

REAL ESTATE ISSUES

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CELEBRATING 25 YEARS OF PUBLISHING EXCELLENCE

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Summer 2000

(deadline for manuscript submission - June 2)

Fall 2000

(deadline for manuscript submission - August 21)

Winter 2000

(deadline for manuscript submission - November 27)

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EDITOR'S STATEMENT - by Richard Marchitelli, CRE

This year marks the 25th anniversary of *Real Estate Issues* (REI). One only has to think back to appreciate how much the world has changed over the past 25 years. When REI was first published, the world was coping with double-digit inflation. That experience influenced how we spent and borrowed money. It caused us to form habits that would be difficult to break.

In 1976, widespread use of personal computers would not begin for almost a decade, yet, since that time, spreadsheets and complex financial models have become routine.

Today, we have different attitudes about place and space — where and how we live, work, shop, and recreate. It is cyberspace that captures our imagination and no longer outer space.

As corporations have gone global so has the economy. It is only natural that the real estate industry would follow.

The influence of Wall Street, particularly over the past five to 10 years, has created new financial and legal interests in real estate, and new ways that such interests are "monetized" and traded. In the process, real estate has been heavily influenced by the discipline of finance as traditional distinctions between property markets and financial products have become less clear.

In 1976, real estate counselors were developing new skillsets, challenging fundamental ideas, examining the strategic implications of applied theory, and adjusting to the economic realities of the marketplace. The more things have changed; the more they have remained the same.

Throughout 25 years of sometimes wrenching change, including two major recessions, REI has been a beacon of stability. It has been a respected repository of applied theory and a forum for new and sometimes controversial ideas. Its emphasis on applied theory has differentiated REI from research-oriented academic journals. Since 1976, *Real Estate Issues* has provided focus, clarity, and understanding to real estate consultancy.

The current Editorial Board understands the tradition of REI and accepts the challenge of building on the solid foundation created by Co-Editors in Chief **James H. McMullin** and **Jean C. Felts** (1976); and Editors in Chief **Jared Shlaes** (1977-1986); **Rocky A. Tarantello** (1987-1993); and **Halbert C. Smith** (1994-1998).



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Clarification Note: In the last issue, (Vol. 24, No. 4), there was a service bureau error on page 4, column 2, of *The Impact of E-commerce on Real Estate*. The correct column follows:

WHY IS REAL ESTATE THREATENED BY E-COMMERCE?

Both B2B and B2C e-commerce threaten real estate, although in different ways. This is due to some fundamental propositions:

- The Internet represents revolutionary change in the way virtually everything will be done in our society.⁶
- The Internet is based on the use of cyberspace, which is basically non-physical space.
- Real estate, in contrast, is physical space.
- Every transaction that occurs on the Internet is a transaction that will not occur in physical space. Over time, this substitution can result in less aggregate demand for physical space, all other things being equal.
- Even if aggregate demand for a particular property type is not affected, the Internet may require different building configurations and locations, thereby rendering many existing buildings obsolete.

Some may quarrel with the degree or timing of these factors, or parse words as to their meaning, but they are so fundamental that it seems much more productive for real estate people to discuss how to deal with the problem than to assume it doesn't exist. Early attention is critical because, as Peter Pike observes, the impact of technological change is usually overestimated in the short run and underestimated in the long run.⁷

The articles/submissions printed herein represent the opinions of the authors/contributors and not necessarily those of The Counselors of Real Estate or its members. The Counselors assumes no responsibility for the opinions expressed by the contributors to this publication whether or not the articles/submissions are signed.

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WHAT CAN MAKE NEW HOTEL CONSTRUCTION ECONOMICALLY FEASIBLE WHEN NEW HOTEL CONSTRUCTION ISN'T ECONOMICALLY FEASIBLE?

by Karen E. Rubin, CRE

We all know the conventional wisdom about the lodging industry's inherent cyclicality. As hotel room night demand grows in a market with a fixed number of rooms, hotel occupancies increase; at some point the market's hotels can start to move their rates upward. As occupancies and rates increase, profitability and net incomes at the market's individual hotels increase. And, all things being equal, as net incomes increase, values of the individual hotels generally increase. Eventually, values of individual hotels in the market rise to the point where they start to approach, equal, and exceed the cost of building new hotels. At this point, the cost of building a brand new hotel will be equal to or less than the cost of acquiring a pre-existing one. It is easy to see why new hotel construction can be economically justified at this point in the cycle: it is a better deal to build than to buy. This is the part of the cycle where new hotel development is economically feasible.

ABOUT THE AUTHOR

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The rest of the cycle we also know: the new hotel rooms open, supply is diluted and demand is spread out among the increased number of rooms, occupancies decline, rates (sometimes) decline or may cease to grow, and profitability and net incomes decline at the individual hotels. All things being equal, these factors generally cause a decline in the value of the market's hotels. And when values decline to something less than the cost of building new rooms, it is cheaper to buy than to build and the cycle begins anew.

So we all know the conventional wisdom. Now here's the question: how can new hotel construction be economically feasible when the values of the market's existing hotels have not risen to the point where they are at or above replacement cost new? Or, to phrase the question another way, what can make new hotel construction economically feasible when new hotel construction is not economically feasible?

The answer . . . government can.

GOVERNMENT IS INCENTIVIZING NEW HOTEL DEVELOPMENT

Based on the author's own and HVS International's recent and ongoing experience in lodging markets throughout the nation, it has become increasingly apparent that government is becoming involved in new hotel development to a heretofore unprecedented level of frequency and magnitude. It is obvious that cities, counties, and redevelopment agencies throughout the nation have, as a group, decided that new hotel development in their purviews is to be devoutly desired - desired enough, in fact, to do something about. In a substantial number of markets this desire is being translated into significant public subsidies for new hotel construction.

These subsidies are taking a number of forms. One of them is tax increment financing (TIF), which is itself being structured in a number of different ways. This type of development incentive permits a certain portion of what a new hotel property would accrue in real estate taxes to be diverted to pay debt service. We have found that the maximum amount of property taxes usually made available for debt service is the difference between the taxes that would have been paid had the property not been developed (*i.e.*, the taxes that would have been paid on the undeveloped site or on the un-redeveloped land and building), and the taxes payable on the developed (or re-developed) property. While a property owner must still pay property taxes in amounts commensurate with the redeveloped property's value, the amount of cash flow made available for debt service is effectively increased, permitting additional leverage on the deal. The ability to borrow more results in higher leverage, which is very attractive to real estate investors and developers, who like to capitalize projects with OPM ("other people's money"). And given that the cost of debt is generally lower than the cost of equity capital, higher leverage means a lower total weighted cost of capital, translating to better economic feasibility at lower occupancy, rate, and net income levels.

It has become increasingly apparent that government is becoming involved in new hotel development to a heretofore unprecedented level of frequency and magnitude. It is obvious that cities, counties, and redevelopment agencies throughout the nation have, as a group, decided that new hotel development in their purviews is to be devoutly desired - desired enough, in fact, to do something about. In a substantial number of markets this desire is being translated into significant public subsidies for new hotel construction.

Property tax abatements are also popular forms of government incentives. Abatements relieve property ownership from the burden of paying real estate taxes in full or in part, usually for a predetermined period of time. We find that the abatement period typically ranges from 10 to 20 years. Abatements can be total abatements, partial abatements, or a combination of the two. An abatement may start, for example, by requiring no real property tax payment at all; as the property matures in the marketplace, the expiration of the abatement may be phased. In one example, a property owner may pay no taxes for the first five years, then 20 percent of the full tax burden in year six, 40 percent in year seven, and so on, until full property taxes are paid in year 10. Property tax abatements, be they full or partial, can dramatically increase cash flow on the completed project, permitting more debt and higher leverage, increasing 'value,' and improving the economics of a project to the point where it is economically justified.

Municipalities are also incentivizing lodging property development by assisting with the process and the cost of obtaining land. Sale-leasebacks of land are sometimes used to motivate new hotel development. In some instances, a developer will assemble a site per pre-agreement with the city; the developer will then sell the site to the city at his/her cost. The city will then lease the site back to the developer at a favorable or nominal rental under a long-term lease. Rental can be as low as \$1 a year. Or, rent can

start low and be phased in over time to represent market rent.

We have also seen governmental or quasi-governmental agencies assemble a site, prepare it for development, and then make it available for sale to a developer at a favorable (*i.e.*, below-market) price. In one or two instances, we have even seen a city contribute a parcel's title outright to a hotel developer. By eliminating or reducing land cost, total project cost is lowered, and the economics of a project are improved.

Some governmental agencies have floated bonds to help incentivize development. In these cases, the developer's financing can be all or partially provided in the form of municipal bonds that may be guaranteed by the government and therefore bear favorable interest rates, lowering the cost of capital for the project and improving economic feasibility.

We have seen one recent case where a governmental entity essentially "donated" more than \$20,000 a room – in the form of a one-time, up-front, cash contribution to the developer – to spur a lodging facility's development. We have even seen one case where a government agency agreed to rebate, for a specified number of years, its portion of the sales taxes generated by the project once it was up and running!

The federal government is also "in the act," albeit more peripherally. Federal tax credits can enhance a lodging property's economics if it located in a Federal Empowerment Zone, or if it is an adaptive re-use of a historical building. These types of federal incentives are influencing the economics of a number of hotel development projects of which we are aware; however, these efforts are not targeted specifically toward the lodging industry in the way that their local and regional counterparts are.

In short, the ways and means of public incentivization of hotel development vary, and appear to be getting more and more creative. But they all have one common message: governments and quasi-governmental agencies at virtually all levels throughout the U.S. are telling developers to build hotels!

HOTEL DEVELOPMENT IS PARTICULARLY DESIRABLE

Why are hotel projects, in particular, so favored? There are several reasons. As an industry, lodging

is relatively clean. No nuclear reactors, no slag, no smokestacks belching black carbon products into the troposphere. And, lodging facilities create jobs, jobs that require both unskilled, hourly labor and middle and upper managers. Thus, they not only create jobs, they create a number of different kinds of jobs, providing opportunities throughout the labor market spectrum. In addition to creating jobs, hotels can also help to stabilize and define neighborhoods and cities. The right kind of hotel can even enhance a neighborhood's, or a city's, or a civic convention center's prestige.

But even more significantly, hotels by their very nature attract visitors. These visitors bring new dollars into an area and they spend them at local businesses; the business owners have more dollars to spend at other local businesses, and the multiplier effect assures that the increased spending is felt throughout the community. Government and quasi-governmental agencies – especially the more local ones – view hotels as a way to augment the public coffers without additional taxation of the local resident base. This is a good thing, government officials tend to reason, because the folks who comprise the local resident base have a nasty habit of voting government officials out of office for little things like raising taxes.

THE CONVENTION CENTER CONNECTION

Many of the recent hotel development incentives we have seen being offered are connected somehow with the market's civic convention centers. There are three typical scenarios. In one, a city or other governmental agency is trying to get a civic convention center built. Often a new hotel project is seen as instrumental in helping to ground this type of civic project.

In another scenario, a city may be trying to expand its existing convention center. No matter how low area-wide hotel occupancies may be, we find that the local convention and visitors' bureau often believes that its market does not have enough hotel rooms. Given that many hotel markets do have a difficult time housing large groups at peak periods, convention and visitor's bureau personnel may have a point.

In the last typical scenario, the new or expanded convention center is not performing as well as was projected. An oft-cited reason for underperforming civic conference and convention centers is a dearth of hotel rooms, a dearth of quality hotel rooms, and, most particularly, a dearth of

quality hotel rooms proximate to the civic facility. Philadelphia in the mid-1990s provided a very good example of this scenario. A beautiful new convention center had opened between July of 1993 and April of 1994, but no new hotel rooms opened in the market at that time. The convention center's performance was not spectacular - until the brand-new, upscale, $\pm 1,200$ -room Marriott opened adjacent to it in February of 1995. From that time forward, hotel room night demand in the market exploded. In this instance, new hotel rooms really were needed to permit the convention center to reach its potential.

A counter-example is Baltimore. Baltimore expanded its civic convention center in April of 1997 from $\pm 145,000$ to about $\pm 400,000$ square feet. Hotel room night demand in the center city's core convention hotels actually fell slightly that year, and while rate growth in the market has been strong, room night demand has grown more slowly than it did in the early 1990s. With no concomitant new hotel construction, the new convention center doesn't appear to have had the momentum to induce into the market the new kinds of meetings and conventions (and their related hotel room nights) that had been envisioned. Now that one or two new major hotels are expected to open in the next two to three years, we will see what happens.

Hotel development in or near public convention facilities has always been a little problematic, in fact, from the hotel component's side. The challenge has always been that if a hotel relies solely on rooms business generated in tandem with the convention center, it is difficult to achieve occupancy of much more than 55 percent to 57 percent on an annual basis (and these levels are *at best*). This is because major meetings and conventions require time to set up and time to tear down. A three-day trade show may require two or three "dark" days at the convention center before and after the show days. A hotel whose only locational advantage is its proximity to the convention center has a tough time during these "dark" days. So the economic viability of convention center hotel development has, before the current era, typically been seen as something less than assured based on typical locational factors alone. But recent success stories involving convention-oriented hotels in Philadelphia, San Diego, and other major and non-major markets throughout the U.S. have permitted hotel developers to come around to the point where they may permit themselves to be coaxed into such projects - with the right incentives.

While not all current public incentivization of new hotel development displays this "convention center connection," much of it does. And. One of the *quid pro quos* that developers are being asked to give in return for the money can be, in these cases, blocks of rooms. The city may want you to build a new convention headquarters hotel enough to give you money to do it, but they may also want to know at the end of the day, that you are going to cough up the rooms when the city has a chance to book a big group.

EVERYBODY'S DOING IT

The list of governments and quasi-governmental agencies that are providing development incentives for new hotels reads like a "Who's Who" of American cities. Here are just a few of the recent and current efforts:

Atlantic City: The City Redevelopment Agency has provided low-cost financing to assist a number of the market's casino hotels to expand.

Austin: The city offered a fixed payment in lieu of property taxes (also called a PILOT), one-half of the payment to increase with inflation and the other half to remain flat for 10 years.

Baltimore: Property tax abatements and property tax abatements again. Both the new Marriott and the new downtown convention hotel are getting 10 years' worth.

Cambridge, MD: A ± 350 -room Hyatt Resort is apparently being funded with bonds issued by the Maryland Economic Development Department. Property tax and some sales tax abatements are also being provided.

Charlotte: Some development cash and a guaranteed lease by the city for a portion of the connected parking garage are planned to improve the economics of the ± 700 -room Westin planned for downtown, across the street from the convention center.

Chicago: The 800-room Hyatt McCormick Place was partially financed with bonds floated by the Metropolitan Pier and Exposition Authority. The property was constructed adjacent to McCormick Center, one of the nation's largest center-city convention centers, which was expanded in 1997.

Houston: The story of Houston's public involvement in hotel development is a saga worthy of its

own article. Most recently, however, the City Council has approved a plan to go forward with a new convention center hotel that is owned entirely by the public and financed with revenue bonds. The city would also contribute public land valued at \$14 as equity for the project.

Indianapolis: The developer of the Marriott Convention Center here gets to lease the land for \$1/year.

Miami Beach: Government incentivization assisted in the on-going renaissance of the art-deco Miami Beach market. The newly-constructed 800-room Loew's received a reported \$60 million in incentives. The adjacent Crowne Plaza (new construction) also received public funding.

Philadelphia: The ±1200-room Marriott Convention Center started the trend in this city, helped along with both city-sponsored financing and a property tax abatement. Today, hotel projects being offered tax incentives by the city here are more common than those that are not. One recent example includes the new Courtyard by Marriott's tax increment financing.

Pittsburgh: The local transportation authority reportedly floated bonds to pave the way for the new ±300-Room Hyatt Conference Center on the airport terminal grounds.

Sacramento: A new 500-room Sheraton is under construction, and under subsidy, in the downtown area, next to the convention center. A parking garage, \$8 million in cash, and a public bond offering have helped to bring this project to fruition.

San Diego: It looks like San Diego is going to get a new 1,200 to 1,500 room convention hotel. It is rumored (not yet confirmed) that the Port Authority is going to relieve the developer of the financial burden of building the necessary parking and of performing certain site improvements, which may include some substantial amounts for environmental clean-up.

Scranton: Scranton is negotiating. Reportedly, public offers to hotel developers considering building a conference center hotel in downtown have included a \$10 million development grant (a federal subsidy), free land, a commitment from the city to provide parking, and a 10-year freeze on the property's tax assessment at the current level.

Hotel development in or near public convention facilities has always been a little problematic, in fact, from the hotel component's side. The challenge has always been that if a hotel relies solely on rooms business generated in tandem with the convention center, it is difficult to achieve occupancy of much more than 55 percent to 57 percent on an annual basis (and these levels are at best). This is because major meetings and conventions require time to set up and time to tear down.

Tucson: The county is offering a 75 percent rebate for the first 10 years of the lodging tax (two percent) that the new Marriott Resort will generate.

Tulsa: Tax increment financing aided and abetted the development of the Hotel Ambassador, which opened in early 1999.

And there's more, much, much more. Fort Lauderdale; New York City; Denver; Iron River, Michigan; Cambridge, Maryland; Washington County, Pennsylvania, the list goes on. Big and small, urban and suburban, communities throughout the U.S. are putting their money where their mouths are.

THE BOTTOM LINE

What can only be described as massive public incentivizing of lodging development is certain to effect the hotel development cycles in the markets where it is taking place. In some cases, the news will be good. In some markets, new hotel rooms are really needed to enable the market as a whole to grow. The Philadelphia story, referred to above, is a good example. When the 1,200-room Marriott opened in 1995, the new rooms represented a substantial addition to supply: about 16 percent to the total Philadelphia market's supply and as much as 33 percent to the core CBD's supply. The potential for significant supply-side dilution was certainly there, but dilution is not what happened. Growth in demand for hotel rooms commensurate with the growth in supply is what happened. In the same year demand in the greater Philadelphia market grew by 17 percent, and by as much as 35 percent

within the core CBD. Demand growth of 11 percent (both market-wide and in the core CBD) followed the year after. Thus, market-wide occupancies remained flat at first, and then grew. Market-wide room rates then grew. And, ultimately everybody won. In this case, the new hotel rooms were needed to enable the then-new convention center to work. In Philadelphia, the new hotel rooms were to the market and the convention center what gasoline is to an engine: you need it to make it go. In the positive economic conditions of the middle and late 1990s, Philadelphia-like stories are occurring more and more. In these markets, the new, government-approved and -encouraged hotel development may be helping along the values of pre-existing hotels by increasing everyone's occupancies, average rates, net incomes, and (all things being equal) values. In these markets, government incentives are helping the natural hotel market cycle along.

But in other markets, the story is not going to be as sanguine. Go back to the conventional wisdom: when hotel markets receive material amounts of new supply and cannot grow demand commensurately, occupancy declines. And so go, usually, average rates, revenues, net incomes, and (all things being equal), values. In these markets, government's economic intervention to spur new hotel room development before economic nature has taken its economic course may delay or prevent these markets from ascending the up-curve of the typical hotel cycle for a long time to come – at least this time around. In these markets, existing hotel owners may see their values decline as the new, government-subsidized rooms open and reach maturity within the marketplace. I would expect the future to bring us some unhappy hotel owners in these markets.^{REI}

NOTES

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FRAUDULENT TRANSFER RISKS IN A PORTFOLIO LOAN

by Joshua Stein

Lenders like property portfolios. By lending against a group of properties rather than just one property, a lender diversifies the collateral and mitigates the risk that some local aberrational event or market shift might impair the value of a particular property.

Therefore, if a borrower can deliver to a lender a mortgage on a portfolio of properties, the borrower will often obtain more loan proceeds, more flexibility, or other more favorable terms than it could have obtained by financing each property separately. The borrower may also save some transaction costs by closing a single loan for the entire portfolio.

If one entity owns the entire portfolio, the owner can grant a single mortgage on all the properties and the lender can record that mortgage in many recording offices. The entire pool secures the entire loan and no special issues arise of the type discussed here.

Most real estate investors prefer, though, to form a separate entity — typically a limited liability company, sometimes a partnership — to own each property separately. They do this for many good reasons, all beyond the scope of this discussion. The use of separate entities means that no single borrowing entity owns the entire portfolio. Each property owner must deliver its own separate mortgage to secure the entire loan.

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Although a multiple-borrower structure makes perfect business sense, it may create some risks for lenders under bankruptcy law and under the law that generally governs the rights of debtors and creditors. This manuscript explains those risks, assesses their magnitude, and discusses some techniques to respond to them. This is intended as a general discussion of these issues in the abstract. For any particular transaction, competent professional advice must be obtained, as the actual details of any particular transaction, and the laws of a particular

state, may dramatically change the analysis. The reader is cautioned not to rely solely on this manuscript for any particular transaction.

For convenience, this manuscript will use the following terms. Each "Property Owner" owns a single "Property" and delivers a "Property-Specific Mortgage" to the "Lender." The aggregate financing is the "Portfolio Loan."

The credit and collateral structure of a Portfolio Loan can be summarized as follows. The Portfolio Loan is a single loan, cross-collateralized and cross-defaulted. Each Property Owner is fully liable for the entire Portfolio Loan, but usually only on a nonrecourse basis, *i.e.*, its liability is limited to the possible loss of its Property. Depending on the borrower's agenda, each Property Owner will often have a different general partner and different limited partners. The same ultimate parent(s) would own and control the Property Owners or, at least, their general partner(s). (For "general partner," one can substitute "managing member." For "limited partner," one can substitute "passive member.")

The use of multiple Property Owners can create problems for a Lender if a single Property Owner ends up in bankruptcy, or otherwise suffers financial problems that lead its unsecured creditors to look for ways to improve their positions. The first thing any unsecured creditor will do under these circumstances will be to scrutinize Property Owner's secured debt and try to convince a court to convert a secured loan into an unsecured one or invalidate it entirely. The mere threat of doing so can increase the leverage that might be applied against Lender.

While this hypothetical may seem unlikely, it does describe one risk that can actually hit. And protection from precisely this risk — the risk of being an unsecured creditor — is a principal reason why any lender takes security for a loan. If under any circumstance a "secured" loan ultimately might not stay secured, then the "security" exercise may have failed to achieve its fundamental purpose.

Other creditors are not the only parties who might try to set aside Lender's security or to obtain leverage by threatening to do so. If any Property Owner goes into bankruptcy, that Property Owner's own management — the principals of the borrowing group — could threaten to try to set aside the Property-Specific Mortgage or the bankruptcy trustee might try to raise the issue.

The use of multiple Property Owners can create problems for a Lender if a single Property Owner files or involuntarily ends up in bankruptcy, or otherwise suffers financial problems that lead its unsecured creditors to look for ways to improve their positions. The first thing any unsecured creditor will do under these circumstances will be to scrutinize Property Owner's secured debt and try to convince a court to convert a secured loan into an unsecured one or invalidate it entirely. The mere threat of doing so can increase the leverage that might be applied against Lender.

The theory for setting aside any Property-Specific Mortgage would proceed from the perspective of any bankrupt or financially distressed Property Owner as follows. When that Property Owner signed on to the Portfolio Loan, it incurred debt that far exceeded both a). the value of Property Owner's assets (the Property) at that particular moment; and b). the benefits Property Owner received from the transaction. In other words, Property Owner "got ripped off." And, in legal parlance, the transaction might be deemed a "fraudulent transfer."

WHAT CONSTITUTES A "FRAUDULENT TRANSFER"?

In a bankruptcy or a state law "fraudulent transfer" proceeding affecting just one Property Owner, a court might look closely at transactions like this one. If the court concludes that the transaction made the particular Property Owner "insolvent" without providing "fair consideration" or "reasonably equivalent value" to that Property Owner, then the court might decide the Property-Specific Mortgage legally constituted a fraudulent transfer. And courts have the power to set aside any fraudulent transfer.

In deciding whether a Property-Specific Mortgage is a fraudulent transfer, the court might not consider the benefits of the Portfolio Loan to the borrowing group as a whole. Although as a real-world credit matter, Lender makes the Portfolio Loan to the entire borrowing group, a court might very well decide to conduct a separate fraudulent transfer analysis for each Property Owner. (This assumes the multiple Property Owners are not

substantively consolidated in bankruptcy, a possibility discussed below.)

