment Trust (REIT) data, the property universe is much broader in the types of properties

than we cared to believe in the 1980s. But, we must remember that our industry is the new kid on the block in terms of financial maturity, although real estate existed when the first human rolled a rock in front of a cave (CRE James Graaskamp's proclamation). Let us follow the studies that have guided the market's understanding of real estate capital flows.

The RREEF estimate done by Holden in her article describes a method that delivers information about the "size and composition of the real estate asset class." This approach was undertaken by RREEF and provides an estimate of square footage of industrial, office, and retail properties in the 100 largest MSAs in the United States. The Arthur Andersen study employed three different approaches in determining a dollar amount for the real estate universe. The first approach involved gathering and compiling data and previous research on all areas involving the real estate industry. The next approach relied on property tax records and was actually conducted by Hoyt Advisory Services. They were able to estimate a geographic dispersion of retail, office, and industrial property types. The third approach involved conducting a phone survey to gather assessment values. These values were then used to compute fair market values. Finally, the values obtained from the three approaches were reconciled. The Hartzell study used market values derived from tax data obtained from REDI data to derive an estimate. Information was obtained for 47 counties in 20 MSAs. A problem with all of the aforementioned studies is that they fail to include property types other than office, retail, and industrial. All of these studies estimate market value on an inventory assessment, but the authors believe concentrating on the flow of funds is a more practical methodology and relevant measure of the capital pie.

ERE Yarmouth (formerly Equitable Real Estate Investment Management, Inc.) is the only study listed in *Exhibit 1* that estimates capital sources from a flow of funds perspective. As their starting point, they use published estimates of the total investment in real estate capital. They identified Arthur Andersen's study as a benchmark, and then update the Andersen study to current values. The ERE Yarmouth total figure is then broken down into institutional and non-institutional pieces. Their primary focus is following the money trail of the sources of capital from debt and equity. The institutional piece combines the equity and debt pies. This serves only as a basis to foot the sources of capital; it provides the aggregate estimate. A

Figure 1

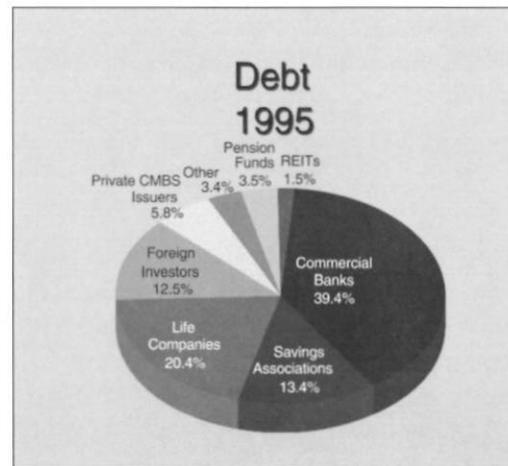
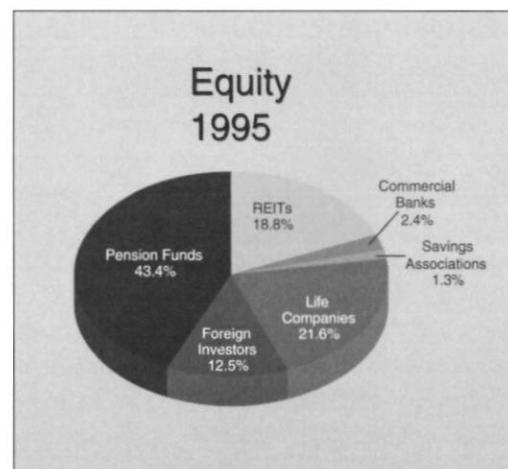


Figure 2



Source: ERE Yarmouth, as published in *Emerging Trends in Real Estate: 1996*

direct comparison of the equity and debt pieces is not appropriate. The properties included on each side of the balance sheet—debt and equity—are not necessarily equally represented. Most notable is the debt component for banks, estimated at \$400 billion, which may not have the full equity value reflected in the equity piece.

In the 1996 issue of *Emerging Trends*, the total U.S. Real Estate was estimated at \$3.08 trillion. The estimate rose to \$3.47 trillion in the 1998 issue. These figures include institutional and non-institutional properties. The total equity piece was estimated

Figure 3

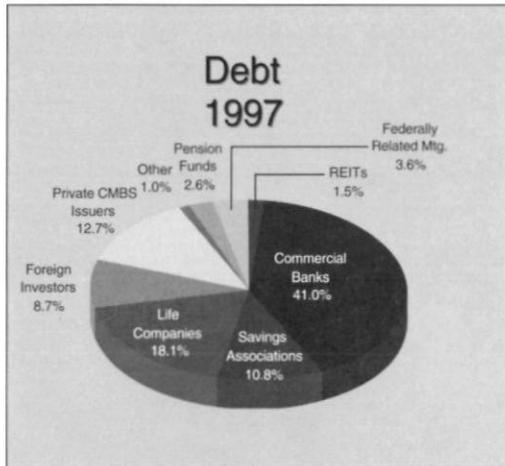
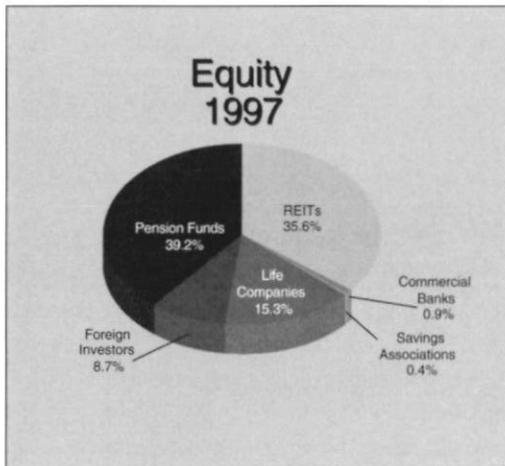


Figure 4



Source: ERE Yarmouth, as published in *Emerging Trends in Real Estate: 1998*

at \$231.55 billion in 1996 and \$320.6 billion in 1998. That is an increase of almost \$90 billion in two years. The more striking difference, though, lies in the distribution of types within the equity piece. All divisions of the equity piece lost shares of the pie except REITs. REITs gained 16.8 percent in two years jumping from \$43.48 billion in 1996 to \$144.3 billion in 1998. Pension funds still hold the largest share of the pie, 39.2 percent, but REITs are closing in quickly. Savings Associations and Commercial Banks both currently hold less than one percent each of the equity piece, and just two years ago they held 1.3 and 2.4 percent, respectively. Life Companies held more of the equity piece in 1996

than REITs, but they have slipped below REITs in the past two years (falling from \$49.88 billion in 1996 to \$49.1 billion in 1998); a 6.3 percent slip. The final equity type, Foreign Investors, has dropped almost four percent in the past two years, from 12.5 percent in 1996 to 8.7 percent in 1998. From this statistical picture it is obvious that REITs are growing at a tremendous rate and are quickly grabbing pieces of the equity pie.

This flow of funds analysis, strengthened by an estimate of the investment universe, is the most useful approach in today's market. This analysis captures the sources of money flowing into real estate that provides market players with an understanding of the current key investors. There are still shortcomings in the fact that operating company real estate holdings are not accounted for on the equity side and a direct comparison of the presented debt and equity is not appropriate. The more important consideration involving the ERE Yarmouth capital flow analysis is with regard to the changing role of investors in this real estate recovery. A decomposition of properties held by REITs is an important exercise in observing the types of investable real estate assets and size of the investment players.

COMPARISON OF REIT PROPERTY TYPES

Exhibit 2 compares the REIT property types by number of REITs and market capitalization from 1993 to 1996. The number of REITs did not change significantly in the three-year period. The striking difference is the change in market capitalization from 1993 to 1996. Some of the most significant increases were in office and hotel REITs, having changes of 2058.7 percent and 1410.0 percent respectively. Many of the other property types had percent changes that ranged from 90 percent to 520 percent. The market capitalization for all REIT companies was over \$100 billion in 1996, confirming the significant amount of capital that is flowing into REITs: there was almost \$80 billion more in REITs in 1996 than had been there just three years earlier. This tells us that REITs have arrived as a major main stream player in the real estate industry. It is also an indicator of how quickly the industry changes; real estate investors have to dump the stale 'buy-and-hold mentality' of the pre-1990s. The information is out there, and we need to constantly be ready to change if investment strategies and approaches to these profound capital flows shift.

Investors are more likely to consider non-traditional investments, and REITs are setting the stage

Exhibit 2

COMPARISON: REIT PROPERTY TYPES BY NUMBER OF REITS & MARKET CAPITALIZATION FROM 1993 TO 1996

Property Type	Number of REITs 1993	Number of REITs 1996 (BILLIONS)	Market Capitalization 1993 (BILLIONS)	Market Capitalization 1996 (BILLIONS)	Dollar Change 1993 to 1996	Percent Change 1993 to 1996
All Companies	175	174	\$38.8	\$118.5	\$79.70	205.3%
Diversified	26	19	\$2.4	\$4.9	\$2.46	102.2%
Health Care	7	7	\$3.1	\$5.6	\$2.45	78.1%
Self Storage	21	7	\$1.8	\$5.5	\$3.67	205.0%
Industrial/Office	25	36	\$5.9	\$36.7	\$30.77	520.9%
Industrial	11	11	\$1.6	\$6.9	\$5.30	332.1%
Office	11	20	\$1.1	\$23.7	\$22.58	2058.7%
Mixed	N/A	4	N/A	\$4.9	N/A	N/A
Residential	35	34	\$10.9	\$24.2	\$13.23	121.0%
Apartments	30	30	\$9.8	\$22.1	\$12.33	125.6%
Manufactured Homes	5	4	\$1.1	\$2.0	\$0.91	80.6%
Retail	43	47	\$13.6	\$27.2	\$13.53	99.2%
Strip Centers	26	28	\$7.7	\$14.7	\$6.96	90.1%
Regional Malls	11	12	\$4.7	\$10.0	\$5.22	110.1%
Outlet Centers	6	5	\$1.2	\$1.7	\$0.49	41.5%
Specialty	18	24	\$2.8	\$14.6	\$11.79	425.2%
Hotel	8	14	\$0.7	\$10.8	\$10.05	1410.0%
Triple Net Lease	7	8	\$1.6	\$2.9	\$1.35	84.7%

Source: NAREIT, as of 10/31/97

for this transformation. Just as the equity pie has shown us that non-traditional investments are becoming more significant, closer analysis of REITs by property type tells us that there is more to commercial real estate than just office, industrial, retail, and multi-family properties.

The composition of REITs by type has changed significantly for properties in the past few years. Office & Industrial showed the most significant changes from 1995 to 1997 in percentages of property types in REITs. Office & Industrial jumped from 9.2 percent of the REIT capitalization in 1995 to 25.9 percent in 1997. The Shopping Centers category fell almost 8 percent from 18.5 percent in 1995 to 10.7 percent in 1997. A new category also appeared in the 1997 chart of REIT capitalization, Mortgage Backed Securities, which hold a full five percent of the pie. The other property types remained steady with an average fluctuation of about 2.5 percent, with more moving down than up, to make room for office & industrial. These categories include: Regional Malls (-2.8 percent); Factory Outlets (-1.2 percent); Manufactured Homes (-0.5 percent); Apartments (-4.8 percent); Hotels (+2.2 percent); Diversified (-4.3 percent); Net Lease (-1.8 percent); Healthcare (-3.4 percent); and Self Storage

(+1.4 percent). With a 16.7 percent increase, the largest percentage of the REIT capitalization pie is now held by Office & Industrial, surpassing Apartments which were number one in 1995. Despite a decrease of 4.8 percent from 1995 to 1997, Apartments are still the second largest occupant of the pie at 17.8 percent. The third largest category is also one that had a significant decrease since 1995, Shopping Centers (10.7 percent in 1997). Since the recapitalization of the market in 1992—REITs bailing out capital starved private portfolios—core assets have moved into the public market.

PUBLICLY TRADED REITS BY PROPERTY TYPE

Despite the fact that office & industrial, retail, and multi-family now dominate REIT property types, there are still less traditional property types (as defined by old real estate investors) that have been excluded from the core portfolio in the past that are emerging as fairly significant players. *Exhibit 3* provides a listing of several REIT property types, the number of REITs in that category, the top two REITs in that category, and the market and implied market capitalization for each of the top two REITs.

Hotels hold a significant 7.5 percent of the 1997

Exhibit 3

**PUBLICLY TRADED REITS
BY PROPERTY TYPE**

Property Segment	Number	Top 2 REITs	Market Equity Capitalization (000s)	Implied Market Capitalization (000s)
Diversified	27	Cousins Properties Incorporated Colonial Properties Trust	\$836,093 \$624,991	\$836,093 \$881,693
Industrial/Office (DIVERSIFIED)	4	Spieker Properties, Inc. Duke Realty Investments, Inc.	\$1,616,243 \$1,406,890	\$1,884,477 \$1,557,087
Industrial	11	Security Capital Industrial Trust First Industrial Realty Trust, Inc.	\$2,205,658 \$932,336	\$2,322,856 \$1,054,827
Office	19	Equity Office Properties Trust Crescent Real Estate Equities, Inc.	\$4,398,287 \$3,041,865	\$4,398,287 \$3,456,461
Apartments	33	Equity Residential Properties Trust Security Capital Pacific Trust	\$3,113,879 \$1,815,716	\$4,083,099 \$1,815,716
Manufactured Homes	4	Chateau Communities, Inc. Manufactured Home Communities, Inc.	\$731,822 \$590,997	\$811,577 \$655,986
Outlet Centers	6	Chelsea GCA Realty, Inc. Horizon Group Inc.	\$601,584 \$317,409	\$737,067 \$376,574
Regional Malls	12	Simon DeBartolo Group, Inc. Westfield America, Inc.	\$3,022,484 \$1,242,056	\$4,974,792 \$1,242,056
Strip Centers	25	Vernado Realty Trust New Plan Realty Trust	\$1,780,735 \$1,348,124	\$1,971,231 \$1,348,124
Self Storage	7	Public Storage, Inc Storage USA, Inc.	\$3,055,851 \$1,125,016	\$3,055,851 \$1,225,816
Hotels	14	Starwood Lodging Trust Patriot American Hospitality, Inc.	\$2,119,592 \$1,611,438	\$2,706,359 \$1,723,042
Triple Net Lease	7	Franchise Finance Corporation of America Realty Income Corporation CCA Prison Realty Trust	\$1,075,776 \$591,997 \$582,831	\$1,075,776 \$591,997 \$582,831

Source: NAREIT, 7/31/97

REIT capitalization pie, with the top five hotel REITs, having a total implied market capitalization of over \$7.0 billion. The top five self-storage REITs have a combined implied market capitalization of \$5.8 billion. The five largest triple net lease REITs have a combined implied market capitalization of \$2.7 billion. This is significant when compared to any of the REIT categories and demonstrating that one should not ignore these and other traditional, labeled, non-core properties.

