REAL ESTATE ISSUES

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REAL ESTATE ISSUES

EDITORIAL CALENDAR

Summer 1999
Articles on general real estate-related topics
(deadline for manuscript submission - April 1)

Fall 1999
Focus Edition - Counselors & the Law
(deadline for manuscript submission - July 1)

Winter 1999
Articles on general real estate-related topics
(deadline for manuscript submission - October 1)

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

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

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

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

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DEPARTMENTS

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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.

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Readers are encouraged to submit their manuscripts to:
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1. Manuscripts **must be submitted on disk** (along with hard copy) in **IBM or PC format only--Mac files cannot be accommodated**: .txt (text) file format or Word for Windows 6.0. All submitted materials, including abstract, text and notes, are to be **double-spaced** on one side only per sheet, with wide margins. Number of manuscript pages is not to exceed 25. **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 Associated Press Stylebook*.

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The *REI Editorial Board* is accepting manuscripts in competition for the 1999 William S. Ballard Award. All articles published in *REI* during the 1999 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 1999 recipient will be honored at The Counselors 2000 Midyear Meetings.)

EDITOR'S STATEMENT - by Richard Marchitelli, CRE

This issue of *Real Estate Issues* is co-sponsored by the American Real Estate Society (ARES). Co-sponsorship reflects the general philosophy of The Counselors to partner with other organizations in worthwhile projects. It also underscores the commitment of *Real Estate Issues* to maintain links with the academic community and to assist real estate practitioners in bridging the gap between the university and applied theory.

The march to the Millennium continues to be punctuated by change. Change is as penetrating and far reaching as it is rapid. The Information Revolution or the Second Industrial Revolution, as it is sometimes called, is causing experts to rethink traditional economic cycles. Some postulate that the record length of the current economic expansion will continue well into the future. Absent some unforeseen catastrophe, they contend that we will be in a boom economy until the Information Revolution ends and the velocity of change dissipates. Proponents of this theory speak in terms of a 15- to 17-year economic cycle. The optimist in all of us wishes to believe such good news, notwithstanding that our personal experience suggests otherwise. Certainly property markets are subject to overcapacity, even in the best of times, and there are always affordability and threshold issues particularly when rents have spiked for several years in a row.

In addition to change driven by technology, the real estate industry has passionately embraced the concepts of consolidation and globalization. Indeed, the pace of movement in those directions appears to have accelerated during the first half of this year. Such phenomena have also caused economists to opine on the "barbell" economy or one in which the majority of companies, particularly service companies (real estate advisory, law, and accounting firms), will be either very large or very small with few companies in between. The large companies will be truly global in scope with offices around the world. Such companies will offer an extraordinarily diverse range of services and products through legions of personnel. The small companies will occupy market niches; specialists or boutiques offering highly personalized services on a more or less local or regional basis. However, like all general rules, there will be exceptions.

It is within this environment that *Real Estate Issues* is constantly seeking to define itself. Like any journal, *REI* must steadfastly maintain its relevance to a changing world. This challenge is complicated not only by the factors mentioned above but also by the nature of counseling itself. Counseling is a process; it is not a discipline. Yet, the process of counseling necessarily involves skillsets and knowledge of one or more highly specialized disciplines. As a journal, *REI* must not only maintain quality on an intellectual level but it must appeal to its diverse readers by being relevant, interesting, and useful.

As editor in chief of *Real Estate Issues*, it is incumbent upon me to articulate a vision--both long- and short-term. While relevance is always the ultimate objective, I have set forth the following additional goals for 1999: continue to improve the quality of manuscripts published and the journal in its entirety; increase the flow of manuscripts; and develop strategies to increase circulation.

In executing this plan, we have changed the appearance of *REI*. In the future, we plan format changes such as adding various departments; a Letter to the Editor section; co-sponsoring certain issues with other organizations, companies, or universities; and introducing a refined advertising program. However, one of the most tangible and perhaps most important measures of a journal is the quality of its content. The Editorial Board and I are especially proud of our efforts to make each issue better than the last. We invite you to enjoy the Summer issue by reading articles authored by some of the leading thinkers—practitioners and academicians—of our industry.

Richard Marchitelli, CRE
Editor in chief

Jonathan Avery, CRE
1999 National CRE President

Real Estate Cycles: Measuring Differences in Retail Subtypes

by William C. Wheaton, CRE, Raymond G. Torto, CRE, & James M. Costello

Overview

Is common sense really that common? For instance, real estate analysts know anecdotally that the market for neighborhood and community center space is very different from that for regional and power center space. However even with this common sense knowledge, one can still frequently see commentary that treats the market for retail space as a single entity.

In this article we will not try to address the reasons why some analysts treat the retail market as a single entity. We will attempt to provide robust support to the notion that retail subtypes should be analyzed separately. This is done by quantifying some of the differences between the retail subtypes in terms of their cycles in supply and demand.

Neighborhood and community centers are shown to have a cyclical pattern in construction, suggesting a quick linkage between the supply and demand of space for these centers. On the other hand, regional and power centers have lumpy construction patterns, with surges in construction that are independent of changes in the broader economy. These differences suggest that any analysis of retail space derived from trends in the market as a whole may be skewed.

Defining Retail Subtypes

To analyze retail subtypes, it is necessary to begin by defining them. There are a number of classification standards against which a shopping center can be measured. The International Council of Shopping Centers (ICSC), the Urban Land Institute (ULI), the National Research Bureau (NRB), and others have defined the basic types of shopping centers based on the type of tenants, site area, and size of the structure. We can spend a great deal of time comparing the different classification

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systems, however they are generally similar with some variation in the size ranges and breadth of center types.

In *The Dollars & Cents of Shopping Centers*, ULI makes a point that in defining a center type, the tenant base is equally important as the physical characteristics of the shopping center and, in this regard, these three classification systems are very similar. NRB is our primary data source for retail space market information and we generally follow their definitions. For purposes of analysis, we modify the NRB shopping center definitions slightly, by grouping regional and super-regional centers into a single regional center category.

MEASURING SUPPLY CYCLES

To measure retail supply, we track the stock of shopping center space over the last 35 years. To construct this series, we use a combination of historical information from the NRB dataset and recent completions from CB Richard Ellis. Because expansions of existing shopping centers represent a significant amount of the total shopping center space, we have uniquely adapted the NRB data to calculate each metropolitan area's stock series. This adaptation is necessary because the NRB dataset only lists the year opened, current space, and the year of any expansion. Thus, we must attribute a share of current space to the year of expansion. In shopping centers that have not expanded, the entire square footage of the center is counted as completed in the year of its opening.

There is the issue that all retail space is not shopping center space. Attempting to equilibrate changes in supply with changes in demand can be skewed from additions to supply that are not in shopping centers. For instance, one might argue that tracking only shopping centers would ignore many of the freestanding stores that have been built in recent years. This concern is only partially correct. To begin with, NRB defines a center loosely enough so they are able to track power centers where several large retailers each own their own pad and share little more than common parking. Secondly, all of the space within shopping centers is measured, including space owned directly by retailers, not just by the center's management.

Additionally, while no longer dominant due to suburbanization and the growth of shopping centers, downtown or 'High Street' retailing still exists in many markets. Presumably the market for these stand-alone retailers is not growing, so changes in metropolitan supply should only impact the shopping center market. Unfortunately, while the shopping center market is tracked and quantified by a number of organizations, there is almost no consistent data available that tracks stand-alone, High Street, retailing.

To examine the construction cycle for each type of shopping center, *Figure 1* displays annual gross investment (new construction) in each center type for the U.S. Each series is measured as a percentage of the stock, covering the period 1968-1998, with the power center series starting in 1982.

To track completions against changes in the broader economy, each graph also depicts the annual percentage change in total employment for the nation. A comparison of each type of shopping center shows that retail real estate certainly does not perform uniformly.

For neighborhood and community centers, there appears to be considerable correlation between real estate and the economy. Shortly after each downturn in the economy, (1975, 1981, 1991) investments show a downturn, with corresponding investment upturns occurring during economic recoveries. This pattern suggests that the neighborhood and community centers react to national or regional economic shocks.

With investment in regional centers, however, there appears to be little evidence of a long-term relationship to the economy. There were two mini-completion spikes in the early and mid-1980s that matched the completion cycle of neighborhood and community centers. In other time periods, regional centers have a completion cycle of their own with high levels of completions during economic downturns in the mid-1970s and early 1990s. Investment in power centers bears no relation to the broader economic cycle, with completion rates similar to those of regional centers in the late sixties and early seventies.

Growth in the economy does not directly lead to increased investment in new shopping centers. Standard investment theory would argue that construction should follow changes in asset values. In neighborhood and community shopping centers, the increased demand spurred by economic growth translates quickly into new completions. This quick turnaround suggests a direct linkage between movements in demand, and movements in neighborhood and community center asset values. Because

Figure 1

Completion Rate by Center Type versus Total Employment Growth

SOURCE: RFA, NRB

the supply of regional and power center space does not move with the underlying demand in the economy, one may question whether or not we are using the proper measure of demand for each shopping center type.

MEASURING DEMAND INTERACTIONS

The demand for retail space is a derived demand in which the sales activity of retailers drives their need for space. We have been using total employment growth as a general measure of economic performance, and while this is one measure that will drive retail sales, it is not the only measure. Where possible, it makes sense to measure demand for retail space by directly examining retail sales.

In order to estimate retail sales by center type at a national level, Wheaton & Torto [1995] used the Retail Trade Survey data from the Census by SIC in combination with ULI estimates of tenant types by SIC. Following this method, we use the ULI survey [1997] of shopping centers to calculate the distribution of tenant types by SIC as a percentage of gross leaseable area for each center type. These percentage distributions are displayed in *Table 1*, and show that regional and power centers are dominated by the general merchandise category that will sell higher-order goods such as appliances. Neighborhood centers are dominated by retailers selling lower-order goods such as food, while community centers sell more of a mix of goods.

Neighborhood and community centers have dominant tenants in common, as do regional and power centers. In terms of physical characteristics, power centers have more in common with community centers than regional centers, but as we are analyzing trends in demand we group the center types based on dominant tenant types to make for a quicker analysis of the patterns in sales. Applying the percentages for the retail tenants to the Census data on retail sales by SIC allows us to estimate the national trend in retail sales by shopping center type.[1] The annual, inflation-adjusted changes in this estimate are displayed in *Figure 2*. While sales at regional and power centers are certainly more volatile than neighborhood and community centers, there is a common cycle in retail sales at these centers. These two series exhibit a correlation rate of nearly 85 percent.

Analysts should use caution with the Retail Trade Survey data for any project that is not national in scope. To develop this dataset, the U.S. Census Bureau compiles retail sales data from annual surveys of select merchandisers. Because all merchandisers surveyed do not have operations in each MSA, this data is not released officially at the metropolitan level as these chains may not be a representative sample of overall retailing. While the Census data is not representative at the metropolitan level, it is officially released at the national level as the aggregation across metropolitan

Table 1

Distribution of Tenant Types by Type of Shopping Center

SIC	Neighborhood	Community	Regional	Power
Building Materials/Hardware	1.9%	0.9%	0.1%	0.0%
Genearal Merchandise	3.6%	24.4%	47.8%	45.6%
Eating/Drink Establishments	7.6%	5.6%	2.7%	0.9%
Food	45.6%	29.1%	0.9%	17.1%
Apparel	3.2%	9.9%	25.8%	6.4%
Furniture	4.4%	4.9%	4.5%	5.0%
Other Consumer Goods	15.6%	12.9%	13.2%	18.0%
Services	18.0%	12.2%	4.9%	6.9%

SOURCES: ULI Dollars & Cents of Shopping Centers, *1997*
ULI Dollars & Cents of Power Centers, *1997*

Figure 2

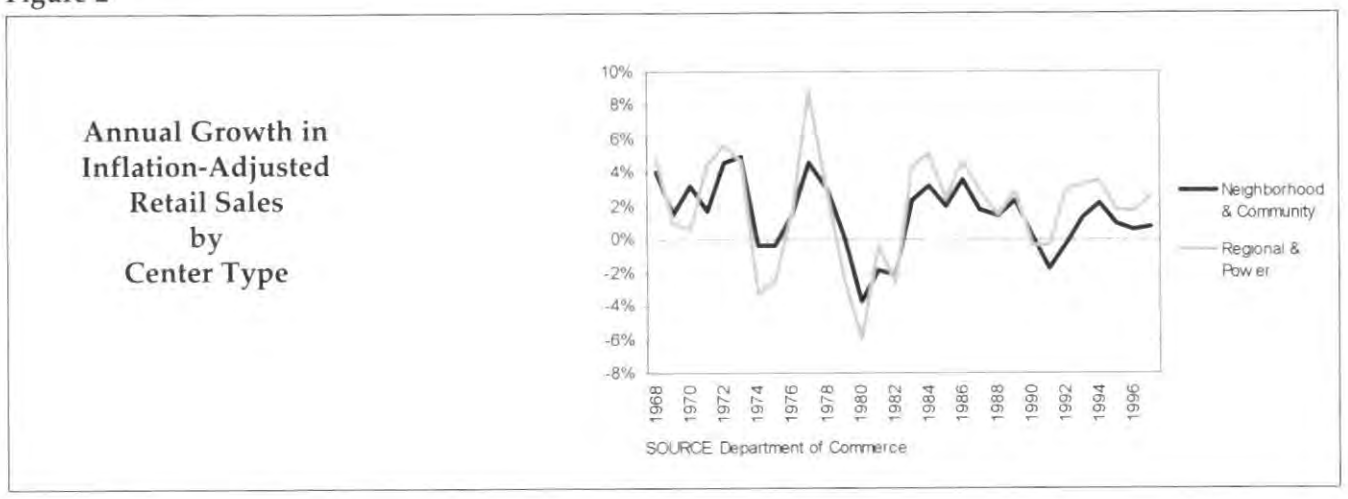
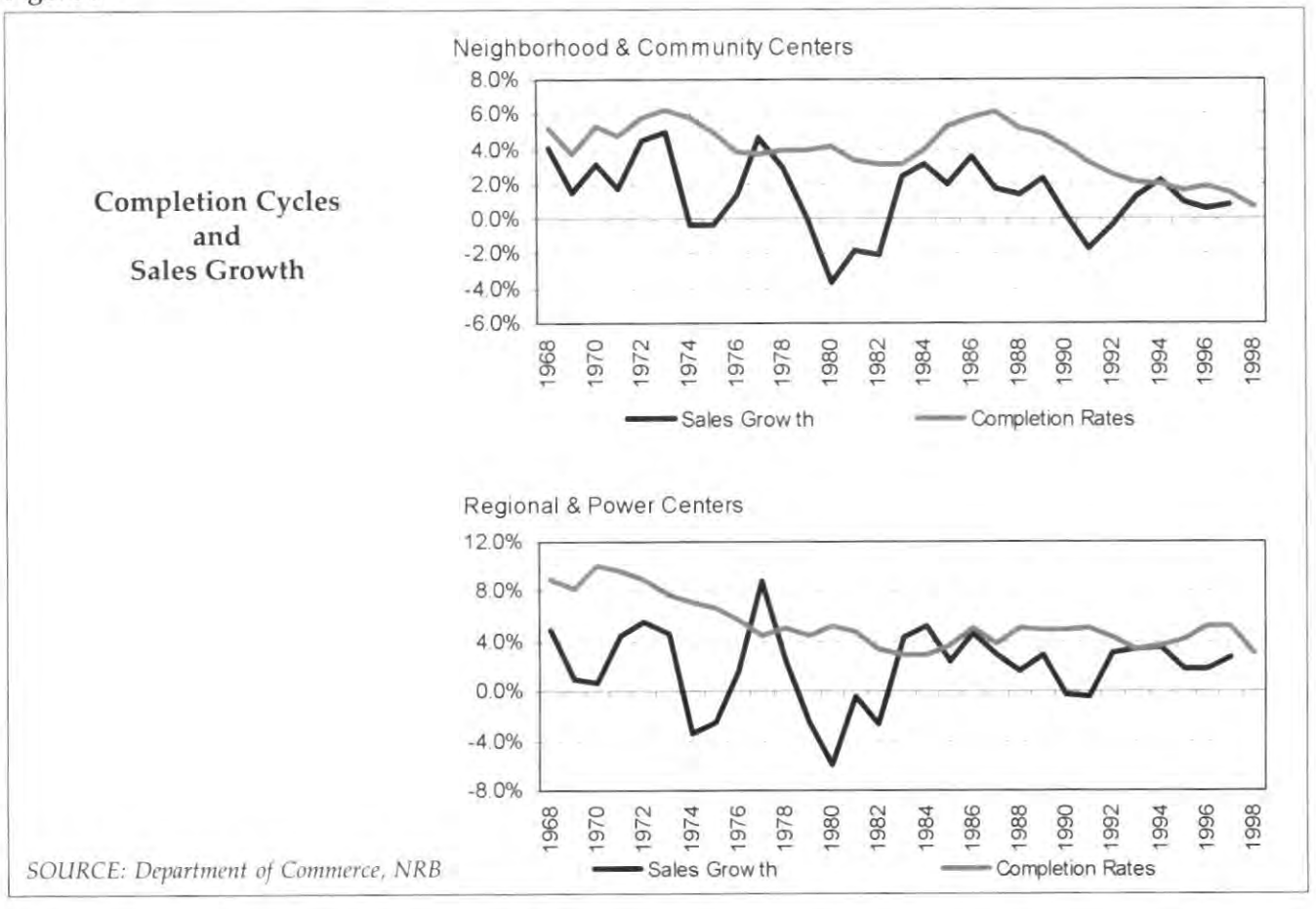


Figure 3



areas is representative of the national trend in sales.

SUPPLY VERSUS DEMAND

To examine the dissimilarity of the construction cycles exhibited by these two markets, we plot the sales data presented in *Figure 2* against the construction series by type from *Figure 1*. *Figure 3* plots the completion rate of neighborhood and community centers against the growth in inflation-adjusted retail sales for product categories typical of neighborhood and community center tenants. Likewise, the completion rate for regional and power centers is plotted against the growth in inflation-adjusted retail sales typical of these centers. The trend in sales versus completions highlights the relationship between demand and investment more clearly than total employment growth. There is some noise in the sales growth series leading to much more movement from year to year than in the completion

series. While neighborhood and community center construction has a 32.5 percent contemporaneous correlation rate with sales growth, it is much more closely related than in regional and power centers. For these center types, sales growth and completions have almost no relationship with only a 2.2 percent correlation rate.

Since neighborhood and community center construction moves closely with the drivers of demand, the risk of investing in these property types is a demand side risk. For these types of centers, one faces danger if one over or under estimates the underlying demand for space. Investment in regional and power centers is not a demand side risk as the long-term construction patterns bear little relationship to the drivers of demand.

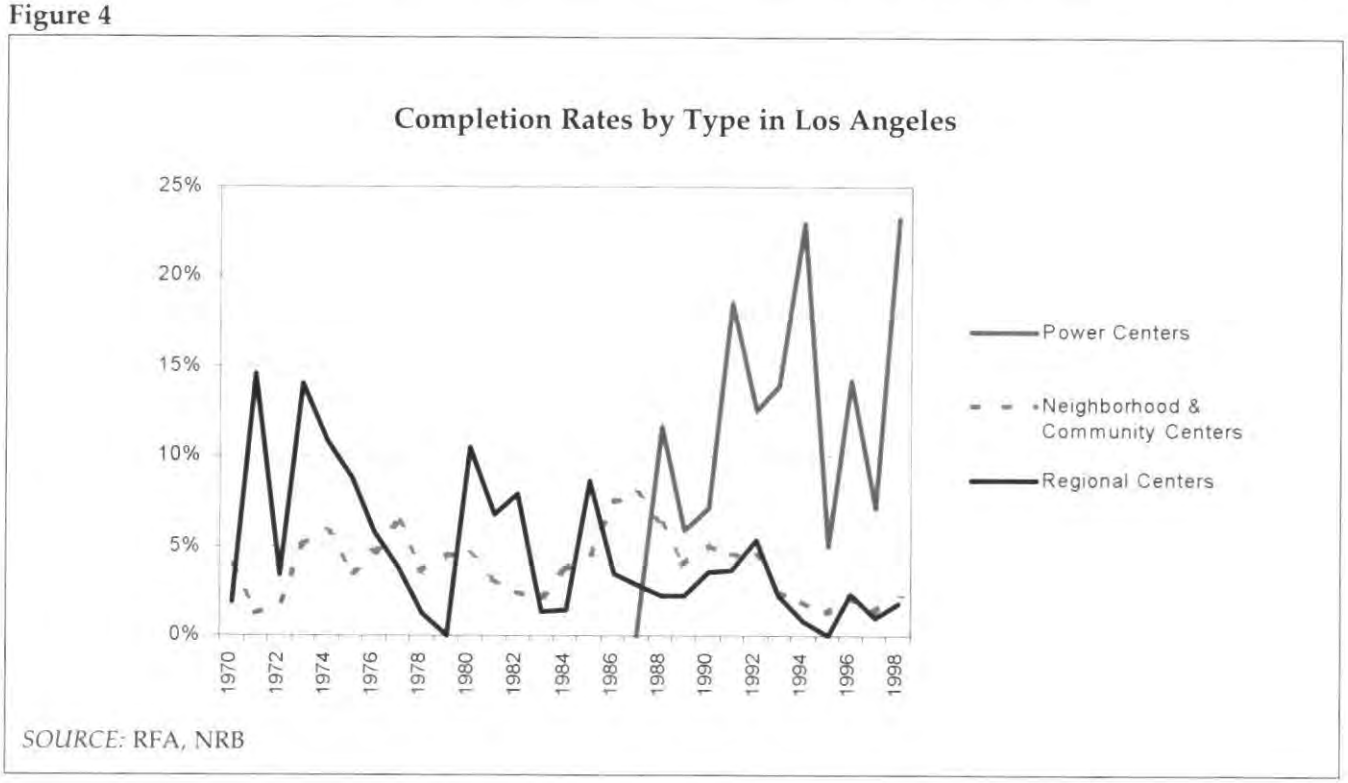
Just because there is no new investment in regional and power centers in periods of economic growth does not mean that there is no demand for such space. Anecdotal evidence points to long lead times in regional mall development with projects that, in some cases, have taken nearly a decade to go through the planning, approval, and development processes. With such a long lead time it would simply take luck to be able to time the delivery of a regional mall with an economic upswing.

Regional centers are lumpy assets and, as opposed to neighborhood and community centers, sufficient quantities of space cannot be doled out as needed. The lumpiness is not as evident when we examine the national construction trends where many centers from around the country are aggregated to form one construction series. On a metropolitan level though, even in a large metropolitan area such as Los Angeles, such lumpiness is evident.

Figure 4 displays the completion rate of neighborhood and community centers together against regional and power centers individually. While the neighborhood and community center completions move relatively smoothly with construction in one period closely related to the next, regional center construction fluctuates wildly with a completion rate of zero one year and in double digits the next. The introduction of a single regional mall can drive such erratic swings in completion rates. However if we ignore the ups and downs of regional center construction and look at a smoothed long-term trend, one can see that the relative peaks of completion rates have been declining over time. In the same sense, the completion of power centers seems to be increasing.

In part, this construction cycle is different due to the non-homogenous nature of the retail formats in which high-order goods have been sold. This non-homogeneity can be seen in both center types and locations over time. During the late sixties and early seventies, the process of suburbanization drew the

Figure 4



SOURCE: RFA, NRB

merchandisers selling high-order goods out of their downtown locations and into newly expanding suburbs. The completion rate for regional centers was relatively high back then, not in response to broader economic demand, but due to a shift in retail formats. Likewise, in the nineties, there has been an explosion of power centers bleeding sales away from traditional regional malls. By offering a wide selection of goods typically found at a regional mall but pricing the goods more competitively and, perhaps most importantly, choosing sites proximate to existing regional malls, power centers have bled sales away from regional malls.