A court will typically evaluate Property Owner's solvency based on a balance sheet analysis — a comparison of assets vs. liabilities. In the alternative, a court could find a fraudulent transfer if it decides that a Property Owner did not receive fair consideration or reasonably equivalent value and at the time of the Portfolio Loan closing was unable to pay its debts or had "unreasonably small capital" given the nature of its anticipated business. The court would perform this analysis with the benefit of 20/20 hindsight at a moment when (presumably) Property Owner is in financial distress. If the court finds "insolvency" but no "fair consideration" or "reasonably equivalent value" to Property Owner, the court might set aside the Site-Specific Mortgage or some or all of Property Owner's liability for the Portfolio Loan.

The outcome of the "fraudulent transfer" analysis of this transaction is by no means hopeless for Lender.

For example, a court sympathetic to Lender might say that if Lender forecloses on a Property-Specific Mortgage and forces one Property Owner to pay the entire Portfolio Loan, then that Property Owner would have a legal right to require the other Property Owners to contribute their shares of the Portfolio Loan. This legal right of each Property Owner is called a "contribution right."

The court could attach a value to a Property Owner's contribution right. The court could then say that the value of the contribution right represents an asset that balances out Property Owner's possible liability for the entire Portfolio Loan; therefore the Portfolio Loan did not make Property Owner insolvent; therefore the Portfolio Loan was not a fraudulent transfer at all.

A court might also recognize that in the real world, a Lender will almost certainly enforce the Portfolio Loan against all Property Owners at once, rather than just single-out a lone, hapless Property Owner as victim. Based on that practicality, the court might discount the prospective liability of any one Property Owner.

Although supported by some of the decided cases, neither a discount for contribution rights nor a discount for improbability is uniformly accepted. A court trying to rescue only a single distressed

Property Owner from its financial plight might instead compare the assets and liabilities of that particular Property Owner; decide Property Owner's new liabilities (the Portfolio Loan) overwhelmed Property Owner's assets; and conclude that Property Owner became insolvent as a result. While this outcome is possible, Lender could certainly argue that it would be improper.

The definition of a "fraudulent transfer" leaves plenty of discretion to the judge. In applying the "fair consideration" or "reasonably equivalent value" tests, courts can be skeptical of indirect or secondary benefits that allegedly accrued to an insolvent borrower. If the other "fraudulent transfer" tests were met, the court might invalidate and set aside a Property-Specific Mortgage. In that case, Lender would become, at best, an unsecured creditor and, at worst, might find that some or all of the Portfolio Loan could not be enforced against the particular Property Owner.

Lenders can add language and structural elements to their loan documents to reduce the "fraudulent transfer" risk in several ways. How far to go depends on the particular Lender's concern about the particular borrower group and the marketplace at the time — *i.e.*, whether the next lender down the street would be willing to overlook this risk and save the borrower some attorneys' fees and potentially some risk. The following discussion summarizes some steps a Lender might take to mitigate the "fraudulent transfer" risk in transactions of this type.

1). Liability Limitation - The loan documents can limit each Property Owner's liability for the Portfolio Loan to the maximum amount of liability that Property Owner can bear without becoming insolvent. Provisions of this type are common in corporate loans guaranteed by all the subsidiaries in a group of companies. They should reduce, but do not necessarily eliminate, the "fraudulent transfer" risk. A court bent on invalidating a Property-Specific Mortgage might decide the liability limitations are self-serving and formalistic and do not alter the underlying substance of the Portfolio Loan. Lender and its counsel would, of course, disagree. The court might also decide that the liability limitations, as written, did not limit liability enough to fully prevent insolvency.

2). Effect of Nonrecourse Clause - Because the Portfolio Loan is nonrecourse for each Property Owner, such Property Owner will, by definition, normally have no meaningful liability or exposure for the

Portfolio Loan beyond the value of its interest in its Property. Each Property Owner's liability is automatically limited, in most cases, to (the value of) its Property. Regardless of how much nominal "liability" any Property Owner appears to have assumed for the Portfolio Loan, that liability is meaningless to the extent it exceeds the value of the Property. A Lender can therefore reasonably argue that, by definition, the Portfolio Loan could not possibly have rendered any Property Owner "insolvent."

That argument may, however, suffer the same judicial response as the liability limitations discussed above. Moreover, bankruptcy would introduce another layer of uncertainty and complexity, because for purposes of Chapter 11 reorganizations, a "nonrecourse" claim will often automatically become a "recourse" claim. But even so, if Property Owner is a single-purpose entity that has only one asset, the Property, totally encumbered by the Property-Specific Mortgage, how can one say Property Owner has any meaningful liability beyond the value of the Property? The answer may depend, in part, on the nature and magnitude of the entity's other creditors (if any).

3). Formal Contribution Agreement - All Property Owners can enter into a formal contribution and indemnity agreement. This agreement could be built into the loan documentation or stand alone. Either way, it would amount to a mutual aid pact among Property Owners. If any one Property Owner ever paid more than its share of the Portfolio Loan, it could look to the other Property Owners for help on an equitable basis. This agreement would try to give each Property Owner an identifiable and formal "contingent asset" to balance out the "contingent liability" created by potentially disproportionate liability for the Portfolio Loan.

A contribution and indemnity agreement could help prevent insolvency of any individual Property Owner. It would do this by having all Property Owners acknowledge, formalize, and strengthen whatever informal contribution rights they would otherwise have among themselves. The value of this approach depends, in part, on the value of the reimbursement claims among Property Owners.

A mutual-aid agreement probably further diminishes the "fraudulent transfer" risk, but may not eliminate it. In addition, any reimbursement rights among Property Owners would need to be subordinate to Lender's Loan and could raise other issues. And, if the entire group of Property Owners becomes insolvent in the aggregate, the mutual aid pact will not help.

4). Structuring and Disbursement - When Lender documents and disburses the Portfolio Loan, Lender can try to demonstrate on paper why a court should allocate the Portfolio Loan among the various Property Owners and not treat it as a huge liability that overwhelms the assets of any individual Property Owner. For example, Lender can:

- Disburse the Portfolio Loan in pieces to the various Property Owners, in recognition that courts have invalidated loans where the lender could not show that the loan proceeds were disbursed to the actual borrower.
- Require the various Property Owners to execute separate notes evidencing their shares of the Portfolio Loan. Each note would be secured by a first mortgage executed by the corresponding Property Owner. Then each Property Owner would grant a second mortgage to secure only the entire Portfolio Loan except the part represented by the specific Property Owner's individual promissory note.
- Establish a record to show that the parties agree and believe in good faith that when the Portfolio Loan is considered and reasonably allocated as a whole, each individual Property Owner remains solvent.

Although these documentation and disbursement measures may help, they may be less likely to help prevent or diminish "fraudulent transfer" problems than the measures previously described.

5). Indemnity to Lender - All Property Owners and their partners (and other affiliates?) can indemnify Lender against any fraudulent transfer risks that might affect any one Property Owner. These indemnities could be secured by all the mortgages on all the Properties, as well as by pledges of all the equity in the deal. Although this arrangement does not provide any meaningful credit enhancement to protect against the fraudulent transfer risk, it does at least make it hard for any borrower affiliate to use the "fraudulent transfer" argument against Lender selectively, for any particular Property.

In deciding whether to require equity pledges, though, a Lender needs to remember that this security device raises its own issues and concerns, primarily relating to the reliability of the security package and what a lender can realistically do if the Portfolio Loan ever goes into default. Also, the equity pledges might themselves be subject to fraudulent transfer attack, depending on the overall ownership structure of the equity owners.

6). Global Bankruptcy - If any one Property Owner

were subjected to bankruptcy proceedings or a “fraudulent transfer” action, the circumstances would probably have already allowed Lender to declare a default on the entire Portfolio Loan, against all the Property Owners. Lender might go a step further and say in the loan documents that commencement of any fraudulent transfer proceedings against any Property Owner would automatically allow Lender to accelerate the Portfolio Loan. Any such acceleration would, in all likelihood, force all other Property Owners into bankruptcy proceedings, if they were not already.

Lender might prefer a single global bankruptcy for all Property Owners as opposed to separate “fraudulent transfer” actions affecting each Property Owner. In a global bankruptcy, the court might treat the assets and liabilities of all Property Owners as if they were assets and liabilities of one entity — a “substantive consolidation.” This would support a single-entity fraudulent transfer analysis that would probably benefit Lender by tending to validate the entire structure. Moreover, based on how particular Property Owners conducted their affairs, the particular facts might provide further basis for substantive consolidation.

Substantive consolidation is, however, a rather flexible and unpredictable legal doctrine. How and when to apply it depends very much on the discretion of the particular bankruptcy judge. It would depend on the particular facts and the positions taken by the unsecured creditors in the case.

In the typical real estate bankruptcy proceeding, a secured creditor will oppose substantive consolidation, but the special facts of a Portfolio Loan might lead a Lender to favor it — at least in dealing with Property Owners that obtained the Portfolio Loan. A Lender might not be as enthusiastic about bringing other unrelated affiliates into the bankruptcy proceeding. While a court might be receptive to Lender’s position, it might also conclude that a Lender cannot assert it after having dealt with the separate Property Owners as separate entities. Finally, if all the Property Owners are insolvent when considered as a group, Lender might disfavor substantive consolidation.

7). Common General Partner - Lender might insist that Property Owners restructure their internal ownership to assure that all Property Owners are general partnerships and they all have the same general partner, with the general partner having recourse liability for the entire Portfolio Loan. That general partner would therefore already be liable for all debts and obligations of every Property Owner, including the Portfolio Loan. It could pay

Lender might simply decide that given the large number of things that need to go wrong and the number of arguments that need to fail for Lender to suffer any loss as a result of the risks described in this manuscript, Lender might decide to treat this risk as background noise — the functional equivalent of the risk of being run over by a bus if one decides to cross the street. This would, of course, be a business decision that should first reflect an understanding of the risk.

that liability from any of its assets, including its partnership interests in all Property Owners.

If not paid, Lender could always proceed against that common general partner, directly, in its capacity as general partner of all Property Owners, without having to consider issues that arose because the general partner had somehow assumed liability for some other entity’s indebtedness. In a typical case, the use of a common general partner would substantially diminish whatever incremental “fraudulent transfer” concerns might arise from cross-collateralization with separate Property Owners.

A borrower may resist the use of a common general partner or single entity to hold all assets. A borrower might express concern that such a structure would be inconsistent with its business needs and desires, and would make it incur significant transaction costs and probably tax exposures.

8). Guaranty - An upper-tier, deep-pocket entity might execute a narrow and limited guaranty, designed to protect Lender only against the risk that any Property Owner’s obligations or Property-Specific Mortgage were ever invalidated based on fraudulent transfer theories.

As an alternative, such a guaranty might be even more narrow, applying only if Property Owner’s management, through skillful manipulation of the bankruptcy process (and its control of the “debtor-in-possession”) ever tried to invalidate any Property-Specific Mortgage on fraudulent transfer grounds. Such a guaranty would give higher-level ownership an incentive to prevent any Property Owner from manipulating the bankruptcy process to Lender’s detriment.

As long as the ownership used its control in a way that did not hurt Lender, the guaranty would

never trigger. Thus, Lender would continue to bear whatever risks might arise from any fraudulent transfer actions that other creditors (e.g. trade creditors, slip-and-fall plaintiffs, and environmental claimants) might take to set aside the Property-Specific Mortgages. An upper-tier guaranty would, however, give some protection against bad faith on the part of the very parties most likely to exercise it — Property Owner's management.

A guaranty of this type should raise few legal issues or problems of its own, such as questions about its validity. And if the borrowing group is proceeding in good faith, it is hard to see how the borrowing group can make any good arguments for not giving such a guaranty, other than general aversion to contingent obligations and personal liability of any kind.

9). Purchase Agreement – As a variation on the theme, Lender might request that some higher-level entity agree to purchase the Portfolio Loan at par (plus a prepayment fee) from Lender if anyone ever tries to invalidate any Property-Specific Mortgage as a fraudulent transfer. An obligation to purchase the Portfolio Loan would eliminate potential issues about measurement of Lender's damages and hence about the amount of Lender's claim under a limited guaranty – but perhaps raise issues about whether the arrangement is really a guaranty after all.

If a Lender adopts some or all of the deal structures suggested above, this should significantly diminish the likelihood that Property Owner's management could use the bankruptcy and fraudulent transfer process as a creative technique to leverage Lender. A borrower's reaction to any of these structures might include the following arguments:

- This is a nonrecourse loan without any credit enhancement, period, paragraph.
- Assuming a multi-branch ownership structure, no branch of ownership can control another. (Lender would respond that these branches can and should, without much trouble, negotiate appropriate covenants and internal indemnities. Lender would be happy to help all ownership branches solve their "internal imbalance" problem by obtaining the same good-guy guaranty from all branches. Lender might even agree to allocations of liability rather than joint and several liability. And, if the branches of ownership are not comfortable enough with one another to stand shoulder-to-shoulder on this type of risk, Lender may legitimately ask larger questions about the group as a whole.)

- There is no single upper-level entity that indirectly has the benefit of all the equity in all the assets and thus is an appropriate guarantor.
- No upper-tier entity in any branch of ownership is otherwise interested in assuming any potential exposure for any of these risks.
- The rest of the world closes multi-property, multi-borrower secured loans without worrying about these problems, or by adopting only some of the measures suggested above — and, in particular, does not require guaranties to address this issue. (But, is this really true? . . .)

How far these arguments will go may depend on such considerations as how badly Lender wants to make the Portfolio Loan; whether the borrower has other financing sources; and how the borrower would behave under stress (considering the borrower's possible obligations to third-party investors that might preclude the borrower from behaving reasonably). Also, some of the structures suggested above might incur significant extra transaction costs (e.g., a doubling of the number of mortgages), and these costs might be regarded as excessive compared against the likely risk being addressed.

As a reasonable middle ground, Lender might settle for: a). limitations on the liability of each Property Owner; b). some form of simple contribution agreement; and/or perhaps c). equity pledges. As noted, these three measures do not eliminate the issue, but should diminish it.

Finally, Lender might simply decide that given the large number of things that need to go wrong and the number of arguments that need to fail for Lender to suffer any loss as a result of the risks described in this manuscript, Lender might decide to treat this risk as background noise — the functional equivalent of the risk of being run over by a bus if one decides to cross the street. This would, of course, be a business decision that should first reflect an understanding of the risk, which this manuscript has attempted to provide. That business risk would need to be analyzed in light of the overall financial strength of the parties and whatever level of financial pressure the transaction itself will create, *i.e.*, whether the overall loan-to-value ratio is 45 percent or 90 percent.

The real issue might not be the size of the risk, but rather who should bear it. Why should this problem be Lender's risk at all, even if it is very small?^{REI}

SHOPPING CENTER BRANDING: DOES IT MAKE SENSE?

by Mark G. Gambill

INTRODUCTION

A rancher was asked the name of his ranch. He replied, "It's the ABCDEFGHIJKLMNOPQRSTUVWXYZ Ranch." He was then asked how many head of cattle he had and he said, "Not many." "Why not," the rancher was asked. The rancher said, "Because most of them do not survive the branding."

Branding is a complex topic in the world of marketing. Many marketing theorists and researchers hold that branding correctly done can be the key to the success of a company, product or service. While some companies should utilize branding, it is not always a practical solution in every case and does not lend itself to every application. Many companies that try to brand either themselves or their products or services do not do it correctly and, as a result, do not survive the process.

This manuscript will focus on the efforts of retail real estate companies to brand themselves. The process of branding will be explored; why real estate companies feel compelled to brand; and how real estate companies brand themselves.

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WHAT IS A BRAND?

A brand is a name, term, sign, symbol, or design or a combination of these intended to identify the products or services of one seller or group of sellers and to differentiate them from those of competitors.¹ A brand is a seller's promise to consistently deliver a specific set of features, benefits and services to buyers.²

The art of naming a brand, i.e., a company, the products they manufacture, or the services they provide, is called *semonemics*. This is a word derived from the Greek – *semon* (identifier) and *semein* (to assign).

Branding is the creation of a connection of that name to the company, product, or service.

Charmasson³ indicates that, "A name is a goodwill ambassador, a herald, a promise, the first thing that a consumer hears about a firm or its product. That first contact often determines the consumer's attitude toward the firm or product that the name identifies." ⁴

According to Professor John Philip Jones of Syracuse University, a brand is a product that provides functional benefits plus added elements that some consumers value enough to buy.⁵ The difference between a name and a brand is that while a name is an identifying designation, the brand name adds to that a sense of definition and personality.⁶

Murphy⁷ states that a brand is the product or service of a particular supplier, which is differentiated by its name and presentation. He says that a brand is a complex thing. Not only is it the actual product, but it is also the unique property of a specific owner and developed over time so as to embrace a set of values, both tangible and intangible, which meaningfully and appropriately differentiate products which are otherwise very similar.

THE PSYCHOLOGY OF BRANDING

A brand exists in psychological space, in the consumer's mind, according to Randazzo.⁸ He indicates that a brand is dynamic and malleable. Randazzo says that advertising is the vehicle that allows access to the consumer's mind, wherein a perceptual brand space is established. A brand takes on an almost mythical quality in the mind of the consumer, where the brand serves to engage the very psyche of the individual.

Gregory⁹ states that corporate image is comprised of "familiarity" – how well relevant audiences know the company – and "favorability" – how well audiences regard the company in terms of specific qualitative attributes. In the end, according to Gregory, the brand is the reputation and the reputation is the brand. Quoting Charles Brymer, CEO of Interbrand Scheter, Gregory posits that, "A product becomes a brand only when it stands for a host of tangible, intangible, and psychological factors. A key point to remember is that the manufacturer does not create brands. They exist only in the eye of the beholder; the customer."¹⁰

Gardner¹¹ indicates that marketers do not have the power to build a brand. The actual creation of a

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brand and brand identity is done in the minds of each individual consumer.

The primary function of a brand is to identify and distinguish a firm from other firms or the firm's products or services from those of competitors. Psychologists call the impression left by a name an "engram."¹² This is the impact the name has on the mind independent of the designated person or object. Davidson¹³ states that a brand is a constantly changing mental inventory inside the customer's mind. Every facet of the marketing mix influences its image.

Ries and Ries¹⁴ state, "We believe in the process of branding. Marketing is building a brand in the mind of the prospect. If you can build a powerful brand, you will have a powerful marketing program. If you can't, then all the advertising, fancy packaging, sales promotion, and public relations in the world won't help you achieve your objective. Today, most products and services are bought, not sold. And, branding greatly facilitates this process. Branding "pre-sells" the product or service to the user. Branding is simply a more efficient way to sell things."¹⁵ Ries and Ries indicate that a brand name is nothing more than a word in the mind, albeit a special kind of word.

WHY BRAND?

Branding has a dramatic effect on retail performance, according to *Chain Store Age*, a news magazine for retail executives, compiled by Arthur Andersen.¹⁶ Creating a powerful brand appeal is paramount in today's overstored environment.¹⁷ The successful retailer of the future will focus its brand building activities, both in-store and externally, on a select group of core target shoppers who appreciate and value the brand's attributes. *Chain Store Age* states that these "best customers" become the true basis of future growth. It has been a long-held belief in retail circles that Pareto's so-called

"Golden Ratio" applies, *i.e.*, that 80 percent of sales come from 20 percent of customers. It would appear that *Chain Store Age* is advocating that shopping center companies tap into the core of "best customers."

Even though relationship marketing has been criticized in certain circles, the essence of the concept is inherent in the branding process. Branding is an attempt by a marketer to form a bond or lasting relationship between that certain company, product or service and the consumer.

Fox indicates that a number of companies are beginning to experiment with corporate branding and the motives behind the campaigns vary widely, but all are symptomatic of a newfound enthusiasm for corporate chest beating.¹⁸ Fox also states that because of external forces acting on companies from all sectors, the increasing difficulty of carving out a competitive edge and the cost of supporting single brands, corporate branding is a sensible marketing option.

Cebrzynski¹⁹ states that of all the techniques available to marketers, branding is the most powerful. He says branding is intended to be a long-term commitment to building and nurturing a loyal customer. According to Cebrzynski, branding is often an emotional appeal, speaking to how consumers want to feel about themselves.

Marconi²⁰ states that price with quality equals value and value is why people choose one brand over another. That, he says, and that "feel good" quality. Image, according to Marconi, is a major factor in the buying decision and sometimes it has to do with not only the image to which one aspires, but to one that is sort of a "creed."²¹

Lindquist²² quotes Martineau²³ talking about store image, "It is the way in which the store is defined in the shopper's mind, partly by its functional qualities and partly by an aura of psychological attributes." Lindquist also states that the brand image consists of everything people associate with the brand. He says that the word "store" could easily be substituted for the word "brand." It could be further argued, in the context of this manuscript, that "shopping center" could also be substituted for the word "brand" to capsulize the efforts of shopping center companies to brand themselves.

Nilson²⁴ states that the role of a brand is to trigger a set of 'stored' values in the minds of customers.

Brands are developed to tap into the customers' ability to retain impressions and link them to a visual or oral expression. According to Nilson, brands are built out of key values. These values are tangible benefits and intangible character.

Murphy²⁵ indicates that brands are important to brand owners at two different levels. Brands serve to focus consumer loyalties and they develop as assets, which ensure future demand and cash flows. The brand, Murphy says, also serves to capture the promotional investment which has been placed behind it; benefits that can accrue even years later.

According to Upshaw,²⁶ brands have become "the atomic core of our consumer-driven capitalistic economy." He goes on to say that, "A brand is an assortment of expectations established by the seller that, once fulfilled, forms a covenant with the buyer."²⁷ Upshaw states, "Creating and sustaining trust within a franchise requires the matching of what is expected with actual performance. A formidable brand identity is the end product of that process."²⁸

Brands are part of a strategy aimed at differentiating supply.²⁹ According to Kapferer, companies seek to better fulfill the expectations of specific groups of customers. He says that the company wants to leave its mark on a given field and its imprint on a product.

Kapferer also states that "the spirit of a brand can only be inferred through its product and its advertising. The content of a brand grows out of the cumulative memory of these acts, provided they are governed by a unifying idea or guideline."³⁰ He says that the brand tells why products exist, where they come from and where they are going. By creating satisfaction and loyalty, the brand enters into a virtual contract binding it to the market. In exchange, the brand earns an automatically favorable opinion of any new products it introduces.³¹

Dr. Richard Tedlow, professor at Harvard Business School and a branding researcher, explains branding as a "promise of reliability."³² He says, "branding is in some sense a promise and brand equity, brand value, comes from the keeping of that promise. Generally speaking, branding is about reassurance, about consistency, about loyalty, about repurchase behavior."³³ Tedlow is creating a case study based upon the Westfield branding efforts.³⁴

BUILDING A BRAND TODAY

It used to take years to build a brand. A company like Proctor & Gamble or General Electric would make quality products and over time, consumers would come to associate that quality with the company name. When they went to stores, these consumers would look for and purchase the given products because certain companies made them. The company itself became a brand name and the products they made became brands as well. Marconi³⁵ says that marketers spent years creating brand identification and recognition and building brand loyalty.

Today, society has instant everything. Faxes and Fed-Ex'ing of packages are the norm instead of the exception. Microwave ovens cook, in minutes, foods that used to take hours. Computers now do, in seconds, computations and tasks that used to take hours or even days.

The same is true with branding. The efforts of systematic brand building have been overshadowed by instant brand building in the twentieth century. Technology and technologists with their "laser-like vision" have created a world of instant branding.³⁶

According to Marconi,³⁷ the power of instant branding reached new heights in the 1980s when Apple Computers and Nike spent virtually their entire advertising budget to run one-minute commercials during the Super Bowl. Randazzo³⁸ indicates that to build a brand is to create a mythology. The key to building a strong, enduring brand mythology is advertising. Advertising provides a powerful vehicle to create an appropriate perceptual inventory of imagery, associations, and feeling for a brand.

Ries and Ries³⁹ state, "Marketing is branding. The two concepts are so inextricably linked that it is impossible to separate them. Furthermore, since everything a company does can contribute to the brand building process, marketing is not a function that can be considered in isolation. Marketing is what a company is in business to do."⁴⁰

In her book, *Warp Speed Branding: The Impact of Technology on Branding*, Winkler⁴¹ states that brand building in the technology world has grown up with an entirely different set of assumptions stemming from the very nature of innovation. Winkler says that the need for speed

has changed how the business environments, processes, and consumers perceive products, services, and their respective roles.

