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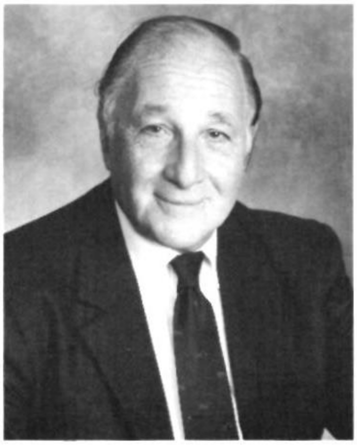
REAL ESTATE ISSUES

COUNSELORS OF REAL ESTATE

Counselors of Real Estate . . .
40 Years of CREative Problem Solving

DANIEL ROSE, CRE, RECEIVES 1992 LANDAUER AWARD



Daniel Rose, CRE

The Counselors of Real Estate have named Daniel Rose, CRE, president of Rose Associates, New York, as the recipient of the 1992 James D. Landauer Award. The award is given annually, when appropriate, to a real estate professional who has furthered the ideals of The Counselors and its CRE (Counselor of Real Estate) designation.

During his real estate career, Rose has developed such properties as the award-winning Pentagon City complex in Arlington, Virginia and One Financial Center office tower in Boston. As an institutional consultant, his credits include the creation and implementation of the "housing for the performing arts" concept for New York's Manhattan Plaza. Rose has served as president or chairman of various groups such as the Horace Mann-Barnard School, the National Jewish Welfare Board and the Harlem Educational Activities Fund; and he has served as officer or director of a wide range of non-profit organizations including the Police Athletic League, the Jacob Javits Convention Center Development Corporation, the New York Council for the Humanities, the Museum of the City of New York, the Institute for Urban Design, the Foreign Policy Association and the Institute for East-West Studies.

Mr. Rose, who is a director of the Dreyfus Money Market Fund, Inc. and a trustee of Corporate Property Investors, teaches, lectures and writes on a variety of real estate and planning subjects. He has also served as "Expert Advisor" to the U.S. Secretary, Department of Housing and Urban Development and as "Expert/Consultant" to the U.S. Commissioner of Education, Department of Health, Education and Welfare.

The Landauer award is named for the late James D. Landauer, CRE, who played a key role in the establishment of The Counselors and the preeminence of the real estate counseling profession. Other recipients have included CREs Roland Rodrock Randall (1986), James E. Gibbons (1987), Roy P. Drachman (1988), John Robert White (1989), Boyd T. Barnard (1990) and George M. Lovejoy (1991).

EUGENE G. BOWES, CRE, NAMED RECIPIENT OF 1993 LUM AWARD

Eugene G. Bowes, CRE

Eugene G. Bowes, CRE, president of Bowes and Company, Denver, has been named the 1993 recipient of the Louise L. and Y.T. Lum Award. This honor recognizes Bowes' distinguished contribution to the advancement of knowledge and education in the real estate counseling profession.

The award was established by the late Y.T. Lum, CRE, to encourage the continuing professional education of those engaged in real estate counseling through an understanding of its principles, theories, techniques and practices. Bowes' distinguished career exemplifies the standards set forth by this award.

A member of The Counselors since 1964, Bowes served as president in 1976 and continues to serve on numerous committees. As a CRE (Counselor of Real Estate—member of the Counselors of Real Estate), Bowes specializes in counseling, custom brokerage and appraisals regarding retail, commercial, industrial and other investment real estate.

Bowes entered the real estate business in 1937. Shortly after World War II, he founded Bowes and Company—Real Estate Appraisers and Counselors and Brokers. In addition to his association with The Counselors, Bowes was a director of the Denver and Colorado Boards of Realtors and the National Association of Realtors.

Bowes was founding chairman of the Denver Partnership (Downtown Denver, Inc., and Denver Civic Ventures), a founder of Spalding Rehabilitation Center, and a member of the Board of Directors of Cherry Hills School District. He has been a member, director, and officer of The Denver Club, the Denver Country Club, and The Rotary Club of Denver.

Previous recipients of the Louise L. and Y.T. Lum Award include CREs John McMahan (1992) Wayne D. Hagood (1991), Charles W. Bradshaw, Jr. (1990), Jared Shlaes (1989), John R. White (1988) and Thurston H. Ross (1987).

THE PRESIDENT SPEAKS

THE COUNSELORS AT 40: A TIME OF CHANGE

An anniversary is a time to reflect on where we have been and where we are going. The American Society of Real Estate (the Counselors of Real Estate) was founded in 1953 as the Society of Real Estate Counselors by a group of outstanding Realtors who met in Miami to address the needs of a changing industry. When we meet in Miami this November, we will return to a very different challenge.

Many of the decisions of the founders are still a living part of our culture, in particular our invitation process and the standard of excellence by which prospective members are measured. The requirements for membership have changed over the years, recognizing the emergence of new forces in the real estate world. A Counselor in 1953 was the head of his firm, had many years of experience and probably never had seen a computer. Today, our members represent all facets of the industry, from the single practitioner to the institutional department chief. Also, our membership now is international.

Our world is changing. Real estate still is a localized business, but the players are frequently global. The emergence of the pension funds as major investors has created new funding, even as the savings and loan and banking crisis removed many traditional lenders from the market. The depression which plagued the oil producing states and now is affecting even "Golden California," has created a new level of caution among owners and investors.

Regulation has become a fact in the 1990s. As Counselors, we are not as directly affected as the appraisers or bankers, but the losses in portfolio value, the increasing amount of litigation and the consciousness of potential regulation have made most clients aware of the need for careful evaluation of all their decisions. The integrity and experience of the Counselor is more in demand today than was the expertise of the founders in 1953.

What of the future? A new administration has just taken office in Washington, D.C., with high hopes of correcting many of the ills of our society. There will be many changes as the programs to rebuild the infrastructure, address the health care crisis and balance the budget are configured in the Congress and the White House. The Counselor, with a broad-based, multi-disciplinary approach, is the ideal real estate expert to assist in the great changes which will take place between now and the turn of the century.

The Richard Day Research Study clearly revealed that Counselors are usually retained because of their personal reputation rather than because of their CRE Designation. The vision of the founders still is true. As Counselors, all of us have the task to create awareness of the designation and the need for counseling services, with continued emphasis on the integrity which has been the hallmark of the Counselor for 40 years.

Jean C. Felts

Jean C. Felts, CRE
President
Counselors of Real Estate

REAL ESTATE ISSUES

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Reprint Information

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CORRECTION
In Table 2 of "Rates of Return in Hotel Investment" (Real Estate Issues, Fall/Winter 1992, p. 48), the number listed under the heading *Total Property Yield for the First Class Hotel in Buckhead, Georgia,* should be 13.8%, not 3.8% as listed.

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PRESIDENT CLINTON: NEITHER FRIEND NOR FOE OF THE REAL ESTATE INDUSTRY

During the election campaign last Fall, I, along with the rest of the U.S. electorate, eagerly awaited the announcement of some bold economic plan to carry us into the 21st century. As it turned out, I didn't think much of Clintonomics. But to be perfectly fair, I thought less of Bushonomics, whatever his plan was supposed to be. The Bush message never was very clearly articulated.

I didn't like Bill Clinton, but not because I disagreed with his modest economic program. My reason was much simpler. I have a good memory, and I remembered what happened the last time the American people elected an inexperienced, well-intentioned Southern Democrat to the White House. I now have the advantage of approximately 90 days of insight to assess our new president and his economic proposals. And whether you like it or not, support his proposals or not, the early signs are encouraging.

Presidents are notoriously self-absorbed in their ability to provoke change through the wisdom of their leadership and morality of political philosophy. Of course, the rest of us realize full well that this attitude is just so much "bunk" and that presidents don't have any real power anyway. They can't pass laws, cut spending, invoke taxes or control the Fed. In fact, other than make a lot of noise and puff around a bit, there is little a president can do. So before we give too much credit to Bill Clinton, George Bush or any other recent White House resident, lets be sure to keep these presidential limits in mind. Only Congress and the Fed have any real power, and in recent years Congress doesn't seem predisposed to use it very wisely. However, we can thank our lucky stars for the masterful leadership of Paul Volcker and Alan Greenspan at the Fed.

Economic growth in the fourth quarter of 1992 was up a strong 4.8%, the highest rate of annualized growth since 1987. Despite the rapid economic growth, prices barely edged up at an annualized rate of 2.9%. Bill Clinton deserves as much credit for this as he does for the last full solar eclipse - none. But my attitude is, so what? If it makes people feel good, maybe they spend a few more dollars because Bills in, George is out, the news is good so what the heck! Hey, if it works, who are we to criticize. Whether Clinton is responsible for the good news or not, people seem to be feeling better since the election and eventually that pays off. Consumer confidence is an important component of a growing economy. I am all for anything that makes consumers feel good.

Since the late 1970s when former president Jimmy Carter appointed Paul Volcker to become the chairman of the Federal Reserve Board, it was Volcker who would eventually stem the tide of the 1970's inflation spiral. Every president since Herbert Hoover has tried to grab the credit for doing this, but we're not fooled, it was Volcker. Simple truth is federal reserve boards control money supply, not presidents. International credit markets watch our fiscal policies and Central Bank policies to influence the flow of capital and credit and the interest rates they command. Since taking office earlier this year, long-term interest rates have fallen nearly 100 basis points during the Clinton regime. Everything from long-term U.S. Treasury bond yields to mortgage rates have fallen to 20 or even 30-year lows. Home buyers and other borrowers are bound to be encouraged to spend and borrow more by these historically low rates. Another good sign for the economy, another incredible example of Clinton's masterful economic helmsmanship?

Let there be no mistake, however, as historically low interest rates are added to growing consumer confidence with even modest national job growth, things really do start to improve. Deserving or not, Bill Clinton will get the credit, and we will be happy to give it to him and wish him continued success.

Finally, let us all take a moment and thank our president for something he hasn't done. He hasn't proposed any changes within the real estate industry which might send us down for the final count. He hasn't proposed limited home mortgage interest deductions, significantly limited depreciation standards for commercial or residential real estate, forgotten his passive-loss relief plan, nor proposed terminating mortgage revenue bonds or low income housing credits.

All in all, Bill Clinton hasn't done much for real estate other than leave it alone. And for that, we should be grateful. For that matter, maybe if he would do the same for the rest of the U.S. economy, we would all be better off, and he can have all the credit.

Editor in chief

TENANT REPRESENTATION BY ADVISORS AND BROKERS

Tenants seeking advice and counsel to represent their interests is on the upswing due to changing market conditions.

by Peter E. Pattison, CRE

Mr. Pattison presents here Chapter 19 of the just released book "The Office Building From Concept to Investment Reality." Published as a joint venture of the Counselors of Real Estate, the Appraisal Institute and the Society of Industrial and Office Realtors Educational Fund, this book presents 43 authors addressing everything from landlord/tenant negotiations, discussed in this article, to the issues of overbuilt markets, financing difficulties and more. For additional information on this comprehensive book, contact the Counselors of Real Estate, 430 North Michigan Avenue, Chicago, IL 60611, 312.329.8431, Fax: 312.329.8881.

Introduction

This chapter looks at the office building from the perspective of the tenant and his advisors—a viewpoint significantly different from that of the group of real estate professionals who are called upon to maximize the value of the property.

Owners and developers buy or build office buildings and in doing so they take two sizable risks: (1) the control and management of the development process and related costs to completion; and (2) the marketing or leasing risk. Owners take these risks with the expectation of achieving the highest rental rate and best terms possible—the maximum profit.

Office buildings are produced for tenants who need business housing. Next to personnel costs, occupancy costs are the biggest expense most businesses incur. Accordingly, users want to pay the least amount possible and extract the most favorable terms.

Owners are usually highly experienced, having produced office space year in and year out. The tenant, on the other hand, is usually inexperienced since a relocation typically occurs only once in a senior executive's career. This is a compelling reason for most prospective tenants to seek the best possible counsel to help them work through the many pitfalls of leasing or purchasing space.

Tenant Advisors

Because of the complex issues facing prospective tenants, typical large transactions require a comprehensive group of tenant advisors to help the tenant through the myriad of questions, contrary facts, market assessments and programming issues with which he is suddenly confronted. These advisors can be divided into three broad groups:

1. A real estate advisor who may be an open agency broker or a tenant representative. A real estate advisor deals with the lease negotiations and the real estate market.
2. Interior architects, space planners, programmers, engineers and other consultants whose task is to deal with how the tenant functions in the premises and the resulting physical layout.
3. Real estate attorneys.

Real Estate Advisors

The primary advisor for most tenants in their consideration of leasing or purchasing office space is the real estate advisor. In smaller transactions, a real estate advisor is often the only outside help required

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by many firms who rely on building owners for architectural and engineering services and use in-house counsel. For larger transactions a more extensive team is normally required. The remainder of this chapter focuses on larger tenants who need more comprehensive services.

Over the past 45 years the vast majority of tenants have used open agency brokers ("brokers") as real estate advisors. Brokers act as middlemen to bring together a willing buyer and a willing seller. They give advice and counsel to the tenant, but in almost all real estate markets in the United States they are paid by the owner of the office building. A broker gets his authority to offer properties from the owners of properties under consideration. This authority entitles him to offer all properties to the prospective tenant whom he in fact represents. The broker's payment is contingent upon successful completion of a transaction, at which time the broker is paid a commission as the procuring cause. The definition of "procuring cause" is enormously complicated and varies from jurisdiction to jurisdiction, but in general, the broker must produce a tenant and propose terms which may be modified but usually are acceptable to both parties.

At one time, brokerage commission rates were set by local real estate boards, but the U.S. Attorney General stopped this practice in the 1970s. Commission rates now are proposed by brokers and are subject to negotiation. The Attorney General had assumed that an open market would drive rates down, but his ruling has had the opposite effect in markets where brokers determine the success or failure of buildings. Open market brokers set rates where they want and usually prevail because they have become powerful market forces. Their ranks include such legendary figures as Charles F. Noyes, Leon J. Peters, Robert Byrne, Joseph Bernstein, John Dowling and John Cushman.

The Broker's Conflict On Representation

Historically, it has always been paradoxical that tenants' interests were represented by brokers who were paid by the parties they negotiated against. This issue was seldom confronted head on in periods when market pricing and terms did not vary dramatically from building to building. With the rapid escalation and following de-escalation in rental rates and the diversity of lease terms over the past 15 years, however, more and more tenants have engaged brokers or consultants as their advisor to obtain the best representation and to avoid any conflict of interest. Even more serious is the situation where the tenant is not fully informed about how the broker gets paid or the total amount of the proposed commission. It is essential that all parties to a lease transaction identify their allegiances at the outset.

The alternative to the open agency broker is the real estate consultant or tenant representative ("real estate advisor"). Real estate advisors are paid by the prospective tenant—a practice common in other international jurisdictions. This practice was pioneered in the United States 35 years ago by James D. Landauer, and until the mid-1980s the Landauer firm was the principal tenant advisory group in the country. Other major advisors who followed Landauer were Henry Hart Rice, Peter Pattison (the author), and in recent years, brokers turned tenant representatives such as Julien Studley and John Cushman.

Real estate advisors are compensated in various ways, but usually they are paid an agreed-upon monthly retainer for a stipulated period with a bonus payment upon completion of a successful transaction. Because the bulk of the fee is usually certain and a smaller portion is contingent, compensation tends to be significantly less than a brokerage commission, usually 25%-50% of the customary brokerage fee on large transactions. In the case of smaller transactions the fee is comparable to a commission because most real estate advisors calculate the time and effort involved and price their services accordingly. It often takes as much time to do a 20,000 square foot transaction as it does to do a 100,000 square foot transaction.

While historically brokers have performed the bulk of transactions, since 1980 the number completed by real estate advisors has increased steadily. Today most major transactions are handled by real estate advisors. In addition, investment brokerage firms have started to offer real estate advisory services on a fee basis, and major real estate brokerage firms now offer tenant representation services as an alternative to commission work. It seems likely that the future will see more and more transactions undertaken by real estate advisors, with an increasing number of brokerage firms performing an advisory role.

Qualifications And Experience For Real Estate Advisors

A good real estate advisor must be experienced in the real estate marketplace. This experience begins in many ways—as a canvasser, at a listings desk, in building management, in appraisal. Whatever the genesis, most real estate advisors go through an apprenticeship that centers on exposure to market conditions and negotiating smaller transactions. Getting to know the market is fundamental to giving good advice. Some markets can be learned in a relatively short period of time (6 months to one year), while other markets (major cities such as New York) require many years of experience. Historically, most good real estate advisors begin their careers by cold calling and knocking on doors, talking to potential users, learning about their needs and trying to match them with existing inventory. With persistence, the advisor completes a small transaction, then another. Suddenly the neophyte has a few successes behind him and he is ready for the new challenge of larger space users or more complicated transactions. The path is arduous—20 turndowns for each sympathetic listener or prospective client. However, most successful real estate advisors would not trade this experience for an easier path. Like military basic training, this experience is hard to get through but can never be replaced.

While there is no better way to become known in the marketplace than by cold calling and knocking on doors, other forms of self promotion can prove valuable. Joining business associations, doing charitable work, attending social gatherings, joining college and school associations all provide a basis for talking about one's work, listening to the problems of others, and perhaps discovering an opportunity to provide real estate advisory services. In the past, making one's experience known was sometimes enough to get a major assignment. However, in most markets today numerous brokers and real estate advisors are competing fiercely for the same assignments and most prospective tenants find themselves overwhelmed by would-be real estate representatives offering similar services.

Getting The Assignment

Thirty-five years ago it was common to acquire assignments at the country club, and being in the right place at the right time was sometimes all that was needed to secure a major assignment. In those days, the difference between a favorable deal or a bad deal was 25¢ to $1.00 per square foot with a long-term fixed rental rate. Today rents are seldom fixed over a long term, and usually escalate either on a stepped basis or subject to some form of index. Sometimes the difference between an average and a well-negotiated transaction will determine whether a firm can make a profit or remain in business. Numerous firms in recent years have folded because of badly conceived and negotiated office space leases. Proper real estate representation has gotten to be very serious business indeed. No longer are office leases assigned to office managers, to be signed and blessed by senior executives only upon completion. Top management now routinely is involved in major office lease decisions and is instrumental not only in deciding by whom and how they will be represented, but also in the process of negotiating terms.

To obtain an assignment, brokers and real estate advisors must contact the prospective tenants. In large brokerage firms, numerous canvassers and brokers continuously call every logical tenant. Smaller brokerage firms do some canvassing but rely more heavily on networking. Whatever means is used, the real estate advisor can only obtain an assignment when he knows which tenants are in the market. The real estate advisor must tell his story, differentiate himself from the many others seeking the business and explain why he or his firm will achieve the best possible results for the client. If he is persuasive, he has an excellent opportunity to make the short list—usually two to four firms—asked to submit a detailed proposal or make a formal presentation to a real estate committee or senior management. Formal presentations and proposals are a fairly recent phenomenon in the real estate advisory business, and are a further indication that major lease and occupancy commitments are taken seriously at the highest levels of management.

Often the selection of a real estate advisor is based not only on his qualifications, but also on the chemistry between the advisor and the client. Clients hire people with whom they feel comfortable. After the presentation has been made, no feeling is more exhilarating than being asked to return to discuss contract terms. Real estate advisory contracts tend to be short and to the point. They should specify the amount of compensation and terms of payment, termination and a clear description of the tasks required and the tasks not covered in the agreed-upon fee.

Interior Architects, Planners, Engineers And Other Consultants

When a tenant relocates to new premises, he must evaluate his space needs for the present and the future. A relocation is an opportunity for the tenant to evaluate how his business is organized, to analyze work flow, spatial and circulation requirements, adjacencies, communication relationships and proposed project standards, i.e., the size and function of offices and work stations. This work is almost always carried out by an architectural or space design firm, because a relocation to new premises requires constructing a building within a building to the exact specifications of the incoming tenant.

Most space planners work directly with the tenant, although their efforts are closely coordinated with the real estate advisor and the real estate attorney. While the architect is the main advisor in this phase of the work, he is often assisted by mechanical, electrical and structural engineers; construction managers; special consultants for such things as acoustics, lighting and telecommunications; as well as relocation advisors who coordinate the actual physical move. The space planner works closely with the real estate advisor in analyzing the cost of building the tenant's premises and allocating these costs to the owner/developer for a cash payment or customized work letter. This project cost analysis is extremely important, as the capital cost of a relocation can be very expensive.

Real Estate Attorneys

The real estate attorney is usually retained early in the process to give the prospective tenant insight into the legal problems that might emerge and to respond to the lease documents initiated by the owner's attorney. The lease documents should reflect all the terms, issues and agreements of the lease negotiation, and any legal issues that should be settled prior to the final agreement of terms, such as liability, subleasing rights and guarantees. Other clauses such as bankruptcy, condemnation, fire damage and user rights are usually left for negotiation after the first draft of the lease has been submitted.

The Tenant Representation Process

The following section sets forth the process of tenant representation, describing how the various advisors carry out their roles and how these roles are coordinated to achieve the best possible results. For purposes of illustration, the process described is comprehensive. Not all transactions have so many steps or go into as much detail. It is the role of the real estate advisor to determine the level of service necessary in a specific situation.

Formation Of The Real Estate Advisory Team
The real estate advisory team usually consists of: (1) a senior executive or principal who oversees the assignment and typically engages in the real estate negotiations; (2) a project executive whose principle job is to ensure that all of the required tasks are undertaken, set up meetings and schedule events, and manage the day-to-day tracking of the project; (3) a financial executive who prepares estimates, budgets and long-term projections; and (4) if necessary, a junior associate who carries out market research, conducts tours and performs the small but necessary tasks associated with a major transaction. Outside the real estate advisor's firm, other team members who need to be put in place normally include a programmer/space designer, real estate counsel, engineers, a construction consultant and perhaps a telecommunications consultant.