Investing in regional and power centers is not so much a demand side risk as a supply side risk. As the name implies, regional centers serve the needs of a large customer base in a wide region over which they enjoy a relative monopoly. These centers benefited as the traditional downtown retailers lost a relative monopoly when their customer base moved away from downtown locations during the process of suburbanization. These centers then suffered as power centers located proximate to their existing locations and ate into the monopoly status of regional centers. Some have suggested that power centers themselves face a supply side risk from the Internet. Power centers focus more on goods that are commodities, which at this point is what is being sold on-line.

CONCLUSION

Even with the common sense knowledge that the retail subtypes exhibit different behavior, much commentary still treats the market for retail space as a single entity. In this article, we presented the following differences between the retail subtypes:

- The construction cycle for neighborhood and community centers exhibits a cyclical pattern that moves closely with changes in the broader economy;
- Regional and power centers construction patterns do not have a similar relationship to the broader economy;
- There is a strong correlation in the sale of goods typically found at each center type, but the construction of neighborhood and community centers moves more closely with retail sales than the construction of regional and power centers;
- Investing in neighborhood and community centers has a demand side risk where the danger is in under or overestimating demand;
- The risk in regional and power center investment is not from the demand side but the supply side, where centers face the danger of losing sales to competitors in other locations or to other formats.

These differences suggest that any analysis of retail space derived from trends in the market as a whole is missing part of the story. If each of the subtypes exhibits different construction patterns, and each faces unique investment risks, one retail subtype could be doing quite well while others suffer. REI

NOTES & REFERENCES

1. The Census data measures retail sales and while presented in *Table 1*, we exclude the services category from the analysis as it is not directly comparable.

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Urban Land Institute *Dollars & Cents of Power Centers: 1997;* Washington, D.C.,: ULI

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(continued from page 1)

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The Role of Trust in Real Estate

by Stephen E. Roulac

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Behavioral researchers identify real estate transactions as amongst the most highly stressful of life's experiences. The forces that influence real estate outcomes are many, varied, and complex, and the circumstances, procedures, timing, and costs of real estate investment transactions are more cumbersome, involved, prolonged, and expensive than apply for virtually any other type of transaction.

While business contracts and corporate securities sales of virtually any financial magnitude can be authorized and binding on the basis of verbal representation, these reasons are no doubt why real estate transactions require a written contract. Documentation of real estate transactions frequently involves numerous voluminous written instruments. Because of the above reasons as well as the inherent complexity and high stakes involved in real estate, the legal process generally—and lawyers' contributions specifically—have a disproportionate impact on real estate activities, relative to other sectors of commerce.

Even so, trust looms very large in real estate involvements. Those investors and service providers who understand the role of trust and effectively embrace the concept of trust in their real estate involvements can achieve performance significantly superior to those who do not. Notably, speaker and trainer Marianna Nunes observed, "Who you are, and how much trust others feel when they deal with you, is as important to your customer as what you're selling." Although Marianna Nunes was describing business generally, the imperative of trust is pervasively important to real estate involvements—for real estate involves daunting decisions of extraordinary financial magnitude, whose outcomes are dependent upon the

multiplicity of forces influencing the plans, priorities and actions of individuals and businesses.

Because real estate decisions are inevitably based on uncertain, imprecise, and incomplete information, trust looms large. The initial level of trust is of oneself. This trust of self embraces the need for initiative to take action in the face of inherent ambiguity and uncertainty. The second level of trust is of colleagues and co-workers, followed by the third level of trust of service providers and agents. The fourth level of trust extends to parties in the transaction, particularly those who are buying, selling, leasing, investing, and financing.

Those people and organizations, considered worthy of trust, tend to possess in greater depth certain factors that contribute to high trust than do those persons and organizations who are considered less worthy of trust. These factors include:

1. Professionalism
2. Passion
3. Commitment
4. Involvement
5. Learning Initiative
6. Expertise
7. Experience
8. Authenticity
9. Reliability
10. Brand Identity
11. Responsiveness
12. Emotional Intelligence

These 12 factors are explored below.

Although trust is mostly thought of in a conceptual context, trust in fact has significant concrete applications. A manager who is perceived as trustworthy, is more likely to gain access to capital and to reputable professional service providers on advantageous terms, than is a manager who is perceived as less trustworthy. Thus, from the perspective of the institutional investor, doing business with managers and advisors who engender a high degree of trust may mean that, on the margin, resources that might not otherwise have been accessed may become available, and critical resources may be provided to a project on more advantageous terms than might apply were such trust lacking.

On the flip side, management perceived as low in trust may encounter difficulty in getting access to resources and be required to pay a premium for those resources that are available. As professional services firms may be disinclined to work on behalf of those perceived to be less trustworthy, the number of professional services firms willing to work with low trust clients is more limited and the cost of retaining professional service providers may likely be higher. The consequence of these conditions is to place lower trust organizations at a competitive disadvantage relative to higher trust organizations. As a case in point, because of his reputation for bombast and representations that tend to transcend prevailing perceptions of reality, certain financings that Donald Trump promotes require premiums over what might be required for non-Trump financings. Further, those securities may sell at discounts to prices which might be commanded were Trump not involved.

Every real estate transaction involves both explicit and implicit consideration of investment attributes and trust factors, collectively and/or individually. What is treated as explicit or implicit is up to the individual decision maker. Some might explore credentials very explicitly, and then treat the data very implicitly. For many, the real estate transaction involves the *explicit* consideration of both the plethora of factors that collectively represent a property and its prospective benefits to the purchaser and also all considerations that influence that future performance as well as the *implicit* trust in the reliability of representations, professional competence, and responsibility of those involved in the transaction. Depending upon the investor and the circumstances, in some instances the explicit considerations may dominate, while in other circumstances the investor may largely rely on trust.

One approach to investing is to concentrate attention on the specific decision components, emphasizing analysis of the relative appeal of different property types, geographic regions, and real estate strategies. This emphasis on the specific decision components combines concentrated due diligence to evaluate the property's neighborhood, site, physical structure, energy systems, environmental compliance, construction quality, maintenance and capital expenditure needs, plus thorough scrutiny of tenants, leases, revenues, operating expenses, financing terms, as well as careful review of legal documents, financial records, reports concerning the property and its market, and other materials. In addition, this approach includes evaluating the backgrounds, qualifications, capabilities, and contracts of all firms and individuals involved with the project, and then undertaking detailed financial modeling of the property's/portfolio's probable

future performance. For some investors, this process is absolutely necessary, and indeed is the essence of what such investors perceive as the responsible implementation of their fiduciary responsibility.

Other investors, while not necessarily discounting the relevance of such an explicit detailed approach, place more emphasis on an implicit assessment of many specific attributes of the investments proposed by and the related representations made by those with whom they do business. These investors place primary reliance on their trust of the advisor(s) that represent(s) them and their interests.

Most investors employ a combination of trust and the explicit substance of due diligence in their investing. One of my clients in charge of real estate investing for a large pension fund expressed it this way, "I expect to have implicit trust in my advisors, and then I want complete assurance and confirmation that everything that is supposed to be done is in fact done."

The role of trust in real estate investing decisions can be considered to be both a *substitute* for and *complement* to real analysis. The real estate trust chain, as depicted in the accompanying graphic exhibits, embraces certain basic components of trust in real estate decisions. One version of how the real estate trust chain is applied in the selection and retention of a specific manager appears in *Exhibit 1*. Indeed, some investors may seek to satisfy themselves explicitly about one or more of the elements of the trust chain depicted in *Exhibit 1*. Each of the four statements follows from and reflects an individual trust premise. Each sequential statement incorporates the cumulative trust premises of those that have gone before. The decision to retain a specific fiduciary for a real estate investing program, then, relies upon the implicit chain of trust premises—for the individual investor; *i.e.*, the particular items which that investor treats implicitly—that precede it.

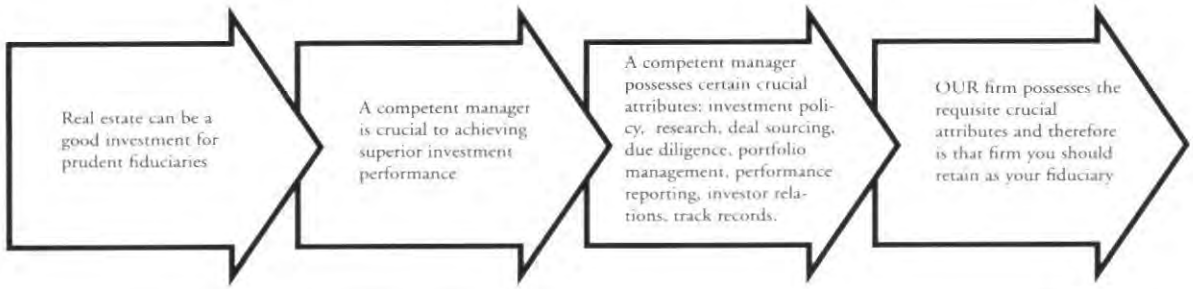
The real estate trust chain for a specific investor property and portfolio is depicted in *Exhibit 2*. In common with the real estate trust chain for a manager, the real estate trust chain for a specific property and portfolio incorporates a series of individual trust statements, which cumulatively gain strength when combined with the prior trust statements, and lead to the final decision/recommendation. The final decision/recommendation reflects the cumulative trust statements that have gone before. While each component of the real estate trust chain can be separately evaluated, the process is more right-brained than left-brained, more impressionistic than linear.

Each link of the real estate trust chain is comprised of two parts that make the statement a valid, trustworthy building block leading to the overall conclusion as to the appropriateness of a particular investment. Each statement is supported by both an articulation of 1). *because reasoning* — often, but not necessarily always, explicit substantive rationale; and 2). also a *trust representation*, which may be explicit, as in the form of a "you can trust this representation" statement, but most often is implicit.

Consider the first element of the real estate trust chain: *real estate is a good investment*. This statement really is of two parts. The first part is that real estate is a good investment. The proposition that *real estate is a good investment* is derived from assessment of many factors, some of which reasons are listed in *Exhibit 3*. All of these factors represent the *because reasons* that support the rationale for the *real estate is a good investment* premise.

Exhibit 1

Trust in Real Estate Investing: Manager



But there is also a critically important *trust premise* behind the *real estate is a good investment* statement. The trust component of the statement that *real estate is a good investment* statement is that an expert fiduciary making the statement is implicitly representing a number of trust substatements, which may include such considerations as:

- "I have done my homework, and if I say real estate is a good investment, you can believe me, that real estate is a good investment."
- "I am at risk by making this statement, and you can count on my not making a statement that would put at risk my reputation, my relationships, my business, my dollars, unless I were highly confident of the validity of this representation."
- "You can trust me when I say real estate is a good investment, because I stand behind my statements. If something goes wrong, I will not walk away. Because I stand behind my statements, I will do what needs to be done to make sure what I represent comes true for you."

Investors committing capital to real estate are buying the comfort of the trust representations of their advisers as much as they are buying the tangible real estate itself.

Certain managers encounter difficulties in retaining their clients' confidence, not so much because the quality of their ideas compares unfavorably to competitors' or that the relative appeal of the investment opportunities they propose for their clients is unattractive, as that the clients have lost trust in those advisors. Without trust, the credibility of representations is materially compromised.

Considering the accompanying real estate trust chain, the final element — *you should invest in this real estate property/portfolio* — reflects both explicit analysis and implicit trust. The explicit analysis might embrace considerations that a particular real estate investment will complement portfolio objectives, meeting specified portfolio allocation and composition goals, geographic and property type diversification guidelines, investment parameters of size and particular attributes of desired properties, plus economic and financial parameters of return and risk.

The most important decisions transcend mechanics and calculus to turn on judgment, the assessment of multiple factors, and emotion: blending optimism, fear, hope, and other desires and concerns. Ultimately, what it can come down to is the investor's reliance on the representation, more often implicit than explicit, by the advisor that *I have done my homework, this is a good deal, and this is the right deal for you at this time.*

The implicit, or what might be considered soft, side of the real estate investment decision process is inherent in every real estate decision, irrespective of how detailed and disciplined the due diligence analysis might be. While those participating in the institutional real estate investing process place great emphasis on research, reporting, right strategy and right location, trust is often taken for granted. Trust is equally important in the investor's decision and ultimate satisfaction with the decision, as is the real estate purchased and the performance delivered by that real estate.

If an investor makes a point of looking more deeply at the elements within a financial interaction that evoke trust, that awareness can then be applied in choosing a portfolio manager or advisor. Similarly, understanding how to create authentic trust can also enable managers and advisors to better serve investors.

Exhibit 2

Trust in Real Estate Investing: Particular Properties/Portfolio

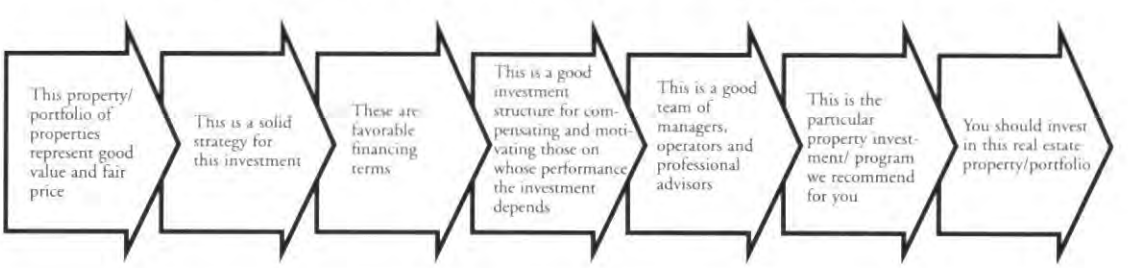


Exhibit 3

Reasons Why Real Estate Is a Good Investment

- Significance in the economy
- Importance as a factor of production
- Long-term financial performance
- Diversification contributions
- Risk-reward attributes
- Academic research showing real estate portfolio reduces risk for a given level of return and increases return for a given level of risk
- Inflation hedging capacity
- Potential for superior returns in an inefficient market
- Needs for more space in the growing economy
- Acquisition price relative to reproduction cost
- Contemporary investment pricing relative to corporate securities
- Susceptibility to strong performance because of superior management
- Potential advantage through the legal use of insider information
- Creation of monopoly position

While numerous factors contribute to an assessment of trust, the dozen trust factors that follow can be used by investors and managers alike in thinking about what trust means to them in interactions around financial commitments. Most institutional investors will find that their managers and advisors who score high on the following trust factors will likely be the managers and advisors they trust enough to retain to implement their real estate investing program:

Professionalism— Investors are more likely to trust those whom they perceive to be professionals rather than amateurs. Professionals have mastered their fields. Such professionals exude confidence, competence, continuity, and commitment in what they do and how they do it. Professionals have done what they do for an extended duration and by their demeanor convey the message they expect to continue to do what they have done for an extended duration. Amateurs, by contrast, often have a much shorter duration of involvement in a field. Offices, systems, and organizations can communicate the long-term commitment of the professional who makes and delivers on commitments and thereby encourage trust.

Passion – Passion engenders trust. Those who are passionate about what they do, being positive, enthusiastic, really caring, are more trusted than those who are less emotionally involved, approaching what they do as *just* a job. Investors can consider whether managers and advisors approach their work with the enthusiasm and emotional involvement that one brings to a true calling. Those who experience their work as a true calling are often passionate about what they do. Those who experience what they do *as just a job* are seldom passionate about what they do.

Commitment – Evidence of commitment engenders trust. Commitment is conveyed by conscientiousness, dedication to the task, and seriousness of purpose. Commitment is doing the work, no matter how hard or unpleasant it might be, following through to deliver what is promised, and doing whatever it takes to get the job done. Recently, one litmus test of commitment that certain institutional investors have employed is co-investing, insisting that managers put their own money at risk.

Involvement – Organizations whose leaders and senior executives are directly involved in working with clients are perceived as more worthy of trust than those who are nameless and uninvolved. The phenomenon of a salesperson creating a relationship but turning its execution over to another can compromise trust, just as can the lack of any connection between those who actually do the work and the client. The direct personal involvement of an organization's principals in the client's affairs engenders trust.

Expertise - An investor expects the managers and advisors with whom it works to be highly knowledgeable about the technical substance of what they do and the markets in which they do it. Institutional investors will place more trust in those advisors and managers who are highly competent in their work by virtue of having their thinking already done. Expertise extends beyond thinking already done to embrace informed contemporary knowledge of forces that influence the situations the expert might expect to confront. Thus, expertise embraces monitoring current development in markets, industries, business practices, regulations, values, style and fashion, that individually and

collectively influence society, business and investment performance. Additionally, a crucially important attribute of expertise is the creative capacity to solve the unstructured problem. Accordingly, expertise is not just the content attributes of knowledge but the process attributes of its original and innovative application.

Learning Initiative — People who are self-educating tend to command greater trust than those whose orientation to learning is more passive. Those who embrace personal and professional development as a lifelong process, take initiative and responsibility for their own ongoing learning. Since investment fiduciaries, perhaps more so than most, deal with the financial consequences of the application of uncertainty, those advisors and managers who are pursuing ongoing programs to enhance and extend their expertise and gain understanding of the forces of change that cause uncertainty will more often command trust than those who have less of a learning commitment. Investors can more confidently trust those whose commitments to learning extend to creative approaches, fresh ideas, and non-standardized thinking that can be translated into strategies that achieve superior investment results.

Experience – Those who are perceived to have substantial experience, generally and specifically, are much more trusted than those who are perceived to be less experienced. If one is embarking on a journey into uncharted territory, one wants a guide who has been there before. If one is sailing in dangerous waters, one wants a captain who has accomplished many successful voyages. Generally in business, those who are perceived as experienced, having seen a multitude of varied situations and developed perspectives and judgements from their experiences, are more trusted than those whose experience is limited. Further, those whose experience provides relevant knowledge are more trusted, as there is a belief that such advisors will not be reinventing the wheel, but rather drawing upon knowledge already obtained.

Authenticity – Authenticity is integral to trust, as it goes beyond appearances to the substance of people and organizations. People and organizations who possess authenticity *walk their talk*, behaving in ways consistent with their representations. Beyond the attributes that suggest the appearance of trust, one might consider how it feels to be with an authentic person. Those people and organizations who possess authenticity manifest consistency and congruence in their behavior, with a strand of consistency through their actions over time and the actions themselves being congruent with representations that they make about their values, priorities, and standards. Further, those people and organizations that possess authenticity are able to be as honest about their shortcomings and failures as they are about their accomplishments and successes.

Once trust is established, that trust creates certain expectations about performance. Then, once those performance expectations are realized, the performance that justifies trust reinforces trust. The result is a virtuous circle of trust.

Reliability – Reliability is fundamental to trust, as people and organizations who are considered reliable tend to be trusted. Reliability is achieved by the presence of positive experiences and the absence of negative experiences. Specifically, representations made and honored enhance reliability, while deadlines missed, performance shortfalls, and a lack of predictability are negative experiences that diminish reliability and therefore trust.

Brand Identity— A business entity's brand conveys its marketing position. The effective brand image is created over time and continually reinforced by encounters with a multitude of elements that comprise a company's identity. Just as recognized brands such as Coca Cola and Tiffany engender trust, investors have greater trust in those individuals whose identity in all its forms reflects a recognized brand. Identity is created through the composite of messages reflected by advertising; written communications through articles and reports; media coverage; sales literature and materials; office environments; and personal appearance. Investors can assess trust by considering whether the presentation of the manager's and advisor's identity is strategic, consistent, and congruent. While all of the trust factors are important, research into interpersonal communications effectiveness has determined that visual appearance is many times more important than content. Consequently, trust often is much more a function of the messenger and the messenger's style than the actual message.

Responsiveness – Those organizations which are directly responsive to clients, as opposed to being distant and indifferent, are more trusted than those that are not. Responsiveness corresponds to personal interest and involvement, and this personalizing of the client relationship contributes to and reinforces trust, for customized approaches are experienced by clients as personalized approaches. Customized approaches to clients and their problems engender greater trust than do those that are canned or "off-the-shelf." Further, responding to clients as individuals and on their terms, rather than treating them as a generic customer in ways determined by the service provider, reflects a more personalized approach that engenders trust.

Emotional Intelligence — The role that emotional intelligence plays in who gets ahead in business is increasingly recognized. Accordingly, interpersonal skills are a critical contributor to creating and sustaining trust. Those individuals who express interest in others, make them feel special, convey that they care about and also that they trust them, *tend* to be more trusted. As a senior financial executive told me a long time ago, "People tend to do business with those they like." And his statement can be amended by the addition that people tend to do business with those who manifest self-confidence, reflecting their own trust in their own competence.

Collectively, these 12 elements of trust correspond to the attributes and style of professionals and managers who command their clients' trust.

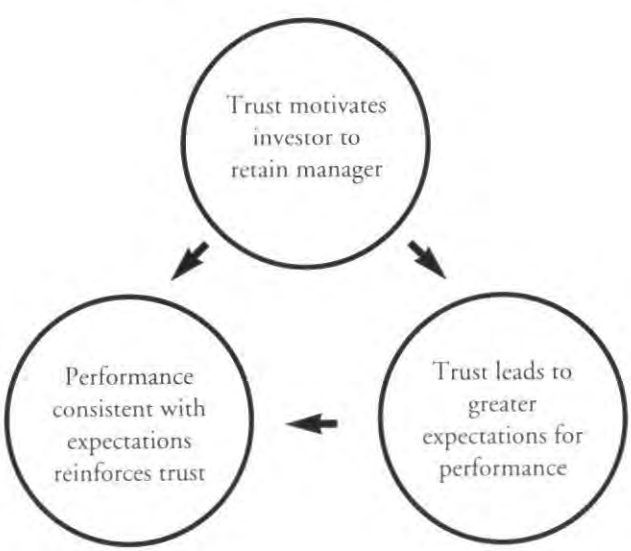
Equally important as trust is the ability of a manager to perform for the benefit of the client. If decisions by the investment manager and the performance delivered are incompatible with the trust attributes discussed above, that inconsistency will inevitably diminish trust.

Trust is not a substitute for, but rather a complement to, the essential content attributes of the real estate investment decision-making process. Those who aspire to trust in their relationships with their service providers and clients, would do well to consider that the greater the trust, the higher the expectations of the substance of the content of the performance.

Consequently, it is critically important to consider the necessity of clearly articulated strategies, responsive planning and control systems, and clear communication of what is to be done and reporting of what has been done. Once trust is established, that trust creates certain expectations about performance. Then, once those performance expectations are realized, the performance that justifies trust reinforces trust. As depicted in *Exhibit 4*, the result is a virtuous circle of trust. REI

Exhibit 4

Virtuous Circle of Trust



LAND INVESTMENT IN THE 21ST CENTURY

by James R. MacCrate, CRE, & David L. Peterson

This article examines some of the ways that U.S. land investment in the 21st century will be different from what we know today. We will look ahead five to 10 years to predict which of today's practices and patterns will have changed - and how dramatically. We will also examine how these changes could affect returns and investment strategies.

Before beginning this look into the future, we describe the basic elements of risk and related strategies that are always present in land investment. We then review recent history to see how land investment has changed over the past 10-15 years. This information provides a baseline from which we can analyze expected changes in risk elements and strategies and their effects on investment returns.

BASIC ELEMENTS OF RISK AND STRATEGY

Risks

Land investment is always subject to a number of risk factors. The character of risk changes as development moves forward. The types of risk associated with land investment include:

- Market risk - supply and demand fluctuations. As the window of development opportunity becomes smaller, timing becomes more important and market risk may increase. On the other hand, as the quality of information improves and as market data can be retrieved and analyzed more quickly – almost in real time – market risk may be reduced in some instances.
- Governmental risk – This type of risk is becoming increasingly important as more jurisdictions regulate more aspects of the development equation more closely. Regulation by its very nature limits what the owner can do with land. Simple zoning and subdivision

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regulations have now been expanded in many jurisdictions to include growth impact fees, school construction contributions, affordable housing exactions, and many other potentially costly requirements.

- Financial risk – The willingness of lenders to back projects and the percentage of value and interest rates at which they are prepared to lend are always important variables. Some but not all financial risk can be hedged against. The recounting of recent land investment history, in a later section, shows how fluctuations can impact markets.

- Environmental risk – Some environmental risk events can be hedged or insured against by pre-purchase due diligence, but some so-called "Acts of God" cannot be. Accumulated pollution from past decades and even centuries is an ever-present and significant factor in development calculations.