CONCLUSION

Following the money trail provides a building block

for prudent investment strategies and also pieces together the past events in the industry. There is now adequate information that allows investors to cast a watchful eye on key players in their respective domain—debt and equity. Capital flows provide information on the direction of the market for investable real estate as well as the nature of pricing the asset class.

As presented, the pulse is racing for real estate—especially as measured in the public markets. Investable real estate is profoundly being redefined from both a source of capital and the type of

property chosen. Who would have ever thought of a prison REIT one year ago?... Check the ticker tape for CCA Prison Realty Trust at over a one-half billion dollar market capitalization. Keep your mind and pocketbook open to future real estate opportunities. Our world has changed just in time for the new millenium._{REI}

NOTES

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3. Arthur Andersen Real Estate Services Group, *Managing the Future: Real Estate in the 1990s* (Institute of Real Estate Management Foundation, June 1991).
4. D.J. Hartzell, R.H. Pittman, and D.H. Downs, "An Updated Look at the Size of the U.S. Real Estate Market Portfolio," The University of North Carolina, April 1992.
5. ERE Yarmouth and Real Estate Research Corporation, "Capital Sources: The Flow of Funds," *Emerging Trends in Real Estate 1998*, October 1997.

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REAL ESTATE CAPITAL MARKETS: A NEW PARADIGM?

by Bowen H. "Buzz" McCoy, CRE

If we can maintain the self-discipline we were forced to acquire in the early 1990s, together with improving the flow of data about real estate investment, the millennium could prove to be a golden age for all of us associated with commercial real estate investment.

This is an adaptation of an article: "Commercial Real Estate Finance Trends," which appeared in the May 1997 issue of Urban Land. Adapted and reprinted with the permission of Urban Land.

INTRODUCTION

The purpose of this article is to examine commercial real estate finance trends over the remainder of the current real estate cycle—or over a medium term of five years or so. Such an approach differs from the usual focus on the immediate pricing and availability of the capital markets. Instead, it is the purpose to focus more on the longer range significance of current trends than on the immediate situation.

Let us begin with the general economic framework. There are those who maintain that we have entered a new economic paradigm driven by globalization and technology, which will have the effect of dampening (or even eliminating) the business cycle as we have known it. Just-in-time inventory controls should eliminate the inventory swings which caused several of

our post-World War II inflations. Globalization provides lower manufacturing costs throughout the world. The old basic heavy industries moved to Asia, and they will probably move next to Africa, as techno-service economies replace them.

Others postulate that the long sustained growth in U. S. corporate earnings has been caused by much more traditional factors, such as lower interest rates and lower depreciation charges from the large corporate restructurings of the past decade. This view would predict more normalized economic growth of around 2.5 percent a year, calculated on an average annual population growth of 1 percent and an average 1.5 percent annual growth in productivity. Inflation should not be a major factor over this period, as a result of globalization, the transfer of manufacturing to lower cost producers, and corporate downsizing.

No five-year projection ever includes a recession, yet one is likely over this

time frame. In any event, such a slowdown in the economy should have far less impact on real estate than usual, as we will have about worked out all the excesses of the late 1980s, and significant over-building should not as yet have occurred.

Service businesses will no doubt remain sluggish in terms of ultimate productivity. Skilled labor bottlenecks should be occurring in such sectors as airframe production, software engineering, chip manufacturers, and the like. The government deficit, especially entitlements, should remain a major issue throughout the period. Interest rates should remain historically high as a result of the global demand for capital. Speculative real estate building will be underway once again in such products as industrial, hotels, suburban office, and apartments.

LONGER CYCLE IMPACTS

Even a five-year time frame fails to take account of true long-term trends. It may be useful to briefly review certain trends which may ultimately play a major role in the pricing and availability of real estate capital.

Economic historians have studied the longer term implications of technology. It is interesting that the initial use of the electric dynamo on the manufacturing process was to shed light on water and steam-driven shaft and pulley manufacturing processes. It took over 50 years for the electric dynamo to be utilized efficiently in the manufacturing sector. The same may be true of the computer in the service industry. It could well be 2010 before the endless cycle of changing hardware, changing software, and continual human resistance reverts from anti-productive to productive. When it does, there will be immense productivity gains throughout the service sector.

"Unconventional" retail sales today have replaced about 110 regional malls. The average fully occupied office floor is 25 percent vacant at all times. Hoteling and personal data and communication packages will cause office use to become far more efficient. A 6-10 percent adaptive re-use and efficiency gain on the \$3.3 trillion of commercial real estate in place could produce a dividend of several hundred million dollars. Despite such opportunities, significant quantities of retail and Class B and Class C office buildings must be completely reconfigured.

The securitization of commercial real estate is being held back chiefly by lack of better and more available data. When such data becomes available,

The securitization of commercial real estate is being held back chiefly by lack of better and more available data. When such data becomes available, as it will, there will be easier valuation, greater trust in the secondary market pricing of securities, and even greater re-cycling of assets among financial institutions.

as it will, there will be easier valuation, greater trust in the secondary market pricing of securities, and even greater recycling of assets among financial institutions. We will have synthetic securities to allow us to go both short and long on various property types and geographic markets, as well as the real estate market as a whole.

The continued globalization of the worldwide money and capital markets as three billion new members are added to the market economies of the world will provide immense opportunities for investment capital.

The computer will drive further de-institutionalization of investment capital. Insurance companies must totally reposition their balance sheets, as defined contribution and 401(k) self-administered pension plans gain continued momentum. There will be public market access to real estate debt and equity through real estate mutual funds and worldwide trading over the Internet.

Demographics will drive the transfer of hundreds of billions of dollars of post-World War II wealth. Retirees will hold a greater percentage of the nations' invested wealth and will change patterns of retailing, entertainment, and the like.

At some point it would seem that inflation must raise its ugly head once again in the face of potential shortages of commodities, agricultural products, oil and gas, and highly skilled human capital.

This article does not attempt to address public policy issues which may also impact real estate over the medium-term. Clearly, such issues as capital gains tax reduction, indexing of capital gains, or reinvestment roll-over provisions (free of capital gains taxation) could have a major impact on the liquidity of the real estate capital markets.

Finally, are consolidation and securitization cyclic trends or fundamental changes in real estate economics? . . . The combination of larger real estate firms having access to public capital markets and driving down their cost of capital is presumed to be a secular trend. This begins to follow the models in England, Holland, Hong Kong, and elsewhere. Capital cost is a large element in real estate development. If larger companies are better managed (not always a proper assumption) and have a significant cost advantage in the marketplace, this trend should continue. To assure this as a long-term trend, however, much work is still required to provide the reliable data on real estate which the public markets require.

Irrespective of the longer term nature of these trends, local knowledge and impact on land entitlement issues will continue to drive many aspects of the real estate markets. As larger consolidations of real estate companies become more bureaucratized, they will leave in their wake increasing opportunities for local players. Moreover, real estate will continue to function as part of the stock market and interest rate cycles, and there will be times when it is out of favor in the public markets. At such times the traditional arbitrage between public and private market prices of real estate assets will create opportunities and cause some of the consolidated public companies to take advantage of pricing anomalies to deconsolidate and return to private status.

STATE OF THE CAPITAL MARKETS

Financial Institutions

When analyzing the probable reaction of individual players in the capital markets, it is useful to attempt to look at the flow of funds through each of the major types of financial institutions. What is the nature of its liabilities? . . . How is it funded? . . . To what regulatory pressures is it subject? . . . What do security analysts and bond rating agencies take into consideration when evaluating its own debt or equity securities? . . . How does it make money? . . . For what behavior are its senior executives likely to be rewarded? . . . How can I design my financial offering in a manner which helps them solve their own internal problems and meet their objectives?

Commercial Banks

As we know, in recent years commercial banks have moved into spread pricing of funds at a premium over their cost of capital. Such a spread should account for the cost of underwriting the loan as well as the inherent risk that the loan may be delayed in

repayment or go into default. Risk-based capital rules force banks to allocate more higher cost equity capital to real estate than they do, for example, to government bonds. Mark to market accounting (which may spread over the five-year period to "off balance sheet" derivatives and hedges) further increases the amount of higher cost capital a bank must carry. Third party market arbiters such as bond rating agencies and Wall Street security analysts put further pressure on banks to sustain a fairly high rate of return on equity capital. As a result of all these pressures, many banks have become intermediaries themselves, packaging portfolios of real estate investments to sell at a spread or for a fee to smaller banks or other financial institutions. Other banks have substantively withdrawn from the real estate business, as a result of their losses in the 1990s.

Banks will continue to be a major factor in the real estate finance business. The major issue is whether they can resist competitive pressures to lower underwriting standards. At present, loan to value ratios are deteriorating, with less equity and pre-leasing being required. Other types of underwriting standards are beginning to slip also, such as tenant improvement allowances, the number of months required to re-rent space, rent "spikes," and the like. As the real estate cycle stabilizes and new construction gains in volume, it is likely that lending spreads will continue to deteriorate and that underwriting standards will weaken. The commercial banks will no doubt, once again be the engine that drives new real estate construction. A new generation of construction loan technicians will have to be trained. On-the-job training in this field tends to be costly. Fewer banks than ever will probably engage in this process. Several large money center banks will be in real estate only to package and resell securitized product to others.

Insurance Companies

Insurance companies were the perfect long-term lender to real estate when their liabilities consisted of 20- and 30-year pay whole life insurance policies. Now that their liabilities are term insurance and a range of other short-term products, they can no longer survive as long-term investors. In addition, insurance companies have been subject in recent years to rigorous risk-based capital rules which harshly penalize their traditional real estate investments. The joint-venture financing of a larger single asset in a partnership with a major developer would now be subject to a 30 percent capital hit on the new rules, whereas a high-grade bond would have a

capital hit of 0.3 percent. Thus we see many traditional real estate investors including Aetna, Prudential, and Travelers drastically shrinking their real estate portfolios.

Separate account investments for pension funds remain a long-term source of capital for insurance companies, although one may question the willingness of pension funds to commit such capital to an insurance company which has retreated from that business for its own account. Securitization also remains a major commitment of insurance companies. They are recycling their old portfolios through Wall Street and buying back the investment grade rated "top" pieces where they have augmented liquidity and a nominal capital requirement. Several insurance companies, such as Northwestern Mutual and Teachers' Insurance have remained strong participants in the real estate investment process, so it is difficult to characterize the entire industry. It is safe to predict, however, a greatly diminished capacity to service the real estate industry with the traditional forms of capital. Real estate investment will become less a principle business and more an agency business, as insurance companies attempt to intermediate the investment funds of others.

Wall Street: Real Estate Investment Trusts (REITs)

REITs have served a powerful role in the recapitalization of and re-equitizing of many important real estate businesses. The result is that the current generation of REITs benefit from much higher grade property holdings than was the case in the 1970's model. In addition, for the most part, current REITs are less leveraged. Indeed, about 20 percent of the current REITs enjoy investment grade bond ratings on their debt. Taking these real estate assets into the public market has created a cheaper cost of capital and a much better public flow of information than was the case for these properties when held privately.

As one who had considerable experience with REITs in the 1970s, however, certain generic questions remain concerning the REIT structure. Is there such a thing as passive real estate? . . . Is not something lost when one removes the ultimate investor such a great distance from the properties themselves? . . . How do REITs provide the growth story which Wall Street calls for as acquisition properties revert back to replacement or greater than replacement cost? . . . REITs cannot retain significant capital due to the tax laws and investor preferences for a high dividend payout. Can the properties support a continually growing dividend payout throughout the real estate cycle? . . . Where

In my opinion, the new paradigm in real estate finance is not a dampening of the cyclical nature of the business, but the potential for a much broader and deeper marketplace for real estate capital driven by increased disclosure of information.

do funds come from to provide necessary property replacements and renewals? . . . After the third or fourth year, there is mounting pressure on REIT trustees to trade-off between required capital expenditures and dividend payouts.

Over the next five years we will see growing consolidations among REITs. One requirement for an investment grade bond rating is a significant capital base. We would also see questions raised about the trade-off between low leverage and an investment grade rating and higher leverage more traditional for real estate assets. Mounting pressures to pay dividends and investor dissatisfaction with slow growth and relatively lower investment yields will cause REIT values to trail the market in general. This in turn will produce situations where the real estate shares are trading at significant discounts to the inherent underlying real estate values, thus causing firms to de-REIT, liquidate, go private, and the like.

In summary, one may predict a triage of REITs, with many being acquired; many limping along with depressed share prices and a higher cost of capital; and a few giants with good credit ratings and an industrial "General Electric-type" mentality of reducing operating costs, developing new properties, and a market orientation toward their tenants.

Wall Street: Commercial Mortgage-Backed Securities (CMBS)

This market has grown rapidly in part as a result of the requirement for commercial banks and insurance companies to hold investment grade rated real estate securities in order to benefit from the lowest requirement for risk-based capital. The process is to re-allocate cash flows from large single assets or portfolios of properties so that the investment grade rated "top" piece enjoys healthier cash flow support and the more speculative "bottom piece" becomes more risky and volatile. The market for the "top" pieces is virtually unlimited. A major limiting factor is the investment community appetite for the

"bottom" pieces, where mis-pricing is not uncommon and both buyer and seller can anticipate unpredictable windfalls and losses.

CMBS pricing is displaying the same phenomena as applied to highly leveraged "junk" corporate debt in the 1980s. CMBS spreads began quite high and then narrowed considerably, to below spreads charged on comparable debt by banks and insurance companies, as investors became more comfortable with the characteristics of the security and the investment market broadened.