According to Winkler, there are six myths of branding that until recently were held as immutable. They are as follows:

Myth 1. A brand is built over a long time. Communication technologies and computers have created a branding environment that can be measured in nanoseconds.

Myth 2. A brand is precisely crafted for a tightly defined target. A brand must be more expansive, according to Winkler, because of a more complicated group of stakeholder relationships and a more splintered society.

Myth 3. Advertising is the major creator of a brand. Techno-hype creates more of a "buzz" about a product or service, in a shorter period of time, than any traditional advertising medium.

Myth 4. Brand the product. Today, says Winkler, the idea behind the product or service is what companies need to brand rather than the product or service itself.

Myth 5. The brand needs a manager. With so many factors out of a traditional brand manager's control, if there is a person charged with brand oversight, that person could better be called a brand "Shepherd," rather than a manager, according to Winkler.

Myth 6. The brand is a marketing concept. Brands have financial significance and are larger assets than can be simply thought of or handled as marketing commodities.

Gregory⁴² indicates that there are seven generally accepted essential characteristics of any successful corporate branding program:

1. Simplicity – Try not to be all things to all people; focus on the important.
2. Uniqueness – Set yourself apart from the crowd.
3. Appropriateness – Bring attention to the qualities that further corporate objectives, not just the company.
4. Relevance – Hit home with target audiences.
5. Foresight – Create a positive impression before negative opinions can be formed.

6. Continuity – High visibility for the long term.
7. Credibility – Message must match reality.⁴³

The aim of branding is to create a marketing asset that has power in the marketplace; to achieve brand equity. According to Kotler and Armstrong,⁴⁴ brand equity is the value of a brand, based on the extent to which it has high loyalty among consumers, name awareness, perceived quality, strong associations with other brands, and worth as intangible or intellectual property.

Marconi⁴⁵ agrees with that definition and indicates that establishing that value begins with creating awareness. There are two ways to do this, according to Marconi: quickly or slowly. The slow process, argues Marconi, is more likely to achieve lasting results and is done through test marketing, sampling, advertising, sponsorships, promotions, public relations, event or cause participation, and endorsements. The quick way to achieve awareness is to do all of the above, but faster. According to Marconi, this occurs through hype.

Docters⁴⁶ indicates that brand equity produces the highest return when customers lack specific information for evaluating a purchase; do not have clear standards for evaluating the information they do have; either cannot or will not seek out more information; or just do not have the time to do so. He says that, “brand plays an especially powerful role in markets characterized by a high degree of uncertainty or mystery. In such markets, sheer belief or trust on the part of consumers can outweigh nearly all other considerations.”⁴⁷

WHAT ARE SHOPPING CENTER COMPANIES SEEKING TO ESTABLISH IN THE CONSUMER'S MIND?

In mall branding, shopping center companies are trying to establish themselves in the mind of the consumer as the purveyor of THE mall or power center experience. The theory is that if the shopping center company can become the customer's brand, it will become the shopping locale of choice for that consumer. The ultimate goal of shopping center branding is that the mall company name takes on a life of its own in the consumer's mind.

Chain Store Age,⁴⁸ in its “State of the Industry” issue, states, “Most any retailer today can duplicate any other's store design, product mix, advertising, promotions, pricing, or customer-service strategy. However, what's not easily replicated is the unique combination of these and other attributes which

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become compelling enough in the minds of target customers to create an almost cult-like following enjoyed by such chains as Nieman-Marcus, Abercrombie & Fitch, Home Depot, Whole Foods Market, and FAO Schwartz.”

The reality is that shopping center companies would like to do the very same thing through branding. They want to create a “cult-like following” to their centers. If that can occur, shopping center companies will have accomplished, through branding, something that they might not have otherwise achieved: customer loyalty.

*Chain Store Age*⁴⁹ goes on to state that “branding has a dramatic effect on retail performance, which is why creating powerful brand appeal is paramount in today's overstored environment.

Tedlow⁵⁰ states, “Most American malls will probably be branded within the next three years. A name brand offers value to be created and captured.”⁵¹ John Konnarski, senior vice president of the International Council of Shopping Centers, says, “American consumers are more brand-oriented than ever. You have to differentiate yourself. And consumers use the mall as a point of reference as to where they shop. They used to say, ‘I'm going to Bloomingdale's or Macy's. Now they reference the mall. Branding has a strong potential to become a real success for mall developers.”⁵²

A corporation has values, beliefs, rituals, aspirations, a personality, a reputation – a brand.⁵³ According to Gregory, corporate branding is a

purposeful, marketing-oriented communications platform across all business units, product and service brands, media, and audiences. The sum is more than the whole of the parts.⁵⁴

Shopping center companies want to establish themselves as the brand in the mind of the consumer. They are attempting to tap into the psychological core of the consumer with criteria that the consumer values in a shopping center or experience. Shopping center companies are making promises to the consumer. According to Gregory,⁵⁵ a brand is not an icon, a slogan, or a mission statement. "It is a promise—a promise your company can keep."⁵⁶ He says what a brand communicates is the subtext—"You can believe in our company and our products."⁵⁷

Williamson⁵⁸ indicates that name brand marketing means more than just a sign on the door. He cites executives at Simon and Westfield⁵⁹ that state that a shopping center brand has to equal more than a sum of its retailers. Simon is seeking the "power of being able to aggregate nationally."⁶⁰

According to Management Horizons, PricewaterhouseCoopers' retail consulting group, department store purchases have declined, while traffic at discount department stores such as Target, Wal-Mart, and Kmart, and off-price retailers such as Marshall's, TJ Maxx, and Ross Dress For Less have made sizable gains.⁶¹ The shift away from mall-based shopping, particularly at department stores, is even more pronounced when looking at male shoppers, according to Schneiderman,⁶² again citing Management Horizons.

One issue for consideration is that shopping center companies do not have a product. They are somewhat marketing a service, but in reality, it is not exactly a service either. Shopping center companies are selling what Randazzo refers to as perception.⁶³

Turley and Moore⁶⁴ state that the majority of interest in branding has been focused on physical forms or goods, rather than services. The intangibility factor associated with services has led to the opinion that branding and image creation may be even more critical for services.^{65 66}

Onkvisit and Shaw⁶⁷ state that a commodity is an undifferentiated product and a product is a value-added, differentiated commodity. They state that the distinction is not superficial and has significant managerial implications for service marketers.

Onkvisit and Shaw⁶⁸ indicate that whenever possible, a service provider should attempt to become a "power brand" by possessing four characteristics:

1. The company brand is distinctive.
2. The company brand is relevant.
3. The company brand has a tangible quality.
4. The company's most important services are branded and linked.

Even though shopping centers are physical entities, what the shopping centers are branding is intangible. The characteristics of a brand name such as "Simon," "Tanger," or "Mills" revolve more around the non-physical qualities of the given shopping experience than they do around the aspects of the physical plant of the shopping center. Zeithaml, Parasurman, and Berry⁶⁹ identified four unique features of services: 1). intangibility; 2). inseparability of production and consumption; 3). heterogeneity; and 4). perishability. All of these apply to what is being offered by shopping center companies as a product/service and is what these companies are attempting to brand.

De Chernatony and Riley⁷⁰ indicate that part of what is being sold with a service is the overall stature and imagery of the organization and consumers tend to perceive all services offered by a company as components of a single brand. They indicate that the extent of intangible elements in the functional benefit may affect the way the service brand is operationalized.⁷¹

The Internet is threatening the very existence of shopping centers. The bits and bytes of the cybermall are replacing the bricks and sticks of the regional mall. Consumers are turning to the Net as a simpler way to shop. There is a fear among mall companies that the local mall or power center could quickly become a catalog showroom as buyers survey the merchandise and then get online to get the best price and buy. In fact, one mall, The St. Louis Galleria, went so far as to prohibit its tenants from displaying any advertising containing references to Web sites,⁷² but one week later, it revoked the prohibition.

Paco Underhill, author of *Why We Buy: The Science of Shopping*,⁷³ contains significant observations about how customers act and what motivates them, indicates that the Internet is a valuable tool, but it will not replace the "bricks and mortar" of the local shopping center.⁷⁴ Technology, according to

Underhill, is a troubling issue, because as much as it facilitates, it also confuses. Underhill opines that the future of the Net for retailers is that it will become an integrated part of the shopping experience. "Just as I can use my store to drive traffic to the Net, I can use the Net to drive traffic to my stores," says Underhill.⁷⁵ The bottom line according to Underhill is that "we will always have stores."⁷⁶

One thing that malls and community/power centers are selling is the environment. Shopping centers are seeking to make the experience more fun and attractive. If customers perceive that shopping is an enjoyable experience, they will want to return again and again. The local mall or community center needs to be seen by the customer as an entertainment environment.

Other associations that the retail real estate companies are trying to create in the consumer's mind are convenience, dependability, innovation, community-mindedness, good management, safety, selection, and value, among others. The thought is that if these companies can create a link in the customer's psyche between these factors and their shopping center, this will breed loyalty to the shopping center or, on a global scale, the shopping center company generally.

The goal of shopping center branding is to get consumers to invest themselves in the company and its shopping experience. According to Gregory, if all other things are equal, corporate branding can be the tiebreaker that motivates people to buy the corporation's products or services and recommend them to others.⁷⁷ In a chapter called, "Establishing the Key Message," Gregory,⁷⁸ indicates that quality is still the key branding message for many companies.

Ries and Ries⁷⁹ indicate that the brand is not just the name on the package or service. It is the product or service itself. What is delivered is the most important aspect of the branding process.

What shopping center companies are branding is their ability to consistently deliver a high-quality shopping experience. If they fail to do that, all they have is their company name on a shopping center or mall.

In a study on the correlation between consumer emotion and buying behavior, Babin and Darden⁸⁰ found that in-store mood influences customer satisfaction. Negative shopping moods affect patron

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satisfaction to a greater extent than positive moods. This is important from a shopping center company branding perspective, because these companies need to create an environment that influences customer mood in a positive way and, more importantly, eliminates stimuli that would lead to a negative mood on the part of the customer.

SOME EXAMPLES OF SHOPPING CENTER BRANDING

Shopping center companies are taking different approaches to branding, but most are striving for name recognition and association of that name with a quality shopping experience. Connection or association to the particular shopping center company through branding is one significant way that loyalty of the consumer is achieved.

In an article entitled, "More Than a Name," *Chain Store Age*⁸¹ states that although it sounds like a simple concept, branding by real estate developers signals a turning point in the industry. According to this article, developers are relying on intuitive visions and fundamental convictions to create loyal followings among retailers and consumers.

*Chain Store Age*⁸² states that the origins of branding in retail development trace to the rise of "name-brand outlets" in the early 1980s. Tanger Factory Outlet Centers led the way with branded developments that included merchants like Nike, Liz Claiborne, Tommy Hilfiger, and Reebok. Four years ago, Tanger extended the branding concept beyond the use of a common name to include consistency in advertising and communications. Carrie Johnson-Warren, vice president of marketing for Tanger, states, "Consumers want simplicity; branding makes it so much easier to package our information in advertising to shoppers across the country and on the Internet."⁸³

Simon Property Group is the world's largest retail landlord, controlling over seven percent of all of the

retail space in the world and with over 180 million square feet of gross leaseable area. Beginning in 1995, Simon invested millions of dollars to determine what customers were seeking in shopping centers. The results of that study led Simon to the conclusion that it needed to establish itself in the consumer's mind as the customer's shopping center.⁸⁴

It has streamlined its name to "Simon" and is spending \$23 million on a multimedia campaign around the phrases, "Simon, simply the best shopping there is" and "Simply Simon." Each center owned by Simon has the "Simon" name as its preface. Words like "convenience," "selection," "value," and "entertainment" were chosen to convey Simon's branding program core message. Simon's aim is to have the name "Simon" associated with clean, safe, quality shopping environments with the retailers that customers want to shop. The ultimate goal, according to Simon CEO, David Simon, is for "Simon" to become the Microsoft of the shopping center industry.

In May 1997, Colonial Properties Trust, a shopping center company based in Birmingham, decided to unite its 40 shopping centers throughout the southeast under a single brand. Prior to this, each center in the Colonial portfolio was relatively autonomous with its own image and management objectives.⁸⁵ Colonial determined that each of its centers would include the name "Colonial" with a designation of "mall," "promenade" for community or power centers, or "shoppes" for neighborhood centers and the name of the market: for example, Colonial Promenade Montgomery. Colonial indicates that sales at its centers rose following implementation of the branding campaign. In one case, sales increased almost 30 percent.⁸⁶

Colonial won the 1999 Maxi Award from the International Council of Shopping Centers Fall Management and Marketing Conference.⁸⁷ The award was given for Colonial's branding campaign, which was a multimedia effort themed around the metamorphosis of a butterfly, to communicate the changes taking place at each of Colonial's properties.

John Moss, a Colonial senior vice president, states, "The brand helps you set a standard – you can't hide from people knowing who owns the property, so you have to make sure that standards are set."⁸⁸

The Mills Corporation has been extremely successful in branding efforts for its shopping centers.

Mills has used name branding to associate the company with a certain shopping experience at its huge venues. Each Mills has 200 or more stores in an average of 1.5 million square feet of gross leaseable area and often includes five or six times as many anchor stores as most regional malls. Coupling the Mills name with the location of the Mills project (examples: Sawgrass Mills, Potomac Mills, etc.) has led to "destination shopping," according to the Mills corporate profile on the Web.⁸⁹

Mills' advertising talks about a "shoppertainment environment" and leads with the slogan "Building a Brand." The catch phrase of the Mills advertising program is "Jump on the Brandwagon. The Power of The Mills." Mills stated position is that branding for it is not a fad. It is the "cornerstone of our corporate culture and has been for 14 years."⁹⁰

The Mills Corporation is creating a new brand for urban areas called "Blocks." The Block at Orange in California opened in November 1998 and combines a pedestrian walk and Main Street design with nightclubs, restaurants, and cafes along with coffee shops, book and music stores, and fashion boutiques. The next "Block" will be in midtown Atlanta.

According to *Chain Store Age*,⁹¹ The Block at Orange dedicates 70 percent of its square footage to great dining and entertainment and 30 percent to upscale shopping. This differs from even the traditional Mills projects that contain 70 percent value retailing and 30 percent entertainment.

Jerry Engen, vice president and development director for Mills, states, "We're the Lucent Technologies of retail: our track record empowers us to recruit and create store brands within our projects."⁹² Engen credits the Mills success to location and branding. He goes on to say, "Our projects are the number one tourist attraction in every state we're in except for Florida, where we take second place behind Disney World."⁹³

Caylor⁹⁴ quotes Mark Rivers, senior vice president of national accounts for Mills, who states, "We have been using branding as one of the foundations for the way we do business. Ours is not really a branding campaign; ours is more of a branding culture."

Australian shopping center group, Westfield Corporation, claims that it was the first shopping center company to brand itself in the 1960s. In Australia, all Westfield malls carry the corporate name and are

known as “shopping towns.”⁹⁵ Westfield has hired an advertising firm to create the Westfield brand in the U.S., where Cuneo states, malls are traditionally marketed individually.

Frank Lowy, Sr., Westfield’s founder, says that branding is something that Westfield has been doing for many years, even before it knew it had a brand.⁹⁶ Lowy tells about the time he was on the street in Australia and overheard someone say, “Let’s go to Westfield,” instead of, “let’s go to a particular store.” That, he says, led him to understand that he had a brand.

Randall Smith, Westfield’s executive vice president of marketing, states, “Over three years, we developed a customer-service program that means the Westfield Shoppingtown stands for something: quality retail, exceptional customer service, and community involvement.”⁹⁷

The O’Connor Group and New England Development merged in 1996 and formed WellsPark Group.⁹⁸ A committee was formed to create a unified image for the company and its projects. Wells Park’s aim was to convey a central theme through its advertising and standardization of its malls – the mall is the medium for all messages. Quoting Adrienne Davis-Brody, senior vice president of marketing for WellsPark Group, “WellsPark’s goal is to manage the shopper’s visit from the moment she pulls into the parking lot until she pulls out to leave. Customers will be ‘managed’ into the stores so that the optimal experience will be achieved.”⁹⁹

Prime Outlets, the world’s largest owner of factory outlet malls, began a branding campaign for its 51 outlet malls in September 1998. Prime has spent \$12 to \$15 million to brand its portfolio.¹⁰⁰ Prime indicates that it would have spent \$3 million dollars on its regular advertising campaign. David Phillips, executive vice president of Prime Retail Baltimore, states that Prime wants to make a 15 to 20 percent IRR. That being the case, Prime needs to generate \$1.8 million more in NOI to cover those costs.

Holly Lazer, Prime’s sponsorship manager, states that branding has become a key component in the retail sector in setting shopping centers apart.¹⁰¹ She indicates that Prime wanted to create “one uniform product and one uniform experience for the shopper.”¹⁰²

CO-BRANDING

One area where shopping center companies are

One area where shopping center companies are working hardest in their branding efforts is in co-branding.

Co-branding is the practice of using the established brand names of two different companies on the same product. In practical application, however, co-branding goes even farther.

Co-branding has expanded to include synergistic relationships between companies through strategic alliances and marketing partnerships.

working hardest in their branding efforts is in co-branding. According to Kotler and Armstrong,¹⁰³ co-branding is the practice of using the established brand names of two different companies on the same product. In practical application, however, co-branding goes even farther. Co-branding has expanded to include synergistic relationships between companies through strategic alliances and marketing partnerships.

Buss¹⁰⁴ indicates that companies need to dare to work with other brands. As an example, Buss cites big food companies that have discovered that co-branding can yield remarkable synergies while not diluting their own brands. “Co-branding brings two brands together to share costs and command consumer attention that neither brand could get alone.” Banking has used co-branding to great advantage, especially in the marketing of credit cards.

Shopping center companies have taken a different tact with regard to co-branding. They are using the relationships with other branded products to jumpstart their own branding campaigns. In what could be best described as a “riding the coattails” mentality, shopping center companies are linking with other established brands to accelerate their brand recognition efforts.

Simon has affinity relationships with Pepsi, Visa, and AT&T, where products are featured prominently in Simon shopping venues and advertising. These products, on the other hand, access Simon’s 2.3 billion shopper visits, which serves as a vehicle for their continued growth. According to Lauchenaer,¹⁰⁵ these relationships enable Simon to deliver discounts to customers and customers to

the retailers. One of the goals is for Simon to make its malls prime promotional real estate for non-retail marketers.¹⁰⁶

General Growth Properties is using a web site called Mallibu.com as its branding vehicle. It advertises Mallibu.com as the industry's first full interactive, "true" mall web site. General Growth recently conducted a back-to-school promotion and sweepstakes with Pepsi-Cola, Virgin Records, Phillips, TWEC.com, and Playhear.com aimed at creating awareness of the Mallibu.com web site and driving traffic to its malls.

DOES MALL BRANDING MAKE SENSE?

Fox¹⁰⁷ says that in the current marketing climate, when such a premium is placed on accountability, it is surprising that corporate branding is receiving such prominence. Compared with product-related initiatives, it is extremely difficult to measure the impact of branding and justify its expense, according to Fox.

Cebzynski¹⁰⁸ posits that brand campaigns do not always work, usually because the positioning conveyed is confusing. Hal Ritchie, principal of the Ritchie Branded Resource Group, believes that mass merchants have approached branding in an incorrect manner by not knowing what part of the market to go after – some or all.¹⁰⁹

Change for the sake of change is a pretty worthless idea, according to Marconi.¹¹⁰ He says that businesses should not do something without a reason.

In an article in *Shopping Centers Today* magazine, Hazel¹¹¹ asks the question, "Is Branding Working?" Hazel quotes Stephen Moore, an Oxford, Maryland-based marketing consultant who has served in senior marketing posts with retail real estate companies, The Rouse Company and Horizon Properties. Moore says, "It's a mistake for neophyte packagers to think you can put a name on a package and it becomes a brand."¹¹² Hazel says that the answer to the question of whether branding is working for retail real estate companies depends on whom you ask: shoppers or Wall Street analysts.

Gardner¹¹³ states that "branding" is a grammatically suspect term. Branding, according to Gardner, has been "the hot topic in professional circles, the most popular class in graduate marketing programs, the most hyped concept in the field of marketing, and the most misapplied tool marketers have at their disposal."

Docters¹¹⁴ indicates that brands are not always worth the time and attention they are getting. In fact, he says, there are times when companies should invest heavily in a brand and there are other times when they should refrain from heavy investment. The trick is knowing which course to take.

According to Docters, there are so many different definitions of brand equity that many brand managers think of it in fuzzy terms and therefore adopt general or "shotgun" measures for branding. This is a mistake, he says. Brands have specific uses and businesses should invest in branding only with specific aims in mind. This is the "rifle" approach.

Docters says that branding plays an especially powerful role in markets characterized by a high degree of uncertainty or mystery. In such markets, sheer belief or trust on the part of consumers can outweigh nearly all other considerations.

This raises the question of whether there is uncertainty or mystery in shopping centers. If one venue has a certain retailer and one does not, the customer will go to the shopping center that has the desired retailer. Branding does not play a part in that analysis, but rather the customer's need or want to shop where their preferred retailers are located.

Docters goes on to say that, based upon experiences in various markets, branding is most effective when applied with precision to specific customer decisions; the aforementioned "rifle" approach. Using this approach, Docters has formulated three rules for branding:

1. Brand is a function of audience, product, price, and message, not your company.
2. Target the decisions, if you can.
3. Be selective in spending on brand.

Docters states that "brand is most powerful when tailored to the decisions your customers make – a rifle approach. In particular, a brand is a tool for swaying customers and potential customers who cannot or will not fully investigate all aspects of their purchase decision.

Whether shopping center companies are branding a product or service, Murphy¹¹⁵ indicates that 19 out of every 20 new brands fail and frequently the reasons for this failure cannot be determined. He states that failure of a brand can often be traced to the fact that the new products or services are insufficiently differentiated, of the wrong quality,

incorrectly priced, inadequately supported, inadequately distributed or in some other way not appealing to the consumer. The producer of a new brand must be prepared to invest heavily in the new brand even though the chances of success are small.

In a chapter called "Branding the Corporation," Mottram states that, "the key challenge for companies at the end of the twentieth century will be realizing the potential of their corporate brands. In today's markets, companies increasingly compete on the basis of intangible factors and the reputation of the corporation itself is often the most valuable and most misunderstood intangible of all."¹¹⁶

Contrary to the popular marketing mantra that a famous name is all an entity needs, Mottram states that, "Companies are realizing that possessing a well-known name such as Shell, Visa, or CBS does not, in itself, signify a strong corporate brand. Finding techniques for branding the corporation effectively is now more important than ever."

Mottram states that companies that focus on their corporate brands will lead their markets and be the creators of new categories and opportunities. "In tomorrow's competitive markets, only the bravest or most foolish should overlook the potential of their corporate brand."

Hart¹¹⁷ posits that, "Brands are financial assets, every bit as much as plant machinery and stock. Indeed, brands are arguably the most valuable assets of all in that, in theory, they do not have a finite life and therefore will not depreciate."

DOES THE CUSTOMER CARE?

A corollary question to whether mall branding makes sense is the issue of whether the customer cares about the brand of the mall or shopping venue. Cebrzynski¹¹⁸ says that branding is a powerful tool, but it is also the current darling of marketers. He calls it the latest marketing "rage."

Martinez¹¹⁹ quotes Alf Nucifora, of the strategic consulting firm, Nucifora Consulting Group, who states, "My question is: Does the consumer care? My visceral response is that it really doesn't seem to make a lot of sense, certainly not from the consumer perspective. I would doubt that a customer is going to care whether or not the local mall is owned and managed by a certain company."

Rohlander¹²⁰ says that as consumers cultivate discernment, the need to have a brand strategy is

Murphy indicates that 19 out of every 20 new brands fail and frequently the reasons for this failure cannot be determined. He states that failure of a brand can often be traced to the fact that the new products or services are insufficiently differentiated, of the wrong quality, incorrectly priced, inadequately supported, inadequately distributed or in some other way not appealing to the consumer. The producer of a new brand must be prepared to invest heavily in the new brand even though the chances of success are small.

increasing. Branding, he indicates is about creating an image in the eye and mind of the customer.

