REAL ESTATE ISSUES

THE COUNSELORS OF REAL ESTATE™
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ABOUT THE COUNSELORS OF REAL ESTATE™

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

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

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

Enrichment Through Networking, Education & Publications

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

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

What is a Counselor of Real Estate (CRE)?

A Counselor of Real Estate is a real estate professional whose primary business is providing expert advisory services to clients on a non-contingent fee basis or a performance fee under certain prescribed conditions. The counseling fee is rendered for advice given rather than for achievement or outcome of the transaction. CREs have acquired a broad range of experience in the real estate field and possess technical competency in more than one real estate discipline.

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

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

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

Users of Counseling Services

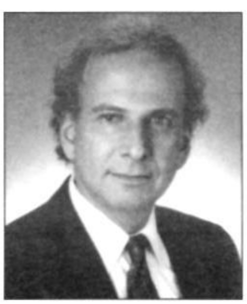
The demand continues to increase for expert counseling services in real estate matters worldwide. Institutions, estates, individuals, corporations and federal, state and local governments have recognized the necessity and value of a CRE's objectivity in providing advice.

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

Only 1,000 practitioners throughout the world carry the CRE Designation, denoting the highest recognition in the real estate industry. With CRE members averaging 20 years of experience in the real estate industry, individuals, institutions, corporations, or government entities should consider consulting with a CRE to define and solve their complex real estate problems or matters. REI

Self-Improvement Through the Exchange of Information

In this technological age, the phrase, "exchange of information," is used to describe so many things, from the most state-of–the art computerized data to good old-fashioned books, magazines, and trade publications. Included in the latter is The Counselors' twenty-two year old journal, *Real Estate Issues (REI)*. Though boasting a long-standing publishing history, its contents are anything but dated! To me, *REI* is a vehicle through which members and non-members alike are invited to share their opinions, predictions, and analyses of elements and trends critical to our success in our chosen profession—real estate.



As CREs, we are constantly innovating to service our clients as we move in and out of the marketplace. We become better individual Counselors by the information we exchange with fellow members and colleagues through publications or programs in which we participate. This form of self-improvement is value-added to holding the CRE Designation. It not only increases our ability to innovate and create, but further, it enables us to better service our clients.

These days, our mailboxes (both postal and e-mail) are inundated with messages and suggestions for sources of information—data services to which we can subscribe; publications we should read or subscribe to; web sites with research data – the list is seemingly endless. As a result, we must sift through so much, to find not only what is the most critical for our needs, but often just what we have time for. One thing I always make time for is the information inherent in *Real Estate Issues*.

Since knowledge is the foundation of any teaching institution, an 'exchange of information' is critical to relationships with the academic community. To this end, The Counselors is most honored to have Virginia Commonwealth University's School of Business as a co-sponsor of this issue. *(For more information on their real estate program, see the narrative on the inside back cover.)*

I encourage you to include *Real Estate Issues* in your "to-be-read" pile and to share it with a colleague. It is through the personal recommendations of those professionals whom we most respect, that we most often better ourselves with increased knowledge. I also invite you directly participate in the 'exchange of information' by submitting a manuscript to *Real Estate Issues* for publication consideration. I look forward to reading the rest of this issue; I trust you will too.

Steven D Leader

Steven D. Leader, CRE
1998 President
The Counselors of Real Estate

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DEPARTMENTS

ADVERTISER'S INDEX

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Based upon the experiences of various industries going through changes of state in the past quarter-century, real estate should not expect the process to be a smooth one. This article, through a discussion of the airline industry's 'change of state' in recent years, offers predictions on the changes expected in the real estate industry. Thus far real estate has been spared much turbulence in the period since 1993 when public-market investments in real estate have exploded. According to this author, "Don't count on this continuing."

The stock price of a REIT, both its level and its growth, is driven by FFO (Funds From Operation). Thus, analysts and investors are concerned about the sustainability of current FFO growth rates. A thorough look at the REIT business model reveals at least eight strategies for fueling future FFO growth: 1). increase rental income; 2). accretive acquisitions; 3). lower the cost of capital; 4). reduce operating expenses; 5). generate non-rental revenue; 6). sell properties at a spread over the investment base and reinvest; 7). generate retained earnings; and 8). grow intellectual capital. The authors examine the practical application of each strategy and how the ingredients combine to create an effective earnings engine.

This article reviews the most common criticisms of the Comprehensive Environmental Response, Compensation, and Liability Act of 1980, and its only amendment, the Superfund Amendments and Reauthorization Act of 1986. Legal writers are critical because they believe the legislation is harsh and unfair; other writers think that it is not cost-effective, with most money spent on litigation rather than cleanup. Moreover, the author reviews the major proposals for amendments to see if they answer the critics.

The 1997 Taxpayer Relief Act, together with demographic, economic, and societal changes, fundamentally alters the tenure choice decision of prospective home buyers and generally favors the decision to rent rather than buy. This manuscript discusses the factors that influence the decision, analyzes the impact of changes in those factors, and illustrates the effects using national and regional house price and rent indexes. The authors apply a discounted cash flow model that incorporates recent tax changes to evaluate the *ex post* financial wisdom of a buy decision under a variety of holding period assumptions. The notion that home ownership is becoming less attractive is supported by the data. The implied trend away from housing investment has important implications, not only for the prospective home buyer, but also for the real estate industry and government policymakers.

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Urban Real Estate Markets in Russia: The Current Stage

Olga Kaganova, CRE

The article reviews major processes and trends in Russian urban real estate markets from 1993 to 1997. It reports on the scope of real estate privatization and the specifics of markets for residential, commercial, and industrial properties. It also discusses the role of local authorities as "actors" in the market; the relationship that exists between real estate investment and development; and the involvement of real estate in the shadow economy. The author points out two positive trends: 1). the almost explosive growth of real estate markets; and 2). the increasing competition among regions and municipalities for attracting private investment in local economic development and reconstruction of their cities.

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Check-the-Box Regulations Allow for Selection of an Entity

Mark Lee Levine, CRE

How one holds real estate—that is, in an entity or in an individual name—has enormous tax, legal, and practical implications. If a counselor is to be effective in working on real estate issues for a client, he/she must be familiar with the Federal tax rules on what determines how the tax laws treat entities holding realty. Here, the author summarizes these Federal tax rules and important changes in this area. If you own or advise owners of real estate, you must be familiar with the basic rules of Check-the-Box Regulations. Since the tax impact is enormous, it is critical to any owner of real estate to know if and how much tax the entity must pay.

CONTRIBUTOR INFORMATION

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

Subscribers to *Real Estate Issues (REI)* are primarily the owners, chairmen, presidents, and vice presidents of real estate companies, financial corporations, property companies, banks, management companies, libraries, and REALTOR® boards throughout the country; professors and university personnel; and professionals in S&Ls, insurance companies, and law firms.

Real Estate Issues is published for the benefit of the CRE (Counselor of Real Estate) and other real estate professionals, planners, architects, developers, economists, government personnel, lawyers, and accountants. It focuses on providing up-to-date information on problems and topics in the field of real estate.

REVIEW PROCESS

Readers are encouraged to submit their manuscripts to:
Real Estate Issues, c/o The Counselors of Real Estate, 430 North Michigan Avenue, Chicago, Illinois 60611. All manuscripts are reviewed by three members of the editorial board with the author's name(s) kept anonymous. When accepted, the manuscript and any recommended changes is returned to the author for revision. If the manuscript is not accepted, the author is notified by letter.

The policy of *Real Estate Issues* is not to accept articles that directly and blatantly advertise, publicize, or promote the author or the author's firm or products. This policy is not intended to exclude any mention of the author, his/her firm or their activities. Any such presentations however, should be as general as possible, modest in tone, and interesting to a wide variety of readers. Potential conflicts of interest between the publication of an article and its advertising value should also be avoided.

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

DEADLINES

See Editorial Calendar on page 51 for deadlines.

MANUSCRIPT/ILLUSTRATIONS PREPARATION

1. Manuscripts **must be submitted on disk** (along with hard copy) in **IBM or PC format only--Mac files cannot be accommodated**: .txt (text) file format or Word for Windows 6.0. All submitted materials, including abstract, text and notes, are to be **double-spaced** on one side only per sheet, with wide margins. Number of manuscript pages is not to exceed 15. **Submit five copies of the manuscript accompanied by a 50- to 100-word abstract and a brief biographical statement. Computer-created charts/tables should be in separate files from article text.**
2. All notes, both citations and explanatory, are to be numbered consecutively in the text and placed at the end of the manuscript.
3. Illustrations are to be considered as figures, numbered consecutively and submitted in a form suitable for reproduction. (Camera-ready form, line screen not to exceed 80 dots per inch-DPI.) If higher DPI is warranted to show greater image blends or contrast, illustrations must be computer-generated as PC compatible using the following formats: QuarkXPress, PageMaker, Illustrator, Photoshop, Corel Draw. Any other formats will not be accepted.
4. Number all tables consecutively. All tables are to have titles.
5. Whenever possible, include glossy photographs to clarify and enhance the content in your article.
6. Article title should contain no more than six words including an active verb.
7. For uniformity and accuracy consistent with our editorial policy, refer to the style rules in *The Chicago Manual of Style*.

THE BALLARD AWARD MANUSCRIPT SUBMISSION INFORMATION

The *REI Editorial Board* is accepting manuscripts in competition for the 1998 William S. Ballard Award. All articles published in *REI* during the 1998 calendar year will be eligible for consideration, including member and non-member authors. The $500 cash award and plaque is presented annually each spring, during The Counselors' Midyear Meetings to the author(s) whose manuscript best exemplifies the high standards of content maintained in the journal. The recipient is selected by a three-person subcommittee comprised of members of The Counselors of Real Estate. (The 1998 recipient will be honored at The Counselors 1999 Midyear Meetings in Seattle.)

EDITOR'S STATEMENT

The economic and real estate cycles are in a period of alignment, which is responsible for the current deal-making frenzy. This close correlation has created an absolutely ideal transactional environment. At the same time, rules of underlying economics at the property level are immutable. Supply/demand fundamentals are still the final determinants of price no matter how much financial engineering has occurred. If history provides a predictive model, the real estate cycle will mature prior to the economic cycle. As these cycles disengage and property markets weaken, real estate professionals will be presented with new challenges. *Real Estate Issues* will be at the forefront of such challenges, attempting to lend clarity and understanding to change as well as the excitement of the future.

Never before has the real estate industry been faced with change in terms of the scope, velocity, and profundity that confronts it today. Industry participants have been trapped in a vortex of confusion, occasioned in part, by the dawn of the Information Revolution. Since this Revolution is still in its formative stages, far more convulsive effects are likely. Multi-level paradigm shifts have already had a profound influence on service providers, academia, real estate ownership, and finance. Many industry participants have profited handsomely from such changes. Others have been plagued by rapidly collapsing business strategies and job displacement. It is certain that the future will be characterized by continued and sometimes wrenching change.

Baen and Guttery contend that, "the ease of collection, assimilation, and processing of information, will have major implications for the real estate industry and future employment prospects." [1] They predict that advances in technology will create informational efficiencies which will markedly influence levels of employment and compensation of traditional real estate industry participants.

Roulac maintains that the discipline of real estate "currently lacks coherence and consensus about what the essence of real estate is and what the operative paradigms are for comprehending and making order of the discipline." [2] He observes that finance is becoming ever more dominant as attention shifts to the myriad of newly created financial products and interests in real property rather than the underlying real estate itself.

There is little doubt that the influence of the public capital markets, which has grown exponentially during this decade, represents another change that is as far-reaching as it is permanent. Many experts maintain that the volatility of past real estate cycles is unlikely to be repeated. They contend that the amplitude of previous cyclical swings will be lessened substantially in the future due to the discipline imposed on pricing by the public capital markets. According to this logic, less-than-prudent decisions will be punished almost immediately. Others hold that this alleged "discipline" is illusory in an atmosphere in which rewards are based solely on deal-making prowess and there is little, if any, accountability for excesses of any sort. They argue that, due to this inherent flaw, the public capital markets will react similarly to the private market—when it is too late.

Regardless of how this debate plays out, individual career paths as well as the economic success of service providers will depend on a willingness to embrace and use technological innovation and the ability to understand industry-wide structural change. As always, the challenge to real estate counselors will be to determine how they can participate meaningfully in the decision-making process.

Richard Marchitelli, CRE
Co-editor in chief

1. John S. Baen and Randall S. Guttery, "The Coming Downsizing of Real Estate: Implications of Technology," *Journal of Real Estate Portfolio Management*, vol. 3, no. 1 (1995), 1-18.
2. Stephen E. Roulac, "State of the Discipline: Malaise or Renaissance?" *The Journal of Real Estate Research*, vol. 12, no. 2 (1996), 111-115.

Changes of State

by Hugh F. Kelly, CRE

Based on experiences of various industries going through changes of state in the past quarter-century, real estate should not expect the process to be a smooth one. Thus far we have been spared such turbulence in the period since 1993 when public-market investments in real estate have exploded.

The evening before New York University's REIT Industry Conference last April, D.K. Patton, chair of the NYU Real Estate Institute, convened some of his most prominent speakers for a private dinner at the Waldorf-Astoria's Peacock Alley. With two dozen of the industry's best and brightest sitting around the table, Patton asked, "What do you think our conference will be about three years from now?" One lawyer offered the opinion, "It could be pretty boring. We'll be talking about many of the same things as we are now, but the industry will be five times as large."

Time will tell whether his growth projection is on target but, right or wrong, that outlook may not be as optimistic as it sounds. Let us set aside the argument that REITs have, at least in part, ridden the bull market in all stocks, epitomized by this spring's move above the Dow 9000 mark. While the possibility of a bear market in stocks should not be discounted any more than the likelihood of a recession sometime during the next 36 months, this would just be part of a normal economic cycle and would not point to the need for anything more than tactical preparations.

Patton's question about anticipating and, to some degree, shaping the future, prompts some reflection about how we arrive at our expectations. On one level, the thought that we will be seeing a $750 billion REIT industry by the year 2001 could simply be a continuation of the growth that has seen the industry leap from $10 billion in size at the beginning of the 90s to $160 billion by early 1998. Indeed, a five-fold increase in size in three years would actually be a slight moderation of the growth rates achieved thus far this decade. The outlook is then an exercise in extrapolation, and that is not as naive as it perhaps sounds. After all, as another expert at the Peacock Alley roundtable said, "Can you identify any other industry that, once it had clearly gained a foothold in the public markets, ever reversed direction?"

The basic tool of the extrapolation technique is the trendline, or projection. Every real estate counselor has seen hundreds, perhaps thousands, of projections over the course of his or her career. We use them ourselves each time we apply a "growth rate" to a market rent level or to an employment statistic in an attempt to estimate some condition in the future. Most of us recognize the uncertainty involved in trying to predict the turns of the economy, and are content to settle for the average rate of change as more reliable over the long haul.

Nevertheless, Counselors have long observed the cyclical nature of both the general economy and the real estate markets. Internal dynamics and external events cause deviations from the long-term trendline. The economy and markets have self-correcting mechanisms that push conditions back toward equilibrium when such deviations occur. Thus, when we see rents at variance from feasibility levels or prices far from replacement costs, we model sharp adjustments in our forecasts of supply/demand conditions and spikes (and, less frequently, slips) in our cash flow and valuation forecasts.

The language of economics and of real estate has, unconsciously, adopted the language of classical physics (that is, the physics of Sir Isaac Newton) as its descriptive terminology. We speak about equilibrium, the dynamics of momentum and inertia. We may identify a pattern of entropy as tightly centralized markets spread into suburbs and as temporary advantage begins to fall to the least common denominator of competitive price. Retail analysts even speak of the "gravity" of shopping centers in calculating capture rates and trade area definitions.

Classical physics is an essentially mechanistic model of events, and tends to simplify in order to understand. Recent advances in physics, especially associated with a group of scientists at the New Mexico think-tank named the Santa Fe Institute, have taken an alternative approach. They seek to understand complex systems on their own terms, rather than reduce them to simpler and presumably more tractable forms. These scientists have found their work popularized as "chaos theory" or the "science of complexity." One of the key findings has been the tendency of systems, whether biological, sub-atomic, or cosmological in scope, to become self-organizing and to evolve. This work has provided much to think about in understanding innovation, by focusing on adaptation in structure as a driver in change over time. One advantage over classical physics, which is fundamentally recursive in nature, is that the new approach accepts an openness toward the

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future as being different from the past. To use Stephen Jay Gould's term, we can see "punctuated equilibrium." Or, to look at the motto on the Great Seal of the United States, we can look for *novus ordo saeclorum*, a "new order of worlds."

Much time can be wasted in revisiting the debate over whether "cyclical" or "structural" changes are the key force shaping real estate's near-term future (taking any time horizon of 10 years or less as defining the "near term"). Of course, both cyclical variation and industry restructuring will influence the commercial property playing field. During the next decade, we should surely expect that the United States will see at least one economic recession. There will, doubtless, come a time when the real estate industry sees more construction than contemporaneous demand - in fact, that is probably already occurring in the hotel sector, and the currently robust office sector will likely follow suit around the turn of the millennium. One or another region of the country will become "hot" as the Southeast was in 1995 and 1996, and as the West Coast has been in 1997 and 1998. Capital sources will rotate forward as market leaders, (as the REITs have most recently done), following in a procession which has included pension funds, syndicators, foreign investors, and others who had a temporary advantage in access to money or cost of funds. Banks and insurance companies may find their roles in the market shifting, and even being blurred as larger and larger financial mergers are consummated, as we have seen with Travelers and Citibank. But there may be something more fundamental afoot, albeit disguised as "more and more of the same."

The scientists exploring complex adaptive systems are telling us of a distinction between "changes of degree" and "changes of state." Think of the process of adding more and more heat to a pot of water on the stove. That is a simple example of a "change of degree" (in a very literal sense). But soon, the water begins to bubble and roll, to boil and to turn into steam. Liquid becomes gas, and the fundamental properties and behaviors differ. A transition point is reached and a new set of rules comes into play. Cumulatively, the changes of degree have triggered a change of state.

The new physicists call this a "phase transition," and they have described such transitions in biology, in ecology, in social structures, and in economies. Researchers working this emerging field of knowledge note that such critical transitions prompt new forms of organization, which are similar across the variety of traditional scientific disciplines. Thus the use of analogical study, enthusiastically employed by Aristotle and medieval thinkers but discarded by most post-Enlightenment scholars, now appears to be deeply rooted in the laws of nature. The more philosophical among them speak of "isomorphism," a term rooted in Greek, meaning "similar in the pattern of changes."

This might appear to be highly abstract, but recent history provides us with numerous examples of industries which have undergone phase transitions, or changes of state. For instance, transportation in all its forms — including ocean-borne shipping, trucking, and the airlines – is a vastly different industry today compared with the 1960s. Consider the change in the telecommunications industry since the break-up of the Bell System in 1984. Or, especially obvious at present, reflect upon the financial industry since the Financial Institutions Deregulation and Monetary Control Act of 1979.

For all, the change of state has included a period of proliferation, as new playing fields were opened, followed by a trend toward consolidation. This then settled down in phases of maturation in which a few large, multi-dimensional service providers are supplemented by smaller, entrepreneurial specialists or niche players. My hypothesis is that real estate will travel a similar path, will display isomorphism with other industries as commercial property moves through its own phase transition.

While any one of these industries might be studied to explore potentially useful analogies for anticipating the challenges of real estate's change of state, the U.S. airline business has some particularly pertinent lessons to present.

Presently, three airlines--United, American, and Delta--share more than 50 percent of all U.S. passenger traffic. Let us look at these three dominant carriers, and some of their competitors both operating and defunct, to see how each coped with the changing business environment.