There is at present perhaps an "illusion" of liquidity, as market makers in depth in the secondary market are few, and limited principally, to the original issuing house. Another inhibiting factor to the growth of this market is the lack of ongoing reliable data to support secondary trading and the issue of who pays the cost of such data. Once these problems are resolved, as in the case of REITs, there will be much more data available for CMBS assets in the public market than was the case when they were privately held. This itself should add validity to this market.

It is likely over the next five years that there will be unanticipated gains and losses from these securities, especially during the next down cycle. The major requirements for the sustainable growth of the market are a broadened investor base for the "bottom" piece and a major improvement in the secondary data dissemination required for price discovery. Despite these problems, unlike REITs, this market should continue to grow dramatically over the period.

Wall Street: Mutual Funds

Mutual funds, despite the huge increase in investible funds coming out of 401(k) plans, have not been a significant factor in the real estate capital markets. As these funds continue to grow, and as individuals become less sanguine about the equity markets, it is quite possible that a family of real estate mutual funds, or tradeable closed-end funds, will come into being. Such funds could hold unleveraged commercial properties, especially if investors do become dissatisfied with the REIT format. They could also provide debt funds for various types of participating or short- or medium-term mortgage instruments, much as the mortgage REITs attempted to do in the 1970s. Finally, higher yield and more risky mutual funds might become a home for the "bottom" pieces of the CMBS originations.

Opportunity Funds

Such funds have served to replace the equity funding of real estate which traditionally came from the life insurance companies. They were viewed as short-term vehicles, initially benefiting from the real estate fire sales of the early 1990s. They are probably here to stay, however, as they provide an opportunistic approach to the real estate markets which many investors prefer as a portion of a diversified portfolio. The relatively short-term payback of these funds allows a new look at rapidly changing investment conditions.

While returns are clearly coming down from the windfalls of a few years ago, such funds should be able to continue to generate returns at a significant premium over normalized equity returns in the stock market.

Opportunities will continue to include insurance company portfolios as they adjust their balance sheets, banks taken over by others, incubator REITs, REITs going private, raw land, incubator land for homebuilders, real estate operating companies requiring a capital partner, and distressed portfolios overseas.

Foreign Investors

From time to time over the years 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, and it occurred in the Middle East in the early 1970s and in Japan throughout the 1980s. Typically such capital flows were 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. Financial intermediaries who tracked such flows and got there first ended up with a lion's share of the business. Instant communications render such windfalls less likely in the future.

It is difficult to predict where or when such surplus flows will be created in the future. Western Europe and Japan 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 Empire, as well as developing market economies in Southeast Asia, Indonesia, and India, for example.

It thus seems less likely that the U.S. will benefit from foreign capital flows in real estate over the next five years to the same extent as we did in the 1970s and 1980s. As mentioned above, real estate seems to come late in the investment cycle, because of the technical nature, lack of available data, lack of trusted third party advisers, lack of liquidity and possible lack of an investment return which compensates for all the above factors as well as currency risk. The one area which is more likely to attract foreign investment is REITs and CMBS because of the relatively better data disclosure and relatively better perceived liquidity.

Pension Funds

Pension funds have not yet lived up to the expectation that 10 percent or more of their assets might be invested in real estate. Currently investment in real estate is less than a third of that amount. Returns on real estate are the lowest of any major asset class over the past decade, although recent returns have compared favorably with historical results (though nowhere nearly as favorable as the stock market up to the end of 1997). Probably no class of financial institution is coming out of the past 10 years more disoriented about real estate nor more capable of being the major capital provider to the industry. Pension funds remain the only major long-term investor left. The duration of their liabilities is perfectly suited to longer term real estate investment. As stock market returns revert back down to their mean (as well as real estate returns reverting back up to their mean), it would seem appropriate to expend major effort to rebuild pension fund's confidence in the real estate investment process.

The loss of confidence goes deeper than disappointment over stated investment returns. The intellectual underpinning of real estate has been lost. It is clearly not an inflation hedge when markets are overbuilt and there is no significant inflation. It may (or may not be) a separate asset class. While the advisory industry to pension funds was uniform in its rationale for real estate investment in the 1970s and 1980s, the advisors themselves now appear disoriented and lack a consistent rationale for the industry as to why pension funds should invest in real estate. There is debate even on what constitutes "core" real estate (for example, single asset transactions or securitized offerings).

Confidence in valuations and price discovery were eroded both on the way up in the late 1980s and on the way down in the early 1990s. Many pension fund portfolios appear to lack a basic

Particularly in the pension fund area, we will see continuing fee pressure on advisors along with a demand for increasingly more and sophisticated services. The public markets will become ever more important, more liquid, more heavily traded, and the source of ever-improving information about the underlying real estate.

strategic orientation, resembling rather more a series of brokered deals, with no sell-side strategy. In some cases there appears to be no basic alignment of interests among pension plan sponsors and their advisors. Pension funds feel they have been subjected to high risk, high fees, and low returns. Certain of the significant pension fund advisors are reluctant to have their performance benchmarked on a basis comparable to that employed in the fixed income and equity asset classes. Software support for real estate is lagging that available for other asset classes. There is a multiplicity of systems, inconsistent reporting of results, and massive amounts of data with little analysis for management decision-making.

Many of these service provider issues are being addressed. New fee structures are being proposed, along with co-investment. Benchmarking systems are being adopted by certain plan sponsors. National property management companies are being formed on the premise of delivering lower cost service with superior management information systems.)

Along with securitized product from Wall Street, pension funds should be a major supplier of capital to real estate over the next five years, especially as they reallocate assets out of the U. S. equity market into alternate asset classes. In order to free up this capital to the real estate sector, however, more work needs to be accomplished on the intellectual underpinnings of real estate investment, as discussed in the following section.

Other Financial Institutions

There will also continue to be other types of powerful financial institutions engaged in commercial real estate finance. There will be finance companies with strong credit ratings and broad and sophisticated access to international capital markets which will find opportunistic ways to intermediate capital

into the real estate business. It is less likely that these will be conglomerates such as Sears and Westinghouse, who attempted to reach into real estate, and then pulled back. It is more likely that they will follow the G. E. Capital model of highly sophisticated and aggressive utilizers of the capital markets process.

INTELLECTUAL UNDERPINNINGS OF REAL ESTATE INVESTMENT

The somewhat simplistic intellectual rationale of real estate investment as an inflation hedge simply does not work anymore. Inflation is not as worrisome as it was a decade ago; and real estate has not performed. Securitization techniques such as REITs and CMBS have only made the debate more confusing. Do REITs trade like small capitalization stocks? . . . Is the value of physical real estate altered significantly when it is placed inside an REIT format? . . . Is there some alchemy that can make a 6 percent yielding asset become a 10 percent yielding asset? . . . How long can the financial levitation last? . . . These queries may become less significant as REIT relative payouts and growth begin to decline.

The further development of real estate derivatives and financial hedges will allow sophisticated investors to sector rotate in and out of real estate, or property types, or locations on a basis impossible when trading physical assets. The major impediment to their development is the lack of broad availability of data on a consistent basis.

The price anomalies which obtain between public and private real estate markets continue to confuse potential investors, many of whom believe the best deals trade to insiders in the game. As mentioned above, such anomalies will surely obtain once again when REITs decline in relative value (caused by lower than expected growth in cash flow and dividends), while the values of the underlying real estate increase along with rents and decreased vacancies.

What is the appropriate return for real estate held in an institutional investment portfolio? . . . How does one know that the return is good or bad compared to other financial assets, (especially in the case where real estate seems to command high fees, is essentially hand-crafted, illiquid, and based upon imperfect price and data discovery)? . . . Some have suggested that real estate, on this basis, should return around 500 basis points over the 10-year Treasury. Such a spread may be intellectually consoling, but can such returns be sustained on investment grade commercial real estate?

How does one obtain consistent reliable data upon which to base sound real estate investment decisions? It turns out that office buildings are measured on different bases in differing locales. The calculation of economic rent varies from purveyor to purveyor, and often important components are left out. How is vacancy to be calculated? . . . How about a downsized tenant paying above market rent on untenanted space?

Pension funds will not meet their potential as real estate investors until these types of queries are resolved. Growing exposure to the public markets should serve to support the development of consistent and reliable data. Those individuals who can deliver the data freely and openly, and not keep it sequestered in the hands of the privileged few owners and brokers, will end up controlling the real estate investment industry.

CONCLUSION

Over the next five years we will see many of the things we have seen in the past. On the margin, there will be too much capital flowing into real estate, primarily from commercial banks, Wall Street, and pension funds. This will carry with it the continual threat of overbuilding in certain markets and locations, although the economic downturn we can anticipate over the time frame will mitigate the severity of such overbuilding in this cycle.

We will experience an unusual degree of functional obsolescence in real estate over this period. Probably several hundred regional malls are already ripe for adaptive re-use. In certain cities, high-rise downtown office structures will continue to give way to suburban offices with cheaper transportation and other costs. Hoteling will further change office usage and the number of square feet utilized per capita. We have already seen high-rise office structures in formerly attractive locations, which may be filled with asbestos, becoming economically obsolescent.

Particularly in the pension fund area, we will see continuing fee pressure on advisors along with a demand for increasingly more and sophisticated services. The public markets will become ever more important, more liquid, more heavily traded, and the source of ever-improving information about the underlying real estate.

In my opinion, the new paradigm in real estate finance is not a dampening of the cyclical nature of the business, but the potential for a much broader

and deeper marketplace for real estate capital driven by increased disclosure of information.

Above, all, what will be required over this period is intelligence; out of the box thinking; creativity; the willingness to risk investment dollars on management information systems; the ability to see the problems of the financial institutions as readily as you can see your own; and the ability to develop longer term trust relationships based upon honesty and integrity.

If we can maintain the self-discipline we were forced to acquire in the early 1990s, together with improving the flow of data about real estate investment, the millennium could prove to be a golden age for all of us associated with commercial real estate investment.^{REI}

ABOUT THE AUTHOR

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NOT ALWAYS BE SOMETHING
YOU WISH TO HEAR.**

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REAL ESTATE CAPITAL MARKET TRENDS & APPLICATIONS

by Scott R. Muldavin, CRE

The explosion in the availability of real estate capital markets data has underscored the importance of determining which information is important, and how it can be applied to assist real estate decision-makers.

INTRODUCTION
The real estate industry seems to have "bought," literally, the assumption that real estate capital markets information is critical to investment decision-making. There are over 100 publications whose primary mission is to inform the industry about trends in the real estate capital markets. These publications include those covering the broad "capital markets" like Institutional Real Estate Inc.'s *Real Estate Capital Markets Report*; Institutional Investor's *Real Estate Finance*; and Warren, Gorham & Lamont's *Capital Sources For Real Estate*, to scores of single source publications such as *Commercial Mortgage Alert*; *Mortgage Banker*; *Institutional Real Estate Letter*; *The REIT Report*; *The Stanger Report*; and the *Journal of Commercial Lending*. Additionally, scores of publications and internet sites propagated by real estate firms, trade journals, and news magazines provide a virtual "title" wave of real estate capital flows information.

The explosion in the availability of real estate capital markets data has

underscored the importance of determining which information is important, and how it can be applied to assist real estate decision-makers. In many ways, today's real estate capital markets "information industry" is similar to the real estate property markets industry 15 years ago. Just like property market information 15 years ago, capital markets information is poorly defined, not appropriately segmented, and has few standard definitions or measurement techniques. However, property market information has become significantly more valuable over the last 15 years, as users determined how and why they wanted to use information. This pushed providers to improve quality and access. Similar trends need to take place in the real estate capital markets "information industry" to enable decision-makers to improve their performance.

This article addresses real estate capital market needs in four ways:

- Defines what the real estate capital markets are and the kinds of real

Exhibit 1

**REAL ESTATE
CAPITAL PROVIDERS**

Private Debt

1. Life Insurance Companies
2. Banks and Mortgage Companies
3. S&Ls and Mutual Savings Banks
4. Pension Funds
5. Mortgage REITs
6. Public Mortgage Partnerships
7. Finance Companies

Public Debt

8. Government Credit Agencies
9. Commercial Mortgage-Backed Securities

Private Equity

10. Pension Funds
11. Foreign Investors
12. Private Financial Institution REO
13. Life Insurance Companies
14. Private Investors (Partnerships, Joint-Ventures, Etc.)

Public Equity

15. REITs - Equity and Hybrid
16. Public Real Estate Partnerships
17. Corporations

Source: Roulac Capital Market Service

estate capital markets knowledge available;

- Segments the users of real estate capital markets knowledge into four distinct groups;
- Presents decision-based strategic frameworks that link specific information needs to specific applications for distinct user groups; and,
- Provides a future forecast of capital market conditions based on The Roulac Group's proprietary historical capital markets indices.

**DEFINING THE REAL ESTATE
CAPITAL MARKETS**

The real estate capital markets are an aggregation of the 17 real estate capital providers shown in *Exhibit 1*. In order to understand the flow and changes in the real estate capital markets, the economic forces and motivations influencing each of the 17 providers must be understood.

The dramatic growth in the commercial mortgage-backed securities and public real estate investment trust marketplace since 1990 have expanded real estate into the "four quadrants" as shown in

Exhibit 1. Real estate capital can be split into: Private debt, Public debt, Private equity, Public equity, and Corporate. The growth in the commercial mortgage-backed securities and REIT marketplace have transformed the real estate capital markets in recent years, bringing the liquidity, corporate governance, and Wall Street activity characteristic of other asset classes.

The changing structure of the real estate capital markets is shown in *Exhibit 2*. Private debt, still the dominant quadrant, has shrunk from a 56 percent share of the market to only 48 percent in 1997. The private equity marketplace has also declined nearly 7 percent, while the public debt and public equity markets have moved from an 8 percent share in 1980 to nearly a 25 percent share of the market in 1997. These trends are expected to continue.

The total size of the institutional real estate capital markets was approximately \$1.6 trillion, as shown in *Exhibit 3*. Corporations are also major players in the real estate capital markets, although they are not easily classified into any of the four quadrants. Corporations raise capital publicly through equity or debt offerings, as well as privately, and are properly evaluated outside of the "four quadrants" of institutional real estate capital. Estimates of corporate real estate involvements exceed \$2 trillion in the U.S.