- Operating/development risk – A land owner's investment return and profit often depend upon the expertise and reputation of the developers, builders, and contractors with whom he/she is associated. Development is a business and is thus subject to normal business risks which good management can minimize.

Strategies

As land investment moves from raw land status through the acquisition, approval, zoning, subdivision, and other regulatory approval processes, the amount and character of risk will change. The wise investor develops strategies to minimize, hedge against, and otherwise deal with these risks. At least three basic strategies can be identified, each of which presents a different risk/return profile.

The first strategy is to purchase large tracts of unsubdivided land with the intent to hold for long-term anticipated future development. Land purchases of this type are typically not conditioned on approvals. The owner who may or may not be the ultimate developer, assumes all the approval risk in the hope of increasing overall returns. Land investment surveys conducted over the past decade by Price Waterhouse LLP (now Pricewaterhouse Coopers LLP) confirm the speculative, high-risk, high-return nature of this strategy. Survey results have shown expected returns in excess of 50 percent, in contrast to developers' anticipated median returns of less than 30 percent.

The second strategy is to purchase land that is approved for development but remains unimproved. The owner assumes the risks associated with subdividing the land and installing infrastructure. In this case market risk is of greater concern. If the market shifts or weakens the landowner may be caught with obsolete layout or too many parcels. Expected pre-taxed unleveraged returns on these types of land investments have usually ranged between 15 percent and 30 percent. Market conditions, (for example, the housing affordability index), and the short-term interest rate environment can dramatically affect return levels within this range.

The third strategy involves purchase of finished approved parcels that can be developed within one to or two years. Landowners who adopt this strategy are often, but not always, the developers of the ultimate product. Market and financing risk are therefore of greatest concern to this type of investor. Historically, expected returns for such investments have ranged from nine percent for build-to-suit projects to more than 15 percent for speculative ventures.

Whichever strategy is chosen, ongoing micro-market analysis, both economic and political, is an important part of the landowner's risk management activities. This can often take the form of market analysis, with full appraisals required only when significant micro-market changes have been noted. Even though land investment may be financed globally, the factors that determine investment risk and land value – such as political decisions, economic conditions, and buyer preferences – will always remain primarily local.

In the next section of this article, we turn to the analysis of these investment risks and strategies in historical perspective, to see how the nature of risk, the levels of risk and the land investment industry itself have changed in recent times.

HISTORICAL PERSPECTIVE

The Mid to Late 1980s: Time of the Cowboy

The mid- to late-1980s will be remembered as one of the "go-go," "cowboy," boom eras of American real estate. Transactions and development took place with minimal market or regulatory discipline, especially in Texas and the Southwest, but also nationwide. Massive amounts of savings and loan-financed development took place with fees in mind rather than ultimate marketability of the end product. Land "flips," multiple sham purchases and

sales, (some even on the same day), artificially inflated land values in a number of markets. The result was a vast wave of real estate development and investment. Much of this development was ill-conceived and unjustified at the time. All U.S. markets, as well as the real estate regulatory and financing environment, were affected for many years.

Naïve buyers, most notably the temporarily wealthy Japanese, were eager buyers of American real estate. Unsophisticated Americans, many of whom were highly skilled in their own professions but unfamiliar with the ways of real estate, also found themselves trapped in investments with steadily decreasing returns in dramatically overbuilt markets.

The Early 1990s: Rationality Begins to Return

By the early 1990s, the boom of the 80s had begun to collapse. State and federal regulatory actions, such as those of the Resolution Trust Corporation, resulted in the closure of many lending institutions and the liquidation of their real estate holdings. Properties were re-valued downward approaching true market value and repackaged as portfolios to be resold to investors. Regulations governing lending institutions and the appraisal industry were tightened.

The resulting large overhang of undeveloped, developed, and subdivided land placed a lingering cloud over real estate development of all kinds. This limited the launch of new projects for many years. The demand from Japanese buyers also dried up as the Japanese economy entered a decade of contraction and weakness from which it is only now starting to emerge.

Markets shifted in a number of metropolitan areas. In many areas the luxury housing markets collapsed. Lower priced, smaller lot, higher density product came into favor. This often led to costly and time-consuming subdivision redesign with the need to deal with amenities that were appropriate for an earlier decade but represented over-improvements in the early 1990s.

The Mid- to Late-1990s: The Rise of the Public Companies

During the mid-1990s the American economy entered a period of ongoing strength. Slowly but surely the excess development of the previous decade was absorbed. Projects that had been abandoned or delayed were resurrected, often in financially stronger hands.

As land investment moves from raw land status through the acquisition, approval, zoning, subdivision, and other regulatory approval processes, the amount and character of risk will change. The wise investor develops strategies to minimize, hedge against, and otherwise deal with these risks.

At the same time, American real estate became increasingly a "public market" phenomenon. Real estate investment trusts (REITs) and publicly traded real estate companies became more important in the industry. They brought high levels of capitalization that permitted them to accept the high risks inherent in the land development process.

Smaller, often family-owned businesses and localized entrepreneurs were replaced and in some cases absorbed by large, national, well-capitalized, publicly-traded entities. This shift has affected all aspects of real estate, land development and investment among them. Traditional sources of real estate financing have been replaced by Wall Street-based capital raising techniques.

The transition to institutional dominance has not been a smooth or easy one. Even within the past two years, advances and declines in share prices of REITs and public companies significantly affected their investment strategies and their ability to raise capital. The short-term investment horizons of stock and opportunity fund investors have led to correspondingly short-term development planning horizons of REITs. They are focused on using all their assets – including land – productively.

Home building firms, many of them large publicly-traded companies, are similarly affected by short-term share price and earnings pressures. Like REITs, they are interested in maintaining minimal land inventory, using land only as they can build on it. This creates good market opportunities for those land investors who can function as land suppliers to the construction industry. It is expected that housing demand will remain strong, at least in the short-term. Therefore, investing in land for ultimate use by the builder would appear to make economic sense in many cases.

By 1997, as existing land inventories were absorbed, there was a mini-rush of investment into land that could be used immediately for REIT projects. Well-capitalized REITs allied with or purchased developers who had large land inventories and the skills to convert them quickly to profits. New institutional funding vehicles sprang up to finance these land purchases. Although some concern was expressed that this investment might lead to overbuilding, that fear turned out to be largely unwarranted. Market and regulatory controls were more in evidence than they had been in the late 1980s. Returns on land investment declined as many buyers competed for the limited supply of available holdings. In particular, demand increased for smaller, fully-entitled, build-to-suit projects which provided quick profits at reduced risk.

In late 1998, weakness in Asian, Russian, and Latin American economies resulted in short-term declines in the global markets. These market declines affected REITs and commercial mortgage-backed security (CMBS) firms, slowing the flow of investment into land. These publicly-traded firms concentrated on building projects that could be brought to market immediately. Land investment could still be financed, but usually only when significant equity was contributed and legitimate end users identified for specific projects.

Even in this time of caution, there have been occasional outbreaks of aggressive land development lending by financial institutions. These new projects are in areas where housing markets are strong, as in some Southeast U.S. metropolitan areas and Southern California. Regulators face the continuing challenge of monitoring investment flows to insure that development proceeds, but not in an overly risky manner.

Reflections on Recent History

Reflecting on the events of the past 15 years, one wonders how much has really changed. Several of the land investment projects now being financed and sponsored by Wall Street and institutional capital sources, although presented in professional looking packages, may carry as much risk to the typical investor as some of the high-flying deals of the mid-80s. The need to understand the underlying fundamentals of any real estate investment proposal, no matter how packaged, remains critical. Wall Street is just beginning to develop the expertise to understand the subtle nuances of real estate investment, including the more speculative land development process.

The "caution light" warnings and underwriting guidelines that are now being issued by regulators to lending institutions under their jurisdiction bring back memories of the 1980s. One hopes that today's lending institutions and Wall Street are paying attention and that today's regulators perform more professionally than their counterparts of 15 years ago.

The experience of the past 15 years also illustrates the importance of "deep pockets," patience, and cycle analysis in land investment. Investors who were able to hold on through the gyrations of the late 1980s and early 1990s often reaped significant rewards in the late 1990s. Investors who were able to buy into land investments at distressed prices in the early 90s were able to enjoy high returns – in that time period generally in excess of 30 percent for approved but unimproved land.

Finally, one wonders whether some of the regulatory actions of the late 80s and early 90s were perhaps too hastily undertaken - especially where land investment was concerned. Some projects that were once RTC distress properties have become successful developments of the late 90s, providing significant returns to the investors. This suggests that a more flexible and patient regulatory approach might have brought more benefit to both lending institutions and U.S. taxpayers.

Trends of the 90s Provide A Preview of the 21st Century

The late 1990s have seen the beginnings of trends and phenomena that look as though they will have staying power into the next century. These include: use of the Internet as a presentation, marketing, and transaction tool; increased political and environmental concern in the form of so-called "smart growth" initiatives; and the pervasive influence of computing and communications technology affecting the construction and operations of all types of real estate.

The successful 21st century real estate development company will employ these technological innovations to design, develop, and operate real estate projects. Finished products will include technological innovations as amenities to attract potential buyers and end users. Real estate information of all kinds is now cheaper, more readily available, and better able to be precisely analyzed.

While these trends may benefit consumers, they may prove unsettling and threatening to traditional

real estate professionals, such as developers, appraisers, brokers, management consultants, and information providers.

Looking Ahead to the 21st Century

Many of the practices of the 1990s will remain the same over the next five to 10 years. The land conversion industry will continue to perform in predictable ways: upgrading raw land to pre-development, approved, subdivided, and improved status, and moving it into production — especially in the residential sector. Large planned community holdings, such as Newhall's Valencia in southern California, Metro Dallas' Las Colinas, and the massive Del Webb resort/retirement communities across the Sun Belt will work through their development plans, phase-by-phase, to completion. The steady flow of small, localized transactions will also continue.

But at the margin, perhaps less clearly visible, important changes are underway. The social, economic, and political forces that are bringing these changes about are likely to pick up momentum, combine, and interact, becoming more significant with each passing year of the 21st century. We discuss some of these forces and changes in the next sections.

A "MEASLES" URBANIZATION PATTERN: TELECOMMUNICATIONS OPENS UP MORE LAND AT A DISTANCE

We have all read the articles about people running small businesses from their homes far from cities and suburbs and off the traditional grid. In the next five to 10 years a combination of technological advances and cultural changes will make this lifestyle more common. Freestanding scattered development will become a mainstream trend as more areas of the country gain high-speed, inexpensive access to the Internet. Reductions in cost will spur the trend. The coming of wireless connectivity to more locations will speed dispersal even further and faster.

This trend combines with the "bundling of uses" (see below) to make more land developable with less infrastructure investment per unit. Small-scale, dispersed development utilizes and creates more demand for "package plant" technology. Individualized sewer and water treatment and renewable energy facilities will combine with environmentally-conscious lifestyles that reduce generation of waste and energy demands. These trends mean that more land will become available and attractive to end-users. This can create a downward pressure on land prices.

Many of the practices of the 1990s will remain the same over the next five to 10 years. The land conversion industry will continue to perform in predictable ways: upgrading raw land to pre-development, approved, subdivided, and improved status, and moving it into production — especially in the residential sector.

CULTURAL CHANGES FREE THE WORKERS

When employees work for one employer who expects them to be in an office five days a week, they are forced to live nearby. As employers become more flexible about where and when their employees work, and as employees increasingly patch together "portfolio work lives," serving multiple employers, the bonds between home and workplace will loosen. The work force of the 21st century will have more work options and therefore more residential options. Employers will have more options as well in creating space.

LAND USE CATEGORIES MIX AND BLEND

Advances in microchip, telecommunications, and Internet technology increasingly make possible the multi-function residence or "home plus" — a place where families not only live, but also work, shop, learn, and entertain themselves. As this happens, it will affect the way facilities are developed for all non-residential land uses.

There is still demand for the traditionally located and configured office building. Some new or remodeled offices are being designed for the mobile, transient worker - with hoteling, office-sharing, communal meeting spaces, and steadily shrinking square footage per employee. Rather than one office building, an employer may now have multiple smaller locations, where employees can "plug in" for short time periods. More and more employers will invest in laptops, rather than office space, and let employees decide where and when to "office" themselves. Only time will tell whether the traditional or "new style" offices will prevail. Some flexible office experiments have been successful. Others have generated strong employee resistance. The two styles may continue to exist side by side – sometimes within the same building.

Retail spaces will increasingly be used for many things other than shopping. For the time-constrained shopper, pure shopping space will expand to become "shopping plus" - shopping plus entertainment and plus dining. Retail facilities will also increasingly include spaces for assembly, entertainment, and socializing. The bricks and mortar retailer must offer something more and different than the on-line retailer.

Another example of blending of uses is that of resort land combining with retirement communities. This combination will be more evident, especially in the Sun Belt. It will make it increasingly possible for people to "age into" a community over time, perhaps moving from section to section within it.

INTERNET AUCTIONS WILL CREATE A GLOBAL LAND MARKETPLACE

In the 1990s, land marketing has been done the traditional way - with locally-based sellers dominating localized markets. Now, the same global Internet auction capability that has created worldwide trading environments for Beanie Babies, antiques and many new kinds of products is beginning to be applied to real estate and land marketing.

The effects of these new and evolving technologies are not yet clearly visible. By looking at the Internet auction experience with other commodities on sites like EBay we can make some educated guesses about the future impact on land investment and marketing. More parcels will be offered for sale over the Internet. These offerings will be supported by information-rich web sites connected to databases that provide sophisticated price comparisons, detailed interactive maps and live "web-cam" visuals. Standards for land information will be created to reassure potential buyers. With these increased standards in place more buyers will be attracted to the ever-increasing number of offerings.

These changes could bring about a gradual reduction in the role of localized brokers and appraisers — similar to the changes currently impacting the travel-related industries. Intermediaries will have to provide value-added services to transactions in new and different ways. Publicly accessible transaction databases will soon provide the same kind of information that appraisers, brokers, and lawyers provide today. The information, however, will be cheaper, faster and more accurate in many cases.

"Personal service" in this new on-line marketing and information environment will mean user-friendly web sites that let buyers and sellers analyze and transact business quickly, smoothly, and directly. New on-line databases will include all the information that the market participants need to complete the transaction including, but not limited to topographical maps, flood maps, surveys, market information, and legal documents. These sites will cater to both U.S. and international investors. All real estate professionals will have to re-examine their roles in land development and sales. Technologically sophisticated, well capitalized firms are developing and maintaining web sites that could make many real estate professionals obsolete.

As land information becomes standardized we can expect to see the creation of worldwide investment land portfolios. These will be marketed to investors in much the same way that pools of mortgages or auto loans are sold today. This type of packaging will appeal to a larger audience of investors who want to participate in the higher returns that are offered in land investment.

This is not the first time land has been marketed at a distance. The American West is littered with "dead" mountain and desert subdivisions where lots were sold internationally and the promised infrastructure was never developed. Will Internet auctions bring a repeat of these fiascoes? We think not. Regulatory mechanisms at all levels have been strengthened in recent decades. More information is readily available. Furthermore, Internet discussion groups and message boards serve as on-line watchdogs, helping to sort out the real from the fraudulent. Some risk, however, will always remain.

MARKET OPENNESS WILL INCREASE BUYERS' COMFORT LEVELS

People shopping for real estate on the Internet begin with the simplest transactions first and then move steadily up the price and complexity scale. First explorations usually include apartment rentals, hotel room bookings, and time-share or campground vacation bookings. This has already begun.

The next step might be investigations of alternative land investments. When the buyer has chosen a site, his/her custom home can be designed on-line and the prototype viewed in three dimensions. Bidding for construction contracts can then take place on-line. Finally, both architect and owner can watch and monitor construction as it proceeds, via live

on-site cameras, even if they are at a distance from the property.

These advanced applications are not commonplace today but they are technically feasible. The rapid pace of the Internet evolution reminds us that what is experimental today can become widespread and commonplace within a year or two.

TECHNOLOGY AND POLITICAL FORCES WILL COMBINE TO SPUR REUSE

The future is not totally one of far-dispersed, decentralized, small-scale, individualized "measles" development - though there will certainly be a lot of that. At the opposite end of the spectrum, an increasing number of communities will work on public/private partnership projects, intended to reclaim once-developed land for various types of reuse.

On the positive side, improved reclamation technology is making it possible to redevelop inner-city lands that now lie unused because of hazardous waste and similar pollution issues. Communities in most states have the legal power to assemble land, where parcelization may have limited development feasibility. Some funding is being made available to encourage reclamation efforts. However, these inner city programs will be hindered - as they have always been - by the serious problems of crime, security, and social breakdown that exist in most cities.

RECYCLING THE LAND FROM THE COLD WAR ERA

More progress is likely to be made in recycling and re-using the vast acreage of land that had been devoted to military facilities during the Cold War and previous wars. Examples include Glenview Naval Air Station, IL, Pease AFB, NH; March, Norton, and George Air Force Bases in Southern California. These bases have the advantage of being located in suburban and ex-urban locations, where they can benefit from more generally positive trends and conditions. Dealing with the federal government on these re-use issues is not simple — but seems to be becoming easier with the passage of time. Some of these military and military contractor land holdings could well become the large-scale, multi-use planned communities of the early next century.

NEW LAND INVESTMENT VEHICLES AND INSTITUTIONS EMERGE

In the final years of the 1990s we saw the beginning of a new institutional environment for land investment. General and special purpose REITs, public companies, opportunity funds, and others became dominant players in the land market. Their involvement in the land market followed - and fed - their dominant position in the development of buildings.

REIT and public company dominance will likely continue. It is not clear what impact this will have on land prices and returns. The larger and more geographically diversified REITs and other real estate operating companies will be able to treat land as a "factor input" in the way that manufacturing companies treat raw materials or that retailers treat just-in-time inventories. Developers will time their purchases and structure their options to achieve a reliable flow or inventory of land at the best price.

We are also seeing the creation of more specialized land-holding or warehousing entities. For example, using a REIT format, companies have been established to hold only the land under car dealerships or movie theaters. They hold the properties and intend to reuse the sites when the existing uses no longer offer the highest returns. We can expect this specialization of function to continue. A logical next step will be entities set up to hold the land that non-real estate industrial companies have removed from their books and asset bases.

We can also expect more development companies to invest in land with the intention of creating a series of different related products on the land as demographics and demand patterns change over time.

A hospitality firm might initially develop "boomer resort" facilities, then move to more care-intensive retirement/assisted living facilities. They would retain the ability to revert to other uses on part of the property as the boomer "age wave" ebbed.

Following this example a step further, it is likely that occupancy of retirement communities could be sold globally on a time-share basis - as vacation accommodations are today. We can expect to see more use of the time-share concept for all types of real estate investments. The Internet gives buyers and sellers the ability to create global packages in new and innovative ways.

As noted above, the investors of the next century will be attracted to invest in funds that contain portfolios of land investments, as well as in individual parcels

of land. They would thus be able to enjoy the potential high returns associated with land development. Many of the financial institutions that offer other forms of securitized real estate to their global customers can be expected to add land investment offerings in the near future.

SMART GROWTH CATCHES ON: COMMUNITIES PARTICIPATE MORE ACTIVELY

In the years ahead, state and local governments will become more active partners in land development. "Smart growth" plans and strategies and the numerous regulations that follow in their wake are now mainstream phenomena. This fact requires a shift in land investment calculations. There are now fewer pure "land investment" plays and far more "land plus infrastructure" plays.

In most urban and suburban development situations, the analysis of the local regulatory environment is now as important as, often more important than, pure land economic analysis. Determining the cost impact and the timing consequences of regulation becomes critical as developers try to hit short "windows of opportunity" with their projects.

Stability of regulation is another concern. Investors must assess how rapidly and in what direction local regulations may change. Usually, regulation is likely to get tighter and more rather than less complex. Developers who master the new, more complex, and costly environment should be rewarded accordingly.

In the years ahead, we will see changes in the definition of "infrastructure." Greater emphasis will be placed on the telecommunications/Internet infrastructure, relative to transportation infrastructure.

EXPECTED CHANGES BY PROPERTY TYPE

Warehouse/Distribution – There will be a decreasing number of larger facilities. They will be accessible by many transportation modes (air, rail, truck), which can provide almost real-time (just-in-time) delivery of products. Even products purchased on-line have to be delivered from seller to buyer.

Office – We can expect to see more dispersed facilities and fewer "ego towers." There will be increased substitution of computer/network investment for bricks and mortar investment.

Retail – There will be increased attention to intensity and multi-purpose use of space. Highly efficient retailers such as Wal-Mart and 7-11 are likely to prevail over weaker competitors. The electronic commerce revolution will bring new hybrids of on-line and off-line shopping. Traditional stores will have showroom and "demo" space where customers can examine and test products before buying them on-line.

Residential – The home/condo unit will have increasingly more non-residential features included in the package, as discussed above. Technology will be pervasive in the home, first linking computers into home networks, then linking appliances and support systems to one another to create smarter homes.

Many existing structures will have to be upgraded to accommodate the new services that technology has to offer. We can expect older residential, industrial, and office properties to be demolished or retrofitted to provide for the space needs of the 21st century. Those development companies that include technology experts on their teams and develop cutting-edge products will have a competitive advantage.

EXPECTED CHANGES BY GEOGRAPHY

We can expect a continuing migration to the Sun Belt. This will be a selective migration. It will favor smaller, high amenity communities such as college towns. Those communities that combine the ability to cater to workers in the information economy, as well as to seniors and recreation seekers will be the most favored. Those communities that combine air, rail, and highway access with quality of life will be most successful. Don't be surprised to see the reconstruction of railroads to out-of-the-way places.

The Intermountain West is also likely to prosper for a variety of reasons, including climate, pace, and quality of life, and unbundling from major West Coast cities. Relocation of both jobs and residences from major California urban areas to states like Montana, Utah, Arizona, and New Mexico will increase.

FUTURE OUTLOOK FOR LAND INVESTMENT RETURNS

In this final section we examine the forces that will affect rates of return on land investments in the years ahead. We review the results of recent and pertinent PricewaterhouseCoopers land investment surveys.

PricewaterhouseCoopers and its predecessor firm have carried out National Land Investment

Surveys[1] over the past decade under the direction of Mr. MacCrate. In recent years these surveys have shown that returns on land investment move within very narrow ranges. We expect this to continue into the future. *Figure 1* shows the historical Comparison of Median Expected Land Returns, Speculative Grade Yields, and Other Investments reported by respondents to the PricewaterhouseCoopers' National Land Investment Survey, Moody's, and KDP Investment Advisors.

While returns on other investments generally declined from 1991 through 1998 the expected returns offered on land investments remained high. The expected return ranged from 20 percent to 22 percent between 1991 and 1997 and then declined as competition for sites increased and interest rates declined to an expected 17 percent.

By 1999, the expected unleveraged pre-tax returns (IRRs) ranged from nine percent to 30 percent with a sample median of 14 percent for approved land development projects. The low end of the range and the median are lower than the year-end results, indicating continued increased competition for desirable sites for development. These returns were also associated with build-to-suit and pre-leased projects. Expected returns for unapproved sites are generally 1000 basis points higher than for approved sites. Furthermore, leveraging with debt is almost non-existent for acquisition and entitlement of raw land.

Figure 2 summarizes the expected return by all respondents to the PricewaterhouseCoopers' National Land Investment Surveys[1] from 1990 through 1999. Expected returns declined from 21 percent in 1990 to 17 percent in 1999.