All three of the top airlines were major trunk carriers when the Airline Deregulation Act of 1978 went into effect. Historically, Delta's business had been based in the Southeastern U.S., and it had evolved as a significant carrier up and down the East Coast. Its principal competitor was a formidable one, Eastern Airlines. Delta was the pioneer in the "hub and spoke" route system which is now the industry standard. Veteran travelers will wryly recall the old joke about, "If you die in the South, it doesn't matter if you are going to Heaven or Hell, you still have to change in Atlanta." Eastern operated a greater percentage of non-stop flights, keeping the company's load factor - the number of passengers per plane - light when compared to Delta's more efficient system.

Eastern also stayed too long with its fleet of turboprop aircraft, while Delta invested in jets comparatively early and systematically upgraded its fleet. Delta was conservative in its aircraft acquisition policies, never taking on heavy debt to finance its purchase of jets, but over the years built a more modern fleet than Eastern. Even today, travelers through Hartsfield can see signs which may now seem curious - "Fly Delta Jets." These were a not-too-subtle reminder to Eastern customers (Eastern was the second largest airline in terms of traffic through Hartsfield) that Delta passengers were enjoying advantages of speed and comfort. As the era of deregulation dawned, such a competitive advantage became a critical one.

Delta's fleet allowed it to serve transcontinental routes as they became more available, thus allowing it to move from a regional to truly national route system. This forced Eastern to make a big bet on the purchase of new jets, heavily financed by debt just as the high interest rate environment of the 70s and early 80s climaxed.

Throughout the 80s, Delta was able to engage Eastern in a "fares war" in which Delta's greater efficiency and lower cost base gave it all the weapons. The last straw was the Persian Gulf War, which cut into air travel in 1991, and raised the price of jet fuel as well. As Delta took its place among the "Big Three," Eastern went into bankruptcy and ceased operations.

While the Delta/Eastern story of head-to-head competition is dramatic, the two other dominant carriers each navigated the new environment successfully, taking advantage of their own corporate strengths. United Airlines correctly anticipated that the new era would be highly competitive. It played to its image of good customer relations ("the friendly skies"). United sought to defuse labor-management conflict through an employee stock ownership strategy, and executed a business plan which specifically sought to keep costs low, including an investment in fuel-efficient equipment like the Boeing 757 aircraft. Like Delta, United saw that "bigger is better" in the new competitive world, and successfully bid to acquire Pan American Airways' trans-Pacific routes. United also adopted the hub-and-spoke strategy at Chicago's O'Hare Airport, using a mid-continent location to great advantage.

American Airlines used a similar formula. Its D/FW hub is located at one of the most modern airports in the U.S., advantageous for east/west transcontinental traffic and well-situated to serve American's extensive Latin American routes. American also consciously kept its debt levels low, providing financial flexibility during a period of industry *sturm und drang*. And, importantly, American had a leg up on key reservations technology with its SABRE system, which helped the carrier keep its load factors high and allowed it to employ a highly flexible tiered-pricing program.

Other airlines, obviously, were less successful in coping. Some, like Pan Am, are no longer with us. Pan Am, ironically, had a tremendous franchise in the fast-growing international markets and was a visionary in its purchase of wide-body jets like the Boeing 747 to grow its transoceanic market share during the 70s. But these planes turned out to be the airborne equivalents of gas-guzzling muscle cars, and sent the airline's cost basis soaring in the face of the energy crisis. Furthermore, as the hub-and-spoke system proved itself to be the standard for efficient operations, Pan Am found itself without a sufficient domestic feeder system for its world-wide network. Pan Am sought to mitigate this disadvantage by the acquisition of National Airline's equipment and routes. But National's planes were largely Lockheed-manufactured equipment, forcing Boeing-heavy Pan Am to duplicate maintenance and inventory systems, raising its cost structure.

In addition, Pan Am found itself with floating rate debt financing during the high interest rate environment of the late 70s and early 80s. In order to deal with its balance sheet problems, the airline turned to asset sales. Some of these, like the sale of its headquarters property at 200 Park Avenue in Manhattan, were appropriate strategic moves allowing the company to focus capital on its core business. But other sales, including the trade of its trans-Pacific routes and its shuttle routes between New York, Boston, and Washington for ready cash, eviscerated its future business prospects.

Similarly, an ill-conceived expansion strategy, and subsequent sales of assets, paved the path to bankruptcy for Continental Airlines during the 80s. Frank Lorenzo, working from a modest base in the Texas Air Corp. and flush with high-yield bond financing from Wall Street, pursued an aggressive regional expansion program, buying up low cost carriers like People Express in the Northeast and the Denver-based Frontier Airlines. This was a prelude to his acquisition of Continental, one of the nation's largest trunk carriers. Like Eastern, the management strategy at Continental become one of stringent cost controls. Some of these affected the quality of customer service, as the firm sought to bring the "no frills" approach of the short-haul airlines to flights of three hours or more. Customer reaction was not favorable. Lorenzo also emulated Eastern's "take no prisoners" approach to labor relations, and labor-management hostilities brought "by-the-books" slowdowns to its system, further alienating customers. Lorenzo threatened, and then executed, a scorched earth strategy which saw Continental sell off three-quarters of its routes and lay off two-thirds of its workers on its way through Chapter 11. Though it has re-emerged, Continental finds itself in the late-90s operating as a second-tier carrier in the U.S travel market, along with TWA and Northwest.

Of course, numerous operating niches have opened below the level of the trunk carriers. Nimble airlines like Southwest and America West have been able to expand their reach. US Airways has built a dominant presence in its Pittsburgh hub, changing its name from Allegheny Airlines while absorbing smaller units such as Mohawk, Lake Central, Piedmont, and Pacific Southwest in building an extensive route system.

What, if any, are the lessons for real estate? Can the experience of the airline industry in its "phase transition" of the past 20 years shed light on the path ahead for commercial property? Here are some thoughts.

PHASE TRANSITIONS TAKE TIME

While the airline industry is notably different in 1998, compared with its status prior to the deregulation event of 1978, those differences have evolved over the course of two decades. During that period, we have seen a number of business cycles in the U.S., each of which posed opportunities and risks.

Real estate is comparatively early in a phase transition that might be dated from the explosion of capital market real estate activity in approximately 1993. Thus far, the entire period has been an environment of economic expansion in the U.S. and recovery in the real estate markets. In fact, the 1993-1997 period has been a remarkably vigorous period. Employment growth has been consistently above two percent per annum throughout the five years, and real GDP expansion has been above three percent for most of the period. It would not be prudent to assume that such conditions will continue indefinitely.

It sometimes seems that boosters of the REIT phenomenon attribute the real estate recovery to the great popularity of publicly traded REIT stocks. Might it be possible that REITs have proliferated precisely because they caught a rising real estate market? We will not truly see the outline of the real estate industry of the future until the trusts and other investors in commercial property have passed through the crucible of another down-cycle.

BIGGER IS NOT JUST BIGGER, IT IS DIFFERENT

Both Pan Am and Continental found, with varying degrees of pain, that moving up the scale of size is not simply a question of "more of the same." There is a new order of complexity to large companies, and new issues for workers, customer relations, and shareholders. Real estate would do well to bear some of the lessons in mind.

We are already seeing how, as more REITs become a billion dollars or greater in market capitalization, they are driven to focus more attention on larger property acquisitions. Economies of scale become significant. It is very hard to accrete shareholder value by making a $5 million acquisition, no matter how terrific that property might be. In the Fourth Quarter of 1997, REIT acquisitions reported to *the CCIM/Landauer Investment Trends Quarterly* database jumped to an average price of $48 million, three times as high as the mean price for all sales that quarter. Most REITs got underway in the early 90s with specialties in particular locations and/or property types, and many of these were originally real estate operating companies with portfolios of moderately sized, suburban real estate. But the properties meeting economy-of-scale criteria today are, by definition, larger and more complicated, and are frequently only to be found in highly urbanized centers. Buying portfolios of property is different from a succession of one-off acquisitions and, likewise, managing a far-flung empire requires skills beyond those needed when all assets are within a two-hour drive of each other.

The drive toward size also creates opportunities for finding complementary asset profiles. In looking to grow by merger or acquisition, a REIT or large real estate operating company should probably not be looking for a twin. Instead, they require a strategic fit with a firm whose holdings will spread risk by location in markets whose economic structure have a different industry mix and exposure to cyclical volatility. Portfolio theory, in this way, becomes a planning tool for the micro-economics of real estate firms. Counselors versed in this theory and its applications can offer valuable services to such companies.

LOCATION STILL COUNTS, BUT IN A MORE COMPLICATED WAY

Regional, national, and now international scope are becoming more important in an industry in which knowledge of local markets has been one of the historical elements of success. Understanding the local market remains a critical ingredient. This is one reason why I believe that real estate professionals who can operate "under the radar screen," or by nimbly identifying and controlling property assets where such local knowledge can yield high value increments, will always have a significant place in our industry.

But on the scale of the larger players, location takes on another dimension. For the airlines, the "hub and spoke" system emphasizes the *relationship of locations* in an integrated whole. There is a direct analogy for large real estate companies. As property is added to property in an entity's asset holdings, the real estate perforce takes on portfolio characteristics. This creates a new series of considerations, including portfolio balancing, diversification, and risk management. Pension fund investment portfolios have long paid close attention to these issues, and now the REITs must, too.

Interestingly, the drive toward size also creates opportunities for finding complementary asset profiles. In looking to grow by merger or acquisition, a REIT or large real estate operating company should probably not be looking for a twin. Instead, they require a strategic fit with a firm whose holdings will spread risk by location in markets whose economic structure have a different industry mix and exposure to cyclical volatility. Portfolio theory, in this way, becomes a planning tool for the microeconomics of real estate firms. Counselors versed in this theory and its applications can offer valuable services to such companies.

COST ADVANTAGES ARE ONLY PART OF THE PICTURE

One of the disciplines that is frequently heralded by the advocates of the move to publicly-held real estate companies is the drive to return higher margins to shareholders by strict attention to operating margins. Pushing expense ratios ever downward is seen as the sign of superior management. In fact, though, the airline industry experience shows that the "no frills" approach has limitations of its own. For, although shareholders are clearly an important constituency of management, it is the customers who are the basis of all returns. Eastern, Continental, and (to a lesser extent) TWA are object lessons of enterprises who thought they were putting shareholders' interests first, only to squander much of their franchise value in the process of going "lean and mean."

It is vital for real estate managers to make financial decisions with sound tenant relations strongly factored into the equation. Investors have to be educated concerning the payback of tenant retention

There is reason to suspect that REIT growth may have some as yet untested constraints. Given the accretion imperatives in the capital markets, however, one possible adaptation is that the acceptable level of indebtedness might migrate upward. There is no cause for alarm here, of course, expect that such a strategy does, pari passu, narrow the very cost of capital advantage that the REITs have been so assiduously promoting. My point is simply this: despite the disproportionately high share of property acquisitions registered by REITs in the past several years, the real estate industry is going to stay highly competitive and in a competitive market no player can sustain advantage indefinitely.

programs, as compared with the costs of vacancy and the higher level of new Tenant Improvement capital costs compared with T.I.'s typical of lease renewals. Similarly, just as the airlines needed to decide when to shift from gas-guzzling equipment to more energy-efficient planes, so real estate companies must continually evaluate reinvestment in building systems both for their longer-range benefits to operating profits and for the competitive position of the property in the marketplace. Being stingy does not necessary mean being an excellent manager.

Another purported advantage enjoyed by firms with access to the public markets is a lower cost of capital. There is no question that a pool of capital available at advantageous prices is a tremendous business resource. However, a low cost of capital does not, in and of itself, guarantee success. We need only recall that every market leader in the past two decades, including the pension funds, tax-motivated syndicators, and Japanese investors all enjoyed a low cost of capital. For all, such advantage proved temporary and, furthermore, an inadequate shield against their exposure to fundamental swings in the real estate markets. It could be argued that anyone who borrowed from a federally-insured depository in the mid-to-late 80s had the lowest cost of capital of all. But this did not protect against the evaporation of equity. Investors, therefore, should not lose sight of the asset base of any real estate company in a mistaken assumption that the form of ownership will confer some ability to outperform the real estate market in supply/demand terms.

Yet it appears that precisely such an assumption is being made, as REITs find their market capitalization running at a substantial premium over the value of their real estate assets. This is not necessarily a permanent condition. Certainly, it has not often been the case over the course of real estate cycles (for those publicly traded real estate operating companies who have been in business for a lengthy period). And it most definitely has not been the case for firms in other industries. We know very specifically what happens when stock prices undervalue business assets: heavily leveraged buyouts and/or hostile takeovers. The alternative, for an existing management that wishes to ride out the cycle, is selective asset sales. Here again, the experience of the airline industry can be instructive. For some, there will be the opportunity for a shrewd reconfiguration of the property portfolio as cash is raised. For others, there will be a cannibalizing of the portfolio by the sale of assets that are the core of the enterprise. Under the pressure of the market, the fine line between the two may be difficult to discern.

LEVERAGE REMAINS A KEY FACTOR IN REAL ESTATE

Since the 70s, the airline industry has provided examples of adroit debt financing to support strategic route expansion and facilities upgrades. This period also saw prominent carriers succumb to poorly-timed or poorly-priced borrowing.

Analysts covering publicly-traded real estate companies have been frowning on levels of debt that have typically shaped the capital structure of real estate investment. Even if the public company enjoys an advantage of several hundred basis points on the equity component of the deal, the edge in capital costs may shift to a private investor who can secure 75 percent loan-to-value financing compared with a 50 percent debt limit for a public firm.

This is one reason to suspect that REIT growth may have some as yet untested constraints. Given the accretion imperatives in the capital markets, however, one possible adaptation is that the acceptable level of indebtedness might migrate upward. There is no cause for alarm here, of course, expect that such a strategy does, *pari passu*, narrow the very cost of capital advantage that the REITs have been so assiduously promoting. My point is simply this: despite the disproportionately high share of property acquisitions registered by REITs in the past several years, the real estate industry is going to stay highly competitive and *in a competitive market no player can sustain advantage indefinitely.*

TURBULENCE SHOULD BE EXPECTED

Based upon the experiences of the various industries which have found themselves going through changes of state in the past quarter-century, epitomized by the airline industry but by no means limited to it, real estate should not expect the process to be a smooth one. In fact, one of the findings of the Santa Fe Institute scientists has been that phase transitions are typically turbulent, or even apparently "chaotic." Thus far we have been spared such turbulence in the period since 1993 when public-market investments in real estate have exploded. Don't count on this continuing.

I would think that both public-market equity investments (either as REITs or C-Corps) and debt instruments like CMBS are now a permanent part of the real estate industry. We have yet to see how the market will respond to the prospect of diminished opportunities stemming from either economic retrenchment or a market downcycle. Other industries have seen such events as the occasions for winnowing out the weaker competitors. There is no reason to expect that real estate will be exempt from this phenomenon.

Meanwhile, the industry will function as a complex adaptive system, and both the public-market and private-market players will be sharpening their competitive edges. I suggest that, amid the turbulence, real estate service professionals will find ample demand for their services.

And, in a highly competitive, rapidly shifting, and capital-fluid environment, one prediction seems fairly safe to make: It won't be dull.REI

NOTES

Background information for this article has been drawn from a variety of sources. Readers interested in the current state of the REIT industry will find much useful information in the *U.S. Real Estate Almanac*, published by Bear Stearns Equity Research, a book for which the Landauer Research Group developed much of the market content.

Much of the framework of discussion has been built upon research in other disciplines. Readers interested in pursuing these stimulating fields will find the following sources thought-provoking and, for the most part, highly readable.

Relating to the sciences of complexity:

Murray Gell-Mann, *The Quark and the Jaguar: Adventures in the Simple and the Complex*, W.H. Freeman & Company (New York, 1994) pp.392.

M. Mitchell Waldrop, *Complexity: The Emerging Science at the Edge of Order and Chaos*, Simon & Schuster (New York, 1992), pp.380.

Relating to analogy and isomorphism:

Hannah Arendt, *The Life of the Mind*, Harcourt Brace Jovanovich (New York, 1978), pp.521.

Bernard J.F. Lonergan, *Insight: A Study of Human Understanding*, Philosophical Library (New York, 1957), pp.785.

Relating to the theory of punctuated equilibrium:

Stephen Jay Gould, *Wonderful Life: The Burgess Shale and the Nature of History*, Penguin Books (New York, 1989), pp.347.

Relating to the history of the airline industry:

William L. Richter, *Transportation in America*, ABC-CLIO (Santa Barbara, 1995), pp.850.

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The REIT Engine: Is Growth in FFO Sustainable?

by Gary Ralston & Richard Hornbeck

The authors recognize there is considerable uncertainty as to what the future holds for REIT growth engines . . . The changing environment simply requires REIT management to use any and all available resources to create an increase in value for their shareholders.

INTRODUCTION

The stock price of a REIT is driven by FFO (Funds From Operation) per share. So it is only natural that REIT analysts and investors are concerned about the sustainability of current FFO per share growth rates.

In recent REIT history, two strategies—increasing rental income and making accretive acquisitions—have become the predominant methods for maintaining FFO growth. Some observers believe there are natural limitations to REIT growth and, as a result, have suggested the potential for growth in FFO per share is more limited than the earnings growth of traditional operating companies. In effect, some analysts are suggesting that a REIT's FFO can only grow so fast, so long, or so far.

Why is it that Barnes & Noble, Best Buy, Eckerd, OfficeMax, and Pier 1 Imports are considered growth companies, but their REIT landlord is not automatically granted the same status? While some inherent limitations certainly do exist for the REIT, a more comprehensive look at the REIT business model reveals multiple growth opportunities with unlimited potential. The approaches to increasing FFO per share will change, just as engines changed from steam to internal combustion when steam engines reached their limit. This presents an interesting metaphor for the changing real estate industry.

In this article, we describe a fundamental change in attitude now developing amongst real estate practitioners. We then categorize and explore eight strategies for fueling growth in FFO per share, each with multiple variations and tactics. We illustrate how this eight-cylinder REIT growth engine reflects the premium of a REIT's market value over its net asset value (NAV)—in essence, its company (or franchise) value. Finally, we examine how this translates into FFO growth per share and how it mitigates a REIT's operating risk.

REDEFINING THE REAL ESTATE BUSINESS

In the past, landlords simply provided space, and in return, received rent.

The landlord licensed the tenant to use space and thus the focus was on the possession of that space. Today, the real estate business must be redefined more holistically. Landlords must focus on the space user and not solely on the space. A one-size-fits-all approach will no longer work. The landlord must understand the tenant, how the tenant will use the space, and how such space can add value for the tenant.

Change in the real estate industry is apparent, as noted by the growing importance of the REIT structure as an ownership vehicle. We believe this change is even more fundamental than a simple realignment in ownership structure. In today's era of radically expanding customer expectations, users of real estate demand more than four walls and a roof.

The evolution of drug stores from in-line to free-standing is a good example. Drug store customers are demanding a new, higher standard of convenience. Therefore, the landlord must provide not merely space, but space that meets the express needs of today's drug store tenant – highly visible, readily accessible, convenient parking, and a drive-through window. The increased utility of the space generates increased revenues for the tenant and subsequently the landlord.

We expect REITs to evolve from managing the balance sheet (with a focus on size of total assets) to managing the income statement (with a focus on the customer and the resultant revenue generation). If the real estate practitioner or REIT is only in business to provide basic space to its customers, it will remain solely an asset-based company and will cease to grow at some point. On the other hand, if REIT management is able to redefine its business as one that provides the most **useful** space possible to meet its customers' expanding wants and needs, it will become a marketing company, thereby opening significant, unlimited opportunities.

