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The Resurgence of Nuclear Power in the U.S. William N. Kinnard, Jr., CRE & Gail L. Beron

Section 1031 - Tax Deferred Exchanges: 'Real Estate's Best-Kept Secret for Tax Relief' Joel Rosenfeld, CRE

How to Value Commercial Improvements in a National Park Maurice Robinson, CRE, David Dornbusch, Jason Bass & Blaine Chase, CRE

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Articles on general real estate-related topics

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Articles on general real estate-related topics

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Focus Edition: Articles on the globalization of real estate

(deadline for manuscript submission - August 20)

Winter 2001/2002

Articles on general real estate-related topics

(deadline for manuscript submission - November 26)

See "Contributor Information" on page 71 for information on submitting a manuscript or call Faye Porter at 615.498.5858

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EDITOR'S STATEMENT - by Richard Marchitelli, CRE

A this writing, it is mid-January. We have a new President; corporate earnings reports continue to disappoint; the Fed has reversed itself on rates; economists are beginning to speak in terms of a "landing"; Bradlees, Montgomery Ward, and a growing number of other companies are in bankruptcy; and vulture funds are circling Xerox, Chiquita, Fruit of the Loom, and Friendly's Ice Cream. Forecasts of continued economic expansion are being replaced increasingly by predictions of a slowdown. More ominously, "recession" has crept back into the vocabulary of some pundits.

One wonders if current conditions were not signaled by the inversion of the yield curve in the middle of last year. Indeed, every downturn of the last century was preceded by such an inversion. Why should it be different this time? At the same time, Greenspan & Company has achieved its stated objective of keeping inflation in check. As Hugh Kelly, CRE, has often speculated in this publication, the Fed has also achieved its unstated objective of relieving pressure from the speculative bubble of an overpriced stock market. Additionally, the recent Inauguration ensures that the advisability of tax cuts over deficit reduction will be a dominant national debate in 2001. The next several months should be interesting.

This edition of *Real Estate Issues* is the last in the series of celebrating REI's 25th Anniversary. William Kinnard, CRE, and Gail Beron opine on valuation methodology of power plants after de-regulation. This article is an important step in interpreting the new order of the power industry and its real estate implications. It is particularly timely in the wake of the California experience. The increasing popularity of 1031 exchanges and nuances and variations of such transactions are articulated by CRE Joel Rosenfeld. A number of other feature articles round out this diverse edition of REI. In addition, regular columnists Robin Panovka, Hugh Kelly, CRE, and Bjorn Hanson, CRE, provide special informative essays on REITs, the economy, and the U.S. lodging industry, respectively. Halbert C. Smith, CRE, a former REI editor-in-chief, comments on the maturation of *Real Estate Issues*, while Jack Friedman, CRE, presents an insightful "Resource Review" on brownfields.



Richard Marchitelli, CRE Editor in chief



David Kirk, CRE 2001 National CRE President

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- 1-60 Manuscripts
- The Resurgence of Nuclear Power in the U.S. by William N. Kinnard, Jr., CRE, & Gail L. Beron During the eight months from January to September 2000, a series of major events, coupled with historically high electricity demand and petroleum prices, have combined to alter dramatically the pessimistic view of the future role of nuclear power in the U.S. electricity industry held by many. A number of prescient authors foresaw these results, but not necessarily the sequence or timing of the causes. This manuscript briefly reviews the status of information about past and forecast market activity involving nuclear-fueled generating plants over the period 1997-1999, and then summarizes the events and market trends of the subsequent eight months as they impinge on the economic viability of nuclear power stations (NPS). The implications for continued reliance on nuclear power in the U.S. economy are then explored, with particular emphasis on the impact on the value of NPS.
- 12 Section 1031 Tax Deferred Exchanges: 'Real Estate's Best-Kept Secret for Tax Relief' by Joel Rosenfeld, CRE

One of the least understood tax relief provisions of the Internal Revenue Code (IRC) is the tax-deferred exchange under Section 1031 of the IRC. Although the tax shelter days are basically gone for real estate investors, and the passive loss regulations work against them, the tax-deferred exchange lives on as a viable and excellent alternative to defer income taxes upon the sale of real estate. Properly structured tax-deferred exchanges can defer significant gain and the corresponding tax liabilities. Tax-deferred exchanges under Section 1031 of the IRS allow taxpayers a reasonable period of time in which to complete a tax-deferred transaction.

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 - by Maurice Robinson, CRE, David Dornbusch, Jason Bass & Blaine Chase, CRE

The federal government contracts with private concessionaires to build and operate visitor-serving facilities at our National Parks. When these long-term contracts expire, there is an interesting appraisal problem: what is the current value of the concessionaire's improvements? This manuscript describes the innovative methodology used by two CREs in a recent dispute, in which they valued not only the concessionaire's improvements, but the contract and the land in the park itself.

- 26 PROPERTY LEVEL PERFORMANCE MEASUREMENT: THE KEY TO UNDERSTANDING
 - IMPLICIT FINANCIAL ATTRIBUTES by Kenneth P. Riggs, Jr., CRE, Jules H. Marling, Jr., CRE, & Ryan W. Harms Real estate is more heterogeneous in nature compared to other asset classes; there are substantial differences in the risk/return characteristics even among the same property types. Consider the fact that real estate is still a relatively local business, dependent on local employment trends (albeit potentially a national tenant). Relationships to tenants are key, and assets are tied to contract leases that can vary significantly among properties, even those office buildings across the street from one another. As the real estate market moves from a comfortable equilibrium to a riskier future outlook for supply and demand balances, investors need to embark upon a rigorous review of the performance characteristics of each property held in its portfolio. This manuscript is written from a property level or tactical basis to identify performance measures that can assist an investor in culling out the potentially weaker performing assets from the solidly positioned properties. Obviously, the authors recognize that there are secular and broad market trends that affect all properties, but a risk assessment of each property within a portfolio will enable an investor to potentially outperform market indices. After all, that is where investment professionals add value.
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strategically manage their core competencies, suggesting that this be done by identifying underlying causes of this rapidly changing environment and managing the organizations' capabilities to match expected future needs.

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by Alan R. Winger

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RECOGNIZING FORMER EDITORS IN CHIEF

A sany developing organism or institution, *Real Estate Issues* has grown and improved over its first 25 years of existence. Sometimes, however, the growth has been slow and the improvements have come sporadically. But inexorably, progress has occurred; each year has seen improvement over previous years. I am proud to have played a small part in the development of *REI*, along with former Managing Editor Linda Magad and current Managing Editor Faye Porter. Their knowledge and help made my role possible.

While noticeable improvements include the increasing number of editions from two per year at the beginning to four per year now and the transition from being non-refereed to being refereed by an editorial board, less noticeable but equally important improvements in quality have also occurred. The goal always has been to publish articles well written, primarily by top-level real estate professionals. The result has been increasingly relevant and timely articles that are of direct interest and help to real estate professionals.

REI has always published articles that deal with contemporary events and trends. Topics dealing with the economy, securitization, REITs, legal aspects, and social trends have occupied many pages. In fact, special editions have been devoted to some of these topics. One of the trends that I believe is most interesting and that will be of increasing importance to CREs is that of globalization of the real estate business and the consequent opportunities in international counseling. Usually, however, opportunities do not come up and bite us on the toe. We must prepare ourselves, devise educational programs, and develop relationships with real estate professionals in other countries—and, I might add, not just English-speaking countries.

Many CREs are involved in international counseling, and The Counselors is developing relationships with similar organizations in other countries, such as the RICS in Britain. We have also made strides in finding and inducting outstanding real estate professionals in other countries into The Counselors organization; the number of CREs from other countries, however, remains small relative to the U.S. contingent.

A major gift to the James E. Gibbons Educational Development Trust Fund may provide the impetus to an even greater effort in promoting international counseling. The gift is designated for the furtherance of international activities, and I hope it will lead to educational and networking conferences and programs with similar organizations abroad that express a desire to work with us. By combining resources with such organizations, The Counselors can become a truly international society of real estate professionals, and hopefully the content of *REI* will reflect this trend.



Halbert C. Smith, CRE Emeritus Editor in chief, 1994 - 1998

THE RESURGENCE OF NUCLEAR POWER IN THE U.S.

by William N. Kinnard, Jr., Ph.D., CRE & Gail L. Beron

ABOUT THE AUTHORS

William N. Kinnard, Jr., Ph.D., CRE, MAI, SREA, ASA, is president of the Real Estate Counseling Group of Connecticut, and Professor Emeritus at the University of Connecticut. His counseling practice concentrates on "unusual" properties such as nuclear power stations. He is a frequent speaker at conferences and seminars on the economic and fiscal impact of deregulation on electricity generating plants. He has published on related topics in Real Estate Issues, the Appraisal Journal, the Assessment Journal, and the Journal of Property Investment and Jaluation (UK). (E-mail: recgc@snet.net)

Gail L. Beron, MAI, SREA, is president of The Beron Company, West Bloomfield, Michigan. She has valued (Continued on page 11)

In a recent article in *Real Estate Issues*, the authors reviewed the likely impacts of deregulation in the electricity generating industry on real property tax assessments, tax revenues and budgets in local "host" communities (counties, cities, townships). In that context, the consensus view of the future of nuclear-fueled power generation was reported to be generally pessimistic. With some notable exceptions, the "authorities" were forecasting a diminishing role for nuclear power because of increasing numbers of plant closings; limited prospects of license renewal for the remaining operating plants; and (above all) the inability of high-cost nuclear power stations (NPS) to compete effectively with existing coal-fired plants and new, highly efficient and environmentally "clean" combined-cycle natural gas-fired plants.

Since that article was written, a series of major market events, coupled with record-high levels of crude oil, natural gas, and refined petroleum prices, have combined to call for re-evaluation of the likely role of nuclear power in the U.S. economy for at least the first half of the 21st century. This manuscript addresses the significance of those events, and of developments in the markets for fossil fuels, for the likely future of nuclear power.

BACKGROUND TO THE ANALYSIS

The 1992 Comprehensive National Energy Policy Act mandated competition (most especially competitive pricing at the wholesale level) in the electricity generation segment of the U.S. electric utility industry.³ Wholesale electricity price competition was intended to be achieved

through ownership and operation of generating facilities by non-regulated, non-utilities, which have emerged mostly as subsidiaries of regulated investor-owned utility companies (IOUs).

Beginning in 1997, several major states (e.g., California, Illinois, Michigan, New York), plus all the New England states, have sought to accelerate the transition to competitive pricing of wholesale electricity by requiring or "encouraging" their domestic IOUs to divest themselves of all generating capacity. In some states, there was serious debate over whether "non-utility" subsidiaries of domestic IOUs should be allowed to acquire or even bid for their parents' assets.

In a few other states (e.g., Pennsylvania), divestiture has not been required as part of the deregulation process. At the same time, real property tax assessment (and tax collection) has been transferred from the state to local "host" communities.

There have been over 60 auctions or negotiated sales involving more than 225 generating plants reported through August 2000. That process is confidently expected to continue at an even greater pace over at least the near-term future. For non-nuclear-fueled plants, reported sales prices have averaged 132 percent of book value. Nuclear-fueled plant sales prices have averaged well less than book value, however.

Sales prices per kilowatt of capacity (SPKW) for non-nuclear plants have generally increased from late 1997 through March 2000. For example, the sale of 4,276 megawatts (MW) of capacity in 21 plants in Maryland, New Jersey, and Pennsylvania by Sithe Energies, Inc., to Reliant Energy, was announced on February 22, 2000, as a \$2.1 billion transfer at an average price of \$491 per kilowatt (kW). Sithe acquired the same plants from GPU, Inc. on November 14, 1999, for an announced \$1.62 billion. This represents an approximately 30 percent increase in price over a three-month period. These Sithe transactions reflect both increasing competition among a relatively small group of bidders (indicating an oligopsonistic market for generating capacity) and the emergence of a speculative sub-market for nonnuclear generating plants.

The same concentration of buyers is evident in the market for nuclear power stations (NPS). *Table 1* summarizes the characteristics of 10 reported sales agreements for 13 NPS, involving 16 generating "units," from June 1998 through August 2000.

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Except for the sale of a small fractional interest in the Seabrook Power Station in New Hampshire, the reported SPKW of rated generating capacity were quite low over the first 15 months of sales. Some of those transactions were negotiated contracts, rather than auctions. The latter have become the norm for non-nuclear power plant sales. Most of the reported purchases prior to December 1999 were made by AmerGen (a partnership of PECO and British Energy) or by PECO alone. More recently, effective competition has emerged from Entergy, Dominion Resources, Constellation Energy, and Duke Energy.

While some energy industry pundits confidently predicted the demise of nuclear power and the large-scale shutdowns of NPS throughout the U.S., and there have been some closings (e.g., Millstone 1, Zion, Maine Yankee, Connecticut Yankee, among others), *Table 1* shows growth in sales activity, competition, and prices per kW.

Some announced NPS sales are missing from *Table 1:* for example, at least one NPS was transferred when the entire utility company was absorbed in a merger; and details of some pending "sales" were not yet available when this manuscript was written.

Two announced negotiated "sales" (both to AmerGen) were successfully challenged as "not in the public interest" by state public utility regulatory staff, in New York and Vermont. The affected NPS are the Niagara Mohawk interests in Nine Mile Point Units 1 and 2, and Vermont Yankee. These challenges were based on the premise that the bids were not high enough, both in dollar amounts and in "benefits" to the ratepayers in the seller's franchise area. A new form of regulatory agency involvement appears to have emerged to foster the "deregulation" process.

Trends in Sales Price per Kilowatt U.S. Nuclear Power Stations June 1998 - August 2000

Date Reported	Nuclear Power Station	Seller	Buyer	Capacity Purchased (MW)	Year License Expires	Reported Sales Price (\$000,000)	Sales Price per Kilowatt
86/90	Seabrook	Eastern Utilities Assoc.	Bay Corp. Holdings	33.7 (2.9%)	2032	\$3.2	\$95
10/98	Three Mile Island 1	GPU, Inc.	AmerGen	786	2014	\$23.0	\$29
86/11	Pilgrim	Boston Edison	Entergy	670	2012	\$13.0	\$19
04/99	Clinton	Illinois Power	AmerGen	950	2027(#)	\$20	\$21
66/60 66/60	Peach Bottom 2&3 Salem 1 & 2 Hope Creek	{ Conectiv Energy	PECO/PSEG PSEG PSEG	328 (15%) 328 (14.8%) 52 (5%)	2013/2014 2016/2021 2026	\$20	\$28
66/01	Oyster Creek	GPU	AmerGen	619	2009	\$10	\$16
66/01	Vermont Yankee	Multiple	Entergy	540	2012	\$23.5	\$44
12/00	Nine Mile Point 1	NYS E&G	1 Constellation	615	2008	\$273	\$443
12/00	Nine Mile Point 2	Rochester G&E		941 (82%)	2027	2498	8719
03/00	Indian Point 3 Fitzpatrick	(NY Power Authority	{ Entergy	980	2013	\$638	\$353
00/80	Millstone Unit 2 Millstone Unit 3	{ Northeast Utilities	(Dominion Resources	870	2015	(\$1,195	\$614

Source: Utility Company 8-K's; Vermont Yankee; Power OnLine; Yahoo! Finance

Notes: (a) Not operating in 1999

In earlier NPS transactions, SPKW was extremely low because of uncertainty over the likely cost and timing of decommissioning, responsibility and liability for contributions to the plant's decommissioning trust fund, and the likelihood of required on-site storage of spent fuel rods. More recently, some of that uncertainty has been removed by sellers topping off the trust fund as part of the sales transaction, and by a U.S. Court of Appeals decision discussed later in this manuscript.

The events that have occurred since the third quarter of 1999 have enhanced the relative attractiveness of investing in, owning, and operating NPS. The result has been active competition among a few NPS owner-operators. This has been especially noticeable for plants in the Northeastern U.S., where electricity rates are high, heavy user demand is concentrated in a relatively small transmission-distribution area, several NPS (mostly older, less efficient and unprofitable) have already been shut down, and price competition from oil-fired, coal-fired, and natural gas-fired generating plants is less aggressive than in other regions.

MARKET DEVELOPMENTS TOWARD SUSTAINING NUCLEAR POWER

1. Treatment of Decommissioning Costs

NRC requires each NPS owner-operator to set aside an annual sum in a Decommissioning Trust Fund. The amount required for each NPS is determined according to a formula established by NRC. In the past, Trust Funds into which only the annual amounts required by the formula have been paid, have been determined to be underfunded. Accordingly, buyers typically require sellers to "top off" the Trust Fund as a condition of purchasing a NPS. As a result, another element of uncertainty and perceived risk is greatly reduced, if not virtually eliminated.

While the level of anticipated decommissioning and on-site radioactive waste storage costs is still high and remains uncertain, responsibility for full funding of the transferred NPS Decommissioning Trust Fund has generally shifted back to the seller. With up-front or guaranteed "topping" of the fund required (and received) by purchasers, nominal "prices" have risen. Further, the process and technology for decommissioning have reportedly improved.

2. On-Site Spent-Fuel Storage and Monitoring Costs

In addition, the U.S. Court of Appeals for the District of Columbia ruled in early September 2000

that four specific NPS owner-operators have the right to sue the U.S. Department of Energy "for damages stemming from the DOE's failure to remove the fuel, starting in 1998, and transferring it to the Yucca Mountain facility in Nevada."⁴

A "permanent" storage site was mandated by Congress in the 1970s, to be available by 1998. Although several billion dollars were subsequently spent to create miles of deep underground vaults, at Yucca Mountain, and the internal train network to serve them, the facility has never been approved. It has not received any spent nuclear plant fuel.

The preliminary expectation of informed writers is that the Court of Appeals decision is applicable to all NPS sites at which spent fuel is being "temporarily" stored. Therefore, less burdensome storage and monitoring costs are forecast for the future.

3. License Renewal or Extension

Until March 2000, no NPS in the U.S. had had its operating license renewed by the Nuclear Regulatory Commission (NRC). Nevertheless, many observers and commentators during 1996-1998 assumed that such license renewal or extension would occur. By December 1999, NRC reported that over two dozen license renewal-extension applications were in process. This was nearly a decade before the actual expiration date of the earliest license. These early application requests indicated recognition of both the anticipated long application process before the final hearing, and the need to know well in advance whether plant shutdown would be required.

Table 2 shows that two license renewals were approved in March and May 2000. Each was for 20 years, effectively extending the license life of each NPS to 60 years. Three other formal applications were pending by September 2000.

Industry observers now forecast at least a dozen approvals from NRC by 2003. Because of nuclear power's low operating costs, expectations of profitable operations (assuming lower capital amortization requirements) over an extended operating life can lead to substantial deferral of decommissioning activity and expenditures. This reduces their negative present value impact on potential buyers.

4. Recovery of Stranded Costs

In most states actively pursuing deregulation and wholesale price competition for electricity

License Renewal Applications U.S. Nuclear Power Stations

Owner	Power Station	Application Date	Status
Constellation	Calvert Cliffs	April 1998	Approved 03/23/00 ⁽¹⁾
Duke Energy	Oconee	July 1998	Approved 05/23/00 ⁽²⁾
Entergy	Arkansas No. 1	February 2000	Pending
Georgia Power Co.	Edwin I. Hatch	March 2000	Pending
Florida P&L	Turkey Point 3 & 4	September 2000	Pending

Source: Power OnLine: 2/4/00; Yahoo! Finance 9/14/00

Notes: (1) Unit 1: 20 years from 2014 to 2034

Unit 2: 20 years from 2016 to 2036

(2) Unit 1: 20 years from 2013 to 2033 Units 2 & 3: 20 years from 2014 to 2034

generation,⁸ the applicable state regulatory commissions (however labeled) have ruled that IOUs are entitled to recover most or all of their "prudently incurred" stranded costs on generating plant investments. "Stranded costs" are the portions of plant investments judged by those same state regulatory agencies as likely to be non-recoverable in a competitive wholesale price environment. In brief, "stranded costs" are the excess of Net Book Value (depreciated original cost) over current Market Value of generating plants, as determined by the state regulatory agency (or the courts, if necessary). NPS have particularly high "stranded costs."

The recovery of these "stranded costs," in nearly every state where a determination has been made, is achieved through a "temporary" surcharge (usually called a "transition fee"). This "transition fee" is typically added to all electricity bills within the IOU's franchise area for five - nine years. Whenever a generating plant (nuclear or non-nuclear) is sold by an IOU at a price above its Book Value, the "profit" is deducted from the total of "stranded costs" the IOU is permitted to recover. The practical effect of such "profits" is to shorten the duration of the "transition fee." Hence the interest of states to mandate or "encourage" divestiture of non-nuclear generating plants, in particular.

This process has reduced substantially the uncertainty surrounding the recovery of "stranded costs," as well as their amount, for any IOU.

5. Increased Uncertainty Over Coal-Fired Generation

While coal-fired electricity generation remains the second least costly method (after hydro), air quality standards enforcement and control pose a serious threat to the continued dominance of "king coal" usage in power plants. New coal plant construction has effectively disappeared, because environmental permits are virtually impossible to obtain.

Moreover, on March 3, 2000, the U.S. Court of Appeals in Washington, DC, upheld EPA's "State Implementation Plan" (SIP Call). This program requires power plants (and other industries) to comply with stringent nitrous oxide (NO_x) emission limits, beginning with the 2003 "ozone season." Although some Congressional opposition to the plan was reported on March 16, EPA's continued lawsuits against coal-fired power plants combine to add considerable uncertainty to the long-term future prospects for major dependence on coal plants in the U.S. power grid system. This offers additional competitive opportunities for continued NPS operations and profits.

6. Increasing Cost of Natural Gas Plants and Fuel

In the past few years, there has been almost total reliance in the U.S. on gas-fired combined-cycle turbines for new generating capacity. This has had two foreseeable (and foreseen) results: the price of natural gas has increased (and is not expected to decline over the long run), and the cost of gas-fired generating plant construction has increased. While the average cost per kW of capacity over the 1998-99 period was \$457,10 the most recently reported projects have had much higher average costs. Despite economies of scale for larger plants, Duke Energy North America announced the sale of its majority interest in a nearly-completed 500 MW plant to Calpine Corporation on March 7, 2000, for \$599 per kW. Only two years previously, the "going" construction cost was widely acknowledged to be \$400 per kW.11

Since a major competitive advantage of gasfired generation has been its relatively low capital cost (as compared to not only nuclear, but also coal, oil, and hydro), the trend of rising cost per kW of gas-fired capacity also enhances the relative competitiveness of nuclear power. This is especially the case when existing NPS can be acquired for markedly less than \$400 per kW, and have lower fuel costs.¹²

7. Emerging Economies of Scale for Nuclear Ownership

It is widely acknowledged in the power industry that a critical mass of nuclear-fueled capacity is necessary in order to achieve sustained operating profitability over the next 15-20 years.¹³ Indeed, Keuter notes that, "According to some analysts on Wall Street, companies must be willing to own a portfolio of 15,000 megawatts of nuclear generation to get the full benefits of being a large operator." Such companies must therefore be well-funded and capable of operating a NPS "fleet" competently. Keuter notes further that, "The one common thread that runs through all high-performing plants is good employees." 15

As a result, consolidation of ownership is evident, and is expected to continue, in the nuclear power industry. *Table 1* indicates that this is happening already. PECO is a major partner in AmerGen Energy, and has also announced plans to merge with Commonwealth Edison (the largest IOU owner-operator of NPS, with six active plants). Entergy Nuclear will operate Nine Mile Point 1 and 2, for Rochester Gas & Electric, in New York state, and has purchased the two New York Power Authority plants (and Vermont Yankee as well).

Historically, the valuation of NPS under the regulatory regime has been based on original cost less depreciation, as mandated by the Federal Energy Regulatory Commission (FERC). The result has reflected Net Book Value, which is an accounting concept. This procedure has also established the Rate Base of each IOU. The result has been that a hypothetical informed purchaser-investor would pay no more for a property than the present worth of the net income that could be earned from operating a NPS. In the regulatory environment, that led to virtual certainty that "Market Value" would closely approximate Net Book Value.

Dominion (Virginia Power) also bid for the NYPA NPS, and is purchasing Millstone 2 and 3. Duke Energy is another potential contender, according to industry analysts, as is Constellation. So far, that is the list of firms actively seeking to acquire and operate NPS in the U.S. "Competition" has become oligopsony in the market for power plants, and oligopoly in the sale of nuclear-generated power.