The median gross profit margin dropped to 14 percent in 1999 from the year-end survey. The median expected mark-up over project costs remained unchanged from 1998 to 1999 at 20 percent. The highest expected returns continue to be on larger-scale, unapproved/unentitled developments, where unleveraged expected returns can be as high as 60 percent or more. Land cost as a percentage of total project cost continued to show an upward bias for desirable sites in the 1999 survey. The median land cost as a percentage of total project cost was 16

Figure 1

*Comprised of all bonds which are rated Baa by Moody's Investor Service

**Average Discount Rate(IRR) for National Apartment Market

Source: KDP Investment Advisors, Moody's Investor Service, Korpacz Real Estate Investor Service, PricewaterhouseCoopers LLP

Figure 2

Expected Returns - All Property Types
Overall Yield Rates

	1990	1992	1994	1996	1999
Average	21%	21%	20%	21%	20%
Low	10%	10%	10%	11%	9%
High	40%	40%	40%	40%	30%
Low Quartile	13%	16%	14%	16%	15%
High Quartile	25%	26%	25%	25%	24%

Excluding extremes

Source: PricewaterhouseCoopers LLP Land Surveys

percent in 1999, with a range between five percent in speculative areas, to a high of 55 percent for approved sites in desirable residential locations.

While actual returns vary from the expected returns, value is the present worth of future benefits. The expected return drives the decision-making process and provides a basis for estimating value. Near term fluctuations in interest rates will negatively impact the actual returns on current developments.

GENERAL COMMENTS AND OBSERVATIONS

Finally, we highlight some of the variables we think will influence future investment survey results. The dominance of institutional players and the shift of more land investment activity toward shorter term, lower risk activity will result in slowly declining rates of return. The overall environment will remain one of stable returns with small fluctuations. The more open and sophisticated market information environment may lead to slowly declining rates of return as competition for desirable sites increases. The increased use of on-line information, web-based products and automated valuation models will result in more thorough, closer to real-time, value monitoring that can be quickly and precisely targeted to specific parcels.

Other factors and forces may lead to greater volatility of returns. More regulatory involvement can mean greater uncertainty concerning the approval process. This will require greater ongoing attention to the analysis of local political forces and variables. Shorter development windows of opportunity should lead land investors to pay more attention to analysis of market risk, especially micro-market trends and developments.

In summary, more, better-capitalized and better-informed investors will participate in an increasingly sophisticated and globalized land investment marketplace. Land investment can offer significant rewards to investors who understand the unique risks and holding periods that characterize this specialized product. REI

NOTES

1. Contact Katherine Erazo at PricewaterhouseCoopers LLP for copies of the survey at (212) 596-7000.

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Capital Markets & the Modern REIT Era

by Ron M. Donohue

Events in the capital market have heavily influenced the evolution of the modern REIT industry. The following presents one perspective on how the modern REIT industry has evolved and provides some thoughts on where REITs are headed in the next few years. This perspective was developed over six years of REIT analyses and investing using the Hoyt REIT Model, a comprehensive REIT valuation and risk analysis model. That model has reflected the shifting capital market's differential impact on REITs.

The modern, vertically-integrated REIT is a recent phenomenon, with a well-established pedigree. The 1991 offering of Kimco Realty Corporation was the first major offering under a 1986 revision in tax code interpretation that provided for actively managed REITs. This offering paved the way for modern, vertically integrated REITs. The 1992 offering of Taubman Properties launched the public Umbrella Partnership (UPREIT) structure. The UPREIT structure provided real estate developers and owners with a tax protected method for transferring ownership out of relatively illiquid partnership interests. These two offerings legitimized REITs in the eyes of many prominent real estate operators, effectively launching the modern REIT era. Understanding where REITs are likely to go may require at least a brief historical overview of how the capital market helped to drive these offerings.

ABOUT THE AUTHOR

Ron M. Donohue *is executive vice president and director of research for Hoyt Advisory Services. He has been the lead researcher in the development of the Hoyt REIT Model, which provides valuation and risk profiles for over 90 REITs. Dr. Donohue has also consulted with REITs, REOCs, and REIT data providers in numerous areas, including economic analyses, product design, investment analysis, and strategic planning. (E-mail: rdonohue@hoyt.org)*

CAPITAL MARKET INFLUENCES ON REITS

Excess Supply

In the late 1980s and early 1990s, commercial real estate was clearly in trouble, primarily due to an excess of supply and some reduction in demand. The massive overbuilding of the 1980s was the result of an imbalance in space and capital markets.[1] Essentially, user demand for rental space (space market) was low at a time when institutional

investors and other investors had high interest in placing capital (capital market) in real estate. This capital market imbalance was coupled with massive lending by Savings and Loan administrators with little commercial real estate experience. The result was a capital rich environment, particularly debt capital. As the competition to make loans heated up, underwriting requirements were loosened, and eventually the risks were out of proportion with the return expectations. There was significant commercial mortgage default and many traditional capital sources withdrew from the market.

The logical follow-up to an oversupply of credit is restriction of credit. The restriction was quite pronounced in the late 1980s and early 1990s and was generally labeled a credit crunch. The lack of debt capital had two effects on real estate developers. The first effect was a reduction in construction loans, which brought construction to a near standstill. The slowdown in construction gave space markets an opportunity to absorb the oversupply, but spelled the end for many developers and construction companies. The second major effect was that many developers faced balloon loan payoffs at a time when debt financing was not available. This resulted in a search for alternative sources of capital, and the public equity market provided capital – the REIT format was best suited to provide capital. Without this capital, defaults and bankruptcies would have occurred.

Sources of Capital

Equity REITs also grew rapidly in the 1990s because of the availability of positive spread investments, which many analysts referred to as a "cap rate" arbitrage. They suggested that the value of real estate on Wall Street (securities market) was greater than its value on Main Street (space ownership). For the most part, the assertion was based on first year FFO (Funds From Operations) and debt impacts, rather than long-term cost of capital, leaving the question of arbitrage unanswered. At the same time, traditional lending sources were reducing their debt investments. The result was a shift from real estate's traditional reliance on debt toward greater reliance on equity capital. This was a unique opportunity, and many of the top real estate operators in the country elected REIT status to capitalize on the opportunity.

The REIT industry has grown and evolved significantly since the Kimco offering. The years of 1992 - 1994 were characterized by dozens of initial public offerings. These IPOs provided capital to replace balloon payments on loans, as well as providing capital for positive spread acquisitions. Property markets were recovering just as REITs gained access to a seemingly inexhaustible supply of capital. The result was significant growth, particularly for companies that had access to capital due to management reputation and a story that appealed to investors. As a result, 1995 - 1997 saw a slew of secondary offerings as REITs returned to the equity markets for additional capital.

A dramatic increase in REIT debt offerings was also seen in 1995 - 1997. The best REITs actively sought and secured credit ratings and entered the public debt markets. Previously, REIT access to debt had been through mortgages on single properties or pools of properties, generally secured by an individual property or some portion of the property portfolio. REITs began to use corporate debt, some secured and some unsecured. Many of the strongest REITs shifted entirely to unsecured debt, substantially increasing their capital structure flexibility. The result was competition among suppliers of capital, leading to a decrease in the cost of capital such that debt could be used in making positive spread acquisitions. FFOs grew rapidly as REITs used their cost of capital advantage to dominate acquisition activities.

Regulatory Shift

By the beginning of 1998, REITs had established themselves as the premier buyers of commercial real estate. For example, Starwood Hotels and Resorts Trust used its unique status as a paired-share REIT to successfully beat out Hilton in the competition for ITT Sheraton. The result of this and other transactions was a heightened profile for REITs, which attracted investor interest, a long-time goal of the industry. Unfortunately, the heightened profile also attracted increased government and investor scrutiny, which was probably not a goal of the industry.

Real estate has long been subject to volatility due to the tax code. The REIT is a creature of the tax code, and developments in 1998 reinforced the vulnerability of REIT's unique status. On Groundhog's Day, President Clinton made an announcement concerning the administration's position on REITs. The most well publicized of these announcements outlined the administration's intention to effectively "freeze" the assets of paired-share REITs by prohibiting future acquisitions under the structure. The headlines in the popular press and business publications were less than

complete, leaving the impression that the entire REIT industry was in jeopardy of losing its tax status. Although the change outlined by the administration only applied to five REITs, the entire industry took a hit.

Overbuilding Concerns

At the same time, negative signals were emerging from the space markets. First, there were frequent claims that REITs were overpaying for properties, driving cap rates down to unsustainable levels. In the debate that followed, REITs claimed that the prices made sense given their low cost of capital, while critics suggested that REIT management did not truly understand their cost of capital. This type of debate is not unique to REITs. In every real estate bidding process, the high bidder believes that lower bidders did not recognize the "true" value of the property and the lower bidders think the high bidder overpaid. True to form, private investors complained loudly and often that REITs were overpaying. At the same time, some REIT managers were marketing their companies based on their ability to continue to grow rapidly due to their "permanently" lower cost of capital. Capital flows are cyclical in nature and in the future capital market preferences will shift among various investor groups. Currently, private investors hold the upper hand.

Second, anecdotal evidence of overbuilding in select markets began to creep into REIT analyst reports and the popular press. This led to a perception among some investors that "national markets" were being overbuilt. The term "national markets" is a misnomer, as property markets are fundamentally local in nature, and "national markets" are simply a collection of local markets. Overbuilding in several high profile markets led to concern, despite the fact that in the aggregate (and in most markets) fundamentals were still sound. At the individual market level, the outlook varies substantially. Thorough analysis of the hundreds of local markets in which REITs own properties is a massive task and may not be cost effective or feasible for many investors. This type of analysis makes a great deal of sense in the long-term, but in the short-term, stock market effects may override long-term fundamentals. Momentum investors were not willing to do the required work and moved to "easier" sectors.

SHIFTING STRATEGIES

The double-barreled threat of overpaying and overbuilding led some to paint a picture of REITs as growing solely for the sake of growth, without regard for underlying real estate fundamentals. This picture brought back investors' memories of the mortgage REITs of the 1970s, despite claims that the REIT market had seen fundamental change. While today's REIT industry is very different from the past in structure and size, it still remains a small market segment. Many investors view REITs as a group without segmenting by quality of real estate, management, and risk profile. The result is that the REIT industry remains very susceptible to negative news, particularly in the short-term. Investor perception is key, and just as investor perception that real estate was "hot" led to the run up in REIT prices in previous years, the perception that markets had "cooled" led to a significant price decline in 1998.

As the competition to make loans heated up, underwriting requirements were loosened, and eventually the risks were out of proportion with the return expectations. There was significant commercial mortgage default and many traditional capital sources withdrew from the market.

As part of this general decline, the capital market shifted its attention away from real estate, partially because of the REITs and partially because of the blow-up in CMBS. The broader market's strength and perceived growth prospects also contributed to the shift. In this environment, equity offerings slowed dramatically, with few companies willing to sell at the low prices prevailing in the marketplace. Capital needs continued, and REITs shifted to offering preferred equity at attractive rates. When the Asian economic turmoil rocked world markets, there was a flight to quality that drove up the required yield on REIT preferred offerings and further increased the spread between REITs and Treasuries.

All of these factors combined to create a disconnect between real estate fundamentals and REIT pricing. REIT analysts have made the case for the disconnect, using data about real estate fundamentals and REIT performance to suggest that investors should move into REITs. REIT total returns were off 16.9 percent in 1998 versus a gain of 27 percent for the S&P 500.[2] In 1998, occupancy was up five percent and rental rates were up 10 percent.[3] The average REIT enjoyed 13 percent FFO growth.[4] Despite the solid fundamentals and continuing

growth prospects, REITs as a group went from trading at a 20 percent premium to Net Asset Value (NAV) to trading at a five percent discount to NAV. Clearly, investors were influenced by something other than space market fundamentals, most likely the strength and growth prospects of the broader market.

Commercial real estate has undergone dramatic change in the past decade. Securitization of real estate equity and debt has increased enormously, and is expected to do so for the foreseeable future. This provides a tremendous opportunity for those who understand the underlying factors that influence the risk and return characteristics of these instruments. Institutional investors have flooded the market, with average REIT institutional ownership growing from 38.1 percent in third quarter 1993 to 52.2 percent by third quarter 1997.[5] History suggests that the flood of institutional money will eventually drive prices beyond warranted values, and that may have been the case in 1997 as REITs traded at significant NAV premiums. Institutional investment in REITs has leveled off and the market is poised for the next stage in its evolution.

THE FUTURE

The future of the REIT market has been a subject of considerable debate. Industry leaders such as Sam Zell have suggested massive growth and massive consolidation. Peter Linneman, CRE, has echoed Zell's predictions, drawing from the economic history of other capital intensive industries to support his theory that consolidation is inevitable.[6] Under this theory, the REIT industry will consolidate to very large national REITs, with the existing smaller companies driven to consolidate by the cost of capital advantages enjoyed by the large firms. Kerry Vandell offers a different perspective on the character of growth, suggesting that while there will be some consolidation, regional specialists will still have a place in the industry.[7] In terms of the scale of growth, researchers have pointed to the relatively small percentage of investable assets currently under REIT control and suggested that as much as 50 percent of those assets may eventually come under REIT control.[8] While there is considerable skepticism about the 50 percent estimate, the general concept of REITs expanding their market share is widely accepted.

Although there has been some debate over the character and scale of future growth in the REIT industry, there seems to be general agreement that growth is coming. The question is the form and quality of the growth. The investor's biggest fear is growth for the sake of growth, which was one of the major dimensions of the last real estate collapse. From the investor's point of view, when economies of scale diminish, so should growth in scale. Smart managers will grow when growth makes sense, pull back when it does not, and position themselves and their portfolios for the next boom.

Investors will do well to differentiate between REITs with a strategic approach that allows them to shift their tactics as the market evolves and those that have inflexible approaches. Doing so requires segmenting REITs and understanding the differences among them in terms of capital structure, management, and real estate. The overall pattern offers a risk profile that can be used in diversifying a REIT portfolio.

Although there are significant differences among REITs, there are some general trends that are likely to impact the general performance of REITs going forward. These trends are driven by many factors, especially capital market behavior and investor perceptions.

The most striking trend is a shift in the balance among the different areas for growing income and FFO. There are four areas in which REITs can grow income and FFO; the reliance on these areas is a key indicator of overall REIT strategy. The four areas are 1). growth in the existing portfolio; 2). new acquisitions; 3). development; and 4). operating efficiencies. From 1992 to mid-year 1998, investors and analysts seemed to favor acquisitions, especially positive spread acquisitions, as a growth mechanism. As a result, the vast majority of REITs relied heavily on acquisitions for portfolio and income growth.

In the early stage of the positive spread acquisition business, the focus of analysis was on whether or not the acquisition was immediately FFO-accretive. As markets tightened, investors and analysts scrutinized acquisitions more carefully, considering business focus, strategic fit, price paid, and long-term prospects in analyzing acquisitions. High profile acquisitions (or attempted acquisitions) of non-traditional assets such as casinos and cold storage facilities raised questions about business focus. Capital flows were restricted for this and other reasons and acquisitions declined dramatically.

Lacking acquisition to fuel growth, many REITs have begun to focus on operating efficiencies. This

is a logical step, given the new realities of the capital market. Faced with a need for capital and limited access to traditional sources of capital, the alternatives are to use existing capital more efficiently or find new sources of capital. Shrewd REIT managers are doing both.

Joint-ventures with institutional investors and real estate operating companies are emerging as a major new source of capital and avenue of growth for REITs. In some cases, REITs are working with institutional investors to acquire and manage assets, with the REIT providing the investment expertise and the institutional investor providing the capital. In other cases, either the REIT or the institutional investor contributes properties, with the REIT assuming the management responsibilities and capturing fee income. Joint-ventures will continue to increase in importance, as will scrutiny of the "hidden" leverage in these off-balance sheet transactions. REITs will need to address the alignment of interest problems inherent in joint-venture structures.

The new profile of the politically correct REIT reveals a company working to consolidate the gains it made through positive spread acquisitions. It will do so by reducing costs, generating income through innovative programs (like Simon Brand Ventures), and consolidating with other companies to spread fixed costs over a wider base. Business energies will be focused on maximizing the return from the existing portfolio rather than on making the next deal. All of these ideas make sense from a long-term investment perspective. In short, REITs will be solidifying their positions and operations.

These strategies are unlikely to result in the kind of explosive growth that characterized the positive spread acquisition era, but they are likely to result in steady six- to eight-percent growth over the next few years. Long-term investors will benefit and the market will recover, with investors and REITs hopefully having learned from the experience. At some point, economies of scale will offer less marginal benefit and rents and occupancies will stabilize, necessitating finding other ways of growing.

Use of leverage will flatten out, with debt to market cap ratios flattening out as prices recover and companies increase total debt moderately. Investors and analysts will move from their current fixation with the ratio of total debt to market capitalization and expand their analyses to include debt coverage, character of debt, and duration. FFO payout ratios will continue to decline, at least partially because dividend increases are not being fully rewarded in market pricing.

Although there has been some debate over the character and scale of future growth in the REIT industry, there seems to be general agreement that growth is coming. The question is the form and quality of the growth. . . . Smart managers will grow when growth makes sense, pull back when it does not, and position themselves and their portfolios for the next boom.

The likely future of the industry is a segmentation into "haves" and "have nots." "Haves" will concentrate on maximizing shareholders value, minimizing conflicts of interest, and improving the long-term performance of their portfolio. "Have nots" will not do so. They will focus on short term FFO fixes, protect management rather than shareholder values, and grow for the sake of growth. Over time, investors will recognize the characteristics of the "haves" and the "have nots" and segment the mar ket accordingly. REI

NOTES

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Changes in the Hotel Industry's Financial Picture

by Sean F. Hennessey

During the 1990s, the hotel industry has witnessed a stunning turn of fortune. At the start of the decade, the industry recorded its biggest loss ever, at $5.7 billion (after debt service and income taxes). Occupancy levels were eroding, and room rates were losing ground after inflation. Investor interest was down sharply, sending asset prices downward.

Today, the industry is as strong as it has ever been. Profits are at record levels. Occupancies have retreated slightly from 1995's high, but remain strong in most markets. Rooms rates have grown well above inflation levels and are estimated to do so for at least the next four years.

Table 1 presents a summary profit and loss statement for the hotel industry that demonstrates the magnitude of the changes that have taken place.

The sizable changes suggest that counselors and other analysts should have a different approach to analyzing hotel financial statements than they did 10 years ago. The following comments will highlight a few of the major changes that flow through hotel operating results during the 1990s.

OPERATING DEPARTMENTS

Rooms

One significant change has been the importance of cancellation penalties. With market conditions relatively strong, hotels should be capturing penalties for not occupying reserved rooms. Most frequently, hotels charge a fee of 25 percent to 100 percent of the room rate for an unused reservation. Additionally, many hotels now collect

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Table 1

Comparative Hotel Financial Information, 1990 and 1997[1]
(stated in average amounts per available room)

	1990	*Percent of Total[2]*	1997	*Percent of Total[2]*
Occupancy	63.3%		72.9%	
Average Room Rate	$71.07		$112.81	
REVENUES				
Rooms	$17,338	*64.0*	$29,700	*64.2*
Food and Beverage	8,127	*30.0*	13,119	*28.3*
Telephone	650	*2.4*	1,223	*2.6*
Other Operated Departments	568	*2.1*	1,513	*3.3*
Rental and Other Income	433	*1.6*	668	*1.4*
TOTAL REVENUE	27,117	*100.0*	46,223	*100.0*
DEPARTMENTAL EXPENSES				
Rooms	4,872	*28.1*	7,371	*24.8*
Food and Beverage	7,103	*87.4*	9,908	*75.5*
Telephone	584	*89.9*	525	*43.0*
Other Operated Departments	597	*2.2*	1,106	*2.4*
Total Departmental Expenses	13,156	*48.5*	18,910	*40.9*
DEPARTMENTAL PROFIT	13,961	*51.5*	27,313	*59.1*
UNDISTRIBUTED OP. EXPENSES				
Administrative and General	2,874	*10.6*	3,635	*7.9*
Marketing	1,735	*6.4*	2,645	*5.7*
Franchise Fees	380	*1.4*	311	*0.7*
Property Operations and Maint.	1,573	*5.8*	2,208	*4.8*
Energy	1,491	*5.5*	1,643	*3.6*
Total Undistributed Op. Exp.	8,053	*29.6*	10,442	*22.6*
GROSS OPERATING PROFIT	5,908	*21.9*	16,871	*36.5*
Management Fees	624	*2.3*	1,561	*3.4*
INCOME BEFORE FIXED CHARGES	5,204	*19.5*	15,310	*33.1*

a fee for checking out early, without notifying management in advance. Because cancellation fees typically apply to group business as well as other customers, the fees can be sizable. During a recent month, a California hotel derived 10 percent of its room revenue from cancellation fees.

Master folio billing charges, early departure charges and cancellation charges have all been areas of supplemental revenue growth for hotels and can be expected to increase as long as conditions remain strong.

Food and Beverage

In 1990, many hoteliers had practically given up on food and beverage service, tagging it as a money-losing department that most guests didn't appreciate. Today, hotel food service outlets have gained more respect, and travel journals like *Gourmet* magazine regularly cite hotel restaurants among the finest eateries in many cities.

It is important to look at the composition of food and beverage revenue at a hotel. Typical revenue sources include restaurants, lounges, banquet catering, and room service. Most often, the restaurant and room service are unprofitable or marginal due to the round-the-clock labor they require. Catering and lounges, on the other hand, often benefit from tight scheduling and sizable liquor mark-ups. The

composition of revenue from the various food and beverage outlets will inform a proper cost analysis for this department.

A recent trend has been strong increases in room service. Many travelers are using their computers to log on to corporate computer systems at the end of the business day, and as a consequence are forced to spend more time in guestrooms. Hotel managers are responding by increasing menu prices for in-room dining and adding delivery charges and mandatory gratuities to guests' bills.

Another growing area of F&B profitability is meeting room charges. In 1990, meeting space was typically given away to customers in exchange for associated guest room and catering business. No longer is this the case. Meeting rooms are rented as a separate charge in most commercial hotels.

The following list identifies some areas that hoteliers are targeting to improve revenue in the food and beverage department.

- Menu Prices (including in-room dining)
- Banquet Prices
- Banquet Room Charges
- Banquet Bartender Charges
- Minibar Prices
- Banquet and Meeting Cancellation Charges

Telephone

Hotel managers feared a dearth of telephone revenue with the advent of company calling cards and other sophisticated telephony advances. However, there has been ample room for hoteliers to improve telephone revenue. In fact, the predominance of business travelers with computers is likely to foster a strong increase in connection charges as these road warriors log on to proprietary database, Internet, and e-mail services. Zero-plus telephone charges and room-to-room phone charges offer other examples of how managers are driving more revenue from the telephone department.

Other Operated Departments

Formerly labeled "minor operated departments," this category has tripled in importance during the 1990s. Hotels have become more aggressive about charging for health clubs, business center services, and the like.

Amenity fees, business center prices, and the like constitute the major initiatives of hotel managers in driving more revenue from this department.

Rental and Other Income

Proper investigation of rental and other income requires an analysis of this line item's various components. Hoteliers frequently evaluate whether to operate or lease out restaurants, gift shops, and other guest services. While revenue from an operated restaurant would show up in food and beverage revenue, a leased restaurant would be posted to this line item. Similarly, an operated gift shop's revenue is posted to other operated departments, while a leased shop is properly in this revenue category.

Parking Charges are an example of how hotel companies seek to improve the revenue from this department. By simply marking up the cost of parking for hotel guests as well as people attending banquets and meetings, hotels are able to improve their profit picture. Negotiating better commission structures for public telephones, vending machines, and video games is another area of management focus.

UNDISTRIBUTED OPERATING EXPENSES

A recently emerging concern relating to undistributed operating expenses is the propensity for operators to cut back on these expenditures in times of decreasing profitability. While industry profits continue to rise, the pace of improvement has moderated. In order to maintain profit growth, operators sometimes look to cut back on marketing, maintenance and general oversight. The impact of these cutbacks is not likely to be felt in the short term, thereby postponing the pain of weakening revenue growth. However, these "savings" frequently create negative long-term consequences that need to be thoroughly evaluated.

Administrative and General

One change in financial statements has to do with the costs reclassified under the most recent edition of the Uniform System of Accounts for Hotels. Liability insurance, which had traditionally been posted to the administrative and general department, was reclassified as part of the insurance expense under fixed charges. This reclassification is important for both comparative purposes (to prior years and to comparable statements) and for its potential impact on incentive management fees. Since many management contracts have incentive fees tied to Gross Operating Profit levels, moving any expense into fixed charges has the result of increasing GOP and incentive management fees, while reducing the owner's profit.