Arnold, Handelman, and Tigert¹²¹ found that consumers patronize stores that are easier to go to and offer lower prices. They found that the impact of symbolic actions of retailers such as community involvement, attractive displays and other amenities can influence store choice in a positive way in the customers' minds. Since consumer patronage is measured by store choice, the retailers that make extra efforts will capture the customers. Shopping centers that have these retailers will be the ones to which the consumers will gravitate, which lends credence to the position that it is the stores, not the center that contains the stores, that is the determinant of where customers will shop. Shopping center branding may enhance this effect if shopping center companies avail themselves of the co-branding effect of using these retailers as attractors.

Central place theory states that consumers patronize the nearest shopping venue, however, they also tend to make disproportionately more trips to larger centers, which gives retailers at larger centers a competitive advantage.¹²² Agglomeration research shows that centers with more anchors, which by necessity are the larger centers, are better locations for smaller stores because of increased traffic.¹²³

Larger centers are attractive to most customers. Retailers at larger centers have a competitive advantage and the larger shopping centers that can provide space for these retailers have a competitive

advantage as well. If shopping center companies can imprint upon the mind of the consumer that they are the place where consumers can find what they are looking for, this branding should result in increased customer trips and locating of desired retailers in their shopping venues.

This position is confirmed by Huff¹²⁴ and his basic gravitational model which shows that the drawing power exercised on a consumer in an area is directly proportional to the size of the retail center and inversely proportional to the customer's distance or travel time to the shopping center.¹²⁵ According to Nevin and Houston,¹²⁶ a large center means greater utility for the consumer since it has a larger product assortment, but distance represents a dis-utility to the consumer.

In their study, Nevin and Houston added a retail image component to the Huff gravitational model. They found that the assortment of preferred retailers has a strong influence on the consumer's level attraction to a shopping center. Nevin and Houston also found that a "special store" variable is highly predictive of drawing power. According to Nevin and Houston, consumers are drawn to a particular center because of the existence of a special store that appeals to them.

Finn and Louviere¹²⁷ confirm that the nature of the retailers at a center impacts patronage. In a study of anchor store contribution to shopping center image, they found that 70 to 90 percent of the variance in collective perceptions of shopping centers could be accounted for by store mix and the presence of particular major and discount department stores. Discount department stores had a consistently negative impact on such favorable center perceptions as high quality, wide selection, good service, and latest fashions. In fact, Finn and Louviere found that the number of discount department stores accounted for the greatest proportion of image variance.

While branding of a shopping center name has become a major initiative with these companies, the retailers that are available for customers to shop at these venues is of critical importance. There is an assumption as set forth above that the branding effort of the shopping center companies may make their venues more attractive for the retailers desired by the consumers. It would appear, however, that there is a catch-22 working here, in that, shopping center companies need the retailers to attract the customers, but need the customers to attract the retailers. The branding effort may enhance this

In order for branding to be a worthwhile endeavor for a given shopping center company, it needs to bring something to the party that is better than or different from what every other shopping center company is doing. There has to be a special quality or special qualities that one shopping center company has that another does not. With those qualities comes a promise from the shopping center company to consistently deliver them to the consumer.

three-way attraction, but only as long as the shopping center companies can make good on their promises to both the customers and the retailers.

Taher, Leigh, and French¹²⁸ found that customers need to be delighted beyond their expectations to make them recommend a store. Customer delight can be delivered through service augmentation, which is the responsibility of everybody in the retail operation. According to Taher, et.al., patronage loyalty is developed on both past, unexpected delightful experiences and future expectations.

The analog here is that shopping center companies must deliver not only the stores that provide the "delightful" experience, but also must provide a delightful experience for the whole shopping trip. If customers associate their delightful shopping with the name of the shopping center company providing it, then branding would be of some merit. Otherwise, the branding effort may be for naught.

De Chernatony and Riley¹²⁹ talk about the "virtuous circle of service branding." They state, "One might think in terms of a virtuous circle, wherein a strong "company as brand" identity permeates all services provided by the organization and differentiates them from the competition, by providing a relevant focus to both consumers and employees. This can be achieved using internal marketing to motivate the employees, stimulate them to offer a better service, and to delight customers. In turn, this delight makes the service company more differentiated from competitors and more relevant to consumers. Favorable word-of-mouth then spreads, reinforcing an image in consumers' minds consistent with the caring identity the company wants to

project, completing the virtuous circle of service branding."¹³⁰

According to Stephen Moore, it makes no sense to brand a regional shopping center for the shopper.¹³¹ Moore says, "What they're (shopping center companies, supplied) doing is not branding; it's closer to institutional advertising."¹³² Moore goes on to say that the analogy of successful branding of other companies, products, and services may not work with shopping centers. "Think about when the choice of where to shop is made—When we're home 30 minutes from the mall. It's about convenience."¹³³

Ziccardi and Moin¹³⁴ ask the question "Is a Great Name Enough to Make a Successful Brand?" The answer, they claim, is that there is a long list of products and stores that stand for nothing in the minds of customers. Unfortunately, according to Ziccardi and Moin, the people behind these products or running these stores do not know it. They say that consumers are not fooled and, eventually, these products and even the stores disappear.

Mottram¹³⁵ states that, "The most important factor that shapes the corporate brands of tomorrow will be the increasing sophistication of consumers. When it comes to consumption, the public is increasingly media-advertising-design-brand- literate and, after more than 50 years of the consumer society, has lost its naivete. It seems unlikely, therefore, that companies will ever be able to 'dazzle' the consumers with empty promises again. This has fundamental implications for all brands, not least for corporate brands."

CONCLUSION

In order for branding to be a worthwhile endeavor for a given shopping center company, it needs to bring something to the party that is better than or different from what every other shopping center company is doing. There has to be a special quality or special qualities that one shopping center company has that another does not. With those qualities comes a promise from the shopping center company to consistently deliver them to the consumer.

Shopping center companies must create in the minds of their customers an engram, where the name of the shopping center company is independent of the designated shopping venue. As with Westfield (supra), the consumer's mindset as they think about a shopping trip needs to be such that they want to go

to branded mall instead of just a generalized idea to trek to the local shopping venue.

If it can be done correctly, branding can be a powerful tool in the shopping center marketing "tool box." If done incorrectly, all the shopping center company will have accomplished is to slap its name onto its centers with no discernable end result. Branding can enable a shopping center company to tap into a set of stored values and create a covenant relationship with the customer.

Shopping center companies need to realize that the branding process can occur very quickly in the current age of "hype marketing." Brand equity can result in the necessary awareness, perceived quality, and strong associations that shopping center companies want to create in their customers.

It is up to the shopping center companies to deliver the goods. They not only need to market themselves to consumers. Shopping center companies must market their centers to the desired retailers. It is a territorial imperative that the shopping center venues contain the retailers that customers want to shop. A shopping center company can create all the brand equity it desires, but if a customer wants to shop at Old Navy, TJ Maxx, Abercrombie & Fitch, etc. and the given center does not have that particular retailer, the customers will go where those retailers are located.

Central place and agglomeration theories are important in this context. The larger and more proximate the center, the stronger likelihood that customers will shop there. Delighting the customer once they make the journey to the center is the essence of whether branding in a given instance will be effective.

If shopping center companies can deliver the shopping center experience in an entertaining and interesting environment with the kind of retailers that customers want to shop in a convenient venue, then branding may be a worthwhile endeavor. If not, the shopping center company will likely stand for nothing in the mind of the consumer and they will not survive the branding.^{REI}

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IS ORGANIC CHANGE A BETTER OPTION THAN ACQUISITIONS AS A GROWTH STRATEGY?

by John McMahan, CRE, & Tom Hester

Organic growth strategies appear to be gaining favor as real estate firms find a lack of public market support for mergers and acquisitions. This manuscript explores the record of M&A transactions, both in the general business community and the real estate industry, and how they can be utilized more effectively. Organic growth initiatives, which are broadly defined to include all non-acquisition strategies, are then discussed with some thoughts on how they can be successfully implemented.

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HOW DO MERGERS AND ACQUISITIONS MEASURE UP AS A GROWTH STRATEGY IN GENERAL?

Several studies conducted over the last 12 years conclude that most merger and acquisition transactions, involving all types of firms, fail to create positive shareholder value (*Exhibit 1*).

These studies identify the primary causes of M&A failure as being due to a variety of factors:

- Weak core businesses
- Target size too large
- Overly simplistic appraisal of market potential
- Overestimation of synergies
- Overbidding
- Slow post-merger integration
- Inadequate due diligence
- Lack of compelling strategy
- Conflicting cultures
- Lack of vision
- Lack of alignment

Exhibit 1

Post-Merger: Success or Failure? ¹

Study	Year of Study	Number of Companies	Definition of Failure	Percent Failed
McKinsey	1987	116	Did not earn back capital in three years	77%
Mercer	1995	150	Poor shareholder returns after three years	50%
Coopers & Lybrand	1996	125	Low revenues, cash flow, profitability	66%
Mercer	1997	215	Poor shareholder returns after three years	63% (1980s) 48% (1990s)

McKinsey and Company found that only 23 percent of corporate mergers recovered costs. Furthermore, many top managers regarded cultural chemistry as a pesky detail that could safely be left to the folks in human resources.

Some studies indicate that most transaction value, if not all, goes to the acquired firm, with the biggest stock increases occurring just after announcement. Furthermore, while acquisitions outside the acquirer's existing business can be strategic, Wall Street may not recognize added value. Many conglomerates have spun off previously acquired firms in order to avoid Wall Street's pricing "penalty."

Interestingly, neither the strategic nature of the acquisition or the price paid increases the odds of success significantly.² On the contrary, the more strategically motivated the buyer, the higher the premium paid, especially in industries such as real estate that are undergoing fundamental restructuring. After discounting strategy and price as primary factors of transaction success, the probability of creating value is dramatically improved by superior post-merger execution. Basically, an M&A deal is won or lost after it is closed.

REAL ESTATE FIRMS

REIT merger and acquisition activity garnered many of the industry headlines two-three years ago. By 1999, however, activity had decreased dramatically.

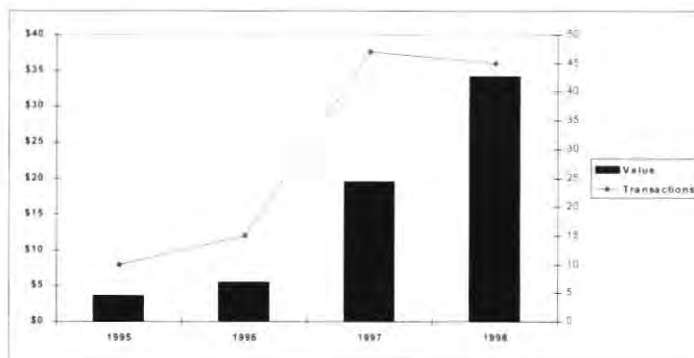
In the first two quarters of 1998, 40 real estate M&A transactions were closed or pending, representing an aggregate value of \$31.5 billion — one and one half times greater than all of 1997.³ In 1999, however, only eight public REIT M&A transactions valued at \$7.8 billion were completed.⁴

In *Exhibit 2*, the frenetic M&A activity in the first half of 1998 was largely driven by a desire to maintain the strong revenue growth that REITs had exhibited in 1996 and 1997. At that time, the REIT market had outperformed the S&P 500 in 13 out of the previous 21 years and five out of the previous seven years.

Several of these mergers reflected REITs becoming more involved in activities with higher returns such as cold storage, gaming, and international real estate. It also reflected increasing venture capital activity with several new REITs focusing on prisons and auto dealerships.

There also was an emerging school of thought that greater economic size was inevitable in a mature industry such as real estate and that mergers were the best way to create larger economic units.⁵ Several managers believed that mergers should be accomplished as rapidly as possible in order to "bulk up" while potential acquisition targets were still available, many at less than their Net Asset Value (NAV). Greater scale also would lead to lower operating costs, it was believed, as fixed costs were absorbed over a larger revenue base. This

Public & Private REIT M&A Transactions



Source: Prudential Real Estate Investors;
Security Data Corporation

(Dollars in billions)

strategy appeared to be generally supported by the market, with larger REITs tending to have higher market valuations.⁶

There were also several “strategic” mergers. Avalon Properties acquired Bay Apartment Communities to create a national organization. Security Capital’s Pacific and Atlantic entities merged to accomplish a similar objective. BRE Properties acquired a division of Trammel Crow Residential (TCR) in order to secure a development pipeline in growth-constrained Western markets and the management to successfully implement that strategy. Merry Land & Investment Co. and Gables Residential Trust picked up other TCR units.

The first two quarters of 1998 represented the end of the 1996–98 REIT merger flurry with only a few transactions occurring during the remaining six months. At year’s end, the total REIT merger volume stood at \$34.2 billion. A significant number of these transactions involved private companies merging into public firms.

How successful were these mergers? Siering and McIntosh compared the investment performance of 34 REIT mergers with the broader Morgan Stanley REIT (RMS) Index for the 1996–98 period.⁷ They concluded that the merged companies generally *under-performed* the RMS benchmark subsequent to the completion date. The researchers attributed this to:

- Investors clearing out positions in one or both of the merging companies;

- Failure to realize cost savings through economies of scale;
- Problems created by a conflict of company cultures

Their conclusions were the same even after testing for different sub-sets of the time period and whether the firm was the bidder or target company. They concluded that there was only a 29 percent to 39 percent chance of a merged firm outperforming the RMS Index. Siering and McIntosh also looked at the level of trading volume of the merged companies and concluded that, while trading volume increased in the first month before the merger, it returned to historical volume levels within 12 months.

HOW CAN MERGERS AND ACQUISITIONS BE UTILIZED MORE EFFECTIVELY?

Most of the research seems to point to the post-merger period as being the critical time during which a merger either succeeds or fails. Hersham identifies three attributes of post-merger management that correlate with above-average success:⁸

- Compelling deal logic, well-communicated both internally and externally;
- Close attention to aligning the merging companies’ cultures and other organizational attributes;
- The overall speed and focus of the transition program

Another study indicates that acquisitions of firms related in product/market or technological terms seem to create higher value than unrelated acquisitions.⁹

THE IBM-LOTUS MERGER¹⁰

Factors that intuitively would result in a successful merger were carefully considered before IBM announced its \$3.5 billion acquisition of Lotus Development Corporation in 1995.

Strategically, IBM gained a leadership position in a key market in which it would have otherwise been struggling. Conversely, Lotus gained the resources to jump-start the sales of its flagship product, *Notes*, which was being pushed into irrelevance by a marketplace increasingly dominated by Microsoft.

Many observers thought that the merger would not succeed, believing that Big Blue's buttoned-down culture would dominate the creative and free-spirited software firm. They also feared that the uncertainty surrounding organization, compensation, and management would cause a large exodus of Lotus executives. But IBM needed Lotus as much as Lotus needed it, and IBM didn't let ego or dominance prevail. Instead, IBM executed a clear, simple, and carefully thought-out plan that:

- Offered a generous price – high enough to halt potential bidders – avoiding protracted talks and negotiations;
- Moved quickly, reassuring Lotus employees its commitment to *Notes*, and of management autonomy, strengthened by an extensive public relations campaign with the high-tech community, investors, and customers;
- Took steps to maintain Lotus' cultural values, including appointing a dedicated communications person between the two companies;
- Maintained Lotus systems, benefits, compensation, and stock option programs;
- Practiced patience at every crucial juncture, acceding to the wishes of the acquired company rather than forcing its will during the volatile period when connections were being made and relationships formed.

By any reasonable measure, the deal has been a tremendous financial success, meeting and exceeding nearly all strategic objectives and projections. With this transaction, IBM turned an \$8 billion loss in 1993 into earnings of \$6 billion by 1997, while adding \$75 billion in market capitalization. It's no wonder why this deal has become a "best-practices" blueprint for M&A.

HOW CAN A REAL ESTATE FIRM SUCCESSFULLY DEVELOP AND USE AN ORGANIC

GROWTH STRATEGY?

Despite the success of the IBM-Lotus merger, a firm that considers mergers and acquisitions as its core growth strategy will, at some point, if not already, be disappointed. REITs and other real estate firms who wish to grow should now, more than ever, give serious consideration to organic growth as a more dependable way to accomplish strategic objectives.¹¹

Initiatives that enhance productivity or increase market share (revenue based), or those that reduce expense or improve efficiency (cost based), allow a real estate firm to grow in an orderly fashion, building a strong organization along the way.

There are numerous ways to stimulate organic growth, encompassing a broad array of restructuring tactics:¹²

- New product introductions and new business initiatives, including joint-ventures, strategic alliances, etc.;
- Cost-cutting programs such as downsizing, shedding poor performing products or business units, space consolidations, etc.;
- Implementing efficiency-enhancing programs such as systems upgrades, reorganizing business units, relocations, etc.

Recent studies of the performance of restructured firms provide some interesting, and often conflicting, findings. Some studies conclude that restructuring can improve economic performance and growth, but others report negative findings. This is probably due to the diverse array of company actions taken, including, for example, selling off mature or unprofitable business lines for new business units, eliminating debt, repurchasing stock, and downsizing work forces.

In a recent review of research on the subject, Bowman and Singh analyzed three types of restructuring:¹³

- **Portfolio restructuring** – significant changes in the mix of assets owned by a firm or the lines of business in which a firm operates, including liquidation, divestitures, asset sales, and spin-offs;
- **Financial restructuring** – significant changes in the capital structure of a firm such as leveraged buyouts, leveraged recapitalizations, stock buybacks, and debt for equity swaps (the current capital markets have made these somewhat more difficult to execute);

- **Organizational restructuring** – significant changes in the organizational structure of the firm, including divisional or operational redesign (increasing productivity or efficiencies), and employment downsizing (reducing costs)

There are clearly some trade-offs in any restructuring. For example, over the short-term, reductions in overhead may appear to have been successful, but the corporation could have exhausted its profit-producing ability along the way. The firm also may not have carefully considered the longer-term impact of its cost cutting activities, and as a result, did not make other changes necessary to improve the likelihood of success.

WHAT ARE THE BENEFITS TO INVESTORS?

Bowman and Singh argue that restructuring performance measures are either based on market performance (movement in stock price, typically realized quickly) or accounting performance (return on equity, return on investment, and growth measures, realized over a succession of periods).

The authors found that financial restructuring had the strongest positive returns among the sample of studies analyzed, but this is largely due to high returns reported in leveraged and management buyout transactions. Portfolio restructuring displayed the next highest returns, with organizational restructuring having the least impact (*Exhibit 3*).

These results indicate that organizational initiatives alone provide little or no impact. The authors further refined their analysis and determined that, when organizational restructuring is combined with portfolio restructuring, a higher likelihood of positive effects on performance will occur. Thus, organizational restructuring is more likely to be effective when accompanied by changes in the business portfolio of the firm, or, in other words, as part of a larger overall strategy. The companies in the Bowman and Singh study offered the stock market a range of reasons for their organizational changes. Among the leading rationales were:

- Preparation for expansion into new markets or product lines;
- Actions to improve decision-making or operational efficiencies;
- Steps to reduce operating costs

An analysis of these firms revealed how the stock market responded to the change announcements. When the announcement offered no explanation, the market, on average, did not move. When the firm reported that its actions sought to take advantage of investment opportunities or to achieve greater operational efficiencies, stock prices increased moderately.

The authors also found that the initial impact on the company's accounting measures was not favorable. Earnings performance generally does not

Exhibit 3

**Average Impact of Restructuring
on Company Performance¹⁴**

Restructuring Method	Mean Improvement	Median Improvement	% Positive Means ¹⁵	Number of Studies	Average Sample Size
Portfolio	5.6%	2.9%	86%	21	154
Financial	38%	25%	86%	27	35
Organizational	-.2%	.1%	50%	4	207

Source: Bowman, Singh

improve in the years immediately after such an initiative. This may be due to higher initial expenses, (for example, capital expenditures, or severance payments connected with employee downsizing), with earnings growth not realized until some time, perhaps even years later.

ORGANIC GROWTH STRATEGIES

AMB

In 1998, AMB Property Corporation, an industrial and retail REIT, announced that it was combining a portfolio and organizational restructuring as a single strategy. The goal was to improve customer knowledge, technology and e-commerce competencies as part of a larger strategy to become a logistics-enabling firm. The portfolio restructuring included a sale of their approximately \$1B+ neighborhood shopping center portfolio. In turn, the funds generated are being invested in high-throughput distribution properties that benefit from the fundamental changes occurring within the supply chain. Much of this change is being driven by just-in-time inventory practices and by e-commerce retailers such as Webvan.

In terms of organizational restructuring, a senior information technology executive was appointed to develop the firm's use of technology into a competitive advantage. AMB's plan is consistent with the research findings that organizational change is more likely to be effective when accompanied by changes in the business portfolio of the firm.

BRE Properties

Since its restructuring in 1996, BRE Properties, a western states multi-family REIT, had relied upon mergers and acquisitions to fuel double-digit annual growth. When the stock market soured on REITs in 1998 – 1999, BRE began a search for an organic growth strategy that would not be dependent on the public capital markets. Two initiatives were undertaken — one traditional and one quite innovative.

The first was a joint-venture program with institutional lenders in which BRE would be the managing partner responsible for implementing each of the projects. BRE would invest its own cash up to 25 percent - 35 percent of the total equity required and receive a carried interest for an additional 15 percent - 25 percent. The institutional partner received a preferred annual return and did not share in construction risk. This initiative did not

have major organizational ramifications other than a new marketing program to solicit investor interest and manage the joint-venture process.

BRE's second initiative was more radical, involving the development of Velocity, a high-speed communications access system for its apartment communities. The program then expanded to include the development of community portals where a resident could surf the web, order goods and services from local and national vendors, and advise the property manager when some aspect of the apartment needed maintenance.

This initiative required significantly different human resources than BRE's traditional businesses. Lacking these skills internally, BRE choose to form alliances with a wide variety of firms such as Cisco Systems to "partner" various aspects of the program. As the program moved into implementation, and it was apparent that it would be successful, BRE decided to spin off the operation into a new company that would be independently staffed and managed. BRE is currently exploring expanding the service to other multi-family owners.

HOW TO IMPLEMENT AN ORGANIC GROWTH STRATEGY

The implementation of an organic growth strategy is going to vary with the individual characteristics of each firm, its culture, and where it is in the marketplace. There are, however, some key elements that will be shared by most firms.¹⁶

It has been suggested that organizational initiatives alone will have a minimal positive financial impact on the firm. Nevertheless, the first objective is to get the current organization under control.

- Concentrate on blocking and tackling. Strengthen core competencies; outsource everything else. Never forget that transforming the existing organization is job #1;
- Start small; pick winners. Focus on manageable projects that can be successfully accomplished in a relatively short time period and that will re-enforce employees' sense of accomplishment;
- Reproduce winning combinations in closely related projects. Apply skills mastered to build a "family" of projects where the whole is greater than the sum of the parts;
- Continually test the organization; discover where it is over-structured and under-structured; re-distribute the former, re-enforce the latter

Once the organization is operating smoothly, begin to undertake some broader, more far-reaching initiatives.

- Bring in a wide range of outside people who think about the future; open up new channels of management thinking. Do it on a regular basis;
- Critically evaluate your record in introducing new initiatives and products into the marketplace; what worked and what didn't and why; evaluate the amount of firm resources required to develop new initiatives; at a minimum, expenditures should be 10 percent to 15 percent of total annual expense;
- Identify key trends in the economy and society; tie each trend to the strengths and weaknesses of the firm as it exists today. Think "out-of-the-box," looking for opportunities where firm strengths can be deployed; identify competitive weakness where the firm could be threatened in the future;
- Monitor the capital markets closely and keep an eagle eye on your competitors. Immediately consider the impact on returns of new financial structures and engineering; understand competitor positioning and pricing, and all key initiatives;
- Continually prioritize the list of opportunities and threats; establish management teams to work on those with the greatest promise (loss); make this an on-going process with senior management personally involved;
- Fund and implement one or more initiatives and monitor them regularly and critically

Organic growth is not as exciting or fast moving as mergers and acquisitions. Properly organized and executed, however, it can provide lasting value to the firm, its customers, and investors. Since organic growth basically leverages existing strengths, it not only can provide new opportunities, but can also help revitalize existing operations by creating a culture of innovation and experimentation. In the long-term this may be more critical to firm success than the dazzle of the merger.^{REI}

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3. "REIT M&A Activity: A Sign of the Times," *Prudential Real Estate Investors Investment Research*, September, 1998.
4. National Association of Real Estate Investment Trusts, April 11, 2000.

