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Storrs, Connecticut

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EDITOR'S STATEMENT - by Richard Marchitelli, CRE

At this writing (early April), the mood of the investment community is growing somber. As signals of a weakening economy increase, anxiety is replacing cautious optimism. Consistent with other transitionary periods, there is a dichotomy of expert advice. Some money managers suggest that this is an opportune time to purchase stocks (*i.e.*, on their way down), while others preach the wisdom of liquidity. If the professionals who manage the mutual funds have not developed effective strategies to cope with the market downturn, it is no wonder that individuals feel a sense of despair as they watch their retirement accounts evaporate.

Confused behavior can be observed in the property markets as well. Some real estate investors have accelerated development in an attempt to beat the impending shift in the cycle, while others have shelved such plans. Disappointing profits, layoffs, and corporate restructurings have become everyday occurrences. Indeed such trends have been chronicled in this column for at least the past nine months (three issues). Because real estate markets tend to lag the economy, it will be interesting to observe which proactive strategies, if any, portfolio and property managers employ to mitigate the effects of slackening demand, increased competition, and new-found tenant empowerment.

In a robust economic environment, there is less innovation simply because property performance is acceptable, if not outstanding. There is a prevailing feeling of security and a reluctance to tamper with success. However, in times of adversity, real estate professionals become increasingly active in seeking innovative solutions to hard-core problems. During such periods, some of the most interesting manuscripts are submitted to real estate journals such as *Real Estate Issues*.

It is difficult to determine where we are in the financial (economic) and real estate (physical) cycles. Property markets lag the general economy because, except for hotels, leases tend to insulate real estate from many of the immediate effects of a changing economy. Nonetheless, one cannot help but feel like a passenger on an accelerating train nearing the point of going out of control. Will the safety brake engage and avert catastrophe or is the train heading over the cliff? . . .

Richard Marchitelli, CRE
Editor in chief

David Kirk, CRE
2001 National CRE President

Lodging Industry Fundamentals Remain Strong Despite Cautious Stance on New Development

by M. Chase Burritt

While U.S. lodging fundamentals are generally strong, increasing economic trepidation may begin to affect lodging industry performance, as the Consumer Confidence Index has softened due to high oil prices, recently announced layoffs and a volatile/declining stock market.

If corporate and leisure travel expenditures begin to moderate as a result, the impact on hotel occupancy levels would be partially tempered by a development pipeline already thinned by the tight capital markets.

As the pace of business change increases, the lodging industry in 2001 will continue to confront new challenges in areas including, but not limited to, finance, development, marketing, and operations.

CAPITAL MARKETS GAP

With the lodging industry coming off one of its most productive years ever in 2000, and with many per unit revenues and profits at historically high performance levels, traditional development theory postulates that capital for new development should be forthcoming to ease tight lodging markets. However, several factors are affecting the availability and cost of capital for both acquisitions of existing properties, and most particularly, new development.

ABOUT THE AUTHOR

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The perception that most hotel assets are performing at or near their peak, with more moderate growth potential, has created a widening gap in the perception of hotel asset values between buyer and seller, with buyers commonly believing that hotel value has peaked and sellers believing that more optimistic current/prospective value appreciation should be reflected in asset pricing. This disconnect has contributed to a softening of transaction activity with respect to existing hotels.

Additionally, the tightening of the capital markets that began in fall 1998 continues, with the financial community taking a cautious stance (i.e., more equity required as a percentage of total capitalization) with respect to lodging investments. These dynamics have created a general impasse on many lodging industry transactions and developments.

However, as of the beginning of this year, rumors of increased activity have emerged. A few large mergers and acquisitions are in the works; lenders have come forth with competitive terms and a willingness to lend, particularly on cash flowing properties; and equity, although highly selective, is available. Construction lending is still the most challenging—although there are a few banks ready and willing. For those equity investors who are well-capitalized, significant and compelling value investment opportunities do exist.

In general, it is safe to say that capital in the lodging sector is still highly selective—with most capital targeting existing cash flow properties; mixed-use development projects (with in-place leases); development projects with high barriers to entry and some public financing component; or leased properties with credit-rated hotel companies.

While the continued capital crunch may have a negative effect on new lodging development on the horizon and on pricing for existing properties currently on the market, a slowdown in new supply should have positive effects on existing hotels and those already far along in the development pipeline.

Although the lodging industry continues its nearly decade long streak of increasing revenues and profits, there is some disagreement among industry analysts about the industry's prospects in the near future, particularly with the recent rise of oil prices, the volatility in the stock market and the slower growth rate of the gross domestic product. Of immediate concern are recent declines in the Consumer Confidence Index (which as of January 2001 fell for the fourth consecutive month and is at its lowest level since December 1996), as well as limited downward revisions of corporate earnings expectations and the effect, though less evident, on corporate travel expenditures.

While the continued capital crunch may have a negative effect on new lodging development on the horizon on and pricing for existing properties currently on the market, a slowdown in new supply should have positive effects on existing hotels and those already far along in the development pipeline.

Despite these macro economic factors, it is anticipated that in 2001 the lodging industry will continue to post relatively steady performance characteristics, although with more modest overall RevPAR growth in 2001 than 2000. Between 1997 and 2000, demand in the industry experienced a cumulative increase of 10.6 percent, with growth in 2000 at 4 percent. In 2001, industry demand growth is anticipated to increase by approximately 2 percent, almost at the same pace as supply, as moderating economic growth tempers lodging demand.

Profit growth in the industry should continue to exist, increasingly becoming a function of efficient expense management and process re-engineering, as well as some development. In 1999 and 2000, industry profits were estimated at \$23 billion and \$24.3 billion, respectively, and for 2001, profit levels are anticipated to increase to approximately \$26 billion.

While nationally the industry exhibits stable performance, there exist some local markets that are experiencing weaker supply and demand fundamentals such as Philadelphia and Seattle. These markets in particular experienced a decline in revenue per available room from 1999 to 2000. Both markets are combating the imbalance of the supply demand equation through the development of additional demand generators, including expansions of their conventions centers and other projects underway.

Between 1997 and 2000, the U.S. lodging industry added approximately 411,459 rooms, representing an estimated cumulative growth of 11.6 percent. In 2001, industry supply growth is anticipated to increase by 2.3 percent, compared with an estimated 2.9 percent in 2000. The 2.3 percent increase represents the lowest growth since 1995. Concerns about new additions to supply are warranted in certain markets - particularly, secondary markets with limited demand generators (i.e., markets that rely heavily on overflow demand or a solitary demand generator such as a convention center). According to *Lodging Econometrics*, 1,261 properties with a total of 139,064 rooms are scheduled to be completed in 2001.

Although concerns exist from a macro economic and micro market perspective, overall, the lodging industry is better prepared to confront these forces and remain profitable. The tightness of the capital markets helps to keep supply and demand in balance and has caused hotel developers, owners, lenders, and management companies to implement new strategic capital plans to maintain growth and increase profitability.

NEW PSYCHOGRAPHY OF AGING

The changing demographics of the U.S. consumer are anticipated to have a significant impact upon lodging demand and particularly the resort segment. While it is possible that in the short term the recent decline of the stock market and portfolio values (and subsequently the recent drop in the Consumer Confidence Index) may somewhat affect baby boomer leisure travel, it is more likely that longer term psychographic trends will more profoundly shape the industry.

The baby boomers are heading for retirement; Gen-Xers are heading into their peak earning years; and the Generation Y or "Echo Boomers" are moving into their adult years. As the baby boomers retire over the next 10 years, more people than ever before will find the means and the time to sample the best that the lodging industry has to offer.

Each generation has its own definition of a vacation, as well as their own unique expectations as to the ideal trade-off between work and leisure time. This substantial demographic shift in the today's consumer will create many opportunities for resorts, but will also create many changes.

The baby boomer generation currently comprises approximately 29 percent (80.5 million) of the U.S. population. As recently reported by the American Automobile Association (AAA), baby boomers account for 40 percent of all travel, and this is expected to increase. Estimates for the annual income of baby boomers generally exceeds $2 trillion, giving this generation 52 percent of the personal income for the U.S.— this is expected to reach 65 percent in 2005, according to research by B.T. Alex Brown. Not only do baby boomers control the majority of the country's income, they are also entering their peak spending years. This generation is wealthier and healthier and is expected to live longer and enjoy more years of retirement than any generation before it. Baby boomers and their tendency to spend will clearly dominate the U.S. economy (and the resort business) during the decade, with an estimated growth rate of 30.1 percent, and reaching a peak in 2015.

Baby boomers are driving the concept of rentability of condominium-style living versus traditional hotel units. The baby boomer generation is investing more in service-oriented real estate. The concept of "rentability" primarily refers to the interest in real estate fully serviced by management companies and located within master planned leisure communities, allowing owners the ability to maintain an established lifestyle at their primary residence while minimizing the perceived risk of investing in a second single asset. As a result, the opportunity exists for resorts to extend the value of their asset by offering condominium style products to their customer base.

While resort operators need to focus on baby boomers for the immediate future, they should not lose focus of the 56 million Generation Xers that follow, (those born between 1965 and 1978). These are the boomer's younger, affluent siblings and children. This generation, as a result of the Internet and the Information Age, are more consumer savvy and have less consumer loyalty than boomers. As they are just entering their peak earning years, they will not dominate leisure travel, but they will certainly have a significant impact in the future. There will be some resort operators that will benefit from this generation through niche marketing and catering to their needs.

Generation Xers' expectations for a vacation experience are quite different than the baby boomers. According to consumer research, Generation Xers are more predisposed to taking all-inclusive vacations than boomers; to staying at the *best* hotels and resorts than boomers; to visit places they have never visited before; and are more likely to utilize spa and other activities of a resort than boomers.

Additionally, Generation Xers are more experience-oriented and as a result are looking for experience- and entertainment-oriented vacations. Being a beneficiary of the Information Age, high-tech amenities, entertainment, and instant gratification is most important to Generation Xers, when it comes to vacationing.

Universal among every segment of the population is lack of time. Time is becoming the most important commodity in a consumer's decision-making process. As a result, consumers are more willing than ever to trade dollars for time. According to research by Yankelovic Partners, today's' consumers are taking more frequent trips, but for less time. Americans are also vacationing closer to home, within 3.5 hours' travel being the optimal distance.

Today's consumers are also more willing to spend more for superior service. This translates to: resorts which can provide their guests with maximum experiences in the most convenient manners will thrive.

OCCUPANCY—FLAT TO SLIGHTLY NEGATIVE

Between 1997 and 2000, occupancy in the industry ranged between a low of 63.2 percent in 1999 and a high of 64.5 percent in 1997, exhibiting a downward trend during the past three years. In 2000, occupancy for the U.S. lodging industry increased slightly, reaching 63.9 percent. In 2001, occupancy is anticipated to decrease slightly to 63.7 percent as a result of continued supply growth.

ADR (AVERAGE DAILY RATE) — FLAT TO POSITIVE

Between 1997 and 2000, ADR in the industry ranged between a low of $74.76 in 1997 and an estimated high of $84.99 in 2000, increasing at a compound annual growth rate of 4.4 percent. Positive ADR growth is anticipated to continue in 2001, resulting in an ADR of approximately $88, an increase of 4 percent over 2000.

REVPAR (REVENUE PER AVAILABLE ROOM)—FLAT TO POSITIVE

Between 1997 and 2000, RevPAR in the industry ranged between a low of $48.19 in 1997 and an anticipated high of $54.32 in 2000, exhibiting a consistent, upward trend during the past three years at a compound annual growth rate of 4.1 percent. In 2001, RevPAR growth is anticipated to moderate, with RevPAR increasing by 3.7 percent.

Increasingly, services offered by lodging companies are overlapping with other real estate and service-oriented industries such as time-share. This competency extension strategy has also created a more complex form of customer relationship management, prompting lodging companies to measure consumers in terms of their lifetime value to their total brand portfolio.

THE INTERNET AND WEB ENABLEMENT

The Internet continues to create new opportunities for the lodging industry and to change the marketplace in innovative ways. On the revenue side, online travel information access and booking are likely to boost the overall amount of travel expenditures, but at the same time make the distribution landscape more complex. Relative to operations, hotel companies are now busy installing high-speed Internet access in guestrooms and are beginning to realize the marketing potential of such services. Online procurement/B2B networks are anticipated to generate cost efficiencies in areas such as purchasing, accounting, energy and repairs, and maintenance. Lodging companies are teaming with service providers to improve profitability and to sell the promise of greater efficiencies to other companies. As Web enablement technology advances, these efficiencies will become more tangible.

MANAGEMENT COMPANY SELECTION

Management company selection has become an increasingly important process in today's lodging industry environment. Encouraged by the Tax Act of 1981, significant hotel development occurred in the early 1980s, putting into place many management-friendly deals that were largely not performance based. Now, with many of these management deals up for review and more industry attention being paid to operating efficiencies through performance clauses (as well as management now often sharing in some of the ownership work), a formal review of the options is becoming more important. Also, today's widespread public/private activity often requires a more structured management company selection process.

BRAND & CUSTOMER EXTENSION

Increasingly, services offered by lodging companies are overlapping with other real estate and service-oriented industries such as time-share. This competency extension strategy has also created a more complex form of customer relationship management, prompting lodging companies to measure consumers in terms of their lifetime value to their total brand portfolio.

ASSET MANAGEMENT

In the face of increasingly complex industry challenges, many individual and portfolio hotel owners are recognizing the value of independent professional asset managers that serve as a vital intelligence link between ownership and management. In addition to providing strong, innovative and profit-driven property management, professional asset management provides the potential for increased profit from operations, the convenience of a central, unbiased point of communication, and the creation of an independent strategic plan.

CONSOLIDATION

At least one or two international transactions are anticipated in 2001, as the difference between public stock values and asset values drive activity. The British company, Bass PLC, which operates or franchises more than 2,900 hotels internationally under brands including Holiday Inn and Inter-Continental, could make a large hotel acquisition with the $3.8 billion of proceeds from the divestiture of its brewing business.

LUXURY SEGMENT

Barring any major economic slowdown that could significantly impact corporate group and individual lodging demand, the luxury segment should continue on its relatively steady growth pace in terms of occupancy, ADR, and RevPAR. While several local markets are likely to experience oversupply, in most metropolitan areas the consistent upward RevPAR trend exhibited by this segment is anticipated to continue, enticing only selective new development based on highest and best use issues.

FIRST CLASS SEGMENT

In 2000, first class supply growth was modest, superceded by supply growth in the mid-scale and economy segments. During 2001, the segment's fundamentals are anticipated to neutralize a bit more, with occupancies stabilizing. As interest rates inch upward, project pipeline development will likely become more selective as financing remains difficult to attain.

UPSCALE SEGMENT

The thinning of the development pipeline and a continual focus on operating efficiencies through innovate new distribution and procurement channels will ensure the health of the upscale segment in the near term. Such innovative operational programs will continue to support increases in profitability at a time when the strong growth in the U.S. may begin to raise human capital costs.

MID-SCALE WITH FOOD & BEVERAGE

The mid-scale with F&B segment continues its stable to slightly negative performance, as its new entries have yet to develop the critical mass to offset the conversions and defections of older, more traditional properties. While there is anticipation of a limited number of new projects developed in the segment, overall there is less attention to product and market innovation occurring in this segment.

MID-SCALE WITHOUT FOOD & BEVERAGE

As historic supply growth has been intense, the continued stability of the mid-scale without F&B segment depends on its ability to moderate and better qualify its development pipeline. It remains to be seen if the segment can calm its zeal for further development as opportunities for dramatic additional operational efficiencies lessen.

ECONOMY SEGMENT

With operations having become more efficient, and additions to supply continuing but moderating, the question remains: How much more value can the economy segment engineer into its properties? As the cycle of U.S. economic expansion continues to moderate, the benefit from the waterfall effect of corporate travel tradedown activity could partially offset other impacts on demand; if the expansion continues, increasing labor costs and interest rates could begin to impact profitability.

RESORT SEGMENT

Favorable consumer demographics, particularly from the aging baby boomer generation, and spending patterns over the next two decades, are anticipated to have a significant positive impact on resorts. At the same time that travel is increasing, however, entertainment and vacation alternatives are also expanding. Increased resort development in 2001 is anticipated to somewhat impact segment fundamentals, however continued high barriers to entry in most markets, as well as tightening capital, continue to protect the supply/demand balance in this segment.

CONCLUSION

Although the lodging industry continues its nearly decade-long streak of increasing revenues and profits, there is some disagreement among industry analysts about the industry's prospects in the near future, particularly with the recent rise of oil prices and the decline in the stock market. It is anticipated that in 2001 the lodging industry will continue to post relatively steady performance characteristics, with more modest overall RevPAR growth than 2000.

Profit growth in the industry should continue to exist, increasingly becoming a function of efficient expense management and process re-engineering, as well as some development. In 1999 and 2000, industry profits were estimated at $23 billion and $24.3 billion, respectively, and for 2001, profit levels are anticipated to increase to approximately $26 million.

While nationally the industry exhibits stable performance, there exist some local markets that are experiencing weaker supply and demand fundamentals. Of immediate concern are recent declines in the Consumer Confidence Index, as well as limited downward revisions of corporate earnings expectations and the effect, though less evident, on corporate travel expenditures. REI

The Future of Real Estate Information

by John A. Kilpatrick

Evolution of Real Estate Standards

"I don't see information technology as a stand-alone system. I see it as a great facilitator. And maybe more important, it is a reason to keep asking yourself the question – why, why, why."

- Paul O'Neill, former Chairman and CEO of Alcoa, now U.S. Treasury Secretary[1]

For real estate counselors, application of information technology would enable projects to be done faster, cheaper, and with less risk. Consider the typical, simple acquisition: assuming a willing buyer and seller, with no particular barriers to the transaction occurring, the due diligence has traditionally taken three or four times as long as the contracting itself. However, in the fast-paced acquisition environment of late, particularly fueled by the REITs, the period between signing the letter of intent and the closing has shrunk to as little as 10 days.[2] If due diligence efficiency could be enhanced, even marginally, the cost savings per transaction would be enormous. Given the current estimates of the size of the U.S. real estate market—$4 trillion at last count—the aggregate cost savings will be huge.[3]

Consider also the after-the-transaction needs for information—reporting, periodic revaluation, tax compliance, and a host of other data needs, both on the subject property as well as on comparable and competing properties. As real property is increasingly securitized or included in institutional portfolios with quasi-securitization reporting requirements,

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the need for timely, accurate information becomes a mandate, not an option.

Couple this with the increasingly sophisticated analytical tools. Counselors who fail to use appropriate analytical tools are at the very least planning their own retirements, and are often guilty of failing their fiduciary duties. However, the simple act of transferring data as it may be available into an analytical data set is horrendously time-consuming and fraught with errors and interpretive problems.

Finally, there is the issue of listing data. Internet-based commercial listing services such as Loopnet have, relatively overnight, become the 5,000 pound gorilla of commercial real estate listing information. As an example, in October, 2000, Loopnet had over $83 billion in for-sale listings and over 1.3 billion square-feet of for-lease listings. Further, Loopnet has emerged as a transaction player as well, featuring over 27,000 purchase and lease "requirements" listings.[4] Savvy commercial brokers now find that they can do an increasing number of deals just through the Internet. For example, Dean Cruci, a Southern California broker, was recently quoted as saying, "Of the last 10 escrows I've closed, nine out of 10 of them have been on the Internet."[5]

In the early 1990s, the National Council of Real Estate Investment Fiduciaries (NCREIF), the Pension Real Estate Association (PREA), and the National Association of Real Estate Investment Managers (NAREIM), together took the first step by creating the Real Estate Information Standards, or REIS. This project was stimulated by the information shortcomings of the real estate field, relative to other investment segments, such as equities and fixed income. Those investment segments are primarily public in nature, and have had many years of scrutiny and guidance by regulatory bodies. That scrutiny has served to increase the confidence of investors and investment analysts that information is conveyed accurately and consistently. Real estate, on the other hand, has been primarily a private market activity until recently, with regulation and information exchange perceived as being less than complete.[6]

The REIS effort culminated in the publication of the first phase of the standards in 1993, and the selection of Deloitte & Touche LLP to provide ongoing monitoring and improvement.

INFORMATION STANDARDS & THE WEB

It was an interesting juxtaposition of timing that

In the late 1990s, it became obvious to many researchers that there was a gap between REIS and the way information was organized on the Internet. A collaboration was formed, including many of the REIS sponsors, as well as representatives from private sector firms (REITs, accounting firms, major real estate firms, and the evolving set of real estate data providers themselves) to systematically integrate real estate information, under the rubric of REIS, into such standards as would be necessary for full utilization of the new generation of information technology resources. The collaboration came to be known as the Data Consortium (DC).

REIS was published just as the World Wide Web was being created. Even though the Internet had existed for almost two decades prior to the early 1990s, it was mainly used for e-mail among research laboratories and universities as well as transfer of fairly large, specialized research data sets among laboratories. To put matters in perspective, when the new President of the U.S. was inaugurated in 1993, there were about 60 "Web" sites in existence, almost unknown outside of a small fraternity, and powered by a now defunct software package developed by supercomputer researchers called "Mosaic."

In the ensuing eight years, the Internet revolution has been both profound and ubiquitous. Ignoring for a moment the e-commerce applications, and focusing only on the data issues, a researcher in Australia or Austria or nearly anywhere in Asia can share data with colleagues in New York, Old York, or Yorktown as quickly as dialing a telephone. Data transfer is nearly free (certainly cheaper than sending an equivalent sized fax, overnight package, or even first-class letter), nearly 100 percent accurate (what you send is almost always exactly what the other side gets), and potentially, immediately usable. For example, if I am working on a spreadsheet analysis in a hotel room in Dothan, Alabama, and need to share that with a colleague in Seattle, Washington, I can not only send the information, but in a format that allows the colleague to immediately re-analyze the data without any additional data entry or data manipulation.[7]

Unfortunately, this particular example, and all examples like it, require "two sided" manipulation of the data. In other words, there has to be both a sender AND a receiver. Additionally, the receiver must be using the same data analysis tools as the sender, or at least some tools which are congruent.[8] Finally, the Web has enabled a huge industry in online databases, enabling an increasing amount of "one-way" traffic in data. Hence, the sources of data (that is, the online databases) must be constructed and designed in such a way to facilitate simple, immediate use of the data in common analytical tools.

EVOLUTION OF THE DATA CONSORTIUM

In the late 1990s, it became obvious to many researchers that there was a gap between REIS and the way information was organized on the Internet. A collaboration was formed, including many of the REIS sponsors, as well as representatives from private sector firms (REITs, accounting firms, major real estate firms, and the evolving set of real estate data providers themselves) to systematically integrate real estate information, under the rubric of REIS, into such standards as would be necessary for full utilization of the new generation of information technology resources. The collaboration came to be known as the Data Consortium (DC).

The DC's agenda was to find ways to utilize the Internet to address 13 specific problems faced by the real estate industry:

- identifying the commercial real estate inventory nationwide;
- locating and maintaining listings of properties for sale;
- locating and maintaining listings of space for lease;
- performing investment underwriting;
- conducting pre-purchase due diligence;
- aiding transactions/transfer of ownership;
- performance reporting to clients, consultants, data vendors, and trade associations;
- integrating disparate property management systems and information;
- compiling operating or occupancy statistics;
- combining property and demographic/economic data;
- facilitating document storage and retrieval;
- fact-finding for risk management; and
- custom reporting for various clientele.