The addition of that small word—**useful**—dramatically impacts both landlord and tenant. Not only is physical space provided, but the locational, linkage, and spatial attributes that impact the tenant can be incorporated into this model. There are many factors beyond the shape and location of the real estate that are important. These include: how that space is used by the customer; how it is serviced for the customer; how it can be adapted to better meet the customer's changing needs; what technological connections it holds; and, how it can provide the user with a competitive advantage over time.

All of these characteristics are part of the bundle of benefits provided by the landlord of **useful** space. Lease terms and structures may change to more specifically meet a customer's goals. Flexibility to meet changing customer needs across many locations will become a competitive advantage and a source of real estate revenue. These factors are limited only by the useful space provider's willingness to meet the customer's need to compete more effectively.

EVOLUTION OF REAL ESTATE INVESTMENT VEHICLES

Figure 1 illustrates the evolution of real estate investment vehicles and their changing nature and characteristics.

Figure 1

Evolution of Real Estate Investment

	MORTGAGE	RE PORTFOLIO	REAL ESTATE COMPANY		GROWTH REIT
		Closed-end Commingled fund	REIT (Advised)	REIT (Self-Adm)	REIT
Growth Drivers	Interest Income				
		Rental income	Rental income Accretive acq.	Rental income Accretive acq. Cost efficiencies	Rental income Accretive acq. Cost efficiencies Other revenue
Mgmt. Focus	BOND-LIKE	ASSET SPACE	ASSET SPACE	ASSET SPACE COST	CUSTOMER USEFUL SPACE REVENUE

Mortgage

Financial institutions often invest in real estate by lending money to real estate owners at a fixed or variable rate of return. Income from this type of investment vehicle is based solely on the interest income of the debt instrument and will not increase over time. There is no opportunity to grow earnings. The mortgage investment is passive and bond-like.

Real Estate Portfolio

Real estate closed-end/commingled funds provide the institutional investor with the option of passively owning real estate. In this case, the sole opportunity to grow earnings is to increase rental income from the assets.

Real Estate Company – Advised REIT

The advised REIT can grow FFO per share in two ways: by increasing rental income; and, by making accretive acquisitions. When a new property is purchased at a price that generates a return greater than the cost of the funds used to purchase it, the positive spread accrues to all existing shareholders. With an external advisor, any cost efficiencies at the management level or any newly generated non-rental revenue are usually retained by the advisor and do not directly benefit REIT shareholders.

Real Estate Company – Self-administered REIT
The earnings growth equation of the self-administered REIT also begins with the basic capability to increase rental income and to make accretive acquisitions. Additionally, this vertically integrated operating company format provides the opportunity to grow FFO per share through numerous corporate and capital efficiencies. However, once optimal cost efficiencies are realized there is no further contribution to growth in FFO per share.

The Long-term Growth REIT
A company becomes a new generation, or long-term growth REIT, by shifting its focus from controlling costs to understanding customers. Management thinking moves from asset-management to customer-management, *i.e.*, creating space utilization that exceeds tenants' expectations.

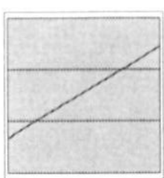
The long-term growth REIT has redefined its business from owning space to providing useful space to meet customers' demands. While it sounds minimal, the effect of such a change in business definition is monumental. It is like changing from steam power to V-8 power.

THE EIGHT-CYLINDER REIT GROWTH ENGINE

REITs that do not recognize the need to change will not be able to sustain growth in FFO per share. They will end up approaching the inherent limits of an asset-based/cost-based philosophy. As noted by Glenn Mueller, there is a limit as to how far cost reduction can go toward increasing FFO.[1]

While true in an asset-based business model, it is not a characteristic of a market or customer-based model. Only a customer-based/marketing approach will be able to exceed these limitations over time. This section outlines the eight cylinders currently available to equity REITs to continue driving and growing FFO well into the future.

Growth Cylinder 1 – Increase Rental Income



The first cylinder of our V-8 engine is the REIT's ability to increase rental income. Increasing overall occupancy rates or increasing rental rates upon re-leasing will generate additional income which increases FFO per share. Beyond this, the REIT is in a position to redevelop or expand property over time to improve the usefulness of the space, thus increasing the potential rent.

Most of today's leases have built-in increases either for inflation or increases from performance-based, percentage rents. In either case, income grows over time. This in itself should deflect the oft-stated claim that REITs act like bonds since bonds do not have automatic increases in coupon rates over time.

Though it may be limited in potential for any one year, this growth cylinder is unlimited over time. It is also not limited by the size of the total real estate portfolio. Whether the portfolio is $500 million or $20 billion, rental increases will add to FFO growth. Each one percent increase in NOI grows FFO per share by almost 1.5 percent *(see Figure 2)*.

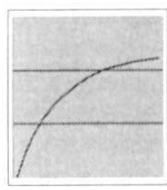
Figure 2

FFO Impact of 1% NOI Increase

Operating cash flow analysis for a typical $1 Billion REIT
(in $millions)

		Increase NOI @ 1%
Real Estate Assets	***$1,000.0***	***$1,000.00***
Net Operating Income (@ 9.50% cap rate)	$95.00	$95.95
less general & adm expenses (@ 5.50% of NOI)	(5.23)	(5.28)
EBITDA	89.77	90.67
less depreciation expense (75% of investment over 39.5 years)	(18.99)	(18.99)
less interest expense 35% leverage @ 7.75% interest	(27.13)	(27.13)
Taxable Income	43.65	44.55
less taxes	-	-
less dividends @ 97% of taxable income	(42.34)	(43.21)
plus depreciation expense	18.99	18.99
[Operating] Cash Flow	$20.30	$20.33
FFO (Taxable income plus depreciation)	$62.64	$63.54
Increase in FFO		1.44%

Growth Cylinder 2 – Accretive Acquisitions



In the 1990s REIT cycle, accretive acquisitions have been the predominant method of growing FFO per share. We expect this method to continue to serve as a primary growth cylinder for some time into the future.

Accretive acquisitions can be either single property purchases or entire portfolios. Currency for acquisitions can be cash, stock, UPREIT units, or any combination thereof. REITs have acquired other REITs, real estate companies, and in some cases, traditional companies with large real estate holdings, such as Vornado's acquisition of Alexander's.

Considering that REITs only own 3.6 percent of commercial real estate,[2] limits to growth in FFO from accretive acquisitions may be more a question of market share than absolute size. Two virtually untapped sources of properties are pension funds and corporations. Many pension funds are actively seeking to swap properties for stock.

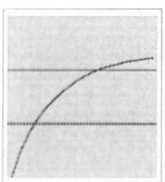
The sale-leaseback potential is gigantic—corporations own $1.7 trillion in real estate, more than 40 percent of the nation's commercial real estate.[3]

When the market value of property exceeds the cost of production, the most accretive acquisitions result from development. Customer-focused REITs are already capitalizing on build-to-suit opportunities and some have created efficient, national programs optimizing space utilization. Many REITs are currently stockpiling raw land or space at favorable prices for future accretive development.

Though continuing as a major generator of growth, the impact of this cylinder will tend to diminish as a REIT gets larger due to the small-base effect.[4] Accretive acquisition growth, while important, is limited in the long-term.

Acquiring properties at a higher return is one way to defer the flattening of the FFO per share growth curve. Sound capital management can position a REIT to take advantage of changing economic conditions. With a conservative debt structure, a REIT can benefit during an economic downturn by acquiring quality properties when others are forced out of the market, thus allowing greater returns attributable to reduced competition.

Growth Cylinder 3 –
Lower the Cost of Capital



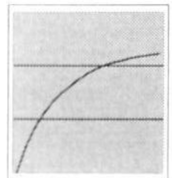
Growth in FFO per share can be created through capital management—lowering the cost of capital, increasing financial flexibility, using alternative sources of capital and dividend reinvestment plans (DRIPS). Fine-tuning the capital mix of debt, preferred stock and equity can minimize the overall cost of capital. Additionally, reducing risk through sound portfolio management and financial structuring will decrease investor return requirements, thus reducing the cost of equity and lowering the cost of capital. When done well, it often leads to an investment-grade rating.

Although lowering the cost of capital generates growth in FFO per share, the benefits available

Customer-focused REITs are already capitalizing on build-to-suit opportunities and some have created efficient, national programs optimizing space utilization. Many REITs are currently stockpiling raw land or space at favorable prices for future accretive development.

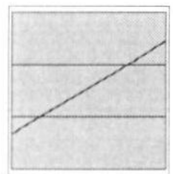
from lowering the cost of capital diminish over time. Cost of capital can only be reduced so far before it stabilizes at some optimal minimum level.

Growth Cylinder 4 –
Reduce Operating Expenses



Operating efficiencies at either the property or the corporate level can increase FFO per share. Additionally, ever-larger REITs are well positioned to take advantage of economies of scale to reduce expenses. While both efficiencies and economies of scale cause an increase in FFO per share, these benefits diminish over time when the maximum reduction is realized.

Growth Cylinder 5 –
Generate Non-Rental Revenue



REITs can generate income from sources other than rent to grow FFO per share. These include internal sources such as tenant services and external sources such as third-party property management and financial services. Possible sources of non-rental income include a multitude of real estate services: site selection, tenant representation, property management, facilities management, disposition of excess space, tenant improvements, and construction management. Various property accounting services can also be provided, including accounts receivable and accounts payable administration. Still other services include CAM administration, tax administration, and audits, as well as environmental and regulatory compliance management. Income can be generated by mortgage originations, mortgage servicing, and mortgage securitization.

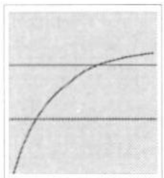
In fact, tenants, their customers, and visitors to their property could be sold an unlimited array of products and services, including insurance, credit cards, business services, or even electricity. These varied revenue streams create continuing income growth potential. Many REITs have already begun to generate greater levels of non-rental income as noted in *Figure 3.*

Figure 3

Types of Other Income

REIT	INCOME TYPE	REIT	INCOME TYPE
AEC	Painting Services	GGP	Strategic Investment
AEC	Construction Fees	GGP	Cable Television
AML	Landscaping	MRY	Mineral Royalties
OAS	Laundry	MRY	Cash Management
OAS	Vending	OAS	Cleaning Fees
CRE	Leasing Fees	RA	Maintenance Fees
AML	Investment Advisory	REG	Brokerage
AML	Asset Management	RET	Consulting
AML	Property Management	SPG	Architectural Fees
BFS	Parking Income	SPG	CO-Branding (Credit Cards)
CEI	Lot Sales	SPG	Financial Services (ATM)
CLB	Marketing Commissions	SRW	Engineering
DRE	Telecommunications	UDR	Dividends
FFA	Equipment Leases	HOT	Employee Leasing
GBP	Olympic Revenues		

Source: Ron M. Donohue, Ph.D., Hoyt Advisory Services

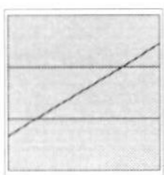


Growth Cylinder 6 –
Sell Properties at a Spread Over the Investment Base and Reinvest

Strategically, as part of a sell-discipline, REITs should dispose of assets to enhance the overall value of the portfolio. If the goal is to continue reinvestment, then the REIT can utilize a 1031 tax-deferred exchange to reinvest the profit, thereby growing FFO per share. This strategy generates new investment capital without raising any new equity or securing any new debt. This revenue source, similar to accretive acquisitions, tends to diminish as the REIT grows.

Growth Cylinder 7 –
Generate Retained Earnings

The REIT business model has the inherent capacity to grow FFO per share through retained earnings. This internally generated capital can be used for new acquisitions or to acquire outstanding shares. *Figure 4* demonstrates that the REIT business model can use retained earnings to grow FFO per share by three percent perpetually, regardless of size.



Growth Cylinder 8 –
Grow Intellectual Capital

Intellectual capital is, "The sum of everything everybody in a company knows that gives it a competitive edge."[5] A growing knowledge base and expanding set of business relationships can increase productivity throughout the organization. These productivity gains grow FFO per share.

Figure 4

FFO Impact of Cash Flow Reinvestment

Operating cash flow analysis for a typical $1 Billion REIT
(in $millions)

Real Estate Assets	***$1,000.00***	***$1,031.23***
Net Operating Income (@9.50% cap rate)	$95.00	$97.97
less general & adm expenses (@5.50% of NOI)	(5.23)	(5.39)
EBITDA	89.77	92.58
less depreciation expense (75% of investment over 39.5 years)	(18.99)	(19.58)
less interest expense 35% leverage @7.75% interest	(27.13)	(27.97)
Taxable income	43.65	45.03
less taxes	-	-
less dividends @ 97% of taxable income	(42.34)	(43.68)
plus depreciation expense	18.99	19.58
[Operating] Cash Flow	$20.30	$20.93
FFO (Taxable income plus depreciation)	$62.64	$64.61
Increase in FFO		3.14%
Reinvestment analysis:		
Total new assets (Cash Flow plus debt @ 35%)	$31.23	

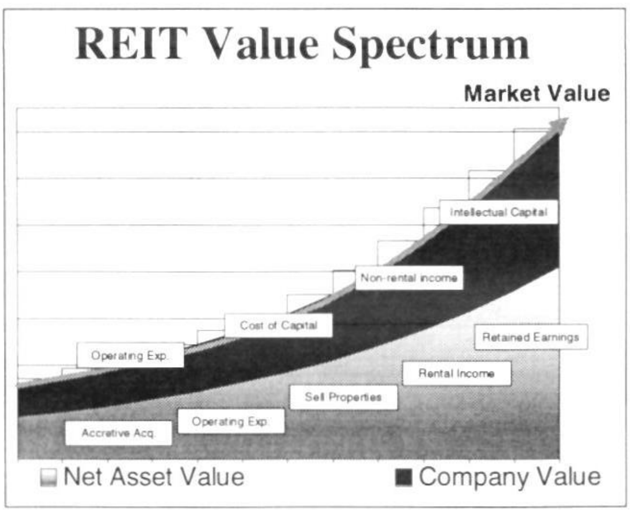
New products and services for customers grow out of this intangible asset. The creative nature of intellectual capital is the catalyst for increasing the utility of space, which not only increases income, but improves the quality and durability of the rental income stream.

Cultivating intellectual capital is the key to continuous improvement resulting in best practices and increasing income. Theoretically, with no boundaries on intellectual capital, there is no limit on growing FFO.

THE REIT VALUE SPECTRUM

Increasing FFO per share leads to growth in net asset value (NAV) and/or growth in the company's value. *Figure 5* illustrates this concept of two primary components of market value, reflecting the REIT Value Spectrum.

Figure 5



Net Asset Value Drivers
Five strategies that primarily drive the increase in net asset value include:

- **Accretive acquisitions**—This is simply the direct addition to net asset value.
- **Increasing rental income**—Though not reflected on the balance sheet, NAV is increased based on the "IRV" formula where **I**ncome divided by **R**ate equals **V**alue.
- **Increased retained earnings**—This is the reinvestment of internally generated funds which increases total assets.
- **Sell properties at a premium and reinvest**—Though no increase in assets is reflected on the balance sheet (original asset basis retained), net asset value grows (based on IRV) due to an increase in the total income stream.
- **Reduce operating expenses (at the property level)**—Lower property expenses increase total net operating income and thus net asset value (based on IRV).

While these drivers of FFO growth most directly impact and grow the NAV component of a REIT's total market value, the other cylinders of the FFO growth engine most directly impact and grow the value of the company.

Company Value Drivers
Four strategies that primarily drive the increase in company value include:

- **Lower the cost of capital**—This aspect of capital management most directly impacts the growth in a company's value by reducing a key raw material cost at the operating level, increasing FFO per share.
- **Generate non-rental income**—By targeting existing tenants, the REIT is able to grow revenues from its existing customer base, increasing the bottom line with a corresponding increase in the company's value.
- **Increase intellectual capital**—Growing FFO is a key result of the application of creative ideas that accrue to the benefit of the REIT and increase the value of the company.
- **Reduce operating expenses (at the company level)**—Lower expenses increase total net income for the REIT and increase the value of the company.

Implications for Growth
Each set of strategies includes some growth drivers whose potential diminish as the REIT portfolio grows and others that can generate unlimited growth opportunities. Those drivers which decrease in impact over time as the REIT grows—accretive acquisitions, selling at a premium and reinvesting, reducing operating expenses (at company and property levels), and lowering the cost of capital—provide particularly strong growth accelerators in the earlier phases of a REIT's life cycle. Those drivers which do not have an inherent limit—increasing rental income, increasing retained earnings, generating non-rental income, and increasing intellectual capital—offer the REIT long-term growth potential without restriction.

As the REIT industry evolves to the long-term growth REIT model, analysts have voiced concern that the REIT will look more like an operating company and thus incur the same level of risk found in operating companies. We disagree. It is true that the four strategies driving the growth in REIT company value are similar to the growth drivers of any operating company. However, a REIT has an entirely different risk profile. Unlike the typical operating company, a REIT has an effective floor on earnings. Its long-term assets are productive and generate some level of return, even if operations cease. An operating company is unable to generate any return on its fixed assets (other than through a liquidation sale) if its operations cease. Therefore, it is unlikely that the market value of a REIT would fall and remain below net asset value. This provides a significant, built-in cushion.

CONCLUSION

We have attempted to present an argument for the sustainability of REIT FFO per share growth. We have identified eight broad strategies, or cylinders for growth, reflecting on the different impact each has on FFO per share. Though the impact of these growth cylinders varies based on REIT size, the real bottom line is that the new growth REIT must maximize output of each growth cylinder throughout its life.

We recognize there is considerable uncertainty as to what the future holds for REIT growth engines. Despite the fact that the V-8 engine may give way to a nuclear engine, some time-tested principles still hold true. The changing environment simply requires REIT management to use any and all available resources to create an increase in value for their shareholders. If they do so, FFO per share growth can and will continue.

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NOTES

1. Mueller, Glen R., "REITs' Growth Cycles: Is Bigger Better? Or

a New Challenge?", Legg Mason Wood Walker, Inc. Real Estate Research Group, February 6, 1998.
2. Lenzner, Robert and Shook, Carrie, "The Unstoppable REIT Juggernaut," *Forbes*, December 29, 1997. Page 68+.
3. Lenzner, Robert and Shook, Carrie, page 68+.
4. Mueller, Glen R., "REITs' Growth Cycles: Is Bigger Better? Or a New Challenge?", Legg Mason Wood Walker, Inc. Real Estate Research Group, February 6, 1998.
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REFORMING THE SUPERFUND ACT

by Jerry T. Ferguson, Ph.D.

A review of events since the passage of the Comprehensive Environmental Response, Compensation, and Liability Act of 1980 (CERCLA) shows that critics may have to wait for major reform. . . . No large support exists for a fairer law. The public will support changes that will get the necessary cleanup at less cost--especially a lesser amount spent on litigation.

This article reviews the most common criticisms of the Comprehensive Environmental Response, Compensation, and Liability Act of 1980 (CERCLA)[1] and its only amendment, the Superfund Amendments and Reauthorization Act of 1986 (SARA).[2] The criticism has been from both legal scholars and economists, although these groups differ on the basis of their objections. The former believe that many provisions and subsequent judicial interpretations are unfair or inequitable.[3] Many economists believe CERCLA is simply inefficient, with rewards to those who can hide the contamination. Moreover, this article reviews the major proposals for amendments to see if they answer the critics.