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7. Barry Ziering and Willard McIntosh, "REIT M&A Outcomes: When to Hold, When to Fold," *Prudential Real Estate Investors Investment Research*, April, 1999.
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12. Restructuring is considered an organic growth strategy.
13. Bowman, Edward; Singh, Harbir; Useem, Michael; and, Bhadbury, Raja, "When Does Restructuring Improve Economic Performance?," *California Management Review*, Vol. 41, No. 2, Winter 1999.
14. Performance defined as market and accounting performance measures.
15. Indicates the percent of studies that reported positive means; e.g., in 50 percent of the cases of organizational restructuring, the impact was positive.
16. This discussion is based on Shona L. Brown and Kathleen M. Eisenhardt, "Competing on the Edge, Strategy as Structured Chaos," *Harvard Business School Press*, 1998.

ABOUT THE AUTHORS

(continued from page 28)

principal. He became managing principal of the firm in May 2000, where he leads the firm's independent fiduciary services and all financial and investment engagements, as well as involvement in strategic planning services. Hester brings 15 years of experience in financial structuring, valuation and due diligence, strategic planning, capital market analysis, and financial restructuring/workouts. (Email: hester@mcmahan-group.com)

EVALUATING THE RESIDENTIAL INVESTMENT POTENTIAL IN OLDER URBAN AREAS: A CASE STUDY

by Richard Gsottschneider, CRE, & Fred Pulitzer

ABOUT THE AUTHORS

Richard Gsottschneider, CRE, is president of RKG Associates, Inc., located in Durham, NH. There, he specializes in adaptive reuse of buildings and urban revitalization and market research. (Email: richard@rkg1.com)

Fred Pulitzer is a senior project manager RKG Associates, Inc., where he specializes in urban revitalization. (Email: fdp@rkg1.com)

Since 1992, the beginning of the current economic expansion, residential real estate has performed very well across much of the U.S., however the evidence suggests that much of this appreciation has occurred either in the suburbs or in the major cities (e.g., New York, Boston, San Francisco). For example, in Massachusetts median housing values for the entire state increased by 10.8 percent for the period from 1990 to 1998, whereas in Boston they increased by 41.7 percent. In contrast, smaller cities in Massachusetts with populations between 50,000 and 100,000 people experienced an overall 2.8 percent decline in residential property values during the same time frame. The purpose of this manuscript is to both explore the question of whether or not these smaller, older urban areas represent an investment opportunity in this new millennium, and to identify what criteria an investor should utilize in helping to evaluate future investment potential in these areas. A case study approach is used to help address this question, and eight cities in Massachusetts form the basis for this analysis. These cities, and their estimated 1998 population, are listed in *Table 1*.

WHY IS THIS ISSUE RELEVANT?

One school of thought regarding the investment potential in an older urban area might be to simply avoid it; too much risk and uncertainty. However one only has to think back 30 years to realize that some of our major cities (e.g., Boston) were once questionable locations for residential investment, and today they represent some of the highest residential values in the U.S. Do the smaller cities represent a similar growth

Table 1

1998 Population of Targeted Cities in Massachusetts

City	1998 Population	% Change Since 1990
Lowell	100,663	-2.7%
New Bedford	96,108	-3.8%
Brockton	92,379	-0.4%
Fall River	90,443	-2.4%
Quincy	85,733	0.9%
Lynn	80,786	-0.6%
Somerville	74,222	-2.6%
Lawrence	68,563	-2.3%

Source: Claritas, Inc. and RKG Associates, Inc.

opportunity when viewed from an investment perspective? The authors believe they do, under certain circumstances.

Several overall trends suggest that the smaller, older urban areas will see improved performance of their residential real estate, and each of these trends are discussed briefly:

- **Smart Growth:** Most of the politicians want to place more emphasis on good planning and mass transit and place less emphasis on suburban sprawl. This should translate into more funding for urban redevelopment, which would directly benefit the small- to medium-sized cities which have the available infrastructure to accommodate growth. Equally important, many suburban areas throughout the U.S., and particularly in the Northeast, are seeking to slow growth.
- **Lifestyle and Demographics:** Two age cohorts, the 20 to 29 year-olds, and the 55 and over groups, have the potential to be attracted into older urban areas if the cultural amenities can be sufficiently enhanced to appeal to the lifestyle interests of these groups. Many smaller cities, such as Portsmouth, NH; Burlington, VT; and

Portland, ME, have already demonstrated this potential by focusing on culture, restaurants, and specialty retail, taking advantage of their waterfront selling. The potential for this trend to continue is substantial, and the opportunity to link this initiative together with colleges located in older urban areas will become increasingly important. Likewise, many smaller cities are becoming more sophisticated, developing urban entertainment centers and sports and cultural attractions, again directed to these targeted markets.

- **Growth in Downtown Employment in the Major Cities:** Many of the major cities in the U.S. have experienced a tremendous resurgence in their downtowns as a result of concerted planning efforts over the last 20 years. For example, Boston has created over 50,000 new jobs in the past decade, many in the financial and legal services and technology sectors. This factor, coupled with the related development of cultural/restaurant venues, has lured workers to the major metropolitan areas, and in turn these people need a place to live. With residential prices escalating in the major cities, close-in urban locations with relatively more affordable housing would be likely beneficiaries. As the following analysis

will indicate, this fact is starting to happen in Massachusetts, and is likely to occur elsewhere in the U.S.

CAN SOCIO-ECONOMIC DATA BE USED TO IDENTIFY INVESTMENT OPPORTUNITIES?

For this case study, 20 variables were evaluated to see whether or not they could help explain the performance of the residential housing market in eight cities in Massachusetts (referenced in Table 1) from 1990 to 1998. Although these cities, when averaged together, under-performed the overall market, some performed better than others. The objective was to see if selected socio-economic data could be used to explain the performance differential between the eight cities, as well as provide a basis for predicting future performance. Residential market performance was measured in terms of median single-family and condominium unit pricing, as well as median rents.

The 20 key variables used in this analysis were grouped into three broad categories, and are discussed below. This data was chosen because it is readily available to prospective investors through both the public sector and private vendors, and because it provides a broad socio-economic overview of a city.

- **Demographic Trends:** These variables included population and household trends; social and ethnic composition; age distribution of the population; change in median household income; and Scholastic Aptitude Test (SAT) scores.
- **Economic Trends:** These variables included labor force and employment trends; trends in the number of businesses; average annual wages; and property taxes.
- **Housing Characteristics:** These variables include the mix of single-family and multi-family units; unit density per acre; the mix of renter versus owner-occupied housing; the age of the housing stock; and the number of rental-assisted housing units in the city.

HOW DID THE RESIDENTIAL MARKETS IN THE EIGHT CITIES PERFORM, AND WHY?

Referring to Figure 1 and Figure 2, the housing market performance of each of the eight cities is graphed. In Figure 1, median single-family residential prices are illustrated for 1990 and 1998. As the graph illustrates, Somerville and Quincy, two cities outside of Boston, outperformed the residential

Most of the politicians want to place more emphasis on good planning and mass transit and place less emphasis on suburban sprawl.

This should translate into more funding for urban redevelopment, which would directly benefit the small- to medium-sized cities which have the available infrastructure to accommodate growth.

Equally important, many suburban areas throughout the U.S., and particularly in the Northeast, are seeking to slow growth.

market of the State as a whole, whereas the remaining six cities actually experienced a decline. For residential condominiums, the performance of all eight cities was significantly below that of the State as a whole (no illustration is provided). Referring to the data in Figure 2, residential rents increased in all eight cities, as well as the state, from 1990 to 1998.

The greatest percentage increases in residential rents were in Somerville and Quincy, the two cities which also experienced the greatest increase in single-family housing values.

Can readily available socio-economic data help explain the overall under performance of the eight urban areas, when averaged together? Secondly, can this same data help explain why Somerville and Quincy outperformed the other six urban areas? The answer, in part, is yes. Let's explore why.

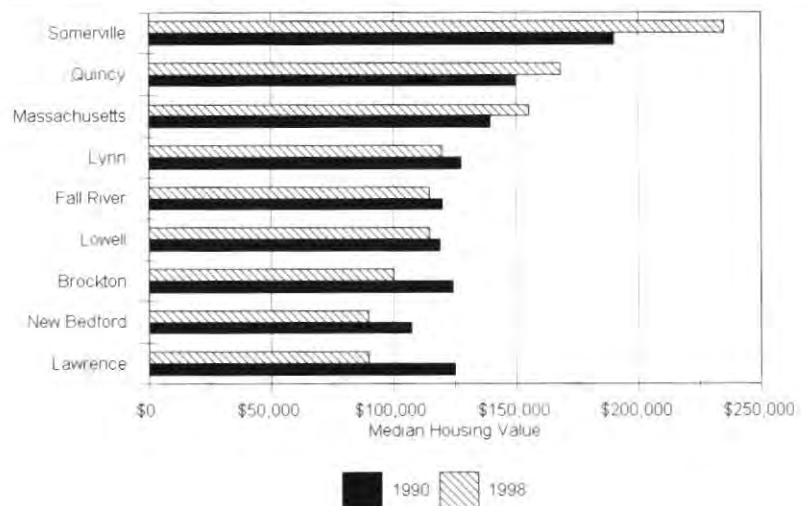
In general, the demographic statistics appeared to be the most revealing, and data relative to the housing stock, the least important in terms of explaining residential appreciation rates. More specifically, all eight urban areas either experienced overall population declines, or exhibited no real increase in population (Table 1). However, while the population was declining, the number of households in a number of cities, particularly Quincy and Somerville, was increasing. Also, the best performing markets had the highest concentration of people in the 20 to 29 age group, which correlates closely with the increase in the number of households.

Figures 1 - 3

Figure 1

Trends in Single-family Median Values

Eight Cities & Massachusetts
(1990 - 98)

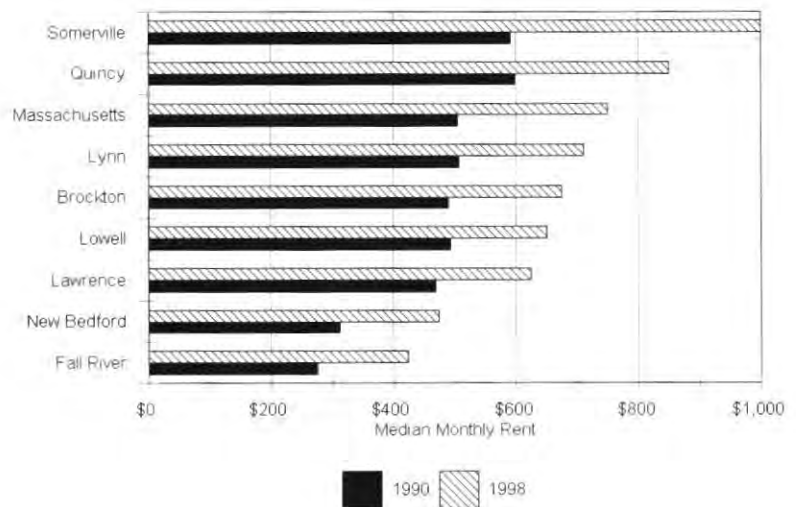


Source: Banker & Tradesman

Figure 2

Trends in Estimated Median Rents

Eight Cities & Massachusetts
(1990 - 98)

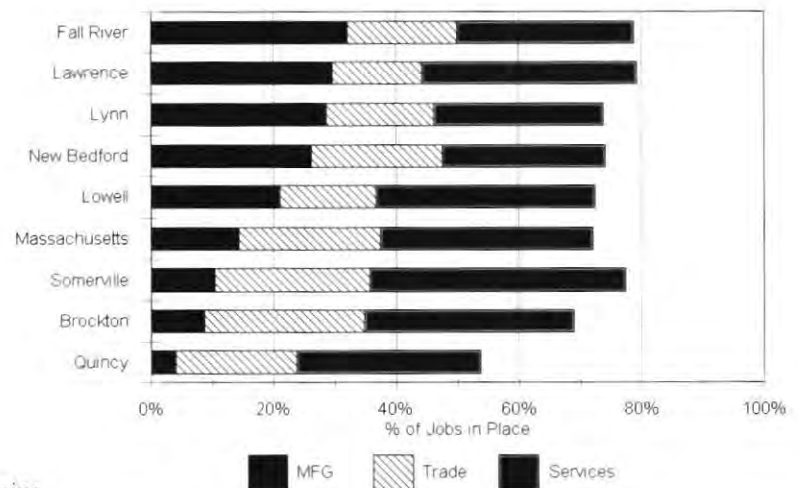


Source: U.S. Census and RKG Associates, Inc.

Figure 3

Distribution of Employment

Eight Cities & Massachusetts (1998)



Source: MA Database of Employment and Training

Concentrations of one ethnic group alone appeared to be a negative factor, but the data was not entirely conclusive in this regard, since ethnic diversity appeared to be a positive factor from a value perspective. Of particular interest was the lack of a direct linkage between residential market performance and SAT scores. In all eight cities, SAT scores were below the state average.

Employment growth in six cities had either declined, or was relatively flat, compared to an eight to 10 percent employment growth in Quincy and Somerville from 1990 to 1998. What also appeared to be significant in explaining residential values was the mix, or type of employment, particularly the mix between manufacturing, trade and services employment. Those cities with the least reliance on manufacturing jobs (e.g., Quincy) tended to exhibit the best performance within their residential markets (*Figure 3*). Cities like Fall River, Lawrence, and Lynn which were relatively more reliant on traditional manufacturing employment, and their for-sale residential market values had declined from 1990 to 1998. It is unclear whether this is a reflection of pay scale differential between manufacturing employment and trade/service employment or a "stigma" associated with living in an older manufacturing community. However, what is true is that the cities in Massachusetts with the greatest concentration of manufacturing were also the furthest away from Boston, the "center of growth," so perhaps they have been slower to transform their economic base to a more service-oriented economy.

Finally, housing stock characteristics were relatively insignificant in explaining for-sale and rental rate differentials between cities. More specifically there was no direct correlation between either the age of the housing stock, or the owner/renter mix, or unit density, in explaining value differences. Also, because these cities are largely built-out, there had been no major additions to the supply of housing during the past decade. Naturally the data utilized did not factor in such intangibles as architectural detail. However, one housing variable did prove to be important, and that related to the percent of the rental stock that was subsidized. This data suggested that cities with more than 10 percent of their rental housing stock allocated to subsidized housing were the most adversely impacted from a residential real estate values perspective.

CONCLUSIONS

Older urban areas outside of major U.S. cities represent a good residential investment opportunity in

the new millennium. Selected socio-economic data can be useful in helping identify which older urban areas to invest in, however by themselves, the data only provides part of the answer for an investor. Demographic trends appear to be important indicators of future residential performance, so an older city which seeks to reposition itself for the 20 to 29 year-old market is one to watch, even if its population is declining and its school system (as measured by SAT scores) is below average. Also of importance appears to be the mix of business within a city, particularly if the emphasis is on the service sector.

Finally, and perhaps most important, the question of location remains an important variable, although one which was not quantified in the case study. For example, both Quincy and Somerville have direct, frequent connections to the Massachusetts Bay Transit Authority (MBTA) rail system, which makes them relatively more accessible to downtown Boston. Other cities, such as Lynn, Brockton, and Lawrence also have rail connection to Boston, however the frequency of service is substantially less than Quincy and Somerville. Clearly the MBTA has market appeal to the 20 to 29 year-old age group, because they are the ones who are driving up residential values in the older urban cities outside of Boston.^{REI}

DEMAND FOR BIOMEDICAL FACILITIES

by Oakleigh J. Thorne, CRE

Prior to discussing the overall market demand for biomedical buildings or laboratories, it is important to understand construction and design attributes relating to various facilities and the safety features presently required to work with bio-toxins. Building design and handling practices and policies have been evolving since 1941. Although modest improvements in interior barrier designs and handling practices were evident since that time, significant and formal building design and practice changes occurred after 1980 with the discovery of the HIV. Even prior to this discovery, there was growing concern over the treatment of medical waste and its disposal. Since 1980, formalized approaches to facility design and the construction of primary and secondary barriers which impede the transmission of harmful pathogens have become national standards.

Present facility design and construction has evolved into four design types known as Bio-Safety Levels (BSL), and building classification depends on the biological agents present in the facility. Understanding the building type enhances the appraiser's knowledge regarding marketability, demand, and probable target industry issues. *Table 1* outlines the current four biosafety levels.

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Each of the BSLs listed in *Table 1* have different design complexities and related costs. Although labor and wage rates vary nationally, material and equipment prices remain fairly constant. At the risk of using a generality, construction costs to produce buildings that are BSL 4 compliant can range in excess of \$700 per square foot and even higher.

A review of the biomedical and microbiological industry provides a brief insight into the demand potential for obtaining tenants to fill proposed or existing laboratory buildings.

Table 1

**RECOMMENDED BIOSAFETY LEVELS (BSL)
AND BARRIER DESIGN STANDARDS**

BSL	Bio-Agents	Barriers	
		Primary Equipment	Secondary Facility
1	Not known to cause disease in healthy adults	None Required	Open bench counters with top sink required
2	Associated with human disease	Containment devices including: lab coats, gloves, and face protection	Autoclave devices should be available as required
3	Indigenous or exotic agents with the potential for lethal consequences	BSL Two plus respiratory protection as needed	BSL Two plus physical separation, negative airflow, and no air recirculation
4	Dangerous/exotic agents which pose high risk of life-threatening disease	Full-body, air-supplied, positive pressure personnel suit	BSL Three plus totally isolated zones, dedicated air supply exhaust, and decon systems

Source: National Institutes of Health

GLOBAL DEMAND ISSUES

According to the U.S. Department of Commerce, International Trade Administration's Chemicals, Pharmaceuticals, and Biotechnology Division, in its publication, *U.S. Industry and Trade Outlook 1998: Chemicals and Allied Products*, the United States leads the worldwide pharmaceutical industry in market share, research and development (R&D) spending, and the development of new therapeutic products. American firms accounted for 30 percent of the total worldwide market in 1994, followed by Europe (27 percent); Japan (22 percent); Latin America (7 percent); Southeast Asia (6 percent); and other areas (8 percent). In terms of R&D spending, U.S. companies account for about one-third of all pharmaceutical R&D work worldwide. U.S. firms spend heavily on new drug R&D, and enjoy a high degree of productivity from those investments. Of the 265 major new drugs developed between 1970 and 1992, almost half originated from U.S. firms, based on data from the Pharmaceutical Research and Manufacturers of America (PhRMA).

U.S. companies have found eager markets abroad, especially in developing and emerging economies. Based on PhRMA data, U.S. pharmaceutical companies expanded their drug sales from \$10.5 billion in 1980 to an indicated \$33.4 billion in 1996. Readily available and relatively low in cost, prescription

drugs are typically the first line of medical therapy throughout the world. With leading U.S. drug manufacturers generating, on average, close to two-fifths of their sales abroad, U.S. firms are affected by overseas demand, the tempo of foreign business, international regulatory conditions, and fluctuations in the dollar compared with other world currencies.

The European Community's Economic Union, formed in 1993, has made marketing in Europe more efficient and has streamlined the process for new drug approvals there. The union's new Committee for Proprietary Medicinal Products is a universal regulatory agency; drugs approved by this organization are automatically cleared for marketing in all 15-member states. In the past, regulatory clearance had to be obtained in each country where a drug was to be sold. Foreign sales have benefited recently from the formation of the economic union, the passage of NAFTA in 1994, and the revision of the General Agreement on Tariffs and Trade in 1995.

DIAGNOSTIC SUBSTANCES

The diagnostic substances subsector (SIC 2835) includes companies that make chemical, biological, or radioactive substances for testing blood or other bodily fluids and tissues. These substances may be

used for in vitro (test tube) or in vivo (administered in the body) testing.

In vitro diagnostic substances are used for diagnostic tests that are performed in containers or instruments and are used for identifying and measuring normal or abnormal constituents of body fluids or tissues. In vivo diagnostic substances are taken internally to enhance the images of targeted body organs or functions during a diagnostic imaging procedure such as magnetic resonance imaging or computed tomography. Diagnostic substances are used for the early detection of disease, to distinguish between diseases, or to monitor a present condition or level of therapy.

Domestic Trends

According to the above-mentioned *U.S. Industry and Trade Outlook 1998*, the diagnostic substances industry is considered a mature industry in developed economies and one dependent on an increase in the patient population and the introduction of innovative products to spur growth. Health care cost-containment, consolidation among producers and users, and advances in molecular biology are among the forces reshaping the diagnostics industry into the next decade. Since the early 1990s, cost-containment programs to reduce health care expenditures in the U.S. and major foreign markets have placed diagnostic tests under greater scrutiny as an area for potential savings. The spread of managed care organizations and consolidation within the ranks of hospitals and clinical laboratories, by far the largest end-users of diagnostic substances, have pressured suppliers to reduce prices. In this cost-cutting environment, there is a trend toward increasing the automation of testing equipment to handle more tests with faster turnaround times.

Nonetheless, an increase in demand for diagnostic tests and U.S. producers' international competitiveness have resulted in healthy gains for the industry over the last several years. The U.S. supplier industry is diverse, comprising more than 500 companies involved in developing new diagnostic tests, although only a handful dominate the U.S. market. Likewise, about 15 companies, mainly U.S. and European, account for 75 percent of the worldwide sales of diagnostic substances. Most of the top foreign companies operate in the United States and have invested in or acquired U.S. firms.

BIOTECHNOLOGY

Biotechnology is defined by various U.S. government publications as a set of enabling technologies

that use organisms or their cellular, subcellular, or molecular components to make products or to modify plants, animals, and microorganisms to carry desired traits. Advances in molecular biology in the last 25 years have led to the development of recombinant DNA or genetic engineering, monoclonal antibodies, gene therapy, DNA amplification, genomics, and other technologies that have become workaday tools in life sciences research. These techniques provide scientists with the means to uncover the genetic codes of organisms, find new substances of potential industrial value, and modify the genetic makeup of organisms with far greater precision and speed than previously possible.

Domestic Trends

More than 1,300 enterprises in the United States, ranging from start-ups to multinationals, are involved in industrial biotechnology, employing well over 100,000 people. Sales of products made through biotechnological means by U.S.-based firms, virtually nonexistent in 1982, were estimated at \$9.7 billion in 1996 and \$10.8 billion in 1997, an 11 percent increase over 1996, according to Consulting Resources of Lexington, Massachusetts. Governments usually gather data concerning industries based on the product or service produced, not on the method of manufacturing. Consequently, sales of products made through biotechnology have not been collected as a separate industry, but have been encompassed within traditional industry categories.

The greatest commercial impact of biotechnology is in the discovery and production of new pharmaceuticals, safer vaccines, and faster and more reliable diagnostic tests. By 1996, 16 different drugs, one vaccine, several in vivo diagnostic imaging agents, and hundreds of in vivo diagnostic tests had reached the market, generating about \$8.9 billion in 1996. Estimates of the exact number of biotech-derived medicines under development vary, but the upward trend is unmistakable. A 1996 survey by PhRMA found that 284 biotech medicines were in development, an 11 percent increase over 1995, with the largest increases occurring in gene therapy and vaccines.

Table 2 lists the seven major applications of biotechnology.