Programmatic And Structural Issues
The real estate advisor prepares a short list of firms specializing in space programming and design for the client's consideration and review, and screens the firms on the client's behalf. He assists the client in interviewing the candidates and making the final selection.

The advisor prepares, with input from the client, a detailed statement of tasks for the planner. He also prepares a schedule and a set of contractual terms and conditions for the planner's employment. The real estate advisor typically negotiates the contract terms and conditions with the selected planner, and reviews the tasks and timing of the project with him, to make the best use of his involvement and the information he has been hired to develop.

The real estate advisor also meets with the client to gain a full understanding of its strategic and economic objectives. He advises the client on the costs and benefits of the various transaction structures that may realistically be obtained, including a straight lease, a lease with equity, a joint venture, an outright purchase, a lease with cash flow participation, a condominium interest and other alternatives. He then integrates the objectives and expectations expressed by the client into the transaction structures he believes to be achievable, and assists in deciding on the preferred type of transaction to be pursued.

Market Review And Solicitation Process
Upon being retained by the client, the real estate advisor begins to prepare a complete inventory of space available in the market that he believes would meet the client's needs. This compilation includes all existing buildings with the necessary space, sites upon which a building may be developed, and projects that are already under development. For each alternative, he prepares a profile that includes an assessment of the appropriateness of the facility, a review of the owner/developer of the project, a summary of the terms and conditions being quoted and an assessment of what terms and conditions he believes may be obtained through negotiation.

The real estate advisor reviews each alternative with the client and planner to determine its appropriateness in terms of layout; floor size; clear spans; mechanical, electrical and structural characteristics; ratios of usable, rentable and gross areas; amount of usable and rentable space per person; and other characteristics. He then eliminates those alternatives that are clearly inadequate or deficient in key respects, and develops a short list of options that can be implemented successfully.

Armed with his detailed statement of space needs and criteria and the short list of buildings, sites and projects that may meet the client's requirements, the real estate advisor prepares a detailed memorandum setting forth the economic and strategic terms and conditions he believes will provide a successful solution for the client. This document serves as the basis for a proposed strategy and for the negotiations that are subsequently undertaken.

Financial Projections
The client is provided with detailed financial projections based on the terms stated in the memorandum. The real estate advisor meets with the client and typically makes a formal presentation of the terms and projections he has detailed. After a thorough review and client input, the real estate advisor makes any changes necessary.

For each short-listed alternative, he provides the client with a further refined set of financial projections based on (1) the "asking" terms and conditions set forth by the owner, and (2) the terms and conditions he believes can be achieved. After the client has approved this, the advisor prepares a detailed Request for Proposal (RFP) for the buildings, sites and projects on the short list, setting forth the proposal format, time frame and type of transaction he would like to pursue.

Selection And Negotiation
When proposals have been received from the short-listed parties, the real estate advisor prepares an analysis of the economic and strategic features of each proposal for review with the client. He furnishes the client with long-term (i.e., 20 year) projections of the occupancy costs they may expect to experience under each proposal, including rental expense, escalations for increases in operating expenses and real estate taxes, the cost of amortizing any tenant work not funded by the other party, and the cost of expansions which may reasonably be expected over time. These projections take into account the benefits that may accrue to the client by virtue of any equity, cash flow or other type of participation that may be proposed as a part of each transaction.

Based on this analysis, the real estate advisor then recommends that one or several of the proposals be pursued as a "preferred" option, with one or more backup alternatives. He meets with top management to present his recommendations and typically is asked to assist in developing an internal consensus and resolve to enter negotiations to implement the selected alternative.

Now the real estate advisor begins the process of negotiation with the selected owner, keeping the client apprised of his progress to ensure that all terms and conditions remain consistent with the client's objectives. As negotiations progress, he furnishes the client with updated financial projections reflecting terms currently under negotiation, together with revised statements of the current status of the transaction terms. He coordinates the negotiations and preparation of budgets with the project team, to ensure that the terms relating to tenant work and other features are handled correctly. He works with the planner to review costs to ensure that these either are dealt with in the transaction or are understood by the client to be part of their expenditures.

As the terms under negotiation begin to converge upon those he believes are acceptable, he begins to prepare a memorandum of understanding among the parties setting forth the precise terms and conditions that will subsequently be committed to documentation. This memorandum is carefully reviewed by the client and serves as the focus of negotiations by the parties as the transaction nears resolution.

When an agreement has been reached, the real estate advisor arranges for the detailed memorandum of terms and conditions to be signed by all parties or transcribed into a letter of intent if required by counsel. As documentation proceeds, he works with the client and its counsel to resolve any issues that arise and ensure that the documents accurately reflect the bargain struck during negotiation.

Implementation

With the signing of the lease documents, responsibility for the project implementation shifts to the owner and the other advisors. The real estate advisor continues to be available to the client to ensure that the other parties live up to the terms and schedules that were negotiated. Often he is asked by his clients to attend project meetings, review budgets, change orders, and other project memoranda, and counsel them throughout the implementation process. Typically, his involvement continues through the move into the completed space and a review of the initial cycle of rental escalation billings.

Principal Issues For Negotiation

Terms and conditions vary from transaction to transaction, but the main elements in contention between the landlord and the tenant are:

1. Rent
2. Area to be leased
3. Lease term
4. Provision for increases in operating expenses and real estate taxes (escalation clauses)
5. Amount of cash or construction items that the landlord will provide to the tenant
6. Strategic rights to increase or decrease space, to cancel or extend the lease term, and to sublet
7. Other inducements which may be offered by, or extracted from, the landlord
8. Liability issues

Rent

The annual rental rate is typically quoted in dollars per square foot multiplied by the rentable area of the premises. This rate is usually expressed in dollars per annum, but in some cities it is quoted as dollars per month. Rates historically have been quoted in gross dollars, that is, the rate includes base operating expenses and an agreed-upon real estate tax base. However, in larger leases rates are often quoted in net dollars, with each tenant paying his proportionate share of operating costs and taxes.

From the end of World War II to the mid 1970s, most rental rates were fixed over a long term of 15 to 20 years. This worked well in a period of low inflation, but the high inflation rates of the late 1960s and the 1970s led most owners and landlords to fix rates for shorter periods and to increase them at programmed intervals, e.g., in years 5, 10 and 15 of a long-term lease. Today, landlords attempt to provide for an increase in rental rates in year 10 or 15 of the lease to the greater of current rents as escalated or fair market value. However, tenants often resist this, preferring to have known rates and to take advantage of favorable market conditions. Rates are the primary point of negotiation because most tenants use rates as a measure to compare their lease transaction to those of friends and competitors. Consequently, many landlords, while trying to achieve higher total dollar rents, artificially "push" rates down by adjusting the rentable area of the premises.

Rentable Area

The aggregate total rent is calculated by multiplying the dollar rate by the rentable area. Measurement techniques have therefore become extremely important as owners and landlords have "grown" buildings dramatically over the last 15 years.

Perhaps the only space measurement in an office building universally agreed upon is the gross floor area, which is obtained by measuring from the outer dimensions of the building with no deductions. Before World War II office building rentable area was defined as the area inside a tenant's demised premises, but after World War II, with the evolution of the modern office building, rentable areas were calculated by measuring the gross area, deducting vertical penetrations and then adding back a proportionate share of common facilities such as air conditioning and electrical rooms. This technique is still recommended by the Building Owners and Managers Association International (BOMA), but many cities prefer instead to use "add on" factors. This number is obtained by calculating gross floor area, deducting elevators and stairways to get the usable area of the floor and then multiplying that number by a common area factor of 1.15 to 1.25. For example, a gross floor area is 200 x 200 or 40,000 square feet. From this is deducted elevators, stairs, risers and ducts having a total of 3,000 square feet, so the usable area is 37,000 square feet. This number is then multiplied by a factor of 1.25 to obtain a rentable area of 46,250 square feet. Measuring techniques and the definition of rentable area have become a major point of contention in many lease negotiations.

Area To Be Leased

The size, shape and location in the building of a tenant's premises all are subject to landlord/tenant negotiation. In most high-rise buildings landlords command a premium rental rate for upper floors. The tenant's principal concern is to lease space that works well for his operation and proposed tenant installation. Tenants also want the best views, adjacent to elevators and contiguous floors. On the other hand, the landlord's concern is to be certain that any space in the building not leased by the tenant is still marketable at projected rental rates.

Lease Term

Most leases vary in duration from 5 years on a short-term lease to 25 years on a long-term lease. The ideal lease for a landlord is long term with periodic increases at fixed rates or adjustments to market. American tenants have resisted these one-way adjustments, favoring leases with fixed rates and the right to cancel at year 10 or 15 for an agreed-upon penalty payment. Smaller leases usually run for shorter terms and have no cancellation rights. The length of the lease has a strong influence on the amount of capital dollars contributed by the landlord; shorter leases have a smaller contribution because of the abbreviated amortization period.

Escalation Clauses

Virtually all leases contain provisions for increases in operating expenses and real estate taxes known as escalation clauses. In addition, landlords in favorable markets often want to include a Consumer Price Index (CPI) or other index, or a portion of the index, to further adjust rates upward so that the capital portion of rent is not diluted. Capital indexing has never been fully accepted by most American tenants and CPI clauses tend to appear and disappear in leases depending on market conditions. Real estate advisors are often able to eliminate CPI clauses, but never escalation clauses. It is the real estate advisor's task to see that these clauses are fairly and properly drawn.

Operating expense escalation clauses are calculated in one of two ways: (1) actual operating expense increases, or (2) increases in accordance with an index, usually the Porters' Wage. A properly drawn actual operating expense clause requires careful definition of expenses that can be included and expenses that are excluded such as leasing costs, capital improvements and executive salaries.

Porters' Wage clauses originated in New York and were common 10 to 15 years ago, but they have become increasingly controversial and are not generally used throughout the country. When the clause was first conceived in the early 1950s, porters' average hourly wage was basically the same as the cost to operate the building expressed in dollars per square foot. A penny for penny increase was fair and generally was accepted by tenants. With the passage of time, however, landlords used this clause as a hidden profit center by increasing the 1¢ for 1¢ to 1¢ for 1.5¢ or 1¢ for 2¢. In addition, in New York City the Porters' Wage (including fringes) is more than double the average operating cost of a building, resulting in distorted increases favoring landlords. In addition, some landlords have made extremely aggressive assumptions regarding the calculation of fringe benefits included in the Porters' Wage index. Therefore, an appropriate lease clause should specify the method used to calculate these benefits. Most well-represented tenants insist on an actual operating expense clause or an index that is equitable.

The tenant must be concerned about two important issues in real estate tax clauses: (1) to be certain that the base year is a full assessment, and (2) to avoid dramatic increases in taxes if the building is sold during the term of the lease. Many municipalities give partial assessments during a building's lease-up period. The first year of a lease term, therefore, is not necessarily an appropriate tax year on which to base increases. The resolution of this problem is complex and often very technical, but well-negotiated leases place the burden of a stable base year on the landlord and not the tenant. In addition, tenants have to protect themselves if major improvements are performed during the lease term, or sale of the building or another capital event precipitates a large increase in taxes. This has become one of the most contentious areas in lease negotiations.

Construction

Landlords typically finish the base building including the core area on tenant floors with electrical and mechanical systems ready for distribution in the tenant area. The balance of the floor is left unfinished so it can be customized for each tenant in accordance with the tenant's plans. Most leases provide for the landlord to do a certain amount of tenant work (workletter) or to make a cash contribution toward work undertaken by the tenant. In new projects, the amount of the contribution usually covers the bulk of the work. Workletters provide for partitioning, doors, floors, ceilings, lighting fixtures, HVAC and electrical distribution, telephone and electrical outlets, and miscellaneous other items such as structural reinforcing and stairwells.

The value of the workletter or the cash allowance fluctuates dramatically—from $15 to $100 per square foot depending on market conditions and such variables as the condition of the space, the rental rate, the length of the lease term and the strength of each party's negotiating position. Negotiation for workletters is therefore a complex undertaking and requires the real estate advisor and the space planner to be fully familiar with costs, different operating systems and the pros and cons of different building standard materials and systems. It is also invaluable to the tenant for his advisors to have expertise in the construction process so they can set up controls for cost, quality and schedule.

If the landlord undertakes the buildout work in accordance with a workletter, he is responsible for completing the work on a timely basis. The lease term commences upon completion of the work. If the tenant accepts a cash allowance instead, it is necessary to negotiate how long he has to complete the work before rent commences. This is almost always a contentious part of the negotiations, as the landlord wants the construction period to be as short as possible while the tenant wants it to be as long as necessary to complete the work. Nothing is more unpopular to a tenant than paying rent before beneficial occupancy. Other issues surrounding tenant work are the approval of plans and alterations, the tenant's right to select his own contractor, and use of building systems such as construction lifts, rubbish removal and temporary electricity. Failure to address these issues can be very costly to the tenant.

Strategic Rights Concerning Space Needs

Long-term planning in most companies is based on 3-to-5-year projections while leases run for 10 to 20 years. Most prospective tenants, therefore, have enormous difficulty assessing their needs over a lease term. Strategic rights to add space or decrease space, to extend or cancel lease terms are often critical to allow tenants the flexibility they need to deal with future uncertainty. While rights to add or modify space commitments give flexibility to tenants, they are major hindrances to landlord leasing programs, and are highly controversial and hard fought. Nevertheless, rights to acquire additional space during the term of the lease or to modify commitments are usually obtained by tenants taking more than one floor or occupying more than 40,000 square feet of space. If the landlord is forced to provide such options, the agreement is usually subject to constraints on the amount of space, timing and flexibility. It is usually not difficult for a tenant to secure the right to extend or renew a lease at fair market value. The right to cancel is more difficult to obtain and is usually subject to significant penalty payments.

Equally important issues are the rights to sublease or assign the lease. The right to sublease is strategically important to tenants while its limitation can be enormously valuable to landlords. It is always best to confront the issue and work out an arrangement that is satisfactory to both parties. Other strategic rights include the ability to name the building, the right to appropriate signage and the right to restrict other tenancies that the tenant deems not to be in its best interest.

Other Inducements

Equity

When a prospective tenant would be the major occupant in a property, it is not uncommon for the landlord to make a portion of the equity or cash flow available to the tenant. Landlords always ask that a tenant pay for an equity position, but under certain market conditions an equity position may be obtained at no cost. There are no fixed rules as to the amount or nature of tenant participation, but one common formula is to grant the tenant 1% of the equity for each 2% of the space it has under lease.

Rent Abatement

Another inducement for tenants is a rental abatement at the commencement of a long-term lease. This is in addition to the period of free rent meant to cover the construction of the tenant's premises. A common procedure in soft markets is for the landlord to maintain the asking rents while granting generous free rent periods at the beginning of the term. This feature is often treacherous for tenants who take the short-term benefit but find themselves saddled with non-competitive rents in the later years of the lease. This situation is referred to as "mortgaging" a firm's future. Recent changes in accounting rules have discouraged this practice.

Liability Issues

Liability issues include personal and corporate guarantees, condemnation, fire damage, inability to perform, defaults and so on. All issues in a lease have an economic impact and should be assessed on this basis. However, liability issues are generally negotiated by counsels for the landlord and the tenant.

This brief summary is not meant to be an all-inclusive list of key issues in a landlord/tenant negotiation. It does, however, highlight some of the main issues vital to the tenant's welfare that must be addressed if the tenant is to be properly represented.

Conclusion

The theme of this chapter has been to demonstrate that the interests of tenants in office buildings are usually very different from the interests of the building owners. The battle to gain strategic advantage with respect to rent and other lease terms is continual. This diversity of interests and rapidly changing market conditions have created a situation in which more tenants are seeking the best possible real estate advice and counsel. They are no longer willing to settle for representation by the building agent or a broker who may not achieve the best possible terms for them. More and more over time tenant representation will become a separate discipline. Agents will represent owners, tenant representatives will represent tenants, and both will be paid by their respective clients. In this next decade, real estate firms will have to confront this issue and adjust accordingly.

APPLYING FAIR MARKET VALUE CONCEPTS TO WATER RIGHTS

Five regional markets for water illustrate how state laws, geographic location, cultural influences and environmental concerns affect changes in water use.

by Bonnie G. Colby

Research on water transactions in the western states was supported by grants from the U.S. Forest Service Rocky Mountain Experiment Station, Resources for the Future, the U.S. Geological Survey and by the Arizona Agricultural Experiment Station. The research is a contribution to U.S.D.A. Regional Research Projects W-133 and W-178.

Market acquisitions of water rights are increasingly common in regions where existing water supplies are fully appropriated and development of new supplies is costly. Both market acquisition and development encourage new water users to bid water away from current right holders. Urban growth, environmental disputes and Native American claims to water all create incentives for acquisition of water supplies. While water right acquisitions often are essential to real estate development, they also are the subject of controversy in state and federal courts, legislatures and administrative agencies.

Water use and transfer is carefully scrutinized and highly regulated in most western states. Within this conflictual environment, water rights valuation has become an important task. Such appraisals provide essential information for potential buyers, many of whom are real estate developers and city governments seeking supplies for growing populations. Appraisers may assess fair market value for the courts to award compensation for damages or takings of water rights; for public agencies who supply water to farms, cities and business; and for conservation organizations who acquire water for wildlife refuges, wetlands and streams.

This article reviews several markets for water rights in the western U.S. and discusses the application of fair market value to water rights and how this differs from other real property in several critical ways.

Background On Water Markets In The Western United States

The markets where water rights are traded vary by region, water source and types of buyers and sellers. Traditionally, a market is defined as a set of arrangements where buyers and sellers are brought together by the price mechanism. For water rights appraisal, it is the interaction of individuals who exchange water rights, water supplies associated with land and water-related infrastructure for other assets, such as money.[1]

A transaction that involves both land (and improvements) and water may still be considered a water transaction if the acquisition was motivated primarily by the desire to obtain water supplies. These transactions are common in Arizona where water transactions often include land acquisitions, due to specific provisions in state law. In Colorado, New Mexico, Utah and Nevada, water rights can be (and frequently are) bought and sold separately from land.

Information on major water sources and uses, transactions and prices for five water market

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FIGURE 1

Selected Market Regions in the Western U.S.

A. Truckee River Basin, Nevada
B. Lower Sevier River Basin, Utah
C. Northeastern Colorado
D. Southern Arizona
E. Gila-San Francisco Basin, New Mexico

regions are briefly described in this article. Figure 1 identifies the five market areas which are located in Nevada, Utah, Colorado, Arizona and New Mexico. Price observations have been made as comparable as possible allowing for time and market areas. Prices have been adjusted, using the Gross National Product (GNP) price deflator, to 1986 dollar values. In addition, several conventions have been adopted to compare different water rights in terms of common units of measure. Water rights may be transferred in perpetuity (sold) or temporarily (leased). Unless otherwise noted, transactions described in this study are for sales rather than leases.

Water Has Rights, Too

In quantifying water rights, it is important to distinguish between diversion rights and the consumptive use portion. Diversion rights refer to the maximum quantity of water which may be withdrawn per unit of time from a water source. Consumptive use refers to the portion of that diversion right which may be removed permanently from the hydrologic system through evaporation, transpiration or other means. The difference between diversion and consumptive use is the "return flow," or the portion of the diverted water which returns to the system and is available for appropriation and use by others. In many areas, transfers of water rights are limited to the consumptive use portion of the water right. This limitation is enforced to protect other water users from having their own water rights adversely impacted as a result of the transfer.

If the water purchased is transferred completely out of the hydrologic system of origin, or if the rate of consumptive use differs between the original use and the new use, the quantity of divertable water that the seller of a right gives up in a transfer usually will not be the same as the quantity of water that the buyer is able to use. Unless otherwise indicated, all descriptions of transfers refer to the quantity of water that may be diverted for use by the buyer.

Buyers of water rights need to be concerned with the capacity of the water resource to satisfy their rights. If the hydrologic capacity of the water resource varies significantly over time, or if many other water users have a senior claim to rights from the same water resource, then the yield of a particular water right may not always be equal to the full amount of the right. Consequently, the actual long-term average yield of a water right often is less than the maximum amount specified in the water right. Unless otherwise indicated, all water transfers in this article are quantified according to their long-term average yield, in acre feet per year.

Truckee Basin, Nevada

The Truckee River flows from Lake Tahoe in the Sierra Nevada Mountains into Pyramid Lake in the northwest Nevada desert. The Carson River flows just south of the Truckee Basin. Water from the two river systems is used conjunctively in the Truckee-Carson Irrigation District (TCID), located downstream and about 50 miles to the east of the Truckee Meadows. The cities of Reno and Sparks form the core of a rapidly expanding regional population in the Truckee Meadows. A federal water master oversees the administration of the Truckee River in compliance with the Orr Ditch Decree. Transfers of surface water and groundwater rights are subject to approval by the Nevada State Engineer.

The majority of water used in the area is primary flow or storage from the Truckee River. Rights to the Truckee River were adjudicated under the Orr Ditch Decree of 1944.[2] Reno and Sparks receive water from a privately owned utility, and Washoe County provides some water service to outlying communities. Irrigators are supplied with Truckee River water delivered by private ditch companies. Lake Tahoe and other reservoirs serve as storage facilities for the Truckee River.

Up to 300,000 acre feet per year of Truckee River water flows into Pyramid Lake.[3] The Pyramid Lake Indian Reservation and the Truckee-Carson Irrigation District are the major Truckee River water users located outside the Reon-Sparks area. Indians, irrigators and municipal users of the Truckee River have been locked in continuing litigation over water resources since the early 20th century.[4] Growth of the Reno-Sparks area has brought increasing numbers of developments and other enterprises which are willing to pay for water.