IMPACT ON NUCLEAR POWER STATION VALUATION METHODOLOGY

Valuation Under Regulation

Historically, the valuation of NPS under the regulatory regime has been based on original cost less depreciation, as mandated by the Federal Energy Regulatory Commission (FERC). The result has reflected Net Book Value, which is an accounting concept. This procedure has also established the Rate Base of each IOU. The result has been that a hypothetical informed purchaser-investor would pay no more for a property than the present worth of the net income that could be earned from operating a NPS. In the regulatory environment, that led to virtual certainty that "Market Value" would closely approximate Net Book Value.

In some states, notably New York, an alternative procedure was mandated by the Courts. It was ostensibly an application of Reproduction Cost New

universally estimated by *trending* Original Cost according to a construction cost index (developed for facilities that were no longer being constructed). ¹⁶ Even in New York state, however, the ultimate "answers" approximated Net Book Value.

Moreover, prior to the onset of deregulation, the real property of IOUs was most often valued for property tax purposes on a statewide basis (usually by a designated state agency). This is termed the Unitary Method of valuation. Since all of the operating assets of an IOU within a state were integrated under a single ownership, the combined total value of those assets was estimated. The values of properties within individual taxing jurisdictions were then allocated by the designated state agency in accordance with state legislation and/or regulations.

In New England, the Middle Atlantic states and some Mid-Western states, however, "situs valuation" was applied. In that system, all of the assets of an IOU within a particular taxing jurisdiction (the town in New England, or the county elsewhere) are assessed and taxed by that local jurisdiction. This meant that towns or counties that were host communities for electric power stations (especially NPS) reaped the fiscal benefits of having a large, high-cost taxpaying facility within their boundaries.

Impact of Deregulation

With deregulation, and more particularly following divestiture of generating facilities by IOUs, each power station, whether nuclear or non-nuclear, is effectively a stand-alone asset. The transmission lines and distribution lines over which the electricity flows continue to be owned and operated by whatever IOU or other entity has the local franchise for transmission and distribution. As noted earlier, the transmission and distribution functions within the electric power industry will continue to be closely regulated by both Federal (FERC) and State (e.g., PUC) agencies. In some states or groups of states, an Independent Service Organization (created under the 1992 Federal legislation) will act as traffic flow manager for transmission lines within that state or region.

For property valuation purposes, however, the notion of unitary valuation is being replaced gradually because of the increasing necessity to value each generating plant (NPS or non-nuclear) as a separate, free-standing asset.

METHODS OF VALUATION UNDER DEREGULATION

With the emergence of a market for generating plants, as summarized in *Table 1*, the opportunity to utilize variants of the standard Three Approaches to property valuation has emerged. Publicly reported sales of individual NPS (or groups) provide a basis for Comparative Sales Analysis. There is an active construction market for new generating capacity, virtually all of which consists of gas-fired turbines. These new facilities provide a basis for estimating Replacement Cost New, at least as far as nuclear generating capacity is concerned.

Finally, industry deregulation has led to competitive markets for wholesale electricity at the generating plant "gate." This can provide the basis for a version of the Income Capitalization Approach, even though generating plants (especially NPS) are typically not leased, nor is there market evidence that any speculative construction projects (non-nuclear) have been undertaken. (The reported sale of Duke Energy North America's 78.5 percent share in the non-nuclear Hidalgo Energy project to Calpine Corporation might be classified as such.)

The market information available to be applied in valuations using the Comparative Sales Approach, Replacement Cost Approach or Income Capitalization Approach is less than ideal. Therefore, only reasonably approximate figures can be produced. Nevertheless, certain market tendencies have emerged, as *Table 1* indicates.

1. Comparative Sales Approach

Table 1 does indicate that substantial market activity in sales of NPS has been reported through auctions and negotiated sales since mid-1998. The 10 transactions covered by *Table 1* include 16 units in 13 NPS. A combined total capacity of nearly 9,500 MW has been transferred. While this is only a small percentage of the total NPS generating capacity in the U.S., it is reasonably representative of the market areas in which divestiture has been mandated or "encouraged."

Most of the activity in sales transfers (and closings) of NPS has been concentrated in the Northeastern U.S. The region is characterized by high-priced electricity, large concentrations of electricity users within relatively short distances from generating plants, and a number of older NPS in single-plant operations.

It has already been noted that, generally speaking, non-nuclear generating plants have sold at nominal prices in excess of their book values. For those

IOUs with nuclear generating capacity, these "profits" have served as a basis to offset stranded costs. This has enabled the selling companies to write down NPS book values substantially, without reporting a "loss."

The nominal prices for NPS acquisition have been well below book value, but rising. Still, they have only recently exceeded 10 percent of book value. While the sort of competition being reported for NPS in New York State (the NIMO and NYPA sales) has resulted in increased nominal SPKW for nuclear facilities, the prices actually paid for the real property (and taxable tangible personal property as well) will likely remain a fraction of book value.

The actual transactions involving transfers of NPS are both complex and complicated. First, the prices commonly include nuclear fuel available onsite (or even contracted for). For example, the reported sales price paid by AmerGen to GPU for Three Mile Island Unit 1 was \$100 million. Only \$23 million was paid for the plant, however; the other \$77 million was the price of the fuel on-site.

Another example of price inflation or "puffery" is the assertion by Entergy that it paid "the State of New York" \$1.42 billion for the Indian Point 3 and James A. Fitzpatrick NPS owned by the New York Power Authority. The present worth of the payments offered for the real property and tangible personal property calculates to \$398.2 million plus an additional \$19.4 million, which would be "offset" by a reduction of \$50 million "related to decommissioning."

These examples illustrate the caution with which reported sales prices must be treated and used. Whatever is reported most likely represents the upper limit to market price, and to market value as well. The necessary conclusion remains that the prices paid for NPS in the recent past, and those likely to be paid in the foreseeable future, are and will represent less than book value, with an upper limit in the range suggested by the NYPA and Northeast Utilities sales.

2. Cost Approach

The only type of power plant that has been constructed in any numbers recently (since 1997 at least) is a natural gas-fired turbine facility, typically in combined-cycle format. Moreover, no NPS has been started in the U.S. since 1973. This means that any truly market-based Cost Approach must start

In brief, no one of the three potentially applicable "approaches" to valuation is clearly superior to the others in every NPS valuation assignment. None alone is likely to reflect fully the detail or quality of market data that is required, or at least highly desirable. The important point that emerges is that an appraiser (or assessor) must spend the time and effort necessary to accumulate as much market information as possible, and interview as many knowledgeable market participants as time and resources permit.

with an estimate of Replacement Cost New. Because of the different technologies involved in gasfired turbines and NPS, the most meaningful basis for any sort of comparison is total generating capacity. This renders any Cost New figure less than "representative" from the outset. Nevertheless, because of the difficulties in developing "clean" sales prices for the real property (and sometimes tangible personal property), the Cost Approach is still widely advocated by many appraisers and most assessors.

With the recent renewals of NPS licenses by NRC shown in Table 2, and the announced backlog of planned applications from over 30 others, there is somewhat more variability associated with the estimate of Remaining Economic Life than was the case when it was regularly assumed that there would be no license renewal or extension. Another important consideration is that total operating expenses per kilowatt hour (kWH) produced at a gasfired turbine plant are higher than they are at an NPS, and recently have been rising with increased natural gas prices. This means that some adjustment must be made for "negative obsolescence," when valuing the NPS using Replacement Cost New based on gas-fired turbines. Thus, there is greater uncertainty and less stability associated with application of the Cost Approach to the value of a NPS than was the case in the regulatory market environment. The Cost Approach is no longer necessarily the exclusive valuation method of choice.

3. Income Capitalization Approach

Because NPS facilities are independent, freestanding entities in a deregulated market environment, it is possible to estimate and forecast the stream of both revenues and operating expenses directly associated with the production and sale of electricity at an individual facility. That electricity is the *product* that is generated and sold at the site. It therefore includes elements of business income as well as income to the real estate (and tangible personal property, if included in the valuation). Therefore, any application of Income Capitalization is likely to represent an overstatement of the Market Value of the real property of a NPS (and possibly personal property as well). Nevertheless, this method of valuation is being widely advocated by experts in the field.¹⁷

One of the important issues to resolve is the identification of the appropriate Capitalization Rate. This must reflect both the risk associated with the ownership and operation of a NPS, and the previously noted uncertainty (admittedly diminished since the Calvert Cliffs and Oconee renewals listed in Table 2) about the Remaining Economic Life of the facility. In the Income Capitalization Approach, the impact of anticipated (and required) future decommissioning costs and possible on-site radioactive waste storage costs must also be considered as a "residual" amount or negative reversion. This negative impact is tempered somewhat by the U.S. Court of Appeals decision about on-site spent-fuel storage costs, discussed earlier in this article. (See Endnote 4.)

4. Summary of Valuation Methodology Issues

In brief, no one of the three potentially applicable "approaches" to valuation is clearly superior to the others in every NPS valuation assignment. None alone is likely to reflect fully the detail or quality of market data that is required, or at least highly desirable. The important point that emerges is that an appraiser (or assessor) must spend the time and effort necessary to accumulate as much market information as possible, and interview as many knowledgeable market participants as time and resources permit. This will help to avoid the easy assumption that the Cost Approach alone will necessarily provide the "best" indicator of the value of the real property only, merely because both the Comparable Sales Approach and the Income Capitalization Approach incorporate elements of intangible business assets and their associated incomes or prices.

IMPLICATIONS FOR NUCLEAR POWER STATIONS AND THEIR VALUATION

Beginning no later than mid-1998, the fortunes and prospects for nuclear power (and hence NPS) in the

U.S. have improved steadily from the depths of suspicion, fear, and stigma that characterized its market status following the Three Mile Island "incident" in 1979, through the Chernobyl meltdown in 1986, to the early days of deregulation (1992-1996). This dramatic shift has come about because of at least 10 market developments and events. The net result has been a reduction in uncertainty and perceived risks about the ownership and operation of NPS among enough operators and potential purchasers to create competitive bidding for NPS and rising market prices.

The important developments and events, not necessarily in chronological order, have been:

- Continuing Increased Demand for Electricity in Supply-Constrained Markets. In some major market areas (e.g., California), little or no new generating capacity of any kind, and little or no new transmission capacity, has been built since the early 1990s. Whatever the reasons (which are many and varied) for this inactivity, the U.S. electricity system cannot tolerate the loss of nuclear generating capacity until a massive program of replacement is planned, executed and operational. No such program is reported to be under way. The U.S. needs as much of its nuclear generating capacity as can be reasonably retained.
- The Overall Quality of the Remaining U.S. Nuclear Generating Plants Has Improved. Many of the least efficient NPS have been closed; a few have been transferred to more experienced, more efficient operators. The net result is an overall increase in average capacity factors, plus an overall decrease in generating expenses (including fuel and O&A).
- 3. A Competitive Market for the Sale and Purchase of NPS Has Emerged. Sales that have occurred since mid-1998 were anticipated earlier. Competitive bidding has emerged (see Table 1). In two instances (New York and Vermont), regulators have rejected proposed negotiated sales prices on the grounds that they were "not in the public interest." This translates to "Not High Enough." In both cases, higher prices were achieved, following mandated competitive bidding.
- Overall, Higher Prices per KWH Have Been Realized Since Competitive Bidding Took Over NPS Auction Sales. (See Table 1). Many experts and students of the market have forecast even higher prices. One

major reason given is the diminution in uncertainty and perceived risk for potential purchaser operators that has been reported and inferred.

- 5. The NPS Generating Industry Is An Emerging Oligopoly, with some eight 10 major, active participants. One-plant operators are being eliminated by the economic realities of the market. Multiplant owner-operators have been able to take advantage of the economies of scale in managing the generating process.
- Increased Probability of License Renewal. By 1997, applications for license renewal of NPS had been requested for over a dozen nuclear plants; by late 1999, that figure had doubled. From the mid-1990s, there was growing optimism that some license renewals would be generated, once NRC's criteria were known and understood.

On March 23, 2000, the Calvert Cliffs NPS of Baltimore Gas & Electric (Constellation Enterprises) was granted a 20-year renewal until 2034 for Unit 1, and until 2036 for Unit 2. Then on May 23, 2000, Duke Energy's Oconee NPS received 20-year renewals for Unit 1 until 2033, and for Units 2 and 3 until 2034. These actions effectively reduced market uncertainty about license renewals for NPS generally, and enhanced the Market Value of not only those two NPS but of all similarly situated plants with comparable operating and safety histories.

- 7. Stranded Cost Recovery. The judicial determination in many states of the amount of both stranded costs and recoverable stranded costs, and the subsequent identification of both the amount and maximum duration of the "transition fee" surcharge, have further reduced uncertainty for large numbers of NPS operators about likely near-term revenues. This reduces perceived risk, and hence the risk rate applicable in the Income Capitalization Approach.
- 8. Decommissioning Costs. The owner-operator of an NPS which has been shut down or whose license has expired must decommission the plant in accordance with NRC regulations and requirements. Decommissioning is an exacting, time-consuming and very costly process. The further into the future it can be deferred, the lower the present worth of that cost is likely to be. Moreover, new technologies may well emerge in the interim, reducing the absolute cost of decommissioning.

Decommissioning costs remain a real and major future liability, but the uncertainty and risk associated with them has been substantially reduced.

- 9. On-Site Spent Fuel Storage and Monitoring Expenses. As a consequence of the failure of DOE to find and develop a "permanent" storage site for spent nuclear fuel, NPS have been required to develop and maintain "temporary" on-site storage facilities, which add to overhead and administration expenses without any offsetting revenue or cost savings. In a recent decision cited earlier (see Endnote 4), the U.S. Court of Appeals in the District of Columbia ruled that four IOUs with NPS have the right to sue the U.S. Government for that failure by DOE. Commentators opine that this decision most probably applies to all NPS. To that extent, there has been a further reduction in uncertainty and risk associated with long-term on-site spent-fuel storage and the expense it entails.
- 10. Diminished Competitive Advantage of Generating Plants Using Fossil Fuel. Increasing (and increasingly volatile) prices of heating or bunker oil, of natural gas, and of low-sulphur coal have worked to widen the spread of non-nuclear fuel costs and operating expenses, over those for NPS. The EPA State Implementation Plan noted earlier has placed the continued operation of many coal-fired generating plants in question, thereby enhancing the need for continued operation of existing NPS. Further, the nearly exclusive reliance on gas-fired combined-cycle turbine plants for construction of new generating capacity in the U.S. has exacerbated the increased demand for, and hence prices of, both natural gas and gas-fired generating turbines.

All of these market developments have enhanced the relative competitive position of nuclear-fueled power generation. As a result, longer remaining production and economic lives are being forecast for more NPS. The ultimate consequence is expected to be a further strengthening of their Market Value at levels closer to, but still below, the Book Values that would have applied under the regulatory regime. REI25

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- 13. Keuter, op.cit.
- 14. Ibid., p. 29.
- 15. Ibid.
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(continued from page 1)

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Section 1031 - Tax Deferred Exchanges: 'Real Estate's Best-Kept Secret for Tax Relief'

by Joel Rosenfeld, CRE

ne of the least understood tax relief provisions of the Internal Revenue Code (IRC) is the tax-deferred exchange under Section 1031 of the IRC. Although the tax shelter days are basically gone for real estate investors, and the passive loss regulations work against them, the tax-deferred exchange lives on as a viable and excellent alternative to defer income taxes upon the sale of real estate.

An exchange is broadly defined as a reciprocal transfer of real property that has certain tax advantages over a sale. Definite procedures must be followed in order to qualify the transfer as an exchange.

The choice of a tax-deferred exchange affords the seller/taxpayer an exceptional opportunity upon selling the property. A tax-deferred exchange can best be defined as a sale without immediate tax implications with a window to replace the property with like-kind property and reduce the basis of the replacement property by the deferred gain, thereby deferring the tax to a future date.

Included here is a series of questions and answers that will help explain how tax-deferred exchanges work:

WHAT IS THE DIFFERENCE BETWEEN A SIMULTANEOUS EXCHANGE AND A DEFERRED EXCHANGE?

Once the provisions of the tax-deferred exchange are understood, the process is perhaps more mechanical and form oriented. The misconception of tax-deferred exchanges lies with the thought and confusion that

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properties must be "swapped" simultaneously. For example, property owner "A" wishes to exchange an office building with property owner "B" who is looking to sell an office building. If both parties agree to exchange their properties, they have entered into a simultaneous exchange. In reality, the simultaneous exchange rarely occurs because of the complications of the identifying process, the timing, and establishing values. A tax-deferred exchange, however, affords the seller a time frame in which to sell the property ("the relinquished property"); seek other property ("the replacement property"); and comply with the provisions of Section 1031 of the IRC. In essence, a deferred exchange can qualify for deferral of taxable gain under Section 1031 of the IRC even if there is a time frame between the seller's transfer of the relinquished property and the purchase of the replacement property. As a result of the time parameters and the available options for selecting the replacement property, the tax-deferred exchange is one of the few remaining tax shelters for real estate owners and investors.

HOW MANY REPLACEMENT PROPERTIES MAY THE SELLER IDENTIFY?

When seeking replacement property, it is advantageous to identify more than one property in the event that the primary property cannot be acquired. The regulations provide that the seller must meet any one of the following three alternatives for property identification:

- One to three properties without regard to the fair market value.
- Any number of properties, provided that the aggregate fair market value does not exceed 200 percent of the relinquished property.
- Any number of properties as long as the acquisition of the replacement property represents 95 percent of the identified properties. (e.g., If you identify \$2,000,000 in replacement property and purchase \$1,900,000.)

Of the three alternatives, the "three property rule" is the one most sellers choose.

WHAT IS "LIKE-KIND" PROPERTY?

What qualifies as a like-kind property exchange is much broader than what many property owners may believe. The physical similarity of the properties, such as an office building for an office building, is not important. The tax regulations simply state that real property must be exchanged for real property. The purpose and intent (investment) of the taxpayer takes precedence. The following examples

illustrate some qualified like-kind property exchanges:

- An office building for a shopping center
- A shopping center for land
- · Land for an industrial building
- A fee simple for a tenancy-in-common
- An industrial building for a multi-family property

Due to the broad definition of like-kind property, the identification of replacement property is easily facilitated. Under no circumstances, however, may real estate be exchanged for a limited or general partnership interest of an entity which holds real estate or for stock in a corporation that holds real estate (such as a REIT).

WHAT AND WHO IS A QUALIFIED INTERMEDIARY?

A qualified intermediary (QI) is an individual or an entity that theoretically acquires the seller's relinquished property, and ultimately resells it to the buyer. The QI will acquire the replacement property and transfer the replacement property to the seller. It is the QI who facilitates the tax-deferred exchange.

The use of a QI is mandatory when entering into a tax-deferred exchange. The selection of a QI that is knowledgeable about Section 1031 will greatly facilitate the process.

One, however, must be very cautious in the selection, as the QI must meet the qualifications established by the tax regulations. The QI must not be the seller, or a "disqualified person." For purposes of a tax-deferred exchange, a disqualified person is a person or an entity that acts as a seller. This includes those who fill any of the following roles:

- Employee
- Attorney or accountant
- Real estate broker
- Any related party (as defined by IRC 267(b) or 707(b) family members, related corporations, etc.)

It is imperative that a seller seeks out an acceptable QI, such as a title company, a financial institution, a trust, or an escrow service company. For unexplained reasons, Section 1031 Exchanges are entered into more frequently on the West Coast than the East Coast. As a result, there appears to be a greater selection of very capable QIs in the West.

There is a misconception in the use of a QI for the mechanical transfer of the property. Under "direct deeding" of the relinquished property, the seller deeds the property to the ultimate buyer (not the QI). Furthermore, the owner of the replacement property directly deeds the property to the seller (not the QI). Hence, the transactions are completed without the QI ever taking title to the relinquished or replacement property.

The following example demonstrates how a gain is deferred on the sale of property:

Seller ("X") owns an office building that he desires to sell, and prefers to defer the gain.

Land	\$600,000
Building	\$3,000,000
Improvements	\$100,000
	\$3,700,000
Less: Accumulated depreciation	(900,000)
Adjusted basis	\$2,800,000
Mortgage on property	\$1,500,000
Selling price	\$3,500,000

If "X" sells the property, and does not enter into a tax-deferred exchange, he will realize and recognize a taxable gain as follows:

\$3,500,000
\$2,800,000
\$700,000
x 25%
\$175,000

^{*} According to the 1997 Tax Act, the tax of 25 percent is based on \$700,000 of depreciation recapture.

If "X" enters into a tax-deferred exchange by identifying like-kind property within 45 days, and closes within the 180-day period, the tax on the gain would be deferred as follows:

Replacement property purchase price	\$3,800,000
Cash down payment	\$1,000,000
Assumed debt	\$2,800,000

Since equity was replaced with equity and debt was replaced with other debt, and the replacement property acquisition price of \$3.8 million exceeds the There is a misconception in the use of a QI for the mechanical transfer of the property. Under "direct deeding" of the relinquished property, the seller deeds the property to the ultimate buyer (not the QI). Furthermore, the owner of the replacement property directly deeds the property to the seller (not the QI). Hence, the transactions are completed without the QI ever taking title to the relinquished or replacement property.

\$3.5 million of relinquished property, "X" receives no net boot. The entire gain of \$700,000 is tax-deferred. The basis of the replacement property is adjusted as follows:

Replacement	
property acquired	\$3,800,000
Gain not recognized	(\$700,000)
New basis in	
replacement property	\$3,100,000

By completing the tax-deferred exchange, "X" has successfully deferred a gain of \$700,000 and a tax liability of \$175,000.

CAN YOU COMPLETE A TAX-DEFERRED EXCHANGE WITH RELATED PERSONS?

Very often when property is sold and the requirement for replacement property needs to be completed, the seller would prefer to use property already owned as the replacement property. An exchange between related persons can qualify for non-recognition treatment under IRC 1031.

A definition of "Related Persons" is described in IRC 267(b) and IRC 707(b) as follows:

- 1. Family members (siblings, spouse, ancestors, and lineal descendants)
- Individual and corporation, where more than 50 percent in value of the stock is owned directly or indirectly by or for such individual
- Two corporations that are part of the same control group
- 4. A grantor and a fiduciary of the same trust
- 5. A fiduciary and beneficiary of the same trust
- A fiduciary of a trust and the fiduciary or beneficiary of another trust where the same person is

the grantor of both trusts

- 7. A fiduciary of a trust and a corporation more than 50 percent in value of the outstanding stock of which is owned, directly or indirectly, by or for the trust or by or for the grantor of the trust
- 8. A person and an IRC Section 501 organization if the organization is controlled by that person or that person's family
- 9. A corporation and a partnership if the same persons own more than 50 percent in value of the outstanding stock of the corporation and more than 50 percent of capital interest or profits interest in the partnership
- 10. An S Corporation and another S Corporation or a C Corporation if the same person own more than 50 percent of the value of the outstanding stock of each corporation
- 11.A partnership and a person owning, directly or indirectly, more than 50 percent of the capital interest, or profits interest, in such partnership
- 12. Two partnerships in which the same persons own, directly or indirectly, more than 50 percent capital interests or profits interests
- An executor of an estate and the beneficiaries of the estate

If property is exchanged with a related person, and the property is disposed of by the related person or the taxpayer of the property, either one received in the exchange within two years of the date of transfer, the gain or loss must be reported. The two-year holding period is critical in order to sustain the tax-deferred exchange. There are certain exceptions to the two-year holding period, but they are too numerous to discuss for the purposes of this article.

The Internal Revenue Service ("IRS") will carefully scrutinize related party transactions to identify tax avoidance schemes. If the related party transaction is an "arms length" exchange and tax avoidance is not the motive, the related party exchange should work.

WHAT HAPPENS IF THE PARTIES DISAGREE ABOUT COMPLETING A TAX-DEFERRED EXCHANGE?

It is not uncommon when a partnership sells its property, the partners may elect to go their separate ways. Still, many desire to use IRC 1031 to tax defer the tax impact of a gain. The split-up of the partnership and the utilization of IRC 1031 can be structured as follows:

If the partners want to split-up:

The partnership can dissolve, and distribute the

property ownership pro-rata into a tenancy-in-common. Under IRC 731, distributions of partnership property is deemed tax-free. Subsequent to the receipt of an undivided interest in the property, each co-tenant may exchange his real property interest for another property interest.