One of the first steps, interestingly, was to determine exactly what those information technology resources were. In the earliest days of the Web, a common language evolved known as *hypertext mark-up language*, or HTML for short. From the user's perspective, the most common manifestation of HTML was the coding for Web pages. However, HTML also provided a template within which data was encoded and hence transferred on the Internet.

While HTML is a good tool for developing pretty Web pages, it unfortunately lacks the structure for efficiently and effectively encoding data. For example, both a street address and a sale price can easily be encoded within an HTML document, but both are essentially coded as text strings. Thus, the HTML document itself provides no clues as to which characters represent a price and which represent a street address. For that matter, a zip code and a price look exactly alike within an HTML document.

Clearly, this unsophisticated level of coding would be insufficient as the Web increasingly became the worldwide transfer mechanism of choice for nearly all forms of data. Hence, the second generation of Web coding quickly took form as the *extensible mark-up language*, or XML. This language provided for the necessary tags to encode data by type, not just as text strings. Within XML, a data set could be sufficiently organized to be useful to a variety of users without the need for complex deciphering of HTML documents. The integration of REIS into the technology age would occur under the rubric of XML.

In the end, the Data Consortium (DC) was formed to bring these issues together under one umbrella. Principal coordination support for the Data Consortium is provided by RREEF, while day-to-day work of the Data Consortium is done by a volunteer working group.[9] The first organizational meeting of the Data Consortium took place in Chicago at NCREIF headquarters on February 10, 2000. Attendees included members of the National Council of Real Estate Investment Fiduciaries (NCREIF) and representatives of the International Council of Shopping Centers (ICSC) and the National Association of Real Estate Investment Trusts (NAREIT). Attendees concurred that the creation of Internet-savvy standards for the interchange of real estate information was an essential task for the group.

The Data Consortium was formally incorporated as a not-for-profit entity on October 12, 2000. More specific information on the Data Consortium and its working group is available at the Web site, *http://www.dataconsortium.org*.

Further helping to define this integration was the predecessor development of the Real Estate Transaction Standards (RETS), promoted by the National Association of REALTORs (NAR). The work of the DC was further complicated with the need to be congruent with parallel efforts of the World-wide Web Consortium (W3C), the Mortgage Bankers Association (MBA)[10] and the American Institute of Certified Public Accountants (AICPA). Additionally, standards development has proceeded globally, most notably in the U.K. through the Property Information Systems Common Exchange Standard (PISCES), further adding to the coordination burden.[11] Finally, since so much of real estate information is also legal information, it quickly became apparent that the work of the DC would have an impact on parallel work being done in the legal community, specifically LegalXML.[12]

The mission of DC was clear—to realize a new class of software oriented to one, vendor-neutral, common information standard. It was widely agreed that without this, the major consequence to the real estate community would be a continuation of the legacy business model based on 'captured' customers whose data are stored in disconnected, restrictive computer systems. Without a unified standard for interchanging information, current vendors would have little incentive to improve their products beyond developing Internet interfaces. Collectively, the industry would miss significant opportunities as Application Service Providers (ASPs) create new and exciting applications for which there would be few customers willing to duplicate/straddle their operations. Real estate standards likely would not result by consensus among all the stakeholders, and the industry's costs to move from a paper-chasing world to an information-chasing world will be far higher than they needed to be.

These efforts are resulting in a set of information interchange standards within XML which has come to be known as the Data Consortium Namespace (DCN). This body of standards will, when published, provide a template that will allow data developed under REIS to be easily shared and utilized among constituent groups.

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DATA CONSORTIUM NAMESPACE

The Data Consortium Namespace is a combination of XML element definitions plus one or more dictionaries of industry-specific terms referenced by the elements. Together, these are used to represent data considered within the "domain" of the namespace. The DCN is generally distinguished from other industry namespaces by two groups of information. The DCN must identify and describe real estate properties available for sale, lease, or assignment. Second, the DCN must accommodate measurements of financial and management performance regarding these properties. Neither requirement is today fully supported by namespaces publicly available from the real estate industry, or from allied industries.[13]

To accomplish this, the DCN is developing three major definitional standards which will tie together four interrelated initiatives. The definitional standards are:

Guide to the Data Consortium Namespace (DCN)

DCN 1.5 is a broad set of specifications which defines XML elements and attributes for expressing information related to commercial real estate listed for sale, lease, or assignment. DCN 1.5 includes a set of terms that are referenced by elements in other documents.[14]

Document Type Definition (DTD) for the DCN

The DTD is a statement of the information schema for the DCN. The DCN applies the latest technologies to the model recently published by the National Association of REALTORs giving a sophisticated, stable, programming environment.[15]

Data Consortium Dictionary (DCD)[16]

The DCD will contain elements used to define references, linking these of Java classes or script objects.

These three basic definitional standards will then form the basis for the development of four interlocking and mutually consistent sets of tools for developers:

1. The DCN Software Development Kit (SDK),
2. The DCN Processes for Information Interchange,
3. DCN Model Applications, and
4. Data Consortium Web Services

DCN Software Development Kit (SDK)

The real estate community would benefit from having a common base of software that can be integrated by vendors into their products. The SDK is envisioned to be a single packaging of software and reference material, and includes samples of all documents within the scope of the DC Namespace. Specific software planned for the SDK includes the following:

DCN Object Classes

The DCN is designed specifically to accommodate a modern software development environment. Most recently, these environments have been based on object-oriented software development methodologies. In keeping with this object-oriented approach, the DCD contains object class names that permit use of software objects from the content of a DCN data stream.

The advantages of this approach to software development are most apparent in the ease of inheriting object behavior across classes arranged in a hierarchy. The 'behavior' of an object class is encoded in a language such as Java, Visual Basic, or Perl, and is reached by sending a message to either a locally-used object or a remotely-used object.

The Simple Object Access Protocol (SOAP) is the messaging protocol of choice for cross-machine communications. Accordingly, message names standardized by the DCN can be recorded in the DCD. Thus, the DCN standardizes both object class names and class message names.

The first objective of the Software Development Kit (SDK) is to standardize object classes that track to the 20 resource and attribute element types defined within the DTD. In addition to classes corresponding to each category defined by the DCD, a DCN Resource class will be defined. The DC Dictionary and Glossary are also designated as object classes.

To support 'push' and 'pull' techniques, classes for DCN data stream 'readers' and 'writers' are required. The 'readers' use objects implied by the DCN data stream, and the 'writers' create DCN data streams from information in the objects.

The specification for each of the DCN object classes will include class and instance message names, and will be specified in a binding-neutral manner (e.g., using the CORBA Interface Definition Language). Subsequently, at least two code implementations will be created: one supporting server-based processing, the other supporting common client environments. At least one of these implementations will use the Java language.

DCN Validation Services

The DCN is designed to require a custom mechanism for an exhaustive validation of a DCN data stream. While XML DTDs and XML schema are adequate for most syntactic validations, a number of syntactic variations allowed and prohibited by the DCN cannot be validated using those conventional methods. Furthermore, validation must address whether undefined dictionary terms are used by elements in the DCN data stream. Validation must be accessible in real-time, and must create a DCN-conforming stream of error messages.

Because some vendors may need terms not defined in the Data Consortium Dictionary, the DCN allows users to create their own custom dictionary. Custom dictionaries may also be subject to validation at the option of the author.

DCN Processes for Information Interchange

DCN E-mail Protocol

A key service for Data Consortium members is the ability to send documents to another party or to a repository using standardized mechanics. This is the input side of the architecture.

This plan proposes an SMTP-based solution for the large percentage of documents that can be e-mailed from a publisher/sender to a repository/recipient. The solution includes a Java program running on a sender's machine that creates an XML stream that the sender can then attach to an e-mail message. The program can also invoke the e-mail client, e.g. Outlook, located on the sender's machine. SMTP-based filter software located on the destination's mailbox is also required. Its job is to identify incoming mail having DCN attachments, and to invoke software on the host machine to route the document to the proper location.

DCN Transformation Services

The DCN can also be used effectively as a persistent storage format. There is a need for interfaces to other XML namespaces encountered by DC members in order to take advantage of the promise of having a single data stream that can serve multiple needs. For example, the Extensible Business Reporting Language, (XBRL) is used for reporting certain financial information that could be stored in a native DCN format. The Data Consortium will also identify other XML namespaces with which transformations might be required.

Transforms can also be created to take XML data streams and display them in HTML, PDF, text, or other formats. These transforms or style sheets will be included with several of the model applications described below.

DCN Model Applications

Model applications are a useful way of conveying the power and capability of the DCN. The Data Consortium will create and post for public review a series of templates showing real-world applications of the DCN in enough detail to allow software developers to extend the templates into commercial products and services. The most commonly requested model applications are as follows:

Property For Sale or Lease

In discussions with Data Consortium members, it has become clear that finding a simple and efficient means to post information about property for sale or lease on a wide array of Web-based listing services is a high priority. Property owners and their agents wish to have a system that permits them to prepare the needed information once, and to allow others to gather that information without further involvement by the publisher of the information. Similarly, the listing services wish to have choice of the data they collect, the manner in which it is stored, and the frequency with which it is collected and updated.

Thus, a model application will be built around this need. The system is based on the DCN Software Development Kit, thereby allowing storage of information about properties and spaces available for lease. Additionally, a 'robot' will be designed to query those storage sites periodically and to extract information needed by commercial property listing Web sites.

The real estate industry has, for most of its life, utilized highly fragmented, proprietary data sets which rarely communicate with one another. However, a significant change is underway which will provide the opportunity to bring these disparate sources together with a common language and via the commonly available Internet.

Sites having information about property for sale or lease will be included in the Data Consortium Registry, described below, to make searches by people or robots more efficient.

Due Diligence Transaction Processing

The process of transacting commercial real estate is complicated and time-consuming, involving dozens of steps and many documents. This activity lends itself to the XML standards being developed by the Data Consortium.

This model application will rely heavily on the DCN-specific e-mail protocol described above in the SDK. In fact, this application and the e-mail protocol are essentially the same initiative.

Property/Fund Reporting Server

The mapping of the Real Estate Information Standards (1999) and associated property and fund level information to the DCN provides the foundation for the development of standards for documents submitted routinely to NCREIF by property owners, managers, and investors. Additionally, these data elements are commonly used to report property and fund performance and supporting material to clients/owners and their consultants or trustees.

The focus of this project is to identify all of the information commonly provided in these reports, and to create an XML-based means of conveying that information in a variety of computer-based and hard-copy formats: HTML, PDF, and others deemed appropriate.

Valuation/Cash Flow Forecasting

Real estate investment decision-making

routinely involves some estimate of value. Since the primary technique for estimating the value of commercial real estate requires computing the present value of net revenues derived from complex lease structures, the problem requires the computational power of a computer. The Data Consortium will create a model application that captures the information typically required to perform valuations and develop the means for extracting that information from legacy systems for transmittal via the Internet to service providers and applications that can process the data.

Data Consortium Web Services

Registry

The Data Consortium will maintain on its Web site a searchable list of databases that adhere to the XML standards developed by the Data Consortium. This registry will make the task of locating real estate information efficient for human users and especially efficient for computer robots that are designed to scan for new or updated information on the Internet.

Other DCN interfaces—such as with RosettaNet and CommerceNet—will be reviewed and mapped, if members wish.

Directory of Technical Support Service Providers

As the Data Consortium identifies people familiar with its XML-based standards who can assist in developing applications, these individuals and firms will be included in a searchable database on the Data Consortium Web site.

Member Pages

The Data Consortium will afford sponsors and consortia of any category of members the opportunity to have individual Web pages on the Data Consortium Web site.

Branding

To help promote the Data Consortium and to allow its members to show their support for the standards, the Data Consortium will develop several icons or graphic images that members can display on their individual Web sites.

SUMMARY

In his book, *Business @ The Speed of Thought*, Bill Gates summarizes both the challenge and opportunity of the information age, "Business Leaders who succeed will take advantage of a new way of doing business, a way based on the increasing velocity of information."[17] Indeed, that is what this, admittedly very technical article was all about. The real estate industry has, for most of its life, utilized highly fragmented, proprietary data sets which rarely communicate with one another. However, a significant change is underway which will provide the opportunity to bring these disparate sources together with a common language and via the commonly available Internet.

Real estate counselors who become fluent in this new schema, and can take advantage of the rapid shifts in information availability will gain almost insurmountable advantages in the market. For example, it is clear that the 30- to 45-day due diligence period will quickly become a thing of the past, and something closer to 10 days will become the norm.[18] Counselors will need to adopt and adapt to this new standard. Listing data, (both on the buy-side and the sell-side), and closing data will quickly move to the Internet, forcing brokers, appraisers, and others dependent on this information to adapt to the changing information world. REI

NOTES

1. Quoted in Gates, Bill, *Business @ The Speed of Thought* (New York: Warner, 1999), p. 295.
2. DeMay, Tracy L., "Real Estate Due Diligence and the Closing Process", *Real Estate Review*, Fall, 1998, pp.45-52.
3. The Commercial Investment Real Estate Institute, as cited in Grebb, Michael, "Hot Property," *Business 2.0*, December, 1999.
4. http://www.loopnet.com
5. Grebb, *op. cit.*
6. *Real Estate Information Standards 2000*, (© 2000, NCREIF, PREA, NAREIM, available on the Web at http://www.ncreif.org/reis.htm
7. This is an actual, recent example from the author's files. Other examples, of course, are too numerous to mention.
8. For example, data input into a spreadsheet is usually readable by, say, higher level statistical analysis packages, such as SAS or SPSS. Unfortunately, the same is not always true with proprietary packages, databases software, or other tools. Further, this cross-platform manipulation often takes a degree of programming sophistication.
9. Other sponsors of the Data Consortium include Constellation Real Technologies, Pension Advisors Consortium on Technology, Management Reports International, and the Realm.
10. The MBA has taken the lead in developing XML standards for residential mortgages through the Mortgage Industry Standards Maintenance Organization (MISMO). For more information on this, visit their Web site, http://www.mismo.org/
11. PISCES is an XML data exchange standard developed for the U.K. property market. Its management and development is being undertaken by a group comprised of suppliers of property management systems and their customers. More information can be obtained at http://www.pisces.co.uk/
12. For more information on the interface between the DC and LegalXML, visit the latter's Web site, http://www.legalxml.org/

13. Much of what follows has been adapted from the original business plan for the Data Consortium, developed by Michael Young of RREEF and Richard Kozak of Management Reports International.
14. The candidate standard, Version 1.5, was released on January 18, 2001.
15. The candidate standard of the DTD is currently available for comment and voting by members of the Working Group.
16. More rigorous definitions of DCN, DCD, and DTD are available on the Data Consortium Web site.
17. Gates, Bill, *op. cit.*
18. DeMay, Tracy L., *op. cit.*

THREE RULES FOR FORENSIC REAL ESTATE DAMAGE VALUATION: DEDUCTIVE, ADDUCTIVE, OR REDUCTIVE RULE?

by Wayne C. Lusvardi & Charles B. Warren

FORENSIC VALUATION: WHAT IS IT?

Forensic real estate valuation is the application of economic principles and methodologies to answer questions of fact as to whether real estate values have suffered a permanent damage. Forensic real estate valuation contrasts with the prevailing valuation theory in the real estate industry that often fails to distinguish permanent loss from the following:

SITUATIONS WHERE DAMAGES ARE IMPERMANENT OR NON-RECOVERABLE

- Where the market has already provided "implicit compensation" for a pre-existing "foreseeable" condition (*i.e.*, the "foreseeability damage test").
- Where the purported loss reflects the real estate market cycle.
- Where the loss was insured and thus recoverable.
- Where the loss is a brief, temporary loss of marketability.
- Where the loss was mitigatable or avoidable.
- Where the loss is speculative or stems from a self-interested claim of "stigma."
- Where any diminution in value reflects a changed highest use of the property rather than full economic loss.
- Where the loss is due to non-compensable regulatory changes.

ABOUT THE AUTHORS

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(Continued on page 22)

- Where there is an interim use, or "next-best use," of a property that serves as a prophylaxis against total loss.
- Where "project influence" from a public project results in an increase or decrease in property value that is legally not to be considered in an eminent domain property appraisal. "Project stigma" is a self-contradictory term because it is legally disallowed in public agency real estate appraisals.
- Where any diminution in property value was possibly due to some extraneous condition or event other than that purported.
- Where there was no discernible damage at all.

Alleged damages might be the result of a physical invasion; proximity to a nuisance; overreaching land use regulations; indirect benefit or burden transfers; some fickle and transitory notion of stigma; or irrational phobic reaction to some uncertain environmental substance or condition. From this starting point the forensic valuation consultant gathers evidence to determine if permanent damages have occurred. Like forensic engineering, forensic real estate valuation is similar to failure analysis and root cause analysis with respect to the methodologies and logic employed.[1]

The term "forensic" is used here to connote the investigation of whether property values have been permanently damaged in the context of a trial of fact, pre-trial settlement, arbitration, or as a matter of public policy. Forensic valuation is like conventional real estate appraisal in that appraisers are held to a standard to not fudge the numbers, to avoid unacceptable valuation methods, and to shun undisclosed assumptions to back up a desired result. But the distinguishing characteristic of forensic valuation is its focus on the measurement of permanent property losses, its insistence on the use of consistent, logical, and legally appropriate valuation methods to the situation at hand, and its adherence to the scientific method that requires the reporting of unwanted results and disconfirming market data.

RE-DEFINING THE THREE CONVENTIONAL APPROACHES FOR DAMAGE VALUATION

Neither law nor real estate appraisal has thoroughly clarified the different damage valuation methodologies that are applicable under tort law, condemnation law, regulatory takings law, and inverse condemnation law in various political jurisdictions. Real estate appraisal generally relies on three cardinal valuation methods: the Cost, Sales Comparison, and Income Approaches. This article shows that there are three methods of damage valuation that generally comport with the three conventional methods of valuation.

Forensic valuation is like conventional real estate appraisal in that appraisers are held to a standard to not fudge the numbers, to avoid unacceptable valuation methods, and to shun undisclosed assumptions to back up a desired result. But the distinguishing characteristic of forensic valuation is its focus on the measurement of permanent property losses, its insistence on the use of consistent, logical, and legally appropriate valuation methods to the situation at hand, and its adherence to the scientific method that requires the reporting of unwanted results and disconfirming market data.

The three conventional valuation methodologies have been incorporated into damage law under different terminology and computation formats. Two rules predominate and have mostly been applied to damage situations involving use of eminent domain powers by public entities:

Existing Nomenclature for Damage Valuation Rules:

- The Federal Rule or Before and After Rule (Comparison Approach)
- The State Rule or Value of the Take Plus Damages Rule (Cost Approach)

The Federal Rule tries to solve the damage measurement problem by using "deductive logic"; the value after the damage is "deducted" from the value before the damage to arrive at an estimate of damage compensation. The Before and After Rule (or Federal Rule) is the dominant damage rule under eminent domain law in 26 state jurisdictions and is also the accepted measure of damages under tort law.

The State Rule, adopted in 24 jurisdictions for eminent domain purposes, uses "adductive logic" to try and solve the damage measurement problem by "adding" the value of the damaged portion of a property with the value of the damages to the remainder to estimate total damage compensation.

There is a newer rule, which we will term here the Reductive Rule, which, to our knowledge, has not been adopted by any political jurisdiction for condemnation or tort law purposes. However, it has been promoted as the universal paradigm for real estate damage valuation in the bulk of the professional literature.

For the purpose of this manuscript the following terms shall be used:

Redefined Rules for Damage Valuation:

- **"Deductive Rule"** (aka Federal Rule) or sales comparison approach
- **"Adductive Rule"** (aka State Rule) or cost approach
- **"Reductive Rule"** (aka Stigma Rule) or income approach in the sense of reduction to net.

These three logic rules are analogous to the Sales Comparison Approach (deductive method), Cost Approach (adductive method), and the Income Approach (reductive method, in the sense of reducing to net) conventionally used in real estate appraisal. Each of these rules is not based on pure deduction, adduction, or reduction, but the name for each rule stems from their central mathematical operation (*e.g.*, subtraction, addition, reduction).

Deductive Rule (Federal Rule) -- The Deductive Rule, also known as the Federal Rule, Before and After Rule, or "Difference Between the Fair Market Value of the Property Before and After the Damage Rule," is misnamed because it is used by both the Federal government and some state jurisdictions to guide the amount of compensation for partial property acquisitions resulting from damages for public works projects.[2] The Deductive Rule is the simplest of the rules to understand because it literally follows a "before and after" methodology to estimate compensation. The underlying logic of the Deductive Rule is obviously "deductive logic."[3] Under deductive logic, damages are estimated by reasoning from the general to the particular. In the eminent domain context, the Deductive Rule translates into a formula where the after value of a property is subtracted, or deducted, from the before value of the property to arrive at the total just compensation due a property owner for damages as shown in *Table 1*:

Table 1

Deductive Rule Formula or Federal Rule (Formula: Vb-Va = JC)	
Value Before	$1,000,000
Minus Value After	$750,000
Equals Just Compensation	= $250,000

This rule might also be called a lump sum analysis because it relies on aggregate level market data to arrive at a lump sum figure that represents both the value of the part taken plus any damages to the remainder of a property. Under the Deductive Rule you cannot itemize the value of the part taken, damages, or offsetting benefits. The value of such items is "lumped" in together as one number.

Strengths and Weaknesses -- Two weaknesses of the Deductive Rule include its inability to exclude offsetting benefits from the damage calculation and to exclude legally noncompensable damages in the after value of a property. Additionally, under the Deductive Rule it is possible to arrive at zero compensation especially where damages are alleged to have resulted from the acquisition of minor easements where the real estate market does not recognize any diminution for such encumbrances; or where it is impractical to measure such diminution from limited or unavailable market data.

A strength of the Deductive Rule, or Federal Rule, is that it is less prone to "double count" damages. The Deductive Rule works best in measuring overall loss in value as a result of takings in fee simple interests by condemnation; and in measuring proximity damages under tort law.

Adductive Rule (State Rule) -- The Adductive Rule, State Rule, or Take Plus Damages Rule, is also sometimes misnamed the "before and after rule."[4] The Adductive Rule separately measures the before and after value of the property to determine whether a physical taking for a public works project results in any damages. The Adductive Rule relies on "inductive logic."[5] Under inductive logic, damages are estimated by reasoning from the specific to the general. With the Adductive Rule, the value of each item is added rather than deducted. This is in contrast to the Deductive Rule (Federal Rule) where

Table 2

Adductive Rule Computational Format (State Rule)	
a. Value of whole property before taking	$1,000,000
b. Value of part taken as part of whole	$200,000
c. Value of remainder before taking as part of whole (a-b)	$800,000
d. Value of remainder after taking as part of whole	$700,000
e. Indicated severance damages (c-d)	$100,000
f. Minus Benefits	$50,000
g. Net Damages (e-f)	$50,000
h. Plus value of part taking (from "b" above)	$200,000
i. Estimate of Just Compensation (b + h)	$250,000

damages are derived by a process of subtraction. The Deductive Rule processes aggregate market data and the Adductive Rule processes itemized data as shown in *Table 2*.