Credit card commissions are showing a slightly downward trend. More hoteliers are negotiating commissions with credit and charge card companies.

Miscellaneous sources of short-term savings in the administrative and general category (as well as other operating departments) include cutting back on training and bonuses. A savvy counselor will identify these items and evaluate their potential impact on future performance levels.

Marketing

The biggest area of change has been the growing cost of frequent guest programs. These loyalty programs have not been as powerful a tool in the hotel industry as is the case in the airline industry, but their popularity is increasing. Studies have shown that the loyal customers tend to pay higher room rates (up to 25 percent more), spend more per visit and visit more often. These fees can surpass $10 per occupied room, and thus can be more expensive than even property maintenance. The recent announcement by Starwood of its new frequent guest program is widely expected to create a "points war" where the customer will be offered ever-richer rewards.

Franchise Fees

While the strength of brands may be ebbing in consumer products, it continues to be an increasing trend in the hotel industry. Even as franchisees unite and look for a better deal from franchisors, there is little evidence that royalty fees will moderate. Although franchise fees decrease as a percentage of total revenue in the Smith Travel data, reporting differences distort what has generally been a rising cost.

An important value consideration with franchisors (and some management companies) concerns the issue of Product Improvement Plans (PIPs) required as part of any change of ownership. Now that there is more profit to be distributed in the industry –and new brands emerging as competitors- many franchisors are requiring substantial capital expenditures to meet ever-higher standards. For small and mid-sized hotels in particular, it is not unusual for the PIP to be 10 percent or more of the asset value.

Property Operation and Maintenance

Maintenance is an area where hoteliers have spent a lot of effort in recent years. Strong profits have encouraged owners and operators alike to take care of accumulated maintenance needs. In many properties, a detailed view of maintenance expenditures can reveal items that are non-recurring and thus suggest future moderation in PO&M expenses.

Since 1990, every additional dollar of revenue taken in by the industry has resulted in 70 cents of GOP. This demonstrates the high operating leverage of the hotel business: that it costs relatively little to rent each incremental room. In addition, hoteliers benefited from the demand-pull inflation that accelerated room rate increases without requiring corresponding improvements in product quality.

Maintenance expenses should be evaluated together with capital expenditures. Many expenses can properly be considered either capital or operating in nature. Further, certain capital expenditures have the effect of reducing ongoing maintenance expenses.

Energy

The deregulation of utility companies and increasing efficiencies for major equipment has facilitated cost controls in the energy department. However, since service costs are relatively fixed and there is no labor in this department, opportunities for gains are generally related to improved equipment efficiency and manipulation of peak load periods. One benefit of improving technology is increasingly sophisticated property management systems (PMS's) that help control energy expenses.

GROSS OPERATING PROFIT

The industry's profit improvement discussed at the outset of this article is most dramatically seen from the context of Gross Operating Profit. Since 1990, every additional dollar of revenue taken in by the industry has resulted in 70 cents of GOP. This demonstrates the high operating leverage of the hotel business: that it costs relatively little to rent each incremental room. In addition, hoteliers benefited from the demand-pull inflation that accelerated room rate increases without requiring corresponding improvements in product quality.

Management Fees

Fees associated with retaining professional management are one of the few areas that have moved up during the 1990s. With scant new unit growth in the early 1990s, operators often discounted the price of management services as an enticement to owners. Now, growth options are more plentiful for operators, and strong profitability levels have created a "plenty of money for everybody" attitude.

That said, long-term management contracts — five years or more — continue to be a very strong negative value influence. Up until two years ago, it would have been appropriate to estimate market value by calculating the unencumbered estate's value and then subtracting out the estimated liquidated damages associated with terminating the long-term contract. Since many contracts are silent regarding early termination, values of these properties were subject to wide confidence intervals. Today, there is a minimal value discount for highly desirable properties with long-term management. Mid-market and economy hotels, however, remain marketable only unencumbered.

FIXED CHARGES

Property Taxes

As hotel prices fell dramatically in the early 1990s, so too did the assessments underlying real property taxes. Although values have improved sharply throughout the decade, assessments, by and large, have not kept pace. This has led most buyers to be wary of "reassessment risk," i.e., that upon sale, the assessor will increase the assessment to reflect the property's enhanced value. In some cases, it is possible for taxes to increase by more than 100 percent. It is fundamental to proper counseling to consider this risk in advising clients.

Insurance

As mentioned under administrative and general expenses, liability insurance is posted to this account, along with property insurance.

Reserve for Replacement (of short-lived assets)

Escrowing funds for ongoing asset replacement has become more pervasive than ever in the hotel industry. In part, this is the direct result of research published by the International Society of Hospitality Consultants. In its landmark *CapEx* study, it found that the traditional reserve of two-to-four percent of total revenue was woefully insufficient. The real economic cost of replenishing furniture, fixtures, and equipment at a level that ensures ongoing competitiveness was found to be closer to nine percent. As a consequence, the funds escrowed for replacement reserves are continuing to move upward.

SALARY RECAP

Most analysts recognize that the hotel industry is labor intensive. However, it is important to see just how far managers have been able to reduce payroll in the current market. Labor costs are certainly decreasing as a percentage of total revenue, amounting to 37.5 percent of revenues in 1990 and falling to 25.1 percent of revenues in 1997. However, in absolute dollars, payroll has basically been flat during the 1990s, as shown in *Table 2*.

Table 2

Comparative Payroll Costs[1]
(stated in amount per occupied room)

	1990	1997
Rooms	$12.70	$14.30
Food and Beverage	15.04	15.96
Telephone	0.47	0.48
Other Operated Departments	2.84	1.31
Administrative & General	6.02	5.36
Marketing	2.92	3.12
Property Operation & Maintenance	3.13	3.15
Total Payroll	**$43.12**	**$44.16**

The upshot is that hotels that have not kept pace in reducing labor costs have been left behind in today's market. While new hotels are designed to be much more efficient than older properties, there are still numerous techniques for managing payroll in every hotel. Positions such as night auditor have effectively been eliminated at many hotels, and several back office jobs such as accounting and payroll clerks that were once full-time are now part-time. A thorough review of payroll expenses is often a fertile area to investigate additional potential for expense minimization and profit growth.

CONCLUSION

The industry has seen a strong shift in profitability during the 1990s. This article has set forth a comparison of the industry in 1990 and 1997, showing the dramatic turnaround, and several reasons for the changes were cited. Now that the industry is heading into a period of more moderate profit growth, managers will look for ways to continue to generate strong earnings. Several examples of supplemental revenue growth were cited. The combination of background and current practices should enable professional counselors to approach hotel analysis with an enhanced perspective. REI

NOTES

1. Smith Travel Research, *Host Report*, 1991 and 1998 annuals
2. Departmental expenses are shown as a percentage of departmental revenue.

Estimating Market Rent for Major League Stadiums

by William N. Kinnard, Jr., CRE, & Mary Beth Geckler, CRE

Introduction: Background to the Research

In April 1997, an article titled "Team Performance, Attendance, and Risk for Major League Baseball Stadiums,"[1] was published as part of the ***Real Estate Issues*** series on counseling opportunities in the major league sports industry. That presentation noted the growing importance of venue revenues[2] to both the owner of the stadium (typically a municipality, county, or public authority) and the owners of the team franchise. The emphasis in the article was on Major League Baseball stadiums, although many venues were dual-sports facilities housing National Football League (NFL) teams as well.

The reported findings demonstrated the importance of gameday ticket revenues to both the stadium owner and the franchise. In recent years, however, gross ticket revenues have represented a declining percentage of total venue revenues. Not surprisingly, on-field performance by Major League Baseball (MLB) teams was a major determinant of attendance, which determines revenues from ticket sales as well as concessions and parking. Moreover, the dollar volume from sales of short-term licenses on luxury boxes/suites and club seats tends to fluctuate directly and nearly proportionately with on-field team success (particularly in the preceding year).

Within the framework of subsequent assignments to value leasehold/possessory interests of major league teams in both MLB and the NFL, we have been required in each instance to estimate market rent. Moreover, we served as consultants in the 1989-1990 property tax appeal of SkyDome in Toronto, as well as its 1995 sale. In both those cases, the identification of market rent payable by the tenant MLB franchise was a major issue.

About the Authors

William N. Kinnard, Jr., Ph.D., CRE, *is president of the Real Estate Counseling Group of Connecticut; Professor Emeritus of Real Estate and Finance at the University of Connecticut; and a principal in the Real Estate Counseling Group of America. Dr. Kinnard has participated in the valuation of ownership and leasehold interests in major league stadiums in the U.S. and Canada and also testifies regularly as an expert witness on appropriate methodology for valuation of property and intangible assets. (E-mail: recgc@mail.snet.net)*

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(Continued on page 44)

Table 1

New/Renovated or Planned Major League Baseball Facilities Since 1990			
STADIUM	**TEAM**	**YEAR BUILT**	**STATUS**
Reds Stadium	Cincinnati Reds	2001	New
Ball Park at Union Square	Houston Astros	2000	New
Miller Park	Milwaukee Brewers	2000	New
Pacific Bell Park	San Francisco Giants	2000	New
Tigers Ballpark	Detroit Tigers	2000	New
Twins Ballpark	Minnesota Twins	2000	New
Mariners Ballpark	Seattle Mariners	1999	New
Bank One Ballpark	Arizona Diamondbacks	1998	New
Qualcomm Stadium	San Diego Padres	1998	Renovated
Tropicana Field	Tampa Bay Devil Rays	1998	Renovated
Edison Field	Anaheim Angels	1998	Renovated
Oakland-Alameda County Coliseum	Oakland Athletics	1996	Renovated
Turner Field	Atlanta Braves	1996	New
Coors Field	Colorado Rockies	1995	New
Ballpark at Arlington	Texas Rangers	1994	New
Jacobs Field	Cleveland Indians	1994	New
Camden Yards	Baltimore Orioles	1992	New
Comiskey Park	Chicago White Sox	1991	New
Olympic Stadium	Montreal Expos	Planning Construction/Renovation	
Shea Stadium	New York Mets	Planning Construction/Renovation	
Veterans Stadium	Philadelphia Phillies	Planning Construction/Renovation	
Three Rivers Stadium	Pittsburgh Pirates	Planning Construction/Renovation	
Fenway Park	Boston Red Sox	Planning Construction/Renovation	
Yankee Stadium	New York Yankees	Planning Construction/Renovation	
New/Renovated or Planned National Football League Facilities Since 1990			
New Seattle Stadium	Seattle Seahawks	2002	New
Ford Stadium	Detroit Lions	2000	New
Paul Brown Stadium	Cincinnati Bengals	2000	New
Nashville Stadium	Tennessee Oilers	1999	New
New Baltimore Stadium	Baltimore Ravens	1998	New
Qualcomm Stadium	San Diego Chargers	1998	Renovated
Tampa Bay Community Stadium	Tampa Bay Buccaneers	1998	New
Jack Kent Cooke Stadium	Washington Redskins	1997	New
Ericsson Stadium	Carolina Panthers	1996	New
Oakland-Alameda County Coliseum	Oakland Raiders	1996	Renovated
Alltel Stadium	Jacksonville Jaguars	1995	Renovated
Transworld Dome	St. Louis Rams	1995	New
Georgia Dome	Atlanta Falcons	1992	New
3Com Park	San Francisco 49ers	Planning Construction/Renovation	
AstroDome	For Possible NFL Team	Planning Construction/Renovation	
Foxboro Stadium	New England Patriots	Planning Construction/Renovation	
Los Angeles Coliseum	For Possible NFL Team	Planning Construction/Renovation	
Metrodome	Minnesota Vikings	Planning Construction/Renovation	
Mile High Stadium	Denver Broncos	Planning Construction/Renovation	
New Cleveland Stadium	For Possible NFL Team	Planning Construction/Renovation	
Soldier Field	Chicago Bears	Planning Construction/Renovation	
Sun Devil Stadium	Arizona Cardinals	Planning Construction/Renovation	
Three Rivers Stadium	Pittsburgh Steelers	Planning Construction/Renovation	
Veterans Stadium	Philadelphia Eagles	Planning Construction/Renovation	

SOURCE: Price-Waterhouse LLP's, Sports, Convention, and Entertainment Facilities, Advisory Group, Tampa, Florida.

This manuscript presents the results of analyzing the body of lease and rental data for MLB, NFL and dual-sport stadiums. The indicated market rent model derived from that analysis is also shown.

FEASIBILITY ANALYSIS AND VALUATION OF LESSEE INTERESTS

Table 1 lists the new MLB and NFL stadiums built in the 1990s, major renovations of existing stadiums, and new construction under way or planned as of 1998. Virtually every existing or planned MLB and NFL venue is on that list. At least one feasibility study was conducted for each project, whether completed, in process, or proposed. Feasibility studies are necessary to obtain project financing, much of which takes the form of debt plus "equity" participations represented by the sale of such intangibles as naming rights, exclusive product sales rights, or advertising rights in the new or renovated stadium. Indeed, sale of these intangibles has provided a major proportion of the up-front money that constitutes "equity" in recent major league stadium construction projects.

In any feasibility study, anticipated revenues are necessarily forecast (often optimistically). One of the major elements of revenue, but far from the only source, is the rent to be paid by the tenant franchise for the use of the stadium. Because the lessor is typically a public body, that rent is required to be "market rent," which is defined by the Appraisal Institute as, "the rental income that a property would most probably command on the open market, as indicated by current rentals being paid and asked for comparable space, as of the date of the appraisal."[3]

Over 30 MLB and NFL leases were studied as part of the research on which this article is based, to identify what (if any) market pattern of rentals exists. Information on other leases came from the publication, ***Inside the Ownership of Professional Sports Teams: 1999***.[4] Both NFL and MLB leases specify and distinguish carefully between "rent" paid by the lessee franchise and revenue-sharing by the stadium owner (nearly always a public body) with the lessee franchise owner. These leases are signed well in advance of construction, and provide an important basis for acquiring both equity participations and debt financing. Typically, therefore, the analysis of "feasibility" incorporates a consideration of market rent.

In addition, property tax authorities in many states are empowered to assess and tax the leasehold interest that a private lessee-user holds in tax-exempt real estate (especially that which is publicly-owned). In some jurisdictions (e.g., California), the "Possessory Interest" held by a private lessee on publicly-owned property is taxed as the present worth of net operating income based on market rent (or occasionally as the present worth of *net* market rent). In other states (e.g., North Carolina), the leasehold interest of a private lessee in publicly-owned real property is taxable when the present worth of market rent exceeds that of contract rent. In either set of circumstances, the market value of the lessee's interest in the stadium real property is measured via income capitalization, which in turn requires an estimate of market rent.

Finally, in the relatively rare instances of privately-owned major league stadiums whose owners are not the team franchises themselves (e.g., SkyDome in Toronto, the New Baltimore stadium, Ericsson Stadium in Charlotte), income capitalization is also employed to value the stadium real estate for property tax purposes. Once again, market rent is one of the necessary ingredients in the analysis.

THE NATURE AND MEANING OF MARKET RENT

For purposes of this analysis, the differently worded definition of "market rent" from the International Association of Assessing Officers, with the same meaning, is more to the point:

> "The rent currently prevailing in the market for properties comparable to the subject property. Market rent is capitalized into an estimate of value in the income approach."[5]

The critical point in both the Appraisal Institute and IAAO definitions is that rental data are to be derived from "the market" for comparable or competitive properties, which consists of major league stadiums located throughout the U.S. and Canada. The data reviewed for this research were the rents called for in 22 MLB leases and 25 NFL leases in force as of 1998. The results of those lease reviews are summarized in *Tables 2 and 3* for NFL leases, and *Table 4* for MLB leases.

It is important to reiterate the fact that both NFL and MLB leases differentiate carefully between payments made by tenant team franchises that are labeled "rent," and allocations of revenues from such items as naming rights, concessions, advertising, or parking. All of these latter items, unless identified explicitly as part of "rent" (e.g., Denver

Table 2

NFL Rentals, By Franchise, in (Mostly) Ascending Order

RENTAL TERMS	YEAR	FRANCHISE	AVERAGE ATTENDANCE (1992-1996)[4]	AVERAGE 1996 TICKET PRICE
0 (Zero Rent)	1995	Baltimore Ravens[1]	534,520	$40.53
0 (Zero Rent)	1995	Baltimore Ravens[2]		
$25,000 per Game vs. 5% Ticket Gross ($800,000 Maximum)	1993	New Orleans Saints	452,500	34.84
$250,000 Per Year	1995	St. Louis Rams	413,120	33.57
$250,000 (Yrs. 1-5); $500,000 (Yrs. 6-10); $1,000,000 (Yrs. 11-20); $1,250,000 (Yrs. 21-25)	1995	Jacksonville Jaguars	544,150[3]	36.59
5% Gross Revenues $7.5-12.5MM; 4% $12.5-17.5MM; 2% over $17.5MM vs. Base $450,000	1980	Kansas City Chiefs	606,560	34.20
$250,000 + $25,000 per Playoff Game + 5% Admissions Tax	1984	Indianapolis Colts	415,020	31.76
$25,000 per Game + $15,000 + $2 per Ticket	1989	Green Bay Packers	464,280	30.61
$500,000 + $1 per Ticket Use Surcharge	1994	Oakland Raiders	420,060	51.41
$63,000 Per Game[3]; $3,000,000 After 1996	1996	Tampa Bay Buccaneers	389,900	33.06
$852,000 + Average Above 10% Revenues	1970	Pittsburgh Steelers	448,260	35.76
7% Ticket Revenues	1976	Seattle Seahawks	401,660	34.14
7% Gross Event Revenues vs. $12,000 Per Month	1973	Detroit Lions	539,380	33.70
10% 1st $6MM Ticket Revenues; 8% Above $6MM	1985	San Diego Chargers	454,220	38.96

Table 2 *(Continued)*

RENTAL TERMS	YEAR	FRANCHISE	AVERAGE ATTENDANCE (1992-1996)[4]	AVERAGE 1996 TICKET PRICE
10% Gross Ticket Revenues	1990	Atlanta Falcons	472,640	31.49
10% Gross Ticket Revenues	1979	Minnesota Vikings	457,000	36.95
10% Gross Ticket Revenues	1970	San Francisco 49ers	494,080	45.00
6% Gross Ticket Rev. + 8% Lux. Seat Revenues	1987	Denver Broncos	587,120	35.83
Minimum $500,000 vs. 9% Ticket Rev. to $5MM; 4% to $7.5MM; 2% above $7.5MM; plus $0.25/Ticket Surcharge	1972	Buffalo Bills	599,620	33.46
$950,000 vs. 8% Ticket Rev. + 8% Lux. Seat Rev.	1985	Dallas Cowboys	513,100	38.25
10% Ticket Revenues + 6% Club Seat Revenues	1987	Arizona Cardinals	386,080	35.49
10% Ticket Revenues + 10% Use Tax	1967	Cincinnati Bengals	389,980	34.28
13% Ticket Revenues, Decreasing to 11%, 10%	1975	New York Giants	559,700	35.59
12% Ticket Revenues + 20% Luxury Box Revenues	1980	Chicago Bears	486,560	38.18
15% Ticket Revenues	1984	New York Jets	600,360	30.00
$3,000,000 + "x"% Ticket Revenues	1968	Houston Oilers	378,860	31.33
			Mean: 472,580	Mean: $35.89

Not Included: Team-Owned Stadiums: Charlotte, Miami, New England, Washington
Rent Not Given: Philadelphia Rent Not Announced: Nashville (Cleveland Reported at $250,000 per Year, Fixed)

[1] Municipal Stadium [2] New Baltimore Stadium [3] 1995, 1996 Only [4] Average Attendance: Charlotte 606,840 (1995/1996)

SOURCE: ***Inside the Ownership of Professional Sports Teams: 1997***, Team Marketing Report, Inc., Chicago, IL; Selected Leases.

Table 3

National Football League Leases
By Year Signed (Newest First)

Lease Date (Year)	Term (Years)	Rent Percentage[a]	Team
1996	30 (+[4x5])	12.0%	Tampa Bay (New)
1995	3	0.0%	Baltimore (Old)
1995	30	0.0%	Baltimore (New)
1995	25	2.5%[f]	Jacksonville
1995	30	2.0%	St. Louis
1994	16	6.6%[b]	Oakland
1993	25 (+[2x5])	6.5%	New Orleans
1990	30	10.0%	Atlanta
1989	Yr.-to-Yr. to 2024	9.5%	Green Bay
1987	20	7.4%	Denver
1987	30 (10 + [4x5])	14.0%	Arizona
1985	35	8.7%	San Diego
1985	24 (+25)	15.7%	Dallas
1984	25	15.0%	New York Jets
1984	20	2.0%[b]	Indianapolis
1980	25	4.3%	Kansas City
1980	20	21.5%	Chicago
1979	30	10.0%	Minnesota
1976	30	7.0%	Seattle
1975	50	11.0%	New York Giants
1973	30	7.8%	Detroit
1972	25[e]	4.8%[b,c]	Buffalo
1970	30	7.5%	Pittsburgh
1970	27 (+[3x5])	10.0%	San Francisco
1968	30[d]	25.3%	Houston
1967	40	10.0%[b]	Cincinnati

NOTES:
(a) Percentage of Gross Ticket Revenues Only
(b) Tax Surcharge Omitted
(c) Plus Stadium Maintenance
(d) Departed
(e) Expired; Year-to-Year
(f) Graduated

SOURCE: See Table 2.

Broncos, Dallas Cowboys, Arizona Cardinals, Chicago Bears, as indicated in *Table 2*), are revenues that would normally come to the owner of the stadium. In the current market, however, they are increasingly shared by the stadium owner with the franchise team as an inducement either to come to the stadium, remain at the stadium, or both. Nevertheless, they do not represent "rent," nor do they serve as indicators of market rent.

If revenues from concessions, parking, advertising, luxury boxes/seats, or naming rights are shared between the stadium owner and the franchise team, it is because the stadium owner chooses to do so. A tenant has no inherent legal right to venue revenues which are generated at or by the real estate. Accordingly, such revenue sharing (or allocation solely to one party or the other) is not part of rent, regardless of the method of collection and distribution. This is analogous to the collection of taxes by the team as part of ticket revenues, and their subsequent distribution to the taxing authority (local, county, or state).

THE MARKET RENT MODEL FOR MAJOR LEAGUE STADIUMS

Market rent information from 25 NFL franchise leases is presented in *Tables 2 and 3*. One tenant franchise (Philadelphia Eagles) would not provide the requested information. Moreover, three NFL stadiums are owned by the team, while the Carolina Panthers' stadium is owned by a related private corporation.

Similarly, *Table 4* provides rental information for 22 MLB leases. Five MLB stadiums are owned by the team, and one stadium (SkyDome) is privately owned by an investment group.[6]

The information provided in *Tables 2 and 3* for NFL franchise leases and *Table 4* for MLB franchise leases indicates that there is a rather wide range of percentage rent payments. Yet the underlying formula is remarkably consistent: Rent is paid as a percentage of gross ticket sales revenues. This is the NFL stadium market rent model. As noted earlier, four NFL franchises also pay a percentage of "luxury" seat revenues: the Arizona Cardinals, Chicago Bears, Dallas Cowboys, and Denver Broncos. It is noteworthy, however, that these four leases all pre-date 1990, with the most recent (Broncos and Cardinals) dating from 1987. No such arrangements are found in any subsequent leases.

As *Table 3* shows, with the exception of the Tampa Bay Buccaneers lease of 1996, the leases signed after 1990 generally called for a lower rent percentage than did earlier leases. It is also instructive to note the effective rent percentage being paid by the Tennessee Oilers in their former Houston venue, which may help explain the relocation of the franchise.

Table 4 summarizes the effective rental rate for 22 MLB franchises, in ascending order of percentage. All of the MLB leases also provide that rent shall be calculated as a percentage of gross ticket sales revenues. Thus, the market rent model for major league sports stadiums is simple and straightforward: the lessee team franchise pays rent as a percentage of gross revenues from ticket sales.