If the partners want to continue their relationship:

Each partner can identify a separate replacement property, allowing the partnership to exchange its property for specific replacement properties. After taking title to the replacement properties, the partnership may distribute the properties in a taxfree liquidation of the partners interest.

Depending on the desires of the partners, another option available is the designation of property by each partner, whereby the partnership exchanges its property for the designated property. They will then continue to operate with special allocations of the income or losses to each respective partner.

WHAT HAPPENS IF THE REPLACEMENT PROPERTY IS IDENTIFIED BEFORE THE SALE OF THE RELINQUISHED PROPERTY?

In certain situations, it is likely that a taxpayer may identify the replacement property before the relinquished property is sold. If the seller of the replacement property is willing to extend the closing date in order to sell the property, then a deferred exchange can be completed. If the seller does not agree to an extension of the closing date, the taxpayer may use a *reverse exchange*.

By entering into a reverse exchange, an unrelated third party to the exchanger acquires and holds the replacement property. This is known as "parking" the property.

The selection of the unrelated third party is often the Ql, who will park the property until the seller disposes of it. At that time, the Ql will assist in the completion of the exchange by conveying the replacement property to the seller.

There has been some question as to the use of the parking method. Until recently, the IRS had reserved judgment as to whether Section 1031 applies if the replacement property is acquired before the relinquished property is transferred. Recently, however, the IRS issued Revenue Procedure 2000-37, which provides a Safe Harbor for a taxpayer engaging in the parking of property. The regulation cites a). the qualification of property as "replacement property" or "relinquished property"; and b). the

acceptance of the QI as the beneficial owner of the property for federal income tax purposes (as long as the property has been acquired on or after September 15, 2000). As a result of this, we can anticipate that taxpayers may engage in more reverse exchanges.

CAN A REFINANCE OCCUR PRIOR TO EXCHANGING AND SUBSEQUENT TO EXCHANGING?

Pre-Exchange Refinancings

The current position of authority states that where a pre-exchange refinancing is completed as part of an exchange transaction, the cash received by a taxpayer from the refinancing will be treated as cash ("boot") received on the disposition of the relinquished property. And consequently, the boot will be taxable.

Post-Exchange Refinancings

If the taxpayer completes a post-exchange refinance, there should be less concern for tax purposes than a pre-exchange refinance. Thus, if a taxpayer refinances property immediately upon taking title, receipt of the cash will not be treated as boot and will not be taxable.

The theoretical difference between the pre- and post-exchange lies with the concept of repayments of the debt. In a post-exchange refinancing, the taxpayer has the responsibility for repayment of the debt, whereas the taxpayer in a pre-exchange refinancing is relieved of the liability upon the transfer of the relinquished property.

CONCLUSION

Sellers should view tax-deferred exchanges as a viable tax planning tool. Properly structured tax-deferred exchanges can defer significant gain and the corresponding tax liabilities. Most important to remember is that sellers do not have to enter into a simultaneous exchange which, more often than not, is nearly impossible to effectuate. Tax-deferred exchanges under Section 1031 of the IRS code allow taxpayers a reasonable period of time in which to complete a tax-deferred transaction. RELES

GLOSSARY OF KEY TERMS

- Adjusted basis the basis of the property, plus any improvements, reduced by any depreciation taken on the property
- Basis the seller's original cost of the property (before depreciation)
- Boot any considerations (cash or property) received

- other than real property. It does not qualify under Section 1031 and may be taxable
- Deferred Exchange an exchange qualifying for nonrecognition of gain, whereby the sold property (relinquished property) is replaced (replacement property) within the statutory time, as provided by the IRC
- Exchange Period date that seller must close on the replacement property before the earlier of 1). 180 days after the transfer of the relinquished property; or 2). the due date of the seller's federal income tax return (including extensions) for the year in which the relinquished property is transferred
- Identification Period begins on the date the seller transfers the relinquished property and ends on midnight of the 45th day thereafter
- Parking term used to refer to the holding of a replacement property by an unrelated third party in the case of a reverse exchange
- Qualified Intermediary (QI) a person or entity that acquires the replacement property for the seller in exchange for the seller's relinquished property
- Realized gain the difference between the sale price (cash and other property), and the adjusted basis
- Recognized gain that portion of the realized gain that is taxable
- Relinquished property the property that the seller disposes of in the exchange
- Replacement property the like-kind property the seller acquires in the exchange
- Reverse exchange strategy used by the seller to complete a deferred exchange whereby an unrelated third party acquires and holds the replacement property until the relinquished property can be sold.

How to Value Commercial Improvements in a National Park

by Maurice Robinson, CRE, David Dornbusch, Jason Bass & Blaine Chase, CRE

Recently, we were engaged by the National Park Service (NPS) to appraise the structures and other improvements that have been constructed by commercial vendors or "concessionaires" operating hotels, restaurants, and other hospitality services in National Parks. The results of these appraisals are being used to determine the compensation due concessionaires for their in-park investment in fixed improvements upon expiration of the contracts conveying them the right to do business within parks.

The distinctive setting of a National Park, the myriad of statutory rules governing concession contracting, the historic nature of many park improvements, and the numerous benefits and controls that the government provides and imposes, respectively, on park concession operations combine to make the appraisal of commercial facilities in a National Park uniquely challenging. While we cannot, for reasons of confidentiality, divulge any of the specific elements of our completed or ongoing appraisal assignments, we can discuss portions of what we believe to be the appropriate methods for appraisal in a National Park. Accordingly, the purpose of this manuscript is to summarize some of these methods and hopefully, initiate some professional discussion as to their merit.

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Blaine Chase, CRE, leads Chase & Co., a real estate appraisal (Continued on page 25)

BACKGROUND

Thanks to visionaries like John Muir and Teddy Roosevelt, certain federal lands within the United States, containing great natural beauty or historic significance, have been preserved as National Parks for future generations to enjoy. The country's first National Park, Yellowstone, was founded in 1887. Though several other National

Parks were also established before the end of the 19th century, it was not until 1916 that the federal government created a separate agency, the National Park Service (NPS), to administer the growing National Park system. Even then, it was an additional 17 years, 1933, before the NPS actually assumed management of many of the country's National Parks from other federal agencies such as the National Forest Service and Department of Defense.

Since its inception, the NPS has sought not only to fulfill its explicit mandate to protect park natural and cultural resources for the benefit of future generations, but also to provide the current generation of park visitors with adequate access to those resources and on-site amenities to facilitate their enjoyment. Specifically to address visitor needs, the NPS has often sought private sector assistance. In fact, even before the NPS was established, the government frequently partnered with vendors in an effort to make remote, and in many cases inhospitable, park locations more accessible and convenient to the public. From the beginning, most of this collaboration took form as concession contracts. Under these contracts, the government granted vendors, or concessionaires, the right to provide park visitors with specific commercial hospitality services while inside parks (e.g., lodging, food & beverage, retail, transportation services, etc.).

These contracts were not distributed through competitive bidding, but instead negotiated with selected vendors who, for the most part, were at the time already providing some unsupervised visitor services within and adjacent to the parks. The goal, and in some cases, requirement, of these contracts was that concessionaires would pay for the development of many of the facilities necessary to access and operate their concessions. To maximize their incentive to invest in parks, concessionaires were usually given extremely long contract terms and guaranteed exclusive operating rights during those terms. In addition, concessionaire payments to the government for the rights and privileges conveyed by the contracts, called "franchise fees," were fixed at nominal levels.

When the NPS gained full control of the nation's parks in the 1930s, it also assumed oversight responsibility for the parks' private concession operations. Presumably in an effort to solidify and codify its control of these concessions, the NPS entered into new operating contracts with each of the park concessionaires. The majority of these new

When the NPS gained full control of the nation's parks in the 1930s, it also assumed oversight responsibility for the parks' private concession operations. Presumably in an effort to solidify and codify its control of these concessions, the NPS entered into new operating contracts with each of the park concessionaires. The majority of these new contracts had 30-year terms with little or no change to the operating and financial obligations stipulated in the concessionaires' previous contracts.

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In 1965, Congress passed Public Law 89-249, generally referred to as the NPS Concession Policy Act of 1965 (the Law). The Law's primary purpose was to provide clear legal direction for future NPS concession contracting. Congress anticipated that many concession contracts might change hands following their expiration. Accordingly, the Law set forth guidelines for the transfer of concession assets between an outgoing and incoming concessionaire, making it very clear that concessionaires had a right to receive compensation for the value of their investment in fixed structures and other improvements at the end of their contract term. Since the government holds title to all improvements within the parks, the Law refers to this property right as the concessionaire's "possessory interest" in improvements.

The determination of the value of concessionaires' possessory interest is now a central component of the National Park concession contracting process. An estimate of the possessory interest value must be reported within the contract prospectuses issued by the NPS since the buyout of possessory interest represents the primary cost to prospective new concessionaires to acquire the subject contract. If the incumbent concessionaire does not agree with the government's valuation of its possessory interest, then disputes are to be resolved through arbitration.

THE APPRAISAL PROBLEM

From a general real estate standpoint, National Parks can be thought of as magnets for visitor demand. Depending on the park, large numbers, in some cases millions, of visitors are attracted every year to enjoy the beauty of the parks. Therefore, it is no surprise that often private property located in proximity to parks has realized significant increases in value, particularly lands that support visitor services, such as hotels, restaurants, and gift shops. An even greater potential for generating visitor-related revenues and profits lies within the parks themselves. Therefore, many parks have significant commercial value.

The value of revenue-producing activities within a National Park is derived from a number of sources. Certainly, the attractiveness of the park itself, as well as the quality of the visitor services and facilities, is important. However, the value can also be attributed to the rights granted by the NPS to the operator of those commercial services. For example, concession contracts limit the number of enterprises that may operate commercial facilities inside a park. As a result, many concessionaires operate in a monopoly-like setting, in that only one concessionaire typically has the right to provide a certain type of service in each park — such as lodging, food and beverage, retail sales, or a combination of those services. Certainly, this exclusive right to operate visitor-serving facilities inside a National Park has value.

But who "owns" this value—the concessionaire or the government? Historically it has not been necessary to answer this question, since few concessions have changed hands following expiration of a concession contract. However, it is evident that to properly appraise a concessionaire's possessory interest, this question must be answered. Specifically, it is necessary to identify and then quantify the value contributed to the concession enterprise by the government from that contributed and belonging to the concessionaire. In the unique setting of a National Park, we must recognize that the concessionaire is essentially acting as a service provider; though in most cases, the concessionaire also pays for some or all of the improvements used in its operation. So, in answering the question of who owns the value inherent in a National Park concession, we must make distinctions between the various components of the concession's overall enterprise value, including the:

1. Concession facilities (possessory interest) and

- personal property funded by the concessionaire:
- 2. Management provided by the concessionaire;
- 3. Concession facilities funded by the government;
- National Park land used for concession purposes; and
- Commercial operating rights and privileges provided by the government through the concession contract.

In particular, the last three value components need to be isolated from the first two, recognizing that only the first two are "owned" by the concessionaire. In other words, the concessionaire contributes their improvements and personal property, as well as their management expertise, but the government contributes the other components of value.

THE LEGAL FRAMEWORK GOVERNING THE APPRAISAL ASSIGNMENT

As stated previously, in appraising a concessionaire's possessory interest, it is incumbent upon the appraisers to follow the provisions of the Law. It is also the appraisers' responsibility to evaluate and assess the specific provisions of the contract between the concessionaire and the NPS, though these provisions generally mirror the Law.

The Law specifies the concessionaire's protection against lost values, as follows:

The Secretary may include in contracts for the providing of facilities and services such terms and conditions as, in his judgement, are required to assure the concessioner of adequate protection against loss of investment in structures, fixtures, improvements, equipment, supplies, and other tangible property provided by him for the purposes of the contract, but not against loss of anticipated profits.

The Law limits possessory interest to structures, fixtures, and improvements, as follows:

A concessionaire who has heretofore acquired or constructed or who hereafter acquires or constructs, pursuant to a contract and with the approval of the Secretary, any structure, fixture, or improvement upon land owned by the United States within an area administered by the NPS shall have a possessory interest therein, which shall consist of all incidents of ownership except legal title, and except as hereafter provided, which title shall be vested in the United States.

The Law specifies the method for valuing possessory interest to be "reconstruction cost less depreciation,

but not to exceed fair market value," as follows:

The said possessory interest shall not be extinguished by the expiration or other termination of the contract and may not be taken for public use without just compensation. The said possessory interest may be assigned, transferred, encumbered, or relinquished. Unless otherwise provided by agreement of the parties, just compensation shall be an amount equal to the sound value of such structure, fixture, or improvements at the time of taking by the United States determined upon the basis of reconstruction cost less depreciation evidenced by its condition and prospective serviceability in comparison with a new unit of like kind, but not to exceed fair market value.

After examining the Law, specific concession contracts and other documents setting forth the legal framework for concession contracting, we concluded that a concessionaire's possessory interest must be appraised applying two separate valuation approaches. First, we must appraise the cost to reproduce the subject buildings and infrastructure funded by the concessionaire, less accrued depreciation from all causes. Second, we must estimate the fair market value of those same buildings and improvements, considering each of the three primary fair market valuation methods: the Cost Approach, Income Approach, and Sales Comparison Approach. We believe that in this instance of fair market valuation, application of the Cost Approach requires the use of a replacement cost rather than a reproduction cost analysis. In addition, only secondary consideration can be given to the Sales Comparison Approach, since no direct comparables for National Parks exist.

"RECONSTRUCTION" COST

A review of early editions of *The Appraisal of Real Estate* textbooks in use when the Law was written suggests that the term "reconstruction cost" had the equivalent meaning of reproduction cost. Accordingly, we feel it is appropriate to use a reproduction cost approach to comply with the first valuation method stipulated in the Law.

During their tenure, many concessionaires have built structures and associated site and infrastructure improvements. Some of the structures are award-winning, unique buildings, and have been named to the National Register of Historic Places, while many others are simple wooden structures used for operation support such as employee housing and storage. For the Reproduction Cost portion of the appraisal, we measure every building that the

For the Reproduction Cost portion of the appraisal, we measure every building that the concessionaire owns, and estimate the cost of reproducing the existing structures.

In parks with larger concessions, we recognize that the hypothetical task of reproducing every structure could be similar in scope to building a small community, involving hundreds of workers toiling over a multiple year period, requiring the coordinated delivery of materials to the site, housing of laborers, and added cost to transport both people and product to what is frequently a relatively remote location.

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We also must assess the relative amount of depreciation and deferred maintenance, if any, present in each structure. Since many buildings in National Parks are on the National Register of Historic Places, items of both curable and incurable functional obsolescence, in addition to economic obsolescence, need to be carefully evaluated.

Though complex, estimation of the "reconstruction cost less depreciation" is not the most difficult appraisal approach utilized within a National Park setting. The Law states that the possessory interest value is "not to exceed fair market value." Thus, to comply with the Law, we must also employ the traditional approaches to estimate fair market value, the most interesting element of which, the income approach, is addressed in some detail here.

THE INCOME APPROACH

To apply the income approach to assess the value of a National Park concessionaire's possessory interest, we first analyze the concession operation itself.

Since concessionaires must report the financial details of their operation to the NPS, we typically have access to a long historical record of a concession's annual receipts and operating and capital expenditures. In addition, the NPS carefully tracks visitation to its Parks. Therefore, the levels and trends in both the financial performance of a concession and park visitation can be carefully examined to project a concession's future anticipated income stream. When this income stream is determined to be stable. the direct capitalization method of the Income Approach can be used to derive the capitalized value of the overall concession operation. Specifically, we can apply a market capitalization rate to the operation's stabilized net operating income (NOI) to estimate the fee simple value of the entire property that is the concession.

Since the income stream of a concession cannot be attributed solely to the concessionaire's possessory interest, this capitalization analysis alone does not provide an estimate of the fair market value of that possessory interest. Specifically, the government often funds some of the improvements used by the concession, certainly provides all of the in-park land used by the concession, and conveys a variety of additional rights and privileges to the concessionaire through its concession contract. All of these tangible and intangible assets contribute to the income stream of the concession, and therefore, its capitalized value.

Normally, and as previously noted, concessionaires pay the government some form of rent or "franchise fee" to compensate for the use of land and other rights and privileges conveyed by a concession contract. Lacking additional information, one might presume that this franchise fee accounts for the return to the land and other rights and privileges of the concession contract. If this were true, then the estimated stabilized income of the concession would arguably represent the return to the concessionaire's possessory interest. However, according to the Law, the assignment is to determine the fair market value of a concessionaire's possessory interest. Since the income-based valuation analysis starts with a determination of the fair market value of the entire concession contract, to derive the fair market value of a concessionaire's possessory interest from this overall concession value, we must remove the fair market value of the other contributing assets.

Unfortunately, historical franchise fees of recently expired and soon to expire concession contracts

were negotiated by concessionaires and the NPS and rarely determined through fair market competitions for the subject concession contracts. Accordingly, while we do not necessarily presume it to be the case, we do not accept, out of hand, that historical franchise fees provide an accurate measure of the fair market rent for the use of land and other rights and privileges of individual concession contracts. Therefore, we calculate the concession's stabilized income without any account of franchise fees. As such, the stabilized concession income that we start our analysis with represents a return to both the concession's and government's contribution of assets to the operation. It is then incumbent on us to determine the fair market value of the government's contribution to this income, which is implicitly the fair market franchise fee.

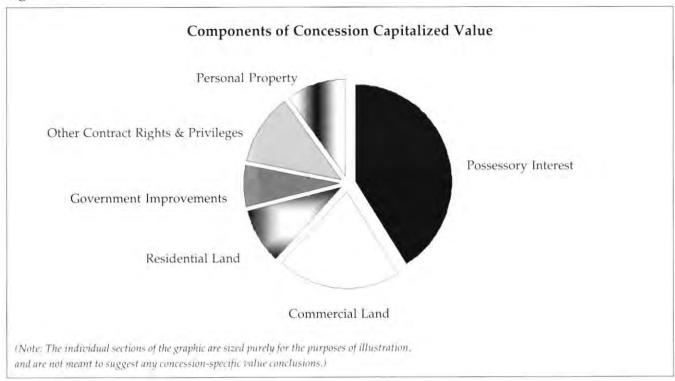
Clearly, the value of the government contribution should not be included within the concessionaire's possessory interest. So in many ways, the contracts resemble a ground lease. And since the goal of the appraisal is to estimate the value of only the concessionaire's improvements, it is logical to use a Building Residual valuation methodology. To perform an accurate Building Residual appraisal, we need to isolate each of the elements of the capitalized value of the income stream and allocate them between the concessionaire and the government. In essence, we need to identify the elements of value that are attributable to the government's contribution and then subtract the value of those contributions from the fee simple value of the entire concession. The residual value represents the value of the concessionaire's investment in the concession, including its possessory interest exclusively in the improvements that it funded.

While this may sound simple, quantifying the various elements necessary for the analysis is not. The elements include:

- The value of the government-funded improvements used by the concessionaire;
- An overall capitalization rate (OAR) for National Park concession contracts;
- The value of commercial and residential land used by concession facilities;
- The value of other rights and privileges provided by the government to the concessionaire during the term of the contract.

Figure 1 provides a graphic representation of the capitalized value of a hypothetical concession and its individual value components. (*Note:* The

Figure 1



individual sections of the graphic are sized purely for the purposes of illustration, and are not meant to suggest any concession-specific value conclusions.)¹

GOVERNMENT-OWNED IMPROVEMENTS

The value of the structures and infrastructure funded by the government, but assigned for use by a concessionaire to support its operation, can be determined by applying the Replacement Cost method, less accrued depreciation from all causes. We use a Replacement Cost method instead of the Reconstruction Cost method because in many cases the government's buildings in National Parks are overimproved relative to their current use, or suffer from elements of functional obsolescence. The Replacement Cost method values only the portion of the structures that the concessionaire uses, and according to its actual use. Since this value is deducted from the capitalized value of the entire concession operation, the concessionaire is not penalized for any unused potential value in government-funded buildings occupied by the concession operation.

THE OVERALL CAPITALIZATION RATE (OAR)

Fortunately, there is a market, however limited, for National Park concession contracts. In fact, there were two sales of such contracts in early 1999. Additionally, there were two other transfers of large concession contracts during the past decade, for which enough information was available to calculate implied overall capitalization rates (OARs).

We have interviewed executives from the buyers and sellers of each sale and transfer of National Park concession contracts in the past 10 years to understand their valuation approaches, motivations, desired rates of return, and implied OARs.

We also have done an extensive analysis of OARs for fee simple and leasehold full-service resort sales, since these properties are operationally similar to many concession operations. However, discussions with the buyers of concession contracts revealed substantial differences, from an investment perspective, between such resort properties and a park concession. These interviews convinced us, based on the relative risk profiles, that it would be incorrect to consider the OARs for such fee simple resort properties to be representative of OARs for a concession contract. So we believe it is appropriate to place greater weight on the sales of comparable concession contracts in determining the OAR for an income valuation analysis of possessory interest.

The OAR is applied to the estimate of a pre-franchise fee stabilized NOI from the existing concession operation to obtain an estimate of the entire concession enterprise value. However, as already discussed, this results in a fee simple value that

includes all buildings, whether owned by the concessionaire or the government, all of the land necessary to support the operation, and other government contributions. In order to isolate the concessionaire's improvements, we still need to deduct certain elements of value from this estimate, as per our Building Residual valuation methodology.

VALUING THE LAND

To estimate the value of the land used by a concession, we must consider its contribution to the value of the operation. Specifically, there are two components of land that the government typically provides to the concessionaire to support its operation:

1). the land under the commercial, revenue-producing portions of the concessionaire's operation; and 2). the land under the concessionaire's employee housing (if any).

For the commercial land component, we can utilize the Ground Lease methodology. We assembled data from a large number of ground leases for fullservice hotels and stand-alone retail and restaurant operations across the United States. We analyzed this data on both a percentage of departmental revenue basis and on a percentage of total revenue basis, and discovered remarkably stable tendencies, regardless of size, location, or facility quality.

We use the lease data to estimate a fair market ground lease rental structure for the subject concession operation, as if it were a commercial ground lease. Certain percentages of revenues are identified for the concession's major departments, such as lodging, food and beverage, and retail sales. After considering the particular mix of business at the subject concession and ground lease data referenced above, we can conclude a reasonable estimate of the fair market rental structure for the commercial land, based on a percentage of concession receipts.

Applying this Ground Lease methodology to the estimate of stabilized revenues from the concessionaire's operation, we are able to estimate a stabilized annual fair market ground rental payment, as if the concession were on a typical ground lease in a competitive market environment. By applying a land capitalization rate to the estimated annual rental stream, we can calculate the value of the commercial land supporting the subject operation.

As a test of reasonableness, we may convert our total estimate of the commercial land value to a

dollar per square foot unit value. We can then utilize the Sales Comparison Approach by gathering comparable sales data for commercial land sales in the gateway and neighboring communities surrounding the park. If the estimate of land value on a per square foot basis in the park is within the range for out-of-park land sales, this would provide support for the reasonableness of the estimate. In fact, such a result usually indicates that the estimate is conservative, since the land inside the park is intuitively more valuable than the land immediately outside of the park.

Next, we estimate the value of the land supporting the concessionaire's residential operation, if one exists. In many parks, the concessionaires build employee housing units for their workers on government-owned land inside the parks. Although the concessionaire is entitled to possessory interest recovery for the residential improvements, it is necessary to deduct the value of the governmentowned land from the total enterprise value, since the concessionaire would incur some cost for residential land were it operating outside the Park. Using the Sales Comparison methodology as our primary indicator of value for this land, we search the surrounding communities for recent sales of multi-family-zoned private land. Applying this per square foot estimate to the amount of land allocated to the concessionaire's residential operation yields an estimate for the value of residential land that is being used by the concessionaire, but owned by the government.

The estimated values of commercial and residential land, used by the concessionaire but owned by the government, are subtracted from the estimate of the fee simple value for the entire concession operation.