Pricing History

Until the late 1970s, almost all transfers of surface water rights involved the sale of irrigation rights to the regional water utility. By 1979, urban interests became aware that water rights were not being acquired fast enough to keep up with the growing demand for service.[5] Increasing awareness of the scarcity of water has driven prices up more than twenty-fold since 1979 and has brought many new participants into the market. A precondition for project approval is that real estate developers acquire Truckee River water rights and then must dedicate them to the cities of Reno and Sparks. Rights acquired by the local governments through dedication are leased for 99 years to the water utility at $1,500 per acre foot.[6]

Prices paid for water rights averaged about $100 per acre foot between 1946-1959, rose to over $150 per acre foot between 1960-1964, fell to $140 per acre foot between 1965-1970, and fell again to less than $75 per acre foot by 1979. Price offers by the regional water utility rose to over $100 per acre foot in the early 1980s, but higher offers from other buyers, primarily real estate developers, left few individuals willing to sell at that price.

The Market For Water

Since early 1985, the cities of Reno and Sparks have been soliciting urban owners to sell their old irrigation rights. The price offered of $422 per acre foot is set by joint agreement of Reno, Sparks and Sierra Pacific, the private utility. The low offer price is intended to reflect the high transactions costs, primarily the title search, involved in transferring small quantities of water rights for lands which often have been subdivided and changed hands.[7]

Several private water brokers operating in the Truckee Meadows have been outbidding the cities. Typically the prices offered by the brokers range from $600 to $800 per acre foot, less a brokering fee. The brokers assemble several small water rights into a larger package for resale to a local real estate developer. Prices for these larger packages of urban water rights have exceeded $2,000 per acre foot.[8]

The market for water has been heavily influenced not only by policies of the state of Nevada and local governments, but also by tribal governments and the federal government for a national wildlife refuge in the area. Litigation over water needs for the environment and for indian tribes has contributed to upward pressures on water prices. Senior water rights are selling for $2,600 per acre foot.[9]

Lower Sevier Basin, Utah

The Sevier River Flows north from the high plateaus of southwestern Utah, terminating in the Sevier Desert 140 miles southwest of Salt Lake City. Four mutual stock irrigation companies—Delta, Melville, Abraham and Deseret (the DMAD companies), control virtually all surface flow rights on the lower stretch of the river. Until recently, water delivered by DMAD was used exclusively for irrigation. In 1980, the Intermountain Power Project (IPP) bought 20% of DMAD company stocks, thousands of acre feet of privately held groundwater rights and 80% of the water stock in another ditch company upstream of DMAD. The total package of water rights, with a yield of 45,000 acre feet per year, cost approximately $2,400 per acre foot. The water was acquired for cooling a new coal-fired power plant which began operations in the late 1980s. The projected size of the power plant operation was reduced after IPP had already purchased the water rights. Consequently, about half the water rights are not needed for power plant operations and IPP rents unused water to irrigators and plans to continue this practice.[10]

The vast majority of water transfers in this basin are seasonal water rights rentals among irrigators. Studies conducted between 1948-1964 indicate that there has been no long-term upward or downward trend in the real price of surface water.[11] Short-term price fluctuations, documented since the 1940s, have followed the hydrologic cycle of the river—rental prices are higher in dry years and lower in wet years. Over the last several decades, rental prices have varied between $7 and $75 per acre foot. Sales of mutual water company stocks (nearly always for irrigation) and groundwater rights purchases have generated prices ranging from $300 to over $2,400 per acre foot since 1978. Prices rose sharply in the period preceding and immediately after IPP's purchases in 1980, but leveled off to between $300 and $500 per acre foot in 1985 and 1986.

Northern Colorado Water Conservancy District, Colorado

The Northern Colorado Water Conservancy District (NCWCD) lies north of Denver and east of the Rocky Mountains. Urban centers include Boulder, Fort Collins, Loveland, Longmont and Greeley. Irrigation is extensive but has been declining in the face of urban growth.

Surface water supplies originate as snowmelt and runoff from the Rocky Mountains. Natural seasonal flows are erratic and highly variable. The majority of water supplies comes from surface water which is stored and then delivered by water supply organizations. The Colorado-Big Thompson (C-BT) project is the largest single supplier in the area, but does not operate local distribution systems. Instead, a large and sophisticated array of diversion, storage, distribution and treatment facilities are owned and operated by a variety of mutual water stock companies, municipal water systems, water districts and water user associations. Although the C-BT project originally was developed as a supplementary water supply for irrigation, approximately one-third of C-BT allotments now are in municipal or industrial ownership.[12] Water is used to offset fluctuations in natural surface water flows. C-BT annual releases range from 155,000 to 310,000 acre feet. In dry years, the NCWCD will release more C-BT water, and less in wet years.

Water right transfers in Colorado must be approved by a state water court. This procedure can be time consuming and expensive but generally is unnecessary in the case of water stock transactions within the service area of a water district.[13] Water rights represented by company water stock therefore are very marketable rights. The larger the company service area, the larger the area over which the water may be marketed without formal proceedings. The high value attached to C-BT water is because the project functions as a mutual stock water company, with the largest service area of any such organization in Colorado. Water rights controlled by the Colorado-Big Thompson project (represented by shares, or "units," each one entitling the holder to 1/310,000 of the water delivered by the project in a given year) may be used or transferred anywhere within the NCWCD.

Deliveries of C-BT water started in the late 1950s. In 1961, C-BT units sold for about $97 each. Assuming a long-term average yield on C-BT units of about 0.75 acre feet per unit, that price was equal to about $130 per acre foot. Prices per acre foot rose to $440 in 1965, $920 in 1970, $1,090 in 1975, $2,540 in 1977, $3,050 in 1979, and peaked at about $3,600 in 1980. Since 1980, the real price of C-BT water had fallen. In the mid 1980s it stood at about $1,500 per acre foot. However by 1992 the price had increased to $2,200.

Southern Arizona

In Arizona, several distinct types of water rights have been purchased by real estate developers and municipal interests in the Tucson and Phoenix Active Management Areas (AMAs).[14] Active Management Areas were created by state law in 1980 to regulate groundwater use in regions where declining water levels were a concern. These include agricultural groundwater pumping rights that can be converted to nonirrigation uses, nonirrigation groundwater rights, groundwater rights originating outside of the AMAs, surface water flows and reclaimed sewage effluent. Unlike some other states, Arizona prohibits purchase of irrigation rights without simultaneous purchase of the farm land to which they are appurtenant.[15]

Within the Tucson AMA, the market for agricultural groundwater pumping rights is dominated by the city of Tucson. Tucson has been purchasing and retiring irrigated farmland in the neighboring Avra Valley since the early 1970s. Assuming that the land has no value apart from the water rights (not an unreasonable assumption in remote areas of the desert), and based on a transferable quantity of three acre feet of groundwater per irrigated acre, prices for Avra Valley water have increased from a range of $400-$500 per acre foot in the early and mid-1970s to a range of $650-$1,000 per acre foot in the late 1980s.

Numerous purchases of agricultural groundwater rights for conversion to urban uses have occurred in the Pinal and Phoenix AMAs. The city of Mesa, located in the Phoenix AMA, purchased over 11,000 acres of irrigated farmland, located in the Pinal AMA, generating about 30,000 acre feet of water that can be converted to nonirrigation uses. A Phoenix-area development group purchased farms in the Phoenix AMA with over 8,000 irrigated acres. The irrigation water rights are convertible to nonirrigation uses with a yield of over 20,000 acre feet per year. These and other transactions in the mid 1980s occurred at prices ranging from $1,000-$1,500 per acre foot.[16]

Type II groundwater pumping rights are held by golf courses, mines, power plants and businesses which obtain supplies of groundwater independently of municipal water service organizations. In contrast to other water rights in Arizona, Type II nonirrigation groundwater rights are transferable without an accompanying land acquisition, to other locations within the same AMA.[17] The supply of Type II rights is limited, and it constitutes only a small proportion of the total water rights in Arizona's Active Management Areas. Demand for Type II water rights is limited mostly to independently supplied nonagricultural water users and to new water service organizations. Typical prices in the Tucson and Phoenix AMAs have ranged from $500-$2,000 per acre foot between 1984-1991.

Numerous purchases of groundwater and surface water rights have taken place in Arizona outside of the Active Management Areas, mostly in western

Arizona. In 1984 the city of Scottsdale purchased the 8,400 acre Planet Ranch, with an estimated yield of 13,500 acre feet of surface water rights, for about $900 per acre foot. The city hopes to transport water from the Bill Williams River to the CAP aqueduct, which would then carry the water to Scottsdale.[18] A series of acquisitions by real estate developers occurred in the 1980s, with prices ranging from $550-$950 per acre foot.

In 1986, the city of Phoenix purchased 16,000 acres in the McMullen Valley of western Arizona, for slightly over $30 million. The city estimates that between six and seven million acre feet of recoverable groundwater are in the aquifer underlying the lands. The city plans to transfer approximately 30,000 acre feet of water per year to the city starting in the year 2005.[19] Since the McMullen Valley lies outside of Active Management Areas, legally Phoenix is free to pump as much water as it wants, so long as the water is being put to "beneficial use." However, under Arizona law, in principle, groundwater exporters can be held liable to pay damages to third parties who demonstrate that the export of the water is causing them harm.[20]

Gila-San Francisco Basin, New Mexico

The Gila and San Francisco Rivers drain the southwestern corner of New Mexico. The Gila-San Francisco Basin is sparsely populated, but Silver City, a town of about 20,000 people, is located just on the other side of the Continental Divide. The Gila-San Francisco Basin effectively has been closed to additional groundwater appropriations since the late 1960s. New groundwater wells may still be developed, however, by converting a surface water right to a groundwater right and changing the point of diversion to the desired well location.[21] Since the 1960s, as changes in land use have created demands for water distant from old irrigation ditches, many surface water rights have been retired and exchanged for groundwater rights.[22] Water rights in the state of New Mexico are under the jurisdiction of the state engineer. Any change in the point of diversion, purpose of use or place of use of a water right must be approved by the state engineer.

Rights to the Gila and San Francisco river systems were adjudicated in the early and mid-1960s as a result of the settlement of the Colorado Basin lawsuit, *Arizona* v. *California*.[23] Approximately 30,000 acre feet of Gila and San Francisco River water may be used in New Mexico's Gila-San Francisco Basin. Until the mid-1960s, agriculture was the major user of water in the Gila-San Francisco Basin. The pattern of water use changed substantially in 1968, when a large mining company acquired land and approximately two-thirds of all the water rights in the Gila sub-basin. Developers and other buyers also have entered the market to acquire water rights.

Water rights purchases by area mines have constituted the largest volumes of water transferred during the 1970s and 1980s. Prices from these transactions are difficult to document, because mining companies generally are unwilling to disclose information on their purchases and sales and prices for water rights are not a matter of public record. Data on private sales to the mines were made available from area realtors and sellers. The typical price for an acre foot for water rights ranged between $1,500-$1,800 in the early 1970s. Prices remained fairly constant until the late 1970s, when they rose to a range of $2,000-$3,200 per acre foot. Prices declined in the early 1980s to a range of $1,100-$1,400 per acre foot and rose again at the end of the decade to $1,800 per acre feet in 1991.

Summary of Market Descriptions

As these five examples illustrate, regional markets for water differ substantially from one another in terms of numbers of transactions, quantities of water traded and prices. Markets are heavily influenced by state laws which govern changes in water use and by conflict and litigation over water rights of Native American tribes, water for endangered species and water quality concerns.

Water Markets And The Definition Of Fair Market Value

One definition of fair market value used in the appraisal profession is: "The most probable price, as of a specified date, in cash, or in terms equivalent to cash, or in other precisely revealed terms, for which the specified property rights should sell after reasonable exposure in a competitive market under all conditions requisite to fair sale, with the buyer and seller each acting prudently, knowledgeably, and for self interest, and assuming that neither is under undue duress".[24] There are several concepts included in this definition which require a careful interpretation when applied to water rights, and which must be adapted from their typical application to real estate.

First, in many areas of the west, the time period of "reasonable exposure" for a water right is one to three years. Potential buyers need time to satisfy themselves as to the legal and hydrologic characteristics of the water right. This often involves hiring an attorney and an engineering firm to assess:

1. the priority date of the right relative to neighboring water claims;[25]
2. its susceptibility (if any) to forfeiture or abandonment findings under state law;
3. ambiguities (if any) regarding title (title companies in some areas routinely exclude water rights from their policies);
4. the firm yield of the right during dry years (that is, the amount of water that can be used under the right when streamflows are very low);
5. the typical yield of the right during years of normal streamflow;
6. the probable quantity of water that could be transferred to new locations and uses (usually based on historic consumptive use);
7. threats to the exercise of the right stemming from litigation involving the stream or aquifer that is the water source for the right, endangered species, Indian water rights, Clean Water Act requirements, and so on;

8. financial, legal and engineering feasibility of conveying water to distant locations where its economic value is higher.

These inquiries typically take months and can take years for complex water acquisitions. Moreover, some potential buyers seek state approval for a transfer of the right to the buyers intended place and purpose of use before closing on the acquisition. The state approval process typically takes six to twelve months in Utah, Colorado, Arizona, and New Mexico. See Colby et al.[26] and MacDonnell[27] for a discussion of state procedures to review and approve changes in the place and purpose of use of a water right.

In addition to the lengthiness of reasonable exposure, water markets often deviate from markets for other real property in their "competitiveness," and this needs to be taken into account when evaluating fair market value. Water markets are typically "thin," meaning there are only one or two major water buyers in a region and there may be only a few potential sellers. It is not unusual for a water market to involve the one large city in an area as a buyer and a few farmers or a single irrigation district as potential sellers.[28] In some areas, a water right acquisition may only occur every few years, while in active areas there are several transactions a month.

The "undue duress" clause in the definition of fair market value also needs to be carefully interpreted with regard to water right transactions. Water acquisitions nearly always are motivated by some form of duress. Water utilities seek to acquire rights in order to prevent water shortages within growing service areas, to improve water quality so as to comply with state and federal regulations, or to replace water supplies that were lost or restricted through endangered species or other environmental litigation. Municipal, state and federal agencies, as well as environmental organizations, acquire water rights to preserve fish and wildlife habitat and wetlands.[29] Drought motivates water users to purchase senior water rights that are less vulnerable to dry year shortages. Water use and management are heavily influenced by state and federal regulations and by litigation. For instance, a California court ruling in the mid 1980s (the Mono Lake Case) required Los Angeles to find alternative water sources so that its diversions from the high mountain streams feeding Mono Lake could be reduced in order to restore the ecological balance of the lake and environs.[30] This precedent-setting decision paved the way for further administrative and judicial decisions that affected access to water sources and rights for agriculture, cities and other offstream water users. Water right acquisitions in the west also may be stimulated by litigation over Native American water claims which sometimes are satisfied by federal acquisitions of water rights. In short, water acquisitions are typically linked to some regulatory or judicial requirement and therefore are seldom entirely free of duress.[31]

The self-interest motivation included in the definition of fair market value also requires careful interpretation. Financial profit frequently is not the primary factor motivating a water acquisition. Many buyers are public utilities which do not earn profits, or are environmental groups or government agencies with fish, wildlife, water quality or hydropower responsibilities that must be satisfied. Where water acquisitions are made by businesses for investment purposes, profits tend to be based on a long term return, rather than realized in one or two years.[32]

Real estate professionals frequently must assess the value of water rights, either as a portion of the overall value of real property, or as a separate asset that is bought and sold apart from land.[33] Water right appraisals require understanding of the unique characteristics of the regional market and prudent application of fair market value concepts. Water rights have a longer period of "reasonable exposure" on the market than other real estate and water markets typically are less active and less competitive than land markets. Moreover, transactions seldom are free of duress. Water rights acquisitions are heavily influenced by regulation and litigation and a profit motive may be absent. State and federal agencies and courts frequently make decisions which affect the sources and types of water rights available to water users and their actions motivate water acquisitions by the private and public sectors. These important differences between water markets and markets for other real property influence evaluation of fair market value for water rights.

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SHORT RUN BREAK-EVEN ANALYSIS FOR REAL ESTATE PROJECTS

The cash-on-cash return ratio is used to analyze the short-term question "What if?".

by Lawrence F. Sherman, Jae K. Shim and Mark Hartney

Cost-volume-profit analysis for real estate projects is a new application of an old but trustworthy accounting analysis technique. This article describes this technique by citing a congressionally-chartered nonprofit service organization which was going to build an apartment complex specifically designed for veterans with a traumatic spinal cord injury. The model is also applied to for-profit organizations, under the assumption that taxes will be paid, to further demonstrate this method for short run analysis.

Facts Of Project And Analysis

A $1,936,400 loan funded by the U.S. Department of Housing and Urban Development (HUD) will be used to construct and maintain a 24-unit apartment facility. A down payment of $194,500 is planned. The loan is expected to be at 9.25% fixed interest for 40 years. The federal government will subsidize 70% of the annual loan amount.[1] The monthly payment, or debt service, is $15,310. Since 70% of the payment will be subsidized, the organization will be responsible for $4,593 (e.g. $15,310 x .30) per month for debt service.

The analyses contained in this study were based on assumptions relevant at the time of this report. When the complex is actually opened, other costs are likely to be incurred. Since the facility will be designed for physically-handicapped citizens, additional costs peculiar to this project will be necessary (e.g.,transportation, aid and attendance, and recreation).

Management must maintain accurate accounting records. Depreciation was not included in the analysis, since as a not-for-profit organization, there will be no taxable income. The question of depreciation in nonprofit organizations is an issue that continues to draw controversy.[2]

It is wise to establish operational-accountability reporting procedures for this fixed expense. Any excess funds should be transferred to a separate account for future expenditures. These excess funds should be utilized for periodic maintenance, improvements and unexpected costs.

All income/expense data implemented in this report were compiled utilizing 1989 statistics obtained

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from the Institute of Real Estate Management. The data selected was strictly for low rise buildings located in the Los Angeles metropolitan area, and it relates specifically to federally-assisted complexes such as the subject project.[3] To describe the data, the sample size for each income/expense item ranges from zero to seven. Anytime the sample size for a specific operating cost is less than five, the value should be used with caution.

The costs are estimated based on the average apartment unit being 675 square feet for a total of 16,200 square feet of rentable space. The common area was 3,800 square feet and the total complex land area is 20,000 square feet. In order to calculate expenses from the income/expense analysis, the cost per square foot values were totaled for each income and expense item which were then computed to a per/apartment unit basis.

To determine the effect of setting an appropriate rental rate to apply, the technique of break-even analysis was used based on two possible competitive rental rates of $400 and $500. In order to fully understand the economic consequences and effects on the project from choice of the rental rate, an income/expense analysis was conducted to provide a comprehensive study of the potential risks involved in the "investment capital" for this project over the life of the investment.

Breakeven Capital Budget Analysis

Rental property normally does not incur variable costs.[4] Whether the complex is fully utilized or not, the cost of operating real estate does not materially change, except for physical depreciation. As a result, the first step of the study will treat all costs as fixed. Income properties determine the break-even point, or default point, only in terms of the occupancy rate. This rate is calculated by dividing monthly gross possible income into the sum of monthly operating expenses and debt service.[5] Here in Equation 1, this is defined as:

$$R = \frac{e + d}{GPI}$$

where:

R = break-even occupancy rate (%)
e = operating expenses
d = debt service
GPI = gross effective income (after vacancy charge).

Assuming the rental rate is $400 per apartment, the gross effective income is $9,600 ($400 x 24 units). The operating expenses total $4,137 and the debt service is $4,593 (see Table I).

By inserting the values in Equation 1, the breakeven occupancy rate was found to be 90.9%.

$$90.9\% = \frac{\$4,137 + \$4,593}{\$9,600}$$

Therefore, in order for the project to break-even (meaning no profit or loss), 22 units must be occupied. If this level is not achieved, then management must "seek" additional tenants.

TABLE I

Low Rise Buildings—Los Angeles, California
Monthly Median Income and Operating Costs

Income Total	Square Feet	
Rents (24 Units @ $400/Month)		$ 9,600
Other Income (7)	.07	1,100
Gross Potential Income		10,700
Vacancies/Rent Loss (7)	.03	500
Total Collections (7)		10,200
Expenses		
Management Fee (7)		300
Other Administrative (7)		500
Subtotal Administrative (7)		800
Supplies (6)	.04	55
Heating Fuel—CA Only*(1)	.09	30
Electricity—CA Only*(2)	.23	70
Water/Sewer—CA Only*(7)	.10	32
Gas—CA Only*(3)	.02	15
Building Services (6)	.09	120
Other Operating Expenses (2)	.10	135
Subtotal Operating Expenses (7)	1.72	457
Security (1)	.08	110
Grounds Maintenance (7)	.15	200
Maintenance-Repairs (7)	.74	1,000
Painting/Decorating (7)	.11	150
Subtotal Maintenance (7)	1.08	1,460
Other Tax/Fee/Permit (6)	.02	325
Insurance (7)	.17	230
Subtotal Tax & Insurance (7)	.19	555
Recreational/Amenities (13)	.10	135
Other Payroll (4)	.54	730
Total Expenses (7)		$ 4,137
Net Operating Income (7)		$ 6,063

*: California Only—indicates common areas only
(): Figure in parentheses indicates sample size

Source: Income/Expense Analysis: Apartments, 1990

Another concern for management is to generate additional funds from the tenants to cover unexpected costs and keep the project financially sound. Therefore, a nominal profit should be generated. This will modify the original equation by including a profit. The revised equation is:

$$R = \frac{e + d + \pi}{GPI}$$

where:

π = profit.

For instance, if the complex wishes to generate a profit of $1,000 per month, then the occupancy rate must be 100.1%, or more than 24 units.

