REAL ESTATE ISSUES®

THE COUNSELORS OF REAL ESTATE™
www.cre.org

Fall 2003
Volume 28, Number Three

REAL ESTATE ISSUES

1976 - 2003
28 Years of Publishing Excellence

REAL ESTATE ISSUES®

1976 - 2003
28 Years of Publishing Excellence

EDITORIAL CALENDAR

Winter 2003-2004
Articles on general real estate-related topics
(deadline for manuscript submission - February 6, 2004)

Spring 2004
A special edition focusing on the history of real estate, in the previous 50 years, as well as the trends that will shape the industry in the next 50 years.
(deadline for manuscript submission - March 16, 2004)

Summer 2004
Articles on general real estate-related topics
(deadline for manuscript submission - June 14, 2004)

Fall 2004
Articles on general real estate-related topics
(deadline for manuscript submission - September 13, 2004)

Visit www.cre.org for information on submitting a manuscript for publication consideration or contact info@cre.org; 312.329.8427.

SUBSCRIPTION INFORMATION

Real Estate Issues publishes four times per year (Spring, Summer, Fall, Winter). To subscribe to ***Real Estate Issues*** or for additional information, contact The Counselors at **www.cre.org;** info@cre.org; 312.329.8427.

ADVERTISING OPPORTUNITIES

FALL 2003

Volume 28, Number One

REAL ESTATE ISSUES

published by

THE COUNSELORS OF REAL ESTATE

1976 - 2003

28 Years of Publishing Excellence

TABLE OF CONTENTS

Currently published quarterly by The Counselors of Real Estate, a not-for-profit organization, of the National Association of REALTORS®, 430 North Michigan Avenue, Chicago, Illinois 60611.

Third class postage paid at Chicago. Real Estate Issues publishes four times annually (Spring, Summer, Fall, Winter). Subscription rates are: $48 for one year (4 issues); $80 for two years; $96 for three years; $42 per year to students and faculty; $54 foreign rate, submit in U.S. currency; single copy $15. Remittances may be made by credit card or personal check, payable to The Counselors of Real Estate. Remittances, change of address notices, undeliverable copies, orders for subscriptions, and editorial material should be sent to *Real Estate Issues*, The Counselors of Real Estate, 430 North Michigan Avenue, Chicago, Illinois 60611. *Phone:* 312.329.8427; *Fax:* 312.329.8881; *E-mail:* info@cre.org; *Website:* www.cre.org

Library of Congress card number LC 76-55075

ABOUT THE COUNSELORS OF REAL ESTATE™

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

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

CREs achieve results, acting in key roles in annual transactions and/or real estate decisions 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' quarterly award-winning journal *Real Estate Issues* which offers decisive reporting on today's changing real estate industry. Recognized leaders contribute critical analyses not otherwise available on important topics such as institutional investment, sports and the community, real estate ethics, tenant representation, break-even analysis, the environment, cap rates/yields, REITs, and capital formation. Members also benefit from the bi-monthly member newsletter, *The Counselor*, and a wide range of books and monographs published by The Counselor organization. A major player in the technological revolution, the CRE regularly accesses the most advanced methodologies, techniques and computer-generated evaluation procedures available.

What is a Counselor of Real Estate (CRE)?

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

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

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

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

Users of Counseling Services

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

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

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

CONTRIBUTOR INFORMATION

Real Estate Issues publishes four times annually (Spring, Summer, Fall, Winter). The journal reaches a lucrative segment of the real estate industry as well as a representative cross section of professionals in related industries.

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

Member and non-member authors are encouraged to submit their manuscripts to:
Real Estate Issues, c/o The Counselors of Real Estate, 430 North Michigan Avenue, Chicago, Illinois 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. If a product, service, or company is featured, it should be informational vs. promotional in nature. Potential conflicts of interest between the publication of an article and its advertising value should also be avoided.

Every effort will be made to notify the author on the acceptance or rejection of the manuscript at the earliest possible date. Upon publication, copyright is held by The Counselors of Real Estate (American Society of Real Estate Counselors). The publisher will not refuse any reasonable request by the author for permission to reproduce any of his/her contributions to the journal.

DEADLINES

See Editorial Calendar on inside back cover for deadlines.

MANUSCRIPT/GRAPHICS PREPARATION

1). Manuscripts **must be submitted via e-mail or disk** (along with hard copy) in **IBM or PC format only—Mac files cannot be accommodated**: .txt (text) file format or Word for Windows 6.0. All submitted materials, including abstract, text and notes, are to be **double-spaced**. Number of manuscript pages is not to exceed 25 single-sided sheets (approx. 7,000 words). **Submit a 50- to 100-word abstract* and a brief biographical statement, including author's e-mail address. Computer-created charts/tables should be in separate files from article text.**
*(*If the manuscript is accepted for publication, the abstract/brief synopsis would appear on the table of contents page.)*
2). Graphics/illustrations are to be considered as "Exhibits," numbered consecutively and submitted in a form suitable for reproduction. Graphics must either be submitted camera-ready or computer-generated as PC compatible ONLY. DO NOT submit colorized computer files—the graphics must be created in grayscale or black and white only. If possible, save in all of or at least one of the following formats: .emf; .eps; .wmf.
3). Number all graphics (tables/charts/graphs) consecutively. All graphics should have titles.
4). All notes, both citations and explanatory, are to be numbered consecutively in the text and placed at the end of the manuscript.
5). If appropriate, and of good quality, include photographs to clarify and enhance the content of the article.
6). Article title should contain no more than eight to 10 words including an active verb.
7). For uniformity and accuracy consistent with our editorial policy, refer to *The Associated Press Stylebook.*

THE BALLARD AWARD MANUSCRIPT SUBMISSION INFORMATION

The *REI Editorial Board* is accepting manuscripts in competition for the 2002 William S. Ballard Award. All articles published in REI during the 2002 calendar year will be eligible for consideration, including member and non-member aauthors. 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 2002 recipient will be honored at The Counselors 2003 Midyear Meetings.)

REAL ESTATE ISSUES

EDITOR'S STATEMENT - by Hugh F. Kelly, CRE

CRE Hugh F. Kelly

By the time this edition of *Real Estate Issues* reaches you, we will have moved into the year 2004. Most folks use the time around New Years Day to take stock of themselves at this point in time, and to look forward to plans for the future. For the Counselors of Real Estate, this is a auspicious moment to do likewise. For we have just celebrated our 50th anniversary at the National Meetings in Miami Beach, and embark on an exciting journey as we craft our future as an organization.

We do this, naturally, within the context of an evolving world and an evolving industry. *Real Estate Issues* offers us all a forum to think about matters of past, present, and future. We have invited a number of CREs to contribute articles for this and future numbers of REI, and are very pleased to publish several thought-provoking pieces.

Bill Mundy, CRE has collaborated with three colleagues (John Kilpatrick, John Carruthers, and Ron Throupe) on a major essay entitled, "Looking Backward and Forward: Economic Restructuring and United States Real Estate Markets." The authors examine some of the far-reaching changes of the past half-century—explosive suburban growth, migrations to the Southern and Western regions of the country, the shift from manufacturing to services, the accumulation of household wealth—and some of the contemporary results—changes in urban structure, the information economy, and the rise of the so-called "creative class." They examine the question, "How do non-market goods affect our understanding of 'market value'?"

Ken Riggs, CRE reminds us of the trade-offs of risk and reward we face in a changing world. Economics and politics, together with some of the demographic forces discussed by Mundy, et al, have shaped the rhythm of cyclical change. The past few years have demonstrated that those who thought the "new economy" had lessened cyclical risk were far too optimistic. Risk is fundamental to investment, leaving us the question, "How do we get paid appropriately for the risks that we take?" This is a perennial question that Riggs has worked on for many years as an analyst of real estate trends who has interviewed hundreds of the industry's top professionals.

continued on page iv

EDITOR'S STATEMENT

continued from page iii

Globalization has become a fact of life in the world of business, and that is directly affecting the way that corporations think of their real estate assets. Maureen Ehrenberg, CRE and her British co-author, Steve Mallen, offer their perspective on real estate services and property as a globalized asset class. They examine the trend toward placing white collar jobs, as well as goods-production positions, in low-cost environments like India and China. Additionally, they look at the way shifts in global capital markets are altering the way real estate investment judgments affect the deployment of capital. A worldwide perspective, and an understanding of how evolving markets abroad affect home markets everywhere, have become indispensable tools for working in the real estate business.

Any consideration of the future must take into account the passing on of the leadership function. Because of this, we initiated in the Summer 2003 issue a series of articles on linking university programs in real estate to the educational demands of an increasingly sophisticated business. Joseph Rabianski's article in our prior edition presented a conceptual matrix seeking to fit the pieces together for a fruitful collaboration between academia and industry. We continue this reflection with a Kerry Vandell, CRE, essay, "Preparing the Next Generation" that traces the evolving efforts to link practice and theory in a way that will make us both more enlightened and more effective going forward.

The issue is rounded out with several additional features, plus our "Insider's Perspectives" and "Resource Roundtable" segments. As we go to press, there are many signs that the long-awaited recovery in U.S. employment will put the final component of economic revival into place. Revised figures have put recent GDP growth above eight percent on an annualized basis. The stock market is finally pulling out of the bear market that was triggered by the dot-com bubble bursting. If good times are returning, then it is especially propitious to think clearly about how to shape our futures. We will be pushing to do that in the year ahead. Any thoughts or suggestions our readers might have on the subject would be most welcome. Feel free to contact me by e-mail at hughkelly@hotmail.com. I'd be enthusiastic about receiving your ideas.

Real Estate Services and a Globalized Asset Class

By Maureen Ehrenberg CRE, and Steve Mallen

"It was the best of times, it was the worst of times"
(Charles Dickens, *A Tale of Two Cities*, 1859)

The last 20 years of the 20th Century will go down as a period when the international real estate market achieved two things: maturity and global spread. Like a wayward teenager, real estate learned from its mistakes, went to college and became better educated and then demonstrated more prudence and caution than previously. At the same time, with international commerce, trade liberalization, and globalized capital came a passport and escalating air miles.

In the early years of the new century, real estate, on a risk-adjusted basis, looks like a preferred investment asset class throughout much of the world. Cycles come and go, but supply and demand are, for the most part, relatively well balanced in historic terms in most countries. Prices are shifting incrementally rather than dramatically and the volume and profile of capital and debt entering the sector is far better regulated and subject to far more due diligence than before. With an aging global demographic and volatility in other asset classes, real estate has become a target for both venture capital and annuity, bond-style investors seeking retirement profile income. "How are we going to fund our retirement?" is

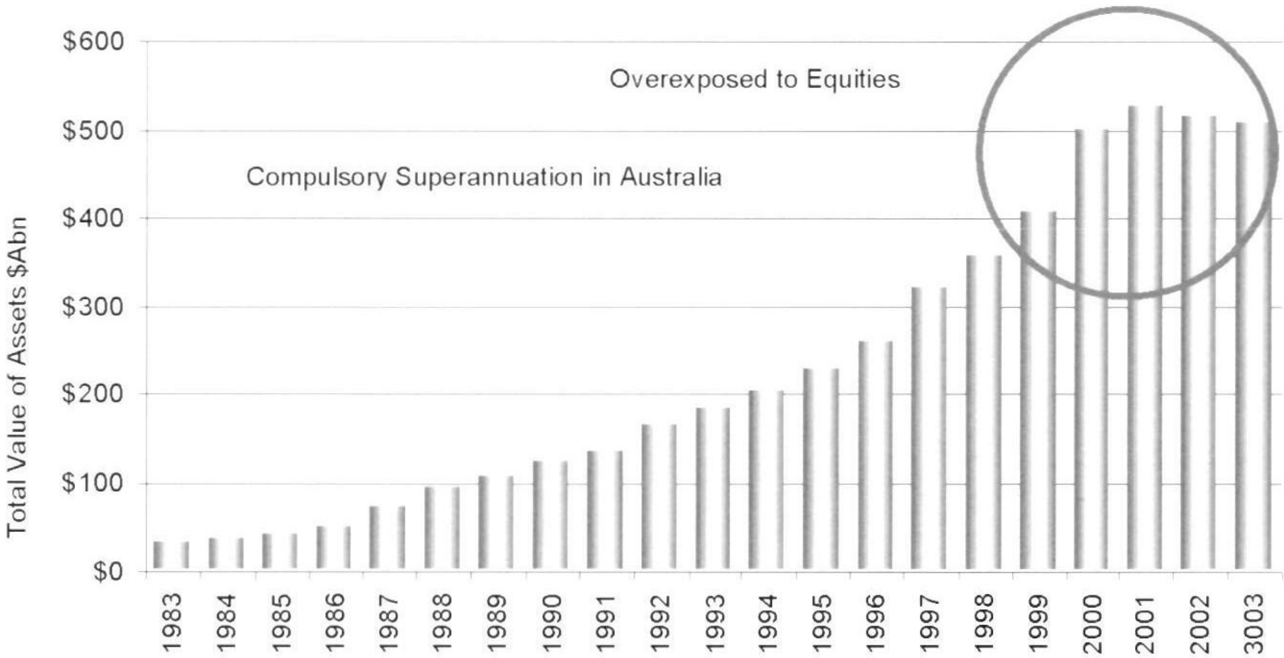
ABOUT THE AUTHOR

Maureen Ehrenberg, CRE, *is executive vice president of Grubb & Ellis Company and International Services in Chicago.*

Steve Mallen, MA, *is partner and head of Global Research & Consulting, Knight Frank in London.*

Exhibit 1

Growth in Superannuation Funds in Australia



Source: APRA

Item One on the sociopolitical agenda in the Western world with real estate right there alongside in the action column. Expectations are high.

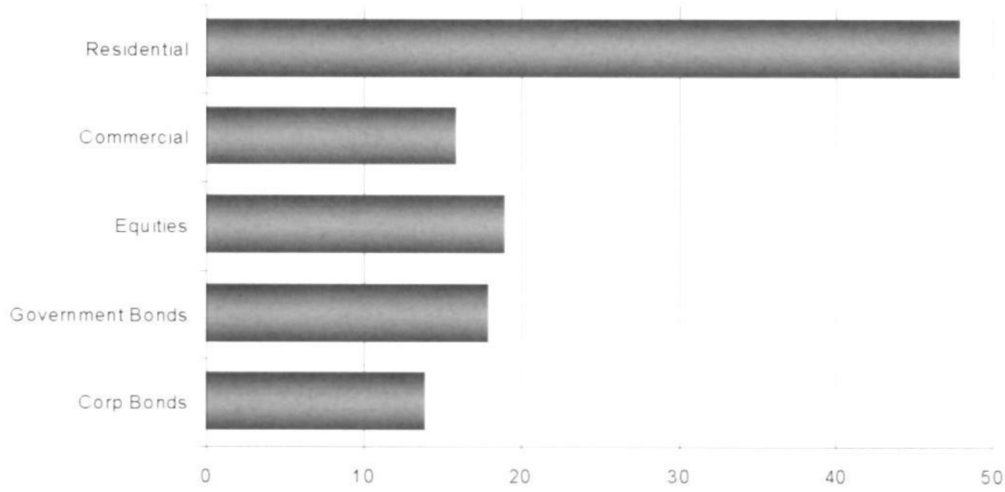
By way of illustration, the Australian Government has introduced compulsory pension contributions for all employees in defense against a poverty-stricken retired population in the medium to long term. The net inflow of capital into Australian superannuation (pension) funds has increased at an unprecedented rate in consequence and, by volume, is set to overtake the value of the nation's entire fixed asset base. Asset and geographical diversification are now not only a certainty but mission-critical from a risk perspective. Real estate will figure prominently as a result of its ability to offer stabilized, annuity style returns over time, thereby matching policy liabilities against capital and fund liquidity requirements. It is only a matter of time before the other developed nations of the world follow the same route. Global capital flows in real estate will escalate dramatically in the next 20 years. The public and private REITS in the United States currently represent dramatically different options for investors and yet both have thrived in recent years with high expectation for both.

Capital alone however, does not a market make. The intensity with which qualifying investment opportunities are being bid up by investors anxious to place capital or take advantage of a cost of finance to income arbitrage environment that has not been seen in more than a generation, means that cap rates are being driven down while the underlying demand for the commodity, in this case real estate, is weakening. This is an imperfect market in any textbook. There is perhaps still more maturity required for this very new market type predicament, which has created a fundamental disconnect in many real estate markets around the world.

The stakes are high. The combined value of the developed economies' residential and commercial property markets is greater than the combined value of all the international equity and bond markets added together. In many countries, imperfections in the real estate sector are actually directly impacting upon that country's largest fixed asset base. Real estate really is big business. Indeed, its fixed capital position and its investment expectation

Exhibit 2

Asset Values – Developed Economies



Source Economist / Knight Frank Research $ Trillion

profile arguably make it the biggest business of all moving forward. It is also worth noting that around 30% of the developed world's commercial real estate by value (some $4.7 trillion) is located in the United States.

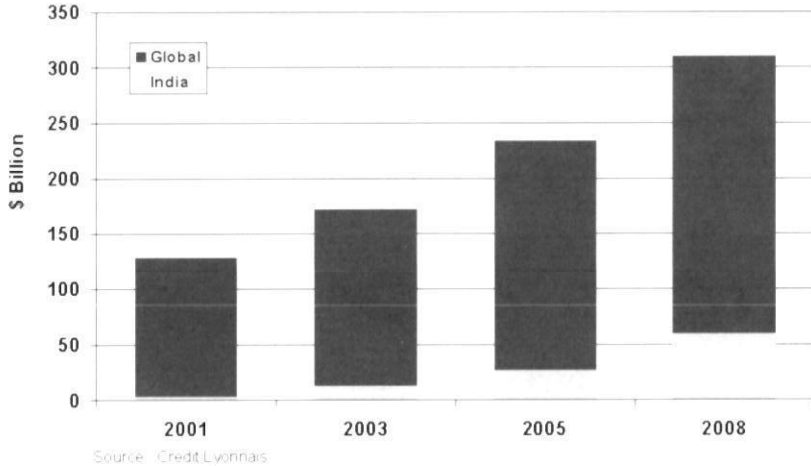
So, what of demand? The equity markets are inching back upwards on the back of gradually improving corporate profitability and all economic forecasts point towards better economic performance throughout the world in the middle years of the decade. At the same time though, reserve real estate capacity is high, head-counts are being closely scrutinized and the emphasis on cost control and reduction has arguably never been greater. There will be no bounce-back in demand and it will be some years before a more positive corporate climate puts real estate rents and prices back in the sunshine.

Moreover, global capitalism continues to evolve. To what extent will future growth in the West actually be articulated in the real estate markets of the East? The compelling cost advantages of India, China, and Eastern Europe have become impossible to ignore and this issue is rising rapidly up the political agenda. Protectionist rhetoric and trade union opposition is mounting, but, in a post-Enron world where transparency and shareholder return are everything, international decisions that see dramatic cost reductions in two key factors of production, labor, and real estate, can not be overlooked. One could go further: any Multinational Corporation (MNC) that has not at least considered offshoring or outsourcing could now be considered negligent in the eyes of its shareholders. The globalization of real estate has become a structural certainty.

Current forecasts vary, but consensus suggests that the U.S. will lose perhaps upwards of 3 million jobs to offshore markets by 2015, comprising both migrated posts and new growth transferred elsewhere. Even in an economy the size of the U.S., this is a big number. In real estate, it is a very big number, perhaps equating to a loss of stock approaching 500 million sq ft (nearly twice the office stock of metropolitan Washington, D.C.). Since the 2000 presidential election, the U.S. has lost 1 in 6 of its manufacturing jobs (some 2.8 million positions) via contraction and, increasingly offshoring. This is one of the reasons why the current "recovery" is "jobless." There is of course the fact that offshore operations will generate revenues back to the home country and thereby continue to bolster domestic economic performance. However, where is the real estate? Where is this key factor of production and where is its value accounted for and traded? It is increasingly no longer just around the corner and may not even be on the same continent. Therefore, how does a global economy relate to local real estate investors and their respective returns?

Exhibit 3

Business Process Outsourcing



Observers will say that this is not new, remembering the 1970s and 1980s shifts in manufacturing to Mexico, Latin, and South America. Worries of becoming a nation of "CEOs and burger-flippers" proved unfounded as the economy grew and developed new services and industries, not least of which was the ICT (Information and Communications Technology) phenomenon. This time however, the pace of outsourcing and offshoring is more rapid, the fiscal arguments more compelling and the ability of the domestic economy to innovate and realign more questionable.

Moreover, the current shift is not restricted to "low value, low order" functions, but has moved up the service sector food-chain into IT development and maintenance, business analysis, and corporate accounting. It is no accident that in the UK the government has announced a new initiative to relocate public sector jobs away from the expensive South of England to the cheaper, more disadvantaged North of the country. While this will partially placate concerns about ballooning public debt and mounting costs, it will also offset some of the inevitable economic contraction and employment reduction which will undoubtedly occur in the regional cities (Cardiff, Leeds, Glasgow etc).

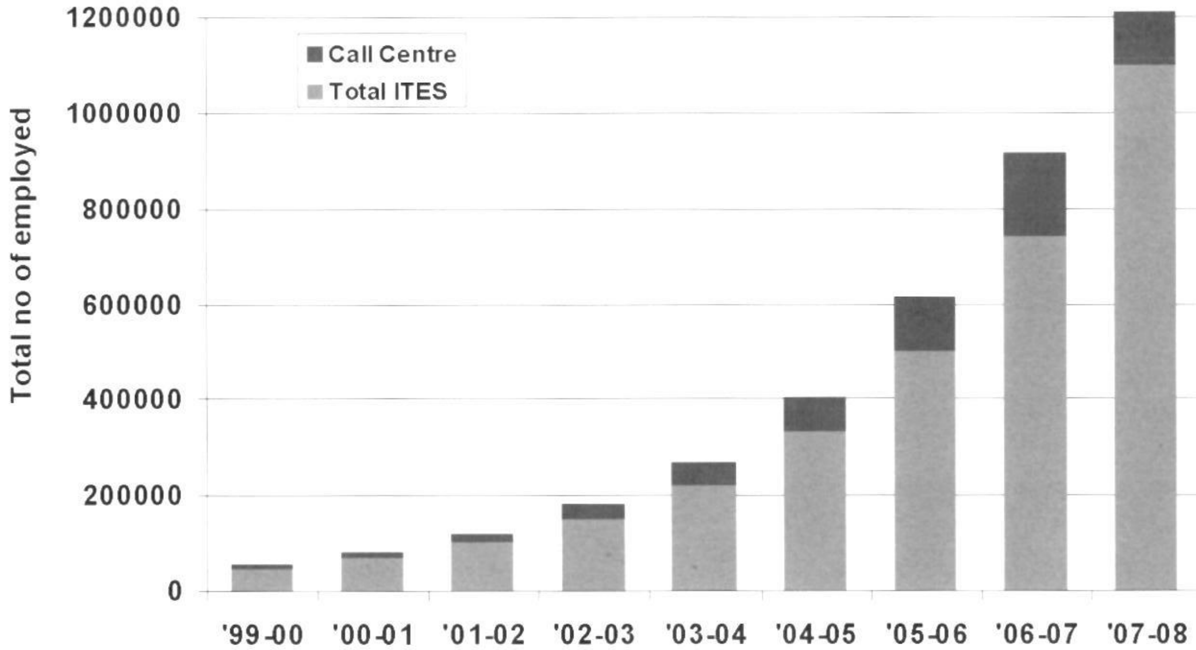
Detailed and highly credible research recently issued by Goldman Sachs suggests that the size of the Chinese economy will overtake France next year, the UK the year after that, Germany in 2007 and Japan in 2016. In 2041, America will finally cede its throne to China. From a lower economic base, India will become the world's third largest economy within 30 years behind the U.S. and China. Within Europe, projected foreign investment flows into the Eastern nations that are shortly to accede to EU membership are substantial. In the case of Poland, Russia, and the Czech Republic, annual foreign investment over the period 2001-2005 will exceed that of the UK, which is the fourth largest economy in the world and already long since integrated into the world order of commerce.