VALUE OF OTHER CONTRACT RIGHTS AND PRIVILEGES

In addition to land, the NPS contributes some unique benefits to concessionaires through the special rights and privileges it conveys in its concession contracts. Occasionally, these benefits may be offset by costs contractually imposed on a concession operation that a concessionaire would probably not incur in the normal course of doing business absent the concession contract. Accordingly, it is very important to recognize not just the benefits but also the costs derived from the stipulations of the concession contract in determining the fair market value of the government's contribution to a concession operation.

In our effort to quantify the effect of concession contract-related benefits and costs on a concession's income stream and thus overall concession value, we must first identify any potential contract-related influences on the concession operation. These influences may include, but may not be limited to: A). the use of federal land; B). a unique location; C). a monopoly at that location; D). controls on concession prices charged to visitors; and E). minimum repair and maintenance (R&M) spending requirements.

The next step is to examine the concessionaire's income statement to determine how, if at all, these potential influences are expressed in terms of operational receipts and expenses. For example, citing item A above, the concession operation may benefit from the simple fact that it is operated on federal land. Specifically, a concessionaire may pay no property taxes on the in-park land that it uses, although the NPS provides many of the services that would normally be available to such an enterprise operating outside of a park. The opportunity to avoid certain property taxes translates to higher net income for the concessionaire. While this additional income is included in the process of capitalizing the value of the total concession, it is not part of the return to the concessionaire's possessory interest, but effectively part of the return to the government's contribution to the concession. To determine what property tax expense, if any, a concessionaire is avoiding, we estimate the property tax burden on the concessionaire if it were operating on land adjacent to the park, and compare this to what it is actually spending on property taxes. The difference represents the annualized value of this federal land benefit.

Citing items B and C above, some concessionaires may not have to spend a lot on marketing because their unique location attracts visitors to its lodges, restaurants, and retail stores, irrespective of the specific services it is providing. And, the monopoly-like privileges of the concession contract mean that the concessionaire does not have to compete with other enterprises for those visitor dollars. Accordingly, we might examine a concessionaire's spending on advertising/marketing to determine if that spending is in line with industry norms. If not, depending on the circumstances, we might interpret the difference to represent at least a portion of the fair market annual return on the government's contribution to the concession of a unique location and monopoly rights.

In our effort to quantify the effect of concession contract-related benefits and costs on a concession's income stream and thus overall concession value, we must first identify any potential contract-related influences on the concession operation. These influences may include, but may not be limited to: the use of federal land; a unique location; a monopoly at that location; controls on concession prices charged to visitors; and minimum repair and maintenance (R&M) spending requirements. The next step is to examine the concessionaire's income statement to determine how, if at all, these potential influences are expressed in terms of operational receipts and expenses.

Citing item D above, the NPS carefully regulates the prices concessionaires may charge visitors for their goods and services. The NPS determines these rates by conducting fairly extensive annual surveys of prices charged by businesses operating outside of parks that are of similar scope and nature (including historic characteristics) to those inside parks. These surveys are aptly called "comparability studies." It might be argued that in many parks, the concession prices, and thus income, are kept artificially low as a result of this NPS rate-setting. Taking this to its logical end, one might conclude that NPS rate-setting suppresses the income-based value of concessionaire's improvements (possessory interest) below its fair market level. But what characteristics distinguish the businesses included in the comparability study from the subject that might allow above market prices to be charged in the park? We believe that by and large it is not the improvements themselves (since these presumably are already addressed in the comparability study), but instead the unique and special attributes of the park location. Therefore, any costs (or lost receipts) imposed on concessionaires by NPS rate-setting do not represent lost returns to the concessionaire's investment in improvements, but simply unrealized returns of the government's contribution to the concession operation. Accordingly, we need not make any adjustment in the income-based analysis for contract-related NPS controls of concession prices.

Finally, citing example *E*, some concession contracts explicitly require a concessionaire to spend a certain percentage of its receipts on R&M. In such a case, we would examine that spending to determine if is above levels that would typically be required to maintain the concession's facilities in adequate operating condition. If so, to ignore this negative impact on the concession's income in our analysis would possibly undervalue the incomebased fair market value of the concessionaire's possessory interest.

To summarize the Income Approach, we start with the fee simple value of the entire concession operation by capping the stabilized, pre-franchise fee NOI. Then we identify, appraise, and deduct the value of the government's contributions to the value of the concession. We subtract the value of the government-owned improvements and land that the concessionaire uses to support the operation, as well as the value of the extraordinary rights and privileges bestowed by the government to the benefit of the concessionaire. The remaining value in this Building Residual approach belongs to the concessionaire. To avoid double counting, any values that the concessionaire recovers from the sale of its personal property should also be deducted from the residual to isolate the exclusive value of its possessory interest in structures, fixtures, and improvements. One last caveat: if there is deferred maintenance on these structures, whatever amount is needed to improve the buildings to serviceable levels would need to be subtracted as well.

OTHER FAIR MARKET VALUE APPROACHES

In keeping with our charge to determine the fair market value of the concessionaire's improvements, we also utilize the other two traditional approaches for real property valuation — Sales Comparison and Replacement Cost Approaches — and reconcile any differences.

The Sales Comparison Approach is not able to produce an overall value estimate per se, although elements of it can be used in several aspects of the Income Approach. Specifically, these comparable sales can be used to:

- Derive the appropriate concession OAR (from comparable sales of concession contracts);
- Value the land components (from private land sales for commercial and multifamily residential land located outside of the Park); and
- Estimate the appropriate ground lease rent percentages for the subject operation (from ground

leased properties of other full-service hospitality operations across the U.S.).

We also check the value derived from the Income Approach with the value estimated using the Replacement Cost Approach. Then we reconcile the final fair market value by considering the values derived from the both Income and Replacement Cost Approaches.

RECONCILIATION OF SOUND VALUE

The final step in the valuation assignment involves the reconciliation of the sound value. As stated above, within this assignment it is incumbent upon the appraiser to first estimate the new reproduction cost less depreciation. The resultant figure is then compared to the value as determined from the analysis of the fair market value, which represents a reconciled estimate of value between the Replacement Cost and the Income Approaches. From these two value conclusions, as per the Law, the lowest figure is adopted as representative of the possessory interest value to be paid to the concessionaire.

CONCLUSION

This concludes a partial description of the methodology utilized to conduct a most unique appraisal assignment. We hope that we have provided an informative insight into some of the elements of value in the world of National Park concession contracts._{RE125}

NOTES & REFERENCES

It is important to note that the views expressed in this article are solely those of the authors, and are not represented as those adopted by the National Park Service, Department of the Interior, or any other Government agency. The authors would appreciate feedback from appraisers, hospitality consultants, land economists, and other professionals in their efforts to continually refine the complex process of appraising these concession contracts. (See author e-mail addresses below and on pg. 17)

We did not allocate a separate component for Enterprise Value. Since the concessionaires deduct a management fee, in addition to other actual expenses, we have assumed that the deduction for management fee adequately represents the Enterprise Value.

ABOUT THE AUTHORS

(continued from page 17)

firm in Littleton, Colorado (E-mail: blaine@chase-co.com).

The Counselors of Real Estate recently named Maurice and Blaine 2000 recipients of its James Felt Creative Counseling Award for their innovative methodology and appraisal of the Grand Canyon National Park concession contract.

PROPERTY LEVEL PERFORMANCE MEASUREMENT: THE KEY TO UNDERSTANDING IMPLICIT FINANCIAL ATTRIBUTES

by Kenneth P. Riggs, Jr., CRE, Jules H. Marling, Jr., CRE, & Ryan W. Harms

NTRODUCTION

The warning signs of a pending economic, financial, and real estate L slowdown are clearly evident in almost every piece of news and information that we touched in the final quarter of 2000. The automobile industry idled production plants, the NASDAQ was down 50 percent from its high watermark of 5,000, and Wall Street announced layoffs; all recent news reports from fourth quarter 2000. Ironically, the automobile industry broke record unit sales for 2000 and Wall Street had a banner year for profits and potential bonuses, but they quickly admit that the first three quarters carried the year and the immediate future will not resemble the recent past. As the brass of these firms hunker down on their business strategy for 2001 and beyond, real estate industry leaders quickly scramble to review both strategic (long-term) and tactical (short-term) positions in the real estate market. As reported in *Emerging* Trends in Real Estate 2001, "Today's real estate investors sense that the clock has stopped moving... There is no juice left in the markets... There is no easy money to be made." However, most objective investors would agree that real estate going forward in 2001 offers better riskadjusted returns compared to that of stocks.

Real estate is more heterogeneous in nature compared to other asset classes; there are substantial differences in the risk/return characteristics even among the same property types. Consider the fact that real estate is still a relatively local business, dependent on local employment trends (albeit potentially a national tenant). Relationships to tenants are key, and assets are tied to contract leases that can vary significantly among properties, even those office buildings across the street from one

ABOUT THE AUTHORS

Kenneth P. Riggs, Jr., CRE, CFA, MAI, is chief executive officer of Real Estate Research Corporation (RERC). He is active in bringing sophisticated and solid research to the real estate industry. Riggs has spearheaded the primary research behind Emerging Trends in Real Estate since 1992 and has served as editor-in-chief to the Real Estate Report, a quarterly real estate investment report published by RERC. (E-mail: Riggs@rerc.com)

Jules H. Marling, Jr., CRE, MAI, is a managing director and principal of Real Estate Research (Continued on page 35) another. As the real estate market moves from a comfortable equilibrium to a riskier future outlook for supply and demand balances, investors need to embark upon a rigorous review of the performance characteristics of each property held in its portfolio. This manuscript is written from a property level or tactical basis to identify performance measures that can assist an investor in culling out the potentially weaker performing assets from the solidly positioned properties. Obviously, the authors recognize that there are secular and broad market trends that affect all properties, but a risk assessment of each property within a portfolio will enable an investor to potentially outperform market indices. After all, that is where investment professionals add value.

Here, the authors' focus is to examine property performance information that has implicit relationships—overall capitalization, cash flow, appreciation, and total return rates—and to use this information to make a risk assessment of a particular property compared to a similar property or to another real estate asset type. This financial rate analysis and the reading of an article entitled The Graaskamp Legacy² reminded one of the authors of an earlier career experience. Ken Riggs, Jr., CRE, had the fortune, albeit only on one occasion, to complete a large asset valuation that the late James A. Graaskamp, CRE, reviewed as part of his role as a pension fund consultant. It was an acquisition analysis in excess of \$100 million on behalf of a major pension fund. One of the requirements of that engagement was to complete a discounted cash flow analysis; but key to this analysis was that the cash flow and value had to be unbundled to examine Graaskamp's defined "assured" versus "unassured" components of the property's value. This analysis did not change any valuation premise but allowed an investor to determine what percentage of the value was derived from contract leases and initial price versus speculative renewal assumptions and value appreciation. This analysis lead to further consideration of partitioning out the discount rate by its components; however, Graaskamp conveyed that was not the way discount rates were extracted and stressed that the purpose of unbundling the value was for risk assessment and comparative reasons. As further stated by Mike Miles et. al., one of Graaskamp's views on valuation appraisals was that, "the appraisal document that does not enhance decision outcomes, ceases to add value...Within these larger decision models, there exists a series of computational models that assist in the value decision."3 Investors, for the most part, have not required this unbundling of the implicit financial components since the late 1980s. Graaskamp's imprint on our industry is still profound, but it appears that this unbundling discipline has explicitly expired. Clearly, investors implicitly complete this type of risk analysis; however, few have the capacity to complete this solely by a review of forecasts and valuations reports, and then retain all of the financial parameters. Graaskamp also felt that the real estate industry often did not recognize and pay for potentially useful appraisals done by top-rate, competent professionals.

Even though tough lessons were learned during the 1990's real estate depression, the appraisal function has become even more commoditized. Blame it on the real estate industry, the appraisal profession, the firm, or the individual appraiser, but the fact still remains—appraisals are not looked upon as a decision-making tool. The authors strongly prescribe to the position that an appraisal of a property is not only necessary, but serves as one of few tools that an investor has to make an independent assessment of a property's market position. With proper appraisal guidelines—those that go beyond using traditional approaches and the appraisal gibberish—that require the appraiser to complete a rigorous financial interpretation of their conclusion, an investor has a valuable tool as opposed to a file stuffer.

FINANCIAL CHARACTERISTICS OF THE INCOME APPROACH TO VALUE

Commonly, there are three basic approaches used to reach an expert judgement within the appraisal process. The purpose of this manuscript is not to argue the merits of one valuation approach over another, but to focus on the approach to value that is accorded the greatest weight in valuing an income producing real estate asset. This approach, the income approach, is based on an opinion of value by completing a discounted cash flow (DCF) and a direct capitalization analysis. The direct sales comparison serves as a buttress to the income approach conclusion, and many times the cost approach is not utilized. Within the income approach, depending on the income characteristics of the property and market conditions, the analyst places greater weight on the DCF analysis, and may not even explicitly complete a direct capitalization of first year's income in the report. Later in this manuscript, we will show that implicit consideration to the direct capitalization is required to complete the financial analysis of an asset.

In order to embark upon an evaluation of financial characteristics of a property, we must first determine what factors are important in the property risk assessment and how to go about benchmarking the reasonableness of these factors. Initially, the analyst completes a forecast of revenues, operating expenses, and capital expenditures for an income producing property. Generally, the revenue and expense estimates are relatively straight forward, especially for a well-established asset. Maturity of the property and market conditions can alter the reliability of this premise, but like many economic evaluations, the starting point has to be the assumption of a more ideal situation. Revenues are tied to lease contracts and determining the expenses of a mature property is not terribly difficult. A significant but tricky part of a property's volatility in a cash flow forecast rests with capital expenditures (tenant improvement costs, leasing commissions, and property structure capital improvements). Many writers, including Jeffrey Fisher, Dunn Professor at the University of Indiana, have analyzed the components associated with capital expenditures. In one of Fisher's articles, he analyzed trends in NOI and cash flow rate, specifically examining the impact of capital expenditures relative to the overall capitalization rate.4

Once the cash flow forecast is completed for a property, the value via the DCF is achieved by discounting the cash flows and reversion by an appropriate discount rate. The discount rate, goingin overall capitalization rate (OAR), and terminal OAR are arrived at by an analysis of actual transactions, indexes, surveys, and spreads over alternative investments.5 When these analyses are completed, they generally yield a discount rate of 10.5 percent to 12.0 percent, with a mean in the range of 11.5 percent, and going-in OARs of 8.5 percent to 10.0 percent, with a mean in the range of 9.0 percent. The terminal rate is based on loading the going-in rate by 50 to 100 basis points, or a 9.5 percent to 10.0 percent range. These ranges by no means suggest that the authors believe that the conclusions are a given nor should they be glossed over, but the reality is that these rates are what are generally used for quality income-producing properties. In this respect, the industry is what it is-we do not make up the rules.

The first step in financial risk assessment of the valuation conclusion is to review these financial elements for consistency relative to original growth and return expectations. This involves making sure that the financial forecast and valuation conclusion

is reasonable given the analysts' experience and expectations. Is income growing approximate to the intended rate of inflation? If it is not, the analyst needs to determine if the contract leases in place cause this variation. Another key issue is quality control. All analysts talk about the highest quality standards applied to each cash flow analysis, but everyone is faced with deadlines and last minute changes—it is a tough, rigorous process to get correct. As a general rule, it is better to have the quality control done by someone within your group to serve as an experienced objective party. In many situations, analysts are too close to a project to find the pitfalls and mistakes.

After drudging through the above process and an estimated value via the DCF approach has been completed, the analysis has many explicit assumptions that yield embedded financial relationships that need examination in order to make an assessment of the reasonableness of the valuation conclusion.

The next step is to determine which financial characteristics have the greatest explanatory power to unearth the earning characteristics of a real estate asset. As will be analyzed later in this manuscript, the authors have focused on the following financial attributes: net operating income (NOI) capitalization rate; cash flow (CF) rate; spread between NOI rate and CF rate; implicit growth rates for income, expenses, NOI, CF, and appreciation of value; and value allocation of cash flow and the reversion. There are more financial factors that need consideration, but these are nuts and bolts of a valuation conclusion.

In assessing the reasonableness of a property's financial characteristics and benchmarking the relative performance of an asset, a consultant has the choice of using a proprietary database or using data from published indexes, or both. For the purposes of this manuscript the authors have chosen to use a nationally recognized index-NCREIF NPI. The authors believe and many others agree that the National Council of Real Estate Investment Fiduciaries (NCREIF) will lead the industry in developing more relevant data series. The NCREIF Property Index (NPI) will be used within the context of this manuscript. As presented in Exhibit 1, the data from NPI can be used for more than a total return series. It is valuable in providing capitalization rates, cash flow rates, capital expenditure levels, etc. The authors caution, as have other writers, the NPI is only one source of information—it has its

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	Index	Industrial	Apartments	Office	Retail
NOI Capitalization Rate	8.00%	8.49%	0/066-7	7.84%	7.79%
Standard Deviation	0.81%	0.79%	0.75%	1,01%	0.85%
Cash Flow Rate	5.36%	5.90%	6.61%	5.15%	4.81%
Standard Deviation	1.11%	1.07%	0.68%	1.18%	1.63%
NOI Rate Spread over CF Rate	2.64%	2.60%	1,39%	2.69%	2.98%
Standard Deviation	0.55%	0.95%	0,30%	0.74%	1,34%
Implied Capital Expenditure Rate	32.96%	30.59%	17,35%	34.30%	38.27%
Appreciation	4.18%	4.13%	3.54%	3.95%	4,26%
Standard Deviation	5.85%	6.02%	4.41%	8.67%	4.97%
Total Return	9,73%	10.22%	10.32%	9.28%	9.22%
Standard Deviation	6.57%	6.42%	4.64%	9.57%	5.02%
Total Return/Std. Deviation	1.48	1.59	2.22	76.0	1.84
Cash Flow Rate plus Appreciation	9,55%	10.03%	10.15%	9,10%	9,07%
Inflation	d	4.69% NASDAQ			12.21%
Standard Deviation Avg. / Std. Deviation	6.5	3.14% St 1.49 Av	Standard Deviation Avg. / Std. Deviation		13.94% 0.92
Dow Jones Standard Deviation Avg. / Std. Deviation	7.55	12.94% S&P 11.56% St 1.12	Standard Deviation Avg. / Std. Deviation		18.44% 16.70% 1.10

Source: Real Estate Research Corporation, National Council of Real Estate Investment Fiduciaries, Economy.com

Historical Trends of Key Financial Figures

	1978-2000 Average	1990-2000 Average	1991-2000 Average	1992-2000 Average	1993-2000 Average	1994-2000 Average	1995-2000 Average
NOI Cap Rate							
Total Index	8.00%	8.23%	8.39%	8.57%	8.70%	8.77%	8.77%
Industrials	8.49%	8.96%	9.11%	9.27%	9.41%	9.47%	9.45%
Apartments	7.99%	8.42%	8.54° a	8.70%	8.76%	8.74%	8.68%
Office	7.84%	8.30%	8.50%	8.71%	8.84%	8.90%	8.83%
Retail	7.79%	7.68%	7.83%	8.01%	8.16%	8.29%	8.40%
Cash Flow Rate							
Total Index	5.36%	5.61%	5.80%	5.940 0	6.07%	6.18%	6.28%
Industrials	5.90%	6.12%	6.33%	6.41%	6.41%	6.43%	6.5200
Apartments	6.61%	6.89%	7.01%	7.17%	7.17%	7.08%	7,090 a
Office	5.15%	5.21%	5.34%	5.47%	5.63%	5.71%	5.70%
Retail	4.81%	5.32%	5.57%	5.76%	5.98%	6.25%	6.50%
Appeller a constant	Carlo Ti						
NOI Rate Spread O		7.140	220	2420	5.5219	7 550	
Total Index	2.64%	2.62%	2.59% h	2.63%	2.63%	2.59%	2.49%
Industrials	2.60%	2.84%	2.78%	2.86%	3.00%	3,05%	2.93\%n
Apartments	1.39%	1.53%	$1.53^{\circ}/_{\circ}$	1.53%	1.59%	1.66%	1.59%
Office	2.69%	3.09%	3.16%	3.24%	3.22%	3.19%	3.12%
Retail	2.98%	2.370%	2.26%	2.26%	2.190%	2.04%	1.90%
Implied Capital Ex							
Total Index	32.96%	31.85%	30.87%	30.70%	30,26%	29,50%	28.42%
Industrials	30.59%	31.66%	30.52%	30.84%	31.89%	32,16%	31,03%
Apartments	17.35%	18.15%	17.96%	17.59%	18.10%	18.97%	18.35%
Office	34.30%	37.22%	37.18%	37.19%	36.36%	35.83%	35,37%
Retail	38.27%	30.79%	28.83%	28.15%	26.77%	24.62%	22.59%
Appreciation							
Total Index	4.18%	0.80%	1.02%	2,22%	3.61%	4.66%	5.31%
Industrials	4.13%	1.31%	1.65%	2.84%	4.49%	6.10%	6.83%
Apartments	3.54%	2.11%	2.32%	3.31%	4.37%	4.870	4.89%
Office	3.95%	0.43%a	0.96%	2.74%	4.57%	6.46%a	7.83%
Retail	4.26%	0.26%	-(),()30/0	0.59°	1.42%	1,52%	1.57%
Total Return							
Total Index	9.73%	6.47%	6.89%	8.27%	9.84%	11.05%	11.83° a
Industrials	10.22%	7.51%	8.07%	9.39%	11.13%	12.82%	13.69%
Apartments	10.32%	9.12%	9.46%	10.66%	11.77%	12.21%	12.23%
Office	9.28%	5,69%	6.37%	8.35%	10.39%	12.44%	13.86%
Retail	9.22%	5.60° a	5.56%	6.39%	7.47%	7.85%	8.15%
Inflation	4.69%	3.05%	2.81%	2.66%	2.61%	2.56%	2.55%
Dow Jones	12,94%	14.86%	15,99%	16.38%	17.11%	18.33%	21.06%
NASDAQ	12.21%	14.44%	16,11%a	15.72%	16.28%	17.56%	19.29%

Source: Real Estate Research Corporation, National Council of Real Estate Investment Fiduciaries, Economy.com

NCREIF NPI Averages 1994 through 20000

	Index		Industri	ial Apartments	Office	Retail
NOI Capitalization Rate	8.77%		9.47%	8.74%	8.90%	8.29%
Standard Deviation	0.30%		0.39%	0.43° /a	0.61%	0.34%
Cash Flow Rate	6.18%		6.43%	7.08%	5.71%	6.25%
Standard Deviation	0.34%		0.37%	0.40%	0.41%	0.78%
NOI Rate Spread over CF Rate	2.59%		3.05%	1.66%	3.19%	2.04%
Standard Deviation	0.33%		0.370°	0,30%	0.41%	0.51%
Implied Capital Expenditure Rate	29,50%		32.16%	18.974/0	35.83%	24.62%
Appreciation	4.66%		6.10%	4.87%	6.46%	1.52%
Standard Deviation	3.21%		2.54°	0.93%	5.41%	$2.67^{n_{0}}$
Total Return	11.05%		12.82%	12.21%	12.44%	7,85%
Standard Deviation	3.42%		$2.83^{o/o}$	0.98%	5.52%	3.10%
Total Return/Std. Deviation	3.23		4.54	12.49	2.26	2.53
Cash Flow Rate plus Appreciation	10.84%		12,52%	11.95%	12.17%	7.770n
Inflation		2.56%	NASDAG	Q		17.56%
Standard Deviation		0.59%		Standard Deviation		9.80%
Avg. / Std. Deviation		4.35		Avg. / Std. Deviation		1.79
Dow Jones		18.33%	S & P			28.04%
Standard Deviation		9.92%		Standard Deviation		15.03%
Avg. / Std. Deviation		1.85		Avg. / Std. Deviation		1.87

Source: Real Estate Research Corporation, National Council of Real Estate Investment Fiduciaries, Economy.com

limitations. However, used in the right context it can provide financial benchmarking capabilities. A review of Exhibit 1 illustrates the concern some participants have with the index, specifically with total returns. A total return for real estate of 9.73 percent for a 20-year plus period does not seem to be a correct proxy for forecasting a total return for real estate. The consultant needs to complete a review of various historical time frames of the NPI and make a determination of which period appears to be a better basis for normalized trends. Generally, it is believed that if there is enough historical data it will predict the future. Simply put, the future will reflect the past. This may be an incorrect assumption. Look at the stock market performance over the past seven years. Historical stock returns dating back to the 1930s did not predict the volatility of NASDAQ. It is up to the consultant to assess the quality of data and determine the usefulness of the time series. *Exhibit* 2 shows the same real estate financial factors as derived from NPI for seven periods. Our assessment of these various time frames suggests that the period of 1994 through 2000 reflects financial factors that are relevant to our analysis (*see Exhibit 3*). The purpose of this manuscript is not to complete a dissertation on the use of NPI and the appropriate time periods. Rather, as will be demonstrated, the authors' assumption is that this data can serve as a useful tool to assess the consistency of the implied financial attributes of a property.