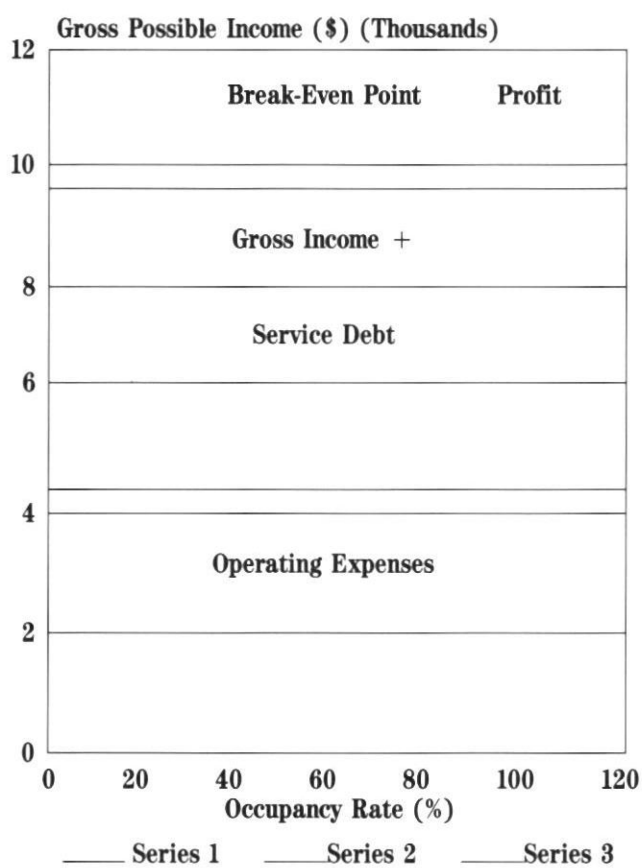
$$100.1\% = \frac{\$4{,}137 + \$4{,}593 + \$1{,}000}{\$9{,}600}$$

This rent price is obviously too low for the project to be profitable. Therefore, a higher price is necessary for the complex to be profitable and survive.

The formula is shown in Table II.

TABLE II

Break-Even Chart



By plotting occupancy rate on the horizontal axis and gross effective income on the vertical, the range of occupancy rates is illustrated to cover operating expenses, debt service and profit.

Variable And Fixed Cost Approach

Discussion so far has treated all costs as fixed. However, while the facility would incur costs in this fashion, another approach is provided here to accommodate the objectives of the apartment complex.

As noted earlier, the purpose of the facility was to help newly-disabled veterans adjust to their injury. One problem is that tenants may not be able to meet their expenses. It may be necessary to establish a policy whereby management pays certain utilities. Considering the occupants, such a policy would enable the veterans to remain focused on recovery and gaining independence.

If this policy was implemented, then a different approach could be taken. While most of the costs remain fixed, some would change to variable costs. According to *Barron's Real Estate Handbook*, some costs can be identified as variable.[6] That is, as the occupancy rate increases, so do certain costs. Fixed costs remain the same regardless of the activity level. The unit rental price will have to be adjusted to cover the additional expenses paid by the organization. The original price will increase by the total unit variable costs not accounted for in the fixed cost method. Here the traditional cost-volume-profit analysis formula can be applied. The basic principle underlying the formula is that the difference between the unit sales price (in this case, the rental rate) and the unit variable costs must cover the total fixed costs.[7] Stated in equation form:

$$R = \frac{a}{p - b}$$

where:
- R = occupancy rate (units)
- a = fixed costs
- p = unit rental price
- b = unit variable cost.

Table III separates costs into fixed and variable costs.

TABLE III

Monthly Fixed and Unit Variable Costs

Fixed Costs	Total
Management Fee	$ 300
Other Administrative Expenses	500
Building Services	120
Other Operating Expenses	135
Security	110
Grounds Maintenance	200
Maintenance-Repairs	1,000
Painting/Decorating	150
Other Tax/Fee/Permit	325
Insurance	230
Recreational/Amenities	135
Other Payroll	730
Total	$3,935
Variable Costs	**Unit Cost**
Electricity	$ 36
Gas	11
Heating	16
Water/Sewer	16
Total	$ 79

Source: Income/Expense Analysis: Apartments, 1990.

By substituting the financial analysis into the third formula, the break-even occupancy rate is 22 units.

$$21.1 \text{ Units} = \frac{\$3{,}935 + \$4{,}953}{\$500 - \$79}$$

The second approach changes the result from a percentage to a unit value. Or, this is the number of units that must be occupied to at least break-even. If more units are rented, then possibly rental rates would be reduced.

A profit can also be incorporated into the formula. Including it with the fixed costs allows the unit contribution margin (unit rent price less unit variable cost) to account for the desired profit. Thus, the following equation is formed:

$$R = \frac{a + \pi}{p - b}$$

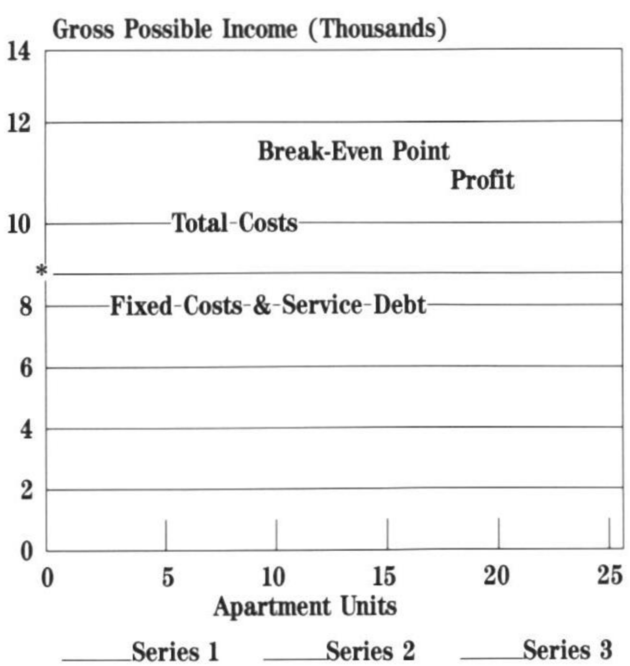
where:
- R = occupancy rate
- a = fixed costs
- π = profit
- p = unit rent price
- b = unit variable cost.

Again, applying the average costs available from Table III and adding $1,000 per month surplus revenues for contingencies, the desired occupancy from rental activity would be 23 units. A break-even chart, Table IV, is developed from this alternative to visually assess the potential risk of the project.

$$22.6 \text{ Units} = \frac{\$3{,}935 + \$4{,}593 + \$1{,}000}{\$500 - \$79}$$

TABLE IV

Break-Even Chart



While the discussion so far has been limited to assessing the potential risk of the new project, a sensitivity analysis will be applied now which will offer a better judgment on the overall risk factor of the apartment complex.

Cash-On-Cash Return (COC) Analysis

Most owners want to know the rate of return on their equity investment. For-profit organizations return on equity is measured by relating pretax and aftertax cash flows for a particular year to the owner's down payment, commonly known as *initial equity investment*.[8] However, for a nonprofit organization, the aftertax approach is disregarded for the nonprofit organization (e.g. assume a tax rate of 0).

The cash-on-cash return analysis uses the data compiled in the fixed cost approach described earlier. In order to compute the cash-on-cash (COC) return ratio, annual cash flow data and initial equity must be available. The ratio is computed by dividing the initial equity investment into the cash flow value.[9] The equation is:

$$COC = \frac{C}{I}$$

where:
- COC = cash-on-cash return
- C = cash flow
- I = initial equity investment

Table V illustrates the pro forma cash flow statement for this project in Year One.

TABLE V

Pro Forma Cash Flow Statement at
95% Occupancy Rate
Year One

Gross Possible Income ($400 × 12 × 12)	**$ 115,200**
Vacancies (3%)	**(5,760)**
Total Actual Collections	**109,440**
Operating Expenses	**(49,644)**
Cash Available for Service Debt	**59,796**
Less: Debt Service	**(55,116)**
Cash Flow	**$ 4,680**

The initial equity investment is $194,500. From here, the equation is applied, giving a COC of 2.4%, based on a 95% occupancy rate (23 units).

$$2.4\% = \frac{\$4{,}680}{\$194{,}500}$$

Knowing the cash-on-cash return ratio, sensitivity analysis is applied to determine how far the occupancy rate could drop and still generate a predetermined minimum COC return.[10] The following equation is used to solve for the required occupancy rate to reach the previous specified COC return of 2.4%:

$$COC = \frac{r \times 12 \times u \times R) - e - d}{I}$$

where:

r = monthly rental price
u = totalapartment units
R = occupancy rate (%)
e = operating expenses
d = debt service
I = initial equity investment.

Given the formula to compute the minimum occupancy rate, it could drop to 95% and provide a 2.4% return on the owner's initial equity investment of $194,500. The formula is applied in the following manner:

$$2.4\% = \frac{\$400 \times 12 \times 24 \times R) - \$49{,}644 - \$55{,}116}{\$194{,}500}$$

$$.024 = \frac{\$115{,}200R - \$49{,}644 - \$55{,}116}{\$194{,}500}$$

$$\$4{,}668 = \$115{,}200R - \$104{,}760$$

$$\$109{,}428 = \$115{,}200R$$

$$.95 = R$$

A 2% return on investment is extremely low for this industry, and it could be dangerous, financially speaking.

Let us assume that the approximate real estate industry standard for COC, or the expected COC return, is 9%. The project's cash flow requirement would be $17,505 (.09 × $194,500). If the rent price was increased to $500, the occupancy rate could drop to 85% and still generate a 9% COC return.

$$9\% = \frac{(\$500 \times 12 \times 24 \times R) - \$49{,}644 - \$55{,}116}{\$194{,}500}$$

$$.09 = \frac{(\$144{,}000R) - \$104{,}760}{\$194{,}500}$$

$$\$17{,}505 = (\$144{,}000R) - \$104{,}760$$

$$\$122{,}265 = \$144{,}000R$$

$$.85 = R$$

Table VI illustrates an annual pro forma cash flow statement for a rental price of $500 and an occupancy rate of 85%.

TABLE VI

Pro Forma Cash Flow Statement at 85% Occupancy Rate
Year One

Gross Possible Income at $500/Unit	**$144,000**
Vacancies (15%)	**21,600**
Gross Actual Income	**122,400**
Operating Expenses	**49,644**
Cash Available for Service Debt	**72,756**
Debt Service	**55,116**
Cash Flow	**$ 17,640**

$$\text{Cash-on-Cash Return} = \frac{\$17{,}640}{\$194{,}500}$$

$$\text{COC} = .09 = 9\%$$

The end of year cash flow remains at the 9% COC return rate. This indicates that it may be necessary to raise the rental rates (from $400 to $500) to meet the apartment expenses, debt obligations and obtain a desirable rate of return on the investment.

The previous formula for computing occupancy rates for a desired cash-on-cash return ratio can be further improvised to determine how much operating expenses can rise and still deliver a zero or minimum COC return.[11] The equation is revised to:

$$\text{COC} = \frac{(r \times 12 \times u \times R) - \text{OE(net 9\% Return)9} - d}{I}$$

The symbol OE9 signifies the operating expense level that results in a 9% COC return. Assuming the original vacancy rate of 5% and the rent price of $400, operating expenses would have to decrease to $36,819 to yield a 9% COC.

$$9\% = \frac{(\$400 \times 12 \times 24 \times .95) - \text{OE9} - \$55{,}116}{\$194{,}500}$$

$$.09 = \frac{\$109{,}440 - \text{OE9} - \$55{,}116}{\$194{,}500}$$

$$\$17{,}505 = \$54{,}324 - \text{OE9}$$

$$\text{OE9} = \$36{,}819$$

However, if higher rent prices are established, then expenses may be allowed to rise to a higher level before the 9% COC is diminished.

Assume the rent is increased to $500 and the original vacancy rate of 5% is unchanged. Operating expenses could rise to $64,179 and yield a 9% COC. Expenses could also rise to $81,684 before a zero COC would occur. The computations are as follows:

$$9\% = \frac{(\$500 \times 12 \times 24 \times .95) - \text{OE9} - \$55{,}116}{\$194{,}500}$$

$$.09 = \frac{\$136{,}800 - \text{OE9} - \$55{,}116}{\$194{,}500}$$

$$\$17{,}505 = \$81{,}684 - \text{OE9}$$

$$\text{OE9} = \$64{,}179$$

Assuming the figures are accurate, it may be necessary to set the rental rate at $500 per unit or higher. That way, the complex has the ability to meet all its expenses and still have surplus revenue for unexpected future expenditures. However, the rental rate must be determined based upon the vacancy rates and the tenant's financial position.

Allowing A Margin Of Safety

The margin of safety measures the amount of cash flow available to cover the debt service.[12] The amount by which the net operating income exceeds debt service gives some indication of how the debt was repaid. The margin of safety formula is:

$$M = ni - d$$

where:
M = margin of safety ($)
ni = net income
d = debt service

The margin of safety for a $400 rental rate is $4,680 ($59,796 − $55,116). For a $500 rental fee and 85% occupancy rate, the margin of safety equals $17,640 ($72,756 − $55,116). The margin of safety is the same as the net cash flow in this example because the organization is a nonprofit entity and will not pay taxes. However, in a for profit organization taxes must be considered as an expense of doing business.

Probability Analysis

In the course of the analysis, we have not considered the uncertainty of the estimates made through the use of probability analysis. However, break-even analysis can easily be modified for the effect of uncertainty and/or risk of the assumptions in the analysis already provided. Assumptions can be made on the probability of occupancy rates at different rent levels either discretely or through the use of a probability distribution. Next, would be to calculate the cash on cash return (COC) as the expected value of the outcome that is most reasonable to occur. Occupancy rates are directly related to rental rates (e.g. the higher the rental rate, the lower the occupancy; the lower the rental rate, the higher the occupancy which, we shall note, can never exceed 100% occupancy). If the property is in an urban market, data can be gathered from neighboring properties or by direct experimentation with incremental changes in the rental rate and associated vacancy rate. Also, it is important to note the relationship of expense ratios to the level of effective gross income which varies with rental rate, occupancy and the tax rate. The relationship is as follows:

Rental Rate	Occupancy	Expenses Ratio
Low	Higher	Depends*
Low	Lower	Higher
Medium	Medium	Medium
High	Higher	Lower
High	Lower	Depends*

* The direction of change depends on the relative incremental changes in occupancy caused by changes in rental rate. If occupancy changes at a greater proportionate rate than the rental rate, then expense ratio would be higher and, conversely, then lower.

The relationship between rental rate, occupancy (e.g. vacancy) and the expense ratio is important and may vary based on economic conditions, changes in demand and supply of renters and uncertain random factors which affect occupancy and which are not attributed to rental rate. The relationship, from a decision theory point of view, would improve the assessment of planning for profitability through analysis of controllable factors such as rental rate.

Conclusion

This simple and short-term risk analysis enabled management to view the project from a managerial accounting perspective. Using the simple break-even analysis, cash-on-cash return ratio and margin of safety formulas that were presented, the illustrated project has a relatively low risk factor based on estimated fair rental rates.

Once the project is operational, the accounting records will provide a better indication of actual cost behavior. Actual costs should also be compared to industry standards. The Income/Expense Analysis published by the Institute of Real Estate Management is one of the most accurate sources for expense analysis. The statistics are expressed in square footage and can be converted to an apartment unit basis. Some costs will remain fixed while others will be variable, and it is the particular property which determines those factors.

For some projects, the use of cost-volume-profit analysis is a meaningful technique in the analysis of the project's feasibility. While decision analysis using simulation techniques, risk analysis and scenario analysis are possible extensions, the analyst must blend the nature of the project to the complexity of the task and then consider the outcomes. Break-even analysis is a useful, yet simple technique to model the relationships of rental rates, vacancies and operating expenses in an easy to understand approach. Understanding these relationships is important because they are the key determinative factors that affect profitability.

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REAL ESTATE AND MORAL HAZARD

A look at real estate today and the truth about financial markets.

by Bowen H. "Buzz" McCoy, CRE

There is plenty of credit available and at attractive rates. It is just not available to real estate. This is true for several reasons, primarily because of the one to twelve year oversupply of commercial real estate, depending on product-type and location. The over-borrowing binge of the 1980s has created a hugh backup of short-term financed real estate assets held primarily by commercial banks and insurance companies. This classic mismatch of long-term assets financed on a five year, non-amortizing basis was created in the expectation that supply and demand of product would remain in balance and that credit would be available to refinance the debt as it came due. Neither assumption was accurate. As a result, loans are being called, and the value of much commercial property, because of wholesale liquidation, has plummeted to as low as $.40 on the dollar.

Despite the agony of the past three years, there remains close to $400 billion of short-funded real estate assets in the commercial banking and insurance systems. Much of this debt will come due in the next three years. Thus, it becomes simple to predict a credit crunch in commercial property lasting well beyond the midpoint of this decade.

Repercussions of poor lending practices have struck at the core of these financial institutions. Rating agencies such as Moody's and Standard and Poors have lowered the credit ratings of financial institutions having "excessive" real estate assets in their portfolios, creating serious funding problems for certain entities. Likewise, financial institutions wishing to issue equity securities to bolster their capital ratios have run afoul of security analysts who also take a dim view of "excessive" real estate holdings.

At a time of relatively low, short-term borrowing rates and relatively high, long-term Treasury rates, banks are enjoying historically wide earning margins by short funding and investing in "riskless" government securities. At the same time banks are avoiding the high costs of originating, underwriting, monitoring and defending to regulators and others any new real estate loans. The impact of this real estate credit allocation will resonate well beyond the current decade, much as debt aversion extended well beyond the 1929-1933 Depression.

On the margin, one may expect to obtain real estate finance from REITs and other public vehicles, securitization, wealthy individuals, foreign investors and certain pension funds. Nevertheless, without significant participation from commercial banks and insurance companies, real estate finance will remain severely constrained.

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Risk-Based Capital Rules

The late John M. Keynes coined the phrase "moral hazard" to describe unintended bad consequences of an otherwise positive act. One may trace the current over-borrowing and over-building of commercial real estate to the moral hazard from the misuse of funds raised by government insured deposits. Relatively inexpensive "riskless" capital was utilized to fund increasingly risky investments. The fact that the federal government guaranteed the deposits changed the demeanor of certain bankers from that of stewardship to that of imprudence. Compounding this was the federal government's lack of zealous regulation, the politicization of the regulatory process by certain members of Congress, and overall government policies which resulted in interest rates rising precipitously in the early 1980s, causing thrifts to choose increasingly risky projects.

The cure for the misuse of government insured deposits has been the implementation of risk-based capital rules for both banks and insurance companies. Putting it simply, banks are not required to have equity capital to invest in U.S. government securities and must hold about 8% as a capital reserve against commercial, industrial and real estate loans. These rules, whether applied by regulators or by the private sector arbitrators of capital access (rating agencies, security analysts, accountants, etc.) compound the trend of highly liquid banks loading up on government securities and going out of the commercial loan business. The moral hazard to risk-based capital rules is that, once again banks are short funding long-term assets. Just a whiff of inflation from the new Democratic government could flatten out the yield curve and create a banking crisis on a scale seldom before imagined.

Risk-based capital rules will stifle the current economic recovery, hinder the growth of small business and change the traditional temporal intermediation function of banks to being risk averse investment companies with deteriorating talent to underwrite loans and evaluate risk.

Mark-to Market Accounting

The accounting profession, the Securities and Exchange Commission, bank regulators, pension fund administrators and the credit rating agencies are united in proposing that financial institutions mark their assets (loans and investments) to market. At present, investment banks mark-to-market, while commercial banks and insurance companies do so only for publicly traded securities. Pension funds in particular are anxious to develop a basis for periodic market valuations of real estate assets in order to incorporate real estate into the capital asset pricing model and make real estate truly fungible with other financial assets. As laudable as the notion may be, it ignores the specificity and idiosyncratic nature of individual large commercial real estate projects. Moreover, any attempt to write all real estate assets to current liquidation value in a market severely lacking in both willing purchasers and willing sellers would threaten the stability of our financial system.

Public policy efforts should be focused on continuing to allow banks to hold real estate assets for future recovery while keeping short interest rates low, thus allowing the banks wider than customary margins to build reserves for future real estate write-offs. A multi-year solution to the real estate problem while prolonging the agony, will preserve the stability of our banking system.

It is ironic that, under the prevailing low, short-term interest rate structure, banks are now realizing larger profits on restructured, classified real estate loans than they did before when the loans were paying their contracted rate of interest.

Valuation Terminology

Another form of moral hazard in the current environment is the degeneration of appraisal terminology and methodology and of appraisers themselves. A typical scenario has a developer explaining his property to a bank in terms of a ten-year, hold-to-recovery and a *discounted investment value*, while the bank is examining the same property in terms of a three-to-five year-hold and a *current market value* and simultaneously the bank examiner is scrutinizing the same property in terms of immediate disposition and a *liquidation value*. All three parties argue with one another while utilizing terminology which the others do not comprehend. The property may, or may not, have an *intrinsic value*, but whatever that value is, it is impacted by the capital structure and holding power of its current owner.

This current cacophony of terminology is creating increasing dissatisfaction and confusion with the appraisal process. More and more individuals add to the confusion by attempting to clarify the issues. Kenneth Leventhal & Company suggests classifying real estate assets as follows:[1]

1. Quality assets with acceptable cash flows (given the weak economy) and some long-term potential. Such assets could be held or sold.
2. Assets that could be rehabilitated and converted to new uses and then either held or sold.
3. Problem assets that must be restructured, held until the economy and market improves and then sold.
4. "Trapped" assets that cannot be sold because they are in litigation or bankruptcy.

James R. Cooper of Georgia State University suggests these categories:[2]

1. *Investment Value:* An optimistic view of the value of a property if held in a financially stable, long-term portfolio and sold in the future in a stabilized market.
2. *Market Value:* The most probable price for cash that a property will bring if sold in a competitive and open market under all conditions requisite to a fair sale, both buyer and seller acting prudently with available financing and no undue stimulus.
3. *Current Value:* The most probable selling price under whatever conditions exist at the date of appraisal.

4. *Liquidation Value:* The price an owner is compelled to accept when the property sale is mandatory with less than reasonable market exposure; the lowest price that a democratic capitalistic system produces under conditions of market failure; a buyer dominated market.