Real Estate Capital Markets Knowledge

The next step in being able to apply real estate capital markets knowledge to decision-making is to understand the different types of real estate capital market knowledge required by decision-makers. Most importantly, for strategic purposes, decision-makers need to be able to predict future changes in capital flow activity. Historic information is

Exhibit 2

**CHANGING STRUCTURE OF
THE REAL ESTATE CAPITAL MARKETS
1980 - 1997**

Quadrant	1980	1990	1995	1997⁽¹⁾
Private Debt	56%	54%	52%	48%
Public Debt	7%	9%	14%	16%
Private Equity	36%	35%	29%	29%
Public Equity	1%	2%	5%	7%
	100%	100%	100%	100%

⁽¹⁾ Estimate based on annualized data from 2nd quarter 1997.
Source: The Roulac Group, Real Estate Capital Market Services.

necessary to provide a context for interpreting the present and future, but alone does not provide adequate insight to make strategic decisions. Accordingly, the foundation for the analysis of overall trends in the real estate capital markets is the detailed fundamental analysis of each of the 17 real estate capital market providers shown in *Exhibit 1*.

Projecting real estate capital markets trends has a lot of similarities to projecting property market trends. If you want to project property market trends, knowing today's occupancy rates and rents is not sufficient, and you must look at employment trends, demographic changes, and the economic outlook to build up a model of the factors that will influence future rents and vacancy rates. Analogously, in the capital markets, if you want to project changes in flows of capital in the future, a detailed model of the factors influencing the flow and performance of capital for each of the 17 providers shown in *Exhibit 1* must be developed. For example, to project life insurance company debt flows in the future, one must understand risk-based capital rules; historic life insurance company real estate performance; asset/liability matching requirements; and other industry-specific factors. Combining this industry-specific knowledge with current trends in capital flows, reasonable projections of the short-term future can be estimated.

Specific categories of real estate capital markets knowledge needed by decision-makers are summarized below:

1. Historic Capital Flows: the market size, net flow, and activity for each of the 17 capital market providers needs to be understood to provide a context for interpreting present and projected changes in the real estate capital markets.

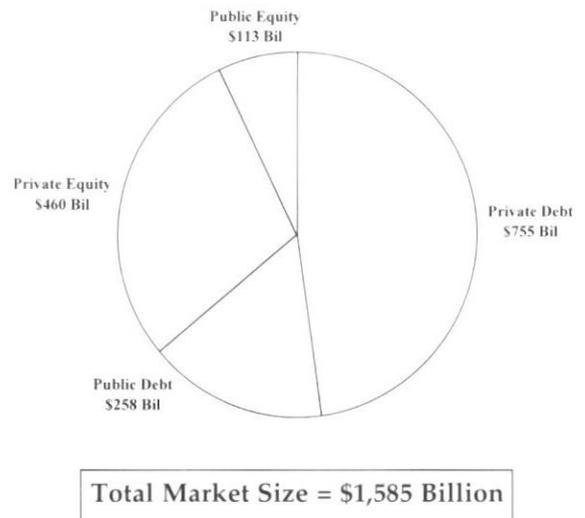
2. Projected Real Estate Capital Flows: 12- to 24-month and longer-term projections of changes are key to successful strategic decisions and competitive advantage.

Projected changes in the flow of the capital markets have significant performance and value implications overall, while projected changes in capital flow by capital provider is more significant to service providers and lenders.

3. Segmentation of Real Estate Capital Flows: segmentation of capital flows by property type, location, size, and ownership are critical to strategic decision-making. For financing flows, segmentation by new versus existing, mortgage type or structure, property type, and geographic region are also critical.

Exhibit 3

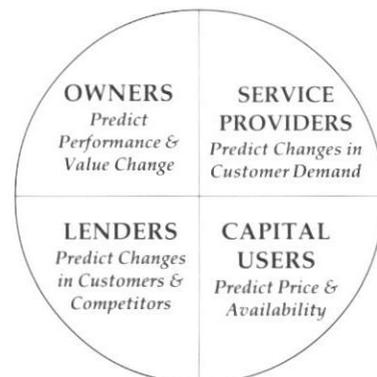
**PUBLIC & PRIVATE
REAL ESTATE CAPITAL MARKETS
1997¹**



¹Total size of aggregate market projected through year-end 1997.
Source: The Roulac Group, Real Estate Capital Market Services.

Exhibit 4

**APPLICATIONS OF REAL ESTATE
CAPITAL MARKET KNOWLEDGE**



Source: The Roulac Group

4. Pricing and Investment Criteria: detailed information on pricing, deal terms, and investment criteria by both debt and equity sources is critical to investment and mortgage product design, capital access decision-making, performance benchmarking, and other decisions.

5. Future Trends Influencing the Real Estate Capital Markets: detailed information, for the market overall, as well as for the 17 different providers of capital are required. Information on regulatory trends, technological innovations, environmental issues, global real estate capital market activities, economic and real estate market trends, and other

Exhibit 5

APPLYING CAPITAL KNOWLEDGE TO PENSION/OWNER REAL ESTATE DECISION-MAKING

REAL ESTATE CAPITAL KNOWLEDGE	APPLICATION TO PENSION FUNDS
Historical Capital Flows	<ul style="list-style-type: none"> What types of real estate investment vehicles make the most sense now? How much should I invest in real estate? How should real estate investment opportunities (REITs, mortgage securities, mortgages, etc.) be treated from an allocation context?
Projected Volume of Real Estate Capital Flows	<ul style="list-style-type: none"> Suggested change in overall allocation to real estate. Suggested reallocation of capital between investment vehicles. Should I refinance or restructure any debt during the next year? How does my portfolio compare to the industry on an allocation basis?
Segmentation of Real Estate Capital Flows	<ul style="list-style-type: none"> What types of properties and markets currently have high investor interest? What types of properties and markets are currently out of favor? Does current investor interest and property pricing seem sustainable? Do segmented capital market flows indicate potential over-building or over-investment in any specific sectors or markets? Is now a good time to sell? Are there any capital market phenomenon that are distorting the sales market? Who are the most likely buyers of real estate?
Future Trends Influencing and the Real Estate Capital Markets	<ul style="list-style-type: none"> Anticipate changes in capitalization and discount rates to improve disposition acquisition strategies. Improve predictability in all the key applications discussed above? Assist in making decisions about "specialized" investment sectors.
Pricing and Investment Criteria By Source	<ul style="list-style-type: none"> What financial criteria and objectives are appropriate for acquisitions? What is the likely breakdown of real estate returns between income and capital appreciation by investment vehicle? Should I refinance or restructure any existing debt? What are likely diversification and inflation hedging benefits? What capitalization and discount rates are reasonable for the purposes of portfolio valuation and liquidity assessments?
Specialized Analyses	<ul style="list-style-type: none"> Numerous specific applications dealing with overall investment policy, property acquisitions, property dispositions and asset management.

critical events form the basis for projections of activity.

6. Mergers, Acquisitions, and Alliances: ongoing tracking and analysis of mergers, acquisitions, and alliances is critical to projecting changes in capital flows and the delivery of financing and real estate management services.

7. Specialized Analyses: utilizing the information identified above, many specialized analyses, including red flag analysis of potential excess capital in a market or property type; capital sustainability assessments; bench-marking analyses; new investment opportunity assessments; market share analyses; acquisition and disposition transaction volume projections; and other analyses can provide very specific and detailed strategic insight for real estate decision-makers.

THE APPLICATION OF REAL ESTATE CAPITAL MARKETS KNOWLEDGE

The application of the real estate capital markets knowledge identified above can be separated into four distinct user groups, as shown in *Exhibit 4*. Owners, service providers, lenders, and capital users each have a different emphasis in their need for real estate capital markets information. Real estate owners, including pension funds, investment managers, REITs, and others, are primarily interested in being able to predict performance and value changes due to changes in the real estate capital markets. Service providers, such as architects, lawyers, and asset managers, are most interested in predicting changes in customer demand. Lenders are interested in borrower (customer) changes, as well as competitors. Lenders are also interested in value change from a risk management perspective. For capital users, who are seeking debt and equity capital to fund new or existing projects, the ability to predict the price changes and availability of capital is paramount.

DECISION-BASED STRATEGIC FRAMEWORKS

Perhaps one of the greatest challenges for real estate decision-makers is to make sense of the voluminous real estate capital and property market information that is available today. With the rapid acceleration in the growth of on-line real estate data providers, the growing numbers of real estate capital and property market information publishers, and the cross-fertilization of previously distinct sectors of the real estate industry, decision-makers are faced with an almost untenable job of sifting through data to make good decisions.

Given this difficult situation, decision-makers must do at least two things: 1). develop explicit strategy models that identify specifically the type of information required for each strategic decision; and 2). be able to screen and appropriately interpret the information that will feed the strategic models. Significant progress is being made in developing standards for performance measurement, improving due diligence and underwriting systems, and making asset and portfolio management more systematic. However, substantial work still needs to be done.

As to screening and interpreting information, some progress has been made, but the rapid recent proliferation of data has made old approaches to this task obsolete. The new approach to screening and interpreting data must involve first and foremost a strategic approach where significant time is spent to determine precisely the questions that need to be answered and the types of information that can help answer the questions. Once these very specific decisions are made, a process needs to be put in place to find the best information and then continually review and upgrade it to ensure that the best inputs are being obtained. Additionally, data collection must become more sophisticated and strategic because in many cases, the data needed to answer a specific strategic question must be developed by compiling and integrating disparate sets of data in creative ways.

The strategic link between real estate capital flows and decision-making is evaluated below in more detail for owners and service providers—two key user-groups with distinctly different applications of capital markets information.

Pension Fund/Portfolio Owners

For real estate owners, the critical link to the real estate capital markets is through the effect of capital market changes on performance and value. Investment strategy and policy considerations should guide owners' decision-making related to the investment vehicles they choose to invest in and the property markets on which they focus. Real estate capital markets information can be especially important in setting investment objectives, making overall asset allocation decisions, and developing overall portfolio composition guidelines. However, real estate capital market information is most critical to evaluating investment options and conducting property market due diligence.

Real estate capital markets information can also provide specific input to assist in assessing the

relative appeal of different investment vehicles that might be employed to achieve a pension fund's real estate investment objectives. For example, real estate capital markets information and analysis can help in determining whether real estate equity is being sufficiently rewarded for greater risk than debt, as well as identifying potential advantages and/or disadvantages to investment in commercial mortgage-backed securities, private REITs, or closed-ended commingled real estate funds.

Key real estate capital markets knowledge requirements, and the application of the information to pension/portfolio owner real estate decision-making is outlined in *Exhibit 5*. Key information requirements include historic and projected flows of real estate capital by source; detailed segmentation of capital flows; identification and analysis of new pension fund investment opportunities; and a specialized "Red Flag" analysis that identifies property types/markets where there appears to be a divergence between the economic fundamentals of a particular property type and market and the flow of capital to that marketplace.

Service Providers

There is a critical, explicit linkage between capital flows and the demand for real estate services. Real estate capital availability is a crucial determinant of transaction activities that create the demand for real estate services as well as a primary influence on changes in valuation and investment performance. Comprehensive real estate capital markets information is also needed to improve strategic decision-making regarding resource allocation, competitive positioning, "product" design, and new service opportunities.

The segmentation and complexity of buyers of real estate services has increased the need for more sophisticated pricing and product differentiation strategies. Whereas the bulk of most service providers' business is typically a commodity, it is the smaller percentage of service business that is not a commodity where service companies need to make premium profits for their value-added services. However, if service firms cannot deliver their commodity services cost effectively, they cannot get into the "game" and be able to get in the market to sell their premium services. Accordingly, service providers must carefully segment and price their services in order to maximize their revenues. This segmentation and pricing must be driven by customer perceptions of the value for each segment of service. It is up to the service provider, just like

Exhibit 6

APPLYING CAPITAL MARKET KNOWLEDGE TO REAL ESTATE SERVICE COMPANY STRATEGIC PLANNING

REAL ESTATE CAPITAL MARKET KNOWLEDGE	REAL ESTATE CAPITAL MARKETS DATA	APPLICATION TO SERVICE PROVIDERS
1. Historic Capital Flows	<ul style="list-style-type: none"> ▪ Total real estate capital flows ▪ Change in total flow of real estate capital ▪ Total equity flows ▪ Total debt flows ▪ Level of refinancing ▪ Levels of new construction ▪ Transaction volumes 	<ul style="list-style-type: none"> ▪ Market share analysis ▪ Changes or enhancements needed to retain existing business ▪ Reassessments of ability to achieve planned revenue and expense levels ▪ Performance monitoring ▪ Suggested changes in business strategy, organizational structure, systems, technology or personnel
2. Projected Volume Of Real Estate Capital Flows	<ul style="list-style-type: none"> ▪ Total real estate capital flows ▪ Change in total flow of real estate capital ▪ Total equity flows ▪ Total debt flows ▪ Level of refinancing ▪ Levels of new construction ▪ Transaction volumes 	<ul style="list-style-type: none"> ▪ Suggested reallocation of resources between business units or market areas ▪ Budgeting and strategic planning for next year ▪ Enhancements needed to retain existing business in the coming year ▪ Reassessment of what businesses to be in ▪ Assistance in assessing major capital expenditures ▪ Assistance in assessing major organization or personnel changes
3. Mergers, Acquisitions, and Alliances	<ul style="list-style-type: none"> ▪ Identification and analysis of alliances ▪ Identification analysis of mergers in key service sectors 	<ul style="list-style-type: none"> ▪ Assist in response to competitor moves ▪ Background knowledge to assist sales and marketing efforts ▪ Insights into strategic positioning of competitors
4. Segmentation Of Real Estate Capital Flows	<ul style="list-style-type: none"> ▪ New construction versus existing ▪ Ownership ▪ Geographic location ▪ Property type ▪ Financing structure ▪ Mortgage type ▪ "Red Flags" that threaten our current and long-term business goals 	<ul style="list-style-type: none"> ▪ What new product and service opportunities are available? ▪ Do we need to make any changes in our existing products and services to maintain or expand market share? ▪ Are our marketing and promotion programs adequately targeted by segment? ▪ Are we focusing on the right segments? ▪ Are we allocating marketing and organizational resources appropriately given changes in market segmentation? ▪ Bench-marking for assessment or performance by market segment.
5. Future Trends Influencing The Real Estate Capital Markets	<ul style="list-style-type: none"> ▪ Regulatory trends ▪ Technological innovations ▪ Securitization ▪ Competitive changes ▪ Detailed analysis of trends influencing each capital source 	<ul style="list-style-type: none"> ▪ Anticipate new service requirements ▪ Anticipate changes in existing services ▪ Make determinations about potential alliances or mergers to meet future customer needs. ▪ Develop detailed understanding of the motivations driving customers to improve services and sales materials ▪ Identify potential "red flags" to business interests ▪ Determine potential legal and political actions to take to preserve and enhance business ▪ Review of major capital expenditures and investments in human capital

Source: The Roulac Group, Inc.