Exhibit 4 is an example cash flow forecast and valuation conclusion via the discounted cash flow method, which will serve as the basis to complete a financial benchmark analysis of the subject property. The cash flow forecast was done on a simplified

ormance Measurement	sis of Property
Example Perfo	Analy

Category	Period 1	Period 2	Period 3	Period 4	Period 5	Period 6	Period 7	Period 8	Period 9	Period 10
Uffective Gross Income Growth	\$1,425,000	\$1,453,500	\$1,482,570	\$1,556,690 2,00%	\$1,587,832	\$1,619,589 2,00%	\$1,651,981 4,00%	\$1,718,060	\$1,803,963	\$1,840,042
L'apenses Growth	\$400,000 3,00%	\$412,000 3,00%	\$424,360. 3,00%	\$437,091 3,00%	\$450,204	\$463,710 3,00%	\$477,621 3,000%	\$491,950 3,00%	\$500,708	\$521,909
Net Operating Income Implied Growth	\$1,025,000	\$1,041,500	\$1,058,210	\$1,119,608 \$.80%		\$1,155,879	\$1,174,360 1,600°0	\$1,226,111 4,41° °°	\$1,297,255 5.80° n	\$1,318,133 1.61%
Capital Expenditures	\$256,250	\$208,300	\$264,553	15,00%	\$341,280 30,000a	\$346,764	\$234,872	\$306,528	\$250,451	\$263,627
Cash Flow Implied Growth	5768,750	\$833,200	\$793,658	\$951,667	\$796,340	\$809,116	\$939,488	\$919,583	\$1,037,804	\$1,054,507
Net Present Value of Cash Flows:	Cash Flows:	\$4,999,201								
Reversion: NOI Terminal OAR		\$1,805,244								
Future Value Less: Costs of Sale (3%) Future Net Value NPV of Reversion		\$19,438,397 \$583,151,90 \$18,855,245 \$6,348,681								
Total Value of Asset:		\$11,347,882								

Source: Real Estate Research Corporation

Financial Benchmark Analysis

Implied Group, In Capalizone Ram Introduced Control (277%) NOT Race Spearad over CT Rac Spearad Control (277%) Spearad Con	Financial Rates:	Subject*	Benchmark Range ** Co	Comments
Cash-on-Cash Rate 6.77%, 6.00% 6.59% over CF Rate 2.26%, 2.56% 2.55% over CF Rate 2.26%, 2.56% - 1.00% over CF Rate 1.72% 0.05% - 1.00% over CF Rate 1.72% 0.05% - 1.00% over CF Rate 1.72% 0.05% - 1.00% over CF Rate 1.50% - 1.00% over CF Rate 1.50% over CF Rate	Implied Going-In Capitalization Rate	9.03° a	8.7.5% - 9.25%	The implicit going in OAR is consistent with the benchmark and reflective of a market risk level.
over CF Rate 2.26%, 2.50%, 2.55%, 2.75%, 2.85 Coung-In OAR 0.72%, 0.50%, 1.00%,	Implied Going-In Cash-on-Cash Rate	0/0229	6,00% = 6.50%	The implicit going in eash flow rate is above the range and provides an initial lower risk profile for the property
ss Goang-In OAR 0,72%, 0,50%, 1,00% eturn of Growth: 2,88%, 2,60%, 2,50%, 3,50%, 2,88%, 1,50%, -4,00%, 2,50%, 2,50%, 2,83%, 1,50%, -4,00%, 2,50%, 2,43%, 1,50%, -3,00%, 2,43%, 1,50%, -3,00%, 2,43%, 1,50%, -3,00%, 2,45%, 1,50%, 2,48%, 1,05%, 3,45%, 1,180%, 2,48%, 1,05%, 2,48%, 4,95%, 1,45%, 1,180%, 2,48%, 1,45%, 1,45%, 1,03%	NOI Rate Spread over CF Rate	2.26%	2.5000 2.7500	Consistent with the above finding, this spread demonstrates a lower risk profile or points to a below average estimate for CapX.
of Growth: 11.50% 11.00% - 12.00% of Growth: 2.88% 2.00% 3.50% 2.80% 1.50% - 4.00% 2.83% 1.50% - 3.00% 2.83% 1.50% - 3.00% 2.83% 1.50% - 3.00% 3.45% 1.50% - 3.00% 3.45% 4.50% 2.48% 1.55% 3.45% 1.50% 3.30% 3.45% 1.50% 3.30% 3.45% 1.80% 3.30% 3.45% 1.80% 3.30% 3.45% 0.68% 1.45% 3.45% 0.68% 1.45% 3.40% 1.45% 3.40% 1.45% 3.40% 1.45% 3.40% 1.45% 3.40% 1.45% 3.40% 1.45% 3.40% 3.40% 1.45% 3.40% 3.	Terminal OAR Less Going-In OAR	0.72%	0.50% - 1.00%	The spread between the implicit going in OAR and terminal OAR is at an acceptable level:
of Growth: 2.88% 2.88% 2.00% 4.00% 2.56% 3.50% 3.50% 2.88% 1.50% - 4.00% 2.56% 3.50% 2.88% 1.50% - 4.00% 2.56% 3.50% 2.44% 4.50% 3.50% 3.44% 4.50% 2.50% 3.45% 1.55% 1.65% 3.45% 2.48% 4.95% 3.45% 1.80% 3.30% 3.45% 0.058% 1.65% 3.46% 0.058% 1.65% 3.46% 0.058% 1.65% 3.46% 0.058% 1.65% 3.46% 0.058% 1.65% 3.46% 0.058% 1.65% 3.46% 0.058% 1.65% 3.46% 0.058% 1.65% 3.46% 0.058% 1.65% 3.46% 0.058% 1.65% 3.46% 0.058% 1.65% 3.46% 0.058% 1.65% 3.46% 0.058% 1.65% 3.46% 0.058% 1.65% 3.46% 0.058% 1.65% 3.46% 0.058% 1.65% 3.46% 0.058% 1.65% 3.46% 0.058% 0.058% 3.46% 0.058% 0.058% 3.46% 0.058% 0.058% 3.46% 0.058% 0.058%	Internal Rate of Return	11.50%	11,00% - 12,00%	The property has an acceptable IRR based on NCREIF returns, actual tranactions, and interviews with investors around the country
1.500	Compound Rates of Growth:			
3.00% 2.50% 3.50%	Effective Gross Income	2 88%	2,000% - 4,00%	Acceptable and within the range, but given the long term contract leases, one would expect it to be lower.
2.83% 1.50% - 4.00% 1.50% - 3.00% 6.16% 4.00% 7.50% - 3.00% 7.50% - 3.00% 7.50% - 3.00% 7.50% 1.50% - 3.50% 7.50% 1.50% 1.50% 7.50% 1.50% 1.50% 7.00%	Expenses	3,(10)%	2,50% 3,50%	Expenses have and are expected to increase at the approximate rate of inflation.
1.50% oral Value 1.50% oral 3.00% π oral NOI) ±3.00% oral NOI) ±3.00% oral NOI 2.5.00% oral NOI ±3.00% oral NOI ±3.00% oral NOI 1.57% oral NOI ±5.00% oral NOI ±5.00% oral NOI 1.57% oral NOI ±3.00% oral NOI ±3.00% oral NOI 1.57% oral NOI ±3.00% oral NOI ±3.00% oral NOI 1.57% oral NOI ±3.00% oral NOI ±3.00% oral NOI 1.50% oral NOI ±3.50% oral NOI NA - 9.50% oral NOI 1.0 35% oral NOI NA - 7.05% oral NOI 1.0 an NOI, comparative databases, and REEC's surveys and experience.	ION	Z.K3%)	1.50% 0 - 4,00%	Same comment as discussed for effective pross income.
oral Value	Cash Flow	1,57%	1.50% - 3.00%	Is high and suggests that the forecasted revenues need closer examination for specific risk factors.
### 44% 45,00% - 35,00% ##################################	Appreciation of Total Natue	0.102.0	4.18 70 15.18 17	The level of appreciation is considered high given a decelerating financial and physical market cuttous.
### ### #### #########################	Werage CapX Rate (%0.03 NOI)	93,0490	25,00% - 35,00%	The property is at the low end of the range in capital expenditures, with many years at or below 20.0%. Need to determine if thus is consistent with age and contract lease duration.
1,57% 1,65% 1,65% 1,65% 1,65% 1,65% 1,65% 1,65% 1,65% 1,65% 1,65% 1,80	Value Attribution: PV of Cash Flows	44%	45.00% - 55.00%	The subject's percentage of value from (ask 1 lows is much lower than the market's benchmark, creating risk.
1,57% 0,68% o 1,65% Presents risk of failing short of 3,48% 1,80% 2,48% 4,95% Risk profile is high, froo much of 5,02% 2,48% 4,95% Risk profile is high, froo much of 11,80% NA 11,45% Consistent with assumptions, be srowth (rough DR) 10,35% NA 9,50% Same confinent as above; rowth (CF Rate) 6,48% NA 7,05% Suggest that there is very aggre on example in Table 4 (2) (2) (3) (4)	PV of Reversion	56%	45,00% - 55,00%	Higher than warranted value creation in the reversion, general focus away from high value increases.
3.45% 1,80% 3.50% Presents risk of falling short of 5,02% 2,48% 4,95% Risk profile is high, roo much vital sight, roo much vital sight, roo much vital sight. 0.02% NA 11,45% Consistent with assumptions, but vital sight. 0.00%	Weighted Growth Cash Flow	1,57%	0,68% - 1,65%	Presents risk of falling short of expectations in a declining market; need to examine duration of lease contracts.
11.80% NA 11.45% (Consistent with assumptions, b 10.35% NA - 9.50% Same comment as above; 10.35% NA - 7.05% Suggest that there is very aggre that there is very aggre Brief Conclusions; (2) 3able 4 (4)		3,45°°° 5,02°°°	1,80°°° 3,30°°° 2,48°°° 4,95°°°	Presents risk of falling short of expectations in a declining market; need to examine terminal value estimate. Risk profile is high, too much value creation based on future assumptions.
HQ 10.35% NA -9.50% Same contracts as above. 6.48% NA 7.05% Suggest that there is very aggree that there is very aggree. (2) rin Table 4 (3) (3) re in Table 4 (4) (4)	CF Rate Plus Wght. Growth (DR Ra			Consistent with assumptions, but may suggest risk regarding implicit growth assumptions,
6.48% NA 7.05% Suggest that there is very aggregate and ranked and raperience.	CF Rate Plus CF Growth (rough DI		ź	Same comment as above,
Brief Conclusions: (4) (5) (5)	DR Less Wght, Growth (CF Rate)	6.48%		Suggest that there is very aggressively built-in value appreciation, although it has a solid cash flow rate.
	* Subject Information based on example	m Table 4 e databases, and RE	RC's surveys and experience.	

Source: Real Estate Research Corporation, National Council of Real Estate Investment Fiducianes

basis but reflective of a typical property forecast with a discount rate and terminal capitalization rate appropriate in today's market. Once the consultant has completed the valuation of the property via the DCF method (this assumes that the value has been reconciled to the other approaches to value and the DCF conclusion is deemed appropriate), the financial rates, growth rates, capital expenditure levels, and value attribution can be calculated for the property. In addition, the consultant needs to review the relationship of the discount rate, cash flow rate, and growth of rate of both the cash flow and value. This relationship was well covered in an article by D. Richard Wincott, CRE, et. al. entitled Capitalization Rates, Discount Rates and Reasonableness. The authors of the article point out that the old equation of "yield = overall capitalization rate plus the income growth rate" is misunderstood and misused.7 The authors would agree with this conclusion in the article. The yield relationship analysis has to be based on the cash flow rate plus the CF growth rate, but adjusted for differences between the growth in the cash flow and value components and timing elements of each component.

As we discussed earlier, to assess the reasonableness of a property's financial characteristics, the consultant must base the analysis on the property's financial information against some type of benchmark or a proprietary database, or a combination thereof. For our analysis, we have again utilized the NCREIF index (emphasizing the data from 1994 through 2000), comparative data from similar properties, and RERC's survey. The authors feel the combination of these data best represent financial characteristics of a property in today's maturing real estate market.

Exhibit 5 presents a financial benchmark analysis of key implicit earning characteristics for an example subject property as derived from the DCF analysis shown in Exhibit 4. As demonstrated in this exhibit, there are many explicit assumptions made regarding growth and rate of return that do translate equally to the cash flow analysis, which is a result of contract leases having specified terms that do not parallel growth assumptions. These results in the relationships of return (going-in OAR, cash flow rate, and terminal rate) are being altered to mirror the uneven changes in the cash flow forecast. Exhibit 5 provides comments regarding the subject's financial earning characteristics. The conclusion for this particular example is that there is generally internal consistency among the implicit assumptions and they are consistent with the benchmark.

The only way to fully understand and appreciate the risk of a property is to delve into an analysis that is similar in nature to what is presented in this manuscript—a rigorous financial analysis of the cash flows, and a risk management analysis. This analysis needs to be done by those that truly understand the mechanics of a cash flow, and have a financial training in rate interpretation.

Given the expectations for the future economic and real estate environs, an investor can determine which properties within a portfolio are solid performers and which properties are at risk. In this case, an investor with proper portfolio alignment may choose to sell this asset. An entire report can be written exploring the implications of the analysis. It would be unreasonable to ask a reader to endure such an analysis within a manuscript of this nature. It does, however, provide the reader with constructs to reexamine the DCF value conclusion, and assess the relative performance of the subject to a benchmark.

CONCLUSION

Clearly the focus of real estate analysts have swayed from this real estate bull market-regrettably, the market is turning to an uncomfortable, maturing market equilibrium. We are clearly past the nobrainer phase of simply buying targeted assets to fill up portfolios. Tactical decisions regarding which assets have the best risk-adjusted prospects for the future are the decisions to be made in this new market order. The only way to fully understand and appreciate the risk of a property is to delve into an analysis that is similar in nature to what is presented in this manuscript—a rigorous financial analysis of the cash flows, and a risk management analysis. This analysis needs to be done by those that truly understand the mechanics of a cash flow, and have a financial training in rate interpretation. To borrow once again from the footnotes of the manuscript The Graaskamp Legacy, "if you can't buy the assumptions as presented, you cannot afford the real estate product about which those assumptions were made, no matter how good the site and attractive the building. Specifically, Graaskamp wanted to see a line-by-line defense of the income, expense, and capital items in a discounted cash flow analysis."8

Making better uses of the foundation of the appraisal practice, specifically in the income approach, can result in more confident buy/sell decisions. Benchmarks, already available to the appraisal profession, can provide the support appraisers and analysts need to make sound investment recommendations. Real estate analysts must also rely on their own instincts backed with plentiful, supportive data. With an economic, financial, and real estate downturn lurking on the horizon, the tools presented in this manuscript are not only beneficial, but necessary, in making valuation and investment decisions. REIJES

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ABOUT THE AUTHORS

(continued from page 26)

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BUILDING A REAL ESTATE BUSINESS BASED ON CORE COMPETENCIES

by Thomas H. Bomba

It is no secret that the real estate industry has undergone dramatic changes, and is likely to continue changing. Rapid consolidation within the industry, an evolution in occupants' real estate needs, and many other factors are catalyzing the change. Such factors are driving real estate executives towards taking a more strategic – and fluid – competitive stance with their companies.

The future competitive environment is uncertain, but a real estate executive can take steps to better understand it. The organization itself can be designed to serve the uncertain future needs of customers by structuring it around core competencies.

ABOUT THE AUTHOR

Thomas H. Bomba is a senior director of Jones Lang LaSalle's Global Consulting Group. Global Consulting draws upon the firm's collective resources and offers services in strategy development and implementation planning for the public and private sectors. Mr. Bomba is worldwide leader of two of the group's consulting practices. The Mergers and Acquisitions practice assists corporate clients that are undergoing mergers with pre-transaction preparation, organizational and infrastructure change, portfolio restructuring, and implementation. The (Continued on page 42)

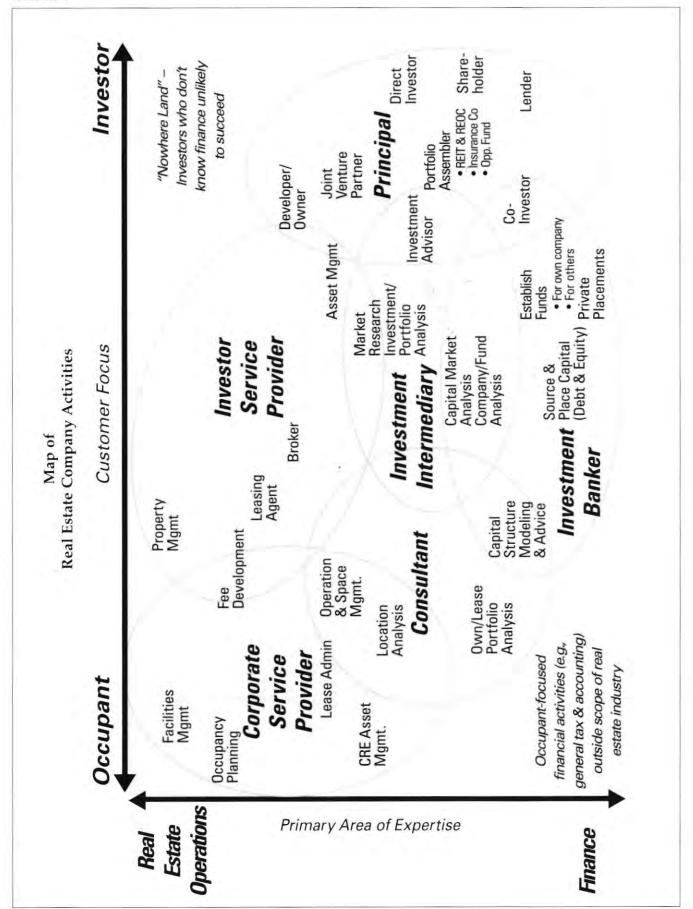
HOW DO YOU DEFINE YOUR FIRM'S MARKET SEGMENT?

The real estate industry as a whole is too diverse and fragmented to be considered a single industry. Real estate firms have historically operated on a local scale and have only in the recent past become focused on operating in a more expanded way. Real estate firms compete in different parts of the industry or different parts of the globe. As an example, firms that manage corporate facilities do not compete with real estate opportunity funds.

Real estate activities are primarily differentiated by:

- the primary expertise needed for the function (real estate operations vs. finance), and
- customer focus (occupants vs. investors).

Using these as the axes, various types of real estate company activities can be mapped out as in *Exhibit 1*.



Each activity can be a potential area of competition between firms, but many companies compete in more than one area. As an example, Jones Lang LaSalle and CB Richard Ellis offer a wide range of real estate services for a diverse group of clients cover almost the entire map. Conversely, Commercial Net Lease Realty, a firm that specializes in freestanding net leased retail, offers services to a small segment of the overall industry.

Using such a visual helps a firm understand its market position vis-à-vis other real estate companies. Benchmarking and best practice assessments allow you to improve your company's efficiency in the competitive environment. However, most environments define the landscape that currently exists, and most benchmarking compares your performance to that of existing competitors. When the competitive environment changes as rapidly as it does today, you can find yourself being a very efficient buggy-whip manufacturer in an automobile-driven society. While more difficult to do, competitive environments of future business spaces (which may not even currently exist) should also be developed.

Some companies appear to have an uncanny knack for successfully entering new competitive business spaces, even when they don't appear to be directly related to existing lines of business. Such business spaces may not even appear on the competitive landscape. These companies are "shapeshifters." They analyze changes in the market-place in unique ways, and build profit centers around opportunities that others might not detect.

The competitive question therefore goes deeper. It depends on understanding what value you bring to your customers, and how your company can provide new or better value as opportunities and customer needs change. As a result, you can lead the market rather than mimicking the success of others. Even the best mimic is always a step or two behind the leader.

WHAT VALUE DO YOU PROVIDE TO CUSTOMERS?

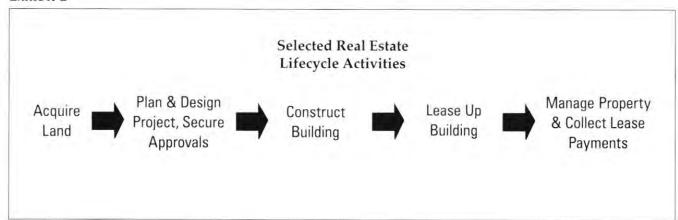
The main value that a real estate asset has to an investor is in providing sufficient financial returns to make the asset a better investment than other opportunities. Since the future is uncertain, the risks involved with achieving the projected returns must also be acceptable at both the asset and portfolio levels.

Ideally, each activity performed by investor-oriented real estate companies provides some value towards reaching these two goals. For instance, the first three activities in *Exhibit* 2 provide the value of the empty building plus the initial cost of the land. This could be broken down further as needed; for example, as the land's value rises when it is rezoned.

In the first four steps, the value rises as investment risk drops because the future cash flows become known with more certainty. Only in the final activity, "Manage Property and Collect Lease Payments," is the promised value (the cash flows) actually delivered.

The final activity is where real estate occupants and investors actually receive value from the real estate. In the end, the value you provide investors (your customers) is based on the income derived from occupants (your customers' customers). The value you provide occupants is more complex since it is based on their business needs, which may vary.²

Exhibit 2



Occupants' Value Chain Activities & Their Real Estate Implications

Forms Infrastructure: Place location and space attributes largely influence effectiveness of administrative support functions & operations

Human Resources Management: Strategic decisions concerning place & space have profound implications for work experiences, & can represent a primary corporate real estate strategy

Technology: Decisions concerning location, and space configurations conducive to innovate work are internal to value additivity sought via technology development

Procurement: Ambiance of space can influence implementation of procurement activities

Inbound	Operations:	Outbound	Marketing/	Service:
Logistics:	Efficient	Logistics:	Sales: Real	Customer
Accessibility and relationships to	functional workspace;	Access to transportation to	estate serves promotion &	convenience & access to
supplier locations	access to workforce	reach distribution system	advertising purposes; direct selling environments	service facilities and service team

Sources: Porter (Value Chain), Roulac (Implications)

A "value chain analysis" is a more formal analysis than the simplified approach just discussed. It is similar in purpose because it disaggregates a business into its value activities to understand such things as the behavior of costs compared to value, and the existing and potential sources of differentiation (see Exhibit 3). Although too detailed to include in this manuscript, learning how to perform the analysis can be of benefit when examining your own and other companies' product and service delivery activities.³

HOW ARE CORE COMPETENCIES USED TO CREATE VALUE?

Core competencies enable an organization to excel at the various activities it does to provide value. They are also what will enable an organization to adapt to changes in existing value chains, or to conquer new ones in the future.

According to Prahalad and Hamel⁴, the core competencies of a company are the real roots of its competitive advantage. Products and markets change over time, but competencies are the basic building blocks for everything the company undertakes.

Viewing the corporation in terms of core competencies is quite different from viewing it in terms of business units. Business units are an organizational structure geared towards producing products or services according to a specific set of delivery activities. They are less fluid, and in fact can be at odds with the successful use of core competencies if they hinder the competencies' movement within a company.

Core competencies result in the ability to produce a set of core business products that provide value to customers. Core business products for a real estate company include the areas outlined in *Exhibit 1* such as service provider, principal, investment banker, etc. (Most companies, of course, define their business products more specifically than in this generic example.)

Ultimately, the value to customers impacts the price you can charge for a product or service. In some market spaces, prices may be driven almost entirely by value to customers rather than by competition. This is particularly true in new or quickly changing market spaces.

HOW DOES A REAL ESTATE COMPANY IDENTIFY ITS CORE COMPETENCIES?