The most frequently encountered weakness with the Adductive Rule is the tendency to "double count" damages, especially when estimating the loss in value, if any, from the imposition of easements on a property. This is easy to do because many appraisers do not understand that you cannot consider the difference in sales prices of properties with and without easements under the Adductive Rule. In appraisal terminology, using a "paired sales" analysis under the Adductive Rule is prone to resulting in the double counting of damages. This is because the computational format for the Adductive Rule results in overlapping values (*e.g.*, value of take, severance damages, offsetting benefits, etc.).

Strengths and Weaknesses -- One of the reasons the Adductive Rule came into existence is to provide compensation for public takings where none is indicated from the market, or can be practically estimated from available market data. In so doing, public agencies and utilities avoid the appearance of not providing just compensation for property rights taken. The strength of the Adductive Rule is its usefulness in providing some compensation for partial acquisitions, such as easements, where the market would indicate a negligible loss or where it would be difficult to find relevant market data to measure the loss from a part taking for a public works project.

Reductive Rule (aka Stigma Rule) -- A more recent rule that has been promulgated for use in real estate damage cases is what will be called here the Reductive Rule.[6] By definition, this rule is based on "reductive logic," which is a lessening or reducing computational process. Reduction is not the same as subtraction. Under the Reductive Rule, the "unimpaired value" of a property is reduced by costs-to-cure the damages rather than extracted from the market. The term reduction implies a process that is involuntary and does not originate in the real estate market (*e.g.*, "your benefits have been reduced"). The Reductive Rule is a hybrid of the Comparison and Cost Approaches to valuation. The typical steps to the Reductive Rule are shown in *Table 3*.

The Reductive Rule is seemingly more applicable in those cases where there is a relatively rapid and often incurable decline in a property's value, not necessarily as a consequence of a physical taking for a public project, but due to such events as:

Where the Reductive Rule Is Usually Applied:

- a landslide
- a regulatory downzoning

Table 3

Reductive Rule or Stigma Model (Formula: I = U – C – S)			
Unimpaired Value **(Value Before)**			$1,000,000
Minus:			
	Mandated assessment costs	$25,000	
	Mandated cleanup costs	$100,000	
	Mandated ongoing monitoring costs	$25,000	
	Stigma or market resistance	$100,000	
	Total costs	$250,000	$250,000
Impaired Value **(Value After)**			$750,000

- designation as a toxic waste site
- historic designation
- identification as asbestos hazard building
- construction defect
- wetland delineation
- proximity to some unforeseen nuisance
- undue delay of a public project resulting in pre-condemnation blight
- physical invasion by flooding due to diversion of upstream storm runoff by a nearby property owner
- ground failure caused by negligence of an adjoining property owner
- exaction of critical amount of portion of land or mitigation fees by a municipality as a condition of development that is unconnected to actual development impacts, or
- some unforeseen event or condition over which a property owner can exercise little control.

Usually in such situations the market demand for such a property vanishes or is reduced for deep discount buyers wanting to purchase it for a nominal or below equity price. The market typically reacts to such sudden drops in property value by trying to determine:

Market Reaction to Economically Incurable Obsolescence

- ascertain the magnitude of the loss
- the amount of time over which the loss will likely be sustained
- any likely sources of recovery to mitigate or offset the loss
- the degree of uncertainty that accompanies a property with the risk of an unidentifiable market or uncertain and possibly uncontrollable costs to cure it of the condition, which hinders its full market value.

Markets dislike uncertainty and thus there is usually a market aversion to such properties until the risks, costs, and timing can be quantified in a more predictable way. This condition of uncertainty has been mislabeled with the disapproving term "stigma."

Strengths and Weaknesses -- The Reductive Rule can be a plausible valuation model where it reflects adverse reductions in value resulting in full incurable obsolescence or regulatory capture. However, the Reductive Rule valuation format does not address the critical issue of a changed highest and best use for a property after suffering full economic obsolescence of its former highest use. For example, toxic waste sites can become "brownfields," waste recycling facilities, or used for open storage without triggering the legal requirements to clean up the site. Such uses are often economically productive, albeit often not equivalent to the same level of their former productive use.

Many of those who tout the Reductive Rule mistakenly claim it is a universal framework for property damage valuation. The Reductive Rule has been used to categorize hundreds of environmental conditions as damaging. Carrying the Reductive Rule to such an extreme has led to the criticism that it is prone to the logical fallacy of "Reductio ad Absurdum" (Latin for reduced to an absurdity or proof by contradiction) because if everything is damaging nothing is.[7] Damage valuations that place mistaken reliance on the Reductive Rule are susceptible to the criticism that they are logical fallacies.[8]

The Reductive Rule has been accepted on a limited basis in some property tax assessment appeal situations where a lowered assessment has been sought to account for cleanup costs of a contaminated property.[9] It has also been applied to lessen the just compensation award for eminent domain acquisition for contaminated school sites by deducting the cleanup costs.[10]

In situations where there is a "free fall" in property value; the loss sustained is often unrecoverable as in regulatory actions; landslides that are often uninsurable; removal of a freeway ramp next to a gas station; termite damage, etc. These are what economists call "externalities" over which a property owner may have little control.[11] In such calamitous situations, the value of affected properties becomes highly uncertain, the marketing time is protracted, and liquidity is very limited. Properties with limited or no marketability due to negative externalities are often said to reflect a "shadow price"[12] rather than a true market value. Appraisers who claim to specialize in "damage valuations" of properties where the whole property suffers from incurable obsolescence often cannot be proven wrong because the property's value is so uncertain.

One way proposed to appraise properties suffering from such incurable obsolescence is to value the property free of the "reductant" (*i.e.*, value reducing agent or condition). From this "unimpaired value," the costs to cure the depressing situation usually follows one of these scenarios:

Cost-to-Cure Scenarios:

- Curative measures are imposed on the property by regulatory entities often regardless of cost. These costs often are applied against the business component or "going concern" and typically do not apply against the real estate unless the business is insolvent or the principal responsible party is defunct.
- Remediation costs are recovered from original principal responsible parties, insurers, government funds, or other third parties, or are self-mitigated, with additional cost and delay.
- Costs-to-cure remain unquantified.

A real estate appraisal can provide no more certainty than the market. Thus, real estate appraisals of properties in such overwhelmingly distressed situations are more reliable when estimating the property's unimpaired value; and less reliable when estimating the "impaired value." This is because markets often do not determine the magnitude of the costs to cure or the length of time to remedy the situation. And because properties suffering such economically incurable obsolescence sometimes cannot be exposed to the market to find their true market value, and many only reflect a "shadow price," speculative appraisals often abound.

Consultants serving corporate clients, real estate investment trusts, and government entities, or legal counsel for alleged damaged property owners, need to be cognizant of the differences in the three damage valuation rules when pursuing or defending real estate damage claims.

The much-ballyhooed notion of "stigma" that is frequently attributed to tainting the value of such properties (even after they are "cured") is also another often misunderstood and over-worked concept in real estate literature. After such properties are "cured" of their physical defects or other impediments the following axiom, borrowed from thermodynamic entropy theory, reflects the typical market reaction:

The Stigma Decay Axiom: *The further the causal event is in the past, the smaller the uncertainty becomes; and will likely disappear entirely during market cycle peaks.*[13]

The long-term value of stigma is that it doesn't have any lasting value. This is an inherent problem of valuing the effects of externalities because such effects are highly elastic and can disappear suddenly. Thus, to compensate property owners for stigma loss that may eventually dissipate, or would otherwise be recoverable through insurance or avoidance, may result in double compensation.

CONCLUSION

Three legal logic systems have been examined in this manuscript for measurement of real estate damages for forensic real estate valuation: the deductive rule, adductive rule, and the reductive rule. Mathematician J.R. Newman stated that, "Logic is neither science or art, but a dodge."[14] However, it is not believed that property damage valuation models currently in fashion in the real estate industry are

Table 4

Forensic Real Estate Damage Valuation Rule Chart

	Deductive Rule (Aka Federal Rule)	**Adductive Rule** (Aka State Rule)	**Reductive Rule** (Stigma Rule)
Logic system	Deduction	Induction	Reduction
Method	Before and After	Take Plus Damages	Value/Time=Damage
Similar Value Method	Sales Comparison	Cost Approach	Income Approach
Damage estimation procedure	Paired sales comparison	Subjective percentage analysis by expert	Costs to cure; or non-economic transfers
Focus on:	Overall loss from fee part takes	Easements and curable costs	Damages from externalities & incurable obsolescence
Type of data analyzed	Aggregate data	Itemized data	Diminution or Imposed costs
Formula	B – A = C Before Value Minus After Value = Compensation	T + (D-B) = C Value of Take Remainder Value Before Remainder Value After Gross Damages Minus Benefits Net Damages = Take + Net Damages	I = U – C – S Unimpaired Value Minus Assessment Cost Minus Repair Cost Minus Ongoing Costs Minus Stigma = Impaired Value
Legal Precedent in Eminent Domain Law	Yes	Yes	Limited (contaminated sites for public schools only)
Considers damage offsets (benefits)	Yes	Yes	Limited to insurance recoveries, indemnifications
Project Influence	Inadmissable	Inadmissable	Admissible
Prone to Double Compensation	No	Yes	Yes
Excludes proximity damages to property not physically taken	Yes	Yes	No
Excludes speculative, remote, trivial damages	Yes	Yes	No
Separates damages for which owner could later recover under a tort action	Yes	Yes	No
Separates stigma from phobia	Yes	Yes	No
Lesser-Of Rule	Lesser of diminution or cost to cure	Lesser of diminution or cost to cure	Cost-to-cure plus stigma
Foreseeability Principle	Yes	No/Yes	Yes
Harm-Within-Risk Test	Yes	Yes/No	Yes
Complies with scientific method	Yes	No	No
Pre-Post research design	Whole before & after	Take before; remainder before & after	Value before; costs after + stigma after
Value indicated	Market value loss	Loss + public policy compensation	Shadow prices

necessarily fraudulent or evasive, but that they are sloppy, illogical, oversold, and undisclosed.

The three rules discussed in this article are for the most part not interchangeable and the synthetic mixing of these rules is at minimum illogical and at maximum misleading. *It is believed that the promulgation of the Reductive Rule by the real estate industry as an apparent universal framework for all types of real estate damages is badly chosen and is resulting in methodological chaos in the real estate industry.* Inconsistent use of these three damage rules may lead to inaccurate damage valuation conclusions, unnecessary disparities between damage appraisals, "double damage" awards, and lowered public confidence in appraisers.[15] The following general logical rules are offered for review and consideration as to the proper method to use for different legally defined damage valuation situations:

"Eminent Domain Computational Damage Rules:
Federal Rule: ***Deduce, but don't reduce, unless compelled by law otherwise.***
State Rule: ***Adduce, but don't reduce, unless compelled by law otherwise.***

Tort Damage Computational Rule: ***Deduce but only where there first is proven "proximate cause." Avoid reducing where damage estimates must meet the requirements of the scientific method (i.e., "Daubert tests").***

Regulatory Taking Computational Rule: ***"Deduce or reduce; unless compelled by law to meet the scientific method (i.e., "Daubert tests"), then deduce."***

Consultants serving corporate clients, real estate investment trusts, and government entities, or legal counsel for alleged damaged property owners, need to be cognizant of the differences in the three damage valuation rules when pursuing or defending real estate damage claims. REI

NOTE:

The views and opinions expressed in this article are exclusively those of the authors.

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4. Eaton (1989), pp. 10-26.
5. Induction – the act of process of inducting, bringing forward, adducing. *Webster's* (1984), p. 615.
6. Reductive – oversimplifying complex things and ignoring the subtleties or important details. Reductionism – misguided belief that everything can be explained in simple terms. *Encarta World English Dictionary*. New York: St. Martin's Press, 1999, p. 1505.
7. Tom Tymoczko and Jim Henle, *Sweet Reason: A Field Guide to Modern Logic*. New York: Springer, 2000, p. 326.
8. L. Deane Wilson, "Are Appraisals Logical Fallacies?" *Appraisal Journal* (April 1996), pp. 129-133.
9. Schmidt vs. Utah State Tax Commission, Supreme Court of Utah, May 19, 1999.
10. California Code of Civil Procedure, Section 1263.720 (a) (b); and Section 1263.740.
11. Externality – the likelihood that one land use may make neighboring uses more or less desirable. Donald Hagman and Dean Misczynski, *Windfalls for Wipeouts: Land Value Capture and Compensation*. Chicago: Planner's Press, 1978:xxxi.
12. Shadow price – the estimated price of goods or a service for which no market price exists. *Encarta* (1999), p. 1644.
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FINALLY: AN "APPROVED" PROCESS FOR REVERSE EXCHANGES

by Mark Lee Levine, CRE

INTRODUCTION

Most commercial real estate practitioners, investors, CPAs, and attorneys have some involvement with tax-deferred exchanges under Code §1031.[1] Under Code §1031, there are provisions for what is loosely referred to as "tax-free exchanges" and is more correctly labeled as "tax-deferred exchanges."

Without examining the fundamentals of Code §1031, and assuming the reader is familiar with the basic requirements of Code §1031 to defer federal income tax on a qualified exchange of like-kind property used in the trade or business or for qualified investments, the discussion can proceed to the main focus of this Note,[2] *i.e.*, nonsimultaneous exchanges[3] that involve what are referred to as a "reverse exchange."[4]

The concept of nonsimultaneous exchanges are sometimes labeled as "deferred exchanges." They exist as a result of changes that have developed where an exchange did not occur simultaneously; that is, the taxpayer may have transferred property at one point in time and did not simultaneously receive replacement property.[5]

Assuming for the moment that the principles of tax-deferred exchanges are well in hand relative to Code §1031; and, assuming for the moment that the concept of deferred exchanges, that is nonsimultaneous

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exchanges are accepted (since this has been the position for some time),[6] the focus of this Note is on the ability of taxpayers to undertake such nonsimultaneous (deferred) exchanges by means of a reverse exchange.

OVERVIEW OF REVERSE EXCHANGES

One might have concluded that transfers of property in general might be subject to income tax.[7] That is a reasonable position to take, since this is the basic law for most transactions.[8] It would also be reasonable that even if an exchange was allowed, as noted, under Code §1031, one might infer that the exchange would take place on a simultaneous basis (X transfers X-1 to Y at the same time Y transfers Y-1 to X) with the relinquishment of the property by the taxpayer and the simultaneous replacement of that property by the taxpayer. This subject has been well discussed.[9] However, case law has made it clear that because of a change in Code §1031(a)(3), and Regulations thereunder,[10] the ability to utilize a tax-deferred exchange, nonsimultaneous in nature, is well established, if the taxpayer complies with the requirements under the Code.[11]

What has not been well established is the ability of a taxpayer to undertake an exchange, nonsimultaneous, where the taxpayer first acquired the replacement property and then subsequently transferred his or her relinquished property. (X transfers X's X-1 property to Y on Day 30, but receives Y-1, qualified property, from Y [or an intermediary] on Day 1.) Although one might have argued that it was reasonable for such order to take place, the exchange Regulations specifically prohibited this approach.[12]

Taxpayers voiced substantial opposition to the government's argument that a reverse exchange could not take place within Code §1031. Nevertheless, the Regulations asserted that a reverse exchange was improper and was not approved under Code §1031(a)(3).

Notwithstanding the government's position, there have been many suggested inroads for the use of a reverse exchange. This author communicated with one intermediary company[13] in which they recently informed the author that they had formed "over 1,000 reverse exchanges in our 10-year history." It seems questionable for an intermediary to assume that such position provides for bragging rights. It might, in turn, provide for 1,000 cases of exposure, given that the Service has made it very clear that it did not approve a reverse exchange position.

Taxpayers voiced substantial opposition to the government's argument that a reverse exchange could not take place within Code §1031. Nevertheless, the Regulations asserted that a reverse exchange was improper and was not approved under Code §1031(a)(3).

Some salvation for this intermediary, and for others that have asserted the use of a reverse exchange, may be found as a result of recent developments in which a Revenue Procedure was issued, allowing for some reverse exchanges.[14]

Anticipating that such a release or approval was coming, a number of articles were issued touting the "possible" planning opportunities with the reverse exchange. *(See the Footnotes for some of these anticipatory articles.)*[15]

Nevertheless, to assume that a release would be forthcoming, but knowing it had not been released, and having the "benefit" of specific statements by the government that reverse exchanges were not within Code §1031,[16] I authored an article arguing that one should "say no" to reverse exchanges until and unless safe harbor guidance was issued.[17]

However, as mentioned, the Service recently announced that taxpayers now have a safe harbor, allowing for reverse like-kind exchanges, assuming they meet all the requirements of this Ruling.

REVENUE PROCEDURE 2000-37: REVERSE EXCHANGES "APPROVED"

Under a release dated September 19, 2000, *(see copy at end of article)* the Service issued Revenue Proc. 2000-37.[18] In this Revenue Procedure, a safe harbor is provided. It is stated that the Service will not challenge the qualification of the property as replacement property or as relinquished property, as those terms are used within Treasury Reg. §1.1031(k). Further, it will not challenge the treatment of what is known as an exchange accommodation titleholder as one that is the beneficial owner of the property in question, assuming the taxpayer meets all the requirements under this Revenue Procedure.

The Procedure says that no gain or loss will be recognized if Code §1031 is met relative to the special time limits provided under Code §1031(a)(3).

These time limits generally provide that a taxpayer (X) must identify replacement property (Y-1 in the prior example) within 45 days of the transfer of the taxpayer's relinquished property (X-1); X and the taxpayer must also comply with an outside date to complete the transaction, which outside date is the earlier of 180 days after the transfer of the relinquished property or the due date of the taxpayer's return, with proper extensions, where applicable.[19]

The release specifically noted that the Treasury Department and the Service had regulations relative to exchanges wherein the preamble to the regulations specifically stated that the safe harbors in the regulations were not applicable to reverse-Starker exchanges. They define this as situations where the replacement property is acquired before the relinquished property is transferred.[20]

Notwithstanding the limits, as noted by the government on reverse exchanges that have existed since the regulations were issued, the Revenue Procedure noted that taxpayers have nevertheless undertaken transactions that might be considered to be reverse exchanges. Often the taxpayer might be engaged in what is sometimes labeled as a "parking" position. The Revenue Procedure stated that "parking" results in the taxpayer (X) parking or placing the replacement property (X-1) with an accommodation party (AP) (intermediary) (I)[21] until the time when the taxpayer can arrange for the transfer of his or her relinquished property to the appropriate party.

There are other possibilities. For example, the accommodation party (AP) [intermediary] (I) might acquire the replacement property (Y-1) on behalf of a taxpayer or in connection with a taxpayer.

The accommodating party (AP) or intermediary (I) would then exchange that property with the taxpayer for the relinquished property (X-1) owned by the taxpayer. After that, the relinquished property would be held until the taxpayer would help arrange for a transfer of the property to the ultimate acquirer of the property (some third party). The key in this setting would be to avoid having the accommodation party/intermediary treated as an agent of the taxpayer; rather, the argument is that the intermediary or accommodating party would be the owner of the property, because it had "incidents of ownership." These circumstances are in question and could raise areas of exposure to taxpayers in these types of settings. Therefore, the idea of the Revenue Procedure is to allow a safe harbor for taxpayers to properly accomplish the nonsimultaneous exchange on a reverse basis.

The Revenue Procedure makes it very clear that it only applies to issues for qualifying for a safe harbor relative to an exchange. These are sometimes now labeled as a Qualified Exchange Accommodation Arrangement (QEAA).

On a parenthetical type approach, the Procedure also noted that there are other federal income tax issues which are not addressed in this Revenue Procedure. For example, there are issues relative to fees for the accommodator, whether the accommodator would be precluded from claiming depreciation deductions, arguing that the accommodating party was actually a dealer, etc. Again, these issues are not addressed in this Procedure.

The Ruling also made it clear that if the formal requirements of the Revenue Procedure are not met, the Procedure does not apply.

Assuming that the requirements are met, the Service noted that it ". . . will not challenge the qualification of property as either 'replacement property' or 'relinquished property' (as defined in section 1031(k)-1(a)) for purposes of section 1031 and the regulations thereunder or the treatment of the exchange accommodation titleholder as the beneficial owner of such property for income tax purposes, if the property is held in a QEAA."

1. Basically the requirement is that the ownership of the property must be held by a person, that is, the exchange accommodation titleholder, who is not the taxpayer or a disqualified person, as that term is used under Treasury Reg. §1.1031-(k), and either such person is subject to federal income tax, or is otherwise qualified as a partnership or an S Corporation, with certain other requirements.

2. At the time the qualified indicia of ownership of the property is transferred to the exchange accommodation titleholder, it has to be the taxpayer's bona fide intent that the property to be held by the exchange accommodator represents either replacement property or relinquished property within Code §1031;

3. No later than five days after the transfer of the qualified indicia of ownership of the property to the exchange accommodation titleholder, the taxpayer and the exchange accommodation

titleholder must enter an agreement (labeled as the "Qualified Exchange Accommodation Agreement") to provide that the exchange accommodation titleholder is holding the property for the taxpayer to facilitate the exchange under Code §1031 and that the taxpayer and the accommodator agree to report the activity (as noted below) as provided in this Revenue Procedure.

Both parties must properly report their income tax attributes of the property on their Federal income tax returns.

4. Within 45 days of the transfer of the qualified indicia of ownership on the replacement property, as noted, to the accommodating party, the relinquished property must be properly identified, as that term is used within Treasury Reg. §1.1031(k)-1(c). (The taxpayer can identify multiple and alternative properties, within the meaning of the Regulation.)[22]

5. Within 180 days after the transfer of the qualified indicia of ownership, the property must be transferred, directly or indirectly, through an intermediary or otherwise, to the taxpayer as replacement property; or, the property must be transferred to a person who is not the taxpayer and who is not a disqualified person, as relinquished property; and

6. The combined time period that the relinquished property and the replacement property are held within the QEAA cannot exceed 180-days, as previously indicated.

Knowing that there will be a number of additional issues, the Revenue Procedure further provided for what are labeled as "permissible agreements." This means that property will not fail to be treated within this QEAA because of one or more of the following special arrangements:

1. An exchange or accommodation titleholder that satisfies the requirements of the qualified intermediary safe harbor rules under existing Treasury Reg. §1.1031(k) may enter an exchange agreement to serve as an intermediary;

2. The taxpayer (X), or a disqualified person, guarantees some or all of the obligations of the exchange accommodation titleholder, including secured or unsecured debt, or indemnifies the exchange accommodation titleholder for expenses and costs; (as an example, X-1 could guarantee performance on loans, title, etc.);

3. The taxpayer (X) or a disqualified person loans or advances funds to the exchange accommodation titleholder or guarantees a loan relative to this exchange;

4. The property is leased by the exchange accommodation titleholder to the taxpayer or a disqualified person;

5. The taxpayer or disqualified person manages the property or supervises it, or acts or provides services to the accommodation titleholder relative to the property;

6. The taxpayer and the exchange accommodation titleholder enter into agreements as to the purchase or sale of the property, including puts and calls at certain fixed or formula prices, for a period not in excess of 185 days from the date the property is acquired by the exchange accommodation titleholder; and

7. The taxpayer and the exchange accommodation titleholder enter agreements providing that any variation of the value of the relinquished property from its estimated value relative to the date of exchange accommodation titleholder's receipt of the property be taken into account upon the exchange accommodation titleholder's disposition of that property.