QUICK AND CONSTANT CRITICISM

The ink was hardly dry on President Carter's signature of CERCLA when legal writers began questioning the fairness of the law. They pointed out that it was hastily drawn legislation, neither well-written or thought out.[4] In fact, it was a hurried political reaction to media and public outcry over the discovery of contamination at Love Canal in New York and Congressional desire to appear as a public guardian.[5] The legal writers correctly predicted that the courts and the EPA would have to finish writing the law by interpretations of a vague Congressional intent.[6]

Yet, one fact about Congressional intent was clear: CERCLA was meant to defray contamination cleanup costs from the federal government and reach into the supposedly deep pockets of major private companies, often only marginally responsible for the contamination.

During the 18 years since passage of CERCLA, legions of writers have been either critical of provisions and judicial (or EPA) decisions or advisory to buyers, mortgage lenders, appraisers, landlords, and real estate brokers about acts to avoid contamination liability in real estate transactions.[7] Among the criticisms are the following:

1. The liability is retroactive with no effective statute of limitations.[8]
2. Any person or company that falls under the definition of responsible party is forced to prove himself innocent.[9]
3. The courts have not allowed traditional common law defenses.[10]
4. Because liability is joint and several, any liable party can be compelled to pay for the entire cleanup cost and be forced to sue other parties for contribution.[11]
5. Defendants who fight an EPA cleanup directive in court face large civil penalties if they lose.[12]
6. Lessors are forced to be environmental police for operation of lessees.[13]
7. Foreclosing lenders that end up with the contaminated property will be forced to pay for cleanup if a buyer cannot be found quickly.[14]
8. It allows for compensation in excess of actual damages.

In addition to the legal criticism, other authors have pointed out that CERCLA has made local government efforts to revitalize or rehabilitate older, often abandoned, industrial sites difficult or impossible.[15] If the locality takes title to an abandoned industrial site because of no bidders at a tax sale, it would be liable for any contamination discovered later. Lenders are also justifiably reluctant to make loans for the purchase of such property.

Then there is the debate over CERCLA's cost efficiency. The Rand Corporation estimates that the costs in legal and consulting fees account for almost one-third of all private-sector costs associated with the law.[16] Of insurance funds paid out because of environmental contamination, 88 percent has been to defend insureds against claims by government and individuals, or litigation over coverage of the contamination; only 12 percent has been for cleanup.[17]

If the EPA wins in court and a cleanup is ordered or even if judgment is granted for government cleanup, the defendant often declares bankruptcy.[18] If this happens, the government must seek to have the bankruptcy trustee pay for the cleanup as a "priority administrative expense." [19] The trustee may pay such an expense from the bankruptcy estate (company assets) to preserve the estate prior to paying creditors. However, any prior government expenditure for cleanup does not take precedence over secured creditors. In this situation, the government must wait to see if a creditor (say a mortgagee) decides to foreclose and if the sale brings more than the creditor's interest before hoping for repayment. Many lenders have decided against foreclosure and let the government's lien prevail.

One reason that lenders are reluctant to foreclose, unless contamination and cleanup appear slight, is the time taken by the EPA to select a cleanup method. After a site is selected for cleanup, the EPA averages 58 months in selecting a remedy.[20] Until then, the cost of cleanup is not fully known. In addition, the remedy selection process, wholly apart from performing the remedy, can cost millions, especially at complex sites.

Because the law does not make non-reporting of discovered contamination a crime, the present owner, fearful of not being able to prove the facts necessary to plead the innocent purchaser defense, may risk a fine and remain silent or cover up the contamination.[21] Outside discovery may be a remote chance unless off-site damage occurs, such as groundwater pollution. CERCLA penalizes those reporting individuals and companies that meet the statutory definition of responsible party. Economic self interest dictates doing nothing or covering up and hoping outside discovery is a long time in coming. Risk of future fines may not be enough to cause companies to commit economic suicide.

The question is: Can these and other criticisms be answered by an overhaul of the Superfund Act and yet not obligate the federal government to spend general tax revenue to clean up an increasing list of contaminated properties?

PROPOSED CHANGES

Insurance companies have proposed two major alternatives to the approach taken by CERCLA. In turn, these alternatives have become the basis of the Clinton administration's recommendation to Congress.

The first alternative would convert the future effort of cleanup from a liability-based one to a government operated and funded program. Under this approach, commercial insurance companies would pay a $300 million annual tax on commercial insurance premiums and other industries would pay a surtax that, combined, would be enough to pay claims caused by acts prior to 1986.[22]

The second alternative is aimed at reducing litigation over whether the responsible party's liability policy covered contamination that occurred while the policy was in force. Since the passage of CERCLA and as the government began to determine which sites have to be cleaned, polluters have demanded coverage for cleanup costs and/or resulting off-site damage claims under their comprehensive general liability policies. The modern policy clearly exempts such coverage, but the contracts in force until 1986 were not so clear. The various state and federal courts have interpreted the older policies inconsistently.[23] The Supreme Court, with its traditional reluctance to decide contract disputes, has not agreed to hear appeals; so a consistent reading of the law appears unlikely any time soon.

To reduce coverage litigation, the insurance companies propose the following:[24]

1. Insurers would make payments into a new Environmental Insurance Resolution Fund (EIRF) to handle claims for insurance coverage of cleanups of pre-1986 wastes. Depending on the Fund's needs, insurers would provide between $2.5 billion and $3.1 billion over the first five years - and up to $8.1 billion over 10 years.
2. Before they could initiate or continue legal action against their insurers, parties responsible for the cleanup of hazardous sites would be required to file a claim with the Fund for reimbursement of cleanup costs at all their Superfund sites on the national priority list. All litigation would be stayed during this claims process.
3. Claims would be contingent on certain proof of insurance by the potentially responsible party.
4. The Fund would offer a settlement for a percentage of the claims, based on the likelihood of the responsible party recovering from insurers in relevant state courts. Those percentages would be based on the history of court decisions in each state as of January 1, 1994, with 60 percent in states where decisions generally favor business; 20 percent where decisions favor insurers; and 40 percent in states where the law remains uncertain.
5. Responsible parties not accepting the Fund's offer could choose to sue their insurer, but the insurers would be protected up to the settlement amount offered by the Fund. Also, a disincentive would be included to encourage businesses' participation in the Fund system.
6. The settlement would include all past, present, and future claims over those sites.
7. The Fund would not begin payouts until 85 percent of all existing responsible parties decide to accept the Fund's offers. If the Fund went out of business, insurers would be refunded their contributions to the Fund, minus administrative expenses.

FEW ANSWERS

The proposed changes answer few of the questions posed by legal or economic critics. They will reduce sums spent in coverage litigation, but insured polluters would need to clean up the site before seeking compensation. If the insured company is located in many states, the question remains how the percentage of compensation would be determined (based on the 60/20/40 percentages). The complaint about retroactive liability becomes "moot," except as a poor legal precedent or for those polluters who had no policies.

Congress has shown interest in making the remedy selection process more timely. Several legislators have proposed two types of changes. The first of these proposals involves reducing or simplifying the substantive requirements that a remedy must meet to comport with the law. The second seeks to change the means by which a remedy is to be selected at some sites.[25]

Reducing the requirements is the more controversial of the two proposals. It is an admission that returning the polluted site to its original state is often economically not feasible or necessary. However, even if standards for cleanup are lessened, any remedy must meet eight other tests, including state and community acceptance.[26] The more promising proposal is to use past remedies that were acceptable on sites that are similar in the contaminants found on the site.[27] This change would avoid the costly and lengthy step of extensive engineering studies to gather data for individual site models (for computer simulations using alternative cleanup remedies). This archival system would necessitate future site reports to list not only the types of contaminants found but also measures of their concentration. If the system is developed, it would aid in the clean up of sites on the EPA Priority list and on other sites targeted for cleanup by states or private companies.

Unless Congress vastly adds to the administration's proposed amendments, few legal or economic criticisms are answered. The EPA has issued directives to lenders as guidelines on how to foreclose without incurring liability for cleanup. These guidelines also explain how much a lender can be involved in the borrowers' business decisions without becoming an equally responsible party for the borrower's contamination.[28] Analysts have said that the EPA guidelines were issued to lessen major legislative reform efforts pushed by lender associations.[29]

A review of events since the passage of CERCLA shows that critics may have to wait for major reform. The public is no longer hysterical over undisclosed contaminated sites. The media are no longer making the discovery of a new site seem an omniscient threat. Yet, no large support exists for a fairer law. The public will support changes that will get the necessary cleanup at less cost--especially a lesser amount spent on litigation.

As for "innocent" puchasers and lenders stuck with contaminated property, they would have to cleanup the contamination, regardless of CERCLA, or have property of little market value.[30] It is only when the contamination has affected off-site property and individuals that CERCLA's provisions seem harsh.
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1. 42 U.S.C. § 9601 et seq (1980)
2. 42 U.S.C. § § 9601 - 9675
3. "Inequitable" as used by lawyers differs from the use by economists. The latter use the term to describe tax or cost burdens relative to value or income; the former, when an act or case decision goes against established common law principles or a general sense of fairness.
4. *Artesian Water Company v. New Castle County Federal Supplement*, 659, p. 1277 (D.N.Y. 1986); *U.S. v. Mottolo, Federal Supplement*, 605, pp. 898, 902 (D.N.H. 1985); *U. S. v. Price*, Federal supplement 577, pp.1103, 1109 (D.N.J. 1983). All three cases discuss the vaguely drafted wording and confusing, if not contradictory, legislative history.
5. "Diana L. McDavid,"Liabilities of the Current Innocent Owner of Toxic Property Under CERCLA," Univ. of Richmond Law Review, Vol.23, No. 3, p. 404 (Spring 1989). In Love Canal, more than 21,000 tons of hazardous waste had been buried in an area later developed for residences. Nearly 1,000 families were moved at government expense and their homes destroyed or boarded up.
6. Henry Dubuc and Ronald L. Evans, "Recent Developments under CERCLA," *Environmental Law Reporter*, Vol. 17, p. 10197 (June 1987).
7. Jerry T. Ferguson and George R. Gray, "Environmental Liability of Brokers and Other Parties," *Real Estate Law Journal*, Vol. 19, p. 218 (Winter 1991).
8. Lowell McDavid, "Liabilities of the Innocent Current Owners of Toxic Properties under CERCLA, *Univ. of Richmond Law Review*, Vol. 23, p. 407-413 (Fall 1989); also Marvin Freeman, "Unconstitutional Retroactive Application of Superfund Liability," *Business Law*, Vol. 42, p. 215 (1986).
9. Dubuc and Evans, Supra, p. 10198.
10. McDavid, supra, note 90, p. 415-416.
11. See *Federal Supplement*, 572, p. 802 (S.D. Ohio 1983) and Dubuc and Evans, Supra, note 4, pp. 1529-31.
12. Linda B. Anderson, "Enforcement of CERCLA, *Duke Law Journal*, vol. 100, p. 483 (1985).
13. Michael B. Kupin, "Alterations of Lender Liability, after Fleet Factors," *Real Estate Law Journal*, Vol.19, p. 215 (Winter 1991).
14. Jerry T. Ferguson & Phyllis Myers, "Managing the Hazardous Waste Risk of Landlords and Lenders, "*Journal of Risk Management*, Vol. 43, p. 38 (January 1996).
15. Robert Simons, "How Clean is Clean," *The Appraisal Journal*, vol. LXII, pp. 429-427 (July 1994)
16. Lloyd S. Dixon, Deborah S. Drezner, and James K. Hamnit, "Private-Sector Cleanup Expenditures and Transaction Costs at 18 Superfund Sites," *Rand*, MR-204-EPA (1993).
17. Franklin W. Nutter, "The Role of Government of the United States in Addressing Natural Catastrophes and Environmental Exposures," *The Geneva Papers on Risk and Insurance*, Vol. 19, p. 255, (July 1994).
18. The court will order a clean up only if the contamination offers a continuing or imminent hazard to the public. See 42 U.S.C. §§ 9604 (a)-(b).
19. Robert S. Bozarth, "Environmental Liens and Title Insurance," Univ. of Richmond Law Review," Vol. 23, p. 327 (Spring 1989). McDavid, supra, p. 410.
20. Robert H. Abrams, "Using Experience To Select A Remedy," *Univ. Of Richmond Law Review*, Vol. 29, p. 587 (May 1995).
21. CERCLA's innocent purchaser defense is codified at 42 U.S.C. §§ (b) (3) (1982). SARA clarified conditions for the defense in 42 U.S.C. §§ 9601 (35) (Supp. IV 1986). Basically, the purchaser must show that he thoroughly investigated previous uses of the property and inspected the land in light of what was discovered. Any previous use that indicated hazardous materials was involved would require a very close scrutiny with professional soil tests.
22. Nutter, Supra, p. 255.
23. A survey was revealed that in 41 states, where the case was at the appeals or superior level, insurance companies won 21 times but lost the remainder. See discussion in Jerry T. Ferguson, "Property Management and CERCLA Imposed Responsibilities, "*Journal of Property Management*, Vol. 60, p. 26 (July / August 1995).
24. Nutter, Supra p. 255.
25. See Section 1834, 103d Congress, 2nd Session §§ 501-503 (1994); also House Resolution 3800, 103d Congress, 2nd Session (1994).
26 Abrams, Supra p. 587
27. Id., pp. 593-597
28. EPA, "Guidelines for Lender Participation in Borrower Operation To Avoid CERCLA Responsibility," Government Printing Office (March 1995).
29. Ferguson and Myers, Supra, p. 39.
30. One expert, who testifies regularly on the effect of contamination on property values has said: "To my knowledge and that of all my associates, no purchase of a industrial or commercial property has been held by the courts or EPA to be an innocent purchaser." See Albert R. Wilson, "The Environmental opinion." Basis for an Impaired Value Opinion," *The Appraisal Journal*, Vol. LXII, p. 411 (July 1994); See discussion of sales of contaminated poverties by Peter J. Patchin in the same issue of *The Appraisal Journal*.

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A New Look at the Home Ownership Decision

by John R. Knight & Cynthia Firey Eakin

Prospective home buyers should consider several factors that favor the decision to rent rather than buy. Discussed here are the factors that influence the decision and the impact of changes in those factors. Also provided is an illustration of the effects using both national and regional house price and rent indexes.

Should you rent or buy your domicile?. . . The question has not changed, but answering it involves an increasingly complex cost-benefit analysis in which both costs and benefits are influenced by financial and non-financial factors. Although non-financial factors such as pride of ownership and community belonging continue to favor home ownership, the financial rules of thumb that were applied with great success in the past are no longer operative.

From a financial perspective, demographic, economic, and societal changes have fundamentally altered the tenure choice decision of prospective home buyers. Many of the changes now favor renting over buying. Although non-financial factors continue to be important, and may even dominate the home ownership decision, the changes in the financial aspects of the decision nevertheless have important implications for policymakers and prospective home buyers. This manuscript re-examines the financial aspects of the residential rent-buy decision, recognizing the new character of the decision-making environment.

There is a rich literature concerned with the tenure choice decision, a large part of which focuses on the determinants of total housing demand, mobility, the characteristics that distinguish home buyers from renters, and housing attributes that distinguish a house selected by a renter from one selected by an owner. Goodman (1988) is a good recent example of such work. These studies typically concentrate on the consumption aspect of housing. Other articles examine the investment aspect of housing, especially in a portfolio context [Webb and Rubens (1986), Goetzmann (1993)], but pay little attention to the housing services associated with the asset. The closest antecedents to this article are Mills (1990), Peiser and Smith (1985), and Johnson (1981), which also employ discounted cash flows to measure the effects of specific changes in the decision-making environment on the decision to rent or buy.

The housing asset has both a consumption and an investment component, but the criteria for evaluation are the same as for other prospective investments: holding period, expected return, and perceived risk. Here we discuss the factors that influence the decision to rent or buy, and analyze the impact of changes in those factors using data from the 60s and 70s as a basis with which to compare data from the more recent past. The consumption aspect of housing is incorporated into the analysis by allowing rental rates for comparable housing to proxy for the opportunity cost of housing services by the home owner.

A DISCOUNTED CASH FLOW MODEL FOR THE RENT-BUY DECISION

While the housing asset has both consumption and investment components, the decision to rent or buy is an investment decision. By making an equity investment, home owners participate in the gains and losses accruing to changes in housing prices in the area. Government attempts to encourage home ownership by allowing home owners to enjoy certain tax benefits such as deductibility of mortgage interest and property taxes. In addition, recent changes in tax law permit most home owners to exclude from taxation capital gains realized on the sale of the home. Renters forgo these investment benefits, but face a more certain, less risky, stream of after-tax cash flows.

Two decision models are available for the prospective home owner: a rule of thumb, and a discounted cash flow approach. Both of these models involve assumptions about differential costs of owning versus renting and about the resident's length of tenure. Both also assume that the decision maker is in a financial position such that he/she is able to choose, *i.e.* the down payment associated with home ownership is not a binding constraint.

The basic rule of thumb can be stated as follows: "Buy if you will be in the home long enough for price appreciation to cover buying and selling costs, otherwise rent." This rule is overly simplistic, but there is much to be said for simplicity that works. And the model has served the prospective home buyer in the United States very well until quite recently.

The more sophisticated tenure choice model uses discounted after-tax cash flows as the basis for the decision. Initial costs, regular periodic outlays, and terminal cash flows of home ownership are compared with those of renting. The differential cash flows are then discounted to the present, and the analysis yields a net present value of the decision. A major benefit of the net present value approach is its consideration of the time value of money. This is important for the rent-buy decision because large cash flow differentials occur at the very beginning (down payment) and at the very end (capital gain or loss from sale) of the holding period. To apply the discounted cash flow model, key assumptions must be made about the periodic and reversionary after-tax cash flows, the length of the holding period, and the discount rate. A description of the discounted cash flow model in the context of tenure choice is included as an appendix.

A CHANGED DECISION-MAKING ENVIRONMENT

The viability of existing models for the tenure choice decision is questionable in the economic environment of the 90s. In particular, the real estate and labor markets, as well as the society that includes these markets, have undergone substantial shifts. Tax laws affecting home ownership have changed as well. The changes, and how they affect the decision-making rules are discussed below.

Changes in Residential Markets

One very important change in the decision-making process is the relatively recent recognition that house prices can go down as well as up. Except for some isolated instances, nominal house prices have trended upward throughout the nation from the end of World War II to the beginning of the 1980s. Since then, a rolling recession has resulted in significant declines in house prices in the oil states, the Northeast, and more recently California. As a result of the experience, the housing asset is no longer viewed as an investment that only goes up in value.

The entire basis of the rule-of-thumb model is price appreciation during the holding period. If prices are expected to decline during the holding period, the decision maker using the heuristic rule is likely to choose to rent rather than buy for any assumed tenure period because the transaction costs of buying and selling the home will not be covered.

Less predictable house price trends have a similar but more subtle effect on the decision maker employing a discounted cash flow model. As with the rule of thumb model, acknowledging the possibility of price depreciation affects the expected returns of home ownership. But the discounted cash flow model also accounts for the increased riskiness of those returns. Greater uncertainty leads to choosing a higher discount rate, which decreases the importance of equity reversion in the tenure choice, especially for long tenure periods. For risk averse investors, the possibility of loss is avoided more intently than the possibility of an equal gain is sought. The net effect is for discounted cash flow decision makers, on average, to choose renting over buying in volatile housing markets.

Those who have experienced the downward variability of housing prices firsthand are especially likely to make the decision to rent at the next opportunity. Their respect for the riskiness of the housing asset has grown while their funds available for an equity investment in housing have shrunk.