In real estate there has always been a pronounced tendency towards "short-termism": when will that transaction close? Who is best qualified to provide security services at my building? Will my performance as a fund manager provide the bonus I need for that second home? And so on. Real estate is not especially unique in this regard, but in an advisory environment where the greatest compensation flows are from transactions and where remuneration to individuals in most countries is commission oriented, our industry often finds it very difficult to see beyond and plan for much more than the next two or three quarters. If the real estate advisory community is to survive and prosper, it is the contention of the authors that we have to embrace and understand the multiple profound and structural changes in the economic and business landscape which will shape our clients' needs in the future. Failure to plan now will lead to a mismatch between client expectation and service delivery capability.

Simmering in the background for at least a decade, the challenge this presents to the real estate advisory and service provider community has now come

Exhibit 4

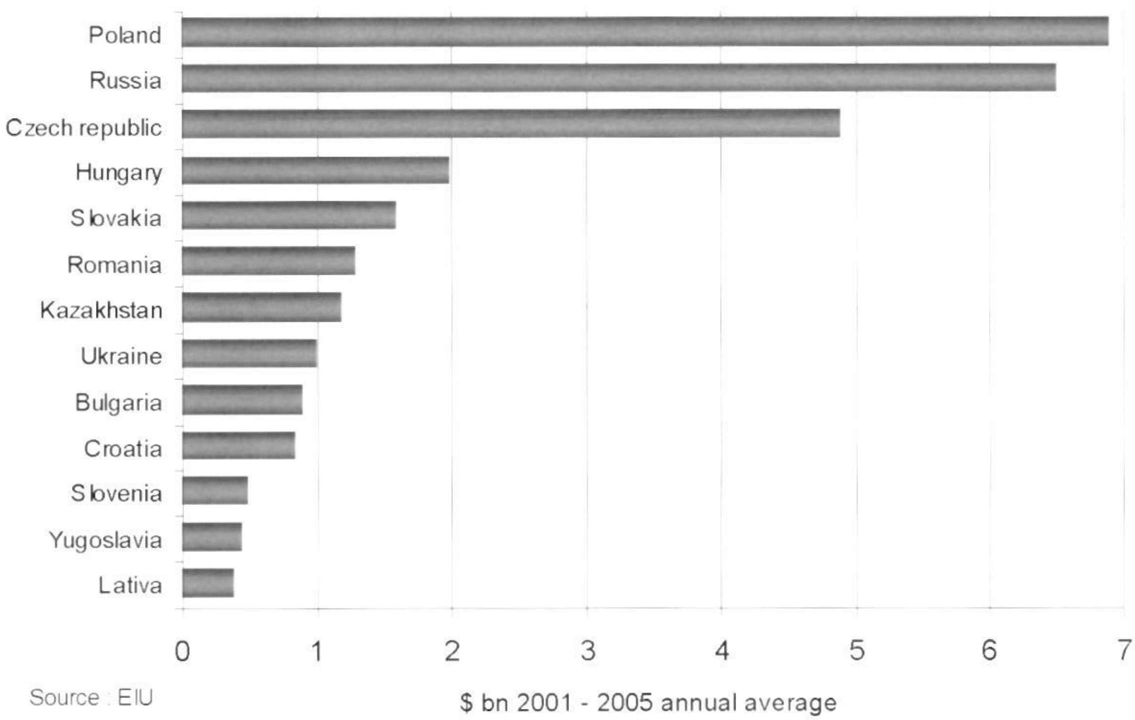
IT Sector Employment Generation (India)



Source : NASSCOM – McKinsey

Exhibit 5

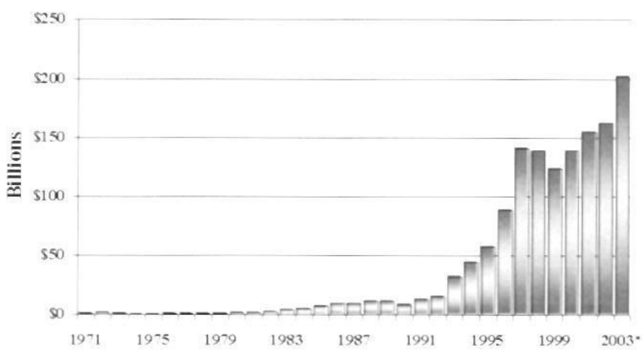
Foreign Investment in Eastern Europe Forecast (2001-5)



Source : EIU

Exhibit 6

US REIT Market Capitalization



* As of September 30th

Source: NAREIT

to a boil. Real estate has become a global commodity with preferred status throughout much of the investment community. However, real estate is essentially, and some would say irrevocably, a parochial construct that can only be fully understood, transacted, and managed at a local level. This is embodied in the "think globally, act locally" mantra, and its infinite variations, which have passed into mainstream parlance throughout the industry in recent years.

The corporate community, naturally and quite rightly, expects a service delivery platform which embraces all markets and skillsets. However, in a world where real estate legislation and codes of practice have almost infinite variety between countries and indeed, between sectors, this is a difficult expectation to meet. The capital cost of recruiting, training, and retaining the thousands of personnel that collectively encompass the local expertise and technical skills necessary to administer real estate around the globe is enormous. Add to this the challenge of global technological infrastructure, the need to enmesh multiple cultures and languages and the requirement for an administrative and management framework to oil the entire machine and the task becomes near daunting. And this is to say nothing of regulated professional standards, best practice conformity and the pernicious curse of indemnity protection in an increasingly litigious world.

In response, the service delivery community is polarizing. Large firms have coalesced into quasi-corporations and gone to the capital markets for expansion finance and operational debt facilities. Smaller firms have realized their strengths, limited their aspirations, and carved out niches in the market whether these be geographical, sectoral, or skill based. Middle league players are at a crossroads: return to the comfort zone of niche services or gear for growth and new market penetration. With turnover in the occupational market slowed by the economic climate and with the direct investment sector frustrated by access to qualifying stock around which to base transactions, the revenue flows from the market are not as high as they might be. This makes leverage and risk in the service provider community a brave and challenging proposition.

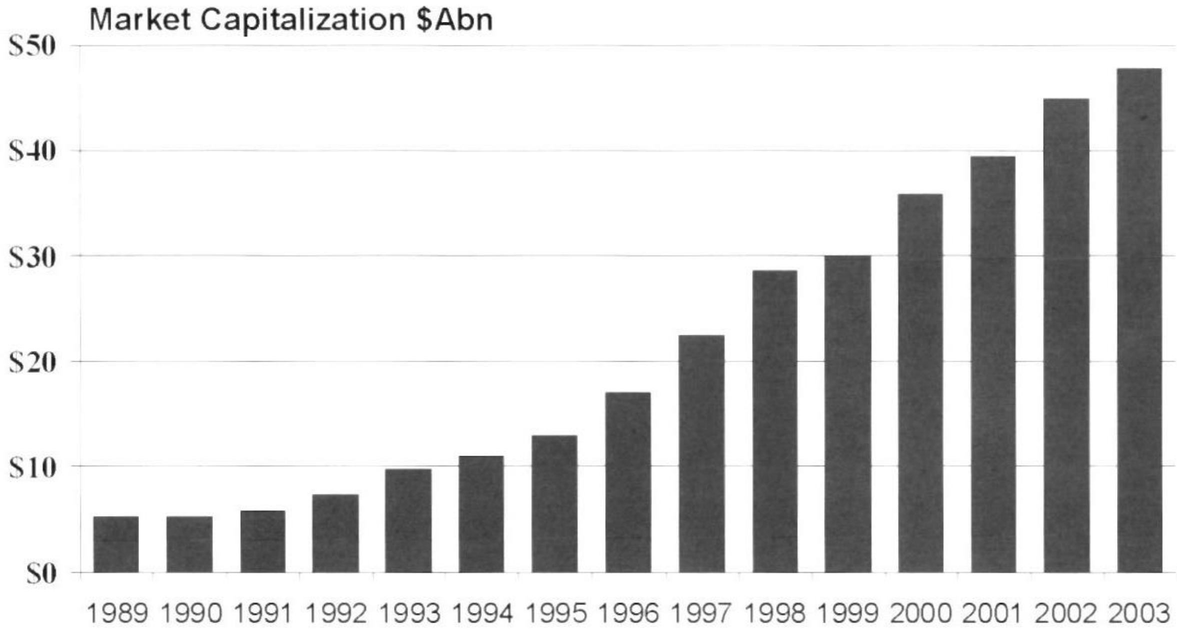
To further confuse the picture, it is becoming abundantly clear that no one service delivery model can actually deliver the full range of consulting, accounting, legal, tax, transactional, management, and technical skills necessary to service the corporate real estate user and owner. The plethora of accountancy, legal, brokerage, banking, and FM providers required to run and generate value from an MNC portfolio on an international scale has presented the corporate real estate director with a bewildering array of service options. Moreover, accountants are entering the transaction market, bankers are creating marriage value where it previously did not exist, brokers are becoming consultants, and everyone purports to be able to value and manage the assets. What you see is no longer necessarily what you get and advisors have become chameleon-like in their service offering, subject to the nature and identity of the people on the other side of the RFP table.

So what's next? What will the real estate services community look like two decades from now? What should we be doing today in order to be better placed as organizations and in order to better serve our industry tomorrow? Not surprisingly, the answers to these questions are far from straightforward.

In adding clarity to the position, a clear distinction between the supply and demand sides of the property equation is perhaps beneficial. From a development and investment perspective, the very diversity, complexity, inefficiency, and opaqueness of the global real estate market is what gives it lifeblood. Knowledgeable investors, who have taken time and deployed capital to understand new markets and forge appropriate local relationships, are well placed to take advantage of differential market

Exhibit 7

Growth in Australian Listed Property Trusts



Source: Property Investment Research

cycles, varied tax structures, government assistance, planning loopholes, leasehold reform, currency plays, debt arbitrage positions, new demand sectors, imported construction techniques—the variables are infinite.

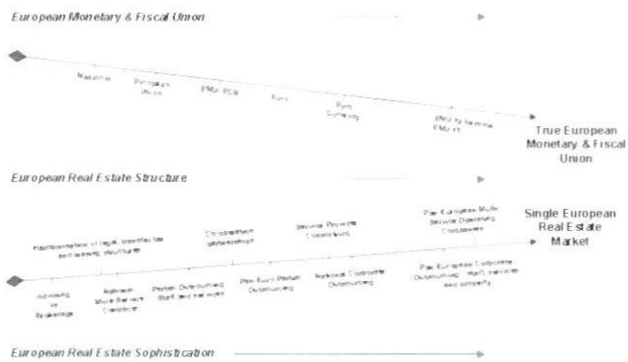
The very inefficiency of real estate as an asset class encourages international capital flow, facilitating healthy profit or mistake level losses, subject to the preparation and judgement (and sometimes luck) of the investor. If real estate were a transparent commodity, the drivers behind international investment would be no different from those of the equity market—geographical and sectoral spread over a unified, largely transparent investment landscape. This would clearly still produce substantial capital flow as investors spread risk and seek returns. However, in real estate, market complexity and diversity is a more powerful force. Shifting economics and local market dynamics make it possible, for example, for U.S. private equity to interface with the markets of Eastern Europe and generate internal rates of return in excess of 25%. Here, preparation is lengthy and risk is high, but the returns are seductive. Real estate is one of only a handful of capital plays in which this is possible. Moreover, in the low inflation, low growth, and lackluster domestic return environment that now persists in most developed markets, the drive towards seeking enhanced returns becomes more pronounced. Global capital flows will accelerate in consequence in the years ahead.

The perspective from the demand side of the market is however, fundamentally different and indeed, contradictory. The sheer complexity of the international market is the very thing which frustrates the corporate occupier. Market inefficiency, local complexity, and overall illiquidity makes real estate a capital and risk item which bedevils the corporate real estate director and the CFO. It is little wonder that moving real estate off the corporate balance sheet is likely to be one of the most powerful drivers in the real estate sector in the next decade and beyond. It is also entirely logical that corporate occupiers are perpetually seeking new ways of improving transparency, developing multinational management systems, and aligning real estate flexibility with the shifting demands of business. This becomes a second fundamental driver in international real estate for this decade and beyond.

It is important to note that, for both the investment and corporate occupier sides of the equation, the complexity and inefficiency of the market is a key

Exhibit 8

European Economic & Real Estate Convergence



support to the international advisory community. Whether for supply or demand protagonists, international service providers derive substantial revenue from educating or representing clients in new markets and sectors. Market complexity is thus a prime support for such a large real estate advisory industry. Without that complexity, the advisory sector need not and will not be so large.

There is however, a dialectic position here. In the next two decades, the apparently contradictory positions of supply and demand are likely to converge into a more integrated paradigm.

The investment market will increasingly be driven by securitization and the development of secondary trading in financial products. This is already apparent in the global drive towards the construction of REIT style markets and the ongoing development of an international CMBS sector. REIT legislation now exists in at least the U.S., Japan, France, Singapore, Australia, South Africa, and Belgium. The UK and Hong Kong lead the list of additional countries close behind. There are obviously several fundamental drivers to real estate securitization. In the future, the combined forces of investment market liquidity, spreading of risk and return and the need to provide better exposure to the real estate sector for retail level investors (who are increasingly worried about their pensions), will be crucial.

The phenomenal growth of the REIT market in the U.S. over the past 15 years and the exceptional returns being delivered by the Listed Property Trust (LPT) market in Australia—the only major market where real estate stocks consistently trade at a positive net Asset Value (NAV) level—illustrate the demand for this type of investment and the returns that are available. In the CMBS sector, most of the major U.S. investment banks are developing products in Europe and beyond, leveraging their U.S. expertise and experience. This market will balloon too over the next decade as investors seek what to many have become the twin holy grails of real estate investment: syndicated risk and liquidity.

Ongoing securitization and real estate listing will fundamentally enhance market transparency, improve capital flows and broaden investment appeal. Real estate investment will thus move towards a more perfect commodity model and away from the dense parochialism by which it is currently characterized. Retail investors, together with institutional and private capital, will be able to gain liquid, multi-market and multi-sector exposure with comparative ease on a global scale. It will be more possible to construct portfolios more closely aligned with the efficient frontiers of portfolio theory.

The other half of the dialectic response comes with the occupational market. MNC occupiers—that after all, are what actually drive the entire asset class—will demand structures of leasing, owning, and managing property which iron out market parochialism, conform to international templates and benchmarks, provide operational flexibility and offer a financially efficient and acceptable profile. In theoretical terms, there is no reason why, for example, an international corporation could not access a standard leasehold and property management package on a global scale, making location largely inconsequential whether it be Dallas, Dubai, or Dar es Salaam.

There are two barriers to synthetic leasing. Firstly, market dogma and parochialism, sometimes supported by local legislation and secondly, an insufficiently developed international capital market to underwrite risk, securitize the income stream, and provide the deep capital context to develop and run such a model. This is where the marriage occurs and the dialectic is resolved: the capital markets will catch up with the occupier markets to create value and service factor of production requirements.

As an aside, local legislation merits brief attention. In India, by way of example, tens of millions of square feet of world class real estate leased to MNC, blue-chip covenants and build to suits have and will be developed. However, foreign ownership of

Indian real estate is not permitted. These laws will be reformed—they will have to be if India truly wants to realize its dream of mainstream capitalism. If this occurs suddenly in say, ten years time, one of the largest real estate markets in the world will open up overnight. A sophisticated capital market model will facilitate this.

In Europe, EU legislation has touched virtually all forms of commercial activity and social life. The notable exception is real estate. This is adjudged so complex and so vested with history that even the bureaucrats in Brussels balk at the challenge. The corporate occupier community however, is demanding standardization. How long before there is a standard lease enshrined in legislation across the 20+ countries that will make up the EU? If legislation does not assist, the market will find a way through code of practice and client insistence. Here again, the necessary precursor is a sophisticated capital market.

Lastly, South Africa. Here, exchange controls prevent capital rich and highly sophisticated domestic institutions and developers operating offshore in any substantial fashion. These controls will be lifted to permit the nation to join the free trade world. The capital outflow from South Africa into the capital and real estate markets will be substantial. This will provide further impetus to capital market development, secondary trading, and overall liquidity.

There are many triggers and valves around the world that will be released over the next decade, which will add further impetus to the global real estate capital market. The migration of corporate real estate assets and liabilities off the balance sheet, together with more standard models of occupancy and management will provide much of the fuel to the capital market fire.

The above hints at utopianism. Pragmatically, there are still significant barriers, on the occupier side of this debate. The world's MNCs are, in reality, at very different stages in the evolution of their real estate methods and models. Some have developed highly efficient, multimarket systems that perpetually monitor cost, measure performance, and respond to business need. Others, even today, struggle to even provide an inventory of their freehold and leasehold exposure beyond a national level. Very few have made any real transition to an off-balance sheet model. The diagram below was constructed in a European context, but its central precept is global.

The differential progress of corporate occupiers will retard the process of globalization and the alignment of stock with the capital markets. The challenge for real estate consultants and advisors is to really listen to the corporate occupiers and truly hear how they describe their changing business and real estate requirements. Sound real estate advice is critical, but it appears that the time has come to turn the adage of "think globally and act locally" on its ear. Standardization of processes amongst occupiers, offshoring, benchmarking, emerging market opportunities, acquisitions, and so on has also created a need for real estate service firms to work with their clients to think locally and act globally, which is not nearly as easily executed as the converse. The value that real estate service firms can provide to MNCs is enormous, however, the measure against which value is perceived is changing. We must be able to innovate, test our paradigms from which we typically offer solutions, act locally effectively, and to participate and execute more globally in a very changing world of business, politics, economics and, yes, real estate.

The U.S. occupies center stage in this unfolding drama. Not only is the U.S. market by far the largest in the world, it is also the most transparent, the best researched and, most importantly of all, the most sophisticated in terms of its asset management models and capital market development. U.S. market practitioners lead the field in many aspects of real estate advice, finance, innovation, and management. However, and here is the real challenge, if the past 50 years have taught us anything it is perhaps that American cultural and commercial principles overlaid upon a complex world without proper recourse and deference to local practice, custom and culture is at best misplaced and, at worst, downright dangerous. The challenge for the next 50 years thus rests on the ability of the U.S. to export its experience and models in a manner which is highly sensitized to the importing local environment. The future success of the global real estate market depends on this. Travelling more and seeing the market through the eyes of others is not just tourism, but essential to the prosperity of one of the world's most important asset classes. In these often troubled and turbulent times, the subtext here, that extends well beyond real estate, is, we hope, obvious.

Looking Backward and Forward: Economic Restructuring and United States Real Estate Markets

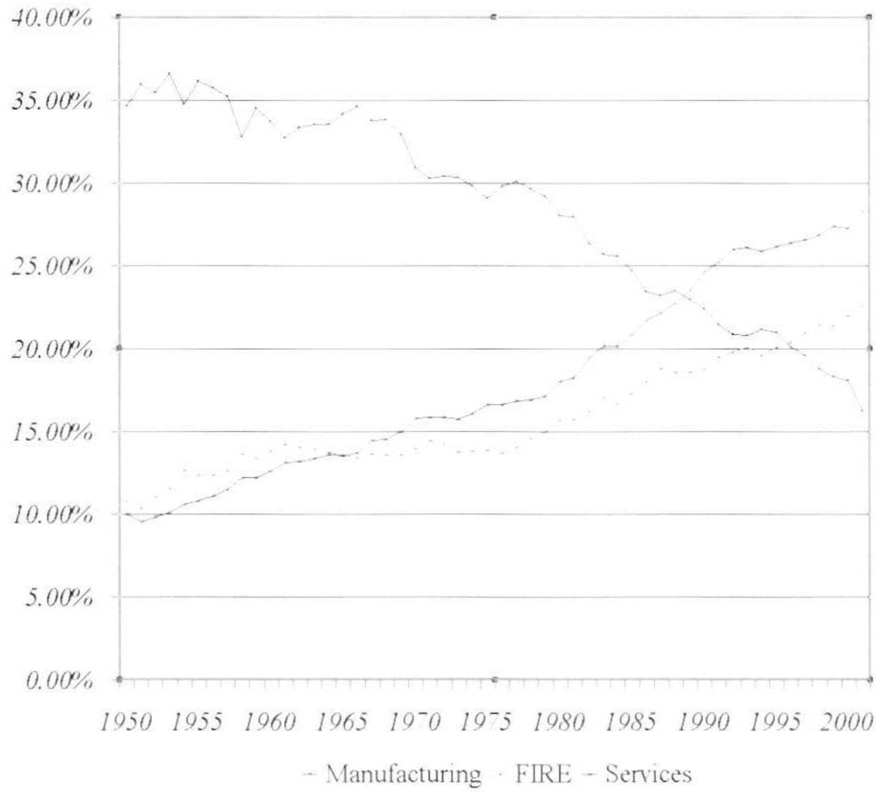
By Bill Mundy, PhD, CRE, John A. Kilpatrick, PhD, John I. Carruthers, PhD, and Ron Throupe, PhD

Two interconnected trends with far reaching implications for the real estate industry have evolved in the United States over the last 50 years. First, the nation has steadily moved away from its traditional manufacturing base to become more specialized in services and information-producing industries, creating a demand for new kinds of employees and workplaces. Second, people have realized outstanding gains in personal wealth and disposable income and, as an outcome, are increasingly able to define where and how they want to live. Working in combination, these changes have dispersed growth from older, more built-up areas in the Northeast and Midwest to newer, less developed areas in the South and West and, at the same time, from the core to the periphery of metropolitan areas nationwide. What is the connection between economic restructuring and real estate markets? How does it manifest itself? And, looking forward, where is the relationship heading?

This article explores these questions by first placing them in an appropriate historical context, then discussing how economic restructuring has altered real estate markets, and, finally, suggesting the possible shape of things to come. The core idea is that, increasingly, people no longer choose to live where physical things are produced; they use land

ABOUT THE AUTHOR
Bill Mundy, PhD, CRE, John A. Kilpatrick, PhD, John I. Carruthers, PhD, and Ron Throupe, PhD *are with the firm of Mundy Associates, Seattle, Washington.*
(E-mail: bill@mundyassoc.com).

Figure 1—Percent United States Earnings in Manufacturing, FIRE, and Services, 1950—2001



and value location not just for its economic productivity but also for its aesthetic or intrinsic characteristics. In response, the real estate industry should explicitly embrace the notion that non-market goods are responsible for a growing proportion of market value.