An additional permissible position is to allow that the property will not fail to meet the requirements as QEAA because of accounting, regulatory state, local, or foreign tax treatment of the arrangement between the taxpayer and the accommodator being different from the treatment described above.

For those taxpayers who find themselves in a position where a nonsimultaneous exchange is imperative to the transaction, they now have the added flexibility of the possibility of a safe harbor for a reverse, nonsimultaneous exchange, assuming compliance with Revenue Procedure 2000-37.

The effective date for this new position is for exchange accommodation titleholders that acquire qualified indicia of ownership on or after September 15, 2000. (This means that those transactions, such as the ones referred to earlier in this article, are not covered within this Ruling on the basis of some retrospective safe harbor position.)

The safe harbor provided by this new Revenue Procedure is beneficial to taxpayers, if for nothing else than it blesses the idea and position that one can provide for a reverse exchange. However, to meet the safe harbor position, taxpayers must be certain to follow the specifics, as noted.

CONCLUSION

The conservative answer is to avoid reverse exchanges, given the limitations and the specific language in Treasury Reg. §1.1031-(k), prohibiting reverse exchanges. However, this Revenue Procedure makes it clear that such reverse exchanges are permitted, so long as taxpayers clearly comply with the safe harbor provisions of Revenue Proc. 2000-37.

It has long been my suggestion to clients that they structure their transactions as simultaneous exchanges, avoiding many of the hurdles and limitations that exist for nonsimultaneous exchanges, whether in a format of a reverse exchange or simply a deferred exchange that occurs on a nonsimultaneous basis. In my mind, this suggestion continues as good advice. However, for those taxpayers who find themselves in a position where a nonsimultaneous exchange is imperative to the transaction, they now have the added flexibility of the possibility of a safe harbor for a reverse, nonsimultaneous exchange, assuming compliance with Revenue Procedure 2000-37.REI

NOTES

1. See 26 U.S.C.A. (IRC 1986), Section 1031, hereinafter generally referred to as Code Section 1031 (Code §1031).
2. For more details on this entire area, see Levine, Mark Lee, *Exchanging Real Estate*, PP&E, INC., Denver, Colorado (3 Volumes) (2001). This text is also on-line at www.recyber.com. See also the Levine text, *Real Estate Transactions, Tax Planning*, The West Group, St. Paul, Minn. (2001 Edition).
3. See Code §1031 and the specific provisions that allow for a nonsimultaneous exchange under Code §1031(a)(3). For more in this area, see also the initial "lead" case, Starker v. United States, 602 F.2d 1341 (9th Cir., 1979). This case is discussed in detail in the Levine text, *Real Estate Transactions, Tax Planning*, Section 577, The West Group, St. Paul, Minn. (2001 Edition).
4. The concept of "reverse exchanges" is not stated within Code §1031. Rather, it has come about because there are circumstances, as described later in the article, where the taxpayer acquires the replacement property prior to transferring the relinquished property. This is labeled as a "reverse exchange." For more in this area, see the Levine text, cited *supra*, Footnote 3.
5. See the Levine text, cited *supra*, Footnote 3.
6. For a detailed discussion on the origin of nonsimultaneous exchanges, see the authorities cited in the Levine text, *supra*, Footnote 3, as well as the detailed discussion of this issue in the Starker case, *supra*, Footnote 3. For a collection of authorities on this issue, and a discussion of the concept of the government's position, see Section 577 of the Levine text cited *supra*, Footnote 3; see also Treasury Reg. §1.1031(k).
7. See Code §61.
8. See Code §61 and §62.
9. See *supra*, Footnotes 2 and 3.
10. See Treasury Reg. §1.1031(k).
11. See Code §1031(a)(3).
12. See Treasury Reg. §1.1031(k).
13. See Levine, Mark Lee, "Just Say 'No' To Reverse Exchanges," *Florida Real Estate Journal* (October 1999), pp.16-31.
14. See Revenue Proc. 2000-37, 2000WL1338979, released September 19, 2000.
15. See Sutton, Philip, "Guidance May Be Coming For Reverse Like-Kind Deals," *Real Estate Forum*, (April, 2000), p. 104. See also some of the authorities cited in the Levine, *Exchanging Real Estate* text, cited *supra*, Footnote 2.
16. See the Preamble to Treasury Reg. §1.1031(k).
17. See Levine, Mark Lee, "Just Say 'No' To Reverse Exchanges," *Florida Real Estate Journal* (October 1999), pp.16-31. See also this discussion in the Levine, *Exchanging Real Estate* text, cited *supra*, Footnote 2.
18. See Revenue Proc. 2000-37, 2000WL1338979 (released September 19, 2000) which addressed the provisions relative to Treasury Reg. §1.1031(k)-1.
19. See Code §1031(a)(3) and see Treasury Reg. §1.1031(k)-1.
20. T.D. 8346, 1991-1 C.B. 150. The Service indicated it would continue studying this issue.
21. See *supra*, Footnote 18.
22. *Ibid*.

Copy: LIKE-KIND EXCHANGES; REPLACEMENT PROPERTY; "PARKING" ARRANGEMENTS

Internal Revenue Service (I.R.B.)
Revenue Procedure 2000-37
2000-40 I.R.B. 308, 2000 WL 1338979 (IRS RPR)

Released: September 19, 2000
Published: October 2, 2000

26 CFR 1.1031(a)-1: Property held for productive use in trade or business or for investment; 1.1031(k)-1: Treatment of deferred exchanges.

Like-kind exchanges; replacement property; "parking" arrangements. This procedure provides a safe harbor under which the Service will not challenge (a) the qualification of property as either "replacement property" or "relinquished property" for purposes of section 1031 of the Code or (b) the treatment of the ""exchange accommodation titleholder" as the beneficial owner of such property for federal income tax purposes, if the property is held in a "qualified exchange accommodation arrangement" (QEAA).

SECTION 1. PURPOSE

This revenue procedure provides a safe harbor under which the Internal Revenue Service will not challenge (a) the qualification of property as either ""replacement property" or "relinquished property" (as defined in s 1.1031(k)- 1(a) of the Income Tax Regulations) for purposes of s 1031 of the Internal Revenue Code and the regulations thereunder or (b) the treatment of the ""exchange accommodation titleholder" as the beneficial owner of such property for federal income tax purposes, if the property is held in a "qualified exchange accommodation arrangement" (QEAA), as defined in section 4.02 of this revenue procedure.

SECTION 2. BACKGROUND

.01 Section 1031(a)(1) provides that no gain or loss is recognized on the exchange of property held for productive use in a trade or business or for investment if the property is exchanged solely for property of like kind that is to be held either for productive use in a trade or business or for investment.

.02 Section 1031(a)(3) provides that property received by the taxpayer is not treated as like-kind property if it: (a) is not identified as property to be received in the exchange on or before the day that is 45 days after the date on which the taxpayer transfers the relinquished property; or (b) is received after the earlier of the date that is 180 days after the date on which the taxpayer transfers the relinquished property, or the due date (determined with regard to extension) for the transferor's federal income tax return for the year in which the transfer of the relinquished property occurs.

.03 Determining the owner of property for federal income tax purposes requires an analysis of all of the facts and circumstances. As a general rule, the party that bears the economic burdens and benefits of ownership will be considered the owner of property for federal income tax purposes. See Rev. Rul. 82-144, 1982-2 C.B. 34.

.04 On April 25, 1991, the Treasury Department and the Service promulgated final regulations under s 1.1031(k)-1 providing rules for deferred like-kind exchanges under s 1031(a)(3). The preamble to the final regulations states that the deferred exchange rules under s 1031(a)(3) do not apply to reverse-Starker exchanges (i.e., exchanges where the replacement property is acquired before the relinquished property is transferred) and consequently that the final regulations do not apply to such exchanges. T.D. 8346, 1991-1 C.B. 150, 151; see Starker v. United States, 602 F.2d 1341 (9 superth Cir. 1979). However, the preamble indicates that Treasury and the Service will continue to study the applicability of the general rule of s 1031(a)(1) to these transactions. T.D. 8346, 1991-1 C.B. 150, 151.

.05 Since the promulgation of the final regulations under s 1.1031(k)-1, taxpayers have engaged in a wide variety of transactions, including so-called ""parking" transactions, to facilitate reverse like-kind exchanges. Parking transactions typically are designed to "park" the desired replacement property with an accommodation party until such time as the taxpayer arranges for the transfer of the relinquished property to the ultimate transferee in a simultaneous or deferred exchange. Once such a transfer is arranged, the taxpayer transfers the relinquished property to the accommodation party in exchange for the replacement property, and the accommodation party then transfers the relinquished property to the ultimate transferee. In other situations, an accommodation party may acquire the desired replacement property on behalf of the taxpayer and immediately exchange such property with the taxpayer for the relinquished property, thereafter holding the relinquished property until the taxpayer arranges for a transfer of such property to the ultimate transferee. In the parking arrangements, taxpayers attempt to arrange the transaction so that the accommodation party has enough of the benefits and burdens relating to the property so that the accommodation party will be treated as the owner for federal income tax purposes.

.06 Treasury and the Service have determined that it is in the best interest of sound tax administration to provide taxpayers with a workable means of qualifying their transactions under s 1031 in situations where the taxpayer has a genuine intent to accomplish a like-kind exchange at the time that it arranges for the acquisition of the replacement property and actually accomplishes the exchange within a short time thereafter. Accordingly, this revenue procedure provides a safe harbor that allows a taxpayer to treat the accommodation party as the owner of the property for federal income tax purposes, thereby enabling the taxpayer to accomplish a qualifying like-kind exchange.

SECTION 3. SCOPE

.01 Exclusivity. This revenue procedure provides a safe harbor for the qualification under s 1031 of certain arrangements between taxpayers and exchange accommodation titleholders and provides for the treatment of the exchange accommodation titleholder as the beneficial owner of the property for federal income tax purposes. These provisions apply only in the limited context described in this revenue procedure. The principles set forth in this revenue procedure have no application to any federal income tax determinations other than determinations that involve arrangements qualifying for the safe harbor.

.02 No inference. No inference is intended with respect to the federal income tax treatment of arrangements similar to those described in this revenue procedure that were entered into prior to the effective date of this revenue procedure. Further, the Service recognizes that "parking" transactions can be accomplished outside of the safe harbor provided in this revenue procedure. Accordingly, no inference is intended with respect to the federal income tax treatment of "parking" transactions that do not satisfy the terms of the safe harbor provided in this revenue procedure, whether entered into prior to or after the effective date of this revenue procedure.

.03 Other issues. Services for the taxpayer in connection with a person's role as the exchange accommodation titleholder in a QEAA shall not be taken into account in determining whether that person or a related person is a disqualified person (as defined in s 1.1031(k)-1(k)). Even though property will not fail to be treated as being held in a QEAA as a result of one or more arrangements described in section 4.03 of this revenue procedure, the Service still may recast an amount paid pursuant to such an arrangement as a fee paid to the exchange accommodation titleholder for acting as an exchange accommodation titleholder to the extent necessary to reflect the true economic substance of the arrangement. Other federal income tax issues implicated, but not addressed, in this revenue procedure include the treatment, for federal income tax purposes, of payments described in section 4.03(7) and whether an exchange accommodation titleholder may be precluded from claiming depreciation deductions (e.g., as a dealer) with respect to the relinquished property or the replacement property.

.04 Effect of Noncompliance. If the requirements of this revenue procedure are not satisfied (for example, the property subject to a QEAA is not transferred within the time period provided), then this revenue procedure does not apply. Accordingly, the determination of whether the taxpayer or the exchange accommodation titleholder is the owner of the property for federal income tax purposes, and the proper treatment of any transactions entered into by or between the parties, will be made without regard to the provisions of this revenue procedure.

SECTION 4. QUALIFIED EXCHANGE ACCOMMODATION ARRANGEMENTS

.01 Generally. The Service will not challenge the qualification of property as either "replacement property" or "relinquished property" (as defined in s 1.1031(k)-1(a)) for purposes of s 1031 and the regulations thereunder, or the treatment of the exchange accommodation titleholder as the beneficial owner of such property for federal income tax purposes, if the property is held in a QEAA.

.02 Qualified Exchange Accommodation Arrangements. For purposes of this revenue procedure, property is held in a QEAA if all of the following requirements are met:

(1) Qualified indicia of ownership of the property is held by a person (the "exchange accommodation titleholder") who is not the taxpayer or a disqualified person and either such person is subject to federal income tax or, if such person is treated as a partnership or S corporation for federal income tax purposes, more than 90 percent of its interests or stock are owned by partners or shareholders who are subject to federal income tax. Such qualified indicia of ownership must be held by the exchange accommodation titleholder at all times from the date of acquisition by the exchange accommodation titleholder until the property is transferred as described in section 4.02(5) of this revenue procedure. For this purpose, "qualified indicia of ownership" means legal title to the property, other indicia of ownership of the property that are treated as beneficial ownership of the property under applicable principles of commercial law (e.g., a contract for deed), or interests in an entity that is disregarded as an entity separate from its owner for federal income tax purposes (e.g., a single member limited liability company) and that holds either legal title to the property or such other indicia of ownership;

(2) At the time the qualified indicia of ownership of the property is transferred to the exchange accommodation titleholder, it is the taxpayer's bona fide intent that the property held by the exchange accommodation titleholder represent either replacement property or relinquished property in an exchange that is intended to qualify for nonrecognition of gain (in whole or in part) or loss under s 1031;

(3) No later than five business days after the transfer of qualified indicia of ownership of the property to the exchange accommodation titleholder, the taxpayer and the exchange accommodation titleholder enter into a written agreement (the "qualified exchange accommodation agreement") that provides that the exchange accommodation titleholder is holding the property for the benefit of the taxpayer in order to facilitate an exchange under s 1031 and this revenue procedure and that the taxpayer and the exchange accommodation titleholder agree to report the acquisition, holding, and disposition of the property as provided in this revenue procedure. The agreement must specify that the exchange accommodation titleholder will be treated as the beneficial owner of the property for all federal income tax purposes. Both parties must report the federal income tax attributes of the property on their federal income tax returns in a manner consistent with this agreement;

(4) No later than 45 days after the transfer of qualified indicia of ownership of the replacement property to the exchange accommodation titleholder, the relinquished property is properly identified. Identification must be made in a manner consistent with the principles described in s 1.1031(k)-1(c). For purposes of this section, the taxpayer may properly identify alternative and multiple properties, as described in s 1.1031(k)- 1(c)(4);

(5) No later than 180 days after the transfer of qualified indicia of ownership of the property to the exchange accommodation titleholder, (a) the property is transferred (either directly or indirectly through a qualified intermediary (as defined in s 1.1031(k)-1(g)(4))) to the taxpayer as replacement property; or (b) the property is transferred to a person who is not the taxpayer or a disqualified person as relinquished property; and

(6) The combined time period that the relinquished property and the replacement property are held in a QEAA does not exceed 180 days.

.03 Permissible Agreements. Property will not fail to be treated as being held in a QEAA as a result of any one or more of the following legal or contractual arrangements, regardless of whether such arrangements contain terms that typically would result from arm's length bargaining between unrelated parties with respect to such arrangements:

(1) An exchange accommodation titleholder that satisfies the requirements of the qualified intermediary safe harbor set forth in s1.1031(k)-1(g)(4) may enter into an exchange agreement with the taxpayer to serve as the qualified intermediary in a simultaneous or deferred exchange of the property under s 1031;

(2) The taxpayer or a disqualified person guarantees some or all of the obligations of the exchange accommodation titleholder, including secured or unsecured debt incurred to acquire the property, or indemnifies the exchange accommodation titleholder against costs and expenses;

(3) The taxpayer or a disqualified person loans or advances funds to the exchange accommodation titleholder or guarantees a loan or advance to the exchange accommodation titleholder;

(4) The property is leased by the exchange accommodation titleholder to the taxpayer or a disqualified person;

(5) The taxpayer or a disqualified person manages the property, supervises improvement of the property, acts as a contractor, or otherwise provides services to the exchange accommodation titleholder with respect to the property;

(6) The taxpayer and the exchange accommodation titleholder enter into agreements or arrangements relating to the purchase or sale of the property, including puts and calls at fixed or formula prices, effective for a period not in excess of 185 days from the date the property is acquired by the exchange accommodation titleholder; and

(7) The taxpayer and the exchange accommodation titleholder enter into agreements or arrangements providing that any variation in the value of a relinquished property from the estimated value on the date of the exchange accommodation titleholder's receipt of the property be taken into account upon the exchange accommodation titleholder's disposition of the relinquished property through the taxpayer's advance of funds to, or receipt of funds from, the exchange accommodation titleholder.

.04 Permissible Treatment. Property will not fail to be treated as being held in a QEAA merely because the accounting, regulatory, or state, local, or foreign tax treatment of the arrangement between the taxpayer and the exchange accommodation titleholder is different from the treatment required by section 4.02(3) of this revenue procedure.

SECTION 5. EFFECTIVE DATE

This revenue procedure is effective for QEAAs entered into with respect to an exchange accommodation titleholder that acquires qualified indicia of ownership of property on or after September 15, 2000.

SECTION 6. PAPERWORK REDUCTION ACT

The collections of information contained in this revenue procedure have been reviewed and approved by the Office of Management and Budget in accordance with the Paperwork Reduction Act (44 U.S.C. 3507) under control number 1545-1701. An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless the collection of information displays a valid control number.

The collections of information are contained in section 4.02 of this revenue procedure, which requires taxpayers and exchange accommodation titleholders to enter into a written agreement that the exchange accommodation titleholder will be treated as the beneficial owner of the property for all federal income tax purposes. This information is required to ensure that both parties to a QEAA treat the transaction consistently for federal tax purposes. The likely respondents are businesses and other for-profit institutions, and individuals.

The estimated average annual burden to prepare the agreement and certification is two hours. The estimated number of respondents is 1,600, and the estimated total annual reporting burden is 3,200 hours.

The estimated annual frequency of responses is on occasion.

Books and records relating to a collection of information must be retained as long as their contents may become material in the administration of any internal revenue law. Generally, tax returns and tax return information are confidential, as required by 26 U.S.C. 6103.

DRAFTING INFORMATION

The principal author of this revenue procedure is J. Peter Baumgarten of the Office of Associate Chief Counsel (Income Tax and Accounting). For further information regarding this revenue procedure, contact Mr. Baumgarten at (202) 622-4950.

Agricultural Consulting: Management of City Property

by William D. Davis, Jr., CRE

ABOUT THE AUTHOR

William D. Davis, Jr., CRE, *is a partner in the Kansas City firm of Appraisal Associates and is president of the firm of Farm Management Associates, Inc., a 70 year-old firm which manages agricultural property for non-resident owners in the central Midwest. (E-mail: gofarm @swbell.net)*

OVERVIEW

Our system of American government has grown in the belief that *government knows what's best* and rarely is there an opportunity for private firms to assist governmental institutions in specialized areas. This manuscript reports on a successful partnership between a Counselor of Real Estate and the City of Kansas City, Missouri, in the management of 7,000 acres of land held for future growth, use, and airfield protection at the Kansas City International (KCI) Airport.

BACKGROUND

Over the past 50 years, farsighted local political leaders assembled 10,000 acres of land for the Kansas City International Airport in anticipation of airport and future industrial expansion and as the solution to future problems of noise and air pollution, and wildlife. An initial 3,000 acres were acquired in the early 1950s as the Kansas City Industrial Airport, primarily to accommodate the huge maintenance base of Trans World Airlines, (at that time, the second largest airline in the world by number of aircraft).

Twenty-five years later, passenger traffic was moved to the new location, state-of-the-art terminals were constructed, and KCI became the main passenger airport for Kansas City. Along the way, an additional 7,000 acres of farmland was acquired. In some instances, certain farmland areas were contracted by Aviation to the Conservation Reserve

Of great importance to the success of the project was in finding farmers/operators who would do the best job of farming and, due to the rolling land, a water management/erosion control/ terracing program was considered essential. As many of the operators who had been farming the lands for several years were very competent farmers, as managers, it was our desire that they continue farming the property, as their experience with these lands eliminated a learning curve.

Program simply to produce revenue, while former owners or heirs of former owners continued to farm the cleared and crop areas on a modest cash-rental basis. Former pastures, roadways, and areas that were not maintained grew up with trees and brush and there was little concern as to soil erosion or land preservation. Airport officials, concerned with an immediate need for those lands (which was not the case), had very little concern for their improvement. Subsequently, there was absolutely no effort to improve those lands.

THE SELECTION PROCESS

In 1999, after an expression of governmental and citizen concern, airport officials, still wary, but spurred on by the chair of the City Council Aviation Committee who was committed to agriculture, developed a request for proposal for the professional management of the agricultural lands. An interview and selection process followed with the selection of the author's firm, Farm Management Associates, a management firm that had operated in the Kansas City area for over 70 years. This process extended over a seven-month period but eventually resulted in approval by the City Council. The proposal of Farm Management Associates was thorough, with recommendations based on a careful pre-inspection of the property and with a proposed land improvement budget for the foreseeable future. This eventually turned out to be very important in the continuation of the project.

INITIAL RECONNAISSANCE AND PLANNING

In its first step, the Farm Management firm walked the area, inventoried the quality of the soils, and did an extensive program of soil sampling so as to be aware of needed nutrients.

Of critical importance was the need to develop a protective strip for the control of wildlife that might invade the runways. This became the first responsibility.

Over the years, deer and flocks of birds on the runways have become a hazard to flying aircraft nationally, even disabling them. The purpose of the protective strips is to plant them to a crop which would deter wildlife. These strips are 2,000 feet from the center of the protected runway. The KCI Airport has two north/south runways and one east/west runway. The south end of the airport was already in grasses from a CRP program that had expired, so the objective was to put these grasses to a profitable use, but approximately four miles of a protective strip to the north/south runways had been recently cleared of timber and needed to be planted to brome before extreme erosion occurred. Also, deer are deterred by livestock so the objective was to develop these areas for livestock protection. As the first activity of the farm manager, a plan was laid out for the eventual agricultural use of these lands and a fall 1999 seeding of brome pasture was accomplished.

THE FARMING OPERATION

Previously, the 7,000 acres were farmed as 25 separate units. The farm managers then aligned the property into 13 productive units ranging from 400 to 800 acres in size. While most quality farm operators feel they need at least 1,000 acres per family to support their lifestyle, this program was designed to be supplementary rather than primary, so if the lands were needed for aviation purposes, this relinquishment would not cause irreparable hardship.

The land quality, even though rolling, proved to be some of the best quality upland in the state, the Higginsville Silt loam soils. Of great importance to the success of the project was in finding farmers/ operators who would do the best job of farming and, due to the rolling land, a water management/ erosion control/ terracing program was considered essential. As many of the operators who had been farming the lands for several years were very competent farmers, as managers, it was our desire that they continue farming the property, as their experience with these lands eliminated a learning curve. Some operators developed a militant stance citing assurances of airport officials up to 30 years ago that they could continue to farm the land. On previous occasions, airport personnel had addressed all operators together, and several had voiced threats to the airport management.