The degeneration of appraisal terminology has been abetted by under-qualified government regulators requiring documentation which, at times, has been unnecessary and irrelevant. The confusing state of the market has been acknowledged by the Appraisal Institute. In June 1992, its special task force issued a report on value definitions. Yet The Counselors' own CRE and past president, James Gibbons, has stated "We do not need more definitions. We have enough; and they are well understood; the recent difficulties arose from inappropriate data inputs. Our major difficulty seems to be inadequate or faulty communication."[3]

Valuation Methodology

FIRREA and government regulations have forced wholesale appraisals of real estate loans and investments held by financial institutions. Real estate professionals are complaining more than ever about the inadequacy and irrelevancy of the appraisals they receive. Tens of millions of dollars are being spent on appraisals which have no use in business decisions and are mere window dressing for the files. As appraisals became de-linked from market clearing prices on the way up, they are likewise not reflective of either the market or the intentions of the real estate holder's assets on the way down. As Gibbons stated, there is a vast communication problem among the requirers, holders and makers of appraisals.

In the absence of comparable sales data or even a market for property, it seems an appraisal must more and more focus on the holding power and intentions of the holder of the asset. An appraisal must reflect the most likely pattern of the market recovery over the term of the established holding period. An appraisal also must incorporate a business plan for continuing investment, repositioning and marketing of the asset.

A final economic value may well be the calculated expected value of probable outcomes. Such a detailed economic model of a project would not be warranted for assets with a value of less than, say, $50 million. Such an appraisal would have a major impact on the holder of the asset's business decision.

Such an economic evaluation should provide lucrative employment for fellow CREs. As Counselors, we must be concerned with the devaluation of valuation methodology. Whether or not we also serve as appraisers, Counselors cannot afford to allow major capital pools, such as pension funds, to consider our industry as unprofessional and chaotic.

Data Collection And The CREs' Role

A major inhibiting feature of real estate as an investment asset category is the deterioration of a reliable database. Pension funds, in particular, will not return to the marketplace until they are convinced that a credible database exists for real estate.

In the current marketplace, there is no coherent basis for determining demand for space or for determining true economic (net effective) rents. Thus, there is no coherent basis for determining value. Contract rents are meaningless in the welter of kickbacks, side payments, free services and the like. Buildings are measured differently in different cities. Seemingly modern structures are technologically outmoded or riddled with asbestos.

A true moral hazard has been created in that many major institutional investors no longer trust real estate data. The current supply-demand situation will resolve itself temporally, as will the burden of past due and delinquent debt. The resonance from the lack of trust in real estate as an asset class will last longer. Here is where CREs can add clarity and professionalism to the process as advisors to financial institutions and by convincing clients that their long-run interests are best served by sharing and opening up their databases, heretofore deemed proprietary.

NOTES

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MILITARY BASE CLOSINGS: THRIFTY, OBJECTIVE SPENDTHRIFT PROCESS

It's time to take another look at the government's motivations behind military base closings.

by J. D. Timmons and R. A. Collinge

There is a curious anomaly in public policy toward military base closings. Bases are closed to reduce the federal budget deficit and increase economic efficiency.[1] However, the way in which surplus bases are given away to local governments prevents this from happening. It is as though the two policy objectives of reducing the Federal budget deficit and increasing economic efficiency are forgotten when the policy is put into effect.

This article brings together Department of Defense estimates of the value of surplus bases and economists' estimates of the marginal cost of taxation. Using the logic of optimal tax theory, a lower bound estimate is presented of the deadweight loss (also called excess burden) to the economy from not competitively auctioning the surplus bases. This deadweight loss also is compounded by the allocative inefficiencies when "free" bases are allocated to local governments.

While the information presented does not claim to estimate more than a rough lower bound of these costs, they do exist, and should be considered by the public. Using lower bound estimates of roughly $3 to $4 billion for the bases identified in this article, the magnitude of waste from the current practices can be quite significant.

Closing Process

The base structure of the Department of Defense (DoD) comprises over 5,500 properties with almost 27 million acres of land. These properties have an original investment cost of approximately $66 billion and a replacement cost of around $460 billion.[2] The properties range in size from unmanned navigational aid stations of less than an acre, to enormous bases such as the naval station at Norfolk, Virginia with over 60,000 employees and Nellis Air Force Base in Nevada with over 3 million acres (roughly four times the size of Rhode Island). Table 1 summarizes these aggregates.

In 1988, a 12-member Defense Secretary's Commission on Base Realignment and Closure recommended that the Pentagon close 86 bases, 13 of which were considered major bases. Another five were slated for partial closure, and 54 were recommended for realignments of personnel being added or subtracted.[3] The closings and reductions, intended to save the Pentagon $5.6 billion, began in January 1990 and are scheduled for completion by the mid-1990s. Of the major installations picked for closing, Pease Air Force Base, Newington, New

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TABLE 1

Department of Defense Real Property Summary—September 30, 1987

Military Departments	United States	U.S. Territories and Possessions	Foreign Areas	DoD Total
Number of Properties				
Army	1,250	15	977	2,242
Navy*	504	18	63	585
Air Force	2,027	24	661	2,771
Total	3,781	57	1,701	5,598
Acreage (Millions of Acres)				
Army	11.619	.017	.462	12.098
Navy	3.635	.082	.245	3.962
Air Force	9.157	.026	1.743	10.926
Total	24.411	.125	2.450	26.986

*Note: Navy figures include Marine Corps.

Hampshire., was the first to actually cease operation, and this did not happen until April 1, 1991.

The pace of base closings has not moved very rapidly due to time-consuming logistical details and foot-dragging related to political sensitivities. Historically, when closed bases have been acquired at minimal cost by local governments or private business, they are converted to office and industrial parks or used to house educational institutions (primarily vocational-technical schools or community colleges). Many of the air bases have become municipal or general aviation airports.

In April 1991, U.S. Defense Secretary Dick Cheney issued a revised list of 31 U.S. bases targeted for closing. This list included such well-known posts as Fort Ord in California, Fort Dix in New Jersey and the Philadelphia Naval Shipyard in Pennsylvania. (See Table 2 for listing.) Cheney also suggested closing 12 minor installations and reducing or transferring forces at 28 other sites.

The secretary's suggestions went to an independent, eight-member panel empowered to add or subtract sites from the list. When the panel completed its work, the list went to the President, who could only choose between rejecting or accepting the list in its entirety. The President accepted the list as did Congress. The Department of Defense published another list of bases destined for closure or realignment in March of 1993. By June, the President has to accept or reject that list as the process continues of down-sizing the military.

Following presidential and congressional approval of the bases to be closed, several steps remain before the properties are available for non-military use. Base-closing legislation requires that military property first must be offered to other Department of Defense organizations, with highest preference given to the body willing to pay so called "fair market value", as determined by the use of the property or facility on December 31, 1988. However, because opportunity costs are ignored, the DoD's idea of fair market value is not consistent with an economist's or real estate appraiser's idea of fair market value. After offering the site to a DoD group, the DoD secretary then must consult with the governors of each of the states affected and with their respective state and local government heads before making other arrangements to dispose of the property.[4] Normally the properties are sold for a nominal amount to the state or local governments; in effect, the properties are given away.

It is quite likely that thousands of acres—some in very attractive locations—will be transferred to state and local governments for a small fraction of their opportunity costs. Many military installations are located in or near some of the country's most valuable commercial properties. To sell that land based on the value of its use in 1988 is not consistent with the base closing motivations of economic efficiency and deficit reduction. A good example of a property that is cited for closing is the Presidio, a base nestled within Golden Gate Park in San Francisco. Under a 1972 law, when the Presidio is closed it must be sold to the Interior Department and become part of the Golden Gate National Recreation Area. No doubt the addition of 1,416 acres will enhance the park, but there also will be monumental opportunity costs foregone in terms of development. This acreage is quite likely some of the most valuable urban property in the United States. Stephen Roulac, a noted real estate analyst, estimates the Presidio value as raw land is approximately $1 billion, assuming it was developed as condominiums or as a mixed-use luxury project.[5] Even if the recreational value of this land constitutes "highest and best use," it is not clear that all the land is needed for that purpose. By not requiring the Interior

TABLE 2

Selected Bases Scheduled For Closing

Army	Acreage
Fort Sheridan, Highland Park, IL	695
Fort Ord, Seaside, CA	28,016
Fort Benjamin Harrison, Indianapolis, IN	2,501
Fort Devens, Ayer, MA	10,572
Presidio of San Francisco, San Francisco, CA	1,416
Kapaloma Military Reservation, Hawaii, HI	87
Sacramento Army Depot, Sacramento, CA	485
TOTAL	43,772

Navy	Acreage
Philadelphia Naval Shipyard, Philadelphia, PA	904
Philadelphia Naval Station, Philadelphia, PA	522
Naval Weapons Station, Yorktown, VA	10,624
Naval Construction Battalion Center, Davisville, RI	900
Naval Air Station–Chase Field, Beeville, TX	9,633
Puget Sound Naval Station, Seattle, WA	271
TOTAL	22,854

Marine Corps	Acreage
Tustin Air Station, El Toro, CA	1,709
TOTAL	1,709

Air Force	Acreage
Eaker AFB, Blytheville, AR	3,915
Lowry AFB, Denver, CO	5,527
Grissom AFB, Peru, IN	3,180
Wurtsmith AFB, Oscoda, MI	5,223
Williams AFB, Chandler, AZ	4,762
Castle AFB, Merced, CA	3,257
England AFB, Alexandria, LA	28,614
Loring AFB, Limestone, ME	11,116
Richards-Gebauer ARS, Belton MO	2,629
Rickenbacker AGB, Lockbourne, OH	2,327
Myrtle Beach AFB, Myrtle Beach, SC	3,998
Carswell AFB, Fort Worth, TX	3,426
Bergstrom AFB, Austin, TX	3,972
TOTAL	81,946
GRAND TOTAL	150,281

Department to pay opportunity costs for the land, there is no safeguard to insure that an efficient allocation will occur.

Other bases scheduled for closing also contain property that would be quite valuable if developed for alternative commercial uses. A few examples include:

- Fort Ord, California, 28,000 acres, located on the Pacific Ocean, Monterey Peninsula;
- Philadelphia Naval Base, 1,426 acres on the waterfront, where the Schuylkill and Delaware Rivers meet;
- Fort Devens, Massachusetts, 10,572 acres, located about 30 miles west of Boston with rolling green hills and two lakes;
- Fort Sheridan, Illinois, approximately 695 acres, located just north of Chicago on the shores of Lake Michigan;
- Naval Construction Battalion Center, Davisville, Rhode Island, 900 acres, located on Narragensett Bay about 21 miles south of Providence.

The bases listed in Table 2 represent a diverse group of sites with regard to size, improvement and location. Each property has unique characteristics for several types of non-military use. The only accurate way to know the aggregate value of these properties is to place them on the market and offer them to the highest bidder. A proxy of the property values might also be determined by allowing professional real estate appraisers to conduct "highest and best use analysis" on the sites. Neither of these procedures are currently utilized by the Pentagon when disposing of obsolete bases. Nevertheless, it is possible to arrive at a lower bound estimate for the revenue potential the federal government could realize through competitive auction of these bases.

In 1989, the DoD valued its 27-million acres of base installations and improvements at a replacement price of $460 billion.[6] This suggests that, in the aggregate, the value per acre is $17,037. Obviously this is a very crude technique for placing a value on any given acre of property. However, using this figure, the estimated value of the 150,281 acres contained in those bases scheduled for sale would be $2.56 billion. Since the idea behind base closings is that the land is worth more if used otherwise, this $2.56 billion is viewed as a lower bound for subsequent analysis. Casual empiricism suggests the true value to be much higher.

Application of Optimal Tax Theory

Since the mid-1970s, various authors have attempted to estimate the marginal tax burden on the U.S. economy. The idea is that incremental dollars of tax or borrowing revenues involve disincentives for work and investment in addition to transferring those dollars from the taxpayer to the government. Per dollar of revenue at the margin, this excess burden has been estimated recently at between $.05 to $.50,[7] although other estimates range higher.[8] Thus, when the marginal excess burden of additional revenues is coupled with the $2.56 billion figure already suggested, the federal government forgoes $2.94 to $3.84 billion of revenue when it gives away obsolete military bases.

Another source of inefficiency in the process concerns the efficiency with which the former bases are allocated to other uses. If we assume a lack of externalities, a standard model of competitive markets predicts that the sale of the land to the highest bidder would result not only in the highest revenues to the government, but also in allocation of the land to its highest valued use. The reason for this is simple: the bidder envisioning such an allocation has the most to gain from acquiring the land and, therefore, is willing to submit the highest bid.

Unfortunately, when the federal government forgoes the option to sell the land in favor of the option to give the land to local governments, the presumption of efficient allocation no longer prevails. In principle, an equivalent result would occur if the local governments turned around and sold that land, using the resulting revenues to replace other revenues raised from less efficient sources. In practice, however, the story is likely to be quite different. To start, there is the "flypaper effect,"[9] based on the empirically validated proposition that money tends to "stick where it hits." In this case, were the bases to be sold, the proceeds would not return to the taxpayer but would rather expand the size of government. Since voters have yet to choose this option, this expansion can be presumed inefficient.

Just because the federal government chooses to divest itself of the land does not mean that local governments will follow suit. It is more likely that local politics would preclude sale of some of the land, and preclude sale of the balance to the highest bidder. Interest groups or the well-connected may have their own ideas about using former bases. In this case, the inefficiency of the federal government forgoing a revenue source is compounded on the local level by their inefficiency in use of the former site. While there is little opportunity empirically to estimate this effect since it depends on local political choice, it certainly adds to the estimated costs.

Figure 1

Value of Excess Bases

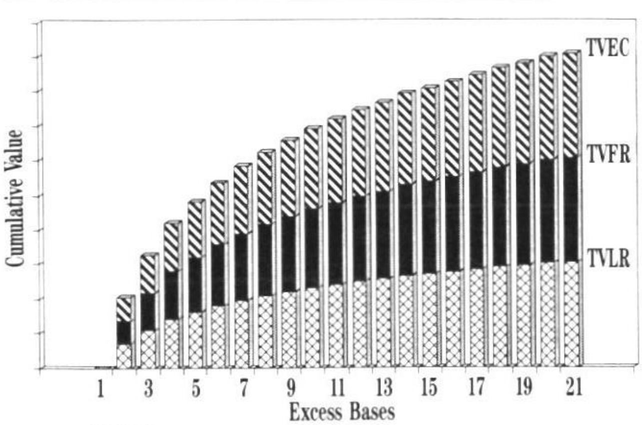

Figure 1 uses a simple cumulative function to convey the idea of selling bases in order of the most valuable to the least valuable. If the federal government auctions the bases in this order to the highest bidders, it obtains the revenue schedule of "TVFR," or total value to the federal government of the revenues it would receive. "TVEC," referring to the total value to the economy, adds to TVFR the savings in excess burden from forgoing additional taxation or borrowing.

Symbolically,

TVEC = $(1 + \Theta) *$ TVFR, where Θ refers to the marginal excess burden of federal revenues.

A value for Θ of 50% was used since, even though this may be at the upper end of the plausible scale, we are not including any cost of inefficient land use that could result if the auction process is not used. "TVLR" is the value of revenues received by local governments if the land is given to them. This is arbitrarily assumed to be one-half of "TVFR." While that may not be the exact fraction, we know that even if local governments were to auction off all the property, they would match but not exceed "TVFR." In reality, much property can be expected either to remain in the public sector or transferred to private interests at less than full market value. Consequently, while Figure 1 does not purport to provide a precise empirical estimate, it does convey some possible orders of magnitude that can be expected to occur.

Perhaps the most striking aspect of Figure 1 is the tremendous opportunity for efficiency gains if military bases are auctioned rather than given away. Localities would cumulatively value the bases in an amount equal to the crosshatched vertical distance, as illustrated in Figure 1, plus any use value of lands retained in the public sector. The opportunity cost to the nation's economy would equal that crosshatched area plus the solid and diagonally striped areas, for an order of magnitude triple the value to the localities. Thus, the cost of buying local acceptance of base closings through land giveaways comes at a cost of roughly triple the value received by the localities.

Indeed, the addition of the property to the local tax rolls increases the local tax base. If this increase is not offset by local services expected by the prospective property owners, it will result in a lowering of the revenue potential to the federal government and an increase to the localities of revenues net of costs. Localities may also gain in other ways from base closings by enacting zoning and land use restrictions over the property previously denied by federal jurisdiction.

Localities face both pluses and minuses from base closings.[10] According to a study conducted in early 1990 by the Pentagon's Office of Economic Adjustment, most communities losing bases have little to fear even when the bases close.[11] Regarding the 100 base closings over the past 30 years, the initial short-term economic pain ordinarily was offset by positive long-term economic adjustments. Thus, even if we accept that reparation to local residents is a valid political objective, the magnitude of reparations required to achieve this objective is likely to be insignificant relative to the potential economic gain from base auctions.

Conclusion

This article highlighted the inconsistencies in the public policy toward "disposing" of surplus military bases. Specifically, the objectives are federal budget deficit reductions and economic efficiency. However, these objectives are abandoned when bases are effectively given away to placate local communities. Existing information was presented on the bases involved and theoretical results pertaining to the marginal efficiency of taxation to arrive at a rough order of magnitude for the revenue losses and efficiency costs associated with this policy. The order of magnitude is quite large, equalling one-tenth of one percent of America's gross domestic product for the prospective base closings selected in this study. Adding additional base closings and the disposition of other bases already closed would increase this already substantial amount.

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THE IMPACT OF PUBLIC HOUSING: A NEW PERSPECTIVE

Scattered site public housing does not reduce property values in surrounding neighborhoods, and it may increase values by improving abandoned or neglected structures in inner city areas.

by Mittie Olion Chandler, Virginia O. Benson and Richard Klein

This article examines how the use of existing structures for public housing affects surrounding residential property values. The Cuyahoga Metropolitan Housing Authority (CMHA) in Cleveland, Ohio, has, for several years, administered the Acquisition Housing Program (AHP), which uses, as public housing units, existing houses in neighborhoods dispersed throughout the city. This scattered site approach is considered a preferable alternative to conventional public housing developments that concentrate low-income and usually minority households in the poorest city neighborhoods.

Since the late 1960s, government policy-makers have favored dispersed public housing locations rather than concentrated, high-density developments. For example, high-rise structures associated with such ignoble developments as Pruitt-Igoe in St. Louis (which fell to the wrecking ball 20 years after being built) now are deemed unsuitable for family housing.

Some previous research has focused on the resistance that the location of public housing encounters from private home owners.[1] Opposition here stems from the belief that property values will decline once public housing is placed in their neighborhoods. In spite of considerable research contradicting this assumption, resistance to the placement of public housing has not abated.

Research findings regarding the impact of subsidized housing on surrounding neighborhoods have been mixed.[2] In all cases, property value changes in public housing neighborhoods either were consistent with control (non-public housing) neighborhoods or slightly to moderately higher when compared to control neighborhoods. Data indicating a negligible negative effect of public housing on property values also reveal that having some public housing (less than 9.3% of all existing housing) was associated with higher property values.[3]

Investigations of other subsidized housing programs, such as Section 8, Section 23, Section 236 and Section 221(d)(3), similarly found that the location of federally assisted housing did not produce differences in home sale prices in test and control

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neighborhoods. The research reported a slight positive impact in some cases.[4]

None of the foregoing studies, however, considered the impact of dispersed public housing on surrounding properties. This article expands upon the existing research, which concentrates on multifamily developments, by assessing the impact of one- or two-family scattered site housing units. The article reports on research that compared market transfer prices of surrounding properties before and after the acquisition of neighboring older homes by the public housing authority. The subject cases were 12 census tracts in Cleveland that fell within eight larger urban planning districts called strategic planning areas (SPAs).

The Cleveland Housing Market

During the 1980s, the city of Cleveland underwent considerable reinvestment in its downtown area. However, its neighborhoods continued to lose population to the suburbs. Efforts to revitalize city neighborhoods and to provide new housing had minimal results. Although suburbanization has been a feature of most American cities, Cleveland's population loss was intensified by public perceptions that the quality of the public schools had declined, crime had increased, public services were inadequate and local banks were not interested in making loans for new housing construction in inner city neighborhoods.

According to the *1988 Sellers of Single-Family Homes Report*,[5] more than twice as many households were leaving Cleveland as were moving in. For every household moving into the city, 2.2 households moved out. The report indicated that outward movement occurred in all neighborhoods and that the city had not been able to retain residents because of dissatisfaction with schools, security and neighborhood conditions.

Cleveland's Cuyahoga River traditionally has been the dividing line between the east side and the west side of the city. Population of the east side is predominantly black; the west side is predominantly white. Most eastsiders who relocated to the suburbs in the 1970s and 1980s moved to Cleveland's eastern suburbs, while west side white ethnic groups migrated to western suburbs. Many of the remaining residents of the city were fixed-income elderly people. Until the late 1980s, no new housing had been constructed in Cleveland for 50 years. Some new household formation currently is taking place in spite of the paucity of new housing.

Since the above-mentioned factors affected the city as a whole, the researchers assumed that their impact on the specific neighborhoods in this study would be fairly comparable. Also, although the neighborhoods in the study had some differences, they were similar in most characteristics that influence property values, such as age of housing, income of residents, level of home ownership, vacancy rates and general maintenance of individual properties.

Public Housing Location And Site Selection

Public housing in Cleveland began in 1937 when units were built on inner-city land that had been cleared of slum housing. Initially, public housing developments were racially homogeneous, in keeping with the tenor of the times and federal policy. Legislative changes in the 1960s prohibited racial segregation in public housing. During the 1960s and 1970s, however, regulatory amendments that required non-poor families to move out of public housing units and population outmigration turned public housing units into the habitat of low-income, predominantly black households with limited options elsewhere. By 1971, the cumulative effects of public housing site selection decisions were evident in Cleveland. The sites chosen for public housing were clustered in areas where little or no resistance to their construction had been encountered. In 1971, therefore, CMHA operated 10,588 units concentrated on the east side of Cleveland. In contrast, little public housing had been built on the west side.