Real estate companies require many competencies to operate, but what makes a competency "core"? First, a core competency should significantly contribute to the benefits a customer gets from the end product or service. Jones Lang LaSalle has a strong finance, tax, and accounting competency that is essential in advising corporate clients on structuring the ownership of the real estate they occupy in order to manage the balance sheet and P&L impacts on the company.

Ideally, a core competency is difficult for competitors to imitate. CB Richard Ellis has invested some research funding and time to develop their knowledge of commercially-available real estate software applications. Their competitive position is enhanced by this knowledge base. It can be made more defensible by continuing to build it and develop a market image around it. However, with software quickly evolving and competitive cooperation between real estate firms growing in the area of technology, this may become a difficult way for CB Richard Ellis to differentiate itself.

Finally, a core competency should provide potential access to various products or markets. Why is Johnson Controls even in the facilities management business? Because its core competency in building systems gave them a competitive edge in building operations and maintenance, particularly in complex technical environments such as the Kennedy Space Center. The broader facility management competency grew from there.

Ultimately, a company's competitive advantage often relies on those things that it does better than other companies.

The lesson to be learned is exactly what your parents told you as a child: If you're going to do something, do it well. A company can achieve success as a boutique firm known for one or two core competencies. It can be a large player with many competencies. Players who don't particularly excel at anything are the ones most likely to be squeezed out in the long run. You compete on your strengths, not your mediocrity.

COMPETING ON YOUR CORE COMPETENCIES

Based on the definition of competing on your core competency, three examples are discussed based on the concept of refining an existing core competency, evolving core competency to meet your customers needs, and evolving your core competency to meet the changing trends.

Refining An Existing Core Competency

Some companies successfully follow a strategy

Today, your toughest future competitors are thinking through two crucial questions: "What value will my company provide our customers?" and "What products or services will we be capable of producing to provide that value?" Delivering value is key to bringing that future vision into focus.

Core competencies are key to delivering that value.

of "sticking to what they're known for." Cushman Realty Corporation is an example of a real estate services firm that is focused on representing tenants in lease transactions. While the firm does offer other related services, tenant representation is generally acknowledged as the core competency of the firm. The general view from the street is that the firm's focus is not to add additional service lines but to continue to refine its core competency by improving its client value.

Evolving to Meet Your Customer Needs

Although it's outside of the real estate industry, Ryder Transportation Services provides a good example of evolution. Ryder exemplifies a company that is divesting its non-core businesses and building its strategic core competencies.

The company states that it has three competitive priorities, which are "to help businesses improve customer service, reduce inventory, and speed products to market." Ryder's core competencies are global integrated logistics, truck leasing and rental, and public transportation services. Ryder Integrated Logistics is the largest third-party logistics company in the U.S.

Ryder has continually disposed of businesses that were once core to the company (such as Ryder Freight Systems) and acquired or developed businesses it sees as necessary core competencies (such as LogiCorp, a logistics management company). It established a strategic logistics and technology relationship with Andersen Consulting and IBM Global Services. As a result, its supply chain management system has grown dramatically in the last 10 years to equal approximately 1/3 of Ryder's revenues. Ryder's strategy is a major shift away from commodity services such as hauling freight into higher value-adding services.

Evolving To Meet The Changing Trends

AMB Property Corporation views itself as a proactive operating company. The firm has recognized the potential impact that the advent of the Internet, just-in-time inventory management, and e-commerce could have on retail properties. AMB has sold the majority of its retail centers and refocused its efforts on High Throughput Distribution™ facilities.

AMB's view is that supply chain management in the new economy stresses speed and efficiency, not storage. The retail business is transforming from the tradition storefront to the distribution focus of e-commerce. They understand the dynamics of transport and logistics, and can deliver nationwide facilities solutions to customers.

They are expanding efforts in this area, both through the redeployment of capital from existing assets and by exiting smaller markets, to further concentrate their holdings in hub distribution markets.

In this case, AMB has made the decision to migrate from traditional retail oriented real estate to e-commerce focused retailing. They have seized an opportunity adapt their core competency to meet the needs of the changing real estate industry landscape.

HOW DO CURRENT TRENDS IMPACT THE CORE COMPETENCIES REAL ESTATE COMPANIES WILL NEED?

Many factors are impacting the real estate industry today. Some we've seen before, such as economic cycles and capital availability. Some are new, for example in the "virtual world" retail economy where certain occupants may ask, "Why do I even need real estate?" By looking at these trends in terms of their impacts – particularly impacts to value chains – companies can gain important clues as to which competencies are core to their future success.

As already noted, e-commerce is one such trend. By listing its overall impacts and then brainstorming and analyzing how they affect real estate-related value chains, you can start seeing what types of competencies companies may need in the future. Such a chart (see *Exhibit 4* for a partial chart) creates a laundry list of competencies that might be appropriate to develop, depending on the firm's market segment and strategy.

As with e-commerce, other trends can be examined in the same manner for their competency

Exhibit 4

	ome Competency Implications of tate Occupants' Move into E-Cor	
Overall Impacts	Real Estate Impacts	Competency Needs
Product sales moving from retail space to virtual space	Impact on retailers' value chain to their customers resulting in: More emphasis on "entertainment experience" and less on efficient product delivery Logistics needs of increased direct product delivery	 Tenant due diligence Logistics and distribution facilities Entertainment facilities
Radically changing industry economics – impacts differ by industry but overall trends of • Lower margins • Disaggregation of value chain	More cost-consciousness of items not adding value to end customer (including real estate) More focus on core activities and less on non-core (such as self-managing corporate real estate)	Knowledge of technology's impact on tenants' industries Micro and macro economics Outsourcing capabilities (various types)

implications. Such trends might include:

- a broader adoption of e-commerce by the real estate industry itself
- the trend toward corporate disposition of real estate ownership
- real estate company mergers
- shifting demand patterns as baby boomers and echo boomers age
- the long-term, mature U.S. economic boom
- the lowering of trade barriers

The core competency impacts of these trends cover a wide gamut, for there is no magical "standard set" of core competencies that a real estate company will need. It depends on who your customers are, and how you will need to provide them value.

HOW DOES A COMPANY STRATEGICALLY MANAGE ITS CORE COMPETENCIES?

How do you implement? In this case, there is a three-step sequence to develop your own core competency strategy. To be effective, each of the three steps requires quite a bit of work – investigation, analysis, and planning. The sequence itself is quite simple.

Step 1: Understand what value you currently bring to your customers. Examine the value you provide to investors, your building occupants, any customers of theirs that you significantly impact, even for yourself and the other owners of your privately-held company. Examine and understand what your current core competencies are across the activities you perform to deliver that value.

Step 2: Determine what types of value your company should provide in the future. This involves researching and developing your ideas on future customer needs and competitive trends. Understand which types of value your company could potentially impact based on current core competencies as well as those you might acquire. Especially important: some creative thinking on new ways to deliver value, particularly if they can replace existing ways of doing things.

Step 3: Planning and communication are crucial. How will you acquire the competencies and enter the markets you'll need in the future? You might buy, build, hire, or take on strategic partners. How will you communicate your intent internally, to the capital markets, to customers, and to competitors?

Today, your toughest future competitors are thinking through two crucial questions: "What value will my company provide our customers?" and "What products or services will we be capable of producing to provide that value?" Delivering value is key to bringing that future vision into focus. Core competencies are key to delivering that value. REIZS

NOTES & REFERENCES

Special thanks to John McMahan and The McMahan Group for providing input and contributing examples. Mr. McMahan is the founder and executive director of the Center for Real Estate Enterprise Management, a non-profit group that provides research, conferences, publications and management training on strategic real estate issues.

The views expressed are those of the author. While much of the information was obtained from individuals at the firms identified prior to the writing of this article, it does not reflect the official position of any of the companies mentioned. Please consider the examples as being illustrative.

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ABOUT THE AUTHOR

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LOGISTICS & THE RISE OF AEROTROPOLIS

by John D. Kasarda, CRE

ore than a decade ago, futurist Alvin Toffler predicted that by the beginning of the 21st century one indisputable law would determine competitive success: *survival of the fastest.*\(^1\) In Toffler's view, producing high-quality goods at competitive prices would still be necessary but no longer sufficient for commercial success. Speed and agility would take center stage, as industry increasingly emphasized accelerated development cycles; international sourcing and sales; flexible, customized production, and rapid delivery.

How right he was. During the 1990s, the most successful companies used advanced information technology and high-speed transportation to source parts globally, minimize their inventories, and provide fast and flexible responses to unique customers' needs, nationally and worldwide. They sought international partners, just-in-time suppliers, and sophisticated distributors and logistics providers. By combining flexible production systems with information systems that connected companies simultaneously to their suppliers and customers, firms reduced cycle times and customized their products to create additional value. They also offered the same speed and flexibility in the delivery process from the time the finished goods left the factory until they arrived at the customer's doorstep.

The rise of the Internet and e-commerce further heightened time-based competition. As late as 1995, sales through the Internet were essentially zero. By 1999, U.S. Internet-based business-to-consumer (B2C) sales had grown to nearly \$7 billion. According to Forrester Research, 166 million packages were shipped in 1999 by Internet retailers (e-tailers), with approximately 70 percent going by express delivery.²

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By 2003, e-tailers are expected to ship 1.1 billion packages annually, with overall global e-commerce approaching \$7 *trillion* in transactions in 2004.³

Most of this explosive growth is expected to be business-to-business (B2B), supply-chain transactions where materials and components will be ordered through the Internet and shipped to nextstage producers. Air cargo and air express have become the preferred modes of shipping and receiving of high value to weight B2B transactions such as microelectronics, automobile electronic components, mobile telephones, fashion clothing, pharmaceuticals, optics, and small precision manufacturing equipment as well as perishables such as seafood and fresh-cut flowers. The introduction of e-marketplaces (auctions, aggregators, bid systems, and exchanges) will greatly expand B2B e-commerce: Forrester Research predicts that e-marketplaces will account for up to three-quarters of B2B supply chain transactions by 2004.4

However, as many e-tailers discovered during the 1999 Christmas season, as valuable as the Internet is in generating sales, the Web cannot move a box. Order fulfillment frequently broke down, and the WWW—worldwide wait—cost e-tailers plenty.

To meet the imperative of speed in order fulfillment, e-commerce distribution centers are being built near airports that have extensive flight networks, a location trend that's sure to accelerate in the decades ahead. This will especially be the case at the nation's two air express mega hubs: Memphis International (FedEx) and Louisville (UPS). These gateway express airports actually extend the business day for e-commerce fulfillment by allowing shippers to take orders for next day delivery as late as midnight. Dozens of e-tailers have thus already located their fulfillment centers near Memphis International Airport including barnesandnoble.com, PlanetRx.com, Toysrus.com, and williamssonoma.com. The same story holds for Louisville International Airport where such companies as Nike.com, Drug Emporium.com, and Guess? have sited e-commerce fulfillment centers.

Complementing these aviation-linked distribution centers are flow-through facilities for perishables (either in the physical or economic sense), just-in-time supply chain and emergency parts provision centers, and reverse logistics facilities for the repair and upgrade of high tech products such as computers and cell phones. The clustering of such time-sensitive goods facilities around airports is

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stimulating further expansion of air cargo, air express, less-than-load (LTL) trucking, freight forwarders, and third-party logistics providers along major arteries leading into and out of gateway airports. All of these functions and facilities are leveraging off of each other.

Speed and agility have become so critical to the new economy that air commerce is quickly becoming its logistical backbone. Forty percent of the value of world trade already goes by air, and the percentage is steadily rising.⁵ Further evidence that we have entered "the fast century" is offered by data showing that nearly two-thirds of all U.S. air cargo is transported via 24- to 48-hour door-to-door express shipments, with the FedEx hub at Memphis becoming the world's leading air cargo airport.⁶

Not only time-sensitive goods-processing and distribution facilities are being drawn to gateway airports. As our service economy also shifts into fastforward, these airports are becoming magnets for corporate headquarters, regional offices, and professional associations that require officers and staff to undertake considerable long-distance travel. Airport access is likewise a powerful attraction to service-sector industries such as consulting, advertising, legal, data processing, accounting and auditing, and public relations, which often send out professionals to distant customers' sites or bring in their clients by air. Business travelers, overall, benefit considerably from access to major airports, which offer greater choice of flights and destinations, more frequent service, more flexibility in rescheduling, and generally lower travel-related

costs, (for example, hub airports make it easier to avoid the time and expense of overnight stays).

With intellectual capital supplanting physical capital as the primary factor in wealth creation, time has taken on heightened importance for today's knowledge workers. So has the mobility of these workers over long distances. Research has shown that technology workers travel by air between 60 percent and 400 percent more frequently than those in the general workforce.⁸

Some observers have suggested that advances in Internet access, videoconferencing, and other distributed communications technologies will diminish the need for air travel. The evidence indicates that telecommunications advances often promote additional air travel by substantially expanding long-distance business and personal networking. Indeed, innovations in telecommunications technology have generated spatial mobility at least since the days of Alexander Graham Bell—whose first words over his newly invented telephone were "Watson, come here, I need you."

URBAN ECONOMIC AND LAND USE IMPACTS

In an economy increasingly geared to speed, mobility, and global access, frequent and extensive air service has become essential to attracting major conventions, trade shows, and merchandise marts. Two facilities-Infomart and Market Center, both of which are located on the I-35 corridor between Dallas' Love Field Airport and the Dallas-Ft. Worth International Airport-offer examples of this attraction. Infomart is a huge, ultra-contemporary merchandise display building for telecommunications and information technology companies. Market Center-a cluster of six large buildings that contain nearly seven million square feet of display space for fashion clothing and home merchandiseis the world's largest wholesale merchandise mart. Hundreds of thousands of buyers and vendors fly into Dallas annually to conduct business at Infomart and Market Center. In 1999, the Market Center alone attracted buyers and vendors from all 50 states and 84 countries, who purchased 300,000 airline seats and filled 720,000 hotel rooms while conducting an estimated \$7.5 billion in wholesale transactions.

Clusters of high-tech facilities and information technology companies are likewise locating along major airport corridors, such as those along the Dulles International Airport access corridor in Northern

Virginia and the expressways leading into and out of Chicago's O'Hare International Airport. The experiences of Dulles and O'Hare are being replicated across the country, with airport scale becoming a primary predictor of an area's high-tech job growth.

Kenneth Button and Roger Stough conducted a comprehensive study of the impact of hub airports on employment growth in high-tech fields." Their multiple-regression analysis (which controlled for other factors that may affect high-tech job growth) covered all 321 U.S. metropolitan statistical areas (MSAs) and generated convincing results. Button and Stough showed that the presence of a hub airport in a MSA increases the number of hightechnology jobs in the area by over 12,000, and their multiple-regression model explained over 64 percent of the variation among metropolitan areas in high-technology employment growth. Additional analysis revealed that the causal link between job growth and the level of airport services flowed from air transportation to the creation of high-tech employment, and not vice versa. This finding has been corroborated by research that the author and Michael D. Irwin conducted, demonstrating that airports have pervasive effects on overall metropolitan employment growth and that the causal relationship flows from extensiveness of air connections to employment growth.10

Across the U.S. and around the world, gateway airports are having dramatic effects on urban economies and land use. For example, Los Angeles International Airport (LAX) is responsible for over 400,000 jobs in the five-county Los Angeles region; 80 percent of which were in L.A. County, where one in 20 jobs was found to be tied to LAX. The airport currently generates \$61 billion in regional economic activity, which translates to \$7 million per hour.

Dallas-Ft. Worth International Airport has become the primary driver of Metroplex's fast-growing economy. The number of companies located within the dynamic Las Colinas area, just to the east of the airport, has expanded to more than 2,000 and includes Abbot Laboratories, AT&T, Exxon, GTE, Hewlett-Packard, and Microsoft.

In the 26-mile commercial corridor linking Washington, DC's two major airports-Reagan National and Dulles International—employment grew from 50,000 in 1970 to over 600,000 by 1996.¹¹ This represents a 1,100 percent increase: in contrast, overall U.S. employment growth during this period was 59 percent. Among the companies located along the

airport corridor are America Online, Computer Associates, Nextel Communications, Cisco Systems, and EDS.

In the Philippines, Subic Bay Freeport is rapidly expanding around a former U.S. naval air base that was converted to commercial use in 1993. Since FedEx located its Asia/Pacific hub at Subic Bay in 1994, over 150 firms—employing 40,000 workers—have located there, generating almost \$2.5 billion in investment. Between 1994 and 1999, the annual value of exports from Subic Bay jumped from \$24 million in to \$559 million. In late 1998, Acer opened its largest personal computer assembly facility in the world at Subic Bay; the facility relies heavily on air freight for its supply-chain management.

By 1997, nearly 50,000 people (the traditional city size threshold for U.S. metropolitan status) were employed on the airport grounds at Amsterdam's Schiphol Airport, a 7.2 percent increase over the previous year. In 1998, nearly half of the 547 companies linked to Schiphol grew—compared with 31 percent in 1995. Schiphol alone accounts for 10 percent of the European air cargo market and 1.9 percent of Netherlands' GNP; the airport forecasts that by 2015, it will generate 2.8 percent—approximately \$14 billion.

The impact of airport-induced job growth on land use in the vicinity of airports is substantial. An analysis of employment growth in the suburban rings of U.S. metropolitan areas showed that areas within four miles of airports added jobs two to five times faster than the overall job-growth rate of the suburban ring within which the airport was located. Most of the employment was concentrated around the airport or along a major access corridor within 15 minutes of the airport.¹²

THE RISE OF THE AEROTROPOLIS

Emerging corridors, clusters, and spines of airportinduced businesses are giving rise to new urban forms as much as 15 miles from major airports. These represent the beginnings of the aerotropolis. In response to the new economy's demands for speed and reliability, the aerotropolis is based on low density, wide lanes, and fast movements. In other words, form is following function.

Although aerotropoli have so far evolved largely spontaneously—with previous development creating arterial bottlenecks—in the future they will be improved through strategic infrastructure planning. For instance, dedicated expressway links (aerolanes)

To many, this new spatial structure will appear simply as additional sprawl along main airport corridors. Yet the aerotropolis will actually be a highly reticulated system based on time-cost access gradients radiating outward from the airport; in short, the three "A's" (accessibility, accessibility, accessibility) will replace the three "L's" (location, location, location) as the most important commercial real estate organizing principle.

and high-speed rail (aerotrains) will efficiently connect airports to nearby and more distant business and residential centers. Special truck-only lanes will likely be added to airport expressways, as well. Seamlessly connected multi-modal infrastructure will accelerate intermodal transfers of goods and people, improving logistic system effectiveness and further influencing business location and resulting urban form.

The metric for determining commercial real estate value (and corresponding urban structure) will be time-cost access to the airport. Firms of various types will bid against each other for accessibility predicated on the utility each gives to the related combination of time and cost of moving people and products to and from the airport. Land value will no longer be measured by traditional bid-rent functions that decline linearly with spatial distance from the primary mode (here, the airport), but by speed to the to the airport from alternative sites via connecting highways and rail arteries.

To many, this new spatial structure will appear simply as additional sprawl along main airport corridors. Yet the aerotropolis will actually be a highly reticulated system based on time-cost access gradients radiating outward from the airport; in short, the three "A's" (accessibility, accessibility, accessibility) will replace the three "L's" (location, location, location) as the most important commercial real estate organizing principle.

Air-commerce clusters and spines are already taking on distinct spatial form around gateway airports such as Miami International, New York's Kennedy, LAX, London's Heathrow, Paris's Charles de Gaulle, and Amsterdam's Schiphol. In the United States, even smaller, specialized air-cargo airports such as Alliance Airport, near Ft. Worth, Texas, and Rickenbacker Airport, in Columbus, Ohio—are generating mini-aerotropoli in the form of low density cluster and spine development. Commercial real estate development surrounding Southern California's Ontario Airport—which cornerstones the Inland Empire logistics complex 40 miles east of Los Angeles—offers an excellent contemporary illustration of an aerotropolis in evolution. Over 12 million square feet of distribution space was added in 1999 adjacent to the airport and along I-10 and I-15 radiating from it. As of mid-2000, another 10 million square feet was on the way. Moreover, the size of Inland Empire distribution facilities has dramatically increased from an average of 200,000 square feet in 1985 to over 500,000 square feet in the late 1990s, with some facilities in the 800,000 to 1 million square feet range.13

In Brazil, one can observe an emerging aerotropolis centered around Viracopos International Airport in Campinas, located 60 miles east of Sao Paulo, where high-tech manufacturing, distribution, and logistics industries are clustering. Viracopos will likely become the air cargo and e-commerce fulfillment center of South America over the coming decade with aviation-driven urban form resulting from these logistic and high-tech clusters radiating outward from the airport.

Aerotropoli are also emerging in distinct patterns around new international airports in Asia. One example is Lantau Island, where the newly opened Hong Kong International Airport is spawning highly visible business and residential clusters directly linked to the airport. In late 1999, the Walt Disney Company announced that it would locate its third international theme park (Hong Kong Disneyland) on Lantau Island to take advantage of the international airport and its high-speed rail and expressway links to Hong Kong. This siting decision is not unlike those Disney made earlier for Tokyo Disneyland, near Narita International Airport, and EuroDisney, near Paris's Charles de Gaulle Airport.

A major planned aerotropolis is under development at Inchon, Korea, where the government is creating a 24-hour aviation city on Yongjong Island, about 40 miles west of downtown Seoul. The new international airport (scheduled to open in 2001) will anchor an expansive urban agglomeration composed of commercial, industrial, residential, and tourism sectors. Its centerpiece will be Media

Valley, Korea's version of Silicon Valley. Designed as a center for global high-tech industries, Media Valley is being constructed adjacent to the airport on a 3.6-million-square-meter site that will include a large techno-park and a university research center.

As of mid-1999, 625 companies—including 49 companies from Canada, Israel, Japan, The Netherlands, Taiwan, and the United States, among others—had submitted letters of intent to move into Media Valley. Arthur D. Little predicts that by 2003, a total of 1,300 companies will be located in Media Valley's campus-like setting, and by 2005 slightly over 2,000.¹⁴

A new town is being developed to serve as a residential base for those employed at Media Valley and in other sectors of this emerging aerotropolis. Dedicated expressways will give both Media Valley employees and the new town residents high-speed access to Inchon Airport.

By 2004, the airport, (currently over 90 percent complete), will be complemented by a seaport and a teleport now under construction. The plan is to form a consolidated "triport" for 21st-century transportation, distribution, and information processing.

An even more ambitiously planned aerotropolis radiates northward from the Kuala Lumpur International Airport in Malaysia. This massive new airport will provide the aviation foundation for Malaysia's Multimedia Super Corridor (MSC), a high-tech government, commercial, education, and residential zone about the size of the city of Chicago. Promoted internationally as the future information technology center of Asia, MSC will contain two new cities (Putrajaya, the relocated government capital, and Cyberjaya, or Cyber-city, each of which will house about a quarter of a million residents), along with a multi-media university to train IT workers. MSC's advanced infrastructure will be complemented by laws and policies designed to create the ideal commercial environment for developing and merging 21st-century audio, video, and data transmission technologies.

REAL ESTATE COMMUNITY RESPONSES

Hong Kong's Lantau Island, Korea's Inchon-Aviation City, and Malaysia's Multi-media Super Corridor demonstrate that gateway airports will be the cornerstones of dynamic new forms of 21st-century urban development. The commercial real estate

community has already begun to take serious notice and respond. For example, both the Trammell Crow Company and Hines have established airport property divisions as new units in their corporate structures. The Perot Group spun off Hillwood Development to focus on maximizing real estate returns on the 16,000 acres linked to its successful Alliance Industrial Airport and associated Hillwood Strategic Services to replicate the Alliance model elsewhere.

Real estate investment trusts such as Prologis and AMB are likewise giving primary emphasis to airport-linked logistics and distribution properties. In fact, AMB is disposing of much of its traditional warehousing and retail properties to focus its investments on high velocity flow-through distribution facilities near America's largest airports. At the same time, specialized commercial real estate companies including International Airport Centers, headquartered in Birmingham, Michigan, are concentrating on building business and distribution parks around the nation's top airports while firms such as DAMG of New York are introducing innovative public/private financing instruments to develop air cargo airports (e.g., San Diego Air Commerce Center) and commercialized cargo complexes of existing airports (e.g., Denver International). Finally, even multi-national engineering and construction enterprises such as Bechtel are establishing subsidiaries (Alterra Partners, headquartered in London) to purchase privatizing airports around the globe and develop adjoining real estate. These firms and others understand the powerful role that logistics, in general, and air commerce, in particular, will play in business strategy and location in the 21st century. They are placing their commercial real estate bets accordingly.