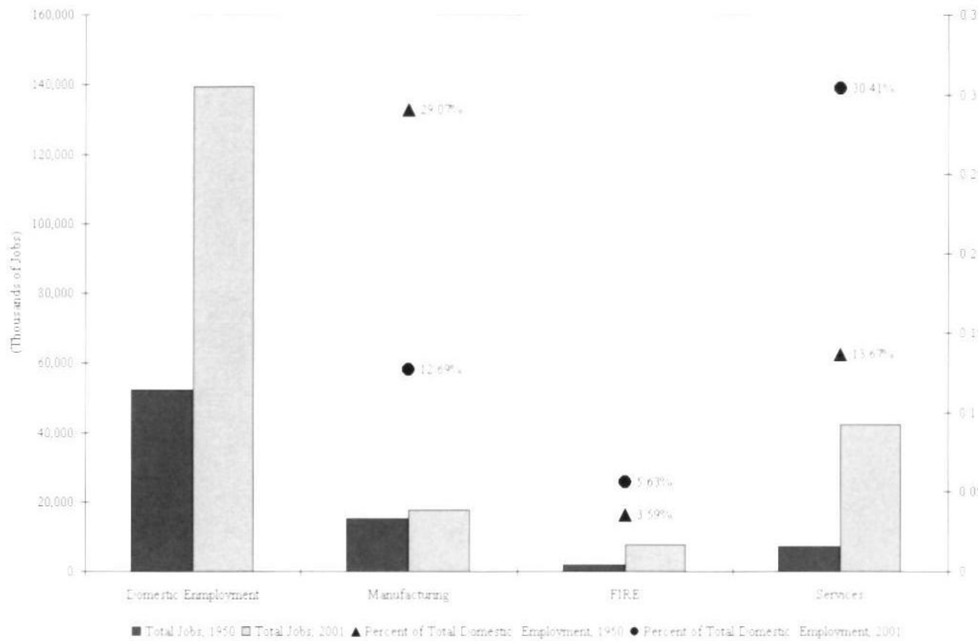
LOOKING BACKWARD

It is well known that the population of the United States has spread steadily from the Northeast and Midwest to the South and West over the past 50 years; less widely understood, are the underlying economic mechanisms involved, and how they affect where people end up living. The driving force behind the process of population deconcentration, as it is called, is the expansion of the information economy and the increased locational flexibility that it offers both people and firms. A significantly smaller proportion of Americans works in manufacturing jobs than did a half-century ago, and a greater proportion works in service-related industries. This is illustrated in Figure 1, which shows the percentage of national income earned in the manufacturing, finance, insurance, and real estate (FIRE), and service sectors between 1950 and 2001, the most recent year for which data are available.

Figure 2 provides another look at how the nation's industrial structure has changed over the last 50 years. The columns show the total number of domestic jobs, plus the number of jobs in manufacturing, FIRE, and services in 1950 (dark grey) and 2001 (light grey). Meanwhile, the black symbols show the percentage of total domestic jobs in the three industries in 1950 (triangles) and 2001 (circles). The figure demonstrates the scale of employment growth in the country, and how its economic base has shifted steadily from manufacturing to the two service sectors. In 1950, FIRE and services accounted for 17.26% of employment combined; by 2001, the proportion had more than doubled to reach 36.04%, at the expense of manufacturing, which fell from 29.07% to just 12.69% of all jobs. In short the U.S. economy has undergone a fundamental restructuring over the last half-century.

At the same time, investment in different kinds of real estate has changed in a similar way. Figure 3 shows the amount of money spent on new industrial, commercial, and housing developments in 2000 constant dollars over the same timeframe. Beginning in the early 1970s—when proportion of employment in the FIRE and service sectors began

Figure 2— United States Economic Structure, 1950 and 2001



to take off—investment in commercial space rose sharply, and investment in industrial space for the most part leveled out. Investment in housing continued to grow over the five decades, following cycles corresponding to the prime interest rate. Figure 4 illustrates another aspect of these trends, illustrating that investment in new commercial structures as a proportion of all private fixed investment in structures has also grown significantly: in 1950 the share within the asset class was under 5% but, by the turn of the century, it accounted for over 15%. During this time, the proportion of investment in new industrial structures and new housing remained relatively stable, fluctuating only with cycles in the economy as a whole.

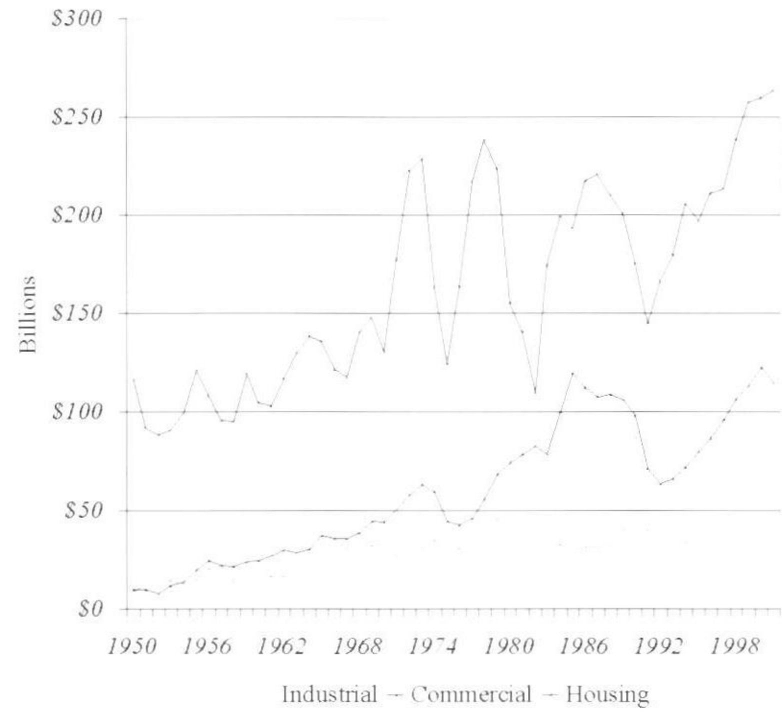
Finally, the associated rise in the per capita gross domestic product and per capita income and disposable income in constant 2000 dollars is shown in Figure 5. Although income and wealth are not the same thing, the figure provides an indication of just how much more people have to spend on nonessential goods and services or to invest than they did 50 years ago: each of the three series shown in the figure has grown by more than 250%, even after adjusting for inflation. Not only are Americans more productive than ever before, they increasingly have the means to define for themselves where and how they want to live.

THE CONNECTION TO REAL ESTATE MARKETS

What emerges from the preceding discussion is a portrait of a nation that has undergone massive economic restructuring, precipitating equally large changes in the kinds of employees and workplaces demanded. This, coupled with the corresponding increases in productivity, income, and wealth, have transformed the economic landscape of the United States in ways that have far reaching implications for the real estate industry. The following paragraphs elaborate on this connection.

According to Janet Pack, a Professor in the Wharton School at the University of Pennsylvania, the restructuring shown in Figures 1 and 2 has been accompanied by economic convergence, or a redistribution of people and firms to smaller places. General movement to less developed areas partially explains the rapid growth of the South and West, which are attractive to firms for their inexpensive land and comparatively low wages, but not completely. A more thorough explanation incorporates the residential consumer preferences of people, who choose locations based on their relative desirability as places to live. Moreover, despite the visibility of growth in the South and West, economic restructuring has not favored these places. Matthew Drennan, a Professor of City and Regional Planning at Cornell University, finds that information-producing industries have grown nationwide, but mostly in places with high endow-

Figure 3—Investment in New Industrial, Commercial, and Housing Developments, 1950—2001



ments of human capital. So, while population and employment growth exhibit an uneven spatial distribution that is easily visible, the expansion of quality, high-paying jobs does not.

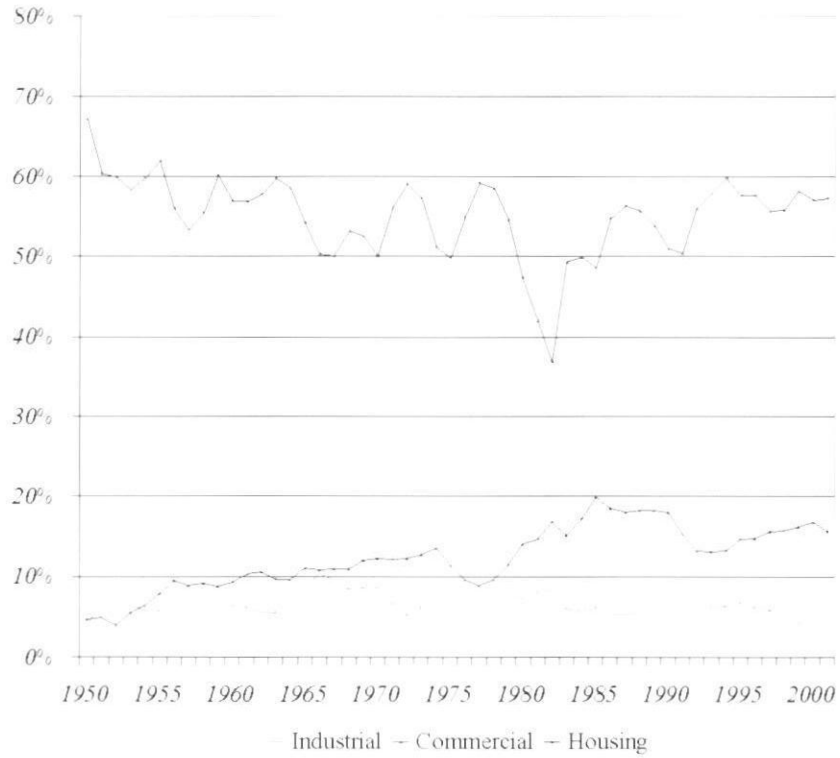
The distribution of positions in information-producing industries is determined in large part by where the workers they employ wish to locate. Expanded infrastructure systems, including affordable airfares, fiber optics, cellular networks, the Internet, and others, provide contemporary firms with an unprecedented degree of locational flexibility; companies may easily interface with clients or branch offices that are hundreds, or even thousands, of miles away. Mundy Associates LLC, for example, is based in Seattle but draws a relatively small proportion of its business from the local market. Further, its researchers commonly collaborate with people from other firms and universities in distant parts of the county, all without ever meeting face-to-face.

The sweep of this transformation is so wide that it has created a whole new class of workers—what Richard Florida, a professor of public policy at Carnegie Mellon University, calls the creative class. "If you are a scientist or engineer, an architect or a designer, a writer, artist, or musician, or if you use your creativity as a key factor in your work in business, education, health care, law, or some other profession," Florida writes, "you are a member."

Further, the advent of this group may even be transforming the very economic function fulfilled by American cities. Edward Glaeser, a Professor of Economics at Harvard University, and his colleagues argue that the role of cities has essentially been turned on its head: they are becoming centers of consumption rather than centers of production, as evidenced by the growth in urban rents outpacing the growth in urban wages and the large number of people who choose to reverse commute. In short, the economic restructuring discussed above has changed not only where Americans live, but how, in meaningful and lasting ways.

One of the most significant outcomes of this is a "chicken-or-egg" situation where employment growth drives population growth and the other way around—that is, jobs are drawn to people even as people are drawn to jobs. For example, research by John Carruthers, of Mundy Associates LLC, and Gordon Mulligan, a Professor of Geography and Regional Development at the University of Arizona, reveals a positive relationship between the two types of growth in metropolitan areas nationwide during the 1980s and 1990s. What this means, is that many people are first choosing where to locate, then finding or creating a job. This kind of (labor) supply induced growth has very different implications for real estate markets than more traditional forms of (labor) demand induce growth: in both cases rents rise but only in

Figure 4—Percent Private Fixed Investment in Structures, 1950—2001



the latter do wages rise correspondingly. One possible negative outcome of this is that those who can afford to locate where they choose will, but those without similar means will find themselves edged out, due to heightened competition over urban space. Other possible implications are explored below.

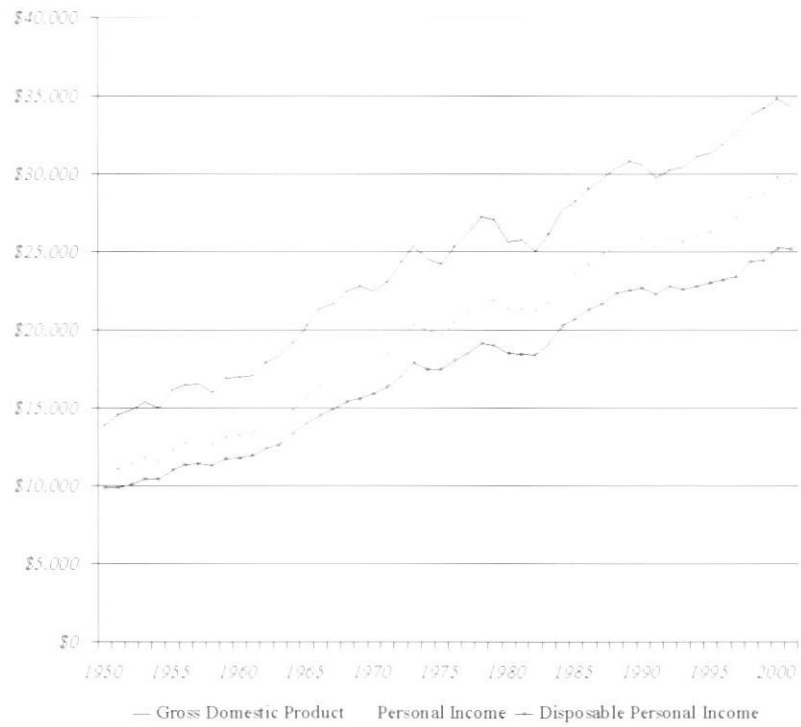
LOOKING FORWARD

Picking back up on the idea advanced in the introduction—that, because many Americans no longer choose to live where physical things are produced, they increasingly use land and value location for its aesthetic or intrinsic characteristics—the article concludes by outlining several future implications of the connections between economic restructuring and real estate markets. The emphasis here is on the possible shape of things to come—raising questions about how members of the real estate industry can respond or adapt to them.

Urban Spatial Structure—The United States witnessed three waves of suburbanization during the 20th Century: the early street car suburbs, the post-World War II suburban housing boom, and the decentralization of employment that has created so-called edge cities. Given rising incomes, more flexible work schedules, and falling commuting costs, American cities are likely to continue on their trajectory from a monocentric to a polycentric urban form. Further, central cities may increasingly become centers of recreation and housing for affluent professionals who choose to live in them for their nightlife and other activities. Meanwhile, other people are likely to continue moving even farther out, from the suburbs to the exurbs at the far urban fringe.

Urban Villages and Campus Style Suburban Development—As an extension, the character of the interior versus the exterior of metropolitan areas is becoming increasingly polarized. A model of growth that has become popular on Seattle, Washington, for example, is the so-called urban village concept, where planning efforts are focused around semi-autonomous neighborhoods. A similar strategy has been advanced in Phoenix, Arizona under the rubric of satellite cities. At the periphery, however, United States metropolitan areas continue to grow more spread out; indeed, Brookings Institute economist Anthony Downs, CRE, notes that key factors shaping American development patterns are people's affinity for single-family housing, low-rise, campus-style workplaces, and automobile transport. So, even as centralized areas undergo significant transformation, so too do areas

Figure 5—Per Capita Gross Domestic Product, Income, and Disposable Income, 1950—2001



located further out, simultaneously creating two new and distinct types of real estate markets, governed by very different sets of preferences and demands.

Real Estate Asset Mix—The transformation just discussed has direct implications for the kind of real estate asset mix that will be demanded. On the one hand, trends suggest that there will be increased demand from people living or working in downtown areas for high-rise apartment/condominium units, commercial space to accommodate their recreational needs, and office space designed to meet the needs of an information-intensive economy. Consider, for example, how the structure of real estate markets in Manhattan has been transformed over the last decade. On the other hand, there is every indication that more suburban areas will also continue to grow via their present trajectory. All of this has direct implications for real estate practitioners: How should a solid investment portfolio be structured, given this polarization? How should the two kinds of markets be valued? These and other important questions must be addressed explicitly within the context of the kind of change described in this article in years to come.

Valuing Places Based on Realtive Quality of Life—The rising incomes and increased locational flexibility precipitated by economic restructuring in the United States portend rapid changes in the very way people value real estate. For one thing, if people continue to choose where they want to live based on their individual preferences, places that meet these preferences will capture ever greater proportions of growth. Consequently, they will also exhibit new forms of competition over the most desirable locations within them. At the same time, places that cannot compete from a quality of life standpoint may fail to thrive in years to come. As an outcome, real estate markets will likely need to be valued in direct relation to one another; certain places may be over or under valued, depending on their relative quality of life. Measuring this-and how it translates into local prices, via the supply of and demand for location in-and-of itself-will pose significant and invigorating challenges for the real estate industry in years to come.

Economic Value of Non-Market Amenities—Last, due to rising incomes, people have greater than ever opportunity to consume non-market amenities that vary from location to location. Non-market attributes are those that are not produced, sold, purchased, or consumed in the traditional sense but, instead, attach to a commodity, such as a land. A good example of this is trophy properties, which, until relatively recently, have not been a significant aspect of real estate investment. Due to the way the market for such properties has changed, our firm now does a significant proportion of its business in translating the intrinsic value of rare properties to monetary value; whether the subject is an old growth stand of redwood forest, a custom-built home, a remote, high-amenity ranch, or other unique form of property, valuation poses special challenges that require new and creative types of thinking about real estate markets. Even—or maybe especially—history now carries an implicit economic value that shapes people's willingness to pay.

The goal of this article has been to highlight significant changes affecting the real estate industry in the United States over the last 50 years. The thoughts provided in this conclusion are not intended to be exhaustive or mutually exclusive. Rather it is the authors' hope that they will inspire further thinking, discussion, and even healthy debate. The real estate industry is exemplary of one that changes with the times. Staying at the forefront of this change is not only important for industry leaders but, in turn, for the industry itself.

RISK VS. RETURN: A FRESH PERSPECTIVE

By Kenneth P. Riggs, Jr., CRE

ABOUT THE AUTHOR
Kenneth P. Riggs, Jr., CFA, MAI, CRE, *is chief executive officer of Real Estate Research Corporation (RERC). RERC offers research, valuation, consulting, portfolio services, corporate advisory services, litigation support, and other real estate-related solutions. Investment criteria (capitalization rates, yield rates, and expense and rental growth expectations) are presented for nine property types on a national and regional level and for 40 major U.S. markets each quarter through the RERC Real Estate Report and the RERC DataCenter.*
(E-mail: riggs@rerc.com)

It is always a challenge to confidently price commercial real estate. The concern generally heats up when space fundamentals are at their cyclical lows and cash flow forecasts are in question. But even in the best of times, the goal for investors is to earn returns at least as good or better than the rest of the market on a risk-adjusted basis. Still, who can predict what the future will bring, and how does this impact our expectation for risk and return?

This article outlines an approach in developing an appropriate level of return given the amount of risk that is taken on. It also lays the foundation for bringing capital market behavior into focus, and discusses the author's view of the development of return expectations given an investor's outlook for risk.

For the purposes of this article, the author has identified and defined what various investment concepts mean. Exhibit 1 is a glossary of these concepts and terms.

WHAT'S RISK AND RETURN ALL ABOUT?

The real estate market has always had to adjust to financial, economic, and investor expectations. However, with everything the real estate market has gone through since 2001, it is even more challenging to deal

Exhibit 1

Making the Connection to the Terms

Term	Definition
Risk	The uncertainty that an unforeseen event(s) will occur to cause one not to ahieve and expected return.
Return	A financial return in owning a property, which incorporates benefits such as diversification, stable returns, tangible assets, etc.
Market Price	The amount that a particular purchaser agrees to pay and a particular seller agrees to accept under the circumstances. The amount that clears the market.
Market Value	The monetary worth of a property to buyers and sellers at a given time and the present worth of future benefits that accrue to real property ownership. Market value has a range and can vary depending on the intended use (i.e., purchase, loan, transaction, etc).
Cost-Push Inflation	Rising prices caused by increasing costs of production that are passed onto consumers or users.
Demand-Pull Inflation	Rising prices caused by excessive demand for space or service beyond that caused by traditional cost-push inflation.
Required Return	The return an investor requires to be fairly compensated for assuming risks of the asset or portfolio being acquired. Expected return that a property is targeted to receive, plus appreciation (or depreciation). A forward-looking concept.
Realized Return	Actual income that a property received, plus appreciation (or depreciation). A backward looking concept.
Leveraged Return	Financial return available to invested equity after debt service, which is assumed to exist on the investment.
Unleveraged Return	Return available to invested equity, which assumes that there is no debt on the property. A free and clear return.
Cash-on-cash Return	The ratio of annual equity income to the equity investment. Cash-on-cash return can also be referred to as the equity capitalization rate, cash flow-rate, or equity dividend rate.
Total Return	Total return is the most basic and complete measure of periodic return.Total return includes both the change in the capital value of the asset during the period and any income paid out by the asset to the investor during the period.
Discount Rate	An interest rate used to convert future payments or receipts into present value. The discount rate may or may not be the same as the internal rate of return (IRR) or yield rate, depending on how it is extracted from the market or used in the analysis.
Overall Capitalization Rate	First year (stabilized) NOI (before capital items of tenant improvements and leasing commissions and debt service) divided by present value (or purchase price).
Yield Rate	A rate of return on capital, usually expressed as a compound annual percentage rate. A yield rate considers all expected property benefits,including the proceeds from sale at the termination of the investment.
Internal Rate of Return (IRR)	The annualized yield rate or rate of return on capital that is generated or capable of being generated within an investment or portfolio over a period of ownership. The IRR is the rate of discount that makes the net present value equal to zero.
Risk-Adjusted Return	Return that is adjusted to offset one or more risk factors. A term used to indicate that the return reflects the relative risk take on for a specific investment

Sources: The Dictionary of Real Estate Appraisal, Fourth Edition, and RERC

Exhibit 2
10-Year Treasury Bonds

Total Return % as of 6/30/2003			Annualized Returns			
Market Indices	**YTD**	**12-MONTH**	**3-YEAR**	**5-YEAR**	**10-YEAR**	**15-YEAR**
S&P 500 Index	11.75%	0.25%	-11.19%	-1.61%	10.04%	11.41%
Dow Jones Composite Index	9.84%	-3.70%	-2.79%	-0.18%	9.61%	11.00%
NASDAQ Composite Index	21.51%	10.91%	-25.76%	-3.05%	8.71%	9.88%
Wilshire 5000 Index	12.92%	1.29%	-10.57%	-1.30%	9.54%	10.94%
Lehman Government Bonds Index	3.63%	11.33%	10.16%	7.66%	7.16%	8.47%
T-Bills (3-Month)	5.70%	1.35%	3.05%	3.88%	4.44%	5.04%
Consumer Price Index	1.44%	2.00%	2.10%	2.40%	2.43%	2.99%

Source: Morningstar

with the inherent difficulties associated with investment. When one finally strips away all the debates and emotions, both sides of investor behavior remain—efficient market theory and behavioral finance theory. The basic tenet of efficient market theory is that the market is mechanically driven by data, somewhat robotic in its way of approaching risk and return. On the other hand, behavioral finance views the world from a human dimension where the decision-making process for risk and return is more emotional and driven by gut instinct and backed by historical data.

In developing an informed opinion regarding an acceptable rate of return for commercial real estate and in understanding how to assess the risk that goes along with the expected return, it is important to remember that reaching a final decision on return criteria is a circular process that is based on one's understanding of the relative risk. As will be discussed later, the development of the market's view of risk and return is done within a mixed-asset diversification context. For the purposes of this article, risk is considered to reflect the probability of not achieving the return that one initially expects.

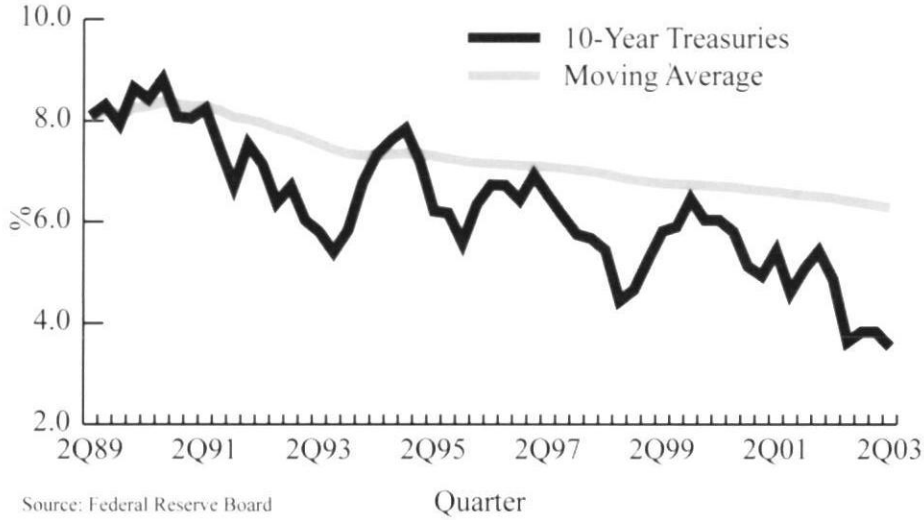
The author would suggest that first analyzing total required returns with an understanding of overall capitalization rates in commercial real estate may paint a clearer and more direct picture. Investors are primarily focused on realizing a certain targeted total return (required return), rather than achieving a certain capitalization rate because capitalization rates are a single point in time and can have extreme distortions (above market rents, high vacancy, roll-over risk, etc.) during market inflection points. Nothing is done in isolation, and once one has an informed view of the total return, the development of overall rates completes the picture. As we know, total returns, growth expectations, and overall capitalization rates are linked.