Biotechnology plays a vital role in the development of tests to diagnose elusive food pathogens. A 1996 federal regulation designed to reduce the incidence of food poisoning in meat and poultry

Table 2

THE SEVEN MAJOR APPLICATIONS OF BIOTECHNOLOGY

Health Care

- Pharmaceutical
 - Therapeutic drugs
 - Vaccines
- Diagnostics
 - Monoclonal antibody-based tests
 - Genetic probes and DNA amplification
 - Agents to improve in vivo diagnostic imaging
- Gene therapy
- Tissue replacement
- Veterinary disease diagnostics, therapeutics, and vaccines
- Animal and plant “factories” to produce pharmaceuticals and chemicals

Agriculture

- New plant varieties for new or improved foods
- Safer pest control
- Plant disease diagnostics
- Improved livestock for food production
- Veterinary disease diagnostics, therapeutics, and vaccines
- Animal and plant “factories” to produce pharmaceuticals and chemicals

Food Processing

- Microbial starter cultures, enzymes, and vitamins
- Food contamination test kits

Marine Biotechnology

- Novel pharmaceuticals, chemicals, and biomaterials

Industrial Processes

- Organic chemicals
- Mineral recovery
- Bioelectronics
- Waste stream reduction
- Environmental clean-up (bioremediation)
- Energy production

New Understanding of Biological Systems

- Understanding human disease
- Deciphering the human genome
- Sequencing genomes of microorganisms and plants

Laboratory Instrumentation and Techniques to Support Life Sciences Research, Development, and Manufacturing

- Nucleic acid amplification technology
- Combinatorial chemistry

Source: Adapted from Biotechnology, May 1995, California Trade and Commerce Agency

products caused by E-coli and Salmonella bacteria will spur growth of this segment. Biotech-derived diagnostics are also being used to detect pesticide residues in crops, drug residues in food animals, and environmental pollutants.

Biotechnological techniques also are revitalizing the enzyme industry by providing more economical methods of changing chemical structures to enhance performance. Before genetic engineering, enzymes added to laundry detergents to remove stains and brighten colors could not be produced economically. According to some industry observers, most industrial enzymes will be produced by genetic engineering within the next decade.

Industrial biotechnology activity focuses, to a large extent, on research and the discovery of biological information useful to the development of new products. According to *U.S. Industry and Trade Outlook 1998*, most biotech companies are unprofitable and rely instead on income from equity investments, public offerings, and research and development contracts. The U.S. biotechnology enterprise is research-intensive, spending roughly 10 times more on research than other U.S. industries. New information about the genetic origin and pathway of diseases is being uncovered at a remarkable rate, and drug companies, both U.S. and foreign, have increased acquisitions and alliances with U.S. biotech companies to gain a foothold in the latest generation of technologies and to access genetic information to develop new products. Many of the strategic alliances occurring in the 1995-1996 period between biotechnology companies and established firms were in the emerging areas of genomics and gene therapy.

U.S. INDUSTRY GROWTH PROJECTIONS FOR THE NEXT FIVE YEARS

Although trade data on biotech-derived products are unavailable, the U.S.-based biotechnology industry contributes to a positive trade balance. Most top-selling biotech products on the market are developed by U.S. companies and are being produced domestically for export or licensed for production abroad. Biotech companies also receive patent royalties and contract research and development payments. The major foreign markets for U.S. biotech products closely parallel those of the pharmaceutical industry, e.g., the European Union, Japan, and Canada. The positive export earnings trend should continue at least for the next five years as the U.S. private and public sectors still account for the

Future growth rates will depend on the level of research and development, regulatory approval of new products, demonstration of price/performance advantages, and consumer acceptance.

Medical biotechnology revenues are expected to increase by at least 10 percent annually over the next five years.

preponderant share of worldwide research dollars and numbers of biotech products in development. However, export growth of genetically modified crops will hinge on timely approval by foreign regulatory authorities and acceptance by consumers.

Future growth rates will depend on the level of research and development, regulatory approval of new products, demonstration of price/performance advantages, and consumer acceptance. According to *U.S. Industry and Trade Outlook 1998*, medical biotechnology revenues are expected to increase by at least 10 percent annually over the next five years, given an increase in the number of biotech-derived medicines in advanced stages of development and because of progress in FDA regulatory reform which is leading to quicker approval of new medicines. Sales are expected to climb at nearly 20 percent annually over the next five years. Overall sales for the biotech sector are expected to reach \$12 billion by 1998 and \$18 billion by 2002.

INDUSTRY LINKAGES WITH MEDICAL SCHOOLS

The relationships between Colleges of Medicine and the need for nearby laboratories is evident from prior historical relationships. Most campus land areas have very limited available sites to provide the space for new lab buildings. Funding and delivery systems necessary to satisfy growth opportunities in the biomedical testing industry is better suited to the private sector as opposed to the inexperienced constructing staffing in the college environment. A college usually links its research effort to contract research grants from several domestic pharmaceutical companies with testing activities occurring not only on campus, but on the critical mass (available sites) to expand the connection between academia and private industry. Below are

a few examples where universities have engaged in joint-ventures with the private sector for mutual advancement.

University of Connecticut at Storrs - Pfizer Pharmaceutical Company recently executed an agreement with the University of Connecticut at Storrs to build and lease back a 52,000-square-foot biomedical building costing about \$19 million or \$365 per foot. Pfizer, currently located in Groton, Connecticut, outgrew its space and had no expansion room. UCONN offered to lease the land to the drug company and enter into a sale-leaseback on the building in exchange for the right to occupy about 20 percent of the total building's space. Pfizer was expected to link its needs for biomedical testing with UCONN's science and medical schools to advance its drug manufacturing business. In this situation, Pfizer is forced to separate its divisions from its primary headquarters in Groton.

Unfortunately, the local community recently rejected the proposal. Pfizer is now back in the market looking for another expansion site near a major university.

Massachusetts Institute of Technology - In 1983, the Massachusetts Institute of Technology selected Forest City Enterprises, a national publicly-traded real estate company headquartered in Cleveland, Ohio, to develop its 27-acre parcel directly adjacent to the MIT campus in East Cambridge, Massachusetts. University Park at MIT, Boston's only corporate park affiliated with a major university, is a three-building campus of retro-fitted, turn-of-the-century, multi-story manufacturing lofts totaling 350,000 square feet of space. The first building opened in December 1987, contains just over 100,000 square feet of rentable floor area in five stories, and is leased by ARIAD Pharmaceutical, NEMAPharm, PFN, Inc., and SensAble Technologies. The second five-story building opened in March 1989 and contains over 121,600 square feet; its major tenants include OraVax, ProScript, Genszyme Tissue Repair, Acusphere, Etex Corp, and OnLine Environs. The third five-story building of 126,100 square feet was finished in 1990 and is occupied by Alkermes, Genzyme Tissue Repair, Ascent Technology, and others. A fourth multi-story building of 75,000 square feet opened in the fall of 1998.

The MIT Park offers state-of-the-art, flexible, and first-class space accommodating firms of all

sizes from start-ups to major corporations. Special features include fiber optic telephone cabling, clean rooms, redundant electrical service, and upgraded HVAC and floor loading capacities. The mission statement for the Park is to link its related departments to national pharmaceutical and molecular bioscience firms for the advancement of both MIT and the national firms who seek access to the MIT's academic pool of skilled researchers. The Park also has surplus land on which a 212-room independent hotel and conference center opened in late 1998. Although the Park and campus are close, an auto or shuttle bus is required between the two locations.

George Mason University - Prince William County, located in the Northern Virginia portion of Washington's metropolitan region, recently entered into a public-private development program with nearby George Mason University. The county, long known as a bedroom community, recently set aside a 1,200-acre campus to entice the private sector and academia to a joint-venture in achieving common goals. As a result of this effort, the first of three buildings opened in Spring 1997. Building One consists of 100,000 square feet of classrooms, administrative space, and state-of-the-art wet labs. The building, as well as 45,000 square feet of laboratory and office space at George Mason University, is occupied by American Type Culture Collection (ATCC), the world's largest and most diverse archive of biological materials. Building One's base costs were \$180 per foot, and ATCC added another \$200 per foot in special fit-up. In addition to its bio-archives, it also is a patent repository of microbiological products and processes.

Building Two opened in mid-1998 with about 100,000 square feet of laboratories and classrooms, housing ATCC's research and education programs. GMU's new Molecular Biosciences and Technology Institute (MBTI). MBTI has created a joint-venture with ATCC to further advance two new technologies: 1). high-throughput signal conditioning and base-calling in real time, and 2). pattern recognition software to analyze data from gel-based automated DNA sequencing instrumentation. The University has established 10 new teaching positions to work with ATCC in the fields of cellular and molecular biosciences and bioinformatics. The campus is 20 minutes drive time from GMU. George Mason researchers are helping a group of companies led

by BDM International, Inc., in McLean to perfect a method for transmitting huge flows of data between computer microprocessors more rapidly by using light signals instead of wires.

Rensselaer Polytechnic Institute - Located just outside Albany, New York, in East Greenbush Township is a project with more than 825,000 square feet in place owned by the Rensselaer Polytechnic Institute and is a university-related park for technology joint-ventures between industry and education. The primary objective of the venture is to develop interactions between tenant companies and the University in order to enrich the educational environment of the University and assist the companies in staying on the leading edge of their technologies. The Park has over 50 tenants (and in excess of 2,000 employees) with a diversity of research technologies including electronics, physics, biomedicine, and software. Of the 20 buildings in the Park, 12 are University-owned, multi-tenant facilities and eight are single-purpose, tenant-owned facilities. It is the policy of the University that land sites are available only for lease. The Park is located roughly five miles south of the University campus.

The list continues with such examples as the Princeton Forestall Center in Princeton, New Jersey, and Research Triangle Park in Raleigh-Durham, North Carolina. Additional industry/academic relationships include MetaMorphix, Inc., of Baltimore, which is developing protein-based products created through genetics research at Johns Hopkins

University. The products can be used to repair human tissue, combat neuromuscular disorders, and dramatically increase muscle mass in livestock. Hughes Network Systems, a Montgomery County company, is collaborating with researchers at the University of Maryland to develop complex voice and data transmission technologies that draw simultaneously on satellite, fiber-optic and cable systems. Throughout the Midwest and western U.S., there are about 20 additional examples of ventures between industry and academia. Proximity to the schools and laboratories does not appear to be a significant issue.

New England is second to the San Francisco Bay area with regard to concentration of biotechnology companies. Most of the New England firms are found along I-95 in Connecticut and in the Boston/Cambridge area of Massachusetts. *Table 3* compares the concentrations of biotechnology companies by location in the United States.

The biotech and pharmaceutical companies seeking relationships with universities place a high priority on local labor skills and availability, labor costs, transportation systems, reputation of the academic institution, and costs of living. Biotech and pharmaceutical companies rank competing universities according to number of degree programs for its employees, number of faculty consultants in its field of endeavor, access to laboratories, and faculty research activity. Other intangible goals for the private sector include the academic linkage for the transfer of technology. The mechanisms for

Table 3

BIOTECHNOLOGY INDUSTRY CONCENTRATIONS

Region	Number of Companies	Percent
San Francisco Bay Area	192	28.8
New England	172	25.8
Mid-Atlantic	114	17.1
San Diego	102	15.3
New York	86	12.9
National Firm Total	666	100.0

Source: U.S. Department of Commerce's U.S. Industry and Trade Outlook 1998 and Thorne Consultants, Inc.

transferring new ideas emanating from basic research housed in a university to the corporate world provide a vital link in the sequence of events leading to innovation and eventual patents.

THE DEMAND FOR NEW LABORATORY FACILITIES

The National Science Foundation (NSF) is the largest source of grants for the exploration of science, medicine, physics, engineering, and agriculture. As a consequence of its major funding role, NSF conducts biennial surveys in which it collects data on issues related to science and engineering (S&E) research facilities in the nation's colleges and universities. One objective of the surveys is to insure that NSF grants provide the highest returns for its stated mission of advancing science and technology. An equally important objective is to determine the adequacy of presently configured laboratory space (age, condition, and quality of labs) and the additional space needed to accommodate science's changing technologies. The latest (1996) NSF "Survey of Scientific and Engineering Research Facilities at Colleges and Universities" was mailed to a sample of 314 institutions representing 560 research-performing colleges and universities. The survey found that:

- At least half of the surveyed institutions indicated inadequate amounts of science and engineering (S&E) research space in the biological sciences outside of medical schools, the physical sciences, engineering, the agricultural sciences, and the medical sciences, both within and outside medical schools.
- Eighteen percent of all S&E research space was considered to require major renovation or replacement. This portion of space amounts to 24.5 million net assignable square feet (NASF).
- Since 1988, the amount of research space requiring repair/renovation or replacement in many of the S&E fields has increased. In the agricultural sciences, the amount increased from 3.6 million NASF in 1988 to 5.3 million NASF in 1996; in the biological sciences outside of medical schools, the amount increased from 2.4 million NASF in 1988 to 3.4 million in 1996; engineering space in this condition grew from 2.2 million to 4.0 million NASF.
- The construction of S&E research space by research-performing colleges and universities has declined from projects valued at \$3.4 billion in 1990-1991

fiscal years; to \$3.0 billion in 1992-1993 fiscal years; to \$2.8 billion in 1994-1995 fiscal years.

- In 1996, 88 percent of the research-performing institutions had laboratory animal facilities. Most of the 12.2 million NASF of animal research space (93 percent) was contained in doctorate-granting universities. Institutions with animal research space reported that roughly 10.0 million NASF (82 percent) met government regulations designed to ensure the safekeeping and proper use of animals in research. Another 1.2 million NASF (10 percent) needed limited repair/renovation to meet regulations, and 1.1 million NASF (9 percent) required major repair/renovation. Only 6 percent of the research-performing institutions with animal research facilities were scheduled to construct animal facilities in fiscal years 1996-1997.

Information focused solely on the amount of S&E research space and its growth or decline over time is insufficient for understanding whether there is enough space to conduct any form of research, and whether the condition of that space is suitable for conducting particularly sophisticated research. Assessments of both the quantity and quality of existing research space made by respondents to the NSF "1996 Survey of Scientific and Engineering Research Facilities at Colleges and Universities" are examined below. The survey focused on the following questions:

Adequacy - Respondents were asked to rate the adequacy of the amount of research space in each field at their institution ("adequate" indicated the space was sufficient to support all current S&E program commitments in the field; "inadequate" indicated the space was not sufficient or was non-existent, but needed).

Condition - For each field, respondents indicated the condition of research space by reporting the percentage of space falling into one of the following categories: "suitable for use in the most scientifically competitive research in the field"; "effective for most levels of research in the field, but may need limited repair/renovation"; "requires major renovation or replacement to be used effectively"; or "not applicable or no research space in this field."

Responses to the survey were based upon the *subjective* assessments of a variety of different individuals, including the survey coordinator at the

institution, as well as deans and other administrators.

Regarding the adequacy of research space, reports of inadequate research space varied across field and institution type. The percentage of institutions indicating that the amount of available S&E research space was inadequate ranged from 30 percent for mathematics to 66 percent for the medical sciences in medical schools. Over half of all institutions also reported inadequate amounts of space in engineering (57 percent); medical sciences outside of medical schools (57 percent); physical sciences (54 percent); biological sciences outside of medical schools (53 percent); and agricultural sciences (52 percent). Nearly half of the institutions reported inadequate amounts of space in five additional fields: social sciences (47 percent); biological sciences in medical schools (46 percent); earth, atmospheric, and ocean sciences (46 percent); computer sciences (44 percent); and psychology (44 percent).

The top 100 institutions surveyed were most likely to indicate inadequate research space in the biological sciences outside of medical schools, with 61 percent reporting this to be the case. Three other fields were reported to have inadequate research space by over half of the top 100 institutions: physical sciences (56 percent), social sciences (55 percent), and engineering (57 percent).

Medical science space was most likely to be reported as inadequate by the other doctorate-granting universities, both outside medical schools (65 percent) and within (69 percent). In fact, the percentages of those institutions, indicating medical science space to be inadequate, were much higher than for the top-100 institutions.

Two fields, the biological sciences outside of medical schools (52 percent) and the physical sciences (51 percent), were listed by over half of the nondoctorate-granting institutions as having inadequate S&E research space.

Regarding the condition of S&E research space, an overall 37 percent of the S&E research space at the surveyed research-performing institutions was rated as suitable for use in the most scientifically sophisticated research. Forty-four percent of the institutions reported that their S&E space was effective for most levels of research in the field. However, the institutions classified 18 percent of their S&E research space as requiring either major repair/renovation or replacement. There was general

The pressure on pharmaceutical companies to lower the costs of drugs and the 11-year patent horizon for new drugs are contributing factors which impact the efficient use of capital. More specialized building design is necessary to accommodate more specific procedures, which indirectly effects the pace of obsolescence. However, the present wave of consolidations in the industry should provide the efficiencies needed to advance research and development funding.

consistency among the different types of institutions regarding the amount of S&E research space in this condition, with 19 percent of the S&E research space at the top 100 doctorate-granting institutions, 17 percent of the research space at other doctorate-granting institutions, and 18 percent of the research space at nondoctorate-granting institutions requiring major repair/renovation or replacement.

Such similarities across institution types mask large differences in actual amounts of space. The 18 percent of space rated as needing major repair/renovation at the top 100 universities, for instance, actually represents 17.6 million NASF, whereas the 18 percent of space rated in the same category at nondoctorate-granting institutions represents only 1.1 million NASF. In total, the nation's research-performing institutions reported that 24.5 million NASF of research space required major repair/renovation or replacement.

In conclusion, the 1996 NSF survey reveals aging facilities that are increasingly inadequate to serve the needs of research across all sciences, resulting in a pent-up demand for additional space to accommodate industry growth. New England is second behind the Bay Area in the concentration of biotech companies. The concentration of medical sciences stretches from Stamford, Connecticut, to Boston, Massachusetts. Demand for lab space can be expected to arise from outside the market area and perhaps even these states. The large cities in the New England and Mid-Atlantic regions of the U.S. are most likely to produce the well-capitalized incubator firms searching for lab facilities throughout

the Boston-Washington corridor. The Bay Area of San Francisco, on the other hand, has such a large critical mass that new and expanding lab and biotech firms can arise from within its market.

CONCLUSIONS

In the last four years, since NSF's survey, little has changed to alter the landscape between user demand and the relationship to the available supply. A more recent survey of 660 research performing institutions in 1998 by NSF (published in mid-November 1999) reported that 64 percent of biological science firms outside of medical schools have inadequate space. A material increase over the 50 percent reported in the 1996 survey. According to this more recent survey, 13 million square feet of newly constructed space is required to fulfill the needs of both the physical and biological science industries. In total, all sectors of the S&F market demands 41 million square feet of space by institutions and private firms to carry out their scientific mandates.

These are very expensive buildings to construct, requiring substantial amounts of venture capital. NSF's more recent survey reports that 61 percent of funding for new construction comes from the private sector, while federal, state, and local funding provide the balance. The pressure on pharmaceutical companies to lower the costs of drugs and the 11-year patent horizon for new drugs are contributing factors which impact the efficient use of capital. More specialized building design is necessary to accommodate more specific procedures, which indirectly effects the pace of obsolescence. However, the present wave of consolidations in the industry should provide the efficiencies needed to advance research and development funding.

Despite the apparent pent-up demand for more modern facilities, the presence of waiting users (tenants and owners) is not a given. Market analysts must have the market knowledge regarding local concentrations (research activities) and related linkages to Universities and native industries that can exploit a relationship with a biomedical firm.

Adaptive reuse of existing facilities for second generation users is generally very poor. Seldom does another bio-firm, even requiring the identical BSL type facility, equate the same dollar value to the facility as the vacating first user. Consequently, interior layout of administration and scientific offices, isolated bio-hazard areas, and research rooms are typically gutted and replaced by a new layout

designed by the second or the third generation users. Technological advances in the industry are also contributing factors as to how older space is viewed by subsequent facility users.^{REI}

CONVERTING CORPORATE HEADQUARTERS TO MULTI-TENANT BUILDINGS

by Arthur M. Delmhorst, CRE

Downsizing, rightsizing, spinoffs, layoffs and buyouts have been the buzzwords of the 1990s. For the real estate profession they mean reduced office space requirements. As corporations endeavor to make themselves more competitive, making their headquarters leaner is one of the first goals. In an age of buyouts, corporations swallow corporations. This happens even to those once thought to be too large to disappear; witness Chrysler, McDonnell Douglas, and Scott Paper. The result — corporate headquarters with a vacancy sign out front.

Although former headquarters are often architecturally attractive, (built with high quality materials and systems, in desirable neighborhoods and located amidst beautifully landscaped grounds), they can prove to be very difficult to market. There are many reasons for this difficulty and recognizing them can help bring the real estate counselor closer to developing a solution. Following is a look at these problems and some possible solutions.

ABOUT THE AUTHOR

Arthur M. Delmhorst, CRE, is a principal of Delmhorst & Sheehan, Inc., a real estate advisory firm he co-founded nine years ago. The firm was engaged to reposition and market the corporate headquarters of the Stauffer Chemical Co., UPS, Waldenbooks, and Union Carbide Corporation. Delmhorst has been a member of The Counselors since 1989. (E-mail: adelmhorst@delmhorst-sheehan.com)

LOCATION

Although headquarters used to be downtown in major cities, they now can be located anywhere. Beginning in the 1970s supposedly reliable economic studies proved that the best locations were within 15 minutes of the then-chairman's home or golf club. The problem with these locations is that often only the chairman and the president can live within a comfortable commuting distance. This is a significant problem for companies with a conscience. Unfortunately, until there is an easy way to pick up and move corporate headquarters, it is an insurmountable problem.

This problem is a real one. United Parcel Service (UPS) moved from Greenwich, Connecticut, to Atlanta, Georgia, in large part, to escape the high residential costs of southwestern Connecticut. A comfortable house in suburban Atlanta, then costing \$200,000, would cost \$600,000 to duplicate close to Greenwich.

In marketing to sell the former UPS space, Delmhorst & Sheehan, Inc., had to seek small companies, typically with a greater proportion of highly paid executives. The space was simply not appropriate for large clerical operations, as few of their employees could afford to live in close proximity.

Housing costs are not the only problem with suburban headquarters. The cost of commuting is another concern. A well-paid executive can easily have a car to drive to work. Lower compensated employees often cannot afford a second car and mass transit service to remote headquarters sites is frequently not available.

To remedy a situation such as this, a van between the former headquarters and the nearest mass transit depot is a viable solution. Sometimes, the local municipality or a "transit district" will operate a van service. Other times, the owner of the property or its major tenant may operate it. New tenants will want assurance that this service will continue to be provided in the future. It cannot be a short-term service.

SIZE

There are certain features about corporate headquarters that may be detrimental to their reletting. For instance, a small- or even medium-sized tenant may not want to be the "small fish in a big pond." If the balance of the property is occupied by a much larger tenant, the smaller tenant may not find the property to its liking. New entrances can overcome this. At Nyala Farms in Westport, Connecticut, (the former headquarters of Stauffer Chemical Company), a new lobby was constructed between two of the former headquarters' buildings. This gave several small tenants the opportunity to access their space in a location separate from the main entrance. It was designed to include two elevators, planters, and a graceful staircase to the basement garage and the two floors above.

DESIGN

Corporate headquarters are often designed with no alternative use in mind. The companies for which they are being constructed cannot, or do not,

conceive that the building will ever be anything other than its glorious corporate headquarters.

This lack of farsightedness results in buildings which are not easily subdivided or converted to multi-tenancy. They may have very large lobbies, suitable for the grandeur of a corporate headquarters but considered a waste of space by a subsequent user. These lobbies are apt to be designed to serve only one tenant and are awkward when trying to lead visitors to more than one tenant's space following subdivision. Elevators may be poorly positioned for a multi-tenant building as well.

Most headquarters were designed to have large executive offices and not a lot of open work space. If the new forces in the marketplace are employee intensive, these large offices are detrimental to the marketing effort. Health Maintenance Organizations (HMOs), for instance, would prefer a building with large, rectangular, open spaces, whereas a former headquarters probably has many offices, often configured in a manner that provides a maximum of window space, but not necessarily a neat clean, rectangular interior.

TENANT IMPROVEMENTS

There may be executive wings that are improved to such an extent that they exceed the needs of any new prospective tenant and must be removed in spite of their high initial cost. A number of years ago, the American Cancer Society, which took over a major paper company's headquarters, explained away the sumptuous appointments by placing a plaque in the reception area thanking the paper company for "donating" the improvements to the new tenant.

Opulence is another possibly unattractive feature. AT&T, for example, had numerous marble fireplaces in its old headquarters at 165 Broadway in lower Manhattan that required removal. Certain improvements to the former Nestles headquarters in Purchase, New York, were deemed to be excessive even for IBM, its new occupant. This problem is not restricted to large corporations. Some real estate entrepreneurs treat themselves to large offices. When one major New York developer failed, he had great difficulty finding a new tenant for his space as the size of those offices exceeded the desires of all but the most egotistical new tenants. The space went unrented for a long time.

The Graybar Electric Company, in its midtown Manhattan office building, had a lavatory in each

vice president's office. This luxury is now uncommon.