Calculation of Market Rent

For NFL franchises, the median and modal rent percentage is 10 percent of gross ticket sales revenues. More leases call for less than 10 percent than require rent in excess of 10 percent. Moreover, the percentage rents for most of the reported leases signed in the 1990s are at substantially less than 10 percent of gross ticket sales revenues. Nevertheless, 10 percent of gross ticket sales revenues was selected and used as the best indicator of market rent for NFL stadiums over the past three to five years.

For MLB stadiums, on the other hand, the mean effective rental percentage rate is 6.7 percent of gross ticket sales receipts, while the median is 6.75 percent. This is noticeably lower than the percentage for NFL stadiums. A number of factors combine to explain this difference.

First, MLB teams play eight times as many home games (81) as do NFL teams (10, including two exhibition games). Second, home attendance at MLB stadiums averaged 2,150,000 in 1996, which is approximately 4.5 times the average of NFL home attendance between 1992 and 1996. At the same time, average ticket prices for MLB teams were approximately one-third the average ticket price for NFL games. Interestingly, however, the average gross ticket sales revenues were approximately the same for all NFL teams combined, as compared with the average for all MLB teams combined.

The important finding is that rent payments for NFL team franchises and for MLB team franchises are both calculated effectively as a percentage of gross ticket sales revenues. Over the period covered by the data in our analysis, the indicated market

Table 4

Major League Baseball Rentals, By Franchise
In (Mostly) Ascending Order

Year Signed	Term (Years)	Effective Rental Rate[1] (Percent of Ticket Revenues)	Franchise	1996 Attendance (000,000)
1994	20	0.9%[2]	Cleveland Indians	3.32
1977	20[3]	3.4%	Seattle Mariners	2.72
1983	23	3.7%	Houston Astros	1.98
1996	20[3]	5.0%	Atlanta Braves	2.90
1973	35	5.0%	San Francisco Giants	2.61
1990	25	5.4%	Kansas City Royals	1.44
1979	30	6.0%	Minnesota Twins	1.44
NA	NA	6.4%	Milwaukee Brewers	1.33
1995	20	6.5%	Oakland A's	1.15
1970	40	6.6%	Cincinnati Reds	1.86
1994	17[3]	6.6%	Colorado Rockies	4.48
NA	NA	6.9%	Montreal Expos	1.62
1991	30	7.0%	Baltimore Orioles	3.64
1994	30	7.4%	Texas Rangers	2.89
1996	33	7.5%	California (Anaheim) Angels	1.82
1985	20	7.5%	New York Mets	1.59
1972	30[3]	7.7%	New York Yankees	2.25
1979	30	8.1%	Detroit Tigers	1.17
1971	40[3]	9.5%	Philadelphia Phillies	1.80
1970	30	10.0%	Pittsburgh Pirates	1.33
1988	12	10.0%	San Diego Padres	2.18
1990	20	10.4%	Chicago White Sox	1.68

Mean Percentage: 6.70%
Median Percentage: 6.75%

Not Included: Team-Owned Stadiums: Boston Red Sox, Chicago Cubs, Florida Marlins, Los Angeles Dodgers, St. Louis Cardinals
Private Stadium: Toronto Blue Jays (Leased Land, $2 Per Year)
Not Yet Operating: Arizona Diamondbacks, Tampa Bay Devil Rays

(1) 1997 Lease Data
(2) Plus 7.4% "Pro Bono" Payments
(3) Plus Renewal Options

SOURCE: ***Inside the Ownership of Professional Sports Teams: 1997***, Team Marketing Report, Inc., Chicago, IL; Selected Leases.

rent for NFL teams and stadiums is 10 percent, while for MLB teams and stadiums it is 6.75 percent.

CONCLUSIONS

There is a pattern in the rentals paid by NFL and MLB teams. The model is that market rent is a percentage of annual gross ticket sales revenues: 10 percent for NFL teams and stadiums, and 6.75 percent for MLB teams and stadiums. These are not immutable percentages, however. Both MLB and NFL leases show wide ranges in effective rental percentage rates. Moreover, with increased competition among cities for both NFL and MLB franchises, new stadiums and new leases show trends toward lower levels of percentage rents for the team franchise tenants. It is reasonable to expect market rents to decline as even lower percentages of gross ticket sales revenues are experienced for new stadiums, new leases, and renegotiated lease renewals in the foreseeable future.

From the point of view of financial feasibility for NFL or MLB stadiums (dual-sports stadiums are currently out of vogue), rental payments from the tenant team do not represent the only revenue source to the public owner. With increased competition for franchises as *local* tenants, however, the trend is toward giving away larger shares of those other, alternative revenue sources, either to attract or to retain the MLB or NFL franchise tenant.

Market rent remains an important consideration in valuing the leasehold interest/possessory interest of the tenant team franchise, or in evaluating project feasibility. Therefore, ticket sales and attendance still matter. Attendance determines not only gross ticket sales revenues, but also revenues from concessions and parking, and even on-site advertising rates. Attendance also affects revenues from those luxury boxes or club seats available for sale on a game-by-game basis, which in turn influences total venue revenues.

In the final analysis, it is still preferable for both the franchise owner and the stadium owner to have a winning team. As our April 1997 article demonstrated unsurprisingly, winning teams enjoy higher average attendance. If no-shows have already paid for season tickets, their absence still has an impact on concession and parking revenues. In a zero-sum game, which is what NFL and MLB teams play, winning more often than losing enhances market rent, leasehold value, and stadium feasibility. REI

ABOUT THE AUTHORS

(continued from page 36)

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NOTES

1. Kinnard, William N., Jr., Mary Beth Geckler and Jake W. DeLottie, "Team Performance and Risk for Major League Baseball Stadiums: 1970-1994," *Real Estate Issues*, April 1997.
2. In the literature of US major league sports (baseball, basketball, football and hockey), stadiums and arenas are termed "venues." The proceeds from ticket sales, premium seating licenses or fees, food and beverage sales, program sales, souvenir sales, parking and on-site advertising are all called "venue" revenues. See, for example, Friedman, Alan, and Paul J. Much, *Inside the Ownership of Professional Sports Teams: 1999*. Chicago, IL: Team Marketing Report, Inc., 1999.
3. Appraisal Institute, *Dictionary of Real Estate Appraisal*, Third Edition. Chicago, IL: Appraisal Institute, 1993, p. 221.
4. Friedman, Alan and Paul J. Much, *Inside the Ownership of Professional Sports Teams: 1999*. Chicago, IL: Team Marketing Report, Inc., 1999.
5. International Association of Assessing Offices, *Glossary for Property Appraisal and Assessment*. Chicago, IL: IAAO, 1997, p. 84.
6. As an interesting aside, both SkyDome (Toronto Blue Jays) and Ericsson Stadium (Carolina Panthers) are privately-owned facilities on leased publicly-owned land. Contract Rent for each is $1.00 per parcel per year. SkyDome is on two parcels.

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Settlement of an Oil Pipeline Leak with Contaminated Residential Property: A Case Study

by Robert A. Simons

Introduction

Petroleum pipelines transport natural gas, crude oil, and partly and fully refined petroleum products from sea ports and domestic oil production areas throughout the United States. According to the Federal Department of Transportation Office of Pipeline Safety (OPS), there were about 2,000 natural gas firms and 300 companies operating petroleum distribution pipelines in 1997, with over two million miles of moderate-to-large (e.g., diameter 8-40 inches) pipelines in service.[1] Unfortunately some pipelines have experienced a chronic weakness in line integrity resulting in pipeline ruptures which have released petroleum product into the environment. Some leaks may be abrupt, while others may go undetected for a long period of time. Under these circumstances, a plume of petroleum product may infiltrate the groundwater, and contaminate drinking water wells. Once contamination has been detected, property values of affected residences can decrease markedly. The pipeline leaks described in this case study went undetected for several decades.

Because appraisers always consider the arms length of transaction (favorable terms, etc.) the sales in this case study, like any which have inducements or are sold or bought with one party under duress, would normally be discarded. However, the information about the properties in this case study neighborhood reflects the discounted cost of contamination to the responsible party. Thus, it would set an upper boundary on what a free market discount would be.

This study examines how much a negotiated settlement package affects the sales price, under various scenarios, and thus reveals a corporate policy of discounting sales. The case setting considers the effect of petroleum groundwater contamination on the value of rural/ex-urban residential properties on well water, with full information, where a district-wide area is affected.

ABOUT THE AUTHOR

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LITERATURE REVIEW

Several studies address the effects of petroleum contamination on residential property. A recent investigation regarding residential property value decreases along pipeline easements in suburban Virginia found losses of one percent to two percent for townhouses and up to four percent to five percent for single family detached homes. These properties were on municipal drinking water and, due to extensive publicity, the market perceived the eventuality of possible repeated discharges.[2] Registered LUST (leaking underground storage tanks) sites in greater Cleveland, Ohio, experienced losses of between 14 percent and 17 percent. Virtually all of these units were on municipal drinking water systems, and all were within 300 feet of a known LUST and/or had actual groundwater contamination.[3]

Page and Rabinowitz found that groundwater contamination had no measurable effect on residential sales price, but their research design was a relatively weak case study approach. Dotzour also found no negative effect on residential property values from groundwater contamination in the Wichita, Kansas, area. However, both of the last two studies mentioned did find negative effects on commercial property.[4]

Des Rosiers et al found a five percent to eight percent decrease of residential property values resulting from persistent groundwater contamination in the province of Quebec.[5]

Abdala, Roach, and Epp looked at averting expenditures on the part of the owners of contaminated property as a way to estimate value loss. They concluded that this technique was a "conceptually valid estimate" of the cost to the property owner, and can be easily quantified.[6] The expenses they considered included filtration, bottled water, etc. This last study is germane to the research at hand because this research also evaluates non-market inducements (although they are positive rather than negative), and considers their effect on property value.

BP PIPELINE CASE STUDY

The following case study examines the effects of a British Petroleum (BP) pipeline rupture on residential property in Franklin Township, Summit County, Ohio, a suburb of Akron. The case provides a good indication of the extent of property damage that a pipeline leak can have on rural, residential property that is actually contaminated, and where a considerable amount of contamination lingers until the present.

Case Background

Inland Corp. owns a pipeline in northeast Ohio that carries petroleum products. The pipeline is operated by BP. It is a 12-inch line, which replaced a smaller line installed around 1940. The smaller line apparently leaked several times between 1948 and 1962, and attracted the attention of the Ohio EPA and Summit County health department, who were actively working on the case in 1990. Of the 100 homes in the study area that were tested, 13 had detectable levels of hydrocarbon contamination, and six of these had benzene levels above federal standards for municipal water systems. At the time the incident was discovered, all these homes were on well water.

A consent order with the Ohio EPA was signed in 1991, and BP conducted testing to determine the extent of contamination. About this time, local property owners filed lawsuits. The testing proceeded through 1993, with 19 or more monitoring wells. A more recent OEPA document shows that environmental testing continued through late 1998. An inspection of the site in late 1998 revealed that a number of large green water testing trailers were in place.

Data Gathering Procedures and Analysis

A data set of Summit County property transactions was acquired from the Amerestate Corporation. Based on these actual transaction data, it could be verified that BP Oil Pipeline Co. acquired 41 parcels in the impact area, nearly all since 1993. According to public records, BP still retains ownership of 18 of these homes, and has subsequently sold 23 of them. After deleting double counts, these parcels represent 35 residential properties.

Analysis of BP's Direct Real Estate Transactions in Franklin Township

Figure 1 shows a sale/resale analysis of the 23 properties acquired and resold by BP in the market. Sales data were available for 21 of these residential properties. Before adjusting for carrying costs, market inducements to buyers or appreciation over a holding period averaging 36 months, 19 of these properties decreased in value, and two increased. The two that increased were for properties acquired in the mid-1980s. The average decrease in value was 20.4 percent (between –13.4 percent and –27.2 percent, based on a 95 percent level of confidence). The weighted average decrease was larger, at 27.2 percent. These figures represent the direct loss associated with an oil pipeline leak with groundwater contamination in an area on well water, before

accounting for the time value of money. Overall, a reasonable discount for these properties would be 25 percent. These figures should represent market forces on the buyers' side during the most recent round of sales, and a loss-minimizing discounted sales policy on behalf of the seller.

Present Value Analysis of Sales

The sale/resale analysis understates the actual loss because it does not account for the time value of money in holding the properties prior to resale, including those that have not yet been resold. This present value analysis considers the 21 bought and resold properties presented in *Figure 1*, as well as the remaining 14 houses BP has acquired in the impact area, for a total of 35 residential units. It extends the sales experience of the 21 sold units (the best available information) to the 14 unsold ones, and puts all 35 in the context of time. Including previously unsold units is important because their sales revenues would be included in the analysis, thereby avoiding overstating the loss. Because remediation is still underway, it is assumed that these remaining 14 properties would also be held for three more years, and then resold at a 25 percent discount. For selection of a discount rate, BP's discount rate was assumed to be 12 percent, which reflects the firm's published return on equity over the past nine years.[7]

Figure 2 examines the present value of the loss experienced by BP in these real estate transactions. Based on these assumptions, the present value of the loss would be $1.9 million on a property base value of $4.7 million. This represents a present value loss to BP of just over 40 percent.[8]

Figure 1

BP Pipeline Leak Sale/Resale Analysis
Summit County, Ohio

PARCEL*	RESALE AMT	RESALE DATE	PURCHASE	PURCHASE DATE	DIFF	% DIFF
1	$100,000	3/19/96	$125,000	7/20/93	-$25,000	-20.0%
2	$104,000	4/25/97	$130,000	8/24/93	-$26,000	-20.0%
3	$108,000	5/31/96	$160,000	8/31/93	-$52,000	-32.5%
4	$100,000	4/26/96	$135,000	4/22/94	-$35,000	-25.9%
5	$88,000	5/13/96	$110,000	10/28/93	-$22,000	-20.0%
6	$122,000	4/23/96	$153,000	4/3/93	-$31,000	-20.3%
7	$90,000	7/18/96	$116,000	10/31/95	-$26,000	-22.4%
8	$75,000	11/26/96	$111,750	5/2/95	-$36,750	-32.9%
9	$80,000	12/1/95	$100,000	12/15/92	-$20,000	-20.0%
10	$75,000	11/22/95	$72,500	10/15/86	$2,500	3.4%
11	$75,000	11//22/95	$93,500	8/23/94	-$18,500	-19.8%
12	$72,000	2/16/96	$90,000	12/15/92	-$18,000	-20.0%
13	$96,000	5/31/96	$120,000	8/24/93	-$24,000	-20.0%
14	$136,000	2/28/96	$460,000	8/9/93	-$324,000	-70.4%
15	$65,500	6/26/96	$82,000	8/22/94	-$16,500	-20.1%
16	$128,000	2/29/96	$160,000	11/17/93	-$32,000	-20.0%
17	$186,000	10/31/95	$240,000	10/22/93	-$54,000	-22.5%
18	$186,000	10/31/95	$240,000	10/22/93	-$54,000	-22.5%
19	$116,000	7/26/96	$145,000	8/31/93	-$29,000	-20.0%
20	$120,000	4/17/96	$87,000	10/29/86	$33,000	37.9%
21	$136,000	3/18/96	$170,000	8/24/93	-$34,000	-20.0%
					(ave. loss)	**-20.4%**
TOTAL	**$2,258,500**		**$3,100,750**		**-$842,250** (weighted ave. loss)	**-27.16%**

* IN SUMMIT COUNTY TAX BOOK PAGE 23

Figure 2

SUMMARY: BP FRANKLIN TOWNSHIP CASE STUDY: PRESENT VALUE OF DIRECT REAL ESTATE TRANSACTIONS ONLY

ITEM	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002
BUY 35 UNITS	-$350	-$3,178	-$852	-$228	-$87						
RESELL 35 UNITS*				$602	$1,553	$104			$1,200		
TOTAL	-$350	-$3,178	-$852	$374	$1,466	$104	$0	$0	$1,200	$0	$0
DISC FAC@12%	0.893	0.797	0.712	0.636	0.567	0.507	0.452	0.404	0.361	0.322	0.287
PV/YR	-$313	-$2,533	-$607	$238	$832	$53	$0	$0	$433	$0	$0
SUM OF PV	-$1,896										
BASE VALUE (35 UNITS)	$4,694										
LOSS	**-40.43%**										

ASSUMPTIONS

ALL DOLLARS IN THOUSANDS

	NUMBER OF UNITS	AVERAGE VALUE	TIME/YEARS DURATION
UNITS IN STUDY AREA	100	***$111.94***	
UNBOUGHT UNITS*	65	***$100.00***	
BP BOUGHT THEN RESOLD	21	$147.65	
BP BOUGHT /HELD	14	$113.84	

ITEMS EXCLUDED FROM ANALYSIS

RENTAL INCOME
REMEDIATION COSTS
RELOCATION EXPENSE

DISCOUNT RATE 0.12 BASED ON BP'S RETURN ON EQUITY (9 YEAR AVERAGE) OF 12%

* AVERAGE SALES PRICE $100,000
NOTE $1.2 MILLION IN SALES IN THE YEAR 2000 IS AN ASSUMPTION, SEE TEXT

Figure 3

SUMMARY: BP FRANKLIN TOWNSHIP CASE STUDY. PRESENT VALUE OF MARKET SUPPORTS TO ALL 100 UNITS

ITEM	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002
BUY 35 UNITS	-$350	-$3,178	-$852	-$228	-$87						
RESELL 35 UNITS				$602	$1,553	$104			$1,200		
MAINT. GRANTS-65 UNITS		-$130	-$130	-$130	-$130	-$130					
PRICE GUARANTEES-65 UNITS		-$130	-$130	-$130	-$130	-$130	-$130	-$130	-$130	-$130	-$130
TOTAL	-$350	-$3,438	-$1,112	$114	$1,206	-$156	-$130	-$130	$1,070	-$130	-$130
DISC FAC@12%	0.893	0.797	0.712	0.636	0.567	0.507	0.452	0.404	0.361	0.322	0.287
PV/YR	-$313	-$2,741	-$792	$73	$684	-$79	-$59	-$53	$386	-$42	-$37
SUM OF PV	-$2,972										
BASE VALUE (100 UNITS)	$11,194										
LOSS	-26.55%										

ASSUMPTIONS

ALL DOLLARS IN THOUSANDS

	NUMBER OF UNITS	AVERAGE VALUE	TIME/YEARS DURATION
UNITS IN STUDY AREA	100	***$111.94***	
UNBOUGHT UNITS*	65	***$100.00***	
BP BOUGHT THEN RESOLD	21	$147.65	
BP BOUGHT /HELD	14	$113.84	
MAINTENANCE GRANTS	65	$2.00	5
PRICE GUARANTEE**	65	$2.00	10

ITEMS EXCLUDED FROM ANALYSIS

RENTAL INCOME
REMEDIATION COSTS
RELOCATION EXPENSE

DISCOUNT RATE 0.12 BASED ON BP'S RETURN ON EQUITY (9 YEAR AVERAGE) OF 12%

* AVERAGE SALES PRICE $100,000
** PRICE GUARANTEE BASED ON A 20% LOSS, SALE EVERY TEN YEARS. $100,000 * .20* 1 = $2,000/UNIT/YR

Negotiated Settlement

Beyond the direct sale and resale of units, there were another 65 units affected by the pipeline leak. According to a public presentation by BP staff, there was a negotiated settlement between BP and the residents in a specific study area (approximately 100 homes). The deal was facilitated by the Urban Center at the Levin College of Urban Affairs at Cleveland State University.[9] In addition to paying for remediation of contamination:

- BP offered to buy out, relocate, and compensate those households who wanted to leave for their " pain and suffering." BP was free to resell these homes (the 35 units referred to above).
- BP also offered to give each household a $2,000 grant per year for five years for home improvements (all but three made use of these).
- BP also offered to give each household an indemnification against declining property values for 10 years.

Because this was a negotiated settlement, it helped the residents get on with their lives, and appeared to be well-received. The next section analyzes the present value of these market-supporting strategies.

Present Value Analysis of Settlement Package

An analysis of the present value of the overall settlement package between BP and the residents is shown in *Figure 3*. These figures are assumed to be net to BP, and exclude remediation costs, or any payments to residents for relocation or personal matters. They also exclude rental income to BP from the houses they own and hold. The figures are based on the 35 units presented above, as well as the 65 additional units which BP did not buy, but which received a $2,000 annual maintenance grant for five years, and a guaranteed sales price for 10 years. It was assumed that the 35 homes sold did not receive these non-market supports.[10]

When these other non-market factors are included, the present value of the loss to BP for all 100 units in the study area (a combination of those directly impacted and within the impact area but not contaminated) would be just under $3.0 million on a property base of $11.2 million. Thus, the present value of the direct real estate losses and other non-market support activities to BP for the study area in this case, exclusive of remediation, would be -26.5 percent. Because this figure reflects a blend where one-third of the units were directly acquired by the responsible party, and the rest were offered market supports, it is not generalizable beyond this case.

However, those 65 properties in the impact area but not bought by BP received non-market price supports with a present value of $1.1 million, on a property base of $6.5 million. This represents just under 17 percent of the value of these properties, which may be generalizable if a similar settlement package is offered.

CONCLUSIONS

This case has analyzed residential sales contaminated by a known pipeline leak where remediation is being undertaken, and the houses are on well water. The case study reveals that single-family homes contaminated by a well-publicized pipeline rupture experienced a loss in real estate value of approximately 25 percent, after the rupture and when remediation is underway. The motivation of the responsible party was an important factor in this analysis. The present value of this reduction in value to the responsible party (exclusive of remediation costs) was 35 percent to 40 percent, depending on the assumptions used.

Secondly, neighboring residential properties within a designated impact area that were not acquired by the responsible party (within the study area but not shown to be directly contaminated) received an array of price supports with a present value equivalent to 17 percent of their market value.

This latter figure is a substantial amount. Further, the settlement terms are not generally available using conventional real estate research methods (e.g., no lien, no responsible party seller, not on a deed registration document). If and when these homes are resold, and if remaining time on these price supports are transferable to new owners, they should be capitalized into the sales price value of the properties. REI

NOTES

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5. Francois Des Rosiers, Alain Bolduc and Marius Theriault (1997). Environment and Value: Does Drinking Water Affect House Prices. Presentation at the 1997 Meeting of the American Real Estate Society in Sarasota FL.
6. C.W. Abdala, B.A. Roach and D.J. Epp. (1992) Valuing Environmental Quality Changes Using Averting Expenditures. *Land Economics*. Vol. 68, no. 2 p 163-175.
7. It was decided to use the published return on equity rather than the firm's hurdle rate or target rate because these are not available. The return on equity is an adequate measure of the opportunity cost of capital.
8. This figure was subjected to sensitivity analysis. If the properties were resold faster, in the second year, at only a 10 percent discount, and assuming a discount rate of 18 percent (well above the return to stockholders), the resulting loss is 39 percent, about the same at the figure derived above. If the same sale assumptions are kept, but if BP's discount rate is assumed to be 8 percent, consistent with financing the costs with corporate debt, the overall loss would be 35 percent.
9. Bill Hollis, BP Corp. Public Meeting, Levin College of Urban Affairs, Cleveland State University, April 1997.
10. If a property is sold every ten years, and if there is a 20 percent loss upon sale, then for an average sales price of $100,000, the annual expected expense to cover the losses would be $2,000.

Tax Planning for Real Estate Investors for 1999 & Beyond

by J. Russell Hardin & Jack R. Fay

Introduction

The Internal Revenue Service (IRS) Restructuring and Reform Act of 1998 (the Act) was signed into law by President Clinton on July 22, 1998. The law is far-reaching and multi-functional and is surprisingly complex; it affects a broad cross-section of taxpayers in a variety of significant ways. The 1998 Act is actually six acts rolled into one piece of legislation. The law represents a major attempt to rein in the IRS through a ground-up reorganization. The Act also lowers the holding period for the most favorable capital gains rate; makes several technical corrections to the Taxpayer Relief Act of 1997 (TRA 1997); enacts the "Taxpayer Bill of Rights 3;" carves out a separate Electronic Filing section; and adds a list of "revenue raisers" that affect both individuals and corporations.