Proctor & Gamble when they are selling soap, to communicate effectively to the customer the differentiation in services and the reasons for the differentiated pricing.

The cost to real estate service providers who do not implement a more structured and strategic approach to their business include:

- Missed opportunities when new markets or market segments are created;
- Missed strategic shifts, that on a mid- to long-term can make them uncompetitive or obsolete;
- Loss of customers due to misunderstanding of

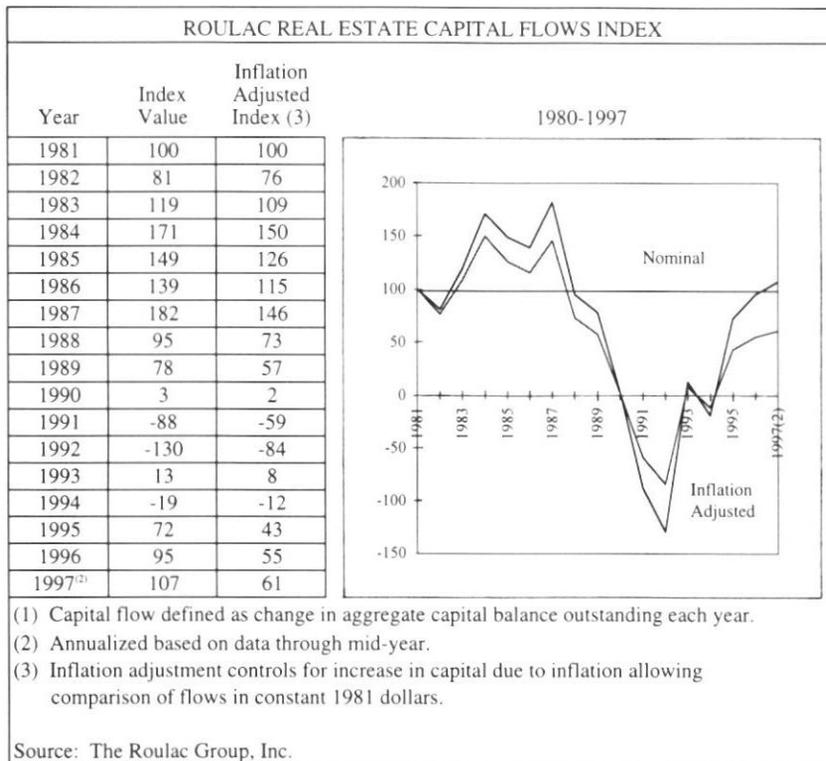
changing needs;

- Poor estimates of revenues and expenses that cut profitability;
- Technological obsolescence of systems; and
- Misdirected capital expenditures.

The direct linkage of the real estate capital markets to the real estate services markets is shown in *Exhibit 6*.

Capital markets knowledge can be obtained through careful and detailed analysis of real estate capital flows statistics, surveys, literature reviews,

Exhibit 7



and other means. The more detailed and segmented the information, the more valuable it will be to real estate service providers. Of particular importance is the projected volume of real estate capital flows and an understanding of the future trends that influence the capital markets and the projections.

REAL ESTATE CAPITAL MARKETS OUTLOOK

The real estate capital markets, by any measure, are very active today with substantial debt and equity available for worthy real estate projects. Based on a snapshot perspective of today's real estate capital markets, many investors are beginning to express significant concerns about the mostly anecdotal evidence that excessive real estate capital is entering the real estate market.

However, based on our analysis of the newly-developed Roulac Real Estate Capital Flows Index, (which tracks aggregate institutional real estate capital flows over the last 17 years), current capital flows appear sustainable, as do the prices that the capital flows sustain in the marketplace. As shown in *Exhibit 7*, the Roulac Real Estate Capital Flows Index is projected to reach 107 by the end of 1997, after hitting a low of -130 in 1992. However, despite this substantial increase in capital since 1992, when there was a net outflow of capital from the real estate industry, today's capital flow is still down over 40 percent from its peak in 1987. Perhaps more

importantly, on a historical basis, 1997 capital flows of over \$90 billion are substantially below their peak of nearly \$160 billion in 1987.

The sustainability of current capital flows is underscored by looking at capital flows on an inflation-adjusted basis, which enables a comparison of each year's real estate capital flows on a constant dollar basis. For example, 1997's inflation-adjusted index value of 61 indicates that 1997's flow of over \$90 billion is down nearly 60 percent from its peak in 1987, after the effects of inflation are factored out.

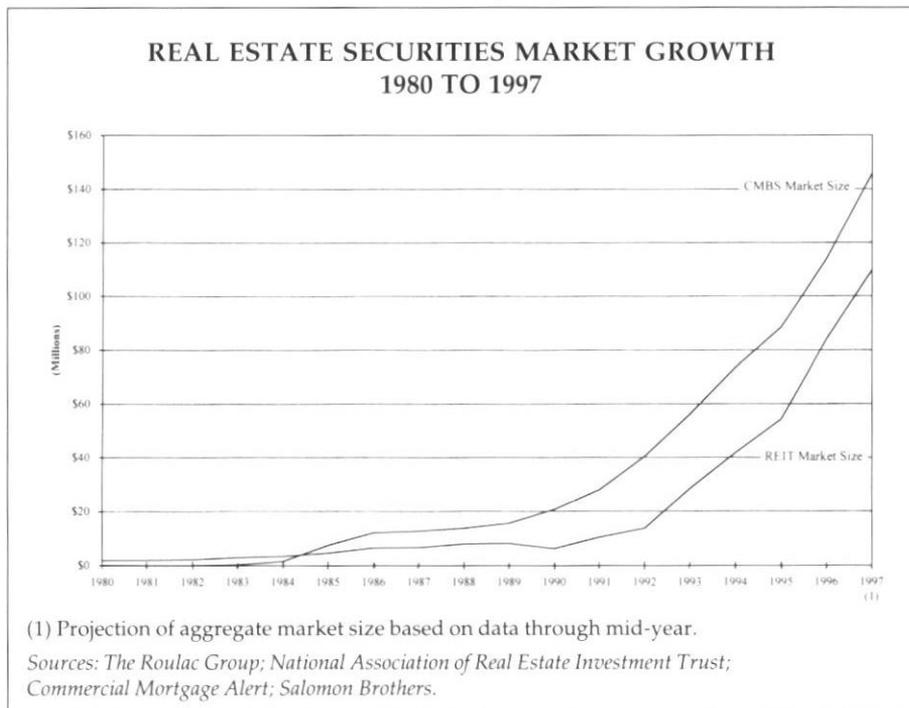
While today's flows of capital are not excessive on a historical basis, the incredible volatility of capital flows, as shown in *Exhibit 1*, is an issue of significant concern. While capital flows' volatility will continue in the future, less cyclic variability should result from recent securitization trends and continuing improvement in capital provider risk-management practices. While underwriting has loosened during the last year due to strong capital availability, capital providers still appear to be holding the line on too many speculative or unworthy investments and are intelligently constraining their investments.

Real Estate Securitization Trends

The most dynamic sector of the real estate capital markets is real estate securities. Real estate securities, which combines both the commercial mortgage-backed securities and REIT industries, has grown from \$264 million in 1980 to over \$60 billion of new activity in 1997, a compounded growth rate of near 38 percent over the 17-year period. This tremendous growth in annual activity, along with stock price appreciation, has pushed the market size of both the REIT and CMBS industries over \$100 billion in 1997, as shown in *Exhibit 8*. REITs are projected by the end of 1997 to exceed \$110 billion in capitalization, while the commercial mortgage-backed securities industry will approach nearly \$150 billion in capitalization.

Numerous factors have lead to the growth of the REIT industry since its "rebirth" during the credit crunch in 1992. The ability to access capital cheaply through the public markets; the numerous investment opportunities created by the recovering real

Exhibit 8



estate market; the development of the UPREIT structure, which enabled large, private owners of quality real estate to form REITs on a tax advantage basis; the growth in mutual fund and institutional interest in REITs; and the substantial returns that have been achieved are some of the most important factors that have driven REIT growth.

Given the strong growth of the REIT market, there is substantial debate in the industry about the possibility of a significant transition of the real estate capital markets from a private market to a public market. While the answer to the debate has already been somewhat answered due to the fact that public REITs have gone from a 1 percent market share in 1980 to over a 7 percent share in 1997, the debate continues about the potential size of the shift from private assets to public assets. One thing is clear: with some public REITs trading at prices that reflect over a 50 percent premium to underlying net asset values, all investors and fiduciaries who hold private assets must at least be considering this phenomenon and its sustainability and applicability to their portfolios.

Based on an automated real-time survey of the participants at the fall 1997 Pension Real Estate Association Conference, as reported by the *Institutional Real Estate Newslines*, interest in making direct private equity investments in real property is far from dead. While at least 70 percent of the plan sponsors in attendance said they expect to invest in

REITs in 1998, 92 percent also said they expect to invest in the private real estate markets. On the debt side, 33 percent of plan sponsors expect to invest in public real estate markets, compared to 38 percent who expect to invest in the private markets.

Furthermore, 76 percent of pension investors reported that they will invest more new dollars in 1998 in private equity versus public equity, while only 19 percent said they will invest more new dollars in public real estate securities than private equity. Over 80 percent of plan sponsors believe public real estate investments will not dominate pension funds' future real estate holdings. However, despite these indications, the interest in invest-

ment in the public real estate markets has significantly increased in recent years, largely due to the high returns and substantial growth in the size of the REIT market.

Private Debt

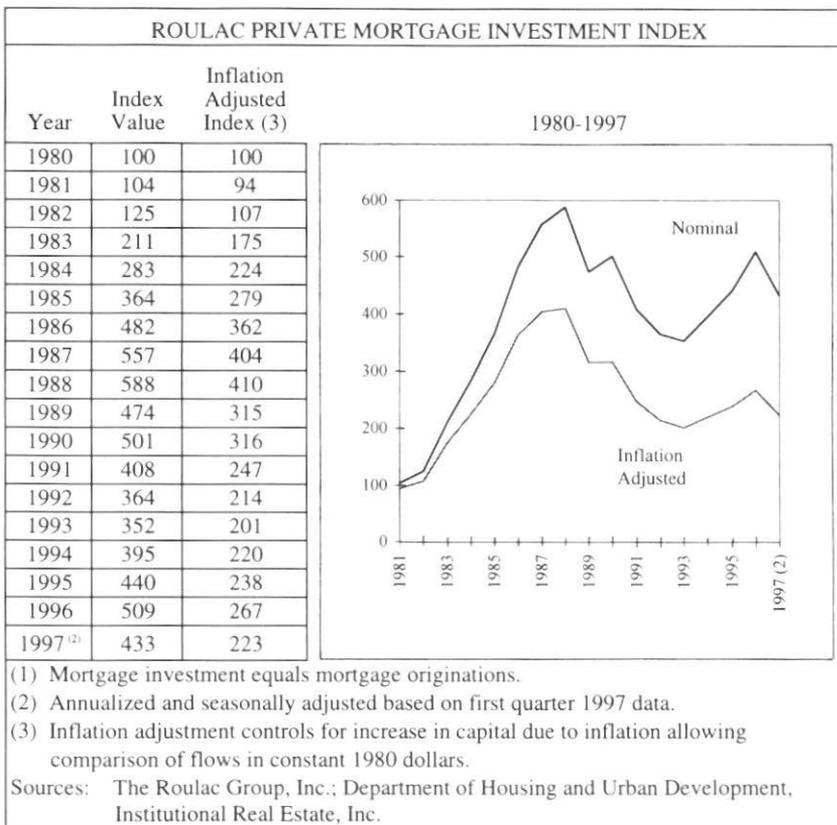
Mortgage origination activity has grown rapidly in recent years following the credit crunch that hit its bottom in 1993, as shown in *Exhibit 9*. The Roulac Private Mortgage Investment Index reached 509 in 1996, its highest level since 1988, but is projected to decline somewhat in 1997. On an inflation-adjusted basis, mortgage originations have dropped between 35 percent and 45 percent from their peak in 1987 and 1988.

A sign of health in the mortgage markets is that the net flow of real estate debt has not been excessive. While originations have been strong in recent years, there have also been substantial sell-offs of loans and refinancings of existing debt. Combining originations, sell-offs, and refinancings, there has been a modest net flow of around \$15 billion to \$20 billion per year between 1995 and 1997. This compares to a net outflow of nearly \$60 billion per year between 1990 and 1992 and a net positive inflow of capital of nearly \$85 billion per year between 1985 and 1987.

CONCLUSION

In summary, real estate capital markets can provide vital intelligence to assist in strategic

Exhibit 9



decision-making. Importantly, to maximize its applicability to decision-makers, the specific type and presentation of real estate capital markets information must be customized to a specific firm's decisions. As discussed in this article, differentiating the needs of owners, service providers, lenders, and those accessing capital is a critical first step, but only the first step in achieving competitive advantage and profit from capital markets knowledge.^{REI}

NOTES

Exhibits 2,3, and 7: The Roulac Real Estate Capital Flows Index and related statistical exhibits are derived from The Roulac Group's proprietary historic capital flows database which tracks, on a quarterly and annual basis, the aggregate market size, net flow, and capital market activity from the 17 key real estate capital providers. Key sources incorporated into our capital flows model include: U.S. Housing and Urban Development Survey of Mortgage Lending; Money Market Directories; Institutional Real Estate Inc.; Commercial Mortgage Alert; National Association of Real Estate Investment Trusts; Robert A. Stanger & Co.; CCIM/Landauer *Investment Trends Quarterly*; Department of Commerce; Bureau of Economic Analysis; American Council of Life Insurance; Federal Deposit Insurance Corp.; Historical Statistics on Banking; and the Federal Reserve's Flow of Funds Accounts.