WHAT ARE THE RETURN CUES FROM THE FINANCIAL MARKETS?

Most experts agree that real estate is an extremely cyclical industry that lags the national economy but equally is impacted by secular trends. Each generation seems to learn on its own that diversification is key to a proper investment strategy, and our risk and return expectations are influenced by what happens in the broad financial markets. As demonstrated in Exhibit 2, the equity market for stocks is finally making the connection with investors and giving back some of the return that it plucked from their hands over the past three years. Investors do not expect this pace of return to continue for an extended period, but it is at a necessary level in order to get the market back on track. It will take more time for the stock market to recover, but what is more relevant are returns over a 10- to 15-year period or longer.

As applied to the future, a historical review of this data suggests a stock market return in the 10-12% range, which is higher than some major Wall Street firms are predicting. The stock market is one asset class used as a comparative benchmark to real

Exhibit 3
Annualized Returns



Source: Federal Reserve Board

estate, but expectations that unleveraged institutional commercial real estate will be above this range are unreasonable. Remember, stocks are a leveraged return that has whipsawed investors' emotions back and forth for the past 10 years—this is the risk that investors do not like. (Studies show that investors dislike losses more than they like gains from a proportion view. For example, on average an investor is more upset with a 10% loss than he or she is happy with a 10% gain. This is referred to as an asymmetrical payoff.)

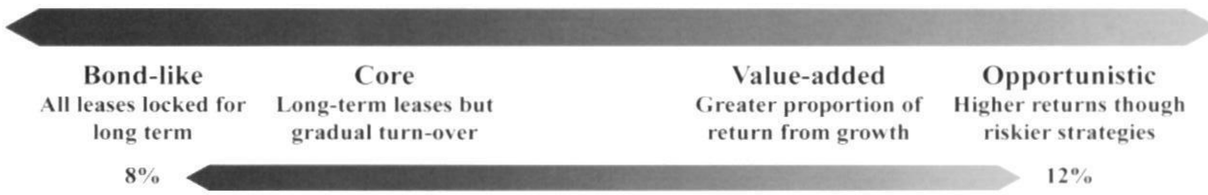
For institutional commercial real estate, this conclusion provides the upper limit for unleveraged total returns. For the lower end for return expectations, we look at 10-year treasury bonds. Exhibit 3 illustrates the 10-year T-bond returns since 1989. These safe-haven investments hit their peak in third quarter 1990 with an interest rate of 8.82%. Conversely, T-bonds hit their trough in second quarter 2003 at an interest rate of 3.54%. Talk about a dynamic shift during the last 14 years!

The question in analyzing T-bond returns have many investors asking how much of this low return is cyclical versus secular. First, the primary reason that 10-year T-bond rates have decreased over the past 10 to 15 years is because the U.S. rate of inflation has fallen so low that economists have been speculating about deflation, and the Federal Reserve has lowered the discount rate to 1.0%. Like all life experiences that ebb and flow, these rates will not last forever. The answer to developing a future view is that there have been both cyclical and secular changes in the foundation of interest rates.

The author believes that 10-year T-Bonds will increase as the economy gets on track. It is expected that 10-year T-Bonds will move to approximately 4.5-5.0% by the beginning of 2004, increase to the mid 5.0% range by the end of 2004, and reach a level of around 6.0% for 2005, but there is no information suggesting that 10-year T-bonds will reach their 13-year high of 8%. The author suggests that 10-Year T-bonds serve as one of the building blocks in developing investment return expectations.

As illustrated in Exhibit 4, pricing, or the return requirements of commercial real estate, is based on a hybrid approach lying somewhere between that of stocks and bonds. Given the economic, financial, and commercial real estate outlook today, a total unleveraged return for institutional real estate in the 8-12% range is reasonable. The final return depends on the specific asset's lease duration, tenant credit, and the financial structure that yields specific earning characteristics. The longer the lease duration and the higher the tenant credit, the more real estate behaves like a bond. Conversely, the shorter the lease duration and the lower the tenant credit, the more real estate returns will mirror a stock. Using this approach, an investor can change the return requirement given new information.

Exhibit 4
Annualized Market Indices Table



Source: *Expectations and Market Realities in Real Estate 2004*

USING SURVEY RETURNS

Among its core research activities, the author's firm conducts independent investment surveys that are designed to gain an understanding and interpretation of property underwriting criteria of key players in the industry. This survey research has served as the foundation of the real estate industry's use of required return expectations (pre-tax total returns, going in and terminal capitalization rates, rental growth, and expense growth) used to price and value real estate. This information continues to be gathered for institutional-grade real estate on a national and metropolitan level.

These surveys are used directly or in conjunction with the firm's models to develop investment criteria for various classes of properties on a national level. Regional and metropolitan criteria are also offered for average/second-tier level properties. This survey information is released each quarter for nine property types through the *RERC Real Estate Report*. An excerpt of that information for third quarter 2003 is shown in Exhibit 5.

Recognizing that many factors affect the investment potential of real estate, RERC recently expanded its use of independent survey returns. This more inclusive information also can be used as benchmark, and provides useful data in today's maturing market where averages do not allow for well informed, risk-adjusted decision-making.

For the national market, the property classes were divided into first-, second-, and third-tier property levels by using a standard deviation around the mean survey response. The second-tier required total return for apartments of 9.9% is reflective solely by the national survey results, and the first- and third-tier required total returns are an estimate based on RERC's standard deviation calculation around the average survey result. In this case, the apartment first- and third-tier required total returns are 9.2% and 10.5%, respectively. This approach was developed for the national returns in order to maintain the integrity of the survey responses and historical relevancy of the time series. This information is known as the *RERC National Forecast*.

For the regional and metropolitan markets, RERC's required return expectations take into account the independent survey information, and also such elements as demand expectations, economic realities, employment data, space market (information sourced by Torto Wheaton Research), vacancy rates, absorption, completions, and rent. These additional factors are modeled into the RERC regional and metro-level forecast because survey responses alone are not sufficient for an adequate sample and the historical survey information does not exist.

These required returns serve as a barometer of the targeted returns that real estate investors are requiring, and are one of several benchmarks, or tools, that investors can use to arrive at expected returns. Other useful benchmarks include an analysis of alternative investment returns, actual targeted returns in specific deals, and historical indexed returns. (A discussion of the author's view of pricing risk for real estate was printed in *Real Estate Issues*, Aug. 1996.)

Exhibit 5

RERC's Required Return Expectations by Property Type

Real Estate Investment Criteria by Property Type	INDUSTRIAL		RETAIL			OFFICE		APARTMENT	HOTEL	AVERAGE
	Warehouse	R&D	Regional Mall	Power Center	Neighborhood Community	CBD	Suburban	Apartment	Hotel	All Property Types Average
Pre-tax Yield (IRR) (%)										
Range	9.3 - 10.9	10.2 - 11.6	9.3 - 10.9	9.7 - 11.3	9.4 - 11.0	9.5 - 10.9	10.1 - 11.5	9.1 - 10.5	12.0 - 13.4	9.6 - 11.6
Average	**10.1**	**10.9**	**10.1**	**10.5**	**10.2**	**10.2**	**10.8**	**9.8**	**12.7**	**10.6**
Going-in Cap Rate (%)										
Range	7.8 - 9.0	8.6 - 9.8	7.4 - 8.6	7.9 - 9.3	7.7 - 8.9	8.1 - 8.9	8.5 - 9.5	7.2 - 8.0	9.9 - 11.5	7.8 - 9.6
Average	**8.4**	**9.2**	**8.0**	**8.6**	**8.3**	**8.5**	**9.0**	**7.6**	**10.7**	**8.7**
Terminal Cap Rate (%)										
Range	8.4 - 9.4	9.0 - 10.0	8.0 - 9.2	8.6 - 9.8	8.4 - 9.4	8.4 - 9.4	9.0 - 10.0	7.8 - 8.6	10.5 - 11.9	8.3 - 10.1
Average	**8.9**	**9.5**	**8.6**	**9.2**	**8.9**	**8.9**	**9.5**	**8.2**	**11.2**	**9.2**

This survey was conducted in July, August, and September 2003 and reflects required returns for Third Quarter 2003 investments.

The low range of each property type is the required return for 1st-tier investment properties, which is defined as new or newer quality construction in prime to good locations.

The high end of the range of each property type is the required return for 3rd-tier investment properties, which is defined as older properties with functional inadequacies or marginal locations.

The average stated for each property type is RERC's required return for 2nd-tier investment properties, which is defined as aging, formerly 1st-tier properties, in good to average locations.

Source: RERC Real Estate Report, Fall 2003

Our firm's total required returns have experienced a slight roller coaster effect over the past 10 to 15 years. However, during the last 12 years, average total required returns for the core properties have ranged between a high of 12.5% in the first quarter 1992 and a low of 10.6% in third quarter 2003. Interestingly, our view is that top quality assets have total required returns much lower than the surveyed results would indicate. Applying the average to these top tier assets becomes problematic in that the range around the average becomes much larger and more difficult to interpret. With the proper analysis, investors can use these required returns as one useful benchmark in determining an appropriate required or expected return given any level of risk. Based upon the analysis of the survey data, an investor can develop expectations for unleveraged total return, given various risk elements of a particular investment.

Investors need to pay extremely close attention to the risk they take on relative to the anticipated return. For example, a 10% return for an apartment investment may be superior to an 11 to 12% return for a suburban office, given the significantly different risk levels of the two assets. In a maturing market, the key to getting the returns one expects is in making the connection between risk and return.

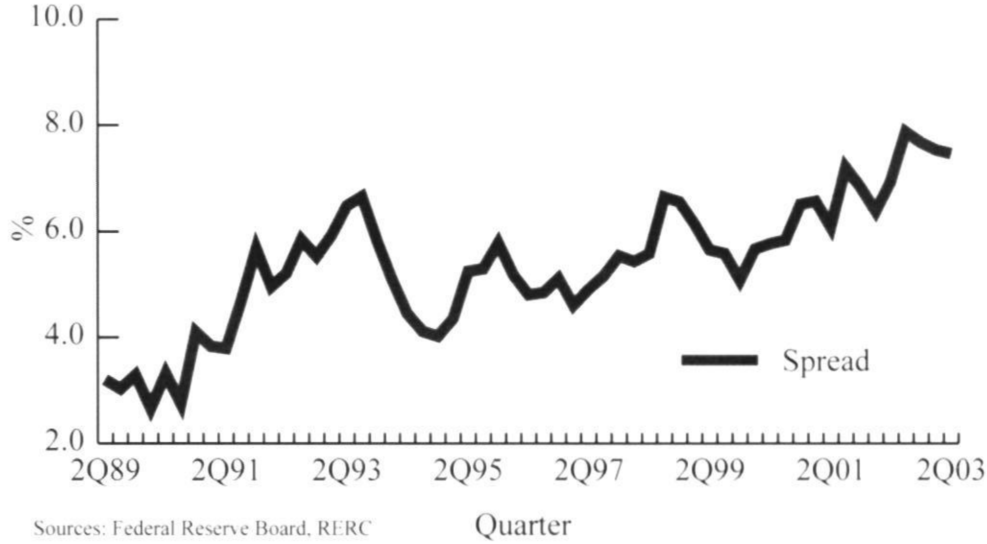
ADDITIONAL USE OF SURVEY DATA

Another way to use the return data provided each quarter in the *RERC Real Estate Report* is to analyze the historical spread of total required returns versus 10-year T-bonds, which in the past, generally has ranged between 450 and 600 basis points. At 10.6% (this is an average for all property types with an average earning structure), RERC's total required return expectations are at the lowest point they have been since we started this survey process over 20 years ago. However, at approximately 650 basis points, the spread between required returns and 10-year T-bonds remains near an all-time high.

Generally speaking, as 10-year treasuries increase or decrease, the "expected" real estate yield lags with, or slowly follows, the same pattern. Since real estate competes with other risky assets for capital, increases in risk-free rates should motivate real estate investors to require higher returns. Exhibit 6 illustrates the yield relationship of the firm's total required returns and 10-year T-bonds with the spread showing a continual increase from 1990 to today. This above average spread will tend to keep discount rates stable in anticipation of interest rates increasing. This allows the spread to normalize and keeps prices relatively steady in the short-term.

The observed high spreads over treasuries are an attempt by investors to avoid the cyclical movements in the financial markets that the real estate markets cannot adapt to quickly, and potentially have a significant negative impact on values and prices if rates move upward unexpectedly. However, the continued high spread is suggesting that the financial market changes are more secular in nature and it is time for real estate to lower its expectation on returns. This is where many

Exhibit 6
RERC Required Returns vs. 10-Year Treasuries



Sources: Federal Reserve Board, RERC

observers feel that there is a disconnect between real estate return requirements compared to alternative investments. However, we view it as a cyclical phenomenon that is turning into more of a secular trend.

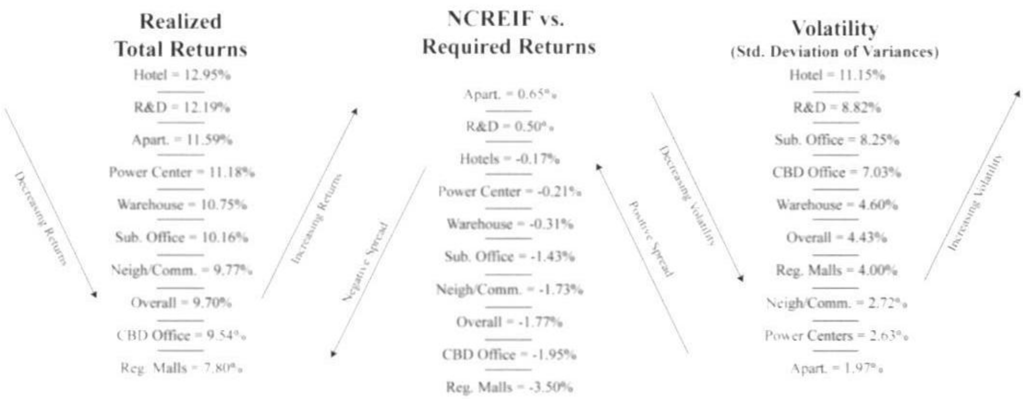
The author's forecast, for illustrative purposes only, is for a normalized spread of 400 to 500 basis points over equal-term treasuries for total required returns. For example, if investors anticipate 10-year treasuries to be 5%, then required total returns will be 9-10% (400 to 500 basis points higher). This reflects our view for institutional core properties that have various lease durations and tenant credit quality but solid cash flow earning structures in place. Further, this reflects an unleveraged return expectation.

ANALYZING RISK USING REPORTED RETURNS VS. REQUIRED RETURNS

Over the years, NCREIF returns have become known as the industry standard in analyzing realized (reported) returns. With access to the NCREIF historical database, our firm uses these returns as a basis in developing an opinion of required total returns, which is to take historical data to predict the future. This comparison of RERC's required total returns to that of NCREIF's reported total returns presents a challenge in that RERC's required return expectations are a forward-looking view, and NCREIF's returns are more of a rearview approach. This historical comparison allows an investor to assess if their required returns (targeted returns) have been met by market realities (realized, or reported, returns).

To keep this analysis on an apples-to-apples basis, we are able to look back at what investors projected during third quarter 1993 for a total required return. We then can compare that information to NCREIF 1993 data going forward 10 years. As an example of this backtracking, we looked at neighborhood and community centers and found that third quarter 1993, investors had a required return of 12.3%. NCREIF reports for a 10-year period going forward that total reported returns were 9.8%. This means that investors surveyed expectations were 2.5% more than what the market delivered (difference between expectations and market realities). Although there are a variety of possible reasons why this occurred, the value of the data analysis rests with comparing, on a relative basis, how well each property type performed. However, this methodology cannot be applied to the more relevant of our required returns because one would have to wait for 10 years until the reported

Exhibit 7
RERC Pyramids



Sources: RERC, NCREIF

returns happen. This is nice for research, but does very little for today's investment decisions.

Keeping in mind the relevance and importance of our firm's current survey data, we took the average of the surveyed returns over that 10-year period (second quarter 1993 through second quarter 2003). The average over that term was 11.5%, which if contrasted to NCREIF's reported return of 9.6%, shows that actual returns were 1.9% below investor expectations. Although this analysis is not completely parallel, it does allow for the recent data to be captured and reflected in the analysis. The author's view is that the importance of this analysis lies in the ability to make a relative comparison among the property types—office, retail, apartments, and industrial. The greater the relative difference of required versus realized (NCREIF reported returns) returns, the higher the level of relative risk or a risk-adjusted return.

For example, this comparison shows that required returns for hotel were 13.10% and reported or realized returns were 12.95% for a -0.15% difference for a 10-year holding period. As such, we would suggest that hotel properties offered a relatively good investment because they provided investors with a return that nearly matched their expectations. This implies that investor expectations matched the risk of the investment at hand. This could be contrasted, for example, to CBD office, which had a required return of 11.6% and a reported or realized return of 9.5% for a -2.1% difference for a 10-year period. In this case, our firm would state that CBD office disappointed investors and delivered below market expectations on a relative basis or risk-adjusted basis.

Despite the difference between forward-looking expectations and rearview realities, our required returns also can be compared to NCREIF's reported total returns for each property type. Exhibit 7, referred to as the RERC Pyramids, illustrates the spread (shows either negative or positive variance) between these two sets of returns, and allows an investor to observe when the variance was the greatest and to identify inflection points in the market. For example, it is important to be able to answer the question that if hotels have historically met investor expectations, where are the returns today? This can be answered by looking at 12-month trailing returns versus what investor expectations are going forward. Today, hotels would reflect a negative spread of approximately 610 basis points (13.6% required minus 7.5% 12-month trailing return). This tells investors that repricing of the asset has to occur, and what the relative level of repricing must be in order for investor expectations to be met in the future.

As mentioned earlier, behavioral finance suggests that investors dislike losses more than they like gains, or returns are not normally distributed around the mean and may have an asymmetrical distribution. If investors do not earn their required returns, less money will flow into commercial real estate. Conversely, if investors do earn their required returns, more money will flow into commercial real estate. However, even the inflows and outflows may be asymmetrical, where more money flows out in a negative market than what flows in during a positive market.

This type of analysis allows investors to see if the market's total return expectations have been met on a historical basis, and to compare and contrast the performance of the core properties on a risk-adjusted basis. The historical view examines whether investors are earning what they require on average. This comparison of NCREIF's reported returns to RERC's required returns allows us to make the connection between market realities and hopeful promises.

Further, to appropriately consider the relationship between required versus reported returns, an investor must analyze the volatility of the returns to understand the risk among the property types (Exhibit 7).

CONCLUSIONS

- Return, risk, and other related terms must be defined especially for real estate. Investors have to make the profound connection between risk and return!

- In developing a solid view of risk and return for commercial real estate, an investor must be able to understand cyclical and secular issues for the economy, the financial markets, and the space capital markets.

- We suggest using a forecast for 10-year T-Bonds as a basis to develop an informed opinion of an appropriate unleveraged total real estate return. It provides a lower end return basis for commercial real estate on an unleveraged basis. Further, developing an appropriate risk-spread adjustment to forecasted 10-year T-bonds aids in addressing risk ratings for equity real estate.

- Be careful with applying average required returns in today's market, or for that fact, anytime in the near future. Returns vary widely, depending on the property types and earning characteristics of each property. Investors need to start rating the earning characteristics of real estate like bonds between "A" and "B" assets.

- Survey return requirements, including our own required return research surveys, should be used only as one tool in the arsenal for developing an appropriate forecast for total returns and overall capitalization rates.

- NCREIF is the industry standard performance measurement and we see the long-term realized total returns can be a useful guide in determining an appropriate required return for the market.

- There is a big difference between an overall capitalization rate and a cash flow rate, especially when you are looking across assets. When looking at the relationship between required return rates and pricing, investors must consider cash flow projections and incorporate the risk of these cash flow projections into pricing.

- The comparison of required versus reported returns provides an investor with an understanding of the risk of each particular property type. Further, this analysis can be used to determine the likelihood of capital flows into or out of that sector.

- Further analysis of the volatility of returns is a must to understand risk.

PREPARING THE NEXT GENERATION

by Kerry Vandell, CRE

The days of the real estate industry being perceived as an army of "gunslingers," the soldiers of which shoot from the hip and live for the deal based on their gut instinct alone, are over. Even at the local level, our world has changed over the last 25 years:

We have gone through some significant industry-wide dislocations, especially in the 1970s and late 1980s—early 1990s, that weeded out many of the most unprepared.

We have been faced with new regulations and legislation (such as the Tax Reform Act of 1986, ERISA, and the Garn-St. Germain Act of 1982 that deregulated banking institutions) that gave us new opportunities in some cases, but also circumscribed our ability to do what we wanted.

New land use regulatory measures have been developed (such as transfer of development rights, TIF's, and inclusionary zoning) that force us to understand and deal with the public sector to a degree that has never been necessary before.

ABOUT THE AUTHOR

Kerry Vandell, CRE, PhD*, is the director of the Center for Land Economics Research and Lorin and Marjorie Tiefenthaler Chair in Real Estate and Urban Land Economics at the University of Wisconsin, Madison. (E-mail: kvandell@bus.wisc.edu).*

New ways of delivering capital to the real estate market, especially through the "public" markets via the REIT and CMBS products, have not only created entirely new sectors in the real estate market, they forced even those on Main Street to understand and reference their role in the marketplace.

Capital has also flowed into the market from foreign sources (and we have engaged in more offshore investing than ever before), creating a true international real estate market.

We have observed as technology has transformed our previous ways of doing business. From e-commerce to new CMBS derivative products, firm-wide computerized networks, vastly improved software for corporate and asset management and feasibility analysis, "green" building technology, and new construction materials and techniques, real estate has participated with the rest of the world in the "new economy."

Many of these innovations have been driven by basic and applied research tools that have enabled their introduction, including the Black-Scholes option pricing model (the intellectual basis for the CMBS industry), Marcowitz, and other portfolio design and management tools, and new designs for market-based policies to accomplish certain community development goals.

Finally (and unfortunately), we have been faced with some embarrassing moments, when some of our most esteemed professional colleagues have been singled out for scrutiny by government and law enforcement investigators for violations of legal and ethical standards that in some cases even resulted in prison terms.

The above examples give ample evidence to the fact that to prepare the next generation for assuming successful roles in guiding the real estate sector through the shoals of the next twenty-five years, we have to ramp up our educational products—the formal education of the college classroom as well as the professional and executive education classroom and the corporate environment through which so much "applied" educational experience takes place. I intend in this article to provide some musings on what the nature of this educational product should be, based upon my observations of having been a part of the business over the last 28 years and having been a part of building educational programs, both at my own institutions and as a consultant for others.

A BROAD, BUT SOLID FOUNDATION

Jim Graaskamp, the University of Wisconsin's legendary "Chief", who educated thousands of loyal alumni and perhaps had one of the most enlightened, holistic views of the place of real estate education in the world, would always announce in one of his introductory lectures that real estate professionals had to become true "Renaissance men and women." While this pronouncement perhaps seemed strange in the 1970s and '80s, given the trade school mentality of real estate educators at the time, as was typical of many of Graaskamp's pronouncements, it turned out to be right on the mark. Graaskamp understood the fact that real estate—as shelter, as an asset, as a symbol—permeated many aspects of the modern world. To be able to effectively deal within that market with such a multiplicity of goals and considerations required one not simply to be in command of the technical tools of the trade, but also to understand and operate from the broader perspective of an agent of human society. If true in Graaskamp's time, his precept is even more true today.