Today, 70% of public housing in the city remains concentrated on the east side. Forty years of site selection decisions are virtually impossible to reverse; however, federal court rulings currently prevent CMHA from introducing new public housing in the same neighborhoods.

The Acquisition Housing Program

A 1982 Federal District Court order governs the placement of housing by CMHA. The order prohibits the placement of additional dwelling units in areas with already high concentrations of public housing. Areas of the city have been grouped into three categories: those where CMHA is enjoined from obtaining any new units (prohibited areas); those where CMHA is enjoined from obtaining more than one-third of its new housing units and more than 25 new units in any one area (restricted areas); and those where CMHA is enjoined from obtaining less than two-thirds of its new housing units (targeted areas).

The district court order requires CMHA to implement an affirmative marketing plan to encourage and promote the integration of CMHA's new and old housing units. It further directs CMHA to use future development monies received from the U.S. Department of Housing and Urban Development (HUD) to develop housing in all areas of its metropolitan housing district, both within and outside the city of Cleveland.

AHP is intended to promote the dispersion of public housing and socioeconomic integration for its residents. AHP's design carries out the district court order in the selection of sites; it places two-thirds of the one- and two-family structures in targeted areas and one-third in restricted areas.

Between 1984 and 1985, AHP acquired and repaired 156 units at a cost of $58,000 per unit. The cost of rehabilitation alone averaged $26,000. Many of the structures were vacant prior to their purchase by CMHA; most were located in middle income areas on the west side of Cleveland.

In previous research concerning the effects of Cleveland's AHP program, Chandler found that less than 30% of the neighbors were aware of the AHP property in their neighborhood.[6] Owners were not likely to react negatively to the proximity of public housing if they were unaware of its presence.

The following additional observations were made by the researchers regarding AHP properties:

1. Public housing units were indistinguishable from other homes in the neighborhoods. Hence, the change in neighbor behavior was expected to be lower than the change in behavior resulting from the intrusion of new, different and incompatible buildings.
2. Some units were vacant prior to CMHA acquisition and renovation; improvements in the properties may have had a positive impact on the neighborhood's confidence level and property values.
3. By design, public housing units comprised a small percentage of structures in any one neighborhood. The dispersed placement was expected to reduce possible negative reactions to public housing among neighbors.

The AHP communities differed from neighborhoods in which conventional public housing was located. In the AHP areas, home ownership, median income and property values were somewhat higher, while poverty rates were lower.

Research Design

In order to assess the impact of AHP scattered site housing on property values in the city of Cleveland, 12 census tracts were chosen with the highest concentrations of AHP units. Standardized measures of these residential parcel transfers were compared at census tract level and at the larger SPA level. (SPAs contain several census tracts that have been aggregated by local planning officials based on their similarity and congruity.) The 12 subject tracts were located within eight of these SPAs.

Computerized sales and property tax data for triennial assessment periods (1981, 1984 and 1987), which track individual transfers in these areas, were provided by the Housing Policy Research Program at Cleveland State University's Urban Center. The benefits of using such parcel level data in urban research were enumerated by David Prosperi.[7]

The comparison employed the price to market value ratio (MVR), a measure used by Benson and Klein in published studies of the impacts of historic districting and nursing home location on property values.[6] The MVR was used to standardize the property value data, and it represented the relationship between the tax assessor's value (adjusted for the fact that the property is assessed at 35% of its value in Cuyahoga County) and the actual transfer price upon sale. An MVR greater than one indicated that the transfer price was greater than the assessor's expectations; an MVR less than one indicated the transfer price was less than expected.

Researchers controlled for the more general factors that correspond to the housing market by comparing the MVR from the study tracts with the MVR of the contiguous SPA, the east/west bisection and the city as a whole as an aggregate measure of market conditions (see Table 1). They expected this comparison to detect any localized nuances of the housing market, e.g., sales activity, high-risk lending and other lending activity.

Findings

Table 1 shows the mean market value ratios of the tracts and the SPAs that contain them before and after AHP acquired units in the tracts. In most cases, the change in the mean MVR was negligible for both the tracts and the SPAs. (A decline in the mean MVR during the period is reflected by a negative sign.)

SPA Results. Half of the eight SPAs showed decreases in value prior to AHP acquisitions. After AHP units were in place, seven SPAs had increased mean MVRs, and MVRs had declined in four of these seven SPAs in the previous period.

Tract Results. Eight of the 12 tracts exhibited drops in MVRs during the period before AHP acquisition. After AHP acquisition, eight tracts showed increased mean MVRs. In six of the eight cases, the areas had decreased MVRs in the earlier period. In three instances, the mean MVRs dropped, but in only one of these cases was the decrease significant, revealing a reversal in direction over the previous period. This is the only documented case of a negative effect from AHP acquisition on its neighborhood. In one case, there was no change.

In 11 of the 12 cases, observed trends indicated that the program did not have a detrimental effect.

Conclusions

The findings of this study revealed no measurable adverse effect by placing scattered site housing units in the areas studied; the changes in property values followed the same pattern in the SPAs and the AHP census tracts. The findings therefore suggested that fears of local property owners were unwarranted.

If the scattered site housing units were truly detrimental to the tracts in question, negative effects would have been evident when the change in the MVR of the smaller tract was compared against the change in MVR of the larger SPA. Those differences would have been even greater between 1984 and 1987 as the impact of such housing development was being felt in the neighborhood. The data indicated this was not the case. In fact, the MVR increase in six census tracts was greater than that of their SPAs in 1987; the differences in MVR in other SPAs and tracts were negligible. These results suggested that scattered site housing actually may have improved the marketability of some neighborhoods after 1984.

In summary, the researchers found that the location of scattered site public housing units did not have a demonstrable negative impact upon housing values in their neighborhoods. The use of existing

TABLE 1

Changes in SPA/Tract Mean Market Value Ratios (MVR)

	Mean MVR 1981	Mean MVR 1984	MVR Change 1981-84	Mean MVR 1987	MVR Change 1984-87
SPA 1	1.24	1.36	0.12	1.30	–0.06
Tract 1a	1.17	1.08	–0.09	1.15	0.07
SPA 2	1.17	1.19	0.02	1.32	0.13
Tract 2a	1.23	1.17	–0.06	1.40	0.23
SPA 3	1.12	1.21	0.09	1.41	0.20
Tract 3a	0.53	1.09	0.56	1.30	0.21
Tract 3b	1.00	1.15	0.15	1.16	0.01
East Side	1.25	1.14	–0.11	1.30	0.16
SPA 4	1.11	1.02	–0.09	1.03	0.01
Tract 4a	1.19	1.06	–0.13	1.06	0.00
Tract 4b	1.10	0.86	–0.24	0.95	0.09
SPA5	1.12	0.99	–0.13	1.05	0.06
Tract 5a	1.17	1.24	0.07	0.92	–0.32
Tract 5b	1.41	0.96	–0.45	1.07	0.11
SPA 6	1.07	1.11	0.04	1.14	0.03
Tract 6a	1.01	0.93	–0.08	1.07	0.14
SPA 7	1.13	1.06	–0.07	1.11	0.05
Tract 7a	1.07	1.05	–0.02	1.09	0.04
SPA 8	1.05	1.03	–0.02	1.06	0.03
Tract 8a	1.08	1.07	–0.01	1.03	–0.04
Tract 8b	0.99	1.01	0.02	0.99	–0.02
West Side	1.00	1.05	–0.06	1.09	0.04
Citywide	1.18	1.11	–0.07	1.13	0.02

structures reduced the adverse reaction that neighboring residents might have had to public housing of the conventional, institutional style. Scattered placement of the public housing units also reduced the possibility that concentrations of such units would pose problems in a community and create tensions between the residents and their neighbors. AHP structures (and their occupants) produced the optimal consequence: their presence in the communities went largely unnoticed and had no negative reaction in the housing market.

Sales activity did not increase appreciably after AHP units were introduced which indicated their was no "backlash effect." This finding, in particular, has important implications for local home owners and investors in the central city residential market. It should allay concerns about the possible loss of value in inner-city neighborhoods and, in fact, support the view that neighborhood property values may improve as a consequence of the acquisition and rehabilitation of existing residences by public housing authorities.

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A CASE FOR MARK-TO-MARKET RESIDENTIAL MORTGAGES

The residential mortgage market is taking a second look at mortgage pass-through securities.

by Robert J. Hartl

The residential mortgage market has expanded tremendously over the last decade-and-a-half. Although the market's annual growth rate has slowed recently, it still equals or exceeds that of any other major debt market over the past 15 years, including U.S. Treasuries. Without question, a major contributing factor for this phenomenal growth is the advent of Mortgage Backed Securities (MBS).

Also referred to as mortgage pass-through securities, the value of these instruments has increased at a much faster rate than even the overall residential mortgage market. From a bare 2.8% of outstanding residential mortgages in 1975, MBSs now account for about 42% of the overall market.[1] While MBSs have contributed to the residential mortgage market in many ways, their primary contribution to housing finance has been to turn a localized financial marketplace into a national credit market. The improvement in liquidity and market exposure has resulted in lower mortgage rates and a more efficient allocation of financial resources than otherwise would have been possible.

The development of the MBS market has not been a bed of roses. It has progressed because of agencies such as the Government National Mortgage Association, a few creative underwriters and many courageous mortgage lending institutions. Nevertheless, this market is not without problems, primarily in the prepayment risk facing investors in fixed rate MBS. While not unlike mortgage prepayment risk in general, MBS prepayment risk has received much publicity in recent years.

Mortgage Prepayment Risk

Investors in mortgages and mortgage back securities are forever in doubt on the timing and size of their cash inflows. Timing uncertainty is due to a number of factors. As market rates fall, large numbers of homeowners move aggressively to refinance their mortgages in an attempt to trim monthly payments. Others who are unable to refinance at the lower rate still make accelerated payments with funds taken from current income and/or the current lower yielding savings accounts. The extent of the prepayment movement depends on interest rate expectations, the shape of the yield curve and even the work load at mortgage lending institutions. Nevertheless, one expects to see a noticeable increase in mortgage prepayment activity when interest rates are falling.

The vagaries of turnover in the used housing market also plays havoc with the timing of mortgage prepayments. This would not be a problem if borrowers were required to maintain their loans

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after the property is sold. However, this seldom is the case. The fact that housing turnover often coincides with falling interest rates tends to magnify the prepayment problem. Accordingly, MBS investors are holders of variable maturity instruments and all the associated problems of reinvestment decision, transaction costs and income taxes.

To make timing matters worse, there is the issue of cash flow size to consider. Simply put, residential home mortgage borrowers universally are obligated for the book values of their loans in the event of prepayment. Unlike corporate debt instruments, mortgages are not burdened with prepayment penalties, i.e., call. This is quite problematical for mortgage investors during periods of falling market interest rates.

When interest rates are low, the market values of outstanding fixed income securities should rise to their discounted cash flow equivalents unless they are callable at a lower price. Such is the case with home mortgages whose prices are restricted on the upside by their book value prepayment provisions. As book value-based cash flows rise, the investor's yield falls. Unfortunately, investors seldom are able to profit during periods of rising interest rates, because most mortgagees find it in their best interests to decelerate prepayment activity. This one-way street is a potential source of trouble to MBS investors and a valuable call option for borrowers. Efforts have been made to correct the prepayment risk problem, most notably by collateralized mortgage obligations. However, the collateralized mortgage obligation medicine has not been able to cure the prepayment disease.[2]

There are two interest rates critical to investors in fixed rate mortgage securities: term yield and call yield. The term yield is the compound rate of interest that equates all scheduled installment payments to the purchase price of a mortgage or mortgage security. This is the promised rate of return and the figure used by investors when making investment decisions concerning fixed income securities. It is expressed mathematically as:

$$P = \frac{I}{(1+Y_t)^1} + \frac{I}{(1+Y_t)^2} + \ldots\ldots + \frac{I}{(1+Y_t)^n}$$

Where: P = purchase price of mortgage security

I = periodic installment payment

n = time remaining to maturity

Y_t = term yield

The call yield takes into account mortgage prepayment. The term yield differs from the call yield in that the latter is influenced by the prepayment amount (i.e., call price) and reinvestment of same in replacement mortgages. The call yield formula is written as follows:

$$P = \frac{I}{(1+Y_c)^1} + \frac{I}{(1+Y_c)^2} + \ldots\ldots + \frac{\dfrac{C - \dfrac{C}{(1+r)^{n-m}}}{r}}{(1+Y_c)^m} + \ldots\ldots + \frac{\dfrac{C - \dfrac{C}{(1+r)^{n-m}}}{r}}{(1+Y_c)^n}$$

Where: Y_c = call yield

m = prepayment period

C = call price

r = reinvestment rate

As the call yield formula indicates, an investor's realized rate of return is determined by the call price (C) and reinvestment rate (r). At call prices equal to market value and subsequent reinvestment at market rates, a call yield can be produced that is equal to term yield. At any payoff price below market value, mortgage investors earn less than the term yield and vice versa. It follows that only a payoff at market value produces the all important term yield. As noted previously, however, all mortgage prepayment activity is done at book value call prices. While most MBS investors would like to earn the term yield, this is almost impossible to achieve with the way mortgage investments currently are structured.

Investors have two additional problems with prepayments: calls made at prices different from book values could generate unplanned taxable gains and losses; holders are forced into a reinvestment scenario along with its associated costs.

Mortgage prepayment at book value is no accident. The federal home lending authorities long ago required nationally chartered and/or insured lending institutions to structure residential mortgages with this provision. State regulatory bodies did likewise. As a consequence, the book value mortgage prepayment provision has become a standard feature. Thus, mortgagees have had the benefit of always knowing their payoff amount in the event a prepayment takes place. Furthermore, some borrowers have taken advantage of interest rate declines to the detriment of mortgage investors, while being subsidized by home owners who cannot avail themselves of this opportunity.

Investors And Mark-To-Market Mortgages

Mark-to-Market Mortgages (MMM) are residential home loans that are structured to be continuously and unfailingly payable at market determined values.[3] Mortgages designed with the mark-to-market feature and MBSs that are comprised of such mortgages are free from prepayment risk. They may not eliminate cash flow timing uncertainty, but they will completely correct for cash flow size problems. That is, there will be no threats to a mortgage investor's "term" yield due to early mortgage redemption. As one might expect, the benefits to MBS investors of MMM are not without costs. And, herein lies the appeal of such mortgages to loan customers. Investors must be prepared to accept lower interest rates on the underlying mortgages in exchange for the reduced prepayment risk. They are also forced to forego book value prepayments that are in excess of market values. The former sacrifice is clearly documented in the corporate bond literature.[4] As for the latter cost, one need only cite the numerous occasions when mortgage borrowers sell their homes in an environment of high interest rates.

Therefore, the benefits of MMM to mortgage investors are two-fold. The main advantage concerns the almost complete absence of a prepayment risk, at least in terms of the all-important cash flow size issue. A subsidiary advantage is the lower transaction costs as the frequency of prepayments decline due to a lack of incentive on the part of borrowers to prepay voluntarily. Mortgage investors can be expected to reward borrowers for these benefits.

Borrower And Mark-To Market Mortgages

At least three individual groups of residential borrowers could benefit from MMM: permanent home buyers, interest rate speculators and payment sensitive borrowers.

Permanent home owners are defined here as those families who plan to live in a particular home for many years, conceivably up to and beyond the maturity of the mortgage. These individuals foresee little likelihood of forced mortgage prepayment since they have no plans to sell the house. Many have little hope for falling interest rates that would lead to refinancing. Among this group of borrowers many would be willing, if given the choice, to accept a reduced fixed interest rate in exchange for a mark-to-market clause in their loans. They would do this because the rate discount is more than adequate to offset the greater interest rate risk exposure.[5] It is difficult to even approximate how large the rate discount might be under these circumstances, given the paucity of empirical research in this area. However, in all probability, the savings are likely to prove considerable once mortgage investors are allowed to compete for these loans. A 1% point reduction, for example, on an 11% - $100,000 - 20-year mortgage would produce a monthly savings of $67.16.

The second group of borrowers to benefit from the MMM are interest rate speculators. Although admittedly a small segment of the home buying market, these adventuresome individuals seek to capitalize on what they perceive to be a low interest rate environment. By taking out fixed rate, long-term mortgages, they hope to gain from rising market rates. The gain would show up as an increase in market determined net worth. Whether this is a financial strategy that individuals should embark upon is not clear. The fact remains, however, that a truly free financial market should provide this possibility.

The final group of interested parties consists of payment sensitive borrowers. A commonly held, though seldom tested, hypothesis states that many, if not most, consumer borrowers focus on monthly payments as opposed to interest rates. Such people are cash flow-oriented rather than net worth-oriented. If this is true, then a further case is made for MMM. Simply stated, MMM permits a payment sensitive home buyer the luxury of knowing that his monthly loan payments will not be affected by interest rate movements no matter how many changes of residence occur over time. Take, for example, the case of a person who purchased a home for $100,000 in 1985 under the following terms: zero down payment, 25-year maturity, 10% interest rate and a monthly payment of $908.71. Let's assume that the home is sold in 1990 for $100,000 at a time when equivalent market rates are 12%. The MMM payoff would amount to $82,528 (as opposed to a book value of $94,167). Should this individual acquire a replacement home for $100,000, the original monthly payment does not have to change. By combining the $17,472 equity from the old home sale ($100,000-$82,528) with a new 12%, 20-year mortgage of $82,528, the monthly payment can remain at $908.17. Thus, even though the cost of the financing is greater for the second home, this individual's monthly payments are unaltered. Should market rates become lower in 1990, the financial situation may be reversed, but the results would be the same (i.e., an inflated loan is exactly offset by a lower interest rate).[6]

Conclusion

An elimination of the prepayment privilege is not being called for here. Nor does the author want to see all residential mortgages structured with a mark-to-market feature. The goal simply is to free-up mortgage lenders so they voluntarily offer MMM to their customers along with the standard mortgage.

NOTES

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COUNSELORS' PERSPECTIVES

Some Personal Career Reflections

by John R. White, CRE

In 1946 I started working in investment real estate, so this is my 47th active year in the business. I must say that life was simpler and less complicated in those days. There was little or no inflation. Rent barely inched ahead and vacancies were low. There were never any headlines about credit crunches or oversupply. Residential rent control was accepted as essential to provide housing at affordable rents. It would have been inconceivable to think that in 1993 it would still be in effect in New York City. The 1946-1960 Truman-Eisenhower Era was one of economic and price tranquility. Real estate values were rock solid and not yet characterized by the surging appreciation which followed.

Property sold for an 8% free and clear return. Mortgage money for new construction was easily available for 75% of the appraised value at 6% interest. We could easily afford to pay 2% annual amortization and still earn 8% and twice as much on our actual cash investment. Balance sheets were real and not inflated with wildly optimistic estimates of real estate market value.

Career Track

I started as a rent collector and division manager for a Bronx real estate company owned by my father-in-law who had built many five-and-six story walk-ups. The lure of Manhattan, however, proved irresistible. After a year of really grass roots management work, I became an appraisal assistant and occasional broker with Byrne, Bowman & Forshay. I stayed there for eight years. For the following nine years I was with Brown, Harris, Stevens, Inc. I started its counseling services department and became a director of the company as well as a CRE (Counselor of Real Estate). The major move of my life was in 1963 when I became associated with CREs Jim Landauer and Peter Haeffner at Landauer Associates. I remained with Landauer for 27 years, eventually serving as its president, chairman and chief executive officer.

Real Estate In The 1960s

Looking back, it was really not until the early 1960s that as realtors we became more sensitive to the economic base of the city, the national economy and those underlying conditions which affect rents and prices. My first memory of a significant office oversupply was in 1963 when the Pan Am Building, with its 2.5 million square feet of space, was completed. The industry built about 6.5 million square feet that year, a record for Manhattan, and it was not absorbed easily. Rents in prime midtown locations, in a softened market, were between $8 and $10 a square foot. Those same original 20-year leases in the Pan Am Building were renewed in 1982-1983 for up to $40 a square foot!

Two other significant events occurred during the 1960s. First, the transitory weakness in the office market was accompanied by the beginning of an intensive decentralization movement out of Manhattan. I recall General Foods moving to White Plains and CB Laboratories moving to Stamford. Many other companies bought land in anticipation of an ultimate move. It was our first realization that not all Fortune 500 companies would remain firmly entrenched in Manhattan. Decentralization flourished thereafter, as dozens of companies eventually moved in the 1960s and 1970s to Greenwich, Stamford and elsewhere.

The second profound event of the 1960s was the sharp increase in inflation. The change from price stability to aggravated inflation resulted from the way President Johnson chose to finance the extraordinary cost of the Vietnam War, by borrowing rather than taxing. This sad and painful conflict provoked increasing budget deficits and was primarily responsible for a more volatile economy with higher real estate rents and prices and, ultimately, higher risks of ownership.

The inflation rate had been under 2% for most of the period from 1946-1965. It simply was not a factor in investments. However, between 1965 and 1970 the inflation rate skyrocketed to 6%. A roller-coaster movement began in our cost of living that led to successively higher peaks and valleys until 1980 when consumer prices achieved a high of almost 16%. Interest rates rose symptomatically as well. Long-term Treasury Bonds at 4% in 1965, rose to 7% in 1970-71, ultimately reaching almost 14% by 1980.

Despite some ebbs and flows after 1965, the nation would experience 15 years of distinctly higher living costs and higher interest rates. This negative trend was broken by 1982 through the tight money policies of Paul Volcker, then chairman of the Federal Reserve Bank. Volcker succeed in reducing the 14% living cost to the 4% level over the next two years, but at the expense of two recessions—a mild consumer induced six-month recession in 1980 and a longer recession in 1981-82.