CONCLUSION

Gateway airports will be as important to business location and urban development in the 21st century as automobiles and trucks were in the 20th century, railroads in the 19th century, and waterborne transport in the 18th century. While multiple transportation modes will continue to shape metropolitan growth, substantial evidence is accumulating that major airports are generating concentrations of commercial activities that are leading to a new aviation-linked urban form—the aerotropolis. Real estate professionals who recognize this megatrend can select strategic sites near gateway airports and position investment to be leveraged by air commerce. Planners and developers who design and build infrastructure and facilities that are consistent with

the new form and function of the aerotropolis can contribute substantially to the economic competitiveness of urban areas and to the emerging needs of business. REIZS

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Taking the Stress Out of Distressed Property

by Thomas S. Smith

REIT investment and other commercial real estate market, REIT investment and other commercial real estate opportunities are greater than ever. Retail sales at shopping centers increased by \$109 billion in 1999, up 7.6 percent over the year before, and accounted for 52 percent of the nation's overall retail sales according to a white paper issued by the International Council of Shopping Centers. Despite the good news, there has been a substantial increase in the amount of surplus retail space or "distressed" properties that cost landlords and tenants a great deal of money. Real estate attorneys and other professionals are working to address this problem by helping retailers with surplus property reduce their cost of operating through a variety of strategies, including subletting at reduced rates. To understand how these strategies work, it is useful to look at the factors that contribute to the creation of distressed property in the first place.

DISTRESSED PROPERTY RESULT OF THREE PRIMARY FACTORS

A retailer may be highly successful with its primary business of selling "widgets," but still have various stores that fail. Three main factors impact the value and health of commercial property: size, location, and condition, any of which may change significantly over time. In the early half of the 20th century, people tended to live in the town where they worked, often establishing retail stores on the first floor of a building and apartments or town homes on the upper floors. Thus, shoppers were able to walk quickly from their place of work to the local hardware store and then to the local bakery or grocery store, which were often located within the same block. Moreover, the majority of retail shops were family-owned and often specialized in a particular trade, product,

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or service. These shoppers went to the bakery to get bread, the grocer to buy milk, and the butcher to buy meat. As a result, most stores required minimal space to sell their wares, with the average commercial property size in the 1930s and 40s ranging from 500 to 20,000 square feet.

At the end of World War II, however, with a booming economy and rapid growth of the automobile industry, more prosperous workers began fleeing to the suburbs. Because it no longer made sense for commuters to drive from one store to the next only to pick up a few items, retailers began stocking a wider range of products, resulting in an increased demand for space. Grocery stores, for example, grew in size in direct proportion to the amount of goods stocked, growing to 25,000 square feet in the 50s and to 35,000 square feet in the late 60s. With the advent of community and neighborhood shopping centers in the late 60s and 70s, grocery operations expanded so shoppers could buy everything from garden hoses and shoe polish to freshly-baked rolls and a gallon of milk. As a result, retail grocery stores grew as large as 50,000 square feet.

As customer demand for department stores and shopping centers grew, many retailers abandoned their original properties in favor of larger spaces or those spaces located in or adjacent to malls, business parks, or other locations that offered increased traffic. While stores such as Wal-Mart, Big K, Costco and other suburban mega retailers are clearly here to stay, the last decade has also seen a revitalization of urban centers, especially in the inner city where public-private partnerships such as the Harlem USA project in New York City are developing chain retail and entertainment complexes funneling jobs and money back into lower-income neighborhoods.2 As a result, so-called distressed properties may be found in almost any area of the country, with small, older strip centers being abandoned for newer, bigger ones down the block or even across the street.

While some companies are able to sell off their original storefronts, many of these surplus properties are subject to long-term leases of up to 60 years with all of the accompanying economic obligations. Meanwhile, these properties grow out-dated and deteriorate due to lack of use. Many retailers are reluctant to renovate or make repairs since such action will result in even greater economic detriment. Retailers, large and small, fall prey to this problem. According to a recent article in *Shopping Centers Today*, Wal-Mart has an inventory of 30 million square feet of excess space.³ Due to

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increased national competition, surplus or distressed property seems especially prominent among supermarket chains and drugstores that have had to replace older, smaller stores with larger, more up-to-date ones or follow demographic changes and move to larger population centers.

FINDING A SOLUTION

Is there a realistic solution for distressed properties? While selling these properties may be an option if the real property is owned in fee, it may not be realistic where a retailer leases the property. Although some landlords may be willing to allow a buy-out or other termination of the lease, most recognize that large national credit chain stores such as K-Mart or CVS Pharmacy make great tenants and landlords are often unwilling to cancel the lease because they are left to fill a vacancy, often with a less stable tenant. As a result, more and more retailers with surplus properties are becoming landlords themselves, subleasing at a reduced rent or assigning their interest in the lease for a small fee to contain or reduce losses.

STOP THE BLEEDING

A good example is one of the author's commercial real estate clients, a large national supermarket chain, which for the purposes of this article will be referred to as ABC Corporation ("ABC"). In the mid-80s, another company he represented was asked to help ABC with its surplus properties. ABC had more than 1,200 surplus properties in about 36 states. Some, including an 80,000 square foot unit in a Chicago suburb had been closed due to shifting demographics. Here, the neighborhood no longer generated sufficient retail traffic to support the costs of operation. Another ABC property in a suburb of Washington, DC, was in an ideal location (in

fact, ABC decided to build a larger, newer store right across the street), but the building was too small and the underlying property insufficient to support a larger "on-site" replacement. As is always the case, each of ABC's surplus properties was unique in its location, condition, size, and reason for no longer being useful for its original intended purpose.

At the end of the day, ABC was carrying this surplus property portfolio on its books at an approximate \$200 million negative value. Clearly, the first priority was to "stop the bleeding" by reducing the amount of ongoing fixed costs. One solution was for ABC to find tenants and subtenants to take over ABC's position in these surplus properties so that ABC could begin to recoup its losses. The challenge was finding the right tenants and subtenants, that, on the one hand, would not be incompatible with ABC's own business and at the same time sold products or services that would succeed at that particular location.

ABC's approach varied from location to location. In some cases, ABC sought tenants and subtenants such as startups or nonprofit organizations with reduced financial resources, that would entertain occupancy of properties that were less than first-class retail locations in exchange for lower rents or other economic incentives. In other locations, ABC was willing to subdivide the building into shop space to accommodate local merchants. In yet others, ABC was only willing to lease to first-class national credit retailers.

Keep in mind that these tenants and subtenants were often in the same boat as ABC, in that time was an enemy to the bottom line. Any small retail business will have a finite time because of economic necessity within which to open its business. For example, ABC entered into negotiations with an entrepreneur who sold handmade items imported from outside the U.S. His brother acquired these items in Central Asia and was prepared to ship them to the U.S. for the entrepreneur to sell, but he had to move the shipment quickly to pay the salaries of the craftsmen who made these items. The entrepreneur therefore had to quickly find a space that he could afford and one that would attract sufficient retail traffic to support his family. ABC offered part of a distressed property to the entrepreneur at a reduced rental rate provided that he took occupancy right away. Both the entrepreneur and ABC were economically motivated to consummate the transaction quickly and with professionals on

both sides of the transaction who understood the nature of distressed property, a favorable result was achieved for both parties.

As you can see, the foregoing is an example of a true win-win situation for the leasing entity that was able to reduce its negative value and the tenant who was able to rent space at reduced rates, open his business quickly, and realize immediate income.

A second challenge for ABC was to reduce the dayto-day costs incurred in operating these properties. The first step for ABC was to get its arms around the various aspects of its economic obligations at each property. For example, many properties had been assessed for tax purposes as operating retail stores, and now that they were no longer fully useful for that purpose; challenging the tax assessments, where appropriate, resulted in many tax reductions. Controlling day-to-day operating expenses, such as making sure that lighting systems were shut down or placed on timers and heating systems were properly taken offline reduced monthly utility expenses. Increasing security activities reduced vandalism costs. While all measures cost money initially, these investments paid handsome dividends in the long run by reducing out-of-pocket costs while ABC sought a replacement occupant.

Because the first priority of ABC was to stop the bleeding, ABC quickly realized that leasing or subleasing these properties, even at reduced retail rates combined with prudent property management strategies, contributed to the reduction of the negative \$200 million value of its surplus property portfolio.

WHAT LANDLORDS SHOULD LOOK FOR

While any entity seeking to lease distressed or surplus property is driven by the need to improve profitability (or at least the reduction of a negative value) as its primary goal, the prospective landlord must still maintain some control of the lease and how the property will be used. Below are some strategies that any prospective retailer/landlord should use when leasing or subleasing its distressed or surplus properties:

• Make sure the prospective tenant understands that the premises are being offered as is, with no representations or warranties as to the condition of the building. Smart landlords will make basic up-front repairs, such as those related to the roof or operating systems and correct defects that are reported within the first 30 to 60 days of the term because those types of repairs will be vital for the tenant/subtenant to run its business safely and effectively (and therefore ensure that rent will be paid regularly). Depending on the tenant's/subtenant's financial resources, the landlord may be able to amortize over the term of the lease the cost of any repairs made in excess of a predetermined or negotiated amount.

- Insist that the lease be "triple net" pure and simple; the tenant/subtenant must pay all taxes, insurance and common area maintenance charges incurred during the term; otherwise, the landlord will have to charge more base rent.
- Negotiate carefully the provisions governing the condition of premises at the end of the term. If the tenant/subtenant chooses to alter the premises in any way, it may jeopardize the lease that the landlord has with its master landlord.
- Be flexible with base rent—remember this may be the only tenant/subtenant available for this particular distressed property. Keeping the lights and heat on and the taxes paid, even if the rent is at a reduced rate, may be advantageous until the market turns and a better tenant/subtenant can be found.
- Require that the potential tenant/subtenant use your lease form and make sure you have developed a form that can be negotiated quickly. While many lease forms are relatively evenhanded in terms of information provided and agreements struck, the document should favor the landlord's position on matters such as triple net expenses, default, condition of premises, alterations, and assignment/subletting. The landlord's lease form should not be a very hard sell to the potential tenant/subtenant, because most will recognize the trade off of a reduced rent, and the landlord's need for ease of administration. Both parties should want to consummate the transition quickly and using the landlord's form may help to speed up the process.

WHAT TENANTS/SUBTENANTS SHOULD LOOK FOR

As stated earlier, prospective tenants/subtenants with limited financial resources may be able to gain access to quality property at a fraction of the price they would otherwise have to pay for similar property. Because many of ABC's distressed properties were underlong-termleases, ABC might have leased property for only \$5 a square foot back in 1960, whereas a similar property leased today might bring \$15 a square foot. Because ABC's main focus was to reduce its losses, ABC often offered to sublease the properties to smaller tenants/subtenants at a lower

An experienced attorney and other experienced real estate professionals can help companies review their distressed property situation in terms of the company's overall business plan and goals and provide advice concerning appropriate alternative economic strategies for each particular property.

than market rent, especially if several smaller tenants/subtenants could be brought in all at once to share a space that might have been too large for a single tenant/subtenant.

Just because a tenant/subtenant has limited economic resources, it does not mean it should immediately take the landlord up on the first deal offered. Tenants/subtenants need to be sure that the reasons the retailer/landlord vacated the property will not negatively impact the tenant's/subtenant's ability to succeed in the property.

If the landlord has vacated the property simply because it has outgrown the space, and not due to its poor retail location or the physical condition of the property, chances are that this property may present an exceptional retail opportunity. The tenant/subtenant should carefully evaluate how the location of the property might impact the products or services the tenant/subtenant offers. For example, a prospective tenant/subtenant that is a nonprofit organization working with a particular clientele may be benefited by an inner-city location because its business will be located in the heart of the community it serves. Personal service providers such as dentists or accountants might also prefer a retail site in a community or strip center location rather than a busy downtown commercial area, because their patients will not have to worry about competing for scarce parking spaces.

Prospective tenants/subtenants should also be sure to conduct a full physical inspection of the premises and surrounding area. Distressed buildings are often in disrepair and the tenant/subtenant may use that fact as a negotiating tool with the landlord. For example, a tenant/subtenant may offer to repair a leaking roof in exchange for a further rent reduction or may request that the landlord pay for a new roof in exchange and allow the landlord to amortize the cost of the roof over the term of the lease. Subtenants of ABC successfully used these arrangements in various ABC sites.

The tenant/subtenant should stay firm on keeping the rent low and should only agree to pay percentage rent when a reduction in base rent or other economic incentive is included. Remember that the property is a significant current expense to the landlord and any amelioration of that expense is a true benefit to the retailer's/lessor's bottom line. The tenant/subtenant may have additional leverage where the distressed property is particularly difficult and the tenant/subtenant is the only real prospect.

NEGOTIATING THE SPECIFICS

Other issues will arise during the course of negotiations and while it is not within the scope of this article to specifically address each provision of a lease/sublease, prospective tenants/subtenants and landlords should develop strategies for each provision before entering into negotiations. The "Use" clause is a good example of the kinds of matters that may arise in this surplus property context.

The use of its surplus properties was one of the biggest challenges for ABC. Using a property in the Washington, DC, area as an example, ABC knew it had to find a tenant/subtenant that could afford and use a large building space, and who would not be put off by the building's older appearance. Because of the favorable retail location of this building, seeking a nonprofit group or even a large discounter was not appropriate. ABC was confident that a better-established national retail tenant who could see the potential of the space would be attracted to the property. As the prospective landlord, ABC needed to think about what sort of control was necessary based on adjoining tenancies, local zoning and market conditions. ABC would not agree to a clause that would permit "any lawful retail use," as such a clause might encourage a further subletting by the tenant at greater rent, depriving ABC of the real property's value. ABC recognized that leasing the few very good properties at market or above-market rents is necessary to offset the other negative value portfolio properties. Additionally, such a clause could raise public relations issues for ABC if the subtenant's business, while legal, did not fit into the character of the shopping center or neighborhood in which it is located. For example, consider the risk to ABC if a family-friendly drugstore sublet to a tenant who operated an adult bookstore or gambling establishment. While both ventures may be legal, ABC believed that these types of uses would certainly compromise the image and community standing of ABC.

Other use issues that ABC had to address included granting of exclusive rights and operating covenants. ABC avoided granting broad exclusive rights out of fear of "handcuffing" ABC's rights when leasing adjoining premises. Carefully crafted and narrowly drawn exclusivity clauses were often acceptable to both parties. ABC often tried to obtain an operating covenant, but recognizing that these are difficult properties to lease, never forced the issue if the tenant opposed it. Tenants/subtenants were often willing to grant ABC the right to recapture the property and terminate the tenant's/subtenant's possession if the tenant/subtenant went "dark" for some extended period (i.e., more than 90-180 days).

In the case of the Washington, DC, property, ABC negotiated a subtenant arrangement with a major bath and linen store that saw the retail potential of the large space and agreed to make necessary renovations to the building and to hike rent. ABC also focused on other specific areas of its leasehold relationships in distressed properties including operations, maintenance and repair of the building and common areas, and assignment and subletting rights.

CONCLUSION

While many entities may feel initially a little uneasy about playing the role of landlord, especially if they are concerned that it may divert them from their "real" business, many retailers, especially larger chains, clearly have begun to realize the benefits of various exit strategies including subleasing their distressed property. While it may take some time to identify and attract the right occupants for its surplus properties, in the long term, companies can significantly reduce the drain on corporate resources that these portfolios often cause. An experienced attorney and other experienced real estate professionals can help companies review their distressed property situation in terms of the company's overall business plan and goals and provide advice concerning appropriate alternative economic strategies for each particular property. The end result may be the identification and realization of substantial value in these properties and the proverbial conversion of a sow's ear into a silk purse. REIZS

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ELEMENTS OF CHANGE, STABILITY & UNCERTAINTY IN THE RETAIL REAL ESTATE MARKET

by Alan R. Winger

The threat of on-line shopping has been an unsettling factor in the retail real estate market for some time now.\(^1\) While the recent problems of many "pure-play dot.com e-tailers" (e.g., Price line.com) may raise questions about just how serious this threat is, on-line consumer shopping continues to grow rapidly. And even though such e-commerce still only constitutes a relatively small proportion of the total, (slightly less than one percent), its continued growth, along with the sustained optimism of the technology guru about its future, continues to cast a shadow on investment holdings of the real estate that houses today's brick and mortar retailers.

Of course, those with a current vested interest in such real estate can take comfort in the fact that forecast of drastic economic change seldom if ever comes close to the mark. But things do change and some times dramatically. How and where we distribute consumer goods and services, for example, is substantially different today from what it was prior to the dominance of the automobile in our lives.

While one of the messages in this article is that it is safe to say that there is no depression in sight for most current investors in retail real estate, there is good reason to believe that change, and possibly significant change, is coming. While we don't know exactly how much and how soon, we do have knowledge and a broad understanding of some of the agents of change, (stability and uncertainty), likely to impact the movement of shopping into the virtual world. After spelling out these forces and how they are likely to influence retail real estate, some thoughts are offered about likely outcomes. To preview these, if the concern is with the next decade or two, technology gurus offer greatly exaggerated views about the likelihood of radical change in where and how we will

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shop in the new economy. As we go further out in time, the prospect of significant change becomes more likely. While there are elements of stability in this market that will leave us with recognizable features even as we approach the middle part of the 21st century, there will be a lot that is different as we respond to the undeniable benefits of bringing our shopping decisions into the virtual world.

SOME BASICS: IT ALL DEPENDS ON SHOPPING BEHAVIOR

What most retailers provide in the current setting is site utility. The space they use in creating that utility (or value) is the retail real estate, the market for which reflects a large array of factors that come into play in market supply and demand. While there are many elements in the retail real estate market equation, at rock bottom lies the shopping behavior of households.

Households, of course, make purchases based on what they want and what they can afford. The shopping experience is how they go about finding what they want at the price they are willing to pay. Retailing is—or should be—a concern in making this experience a success.

What households want when they shop is information, convenience, and a positive experience. The information needed is facts about prices and the qualitative characteristics of what they want to buy. Convenience reflects the ease with which the facts can be collected and a purchase made. Put in terms of costs, convenience is reflected in the time, transportation, and communication costs involved in the purchase. The shopping experience has to do with the socio-psychological elements in the act of purchasing. To some folks, this is more than just an effort to get what they want at a minimum cost. The experience is a part of what they do that gives life its meaning.2 It is also something that provides them with opportunities to socialize with others, which is important to some.

The retail real estate market, if it does its job right, clearly does a lot for households. Precisely what that is depends upon elements that underpin shopping behavior, which means if there is significant upcoming change in the role of retail real estate in getting goods to the final consumer, it will be the result of elements of change that impact this behavior. Pitted against such elements of change are those that engender stability and uncertainty. The outcome can be seen as coming out of the interplay of these three sets of forces.

FORCES OF CHANGE

The big, current threat to the way in which existing retailers operate and hence the real estate they use, comes, of course, from our emerging information technology. Coming out of this technology—now concentrated in the development of the Internet—are economic benefits accruing both to the seller and buyer.

The economics here as they play out in business-toconsumer e-commerce bring forth a number of significant cost savings to the seller. The most obvious of these is the reduction in costs that comes from cutting out expensive shopfront operations as well as intermediaries when possible. Economies of scale and scope also come easier on-line in certain kinds of operations. Once a Web site is set up, the cost of its use in the pursuit of an additional customer, for example, drops to almost zero. And with successful customer contact, it is much easier and less costly to push other products and services. Web contacts also provide the basis for collecting and assimilating more information about the customer at a much lower cost then is now incurred in an off-line operation.3

From the viewpoint of the consumer, electronic linkages allow them to comparison shop in a less costly way. Moving around with the click of a mouse is much less expensive both in terms of travel cost and the time involved in moving from store to store.

The matter of time savings is particularly important to many families, in large part, because of the mass movement of women into the work force.4 This movement, coupled with the growing importance of the extra-curricula activities of their children, has greatly increased the time pressures faced by parents. Large numbers of families now have less time to shop than did previous generations. While leisurely shopping (and the things acquired through the experience) can add to life's pleasures, it is no longer possible for many. Trips to the mall do not fit well into a schedule crammed with work as well as school and home-life activities. Trips to superstores or groups of "killer-ap" stores that make it easier and quicker to find what is needed is one consequence. Eating out more is another. And entry into the virtual world of shopping seems to be fast becoming another.

Of course, shopping in cyberspace is something that requires competence in navigation that many do not have; this means some ability to operate a computer, which is not a skill possessed by all who shop. But it's one that many, especially the young, are acquiring. Furthermore, the skill requirements are being reduced as technology gives us more user-friendly ways to link up with the electronic networks that are the core element of cyberspace activity.

Clearly, the electronic shopping options that are developing provide shoppers with alternatives chucked full of economic benefits in a growing number of areas of consumption.⁵ And the nature of these benefits seems to be important to a growing number of shoppers. Despite the recent problems of many "pure-play" operations, on-line shopping still appears to be an alternative that will, in time, become a dominant way to shop for many things. Or will it?

FORCES OF STABILITY

While no one doubts the presence of dynamic forces in the current economic setting, change, while it can be fast-paced and radical, is more often slow-paced and evolutionary. Forces of stability usually abound. Such forces, as they impinge upon retailing, are not absent today.

One of these is found in demography. That the nation is aging in the sense that proportionately more of its population is falling into older age categories is a demographic fact likely to slow the movement of shopping decisions into the virtual world.6 Older people, not surprisingly, have been much slower to acquire the skills needed to operate in cyberspace. The young now receive training in the early years of their schooling, most of whom quickly become comfortable operating in the virtual world. This training is not so readily available to the elderly, who, in any events, are less receptive to it. Older folks are thus less attracted to the potential benefits of e-shopping. This is not to say they will shun shopping in cyberspace. It is to say that the probability of their doing so will be substantially less than it is for the young. The elderly are a stabilizing force in the sense that their presence will restrain the growth of e-shopping. While this is restraint that, in time, will disappear, it won't happen for quite some time—a generation.

A second development likely to slow up the movement towards cyberspace shopping is the recent widening of the disparities of personal income and wealth. While our recent economic prosperity has enriched the coffers of many, it has failed to reach some. Consider just one brief comparison. In 1979, From the viewpoint of the consumer, electronic linkages allow them to comparison shop in a less costly way. Moving around with the click of a mouse is much less expensive both in terms of travel cost and the time involved in moving from store to store.

the median income of an American in the upper 5 percent of the income distribution was three times the median for the entire population and 13 times that of the median of those in the lower 5 percent of this distribution. By 1997, those in the upper 5 percent had incomes almost four times the population median and 23 times that of those in the lowest 5 percent. Since there are clear indications that the use of new information technology is income sensitive—use is much greater for higher-income groups than those with lower incomes—the way in which the economy is distributing the fruits of its recent glowing performance is slowing down the spread of its use. Those who have not been beneficiaries of the recent economic boom—and their numbers are considerable-are less likely to swell the ranks of those taking advantage of what e-shopping has to offer. They stand as an element of stability in the nation's retail real estate market as it exists today.

Finally, there is the matter of the people themselves. While there is constant change in what we do and how we do it, there is also stability in our behavior that reflects in what is often called human nature. This, as it turns out, is stability that shows up in behavior that has been and should continue to be a stabilizing force in the retail real estate market.

What we do, of course, is influenced by our environment, changes in which account for much if not most of the behavior changes we observe. As that environment is now changing to provide shoppers with a quicker and more convenient way to shop, we would expect them to respond. And respond they have. But the nature of that response is and will continue to be influenced by the human nature of the responder.

The concern here is with aspects of our make-up that have always been a behavior-determining factor. It is something, however, we have become more sophisticated about largely because of the recent work of neuroscientists, behavior geneticists, and evolutionary psychologists. Through their work,

we have come to see our behavior as something that is strongly conditioned by a mind biologically equipped with circuits that help us act and learn in intelligent ways. This is a mind that also comes with emotions that both contribute and interfere with our effective us of this equipment.