One needs first to be literate and articulate. If there is one consistent shortcoming I see in too many students entering the professional world today, it is that they are ill-prepared to present themselves as professionals through the written and spoken word. They get too-little opportunity to present their work to an audience, to be forced to think logically and clearly about the way in which they can most efficiently bring out the points they wish to get across and respond to questions. They are too-infrequently critiqued today in their written essays and reports on everything from grammar and spelling, to sentence construction, organization, and "flow." Whereas it may be too late in real estate higher education to deal effectively with these shortcomings, we at Wisconsin are attempting to at least provide experience in team presentations (where everyone needs to take a turn at bat) and detailed grading of written work by hired English grad students, as well as faculty.

One needs also to have a firm foundation in the liberal arts and especially the social sciences. "Those who cannot remember the past are condemned to repeat it" was uttered by philosopher George Santayana, relating to political leaders, but it could have been just as easily applied to real estate professionals. They make their decisions in the context of a historical tradition of past behaviors premised on laws, customs, cultural traditions, and market forces. Without having a basic understanding of what has gone before, what has worked and what has either not worked or been rejected and why, one will face inevitable failure, either from a lack of success at getting public approval or from a failure of the project once built. This is similarly true for an understanding of our political system and civic institutions, the way that the market economy works and why we find it necessary (regardless of our political ideologies) to intervene in it so frequently, and the way that society is structured and the role that class and race and cultural traditions can play in support or rejection of proposed changes in the built environment. My general notion is that our students vary widely in their degree of preparation in this area. Unfortunately, those coming out of undergraduate business or technical degree programs tend to be the least well prepared. Again, while it may be too late for graduate programs in real estate to fill this void adequately without some prior foundation, we can at least include ample discussion of public policy issues within our curriculum and outside guest lectures.

Finally, one needs a solid foundation in analytical methodologies and an analytical approach to problem solving. This is probably the area in which I find our students best prepared on average, though even here the degree of preparation varies widely. I find frequently that students have been trained in the use of such tools as probability and statistics, evaluation of cross tabular data, and financial analysis; however they often tend excessively to seek a "recipe" for solution of problems, that is simply plugging numbers into a hand-held calculator or a spreadsheet without really setting up the problem in a logical way and knowing exactly what they are trying to get out of the analysis. Our educational program needs to provide ample opportunity to evaluate "real" problems. Whether they be mini-problem sets or full blown case studies, students should be required to separate the wheat from the chaff in terms of the information they are provided, and decide what to do with the information they have. These are not only "number-crunching" exercises; in fact in many cases the quantitative would be minimized in favor of the qualitative judgmental factors that are typically so important in real estate decision making.

THEORETICAL PERSPECTIVES

Theory has never been a favorite subject among real estate professionals. "You don't study real estate, son; you do real estate" was one of my favorite quotes from my days in Texas. "The real world is not theory." And in many ways, this guy was right. Sterile lectures on supply and demand or multiple regression devoid of context and application have often been forced rites of passage for real estate students, reinforcing their negative attitudes about theory. However, I would contend the real problem is not so much with theory in and of itself, but rather how it is presented and the extent to which students are convinced that it can be directly relevant to their practice. It has frequently been my experience that those most contemptuous of theoretical perspectives are not those (primarily grad) students who have had ample experience in the marketplace, for they have a "need to know" premised on their desire to put in perspective some of the phenomena they observed in practice. Rather, the skeptics are the undergrads and others without prior experience, to whom everything they are studying is an abstraction.

This suggests that theory is best presented in the context of applications, especially via case studies or problems that illustrate how an understanding of theory can provide insights and creative solutions that would be otherwise counterintuitive or impossible to discern. It is a difficult undertaking to come up with exactly the right illustration, but such efforts must be made by educators to provide a rational basis for its inclusion in the curriculum, for if such an illustration cannot be provided, we must ask ourselves honestly whether we are including theory because it is truly important or because it is what we "do" and what we find interesting.

The above suggests a number of revisions in the traditional curriculum. Urban economics, consistently one of the most difficult courses to convince real estate students of its relevance, should be transformed to "real estate" economics, which provides numerous applications of location theory, externalities, amenity theory, and the dynamics of supply and demand drawn from relevant professional experience in the marketplace. These should be related directly to the tools generated from market, feasibility, and highest and best use analysis. The tools of appraisal should not be presented in isolation as the "three approaches," but rather as the derivative products of the underlying theoretical principles of the land market and the above analyses. Financial theory, too, should be presented as the solution to a defined problem, thus providing a "need to know," rather than as theory floating in space. Finally, statistical theory -- most often in the form of the application of multiple regression to the estimation of drivers of rents or values, estimation of price indices over time, or simple comparisons of sample means -- is much more acceptable to students who are first presented a real-world problem, accept its relevance, and then recognize the capability of these tools to address it.

THE FOUR-QUADRANT MODEL

Those who have been in the real estate market for any time begin quickly to recognize that its essence can be distilled down into flows of capital into and out of the market. In recent years, the capital markets for real estate have matured dramatically. Many professionals have come to think of the real estate market as embodying today four-sector investment activity: 1) private equity (individual proprietorships, partnerships and LLC's, joint ventures, opportunity and other commingled funds, etc.); 2) public equity (REIT's and REOC's); 3) private debt (mortgages, lines of credit, mezzanine financing, etc.); and 4) public debt (mortgage-backed securities, bonds, etc.). Each of these sectors has become a not-insignificant component of the overall market.

Understanding the investment process in real estate requires the full understanding of each of these four sectors—their size, their legal and institutional structure (the "players"), their growth and dynamics, the economic fundamentals of their market, and the details of the process leading to changes in these capital flows, whether they be new investments, restructurings, or unwindings of positions. For this reason, it seems to me that the "core" of graduate education in real estate (beyond the theoretical underpinnings cited above) ought to revolve around courses dealing with each of these market sectors. That is not to say that all real estate students are going to become REIT analysts, but they need to understand the role REITs play in the market in influencing overall prices and availability of capital. Understanding the public equity markets also play the dual role of guiding students toward an understanding of the underlying principals of corporate finance—the notions of accretion and dilution, preferred shares, and other specialized interests that are so much a part of valuation of real estate firms, whether public or private.

DEVELOPMENT AND DESIGN

As with all assets, real estate is characterized by a production process that creates, repositions, and ultimately destroys it. The developer, of course, serves as the market agent to facilitate this process. Thus, it is important that those becoming versed in the real estate market have a command of the developer's role in shaping it. Many programs have included within their curriculum a "development" course with greater or lesser degrees of success. Having been involved in the creation, oversight, and teaching of various permutations of development courses over the years permits me to offer several observations on what seems to work and what does not.

First, this is a course that should be taught (or at least team-taught) by one who has had significant experience in development practice. Development by its nature is an applied course requiring synthesis of many of the component elements of the deal, and a full understanding of these relationships, especially at the detailed institutional level, is more difficult to impart unless one has "done" it. That is not to say regular faculty do not have an appropriate role in the development curriculum, for one aspect that I have sometimes found missing in such courses taught by practitioners is the provision of a synthesis that places the development process in a broader conceptual framework.

The development course should also be heavily case-oriented; its heart should be a "real" project with a "real" site and a "real" problem. The students, working in teams with the owner or developer, through the course of the semester can undertake the market, feasibility, and highest and best use analysis for the site, but that exercise is not unique to the development process. The next step is unfortunately omitted in most development courses but in my opinion is the essential core of the experience: The construction process should be planned in detail, with scheduling and pricing of various systems, practice in evaluating construction contracts, and studying the process of applying for and administering construction financing. The "deal" should be shaped as the product of an evaluation of the merits of several capital structuring alternatives. Unfortunately, the time frame for the development process is typically too long to directly involve a "real time" development effort. However, by bringing together the right professionals as a review panel to advise and judge teams on their products, one can simulate the forces that move the development process forward.

And finally, the improvements should actually be designed. The one characteristic that makes real estate so interesting as an asset class is the richness of its physical characteristics. Yet ironically there is often little in formal educational programs in real estate that explicitly consider design issues, including architecture and, at the broader scale, urban design. Thus, it is little wonder that developers and real estate professionals in general are considered philistines when it comes to caring about and judging design quality. In fact, research has found strong linkages between design characteristics and economic performance in the marketplace, not only from those characteristics relating directly to efficiency and functionalism but also from those relating purely to aesthetics. Again, this does not mean that one can create a silk purse out of a sow's ear in terms of turning real estate students into architects, but they can at least by this process become sensitized to both the micro-level functional and aesthetic considerations that go into the design process. A course I was involved with a number of years ago at the Graduate School of Design at Harvard perhaps best illustrates this integration of design and development. The students, composed of both Business School students and designers, were forced to both price out alternative design schemes, do a detailed market analysis projecting rents and absorptions, and back out the optimal design program. (By the way, the Inn at Harvard Square is the tangible product of this exercise, reflecting closely the development program proposed by the winning student team).

PUBLIC POLICY AND GOVERNMENT

If real estate professionals are often thought of as philistines when it comes to their design sensitivity, they are positively held in disdain when it comes to an understanding and appreciation of the role of government and public policy. Again, that is not to say that they have to be forced into the largely advocacy courses that unfortunately characterize many of our planning and public policy programs, or to accept the positions taken at the too-often parochial ideological battles characterizing local land use debates. But they do need to come to understand the rational arguments for the existence of land use regulatory policy, environmental policy, taxation of real estate income and wealth, and affordable housing policy and to be able to frame their own efforts in reference to these. Such a perspective in my view not only renders them more effective challengers of parochial policy advocates, it results in better projects more respectful of broader community values.

How is this sensitivity to be imparted in the classroom? There can be a significant dose of policy discussion certainly in the development course, in real estate law, housing policy, and finance. But perhaps one of the most effective exercises I have experienced has been embodied in a simulation game—the old Community Land Use Game (CLUG) developed originally at Cornell University and since elaborated into several derivative products. Players accept the role of planners, public officials, and private sector participants, making sequential decisions about investment and taxation that result in alternative community futures. If this sounds very much like a version of the computer game SimCity, it is. Integration of such game simulations into the curriculum, at least as one module in a broader seminar, could reap substantial rewards in terms of student insights into the planning process and the role of public policy.

THE INTERNATIONAL MARKETPLACE

If there is one aspect to real estate education that has perhaps been most profoundly changed over the last 25 years, it is the fact that the market has clearly become an international one. Institutional portfolios have become diversified internationally as well as domestically as new market opportunities have emerged and investors have come to appreciate the advantages presented by cross-border activity, supported by tax laws and legislation to make it happen. This is equally true of overseas investors in the U.S. and U.S. investors overseas and holds true for individual investors as well as institutions.

The most concrete evidence of the international revolution in educational programs is the growth in the representation of foreign nationals in our real estate programs. Our Masters program in Real Estate at Wisconsin has been about 33% international for a number of years, with representation primarily from Asia (especially China and Korea and, for a time, Indonesia), but also with a solid presence of Germans, Finns, South Americans, Mexicans, and many others (our PhD program is 100% international at present and even our undergraduate program has significant international representation). Many of these students hope to work in the U.S. for a time to gain experience and a certain degree of "status" within their home country, but a large proportion of them intend to return to their home country at some point in the future to build their careers there.

We at the University of Wisconsin have attempted to embrace these students, recognizing that the function of a truly "world class" institution is preparing the "world" for the future. Every year, we undertake at least two international field trips—one to the MIPIM Conference in Cannes France and one to another location (which in the past has included everything from Eastern Europe to Western Europe, South America, Asia, and Africa). We also offer an International Real Estate course, which has provided case studies on cross-border investment issues. We attempt in many of our other courses to provide an international comparative perspective on differences in tax regimes, legal and regulatory rules of the marketplace, and institutional structure. Often, this information is provided by international students who are asked to report on their home country's situation. The international perspective within our educational program is by no means perfect or adequate, but at least we do provide an international reference point from which students (both domestic and foreign) can gauge their position.

HANDS-ON-LEARNING

It should be apparent from the above discussion that, although traditional lectures are fine for providing a foundation, and to some extent theory, for real estate education, they are wholly inadequate in and of themselves for providing students with a sufficient grounding in the market to "hit the ground running" in terms of their abilities to produce for their employers. "Applied" education clearly must be the preferred mode of instruction for graduate education (and even at the undergraduate level for upper-level courses).

Applied education may take many forms, all of which have potential applications in a real estate program. First is "mini-cases" that reflect bits and pieces of "real world" situations. These are quite appropriate for undergraduate students and graduate introductory courses. Full blown cases, which require formal analysis and presentation/ discussion should be the heart of graduate education. (That is not to say that traditional lectures imparting technical analysis skills are not useful; class discussion can take a "time out" from time to time to review relevant principles in a more formal way). Another applied educational experience includes the "real" case using a "real" site being undertaken in "real" time. This would have the potential of being perhaps the most relevant of applied educational experiences, were it not for the fact that the timeline for the vast majority of real estate deals is excessively long to fit into a semester course. Thus, one is typically relegated to a piece of the deal or simulation of proposed solutions under the review of a panel of professionals (see above). A final means of imparting "real world" experience is through an internship or co-op experience. A word of warning on such programs as a universal component of a real estate program, however: To be done right, they require high levels of overhead support and control. Otherwise the students' experiences vary widely in quality and the necessary links between the conceptual process and practice fail to be made.

IT'S THE FIRM, STUPID!

An almost universal shortcoming of real estate educational programs (including our own) is the failure to recognize that the decision-making tools that we spend so much time on are really used in the context of managing and growing a real estate enterprise. Few students are provided understanding as to how to manage growth and change in the firm. They too often see their world as a succession of separate deals and do not realize that a successful real estate firm is more than simply the sum of its constituent deals. Some necessary skills in this regard include understanding how one assembles and organizes (and reassembles and reorganizes) a workforce; how one structures the enterprise legally; how capital is acquired and structured to facilitate operations, investments, and growth; how one markets their products and services and differentiates their products from those of competitors; how one plans strategically to achieve growth targets; how operational and tax efficiencies can be achieved; and how succession of leadership can best be planned.

Now we could require students to go through selected courses in Management and Entrepreneurship, and to be sure, and a current MBA program can insure that all students will have some exposure to such management tools in a number of courses. But there are other more specific and focused ways in which students can be exposed to decision making at the firm level. First is selection of cases such that there is ample consideration of firm-level management decisions. Guest lecturers in seminars and real estate club meetings should also be invited to spin their stories about how they grew their firm and the mistakes they made along the way, as well as providing details of deals. Teams involved in putting together projects for "real" deals should be constituted as an enterprise with a real structure and set of experience.

To be able to move seamlessly into leadership positions within the firm, one must have an underlying "big picture" perspective on the entirety of the firm's operations and how its pieces fit together. Rather than gaining such knowledge through on-the-job "osmosis," one could benefit immensely from the head-start provided by such leadership exposure.

DEALS! DEALS! DEALS!

In spite of what I have said above about the importance of the firm, the world of real estate is clearly a world of "deals," Unfortunately, though, typical textbook treatments of real estate are focused on number-crunching of "dummied down" problems, not real deals in all their complexity and with all of their qualitative (as well as quantitative) aspects. Even cases oftentimes are simplified, or at least presented in a distilled format that eliminates the ambiguity with which one must often contend when putting together a real deal.

What is the solution here? Programs have been effective in getting into the inside of deals via a capstone Seminar in Real Estate Investments. Each week, the principal player in a real deal spends three hours with a class of advanced graduate students who have completed the rest of the curriculum. Background material is provided to them prior to the session—not a formally written case, but a prospectus, a feasibility study, material from a road show, or even transcripts of court testimony in the case of litigation. These are not organized in any particular way (just as in the real world), and the student must read them and separate out the relevant information. The students are graded based upon the quality of their contributions in the session, such as questioning the presenter about various detailed aspects of the case, being able to respond to questions about possible alternative strategies and their pros and cons, and providing unique insights into the various dimensions of the deal. We have found that ample exposure to the transaction/negotiation process and its characteristics is at least as important as the substance of the deal itself. Further, these deals are not confined to typical transactions; a wealth of insights can be obtained by getting into the insides of litigation or workout sessions in which "role playing" by the various parties to the transaction requires the students to think actively and creatively about a situation.

PROFESSIONAL AND EXECUTIVE EDUCATION

Normally, one would not think that an executive and professional education program—including both short courses, seminars, and conferences—would be an important adjunct to a traditional real estate program at the collegiate level. However, we have found it quite valuable. Tenure-track and adjunct faculty and the select group of professionals that develop and lead these programs are provided a rich array of exercises and cases that can be applied in the classroom. Students are given free access to these courses and frequently avail themselves of the opportunity to attend. The constant flow of professional talent in and out of our executive programs, and their attendant interaction with our students, have proven their worth in our program. One component of our real estate center's program that has supported this effort to facilitate interaction between professionals and the students has been our biannual Board Meeting, at which 30 or so of our Board members spend a day and a half on campus in panel discussions about current industry issues and again interact with the students, who are provided free admission. Many employment offers, many leads, and many insights have come out of this forum.

ETHICS AND DIVERSITY

Finally, let us address an issue that we all would prefer would go away as an issue—ethics and diversity within the profession. Generally, our record and history in diversity is not very good, although it is comparable to many other professions. For example, only 5.9% of real estate managers were black in 1990 and only 5.7% Hispanic, while only 3.1% of real estate sales people were black and 3.6% Hispanic (this compares to accountants and auditors at 6.8% black and 4.2% Hispanic and lawyers at 3.4% black and 2.5% Hispanic). It is encouraging to see the ethnic makeup of our students to have changed fairly significantly over the last 25 years. As I indicated above, about 33% of our program today is international, and another 15% or so is minority. We are working with our minority alumni and students to develop a more efficient "pipeline" from employers and schools to attract the strongest minority applicants to our program. It will be equally important to create a similar pipeline to the job market to smooth the entry of these increased numbers of new international and minority graduates.

Our reputation for ethical behavior in the profession is roughly on par with our reputation for diversity, although we generally do better on objective measures of ethical behavior than our reputation would suggest. It may well be that the very economic function that developers serve, as necessary and valuable to society that it is, will always dictate that developers must bear the cross of ambivalent feelings by the lay public toward them. However that is not to say that we cannot in our formal educational program provide opportunity to the students to at least think about the ethical issues that regularly confront us in the workplace.

What are we doing about diversity and ethics education? Wisconsin's new MBA program will insure that every student will take a one credit ethics module in their last semester in the program. However, within the real estate MBA curriculum, we need yet to do more than we are doing. Ethical dilemmas and cases could be interspersed throughout the curriculum, especially in our capstone Investments Seminar. Role playing could be especially effective here in engaging the students in thinking about the conflicts that exist in a real-life context. In this, we could do much better.

CONCLUSION

Please accept the musings above as my goals for an "idealized" educational program in real estate at the collegiate level. It does not represent certainly what the Wisconsin program is today; nor does it even necessarily represent what it wants to become (my colleagues have a lot to say about that). Such a program clearly could require a lot of resources to administer and teach—and may in reality require four years to complete! Nonetheless, in spite of these failings, I hope it serves to point up some areas that we definitely can improve upon relative to where we are. In the end it requires us to recognize that in education, as in everything else, the only constant is change, and that is becoming increasingly true with time. If we can at least prepare our students over the next 25 years to deal effectively, efficiently, and ethically with that change, we will have succeeded.

COMMERCIAL REAL ESTATE MEZZANINE FINANCE: MARKET OPPORTUNITIES

By David E. Watkins, David J. Hartzell, and Dean A. Egerter

David E. Watkins, CFA, *and* **Dean A. Egerter** *are senior vice presidents with with Heitman Real Estate Investment Management in Chicago, IL.*

David Hartzell *is a professor of finance at the Kenan-Flagler Business School at the University of North Carolina, Chapel Hill. (E-mail: dave_hartzell@unc.edu)*

Mezzanine finance has become an important source of capital for commercial real estate acquisitions, development, and refinancings, as traditional first mortgage providers have become more reluctant to finance projects at loan-to-value (LTV) ratios in excess of 65%. The increased conservatism of lenders, partly in response to regulatory requirements and partly in response to commercial mortgage-backed securities (CMBS) market demands, has created a gap between what lenders will provide and what borrowers want from debt sources. Mezzanine finance has emerged to fill the gap. The result has been increased segmentation of the capital structure for specific real estate transactions. The challenge for finance providers is to price the mezzanine segment to provide compensation for the risk taken.

This paper provides background on the mezzanine finance market including changes in the first mortgage market that helped push the mezzanine market into greater prominence. We identify the primary situations in which mezzanine finance can play a role and discuss the risks and implications of extending mezzanine finance. We posit that examination of a borrower's motivations for using mezzanine finance provides insight on risk for potential providers of capital.

Exhibit 1
Loan-to-Value Ratio, 1965-2003

Source: ACLI, Heitman Research

Mezzanine finance can offer favorable risk/reward opportunities for investors, but we do not embrace providing mezzanine finance in all situations. We recommend providing mezzanine finance to those borrowers whose interests are aligned with those of the mezzanine provider and the first mortgage lender. We do not recommend lending to those borrowers where moral hazard appears to be significant.

FIRST MORTGAGE MARKET DEVELOPMENTS

In order to understand the mezzanine market, a brief review of changes in the first mortgage market will be helpful.

A typical real estate deal is financed with a combination of debt and equity. In the 1980s, some lenders were willing to provide mortgage loans at loan-to-value or loan-to-cost (LTC) ratios of up to 95%, with the investor/owner providing the rest of the capital required for property purchase as equity. Some of these 95% LTC/LTV loans turned into loans with LTVs in excess of 100% as property market and capital market fundamentals deteriorated. In 1989, average LTV ratios exceeded 75%, according to the American Council of Life Insurance (ACLI).

More recently, lenders have taken a more conservative approach to underwriting mortgage debt, with the average loan-to-value ratio falling to between 65% and 70% (Exhibit 1). In first quarter 2003, the average LTV was 67%, according to the ACLI. While insurance companies are not the only providers of commercial mortgage finance, they are an important source and give an indication of underwriting standards in the market.

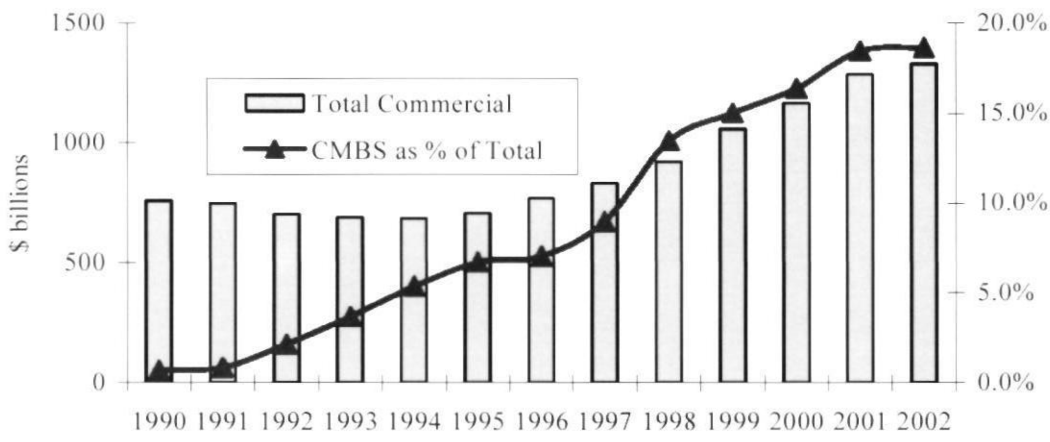
Capital reserve regulations have played an important role behind increased lender conservatism. The Office of the Comptroller of the Currency (OCC), the national banking regulator, has developed a set of bank lending guidelines and an approach to calculating the amount of risk-based capital in the bank's asset portfolio. The "at-risk" schedule indicates the amount of reserves (as a percentage of the loan) that must be set aside for each category of loan. Commercial real estate loans with less than 75% LTV ratios incur a capital charge equivalent to that of investing in BBB-rated (investment grade) bonds. Loans with greater than 75% LTV ratios are assessed greater capital charges. Therefore, banks typically make loans that are less than the 75% LTV threshold.