A headquarters may have a raised floor computer room that is too large for any new tenant. This installation, although costly, will have little value to a new, smaller tenant. It will have to be removed and the space rebuilt.

Many of the most active lessees of office space today are in the financial service industries. Some want to have trading rooms with large floor plates and ceiling heights of 20' or higher. These, again, are not features usually found in corporate headquarters. They may, in fact, not be found anywhere, necessitating new construction. We know of one corporate headquarters where a commodity trading firm removed much of the second floor of a former corporate headquarters, including the boardroom, in order to create a two-story trading room. Alas, after only five years, the commodity firm sublet the space. The new subtenant uses part of the trading floor as a basketball court!

ZONING

Many corporate headquarters were developed in locations where speculative office buildings were not truly welcome. For one reason or another, local officials enacted zoning which permitted the particular corporate headquarters to be built. The property would initially be envisioned as one without heavy traffic, a beautiful building, on beautiful grounds, with few people. Neither the townspeople nor the corporation could ever imagine the company not being there. Hence, in return for rezoning the property, it was agreed that there would never be more than one tenant on it. This can be an immense problem once the company is bought out or merges and moves.

It is often extremely difficult to find a new tenant that will require exactly the amount of office space existing in the newly vacated building. Some require more, some less. The ones needing more must look elsewhere. Those requiring less can use the building, but must have the right to lease surplus space to others.

But, obtaining a change in zoning is seldom easy. Residents who opposed the original corporate zoning will vigorously fight the new rezoning efforts. We have seen instances where nearby residents almost had veto power over changes in zoning or conversion to multi-tenancy.

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Sometimes convincing the neighbors that the number of cars coming to the property daily, rather than number of tenants, is the real problem and multi-tenancy will be granted subject to a restriction on number of cars allowed on the property.

NEW LOBBIES AND SIGNAGE

The name on the building can create a problem. American Airlines will certainly never lease space in a building called "The Pan Am Building." Changing the name to a neutral one is perhaps the first action to be taken in converting a corporate headquarters to a multi-tenant building.

This may become a very touchy subject. The downsized company will think highly of itself and believe that its name on the entrance will attract new tenants. This can be untrue for several reasons.

For one, the new prospects think highly of themselves and may not find it attractive to be located in the "Brand-X Corporation Headquarters." This is particularly true in suburban office buildings. In major cities, a prestigious tenant may find it attractive to be in the AT&T Building or the General Motors Building, but outside the cities, this willingness disappears.

Another reason is the aura that might be attached to the former occupant if it failed. This may not be a company with which new tenants will want their name associated. They want their new space, whatever it is called, to convey the impression of success.

Competitive reasons may apply to more than just the building name. We encountered a cafeteria operator who would not relocate to our client's building unless it were granted the cafeteria operation there. The prospective new tenant felt it would be an insult to its business if their employees had to eat every day in a cafeteria run by one of its competitors.

Assuming that the new tenants coming into the former headquarters are of a moderate size, and, perhaps, using the space for their own headquarters, they will want identity. How this is handled depends upon how many other tenants come into the complex. If only two or three, their names can probably be prominently displayed at the main entrance. If more, then the names should only be on the individual buildings, or if there are many new tenants, then only on the individual floors.

The problem of signage should be addressed early on. The redeveloper cannot give prominent signage to the first few tenants and then try to withhold it from others later on. The signage policy must be well thought-out ahead of time.

ELEVATORS

In some former headquarters, elevators may have to be installed in new locations. When the building was in use as a single-tenant structure, the elevators may not have been near the entrance. With multi-tenant use, elevators will need to be at or very near the entrance. Construction of new elevators is a very expensive undertaking and the need to do so must be confronted early in the financial analysis.

Freight Elevators – Loading docks, freight elevators, mailrooms, and other service facilities may be located at one end of a corporate headquarters. It may serve well to keep these less attractive functions remote from a chairman's office, but when the building is converted to multi-tenant use, there is a need for these operations to be close to the building core where many tenants can easily access them.

We know of one five-building former corporate headquarters, which had freight docks in only two of the buildings. Their absence in the other three buildings, when noticed by prospective tenants, was a negative.

NEW CAFETERIA(S)

A former corporate headquarters probably had one large cafeteria in a central location. When the building is converted to multi-tenant use, either this cafeteria must be operated by the developer or demolished and replaced with several smaller eating facilities. Furthermore, subsidization of cafeteria costs among several tenants may be difficult. Company policies regarding subsidization will vary.

FITNESS CENTERS

The demand for fitness centers cannot be underestimated. The need for a new fitness center is very

similar to the situation with the cafeteria. If the former owner/tenant has one, it may be opened up to all new tenants if its location is accessible. At the former Stauffer Chemical headquarters, two major tenants have their own fitness centers and the owner has built a third for the balance of the tenants. It appears to be very underutilized but its construction was necessary to attract smaller tenants to the complex.

SEPARATE BUILDING SYSTEMS

Not all tenants work the same hours and varying amounts of electronic equipment can emit varying amounts of heat. Office tenants like and *need* to have control of their own heating, ventilating, and air-conditioning systems. This can be very difficult to provide in a complex that was built for a single user but it needs to be done. Engineering cost estimates should be obtained early in the process.

Electricity should also be served separately to individual tenants. Whereas the original corporation probably had one meter, the multi-tenant building will need one for each tenant. Every tenant thinks it uses little electricity, certainly less than the tenant next door. They, therefore, want their own meters so that they do not feel they are paying for their neighbor's extravagant use of electricity. This can usually be accomplished on a building-by-building or floor-by-floor basis, but new master panels and meters are expensive and need to be built into the cost estimates of the conversion.

NEW BUILDING MANAGEMENT TEAM

When the project was a corporate headquarters, managing it was probably simple, but performed by a diverse group. The finance department paid all the bills; the general services department arranged the service contracts; and there was probably one on-site handyman who did all sorts of odd jobs, including picking up the mail at the post office.

Now, as a multi-tenant building, an entity must be set up to carry out all of these functions. It might be located remote from the site but the new tenants need to have someone nearby to call upon who can respond promptly to minor repair needs. If the complex is large, a highly qualified project manager will be needed on site, all of the time.

It is important to budget for a management team that can be freestanding. It will no longer have the support staff of the large corporation, which previously occupied the building.

A former corporate headquarters can be successfully converted to a multi-tenant building, but the problems must be foreseen and dealt with early in the conversion process.

OVERCOMING THE "SINGLE-TENANT" PERCEPTION IN THE MARKETPLACE

When a corporate headquarters has been known for its single tenancy for a long time, it is difficult to entice new tenants there. This is hard to overcome and is done best by wide publicity of individual leasing transactions. "Tombstone" ads and news articles should be used to disseminate the announcements of new tenants. After several of these, the project will lose its perception as a single-tenant building, but getting those first tenants to make the initial announcements is not easy.

Efforts should be made to get real estate brokers into the building, leading them on tours that emphasize the positive features, therefore overcoming the single-tenant perception. How brokers describe a building to their customers is very important in arousing the interest of prospective tenants. The brokers must be convinced of the viability of the property as a multi-tenant one.

Corporate headquarters are usually built to last; they have quality design and quality construction. In this era of buyouts and downsizing, they can be successfully converted to multi-tenant properties, but only if the numerous potential problems are recognized and addressed early in the process.^{REI}

CRE PERSPECTIVE

JUST THINKING ABOUT IT IS ILLEGAL

by Arnold S. Tesh, CRE

Licensing of appraisers in most states has been around for a decade or more. It was inevitable. In view of the 1980's rash of developer insolvency and financial institution failures, appraisers were bound to be caught in the line of fire. It is at least a small miracle that those, whose value opinions can change the course of millions of lives, were ever allowed to *de facto* police themselves. There are few professional appraisers who now have difficulty with the licensing of their industry. The issue is the administration of such licensing. Also of critical importance, is where does one draw the line between appraising and consulting or counseling? This is an issue which all CREs will be facing in coming years. This is why it is important for us to understand what is happening to our professional cousins who appraise real property for a living. Normally, licensing is designed to protect the public while distinguishing those who have earned the privilege of being recognized as able to perform the required functions. This has not happened in the appraisal profession.

THE PURPOSE OF APPRAISAL IS TO FIND VALUE

The appraisal process is consistent. The tools available to practitioners are limited and do not differ geographically. Through a well-defined and rather rigid process, certain approaches and techniques are chosen by the appraiser to arrive at a conclusion of value. The available choices are the same worldwide, and most certainly exist in all 50 states, as well as the federal district and the territories. It is not a matter of local or even federal law or regulation as to whether the income approach, or the sales comparison, or cost approaches are proper for finding market value—it is a matter of economics. It is a function of the type of property being valued and the type of data available for such valuation. An income producing property in Montana will likely be very different from one in New York, or another in New Mexico, but that has nothing to do with the methodologies available to the appraiser in carrying out the valuation assignment. The real question is

whether the appraiser is competent to serve the client in a particular location and for a particular type of property. Local licensing requirements rely on adherence to the Uniform Standards of Professional Appraisal Practice (USPAP) competency provisions and the states have no means, or apparent desire, to individually police or even test for local market knowledge or specific property-type familiarity. USPAP requires the appraiser to come forth and express any competency shortfalls that may exist for any given assignment. Whether the appraiser is the holder of one license, or 50, the same requirement exists.

REAL PROPERTY IS NOT INTELLIGENT

It does not order appraisals or use the conclusions. Appraiser incompetence or negligence does not victimize the property, regardless of which state it is in. However, careless or incompetent appraising can harm humans. Requiring the appraiser to be licensed in the state in which the property is located does not prevent victimization in the form of financial loss or emotional distress. Is it a good idea to license professionals where they practice? Of course it is! Appraisers should be licensed wherever they domicile a practice. For example, attorneys are licensed wherever they practice. Laws differ, as do standards. Lawyers are licensed where they domicile a practice, or where they file or appear to present cases. They need not be licensed in states where they observe, do research, or where assets or liabilities in claims or defenses are simply located.

Barbers, beauticians, and medical doctors are also licensed in the locale in which they practice. Practice for them involves actual personal and physical contact with their customers. However, the fact that an MD licensed in the state of Utah proffers an opinion based on an x-ray examination done in Arizona, has no bearing on whether the patient is properly protected by licensing laws. Such a scenario is perfectly legal and there is no requirement that the doctor in question be licensed in Arizona. If you take this example and supplant the doctor with an appraiser and the x-ray with a site visit, then the appraiser *may be* subject to criminal penalty. Why? It is because the appraiser is looking at an inanimate object which is affixed to the earth in another state? *Just thinking about the value* of this property is illegal. Yes, this results from knee-jerking by those who do not understand the profession and its practice, exacerbated by those that do, but are either not thinking or are afraid to speak up.

Practicing appraisal involves creating a professional product, usually in the form of a written conclusion of value. The fact that third parties will rely on this product makes it important that the people performing the appraisal are qualified practitioners. Simply working towards that conclusion or thinking about it is not practicing appraisal. There is no good reason why appraisal should be treated so differently from other occupations or professions. Appraisal licensing laws are based on where property is located rather than where services are provided. It was a mistake from the outset, produced by a rapidly formed but conscientious group attempting to satisfy bankers and politicians who were covering up their own tracks in the Federal Savings and Loan Insurance Corporation fiasco. What was done, was done in haste, but with *presumably* good intentions. Perhaps appraisal was confused with brokerage—a transactional business where there is an actual transfer of interest in the inanimate object. After all, real estate is real estate, and if brokers need to be licensed where the property is located, why not appraisers? In brokerage, rights and assets are exchanged and the definition of the real property is usually changed. Also, brokerage is a function of local law and regulation. It has a prescribed and legally sanctioned methodology. Its practice is not primarily based on reasoning and opinion, but on selling property and administering a formal process, which varies by state.

Does it make sense that a surgeon licensed to practice medicine in Florida, performs an operation on a resident of New Jersey, while the patient is in Miami, and there is no requirement that the doctor hold a New Jersey license? Yes! Does it make sense that if when the patient returns to New Jersey he suffers

repercussions from a forgotten sponge, but cannot bring a complaint before the New Jersey licensing authority? Again, yes! Why? Simply because even though the subject is a resident of New Jersey, the service received and the resultant harm had its direct cause in Florida. What does society value more—real property that happens to sit in New Jersey, or the human being that resides in New Jersey with an errant sponge left by a Florida doctor? If the patient calls the doctor in Miami and asks about the pain, is the doctor prevented from thinking about or talking about the symptoms because the subject is located in another state? Of course not! If the real issue behind all this provincialism in licensing is state by state liability laws, or limitations, then it is a matter for the client or patient to consider when traveling away from home, or when retaining a professional. It just is not practical to stretch the meaning of “practice” so thin, as has appraisal licensing laws, so as to make it impractical—if not impossible—for good and honorable people to run a business. It also, in many cases, prevents the public from getting the best service available. It restrains trade.

Current licensing goes well beyond where the practice is conducted or where the services are contracted. Borrowing the theme from the prior section, is it right that an appraiser in Pennsylvania is asked by a client in New Jersey to appraise a property in Delaware and the license in question is Delaware? It is not the property in Delaware that is receiving the service, but the client in New Jersey that chose to do business in Pennsylvania. How about the lawyer presenting a case in New Jersey for a New Jersey corporation which owns that property in Delaware?

There is no requirement that this lawyer be admitted to the Delaware Bar, because the asset in question is located there. If valuing property located in Delaware was subject to a law that said, “regardless of what effect it may have on market value, the appraiser must use only that methodology prescribed by local authorities and the appraiser must call the result market value” than licensing on the basis of property location would be justified. Of course any such hypothetical law would not only be silly; it would produce *misleading results*—an unprofessional practice. It is another example of regulation gone amuck.

Someone can be criminally prosecuted for *thinking about value*, while looking at a property in a state where they do not hold an appraisal license. How about the place where the appraiser entered into an agreement with the client? How about focusing on where the appraiser accepted the client’s money with the understanding that competent work is expected and, by law, required? The concept of policing a profession is related to the belief that government has a role in protecting the public against incompetent or unscrupulous practice. Depending on where one looks they will find various definitions which all relate to a professional’s business as the practice and not to a thing which just happens to sit somewhere other than where the appraiser domiciles a practice.

REAL PROPERTY DOES NOT KNOW WHICH STATE IT IS IN

It does not have any awareness of jurisdictional boundaries. Neither does finance or economics—two disciplines that relate directly to the appraisal process. These disciplines are not legislated, except in despotic societies. Law or regulation cannot manipulate the truth. Value is value and that’s what most

appraisal clients are looking for when they do their hiring.

Let us consider the accomplished appraiser who is asked to value the portfolio of a Fortune 50 company with office and industrial sites throughout the United States. Perhaps the appraiser is located in Idaho, and the subject property is scattered throughout 25 other states. Has this appraiser violated the law if the portfolio is valued in the absence of holding 26 individual state licenses? One would hope not; but regrettably this *can be* the case! As we can see, not only is property a thing and not a person, it can be almost anything a person or persons wish it to be.

When multiple properties are involved the subject for valuation can be defined in any combination. Even a single property can be considered in partial interest or as part of a greater whole. For instance, a railroad can be valued in one hundred-mile segments or as an entire system going coast-to-coast. None of these *fundamentally* different scenarios are realistically feasible to analyze under current legislation. Also, none of the clients asking for conclusions based on these subject descriptions are in any way helped or protected by the invocation of an unworkable, poorly conceived, Rube Goldberg matrix of senseless state licensing.

Is counseling in for the same nightmare scenario that the bureaucracy has produced for appraisal. You bet! Only diligence on the part of our profession and The Counselors of Real Estate can prevent the same mindless crusaders from handing our livelihood over to a group of well-intentioned, but uninformed (as well as ununiformed) consulting-police. Just think about it! The number of states requiring licensing for counseling is expanding quickly. Counseling, as a profession, is not

just in danger — it already has a problem.

Many politicians and regulators think of consulting as being synonymous with counseling. They think of it as a branch or subset of appraising. Standards 4 & 5 of USPAP spell out the problem much better than I can. These standards dictate an exact procedure for counseling. Counselors are supposed to follow these unworkable procedures to satisfy a bunch of bureaucrats to the detriment of their profession as well as their clients. If we do not reverse the trend, we will find ourselves like a bunch of whirling durbishes spending most of our time applying for and renewing licenses. We will do this so that we will be allowed to produce sub-quality results for the few clients that will have the patience or the money to waste on our three-humped camel procedures. Welcome to multi-state counseling of the future. Truly, a career from hell!

Imagine, for a moment, a CRE surrendering to local police and admitting, *"While being licensed in another state, and while working for a resident of that state, a property has been viewed and the assessor's office has been visited for data collection in your county. I am not licensed in this state and know that I must face the consequences. Please be gentle and don't secure the handcuffs too tight. I waive my Miranda rights and surrender my HP12C financial calculator and my Elwood tables for state's evidence. I would like to exercise my rights for a phone call since it looks like I am going to have to cancel my reservation for The Counselors' annual High Level Conference."* ... This scenario sounds nuts but, unfortunately, it is based on a plausible set of circumstances. It is only so because government regulation makes it so. If it were not for reckless licensing legislation, the idea of someone going to jail for thinking in the United States

of America would be ridiculous. Unfortunately, this is for real!

Aside from everything else let us be honest and answer the real question. How does any state protect its residents by giving reciprocity to another state and requiring a fee from the appraiser? There is no testing. There is no competency threshold. Even more insane is that there may not even be a resident to protect! Remember, the licensing requirement is based on where the property is located—not the appraiser or the client. Is this just one of these local control for revenue, full-speed ahead and damn the Constitution issues, or is there just something so many of us thinking people simply do not understand?

THE FUTURE

Ultimately, it will take a high level legal challenge to show how truly unjust and unworkable multi-state licensing regulation is. Only this type of test will demonstrate how arbitrary and capricious enforcement is and how both consumers' and the practitioners' rights are being violated. Once again, it should demonstrate that individual rights are not to be trampled upon for the convenience of the bureaucracy. No state should be able to impede or prevent trade or commerce on the pretense that it is protecting its residents.^{REI}

ABOUT THE AUTHOR

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FOCUS ON THE ECONOMY

THE "OLD" ECONOMY, THE "NEW" ECONOMY & THE REAL (ESTATE) ECONOMY

by Hugh F. Kelly, CRE



Serious investors in commercial property need to think clearly about the relationships, both subtle and profound, which link the "new" economy, the "old" economy, and the real (estate) economy. All but the most careful commentators have lapsed into a sloppy pattern of looking at the NASDAQ as the New Economy barometer, regarding it as a convenient index of high technology-oriented companies. They contrast this with the Dow Jones industrial average, which they regard as freighted with corporate dinosaurs.

To quote the teenagers: "As if!" Has anyone recently looked at the composition of the Dow? The 30 business giants whose stock prices constitute the DJIA include some of the most advanced tech firms in the world: AT&T; Boeing; DuPont; GE; Honeywell; Hewlett-Packard; IBM; Johnson & Johnson; 3M; Merck; Microsoft; SBC Communications; United Technologies. What distinguishes them from the high-flying dot.coms? More reasonable price/earnings ratios; real products to sell; real profits to report. These are bad things?

In many ways, those dot.com companies that will succeed are those that will find a ready customer base in the corporations of the so-called "old economy." Up until now, it is business-to-business e-commerce (B2B) that has had the greatest advances in profitability, rather than the e-tailers of B2C, or the business-to-consumer sector. What will success in the B2B world look like? Inevitably it will mean the expansion of the new businesses to significantly larger size. That, after all, is what is anticipated in the stratospheric prices of their stocks. They will be migrating from the stage where the main asset of the business is an idea, into the world of products, business management, marketing, distribution, and customer services. In other words, the winners in the new economy will begin to look a lot like the companies of the old economy. The presence of Hewlett-Packard and Microsoft on the DJIA list give us two good examples of the optimal trajectory.

There will be nothing "virtual" about the real estate needs of the winners. Their employee counts will grow, as will their space needs. Microsoft, for instance, grew from about 5,600 employees in 1990 to more than 31,000 workers by the end of last year. In terms of employees and facilities needs, HP actually dwarfs Microsoft: Hewlett-Packard's payroll counts more than 82,000 workers. As we look at markets around the nation, it is the technology field that consistently is highlighted as the critical source of future demand growth. Amazon.com may already be on the same path. As of year-end 1999, Amazon had 7,600 full-time employees. Just two years earlier, it had 614 on its payroll.

The intense competition for qualified employees in an era of general labor shortage is already having a profound effect on these businesses, and is leading the way into the future for real estate assets. When Ford Motor Company

institutes a policy to provide each of its workers with a computer and Internet access, there is a profound shift in labor-management relations afoot. As workdays have lengthened and technology blurs the distinction between company time and private time, the workplace increasingly features facilities for childcare, health and exercise, shopping, and even personal services. It was Silicon Valley that pioneered many of these trends, now becoming more common across the realm of the Fortune 500. Real estate investors are attuned to such shifts and, as I monitor transaction patterns across the nation, I see ever-increasing interest in flex space or R&D/industrial/office assets, at very aggressive prices. Furthermore, the surge in value in cities with significant technological concentrations has been amply evident. The surprise, to some, may be that such cities include bastions of the "old economy" like New York, Boston, and San Francisco.

During April 2000, the capital markets were particularly tumultuous and we saw the first rumblings of potential investor impatience with the promises-not-performance track record of many "new economy" stocks. More such turbulence is likely in the coming months and years. Investors will be looking more critically at performance expectations, and the "old economy" model may indeed be the image into which the best of the start-ups will morph. In a volatile capital market, there will surely be a cadre of investors who will look to real estate assets as havens of relative stability. After all, buying tangible assets with a first-year income return of 10 percent or so, with cash flow secured by enforceable lease contracts with credit tenants has a certain attractiveness to portfolio managers.

With supply-demand forces in the user markets for commercial property still quite sound, further price appreciation in the commercial property world is still available as well. The year 2000 will provide some interesting benchmarks for comparison between commercial real estate, which enjoys full but not inflated pricing, and stocks, some of which now appear vulnerable to substantial reassessment of their price/earnings relationships.

Meanwhile, real estate companies themselves are using technology in ever more imaginative ways. A cluster of the nation's largest mall owners (Macerich, Rouse, Simon, Taubman, Urban Shopping Centers, and Westfield America) have linked with Cisco Systems, IBM, and Intermedia Communications in

a venture called MerchantWired, to provide the retail industry with sophisticated technology infrastructure. The list of property and mortgage-related Web sites seems to grow daily. A company like TrizecHahn is looking to sell \$1 billion of real property assets, and to redeploy that capital into real estate-related technology ventures such as the broadband communications service Global Switch.

If, indeed, our economy is undergoing a "change of state" (see the Summer 1998 edition of *Real Estate Issues* for an in-depth treatment of that subject), then some turbulence is to be expected. Even with the nimbleness of so-called "gazelle" companies, there are significant advantages that accrue to size. In many ways, the list of real estate companies in the previous paragraph shows that big firms can best afford to tackle innovative ventures. Location still counts, but in a more complicated way. Big cities — 24-hour cities — tend to do well because they offer economies of agglomeration and because they are exciting places to live and work: exactly what the "wired" generation is seeking.

I have often stressed that real estate is a residual economic product, because it ultimately takes its value from its ability to provide well or poorly for basic economic functions. That is as true in the "new" as in the "old" economy. And, I suspect, real estate will best prepare for the future by anticipating that the "new" economy has fundamentally a lot more in common with the "old" economy than the popular press would have you believe.^{REI}

ABOUT OUR FEATURED COLUMNIST

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FOCUS ON THE ECONOMY

REAL ESTATE & THE FREE MARKET E-CONOMY

by Samuel Zell



Much was made in the early 80s of the advent of the "paperless office" as the personal computer hit the desktops of every office worker in America. Yet while electronic mail has certainly flourished, just as impressive is the exponential increase in the amount of paper crossing the average American office desk. Rather than eliminating paper, the shift has been in the speed and number of channels through which paper can now be disseminated.

So too, it is premature to predict the demise of commercial real estate based on the ability of the consumer to shop at home via the Internet, or the office worker to navigate supply chain negotiations via an Internet site. Bringing the customer in contact with the merchandise, or bringing office workers together for the creative interaction that fuels innovation are as unlikely to go away as paper. The tightest office markets in the country are those with the largest "Internet economies," and the mantra of all customer-facing retailing has become the multi-channel marketing strategy.