As one of its first acts, the Farm Management firm made an appointment to personally meet with each operator at their home. While most were known by the farm managers, each operator was asked his or her ideas, a history of each operation was developed, and the attitude of each operator as well as their desire to continue on, was discussed. This was also viewed as a good time to retire if an operator was so inclined.

In a project that involves city lands, it is important that each is treated on an equal opportunity basis; this generally involves women and minorities. As it is very unusual for women and minorities to farm, this was considered a potential problem. A request for proposal was written for farm operators with a special emphasis to attract women and minorities. There was an excellent response from a variety of highly respected and qualified farmers, both in and outside the area, who became genuinely interested after they learned that a farm manager had been hired and the city was serious in handling the lands. The request for proposal asked each operator to propose on as many of the 13 units as they desired, including a unit for buffalo, proposing a cash rental arrangement, and an arrangement based on 50/50 crop share, which is the typical crop share arrangement in the area. They were also asked to list their availability and quality of equipment, level of education, and references. (The buffalo unit was later vetoed by the airport director.)

As previously described, two of the units were reserved for livestock and the planting of grass, (as a protective strip for the airport runways), and third, there was a primarily livestock unit. Many of the airports in the nation have been invaded by various birds and wild animals, that in some instances have severely damaged aircraft, becoming a problem as to passenger safety. It was the responsibility of the farm manager to provide for the operation and management of these protective strips.

For the operation of the various farming units, over 30 responses were received for the 13 units. Each of these responses was studied in detail by both farm management and airport personnel. A letter was sent to references for a response, and based on the proposals and references, a group of prospective operators was developed for further study. For those selected, the farm manager made an inspection of each property they owned and/or rented in order to see the general condition of maintenance of the property and the overall cosmetic appearance. The cosmetic requirements for maintenance at KCI are much higher than a typical farming operation. This was reported back to the farm management committee and a decision was made as to which operators were preferred for each of the units. There were also requirements that each operator provide a letter from their city's department of finance verifying that nothing was owed and further stating that they met the hiring requirements of the city's human resources department.

CROP LAND RENTAL LEVELS

In this area, based on the farm managers' experiences, good agricultural crop land will provide an annual net operating income from \$60 to \$100 per acre per year for the landlord (the City).

From a management standpoint, crop share is generally the fairest to both the operator and the landlord, however, the cash rental proposals for the better laying land were in some instances much higher than \$60 per acre. Further, under crop share, the city had considerable risk as to their ability to profit from the LDP (Loan Deficiency Payment) Program of the United States Department of Agriculture. This was a major problem because in the 2000 crop year, corn and soybean prices were typically far below the support level. At the time of negotiating rentals, there was a \$50,000 limit for each owner or operator (later raised to \$100,000). In the state of Missouri, all governments were considered as one single unit and this was apportioned out on a first-come/first-serve basis. As managers, we preferred the crop share arrangement, as this is where we could have greater impact. This was a major income risk to our client (the City), involving about 20 percent of their potential income. This resulted in about 60 percent of the land continuing on a cash rental basis. The remaining 40 percent of the land was leased on a crop share basis. The result was very positive because in hedging our bet and limiting crop share, all of the city's share of production qualified for the LDP.

CROP PLANNING

Each operator selected was asked to meet personally with the farm managers and airport personnel. In these meetings, the cropping program was laid out on all lands — only corn and soybeans could be grown because smaller grains would attract birds. The farm manager voiced his expectations as to required soil conservation measures (nearly all was no till-farming) and the cosmetic appearance of the farms. As this is city property, there was considerable expectation as to appearance.

IMPLEMENTATION OF THE PLAN

The expectations of the farm managers for land improvements were laid out and final plans were developed. These plans followed the initial recommendations of the City Council and the budget it was based on. As farm managers, we asked that the expected farm earnings in the area of $250,000 per year, be made available for improvements. A considerable part of the plan was to attract operators who would be part of a "team." The plan was very successful in that area. Many of the operators expressed their desire to smooth out ditches in rolling land, build gates for security, and other concerns that they foresaw as they prepared their tracts for planting.

As a result, several operators, at their own cost, brought in their heavy equipment to create more efficient farming units. As was the intent of the farm manager, this immediately created a competitive atmosphere among the operators as to who could do the best job of farming.

The fencing program got underway by issuing a request for proposal for fencing and an outstanding fence builder was hired. There was considerable delay in deciding on the style of fencing, as this style would be followed for many years. Virtually everyone had a different idea. As farm managers, we found that nearly everyone who had seen a fence knew how to build one, better than we did, and all were free in sharing their opinions. Aviation personnel in decision-making positions, had absolutely no feel for fencing and were concerned for their reputations if it turned out to be a poor fence. In the end, the style of the fence was as the fence builder and farm manager had designed.

The next major task was brush removal along the city streets and roadways so that the area started to again look like farming units. Further, the brush needed to be removed so farmers could bring in their large equipment. To date, three contracts have been let for the clearing of the north/south streets through the farming area and cosmetically it looks like farming is finally occurring.

CROP PRODUCTIVITY

In Missouri, the cropping season starts in May/June and ends with the completion of harvesting in October/November. The productivity of crops is

A major lesson that has been learned is, that irregardless of the expertise of the counselor, a problem cannot be solved unless there is respect and cooperation with the level of government overseeing the program.

highly dependent on planting date, seed quality, fertilization practices, the herbicide, and the weather, with the area of no control obviously being the weather. For the 2000 crop year, the weather was almost perfect for two-thirds of the cropping season. This resulted in top yields for corn (155 bushels per acre, which is high in that area), as corn is typically planted early, but modest yields for soybeans which are typically planted later and were caught up in the drought. As the crop share land was the most rolling of the airport lands, they were all planted with soybeans. Even at that, the net income to the city was as high as $129 per acre, over four times that of previous rentals.

CONCLUSION

In conclusion, the management of the lands at the Kansas City International Airport has been highly successful due to the application of the expertise of the real estate counselor in solving a program not understood by government or with government wishing it would just go away. Revenues have increased substantially, nearly three times the $100,000 formerly. Reclamation and land preservation programs are underway, and levels of wildlife near the airport operations area have been greatly reduced.

A major lesson that has been learned is, that irregardless of the expertise of the counselor, a problem cannot be solved unless there is respect and cooperation with the level of government overseeing the program. The program could not have been successful except for the great assistance and support of the city official and the engineer that we worked with directly. Typically, the generations now running airports have no feel for agriculture. Fortunately, the people we work directly with, have the respect of their peers and have been able to express the program to their bosses who are totally unfamiliar with agriculture and who are frequently bombarded with airport field personnel who are ever so critical. To these people, we give our thanks for the success of this program.REI

PUTTING KNOWLEDGE MANAGEMENT TO WORK FOR REAL ESTATE ORGANIZATIONS

by Jennifer Samuells

INTRODUCTION

"Knowledge Management" has become an increasingly popular corporate term over the last decade. But what does it mean to you and your real estate organization? Generally, knowledge management can be summarized as the processes and tools that allow an organization to efficiently capture, maintain, and utilize its information. By organizing information and keeping it current, an organization significantly decreases time lost on the dreaded "reinvention of the wheel."

Knowledge management does not necessarily imply the creation of new knowledge. However, it most definitely involves capturing what you already have. Chances are that there is a plethora of information that has been sitting around any given real estate organization for years, waiting to be centralized, organized, and shared. And much of it may still be in the minds of a company's employees and colleagues.

REAL ESTATE GROUPS ARE KNOWLEDGE-INTENSIVE ORGANIZATIONS

Real estate organizations require real-time access to knowledge on a variety of subjects, including information on the core business and conditions affecting it, the business units' current objectives and corresponding real estate requirements, and the latest thinking in approaches to real estate.

The main goal of knowledge management is to improve efficiency and streamline communication processes, allowing team members to focus

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on creativity and innovation, rather than on locating information. For example, instead of team members spending time collecting data on a business unit's historical space demands to predict future need, they would be able to access information quickly through an organized manual or technology system capturing data specific to that business unit. As a result, the team has more time to focus on creating thoughtful, innovative approaches rather than focusing on data capture from disparate sources.

The results are improved response time and service quality delivered to the business unit. A knowledge-sharing environment also helps strengthen the team by developing, attracting, and retaining and high quality team members by allowing time for more strategic activities.

Thus, within real estate organizations, it is in each team member's best interest to contribute to knowledge management initiatives. The end result will allow them to work "smarter." As an article featured in the December/November 2000 edition of *Knowledge Management Review* concludes, "...if individuals are not motivated to acquire or trade their personal capital, then little learning can or will take place at an organizational level."[1]

DON'T LET YOUR KNOWLEDGE WALK OUT THE DOOR

In today's workplace, it is becoming increasingly difficult to function within an organization when knowledge walks out the door every night with its employees. Even with e-mail, cell phones, and pagers, there is no substitute for immediate accessibility to a team member who is physically present.

As people spend more time out of the office, it becomes more challenging to access their knowledge quickly. According to the 1998 *Business Work-Life Study* completed by the *Families and Work Institute*, 33 percent of reporting companies allow employees to work at home or off-site on a regular basis.[2] Add to that the increased ease and frequency of travel, and you are left with many people operating from multiple locations throughout the workweek. The need to centralize and store information is more critical than ever, so although an employee may not be immediately accessible, a great deal of his or her knowledge is.

Mergers and acquisitions present another ongoing trend that creates a tremendous need for effective knowledge management. As new team members are added and others leave, it is critical to prevent the loss of information during such periods of major structural change.

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As significant increases in outsourcing continue, the need for organizations to document information also intensifies. According to a 2000 Towers Perris survey, 11 percent of responding companies have outsourced non-core activities in the past two years. Looking forward, 44 percent expect to outsource non-core activities in the next two years.[3] When outsourced providers are hired, their knowledge must be documented and stored so that disruption is minimal if the outsourced partnership is ever transitioned.

TAILORING KNOWLEDGE MANAGEMENT TO SUPPORT YOUR NEEDS

Knowledge management can differ greatly from one organization to the next and is not a one-size-fits-all concept. The structure and process of capturing information is not only driven by the particular organization's needs, but also by its size and ability to dedicate time and resources to knowledge management activities. For example, real estate organization "A" may be large and geographically dispersed. Its knowledge management priorities may focus on capturing information specific to each region's real estate needs and corresponding regulations. Real estate organization "B" may be small and centralized, operating with a high degree of outsourcing. Its knowledge management priorities may focus on tracking outsourced relationships and communicating with its outsourced partners.

Whether seeking to monitor project progression for specific business units a company is servicing, or whether seeking to maintain knowledge of the assets it owns and rents, the information may currently reside on several systems, in various places. With this in mind, effective knowledge management should utilize the following strategies for capturing, organizing, and utilizing data.

Technology Systems

This component of knowledge management reviews all existing technology-based systems and databases, then identifies repetition, disconnects, and gaps. Following this review, the resulting knowledge management initiatives should link, or at least formalize, these systems.

A technology-based knowledge management system can be as simple as enabling your team to post documents to an updated, accessible, and user-friendly database. Systems such as Lotus Notes or Quickplace can be used, and in some cases even a shared drive is sufficient if it is monitored, updated, and accessible by all users. Some points to consider in building a successful knowledge management system:

- Knowledge management systems should serve as a repository for ideas, lessons learned, database information, and any other information that is critical to an organization's day-to-day activities, as well as its long-term operations.
- It should help with core activities such as logging customer requests, documentation of financial information, tracking of special project information such as site/location search, dispositions/acquisitions, etc.
- It should be continuously monitored and updated. If information is poorly organized or outdated, users will become frustrated and will not view the system as a viable source of information.

Depending upon a company's objectives, a technology-based knowledge management system can serve two functions. The first is to provide internal information within a work group. The second is to share customer-specific information with clients. Company leadership may chose to give business units or corporate-level executives access to some or all of its technology-based knowledge management system.

Lessons Learned Documents

For each assignment a real estate group takes on, it is likely that at least one or two lessons resulted. A successful knowledge management program will prompt team members to capture those lessons learned. For example, perhaps a project summary is generated at the end of each engagement. Then the document is stored in a centralized place, such as a Lotus program or shared drive. This will allow the group to reference the challenges and successes of that project, and this information may be applied to a current or future project.

Personal Communication

In most organizations, communication processes already exist. For example, weekly team conference calls should formally become a part of the knowledge management program, and a "lessons learned" discussion can be an appropriate topic to add to the agenda, if it does not already exist. This allows participants to voice their experiences with respect to successes and challenges they have recently encountered. The highlights of such a discussion can be recorded and stored as "lessons learned discussions from weekly conference calls."

BUILDING THE FOUNDATION OF A KNOWLEDGE MANAGEMENT NETWORK

It is important to assess the organization's goals and current challenges with respect to sharing information. Once these are identified, an organization can prioritize its knowledge management activities and build a program that will accomplish its objectives, without placing undue stress on those expected to contribute to, or manage, the knowledge management process. Establishing expectations early is critical, and providing team members with the percentage of time expected for dedication to knowledge management activities will help in this process.

First, it is critical to identify and appoint a knowledge management advocate to "sell" the idea of knowledge management. Ideally, this individual is an excellent communicator, with proven credibility, who can effectively promote the knowledge management program. He or she needs to be able to anticipate and answer the "what's in it for me" questions, and should be able to articulate the benefits to those expected to use and contribute to knowledge management initiatives.

Depending on the size of the organization, it may not be necessary to designate or recruit a new team member to act as knowledge manager. If these responsibilities are given a formal structure, it will make expectations clearer for the knowledge manager.

Next, create a technology system that is accessible by everyone, or utilize existing systems. Establish a process to periodically update documents and databases stored. Make the knowledge manager responsible for day-to-day review to make sure it is organized. However, avoid setting up too many policies and layers or team members will get frustrated if the submission process is not user-friendly, or if information submitted does not appear for days or weeks. The following key points will help maintain a knowledge management program:

- Keep the information updated; evolve the structure of the knowledge management program as the business evolves;
- Make sure knowledge management processes and technology systems are user-friendly and accessible;
- The knowledge manager should always understand the expectations of his/her role and be enthusiastic about the benefits of the program.

THE BOTTOM LINE

With the demands of the business world advancing at an ever-increasing pace, a solid knowledge management program can give a real estate organization an invaluable advantage: access to a body of knowledge. Fast, centralized, organized, and accessible knowledge frees up real estate professionals' valuable time to focus on creating thoughtful and innovative approaches rather than focusing on data capture from disparate sources.

Moreover, successful knowledge management results in improved response time and service quality delivered to the business unit. A knowledge-sharing environment helps strengthen a team, allowing counselors more time to focus on their core competencies and providing clients with strategic advice. REI

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Smart Growth: Practical or P.R.?

by R. Michael Joyce

California attempts to plan for expected explosive growth by adopting "smart-growth" policies. However, the fetching title masks the challenges ahead.

The current pace of growth in California is staggering. According to Census Bureau projections, the population of the United States is expected to increase 27.5 percent by the year 2025, with a 56 percent boost in California. Substandard public education, crime, and high housing costs have driven many to areas ranging beyond existing urbanized centers. Yet as development reaches further from metropolitan areas, critics of "sprawl" cite the decline of central cities, worsening traffic congestion, loss of open space, and social separation.

California's need for land planning became apparent during the explosive growth years of the late 1950s. In 1957, 10 new cities sprang up in Los Angeles County alone. In 1963, California enacted legislation that created a Local Agency Formation Commission ("LAFCO") in each county except for San Francisco. These LAFCO's were charged with overseeing city incorporations, annexations, and the creation of special districts. In 1985, three separate local government statutes governing growth issues were consolidated into one body of law called the Cortese-Knox Local Government Reorganization Act (the "Act"). Almost 20 years later, infrastructure systems throughout California are cracking, with shortages of energy reaching crisis proportions. Mirroring concerns nationwide, California seeks the kind of legal reform for land planning as it faces the future.

ABOUT THE AUTHOR

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The future expansion of California is big. By 2020, California will add 11,000,000 citizens to its current 34,000,000, with 20,000,000 more by 2040. This explosion in population will be primarily self-generated, caused more by births exceeding deaths than by immigration. Currently, over 80 languages are spoken in the Los Angeles City School District and more than 25 percent of California's 5.6 million school children have limited English proficiency. California ranks near the bottom of the nation's educational ranking system today, and the state would have to build a school every five days to absorb and serve the additional population over the next 10 years. At the beginning of the twenty-first century, seven of California's metropolitan areas are among the nation's 10 least affordable. Fifteen of these areas rank in the top-25 least affordable areas of the country and three-hour commutes are common.

The future expansion of California is big. By 2020, California will add 11,000,000 citizens to its current 34,000,000, with 20,000,000 more by 2040. This explosion in population will be primarily self-generated, caused more by births exceeding deaths than by immigration... California ranks near the bottom of the nation's educational ranking system today, and the state would have to build a school every five days to absorb and serve the additional population over the next 10 years.

In 1997, California organized "The State's Commission for Local Governance for the 21st Century" to assess growth issues and to make recommendations. In its year 2000 report entitled, "Growth Within Bounds: Report to the Commission on Local Governance for the 21st Century," the commission gave a failing report card to the state of California on the manner in which it currently conducts its land planning. It concluded that at this point:

- California has no plan for growth.
- California's land planning decisions are predicated on the short-term economic interests of local authorities who frequently base their decisions on revenue competition with other municipalities.
- Responsibility for land planning is currently allocated to a hopeless overlap of 58 counties, 407 cities, 4816 special districts, 399 redevelopment agencies, 993 school districts, and 71 community colleges.

Based on the commission's findings and subsequent recommendations to modernize and streamline the Act, "The Cortese-Knox-Hertzberg Local Government Reorganization Act of 2000" ("AB 2838") was passed and enacted by the California State Legislature last year. Echoing the case of smart-growth advocates nationwide, the commission set out five principles for California's growth, including 1). the requirement for regional perspectives; 2). the requirement for greater efficiency of land use; 3). greater public investment; 4). fiscal reform; and 5). adherence to equity considerations. (All references are to the California Government Code.)

First, the public policies of "discouraging urban sprawl, preserving open space and prime agricultural lands, efficiently providing government services, and encouraging the orderly formation and development of local agencies" have been consolidated (Section 56001; 56301) in an effort to give clear definition to the overall objectives of the Act. Second, the commission determined that the assignment by LAFCO to another entity to conduct protest hearings and to hold elections following LAFCO approval of a reorganization historically caused delays and confusion because LAFCO had no control over such entities. AB 2838 addresses this by naming LAFCO as the "conducting authority" for all reorganization proceedings (Section 56895).

The Act also incorporated a number of key provisions with the specific interest of checking urban sprawl and promoting the orderly extension of services. The Act had previously addressed the concept of regional planning by requiring LAFCOs to establish a sphere of influence for each city and special district, to serve as a general plan for orderly growth and development. The spheres of influence were intended to be a guideline for the future expansions of cities. However, the Act did not establish a clear mechanism for a LAFCO to use when establishing this sphere of influence. AB 2838 now requires each LAFCO to update its sphere of influence every five years, by considering trends in growth and development, service capabilities and public preferences. Each LAFCO is required to review the services provided within its county to assist it in making future decisions, and include an analysis of the infrastructure needs and deficiencies, growth and population projections, opportunities for shared facilities, and financing constraints and opportunities (Sections 56425; 56430). In a further effort to "regionalize" planning decisions, pre-zoning is required for any territory proposed to be annexed to a city, to ensure clear knowledge of a plan's potential impacts. Such pre-zoning is to remain in effect for two years unless the legislative body determines that a change is necessary to protect property rights or public health and safety (Section 56375).

Under the Act, LAFCOs will be required to initiate periodic regional or sub-regional service reviews at least every five years to determine local government service needs and adequacy (Section 56430). Following the adoption of the Act, and for the next six years, counties will be required to consult with affected cities prior to approving any development or land-use change within a sphere of influence. The Act requires LAFCOs to give "great weight" to any agreements reached between cities and counties on development within spheres of influence (Section 56425). The Act will also now require that any proposals calling for major infrastructure extensions will be subject to LAFCO review (Section 56133). The Act also expands the definition of "prime agricultural lands" (Section 56064) to make annexations of prime farm land more difficult.

Section 56668 of the Act now requires LAFCOs to consider several additional factors when reviewing proposals, including: (i) the sufficiency of revenues to meet service costs following a boundary change; (ii) timely availability of adequate water supplies to meet projected needs under the applicable urban water management plan; (iii) the extent to which the proposal assists the receiving entity in meeting its regional housing needs; (iv) the comments of affected landowners; and (v) information on existing land use designations.

Lastly, in order to immunize LAFCO decisions from legal challenge, the Act incorporates a revision to Section 56107 to provide that in any proceeding to attack or set aside a determination made by LAFCO, the inquiry shall extend only to whether there was fraud or a prejudicial use of discretion.

AB2838 reflects the mantra of smart growth-advocates who decry sprawl, blaming it for the decline of our cities, mounting traffic, increased energy consumption and pollution, the loss of open space and habitat, and increased social separation. Underlying AB2838 are the core principles of smart growth: the redevelopment and revitalization of existing urban centers. The smart-growth movement suggests a combination of remedies for success, including placing development boundary limits on designated urban areas, regionalizing land use planning in order to foster cooperation among municipalities, creating affordable housing, and improving transportation systems.

By adopting AB2838, the California State Legislature would appear to be taking a step toward achieving the goals of the smart-growth philosophy of land development. However, a number of practical issues present daunting challenges. For example, the boundaries of existing urban centers simply appear too small to accommodate the staggering number of new citizens expected in California. Will the 20,000,000 new citizens be squeezed into existing city centers? A myriad of other functional issues challenges the realism of smart growth, including the basic principals on which land use decisions are made. As noted by William C. Smith in the December 2000 issue of the *American Bar Journal*, the United States Supreme Court, in its seminal decision of *Euclid* v. *Ambler Realty Co.* 272 U.S. 365, clearly established municipalities as near sovereign entities with respect to local land use issues. In order to carry out one of the guiding tenets of smart growth (i.e. regional cooperation), municipalities and their respective residents will be called upon to forfeit much of the land use authority that has been historically ceded to them by federal and state law. Members of city councils and special districts cannot be expected to willingly surrender their powers to regional bodies for land planning issues.

Some of the most significant hurdles to smart growth also stem from apparent human nature. There is a natural inclination of many families to seek single-family homes in suburban settings, notwithstanding long commutes and other related problems. The country has a strong cultural history of pioneering and picking-up and moving when things get crowded. Americans see themselves as highly individualistic. The notion that Californians will be huddled into urban centers enveloped by "no-build" frontiers may be naïve. As reported in *USA Today*: "Limiting Sprawl A Growing Issue. So is Defining It" (February 22, 2001), the City of Portland established an urban growth boundary only to find new development "jump" to areas outside its jurisdiction but within commuting distance.

If new families are to remain in existing urban centers, it would also appear that massive reform/improvement to California's public schools is in order. California's current record in the area of public education is dismal. How can smart-growth proponents expect the state's growing population to remain in existing urban areas without addressing the urgent need to revamp the educational system that is one of the primary forces motivating new families to flee?