A different governing body regulates insurance companies but follows a similar approach. The National Association of Insurance Commissioners (NAIC) has developed guidelines for state agencies to use in regulating insurance company investments. NAIC guidelines are similar to those of the OCC, with a minor difference on mezzanine finance. Though mezzanine loans and first mortgage loans are currently treated the same from an at-risk perspective, the NAIC has been contemplating a change for several years and insurance companies have largely aligned their practices in anticipation of the expected revision.

The CMBS market's development is another factor that has encouraged greater conservatism on the part of lenders. Securitized pools of real estate loans must undergo rating agency review in order to be saleable. The rating agencies rate the tranches according to the characteristics of the underly-

Exhibit 2

CMBS Outstanding as % of Total Commercial Real Estate Loans



Federal Reserve Board, Heitman Research

ing collateral pool of mortgages and the structure of the securities (i.e., subordination and credit protection). As they analyze each loan for its inherent risk, rating agencies and the buyers of the unrated and non-investment grade tranches (B-piece buyers) wield influence in determining underwriting standards on the individual loans that form the collateral. This process has pushed lenders toward greater uniformity in the mortgage market. LTVs and debt service coverage ratios have become more conservative as a result, especially if the loan is headed for a pool to be securitized.

The growing significance of the CMBS market has fostered the change. Securitized real estate loans made up approximately 18% of the total commercial real estate loan volume outstanding as of March 31, 2003 (Exhibit 2). This is up from less than 1% in 1990. The standards pushed by the CMBS market have filtered through the lending universe, motivating first mortgage lenders to evaluate risk/reward more prudently.

MEZZANINE MARKET BASICS

With regulated lenders becoming more conservative, many equity investors are not satisfied with the amount of debt available to finance their properties. Lenders require that the owner provide 30-35% of the value of the property, while many borrowers prefer to limit their equity investments to 10-15% of value. In a stable operating environment, owners find it difficult to contribute a large share of equity and also earn returns on their capital in line with those of the recent past. Mezzanine finance providers deliver additional capital to fill the gap between what the owner wants to borrow and what the first mortgage lender is willing to provide.

In occupying the middle ground, mezzanine finance providers bear greater risk than do first mortgagees, but less risk than equity owners. This reflects the priority of claims on cash flows. First mortgages have first claim on cash flow, mezzanine providers are next in line, and equity investors receive the residual. In the event of borrower default, mezzanine providers have an option to assume the first mortgage obligation. This option must be exercised or the first mortgage lender can foreclose on the mezzanine position and the owner. Alternatively, the mezzanine provider can choose to walk away from the bad investment without the obligations of the original owner (the borrower) or the new owner (the first mortgage lender).

The current pay financing cost of the capital structure increases when mezzanine is introduced and overall debt service coverage ratios decrease and loan-to-value ratios increase. For bearing risk greater than that of first mortgagees, mezzanine finance providers receive an expected return in excess of that of first mortgages, typically in the 8-20%+ range, depending on the part of the capital structure they are providing and the risks inherent in the underlying property.

Mezzanine finance, by definition, defies generalization—there is no typical or standard deal structure. Each financing consists of unique terms and conditions that depend on the preferences of the user and provider and that emerge from a highly negotiated process. The mezzanine piece can be structured as debt or equity, depending on how much capital the owner wants and how much control the owner wants to cede to the mezzanine partner. Second trust debt and junior debt are common names for mezzanine finance, structured as debt, that typically bring the total LTV ratio as high as 85%. Preferred equity and gap equity are common names for equity-type financings that bring the capital structure above 85% LTV.

EXAMPLES OF MEZZANINE FINANCE DEAL TERMS

In all the scenarios indicated below, assume the owner (also referred to as the sponsor) has a stabilized property and has secured first mortgage financing at 70% LTV.

In the most straightforward approach, the mezzanine finance provider offers a debt instrument, often called junior debt, to the property investor or owner. In this case, the first mortgage and mezzanine financing range from 70-80% all-in loan to value. Given the nature of the fixed-income contract, and the relatively low, from a historical perspective, loan-to-value ratio, mezzanine lenders typically receive a fixed-income yield, currently in the 8-12% range. In this example, the mezzanine finance provider is purely a lender to the borrower.

Other owners seek greater loan-to-value ratios, and are willing to share participation in the cash flows of the property. For example, filling the financing gap to bring the property to an 80-90% LTV, often called participating debt or preferred equity, typically includes a fixed-income component and a small participation or exit fee. This type of financing will offer the mezzanine lender a current yield that is slightly lower than that of the junior debt vehicle described above, and a participation in the cash flows of the project. The current-pay interest rate on this type of mezzanine debt ranges from 9% to 11%. The deal typically includes participation of 10-15% in the property's operating cash flows and sale or refinance proceeds that can raise the overall mezzanine IRR to 15-18%.

In the case of preferred equity, the borrower and mezzanine finance provider usually enter into a joint venture agreement in order to effect the transaction. A joint venture agreement can give the mezzanine finance provider more control over the operations of the property, as well as spell out participation, lookback and other terms. Moreover, the JV agreement can expedite the mezzanine provider's ability to take over the property in the event of default and can enable the mezzanine position to keep the first mortgagee from foreclosing and taking control of the property.

Mezzanine financing that fills the financing gap to the 91% to 95% LTV range, often referred to as gap equity, implies that the mezzanine finance provider bears equity risk. The equity owner and the mezzanine provider negotiate a joint venture that offers a current pay interest rate of 9-11%, a lookback provision that raises the yield to 14-18%, and 15-30% of the total proceeds at disposition or refinance. IRRs in this latter type of deal can exceed 20%. The mezzanine provider takes greater risk but has more control and can earn greater overall returns.

FORM OF SECURITY

Security in the property varies depending on the nature of the deal that the borrower and lender have struck. In general, the better the security the lower the return.

Mezzanine deals that are structured as debt instruments usually have one of the following forms of collateral:

- ***Second deed of trust***—This is the most desirable to the lender and provides the most concrete form of collateral. A second deed allows the mezzanine lender to foreclose on the property if the owner defaults on payments to the mezzanine lender. The first mortgage lender typically does not allow this type of arrangement with a second lender, and therefore this type of security is rare.

- ***Assignment of partnership interest***—The most common form of debt security in the mezzanine finance universe, the lender can take the borrower's interest in the property in the event of default. Effectively the mezzanine lender becomes the equity owner and assumes the obligations to the first mortgage lender.

- ***Cash flow note***—The lender receives all cash flow from the property in exchange for the mezzanine loan proceeds and a percentage of the proceeds from sale of the property. The cash flow note is not a recorded instrument and typically does not need an intercreditor agreement. This is also called a soft second.

Deals structured as equity have a different set of characteristics. Equity deals are joint ventures between the equity/owner and the mezzanine lender that are guided by the partnership agreements. Major provisions in the partnership agreements cover decision-making authority and specify decisions that require approval from the mezzanine partner. The owner/sponsor has significantly less overall control over the project and may lose all control if the property does not perform as expected.

Owners sacrifice flexibility, control, upside potential, and will pay more for the capital. In return, they are required to contribute less cash (sometimes as little as 3-5% of the total property value) and they take on a partner who might be able to help them if the property starts to falter.

INTERCREDITOR AGREEMENT

The first mortgage lender and the mezzanine provider negotiate the intercreditor agreement, which provides for communication between the first mortgage lender and the mezzanine finance provider, and gives certain rights to the mezzanine provider in default events. Many first mortgage lenders, including almost all conduit lenders, refuse to negotiate intercreditor agreements, especially if the loan has already closed. In fact, conduit loan documentation routinely prohibits selling or transferring more than 49% equity ownership in the property to a partner. Some non-conduit lenders take the attitude that their interests are already covered in the agreement with the borrower and there is no need to complicate matters by bringing in an additional financial partner with objectives that might not align with those of the lender.

Other lenders take the view and realize that mezzanine lender can bring value to the deal. The additional capital can allow the owner to pay leasing commissions or tenant improvements to bring in a new tenant, renovate the lobby, or pursue other value-added strategies. In this case, particularly when the mezzanine provider is an experienced real estate owner/operator, the first mortgage lender will welcome the participation of the mezzanine provider. The experience factor can be important, as sometimes-reluctant first mortgage lenders can be persuaded that it is in their best interests to deal with an experienced group, especially if the property defaults.

The mezzanine finance provider typically negotiates for several elements in the intercreditor agreement. These include:

- Notification of non-payment or default on the first mortgage. The mezzanine lender wants to know -- from someone other than the owner—that the property is being managed professionally.

- The right to cure any default on the first mortgage. The mezzanine position wants to protect itself by taking over the property and not allowing the first mortgage to foreclose and take possession.

- The right to foreclose on the property if the owner fails to pay the mezzanine position. First lenders hardly ever agree to this clause, as a building that is in foreclosure creates uncertainty among existing tenants (who might elect not to pay rent) and prospective tenants (who might view the property as tainted and unstable).

In summary, intercreditor agreements can be difficult to attain, but can benefit the mezzanine finance provider greatly.

TERMS AND EXIT STRATEGY

The most common mezzanine financing vehicles provide for maturities of two to three years, with the possibility of extension beyond that for one-year periods. If a borrower wishes to extend the mezzanine financing, the lender typically charges a significant fee to protect its IRR.

Takeout of the mezzanine financing can occur in several ways. The best case for the first mortgage lender and mezzanine provider is when the borrower pays back the principal, interest and fees owed to both sources of capital. This can happen when the property is sold and the proceeds pay off the first and mezzanine positions, or when the property's value and cashflows increase enough to allow a new first mortgage to pay both the original first mortgage and the mezzanine provider.

Another possible exit is for the property cash flows to cover all of the debt service on the first mortgage but not all of the current pay portion of the mezzanine. In this case the borrower and the mezzanine finance provider will negotiate an outcome. The borrower usually wants to delay foreclosure as long as possible in order to participate in a future upswing in property-level cash flow or property value. The mezzanine finance documentation and the joint venture agreement become critical at this stage in determining the outcome. The borrower and the mezzanine position will either restructure the mezzanine obligation or the mezzanine position will take title to the property. At that point, the mezzanine position will need to meet with the first mortgage lender because the property has most likely gone into technical default for breaching debt service coverage or loan to value ratios. The intercreditor agreement will be critical at this stage.

The final scenario is when the cash flows decline to a level inadequate to meet the debt service on the first mortgage. In this case, the mezzanine position will have already assumed the role as the equity owner of the property and will negotiate a workout with the first mortgage lender. The mezzanine position, in some cases, will fund cash flow shortfalls if prospects for a turnaround are favorable. In other cases the first mortgage lender will take possession of the property. As in the previous scenario, the intercreditor agreement plays an important role.

In many cases, the mezzanine financing ends at the time of refinancing. Refinancing both the first mortgage and mezzanine positions is favorable to the mezzanine finance provider and the borrower, in that sale of the property is not required. Given the illiquidity of private real estate markets, sale at a specific time to coincide with a mezzanine term may not be possible. That said, however, sale of the property to pay back the first and mezzanine loan can be the best execution.

A refinancing takeout can only be achieved when the value of the property has increased to the extent that the balance of the new first mortgage will be adequate to pay off both the original and mezzanine positions and can be underwritten at traditional loan to value ratios. For example, a lender who refinances will look for an LTV in the 65-70% range, and debt coverage ratios within current underwriting standards. For this to happen a value creation event needs to occur: rents have to increase, expenses have to decline, or capitalization rates have to decrease. To help, mezzanine loans may be fully or partially amortizing, which reduces the loan balance while debt service payments are being made. More typically, however, the mezzanine position takes a current pay, interest-only position and participates in a look-back provision, cash flows above certain levels, or exit fees.

SIZING THE MEZZANINE FINANCE MARKET

The mezzanine finance market lacks a ready source of aggregate data, as it is not tracked by any industry group or government entity. Instead, we estimate the size of the potential market based on our view of the realistic candidates for mezzanine financing. While our estimate of the size of the potential market is grounded in facts, we can only speculate about the actual size of the current market.

A reasonable place to start is with the universe of all commercial real estate, which PricewaterhouseCoopers estimates to be approximately $4.6 trillion as of October 31, 2002. This pool of real estate, however, includes properties that are unlikely to be candidates for mezzanine finance, and we therefore exclude them. For example, pension funds, opportunity funds and REITs maintain conservative capital structures on their holdings, using debt at LTV ratios that can be achieved by borrowing from first mortgage lenders. Other property owners prefer to keep their holdings 100% debt-free. Corporate-owned real estate assets represent another large slice of the real estate universe that are not candidates for mezzanine finance; these properties are typically financed under the corporation's overall capital structure. The $4.6 trillion universe also includes small properties that exist beneath our threshold of interest and properties in nontraditional classes such as marinas, bank branches, and storefront retail with office or residential above. All of these latter types are eliminated.

The assets we eliminate undoubtedly represent a sizable share of the overall real estate universe, but we are unable to quantify their total value with any precision. Although we don't have a sound basis for aggregating the value of the excluded properties, we nevertheless conclude that the universe of potential property for mezzanine finance is something less than $4.6 trillion. We therefore take a different approach.

Exhibit 3
Commercial Mortgages Appropriate for Mezzanine Finance
31-Mar-03

		Multifamily	
Source of Mortgages	**Commercial**	**Residential**	**Total**
Commercial Banks	719.5		96.8
Savings & Loans	82.7	69.8	
Life Insurance Companies	195.4		36.9
Government Sponsored Entities		49.2	
Mortgage Pools		96.6	
Total ($ billions)	997.6	349.3	1,346.9

Source: Federal Reserve Board, Heitman Research

Excludes ABS and other categories deemed to be inappropriate in a mezzanine framework.

Alternate Approach: In the alternate approach to sizing the potential mezzanine finance market, we start with data from the Federal Reserve Board on commercial and multifamily residential mortgages. Properties that have qualified for loans from banks, insurance companies and savings and loans meet our criteria as targets for mezzanine finance. The Fed estimates that total commercial mortgage finance outstanding totaled $1.9 trillion as of March 31, 2003. Grossing up this $1.9 trillion of real estate debt (using a 68% LTV ratio, as discussed below) to the total value of property encumbered by the mortgages gives an upper limit to the potential universe of investable property for mezzanine finance. The upper limit is therefore approximately $1.9 trillion divided by 68% or $2.8 trillion.

This grossed-up number is likely too large, however, as it includes property subject to loans made by conduit lenders and sold via the public markets as CMBS. CMBS documentation and covenants make mezzanine financing on securitized loans difficult—not impossible—but difficult enough to justify excluding them from the universe. Instead, we focus on loans made by commercial banks, savings & loans (S&Ls), life insurance companies (LICs), government sponsored entities (GSEs), and other pools. Outstanding mortgages (both commercial and multifamily residential) in our subset totaled $1.3 trillion (Exhibit 3).

The next step is to determine a reasonable total value of the properties subject to the $1.3 trillion of mortgages, which will then lead us to an estimate for the total potential mezzanine market (Exhibit 4). Conservative mortgage lending underwriting that has characterized the real estate finance world in the past decade suggests that LTV ratios average less than 70%. As indicated previously, the ACLI data on LICs' underwriting standards indicates that the average LTV in first quarter 2003 was 68%. While other types of lenders might use different underwriting standards, we conclude that the overall LIC LTV provides a reasonable proxy for the market's LTV. Grossing up $1.3 trillion of commercial mortgages by 68% results in a mezzanine financeable real estate universe of $2.0 trillion. At an LTV of 85%, which is a standard mezzanine finance and first mortgage capital structure, mezzanine lenders could potentially provide 17% of the total real estate value. This suggests that the potential size of the mezzanine finance market approximates $337 billion (Exhibit 4).

Uncertainty surrounds the size of the current market. No reliable estimates of the current size of the market are available, but our best guess is that the amount of mezzanine financing outstanding approximates $40-50 billion. We base our estimate on a review of industry publications that describe activity. Subtracting our estimate of a current market of $50 billion from the $337 billion estimate of the potential size of the mezzanine market leaves $287 billion.

A portion of properties that have a mezzanine position in place will need to be refinanced each year, though the amount refinanced is likely to be less than the amount of mezzanine finance expirations. With the typical mezzanine term of 3-4 years,

Exhibit 4
Potential Market Estimate
31-Mar-03

Total Mortgages	1,346.9
divided by	68%*
Total Investment RE	1,980.7
times	17%**
Potential Mezzanine Position	336.7
Current Mezzanine Market	50.0
Mezzanine Candidates	286.7
Mezzanine Refi candidates (20% of current market)	10.0
Estimated Total Potential Market	296.7

**Loan to value ratio per ACLI; ** Gap between current LTV and Mezzanine LTV of 85%*
Source: Federal Reserve Board, ACLI, Heitman Research

potentially 25-33% of all mezzanine financings are candidates for refinance. In reality, fewer mezzanine refinancings actually close, as owners are more likely to roll the mezzanine piece into a first mortgage if enough value has been created, or sell the property and pay off the mezzanine provider and the first mortgage provider. Alternatively, the owner will extend the existing mezzanine loan, after paying a fee.

We therefore estimate that 15-20% (rather than 25-33%) of the total outstanding mezzanine universe represents candidates for refinance annually. If the outstanding market for mezzanine finance is $50 billion, then annual refinance volume will be $7.5-10 billion (15% or 20% of $50 billion). Annual mezzanine finance activity includes the refinance amount plus the amount of the remaining $287 billion of the potential market captured in the given year. We therefore conclude that the total amount of potential mezzanine finance activity is approximately $297 billion.

While our number seems large, we view it as a conservative estimate. Some suggest using 90% as the third-party-financed capital structure. The potential portion of mezzanine finance would total 22% (90% less 68%), rather than 17% as assumed above, increasing the overall size by almost $100 billion. Moreover, the average LTV is likely to be less than 68% on average because of conservative borrowing, valuation increases, and amortization of principal—all of which decrease the LTV of outstanding loans and increase the size of the potential mezzanine market. The potential market could therefore be as large as $375-450 billion.

On the other hand, we conclude that the potential market is not that big. Many properties are not appropriate candidates for mezzanine finance because they are located in markets that have unfavorable current conditions such as declining rents or increasing vacancies. In addition, the $1.3 trillion in subset of commercial and multifamily mortgages (referenced above) most likely includes loans on properties not appropriate for mezzanine finance, (eg, small and nontraditional commercial properties). Further, many mezzanine financiers will provide capital only if the entire debt capital structure—both first mortgage and mezzanine piece—can be refinanced in two or three years. Similarly, a property that has a long-term lease with a single tenant that has negotiated flat rents over the term will not be a candidate for mezzanine financing, unless the owner plans to sell the asset at the time of or prior to expiration of the mezzanine term.

Our estimate of market size differs from that of others who have made attempts to quantify the mezzanine market. For example, Prudential Real Estate Investors concluded that the potential mezzanine market is $65-135 billion with annual demand for $18-34 billion. PREI assumes that 10-15% of the $4.6 trillion real estate universe has mezzanine financing as part of its capital structure and that mezzanine represents 15-20% of the value of the property with mezzanine finance in place. PREI includes below investment grade CMBS tranches in its estimate, which increases their estimate. PREI's overall number comes out lower than ours, but is based on a different set of assumptions.

SITUATIONS FOR USE OF MEZZANINE FINANCE

Mezzanine finance users and their motivations differ, and these differences merit discussion. For purposes of this paper, properties fall into the stabilized, value-add, or development category, with each group having specific characteristics that make them more or less attractive to mezzanine finance providers.

Stabilized Properties—Stabilized properties are the most common in the investable real estate universe. Under our definition, these are operational, fully-leased properties that generate cash flow adequate to service a mortgage and provide a return to the equity owner. Stabilized properties are candidates for mezzanine finance when their cash flows can support an LTV greater than that of the typical first mortgage. Owners of stabilized assets will seek mezzanine financing to leverage their returns or limit their at-risk capital.

Mezzanine finance for stabilized properties occurs in two primary situations:

- A buyer seeks financing related to acquiring a property; and
- An owner wants to take equity out of a property.

In the first case, the buyer either doesn't have or prefers not to allocate the entire amount of the equity required by the first mortgage lender in order to close the transaction. The mezzanine financing piece serves as gap or supplemental equity, even though it may be structured as a second mortgage. In the latter case, the owner looks to mezzanine, allowing the owner to realize a return of capital on an existing investment that has increased in value. The owner, in effect, is selling all or a portion of the owner's at-risk capital to another entity, the mezzanine provider.

Non-stabilized or Value-Added Properties—A second category of mezzanine finance opportunity is value-add properties. These are situations in which the cash flow in place is not stabilized. We acknowledge that mezzanine financing has no place in non-stabilized property where cash flows are expected to decrease. We therefore only consider situations where the borrower has identified an opportunity to create value by executing a plan to increase cash flow to a greater level of stabilization.

Existing assets can be undervalued (and therefore candidates for a value-add strategy) for a variety of reasons. Sometimes the asset is underutilized and therefore undervalued because of below market rents paid by significant tenants whose leases expire in the near term and who are likely to renew their leases at (higher) market rates. In other cases the building has significant vacancy and requires leasing activity and tenant build-out or leasing commissions. Other owners plan to make moderate capital expenditures to reposition the property as a higher class and therefore capture greater rents.

We note that execution risk on value-added strategies is significant, thus the operator/owner ability and experience are important investment criteria that must be underwritten. As in our analysis of stabilized properties, mezzanine finance can be provided in two value-add situations:

- *Existing owner needs capital to execute value-add strategy; and*
- *New buyer seeks to execute value-add strategy.*

In both cases the owner has a plan to create value over a pre-determined period of time, and needs capital in excess of what a typical first mortgage lender will provide to implement the plan. We prefer providing mezzanine finance to new buyers as this latter situation allows for better measurement of the equity contribution of the owner and better specification of the risk/reward tradeoffs across the capital structure. Providing mezzanine finance to an existing owner looking to execute a value-added strategy raises the same moral hazard issues discussed below.

Development—Development of commercial property is risky. Developers must build to a budgeted cost and then stabilize properties through lease up. In general, developers are heavy users of leverage in their strategy execution. In a weakening property performance environment, construction lenders are increasingly wary of how their loan, originated on a loan-to-cost basis, will be viewed once the asset is stabilized and valued in a disposition or a long-term refinance. Mezzanine plays a role as construction lenders become more conservative and developers look to be fairly compensated for their risks. Mezzanine is recommended in development situations, but only under certain circumstances. The mezzanine provider is advised to:

Exhibit 5
Mezzanine Finance Situations

Type of Situation	Risks	Favored Mezzanine Strategy	Structure/ Returns
Stabilized Property Refinance	Stability of cash flow Relative returns to equity and mezzanine hard to compare Low borrower's basis in the property after refinance can create moral hazard	No. Moral hazard issues.	If contemplated, preference is to structure as equity with kick out rights of general partner.
Stabilized Property Acquisition	Stability of cash flow Is cost = value Principal risk on reference/sale High leverage mezzanine investment can create misalignment w/ borrower	Yes. Situation allows comparison of relative risk/rewards for mezzanine and equity to help in structuring preferred return.	Long-term mezzanine investment situation. Amount of term refinance risk dictates rate. Mixture of debt and equity return.
Non-stabilized Property w/ negative cash flow trends	Stabilized value is lower, but how low Borrower motivation Projecting cash flow Market/sub-market risk Property risk	No. Hard to imagine a situation where this is an attractive strategy for a non-control investor.	N/A
Value-add Refinance	Going-in value is subjective Relative returns hard to measure Low borrower's basis in the property after refinance can create moral hazards borrower self-selecting?	No. Potential moral hazard.	If contemplated, strong rights to kick out partner are a must. Lack of borrower commitment/fresh equity to property is a major concern.
Value-add Acquisition	Is cost = value Value-add business plan execution Timing of execution Does capping projected stabilized cash flow at exit create alignment between mezzanine and borrower?	Yes w/ existing sponsors who have executed strategy before in property type and market. Alignment with borrower based on relative share of profits for equity risk taken is important to quantify.	Make term of investment slightly longer than business plan. Define exit alternatives upfront. Examine share of "equity" provided to transaction to determine percentage of profits at exit. Structure with declining percentages above target returns.
Development	Execution risk to develop Execution risk to lease to stabilization Timing of execution Market/sub-market risk Property risk	Yes. Mezzanine term should be for the time to create initial cash flow stabilization. Easier to structure with merchant builders than long-term holders. Alignment with borrower based on relative share of profits for equity risk taken is important to quantify.	Greater variability of outcomes from higher execution risk requires higher return for relative slice of the capital structure. Should cap upside only in exchange for high preferred return.