Changes in Tax Law

An important change in the decision-making process between renting or buying a residence is the way gains from sale of a residence are taxed. Under prior law (Internal Revenue Code Sections 1034 and 121), taxation of capital gain from the sale of a residence was deferred only if the seller purchased a new home of equal or greater value than the old home. This is commonly known as the Section 1034 "rollover" provision. If a new home was not purchased, or if the new home was of lesser value than the old, some or all of the gain was taxed as a capital gain in the year of sale. An additional feature of prior law was the so-called "once in a lifetime" exclusion allowed by Section 121. Under this provision, taxpayers 55 years and older could choose to permanently exclude from taxation up to $125,000 of gain from the sale of a residence. However, this exclusion could be taken only once in the taxpayer's lifetime. Gains in excess of $125,000 could continue to be deferred under the rollover provisions of Section 1034. Losses on the sale of a residence were considered to be personal in nature, and, as with most other personal losses, were not deductible.

In periods of price appreciation, prior law not only provided a strong incentive for prospective investors to invest in a home as a way to defer taxation of gains, but also provided an incentive for current home owners to extend their tenure as home owners by "trading up" each time they sold a principal residence. This is because gains on the sale of the home could be deferred as long as the taxpayer was trading up to homes with a higher price. In addition, up to $125,000 of the cumulative, lifetime gain could be permanently excluded when the taxpayer neared retirement and would most likely choose to "downsize" the home.

Many of the changes now favor renting over buying. Although non-financial factors continue to be important, and may even dominate the home ownership decision, the changes in the financial aspects of the decision nevertheless have important implications for policymakers and prospective home buyers.

In periods of housing price variability, prior law also provides incentives for home owners to extend their tenure as home owners. Even in periods of declining prices, as long as there was some amount of gain that would be realized on the sale of the home, the rollover provisions of Section 1034 provided incentives for home owners to retain their investment in a residence as a way to defer the payment of tax on the gain. Thus, prior law provided incentives to extend home ownership tenure.

The Taxpayer Relief Act of 1997 was passed on August 7, 1997, and significantly changed the way gains on the sale of a residence are taxed. The rollover provisions under Section 1034 were repealed, and the $125,000 exclusion under Section 121 was modified. Although taxpayers can no longer defer gains on home sales by purchasing a new home of equal or greater value, under the new law, married home owners are allowed to permanently exclude up to $500,000 ($250,000 for single taxpayers) of gain. Furthermore, the exclusion is available each time the taxpayer sells a principal residence, but, in general, cannot be used more frequently than every two years. Gains in excess of $500,000 cannot be rolled over, but are taxed as capital gains in the year of sale. As under prior law, losses are not deductible.

The new law has important policy implications. In periods of price appreciation, the new law appears to make home ownership all the more attractive because most gains can now be permanently excluded. However, in periods of price variability, the effect of the new law may be to shorten the length of tenure. As an example, consider a home owner who has experienced price appreciation in prior years, but now experiences price decline during a period of price variability. Under prior law, as long as a gain would be realized upon sale of the residence, the home owner had incentive to continue to own a home as a way to defer tax on the gain. Under the new law, the home owner no longer has the incentive to continue tenure as a home owner. This is because the old residence can be sold and the gain (up to $500,000) will not be taxed. Furthermore, if prices continue to decline, the taxpayer has no other incentives to reinvest. Thus, in periods of price variability, the new law allows home owners to "cut their losses" through sale of the home without having to pay tax on the gain or invest in another residence. This has the effect of shortening the length of tenure.

Changes in the Market for Labor

Global competition and the "right sizing" of American corporations is having profound effects on labor markets in the United States. The two most apparent effects are shorter labor contracts and vastly different perceptions regarding job security.

Employment arrangements whereby one works for one company over an entire career, commonplace in the 50s and 60s, are now relics of the past. Independent contractor agreements, contract labor, and temporary employment contracts that do not tie the employer, or the employee/contractor, to long-term commitments are now the norm. This permits companies to respond more flexibly to changes in the market for their products by expanding or contracting the labor force. It also allows workers to earn the market price for their services by changing jobs frequently. In the context of the tenure choice decision, the effect of shorter, more flexible labor contracts is a reduction in the expected length of tenure for the home owner or renter. Even in an appreciating market, the shorter the holding period, the lower the probability that prices will have risen enough to cover the six percent to seven percent selling cost of a home. And the sooner selling costs occur, the less they are discounted for a net present value decision.

Perhaps as important as the reduction in expected holding period is that the threat of unemployment is more keenly felt by a larger and more diffuse segment of the population. Reduced job security influences expectations about duration of tenure, the effects of which have already been discussed. Job security also impacts the way home owners regard their down payment. For many, the down payment on a home represents the largest single commitment of financial resources. It seems reasonable that decision makers with increased uncertainty surrounding their job prospects will be less willing to commit these resources to an investment asset that is not only riskier than other alternatives, but also highly illiquid.

Clearly, recent trends in labor markets affect both the expected length of tenure and the certainty with which length of tenure can be assessed. Increased mobility implies that the decision point for renting or buying will be reached by families more frequently, and the underlying cause for increased mobility, shorter and less secure labor arrangements, implies that the decision, when reached, will more likely be to rent than to buy.

Societal Changes

Family formation and growth are the primary reasons for buying a first home and for trading up to larger homes during the life cycle. One societal trend with the potential for a significant effect on this pattern is the tendency for families to form later, and to stay together less, than in the past. Family dissolution not only affects the motivation for home ownership. It also has important implications for the affordability of a home for the increasingly common single earner households.

Some of the effects of societal changes are already being seen in home ownership rate statistics. While the overall rates have remained stable, the composition by age group has changed dramatically. Between 1973 and 1992, home ownership rates declined from 23.4 percent to 14.3 percent for the under 25 age group; from 51.4 percent to 42.5 percent for those between 25 and 34; and from 70.7 percent to 65.5 percent for the 35 to 44 age group. Home ownership rates have risen for the more settled groups, from 75.9 percent to 77.1 percent for those aged 45 to 64, and from 69.8 percent to 77.3 percent for those over 65.

MEASURING THE EFFECTS OF CHANGES

Careful analysis is not necessary to understand that lower expected returns, greater perceived risk, and a shortened length of tenure expectation all work to make the residential investment less attractive. In the current environment, families faced with the decision are more likely than in the past to rent. The difficulty is not in determining the direction, but rather in assessing the magnitude of the altered attitudes toward home ownership. The home ownership rate does not exhibit sufficient variation to serve as a useful statistic, partly because a relatively small proportion of families are in a position to change their tenure status during any given time period, and partly because of the tendency of home owners to continue choosing ownership at subsequent decision points.

We approach the problem by recognizing that the probability of choosing to buy is directly proportional to the probability that residential investment will be seen as a positive net present value project. We first use historical data for housing prices, rents, and mortgage rates to measure the *ex post* net present value of the decision to buy for a number of assumed holding periods. We then compare recent outcomes with those of earlier periods. The historical data is then used as the basis for numerical simulations aimed at measuring the changes in the probability that net present value for a given holding period will be positive.

Data and Empirical Results

To calculate the net present value of the purchase decision, time series data are needed for rental rates, mortgage yields, and home prices. Also required are assumptions regarding the level of down payment, terms of the mortgage loan, the cost of property taxes, insurance and maintenance, and the marginal tax rate of the prospective home buyer.

We use the series of mortgage yields on fixed rate mortgages disseminated by the Federal Home Loan Bank Board to calculate amortization and periodic interest payments. These yields incorporate discount points and assume a 10-year holding period for the loan. In computing net present values, we allow for refinancing by the home owner whenever mortgage yields fall by more than one percent. We assume that the initial loan is a 30-year, constant payment, fixed rate mortgage for 80 percent of purchase price, and that any refinanced loan is at the new rate, but for the remaining term and for the outstanding balance on the existing loan at the time of refinancing. For each holding period, these assumptions permit calculation of periodic interest payments, and the mortgage balance at equity reversion.

Because reassessments are infrequent in most jurisdictions, property taxes vary little during most reasonable holding periods. Also, the costs of insuring and maintaining the home are relatively low and constant except for some discontinuous lumps. We assume a constant annual rate of two percent for property taxes and 0.5 percent for insurance and maintenance. As to the tax shield provided by interest and property tax expenses, we assume other deductible expenses of the home owner are sufficient to surpass the standard deduction. A marginal tax rate of 28 percent is used.

Two assumptions are made with respect to equity reversion. First, selling costs of seven percent are employed to reflect the typical six percent sales commission plus one percent in other closing costs. Second, the sale of the home is assumed not to be a taxable event. Quite commonly, capital gains will be below the threshold for taxability.

Data from the 60s and 70s

To represent the U.S. house price experience prior to 1980, we use national data from the Federal Home Loan Bank Board covering the period 1967 through 1982. The price index constructed from these data confirms the relatively steady upward march in residential real estate values across the country. To construct a comparable property rent index for this period, we assumed rent during the first period of the data series to be in equilibrium, equating that first period's rent with the periodic after-tax cash flows from buying. We then allowed rental rates to follow the path suggested by the Consumer Price Index Residential Rent Component. *Figure 1* displays the resulting rent index alongside an index of house prices for the period.

Data from the 80s and 90s

Data from two metropolitan areas, Baton Rouge, Louisiana, and Hartford, Connecticut, are used to represent the more volatile price change experience of the 80s and 90s. These markets are good examples because they each demonstrate exactly opposite price paths over the period of study. Baton Rouge experienced a period of price decline followed by a period of price appreciation, and Hartford experienced a period of price appreciation followed by a period of price decline. Although these two cities may not be typical of all real estate markets, many other markets experienced similar price patterns. In addition, these two markets certainly are more typical of current housing markets than the steady upward trend experienced in the 60s and 70s. Home price appreciation has peaked in many areas and price depreciation, albeit at different times in different places, is occurring.

For these localities, constant quality house price indexes are formed using disaggregate data on home sales transactions. For Hartford, rents for comparable housing were obtained directly by using the median listed rental rate for all three bedroom houses for rent on the last Sunday of each quarter during the period. In Baton Rouge, the rent series was pieced together using data from three bedroom duplex and fourplex rentals and an index of three bedroom apartment rentals. The paths of prices and rents in Hartford, Connecticut, and Baton Rouge, Louisiana, are shown in *Figures 2* and *3*.

Empirical Results

Tables 1, 2, and *3* provide some evidence of the effect of changing factors on the net present value of home ownership. These tables record the *ex post* result of a decision to own given the historical path of home prices, rental rates, and mortgage rates. Each row contains all possible results for a holding period of a given length. For example, the first row contains all one-year holding periods within the span of each data series.

The two panels of each table report the results for an assumed five percent and 15 percent discount rate respectively. Net present values are shown rather than internal rates of return, as the positive or negative outcomes better represent the binary financial choice of the decision maker to own or not own. However, since values rather than returns are shown, the reader should not attach importance to the relative magnitudes of the analysis, as each value is the result of a different level of equity investment. Instead, attention should focus only on the sign of the result, positive or negative.

Table 1 bears out the profitable, low-risk nature of the housing investment in the 60s and 70s. All tenure periods of at least five years have a positive outcome at both assumed discount rates. Even more impressive, until 1978 any holding period greater than one year was sufficient to achieve a positive return on equity. The

Figure 1 - Housing Prices & Rents
National Data - Annual

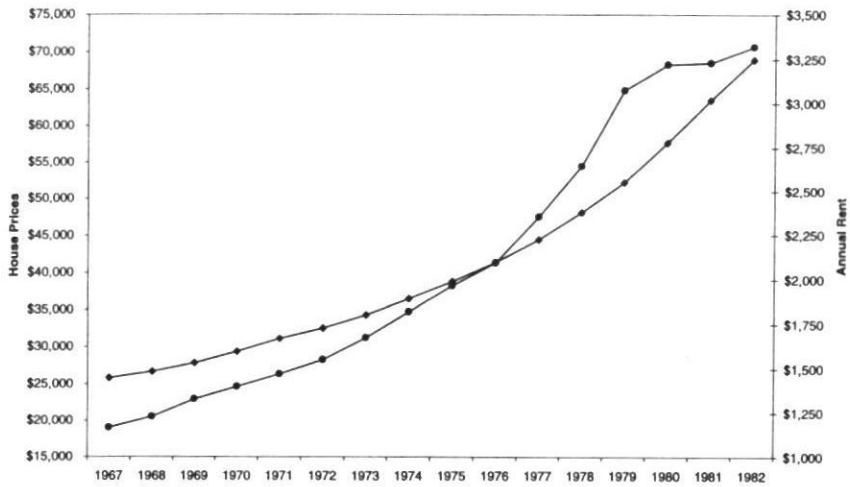

Figure 2 - Housing Prices & Rents
Hartford, Connecticut - Quarterly Data

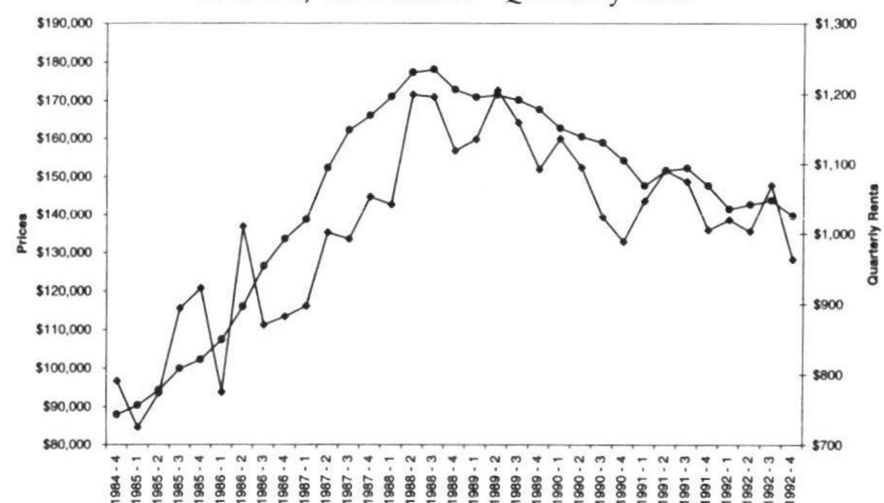

Figure 3 - Housing Prices & Rents
Baton Rouge, Louisiana - Quarterly Data

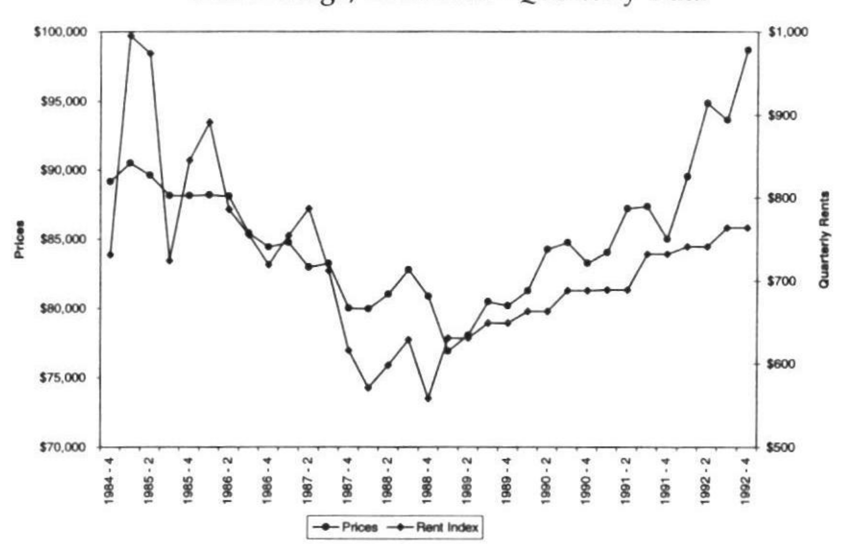

Table 1

Net Present Value of Home Ownership

1967 - 1982: National Data

5% Assumed Discount Rate — Beginning Year of Holding Period

Holding Period In Years	1967	1968	1969	1970	1971	1972	1973	1974	1975	1976	1977	1978	1979	1980	1981
1	723	1349	424	213	349	1200	1330	839	151	2646	2749	4833	-2678	-6531	-5336
2	3417	3367	2350	2207	3350	4601	4619	3567	5445	8474	11183	7110	-3614	-6303	
3	5379	5284	4328	4980	6570	7785	7384	8644	11015	16547	13539	6699	-2702		
4	7242	7245	7043	7964	9583	10467	12377	13982	18723	18830	13325	8024			
5	9145	9904	9956	10757	12119	15268	17610	21354	20914	18663	14756				
6	11710	12747	12683	13100	6674	20295	24772	23471	20773	20061					
7	14448	15408	14977	17370	21446	27157	26922	23365	22120						
8	17011	17653	19102	21850	27966	29242	26946	24675							
9	19176	21639	23425	28000	29938	29300	28311								
10	22996	25808	29334	29821	29980	30634									
11	26990	31485	31117	29809	31238										
12	32417	33229	31151	30957											
13	34098	33304	32288												
14	34187	34426													
15	35271														

15% Assumed Discount Rate — Beginning Year of Holding Period

Holding Period In Years	1967	1968	1969	1970	1971	1972	1973	1974	1975	1976	1977	1978	1979	1980	1981
1	330	875	-11	-233	-139	605	672	163	-526	1697	1684	3465	-3572	-7151	-6063
2	2270	2174	1237	1056	1956	2936	2844	1834	3276	5695	7735	4081	-5256	-7661	
3	3338	3183	2316	2714	3856	4692	4224	4970	6590	10647	8026	2419	-5380		
4	4162	4054	3720	4224	5272	5775	6883	7702	10754	10632	6366	2136			
5	4870	5213	4999	5334	6117	7986	9199	11194	10617	8956	5933				
6	5836	6272	5933	5966	7956	9910	12180	10961	9052	8377					
7	6718	7036	6454	7476	9557	12424	11929	9503	8455						
8	7348	7446	7741	8792	11681	12136	10615	8898							
9	7674	8527	8862	10573	11377	10934	10049								
10	8588	9467	10390	10253	10285	10389									
11	9382	10766	10092	9255	9770										
12	10489	10480	9207	8767											
13	10222	9686	8767												
14	9515	9282													
15	9149														

negative results for holding periods beginning in 1978 and later stem from the leveling off of home appreciation in conjunction with historically high mortgage rates; rates exceeded 10 percent for the first time in 1979.

Tables 2 and 3, reporting *ex post* results of home ownership for Hartford, Connecticut, and Baton Rouge, Louisiana, respectively, provide a sharp contrast to the earlier national experience. The price paths of residential real estate for these two metropolitan areas were almost mirror images of each other. In Hartford, prices rose rather precipitously through 1988 before experiencing a gradual decline. In Baton Rouge, prices reached a nadir in 1989, but have since made a full recovery. Reflecting an experience common in most parts of the country, both cities saw price declines as well as appreciation during the eight-year period from 1985 to 1992.