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The 1970s—A Decade Of Problems And Successes

The 1970s was a perilous decade fraught with numerous problems including an oil shortage; escalating living costs and interest rates; a severe recession; the termination of the Vietnam War and the near fiscal demise of New York City.

This period of distress resulted in many of the large New York metropolitan area insurance companies abandoning Manhattan as a place for mortgage and equity investments. Many other large-scale investors also turned away from the city. There was considerable justification for feeling insecure about Manhattan. From 1974 to 1979 there was virtually no new office building construction as the market struggled to absorb about 68 million square feet of space built between 1967 and 1973, an historic pace of construction never before equalled and never likely to be exceeded. It was the early German and English investors, followed by Canada's Olympia & York, who demonstrated their faith in the ultimate recovery of New York with widespread investments in Manhattan properties at low prices.

Rockefeller Center

Despite the adverse events of the early to mid-1970s, this decade was the happiest and most fulfilling of my career. In 1972-73 I negotiated for Rockefeller Center, Inc., the lessee, the extension of the original 40-year ground lease in a protracted series of negotiations with Harry Helmsley, who represented the lessor, Columbia University. The agreement on the ground rent was made possible, without resorting to the uncertainties of a third man arbitrator. After countless meetings, Mr. Helmsley conceded that a tract of 512,000 square feet in a presumed sale would have to be discounted to realize a sale as one parcel or as subdivided over an extended period where time discounting would lower the aggregate value realized. The lease provided that despite the marvelous buildings on the site, the land value was to be appraised as if vacant, unencumbered and unimproved as one parcel. Obviously the land, under that presumption, did not have a square foot value that was even half, for example, of what a 40,000 square foot parcel would sell for.

Columbia University

We also recast substantial portions of the lease to provide more freedom for the Rockefeller interests in mortgage financing of the leasehold and to permit distribution of the net operating income to the proliferating Rockefeller heirs. A proud moment for me occurred years later when I was asked by Columbia University, as the landowner, to represent them in revaluing the land in anticipation of a possible sale to the Rockefellers. (In the interim, Rockefeller Center had purchased Cushman & Wakefield and could no longer use my service.) I always wanted to attain a totally professional reputation and, with my engagement by Columbia, I knew I had finally reached my goal.

St. Peters Lutheran Church and Citicorp Center

In the mid-1970s, I was engaged by the vestry of St. Peter's Lutheran Church to represent them with Citicorp in the possible sale of the church property at the southeast corner of Lexington Avenue and East 54th Street in Manhattan. The church property was the key parcel in a land assemblage being undertaken by Citicorp under the masterful direction of Donald Schnabel of Julien J. Studley & Co. I was able to negotiate a sale for $9 million of the 15,000 square feet of land, and simultaneously, negotiated a condominium interest for the church in the totally new project which the church would erect on the very same corner with the proceeds of the sale.

Why would Citicorp pay a top market price for the land site and then permit St. Peters to return to the same site? The answer lay in Citicorp's utilization of the excess floor area ratio beyond the church's new building requirements. Except for the church's sanctuary, most activities would take place several floors below grade. Sub-surface building uses do not count as part of the FAR. Thus, Citicorp was able to use about 17/18s of the permissible floor area for its own dramatic tower. At the same time, St. Peters was able to remain in the same location and offer an expanded religious and cultural program, including its jazz ministry in the space below ground, and yet have a dramatically visible sanctuary above ground.

A heartwarming postscript and a surprising turn of events occurred when the same Donald Schnabel, a masterful strategist representing Citicorp, asked me for Landauer's assistance in obtaining the essential parcel to complete the assemblage. Schnabel said he had not made any headway in persuading the doctors group, who owned the stock in Medical Chambers, Inc., to sell their East 54th Street nine-story medical building to Citicorp. I undertook the assignment with misgivings because I knew from prior experience that a group of doctors would be difficult, if not impossible, to unify and satisfy.

After meeting with the leading doctors, it was evident they were more upset about the capital gains tax aspect of the sale than with the offered price. I hit on the idea of offering them stock in the giant Citicorp in exchange for stock in the doctors' corporation. I explained this would be a tax-free exchange and that ultimate payment of the tax could be deferred until they sold their Citicorp shares, in part or in whole, over an extended period. This critical tax deferral made good sense, and the transaction took place shortly thereafter. Now the basis for Citicorp Center was firmly in place.

In the mid-1970s New York City underwent a wrenching reconstruction of its debt after many years of fiscal mismanagement. The city sought to finance its needs with short-term notes in spite of significantly increasing interest rates. Thanks to Felix Rohayton and other business leaders, the city achieved a firm fiscal basis through the Municipal Assistance Corp. and The Financial Control Board. The real estate recovery started modestly in the mid-1970s and continued through 1978 as the industry took advantage of initially moderate interest rates. The recovery gathered enormous inflationary steam thereafter, even as interest rates rose dramatically and prices reached what were considered to be unattainable levels.

The Pan Am Building

In 1977, I approached James H. Maloon, the newly appointed senior vice president of finance for Pan American World Airways, to inform him of Jim Landauer's key role in completing the building following the tragic death of Irwin Wolfson, chairman and part owner of Grand Central Properties, Inc. I had also heard that Pan Am was considering a sale of its leasehold interest, or alternately, a purchase of other minority leasehold interests. This proved to be premature at the time, but we did launch a series of studies for Pan Am on the value of the property and the quality and efficiency of the building's management and operation.

The upshot of these analyses was to recommend to Mr. Maloon that Pan Am purchase the fractional leasehold interests of the Wolfson Estate and of William Zimmerman, Esq. which we were successful in accomplishing. We then waited a year until the landowner, the Penn Central Company, emerged from bankruptcy. Within days, we purchased the land for a very inexpensive price, encumbered as it was with an unprofitable leasehold rental. Now Pan Am controlled 100% of the land and improvements.

Concurrently, three officers of Landauer—Marilyn Weitzman, Glenn Rufrano and John Weyer—were developing a comprehensive new software program. With the assistance of Herb Herman, a software programmer, the program provided for a painstakingly detailed analysis of every business detail of every lease and all operating expenses. Also built into the program were time-discounting techniques which enabled us to estimate with accuracy the probable net operating income over an extended period, as well as the values.

Previously, we thought that the real estate was worth no more than $250 million. The new program led to the conclusion that the Pan Am Building was worth at least $350 million based on the lease renewal potential. Fifty percent of the original 20-year leases were coming due in 1982-83, with another 20% due in 1988.

As a direct result of these studies, and based on a comprehensive offering prospectus which provided pre-qualified prospective buyers every conceivable fact about the property, the Pan Am Building was sold in mid-1980 by Landauer to Met Life for $401,026,000. It was an electrifying price at the time, and it really captivated the market. It was difficult for many investors to fully grasp that the building, with a current return of 2.8% on the equity over a $50 million mortgage, could justify a $400 million price tag or $160 per square foot. In fact, the real estate was a bargain for Met Life. Our studies indicated they would receive, over time, a minimum 14% internal rate of return.

The 1980s—A Go Go Decade For Real Estate

The 16 months of recession during 1980-81 never completely stopped the growing inflation in rents and increases in occupancy, despite spiraling interest costs. The market temporarily cooled down in response to extraordinarily high interest rates in which long-term bonds peaked at 14%. However, the market was only positioning itself for a spectacular burst of frenzy after 1982, which continued until the obvious warning from the stock market crash of October 1987. Even then, the lingering effects of a boom psychology were still felt, especially by commercial bankers who, along with the savings and loans, appeared to be the last lenders in the marketplace to realize the dance was over.

GM Building

In 1981, I was fortunate to obtain from General Motors, as a consulting intermediary, the assignment to sell the GM Building leasehold at 767 Fifth Avenue for $500 million. This was a magnificent structure with impressive views of Central Park to the northwest. Our initial sales effort was thwarted by the high price, high interest rates and concern over the economy. With the capable help of Martin Lipton, a partner at Wachtel, Lipton, Rosen and Katz, who supplied a critical brief on the alternatives to sale, we structured a financing where GM would borrow $500 million on a promissory note, unsecured by the real estate, at 10% interest, a very low rate at the time. In return, the lender would receive an option to purchase the real estate in 10 years.

If the option was exercised, the note would be canceled. If not exercised, GM would have to pay the Corporate Property Investors (CPI) lending group the $500 million. Since the note issued was unsecured, there was no mortgage recording tax to pay. GM also avoided a capital gains tax by financing rather than selling. These savings were significant and came at a time when GM was experiencing a cash stringency. As we now know, the option was exercised and the property has passed to CPI. The financing was closed on New Year's Eve 1981. I couldn't imagine a better holiday gift. There was inevitably a public outcry about tax evasion, but the loan structure was simply good business. The financing method relied on tax avoidance, but this was perfectly legitimate. Nevertheless recordation laws thereafter were tightened as a result of this transaction.

The World Trade Center

In 1982 the Port of New York Authority asked me, through Landauer, to analyze the value of the World Trade Center in consideration of offering the giant 10 million square foot complex for sale. We assigned at least six professionals to the job of restructuring the revenue, expenses and net operating income so this information would be more readily understood by any institutional investment group. This was no easy task. After study, it became apparent that the value was in the $1 billion range.

I was ecstatic about the prospect of realizing ice hockey's equivalent of the "hat trick" by selling or financing three outstanding properties within three years at an aggregate price of $2 billion! But, this did not happen. We had progressed in our sale plans through brochure preparation and even an audio visual featuring Peter Goldmark, Jr., the executive director, when a high level decision at the bi-state gubernatorial levels apparently quashed the staff's recommendation of a sale. In retrospect, a sale would have allowed the Port Authority to use the proceeds for equity purchases of transportation equipment, bridge and airport rehabilitation and modernization. Also, the World Trade Center would have responded well to private ownership and direction.

St. Bartholomew's Church

My career in the 80s was marred only by a distressing series of experiences surrounding my representation of St. Bartholomew's Church on Park Avenue in Manhattan. After careful study and consultation with many experts, I was convinced than an office building could be artfully designed on the site of the existing parish house. This would not only preserve the front courtyard but would also preserve the church to full view in all directions.

After almost eight years of effort, it appears the church, for all practical purposes, lost its case when the U.S. Supreme Court, on constitutional grounds, refused to hear its challenge of the landmarks legislation. The issue has aroused bitterness and resentment between the parties involved. At one point, the president of the Municipal Art Society, a foe of the plan, accused me in the society's publication of being in league with Howard Ronson, the designated developer. I chose to ignore the accusation rather than refute it, since those who know me would automatically dismiss such a reckless accusation.

The real losers were the impoverished and culturally deprived people who would have benefitted from the ground rent generated through the terms of the lease negotiated with Mr. Ronson. Only a major illness in 1983-84 stopped me from continuing the fight for St. Bartholomew's.

Site For The Saturn Plant

In the mid 80s, I was involved in two diverse but equally interesting assignments. The first was leading a Landauer team of 12 professionals on a systematic search to determine the best area for the site of the proposed new Saturn automotive plant. General Motors was about besieged by property owners, chamber of commerces and various public and private development groups, all interested in attracting GM to their property or to their state or city.

GM was particularly concerned about quality of life considerations for its employees, many of whom would be transferred from other GM plants. We devised a list of 100 quality of life factors, and these were divided into nine categories stressing education, affordable housing, climate, convenience to recreationals and political stability. The board of Saturn Corporation and GM's realty division, Argonaut Realty, unanimously agreed with our recommendation of the Nashville, Tennessee area. Ultimately Spring Hill, 30 miles south of Nashville, was selected for the site. The new plant is now producing the popular Saturn car.

More World Trade Center

In negotiating the GM $500 million loan early in the 1980s, I met Courtney Jones, who at the time was an assistant treasurer of the company. About 1986, Mr. Jones, who now was with Merrill Lynch, asked me to represent Merrill Lynch in a series of relocation and sub-leasing moves following the company's decision to lease almost 4 million square feet of office space in the World Financial Center.

The result of our studies led to the assignment to sublet one million square feet in Olympia & York's World Financial Center. Over the next 15 months we negotiated firm letters of intent or signed leases on about 600,000 square feet. For various corporate reasons, Merrill Lynch decided to lease back the entire one million square feet to the developer in exchange for the surrender of Merrill Lynch's equity ownership in the complex. To their great credit, Merrill Lynch nevertheless paid us a very substantial fee for our services even though not all the leases were completed.

The 1980s—In Perspective

The 1980s provoked excesses in development and financing that leave me troubled about our capacity to learn from experience. Intense capital competition forced a decline of underwriting standards to dismally low levels. Previously hard earned real estate appreciation has been wiped out by oversupply, increasing vacancies, declining effective rent, declining prices and insupportable financing. Weakness in our financial systems has created doubt about the rate at which real estate can recover because of the relative absence of financing from bank and insurance companies. We are facing the inevitable over-reaction to a troubled banking system's caution on resuming lending to finance any recovery.

New York City continues to face extraordinary problems in the 1990s. Its current fiscal crisis is a nagging cloud overlaying multiple problems of real estate oversupply and seemingly insolvable socio-economic ills. Meanwhile, white collar employment in New York continues to decline as more and more companies decentralize at least portions of their operations to widespread locations where there is an improved quality of life for their employees. A particularly worrisome note is the recent tendency for large scale service companies, mainly insurance and finance, to locate elsewhere. Previously service companies, of necessity, remained in the central business district.

I choose not to lament about the difficult years still ahead, but rather to foresee a cyclical recovery for real estate. I firmly believe there is a new era ahead where some, if not all, of the prior excesses can be eliminated. The real estate industry can re-establish itself as a premium investment by earning a rate of return over an extended period of time that will compete with all other forms of investment. However, future real estate investment will be more concentrated in smaller cities, at the expense of the nation's large cities.

Real estate has been exceptionally kind to me over the past five decades; I am grateful for my destiny. I strongly believe real estate's dominance will be reaffirmed late in the 1990s, and I am totally confident about an ultimate recovery.

Real Estate Service Firms: Why Partnerships Succeed Or Fail

by Webster A. Collins, CRE

To the best of my knowledge, I don't know of anything written on becoming a partner, what to expect and how partnerships typically work. There are no courses to attend or exams to take. The only exam is experience. Based on my experience, I thought it worthwhile to describe in this article my observations on partnerships gleaned from 30 years in the business.

Typically people become owners of firms because, over time, they have done something right. They have been noticed by others who think they will be a proper "fit" in the ownership of the organization. In the past, ownership was driven partly by the "old boy network" however, today a partner has to earn his right of passage. Often this passage comes with the creation of a new company based on a commonality of interests, or people pulling together for the common good with a very specific set of goals and objectives. One of the most successful real estate firms in Boston was Leggat, McCall & Werner, founded in 1965. Their objectives were followed closely, and in 1986 the company sold its basic business of real estate brokerage at a great profit.

There is only a 50/50 chance that a partnership will work as evident by the number of people changes taking place within the industry. Some of the worst performers are older firms. Here the self-centered characteristics of individuals and the underlying lack of common interests cause these firms to weaken or fail.

Service firms in the real estate industry need to recognize that when it comes to a partnership, one plus one must equal three. Not only must the partner offer his client added value, but internally he must produce a profit for his firm in order to justify its existence. When a firm fails it is often because the partners have lived off the underlying asset; a firm succeeds when it is able to expand on the basic assets already in place and create growth.

Structure Of Ownership

I have been a partner under three ownership structures—corporation, Subchapter S corporation, and partnership. The basic structure of ownership is not what is important, but rather the trust on which the structure is built. When partners are observed "doing their own thing," this is when a partnership comes apart. Partnerships that work have a basic structure driven by written guidelines and understandings.

Partnerships Of The 1990s

Where, typically, partnerships in the 1970s were built on trust, partnerships in the 1990s must have a solid, written business plan requiring partnerships to act with acuity, agility and speed. Let there be no mistake, the 1990s are a time of brutal competition where new business ventures are needed to keep a partnership functioning. Business is becoming very impersonal. Those who do a good job are rewarded, and those who don't cannot continue within the organization.

New Skill Factor

The work place has changed; more flexibility is required and a near-crisis atmosphere exists. Nothing is constant. Now more than ever before, real estate service firms are far more complicated to manage. Gone are the days of one-man at the top with an iron fist approach. This is one of the reasons many firms have failed.

To succeed today, firms must be driven off production. The focus must be first on marketing to bring in business followed by completing the assignment. To handle assignments, I find the team approach is very effective. I do nothing alone. I bring in staff to handle the problem or even to solve it depending on the assignment. Often multiple assignments are in various stages of completion at the same time. While the office can be chaotic, the assignments get done, and we move on to the next.

Broad skills honed by experience and training must be applied if the client is to be well represented. I often refer to that "fat tire in the middle" which must be removed. Here the objective is to give younger people increased responsibility so they do not get mired at an intermediate level. This is the "up and out approach", which requires fair dealing at the partner and non-partner level.

Fair Dealing

Without exception the basis of a partnership is fair dealing. Sharp, sudden changes within a firm cannot take place without commensurate benefit. Over time, change occurs; it is continuous and individuals must adapt. This is how solid, long-term relationships are built. For example, partnerships are not built the day the papers are signed, but rather they are built over time.

Individual fifedoms are not partnerships. They are only accommodations which include the sharing of office expenses. Individual greed, where the focus is making money off the backs of others, can

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misfire in any partnership. Rather partnerships are long-term and change only when the underlying basics of the business are effected.

Perhaps the best real estate example involves syndicators who fundamentally were wiped out by the 1986 Tax Act. An entire division of the National Association of Realtors closed its doors. This was the result of a fundamental change in the industry.

Partnering

Once you have made your deal, you live by it. This is partnering, and it can be for life. When the deal is changed, the partnership can come apart. This does not necessarily mean everyone has to be equal; for example, there can be a huge discrepancy of income. Presidents do not necessarily have the income of the producers. However, presidents are responsible for having their hands on the tiller, and typically their money is made from the value of their stock and the profit of the firm.

Successful partnerships are a balance of those who produce and those who preserve, each with a clear understanding of how this works and with a commitment to a common goal.

Ethical Standards

Any discussion on partnerships is not complete without mentioning ethics. Partnerships typically go through phases. At the beginning there is the euphoria of one's new status and then typically stumbling and bumbling can follow if "the deal" is not clear. In a good partnership, this results in open discussion and the "put back together" of the structure.

From my experiences, one of the biggest problems in a partnership is when someone's hat grows too big. Many stories circulate in the real estate industry, and when I hear one partner say to another, "You could not carry my lunch pail," this is a sure sign the partnership is coming apart.

How Do You Handle Misrepresentation By A Partner?

"Loose cannons" cannot exist within a partnership. Once an agreement is reached, it must be lived by. In simplest terms, you cannot promise what cannot be delivered. The biggest misrepresentation I have observed is in the financial area. The mismanagement of funds is a guaranteed trip out the door.

Also, misrepresentations which appear minor at the onset can become major. The largest minor misrepresentation I have observed involved delivery times. When reports or commitments are not kept, clients will not return.

When a mistake occurs, it must be addressed up front and not buried. Prompt correction and continuous monitoring is required to make sure misrepresentations do not reoccur. Everyone makes mistakes, but they must be kept to a minimum so business, like Ivory Soap, remains "99 and 44/100ths % pure."

Working With Weaker Partners

The true test in a partnership is how one works with weaker partners. Not everyone is equal and when there is a weakness, it requires prompt correction.

Here my view is not to kick out weaker partners. If a partnership is strong, it can bring up to speed weaker partners for the good of the firm. People are important commodities; they are the basic strength of a firm.

Heart-to-heart talks are important. People should be lived with and worked with so their confidence is rebuilt and rejuvenated. If the person previously was good enough to be elected as a partner, he most certainly is good enough to save. The only time a partner should leave is when the partnership just is not working. To illustrate, I served as an outside director of a real estate company where it was necessary to demote the president in order to properly steer the company. Even here it was done only as a last resort. What weaker partners must realize is that to become strong requires hard work and far more effort than was applied when first starting off in business.

How You Terminate A Poorly Producing Partner

From my experience, poorly producing partners just do not manage their careers intelligently. They fail to recognize that they are in charge of their own life, and instead they just sit back and hope for the best. They become lulled into a sense of comfort which does not exist. These partners typically are in the over 50 age group, and they can no longer handle their jobs. This creates internal stress both within the firm and among the partners.

One way we have tried to work around this problem is to require that each person needs a business plan. If they can not live up to the plan, they know they must leave. January 1 of each year typically is the time when partners move in or move out. Partners who are having trouble meeting established goals are given considerable lead time. When their day comes, they are told to pack their belongings and leave. Typically this is handled by a managing partner. Under our partnership agreement the managing partners "have the authority to engage and dismiss."

Terms of Partnership Agreements

My firm's partnership agreement has 11 carefully drafted pages with 31 sections of which five are most important:

1. Restriction on transfer
2. Valuation
3. Termination
4. Voting rights
5. Capital contributions

Restrictions on transfer are standard. They call for internal buy-backs of ownership and prevent partners from mortgaging or pledging their interests in the firm. Each year, as of January 1, the partnership is valued internally and typically it is based on the relationship to the capital actually invested in the firm or the quality of the income that is generated. Where income is high risk, I have seen annual values at two-to-two-and-one-half times earnings. If there is a more stable stream of income, typical internal multiples are three-to-four-times earnings.

Voting rights are critical and if "push comes to shove," this is how decisions are put in place.

Termination upon leaving or retiring is based on a pay-out schedule. The partnership has a right to buy out over five years at a prime rate of interest. If a partner leaves voluntarily to go into business at another firm, he receives 90% of the value of their ownership.

Capital contributions can take multiple forms. The contributions can be in cash or interest bearing notes. If additional capital contributions are required and a partner does not meet the capital call, then a formula exists for dilution of ownership. Today, far more capital is required for partnerships due to the need for computers, research centers and other support services.