- understand the amount of equity being contributed by the owner and its ability to recapture it through development, management, and lease-up fees;
- evaluate returns expected by each of the slices of the capital structure; and
- have a pre-determined plan for exit (i.e., return of invested capital) at or shortly after initial stabilization.

RISKS

A number of risks are common to all real estate projects, and some are particularly relevant from the mezzanine finance provider's perspective. These risks include:

- Tenant risk—the risk that tenants go bankrupt and are no longer obligated to pay rent, impairing a property's ability to service debt;

- Market risk—the risk that market conditions change for the worse and that vacancy rates increase or market rents decline at time of refinance, leading to an inability to pay off in-place financing; and

- Capital market risk—the risk that capitalization rates increase and valuations decline, leading to inability or unwillingness to pay off financed positions.

Moral Hazard—One incremental risk that applies to any situation with a borrower and a lender is referred to as moral hazard. Put simply, moral hazard is the risk that the borrower's behavior will run counter to the interests of the lender. Moral hazard is a risk that increases as the borrower's stake in the property decreases. As the owner's share of equity declines, he/she has less incentive to manage the property to generate steady, consistent payouts to cover debt service on the first and mezzanine finance positions. Instead the owner treats its ownership position more like an option and is tempted to pursue strategies with greater potential payoffs, but with significantly greater risk. First mortgage lenders attempt to mitigate moral hazard by requiring significant equity participation from the borrower, thus the 65% LTV ratios. Mezzanine finance providers bear greater risk from moral hazard, as their capital position will suffer loss before the first mortgage.

Moral Hazard-Stabilized Property—The level of moral hazard provides a framework for evaluating types of borrowers. Consider stabilized properties. Owners of stabilized properties using mezzanine finance to cash out equity from their properties pose a greater risk than do owners seeking a higher LTV/LTC in the acquisition of a stabilized property. Value in the refinance/equity cash-out case is subject to the vagaries of the appraisal and valuation process, and concluded value can be overestimated, resulting in little likelihood of eventually recovering the mezzanine amount at a refinance or sale of the property.

The owner of a stabilized property might use mezzanine financing to eliminate/limit downside equity exposure of property ownership. With mezzanine finance, the owner can take out equity in a property without incurring sale-related tax liabilities. Moreover, he/she can maintain residual ownership of property level cash flows, capture value in excess of the first and mezzanine positions, and continue to earn property management fees.

For example, assume a property was purchased five years ago for $10 million using a 65% first mortgage and the property has now increased in value to $15 million. The owner can secure new first mortgage debt and mezzanine financing that will bring the overall LTV to 80%, allowing him/her to effectively capture the difference between the value of the property and the balance of the loan. The owner will end up with its original $3.5 million of equity and an additional $2 million in cash, assuming the original mortgage had no amortization. The owner, moreover, will retain equity ownership of the property, avoid capital gains tax, and keep the management contract for the property. Having cashed out of its original investment, the owner now is less aligned with the first mortgage lender and the mezzanine provider. With a smaller slice of the cash flow and residual value, the owner's motivation can shift to pursuing a high-risk/high return strategy that provides at least enough to protect the management fee income stream.

A stabilized property's acquirer has less moral hazard than does the refinancing owner, as long as the mezzanine provider makes the borrower contribute meaningful equity in relation to the property management fee that the owner will be earning. Significantly, the loan to value ratio is better defined in the acquisition scenario, being determined by an arm's length transaction between willing buyer and seller. Moreover, the acquirer, the first mortgage lender, and the mezzanine finance provider are allocating capital at the same time to a property that they have all evaluated and concluded makes economic sense.

Moral Hazard-Value-Add—Compared to stabilized properties, value-add properties have a different risk profile and are typically more appealing to lenders from a moral hazard perspective. Foremost, the mezzanine provider extends financing based on actual costs of the project, as opposed to an appraised value. (Owners often receive a credit for contributing land or developer fees, but we ignore these complicating factors in this analysis.) The advantage is that the owner of the project will be far more careful about managing expenditures when he/she has an expected payoff that is tied to the success of the finished product, and when he/she is contributing a portion of the costs of the deal.

Moral Hazard-Development—Development deals are similar to value-add although often different in magnitude and time requirement. The sponsor initiates a development project because he/she thinks the IRR will be favorable. The sponsor has a plan and a specific timetable for completion of construction, leaseup and securing permanent financing. The owner uses mezzanine finance to cover a portion of construction costs, tenant improvements, leasing commissions, and other capital expenditures. As in the stabilized property acquisition, it is critical that the owner has significant equity at risk (relative to development fees earned) in order to mitigate moral hazard.

Mezzanine finance providers can evaluate the project and draw their own conclusions as to whether they think the owner will perform the construction according to the plan and then determine the likelihood of the property achieving the rents and leasing activity that has been projected. If the conclusion is positive, then the mezzanine provider expects to be repaid when the owner receives permanent financing at standard LTV ratios—enough value will have been created for the construction lender and the mezzanine provider to be paid off.

Value-Add and Development-Additional Risks—The risks present in any value-add transaction include tenant risk, market risk and capital market risk, as highlighted above, as well as:

- Plan risk: the risk that the owner has specified a flawed plan;
- Execution risk: the uncertainty regarding the owner's ability to execute the plan;
- Timing risk: the risk that the plan and its execution will encounter unanticipated delays; and
- Exit risk: the risk that the capital market will have changed and first mortgage underwriting will no longer provide enough capital to take out the construction loan and the mezzanine loan.

Pricing of value-add development and redevelopment mezzanine transactions needs to reflect and compensate the provider for the additional risks.

IMPLICATIONS FOR TRANSACTION SIZE FOR THE MEZZANINE FINANCE PROVIDER

Large Loans (Greater than $15 million)—Acceptable deal size is a primary consideration for mezzanine providers. Assuming a 20% mezzanine piece of the capital structure between 65% and 85% LTC/LTV, the property has to be valued at $75 million in order to generate a $15 million mezzanine investment.

Advantages include:

- Large loans allow an organization to put capital to work quickly and at less cost per dollar invested, as the lender must go through the same steps to close a $50 million mezzanine loan as it does to close a $1 million loan.

- The properties on which large loans are made tend to be more institutional quality and have higher profiles and will garner industry press and publicity for the mezzanine lender.

- The large loan market is such that once a mezzanine provider has established credibility, B-note and other deal sources will actively bring transactions to the provider for evaluation.

Disadvantages include:

- Properties that can support a $15 million mezzanine position are less common and the flow of transactions are less frequent.

- The portfolio of a large mezzanine loan provider is by nature less diversified by property type (concentrations in office and hotels) and more than likely by geography (concentrations in CBD office in 1st tier MSA).

- The number of potential capital sources creates competitive bidding situations that drive down returns.

Small Loans (Less than $15 million)—A less competitive and potentially more attractive area for a new mezzanine finance entrant is small mezzanine loans. Using the logic above, a small loan program entails transactions on properties valued between $10-75 million.

Advantages include:

- Providers of small mezzanine loans are more likely to be able to create property type and geographic diversification.
- Borrowers at this level tend to know fewer sources of capital, making the deal process less competitive.
- The $10-75 million transaction segment is the most active and vibrant trading market for real estate property helping a lender see deal flow and enabling exits.
- The $10-75 million first mortgage market is the most competitive allowing mezzanine lenders to leverage off of low cost/higher leverage first mortgage debt to generate mezzanine returns.

Disadvantages include:

- Sourcing is important, especially to create a national diversified portfolio of loans.
- Small loan size means that the mezzanine provider must originate a large number of transactions in order to place a substantial amount of capital.

CONCLUSION

The mezzanine financing market represents an opportunity for both lenders and borrowers. Given our estimate of potential market size of $297 billion, and current outstanding volume estimated at $50 billion, the market has a long way to go until borrower appetite for mezzanine finance is satisfied. However, many aspects of mezzanine financing must be considered prior to either lending or borrowing. This paper identifies situations where mezzanine finance may be a reasonable strategy, pointing out important components of deal structure and potential returns, and also describing the risks that mezzanine providers must acknowledge and underwrite.

Deal terms vary and are highly negotiated, resulting in a market characterized by a lack of uniformity. Mezzanine finance providers take 80% of the equity in a real estate transaction, resulting in LTV ratios, when combined with the first mortgage position, of 70-95%. Returns to the mezzanine finance provider are structured with a range of terms. Varying levels of origination fees, current pay coupons, cash flow participation, lookback provisions, and exit fees are typical components that can be adjusted according the parties' wishes.

One characteristics does not vary across deals: the importance of understanding and underwriting risk. Mezzanine providers are advised to determine the borrower's motivation for tapping mezzanine capital. Extending a mezzanine loan to allow a borrower to cash out of a stabilized property is not recommended as a strategy. Creating a clear joint venture agreement and negotiating an intercreditor agreement and structuring the payoff to align the owner's interests with those of the financial partners are important aspects of a mezzanine transaction that can be profitable for all parties concerned. Structured properly, with the right partner and the right property, mezzanine finance investments are likely to generate favorable returns.

Daniel Rose, CRE

Real Estate: Evolution of an Industry

By Daniel Rose, CRE

Dramatic changes have taken place in the real estate world in the past decades, and they involve every aspect of the field—design and construction, a bewildering variety of financial vehicles, new or modified forms of ownership, and so on.

The Greek philosopher Heraclitus, who first recognized the "permanence of change," and Charles Darwin, who grasped the concept of evolution, would feel at home in the real estate world of today.

Architects of a generation ago wouldn't believe that the most expensive housing units today are designed with dazzling kitchens that, in actual practice, are used chiefly to warm up Chinese take-out food; that the library of the past is now a media room without a printed book in sight; that maids' rooms have gone the way of the buggy whip and the quill pen; that the luxurious baths and home spas today would please even a Roman emperor; and that residents of virtually all economic levels today demand exercise and health facilities that were undreamt of a few years ago. Most interestingly, they would not believe that some of our most lavish and expensive housing units are in old converted factory and warehouse structures in the heart of former industrial districts.

As for office building design, the whole story is told by the fact that IBM had to move out of its lavish headquarters building only 18 years after it moved in, because the structure was so technologically obsolete that it was easier to relocate than to renovate and upgrade.

The jargon in the office development field today includes vocabulary that can elude even seasoned real estate professionals, with terms like "broadband on-ramps," "optical fiber maps and metropolitan loops," "local exchange carriers," and the like.

Even apartment buildings are now going "green" and high-tech, with buildings now on the drawing boards with solar energy collectors, water re-use programs, and dedicated air systems.

In real estate finance, J.P. Morgan himself would probably be bewildered by the more complex derivatives now available for ultra-sophisticated investors who seek high returns with proportionate risk.

It seems only yesterday that the real estate field was bowled over by William Zeckendorf, Sr.'s introduction of his "Hawaiian technique," in which he divided a property's values into a fee position, a ground leasehold, an operating leasehold, and a residual position. Today one hears of a "collateralized mortgage obligation" (CMO) with seven "planned amortization class" (PAC) tranches, one "retail" (RTL) tranch, two "support payer" (SUP) tranches, one "support Z" (SZ) and one "jump-Z" bond and a "PAC residual" (RPC).

The values of all of those fluctuate with the rate of prepayments of the many individual mortgages in the underlying portfolio. At each level, an investor selects his degree of risk in line with his hope of reward. Needless to say, these are not markets for amateurs.

If Morgan himself would be bewildered by the more complex financial derivatives, he would have understood clearly that a capital-intensive industry like real estate sooner or later would attract publicly-traded vehicles for both debt and equity; but even he would be impressed that the market for commercial mortgage-backed securities has now reached $300 billion and is growing, and that the market for Real Estate Investment Trust shares stands today at $150 billion.

Morgan might not have anticipated that control of the nation's capital would shift, as it now has, away from commercial banks and life insurance companies and to pension funds and mutual funds; but he would have understood the drive toward industry consolidation in a globalized economy under conditions where the development of regional malls, say, or of investment grade hotels is generally beyond the reach of local speculative developers, and where the economies of scale can be substantial.

Changes in technology, in building design and in financing have been accompanied by other changes no less striking.

Only a few years ago, New York structures were built, financed, owned, managed and occupied by New Yorkers, just as those in Chicago or London, San Francisco or Paris were controlled locally. In today's globalized world, capital, ideas, and people flow freely across state and national borders. American developers, financiers, brokers, architects and technicians are active anywhere in the world where the rewards justify the risks.

At annual meetings of the Urban Land Institute, our premier national real estate organization, it is not unusual to hear Jerry Speyer of Tishman Speyer tell of his real estate experiences in Germany or Latin America, or Mel Simon compare the results of his Mall of America in Minneapolis with those of his European projects, or to hear Jerry Hines discuss his projects in Russia or China or more than a dozen other countries in which he is active.

Many of the people in this very room have no idea that the net cash flow from the apartment or office rent they pay in New York finds its way to investors in Germany or in England.

Electronic telecommunication, easy air travel and the powerful geo-political changes of the past decade have caused the world to shrink to a degree almost inconceivable a short time ago. Only 64 years ago England's Prime Minister, Neville Chamberlin, could refer to Czechoslovakia as a "far off country of which we know little." The flying time from London to Prague is now under two hours.

Today, globalization and securitization mean that the home mortgage of a worker in, say, Richmond, Virginia can be financed by the life savings of a worker in Brussels or Stockholm, at the lowest interest rates the world's free capital market permits.

In an overview like today's, where we have been and where we are can be seen with clarity; what remain to be considered are the problems of where we are headed.

All of us are aware of several powerful trends that are likely to continue, such as the population movement away from cold, dark and wet areas of this country to warm, sunny, and dry ones. The relentless shift in economic primacy away from blue-collar employment in heavy industry and manufacturing and toward a broad range of white-collar activities (in reality, they now wear sport shirts!) is an old story. We will continue to see the surge of population and jobs beyond the city limits of our largest cities, and certainly a group like this is aware of the increasing degree to which we are becoming a knowledge-based society where electronic handling of information is changing all our lives.

Demographics, too, present facts that must be faced. Thanks to immigration, the U.S. population is expected to grow some 20% in the next 20 years, adding 50 to 60 million people, overwhelmingly from Latin America and Asia. The ramifications of this immigration will be complex, especially in the West and South, where most are expected to settle. But the spillover will be felt everywhere, in center cities, in "edge cities," in older suburbs and in fringe areas that are being called "edge-burbs."

The true costs of old-fashioned sprawl are increasingly obvious, with everyone aware of its impact on clean air and declining underground water tables, of vanishing farmland or open space near cities and painfully lengthening commutation time. This is spurring denser, mixed-use development in "edge-burbs" and in older, revitalizing suburbs with access to mass transit.

How we deal with older, deteriorating suburbs and with dysfunctional older industrial centers is one of the great challenges of the decades ahead. Camden, New Jersey, across the river from Philadelphia, is a case in point. With its industrial jobs having fled, some 20% of its housing units are vacant or abandoned, tax revenues have shrunk and the state of public education is such that an estimated half of its residents are functionally illiterate. The only flourishing enterprise in town is the open-air narcotics business, which employs over 2,000 people and brings in over $200 million annually—a sum greater than the city budget. More than aspirin and band-aids are needed to turn around this sick city.

In the decade of the 1990s, Las Vegas had a population growth rate of 85%, and Scottsdale, Arizona grew by 56%, and Austin, Texas grew by 41%. In the same period, other cities shrank. Hartford, Connecticut, for example, lost 13% of its population, St. Louis, Missouri lost 12% and Baltimore lost 11%. And that was at the height of a boom.

A common joke in Detroit a few years ago was of a sign that said, "Will the last company to leave town please turn out the lights," and perhaps that sign will appear elsewhere. Helping older cities to renew themselves must be high on the nation's agenda.

As investment capital does flow into deteriorated areas and vitality returns, the complex process called "gentrification" takes place. At present, most of the costs of gentrification now seem to fall on the poorest who are displaced, and in time we must learn how to spread those costs appropriately.

But looking ahead, there are two major unanswered questions our society must deal with: first, how our largest cities will reconstitute themselves to adjust to emerging economic, social, and technological conditions; and, second, how will we all adjust to the challenge of terrorism.

About the first, many signs are already clear.

When we add the next 20% to our population, we will not expand our road networks or our parking by 20%, and worsening congestion will force new approaches to density, telecommunications, public transportation, and the needs of pedestrians.

As long as gasoline remains cheaper than bottled water, America will continue its love affair with the automobile; but perhaps in time, cars will be used more for recreation and less for transportation to and from work.

We all know that the industrial city of a century ago is ancient history; its dense business district, its upper-class housing separate but nearby, and its manufacturing and workers housing in the next ring, are gone with the wind.

The post-World War II city, with its new suburbs encroaching on farmland, has evolved into endless sprawl with neither charm nor convenience.

Today's emerging model is a multi-centered, dispersed city/region whose nodes are connected by effective transportation, and whose workspaces, housing, retail, recreational, hospitality, and cultural facilities are intertwined.

The days of segregated and isolated uses of housing, office, and retail are long gone, and good riddance.

Throughout the world, pedestrian-friendly, automobile-free zones are appearing more and more frequently; recycled industrial buildings no longer excite comment; and the impact on urban economy (not culture, mind you, but economy) of the success of Frank Gehry's Guggenheim Museum in Bilbao, Spain, is not lost on planners; and the belief that high-tech communication will lead to an immediate exodus to the exurbs is belied by New York's Silicon Alley and similar areas throughout the world.

Disgusted by the ugliness, cost, and inconvenience of sprawl, planners now discuss "urban containment," with concepts of "greenbelts" to permanently protect a band of open space around a city, or "urban growth boundaries," a line separating urban and rural use, or "urban service boundaries" denoting a line beyond which a city's infrastructure-such as sewer, water or even schools—should not extend.

In physics, the terms "centrifugal" and "centripetal" describe the "push" vs. the "pull" forces of nature; and the same forces are at work on our cities. Some activities will be attracted to urban cores, some to outlying areas, but cities themselves will flourish.

The regional city of the future can be a more livable, more desirable answer to our needs, especially if we can solve two important and perhaps related problems: dense concentrations of poverty and the heartbreaking failure of public education.

We have the knowledge and the means to deconcentrate poverty, and we should. And sooner or later we will realize that the challenge of public education can be solved just as the challenge of public safety has been solved in the past decade.

The day can come again when our public schools are cheerful, non-violent places of learning and upward social mobility.

We had such public schools once and we can have them again, if we demand them.

We can learn again, as we have forgotten, to teach our children from the earliest grades to read with comprehension, to write and express themselves clearly, to count and to compute accurately. Our schools can give the basic knowledge needed to function in our society, and they can again reflect the self-discipline, high aspirations and self-confidence that schools taught in the past. When they do, good things must follow.

One of those good things will be that middle-class children can again flow back into inner-city public schools, which will benefit everyone concerned.

A new city form is beginning to evolve everywhere, and here in New York, the rebuilding of Lower Manhattan will represent the new paradigm.

First, of course, we must get past the nonsense of talking about either reconstructing exactly what was misbuilt there a generation ago, on the one hand, or of creating a 16-acre cemetery in the heart of our financial district, on the other.

The rebuilt area must have state-of-the-art transportation connections to the other parts of the city and the region, and have a 24-hour, seven-day-a-week character. Far from being another white collar ghetto, it must reflect a wide range of uses.

By 2012, when, God willing, the Olympics arrive with all of its additions to the city's infrastructure, New York could be the world's first truly 21st century city.

About the challenge of terrorism, the key thoughts are "vulnerability," "contingency planning," "redundancy," "deconcentration," and "common sense."

Yes, we are vulnerable, and much more so than we previously thought possible; and, yes, the larger the company, the more necessary is appropriate contingency planning.

Back-up facilities and equipment, dispersed but integrated locations on different power grids and communications networks, unprepossessing premises rather than the imposing "trophy" office tower, rethought telecommunications—all are on everyone's mind. Subjects like water supplies and drainage systems are being reviewed, the location of key personnel and the duplication of important records are being studied, and all aspects of operation are up for discussion. We will adapt.

The general exodus from large cities that some have predicted has not and will not happen anymore than it did in a London under IRA attack or a Moscow under Chechen threat.

Life will continue as before, with common-sense modifications, precautions, and redundancies seen as a collective form of necessary insurance.

At various times over the centuries, doomsayers were certain that the end of the world had come. One such period was in New England in the late 1600s, and one particular sect believed it could even predict the very day.

The congregation debated selling all its worldly goods, distributing the proceeds to the poor and gathering in the churchyard at noon to greet the Angel Gabriel with song and prayer. One wise old congregant rose to insist that the Lord loved work and workers. He proposed that they all greet the Lord hard at work as on every other day of the year. As far as we know, they and their descendants are still at work.

I believe that in these uncertain times of Osama bin Ladin and Saddam Hussein, the real estate field should greet the future in the same way.

ABOUT THE AUTHOR

Daniel Rose, CRE, *is chairman of Rose Associates, Inc., in New York. (E-mail: dr@rosenyc.com.)*

FOCUS ON HOUSING

FAIR HOUSING LAW—THIRTY-FIVE YEARS LATER

by Chester C. McGuire, PhD

Chester C. McGuire, CRE, PhD

The year 2003 marks the thirty-fifth anniversary of the Federal Fair housing Law, which in retrospect is one of the most significant public policy measures affecting the American real estate industry. I make this statement based on my own personal involvement in the real estate industry and as a former government official responsible for administration of the law.

THE FAIR HOUSING LAW

The Fair Housing Act of 1968 (Title VIII of the Civil Rights Act of 1968) prohibits discrimination in the buying, selling, renting, and financing of housing based on race, color, religion, national origin, sex, familial status, and disability. Although prior to 1968 some states and localities had ordinances and statutes against housing discrimination, the advent of federal legislation signaled fair housing as national public policy.

The civil rights laws enacted in the 1960s had as their aim eliminating the vestiges of historical discrimination in employment, education, public accommodations, voting, and housing. In housing the vestiges of discrimination were the pervasive urban ghettos, which were rigidly segregated and replete with devastating social problems. There are undoubtedly many profound reasons for the creation and development of today's segregated neighborhoods. However, some of the blame inevitably is conferred on the real estate industry.

During the years following World War II standard practices in the real estate industry included racial steering, outright refusal of service and blockbusting. Minority families seeking housing were steered away from white areas into black or changing neighborhoods. White families were steered away from racially integrated areas. Outright refusal of service to minority customers was the norm. This resulted in all white and all black real estate firms.

In some neighborhoods there was the practice of blockbusting. Real estate brokers used scare tactics on white families to get them to sell their houses at low prices to speculators. Then black families were sold these same houses at inflated prices. Minority neighborhoods were "redlined," so that conventional mortgage money and insurance were unavailable.