The purpose of this manuscript is to summarize some of the provisions to the Internal Revenue Code that are now effective as law or that will soon become effective as law. Individuals and business owners are urged to look closely at this sweeping legislation to seek ways in which they can significantly diminish their future income taxes and to examine the new protections and rights that taxpayers enjoy under the new law. The following discussions focus on some of the major provisions of the new tax bill which, directly or indirectly, affect real estate investors. Some suggestions for tax planning are also included. To determine the particular effect, if any, each of these provisions will have on a particular taxpayer, each taxpayer should consult with his or her CPA, tax attorney, or other tax professional.

Electronic Filing

One important component of the IRS Restructuring and Reform Act of 1998 is the electronic filing rules and incentives. The Act has provisions

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to encourage electronic filing of tax returns and information returns (i.e., 1099s and W-2s). The Act sets a goal that 80 percent of all tax and information returns will be filed electronically by the year 2007. The Act also aims for a return-free tax system for individuals whose tax return information is limited to items already reported to the IRS on information returns. The Act has a goal for this return-free system to begin in the year 2008. In addition, the Act directs the Treasury Department to develop a plan that would require all computer-generated tax returns to be filed electronically by the calendar year 2002.

There are several incentives for filing electronic tax returns. First, electronically filed returns are generally prepared using computer tax preparation software. Returns prepared on the computer have an error rate of less than one percent. This means the taxpayer is less likely to encounter such problems as delayed refunds or certain IRS audits. Another advantage of filing an electronic tax return is the speed with which the taxpayer can potentially receive a tax refund. Whereas a paper tax return generates a refund check in approximately six to eight weeks, an electronically prepared and filed tax return can result in the refund amount being deposited in the taxpayer's bank account in nine to 15 days (when coupled with the electronic funds transfer system). Still another advantage of electronic filing is the almost immediate acknowledgment (usually within a day) from the IRS that the return has been received and accepted. A final advantage of electronic filing is the ability to file the tax return separately from the payment when taxes are due. Under the new rules, a taxpayer can file his or her electronic tax return at any point during the tax season (January through April 15), and the taxpayer can wait and pay the taxes that are due on or before April 15.

To encourage the filing of electronic information returns by employers, the Act has delayed the due date for filing information returns. Whereas employers who file information returns on paper must do so by February 28 of each year, employers who file electronic information returns may wait until March 31 to file. This includes, among other things, reporting wages, interest, dividends, and non-employee compensation. The due date for providing copies of information returns to payees, however, currently remains as January 31 of each year (the Treasury is studying the possibility of changing this date to February 15). The effective date of this change is January 1, 2000.

TAXPAYER PROTECTION AND RIGHTS

Burden of Proof

A somewhat controversial provision of the Act is that the burden of proof shifts to the IRS in certain situations. Historically, an IRS determined tax deficiency has been presumed to be correct. This former rule required the taxpayer to persuade the courts that the IRS determination was incorrect and/or that the IRS position was without merit. The IRS has always had the burden of proof in certain cases such as those involving illegal transactions and fraud. The new law, however, places the burden of proof on the IRS in tax litigation with respect to a factual issue.

Specifically, four conditions must be met for the burden of proof to shift to the IRS. First, the taxpayer must comply with the requirements of the Internal Revenue Code (hereafter the Code) and the regulations issued thereunder to substantiate any item that relates to the litigation. Second, the taxpayer must maintain records required by the Code and its regulations. Third, the taxpayer must cooperate with reasonable IRS requests for meetings, interviews, witnesses, information, and documents. Finally, the taxpayer must either be an individual or must be a corporation, trust, or partnership with a net worth of no more than $7 million and no more than 500 employees. In other words, the burden of proof shifts to the IRS for individuals and small businesses with respect to a factual issue.

This change does not apply to present court proceedings; only those arising in connection with audits that started after the President signed the Act (July 22, 1998). The burden of proof also shifts to the IRS in two other situations. First, the burden of proof is on the IRS if they use statistics to reconstruct an individual's income. Second, the IRS bears the burden when the court case involves proceedings against an individual taxpayer regarding a penalty or addition to tax. This change became effective with the enactment of the Act (July 22, 1998).

Proceedings by Taxpayers

Several changes to proceedings by taxpayers (*i.e.*, court cases) were built into the IRS Restructuring and Reform Act of 1998. First, the Act permits up to $100,000 in civil damages when an officer or employee of the IRS negligently disregards provisions of the Internal Revenue Code or Treasury regulations in connection with the collection of Federal tax with respect to the taxpayer. Further, if the negligence relates to willfully violating

provisions of the Bankruptcy Code relating to automatic stays or discharges, the civil damages can be as high as $1 million. Second, the U.S. Court of Federal Claims and the U.S. District Courts are granted jurisdiction to determine the proper amount of estate tax liability (or refund) in actions brought by taxpayers deferring estate tax payments under Section 6166. The Act also provides that once a final judgment has been entered by one of the above courts, the IRS is not permitted to collect any amount disallowed by the court. In addition, any amounts paid by the taxpayer in excess of the amount found by the court to be currently due and payable must be refunded to the taxpayer, with interest.

Third, the Act allows a record owner of property against which a Federal tax lien has been filed to obtain a certificate of discharge of property from the lien if the owner of record is not the person whose unsatisfied liability gave rise to the lien. The owner of record is required to apply to the Secretary of the Treasury and either to deposit cash or furnish a bond to protect the lien interest of the United States. Fourth, the Act directs the IRS to modify its administrative procedures to allow tax-exempt bond issuers to appeal adverse examination determinations (loss of tax-exempt status) to the Appeals Division as a matter of right. The appeal is then handled by senior appeals personnel with experience in tax-exempt bond issues. Other changes to proceedings include: jurisdiction for small cases is increased from $10,000 to $50,000; actions for estate refunds which have elected the installment method of payment for estate taxes attributable to a closely held business, may now be heard by the Court of Federal Claims or the Federal District Courts; and deficiency notices must indicate the last date a taxpayer may file a timely Tax Court petition. The effective date of these changes was July 22, 1998.

Innocent Spouse Relief

This Act generally makes innocent spouse relief easier to obtain. An innocent spouse is excused from liability for the couple's joint tax, penalties, and interest if five conditions are met. First, the innocent spouse must have filed a joint income tax return. Second, the understatement of tax on the joint return is attributable to an erroneous item(s) of the other spouse. Third, the innocent spouse must be able to prove that, when he/she signed the return, he/she had no reason to know, and in fact did not know, of the understatement of tax. Fourth, when considering all the facts and circumstances surrounding the case, it would be inequitable to hold the innocent spouse liable for the joint deficiency. Fifth, the innocent spouse elects the innocent spouse relief not later than two years after the IRS begins collection activities. Failure to comply with any one of these conditions will result in denial of innocent spouse relief.

To encourage the filing of electronic information returns by employers, the Act has delayed the due date for filing information returns. Whereas employers who file information returns on paper must do so by February 28 of each year, employers who file electronic information returns may wait until March 31 to file.

One of the keys to the successful invocation of innocent spouse relief is the knowledge of the innocent spouse. The courts have held that relevant facts to consider in determining if the spouse had a reason to know about phony deductions include: the spouse's involvement in the family's business and financial affairs; the spouse's education level; the presence of expenditures that appear lavish or unusual; and the spouse's evasiveness and deceit when asked about the couple's finances. A "lack of knowledge" defense can be difficult to prove because the IRS can take the position that even if the innocent spouse claims he/she did not know about a transaction, he/she had reason to know or should have known if the spouse knew of the transaction that gave rise to an omitted item of gross income. The level of knowledge of a phony deduction to prevent the innocent spouse defense is not clear. For example, just because a spouse knows that investment transactions occurred, he/she may not know anything about what deductions might have been taken in conjunction with the investment activities. The innocent spouse protection expanded on July 22, 1998.

Interest and Penalty Relief

This 1998 Act included several changes to the interest and penalty provisions related to various taxpayers. First, the Act establishes a net interest rate of zero on equivalent amounts of underpayment and overpayment of any taxes imposed by the Internal Revenue Code that exist for any period. This provision applies to both self-employment taxes and income taxes. The provision applies after the date of enactment (July 22, 1998); and it applies to interest for periods before the date of enactment

if: the statute of limitations has not expired with respect to the underpayment or overpayment; the taxpayer properly identifies the periods of underpayment and overpayment; and the taxpayer asks the Secretary of the Treasury to apply the zero rate on or before December 31, 1999.

This interest netting provision will be significant for corporations with a tax overpayment exceeding $10,000 in one year (on which the government pays 5.5 percent interest) and a tax deficiency exceeding $100,000 in one year (on which the corporation is charged 10 percent interest). Since years and sometimes decades pass before a final determination is made by the IRS in a multiple-year, large corporation audit, the new interest netting provision could result in millions of dollars in savings for large corporations. Under prior law, a corporate taxpayer could have ended up paying 4.5 percent interest (10 percent - 5.5 percent) even though the tax overpayment and tax underpayment may have eventually been offset with no additional taxes due.

Other changes in interest and penalties include: 1). the penalty for failure to pay taxes is .25 percent instead of the usual .50 percent per month (after 1999) for an individual who is paying his or her taxes under an installment payment agreement with the IRS; 2). the Act permits the taxpayer to designate the period to which each payroll tax deposit is to be applied to help mitigate the failure to deposit penalty; 3). the Act suspends the accrual of certain penalties and interest after one year if the IRS has not sent the taxpayer a notice specifically stating the taxpayer's liability for additional taxes (along with an explanation for how the additional taxes were derived) within one year following the date on which the taxpayer filed a timely return; 4). the Act requires that each notice imposing a penalty include the name of the penalty, a computation of the penalty, and the Code section invoking the penalty; and finally, 5). the Act requires every IRS notice that includes interest to be paid by an individual taxpayer to contain a detailed computation of the interest charged and a citation to the Code section imposing the interest. These provisions became effective on July 22, 1998.

Due Process in IRS Collection Activities

The Act establishes procedures to insure due process where the IRS seeks to collect taxes by levy (including by seizure). Under these new rules, the IRS is required to notify the taxpayer that a Notice of Lien has been filed. During the 30-day period beginning with the delivery or mailing of the notice, the taxpayer may demand a hearing with an appeals officer who has had no prior involvement in the taxpayer's case. Before the IRS can levy against a taxpayer's property, it is required to provide the taxpayer with a Notice of Intent to Levy. Generally, no levy can occur within the 30-day period beginning with the mailing of the Notice of Intent to Levy. During that 30 days, the taxpayer may demand a pre-levy hearing with an appeals officer who has no prior knowledge or involvement with the taxpayer's case. No seizure of a dwelling that is the principal residence of the taxpayer, the taxpayer's spouse, the taxpayer's former spouse, or a minor child is allowed without a court order. This provision is effective for collection actions that started more than 180 days after July 22, 1998.

Confidentiality Privilege

The IRS Restructuring and Reform Act of 1998 extends the present attorney-client privilege of confidentiality to tax advice furnished by any practitioner authorized to practice before the IRS. In other words, the confidentiality privilege is extended to Certified Public Accountants and Enrolled Agents. Privilege may be asserted in any noncriminal proceeding before the IRS, as well as in noncriminal proceedings in the federal courts where the United States is party to the proceeding. This privilege is only available when the tax practitioner is providing tax advice. Privilege may not be asserted for communications made and documents generated for the purpose of preparing tax returns. The Act also excludes from privilege a written communication between a federally authorized tax practitioner and any director, shareholder, officer, employee, agent, or representative of a corporation in connection with the promotion of the corporation's participation in a tax shelter. These rules are effective for communications on or after July 22, 1998.

CHANGES TO CAPITAL GAINS RULES

The Taxpayer Relief Act of 1997 lowered the long-term capital gains tax rate for individual taxpayers from 28 percent to 20 percent (or 10 percent if the property would otherwise be taxed in the 15 percent tax bracket) for property held more than 18 months. The Taxpayer Relief Act also established a 25 percent tax rate on certain depreciable real estate (such as residential rental property) held more than 18 months. The 25 percent maximum rate applies to the gain to the extent of allowable depreciation. The Relief Act additionally established a 28 percent top capital gains rate for collectibles held more than 18 months and sold at an increase. The

IRS Restructuring and Reform Act of 1998 reduced the holding period to qualify for the lower rates from more than 18 months to more than one year. The new one-year holding period applies to capital gains occurring on or after January 1, 1998.

Tax Planning Tip: Capital gains on investments held one year or less are taxed at the taxpayer's regular tax rate. The availability of the lower rates for relatively short-term investments clearly accelerates the need for tax planning strategies that favor capital gains over ordinary income. For example, postponing the sale of a capital asset for just a few more days or weeks may put a taxpayer over the one-year limit and invoke the lower tax rate. Also, taxpayers should be vigilant and keep an eye on the United States Congress since it is contemplating still further reductions in the capital gains tax rates.

PASSIVE LOSSES

Although not part of the 1998 Tax Act, passive loss rules continue to be an important tax planning issue for real estate professionals. A real estate professional who "materially participates" in rental real estate activities may not be subject to passive loss limitations if certain requirements are met. The tax laws allow net losses from rental real estate to offset any other income provided the taxpayer materially participates in the rental activity. In essence, a taxpayer who qualifies as a real estate professional is permitted to treat the loss from the rental activity as if it were a loss from a trade or business. This tax relief is available to individuals and closely held C corporations. A C corporation is closely held if five or fewer shareholders own 50 percent or more of the stock during the last half of the year. The conditions that generally must be met include the following: 1). more than half of the taxpayer's personal services (work) must be performed in real property trades or businesses; 2). the taxpayer must perform more than 750 hours of services in real property trades or businesses; and 3). the taxpayer must materially participate in the rental of real estate.

Tax Planning Tip: A real property trade or business is any real property development, acquisition, conversion, construction, redevelopment, rental operation, management, leasing, or brokerage trade or business. In addition, a taxpayer who is an employee of a business engaged in a real property trade or business qualifies if the taxpayer has an ownership interest in the business that is greater than five percent.

The Taxpayer Relief Act of 1997 lowered the long-term capital gains tax rate for individual taxpayers from 28 percent to 20 percent for property held more than 18 months. The Taxpayer Relief Act also established a 25 percent tax rate on certain depreciable real estate held more than 18 months.

CHANGES TO ROTH IRA RULES

The 1998 Act made several changes to the rules for Roth IRAs. The Taxpayer Relief Act of 1997 originally intended that funds converted from an existing IRA to Roth IRA be held in the Roth IRA for at least five years before withdrawal. However, the law did not stop taxpayers from receiving early withdrawals from their converted Roth IRA and receiving the benefits of the four-year averaging rule on the converted amount, thereby paying no early withdrawal penalty. The 1998 Act imposes a new toll charge on premature withdrawals from the converted Roth IRA. If converted amounts are withdrawn during the four-year spread period, the amount withdrawn will generally be subject to an unfavorable income-acceleration rule.

In addition to the new penalty, the 1998 Act contains three new Roth tax breaks. First, those who convert to a Roth IRA may elect to recognize all income in the year of conversion rather than ratably over four years. Second, taxpayers have until the due date of their tax returns to change their minds about any Roth IRA conversion that took place any time during the tax year (this helps taxpayers who incorrectly project the size of adjusted gross income). Third, a surviving spouse who inherits a 1998 Roth conversion IRA can elect to continue to defer income over the remainder of the four-year spread period.

Tax Planning Tip: Taxpayers should avoid converting an amount so large that they use up their available money to pay the conversion tax. In addition, paying the conversion tax out of IRA funds will be considered a premature distribution with a resulting penalty. Finally, although the 10 percent early withdrawal penalty normally does not apply to withdrawals for education or for first-time home buyers, the 1998 Act prevents these exceptions from being applied to distributions from employer-sponsored retirement plans.

ESTIMATED TAX SAFE HARBOR

Under present law, an individual taxpayer generally must pay a penalty for an underpayment of estimated tax. The individual taxpayer generally does not have an underpayment penalty if he or she makes timely deposits of estimated tax equal to certain safe harbor percentages of the prior year tax liability. For taxpayers with an adjusted gross income of over $150,000, the 1998 Act increases the 105 percent of last year's tax liability safe harbor to 106 percent of last year's liability safe harbor for tax years beginning in 2000 and 2001. The safe harbor percentage for these taxpayers increases from 106 percent to 112 percent for taxable years beginning in 2002.

Tax Planning Tip: There is generally no underpayment of estimated tax penalty for taxpayers who owe less than $1,000 ($500 under prior law) with their tax return or for taxpayers who had no tax liability for the prior tax year.

CAPITAL RECOVERY: DEPRECIATION

Before 1999, taxpayers who elected to use the Alternative Depreciation System (ADS) and the 150 percent declining balance method to depreciate tangible personal property were required to use the ADS life for its computations. Starting in 1999, taxpayers must use the MACRS life rather than the ADS life for property placed in service after December 31, 1998, if the 150 percent declining balance method is selected. Thus there no longer is an election to use the 150 percent declining balance method and the longer ADS life.

There was also a change or clarification in the 1998 Tax Act relating to depreciation limits for electric vehicles. The annual depreciation deduction was tripled for such vehicles in accordance to 1997 legislation, and the 1998 Act clarifies that the maximums for years after the vehicle's six-year recovery period are also tripled.

Tax Planning Tip: Whenever and wherever it is feasible for a company or an employee to use an electric vehicle, this can be a significant tax benefit to take the larger amounts of depreciation deductions.

NET OPERATING LOSS CHANGES

The Tax Act of 1998 made some significant changes in the computation of a net operating loss (NOL) in nonbusiness transactions. Previously, nonbusiness deductions were normally not taken into account in the computation of a non-corporate taxpayer's NOL; however, personal casualty and theft losses (net amounts after reduction of the $100 and 10 percent floors) were treated as business losses for NOL purposes. This apparent inconsistency allowed NOLs from personal casualty and theft losses but disallowed nonbusiness deductions in the computation of such NOLs. The new law [Section 172(d)(4)(C)] now provides that casualty and theft losses incurred in a nonbusiness transaction by a non-corporate taxpayer are taken into account in the computation of a net operating loss; and in the NOL computation, the casualty and theft losses are not treated as miscellaneous itemized deductions subject to the two percent floor or as itemized deductions subject to the three percent cutback.

Another NOL change is that the portion of an NOL which qualifies as a "specified liability loss" may be carried back 10 years instead of the normal two-year carryback period. Specified liability losses [Section 172(f)(1)(B)(i)] include losses related to the following: product liability, reclamation of land, decommissioning of a nuclear power plant, dismantling of a drilling platform, remediation of environmental contamination, and a worker's compensation claim.

Tax Planning Tip: It will be essential for individuals who suffer from casualty or theft losses, farmers who have NOLs, and others who have specified liability losses to spend some time in the computation of NOLs and in tax planning the best route for carryback and carryforward periods to take advantage of these new tax provisions.

CLARIFICATIONS ON GAINS FROM SALE OF PRINCIPAL RESIDENCE

In a decision which benefits many taxpayers, Congress settled the question of how to apply the new capital gains exclusion to the sale of a residence owned and used for less than two years. The general rule indicates that to be eligible for the capital gains exclusion, a taxpayer must have owned the home and occupied it as a principal residence for at least two of the five years prior to the sale or exchange.

The 1998 law states that a taxpayer who fails to meet the two-year test because of a change of place of employment, health, or other unsuspecting circumstance may be able to use a fraction of the $250,000 exclusion (or $500,000 for married, filing jointly) equal to the fraction of the two years that the ownership and use requirement is met. For example, an unmarried taxpayer who owns and uses a principal

residence for one year and then moves because of a job transfer may exclude up to $125,000 (one-half the regular amount of $250,000 exclusion under the Tax Act of 1997). If he or she has a gain of $75,000 on the sale of the residence, it is all excluded rather than only one-half of the $75,000, in accordance to the clarification provided in the Tax Act of 1998.

MISCELLANEOUS ITEMS

A miscellaneous, but significant item, in the Tax Act of 1998 affects all taxpayers who have a tax liability starting in 1999 (effective on 1998 tax returns) as they are to make checks and money orders payable to the "U.S. Treasury," not to the "Internal Revenue Service." Another miscellaneous item that is not part of the 1998 Act but is a change in IRS procedures involves private letter rulings. On January 20, 1999, the IRS announced that businesses with less than $1 million in gross income now qualify for a special $500 user fee when they request a private letter ruling. The fee for most other private letter ruling requests is $5,000. A private letter ruling is a written statement issued by the IRS to a taxpayer that interprets and applies the tax laws to the taxpayer's specific set of facts. This change makes private letter rulings available to small businesses.

CONCLUSION

The IRS Restructuring and Reform Act of 1998 is a complicated piece of legislation that contains numerous amendments and new provisions. Many of these provisions can help businesses of all sizes in many industries reduce their tax burden if properly applied. A law as complicated as this needs a great deal of study if one is to maximize the tax breaks that are potentially available in such a sweeping piece of legislation. Those managers and owners who are responsible for maximizing shareholder wealth and maintaining appropriate capital structures should look very closely at this law. In addition, many of the new tax provisions have a significant impact on individuals. Individuals, business owners, and business managers should consult with appropriate tax professionals to assure proper application and maximum benefit from the new law. REI

NOTES

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ABOUT THE AUTHORS

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Reviving "Sick" Tax Credit Housing Partnerships

by R. Lee Harris, CRE

The devastation of the real estate industry caused by the Tax Reform Act of 1986 has been well documented. However, if there was any silver lining, it was the creation of the Section 42 Low-Income Housing Tax Credit program effective January 1, 1987. By the time Congress made the tax credit permanent in 1995, after years of annual sunset provisions, the Section 42 program had become the most important resource for creating affordable housing in the United States.[1] Unfortunately, this process has had a downside, with an increasing number of partnerships in distress. By some industry estimates, as many as 25 percent of tax credit properties are under-performing.[2]

There are many reasons why this has occurred. The competition for tax credits has never been greater. Inexperienced developers and operators regularly receive awards more frequently while equity syndicators with substantial pools of capital are under increasing pressure to find projects to fund. This combination of inexperience and excess capital has caused the development of a number of marginal projects. In addition, many markets are becoming saturated with Section 42 developments.

Counselors cannot do much about inexperienced developers and saturated markets, but they can play a role in solving some of the operational and partnership challenges encountered by new and existing developments. The most common problems involve marketing, resident screening, compliance, and funding structures.

AN OVERVIEW OF THE TAX CREDIT PROGRAM

Growing communities need a full spectrum of housing including: affordable single-family dwellings; affluent single-family homes;

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multi-family apartments; assisted living residences; and seniors housing. In an effort to address the affordable housing needs of this country, Congress created a program that adopted Section 42 of the Internal Revenue Code. Section 42 was implemented to provide an incentive for developers to build or acquire rental units with restricted rents and make them available to individuals and families earning a specified percentage of the median income in their area.

For over a decade, the development of affordable multi-family housing using the Section 42 tax credit program has successfully contributed to the overall quality of metropolitan and rural housing. More than one million units have been added to the nation's affordable housing stocks including new construction and the acquisition of existing properties for inclusion in the program.[3] Families occupying tax credit apartments often save their money and eventually purchase a "starter home." Without such affordable rental housing, many citizens would not be able to save for down payments.

Tax credit housing is:

- Housing for working individuals, families, and retirees.
- Generally the newest and nicest apartment community in many smaller markets.
- Housing that requires residents to pay the full amount of rent unless used in tandem with a rent subsidy program such as Section 8.
- A way to help revitalize a neighborhood by restoring a community landmark, such as a vacant elementary school or a former department store.
- A proven method for financing affordable housing that would not otherwise be constructed in many smaller communities.

Tax credit housing is critically important to the economic success of a municipality. Without affordable housing, a growing work force has no place to live. Local industry then finds it harder to recruit employees and cannot expand - a factor that is critical to increasing the local tax base.

Who can live in tax credit apartments? The law permits residency based upon individuals or families who earn 60 percent or less of an area's median income. The median income calculation increases relative to the number of residents who occupy the apartment. Rental rates are determined through a formula based upon 30 percent of the median income figure.