ABOUT THE AUTHOR

Scott R. Muldavin, CRE, is managing director of The Roulac Group, Inc., in Larkspur, CA, where he has advised many of the nation's leading real estate organizations and numerous REITs, corporations, developers, operating companies, and foreign investors. Muldavin is a leading expert and advisor on the real estate capital markets and their strategic implications for investors, lenders, and real estate service providers. He is the nation's only consultant designated by both the top real estate consulting (CRE), and top management consulting (CMC), professional organizations.

EXPLORING CAPITALIZATION RATE DIFFERENTIALS ACROSS PROPERTY TYPES

by Petros S. Sivitanides & Rena C. Sivitanidou

The understanding of how asset market behavior differs across property types is important for institutional investors contemplating property-type diversification strategies.

INTRODUCTION
This article presents the results of analytical work intended to empirically identify differences in transaction-based capitalization rates across office, warehouse, retail, and apartment properties during the period of 1986-1996. Three types of differences in capitalization rates across these property types are investigated: *first*, differences in their fixed (time-invariant) component; *second*, differences in the persistence of their time trends or the speed by which they adjust in response to changes in market conditions; and *third*, differences in the pattern of their intertemporal variations.

The understanding of how asset market behavior differs across property types is important for institutional investors contemplating property-type diversification strategies. An intelligent formulation of such strategies requires assessment of the differential return prospects of each property type. Such return prospects are determined

in both the space (tenant) market, in which the time path of vacancies and rents is shaped, and the asset market, in which property prices are set. Capitalization rates are important determinants of the latter. A better understanding, therefore, of how they differ across property types can help investors better assess differential return prospects across property types.

Although existing empirical studies have detected fixed differences in capitalization rates across property types, they have neither accounted for differential persistence nor examined differences, if any, in time trends.¹ Examining aspects of such differential asset market behavior in an integrated fashion will set the platform for more accurate estimates of the different effects.

The second section of this article focuses on the empirical methodology employed in exploring the issue at hand. The third section elaborates on the analysis results and advances

potential explanations for the sources of the empirically identifiable differences in capitalization rates across property types. Finally, the fourth section summarizes the conclusions of the article and discusses potential avenues for future research.

THE EMPIRICAL FRAMEWORK

Recent metro-specific data from the *National Real Estate Index* (NREI) point to non-trivial cross-section and temporal differences in transaction-based capitalization rates across four property types: retail, office, warehouse, and apartments. A cursory examination of capitalization rate patterns across these property types is insufficient in evaluating their statistical significance and magnitude. Thus, a simple empirical model, similar in spirit to models used to examine the differential behavior of vacancy rates, price appreciation, and real estate returns, has been formulated to help validate the statistical significance of the observed differentials.²

Following the aforementioned modeling framework, the capitalization rate for a given property type at any point in time t can be decomposed into a fixed property-type specific component, a_t , and a random fluctuation around this component, ϵ_{it} :

Equation 1

$$C_{it} = a_t + \epsilon_{it}$$

The fixed component represents *that* component of return that compensates the marginal investor for each property type's idiosyncratic risk characteristics.³ The random term, also allowed to vary across property types, reflects deviations from this fixed component due to market-based income growth expectations, as well as additional market-driven risk premia. Random market movements generate time variations in such income growth expectations and risk premia, thereby influencing the capitalization rate required by investors. For given rents, such new capitalization rates are established through adjustments in asset prices. Such asset price adjustments, however, may be hampered by several asset market inefficiencies. The latter include high transaction and adjustment costs; lengthy institutional decision-making processes that may prevent investor entry/exit; and informational inefficiencies hampering the buyer-seller matching process, especially in heterogeneous asset markets. It may thus take more than one period before transaction-based capitalization rates fully reflect the effect of random market movements. As a result, a fraction, ρ , of each period's random deviation from a_t may persist into the next. The random component of the capitaliza-

Although existing empirical studies have detected fixed differences in capitalization rates across property types, they have neither accounted for differential persistence nor examined differences, if any, in time trends.¹

tion rate, ϵ_{it} , can thus be expressed as in *Equation 2*, where both, $F_t(t)$, denoting the random time trend, and ρ_t , obeying $0 < \rho_t < 1$, are allowed to vary across property types.

Equation 2

$$\epsilon_{it} = F_t(t) + \rho_t \epsilon_{it-1} + v_{it}$$

Combining *Equations 1 and 2* yields the empirical formulation in *Equation 3* which sets the appropriate platform for analyzing potential differences in the behavior of capitalization rates across property types.

Equation 3

$$C_{it} = a_t + F_t(t) + \rho_t \epsilon_{it-1} + v_{it}$$

SOURCES OF VARIATIONS IN CAPITALIZATION RATES ACROSS PROPERTY TYPES

The underlying premise of this study is that the components embedded in *Equation 3* that is, fixed effects, persistence, and random time trends, vary across property types. In what follows, an effort is made to discuss some of the potential sources of these variations in order to help rationalize the empirical specification adopted and the tests performed.

Fixed Differentials (a_t)

Potential sources of fixed differences in capitalization rates across property types may involve factors systematically differing across property types and eliciting *typical* risk premia. The latter may include, but not be limited to, the following:

Lease characteristics: Lease length may vary across property types, with office, warehouse, and retail properties normally being characterized by longer leases than multi-family residential properties. Short-term leases characterizing such residential properties may be a source of greater uncertainty regarding future cash flows. Such greater uncertainty may invite a greater premium to compensate for this risk.⁴

Adjustment costs: Typically office properties require higher capital expenditure for accommodating tenant turnover. Office investors may thus require a risk premium to compensate for such greater adjustment costs.

Investment size: The probability of overbuilding may be perceived as greater in the case of office than other property types due to the lumpiness of office investments. Consequently, office investors may require a greater risk premium to compensate for this greater business risk.

Tenant sensitivity: The cash flow of certain property types may be subject to idiosyncratic risks stemming from their reliance on specific tenants. The investment performance of retail properties, for example, may heavily rely on the presence of tenants that are critical to the realization of shopping externalities and, hence, the maximization of sales revenues and investment returns. The risk of not being able to easily replace critical tenants who relocate may warrant a compensatory premium.

Information availability and cost: Investors may invariably rely on information inputs necessary for investment performance monitoring, management, and hold-sell decisions. They may thus require a risk premium when investing in retail properties, information on which may be scarcer and more costly to obtain.

Investor familiarity with product type: Institutional investors may be more familiar with certain product types, such as office and retail, because they are part of their everyday lives. As a result, they may perceive those types as less risky than other types, such as warehouse.

Locational substitutability: Some product types may be more vulnerable to competition because of greater locational substitutability. As such, these product types may be deemed more risky. Large warehouses, for example, are used by tenants that are more footloose because they serve greater geographic areas. As such, they may be facing greater competition than neighborhood and community centers or office space used by tenants serving local markets.

Possibility of conversion to other uses: Certain property types, such as warehouses and distribution centers, may be more difficult to convert to other commercial uses, largely due to their special design and/or location in more isolated or outlying

areas. As such, they may be perceived by investors as more risky.

Time Trends

Movements in market conditions, and hence the random time trend, may similarly differ across property types. Such differences may be due to varying asset market sensitivities to random shocks in national capital market factors (e.g., interest rates, expected inflation or stock returns). They may also be due to differences across property types in their demand and supply drivers that may be subject to different unexpected random shocks, thereby shaping different paths of time-variant risk premia or income growth expectations.

Focusing on demand shifters, these may include FIRE and service employment growth in the case of the office market; industrial output and retail consumption in the case of the warehouse market; and demographics and income growth in the case of the retail and apartment markets. Focusing on supply shifters, these may include costs, expected revenues, and capital availability. To the extent these supply shifters are subject to different random shocks across property types, similar differences in random fluctuations may be present in capitalization rate time paths.

Persistence

The persistence of time trends may vary across property types due to differences in factors that hinder asset price adjustments:

Investment capital requirements: Transaction capital requirements may vary across property types due to differences in the average size of investments. Larger capital, for example, is required in the case of office and retail ventures. If such larger capital is more difficult to secure, capital flows and asset price adjustments may be slower.

Information inefficiencies: Information inefficiencies may vary across property types because of differential information availability, which may in part be due to differences in product heterogeneity. Information availability, for example, is greater for office properties, which are also less heterogeneous than residential or retail properties.

THE DATA

The empirical analysis utilizes semi-annual metro-specific data on capitalization rates obtained from the *National Real Estate Index* (NREI),

a CB Commercial publication. The NREI primarily reports data on transactions that involve about 150 of the nation's largest real estate buyers and sellers. The latter include pension plans, Real Estate Investment Trusts (REITs), banks, savings and loan associations, commercial brokerage companies, and investment program sponsors.

Based on arms-length transactions, the aforementioned area-specific capitalization rates reflect average ratios of actual NOI over the transaction price. The transaction-based prices entering the calculation of the capitalization rate circumvent problems of systematic biases associated with the use of appraised values.⁶ Moreover, although these transaction-based prices are not quality-adjusted through hedonic techniques, they do control, to some extent, for quality, as they refer to properties that conform to certain norms. These properties, for example, represent modern structures characterized by lease and vacancy rates that are not substantially different from their close substitutes within the same metropolis.

The data span over the period 1986-1996. The time period of analysis is dictated by the length of time series available but complies with Marston's (1985) two criteria: first, this time period must be short enough so that the fixed capitalization rate components, a_i , do not change throughout the entire period; second, this time period must be long enough so that any random component in place at the beginning of the period is fully reflected on prevailing capitalization rates by the end of this period. Otherwise, part of this random component will be present over the entire period and can incorrectly be captured by a_i .

THE EMPIRICAL RESULTS

Two variants of the empirical function presented in Equation 3 were estimated. The first, *Model 1*, (presented in Table 1), is intended to explore average national differences across property types, thus assuming no differentiation in estimated parameters across metropolitan locations. The second, *Model 2*, (presented in Table 2), focuses on differences in capitalization rate components across property types at the metropolitan level of analysis.

National Differentials in Capitalization Rate Components across Property Types

Table 1, presenting *Model 1's* results, displays the estimated fixed capitalization rate components in the beginning of the study period, random time effects, and persistence in time trends for each

property type. The results of joint and pairwise equality tests of these parameters are also presented in the same table. *Figures 1 and 2* highlight the magnitude of the various capitalization rate components.

Differentials in Fixed Components

The analysis of fixed effects and differences in such effects across property types lends support to the following conclusions:

1). Fixed effects for all property types are highly statistically significant. Furthermore, such fixed effects are not jointly equal across property types. This conclusion is consistent with the hypothesis that each property type has inherent idiosyncratic traits that elicit differential risk premia.

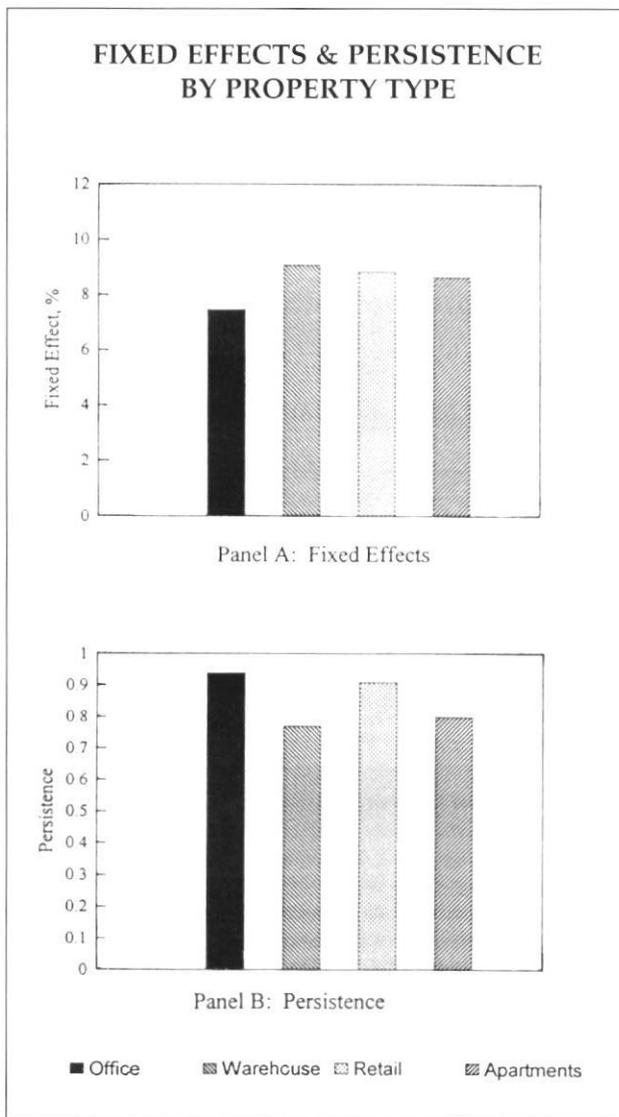
2). Pairwise tests of equality also indicate that the office fixed component is statistically different from the fixed component of the warehouse, retail, and apartment capitalization rates. As indicated by *Figure 1-A*, the overall risk premium typically required by investors for office seems to be statistically smaller than those required for warehouse, retail, and apartment properties. This is consistent with the smaller degree of heterogeneity of office structures, the greater availability of detailed market information for office than for any other property type, and the greater familiarity of institutional investors with such a property type. The lower risk premium office commands compared to apartments may also stem from its three-to-five-year lease contracts that lower the uncertainty of its cash flows compared to the one-year lease contracts typically associated with apartments. Finally, the lower risk premium that office properties command compared to retail may be due to the smaller sensitivity of their cash flows to a particular tenant. Overall, the results suggest that these relative advantages of office (in terms of risk) outweigh its relative disadvantages such as the higher adjustment costs and the greater probability of overbuilding.

3). The warehouse fixed component is statistically different from the respective apartment component, but not statistically different from the respective retail component. These results indicate that the risk premium typically required by investors for warehouse is greater than the one required for apartments. This may be due to the fact that institutional investors may be more familiar with apartment properties than with warehouse properties. Furthermore, warehouses may be located at more isolated locations where conversion to other uses may not be economically feasible. Such properties may also be subject to greater locational substitutability compared to apartments.