Looking at *Tables 2* and *3*, the most immediate and striking observation is that there are quite a few more negative signs than was the case with the national data. In fact, only at the assumed discount rate of five percent does home ownership appear to be, *ex post*, a wise investment in most cases. For this rate, 27 of 36 holding periods yield positive results in Hartford, while this is true in 23 of 36 cases in Baton Rouge. However, at a 15 percent discount rate, home ownership has a positive net present value only nine of 36 times in Hartford (short holding periods with sharp price increases in the early 80s), and only six of 36 times in Baton Rouge (short holding periods with sharp increases in rent in the early 80s, and short holding periods with sharp increases in housing prices in the late 80s and early 90s). Additional analysis at a 25 percent discount rate resulted in a positive net present value for home ownership only three times in Hartford and

Table 2

Net Present Value of Home Ownership
1985 - 1992: Hartford Data

Holding Period In Years	*5% Assumed Discount Rate — Beginning Year of Holding Period* 1984	1985	1986	1987	1988	1989	1990	1991
1	4337	14885	13462	-10156	-14704	-18596	-9481	-9963
2	64677	81081	16391	-13781	-24119	45762	48664	
3	74492	74269	11519	-21272	32156	32357		
4	68839	62725	3799	24326	21151			
5	59301	50220	910	15272				
6	48980	42823	-1688					
7	42867	36592						
8	37718							

Holding Period In Years	*15% Assumed Discount Rate — Beginning Year of Holding Period* 1984	1985	1986	1987	1988	1989	1990	1991
1	-842	6465	3859	-15656	-19137	-21743	-14016	-14070
2	24427	31237	-3041	-22218	-27869	9766	9137	
3	14235	11538	-10445	-27183	-8753	-10422		
4	2957	-1642	-15375	-16051	-20289			
5	-4587	-9537	-17152	-22646				
6	-9106	-13432	-18089					
7	-11335	-15598						
8	-12575							

Table 3

Net Present Value of Home Ownership
1985 - 1992: Baton Rouge Data

Holding Period In Years	*5% Assumed Discount Rate — Beginning Year of Holding Period* 1984	1985	1986	1987	1988	1989	1990	1991
1	-7144	-8131	-8319	-4333	-1790	-2941	-3674	2951
2	31256	28471	-6598	-3918	1097	33308	42936	
3	24729	24331	-5772	-1228	29142	36754		
4	21330	20470	-3170	22526	31964			
5	18159	18903	-1613	24855				
6	16875	17160	3316					
7	15445	18750						
8	16756							

Holding Period In Years	*15% Assumed Discount Rate — Beginning Year of Holding Period* 1984	1985	1986	1987	1988	1989	1990	1991
1	-9534	-10199	-10139	-6975	-4876	-5943	-6613	-1795
2	6743	5449	-10456	-8866	-5795	10924	13656	
3	-4306	-4327	-10978	-9040	2426	3470		
4	-9893	-10074	-10769	-3842	-1840			
5	-13178	-13046	-10875	-6280				
6	-14876	-14860	-10530					
7	-15913	-15655						
8	-16368							

never in Baton Rouge (these results are not included in *Tables* 2 and 3, but are available from the authors).

The results in *Table 2* are primarily a reflection of price change in the Hartford area. Residential rental rates appeared to stay in step with housing prices—a benefit to home owners who locked in relatively low mortgage payments early in the period. The rapid price appreciation in the early 80s produced an uncustomary result: short holding periods beginning in 1984, 1985, and 1986 fared better than longer holding periods. This finding has important policy implications. Part of the reason that short holding periods fared better is related to the new tax law. Whereas the old law required the rollover of the gain into another home to avoid taxation, the new law allows taxpayers to get out of the housing market completely, and still avoid taxation on the capital gain. Thus, the new law makes the decision to leave the home ownership market more attractive than before. If the objective of policymakers is to use tax incentives to encourage home ownership, then, in periods of price volatility, the new law falls short.

It was extremely difficult during the study period to make money through residential investment in Baton Rouge, a fact revealed in *Table 3*. Home owners there benefited from relatively low house prices relative to rental rates on comparable properties, but the price path between 1984 and 1988 was hardly conducive to capital gain. Price appreciation in the latter part of the period improved results for short, late holding periods, but the overall financial experience from home ownership in Baton Rouge was dismal. Again, the new tax law provides little incentive for home ownership in periods of declining prices.

CONCLUSIONS

This study has addressed the impact of economic, demographic, and societal changes on tenure choice. The changes hold two major implications for the discounted cash flow method of analyzing residential investment decisions:

1). Discount rates will be higher; and

2). Expected holding periods will be shorter.

Both of these implications argue against ownership because they highlight two fundamental ways owning differs from renting. Owning involves a high entry cost, the down payment, that is prized more dearly under higher discount rates. As contrasted with renting, owning also involves a high exit cost, primarily the sales commission, that is prized more dearly than the shorter the holding period.

An *ex post* comparison between the recent past, 1984 to 1992, and the more distant past, 1967 to 1982, confirms the effects of many important changes on the financial wisdom of residential investment. At any given discount rate, and for any given holding period, home ownership was more financially rewarding in the earlier period. Moreover, the more volatile, and sometimes negative path of housing prices justifies a higher discount rate, just as changing labor markets justify an abbreviated expected holding period. Making these adjustments to the assumptions underlying the discounted cash flow model merely widens the gap between the recent past and the "good old days" of home ownership. In light of recent experience, as individuals reach the decision point for renting or buying their residence, they are more likely now than in the past to rent. This observation should be important for policymakers when considering tax law changes. Although the new law regarding exclusion of capital gains appears to make home ownership more attractive, in periods of price volatility, the new law actually may cause home owners to shorten their tenure as home owners.

Do these results mean that families will cease to buy homes?. . . Of course not. First of all, owning and renting are complementary components of total housing demand, and therefore compete with each other. Increased desirability of renting allows landlords to raise rents, an action that makes ownership more desirable. In residential housing markets, just as in other competitive markets, the prices of competing products rise and fall until equilibrium is reestablished at a new level. Secondly, while owning and renting are close substitutes for housing services, they are not perfect substitutes. Variety of supply is much greater in the market for house sales, and in many cases, it is not possible for the decision maker to find a closely comparable, or even suitable, rental property. These potential renters become home owners by default. Thirdly, although recent tax law changes may not have the desired effect, federal, state, and local governments will continue to encourage home ownership through tax policies and financing programs. It is unlikely that these entities, which clearly see home ownership as a desirable behavior, would permit any long-term substantial drift toward renting. Finally, the tool for analyzing the decision is only a financial tool. While well-equipped to deal with differential cash flows, the discounted cash flow model is woefully inept at incorporating into the decision framework non-financial factors. Pride of ownership and a sense of community belonging, may, in fact, dominate the strictly financial considerations. It must be kept in mind that owning a home remains, after all, the "American Dream."

Still, the results provide important information to policymakers and to the prospective home owner. Stated quite simply, the risk and return characteristics and the tax consequences of the housing asset have changed, and this study provides evidence of the direction and impact of those changes. Since equity in one's home is the largest single component in the typical family's portfolio of wealth, new information about the expected performance of that investment deserves at least the same attention as information regarding the other assets and securities that comprise the portfolio.

APPENDIX

The Discounted Cash Flow Model

As applied to the home ownership decision, the discounted cash flow model is:

$$NPV_E = -(P-D) + \sum_{t=1}^{T} \frac{ATCF_t}{(1+k)^t} + \frac{ATER}{(1+k)^T} \tag{1}$$

The net present value of the home owner's equity, NPV_E, is equal to the sum of the cash flows resulting from a decision to own, discounted back to the time of the residential investment. The initial cash outlay for the home owner is the down payment, represented by the price of the home, (P), less the amount of mortgage debt, (D).

The periodic costs, $ATCF_t$, are made up of the difference, after-taxes, of owning as opposed to renting. If we assume that property taxes, insurance, and maintenance are fully impounded into the monthly lease payments, then the after-tax cost of renting is simply the monthly rental rate, (R). Correspondingly, the home owner's after-tax periodic costs of housing consumption are interest (I); property taxes (PT); and insurance and maintenance (IM), less the tax shield afforded by the deductibility of interest and property taxes. We can express this as:

$$ATCF_t = R_t - (I_t + PT_t)(1 - \tau) - IM_t \tag{2}$$

This puts the periodic cash flows in an opportunity cost context. If the monthly outlays for renting are greater than for owning, the difference shows up as a cash inflow for owning. Note that only the interest portion of the monthly mortgage payment is considered. The principal portion of the payment is recaptured by the home owner/borrower at loan termination.

The terminal cash flow for the home owner, then, is simply the price (P) less the mortgage balance (MB) at time (T), less selling costs (SC).

$$ATER_t = P_T - MB_T - SC_T \tag{3}$$

Capital gains taxes can be realistically ignored, as recent changes in tax law allow permanent exclusion of capital gain from the sale of a residence. REI

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Urban Real Estate Markets in Russia: The Current Stage

by Olga Kaganova, CRE

For international investors who are thinking about "windows of opportunity" in Russian real estate, it might be useful to systematically monitor the success of real estate reform and market activity in different Russian cities to identify the most promising places.

Scope of Privatization

There is no doubt that urban real estate markets are quickly emerging in Russia due to the high turnover of privatized properties. But privatization itself exists unevenly across subsectors and geographical regions.

On average, more than 50 percent of the residential stock is already privately owned, varying from 30 to 95 percent in different cities. In fact, anyone who wished to obtain ownership in an apartment which he or she occupied has already done so early in the transition. Therefore, the share of privately-owned housing has been increasing slowly during the last three years (three percent in 1996).[1]

No national statistics exist about privatization of commercial and industrial buildings and premises, but indirect data indicate that the share of privately-owned properties may be high. For example, by the end of 1996, in St. Petersburg it was 25 percent.[2]

Because buildings and land are separately regulated,[3] privatization of the building stock has been proceeding without privatization of underlying land sites. Until 1995, almost no urban land was privatized for any commercial or industrial use. Only families had the right to obtain small plots for gardening or single-family homes. By November 1996, 2,927 enterprises across Russia obtained ownership titles to their sites, with a total land area of 36,500 acres, and land privatization applications for another 2,824 enterprises were processed.[4] This process is geographically uneven: a few cities and regions account for more than 50 percent of these purchases, and by December of 1995, 40 percent of regional administrative units had not even begun land sales to enterprises. St. Petersburg is the country's recognized leader in the privatization of commercial and industrial land. By April 1997, more than 1,500 privatized enterprises and businesses in the city purchased underlying land sites. *Table 1* demonstrates the

Table 1

Land Inventory for Ryazan and Chelyabinsk
(as of July 1, 1996)

Indicators	Ryazan	Chelyabinsk
Population (thousands)	537.2	1,111.1
Land inventory		
1.1 Area of documented tenure* of any kind *(percent of total city area);*	14.9	10.8
1.2 Area of documented private ownership *(percent of total city area);*	0.82	8.7
In particular: Area owned by families *(for single-family homes or gardening)*	0.38	8.6
Area owned by legal entities	0.44	0.1
1.3 Area of public lands leased out *(percent of total city area);*	11.4	1.8
In particular: Long-term lease *(more than 15 years)*	3.1	0.7 *(both long-term and mid-term)*
Mid-term lease *(5 - 15 years)*	7.1	
Short-term lease *(up to 5 years)*	1.2	1.1

Source: *Urban Real Estate Reform Indicators*, the pilot project of the Urban Institute in two Russian cities.

Note: * The "documented tenure" means that land users have valid legal documents confirming their land rights. The absence of such documents usually means that a land user has been occupying a parcel for a long time (since obtaining the parcel during the Soviet era) and has not yet undergone the documentation process in correspondence with the current land legislation.

difference in land privatization policies in two provincial Russian cities.

Russian cities have practically not sold any vacant land to developers. As a result of delays in land privatization, the private land market for development is in an embryonic stage and there is a strong shortage of land available for market-oriented construction. Not surprisingly, land, which was privatized underneath enterprises, has experienced heavy market turnover. For instance, in Ryazan during the first half of 1996, 130 sale transactions happened with only 187 land sites owned by legal entities. This is 139 percent turnover rate per year!

Many cities, including Moscow, have declared their intention to develop a market of long-term lease rights for land rather than ownership rights. Nevertheless, experience so far has indicated that land lease rights on public land are not transferable.

LOCAL AUTHORITIES AS ACTORS IN THE REAL ESTATE MARKET

Local (regional and municipal) authorities are major players in real estate. First, the state and municipalities continue to own a large share of real estate. As is clear from above, almost all urban land is publicly owned. Furthermore, local authorities are the biggest landlords for non-residential buildings and premises which they lease to private parties. Thus, by January 1996, St. Petersburg authorities held approximately 22,200 lease agreements for a total of approximately 62,060,500 square feet of space.[5] In the first half of 1996, Chelyabinsk city authorities held more than 700 valid leases; and authorities of Ryazan - more then 900 leases.

Second, because zoning regulation does not yet exist in most Russian cities, municipal authorities are heavily involved in land use control on a site-by-site basis. A private owner of a land site or a building must get permission from authorities for any proposed property development or redevelopment.

Finally, many officials are quite creative searching for their personal interests related to real estate and land development. Often, even strong conflicts of interest cannot be classified as illegal because of a lack of relevant legislation. A typical example: a high-ranking municipal urban planner responsible for approving the type and parameters of land use at a land site has his own private business related to planning and design; when you apply for an approval of your project, you will be advised to order some work from his private firm; if you do not, your project will be stopped indefinitely. Instead of a step-by-step separation of private interests and public services, there is an opposite tendency that might be described as a mixture of "institutionalization of corruption" and "commercialization of government." This means creating special legal entities (usually municipal for-profit enterprises) that allow remarkable fees or commissions to be charged for the monopolistic performance of functions that should be the natural responsibility of municipal authorities (for example, providing good quality titles for privatizing properties). Such municipal enterprises are functioning legally, and respectable companies deal with them because this may be the lone way to find a reliable counterpart on the authorities' side.

MARKETS FOR RESIDENTIAL, COMMERCIAL, AND INDUSTRIAL PROPERTIES

There are a number of existing residential, commercial, and industrial properties available for purchase and rent, especially in big cities. In most cities the supply of existing and new homes is several times higher than the effective demand. The biggest problem for all three sub-markets consists of strong mismatches between location, size, and quality of the supply, and the requirements of effective demand.

For example, in larger cities, a remarkable portion of the apartments offered for sale is in multi-family prefabricated, concrete buildings constructed during socialist times in city outskirts. On the other hand, families that are able to buy apartments for cash (a workable mortgage system still does not really exist) want better quality and location. Some types of demand have not been met at all. For example, rental, residential, multi-family income property practically does not exist as a market type, though it certainly would find the demand, especially in larger cities and those with large communities of foreign professionals. Nevertheless, the housing market is active, reflecting two fundamental processes in the current transition stage of the Russian economy: 1). redistribution of wealth; and 2). large inter-regional migration.

Residential and office markets in the largest cities have two commonly distinguishable components - "Western quality" and "local quality." The former implies better construction materials, amenities, building design, and presence of professional property management (at least, for offices). In April 1997, average apartment prices in St. Petersburg varied in the ranges $40- 60/sq.f. for existing apartments and $38-68/sq.f. for newly constructed ones (both ranges represent mainly "local quality"). In January 1997, average prices on "local quality" apartments in Moscow were $85-133/sq.f.

INSTITUTIONAL INFRASTRUCTURE FOR THE REAL ESTATE MARKET

The real estate market continues to be a cash market. Neither mortgage nor construction finance lending exist in any significant amounts. By mid-1996, only about 5,300 mortgage loans had been issued to

Russian cities have practically not sold any vacant land to developers. As a result of delays in land privatization, the private land market for development is in an embryonic stage and there is a strong shortage of land available for market-oriented construction. Not surprisingly, land, which was privatized underneath enterprises, has experienced heavy market turnover.

home buyers across all of Russia. These loans were predominantly short-term (more than 60 percent were up to one year), with loan to value ratios around 30 to 50 percent, and an annual interest of 90 to 140 percent in rubles or 25 to 45 percent in USD.

Construction loans have been considered by Russian banks as highly risky business loans and they have been practically unavailable unless a borrower was controlled by a bank. In early 1997, the average interest rate on three month loans was 83 percent (nominal), and 113 percent (effective). Borrowing under such conditions creates negative leverage for developers, and they practically do not use bank loans. Such high interest rates on loans resulted from high inflation in previous years and, respectively, the high refinancing rate of the Central Bank of Russia. But the situation was improving, until the crisis of 1998: the annual CPI was 840 percent in 1993; 215 percent in 1994; 131.4 percent in 1995; 21.8 percent in 1996; and about 12 percent in 1997. The refinancing rate has dropped significantly from 200 percent in April 1995 to 28 percent in January 1997.[6] The crisis of 1998 is resulting in new, tremendous fluctuations in the refinancing rate.

The other reason why banks in Russia have not favored lending for businesses and real estate development is associated with state securities. During 1993 to 1995, yields on short-term state Treasury Bills and other federal bonds were very high. These types of securities have been considered so reliable that they absorb the biggest part of the banks' investment resources. It became a problem on a national scale, and since 1996, the reduction of yields on these types of securities has been a part of official state policy in the securities market.

The information infrastructure for the real estate market is strongly underdeveloped and the information that exists is not always reliable. First of all, sale and rental prices are often not reported in order to avoid taxes (see below). Usually the asking prices are what is available through real estate periodicals or brokerage companies. Second, the volatility of many market parameters is incredibly high—(this is typical for such an emerging and unstable market as in Russia). For example, interest rates on loans for the same types issued at the same time may vary by 10 or more percent inside of one bank. Third, information which is typically obtainable from property managers in mature markets (operating expenses, vacancy rates, etc.), is, as a rule, not available because property management as an industry does not really exist yet. Finally, information held by public agencies (such as number of registered sale transactions) is not available in some regions and cities for various reasons.

The professional infrastructure for real estate is growing and institutionalizing very rapidly. Especially successful is the development of real estate brokerage and appraisal, and on a more limited basis - real estate management. The Russian Society of Appraisers (RSA) provides a good illustration of the institutionalization process. The RSA was created in 1993, and by November 1997 had about 2,390 members at 76 regional chapters. The first training course was offered in the summer of 1993 in St. Petersburg and Moscow. It was sponsored by the World Bank and the Eastern European Real Property Foundation (NAR/USAID creation). By the end of 1996, about 10,000 people completed different courses in appraisal. Currently, the RSA is publishing the monthly *Information Bulletin* and *Appraisal Issues*, a quarterly journal. It has also published more than 20 books and brochures, including four textbooks translated from English.

Professional real estate institutions repeat many features typical of the institutionalization of the real estate industry in the U.S.: development and maintenance of professional standards; training for members of professional organizations; sharp competition among different professional organizations; lobbying interests of the profession and the industry, etc. What is probably different from the American experience is: 1). a high level of bureaucratization, at least in the leading professional organizations (which is not surprising, given the long history of Russian bureaucracy); and 2). the orientation of many organizations toward corporate memberships rather than individual ones. Membership in leading professional organizations is not affordable for ordinary practitioners and small companies.

INVESTORS IN THE POSITION OF DEVELOPERS

Income properties in operational condition that would be worth acquisition, practically do not exist in Russian cities. Thus, real estate investors immediately find themselves in the position of developers dealing with either new construction or reconstruction. A special study conducted in St. Petersburg[7] in the fall of 1995 indicated that Russian and foreign investors had different concerns about their developers' role. Foreigners saw two major obstacles for their participation in reconstruction projects: 1). an absence of long-term property rights during the reconstruction period; and 2). several uncertainties concerning a project's economic feasibility. The absence of property rights results from a common practice: Russian cities allocate land sites for the construction period only (on a short-term lease, for instance), with the local authorities' obligation to grant a long-term lease upon completion of construction. Also, an ownership title on a building constructed with private financing has been obtainable only upon completion of the building. Clearly, such property rights are not mortgagable, and, by American standards, they are legally not sufficient.