Assume that the median income for a family of four in a particular community is $38,500. Thus to be eligible, this family can earn up to $23,100 per year. The husband works at the area's 450-employee food processing plant that pays $8.50 per hour ($17,680 per year) and the wife earns $4,500 per annum employed as a part-time clerk at a neighborhood grocery store. The family's combined income is $22,180 - below the maximum allowable income under the tax credit program.

THE MECHANICS OF THE TAX CREDIT PROGRAM[4]

Under current law each state receives an annual allocation of tax credits equal to $1.25 per capita. The housing agency for each state administers the tax credit program for the federal government. Private and not-for-profit developers must submit applications demonstrating need for affordable housing in specified locations and compete for an award of tax credits. Typically, most states receive applications for $3.00 to $4.00 for every dollar of tax credits available.[5] Thus, as state housing agencies evaluate the applications, they pay a great deal of attention to market studies; rental rates (are they below maximum allowable rates?); energy efficiency; construction and intermediary costs; project design and quality; and the general support demonstrated by a community.

Once a developer receives an award, he/she must decide the appropriate strategy for utilizing the tax credits. Through passive loss rules, the Internal Revenue Code limits the amount of tax credits that can be used by an individual each year, offset against income tax liabilities. As a result, a large number of tax credits are sold to corporate investors that are not subject to the stringency of these limitations. The tax credits are calculated at nine percent of a project's eligible basis including construction and architectural costs, developer fees, etc. (land is not eligible, nor are certain financing costs). For example, a new apartment community with an eligible basis of $4,000,000 will generate a tax credit of $360,000 (adjusted for the federal Applicable Funds Rate [AFR]) each year for 10 years. In instances where an existing property is acquired, the developer will receive four percent tax credits for the acquisition costs and nine percent tax credits for the renovation costs, however if tax-exempt financing is used on new or acquisition projects, only four percent credits are applicable.

Corporations, insurance companies, and financial institutions with federal taxable income have been

the largest purchasers of tax credits to date.[6] The typical transaction structure has the developer selling 99 percent of the tax credits to the corporate investor on a net present value basis. Currently, industry pricing ranges from $.75 to $.80 per credit dollar.[7] In the example cited in the preceding paragraph, the developer would be offering $3,600,000 in tax credits (we'll ignore AFR adjustments) over 10 years. A corporate investor would pay $2.673 million to $2.88 million for the use of these credits. The developer would form a limited partnership for which he/she would be the general partner and the corporate investor would be the limited partner. The payment from the corporate investor would take the form of equity, and the developer would seek an additional source(s) of funding in the form of debt. In this example, assume that the total project costs – hard and soft – are $4,350,000. If the corporate investor provides $2.75 million in equity at the commencement of the project, the developer must find another $1.6 million in permanent financing.

Once the project has been constructed and each unit occupied (allowing the tax credits to be "placed in service"), the corporate investor is able to reduce its income taxes by $360,000 per annum over 10 years. Meanwhile the developer must adhere to the median income and rental rate restrictions for a minimum of 15 years under the program (some states require an even longer time frame). The IRS and state housing agencies have strict requirements for certifying the income levels of residents and a variety of documents must be filed each year to remain in compliance with the program.

A significant number of developers do not sell their tax credits directly to corporate investors, opting instead to work with a tax credit syndicator. The syndicator establishes relationships with interested corporations and often pools the interests of several companies into a fund that actually becomes the limited partner for the projects in which it invests. The syndicator buys the credits on a wholesale basis and sells them to corporate participants on a retail basis, making a spread on the transaction. Developers are generally required to provide a variety of guarantees to the syndicator (or to the corporation if the investment is direct) including development deficit funding, operating deficit funding, and tax credit compliance.

COMMON PARTNERSHIP AND PROJECT PROBLEMS

The problems that are being encountered in the tax credit industry fall into four primary categories.

Poor Marketing

While the demand for multi-family housing is strong in nearly every corner of the nation, this does not necessarily translate into the immediate lease-up of a Section 42 property. The market for tax credit housing tends to be relatively narrow due to the income restrictions prescribed by the program. In many communities, there is considerable renter interest in a new property, however as many as 75 percent of prospective residents may be overqualified due to their income levels.[8]

For many prospective residents who do meet income qualifications, rental rates at restricted levels may be too high for prospective residents. A 1997 audit conducted by the General Accounting Office (GAO) found that the average tax credit apartment resident earns only 37 percent of the area's median income.[9] The problem with rental rates can be exacerbated when there is significant competition presented by a concentration of tax credit properties located in medium size and large metropolitan areas. Finally, the Department of Housing and Urban Development (HUD) sets the restricted rent levels through an annual market study process in tandem with area median incomes. Income levels in many markets are rising rapidly as a result of the tight labor market. The HUD process does not respond quickly enough to such rising income levels and thus many prospective residents are rejected, who would otherwise be qualified were the market study to have been conducted in a more timely fashion, acknowledging higher income levels accordingly.

A generic marketing effort will often fall short because it is not adequately targeted to the proper audience. The leasing of tax credit apartments generally requires an intensive highly directed marketing program that reaches the small segment of the population that both qualifies for the program from an income standpoint and can afford the rental rates that must be charged. Many developers do not understand this reality and attempt to implement traditional marketing methods without success.

Improper Resident Screening

Slow lease-ups can lead to problems with resident screening. Management may panic and relax rental standards to accelerate the placement of units in service. Just because a prospect is qualified under the Section 42 program does not necessarily mean that a prospect will be an acceptable resident. Slow payment of rent, poor housekeeping,

unruly children, derelict vehicles, and late night disturbances can be the result of failure to contact landlord references, perform credit checks, and conduct in-depth prospect interviews.

Tax Credit Program Non-Compliance

Compliance issues have moved to the forefront in the Section 42 industry during the past few years. The GAO audit may result in tighter regulation by state housing agencies and a commitment by the IRS to audit more tax credit partnerships.[10] This could spell trouble for a struggling property and its investors. Management that is ignorant of the myriad of compliance requirements and the lack of centralized compliance monitoring are the root cause of such problems. The latter is especially critical during the lease-up phase where leasing agents may receive incentives to achieve high levels of occupancy as quickly as possible.

Corporate equity syndicators will do almost anything to avoid a loss for their investors. Were a loss to be incurred, the syndicator would suffer a devastating blow to its ability to raise capital in the future. However, a number of syndicators are slow to deal with problem situations in a timely manner, hoping that the developer/manager will somehow be able to find the "magic" to put a project on solid footing. Eventually action must be taken, usually after the syndicator finds it necessary to modify the partnership agreement and potentially contribute its own funds to deliver promised returns.

Inadequate Funding Structure

According to the U.S. Census Bureau the overall average construction cost of a multi-family dwelling in 1992 was $67,530 per unit. By 1997, this cost had risen to $79,659 per unit.[11] The 1997 GAO audit revealed that the average development cost for a tax credit project over the 10-year period from 1987 through 1996 was $60,000 per unit.[12] Even with the substantial amount of equity invested in most tax credit projects, debt underwriting standards often do not allow a large enough permanent loan to offset the entire development cost when combined with the equity.

Using the 10-year average construction cost of $60,000 per unit, if financed conventionally, a project would require a monthly rental rate of $743 per month.[13] The GAO audit also found that the average rental rate for a tax credit community was $435 per month.[14] The Section 42 program was intended to help fund the difference of more than $300 per month through the use or sale of the tax credit.

The problem is that the cost to build the project had risen to $79,659 by 1997. The rental rate necessary to sustain the project on a conventional basis had also risen to $918 per month. Now the difference between conventional rental rates and tax credit rental rates had become $483 per month. While the higher construction costs generate more tax credits, the sale of those tax credits is at a discount as previously described. Subsequently, the additional equity provided by the larger tax credit amount, does not fully cover the increased cost of development. Increasing the debt financing in response to higher construction costs is not a viable option because the rent levels have not risen enough to support it. As a result, a number of projects suffer from inadequate funding structures from the very beginning. Without some form of additional capital (CDBG funds, HOME money, Federal Home Loan Bank loans, etc.) the funding gap will be underwritten through deferral of part of the developer's fee. The problem is further compounded when initial rental rates are not achieved and the subsequent lowering of rates does not enable the developer to obtain the targeted permanent loan. Development cost overruns, interest rate increases, and operating expenses that are higher than projected will have the same effect. In some cases the funding gaps are so large that the entire budgeted development fee is lost and still a shortfall exists.

SOLUTIONS

Troubled partnership situations can be resolved but require a great deal of planning and precise execution. The replacement of the developer or general partner may be necessary, but can be messy. Another solution is to keep the original developer/general partner and bring in a new managing general partner.

Attracting a replacement or new managing general partner is made easier when there are still development fees remaining to be paid. The new managing general partner should be given the opportunity to earn the remaining fees through the achievement of various performance benchmarks. If no such fees remain, the syndicator may find it necessary to offer new fees to a replacement general partner.

The remainder of this manuscript examines one of the best solutions to reviving "sick" tax credit partnerships — hiring a new managing general partner. The key qualifications of a managing partner are summarized along with some of the most important initial steps they should implement.

QUALIFICATIONS

What qualifications should the new managing general partner possess?

Management Experience

A new managing general partner should have a strong track record with the management of different types of multi-family properties. Certainly Section 42 experience should be a prerequisite. A well-rounded general partner may have managed properties for his/her own account and for third parties as well. Multiple market experience is also helpful, especially if the property in question is located in a different city than where the new general partner normally operates. Development experience may be necessary if the property has not yet been completed. A general partner that is affiliated with an Accredited Management Organization (AMO®) through the Institute of Real Estate Management (IREM) is a good choice. AMO® firms must continuously meet specific requirements and adhere to a strict code of ethics prescribed by IREM.

Understanding the Big Picture

Not only does the new managing general partner need to be successful in the property management realm, but it also should have a clear understanding of the big picture. Does the new general partner have a strategy to improve the cash flow? Increased cash flows can help the equity syndicator recover funds that it may have advanced to preserve returns for corporate investors. Can the general partner help re-structure the financing to improve the overall profit picture? Does the general partner comprehend the critical nature of compliance? Will the general partner provide in-depth reporting that will keep the equity syndicator informed of the progress that is being made to "cure the ills" of the property?

Relationships With State Housing Agencies

A new managing general partner that has a good relationship with the applicable state housing agency is a real asset to the partnership. Such relationships can help mend fences that might have been damaged when the project became troubled. A new general partner may also be able to secure additional tax credits (federal or state) that could create an additional capital infusion for the property.

POSITIVE STEPS TO SUCCESS

What positive steps should a new managing general partner take to breathe new life into a troubled project?

Property Taxes

If a development is struggling there may be a strong case for a reduction in property taxes. A new general partner will recognize this and develop the evidence needed to appeal property valuations for tax purposes. Rental rates may have been lowered; marketing costs may have been increased; and occupancy is probably lagging. All are factors that can be relevant in a tax appeal effort.

Market Study and Analysis

A new general partner will look carefully at the market study that was performed prior to the development or acquisition of the property. If a study was not conducted, the general partner may commission one. The ensuing analysis should produce information regarding capture rates, lease-up velocity, and an accurate identification of market-acceptable rental rates. It may also be determined that the resident profile should be modified. From this information, the general partner can then develop a comprehensive, targeted marketing strategy to lease the property to qualified residents.

Creative Marketing Concepts

Creativity in the marketing of Section 42 properties has not been the standard in the past. It must become a primary focus in the current environment. A simple ad in the local newspaper and a *"Now Leasing"* banner at the property generally will not ensure a successful lease-up. Direct mail; ongoing employer contacts; the support of local charitable groups and events; a sophisticated neighborhood business referral program; contacts with local churches; day care alliances; and many more techniques, must be carefully coordinated by the new general partner/managing agent. Further, an extensive tracking system must be implemented to provide information on where qualified prospects are learning about the property, and to enable management to aggressively follow-up with a prospect until a lease is signed.

Careful Screening

One of the basics and fundamentals of property management is the careful screening of prospective residents. A new general partner will review the rental standards that exist, or establish new standards if there are none to begin with. Must a prospect have held his/her current job for a specified period of time? How many years of landlord references will be checked? Will the on-site manager actually visit the prospect's current home to view its condition? Is drug screening necessary? What about criminal records checks? Once a policy has been

developed, the new general partner must enforce it consistently.

Centralized Compliance Monitoring

Material non-compliance – these words strike fear in the hearts of everyone involved with the Section 42 program. A new general partner should utilize a centralized compliance monitoring process. A well-trained employee of the general partner and/or managing agent should have the responsibility for approving all new applications for lease after reviewing supporting documentation. This individual should not be connected with the property in any sort of on-site capacity. The employee may also provide the same service for other Section 42 properties in the general partner's portfolio. On a periodic basis, the compliance specialist will review all existing files to make certain that documentation is in place and re-certify the residents accordingly. There are currently a number of excellent compliance monitoring/reporting software packages on the market. The new general partner should offer an automated system for compliance purposes.

Additional Funding Sources

There is a myriad of funding programs available for tax credit properties. The good news for troubled partnerships is the fact that there are many more opportunities for generating new sources of funds than is the case for conventional projects. While some sources may not be eligible for a property that has already been placed in service, there are still a number that are. A new general partner will seek to determine the applicability of the HOME program; CDBG funds; state tax credits; state affordable housing credits; low interest state loans; Rural Housing 502, 521, and 538 programs; tax-exempt bond financing; FHA funds; Federal Home Loan Bank loans; HOPE VI funds; soft community loans; tax abatement; tax increment financing; FNMA and Freddie Mac financing; and other state, local, and private sources. The key to success is the layering of a number of different programs until funding shortfalls have been eliminated.

CONCLUSION

There are many complex elements to resolving difficult partnership and property situations for tax credit housing. The replacement or addition of a general partner is a serious event and will more than likely require the participation of attorneys, accountants, lenders, property management professionals, market experts, and others. Extreme care must be taken to select the right party for the role and to re-structure the partnership and the operation of the property in a manner that will lead to a successful investment. Challenging tax credit partnership situations **can** be addressed in a positive and constructive manner through a diligent, patient, and creative effort. Counselors who develop extensive knowledge of the tax credit program and have experience with the development and/or management of apartment communities can be an invaluable resource to the affordable housing industry. REI

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CRE PERSPECTIVE

The Real Estate Industry Paradox

by Scott R. Muldavin, CRE

The real estate industry is a paradox. Just as property markets achieve their most stable equilibrium in recent history, real estate investors, lenders, and service providers must scramble to meet today's unprecedented challenges.

With real estate property markets in their most stable condition in 20 years, it would seemingly be logical to heed age old advice such as "sticking to the knitting" or focus on "blocking and tackling" in order to maintain market position and returns as overall market growth moderates. However, given structural changes in market cycles, the growth of the public real estate securities markets, and the surge of successful "applications" of technology to real estate, such strategies are unlikely to succeed.

Real estate companies of all types and sizes need to carefully reflect on their investment choices; take a more sophisticated look at their customers, products, and alliance partners; and adopt strategic decision-making frameworks similar to those that have driven the success of many corporations in America that have adapted themselves to the new global economy.

WHY IS CHANGE REQUIRED WHEN MARKETS ARE SO STABLE?

Stable Markets

Stable markets themselves are at the root of much of the change necessary in the real estate industry. Most important, the more stable equilibrium in the real estate property markets today is not just a passing phase, but the beginning of a much less volatile market than has been experienced during the last 15 years.

As shown in *Exhibit 1*, the last 15 years have seen a dramatic period of excess capital and overbuilding in the mid-to-late 1980s, followed by an equally dramatic decline in capital and property values during the early 1990s. Capital flows since 1996 have been strong, but fairly close to the average of the last 18 years on an inflation-adjusted basis. Furthermore, construction levels for all property types on a national basis remain well within long-term norms; early signs of overbuilding in 1998 led to a strong corrective reaction by the industry.

Given structural changes in the finance system, the tax system, information availability, and the ownership of real estate, the likelihood of highly volatile market cycles on a national basis over the next 10 years is remote. This does not mean that there will not be overbuilding and/or capital shortages in certain property types or geographic regions, but overall, the volatility of market cycles should be much reduced over recent history.

Since most of the major real estate businesses today either started or grew dramatically during the last 15 years, and their cultures and businesses reflect an entrepreneurial orientation built around market volatility, reduced market volatility will require investors and lenders to change risk management systems and return goals and force service providers to focus on their customers, products, and potential merger and acquisition candidates to improve their productivity, pricing, and service.

Public Securities Market Growth

A second key change forcing greater sophistication by real estate companies is the development of the public securities industry during the last 10 years. The REIT and CMBS markets have grown from $27 billion in 1990 to nearly $360 billion today. For certain properties and mortgages, REITs and mortgage conduits have become the dominant providers of new capital.

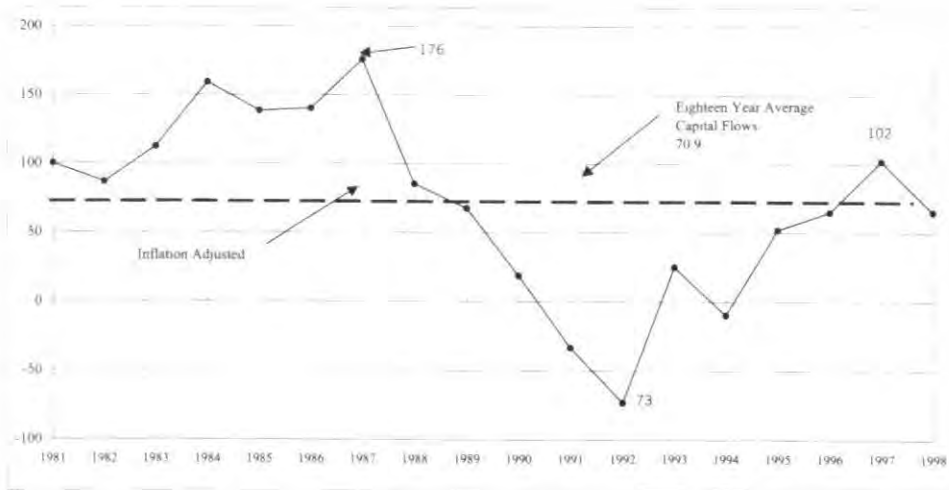
The real estate securities markets are particularly important to monitor because they react so strongly to non-real estate related investment issues. For example, due to concerns over Russian credit, the Brazilian economy, and a few other non-real estate related issues, the CMBS market collapsed in late summer of 1998, pushing mortgage spreads up over 100 basis points, and closing down the mortgage market for many lenders and borrowers.

Similarly, the REIT industry began a steep decline in the summer of 1998 finishing the year with a negative 18 percent return and experiencing market value declines of 20 percent to 50 percent from their peak in October of 1997. Again this all occurred during a period of relatively strong and stable real estate property markets.

Given the dramatic growth of public real estate securities, and their integration with the private real estate capital markets, the most successful companies will watch the dislocations and volatility in the

Figure 1

Overall Capital Flows Near Historic Norms[1]



[1] Index with 1981 set as the base year at 100.

Source: The Muldavin Company

real estate securities market in order to identify risk issues and capitalize on arbitrage opportunities between public and private real estate capital.

Technology Applications

The third key issue that will require real estate companies to stay on their toes is the dramatic increase in successful real estate technology "applications." Certainly, retail sales on the Internet and changes in the way people and businesses use real estate due to technology will be critical issues to follow going forward, but more specifically, real estate companies must stay on top of how technology changes will affect their customers, products, and delivery systems.

During the last six to 12 months, the ability to "apply" technology to real estate issues has increased significantly. Property transactions and financing have been significantly influenced. There are over a dozen major companies and scores of smaller companies offering properties through sophisticated Internet sites. There are a similar and growing number of sources for commercial mortgages and equity. These sources will not necessarily replace existing service providers, but they will change the way business is done, and the way their customers interact with them.

Finally, the magnitude of the changes that technology will bring must also be understood in analyzing real estate investment opportunities. According to International Data Corp, Internet commerce worldwide is expected to grow to more than $1 trillion by 2003. Equally amazing, the Department of Commerce recently released a forecast that almost half of the American workforce will be employed by information-technology-related companies by 2006. Clearly today is not the time to "stick to your knitting" or keep your head down and "block and tackle," but to take a more activist approach to understanding the world in which your business operates.

IMPLICATIONS OF MARKET CHANGES

Changes in the volatility of property markets, the growth of the public real estate securities markets and technology effect real estate companies and investors differently. Some of the responses by various industry sectors are discussed below.

Pension Funds and Investment Managers

Pension funds are still trying to find the best "script" to guide their real estate investment business for the new millennium. Strong real estate returns and the thriving REIT market provided the foundation for their "investment scripts" through mid-1998. Many pension funds were going to move their "core" real estate assets into REITs and invest their private real estate investment dollars into opportunity funds to attract the returns they had grown accustom to.

With the dramatic decline of the REIT industry since mid-1998 and the strong performance of private real estate equity, pension fund plans were turned upside down and many are still searching for the right path to move forward. Reluctant to give up on the liquidity and

other advantages of the REIT vehicle, many pension funds have been involved with REITs in joint-ventures where they share both equity investment and returns.

With the massive delinking of REIT returns from the real estate property markets – for example hotel REITs had a negative 53 percent return for 1998 compared to a 16 percent positive return for private hotel investment – pension funds are still trying to determine where REITs fit in their portfolio. Like the international real estate markets, REITs can provide opportunistic investment, but for at least the next few years, substituting REIT stocks for "core" private equity investment will be slowed as the industry tries again to understand the proper role for REITs in their portfolios.

Pension investment managers have been equally buffeted by changes in the marketplace. Following the poor performance by many investment managers during the early 1990s, and equally poor performance for those managers that handled REITs for their pension clients during the last 12 months, pension investment managers are working closely with pension funds to sort these investment issues out. "Opportunity funds," international funds, co-investment, joint-ventures, and traditional private equity deals are the investments that seem to continue to attract attention in the pension market.

Mortgage Lenders

The demutualization of life insurance companies, the growing financial strength of commercial banks, and the unexpected CMBS collapse in August of 1998 have insurance companies, commercial banks, investment banks, and brokerage companies scrambling to determine the best approach for their businesses. Insurance companies, whose focus on growth has been enhanced as they become public stock companies, are initiating CMBS lending programs and contemplating brokerage, while commercial banks are actively diversifying to become both portfolio lenders and sponsors of their own CMBS issues. Successful mortgage brokers that can access product still have tremendous value in the industry, and these firms are trying to balance the best way to take advantage of their strengths while maintaining long-term relationships and origination volumes.

Mortgage lenders are confronted with these dynamic competitor market changes during a time when overall demand for mortgages is declining. The last two or three years has seen substantial mortgage demand as mortgages that were made during the early 1990s were refinanced at today's low rates. High transaction volume and owners leveraging up (due to the significant increases in the value of their properties), also increased the demand for mortgages. While there still is substantial mortgage demand, the decline in refinancing due to the many years of low interest rates and general slackening in the transaction market has made it critical for mortgage lenders to integrate both mortgage demand analysis and a clear understanding of their strengths in the competitive marketplace to map a successful strategy.

Technology also is beginning to play a key role for mortgage lenders. During the last six months alone, there have been numerous new commercial mortgage Internet sites that have developed and more are sure to follow. The Internet will not make relationship-oriented brokerage businesses obsolete, but it will dramatically alter the way borrowers interact with their brokers and provide distinction for those firms and individuals that use it to greatest advantage.

Service Providers

Service providers, including brokerage firms, property management firms, title companies, lawyers, consultants, and others must also adapt to the less volatile and more moderate growth market environment. Classic corporate strategies such as developing economies of scale, new management approaches, maximizing the application of technology, and improved product and competitor segmentation and analysis will be key to service provider success. The importance of these changes has been noted by many firms as mergers, acquisitions, and alliances amongst service firms continue at a strong pace.

Conclusion

Successful real estate firms must confront the paradox of a more stable and less volatile property market with an activist approach to their real estate businesses. There are still substantial inefficiencies in the marketplace, and the substantial magnitude of the real estate industry, (including the massive volume of corporate real estate), provides a significant pot of gold for those that can successfully navigate their firms through the changes underway in the market today. REI

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