Table 1

Model 1 - Estimation Results ¹				
DIFFERENCES IN CAPITALIZATION RATES AND PERSISTENCE ACROSS PROPERTY TYPES				
A. Estimation Results	Office	Warehouse	Retail	Apartments
Fixed Effects, a	7.46** (16.68)	9.07** (63.78)	8.83** (37.84)	8.63** (42.17)
Persistence, ρ	0.94** (65.64)	0.77** (17.64)	0.91** (42.24)	0.80** (22.16)
b_{1987}	0.01 (0.37)	-0.08* (-1.79)	-0.09** (-2.80)	0.03 (0.50)
b_{1988}	-0.03 (-0.63)	-0.09** (-2.01)	-0.08** (-2.15)	-0.01 (-0.12)
b_{1989}	0.02 (0.51)	-0.06 (-1.21)	0.01 (0.35)	0.01 (0.21)
b_{1990}	0.20** (4.79)	0.05 (1.26)	0.10** (3.50)	0.13** (2.31)
b_{1991}	0.18** (5.23)	0.15** (3.06)	0.22** (6.58)	0.22** (3.67)
b_{1992}	0.29** (7.06)	0.26** (4.19)	0.18** (5.09)	0.50** (4.53)
b_{1993}	0.13** (2.84)	0.19* (1.77)	0.08* (1.68)	0.17* (1.72)
b_{1994}	0.01 (0.21)	0.01 (-0.08)	-0.03 (-0.67)	0.03 (0.29)
b_{1995}	0.05 (0.86)	0.04 (0.89)	0.02 (0.60)	0.01 (0.15)
b_{1996}	0.23** (3.92)	-0.10 (-1.57)	-0.06 (-1.25)	-0.20** (-2.74)
B. Tests of the equality of fixed effects				
		χ^2 - statistic		P - value ²
Null Hypothesis:				
$a_{office} = a_{warehouse} = a_{retail} = a_{apartment}$		17.93		0.00
$a_{office} = a_{warehouse}$		16.32		0.00
$a_{office} = a_{retail}$		8.73		0.00
$a_{office} = a_{apartment}$		9.41		0.00
$a_{warehouse} = a_{retail}$		0.84		0.36
$a_{warehouse} = a_{apartment}$		5.80		0.02
$a_{retail} = a_{apartment}$		0.52		0.47
C. Tests of the equality of persistence				
Null Hypothesis:				
$\rho_{office} = \rho_{warehouse} = \rho_{retail} = \rho_{apartment}$		24.15		0.00
$\rho_{office} = \rho_{warehouse}$		14.05		0.00
$\rho_{office} = \rho_{retail}$		0.97		0.33
$\rho_{office} = \rho_{apartment}$		12.82		0.00
$\rho_{warehouse} = \rho_{retail}$		8.44		0.00
$\rho_{warehouse} = \rho_{apartment}$		0.33		0.57
$\rho_{retail} = \rho_{apartment}$		6.75		0.01
Notes:				
1. t-statistics are in parenthesis below the coefficients; one and two asterisks denote significance at the 10% and 5% levels, respectively				
2. If the P-value is less than 0.1, then there is evidence to reject the null hypothesis at the 10% level of significance				

Figure 1



4). Finally, the retail fixed component is not statistically different from the apartment fixed component. This is not necessarily an indication that there are no risk premia that are idiosyncratic to each of these property types. It may simply mean that their idiosyncratic risk premia add up to the same fixed component.

Differences in Persistence

Focusing now on the speed by which capitalization rates adjust in response to random market fluctuations, the results support the conclusion that there is statistically significant persistence in the time trends of all property types. This suggests that transaction-based capitalization rates for all property types do not change instantly to reflect changes in market conditions. As indicated by the joint equity test, such persistence is not statistically equal across property types (see Table 1). This result reveals

the presence of different degrees of asset market inefficiencies across property types. It furthermore suggests that even if all property types experience the same random shocks, their capitalization rate time paths should exhibit some differences because of differences in the persistence of random market movements.

Pairwise equality tests highlight specific differences in the speed of capitalization rate adjustment across property types:

1). The speed of adjustment of office capitalization rates is statistically different from both the warehouse and apartment adjustment speeds. In particular, as Figure 1-B shows, office capitalization rates appear to have greater persistence (ρ) or smaller adjustment speed ($1-\rho$) than warehouse and apartment capitalization rates. This may be due to the larger investment capital required for the realization of office as opposed to warehouse and apartment transactions. Such greater capital requirements may slow down capital flows and the decision-making process. The size of the investment may, in addition, render office property owners more reluctant to dispose their properties at a time when market conditions are unfavorable.

2). The persistence of the retail capitalization rate is statistically different from both the warehouse and the apartment capitalization rate persistence. More specifically, as Figure 1-B indicates, the speed of adjustment of the retail capitalization rate seems to be lower than the adjustment speed of the warehouse and apartment capitalization rates. These differences may be explained by the same factors cited for office.

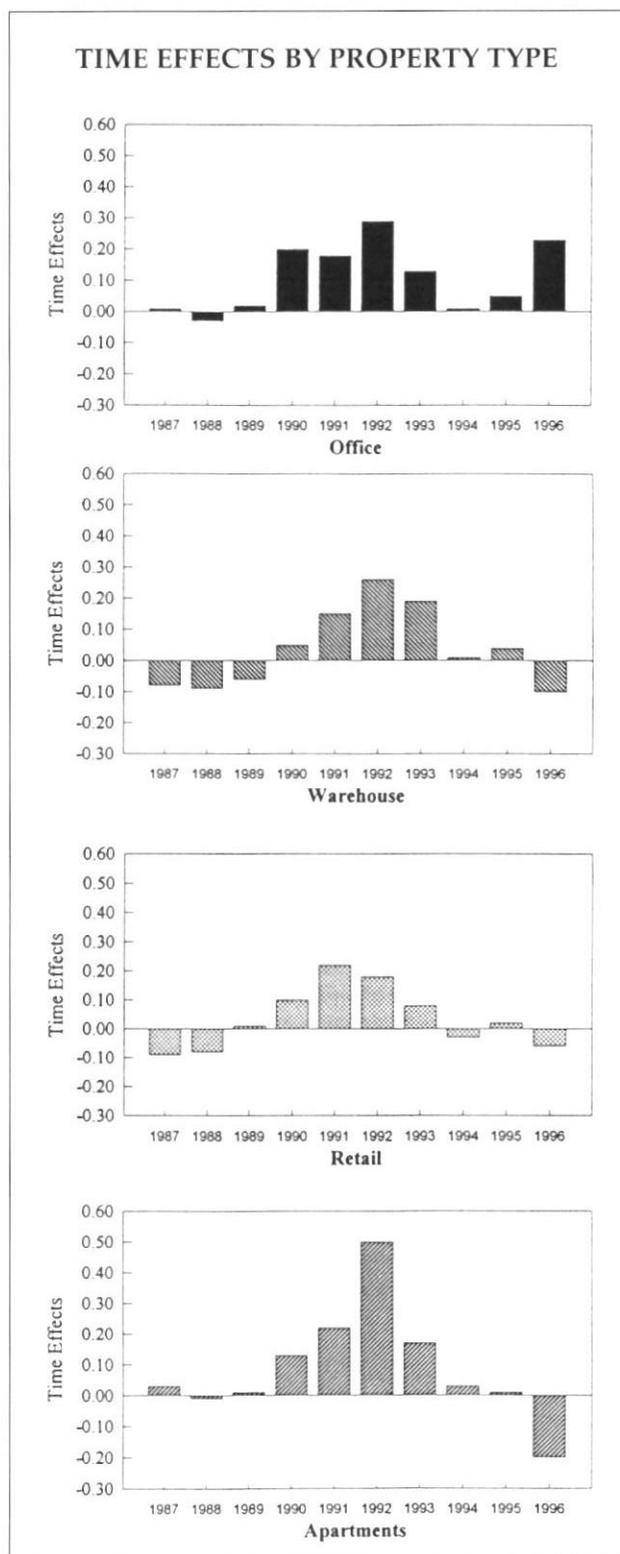
3). No statistically significant differences are detected in capitalization rate persistence between office and retail and between warehouse and apartment properties.

Differentials in Time Effects

The time trends of capitalization rates for each property type are captured by the annual dummies. The coefficients presented in Table 1 and portrayed in Figure 2 represent each year's time effect relative to 1986 (the default year), net of any persistence effects that are idiosyncratic to each property type. The results suggest the following with respect to capitalization rate movements:

1). There are indeed random time fluctuations in capitalization rates across all four property types. Such fluctuations are validated by the statistical significance of a number of time dummies. The results, for example, show a statistically significant deviation of the office capitalization rate from its

Figure 2



fixed component in five years, that is, during the recessionary period of 1990-1993 and in 1996.

2). It is interesting to note that a statistically significant time effect can be observed during the recessionary period of 1990-1993, for all property types.

3). Contrary to office and apartments, warehouse and retail exhibit statistically significant components in 1987 and 1988 but not in 1996.

DIFFERENCES IN CAPITALIZATION RATE COMPONENTS ACROSS METROPOLITAN LOCATIONS

The estimation results of *Model 1* suggest that capitalization rates exhibit differences in fixed effects and persistence across property types on the national level. Similar tests have also been performed at the metropolitan level of analysis based on the estimation results of *Model 2*. The estimates and relevant tests are presented in *Table 2*. The results of these tests indicate universal differences in fixed effects across property types. Of the 20 metropolitan areas included in the sample, fixed effects across property types are jointly statistically different in 16 of them. Differences in adjustment speeds across property types are also validated at the metropolitan level. Such differences, however, are not as common as differences in fixed effects. In particular, such differences are statistically significant in only eight out of the 20 metropolitan areas included in the sample. This may suggest that there are powerful idiosyncratic metropolitan characteristics, such as spatial structure and location diversity, whose effect on real estate space and asset market adjustments may span across all property types.

CONCLUSIONS

This study suggests that capitalization rates across property types differ along three dimensions: in the magnitude of their fixed, time invariant component; in the pattern of their time trends; and in the persistence of these time trends. Potential explanations on the sources of such differences have been advanced, but further empirical work is required to substantiate or contradict these explanations. To this end, the estimated models should be reformulated to account for potential fixed and time-variant determinants of differentials in capitalization rates across property types. Such analysis will set the stage for uncovering specific sources of differential asset market behavior and assessing their relevant importance.

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NOTES

1. See, for example, Ambrose, Brent and Hugh Nourse: "Factors Influencing Capitalization Rates," *Journal of Real Estate Research*, Volume 8, Number 2, 1993, pp. 221-237.
2. See Marston, R.: "Two Views of the Geographic Dispersion of Unemployment," *Quarterly Journal of Economics*, Volume 100, 1985, pp. 57-79; Voith, R. and T. Crone: "National

Table 2

Model 2 - Estimation Results
**CAPITALIZATION RATES: FIXED EFFECTS AND PERSISTENCE
 ACROSS PROPERTY TYPES BY METROPOLITAN AREA**

Metropolitan Area	Fixed Effects				Testing for the Equality of Fixed Effects ($\alpha_o = \alpha_w = \alpha_r = \alpha_a$)				Persistence				Testing for the Equality of Persistence ($\rho_o = \rho_w = \rho_r = \rho_a$)			
	Office	Warehouse	Retail	Apartments	χ^2		Office	Warehouse	Retail	Apartments	χ^2		Office	Warehouse	Retail	Apartments
					Statistic	P-value ¹					Statistic	P-value ¹				
Atlanta	8.29	9.25	8.73	8.58	105.01	0.00	0.29	0.18	0.64	0.39	8.73	0.03				
Baltimore	8.01	9.29	8.61	8.68	29.89	0.00	0.83	0.58	0.84	0.75	3.26	0.35				
Boston	7.08	9.03	8.44	7.83	92.81	0.00	0.76	0.77	0.72	0.87	1.82	0.60				
Charlotte	8.38	9.40	9.09	8.67	100.13	0.00	0.32	0.58	0.71	0.50	8.14	0.04				
Chicago	7.00	9.09	8.48	8.62	15.32	0.00	0.89	0.78	0.81	0.46	4.31	0.23				
Dallas	8.81	9.31	9.27	9.03	15.26	0.00	0.68	0.54	0.63	0.78	3.11	0.37				
Houston	4.46	9.42	9.74	9.13	1.00	0.81	0.97	0.79	0.75	0.85	5.54	0.13				
Los Angeles	5.36	8.74	8.49	8.18	9.63	0.50	0.96	0.70	0.93	0.80	5.54	0.22				
Minneapolis	8.41	9.62	9.17	8.74	83.82	0.00	0.64	0.40	0.80	0.53	4.00	0.25				
Orange	5.36	8.74	8.49	8.18	9.63	0.00	0.96	0.70	0.93	0.80	5.54	0.02				
Orlando	8.39	9.24	8.83	8.76	21.81	0.00	0.57	0.65	0.74	0.19	9.89	0.02				
Philadelphia	8.11	9.37	9.12	8.70	34.90	0.00	0.81	0.58	0.78	0.75	2.86	0.41				
Phoenix	9.01	9.04	9.11	8.89	0.83	0.84	0.45	0.64	0.68	0.38	4.91	0.18				
Riverside	8.57	9.03	8.63	8.55	0.56	0.90	0.82	0.76	0.88	0.73	4.19	0.24				
Sacramento	8.22	9.11	8.62	9.29	16.19	0.00	0.47	0.64	0.88	0.55	6.89	0.07				
San Diego	7.68	8.84	8.50	8.48	10.50	0.01	0.83	0.71	0.90	0.76	3.58	0.30				
San Francisco	6.41	8.90	8.29	7.38	13.26	0.00	0.91	0.82	0.88	0.89	1.08	0.77				
Seattle	7.93	8.92	7.79	8.94	33.47	0.00	0.63	0.24	0.88	0.49	9.69	0.02				
Tampa	8.58	9.39	9.24	8.80	32.07	0.00	0.53	0.48	0.75	0.45	9.36	0.02				
Washington	6.77	9.43	8.23	7.79	32.33	0.00	0.83	0.64	0.91	0.91	6.51	0.08				

Note:

1. If the P-value is less than 0.1, then there is evidence to reject the null hypothesis at the 10% level of significance

Vacancy Rates and the Persistence of Shocks in the U.S. Office Markets," *AREUEA Journal*, Volume 16, 1988, pp. 437-458; and Gyourko, J. and R. Voith: "Local Market and National Components in House Price Appreciation," *Journal of Urban Economics*, Volume 32, 1992, pp. 52-69.