The economic uncertainty usually contained two components. First, the costs of connections to off-site utilities typically were not known before a formal commitment was made by a developer (to make the commitment requires time and money). The cost of utilities connections had been dictated almost arbitrarily by monopolistic providers of centralized systems (such as electricity, heating, gas, sewer), which were municipally owned or already privatized. In 1993 to 1995, such "infrastructure exactions" imposed on developers made up 20 to 50 percent of the total development costs for housing projects in many Russian cities. Second, the standard provision in land lease agreements stipulated the landlord's (municipality's) right to increase ground rent "in correspondence with legislation," without negotiations with the tenant. Such uncertainties prevented an evaluation of economic feasibility and stopped many foreign investors.

The study found that Russian investors were less sensitive to legal rights on land per se, yet the impossibility of using land rights to secure loans was also important for them. They too complained about the heavy burden of "infrastructure exactions."

Since 1995, the conditions for real estate development have been improving. Authorities in most cities have recognized the problem of unfeasible requirements of utility providers and have been trying to improve the situation. Now they also better understand the idea of economic feasibility. The issue of property rights during the construction period has been actively discussed and was partly addressed by the federal government in 1997. Some local governments are beginning to grant long-term rights on vacant land from the very beginning of the development process.

The issue of new approaches to providing utilities for urban development and redevelopment in Russian cities and towns will be a hot topic for years. In particular, the potential market for implementing modern technologies for local utilities systems should be huge.

THE SHADOW ECONOMY AND REAL ESTATE

The real estate sector is involved in the shadow economy mainly through tax evasion. The underreporting of sale prices is common in transactions among individuals. Technically, to underreport the price is not difficult because such sales are often "double cash" transactions: no loans, no bank transfers - just a briefcase of bills going from one to another or, in the best case, through a deposit with an escrow agency.

Rents on commercial properties often have two components: one "official," shown in a lease agreement and subjected to the Value Added Tax, and the other, unofficially paid separately in cash. By the estimates of Moscow brokers, in the summer of 1996, up to 90 percent of all commercial leases had such double rents.[8] Even without discussing the ethical problems for appraisers, double rents complicate the appraisal of income properties. Obviously, two values may be considered: one based on the formal rent, and the other - at a real rent which includes the informal component. The market value of the property should be somewhere in the interval between these two values and should depend on the level of transferability of informal components of rents when the property is sold. But it might be very difficult, if not impossible, to predict transferability of such informal components of rents.

Interests of the organized crime in real estate have at least three forms. The first involves laundering illicit incomes through investments in real estate. Most likely, such investments are not across regions

Some strategically important tendencies in the evolution of urban real estate in Russia have not yet been revealed; and they should also be under close scrutiny by potential investors.

of the country, but instead concentrated in some particular cities.

The second form, widely present in big cities, involves a "protection racket" for the owners or tenants of commercial properties. Charges imposed by organized crime may even be formalized in writing through a "protection agreement." It appears that the process of protection racket in real estate has reached some stabilization. Areas of such cities as Moscow and St. Petersburg have been divided between clans. These clans have established relations with property owners, managers, or tenants, and provided protection from other clans. The alternative for property owners and managers is to elicit protection from the organized crime, i.e. to hire private security. In any event, protection of or from the organized crime adds to the cost of renting a commercial space. So, when preparing to rent a space for business in Russian cities, it makes sense to ask directly whether a protection is included already in the rent rate.

The third form is an informal control of the organized crime over some particular properties. Such control may restrict the real rights of a formal, legal owner of a property in different ways. The owner may be not allowed to change the use of the property, or to change a manager, or to sell the property, or anything else - it depends on the nature of what may be denoted as a "criminal's partial interest" in the property. So, an acquisition of an income property in Russia requires an especially careful due diligence that the property is not loaded with such types of interests.

No reliable data exists on the prevalence of the shadow and criminal practices or the magnitude of consequences in real estate, and this might be a subject for a special study. However, the shadow economy as a whole and the organized crime are considered as serious problems in current Russia.[9]

CONCLUSION

Despite many bureaucratic restrictions, the lack of market infrastructure, and the shortage of investment resources, urban real estate markets in Russia have been growing almost explosively. In the first stage, emerging real estate markets predominantly involved the market turnover of existing buildings and premises. While the amount of privatized commercial and industrial land is increasing, and vacant land is becoming available, the market is entering the next stage where new construction and reconstruction will play an important role, creating a tremendous niche for real estate investors.

Another positive process for investors is competition among Russian regions and municipalities for attracting private investments in local economic development and reconstruction of their cities. Cities that will be first to offer an attractive "investment climate" for investors of regional, national, or international scale will gain a real advantage over competitors. For international investors who are thinking about "windows of opportunity" in Russian real estate, it might be useful to systematically monitor the success of real estate reform and market activity in different Russian cities to identify the most promising places.

Some strategically important tendencies in the evolution of urban real estate in Russia have not yet been revealed; and they should also be under close scrutiny by potential investors. Some unclear strategic questions are:

- What level of suburbanization should be expected in Russian cities?
- What scale and types of retail properties would be vital in Russian cities?
- Given the organized crime interests in some subsectors of real estate, which subsectors would be best for foreign investors?

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8. As I assume, such double rents should be less common in "business centers" with foreign tenants and more formal "Western style" management.
9. Russian governmental sources attributed 25 percent of GDP of the Russian Federation to the shadow economy in 1996 and 40 percent in 1997 and consider this as a threat to the country's economic security. The organized crime in Russia is also considered as a threat to the national security interests of the U.S. (see "Russian Organized Crime. Global Organized Crime Project" - Center for Strategic and International Studies, Washington, 1997).

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Check-the-Box Regulations Allow for Selection of an Entity

by Mark Lee Levine, CRE

If you own or advise owners of real estate, you must be familiar with the basic rules of Check-the-Box Regulations. These Regulations make it less burdensome for the Federal tax position to determine how an entity will be treated. Since the tax impact is enormous, it is critical to any owner of real estate to know if and how much tax the entity must pay.

How one holds real estate — that is, in an entity or in an individual name—has enormous tax, legal, and practical implications. If a Counselor of Real Estate (CRE) is to be effective in working on real estate issues for a client, it should be obvious that the Counselor, not functioning as a CPA or attorney, must, nonetheless, be familiar with the Federal tax rules on *what* determines *how* the tax laws treat entities holding realty. Will there be a tax at the entity level, *e.g.*, a corporation?

The following summarizes these Federal tax rules and very recent important changes in this area. If you own or advise owners of real estate, you *must* know the impact of these Regulations. It may avoid the need to pay a double tax, *i.e.*, at the corporate and personal levels.

OVERVIEW

For practically the history of the Federal income tax law, once entities were considered (aside from new Regulations noted below), there has been the issue as to how one knows, for tax purposes, whether the entity in question would be taxed as a "flow through" to the individual, partnership, a corporation, or other entity or hybrid. When a Counselor addresses the needs of a client, knowledge as to the type of entity being employed by the client to hold real estate is of crucial concern. This issue has been addressed over the years by numerous cases, Internal Revenue Service authority, Treasury Releases, and interpretations, all to determine the tax entity at the local, state, and federal levels.[1]

Although there have been Treasury Regulations issued under Internal Revenue Code '7701, interpreting the definition of an association, partnership or other entity, there continued to be a great deal of confusion as to exactly what the entity is, *for tax purposes*.[2]

Regardless of this tremendous confusion, the momentum of case law and other developments continued the flow of decisions and Releases by the Treasury on the question of how a given entity was to be classified for tax purposes. Under the *Morrissey* Regulations,[3] generated after the *Morrissey* case, there were six main characteristics that were considered as important when determining whether the entity would be taxed as a corporation (association) or as a partnership (pass-through entity).[4]

The six characteristics that were considered crucial in making the decision between an association (corporation) or partnership were the following:
1. Associates (two or more parties);[5]
2. Having the objective to carry on business and divide gains from the business;[6]
3. Continuity of life (perpetual existence);[7]
4. Centralization of management;[8]
5. Limited liability;[9] and
6. Free transferability of the shares of the entity.

In summary, since the first two requirements are common for corporations (associations) and partnerships, the remaining four characteristics were crucial. Prior to the new Regulations (discussed below), if three of the four (dominant number) or four of the four characteristics were present, the entity was classified as an association and taxed as such. This meant it was potentially subject to a corporate tax. If, on the other hand, the entity had only two or less of the main four corporate characteristics, it would not be taxed as a corporation; rather, it would generally be taxed as a partnership, meaning that there would be no entity tax and the gain or loss would generally pass through to the owners (partners in most cases).[10]

Notwithstanding these events, the main focus on the Check-the-Box rules, and the new Regulations discussed herein, is to disregard most of the above discussion on the *Morrissey* case, the *Morrissey* Regulations, and prior Treasury and IRS Releases; instead, favoring the posture, to determine the position of an entity, for tax purposes, on the federal level, in most instances, on whether one complies with T.D. 8697, the new check-the-box rules on determining whether an entity would be an association for tax purposes. Thus, the Counselor needs to have a basic understanding of this position, notwithstanding that the Counselor is not acting as an attorney.

CHECK-THE-BOX REGULATIONS

The Check-the-Box Regulations were issued under T.D. 8697, effective January 1, 1997. There were numerous points of discussion from the time the Proposed Regulations were issued in this area to the time that these Final Regulations were issued in December, 1996. Not all of the issues have been resolved relative to these Check-the-Box Regulations.

Numerous questions will arise as to the difference between state law and Federal law. (If a given state requires that a business entity have two or more individuals involved, such as in a limited liability company, yet it "elects" to be taxed as a sole proprietor for Federal tax purposes under the check-the-box Regulations, the question arises as to whether the entity will be a corporation for *state* purposes, but a sole proprietor for *Federal* tax purposes. These and many other issues must be resolved.)

Summary of Final Regulations on Entity Classification Rules

Under T.D. 8697, the essence of the Rules allows for a more simplified approach to determine whether the entity will be classified as a partnership or other type of entity, by checking the appropriate boxes on new *Form 8832* and filing for the classification.

Looking only to domestic entities, as opposed to foreign entities, (since the foreign entities have special requirements and tests under these new Regulations), the Final Regulations provide that the business entity is not required to be treated as a corporation under the Federal tax position, which entity is labeled as an "eligible entity," by choosing its classification. Under these rules, the eligible entity, having at least two members, *can elect*, generally, to be taxed as a partnership or an association. An entity that is an "eligible entity" for the election, with only a single individual or member, can be classified as an association, or it can be disregarded as an entity that is separate from the ownership position, *i.e.*, it will not be taxed as an entity.

The Regulations allow for the fact that, if most eligible entities with the classification that they desire would like to have that classification without requiring the filing of an election, the Regulations provide for default classification rules. These match the (alleged) expectations with the entities' characteristics. The Regulations have a pass-through default for domestic entities, wherein a newly formed eligible entity will be classified as a partnership if it has two members. It will be disregarded as an entity, separate from its ownership, if it only has one member. Again, these are default-type provisions that apply, absent an election to the contrary.[11]

Under the Regulations, if there is an election, the election is made on new Form 8832. It must be signed by each member of the entity, or officer, manager, or member who has authorization for the same.

Other questions were raised as to the Regulations, and prior to the issuance, when hearings were conducted as to grandfather-type provisions. That is, what happens to existing entities? Generally speaking, the existing entity position will continue to apply. (It is possible that they may subsequently elect to be treated as a different type of entity, assuming they can meet the requirements of the Regulations.)

Timing of Election

The election is made by filing the proper form, assuming one meets the requirements under the Regulations. Although many commentators argued for a position that the election should be made on the tax return, the Regulations provide that the election must be made at the *beginning* of the taxable year. The Regulations allow taxpayers to make the election and provide that it is effective for a given date provided that the date is not more than 75 days prior to the date on which the election is filed, and not more than 12 months after the date the election was filed. (If these rules are not met on the timing, for example where a taxpayer specifies the effective date to be more than 75 days prior to the date of filing, the election is effective 75 days prior to the date of the filing. If the taxpayer specifies an effective date which is greater than 12 months from the date of filing, the election is effective 12 months after the date of filing, regardless of the taxpayer's request.) All elections were effective no sooner than January 1, 1997.

Sometimes in the tax law there has been an argument that it is helpful to file an election (form) because of doubt whether it is or is not needed. That is, in some areas of the tax law, if one is uncertain of the need for an election, one could nevertheless file the election as a "protective election." Such elections are allowed under the new Regulation.

Unless the restriction is waived by the Commissioner of the Internal Revenue Service, only one election can be made without a waiting time.

Although the election must be filed *prior* to the time the tax return is filed, the Regulations also require that a copy of the election be attached to the tax return of the taxpayer. (A failure to attach the election to the tax return does not invalidate an otherwise valid election, but it may give rise to penalties.)

Change of Election

The question was raised by some commentators as to guidance on how one should treat conversions, by election, from a partnership to a corporation or a corporation to a partnership. The Regulations provide: "This issue is outside the scope of the classification rules and is not addressed in these Regulations." [12]

Application of New Regulations

In summary, the new Regulations attempt to provide for this "check-the-box," simplified approach to treatment of an entity, subject to a number of very special statements or rules.

- **Organization for Federal Tax Law** - The Regulations stress that as a matter of Federal tax law, this determines whether the entity is a corporation or partnership for *Federal* (not state) tax purposes, not state law.
- **Single Ownership Entities** - Treasury Reg. '3017701-2 and '301.7701-3, the new Regulations of T.D. 8697, note that certain organizations which have a single owner can choose to be *either* recognized as an entity, or disregarded as an entity, and be treated within the individual's ownership.
- **Domestic or Foreign Entities** - For purposes of the Regulations, an entity is a domestic entity if it is created or organized in the United States or under the laws of the United States or any of its states. (It is foreign if it does not meet this requirement.)
- **Business Entities** - A business entity is any entity recognized for Federal purposes, including an entity with a single owner where it is not disregarded, from the entity's position, and is not properly classified as a trust or otherwise subject to special treatment. (See below for the special treatment rules.)
- **Corporations** - For Federal tax purposes, the Regulations provide that the term "corporation" includes a business entity under the Federal law, an association, as well as a number of other entities.
- **Limited Companies** - Any reference in the Regulations to "limited company" includes companies limited by shares and companies limited by guarantees.
- **Other Business Entities** - For Federal tax purposes, other business entities include an entity that is not a corporation under the rules noted

above and has at least two members.

- **Wholly-Owned Entities** - Generally speaking, a business entity that has only one owner, and is not a corporation as defined above, is disregarded as a separate entity.
- **Classification of Business Entity** - Generally speaking, the business entity that is not classified as a corporation under the rules noted above can elect its classification and be treated as a partnership or as a corporation.

The Regulations provide for a "default classification" for an eligible entity where it does not make an election. It also provides that an election is only necessary where the eligible entity chooses a classification *other than* one of the default classifications, or when the entity is reclassified or changes its classifications.

As for a Domestic Eligible Entity, unless the entity elects otherwise, the entity is:

a). A partnership if it has two more members in its entity; or

b). It will be disregarded as an entity, separate from the owner, if it has only one party involved.[13]

- **Real Estate Investment Trust (REIT)** - A Real Estate Investment Trust (REIT) is an eligible entity *if* it files an election to be treated as a Real Estate Investment Trust (REIT) and is treated as having made no election to be classified as an association under these special Regulations for entity classifications.

CONCLUSION

These new Regulations make it less burdensome for the Federal tax position to determine how the entity will be treated. Normally the entity will be a partnership or an association, or it will file an election to be so treated, assuming it is an eligible entity.

Although numerous articles, cases, rulings, and other public positions have been issued as to classification of entities over the many years since the tax law has existed, these new Regulations are a giant step - or leap - in determining, with the least burdensome current impact, the choice of the treatment of an entity, on the Federal tax level. It is a welcomed addition to this body of law. Every Counselor must be familiar with these basic rules of Check-the-Box. The tax impact is enormous; it is crucial to any owner of real estate to know if and how much the entity must pay.REI

NOTES

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2. For example, although state law may hold that an entity was a corporation, because Articles of Incorporation were properly filed with the correct body of the state, such as the Secretary of State's office in a given state, it has been determined on numerous occasions that such decisions were not controlling for "*Federal tax purposes.*" See the *Morrissey* Regulations, discussed in the authorities cited, *supra,* Footnote 1. See also Fisher, Richard, "Classification Under Section 7701-The Past, Present and Prospects For the Future," 30 *Tax Lawyer 3* (1976).
3. See *supra,* Footnote 1.
4. See *supra,* Footnote 1.
5. See *Elm Street Realty Trust,* 76 T.C. Memo 803 (1981). This generally entailed having two or more parties involved in the entity. This requirement of two or more parties to allow one to select to be a taxable entity continues to be an issue in many states.
6. The necessity of carrying on a business for profit was implied when the concept of "business," as opposed to "personal" use, was associated with these entities.
7. This requirement implies the perpetual existence of a corporation, as opposed to an individual, partnership or many other entities. If the entity will be perpetuated, notwithstanding the death of a given individual, in general, it has the position of continuity of life. See the Levine text, cited *supra* Footnote 1, Section 779. See also Private Letter Ruling 8016097. See also Revenue Proc. 92-35 and Treasury Reg. '301.7701-2(b)(1).
8. Where decisions are made by a main body (centralized group), the concept of centralization can exist. See Revenue Proc. 89-12, 1989-7 I.R.B. 22 and Treasury Reg. '301.7701-2(c)(4).
9. Limited liability generally implies that the assets that are subject to claims by creditors are only those assets in the entity and not those held by third parties (*e.g.,* shareholders). For an examination of this subject, see *Financial Dynamics, Ltd.,* 531 F.Supp. 187 (D.C., Fla. 1980). See also Treasury Reg. '301.7701-2(d)(2).
10. See Treasury Reg. '301.7701-2. See also the Levine text, cited *supra,* Footnote 1, under Section 762.
11. This discussion focuses on domestic entities. For foreign entities, consult the Regulations for the specific rules under T.D. 8697 as to requirements for foreign entities.
12. Under T.D. 8697, the Regulations provide that the Treasury and the Internal Revenue Service are actively looking at the possibility of guidance on this issue for the conversions of entities.
13. If the entity is a foreign entity, which is outside the discussion of this material, unless the entity elects otherwise, the foreign eligible entity will be a partnership if it has two or more members, assuming at least one member does not have limited liability. It will, generally, be an association (corporation) if all the members have limited liability status.

    The entity will generally be disregarded as a separate entity if it has only one owner and such owner does not have limited liability.

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CRE PERSPECTIVE

TRAGEDY OF THE COMMONS: WILL IT BE DIFFERENT THIS TIME?

by Bowen H. "Buzz" McCoy, CRE

The Tragedy of the Commons

The excesses of the real estate development market of the late 1980s may be compared to the "tragedy of the commons." The tragedy describes the circumstance where a village common is overgrazed to the point where there is no fodder left for the village animals. This occurs because individuals feel an entitlement to their share of the common good and no collective sense of responsibility to conserve or renew the food supply. The result is that no one individual destroys the common, but as a group the village common is devastated and trust in the institution of the village is lost.

In the case of real estate development in the late 1980s, each project was deemed in the eye of its beholder as being very special, having unique appeal, and coming on the market at precisely that window of time when the last full building would be executed and before the devastation of overbuilding. Lost in the analysis was the devastation caused to all buildings in a specific locale by the serious overgrazing which resulted from a number of such seemingly isolated and innocuous decisions.

Real estate development has traditionally been a local business, played chiefly by insiders with information not always readily available to the financial marketplace, where individual entrepreneurs attempt to gain windfalls by getting an edge on the market in general. The lack of broadly accessible, accurate, consistent data on real estate has helped to preserve this insider's game, as it has also contributed to the volatility and amplitude of the real estate cycle. The more transparency, the greater the depth of accurate information available to all players in a market, the less chance there will be for such wide swings in real estate as occurred over the past 10 years.