How To Convince Older Partners To Retire To Make Room For Younger People

Large, broadly-based partnerships typically are run by management committees. They operate by fiat, and when a large producing younger person comes on the scene, that person is tapped on the shoulder and invited into the partnership.

Under the present brutally competitive market conditions, older partners often are needed. If they are high producers, they can continue in any firm. If they lose their edge, they are asked to retire. We have had partners who still produced and were well into their 80s, while other have retired in their 50s or 60s. High producing partners might first reach their peak when they are 60 or 70 years old. One very well known CRE (Counselor of Real Estate, member of the Counselors of Real Estate), made a career change in his 70s and now is in a leadership role moving his new firm forward.

This is the main point: In a properly functioning partnership, there aren't any roadblocks for admitting new, high producing partners, and if roadblocks exist, the partnership will have a short life span.

Philosophy Of The Firm

No greater change has taken place in the real estate industry than what has occurred during the past 20 years. We have seen the nation's two oldest real estate firms essentially go out of business because they could not change. We have seen start-up companies succeed because of clear-sighted visions, systems, structure and objectives.

Most successful real estate firms are built around a few top people who bring in the business and then "team" with younger people who do much of the leg work. Where firms run into trouble is when there is a fat middle layer of quasi management where leverage does not exist. This layer typically costs the firm money, particularly in the area of administrative time which takes away from basic production.

In structuring firms, the age of partnerships is important. There must be a spread so that when the top people move into retirement, the slots are filled by younger people. In my firm, one-quarter of the partners are over 55 years old and one-quarter are 30-35 years old.

Incentive Compensation

Proper incentives must always be in place. If incentives are taken away, "rainmakers" will leave the firm and this will damage future performance. Securities houses are well known for incentive performance systems that can result in six figure cash bonuses at the year's end. This same type of incentive is needed in real estate firms.

Having everyone on equal footing in ownership and compensation does not work. Performance must be recognized and compensated accordingly. This can be in the form of cash or increased ownership percentages.

Long-Term Goals

In real estate firms, long-term goals are changing. When I first moved out of the insurance company hierarchy to the private sector, the real estate business was equivalent to a joint venture with producing employees. We had the expression in our office that "the business went down the elevator every night."

This no longer is the case. Fundamental and underlying structural changes are occurring. The top firms within the industry are going to a salary and bonus basis. This enables them to take two or three people, target them to provide service to a particular major account, and work on that account four to five years before results occur. I can guarantee you that when this happens, they can be huge.

In the old days it was the individual that produced business. In a way this still is true. I have only been referred business twice because of the firm. However, this is changing. Under the team approach, the firm must produce business and the individuals must provide the service. Remember client-based firms always win.

Partners In Play

Finally, the main concern facing real estate service firms is when partners are put in play. In our firm, Norman Kenny joined C.W. Whittier in 1918 and retired only upon his death in 1981. People used to stay in firms for life. Today people leave when the philosophy of the firm changes, when partners cannot "pull on the same oar," when partners cannot perform or when the firm's competitiveness declines.

In my judgment to let good people "escape" is stupid. Great sensitivity is required in a partnership. One partner cannot be played off another. What has happened in the marketplace is that strong real estate firms have been built out of former partners who have been put in play. This also has resulted in the creation of new firms.

Sometimes the over-control of existing partners can take away creativity which is so important. In our particular case, I was allowed to create an "instant office" in another city to meet the market demand. As our partnership was not overly controlled and the freedoms and incentives were in place, this was an extraordinarily successful venture.

Conclusion

Some 10 years have passed since I moved from one partnership to another. I knew where I wanted to go and walked into the office of C.W. Whittier in July of 1982 and a deal was cut in 10 minutes. However, it took eight months of refusal on my part to give up on the existing partnership to cause the mutual decision for me to leave.

I look back fondly on these past ten years at C.W. Whittier. From Day One, my partners and I have lived by partnering, by the deal that was cut at the time. I guarantee there is no finer experience that to be in a partnership built on such positive guidelines.

INTERNATIONAL COMMENTARY

Creating An Urban Real Estate Market In Russia

by Olga Z. Kaganova

The author expresses her deep appreciation to John K. Rutledge, CRE, for his useful discussions and editorial assistance in preparation of this article.

Following the collapse of the Soviet Union and the failure of its communist/socialist system, Russia is groping its way toward a market economy. State ownership eliminates the need for numerous public and private services and institutions taken for granted under capitalism and without which private ownership cannot flourish.

Legislation for land and buildings

Soviet law abolished the concept of real estate (land and all improvements thereon) in 1922[1] and new Russian Federation law treats land and buildings separately. The *Property Law*[2] permits full ownership and leasehold tenure for buildings by any natural or legal (corporate) person including foreign citizens. The *Law on Privatization of Housing*[3] provides for families to acquire their state-owned apartments, and fully paid cooperative apartments are privately owned[4].

Land ownership is governed by the *Land Code*[5]. Hereditary life tenure can be obtained for the land under a single family house or garage (apartment dwellers must store their cars off-site) and for gardening and entrepreneurial purposes, but these plots cannot be sold or leased. Russian citizens can buy or sell land on which to build a single family house, but it cannot then be leased for more than five years. All natural and legal persons may lease land from the municipality for up to 50 years without the right to sublet. Under continuing Soviet law (until superseded), state enterprises and joint ventures may obtain a revocable right of use for an indeterminate period.

Under the *Land Code*, transfer of title of a nonresidential building also results in the transfer of the underlying land, either as hereditary life tenure (citizens only) or traditional right-of-use tenure. In the case of a single family dwelling where both land and building are held in full ownership, title to the building is transferred directly and the land is first purchased by a local government agency and then sold to the new owner.

Two sources of law govern property ownership and the process of land reform: laws adopted by the Supreme Soviet (Russian Congress) and presidential decrees. *Decrees of March*[6] *and June*[7] 1992 provide that state enterprises undergoing privatization may acquire full ownership of their sites, citizens who previously obtained land for private enterprise may now register full ownership, and municipalities may auction land for development to newly privatized, former state firms.

The *Law on Mortgages*[8] permits mortgaging any type of private property and leasehold tenure, but it is unclear if privately owned land can be mortgaged to any lender or only to the newly created state Land Bank.

Taxation for land and buildings

Land and buildings are taxed separately under different laws. The law on taxation of private property of natural persons[9] establishes the tax rate on buildings at 0.1% of the "inventory value," a term defined not in the statute but in the implementation order as the depreciated replacement cost. Based on the most recent indexation of construction costs (1990), the average depreciated cost for Moscow residential buildings is 18.8 rubles per square foot. The corresponding figure in St. Petersburg is 10.4 rubles. Actual values in May 1992 were 35 times higher in Moscow and 75 times higher in St. Petersburg.

The law on taxation of buildings owned by legal persons[10] calls for the tax rate to be set by regional authorities at not more than 0.5% of inventory value.

Land taxes are governed by a 1991 law[11] which requires tax payments by natural and legal persons who own land or have right-of-use. The statute sets the rate for each of 12 economic regions, varying according to the quality of agricultural land or the size of city. Multiples of the basic rate are applied to resort areas and cities with "developed socio-cultural potential." Local authorities may vary rates and offer incentives or concessions provided the average citywide tax is unchanged.

The average land tax is 1.25 rubles per square foot in Moscow and .98 rubles in St. Petersburg. The tax rate for agricultural land, private garden plots, and land under the housing stock is set by statute at 3% of the rate for nonresidential urban land. Inflation is not addressed.

Lessees pay a negotiated rent as documented in the lease. For rural land, it cannot exceed the tax rate. The law also introduces the concept of "normative land price" to govern transfers of land to

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private ownership, transfers by gift or inheritance, and mortgage financing. The normative price is 50 times the rate of the promulgated land tax. In Moscow, the average normative price is 62.7 rubles per square foot, with a maximum of 383.7 rubles in the Central Business District. This is less than 2% of market land values for corresponding locations in Los Angeles and New York, based on an exchange rate of 100 rubles per dollar. (The exchange rate as of December 31, 1992, was about 415 rubles per dollar.) The laws do not indicate an intention to move toward a market value assessment process.

Real estate privatization policies of Moscow and St. Petersburg administrations

Before the reforms were launched, all land in Russia was state-owned, and fewer than half of urban land users held documents evidencing their right of occupancy. Today, land privatization is part of a much broader problem which requires documentation of ownership and occupancy rights. In general, legal privatization of urban land and nonresidential buildings is only at the threshold.

Title records and a system for registering land transfers did not exist under state ownership. Nonresidential buildings were all state-owned and managed and disposed of by municipalities and ministries. Housing was state-owned or cooperative, except for privately owned, single family homes. Construction of private houses in major cities was banned in 1961 and the existing stock was actively demolished. In 1991, private housing represented only 1.4% of the total housing floor space in St. Petersburg. Cooperatives comprised 14.2% of floor space and 16.9% of the total number of apartments. St. Petersburg has about 1.5 million apartments, 96% of which are in buildings over two stories high. Moscow has even fewer single family houses, and the proportion of cooperatives is about the same.

The privatization process occurs in three sectors: apartments, nonresidential buildings, and land. The pace is governed by specific legislation for each sector and by the attitude and commitment of local administrations.

Apartments

Federal law permitted privatization of apartments beginning in the summer of 1991, but municipal officials took until winter to make the necessary organizational and financial decisions. By August 1992, about 150,000 Moscow flats and 11,000 St. Petersburg flats had been privatized, and the process was underway in cities across Russia. About 390,000 more families in St. Petersburg have applied for title to their flats. The question of title to the underlying land has not been considered, although the residents will be expected to pay future land taxes.

The privatization of urban land and nonresidential buildings in Moscow and St. Petersburg has featured chaos and conflict, and a leading Russian business journal features reports of scandal almost weekly. Numerous authorities claim the right to develop land strategy and privatization policy, as well as the right to dispose of municipal property. The primary opposing forces are the elected city council and the executive or mayor's office. Competing branches, which are analogous, also exist within administrative subdivisions or districts of these cities, and yet more conflicts arise within different executive departments of city government.

Commercial and residential property and land

The city councils are responsible for funding city budgets, formerly financed by state allocations. They are well aware that municipal real estate sales and leases could generate substantial revenues, thus their understanding of real estate and market forces has evolved quickly. Within a year, prevailing opinion shifted from a leasing orientation to competitive sale of commercial property and dilapidated residential buildings needing renovation, as well as the underlying land.

The Executive Branch policy, however, calls for privately negotiated transactions. A Spring 1992 procedure issued by the mayor of St. Petersburg, Anatoly Sobchak, provides for no competitive bidding and no public access to information about the transaction. Five committee approvals (including Foreign Economic Relations) and about 35 permissive signatures are required, along with an indeterminate number of coordinating approvals. The terms of the sale are not fixed, and title passes only after construction is completed and a special state commission issues an occupancy permit. While this procedure initially may indicate a lack of market experience, the reality is a desire for control and an open channel for private profit through corruption.

For example, the Moscow Executive Branch promoted a development joint venture, contributing 646,000 square feet of prime downtown land valued at $4.5 million. Profits will be remitted to a special hard currency (not ruble) joint venture account, but only the Executive Branch can withdraw funds. This removes it from control by the City Council and prevents its inclusion in the city budget.

However, procedural improvements are being made as officers of the Property Foundation, a body officially empowered to lease and sell municipal property, estimate that it now supervises over half of these transactions, up from 10% in 1991. Improved legislation and President Yeltsin's decree combatting corruption also have helped. Some recent major transactions by the Executive Branch, in violation of regulations, have been canceled.

Some notes on the housing market

The Soviet Union had no legal housing market, but the black market was always present and still continues today. One may illegally purchase a municipal flat by buying domicile registration which entitles the buyer to an "indefinite right of occupancy"[12]. In St. Petersburg the domicile registration costs 10% to 20% less than legally purchased full ownership rights. A second option provides for families to legally exchange flats. However, the accompanying payment for differences in size, location, quality, etc., is illegal. Third is the semilegal leasing of rooms or entire apartments by occupants of municipal housing. Privatized apartments and fully paid off cooperatives are private property, and in 1991 a market for such housing appeared. While legal, however, this market is not financially functional. Up to 80% of sellers demand hard currency, illegal until only recently. Brokers in Moscow and St. Petersburg stress that ruble and hard currency markets are distinct, but prices are comparable at the black market currency exchange rate. Evidence suggests that many brokers have mastered mixed hard currency/ruble sales.

Official data on legal apartment sales is unavailable because there was no system for publicly registering or recording transactions. In Moscow, an office for registering apartment sales was established in March 1992, and legal sales by August were estimated at 5,000,[13] but St. Petersburg still has no such office, and sales appear to be definitely fewer.

In St. Petersburg, most sellers are emigrating families of which about 80% demand hard currency. The average price between July 1991 and May 1992 was about $25 per square foot, about 4,275 rubles by written order (bank transfer), or 3,350 rubles cash. Somewhere between 50%-95% of the buyers are corporations which pay by written order. Severe restrictions limit conversion of corporate bank funds to cash. Consequently, a ruble in cash is worth about 1.3 rubles in the bank. Corporations apparently buy flats for their managers and high ranking officers, but brokers estimate that 20% of flats purchased in St. Petersburg are used as offices or guest apartments.

Prices in Moscow between July 1991 and May 1992 were higher at about $48 or 6,500 rubles (written order) per square foot. Until Spring 1992, demand for flats far exceeded supply, and auctions were a common form of sale. More recently supply has exceeded solvent demand. Moscow brokers report declining prices in massive apartment buildings developed during the 1960s-1980s in the peripheral areas; prices of larger downtown apartments have strengthened.

Housing development is nearly nonexistent because private builders have no access to land, although some entrepreneurs have acquired unfinished housing from insolvent enterprises. A few municipally financed pilot deals have occurred, and new housing seems to sell for about the same ruble price as recently privatized units.

Current prices preclude development of a mass market. A standard two-room flat of about 540 square feet sells for about 1.8 million rubles in St. Petersburg and 2.5 million rubles in Moscow. In June 1992, the average monthly salary in St. Petersburg was officially estimated at 2,000 rubles. With two parents' salaries plus children grants, monthly family income did not exceed 5,000 rubles. Thus the average price of a typical flat is about 30 times the average annual family income. Although real incomes are somewhat higher than official estimates, prices are clearly an obstacle to the development of a mass market.

Brokerage in real estate

Brokers have always worked the black market, receiving commissions in cash. The first officially chartered corporate brokerage firm appeared in late 1990, and today more than 100 firms and numerous individuals practice in St. Petersburg, with even more in Moscow. Most combine brokerage with totally unrelated activities. Brokerage work is concentrated in private apartment sales which represent over 80% of St. Petersburg transactions. The balance is garages, private suburban houses, and summer homes. Less than 20% of the brokers also work in apartment leasing.

Nearly all nonresidential property is state- or municipally-owned, and legal brokers rarely deal with it. Such transactions represent less than 5% of their activity. These sales are connected with illegal privatization and are handled by major black market dealers associated with corrupt administration officers, according to St. Petersburg brokers and some deputies of the City Council.

Brokers are neither licensed nor regulated and have developed their own procedures and forms of documentation. Typically, the only other outside participant in a deal is a notary. Without benefit of instruction, brokers have created a form of title research and have developed escrow procedures. Buyers and sellers who have found each other independently usually engage a broker to close the transaction because they consider the broker to be a guarantor against deceit. Commissions range from 2% to 10% and usually are added to the purchase price as a charge to the buyer.

Brokerage is now a rapidly developing and evolving industry. Brokers are creating ways of dealing with different types of transactions, and they are seeking new interrelationships. In June 1992, a constituent congress of the Russian Association of Realtors was held, and subsequently, regional associations have appeared. They want to establish uniform documentation and a professional code, create an information exchange, and gain access to privatizing nonresidential property.

Obstacles to real estate market development

The first block of obstacles centers on legislation; laws passed by the Supreme Soviet conflict with Presidential decrees. Laws to support the development of a market infrastructure are inadequate, especially regarding the registration of title and transactional data and access to the resulting market information. Separate laws concerning land and buildings must be coordinated or unified. Restrictions on transfers must be lifted. Currently, full ownership of land is restricted. Further, only municipalities are authorized to lease land, eliminating the possibility of leasing privately owned land. Second is the incompetence or lack of commitment by city administrative officials toward the process of privatizing land and nonresidential property. Clear cut and open procedures are essential. Finally, the immature system lacks a market infrastructure. Long term mortgage financing does not exist, professionals in related disciplines have not appeared, and specialized training is not available.

The Russian real estate market has made great strides in a brief period. In many respects, it remains chaotic and immature as it evolves in an environment of continuing restrictions, lack of market experience, and an absence of financing.

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A Common Language?

by Harold Melzack, CRE

While I am not certain who first said it, "Great Britain and the United States are two nations separated by a common language," is a frequently heard quote that to some extent is still true. With the growth in international travel, however, the language difficulties have lessened, except in the world of property.

In major British commercial real estate practices, known as "estate agents," most or all the partners are members of The Royal Institution of Chartered Surveyors (RICS); individual partners are called "Chartered Surveyors." Immediately this is confusing since the majority do not undertake surveys of any type, name or description. The last time I surveyed a building was some 35 years ago.

However, the designation, Chartered Surveyor, embodies a wide range of disciplines including valuation/appraisal, advice on acquisition and disposal of properties, property management, town planning, taxation, etc., all under the category of General Practice. Chartered Surveyors who spend their time surveying are known as Chartered Quantity Surveyors or Chartered Building Surveyors. Quantity Surveyors are concerned with the quantity of materials likely to be used in new construction or in the alteration of an existing building. They also act as cost consultants.

In recent years, the designation "estate agent" has been a somewhat pejorative term in the UK due to the media who regard estate agents as three levels below a second-hand car dealer. Consequently, most agents now describe themselves as Chartered Surveyors, Property Consultants and Valuers, Surveyors and Valuers, etc., anything to avoid the word estate agent.

To be fair, this change of designation mainly applies to commercial property practices, and many residential estate agents retain the description. Here again, there is a difference in terminology; in North America the word "broker" is "estate agent" in the UK.

Overall, while leasing of commercial buildings is the same in North America and the UK, there are differences. Most major commercial buildings in the UK are owned by leading institutional sources such as insurance companies, pension funds, etc., or by Stock Exchange publicly quoted property companies.

The letting of a building

The ideal situation for any major property owner is the letting of a building to a single tenant on a 25-year lease with full repairing and insuring terms. All the landlord has to do here is collect the rent four times a year; every other aspect of the building is dealt with solely by the tenant. The landlord is not concerned with heating, decoration, repairs, maintenance, improvements, insurance, etc.

In addition, these leases contain the landlord's right every five years or so to call for a review of the rental paid. At the time of review, the rent can either remain at the present level or go up; it can never go down. The new rental level is determined by an agreement between parties, or failing agreement, by the appointment of a third party to determine the market rent such as an independent expert or arbitrator. In a consistent or rising property market this is perhaps fair to both sides, however in the present recessionary market, many landlords find they have buildings grossly overrented, with tenants locked into leases that are substantially above the current market rental level.

With multi-let buildings, the ideal situation is for the tenant to

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be responsible for a proportionate cost of all heating repairs, decorations, upkeep, maintenance, renewals, porters (janitors), insurance, etc. Collectively these costs are known as a service charge which is passed on to the tenants. The basic rental paid for the space does not include any element toward these costs.

In the present recessionary market, landlords are taking a more practical view of life, as tenants are reluctant to get locked into long-term commitments or unlimited maintenance obligations. To let a building today, you must be flexible in all the terms you quote. It is doubtful whether the landlord's market of the past ever will be the same.

Valuations/appraisals

In the UK valuations/appraisals are known only as valuations, and unlike U.S. appraisals, they are often shorter in content. All Chartered Surveyors are governed by the rules laid down by the Assets Valuation Standards Committee of the RICS. The standards explain, in considerable detail, how one should approach a valuation including all the various facets, i.e., recent legislation, etc. Compliance by a valuer to the "Red Book" as it is called, is virtually mandatory by all banks, lending institutions and the Stock Exchange.

Code of measuring practice

Regarding the measurement of floor areas, the RICS and the Incorporated Society of Valuers and Auctioneers have a standard measuring system, the Code of Measuring Practice. It covers all types of buildings and is used almost without exception throughout the UK providing consistency in valuation practice. A valuer would need an extremely good reason to depart from the code. For example, all office buildings are measured on net internal floor area for the purposes of valuation or letting, exclusive of staircases, landings, lift shafts, service areas, toilets, etc. The space valued is the actual usable floor area. The code even sets the rules for measuring around air conditioning units and central heating radiators. Obviously, when measuring for rebuilding or replacement costs, the overall gross external floor area would be used in the case of an office building.

When a commercial tenancy ends, unless the lease specifically states otherwise, the tenant is entitled to a new lease for a term not to exceed 14 years, according to the terms of the Landlord and Tenant Act, 1954. The landlord can resist the grant of a new lease, but there are very restricted reasons, such as requirement for own occupation, rebuilding or redevelopment, or the tenant being of an appalling nature! The new lease will be at current rental and may embody more modern lease terms, though generally it should follow the expiring lease. The requirements of the Landlord and Tenant Act are peculiar to the UK, and to the best of my knowledge do not exist in North America or virtually any other country.

Rates

Another term used in connection with property is "rates," or municipal taxes levied by the local authority. They are based on an assessment of the hypothetical rental value of the concerned building or premises on a given date, and the charge applied is known as the "Uniform Business Rate." The rates are payable strictly by the occupier and would only be paid by the landlord if the lease called for it, which is highly unlikely.

In Summary

I could go on at considerable length, but this article is only intended to provide a bird's eye view on real estate-related terms used in the UK. To summarize, a broker is an estate agent who may call himself a property consultant; an appraiser is a valuer; a Chartered Surveyor may not necessarily undertake surveys; and rates are taxes.

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