3. The implicit assumption here is that market conditions rather than idiosyncratic property traits determine income growth expectations. However, certain property-specific traits, such as lease length, may affect in some way expectations for income growth.
4. Lease length differentials may also induce differential expectations for income growth, as longer leases may be associated with smaller rental changes. On the other hand, however, short term leases, may allow investors to easily take advantage of rent increases dictated by improving market conditions.
5. Furthermore, such greater probability of overbuilding may be associated with lower rent growth expectations. The effect of investment size on income growth expectations is unclear as supply side sluggishness can also prolong undersupply and strong rental growth increases.
6. See Wheaton, William and Ray Torto: "Income and Appraised Values: A Reexamination of the FRC Returns Data," *AREUEA Journal*, Volume 17, 1989, pp. 439-449. These authors suggest that appraised values may reflect systematic biases, as they appear to consistently incorporate erroneous expectations regarding future growth in rental incomes.

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CRE PERSPECTIVE

HOW REAL ESTATE DEBT AFFECTS ASSET ALLOCATION

by John K. Rutledge, CRE

Real estate leverage generates results not expected or understood by the typical investment professional. It distorts the performance of the bond portfolio and corrupts the carefully planned asset allocation of the total portfolio.

Investors and real estate investment managers commonly use the term "leverage," or mortgage financing, in discussing real estate investment. Known in certain other systems as "gearing," leverage is simply the use of borrowed money in association with the ownership of an asset. In the investment setting, mortgage debt is commonly nonrecourse, meaning that the lender may claim the property following the borrower's default, but may not recover from other assets of the borrower. The borrowing may occur to fund the acquisition, or at a later date, borrowing could provide funds for capital or operating requirements or for distribution to the owners. Both tax exempt and taxable investors use leverage to improve yield and gain control of property for which capital is not otherwise available, and taxable investors may also use debt to multiply tax benefits.

Consumers typically use mortgage financing in the acquisition of a home because of the lack of otherwise available capital for the purchase. Traditionally, homeowners celebrate the day they pay off the mortgage. Many home buyers would pay cash if it were available. (The argument that mortgage debt is desirable because of the tax shelter benefits is specious. It takes a dollar of interest payment—real money—to save \$.28 of tax at a 28 percent marginal tax rate. The borrower is still out the other \$.72.)

Real estate investment managers acquire property on behalf of institutional and private investors which have allocated a portion of their total portfolio to real estate for three principal reasons: 1). they seek to minimize the impact of volatility of performance of specific asset classes; 2). to hedge against inflation; and 3). to generate attractive levels of current income. These managers may use debt to acquire specific assets or may pledge a group of assets to obtain financing to augment the equity available for real estate investment. If these managers represent only the property component of a portfolio, they are likely to be uninformed about the other components of the institutional portfolio.

Background — The Construction of a Portfolio

A professional portfolio manager carefully constructs the investment portfolio to achieve certain objectives consistent with the needs of the owner of the portfolio. For example, the manager of a pension portfolio strives to assure the payment of accrued benefits to current and future retirees. The manager allocates assets to reflect the ages and years of service of the personnel who will receive pensions. From the individual perspective, a wealthy family may seek capital growth for the next generation, while a retiree may require high current income to cover living costs.

Institutional investors generally recognize asset allocation as being much more important than individual issue selection in achieving portfolio objectives. For example, the selection of an individual stock will be far less significant to the success of the portfolio than will be the decision concerning the proportion of the portfolio allocated to the stock market.

A carefully allocated portfolio typically contains stocks, bonds, and cash equivalents. It may also include real estate, venture capital investments, oil and gas interests, distressed securities, and other asset classes. The stock or equity component may include subsets such as small capitalization stocks and international stocks. The international component may include securities of established firms located in developed countries as well as stocks in new ventures in emerging nations. The opportunities and their combinations are endless.

Each asset class in a portfolio is there for the benefits it imparts. Because each asset class has different characteristics and impacts on the portfolio, the mix of assets chosen to comprise the portfolio represents an optimization designed to achieve the objectives of the investor.

The asset allocation process is technically complex and highly sophisticated. Most institutional investors engage specialized consultants to advise on asset allocation and investment manager selection. This manuscript does not address these issues.

The allocation process views unleveraged real estate as an asset class with unique investment performance characteristics. (This is consistent with the reporting practices of the National Council of Real Estate Investment Fiduciaries

(NCREIF), the recognized leader in the publication of real estate performance data, which reports on real estate as if it carries no debt.)

This manuscript examines the impact of adding debt to the capital structure of otherwise unleveraged real estate. A property can be viewed as a business enterprise appropriately capitalized like any other business with a mixture of debt and equity. Perhaps real estate should be capitalized differently from other enterprises, since unlike a service or manufacturing business, real estate is relatively more dependent on fixed assets (bricks and mortar) and less dependent on working capital and managerial and operating structures.

The Role of Debt

Debt allows the smaller investor to acquire more property than would be possible with equity alone. A dollar of equity can buy a dollar of real estate. A dollar of equity along with three dollars of debt, a typical ratio, will buy four dollars of real estate. If the real estate investment earns more than the debt costs, the leverage is positive and total return of the portfolio is enhanced.

As the savings and loan and the tax shelter industries discovered in the late 1980s, however, debt can cut both ways. Excessive development, financed with mortgage debt, caused supply to overwhelm demand. Rent (the price for the use of space determined by the relationship between the supply and demand curves) fell, and debt went into default. This use of debt was intended to multiply tax benefits by magnifying the amount of depreciable property a dollar of equity could buy. It bore a strong speculative flavor (ultimately disastrous) regarding the property itself but was firmly grounded in

the tax environment of the time.

However, debt may be less costly than equity and can therefore enhance the long-term performance of the real estate investment. Consider for example a property leased for 25 years to a company with impeccable credit. If the return on the property is greater than the prevailing interest rate on 25-year mortgages, use of debt may be beneficial. The rental receipts exceed the mortgage interest payments so that the cash flow remaining after interest cost represents a very attractive return on the equity invested in the property. The wisdom of using such financing is difficult to debate. Of course, principal amortization complicates the calculation, but borrowers believe that debt amortization almost always results in an increase in the value of the equity position.

Attacking Conventional Wisdom

A mortgage is a fixed income investment for the investor supplying the mortgage money to the borrower. It fits into that investor's portfolio alongside the bonds and other fixed income investments. As with other fixed income investments, mortgages come in a variety of terms and interest rate structures. A mortgage may require interest only or be amortized partially or completely over its term. The term may be for 25 years or more, or fewer than five years. It may carry a fixed or variable rate for its term, and the rate may involve a spread over any of a number of benchmark rates such as prime, LIBOR, or Treasury instrument rates.

It naturally follows that, if a mortgage loan is a fixed income investment for the supplier of mortgage capital, then it is a "negative" fixed income investment for the mortgage borrower, the party on the other side of the

same transaction. After all, a liability for one party (the borrower) is an asset for another (the lender).

The mortgage debt has an impact on the portfolio inverse to that of a fixed income asset. In a deflationary environment with asset values falling, a mortgage obligation does not change in dollar terms. In real terms, it increases in value (to the benefit of the lender and therefore to the detriment of the borrower), magnifying the decline in the real value of the underlying equity. With inflation, the opposite is true.

Likewise, a change in interest rates affects the value of a mortgage. Homeowners demonstrate this in seeking to eliminate high rate mortgage debt in a falling rate environment by refinancing. Conversely they preserve a low rate mortgage when rates are rising. Just as a high rate bond increases in value as rates fall, a high rate mortgage becomes relatively more burdensome to the borrower as cheaper financing becomes available. (Typically, fixed rate residential mortgages are more easily refinanced than similar commercial mortgages in a falling rate environment.)

A More Precise Analysis

A borrower of mortgage financing is more accurately issuing debt. While the U.S. government and large corporations can issue unsecured debt, the typical property owner does not have that credibility or, alternatively, wishes to borrow without exposing other assets to the creditor. The only way to issue debt, therefore, is to secure it with an asset, and real estate by convention serves as collateral.

Looking at debt in this fashion leads one to the conclusion that the desirability of issuing debt is unrelated to the ownership of real estate. The only connection between

real estate and debt is in the customary use of real estate as collateral for the financial activity of issuing debt. In considering the issuing of debt, the investor must analyze this financial activity on its own merits separate from the real estate portfolio.

The typical institutional investor is charged with the prudent management of wealth. This wealth represents insurance policy reserves held on behalf of policy owners; pension reserves working to minimize contributions to the plan while assuring the coverage of future pension liabilities; trust funds left by an individual to cover the needs of surviving family members; and other funds.

It is the role of the institutional investor to manage the wealth of others. It is not appropriate customarily for the institutional investor to expose that wealth to the potential or actual claim of a mortgage lender without fully understanding the impact on the total portfolio. An exception, however, is noted below.

The Real Issue

If the institutional investor considers the issuance of debt, the analysis should be based on an "apples-to-apples" comparison. Matching a real estate asset with a fixed income liability (negative asset) is illogical. To avoid distorting the carefully crafted portfolio, the manager must base the decision to finance real estate on opportunities strictly within the fixed income component of the portfolio. If the manager can issue debt at a rate less than is available in the market for fixed income assets, such issuance may be beneficial. Obviously, instruments with similar terms and interest rate structures must be compared.

For example, if the rate on a 25-year bond is more than the rate on

a 25-year mortgage, it may be wise to issue a debt (mortgage) and acquire the corresponding asset (bond), capturing the spread. Credit quality, liquidity, and other considerations bear on the analysis. The manager must also consider both negative and positive reinvestment risk. Specifically, a typical long-term mortgage requires principal amortization, while a bond is interest-only until maturity.

If debt cannot be arranged at a positive spread with corresponding fixed income investments, the investor should not issue the debt. Perhaps the investor should sell bonds (loans to the issuer) from the fixed income portfolio to raise the funds to acquire the real estate. Of course, the investor must face asset allocation considerations very directly in making this shift from bonds to real estate.

If debt is placed on real estate without consideration of the fixed income component of the portfolio, the real impact is to cancel the performance of the bond portfolio to the extent that the mortgage debt has similar characteristics to the bonds. The negative fixed income instrument (mortgage loan) offsets the positive fixed income instrument (bond), with the result being an inadvertent but effective reduction of the bond portfolio. The real estate investment manager who chooses to acquire leveraged real estate for the institutional client has, in effect, multiplied the money handed over by the client and has given the client the performance of real estate to the full extent of the gross real estate value. This concentration of real estate may be higher than the intended allocation by the institutional client to "real estate," and may result in canceling out the performance of a portion of the bond portfolio managed by another investment manager.

The end result is a distortion of a portfolio mix caused by increasing the impact of real estate while reducing the impact of bonds, as compared to the intent of the institutional investor.

To illustrate with a simple example, assume that the portfolio allocation model calls for 55 percent equities (stocks), 35 percent fixed income (bonds), and 10 percent real estate. Further, assume that the real estate investment manager assembles a portfolio of real estate financed with debt equal to 75 percent of its value. To keep the example unrealistically simple, let us further assume that the mortgage debt and the bond portfolio have identical characteristics such as duration and risk. Thus, the 10 percent real estate is matched with debt equal to 30 percent of the portfolio, so that the total real estate value represents 40 percent of the entire investment portfolio.

	<i>Asset Allocation</i>	<i>Impact Of Debt</i>	<i>Effective Allocation</i>
Stocks	55	0	55
Bonds	35	(30)	5
Real Estate	10	30	40
<i>Total</i>	100	0	100

Of course, the impact on the portfolio will be disguised by burying the effect of the "negative bond" in the reported performance of the real estate portfolio which includes the debt. The investor may remain completely unaware of the ultimate effect on the total portfolio caused by the partial cancellation of the performance of the carefully allocated fixed income portfolio.

An Exception

The investor may be wise to use the maximum possible nonrecourse financing in a certain circumstance. If a component of the portfolio is allocated to very high risk real estate investments, the use of heavy debt and minimal equity in acquiring each asset

may in effect give the investor a "put" to be used if the asset does not perform. The small amount of equity allows the investor to "play" and, if the property works, to realize great returns. On the other hand, if the property fails to meet expectations, the investor can put it to the lender at the amount of the loan, capping the potential loss at the minimal amount of equity invested.

Summary

Mortgage debt must be considered for what it really is—a fixed

income liability—which should be associated with the fixed income assets in a portfolio. While real estate serves as collateral, real estate is only incidental to the central activity of issuing debt. If an investor can both lend through the investment in bonds and borrow through the issuance of mortgage debt with a profitable spread, the debt may be useful. In terms of effect on the total portfolio, it is the bond component which is being leveraged. The involvement of real estate as collateral should not confuse the participants as to the real

impact on the asset allocation and performance of the portfolio.^{REI}

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EUGENE CARVER, CRE, NAMED RECIPIENT OF THE 1997 JOHN R. WHITE & JAMES D. LANDAUER AWARD

Recognizing his many years of outstanding dedication to The Counselor organization and contributions to the real estate industry, **Eugene Carver, CRE**, received The Counselors premier award, the 1997 *John R. White & James D.*



Landauer Award in November during the CRE Annual Convention in New Orleans.

Active since his invitation to CRE membership in 1974, Gene served as Counselor President in 1991. He has served three terms on The Counselors' Board of Directors and as a

member and chair of numerous other committees and task forces.

In 1969 Gene became President of Hoffman Associates Incorporated, a privately-owned asset management and real estate consulting firm where he now serves as Chairman. He also serves as a Trustee of the H. Leslie & Elaine S. Hoffman Foundation. His current and former Directorships include: Bank

America Realty Services, Bank-America Mortgage Company, Bank America Realty Investors, Hoffman Electronic Corporation, California Housing Council, St. Barnabas Senior Center.

In 1986, the James D. Landauer Award was created as a memorial to honor CRE Jim Landauer. However, beginning with the 1997 presentation, the award has been renamed the *John R. White & James D. Landauer Award*. Its existence honors the contributions both men made to The Counselor organization and the counseling profession. The award is presented annually, when appropriate, to a real estate professional who has furthered the ethical and professional ideals of The Counselors of Real Estate and its CRE Designation.

Past recipients include: CREs Roland Rodrock Randall, James Gibbons, Roy P. Drachman, John White, Boyd Barnard, George Lovejoy, Jr., Daniel Rose, Jared Shlaes, J. Daryl Lippincott, and non-members Charles Shaw and Charles Spaulding.^{REI}



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