But the inroads of the new economy are indeed being felt by the owners — and ultimately the users — of real estate in the new economy. The key word is not necessarily "new" — rather... it's "economy." While fundamental changes are underway in how business is being done, as yet the basic laws of economics have not been repealed. Regulatory and legislative bodies are particularly susceptible to jumping on a new bandwagon, but current approaches to regulation of the new economic order risk substantially jeopardizing the very growth they wish to promote.

Such an issue is that of "forced access" for telecommunications providers. These proposals at the federal and state levels seek government-mandated access for some telecom providers that would allow them to install their equipment in private buildings at little or no cost. Under these proposals, a select group of providers could be relieved of any obligation to compensate owners for the use of their private property. With the granting of access by fiat rather than negotiation, the ability of real estate owners to provide services such as cable, fiber-optic wiring, satellite antennas/dishes, and wireless technologies based on customer preference and demand would be substantially compromised. Small- to medium-sized businesses have been historically disadvantaged by lack of choice and service options. It is the intent of real estate owners to protect the value of their investments by seeing their customers receive the best of both.

The economics of modern, large-scale real estate rests in large part in that, just as other capital intensive industries, it competes for customers based on efficient use of resources. Economies of scale and scope have become more and more relevant in the competitive environment as tenants recognize and benefit from operating efficiencies. Professional management has taken on extraordinary significance. The introduction of new technologies into the marketplace

are requiring substantial investments, significant R&D, and a great deal of due diligence. Prudent property owners are highly motivated to ensure that a selection of quality providers is available, because today's sophisticated tenant is unlikely to settle for anything less than the most competitive options. Forced building access is not only unnecessary, it is unwise.

Just as damaging as misguided access strategies that favor vendors rather than customers and owners, are taxation strategies that provide preferential tax treatment to one distribution channel over another. National tax policies should promote equal treatment for all commercial transactions regardless of whether sales are made in a store, from a catalog, or via the intranet. Singling out Internet sales for tax exemptions while either maintaining current tax levies or shifting greater tax burdens to in-store retailers clearly significantly shifts economic advantage, towards perhaps unintended ends.

The goal for all such intervention should be towards a competitive landscape, rather than a protectionist one. Engineering of a sales tax disequilibrium is likely to have severe — and unexpected — consequences for local economies and taxing authorities. Existing sales and use taxes provide critical funds for police, fire departments, education, and other essential governmental services. In addition, by providing online retailers a competitive edge over brick-and-mortar retailers, current tax policy confers substantial preferential treatment to a single distribution channel over another that might be equally desirable to consumers.

Regulatory and legislative watchdogs are particularly vulnerable to trying to "solve" the challenges of business in the new economy. But trying to identify where the public good lies is particularly perilous in this new age of driving economic growth. The concept of the "digital divide" is often used as justification of measures that may actually be counterproductive; for example, lower income people may be particularly disadvantaged by limiting their primary access to higher cost distribution channels.

The goal of Washington should still be to maintain a level playing field, where the forces of free-market negotiation and competition will ultimately provide the greatest amount of choice, and spur new investment for greater rewards.

There has been no need to offer tax advantages

to modern manufacturers over paper mills to prime the computer business, nor to protect paper producers against the phone companies. The marketplace will regulate, voting with its dollars.^{REI}

ABOUT OUR FEATURED COLUMNIST

Samuel Zell, *Chicago*, is chairman of the board of Equity Office Properties Trust, Equity Residential Properties Trust, Manufactured Home Communities Inc., and Capital Trust. He manages the two largest REITs in existence and is a much sought-after contributor and speaker for various real estate-related publications and programs.

FOCUS ON RESEARCH

PICKING THE BEST MARKETS

by Raymond G. Torto, CRE



Probably one of the most frequently asked questions we hear is "What are the best markets?"

Often times we answer this question with a question. "What do you mean by best?" While this may seem odd on its face, it is actually meant to suggest that "best markets" mean very different things to different people. Depending on the investment strategy, there can be a wide variety of answers.

For example, the list of best markets for buying stabilized income properties, developing new buildings, taking on leasing risk, or renovating existing buildings are all very different. Other considerations revolve around the risk and return expectations of the strategies. Are you willing to take on additional risk to achieve higher returns or are you risk averse? We can identify two markets with expected IRRs of 15 percent, but one may have a risk of 3 percent and the other 7 percent. Which would you think is "best?"

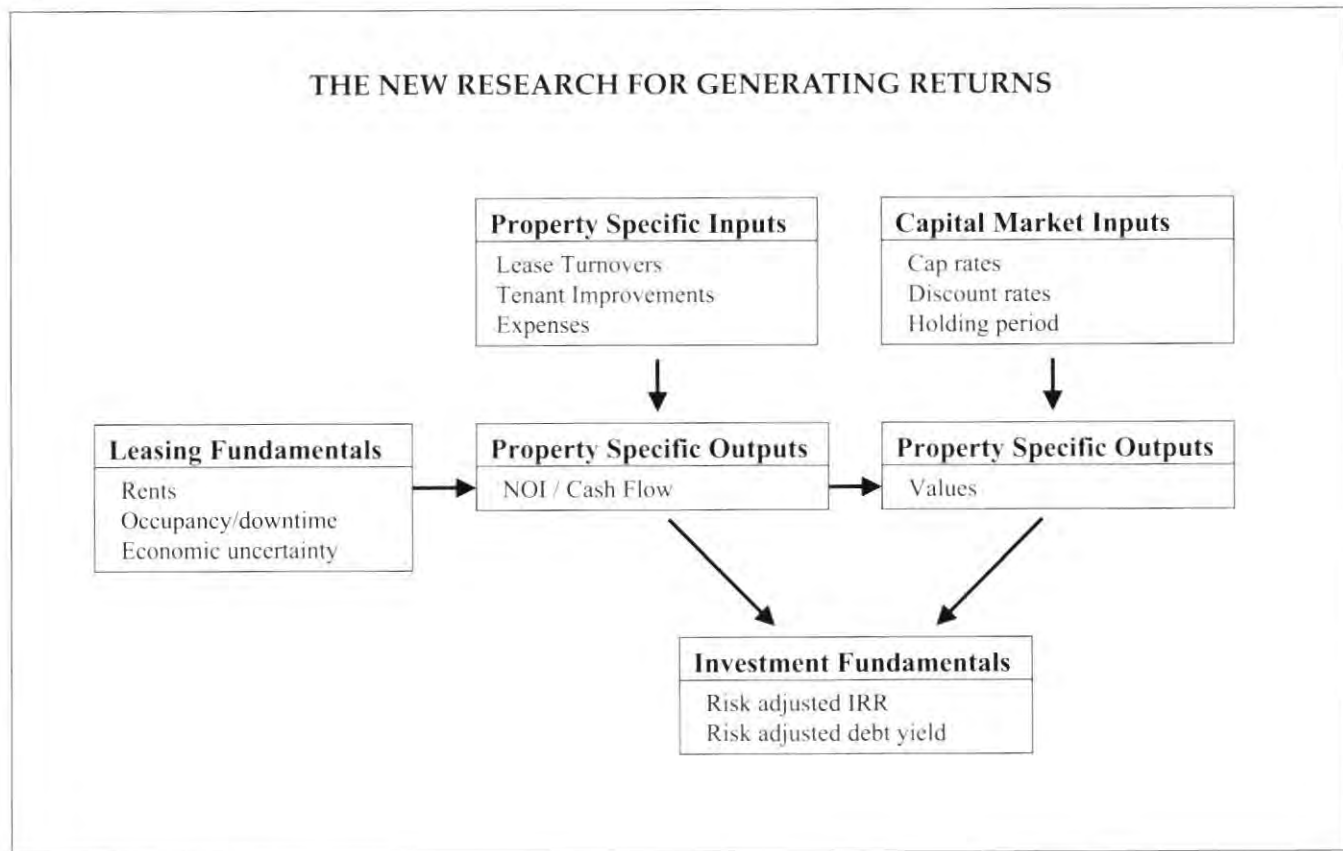
The determination of "best" is multi-dimensional and requires a research approach that provides the proper flexibility. In today's research world, research analysts are combining a top-down and bottom-up approach to market analysis as outlined in *Figure 1*. The goal is to combine the macro-economic approach of forecasting market rents and occupancy with the deal-specific details to forecast property returns.

Market research models in the "old" days produced analyses that ended with the leasing fundamentals box shown on the left side of *Figure 1*. This information provides an excellent starting point to the process of determining market risk and performance, but fails to consider what all this means to a specific investment.

Today investors want to link **market risk** and **deal or property risk**. The property-specific risk is based on the extent to which a specific property is affected by market wide fluctuations due to such idiosyncratic characteristics as its lease rollover schedule, existing rent levels, occupancy percentage, operating expenses, capital expenditures, etc. Thus, in measuring risk and returns it is important to go an additional step and examine how sensitive a specific property's cash flow is to market wide fluctuations, given such idiosyncratic characteristics. This approach is outlined in the balance of *Figure 1*.

Our own research has addressed this issue by generating returns for individual markets and individual properties. Specifically, a discounted cash flow model that takes into account building characteristics and market specific forecasts translates the rent and vacancy forecasts generated from our econometric models into expected cash flow and returns. This cash flow analysis considers existing building rents in place, lease rollover and renewals, operating costs, and tenant improvements. This methodology directly links the fundamental performance of the marketplace to the expectations for property specific NOI growth, expected return, and risk.

Figure 1



So what does this all mean as we look into the new millennium? Clearly, with more reliable and intuitive income, and risk and return measures, real estate research will be applying more advanced applications to both debt and equity portfolios. This includes the application of modern portfolio theory, enhanced techniques for ranking markets, better methods for identifying appropriate investment strategies by market, and the ability to quantify market risk in commercial mortgage and equity portfolios.

We expect the strongest demand for more sophisticated market analysis to come from the financial community, especially rating agencies, buy-side REIT/CMBS analysts as well as sell-side REIT/CMBS analysts, but also from whole loan lenders and private equity portfolio managers.

Real estate research has come a long way.^{REI}

ABOUT OUR FEATURED COLUMNIST

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FOCUS ON LEGAL ISSUES

A WITNESS'S MANUAL OF ARMS: THE MECHANICS OF SUCCESSFUL TESTIMONY

by Edwin "Brick" Howe, Jr., CRE



As a group, members of The Counselors of Real Estate (CREs), are likely to act as fact or expert witnesses at some point, or even often, in their careers. The following is an effort to collect, in one spot, a number of suggestions as to how a witness can maximize his effectiveness.

The setting in which testimony is given will influence the witness's approach to his task. The settings may be divided into two major classes: pre-trial depositions and trials. Depositions, in turn, fall into two sub-classes: depositions that are videotaped and those that are not.

A deposition is normally part of the pre-trial discovery process, in which each side seeks to discover from the other side as much information as the discovering party can to establish its own case and to undermine its opponent's case. Ordinarily, the lawyer conducting a deposition represents the opponent of the party with which the witness is most closely associated. A witness should not attempt to use his testimony at such a deposition to establish the case of his "own side"; this will be the task of his side's lawyer in eliciting testimony at the trial. Rather, the witness's goal at deposition should be to avoid bolstering the case of the "other side" and undermining that of his own side—to the extent that that goal is consistent with his oath to tell the whole truth.

Such a witness should keep his answers as simple and brief as possible, without allowing examining counsel to put words in his mouth; counsel will be entitled to ask leading questions (*i.e.*, a question that suggests its answer by, for example, beginning, "Isn't it a fact that . . .?"), and the witness should examine the content of such a question before answering it. The witness should also consider whether the question is actually a compound of two questions or contains an ambiguity and, if so, request examining counsel to simplify or clarify the point before he answers. The witness's failure to heed these precepts can have at least two unhappy results:

1. The record of the case will contain, perhaps irremediably, evidence unfavorable to the position of the witness's own side.
2. Often worse, the transcript of the deposition will contain material that can be used at trial to impeach the witness. That is, at trial, his unthinking answer at deposition can be proved wrong and used to cast doubt on, or even demolish, his credibility.

The witness should not argue with his examiner, but should answer in a way that eliminates any material adverse mischaracterization introduced by the examiner. The witness should never take umbrage, but may of course state, in answering, that the question is unfair or the like—if that observation has not already been made by way of objection raised by the lawyer representing the client's own side who is "defending the deposition." A witness should never

shade the truth; should never give an answer containing the words "oh, that must have been . . ."; and should never, never guess. Those are surefire routes to his impeachment. If he doesn't recall a particular fact, he should simply say so. As lame as a string of such answers may sound, that is almost always better than proving a point which the other side may not be capable of proving otherwise—or, better than exposing the witness to impeachment.

At deposition, a witness should not volunteer any information not strictly called for by the question. Any such additional information will be subject to probing by a skilled examiner, and this can add hours to the length of the deposition and put on the record facts which the witness would have preferred to keep private. The standard of relevance that will be applicable at the trial is unlikely to protect a witness at deposition. Typically, the standard for admissibility at deposition is information "calculated to lead to relevant evidence," a far more permissive standard than the trial standard, as many an unwary witness has learned to his chagrin.

In giving his answer, a witness ideally should dictate it, much as he would dictate a letter, in clean, clear sentences (and, for longer answers, paragraphs) that follow logically upon one another, though of course without dictation of punctuation and not in a monotone if the testimony is being videotaped or given in open court. In the context of a litigation (though not always in arbitration), there will invariably be a written transcript of testimony, and the transcript needs to read well and be comprehensible and convincing if it is used to impeach another witness, for example, or if a deposition of an unavailable witness is introduced at trial or if the transcript forms part of the record submitted to an appellate court.

Adherence to all of the foregoing can be a tall order for a witness who is also trying to identify documents and signatures, accurately recall what happened (sometimes many years in the past) and live up to, but not beyond, the terms of his oath. What can help the witness perform this complex task? A number of years' work with witnesses, and occasional service myself as a witness, have suggested two basic rules:

1. The "*five-second rule*:" At a deposition not being videotaped, always take at least five seconds—more if you want—after a question is finished completely before answering it. This will give you

time to reflect on the question's possible pitfalls, to focus accurately on exactly what you do or don't recall, and to compose your answer. It will also give the lawyer who is defending the deposition a chance to interpose an objection, assert the attorney-client or other privilege and in some instances instruct you not to answer. If defending counsel says, "I object to the form of the question" or simply "Objection to form," this is probably a tip-off to you to re-examine the question for a mischaracterization, an ambiguity or the like, and to phrase your reply appropriately. If the deposition is not being videotaped, there will be no record of your pause or demeanor.

If the deposition *is* being videotaped or your testimony is being given in open court, a *partial exception to the five-second rule* permits a shorter pause before answering the less threatening questions so that you won't appear fishy to the judge and the jury if there is one. But always pause a couple of seconds, and feel free to take longer before answering the more difficult questions. At a taped deposition you should look directly into the camera as much as possible and, as at trial, your demeanor should be respectful and confident, but never arrogant, and you should appear at peace with the testimony you are giving.

2. *Practice, practice, practice.* Before a deposition, you and the lawyer defending you should go over your part of the case in detail. You and he should explore the scope of the attorney-client privilege (if any) that will apply to your conversations with him. He should show you the documents he expects the other side to work from in eliciting your testimony, and, if the attorney-client privilege does apply, you and he should also go over the weaknesses of your own side's case and the strengths of the other side's. He should take you through a mock deposition, working out jointly the most favorable phraseology for you to use on each material point, with special emphasis on those points that may have awkward aspects.

As shortly before trial as possible, review your deposition transcript with care. Be prepared to replicate the substance of your deposition testimony insofar as possible, and be ready with explanations of any material deviations you'll have to make. At trial your initial examination will be direct examination by your own side's lawyer. This will be friendly, but for the most part he won't be allowed to ask you leading questions. So, before trial, you should sit

down with him again to learn the evidence he wants to get from you and the questions he plans to ask in order to get it. Your pre-trial session with counsel should also include a mock cross-examination that introduces you to the likely tempo and scope of cross-examination at trial and prepares you to deal with the cross-examiner's likely efforts to prove points through your trial testimony or, probably in the alternative, to impeach you.

Inevitably, the other side will ask you if you have conferred with your side's counsel in advance of the deposition or trial. You should answer truthfully. If you are asked about the nature of those conferences and your own side's counsel does not assert the attorney-client privilege, you should again reply truthfully, but giving as little detail as your oath will allow.

Remember that your answer always must be responsive to the question and that an answer may be stricken insofar as it is unresponsive. Remember also that *any* truthful answer is responsive to a "why?" question. So, if opposing counsel asks you a "why?" question during cross examination at trial, you are free to volunteer relevant information that is damaging to the other side and that, for one reason or another, cannot be or has not been otherwise introduced before the court. You may also have that opportunity in response to a "non-why?" question that opens the door to the evidence in question. All of this is part of the challenge – what can be the actual fun, if you are successful – of testifying. It is not a press conference; it is a duel. But remember, as well, to carry yourself always as if you had never heard about that._{REI}

NOTES

The author acknowledges with thanks the thoughtful and valuable suggestions of Thomas E. Engel, Esq., and Edward J. Yodowitz, Esq., of the New York Bar, who reviewed a draft of this piece.

This piece is intended to complement the excellent article concerning Counselors and litigation by Richard C. Shepard, CRE, that appeared in the Fall 1999 edition of *Real Estate Issues*; for the sake of completeness, the present piece reiterates a very few points made by Mr. Shepard.

ABOUT OUR FEATURED COLUMNIST

Edwin "Brick" Howe, Jr., CRE, is a lawyer practicing for 35 years in a range of areas, including real estate, shopping center, business, partnership and international law, taxation, litigation strategy and tactics, and witness preparation. He is currently senior counsel to Howe & Addington LLP, the New York City law firm he founded in 1970. He is also president of The Roseville Company LLC, a consulting firm based in Westport, CT, where he serves on the Town's Land Acquisition Committee. (Email: eah@howeadd.com)

ETHICS IN REAL ESTATE

Research Issues in Real Estate, Volume 5

Edited by Stephen E. Roulac

Howard Hughes Company & American Real Estate Society

Kluwer Academic Publishers, Boston

© 1999, 317 pages



As Reviewed by
Bowen H. "Buzz" McCoy, CRE

RELATED READING RECOMMENDED BY THE REVIEWER

- PETER DRUCKER - anything by him
- JOHN GARDNER - two books, *On Excellence* and *Self-Renewal*
- ROBERT GREENLEAF - pamphlets on servant leadership
- CHARLES S. MCCOY - *Management Values*
- PETERS & WATERMAN'S *In Search of Excellence*

ABOUT OUR REVIEWER

Bowen H. "Buzz" McCoy, CRE, is past president of *The Counselors of Real Estate*. In addition to professional activities, he teaches business ethics at graduate business schools. He also teaches adult education classes in Christian theology and ethics in local churches and at the Graduate Theological Union at Berkeley, California.

ethics in Real Estate, "Research Issues in Real Estate," Volume 5, consists of 15 papers concerning ethics in real estate, organized into topical headings as follows: policy issues, industry practice, environmental issues, ethical issues in the context of transactions, and tenants and ethics. All but two of the papers are written by academics, and thus the general thrust of the volume is a rational, social science approach to ethics.

Several contributors deal with a perceived stigma which attaches to real estate as not always being honest or honorable. One paper states that many believe real estate professionals will cheat and lie, especially when there is an economic downturn. Several papers state that ethics requires a moral community to nourish and support it, and real estate is not always that kind of community. In real estate, the law of *caveat emptor* prevails, and the client must take care of herself. In such an environment, ethics is described by one paper as a longing for goodness, a desire to serve others, and a desire for integrity. Professionalism begins to emerge from such a normative community when one approaches a client in an atmosphere of trust, rather than "buyer beware." Such professionalism has

difficulty emerging if the community does not support it. In this context, one paper points out that the United States ranks but 16th in a list of 52 of the less corrupt political economies in the world.

Rational decision-making seems to condone a little bit of cheating. One contributor even analyses the cost benefit of corruption, seeking to describe an equilibrium where corruption is optimized in terms of benefits to transactions and costs to society. If we base our ethical thinking on group norms, it seems to me that ethics becomes uprooted, cast adrift. We can easily see in our society in recent years how group norms change over time, making

sweeps from conservatism to liberality. This is so in terms of standards of business dress, smoking habits, expressions of sexuality, gender and race issues; and it carries over into such areas as anti-trust, price-fixing, and even the payment of social security taxes for part-time help.

How do we find something we can hold onto in the area of ethical thinking? Dante attempted to provide an answer to this 700 years ago. Dante encouraged the readers



of the "Divine Comedy" to look for: 1). The surface story line, where we each spend most of our lives; 2). The allegorical level, where we use our favorite stories and heroes to make meanings out of our experience; 3). The moral level, the mores of society, the limits of behavior which society conventionally allows from time to time; and 4). The ethical level, the deep, the spiritual, the religious, where we make our intuitive meanings. Thus, a system of law or morality, which is not rooted in the deep ethical level, is without a foundation. The issue then becomes, in a multi-cultural, pluralistic, value-free global economy, whose religion do we use?

If one is Christian, a good place to start is the Great Commandment to love God with all your heart and soul and mind and spirit; and the great corollary, to love your neighbor as yourself. This occurs five times in the New Testament. Interestingly, it also occurs twice in the Hebrew Bible and at least once in the Koran. So, it is one of the great explicit societal organizing principals of three of the world's great religions. I would posit that it is implicit in each of the other great religions as well.

Peter Drucker, our durable and relevant 90 year-old sage of business management, describing the leader of the future, states that a leader must believe in himself, have a genuine love of people, and feel a transcendent passion for the mission of the enterprise. To me, this resonates perfectly with the Great Commandment and its corollary, but expressed in purely secular terms. Drucker goes on to state that a leader for the future must have the emotional strength to manage anxiety and change. Each of the world's great religions likewise focuses on centeredness, a sense of

inner calm and peace, a sense of knowing who and whose you are, and a diminution of the personal ego.

In his opening paper, Stephen Roulac demonstrates that he understands this deeper level of ethics. It is interesting that he chooses Buddhism to support his faith-based ethics, focusing on three of the practices from the eightfold path to enlightenment: right speech (disclosure and honesty); right action (competence, fiduciary responsibility, and trust); and right livelihood (honoring the land). I have no problem with his having chosen that particular religion. In a globalized economy, with real estate becoming increasingly linked to worldwide money and capital markets, we must develop a faith-based system of ethics which encompasses all the great religions. I am intrigued, however, that he does not find the Judeo Christian ethic, which is currently the underpinning of the global marketplace, to have some value as well.

A few of the other contributors tip their hat to religion and spirituality, but they are not certain how to make it apply to a business situation. It is ironic that all the social sciences, including organizational ethics, are a direct derivative of theology. In fact, both Adam Smith and Peter Drucker were trained as theologians. Yet, since the Enlightenment, an academic loses credibility when he moves off his rational knowledge base into faith-based ethics.

We may ask whether there even is such a thing as real estate ethics. If there is, it is a derivative of business ethics, which itself comes out of organizational ethics, itself a subset of societal ethics. By focusing on real estate, as the book does, one can examine current practices ranging from brownfields to bro-

kerage transactions. It is interesting to grapple with the key issue of how to be successful financially and still ethical in a business which does not always follow ethical principles.

I personally prefer a broader approach to organizational ethics. I would recommend to the interested reader almost anything written by Peter Drucker. An interesting book is *Management of Values* by Charles S. McCoy (no relation). McCoy has a theory of covenantal ethics, which obviously has Hebrew origins and permeates the federal, covenantal societies of today. A good leader is sensitive to the implicit and explicit covenants contained in the culture of an organization, and he attempts to lead by resonating with them, not by manipulating them. Robert Greenleaf's pamphlets on servant leadership remain relevant, as do John Gardner's two treasures: *On Excellence* and *Self Renewal*. Finally, I have always felt that Peters and Waterman's *In Search of Excellence*, is a deeply ethical book as it concerns leadership through the building of values.

I would conclude that the chief difference between a profession and a job is that a profession has an ethical underpinning. A profession denotes an unbiased service or value creation for the other and not only personal aggrandizement. This notion is contained in the 15 papers in the book, but it takes a bit of work to dig it out. ^{REI}

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