It is entirely possible that 1998 will be regarded in retrospect as the year of equilibrium; the year when aggregate supply and demand for real estate came into balance; the year in which virtually no new developments caused excessive capacity or declining rents. Along with the achievement of market equilibrium have come the beneficial results of several recent trends—such as securitization, technology, and consolidation. A rising tide lifts all boats, so it is difficult at present to assess whether or not these newer trends in real estate will provide greater stability to the industry. The answer will come only as we swing into yet another real estate recession caused by overbuilding. At the end of a complete economic cycle we will better be able to assess the significance of these new trends. Meanwhile, the issue is: Have these new trends in real estate served to dampen the volatility of the real estate cycle, or is the real estate development game just the same old game being played out in a new wrapper?

The Moral Hazard of Rewards and Punishments

One of the problems with real estate, especially in the late 1980s, is the moral hazard which resulted from a de-linking of rewards and punishments. Those who piled on production in financial institutions, especially savings and loans and commercial banks, were rewarded handsomely for meeting or exceeding targets. Bonuses and longer term incentives were not tied to the outcome of the investment. There was no linking of the rewards for production with the risk involved in the transaction. There was little or no concept of risk- based capital or of risk-adjusted return. This led to loans being made at 100 percent or more of cost to developers with no equity stake or risk in the project, often with all their development fees being paid out on the front end in cash instead of staying at risk in the transaction.

A further moral hazard occurred when entrepreneurs played the RTC game and achieved, in the early years, windfall profits as a result of the Federal government's capital being at risk. The positive side of this event was that we cleaned up the mess in a hurry; a fact that our Japanese friends do not appear to have caught on to. As a result of astute management by Dr. Alan Greenspan, our banking system survived the test quite well. Bank executives were also a beneficiary of this de-linking of rewards and punishments. The Federal Reserve Bank kept rates low, allowing the banks to build up their reserves. Certain bank stock prices initially fell to 20 percent of previous values and then increased eight-fold, giving the bank officers windfall profits on their stock options.

How Can We "Fix" the Real Estate Cycle?

Without the transparency of timely and accurate data on rents, it is unlikely that any system will be developed which will cause punishment to occur prior to overbuilding. The kinds of systems which might produce data in time to prevent overbuilding are probably too draconian to withstand the political and regulatory process. Examples of practices which might prevent overbuilding and truly mitigate the real estate cycle would include the following:

A **national rent index**, with various local components. The Urban Land Institute made some significant progress on this front in the early 1990s, but industry support lagged and then collapsed as the real estate markets improved and it became every institution out for itself once again. Such an index could be derived statistically. It would cost a few million dollars—a cost which could be shared by several of the major financial institutions in the real estate business. The ultimate value could far outweigh the cost. Developers, financial institutions, and tenants could go long or short in various individual geographic markets and product types, smoothing out cycles in local markets.

The index must be monitored by an independent fiduciary in which there is a high degree of trust. The Urban Land Institute could be such a body, as could any one of the major universities involved in real estate education. Such an index would be organized by geographic sector and by major property type. The moral hazard here is the industry's lack of willingness to make real estate a public utility and share the formerly inside information so broadly. Each player feels advantaged to "get an edge on the market." In so doing, they increase the volatility of the cycle and are thus each a cause of the major windfalls and catastrophic losses which occur in the industry with embarrassing regularity.

The Controller of the Currency could require each major bank to report on a **quarterly basis the details of each real estate financing** in which they have engaged, including accurate data with respect to volume of construction lending, loan to value, true equity, degree of risk taken by the developer, rental concessions, amount of preleasing, and the like. As one who is fundamentally anti-regulation, this draconian tactic has little personal appeal, but it could provide a basis for mitigating the cycle if such data were reported out to the public on a real-time basis, i.e. on the Internet.

The Securities and Exchange Commission could require each publicly traded real estate operating company, real estate investment trust, originator of commercial mortgage backed securities, etc., to **report publicly on a quarterly basis net effective rentals** on all of their properties on a consistent basis. Such data could be fed by the Internet to all interested parties, including a public or quasi public utility which would construct the rental indices referred to above.

What Is Different This Time?

In theory, the securitization of a significant amount of real estate, primarily through real estate investment trusts and commercial mortgage backed securities, provides the marketplace with a much greater pool of data than was the case when such assets were held by private institutions. Punishment seems more directly linked to the negative event. For example, if an REIT persists in over-developing a particular market, the word gets out quickly, and the public and the financial institutions will sell the shares of that particular REIT, increasing its cost of capital and most likely making it a take-over candidate. The public disclosure required of publicly held firms provides for a much more rational market, although the punishment does not occur until after the overbuilding has occurred.

Likewise, one may surmise that properties controlled by opportunity funds are likely to be more closely scrutinized and more aggressively dealt with than those financed by large financial institutions which, at least at the beginning of a cycle, have traditionally stretched out problem loans, quarter by quarter, hoping to avoid a write-off.

In general, the current real estate industry structure has more monitoring devices than before. The imposition of risk-based capital rules have forced commercial banks and insurance companies to become more rigid in their real estate analysis. Wall Street common stock analysts as well as credit analysts are quick to punish a public company for a missed earnings forecast, excessive leverage, non-accretive acquisitions, or overbuilding. These stock and bond analysts ride herd on the publicly held financial institutions as well, such as commercial banks and insurance companies; and they are quick to punish excessive financing to real estate on the part of these firms.

In general, real estate benefits from the consolidations and the larger sized real estate firms, both public and private—(especially if their larger size allows them to make the investment in technology that is required to attain efficiencies in operations). Most larger, consolidated firms also have a more conservative debt structure than was the case in the 1980s, as they wish to gain the advantage of an investment grade bond rating and lower cost capital. The consolidations will truly benefit real estate if they can bring off the benefits of professional management, discipline, and scale to an industry which has been highly customized and hand crafted for too long.

What Is The Likely Outcome?

It has been said that "disciplined, speculative" development is an oxymoron. This is somewhat surprising, given all the newly developed risk management tools in the financial markets. If this is true, then the only real discipline in the real estate markets is the flow of capital. So long as the financial sources maintain discipline, the real estate cycle will be moderated. In the late 1980s, the financial institutions became part of the problem themselves as they contributed to the overgrazing of the public commons.

The larger real estate firms need to develop discipline. A truly mature industry should not be relying solely on capital sources and regulators to keep it from excessive behavior. It will be difficult for real estate firms to develop such discipline, however, if a significant portion of new development continues to be carried out by local entrepreneurs who have no incentive other than to get and keep an edge on the market. Such behavior, which is always rational in the individual sense, creates an imperfect and distorted market overall. It is impossible to punish such behavior in advance of overbuilding.

Thus, in the absence of some draconian moves to produce transparency of markets and information, it is highly likely that the real estate development market will remain imperfect; i.e. the same old business in a new wrapper. The major difference at present is that the punishment is likely to come faster and be harder. Those who avoid "overgrazing" and keep their powder dry will be there to mop up the pieces at substantial discounts and take ultimate advantage of such imperfect markets. The tragedy of the commons will continue with all the concomitant windfalls and losses. Perhaps that is the ultimate reason why so many of us find real estate such an entertaining and stimulating place to make our living.REI

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CRE PERSPECTIVE

THE BOARD'S ROLE IN DEVELOPING EFFECTIVE REIT GOVERNANCE POLICIES[1]

by John McMahan, CRE

With the rapid growth in the number and size of Real Estate Investment Trusts (REITs) in recent years, it has become increasingly important for REIT boards to develop and implement effective governance policies to protect shareholder interests.

As a result, there is considerable discussion about corporate governance, both inside and outside of the real estate industry. Not surprisingly, there is little agreement about what corporate governance is or should be.

The dictionary defines governance as "...the act, process, or power of governing...," implying more of a political system than corporate policy. The thesaurus provides synonyms such as "controlling, limitation, restriction, and regulation," also suggesting a governmental oversight process.

And this mirrors the view of many investors — public security markets are safe because of governmental supervision—therefore, directors and managers will do the right thing because of the fear of financial and perhaps criminal sanctions if they do not.

In fact, government agencies involved in regulating corporations and security markets are mostly concerned with disclosure with the view that, if shareholders have accurate information, they can make their own decisions regarding the operation of a firm. The large number of fraud and deceptive trading cases, however, would indicate that sanctions alone do not stop insiders from cheating investors.

To better understand the role and function of corporate governance, we need to move beyond the simple view that government will protect our investment dollars and look for a better understanding of what good governance is and how it should operate.

What Constitutes Good Governance?

The Business Roundtable defines corporate governance as "a structure within which, stockholders, directors, and management can pursue most effectively the objectives of the corporation." [2] This definition seems to move beyond the default (and after-the-fact) position of government regulation to focus on the day-to-day operation of the corporation itself. It also implies that good corporate governance should be a dynamic, preventive process imbedded in the corporate physic at all levels—shareholders, board of directors, management, and even employees.

But, for such a process to work, policies must be in place that assure that corporate governance will function smoothly and, when tested, prevail. In fact, good corporate governance should be an important, ongoing goal of the company, not too different than establishing a strong market position or creating long-term profitability.

This Perspective explores how such a policy framework can be created and function successfully.

Selecting Directors

The board of directors are the designated stewards of the interests of the shareholders. The composition of the board therefore becomes the cornerstone of a successful governance structure.

Unfortunately, boards of REITs and other public companies are often selected during the initial placement offering (IPO) process where the major emphasis may be on marketing the new issue rather than corporate stewardship. As a result, boards may not have an opportunity to begin influencing director selection until original positions turn over, which may be several years down the road. At this juncture, however, there can be little excuse for not selecting directors with independent judgement and wisdom who can contribute constructively to the governance process.

What are the standards by which prospective board candidates should be measured?

Personal Qualifications: It is widely accepted that a successful REIT board must be comprised of individuals with the business experience necessary to oversee the business operations of the firm. Therefore, relevant real estate experience is critical, at least for the majority of the directors.

I believe it is important, however, that at least one of the directors come from a non-real estate background so that the board can benefit from the lessons of running other businesses. This is important because real estate is just now learning many sound business fundamentals that have guided other industries for years.

To the extent possible, it is also desirable that the board reflect a variety of personal backgrounds influenced by gender, ethnicity, and age.

In selecting potential candidates, it is helpful to establish a list of the mix of business and personal characteristics that the company requires to be successful. The board can then monitor the resources of existing board members against this list to determine whether the proper mix is currently being attained.

As new board slots become available, the inventory should be reevaluated to reflect the characteristics lost through turnover and the "voids" that need to be filled. Potential new directors should be screened against this skills inventory to fill the voids.

Time Availability: It is also important that directors have the necessary time to successfully perform their role. Serving on a board requires a considerable amount of personal time and being available, often on short notice, for key meetings or telephone conferences. To make meaningful decisions, directors must read and digest voluminous amounts of material as well as undertake independent research on key issues.

While experience on other public boards is important, director candidates should be restricted to service on no more than two or three other boards (including nonprofit organizations). If the candidate is a full-time CEO, this requirement should be lowered to one or possibly two other boards including his/her own firm.

Absence of Conflicts: Directors also should not represent firms (as directors or management) of firms that are direct competitors. To date, this has been relatively easy in the REIT industry as a result of property type and geographical focus, but will become increasingly difficult as REITs grow in size and influence and broaden their areas of activity.

Directors should not be service providers to the firm, either as professionals (attorneys, accountants, consultants, etc.) or as transaction specialists (investment bankers, mortgage brokers, real estate brokers, etc.). If individuals with these backgrounds are otherwise good candidates, it should be firmly understood that they will not provide these services to the firm.

Although having a majority of independent directors is a goal of the REIT industry, often this independence is in name only, with the situation more likely to involve directors having direct or indirect ties to management. The influence of management on director independence can be reduced by requiring that director candidates not be prior employees of the firm or have worked for the CEO or other members of senior management in positions with other firms (for at least the prior five years).

Major Shareholders: Major shareholders may demand board positions commensurate with their holdings. Others may believe that being an "insider" limits their actions (such as disposing of the stock) or subjects them to unwanted liability exposure. If major shareholders choose to have a board representative, that person, in my opinion, should meet all of the criteria outlined above. Not only is this good for the long-term interest of the firm and its investors, but it reduces perceived conflicts and indicates that the major shareholder wishes to align its interests with all shareholders.

Board Organization

The organization of the board is also critical to effective governance. Again, board composition may suffer from attempts to make the IPO attractive to prospective investors and it may be some time before a more suitable board organization can be realized.

In organizing or re-organizing, certain governance objectives should be considered:

Separation of CEO and Chairperson: Perhaps the most important single aspect of effective board governance is the separation of management and board leadership. Certainly the CEO should be a member of the board, perhaps along with one other management person[3] but the chairperson clearly should be an independent director, *even* if the CEO is the largest shareholder.[4]

The major reason for this separation is that the board is not an extension of management but rather a "peer" function within the organization with different duties and responsibilities than management. At a minimum, boards should:

- Develop and review the firm's strategic plan;
- Review management proposals for implementing the strategic plan;
- Approve annual business plans and budgets;
- Review management performance against business plans and budgets;
- Approve management and board compensation packages;
- Review CEO performance;
- Develop a CEO Succession Plan;
- Conduct annual shareholder meetings.

In addition, an effective chairman can be a communication link between the CEO and the board, helping guide both parties in working together to seize opportunities and solve problems.

This approach requires that the CEO and board chairman work closely together in the best interest of the firm and its shareholders. A board chairman who attempts to micro-manage the firm or second-guess management on tactical issues can be just as disastrous as a CEO who attempts to run roughshod over a board. In many cases, a chairperson who has been a CEO may better understand how the CEO role functions and know when to get involved and when to stay clear. This arrangement also provides the CEO with a personal resource to test ideas and turn to when seeking advice.

While such a relationship may be difficult to establish and often requires careful nurturing, it is essential to good governance and overall company success.

Board Committees: Given the complex nature of today's public companies and the vast amount of material that must be digested between board meetings, many boards function largely through the use of standing committees.

In order to provide oversight and avoid any appearance of conflict, certain board committees— Audit, Compensation, and Nominating/Governance— should be composed exclusively of independent directors. These committees meet at critical points during the year to undertake their individual mission, often with the assistance of outside experts and advisors.

Some REIT boards have been experimenting with the use of board "working committees" for operating activities such as strategic planning, property investment, asset management, and capital markets. In most cases, independent directors are expected to serve on at least one of these committees and each committee is matched with an appropriate member of management.

To date, these experiments seem to demonstrate that working committees can help both management and the board in meeting their respective obligations. The board benefits because at least one member has in-depth familiarity with issues that come before the board for discussion and action. This helps supplement the material that the board members receive in their briefing books.

From a management perspective, working committees provide a good sounding board in reaching decisions and formulating recommendations for board action. The working committee may also avoid wasting management time in preparing proposals that may have difficulty in passing board scrutiny.

In certain cases, the board may delegate interim approval authority to certain working committees or taskforces so that critical decisions can be made between board meetings on matters which the full board has previously approved, but which are subject to final negotiations or fine tuning. This approach can be particularly helpful in dealing with property acquisition due diligence, capital market transactions, and merger and acquisition activity.

Meetings: In light of growth in the size of REITs and board involvement in operating matters, many REIT boards choose to meet monthly. As the board gains more confidence in management and delegates more of the operating decisions to working committees, the goal should be to move to longer meetings, but on a less frequent schedule. This not only reduces pressure on management to prepare for frequent meetings (a big task!) but provides more time for quality thinking about strategic issues, the board's major responsibility. In addition, the board should meet at least once a year without management present in order to independently assess management's performance.

Board Performance Review: The board should also periodically assess its own performance. Individual board members should be evaluated annually against previously adopted standards dealing with issues such as meeting attendance and preparation, participation in standing and working committees, involvement in board discussion, interaction with management and shareholders, independent initiatives to further the interests of the firm, and other criteria the board may determine to be important in effectively performing its function. This evaluation can be undertaken by the chairman, a standing committee (e.g. Nominating, Compensation, or Governance), or a special committee established for this purpose. An outside consultant may also be helpful in reaching meaningful conclusions.

Compensation: In order to better align their interests with shareholders, all or a large portion of directors' compensation should come in the form of stock options or grants.[5] Some director candidates (e.g. academics, retired individuals, etc.) may find this policy unsatisfactory and may receive some cash compensation, as determined on a case-by-case basis.

Tenure: All directors should stand for re-election each year. In order to provide new insights and avoid mental atrophy, independent directors should not serve for longer than eight to 10 years. Some boards refuse to let retiring CEOs continue to serve and many have a mandatory retirement age of 70.

Conclusion

In conclusion, it should be noted that most REITs today do not have all of these governance policies in place and some may have none. As institutional investors increase their involvement in securitized real estate,[6] however, we can expect to see more and more REITs adopting these or similar measures to facilitate the governance process and assure investors that their needs and objectives are understood and paramount in the decision-making process.

NOTES

1. This article is based on material which previously appeared in *Institutional Real Estate Securities*.
2. Statement on Corporate Governance, *The Business Roundtable*, September 1997
3. The board should have a CEO succession plan in place and the named successor(s) should be on the board (or regularly attend meetings) in order to gain familiarity with how the board operates and sound governance principles.
4. In cases where a separate chairman is simply not possible, an alternative, but less desirable, arrangement is to have one of the independent directors serve in a lead capacity to coordinate the activities of all of the independent directors.
5. BRE Properties, a San Francisco-based apartment REIT, adopted a stock-option-only director compensation system in 1995. Since then, shareholder value has increased over 100 percent.
6. As an example, CalPERS issued a statement in 1997 regarding corporate governance principles for all public company investments.

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John McMahan, CRE, Receives 1997 William S. Ballard Award

The Editorial Board of *Real Estate Issues* was honored to recently present its 1997 William S. Ballard Award to John McMahan, CRE, senior principal of The McMahan Group, San Francisco. The honor, given annually by The Counselors, of Real Estate recognizes the author whose work best exemplifies the high standards of content maintained in the organization's 22 year-old professional journal, *Real Estate Issues*. McMahan's piece appeared in the December 1997 special edition on capital formation.

The award-winning article, "Western Real Estate Advisors Case Study: REIT Roll-up," offered readers a slightly different manuscript than the journal's traditional article format. McMahan's was a case study based on a series of roll-up proposals that had been offered institutional investors over the last year. As with most good cases, this provided no single solution to the quandary and challenged readers to weigh the various options. At the end, McMahan analyzed both the investment advisor's and plan sponsor's perspectives, as well as provided alternative courses of action. Yet, the reader was still left to determine his/her own best conclusion.

With a career in real estate than spans 37 years, McMahan currently is senior principal of The McMahan Group, a San Francisco-based management consulting firm. He is also chairman of BRE Properties, Inc., has been president of a mortgage REIT, and has served on several REIT boards. He taught at the Stanford Business School for 17 years and is currently an adjunct professor at the Haas School of Business at the University of California, Berkeley. Prior to The McMahan Group, John was founder and CEO of Mellon/McMahan Real Estate Advisors.

McMahan has been an active member of The Counselors of Real Estate since his invitation to membership in 1982. The REIT Roll-up marks his ninth article published in *Real Estate Issues*. He also writes and speaks extensively on issues of interest to the pension fund community.

Funding for the Ballard Award is provided by the generous contributions of the William S. Ballard Scholarship Fund in memory of the late Ballard, also a Counselor of Real Estate. All manuscripts published in *Real Estate Issues* during 1997 were eligible for the award. The 1998 award will be presented next spring during the CRE Midyear Meetings. REI

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