These pervasive activities in the real estate industry set the stage for the passage of the Fair Housing Act of 1968. Real estate brokers, landlords, property managers, lenders, and developers were clearly targets of the legislation. When the Fair Housing Act was enacted, the real estate industry was perceived as the clear villain, much in need of regulation.

WHAT THE FAIR HOUSING ACT ENTAILED

The Fair Housing Act as enacted in 1968 was not an especially strong piece of legislation in terms of enforcement. The Department of Housing and Urban Development could receive complaints and commence and investigation. If there was evidence of discrimination the mater could be brought to mediation. HUD had no enforcement power. At last resort the Department of Justice could intervene or the individual could file a civil suit. The 1988 amendments to the act provided HUD with more authority.

HUD receives about 10,000 complaints of discrimination each year. Approximately 43% are racially related, 35% for disability related matters, and 18% concerning familial status. The Office of Fair Housing and Equal Opportunity in HUD operates with a staff of less than 500 employees nationwide.

THE INDUSTRY RESPONSE

Members of the real estate industry have never been fond of regulation of any kind. Hence there was much resentment of the Fair Housing Law and its implementation. However, the 1968 legislation included a provision that encouraged voluntary compliance with the law. A very small staff, less than ten people, administered the Voluntary Compliance Program. However, from this quite modest beginning, there developed an extremely useful and important tool for the ultimate implementation of fair housing.

The leadership of the real estate industry began to understand and appreciate the olive branch provided in the voluntary compliance provisions of the Fair Housing Act. A voluntary approach could help the real estate industry achieve two important objectives. First, by taking the initiative and responsibility through its own voluntary measures it might forestall the government's taking harsher measures or more regulation. Second, the real estate industry needed a way to escape from the stigma of negative publicity it received regarding racially discriminatory conduct of some of its members.

Although some members of the real estate industry profited from racially discriminatory practices, most people in the industry did not. Many of those who did not actively engage in racially motivated practices did not want to be associated with the stigma from those persons who did. In fact, it was enlightened self-interest that moved people in the industry toward embracing Voluntary Compliance for the goal of fair housing.

Racial discrimination and racial segregation were simply not good for business. Although some money could be made through discriminatory practices that benefited a few, more money could be made in an open market. The real estate market could be expanded with millions of minority households fairly competing for housing. Thus it was in the best interest of all parties to foster an open market rather than a market burdened with the baggage of discriminatory practices. At least this was the thinking of leaders in the real estate industry beginning in the 1970s.

Organizations such as the National Association of Realtors, National Association of Homebuilders, American Institute of Appraisers, and others, all signed voluntary compliance agreements with HUD. In the beginning these agreements pledged that the organizations would take voluntary steps such as education programs for its members to stress fair housing. Although the steps were quite modest in the beginning, they have certainly borne fruit.

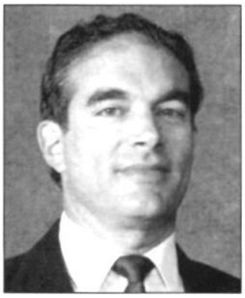
ABOUT THE AUTHOR

Chester C. McGuire, CRE, PhD, *was Assistant Secretary for Fair Housing and Equal Opportunity during the Carter Administration (1977 to 1978). He was actively involved in working with the various components of the real estate industry in implementing the Fair Housing Law. H e is currently a consultant working in Berkeley, California. (E-mail: chetmcg@pacbell.net)*

FOCUS ON THE ECONOMY...

RECOVERY: ARE WE THERE YET?

by Mark Lee Levine, CRE, PhD



Mark Lee Levine, CRE, PhD

Economic recovery is much like the family auto outing across the country, as the children in the back seat frequently ask the parents: "Are we there yet?"

The issue remains: With regard to recovery of the real estate economy, real estate investors, experts in the fields of banking, real estate organizations, REITs, etc., and numerous financial advisors connected with commercial or residential real estate are also asking this perennial question: "Are we there, yet?" The aspirant seeks his or her answer to this continual question; and, the answers are affected by the local economy, as well as the broader economies of the United States and the world economy.

The issue as to whether the real estate recovery has "arrived" is compounded by the consistent inconsistencies that are faced in various real estate markets.

RESIDENTIAL

The housing market continues to set a record sales pace in many areas of the U.S.

The report by Ken Simonson, chief economist, Associated General Contractors of America, for July, 2003, indicated that home ownership numbers continued to remain very strong. Also noted in the Simonson report was the reference to the Census Bureau, indicating that the adjusted sales of new homes totaled $1.16 million, which was an increase of 4% from the revised total for May, 2003. This is an increase of 21% from the June, 2002 total.

Also showing strength is the pricing of the median home throughout the United States, which pricing is running at approximately $187,000.

Although such numbers are favorable, even in the housing industry that has been showing record, positive positions, there is a decline in some areas, when contrasted with the prior year position. The report by the National Association of Realtors (NAR) indicated that the sale of existing houses was slightly down from sales of the prior year.

In general, the residential, single-family home market has had a fantastic run over the past few years. And, it continues with very strong numbers, even if somewhat reduced from the last several months.

As good as the residential real estate market has been, the market has shown some decline, and it will probably continue in this track if interest rates continue to increase.

However, without waiting for the issue of interest rates, it is very clear that many other sectors of the real estate market are adversely functioning from the standpoint of the investors' position, notwithstanding favorable interest rates and refinancing, which gives greater support for cash flow.

COMMERCIAL

Office rents have generally been declining throughout most of the U.S.A., over the past year. The vacancy rates have generally continued to increase, whether in Class A property or otherwise.

These are generalizations. However, as reported by Cushman & Wakefield, in their study undertaken by Gregory Bante, rental rates are falling in most major cities throughout the United States.

Twenty percent (20%) vacancy rates are quite common for office space throughout major cities in the United States. This is true in such cities as Denver, Phoenix, Austin, Chicago, and even in many places in California, such as San Francisco and the Silicon Valley.

Pockets of commercial real estate throughout the country continue to be fairly strong, such as mid-town New York City, which has gained strength as a result of a shifting of some of the office population to mid-town from the lower downtown, following the September 11, 2001 tragedies.

OTHER REAL ESTATE

In addition to a weak office market, other sectors of the real estate market are also suffering. Hotel and resort areas generally suffer from low occupancy and reduced rates.

Building permits are substantially down in the apartment sector, as reported by the Home Builders Association (HBA). Overbuilding in this area is especially prevalent in a number of major cities, such as Denver, which has vacancy rates for multi-family housing in the area of 15%.

Foreclosures are increasing in many parts of the country, whether the foreclosed property involves residential or commercial property. However, because of the lower interest rates, it is true that many property owners have been able to sustain what would have been a very negative cashflow position.

INTEREST RATES

The lower interest rates that have been present for several years, resulting, recently, in the lowest interest rates in the last 45 years, have been the saving grace in not only the residential markets, but also in commercial real estate markets, supporting a positive cash-flow position, even with higher vacancy rates.

The continued ability to acquire or hold property as a result of favorable, low interest rates cannot be over-stressed. The single, key factor of lower interest rates have kept alive many markets that would have otherwise been in dire straits.

It is quite easy to illustrate this impact on the residential marketplace. If the amount of debt in question for a residential property is, for example, $200,000, with interest at 5% on $200,000, this is $10,000 in interest, per year. However, the interest at 8% is $16,000. Therefore, the $6,000 difference results in a payment differential, for only the interest factor, of $500 per month.

Such payment differential makes it clear that many "prospective buyers" would not be able to purchase, as they would be disqualified from this level of home ownership, because of increased monthly payments due to the higher interest rate.

If this same concept is pervasive throughout the residential, single-family home market, with an increase of interest rates from 5% to 8%, as illustrated, this 3% difference would be a disaster for many residential real estate markets, especially for purchases of homes, refinancing, new furnishings for the home, possible home renovation and improvements, and other support activities.

If we extrapolated from the above example, by assuming that there is a debt of $2 million on the property, as opposed to $200,000, the 3% differential, the increase in the interest rate, results in a $60,000 per year increase, or $5,000 per month.

This example becomes further compounded, when extrapolating, if we assume the given debt is $200 million, as opposed to $2 million. Applying this same 3% differential on interest rates makes it quickly apparent that there is a huge and adverse impact by this 3% adjustment. Thus, at any level, the 3% increase had an enormous, adverse impact.

Knowing this interest rate differential, the implicit question is: "When will such rates increase?" The most recent indicators show that interest rates have been increasing, although there have been some blips, up and down. Implications of such movement is magnified, on the negative side, by considering that the slight movement in interest rates from July and August, 2003, resulted in an approximate 25% to 33% decline in refinancing.

As reported in Freddie Mac's *Primary Mortgage Market Survey*, the 30-year fixed rate increased at the end of July to the first part of August, 2003. This dampened the refinancing market.

As reported in the survey by the Mortgage Bankers Association of America, their Real Estate Center online news, August 1, 2003 report, mortgage loan applications for purchases and for refinancing for the end of July, 2003 decreased by almost 25%.

Although the Federal Reserve Chairman, Alan Greenspan, noted in his testimony before the Committee on Financial Services in Congress on July 16, 2003, that the market was somewhat "positive," and that interest rates would remain low, to help the economy recovery, concern continues in many areas. This is especially true considering the higher unemployment rate of over 6%, an increased deficit, increased strain on the economy because of war and terrorism, and other negative positions, such as the decline in high-paying jobs as a result of outsourcing many of these jobs by some companies in hiring employees from outside the United States.

Chairman Greenspan stated that we may be on the verge of an economic growth; but, that is the concern: We are on the verge: We are not "in" a substantial growth position.

It was reported in an article by Adam Shell in *USA Today* (July 15, 2003), that the economy, as seen by Chairman Greenspan, was "poised" for a rebound. The concern is to determine "when" such rebound will occur, and what negative factors may defer such recovery.

"WHEN" DO WE GET THERE?

In the earlier-noted testimony by Chairman Greenspan, made to Congress at the end of July, 2003, many questions have been raised as to how we can have a recovery if unemployment continues to be high, and the nature of the jobs that we are losing, such as high-tech and other well-paying employment positions, are lost to new hirees from outside of the United States. This issue was also recently raised by Representative Michael Castle of Delaware. This issue has been raised by many others, who still seek the answer to the issues as to "when" and "what" will cause the U.S.A. to reach the recovery stage.

As reported by Sue Kirchhoff, in *USA Today* (July 16, 2003), Chairman Greenspan stated, before Congress, that the support for the lower interest rates will remain "for as long as it takes" for the market to recover.

There continues to be concern with the Federal tax cuts, and whether the tax-cut decision by Congress and President Bush will provide an impetus for improvement in the economy, or provide a larger and bigger deficit that will be that much more difficult to overcome. This issue was discussed by Chairman Greenspan in his testimony on July 15, 2003, before Congress and, specifically, before the House Financial Services Committee. The article by David Firestone, in the *New York Times* (July 16, 2003), detailed the concern with these issues and the increased deficit that will further strain the economy.

Chairman Greenspan has supported the position that, with tax cuts, there also needed to be spending restraints by Congress to allow the tax cuts to be effective for the economy to recover. Whether those restraints will come about remains to be seen.

What should be very disconcerting to many investors, lenders and others involved in the financial market, and with particular focus on real estate, is the impact that a strong and continues spike in interest rates will have on the real estate markets.

On the negative side, for whatever reasons the interest rates spike, it is clear that this could be very damaging to the economy. Concern with inflation, deflation, outsourcing of jobs, unemployment, terrorism, an increase in the Federal and state deficits, etc., will seriously impact much of the rental real estate market. Such negative items may produce a concomitant hold-back on expansion by many companies. Vacancy rates would continue to increase. Home sales would slow. Refinancing would, for most intents and purposes, mostly end, whether for residential or commercial property, and there would be continued pressure for financial positions that involve variable rates, adjustable rates, construction loans and other short-term interest rates, where the newer, current rates would be substantially higher than the rates for the first few years in 2000. This scenario would, in turn, cause additional foreclosures, a slowing of activity in the general economy, and a time interval for regrouping within the marketplace.

There is the hope that such spiking of interest rates would not come about. However, the implications of such spiking should at least be considered and substantially weighed by those who are facing debt positions.

Under the current setting, there are certainly favorable performance grades that could be issued for the marketplace. For example, the residential real estate market would continue to receive an "A" grade, as activity in the residential real estate market, and particularly the single-family home market, continues to be strong. Pricing of homes remains strong. (Prior articles and commentaries have discussed the reasons for such positions, including a lack of other alternatives to place monies, the comfort level with "bricks and sticks" as opposed to intangible positions, a reduced desire to enter the bond market because of low rates, the uncertainty and volatility of the stock market, and prior-year losses, among other issues.)

The Consumer Confidence Index (CCI) continues to drop. Should it sustain further losses, this, concomitant position, with the potential increase in interest rates, spells a very negative scenario for the marketplace.

Although home sales for new property generally continue to increase, existing home inventory sales have slowed in many areas; and, the inventory of homes on the market continues to grow in many areas.

Home affordability for home purchasers continues to be favorable, given the lower interest rates. However, the recent increase of interest rates at the end of July, and the first part of August, slightly reduced the affordability ratio.

Vacancy rates in office space continue to rise. Therefore, in many markets, existing vacancy rates would receive a "C" grade, at best.

Motels, hotels and resort properties have also experienced higher vacancy rates and lower rental rates, thereby producing a lower rate or grade of a "C" to "C-" in many markets.

Favorable financing continues to be the key factor. Although financing might have received an "A+" grade over the past year, recent events might reduce that to an "A" under the current scenario.

Other types of commercial property have various grades that might be assigned for performance, but generally would be in the "C+" to "B+" grade range, depending on the type of property and location throughout the country.

Industrial space remains fairly strong in many parts of the country. However, retail space is showing signs of overbuilding in many areas. As reported in the Wall Street Journal (July, 2003), shopping center vacancy rates have increased. (However, occupancy rates are still fairly favorable.)

CONCLUSION

To the question, "ARE WE THERE, YET?" the conclusion is that we are not there yet.

But to the question,"WHEN WILL WE GET THERE?": This answer depends, in part, upon job growth, stimulus in the economy to gain a sustained position for more jobs, and a more positive attitude for the consumer confidence level to be sustained at a higher rate for a number of quarters.

It is unlikely that there is much stimulus in the economy to turn the corner and produce a "quick-fix" to "get us there." Although the tax rate cuts have been made, it is unlikely that they, alone, will provide the stimulus necessary to "jump-start" the activity of the economic engine for the real estate market as well as the economic market in general.

Even if we assume that interest rates remain fairly low, that much of the vacancy in multi-family units and office space is absorbed because of reasonable expansion, a positive attitude, and lack of terrorist activities, the likelihood is that arrival of a strong economy will not occur, until, at best, later in 2004.

RECOMMENDED READING

LEADERSHIP FROM THE DEPTHS

HOW RONALD REAGAN CHANGED MY LIFE

by Peter Robinson

as reviewed by Bowen H. "Buzz" McCoy, CRE

Buzz McCoy, CRE

How Ronald Reagan Changed My Life: *Peter Robinson (Former Speechwriter to the President), Harper Collins, 2003, 263 pages.*

The respected management consultant, Peter Drucker has written that to be a successful leader in the future one must be in harmony with oneself, love his fellow workers and have a passion which draws one out of oneself. Furthermore, according to Drucker, a leader of the future must also have the emotional maturity to remain calm in periods of stress, change and anxiety. In recent years books on leadership have stressed the need for that emotional maturity and stability which arise in one who is centered and capable of sustaining relationships which draw on the intimacy and trust formed out of the deep levels of personality.

Leadership out of the depths is nothing new. The concept is covered in the Bible. For many, Peter Drucker's thoughts resonate with one of the great underlying written premises of Christian, Jewish and Islamic religions that one must be in harmony with oneself, with one's neighbors and with a form of ultimate reality which calls us outside of ourselves and which many chose to call God. Many would agree that a major purpose of all religions is to draw one out of oneself and into relationship with the other, including the Divine Other.

Dante drew on this when he wrote to his protector while in exile from Florence, Can Grande of Verona, describing how he wished his great poem *Divine Comedy* to be read. First, there is the surface level, describing what appears to be going on. Then comes the allegorical level, where one makes meanings through the stories and heroes that move them. Then comes the moral level, which depicts the legal and normative values of the day. Finally comes the fourth level, the depth of spirituality and religion, where the deepest meanings and connections are made. Such a method of thinking was derived by Dante from the lectio divina, the method of deep contemplative prayer utilized by medieval monks.

Centuries later, Soren Kierkegaard utilized similar methodology is arriving at his three levels of living: the aesthetic, the ethical and the religious. For him the aesthete lived on the surface level of self gratification and leisure. As one matured and took on the responsibilities of marriage, family, career and the like, one became ethical. The final religious stage was achieved only when one could let go of oneself and be responsive to the claims and needs of others, including the Divine Other.

Dietrich Bonhoeffer, the German theologian and a leader in the underground movement to eliminate Hitler, wrote of "religionless religion" or "hidden religion" in " a world come of age". By this he meant that in a secular society which no longer treasures, and even disdains, outward religious symbolism, one may still remain deeply religious and spiritual by acting out one's faith in little acts of everyday kindness and grace.

The 20th century theologian, Paul Tillich, wrote in *The Courage To Be* of the self confidence required to bring our spiritual natures into everyday life. University of Southern California professor, Ira Mitroff, reports the results of surveys indicating that, more than financial compensation, most people treasure work that fulfills them as people and that allows them to realize their full potential.

We need current day examples reminding us that great leadership comes out of the depth of our being. In his book *How Ronald Reagan Changed My Life*, former Reagan White House speech writer, Peter Robinson, repeatedly reports on the positive impact of the inner calmness and serenity of the former President on those around him and, indeed, on the world at large.. Despite a life that had all too many of the common causes of misery-divorce, lack of professional success, an alcoholic father-Reagan sustained an almost theological sense of hope, strength, resiliency and an innate sense of the basic goodness of creation.

Robinson was clearly one of the President's most effective speech writers, coming up with the memorable phrase: "Mr. Gorbachev. Tear down that wall!" He lucked into a job in the White House through his friendship with William F. Buckley, Jr. He and his contemporaries on the White House writers' staff (several of whom became life-long friends) would discuss for hours what is was that made the President who he was. As a result they became adept at writing speeches in the President's voice. One of the reasons they could write parts of a speech that sounded like Reagan speaking was because the President had developed a deep consistency and integrity in who he was and what he said and how he said it. He knew who he was, and others could figure out who he was as well. When the State Department tried to put their words in his mouth, they failed.

These were formative years in Robinsons's maturation. Although he writes little explicitly about his personal faith background, it becomes clear that he is on a journey as well. He spent evenings discussing Reagan's religious make-up with a friendly priest. In the course of coming to understand Reagans' faith and prayer life, he also become less self conscious about exploring his own depths as a person.

Robinson reports that Reagan was known to his closest friends as a man of faith, but none could say just why. "We all sensed it-we just knew. But it's not as if Reagan wore his religion on his sleeve. ...He wore it in his everydayness, his treatment of people, including the 'little' people, who were as important to him as the great ones." One of the few times he was seen to be angry, was when he had been overscheduled. "He just hated it when people were kept waiting. He felt it was discourteous"

According to a close friend: "He was a man of prayer. Reagan prayed in all moods and in all circumstances. Even during government meetings, Reagan might offer a brief, silent prayer. I could usually tell when he was in communication with our Lord. When he was leaning back his head and looking at the ceiling, that's often when he was praying."..."He didn't need a church to pray in. He referred to his ranch as an open cathedral with oak trees for walls. On trail rides, Reagan would recite the famous prayer of St. Francis of Assisi that opens: 'Lord make me an instrument of Thy peace.' Sometimes the President would look around and say, 'What a wonderful place for prayer.' And sometimes he'd just look up at the sky and say, 'Glory to God'."

President Reagan connected with the Pope in their deep desire to free Eastern Europe. In a speech draft Reagan wrote: "Our prayers will go with you (the Pope would soon be traveling to Poland) in the profound hope that soon the hand of God will lighten the terrible burden of brave people everywhere who yearn for freedom, even as all men and women yearn for the freedom that God gave us all when he gave us free will. ... Perhaps it's not too much to hope that true change will come to all countries that now deny or hinder the freedom to worship God."

Robinson writes: "Yet if Reagan never wore his religion on his sleeve, he never gave the slightest indication that he ever felt embarrassed about it either. His love of God proved as central to the way he looked at the world-as central to his very being-as did his love of country. Working for him, I was finally able to quit feeling embarrassed about my own faith. Whenever I'd hear someone speak as if only rubes believed in God, I'd remind myself that Reagan had succeeded in radio, motion pictures television and politics-and that it looked as though he was winning the Cold War...Working for Reagan taught me a second lesson about faith, one I still think about almost every day. It enabled me to see how faith and everyday life fit together." Robinson sums up Reagans' religious belief as follows "Ronald Reagan demonstrated an implicit belief in the sacred and equal importance of all men as children of God."

Robinson presents an overall portrait of the President as a genial man who was also a hard worker and a man of action. He portrays Reagan as genial and relaxed almost to a fault, lacking not only the intensity, but also the vulgarity, of several of his contemporaries. Despite media comment to the contrary, Reagan was always a very hard worker, hand writing many of his speeches and radio broadcast scripts as well as thousands of personalized letters. Well into his seventies he continued to put in full, hard days of labor at his ranch near Santa Barbara. Reagan's faith might be summarized in a card one of the White House secretaries had tacked to a bulletin board over her desk: "Pray as if everything depended on God. Work as if everything depended on you."

The media disparaged *Bedtime for Bonzo* and other "B" pictures he made, but Robinson makes the case that the experience of acting out multiple contingencies prepared the President for his leadership role. "He understands open-endedness and contingency. He sees that life is a drama in which a lot of the scenes still haven't been written." He also had developed a businessman's capacity for taking action when all that needs to be known to make a decision is not and cannot be known. This capacity follows also directly from Tillich's *The Courage To Be*. "Getting on with it, especially in the face of complexity, does simply come down to trying something. Ronald Reagan knew how to try something," Robinson observed.

President Reagan's small town background, his unembarrassed belief in traditional values and his basic trust in the American people resonated positively outside he Beltway and allowed him to go over Congress directly to the people, who trusted him.

Another of the speech writers analyzed Reagan as follows: "What's in his head is simple Christian belief as mediated by the democratic ideals of small towns in the Midwest. Reagan doesn't believe he's a superman. He believes everybody's a superman-that all individuals have a kind of supreme inherent dignity. The way he looks at it, he just happens to be the one whose background and talents made him President. But he doesn't consider himself one bit better than anybody else. And with him it's not just an intellectual notion. It's real. It really is. It's so much a part of him that you can see it in the way he treats people every day."

By transparently reporting his own faith journey and his maturing process as a young professional Peter Robinson exposes himself to potential embarrassment and derision. His writing style is open, self deprecating and, at times, humorous. In revealing his interest in accessing Reagan's spiritual nature he displays a self confidence and emotional maturity which stands well in the company of the man he is writing of. He gives to those who honor Ronald Reagan the gift of understanding much better what it is in the man that they admire so much. For those who are not admirers but sustain an open mind, Peter Robinson provides an opportunity to understand why this President was so successful in so many ways. Along with the two recent publications of Ronald Reagans' writings and letters, *How Ronald Reagan Changed My Life* is an invaluable insight into the inner nature of a great leader that will stand the test of time.

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

CRE

50th Anniversary

1953 · 2003

THE COUNSELORS OF REAL ESTATE

430 North Michigan Avenue
Chicago, Illinois 60611-4089

Telephone: 312.329.8427
Fax: 312.329.8881
E-mail: info@cre.org
Website: www.cre.org