Yet another laudable objective of the smart-growth movement is the push for affordable housing to mitigate traffic congestion and social separation. Here, however, smart growth faces the obstacle of so many NIMBY (Not in My Back Yard) opponents protesting perceived threats to schools and property values. Critics of the smart-growth ideology also argue that prohibiting development beyond existing urban boundaries will only increase the cost of housing. Indeed, many anti-growth measures are actually promoted to existing residents on the premise that housing values can be expected to rise once the measures are adopted.

Revitalizing urban communities will require a massive infusion of capital to improve existing infrastructure so that public facilities, including schools and public transportation systems, are vastly improved. In this regard, the California Business Roundtable projects the state's infrastructure needs to be approximately $90 billion over the next decade. Obviously, the call on fiscal resources to improve, let alone fix, California's crumbling infrastructure will strain budgets. In California, sprawling new communities have been able to self-finance their required infrastructure improvements by having new residents pay the cost through increased housing prices and the assumption of public infrastructure debt.

Additionally, there are enormous environmental challenges that can be expected as a result of the massive public infrastructure projects required to revitalize and redevelop urban centers. These projects would demand prompt planning and processing. The current environmental climate in California does not bode well for this; for example, the "Environmental Impact Report" for the proposed Los Angeles Airport expansion is 12,000 pages long.

CONCLUSION

If AB2838 is a first step in the process of adopting smart growth for California, then the state must certainly pick up the pace. California now faces

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chronic shortages of transportation facilities and energy and its public schools are failing. Continued explosive growth (from the births of its current citizens) will add crushing new burdens on the state's already exhausted infrastructure capacity.

Only strong, dynamic state-wide or region-wide cooperation will provide the necessary planning perspectives and infrastructure financing sources necessary to achieve comprehensive land planning for the state's future. Yet even a broad based bipartisan effort to stem sprawl will face vast political, social, and economic hurdles. REI

USES OF INFORMATION TECHNOLOGY IN THE REAL ESTATE BROKERAGE INDUSTRY

by Michael J. Seiler, Vicky L. Seiler & Michael T. Bond

INTRODUCTION

It is now possible for someone working at their computer to tour a property and its surrounding neighborhood and/or get approved for a loan without using a real estate broker or banker directly. With this kind of service available on the Information Superhighway a commonly asked question has become, "Who needs real estate agents if anyone can access property information online?" A group clearly interested in the answer is the residential and commercial real estate brokerage industry. Indeed, the dramatic increase in technology in the last 15 years has been geometric in scope and real estate professionals who ignore these megatrends do so at their own peril.

The purpose of this study was two-fold. First, the study involved determining what types of technology are currently being used in the real estate brokerage industry. Identifying and summarizing how the real estate brokerage industry currently uses and plans to use technology in its businesses is a matter of interest not only to the industry, but their trade groups, and to government agencies related to the real estate brokerage industry as well. Second, previous research has suggested that there may exist a "size effect" in the real estate brokerage industry, although the results are mixed. This study will determine if there exists a size effect as it relates to the current and future use of technology.

There are several potential beneficiaries of this research. First, the real estate brokerage industry will have detailed data on the current use of

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technology in their industry and plans for additional uses in the future. This will allow firms that are "behind the curve" on uses of these innovations to examine the various technological options that are open to them and decide which of these are the most value-added for their businesses. Second, the computer software, computer hardware, and database industry will know what types of technology are being used in the brokerage industry. Once they have information on some of the plans for future uses of technology by real estate brokerage firms, they can target a portion of their research and development in those areas. Third, local, state, and national real estate trade groups and associations will be informed as to uses of technology by their members. This will allow them to disseminate to their members new and relevant information concerning technology and its potential for employment in the industry.

LITERATURE REVIEW

Smith, Rosen, and Fallis (1988) state that residential real estate composes roughly 38 percent of the country's wealth. Of this 38 percent, real estate brokerage firms are responsible for the sales of 81 percent of single-family dwellings (FTC, 1983). Hence, understanding the role of the real estate brokerage industry is critically important.

Much research has been devoted to examining the efficiency of the residential real estate market (Turnbull 1997, Yavas 1995, Greer and Farrell 1993, Miceli 1992, Case and Shiller 1989, Zumpano and Hooks 1988, Guntermann and Smith 1987, Linneman 1986, and Gau 1984). Although the results concerning the degree of market efficiency are mixed, it is clear that intermediaries, (specifically the real estate brokerage industry), improve efficiency (Baryla and Zumpano 1995, Turnbull and Sirmans 1993, Jud 1983). Two of the ways they do so is through 1). the use of technology, and 2). economies of scale.

Increases in the use of improved technology reduce the search time for buyers. This reduction in buyer search costs (time) in turn increases efficiency in the residential real estate market. One such example is the advent and increased use of the Internet for real estate purposes (Kabatim 1996, Royal 1995). Rodriquez, Lipscomb, and Yancey (1996) provide a comprehensive discussion of how the Internet affects the residential real estate brokerage industry. In short, the Internet offers a seemingly endless number of free sites that list (and picture) homes for sale across the country. The introduction of these

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low cost producers (of information) increases competition and arguably drives inefficient real estate brokerage firms out of business and forces home prices to be closer to equilibrium. Benjamin and Chinloy (1995) confirm the finding that the adoption of technology increases efficiency.

Innovations and improvements in computer software are also having significant impacts on areas such as leasing and property management. "Lease by lease" software programs such as *Argus*, *Dynalease*, *Office/2* and *Project* are used extensively in valuing properties that are being considered for acquisition. Other uses of software include property management where managers use the technology for analyzing leasing strategies and specific lease potentials. In addition, there is usually a function available for developing property management budgets and for variance analysis (Hanrahan 1993).

The second source of improving economic efficiency in the real estate brokerage industry relates to the concept of economies of scale. Many of the studies in residential real estate brokerage that consider firm size do so in reference to a firm's ability to reduce time on the market (TOM). It is widely accepted that there exists a trade-off between the selling price of a home and the time it takes to sell it. Haurin (1988), Larsen and Park (1989), Sirmans, Turnbull, and Benjamin (1991) find that larger real estate brokerage firms sell homes faster than smaller firms. Anglin (1997), Jud, Seaks, and Winkler (1996) and Yang and Yavas (1995) find that firm size has no effect on TOM. Somewhere in the middle of these two extremes is a study by Hughes (1995) who finds that buyers receive a higher selling price, everything else constant, when a larger firm handles the sale. However, this is only true for some of the large firms in the sample. Zumpano and Elder (1994) and Zumpano, Elder, and Crellin (1993) argue that there do exist economies of scale advantages in the brokerage industry. However, most firms are too small to take advantage of these possibilities.

The purpose of this manuscript is two-fold: 1). Due to the demonstrated importance of technology in the real estate brokerage industry, and 2). because of the conflicting results surrounding firm size (as it relates to the real estate brokerage industry) and the lack of attention that firm size has been given, this study examines the current and future planned uses of technology in the real estate brokerage industry and the effect that firm size has on these uses of technology.

DATA

The data in this study are from a survey conducted on 3,322 Ohio real estate brokerage firms. The first section of the survey is designed to gather demographic information about the responding brokerage firms. The second part asks a myriad of questions relating to current and planned future usage of computers and computer-related applications as they correlate to doing business in the real estate brokerage industry. A copy of the survey is presented in *Exhibit 1*.

RESULTS

In order to identify the relationships among the variables, the survey results must first be presented in an easy-to-interpret format. Any one of the following four variables: A (number of real estate agents (some REALTORs); B (number of staff employees); C (number of offices); and D (number of sales), could theoretically be used as a variable of reference from which all other responses were segregated. This study uses the number of real estate agents to analyze the sample. This is because 51.4 percent of the sample has only one staff employee. Moreover, 89.9 percent of the sample has five or fewer staff employees. Thus, this variable would not make a good candidate for segmenting the sample because there would be too few observations in too many categories. The number of offices variable suffers from the same problem. Over 80 percent of all real estate brokerage firms sampled have single office businesses; 98.6 percent have five or fewer offices. The relationship between the number of real estate agents and the number of sales is very positive. This makes perfect sense because the more real estate agents a firm has, the more sales they should be able to generate. For this reason, the number of real estate agents is used as a frame of reference in this study and as a proxy for firm size.

Exhibit 2 shows the tabulated results from the survey of real estate brokerage firms. Each column represents the size of the real estate firm as defined by the number of real estate agents at the firm. Other studies use the number of sales as the variable for size, but because the number of real estate agents is so highly correlated, it makes little difference as to how one defines firm size. The rows in *Exhibit 2* represent all other questions on the questionnaire. Each value in the exhibit represents a percentage of the respondents. For example, 71.6 percent of all single brokerage firms have only one staff employee (B1), while 23.9 percent of all single real estate brokerage firms have between two and five staff employees (B2). All questions on the survey are separated by a blank row so as to aid in the understanding of the exhibit.

There is a weak positive relationship between the number of real estate agents at a firm (A) and both the number of staff employees (B) and the number of offices (C). This can be seen by noting that the percentages move from the upper left to the lower right in the exhibit. These results are certainly expected given that the more real estate agents a firm has, the larger the number of offices and support staff the firm will likely need.

The variable, (number of sales made by the firm), is shown in question D. As discussed, there exists a strong positive relationship between the average number of sales and the number of real estate agents. This is the only variable shown in the exhibit that is not in percentage terms. Instead, the number of sales is displayed in absolute terms as an average. The number of average sales ranges from 12.0 for a single agent firm to 1380.8 for real estate brokerage firms with over 100 real estate agents. The average for the entire sample is 103.9 sales per year.

To test for the statistical significance of the results, an Analysis of Variance (ANOVA) test is used. An ANOVA tests the null hypothesis that the means of the variables in each row are all the same for each firm size interval. That is, the ANOVA answers the question, "Does firm size matter?" As noted in the exhibit, the number of sales is significantly different across firm sizes.

Question E asks the types of services that the respondent's brokerage firm currently offers to its customers. E1 through E7 are (E1) brokerage; (E2) appraisal; (E3)guaranteed sale; (E4) buyer's brokerage services' (E5) limited liability insurance for sellers; (E6) financing, inspection, and/or title work; and (E7) property management. Overall, the most popular service currently being offered is brokerage service (83.8 percent), followed by buyer's brokerage services (61.9 percent), and appraisal (45.9

Exhibit 1

Survey of Real Estate Brokerage Firms

Dear Real Estate Professional,

The Center for Real Estate Education and Research at Ohio State University, with the support of the your professional trade group, has funded a research project at Cleveland State University to identify technology trends in the Ohio Real Estate Brokerage Industry. Could you possibly assist in this research by filling out the following short, confidential survey related to your firm's use of technology and returning it in the enclosed prepaid envelope. Thank you for your time! The results of this research will be available from the center by the Summer of 1998.

A.) WHAT IS THE APPROXIMATE NUMBER OF REALTORS AT YOUR FIRM?
1.) 1 2.) 2-5 3.) 6-10 4.) 11-20 5.) 21-40 6.) 41-100 7.) over 100

B.) WHAT IS THE APPROXIMATE NUMBER OF STAFF EMPLOYEES AT YOUR FIRM?
1.) 1 2.) 2-5 3.) 6-10 4.) 11-20 5.) 21-40 6.) 41-100 7.) over 100

C.) WHAT IS THE NUMBER OF OFFICES AND/OR BRANCHES AT YOUR FIRM?
1.) 1 2.) 2-5 3.) 6-10 4.) 11-15 5.) 16-30 6.) 31-50 7.) 51-100 8.) over 100

D.) APPROXIMATELY WHAT NUMBER OF RESIDENTIAL HOME SALES OCCURRED FROM PROPERTIES LISTED BY YOUR FIRM (ALL BRANCHES AND/OR OFFICES) IN 1996?
FILL IN NUMBER ________________

E.) WHAT TYPES OF SERVICES DO YOU OFFER TO RESIDENTIAL REAL ESTATE CUSTOMERS?
1.) brokerage 2.) appraisal 3.) guaranteed sale 4.) buyers brokerage services
5.) limited liability insurance for sellers 6.) financing, inspection, and/or title work
7.) property management 8.) other ___________

F.) WHAT TYPE OF SERVICES DO YOU ANTICIPATE ADDING IN THE FUTURE?
1.) buyers brokerage services 2.) on-line computer listing services 3.) other _________

G.) WHAT APPROXIMATE PERCENTAGE OF YOUR RESIDENTIAL HOME SALES ARE IN THE FOLLOWING PRICE RANGES?
1.) up to 50K 2.) 51K-100K 3.) 101K-150K 4.) 151K-200K 5.) 201K-250K
6.) 250K-300K 7.) over 300K

H.) WHAT APPROXIMATE PERCENTAGE OF YOUR FIRMS REVENUES ARE GENERATED FROM RESIDENTIAL VS. COMMERCIAL CUSTOMERS? ______

I.) WHAT APPROXIMATE PERCENTAGE OF YOUR FIRMS REVENUE IS DERIVED FROM BROKERAGE SERVICES VS. OTHER SERVICES? _____________

J.) HOW MANY YEARS HAS YOUR FIRM BEEN IN BUSINESS? ___________

K.) WHAT IS YOUR GEOGRAPHIC LOCATION IN OHIO?
1.) northeast 2.) northwest 3.) central 4.) southwest 5.) southeast

L.) DOES YOUR FIRM USE COMPUTERS IN ANY WAY? 1.) Yes 2.) No

(continued on next page)

M.) WHAT TYPE OF COMPUTER BRAND
1.) IBM 2.) Dell 3.) Gateway 4.) NEC 5.) Apple 6.) Compaq 7.) Mainframe 8.) other ________

N.) WHAT TYPE OF PROCESSOR DOES THE COMPUTER HAVE?
1.) Intel 486 2.) Pentium 3.) Pentium Pro 4.) Pentium with MMX 5.) Pentium II
6.) 386 Processor 7.) other ________

O.) WHAT IS (ARE) THE MACHINE(S) USED FOR?
1.) word processing 2.) spreadsheet applications 3.) accounting 4.) mortgage analysis
5.) databases 6.) multiple listing access 7.) other ________

P1.) IS YOUR COMPUTER USED FOR INTERNET APPLICATIONS?
1.) Yes 2.) No

P2.) IF YES CAN YOU VIEW AND PRINT INTERNET IMAGES?
1.) Yes 2.) No

Q.) WHAT IS THE NUMBER OF COMPUTERS YOUR FIRM HAS?
1.) 1 2.) 2 3.) 3 TO 5 4.) more than 5

R.) IF MORE THAN ONE ARE THEY NETWORKED IN ANY MANNER?
1.) Yes 2.) No

S.) IF SO WHAT TYPE?
1.) Microsoft 2.) Banyan 3.) Netware 4.) Novell 5.) other ________

T.) IF THE MACHINE(S) ARE IBM OR IBM COMPATIBLE WHAT OPERATING SYSTEM DO THEY USE?
1.) DOS 2.) OS2 3.) Windows 3.1 4.) Windows 95 5.) Windows NT 6.) UNIX 7.) other ________

U.) DO YOU HAVE A WEB PAGE?
1.) Yes 2.) No

V.) IF SO WHO IS YOUR INTERNET PROVIDER?
1.) ATT 2.) AOL 3.) COMPUSERVE 4.) Ohio Online 5.) other ________

W.) WHAT TYPE OF PRINTER DO YOU HAVE?
1.) dot matrix 2.) laser 3.) color capable laser 4.) printer with fax 5.) fax only

X.) IS YOUR COMPUTER USED TO GENERATE MAILINGS?
1.) Yes 2.) No

Y.) DO YOU HAVE A SCANNER?
1.) Yes 2.) No

Z.) ARE YOU ABLE TO STORE IMAGES FOR LISTINGS IN THE COMPUTER?
1.) Yes 2.) No

AA.) DO YOU USE DATA BASES TO IDENTIFY PROSPECTIVE CUSTOMERS?
1.) Yes 2.) No

Exhibit 2

Survey of Real Estate Brokerage Firms by Size

Number of Real Estate Agents

	1	2-5	6-10	11-20	21-40	41-100	over 100	Total
B1	71.6%*	72.3%*	54.2%*	30.4%*	17.9%*	0.0%*	0.0%*	51.4%
B2	23.9*	21.0*	41.0*	63.8*	69.2*	53.3*	0.0*	38.7
B3	1.5*	3.4*	1.2*	1.4*	10.3*	20.0*	0.0*	3.5
B4	3.0*	2.5*	2.4*	2.9*	2.6*	26.7*	44.4*	4.5
B5	0.0*	0.8*	1.2*	1.4*	0.0*	0.0*	44.4*	1.7
B6	0.0	0.0	0.0	0.0	0.0	0.0	11.1	0.2
B7	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
C1	97.6*	87.5*	80.6*	72.9*	70.0*	26.7*	0.0*	80.3
C2	2.4*	11.8*	19.4*	27.1*	30.0*	73.3*	44.4*	18.3
C3	0.0	0.7	0.0	0.0	0.0	0.0	22.2	0.7
C4	0.0	0.0	0.0	0.0	0.0	0.0	22.2	0.4
C5	0.0	0.0	0.0	0.0	0.0	0.0	11.1	0.2
C6	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
C7	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
C8	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
D	12.0*	26.4*	70.8*	112.9*	228.4*	467.3*	1380.8*	103.9
E1	60.0*	85.5*	88.2*	91.4*	100.0*	100.0*	100.0*	83.8
E2	41.2	40.7	48.4	52.9	48.8	53.3	44.4	45.9
E3	5.9*	3.4*	8.6*	10.0*	24.4*	33.3*	11.1*	8.9
E4	37.6*	54.5*	68.8*	71.4*	87.8*	100.0*	100.0*	61.9
E5	1.2	2.8	8.6	1.4	9.8	0.0	0.0	3.9
E6	7.1*	5.5*	10.8*	11.4*	22.0*	33.3*	44.4*	10.8
E7	22.4	35.9	36.6	38.6	36.6	33.3	44.4	33.8
F1	8.2	11.7	5.4	7.1	12.2	6.7	11.1	8.9
F2	15.3*	24.8*	33.3*	28.6*	36.6*	26.7*	55.6*	26.8
G1	21.1	11.0	13.7	10.0	10.3	2.4	1.7	12.3
G2	38.1	44.7	46.4	50.0	36.3	36.8	6.9	43.0
G3	27.7*	25.7*	26.9*	28.2*	39.9*	38.1*	41.3*	28.8
G4	8.9*	9.4*	8.4*	7.3*	8.0*	9.2*	13.3*	8.7
G5	3.5*	4.2*	2.7*	2.5*	3.4*	4.7*	12.1*	3.6
G6	0.5*	1.9*	1.2*	1.5*	1.4*	6.3*	21.3*	2.0
G7	0.2*	3.1*	0.7*	0.5*	0.7*	2.5*	3.4*	1.6
H	65.2*	72.7*	81.0*	85.0*	92.8*	93.5*	93.7*	77.9
I	52.4*	68.9*	79.3*	78.7*	89.8*	68.3*	96.3*	71.8
J	22.4	19.9	18.8	22.8	23.4	29.9	35.4	21.5

(continued on next page)

Exhibit 2, *continued*

Number of Real Estate Agents

	1	2-5	6-10	11-20	21-40	41-100	over 100	Total
K1	34.6%	30.2%	31.1%	23.4%	38.5%	23.1%	44.4%	31.1%
K2	11.1	12.9	13.3	25.0	15.4	38.5	11.1	15.3
K3	18.5	29.5	24.4	23.4	10.3	15.4	0.0	23.1
K4	24.7	20.9	15.6	18.8	28.2	23.1	44.4	21.2
K5	11.1	6.5	15.6	9.4	7.7	0.0	0.0	9.4
L1	86.6*	96.5*	97.8*	98.5*	97.5*	100.0*	100.0*	95.5
L2	13.4*	3.5*	2.2*	1.5*	2.5*	0.0*	0.0*	4.5
M1	20.6%	25.2	19.7	29.8	23.3	14.3	0.0	23.3
M2	4.8	3.5	5.3	1.8	3.3	0.0	33.3	4.2
M3	11.1	9.6	6.6	8.8	13.3	0.0	16.7	9.3
M4	1.6	3.5	0.0	0.0	0.0	0.0	0.0	1.4
M5	1.6	0.0	0.0	0.0	0.0	0.0	0.0	0.3
M6	3.2	4.3	14.5	10.5	3.3	14.3	16.7	7.6
M7	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
M8	57.1	53.9	53.9	49.1	56.7	71.4	33.3	53.9
N1	23.5*	24.1*	23.7*	25.7*	43.9*	53.3*	44.4*	27.3
N2	32.9	43.4	47.3	50.0	51.2	60.0	33.3	44.4
N3	1.2*	2.8*	7.5*	5.7*	7.3*	6.7*	22.2*	4.8
N4	12.8	8.3	10.8	11.4	12.2	6.7	33.3	10.8
N5	3.5	6.9	9.7	10.0	4.9	20.0	11.1	7.6
N6	5.9	11.0	8.6	7.1	7.3	20.0	11.1	9.1
N7	12.9	9.0	8.6	4.3	4.9	13.3	0.0	8.4
O1	64.7*	77.9*	82.8*	84.3*	90.2*	93.3*	66.7*	78.6
O2	37.6*	49.0*	51.6*	54.3*	61.0*	80.0*	66.7*	50.9
O3	44.7*	51.7*	53.8*	58.6*	68.3*	86.7*	55.6*	54.3
O4	28.2*	44.1*	45.2*	47.1*	58.5*	53.3*	44.4*	43.1
O5	35.3*	44.1*	57.0*	51.4*	63.4*	80.0*	55.6*	49.6
O6	48.2*	69.7*	81.7*	84.3*	85.4*	100.0*	55.6*	72.3
O7	34.1	26.2	26.9	35.7	29.3	20.0	33.3	29.4
P1A	86.4	90.5	94.6	90.0	94.1	93.3	100.0	91.4
P1B	13.6	9.5	5.4	10.0	5.9	6.7	0.0	8.6
P2A	44.7	94.7	92.6	95.6	93.8	93.3	100.0	95.5
P2B	55.3	5.3	7.4	4.4	6.3	6.7	0.0	4.5
Q1	50.7*	35.1*	24.2*	11.8*	5.0*	0.0*	0.0*	26.9
Q2	35.2*	35.1*	25.3*	27.9*	12.5*	6.7*	0.0*	27.8
Q3	11.3*	22.4*	35.2*	47.1*	50.0*	13.3*	0.0*	29.0
Q4	2.8*	7.5*	15.4*	13.2*	32.5*	80.0*	100.0*	16.2

"D" is not in percentage. It is the average number of sales in absolute terms.

* significant at 99%

(continued on next page)

Exhibit 2, *continued*

Survey of Real Estate Brokerage Firms by Size, *continued*

	Number of Real Estate Agents							
	1	2-5	6-10	11-20	21-40	41-100	over 100	Total
R1	18.6*	31.9*	36.2*	19.7*	40.5*	66.7*	88.9*	33.0
R2	81.4*	68.1*	63.8*	80.3*	59.5*	33.3*	11.1*	67.0
S1	85.7*	50.0*	70.8*	80.0*	33.3*	55.6*	28.6*	56.6
S2	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
S3	0.0*	0.0*	0.0*	0.0*	6.7*	11.1*	0.0*	2.0
S4	0.0*	23.1*	8.3*	10.0*	20.0*	11.1*	44.4*	18.2
S5	14.3*	26.9*	20.8*	10.0*	40.0*	22.2*	11.1*	23.2
T1	20.0	15.2	14.0	20.0	9.8	13.3	0.0	16.0
T2	0.0	0.7	1.1	0.0	0.0	0.0	0.0	0.4
T3	22.4*	24.1*	22.6*	31.4*	45.1*	33.3*	44.4*	26.6
T4	56.5*	64.1*	75.3*	82.9*	85.4*	93.3*	77.8*	71.0
T5	2.4	0.7	0.0	0.0	4.9	6.7	0.0	1.3
T6	0.0	0.7	2.2	0.0	0.0	0.0	0.0	0.6
U1	14.1*	27.3*	35.2*	40.3*	52.5*	80.0*	100.0*	34.4
U2	85.9*	72.7*	64.8*	59.7*	47.5*	20.0*	0.0*	65.6
W1	31.8	33.1	38.7	47.1	51.2	40.0	22.2	37.4
W2	45.9*	46.9*	50.5*	61.4*	73.2*	86.7*	66.7*	53.9
W3	23.5	25.5	33.3	37.1	26.5	46.7	44.4	29.7
W4	7.1	14.5	11.8	7.1	7.3	6.7	22.2	10.6
W5	2.3	4.8	3.2	2.9	2.4	0.0	0.0	3.5
X1	38.6*	52.3*	52.7*	64.7*	84.2*	93.3*	87.5*	57.0
X2	61.4*	47.7*	47.3*	35.3*	15.8*	6.7*	12.5*	43.0
Y1	36.2*	37.7*	51.7*	56.1*	48.7*	85.7*	100.0*	47.3
Y2	63.8*	62.3*	48.3*	43.9*	51.3*	14.3*	0.0*	52.7
Z1	56.3*	66.4*	74.7*	83.6*	81.6*	92.9*	87.5*	72.3
Z2	43.8*	33.6*	25.3*	16.4*	18.4*	7.1*	12.5*	27.7
AA1	23.9*	38.9*	52.3*	65.7*	73.0*	93.3*	71.4*	49.4
AA2	76.1*	61.1*	47.7*	34.3*	27.0*	6.7*	28.6*	50.6

"D" is not in percentage. It is the average number of sales in absolute terms.
* significant at 99%

percent). When examining the effect of firm size, it is clear that larger firms tend to offer more of each type of service than do smaller firms.

A related survey question was: which types of services the firms plan to offer in the future (F1 and F2). There were 8.9 percent responding that they plan on adding buyer's brokerage services in the future, while 26.8 percent indicated that online computer listing services would be offered in the future. Future buyer's brokerage service offerings are independent of firm size, but online computer listing services are being sought more by the larger firms.

G1 through G7 represent the average percentage of residential home sales that are in various price ranges from lowest to highest, respectively. From the exhibit, it appears that larger firms tend to handle the sale of higher priced homes. Survey question H (the average percentage of firm revenues from residential sales) is asked simply to gain another demographic piece of information about the sample. Large firms are found to generate a higher portion of their revenue from residential sources (93.7 percent versus 65.2 percent).

The average percentage of the responding real estate brokerage firm's revenue derived from brokerage services (as opposed to other services) was asked in question I. Consistent with the results from questions E1 through E7, question I shows that single agent firms receive an average of 52.4 percent of their revenue from brokerage services, while 96.3 percent of revenues are generated by brokerage services for larger firms. In fact, from question E, 100 percent of responding firms with over 20 real estate agents currently offer brokerage services.

The age of a real estate brokerage firm should likely have an impact on the way the firm behaves. For this reason, question J asks the respondents how long their firm has been in business. Over most of the firm sizes, there is no relationship between firm size and firm age. Moreover, a correlation coefficient was calculated for number of sales (which was previously found to closely relate to firm size) and years in business. The correlation coefficient is only .09 which is not statistically significant.

One of the main focuses of this study was the impact of technology on the real estate brokerage industry. Question L asked if the firm uses computers in any way. Of those responding, 95.5 percent indicated that their firm does use computers. Although this number is high over all firm size categories, it is clear that larger firms are more into using computers. In fact, 100 percent of the firms with over 40 real estate agents use computers in their work.

IBM is the most popular brand name of those offered on the questionnaire (question M). Surprisingly, 53.9 percent of the respondents used a brand other than those listed in the survey. Because almost all of them did not indicate their brand, no solid conclusion can be reached concerning the most popular computer brand used in the real estate brokerage industry. These results are consistent across all firm sizes.

The type of computer processor used in the firm's computer was asked in question N. Of those responding, 44.4 percent indicated that their computers used Pentiums, while 27.3 percent noted that their computers were run with the Intel 486 chip. All other processors were used in roughly the same proportion. The results concerning whether this is a function of firm size are mixed.

What real estate brokerage firms use computers for is certainly a variable of interest. This is asked in question O. Word Processing (78.6 percent) and multiple listing access (72.3 percent) are the two most popular features used. Accounting (54.3 percent); spreadsheet applications (50.9 percent); maintaining databases (49.6 percent); and mortgage analysis (43.1 percent) are all being used in roughly the same proportions. In almost all cases, the use of software increases dramatically as firm size increases.

P1 asked if the firm's computer has Internet access. Of the firms with computers, 91.4 percent of them have access to the Internet. Of those firms that do have access to the Internet, 95.5 percent of them can view and print Internet images (P2). Other than for single agent companies, the results are consistent across firm size.

Just as there exists a positive relationship between the number of real estate agents at a firm and the number of sales by the firm, so too should there exist a positive relationship between firm size and the number of computers used by the firm. In question Q, as expected, this relationship is statistically significantly positive. For those firms with more than one computer, question R asked if they are networked. Only one-third of the multi-computer real estate firms are networked. However, there is an understandable robust positive relationship between firm size and whether or not the firm's computers are networked. Only 31.9 percent of firms with two or more real estate agents have their computers networked, whereas 88.9 percent of the firms with over 100 real estate agents are networked. From question S, Microsoft is the overwhelming favorite network system (56.6 percent). Novell (18.2 percent) and "other" (23.2 percent) represent almost all other employed alternatives. The average means are different across firm size, but in no discernable way. That is, being a larger firm does not lend insight into the type of network used.

Information concerning the operating system used by each firm was obtained from question T. Windows 95 (71.0 percent) is by far the most popular followed by Windows 3.1 (26.6 percent) and DOS (16.0 percent). Firm size has little to do with the choice of operating system, although the means are significantly different for various firms.

Web pages are quickly becoming a quick and inexpensive way to communicate with customers. For this reason, it is expected that many firms within the real estate brokerage industry might maintain a Web page. Question U showed that only 34.4 percent of all firms surveyed have a Web page. Moreover, it is definitely the larger firms that have gotten into the Internet. Only 14.1 percent of single agent firms maintain a Web page, whereas 100 percent of the respondents from firms with over 100 real estate agents have Web pages. Question V of the survey asked which Internet provider they use. However, because so many firms use providers that were not listed on the questionnaire (and because the respondents did not list their provider in the "other" section), the authors have left this question out of the exhibit because of the extremely low response rate.

The type of printer used by each firm is asked in question W. The most commonly used is a laser printer (53.9 percent); followed by a dot matrix (37.4 percent); color capable laser (29.7 percent); printer with fax (10.6 percent); and a fax only (3.5 percent). Laser printers and lasers with color capability are slightly more commonly used by large firms.

The remaining four questions on the survey were miscellaneous items that were asked to gain additional information about the real estate brokerage industry. Question X asked whether the firm uses their computer to generate mailings. Question Y asked if the firm has a scanner. Whether or not the firm is able to store images was determined in question Z. The last question (AA) asked if the brokerage firm uses databases to identify prospective customers. The results indicate that approximately half of the firms said 'yes' to questions X, Z, and AA, while 72.3 percent said that they have a scanner (Y). Each of these four questions is significantly positively related to firm size.

In summary, the real estate brokerage industry is using the technology that is currently available, although it appears that larger brokerage firms are able/willing to do so sooner. This may be a function of economies of scale. For example, setting up and maintaining a Web page or outfitting the office with the latest in computers and related peripherals can be very expensive and may not be necessary for a single-person operation.

SUMMARY & CONCLUSION

The results clearly indicate that, as a whole, the real estate brokerage industry is making good use of available technology. Moreover, there is a strong firm-size effect present in the real estate brokerage industry.

Large real estate brokerage firms are more into using computers than are smaller brokerage firms, in general. In fact, 100 percent of the responding firms with over 40 real estate agents use computers in some way. Moreover, the use of software by the real estate brokerage industry increases dramatically as firm size increases. Also, larger firms have gotten into the Internet. Only 14.1 percent of single agent firms maintain a Web page, whereas 100 percent of the respondents from firms with over 100 real estate agents have Web pages. Finally, large firms currently offer more of each type of service than do smaller firms and plan to continue this trend in areas such as online computer listing services.REI

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CRE PERSPECTIVE

Business, Faith & Ethics: Making the Connection

An Impression
by Bowen H. "Buzz" McCoy, CRE

INTRODUCTION

In February 2001, The Counselors of Real Estate held a conference in Tucson, AZ, which featured 10 speakers on the subject of Business, Faith and Ethics, Making the Re-Connection. The first day focused on faith-based ethics, the second day on reason-based ethics, and the third day involved active business persons discussing the relevance of the discussion to their lives.

Speakers included Laura Nash, senior research fellow at Harvard Business School; Andre Delbecq, professor and former dean of the Leavey School of Business at Santa Clara University; Oliver Williams, director of the center for ethics and religious values in business at Notre Dame University; Lynn Paine, professor at Harvard Business School; David Brady, professor and associate dean at Stanford Business School; David Davenport, former president of Pepperdine University and current CEO of Christianity.com; Eugene Kohn, principle of Kohn, Pedersen, Fox, architects; Dan Rose, chairman of Rose Associates, a New York-based real estate organization; Patricia Vandenberg, former CEO of Holy Cross Health Systems; and J. McDonald Williams, chairman of Trammell Crow Company, a Dallas-based real estate organization. I organized and moderated the conference.

FAITH-BASED ETHICS

A number of issues were raised the first day. While statistics suggest that we are "a religious nation," what does that mean? How is that evidenced in the business world? Can we be spiritual and not religious? What is the difference? When do we stop trading off our deep personal values? What are we willing to lose for? Can we be religious and survive in business? How can we be ethical in an unethical environment? Should we compartmentalize our lives?

It may be said that one has the potential of living out a life on four different levels. First is the surface level, dealing with the superficialities which we all must cope with in our daily lives; being socialized. Second is the allegorical level. This is the level at which we make meaning out of stories and heroes. Third is the moral level. This is the level of the limits of the law. It is that behavior which society, as a whole, is willing to condone from time to time. It sets limits as defined by those living around us. The fourth level, or the deep, is the level from which we draw our deepest meanings of life. This is the level of the ethical, the spiritual, and the religious. This is where we define what we are willing to lose for. This is the level of the transcendent, or what many call, God.

We live on all four levels simultaneously. The bulk of our time is spent on the surface level. For most, the least amount of time is spent on the deep level. We move in and out of the different levels all the time. If we have the ability and the support to de-compartmentalize our life, and to bring the fourth level into all that we do, including our jobs, we can be said to have a fully integrated life. It can be said we live a life of integrity. Most of us move in and out of such a state.

The extent to which friendships and relationships are based upon a commonality coming from the respective deep levels, the greater sense of support and well-being an individual is likely to have. Writers have informed us, however, that most of us cannot sustain a plenitude of such deep relationships without beginning to trade off confidences and trust.

Many in today's world have experienced disillusionment, broken promises, token relationships, fragile commitments, and provisional settling for whatever gets us through until we find something which is better. In these cases, a kind of hopeless cynicism emerges and tends to create a self-oriented world for the person who has been disappointed. Such attitudes narrow the field of choices, as we are always suspecting that others will most certainly let us down. Such individuals have little room left for community.

The One Great Commandment to "love the Lord your God with all your heart and all your strength and all your mind and all your spirit,"; together with the corollary to "love your neighbor as yourself," is one of the great societal organizing principles of the world. It occurs five times in the New Testament, twice in the Hebrew Bible, and is explicit also in the Koran. It is implicit in virtually every organized religion. It is Greek in nature. One must be in harmony with oneself, with one's communities and with some powerful, transcendent being or force which takes us totally out of our own self-will, pride, and hubris.

The communitarian movement, started by Amitai Etzioni and John Gardner, among others, is based on this same principle. Communitarians are urged to be in harmony with themselves, with their communities, and with some absorbing, transcendent force. Thus the principal is valid in the totally secular world as well. In Peter Drucker's recent book, *Management Beyond the Walls*, he states that the leader of the future must be self-confident, love people, and have an absorbing passion for the enterprise. To me, this is resonant with the One Great Commandment as well. Drucker goes on to state that the leader of the future must have the centeredness and detachment to manage anxiety and rapid change. Having an integrated life, including the deep level, allows one to gain this sense of detachment, to take risk, and to deal with ambiguity and paradox.

Religion can provide one answer to some universal questions: How do we find our center? How do we gain a sense of detachment in the highly competitive cacophony of current business? Where does the passion come from? For a religious person, business can become a calling, a vocation, a battleground to test out one's faith. For many, the work place can provide their sole community. Young employees may work from 10:00 AM until 3:00 AM, seven days a week. If they cannot form meaningful relationships in the business environment, they become rootless and subject to early burnout.

Most of us, including people of faith, are uncomfortable with any form of evangelicalism at work. We feel it is simply not appropriate behavior on the job. Nonetheless, one should be able to live out of one's religious conviction in the workplace. This is what certain theologians have termed "stealth" religion, or "religion-less" religion. We are respected by our actions, not by the symbols we wear or the attempts we make to recruit others to our faith.

The deep sense of the other which comes out of all deep religious convictions helps to take us out of pride and greed. It causes us to deal with failed leadership and to deal with the complexities of power and wealth. We can become whole, complete, and more relaxed when we discover that we can live out our foundational beliefs. We can become good persons without necessarily subscribing to a particular institutional religion, or to any religion. What we are talking about are foundational beliefs, however attained.

Researchers into the human brain have written about isolating areas in the brain which create a universal longing to know our origins and purpose. Where do we come from? Why are we here? We yearn to find completeness, unity, and wholeness with whatever transcendent power created us. If, in fact, all humans are "hard wired" to desire to be in relationship with a creator (God), such knowledge can have a powerful impact on global interactions and relationships. Perhaps humankind can bond ultimately out of the yearning that comes from the deepest level.

Religion also has the potential to separate us into tribes and shut down reason. Institutionalized religion often puts itself beyond criticism and closes down dialogue. There is thus a conflict between faith and reason. Faith informs reason. It gives us our identity. It makes us whole. Perhaps we should separate institutional religion from the teachings of religion. The teachings of religion provide a context for business. Otherwise it is success at any cost.

Rational behavior regards faith and spirituality as an input, but reason must dominate rational decision-making. We need a way out, a model; for example, utilitarianism, to lead us toward the greater good.

REASON-BASED ETHICS

For even the best of the graduate schools of business administration, the teaching of rational decision-making which incorporates an ethical outlook has been problematic. This is so, in part, because of the structure of the Post-Enlightenment university, which specializes in specialization. Ethics crosses over many boundaries and may include inputs from theology and philosophy as well as sociology, political science, economics, and hard-nosed practical business experience. The university system of rewards and punishments does not reward individuals who cross boundaries and attempt to create unity out of all the areas of specialty.

Another hurdle to bringing ethics into the business school curriculum is the present social norm that one does not criticize the behavior of another unless it causes considerable harm to others. "I'm OK, you're OK" is the norm, thus making it difficult to become critical of the behavior of others. As a result, ethics becomes unrooted from the deepest level and becomes more or less a game of complying with whatever "the law" may be from time to time. This can become treacherous, as there are broad normative swings in how society feels about such areas as dress, smoking, gender, and sexuality, or even price-fixing, antitrust, and insider trading. If we game our behavior up to the limits of the law at a particular time, we could be contemplating this action from inside a prison later on.

Some feel that it is fruitless to attempt to teach today's students what to do, as the ground is always shifting. Ethical decisions require moral courage to go against the tide of current behavior. Sometimes breaking with the current norms of society is exactly the "right" thing to do. Many are of the opinion that such deep and intuitive ethical reasoning is beyond the scope of a professional graduate school, and must be taught at a young age in the family and appropriate religious institutions.

To a large degree, the medium may indeed be the message. The fact that institutions such as Harvard, Stanford, Santa Clara, Pepperdine, or Notre Dame have a required ethics module in their professional schools sends an important message. The best one may hope for is to elevate ethics as a respectable input in a business decision. The purpose of a rational decision-making course in ethics may then be primarily to increase the students' ethical awareness and moral imagination. This can be accomplished through stories and case studies of courageous moral leaders in the business world, who, by their actions, represent what the management consultants might term "best practices."

Reason-based ethics states: Given a set of moral principles, what would you do? It is not benign self-interest, ex post facto rationalization of decisions, imposing values, or resisting temptation. Religion is not rational. Rational ethics deals with decision-making and consequences.

A rational model most often utilized in business schools is that of utilitarianism: "the greatest good for the greatest number." This is the philosophy which drives market capitalism, and it is imbedded in the market clearing price mechanism, input/output analysis and the like. We can determine the number of kidney dialysis machines which is optimal for a given gross national product, and determine a methodology for rationing what becomes limited health care on the margin. The pragmatism of such an approach disturbs some, and they attempt to override the system with a theory of social justice to address the imbalances. Pure utilitarians would claim such theories override and destroy the maximum efficiency of a perfect market system. Others come from a rule-based approach to ethics, and feel that certain deep values must override the market system.

An ideal organization might be said to be virtuous, where employees always do their best, are empowered, and gain rewards consistent with their behavior. Values-based enterprises are cheaper to run (no rule makers, interpreters, or enforcers), and generally attract a like-minded and thus more generally attractive set of employees and clients. Practically speaking, however, any values-based organization requires a reward and punishment system as well, in order to deal with human weakness and frailty, keeping everyone on course.

Recent research by Peter Drucker, Ira Mitroff of the Marshall School of Business at U.S.C., and many others indicates that certain basic values are far more important to employees than financial rewards. Such values include integrity, open communication, respect, interesting work, realizing one's full potential as a person, being involved with an ethical organization, and a focus on shared goals. Thus employees themselves tend to override the rational model when asked about what gives them the most satisfaction at work. This is undoubtedly true of the professors attempting to teach rational decision-making as well.

Global business values are in transition, as the Western model for business exports the values of transparency, opportunity, accountability, and good citizenship. Individuals all over the world are re-prioritizing their values in order to participate in the global marketplace. We in the West tend to value achievement over affiliations. We have a sense of urgency about time. Duties to family and tribe are rearranged and become duties to shareholders. The global marketplace becomes an area of conflicting world views. Capitalism is seen as inhumane. How can one have impartial justice for all without destroying personal relationships? Capitalism appears to amplify the impersonal voice, yet it cannot drown out the personal voice of kinship. The question then becomes how to humanize capitalism and resolve competing rights in the utilitarian model.

As we have seen elsewhere in society, ethical standards raise expectations. Our actions have to substantiate these claims, otherwise we create false expectations. Ethics then becomes dynamic, not static. Managing dynamic change requires that courage which Peter Drucker refers to.

THE BUSINESS RESPONSE

In the early days of our national culture, religion was a dominant theme. Most of our great universities were founded as religious institutions, including Harvard, Yale, Princeton, U.S.C. and many others. In this modern age, faith and culture have become separated and compartmentalized. An irony is that as we have become increasingly concerned with our personal spirituality, we have become less ethical in our behavior. We are so caught up in the surface level, emulating popular heroes and lifestyles, that we have separated ourselves from our deep, intuitive level of concern. Socialization skills teach us to learn to lie to ourselves. These lies create an obstacle to action on behalf of our true nature. One of the accomplishments of religion is to help us find a way to shatter those lies, to make those walls permeable.

We need a way to get back to our roots and overlay utilitarianism with faith. Business can be seen as an incubator for social process. Does our professional behavior add to the general moral tone of society or detract from it? Our actions speak far louder than our professed beliefs. Rational decision-making in order to maximize profit is a useful criteria for running an enterprise, but at times leaders must act on intuition and take risk. They must become role models for those coming along behind them.

Both Paul Tillich, the great Protestant theologian, and Carl Jung, the great psychoanalyst, wrote of the courage involved in ethical decision-making. If we ignore the rules which have governed society for 7,000 years (the Ten Commandments), we do so at our peril, but there are times when we are called to do precisely that. We must at times take the seldom traveled path. We must ignore what everyone else is doing, and do what our deepest ethical discernment indicates is the only thing we can do in order to cease lying to ourselves. In the global arena, how do we re-integrate friendship, reciprocity, and community into a capitalistic market system?

There is a deep ethical issue with the poor and undereducated in our country. If we do not choose to re-civilize our cities, they could become a challenge to our national security. One way to live out our faith as business people is to act out of a philanthropic spirit in the sense of giving, not just our money, but our time to tutoring and mentoring those in need.

As real estate practitioners, we must have a greater dedication to our inner cities in order to preserve the built environment. The environment we create, or allow to deteriorate, has a profound affect on the psyche of future generations who have to live there.

A complete life, a life of integrity, involves a balance among family, profession, public life, philanthropy, physical well-being, and the inner spiritual life. The extent to which one is ignored forces the others out of balance. A "life of leisure" is a state of mind which occurs when all efforts are perceived as being voluntary. Business should be seen as building relationships, not doing deals. How do you wish your obituary to read? Philanthropy can be seen as contemplation, or spirituality, in action.

A business person of integrity focuses on vision, values, and valor. There is an immense difference between a business life bound by the limits of the profession and a business life bound by the limits of one's faith. We do not need to continually re-trade deals or denigrate our competitors. When reasoned ethics and faith converge, there is more energy to accomplish the mission. When we are impressed by exemplary business practices, we will often discover that the root cause is a deep commitment to faith or foundational values. When faith is included as an input, there is far less opportunity for burn out. Our values are formed by the third grade. Do I have to subordinate my values in business? I will be far more effective if my values are congruent with my professional life. We are talking of such values as service to others, respect, and justice. Faith can help sustain valor or moral courage. Ethics is not about winning all the time. It is about what one is willing to lose for. Faith provides the staying power through adversity. If you are CEO of an enterprise which is under serious stress of one kind or another, the employees will look into your eyes each day to see if you have the inner courage to go on.

FINAL THOUGHTS

No rational decision-making system is perfect. In a true ethical dilemma, we are thrown back into our own inner resources. We each become Hamlet. Faith helps us to set our priorities and to live with the consequences of our actions. We need to develop shared values to anchor community in the midst of diversity. In teaching ethics we must somehow reach the morally indifferent, morally deaf, disinterested student—before it is too late. Faith versus reason is not binary. We must develop the courage to balance our intuition with our rational nature. The most important tools we have are the wisdom of the ages and a helping hand. REI

ABOUT THE AUTHOR

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FOCUS ON THE ECONOMY

KAIROS – THE CRITICAL MOMENT – COMES TO THE ECONOMY

by Hugh F. Kelly, CRE

For the Winter 1999/2000 edition of *Real Estate Issues*, I titled this column "The End Isn't Near... But Repent Anyway." The theme of that essay was that, as the economic expansion of the '90s entered the history books as the longest period of growth in recorded U.S. annals, there were some soft spots that needed attention. One of the caveats explicitly stated, "With the Japanese model squarely before us, we need to consider the helium-powered stock market and the potential consequences of Wall Street running out of gas in the near future." The piece concluded with a biblical injunction, "Be watchful. You do not know the day or the hour. The best insurance against the ill effects of a recession, after all, is to anticipate that you will one day need to cope with the downturn. The best time to start that planning is now."

So, how did your planning go? We are now at a critical point for the economy, and the events that transpire during April and May of 2001 will likely determine whether or not we are in for the first recession since 1991. The ancient Greeks had a term for such a moment, *kairos*. The line from the bible, alluded to above, comes from the 13th chapter of Mark's Gospel, and in the verse that says, "You do not know when the time will come," the Greek word for translated "time" is not *chronos*, the usual passage of days, but *kairos*, the critical moment.

Recessions are fomented by excesses, and serve to correct them. While we have had a rather tame Consumer Price Index deep into the growth cycle, this does not mean that we have been without inflation. Without a doubt, equity values in the stock market were inflated in late 1999 ("helium-powered"), measured by price-earnings ratios, by dividend yields, and certainly by speculative expectations that anticipated a "Dow 36,000" over the horizon. A simple definition of inflation is "too much money chasing too few goods," and that was as good a description as any of the climax of the bull market on Wall Street just a year ago.

Will we have a recession in 2001? There is no certain answer to that question in early April as I prepare this column, but by the time *Real Estate Issues* arrives in your mailbox we should have a pretty good idea. A great deal depends upon just a few variables, and how they behave at this moment of *kairos*. In *Table 1*, I chart those variables as I see them and suggest that by Memorial Day the die will be cast for the end or the continuation of the economic expansion.

The decision tree begins, as it should, with the Fed. At its March 20th meeting, the Federal Open Market Committee cut the central bank's discount rate by 50 basis points, to 4.5 percent, in the third such reduction in 2001. The financial markets had hoped for a 75 basis point cut, and reacted immediately by displaying their disappointment. I had felt that a full percentage point cut should have been made, under the theory that such a decline will be ultimately

Table 1

Scenarios for the Economy			
If the Fed Discount Rate on 5/31/01 is:	3.5% - 3.75%	4.0% - 4.25%	4.5%
Then: Dow Average	Stable to modest gains	Moderate to strong drop	Dow loses 2,000 points
Business Investment in 2001	Growth of 8% to 10%	Growth of 2% to 6%	Decline in new investment from 2000
Consumer Confidence	Rebounds	Falls Steadily	Plummets Swiftly
Employment Trend for 2001	Up 1.0% to 1.5%	Fluctuates around zero, say, -0.5% to +0.5%	Down 1.2% to 2.0%
Probability	30%	50%	20%

necessary and that there was little to gain in doling out the stimulus little-by-little, but saw zero chance that the Fed would seize the moment for such a historic move.

The FOMC, in its wisdom, looked at the mixed signals emanating from the economy in the early months of the year and decided that a steady but moderate diet of stimulus was justified. The Fed believes, from long experience, in the efficacy of its policy moves and understands that a lag of six to eight months is normal. It is rare that a three-step, 150 basis point intervention in the price of money does not have the desired effect. There is no evidence whatsoever that the central bank is seeking to precipitate a recession, and every reason to think that it will do what it thinks necessary to craft a "soft landing."

But the Fed, while powerful, is not all-powerful. And its economic vision, while acute, is not omniscient. On a policy basis, Greenspan and colleagues apparently felt it sent the wrong signal to "put a floor" under the stock market. The rationale was that protecting equity values against market decline would encourage future risky speculation by implying a Fed "insurance policy" against losses. This would truly produce irrational exuberance and assure a repetition here of the disastrous financial bubble that Japan is still struggling to recover from. But the stock market does not exist in a parallel universe from the fundamental economy. Ultimately the Fed will need to "look through" the stock market effects if indeed it intends to push the economy to a sustainable and non-inflationary level of growth in the near future.

THREE POSSIBLE SCENARIOS

I see three potential ranges for the Fed discount rate by the end of May 2001. The lowest probability is that the Fed will see its job as largely accomplished with its third cut, and will adopt a wait-and-see attitude that leaves the discount rate at 4.5 percent after Memorial Day. This will prompt a full-blown recession. I would expect that the Dow Jones Industrial Average would plunge over 2,000 points into the 7,500 – 7,750 range. Under this loss in value, corporations would reduce their investment in business equipment and software to levels below those seen in the past year, putting downward pressure on GDP. Consumer confidence would inevitably plummet, no matter how much jawboning the Fed might do. Layoffs would accelerate and a year from now the absolute level of employment would be down 1.2 percent to 2.0 percent, meaning that roughly two million people will be losing their jobs.

That's not a pretty picture, but it is a possible one. As I indicated above, there is just no evidence that this is what Fed intentions are directed toward, and so the full recession scenario has to be accorded a low probability. But I would say the chances are about one-in-five, or 20 percent, that this confluence of variables will turn out to be the case.

More optimistically, the Fed will re-evaluate its incrementalist approach and decide that prudence in this case dictates an unambiguous signal of its commitment to growth. It would show this by making two cuts in the discount rate (one prior to its May meeting, and the other at that meeting), dropping the rate into the 3.5 percent - 3.75 percent range. Wall Street would embrace this enthusiastically, but I don't believe that it would push the Dow up this summer beyond its year 2000 trading range of 10,000 to 11,000. It is hard to see investors again becoming true believers in inflated price-earnings multiples, and the dot-com washout will be continuing in any event. But, stable to moderately rising stock values will keep business fixed investment levels growing 8 percent to 10 percent for 2001, a good but not great rate of increase for a measure that has grown at a double-digit pace every year since 1993. Such investment, however, would keep productivity gains in the economy moving forward. The discount rate cut gets translated into lower consumer credit card rates and lower home mortgage rates. Coupled with a stabilizing stock market, this will cause a sharp rebound in consumer confidence and provide the energy to push 2001 GDP growth into the 2.5 percent to 3 percent range. The tide of layoffs will abate, and employment for the year will end in the positive 1.0 percent to 1.5 percent range.

That's a very pretty picture, and also a possible one. Given the Fed's bias to support growth, it should be accorded a higher probability than the recession scenario. But it certainly doesn't look like the most probable course of events. I would peg its likelihood at 30 percent, meaning that the odds are better than two-to-one that we will *not* get such a rosy outcome.

My expectation is that the Fed will steer a middle course, and aim at one more rate cut at its May meeting. From my perspective, it really won't make much difference by then whether the Fed cuts 25 or 50 basis points, although the signs of weakness will almost surely dictate a cut to 4.0 percent. The procrastination on policy and the impatience of the traders will mean that a moderate to strong drop in the market will see the Dow in the 8,200 to 8,700 range by the time the Fed gets around to the May FOMC meeting. Business fixed investment growth for the year will be at best one-half of its year 2000 level, and could get down to 2 percent, which means "no growth" on an inflation-adjusted basis. Consumer confidence will erode steadily, and we will see no appreciable employment growth for the year. Given the ordinary pressure of labor force expansion, the unemployment rate will rise. Though we may avoid the usual definition of a recession – two consecutive quarters of GDP contraction – many parts of the country will in fact be in recession and the rest will feel uncomfortably stagnant. The Fed will need to continue progressive stimulus through the summer, but the bloom will be off the American economy and we will see minimal growth not only in 2001 but for the first half of 2002.

My estimate of probability for this last array of outcomes is 50 percent. Of course, according even the most likely scenario, only a 50/50 chance is an economist's way of saying that I really can't be confident of any prediction. That's why this is a critical time, a *kairos*, because our near-term future truly is in doubt. But that uncertainty should largely be cleared up by the time you are reading this.

The real estate implications are largely simple to discern: risk has shifted from the supply side of the equation to the demand side. Our self-congratulation about development discipline goes into eclipse if we see employment, income, and investment levels dip in 2001 and 2002. The best time for planning has already passed, but if you haven't already figured out how to cope during a not-so-good old-fashioned business cycle, go figure it out now.

One encouraging word, at the conclusion of this essay. My copy of Lidell and Scott's *Greek – English Lexicon* very helpfully tells us how the Romans translated *kairos* into their vernacular. The pragmatic Romans looked at critical times as moments for action rather than navel-gazing, and expressed *kairos* in a Latin word that doesn't take a degree in classics to translate: *opportunitas*. Who said that economics had to be a dismal science? REI

ABOUT OUR FEATURED COLUMNIST

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FOCUS ON THE MARKETS

Is There Discipline in the Market?

by Raymond G. Torto, CRE

Last December there was a front page *Wall Street Journal* article on the looming over capacity in corporate America. The story focused on the fact that "company after company is finding it has more capacity than it needs." Of note: the real estate sector was not mentioned!

After the disastrous consequences of excess building in the 1980s and the severe impacts on prices and survivability in the early 1990s, real estate professionals have constantly wondered: "will we do it again?" There is a lot of history to support an affirmative answer. The question is valid: will we build real estate to excess and destroy value or will we learn from the errors of our past sins—has real estate learned discipline?

While no one believes we will see a repeat of the 1990s anytime soon, there are two arguments as to why discipline for the development cycle is unlikely, in the short run. First, one characteristic of cyclical markets, such as real estate, is that expectations are at best adaptive rather than forward-looking. Given that the future cannot be known until it arrives, there is nothing irrational about this behavior. In real estate, this behavior is obvious in the leasing market, in development, and in appraisal. For example, if the market had perfect foresight, developers would build in anticipation of low vacancy rates, rather than because of them. Similarly, appraisers rely on existing comparables, rather than anticipate future changes. This is not to say that these methods are unwise, as acting on imperfect knowledge of the future is inherently risky. It is just to say that the market is largely reactive rather than forward-looking.

Second, and perhaps most important, the incentives on the financing side of the equation for local development have not been modified enough to transmit the discipline required. (We admit to some changes below.) Although many lending institutions have stopped vocalizing the most commonly asked question "are you achieving your quota?," they have not stopped thinking it. The incentives for lenders are still the same as they were in the '80s. Pricing, and to a lesser extent, underwriting standards are set by competition. Lenders and developers make money only by lending and developing.

Simply stated, in the short run, the real estate markets are still more significantly influenced by what private local developers and landowners are doing. Thus, the monopolistic competition dimension that derives from location remains unchanged. This is seen in what we refer to as the "developer's dance." Because there is only so much demand for space and because only so many buildings can be developed in a single market, developers and their construction lenders often wind up in a "prisoner's dilemma."

The prisoner's dilemma describes an occurrence when law enforcement officers suspect two individuals of wrongdoing and put the two prisoners in separate rooms. Each is offered a deal: Give evidence to convict your associate and go free. If both prisoners stay silent, no evidence is gathered and both will go free. However, if each accepts, they implicate the other. The equilibrium solution occurs when both prisoners turn in evidence on each other and both wind up in jail.

Similarly, developers with parcels to develop are often in situations in which the ideal is to have only one of them build. The developer's dance occurs as each developer uses various tactics to discourage the other—early announcement of the project, pushing for a quicker completion than the competition, pre-leasing, and other methods. In the end, however, both projects are developed, and both developers and their financial sources contribute to a worst case scenario.

With that said, there are, however, several major differences between today's real estate world and the 1980s. There is a heightened focus on the market by an increasingly large number of analysts ready to sound the clarions call. One example of this is the recent FDIC issued report cautioning banks against excessive construction lending. Most believe that regulator "jawboning" will help reduce the development cycle's amplitude. Certainly with the FDIC, OCC, and FED all watching asset markets and prices very closely, including real estate, the potential for jawboning is great.

Another example is the changing structure of the financial system in the United States. There has been considerable consolidation of banking since 1990 and banks are not eager to take on big risks. The question being asked is whether anyone is doing risky construction financing? Bigger projects in particular are finding a need for lots of equity and preleasing before construction lending is available.

Finally, there has been the elevation of risk managers within financial institutions to an increasing importance in those institutions. This alone is raising the awareness of the risk-related issues surrounding all assets—including real estate.

In summary, the real estate sector is at a new beginning stage, a beginning that may bring, in the long term, more efficiency and perhaps less development volatility. However, the evidence on the nature and magnitude of these benefits is still being collected.REI

ABOUT OUR FEATURED COLUMNIST

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FOCUS ON REUSE

ADAPTIVE REUSE: THE MOVIE

by Dale Anne Reiss

This year, movie theater owners are expected to close hundreds more under-performing theaters across the United States. But not all of these properties have to sit dark and empty.

The real estate industry has a long history of breathing new life into seemingly 'dead' assets, most recently—and notably—in the adaptive reuse of surplus bank branches. The wave of mergers and consolidations in the financial services industry beginning in the 1990s and continuing today has resulted in a vibrant market for discarded bank branch assets and very creative adaptive reuse of these facilities. Bank buildings have been repositioned as retail shops, office buildings, Internet cafes, and even medical centers.

Now the real estate industry is faced with another major area of opportunity, one that will result in even more creative reuse of specialized buildings and also, perhaps, in the establishment of an entirely new industry for the 21st century.

The rapid growth of multiplex cinemas in the 1990s created a glut of movie theaters—leaving some theater companies struggling to survive. According to the industry's own trade group, the National Association of Theater Owners, between 1990 and 1999, the number of theater screens nationwide increased 56 per cent from 23,814 to 37,185.

But demand has not kept up with this increasing supply. In 1999, the number of theater admissions totaled 1.5 billion – the same number as in 1948. And the cost of operating theaters has risen even faster than ticket prices. Industry analysts conservatively estimate that as much as 15 percent of the 7,500 existing movie theaters in the U.S. will have to close. Many of these will be smaller, marginal theaters but even the major national theater chains are facing a major economic crisis that will require the closing of many of their theater properties. Recently, Loews Cineplex Entertainment Corp. announced plans to shutter 112 of its theaters—some 676 screens—nationwide. Loews is not unique; many other major chains will have to adopt similar plans.

The fact of these closings delivers two clear opportunities to the real estate industry. Clearly, the chains owning their own screens will have to adopt fairly aggressive disposition programs to move these redundant assets off their books and potentially recoup some value from their investment. As assets sitting on their books, these theaters are already tying up valuable capital. Disposition strategies will have to take into account the other portfolios sure to hit the market around the same time.

Other properties are leased from third-party owners. Several chains have already filed for bankruptcy, and in some cases are attempting to break leases and return the properties to the owners. So the issue of surplus theaters could have broad impact, encompassing not only the chains themselves but also other owners of theater properties. To the right real estate experts, these properties may no longer have value as theaters, but they could have value as other types of facilities. The good news is that since real estate is all about location, and these theaters typically are in prime locations in large population centers, the same theaters that once drew movie-goers could attract a diverse new base of consumers, like students, shoppers, or fitness buffs seeking a whole new range of goods and services. In fact, they can be renovated and repositioned for a variety of community, educational, recreational, commercial, retail, and other uses.

In Raleigh-Durham, North Carolina, a former theater is being converted into a huge fitness center. In other communities, developers are looking at opportunities to convert theaters into big-box retail outlets, storage facilities, supermarkets, and many other uses. Alternatives are impacted by the type of theater and its location. And in some places, community leaders, theater owners, real estate investors, and government agencies have partnered in the renovation and conversion of historic theaters to new uses such as performing arts centers. One of the most promising uses for theaters could be in education, especially in the area of distance learning.

"The trend towards lifelong education is increasing the demand for training facilities outside the traditional classroom, and theaters offer a new venue. Theaters equipped with high-definition video, satellite, and Web technologies could be transformed into learning centers," according to Tom Wade, president of Enterprise Broadcasting Corporation (EBC). In addition to looking at creating a new breed of learning centers, the Scotts Valley, California-based company is currently moving ahead with plans to use high-definition video to sell high-end luxury items and services—by broadcasting to specially equipped theaters in upscale malls throughout the U.S. Many of these theaters are adjacent to, or part of, the community center mix.

"High-definition video has broad applications not only in commerce but in education," Wade notes. As a next-wave messaging platform, broadcast cinema could also be used to educate and train students in a range of subjects from computer basics to advanced surgical techniques. "It has enormous power to increase the retention of viewers—people remember in stark detail what they saw. They feel as if they have actually experienced what they've seen."

Over the years, properties that no longer served their original purpose have found new life in a different venue. The same could be true of theaters. Movie theater chains could partner with real estate developers or owners in evaluating alternative uses for shuttered theaters, developing reuse plans, finding equity capital to finance renovation projects, and structuring transactions such as sales, sale-leasebacks, or joint-ventures that would enable theater owners to cash out or retain an interest in repositioned properties.

Although real estate is a fixed asset, it can be highly adaptable. Theater owners should explore their options and consider the opportunities in finding new uses for their properties. They won't be the first to see an opportunity in the challenge. These owners only have to look at the banking industry to see that adaptive reuse is a vital component of the real estate industry's ongoing development.

ABOUT OUR FEATURED COLUMNIST

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Essays in Honor of James A. Graaskamp: Ten Years After

Research Issues in Real Estate, Volume 6
Edited by James R. DeLisle and Elaine M. Worzala
Wisconsin Real Estate Alumni Association;
University of Wisconsin, Department of Real Estate & Urban Land Economics; &
American Real Estate Society
Kluwer Academic Publishers, Norwell, Mass.
© 2000, 436 pages

As Reviewed by
D. Richard Wincott, CRE

ssays in Honor of James A. Graaskamp: Ten Years After, consists of 19 essays attempting to cover the life, times, and thoughts of Jim Graaskamp, CRE. The book is divided into topical headings as follows: "Graaskamp's Impact on the Real Estate Discipline," "Personal Reflections on Graaskamp, the James A. Graaskamp Award Winners, and the Wisconsin Program," "Real Estate Feasibility and Development," "Real Estate Valuation," and "Graaskamp and Institutional Economics." The authors are a cadre of former students and colleagues lead by James R. DeLisle and Elaine M. Worzala as editors.

While I cannot profess to be an official member of the "Graaskamp Army," since my educational process did not take me via Madison, I can say that I knew Jim and have contributed to his mystic proliferation. Over the years I have had close association with several of his proteges. I started my first personal business venture (April Fools day 1978) with a fellow named Tim Warner, who introduced me to Jim. About 12 months into our new venture, Tim moved back to Wisconsin to become president of Landmark Research. As part of my initial introduction to Graaskamp, I met a young professor at the University of Texas named Terry Grissom. After several years of attempting to attract Terry out of academia, I successfully hired him as the first director of real estate research for Price Waterhouse, LLP in 1992. Grissom's contribution to this book is probably the most noteworthy of the lot. I believe all that read this book or who knew Jim will agree that his contribution to the real estate industry is significant.

The first two sections and several of the articles throughout the book are basically an homage to Graaskamp, and for those who knew him, it provides interesting reading related to the authors' various personal interactions and perceptions of Jim's contributions to the industry and academia. While this part of the collection makes great reading for adamant followers, it may cause those looking for technical guidance to lose interest before they get to the good stuff. Also, it is interesting to note that it appears to be the position of some of the contributing academics that because Graaskamp was not a prolific publisher, his credibility as an academic is somewhat questioned. Out of the first two sections, DeLisle's chapter is the most insightful, and probably should have lead off the book. Graaskamp basically didn't publish because he felt that there was no money in it. He liked entrepreneurs better than bookworms. Jim's overall strategy was to achieve change by training people, and putting a lot of "guerrilla fighters" on the street. I do not think a few of the authors understand this.

Highlights of the books include Sections III and IV, "Real Estate Feasibility Development" and "Real Estate Valuation." The Kinard/Worzala piece on business enterprise value is one of the better, concise articles on the subject, although industry proponents of that position are still fighting an up-hill battle. As noted earlier, Grissom's "Valuation for Portfolio Analysis: Incorporating Risk and Uncertainty Measurement into the Appraisal Process" provides the most meat of any of the chapters.

Section V provides a little background on the lineage of Land Economics, especially through the Weiss article. However, it only delves into the subject enough to peak one's interest in reading more about Richard Ely and his proteges.

Bottom line, I still think the bulk of insight into the teachings of James A. Graaskamp, CRE, still resides in the minds of his guerrilla fighters. If you did *not* know Jim, a brief skim of the book is a worthwhile endeavor. If you *did* know Jim, there may be parts that give you a little chuckle. REI

ABOUT OUR REVIEWER

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CONTRIBUTOR INFORMATION

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1). Manuscripts **must be submitted on disk** (along with hard copy) in **IBM or PC format only--Mac files cannot be accommodated**: .txt (text) file format or Word for Windows 6.0. All submitted materials, including abstract, text and notes, are to be **double-spaced**. Number of manuscript pages is not to exceed 25 single-sided sheets (approx. 7,000 words). **Submit five copies of the manuscript, a 50- to 100-word abstract* and a brief biographical statement. Computer-created charts/tables should be in separate files from article text.** *(* An abstract is a brief synopsis. If the manuscript is accepted for publication, the abstract would appear on the table of contents page.)*

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7). For uniformity and accuracy consistent with our editorial policy, refer to *The Associated Press Stylebook*.

THE BALLARD AWARD MANUSCRIPT SUBMISSION INFORMATION

The *REI Editorial Board* is accepting manuscripts in competition for the 2001 William S. Ballard Award. All articles published in *REI* during the 2001 calendar year will be eligible for consideration, including member and non-member authors. The $500 cash award and plaque is presented annually each spring, during The Counselors' Midyear Meetings to the author(s) whose manuscript best exemplifies the high standards of content maintained in the journal. The recipient is selected by a three-person subcommittee comprised of members of The Counselors of Real Estate.

ABOUT THE COUNSELORS OF REAL ESTATE™

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

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

CREs achieve results, acting in key roles in annual transactions and/or real estate decisions valued at over $41.5 billion. Over 300 of the Fortune 500 companies retain CREs for advice on real estate holdings and investments. CRE clients include public and private property owners, investors, attorneys, accountants, financial institutions, pension funds and advisors, government institutions, health care facilities, and developers.

Enrichment Through Networking, Education & Publications

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

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

What is a Counselor of Real Estate (CRE)?

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

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

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

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

Users of Counseling Services

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

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

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

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Summer 2001
Articles on general real estate-related topics
(deadline for manuscript submission - June 4)

Fall 2001
Focus Edition: Articles on the globalization of real estate
(deadline for manuscript submission - August 20)

Winter 2001/2002
Articles on general real estate-related topics
(deadline for manuscript submission - November 26)

See "Contributor Information" on page 67 for information on submitting a manuscript or call Faye Porter at 615.498.5858

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Real Estate Issues will bring your advertising message to users of counseling services in targeted industry sectors. To maximize your networking opportunities and reach leading real estate professionals, call **615.498.5858** for pricing information.

REI INDEX OF ARTICLES

The *Real Estate Issues "Index of Articles"* provides over 100 alphabetical subject listings for articles published in the journal during its 26-year history, along with a second alphabetical listing of authors. Access the *Index* through The Counselors' home page at **www.cre.org**

SUBSCRIPTION INFORMATION

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

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