What we have in our biological make-up is something that has been inherited in an evolutionary way over many, many years. As it is reflected in our minds now, it is something that exerts a stabilizing influence on our behavior. It is stabilizing in the sense that it helps produce recurring behavior, one aspect of which is social propensity—the longing to be with family, friends, and communities. The emotions that underlie this propensity also embrace such things as jealousy, status-seeking, infidelity and mistrust. In short, what we call human nature—this socio-biological make-up of the person underlies much of what we do that gives rise to a social world that is a cauldron of experiences which includes conflict as well as relationships of love and friendship. What we have is behavior that reflects the nature of people as they have evolved over thousands of years. Because it is so deeply engrained, it is behavior that is likely to be with us well into the future, which means the continued dominating presence of social relationships in our activities.

The important question as far as the future of retailing is concerned is whether these social relationships will continue to play themselves out in a face-to-face setting. Currently, there are obvious advantages to interacting with others on a face-to-face basis. It is clearly the richest form of interaction embodying as it does all the senses, logical discourse and a feed back mechanism that is both immediate and intimate. But some if not many of these advantages will disappear as our electronic connections begin to mirror more of what we can do in a face-to-face setting.⁷

How will we respond to such changes?

There is some evidence in the way in which the telephone worked its way into our everyday lives that suggests face-to-face communication will remain of some importance as electronic connections develop. While the telephone replaced some, if not many, earlier face-to-face interactions, it also greatly expanded the number of contacts or potential points of interaction. This in turn led to new social interaction in a face-to-face setting. And apparently it did, because there is something in the nature of the person that places a good deal of importance on such contact.

Significantly, that something seems to be present as the Internet works its way into our connections with others. While our electronic connections are rapidly expanding, this is not happening at the expense of face-to-face meetings. These seem to be holding up.⁸ As the technology has developed thus far, there certainly seems to be good reason to expect that physical proximity will remain important in many of our social relationships, which implies some behavior stability that works to the benefit of retail real estate as we know it today.

FORCES OF UNCERTAINTY

One element of uncertainty in the current setting is the economy. While our strong economic performance throughout most of the 1990s helped fuel the rapid pace of innovation that gave us the ability we now have to shop in cyberspace, the continuation of that performance is by no means assured. While the innovation itself has been a part of the reason why there has been so much strength in the economy and what it has given us has eased some areas of cyclical vulnerability in the economy, few believe the business cycle is dead or that inflation and economic stagnation are problems of the past. Indeed, as we entered the year 2001, there were signs pointing to a possible cyclical downturn. Since we don't know exactly when the down times will come or how far down we will go when it happens, there are clouds of economic uncertainty out there, as there always have been. And the consequences of this uncertainty as far as the virtualization of household shopping is concerned are also uncertain. Concerns about a recession are likely to restrain movement into that world by reducing the incentive for the innovation needed to get us there. They could also make households more cautious in their shopping behavior, making them less likely to do things differently. But if the economic benefits turn out to be as big as some now say, the appeal of electronic shopping could increase in an era of uncertain economic times. Those in search of bargains, whose numbers would grow in the face of a prospect of economic hard times, could be attracted to the economic benefits of shopping in cyberspace during such periods. How all this might work itself out is unclear at this point, which means clouds of uncertainty will likely hover over future decisions made that could lead to more virtual world shopping.

There is also another more subtle source of uncertainty that could influence future shopping decisions in ways that impact retail real estate. It stems from the patterns of recent consumption that some have characterized as obsessive.9 As incomes have risen, allowing us to spend relatively more on discretionary items of consumption, many of us have taken full advantage of the opportunity and have done so in part because of innovative business efforts aimed at encouraging increased spending. There are a lot of businesses offering differentiated products they present as being much better than the competition. The emphasis in such offerings is usually not so much on the intrinsic characteristics of what is being offered, but on the experiences that come from consuming. There is nothing new in this. What is new is the extent and degree to which it happens. Much of what we now consume is being presented to us as something that will give us a better life in terms of the experiences that are important to us.10

In the current setting, many of us as consumers go after bigger and better packages of experiences which businesses have been more than willing to provide. While the age-old economic principle of diminishing utility lurks in the background as we behave this way, so far it hasn't slowed us down. Whenever our interest wanes, the market seems more than willing to provide that something bigger and better which, for a time, satisfies what we crave.

Obvious illustrations of such consumption can be found in entertainment spending. It shows up in trips to places like Disney World, Las Vegas, or exotic cruises. Our pleasure from such trips comes out of the experiences we have. And one very interesting feature about those experiences is that while they surround us with others, social interaction really isn't a big part of the experience. What is important are the experiences associated with the things that are a part of the physical environment and those things are there in abundance. What we are increasingly provided with in such settings are simulations of far-ranging parts of the world and life experiences that are presumed to be of interest. And electronics through computer technologies have made such simulations easier to produce in traditional sites of consumption. Witness what we are offered in major entertainment centers such as Disney World.

That we are able to produce bundles of experiences that are so appealing to the consuming household has led more than a few to believe that much retailing in the 21st century will be carried out in mega malls that will also serve as entertainment centers.¹¹ If this turns out to be the case, the retail real estate markets may be less affected by the

As incomes have risen, allowing us to spend relatively more on discretionary items of consumption, many of us have taken full advantage of the opportunity and have done so in part because of innovative business efforts aimed at encouraging increased spending.

emerging information technologies than many technology gurus now think.

But there is another side to this. If a growing proportion of our acts of consumption include less socializing as is now argued, why wouldn't it be possible to attract the consumer to electronic options if the experiences they're after can be simulated electronically in a way that is much less expensive?

There is no clear answer here to be found in our current knowledge and understanding of consumer behavior. What we have is uncertainty about how households will respond to what our innovative businesses will be offering them. And this just happens to be a response that could have important bearing on the future shape of the retail real estate market.

WHAT DOES IT ADD UP TO?

There can be no disputing the fact that there is the potential for big economic benefits in electronic shopping compared with the way we do it now. If that potential is realized, there could be significant changes in the way we shop, changes that could radically alter the way in which we get goods and services to the final consumer.

But will this happen? There are two answers to this question: 1). "No," if the concern is with the next decade or two; or 2). The other is probably "yes," if the concern is with the years that lie beyond 2020.

THE NEXT 20 YEARS

There are several reasons for believing that electronic shopping, while it will continue to grow over the next 20 years, will remain small relative to the total. The first of these is that generational matter. The technology, no matter how user-friendly it becomes, is likely to continue to meet with resistance by the elderly who are a growing part of the nation's population. While this is something that will gradually disappear, it won't happen overnight.

Second, there is the matter of economic uncertainty. If the business cycle is not dead, as certainly appears to be the case, there will be economic uncertainty that will reduce the incentive for the innovation necessary for the infrastructure needed to get masses of people into the world of virtual shopping. Over time, there will be periods of economic prosperity that foster such incentives, but with clouds of economic uncertainty overhead, the process of getting what we need will take longer than some now believe.

Finally, there is the matter of working the bugs out of what will be forthcoming to get us where we want to go. Assume we are able to incorporate into our electronic connections much of what we are now able to do in a face-to-face setting. It's not going to be easy getting there. We already have some sense of this in the inventory and delivery problems encountered by early e-tailers. Traditional retail means of storing and moving goods out of inventory do not work when the concern is with individual items going to individuals. And deliveries of those items to households who are absent from home much of the time is not easy to do. While these are problems that are being resolved, they are only the tip of the iceberg. There will be a number of bumps encountered on the rocky road that will take us to where the visionaries tell us we are headed. Assuming we get there, it's going to take at least a decade or two. All this implies some stability in our retail real estate markets over the next 10 to 20 years, even if radical change is on the way.

BEYOND 2020

There is certainly reason to argue that the retail real estate landscape will change—probably substantially—just as it did when the automobile came to us. Those anticipated economic benefits from electronic shopping will surely bring this about. But it is also likely that there will remain recognizable elements in that landscape, just as there are features in today's world that no doubt look familiar to those who remember what it was like prior to the automobile. Human nature being what it is, there will be some continuity in where and how we distribute what we consume.

How the technology develops will have important bearing on our shopping behavior. Just how much we are able to mimic what we can do now face-toface will certainly influence the extent to which we become cyberspace shoppers. While many of the current advantages of "being there" when making a shopping decision are going to disappear, we don't know exactly what *many* means and we certainly don't have a stellar record of forecasting the technical consequences of changing technologies.

How we behave as consumers will also have bearing on the outcome. While human nature, being what it is, will work to keep some shopping out of the virtual world, how much inertia it creates will depend partly on how we respond as consumers to the bundle of experiences that firms will be giving us. The uncertainty here is just what experiences or packages of experiences will turn out to be most attractive to us.

Excursions into a fantasy world have been growing, most of which have been taken in places outside cyberspace. Such shopping augurs well for retail real estate as we know it today, even though the location and scale of such retailing may change in the future. But such excursions are becoming increasingly possible in the world of cyberspace at a much lower cost. It's hard to conceive of most of us turning away from the virtual opportunities we will be offered. While human nature, as we know and understand it, will limit the amount of such pursuits, cyberspace in-roads will be made. And significant gains, say by the time we reach the middle part of the 21st century, are possible.

SOME FINAL THOUGHTS

Just as the automobile brought about radical change in how we go about shopping, so will those electronic network connections we are now building. By the second half of the 21st century, the majority of our spending on consumer goods is likely to involve an electronic connection in one way or another. But what all this will mean with respect to how what we produce gets distributed to the consumer is not so clear. Shopping will not simply be a matter of making decisions electronically at home with direct deliveries there. While this kind of shopping will grow increasingly important, it won't totally dominate our shopping behavior. Trips to places that provide entertainment as well as shopping opportunities for certain kinds of consumption will not disappear. Human nature and the continued increases in the sophistication of the simulations of experience that will be possible in real world settings will continue to keep many of us shopping for more than a few things in "traditional" ways - ways that involve real estate as we know it today. While these ways will become less important—maybe much less important—they won't disappear.

For those with an interest in investment possibilities in the current retail real estate market, these broad-brushed statements of what it could be like 50 years from now might seem something less than relevant to what are taken to be more immediate and pressing concerns. We are talking now about developments and changes that won't happen over night. If our time horizons only take out a decade or two, aren't these matters that will only clutter up our view of what's important in the investment decisions we make? Isn't this something that might be best ignored?

Perhaps; but it is well to remember that the dynamics of the retail real estate market are changing now in ways that are not fully understood. Stretching the mind by venturing our thoughts further into the future can help us think better about the things that might be relevant to these unfolding dynamics. Change, perhaps radical change is coming. There is time to prepare for it. But successful preparation requires a solid understanding of the underlying dynamics of the market. Now, it would seem, is the time for those who study this market to initiate the research that will lead to such an understanding. And a good place to start might be with a careful review of a framework set forth by Evans and Wurster in their effort to explain how the new economics of information is transforming the strategies of many businesses including those in retailing. 12 RE125

NOTES

- L.W. Fiedler and N.M. Weisenberger raised the issue back in the early 1990's in their article "Will Neighborhood Shopping Centers Be extinct by the Twenty-First Century," Real Estate Review, Summer 1994, 45-49. More recently, Frank Feather added fuel to the fire in his view of the future shopping behavior of households as it impinges upon the distribution of consumption goods. See F. Feather. The Future Consumer. Toronto, Canada: Warwick Publishing Group, 1997.
- See D. Miller. A Theory of Shopping. Ithaca, N.Y.: Cornell University Press, 1998 and S. Miles. Consumerism as a Way of Life. Thousand Oaks, CA: Sage Publications, 1997.
- For a more detailed discussion of these economics in what The Economist calls "webonomics," see "Shopping Around the Web: A Survey of E-commerce (Special Supplement), February 26, 2000, pp.6-15.
- 4. The labor force participation rates of women more than tripled between 1960 and the end of the 20th century. For one description of how the life style of many two-income families has changed and how this is altering their shopping behavior see "Once Upon a Time Understanding Consumer Motivations Seemed So Simple." American Demographics, January, 1999, pp.61-65.
- Currently, the benefits are greatest in areas where the product can be delivered over the Internet such as computer software, airline tickets and financial services. Items that consumer prefer to see and touch before they buy such as fruits and vegetables, clothes and shoes are much slower in

- getting into cyberspace. The visionaries see ways in which this can happen, however.
- In 1999, people 55 and older made up 21 percent of the population. By year 2010, that proportion increases to 25 percent.
- For one view of how the technology might evolve see M. Dertouzos. What Will Be: How the New World of Information Will Change Our Lives. New York: HarpersEdge, 1997.
- See W.J. Mitchell, e-topia, Cambridge MA: MIT Press, 2000, Chapter 6.
- Obsessive is a judgmental term often found in sociological tracts concerned with consumption. See for example G. Ritzer. Enchanting in a Disenchanted World: Revolutionizing the Means of Consumption. Thousand Oaks, CA.: Pine Forge Press, 1999.
- See B.J. Pine and J.H. Gilmore. "Welcome to the Experience Economy." Harvard Business Review, July-August, 1998, pp.97-105.
- See M.D. Beyard, et. al. Developing Urban Entertainment Centers. Washington, DC: Urban Land Institute, 1998.
- See P. Evans and T.S. Wurster. Blown to Bits: How the New Economics of Information Is Transforming Strategy. Cambridge, MA.: Harvard Business School Press, 2000.

FOCUS ON THE ECONOMY

READING THE TEA LEAVES

by Hugh F. Kelly, CRE



One of my high school English teachers gave our class what many considered an insulting assignment. We were to report on a text called *How to Read a Book*, by Charles Van Doren. With all the confidence of presumptuous teenagers, we objected that we already read dozens of books a year. Besides, how could we read a book called *How to Read a Book* if we didn't already know how to read a book? It appeared, though, that our teacher had been down this road with other classes before us, and the assignment stood. I'm glad it did, because I learned a lot from one of the great humanities scholars the U.S has produced.

This early learning experience comes to mind because the sudden deceleration of the economy has prompted most real estate professionals to look even more closely at the economic news during the fall and winter of 2000 - 2001. Nearly every day, the Federal Government produces an economic indicator that is released, with an instant commentary across the media and the Internet, to be followed inexorably by a graph and capsule interpretation in the next day's *Wall Street Journal*. It all seems so normal and natural, so transparent and straightforward, that the direction of the economy should be pretty easy to puzzle out. So why does it seem that the only certainty about economic predictions is that they will be wrong in the details even more than the sevenday forecast for local weather?

Some of the problem stems from the understandable emphasis on the "new" in the news. It is change that captures our attention, and so reporting stresses volatility over constancy. My favorite example of this is the graphic published each day that shows the minute-by-minute change in the Dow Jones Industrial Average. This is a splendid collection of mostly meaningless detail. The one useful thought that it conjures up is a healthy skepticism that the stock market actually provides a rational measurement of future profit expectations. The fundamental outlook for earnings simply doesn't wobble with anything like the skittishness of the Dow, or any of the other market indexes for that matter.

To take a more common example of a data series watched intensely by economic commentators, consider the numbers on Factory Orders as displayed on the front page of the *Journal* last December 6th. This was presented in a graph showing the month-to-month percentage change in new orders for manufactured goods for the most recent 12 months. Seven months were up, with the best months showing slightly more than 4% growth, and five months were down, with one month dropping 8%. What are we to conclude? From the graph as published, really not very much. Certainly there would be more useful information if some kind of moving average of the data were calculated to indicate a trend, or even some comparison of the amount of factory orders as

they have fluctuated on a year-over-year basis. Such comparisons take a lot of the drama out of the statistics, but provide a better perspective on where we are actually heading.

Then there are data series that look like they are going down when they are really going up. For example, the Federal Reserve released the Industrial Production figures on December 18th. This information was usefully converted to year-to-year percentage change (which you can tell if you read the fine print in the axis scale), and shows that between August and November the trend had been downward, and fairly steeply so. Back in the summer, industrial production was growing more than 6% annually, and by November it was - oh my! under 5%. What was the problem? Nothing more than a graph whose entire y-axis range went from a low of 2% to a high of 8%, thus exaggerating any small change in the data. But, even more obfuscatory, the entire picture of downward movement is actually one of continued growth, albeit at varying rates. But, in any event, isn't the deceleration a worrisome sign? Maybe, or maybe not. After all, from January 1998 to January 1999, this same measure dropped from 7% growth to just about 3% - and then the overall economy grew a robust 4.7% for all of 1999, and as much as 8.3% in the final quarter of that year.

Readers who look at the Industrial Production figures as an indicator of future trends might be surprised to find that the production index is considered a coincident, rather than a leading indicator of economic direction. Other such data series, that tend to move simultaneously with GDP trends, are nonagricultural employment, personal income, and sales in the manufacturing and trade (wholesale and retail) sectors. The Index of Leading Indicators, the predictive index, is composed of 10 variables, and it is worth knowing what these are. Two of the variables relate to labor conditions: the average weekly hours worked in manufacturing jobs, and the number of initial unemployment claims. Three variables cover the world of finance: the S&P 500 Index, the monetary aggregate M2, and the interest rate spread between the Fed Funds rate and the 10-year Treasury rate. Two factors indirectly measure consumption elements: housing permit activity, and the Index of Consumer Expectations. The final three components look at production trends: new manufacturing orders for consumer goods, new orders for non-defense capital goods, and the speed of vendor deliveries to businesses.

The most intriguing feature I see in reviewing the leading indicator components is that, individually, not one of them stands out as a dependable litmus test for the economic future. Of the 10 series, I would say that housing permits offer the most consistently accurate read on a potential recession, followed by the interest rate spread measure. Neither is by any means infallible, though. In 1966 -1967, for instance, housing permits dropped from about 1.5 million to less than 1 million, but the long expansion of the Sixties continued and permits recovered to their prior level in 1968 and stayed high until the recession of 1973 - 1974. And the end of the Reagan-era briefly saw a negative yield curve in 1988, as did the Clinton-era expansion in 1998, though the economy continued to grow for at least two years thereafter in each case.

It is the combination of the 10 variables that has the best predictive power. This was true when the indicator approach was first developed by the National Bureau of Economic Research in the 1930, and remains true in its present incarnation as maintained by The Conference Board. Even so, the index has been known to trigger false alarms, slipping into negative (recession-alert) territory in 1966, 1984, 1993, and 1995 without an economic contraction subsequently emerging. This may in fact be a success story for the Index, since it serves as a danger signal of weakening conditions and thus alerts businesses, consumers, and Fed officials that changes in behavior are called for if a downturn is to be averted.

That interaction between new information and the adaptations it prompts among economic actors is, of course, what makes economic forecasting a considerable challenge. "If you must forecast," John Kenneth Galbraith said, "forecast frequently." Nevertheless, it is fairly amazing how loudly some economists and CEOs have been professing their surprise about the slowdown that began in 2000's fourth quarter. They remind me of Captain Louis in Casablanca, who professed to be shocked, shocked to learn that there was gambling occurring in Rick's establishment. If our managers and pundits were truly unprepared for deceleration, what exactly did they think the regimen of interest rate increases in 1999 and early 2000 were designed to do?

The Fed, meanwhile, appears at least to be consistent in its long-term management policies,

directed toward moderate, sustainable domestic growth, with very low inflation in the U.S. and a reduction of volatility in worldwide economic trends. As Alan Greenspan knows very well, no single number serves as the weathercock. Those looking for simple indicators in the day's statistical releases share something of the attitude my class had back in high school, when we thought we couldn't benefit from reading Van Doren, despite the fact that we had barely scratched the surface of world literature, science, and the humanities. The fact is that economic statistics require perspective and considerable breadth of vision before they yield their secrets.

Greenspan himself offered some succinct advice in a speech to the National Association of Business Economists in October 1998. He said, "For those of you who want to get an objective view of what is going on in the world, it's probably wise to put your newspapers in your In Box and leave them there for a week, and then you can read them." That's one way of saying, "Don't get caught up in the hype, and don't rely just on today's headlines." Investors in long-lived assets like real estate, and the Counselors who assist them, will find that good advice indeed. RE125

ABOUT OUR FEATURED COLUMNIST

Hugh Kelly, CRE, New York City, is chief economist for Landauer Realty Group, Inc., (a Grubb & Ellis Company), who spends much of the year speaking and writing about the domestic and international marketplace. He was a 2000 national vice president of The Counselors of Real Estate, chair of its New York Metropolitan Chapter, and has served as editor in chief of "The Counselor" newsletter, 1997-1999.

FOCUS ON REITS

CRITICISM OF REITS GOES TOO FAR – SELLING OUT OR MERGING ISN'T ALWAYS BEST FOR SHAREHOLDERS

by Adam O. Emmerich & Robin Panovka

One of the latest fashions in the popular REIT press is to bash indiscriminately the management and directors of REITs that seek to remain independent or explore alternatives in the face of a potential merger or other strategic transaction. A recent REIT M&A transaction, for example, drew comments from one analyst to the effect that "it is very rare to be associated with a REIT management team that holds its responsibilities to shareholders in such high regard" and, in similar vein, a statement from a different commentator that "doing the right thing for [REIT] shareholders shouldn't be noteworthy, but it is." Similarly, REITs' adoption of shareholder rights plans (so-called "poison pills"), common in the rest of corporate America, has prompted some REIT commentators to argue that the credibility of the REIT industry is being damaged by the adoption of "unnecessary" and "anti-shareholder" measures.

These attacks go too far. They are based on a flawed perception that any resistance to a sale of the company is not in the best interests of shareholders. In reality, the ability to resist and negotiate can often be advantageous to the shareholders, and a sale – even at a seemingly attractive price – can mean a less favorable result for shareholders than pursuing the REIT's long-term strategic objectives.

An analysis of the impact of rights plans is instructive. Rights plans protect against takeover abuses, give companies and their shareholders and boards of directors breathing room in which to make decisions on potential takeovers, and strengthen the ability of the board of directors of a target to fulfill its fiduciary duties. Studies have shown, over and over again, that "poison pills ... are reliably associated with higher takeover premiums for selling shareholders, both unconditionally and conditional on a successful takeover ... Antitakeover measures increase the bargaining position of target firms, but they do not prevent many transactions." As a result, rights plans have become a familiar part of the landscape in corporate America, having been adopted by over 2,300 public companies, including at least 45 percent of the Fortune 500 Companies. But despite the empirical evidence, in the eyes of some popular REIT commentators, rights plans are still too often viewed as tools to entrench management and make REITs takeover proof, at the cost of shareholders.

One of the myths that has contributed to the perception that REITs that adopt rights plans are taking excessive anti-shareholder action is the notion that REITs are "bullet proof" by virtue of their built-in 9.8 percent (or lower) share ownership limitations. REITs, the argument goes, are inherently well-fortified, and the adoption of rights plans on top of their ownership limits makes them far more difficult to take over than non-REIT public companies. The argument is fundamentally flawed – as we have long argued, REITs with rights plans are no more "takeover proof" than other public companies with rights plans. In reality, REITs' share ownership limitations are largely untested as anti-takeover defenses and may be inherently vulnerable because

of their grounding in the tax code. Moreover, the consequences of violating a typical share ownership limitation are less draconian than the consequences of violating rights plans and they therefore have a weaker deterrent effect.

Excessive skepticism as to the motives of REIT executives is unfair and can force a "short term" mentality on executives that is ultimately harmful to shareholders and to the REIT industry. Certainly, there are bad apples in the REIT industry, as there are in other industries, but it is a mistake to extrapolate too quickly and to condemn the entire industry for taking actions which are in fact in the interests of shareholders and are entirely consistent with mainstream corporate governance practices outside the REIT area. REIZ

NOTES

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 "Poison or placebo? Evidence on the deterrence and wealth effects of modern anti-takeover measures." Robert Comment and G. William Schwert, Journal of Financial Economics. Vol.39 (1995), pp.3-43.

ABOUT OUR FEATURED COLUMNISTS

Adam O. Emmerich and **Robin Panovka** are partners of Wachtell, Lipton, Rosen & Katz in New York, where they specialize in REIT and real estate mergers and acquisitions and other strategic real estate transactions.

FOCUS ON HOSPITALITY ISSUES

U.S. LODGING INDUSTRY UPDATE 2001-02

by Bjorn Hanson, CRE



A ccording to Smith Travel Research (STR), U.S. lodging industry RevPAR (revenue per available room) grew between 4 and 6 percent for 2000. PricewaterhouseCoopers' (PwC) forecast was 5.5 percent. This strong growth in RevPAR, the highest since 1996, is supported by a healthy room demand growth of 3.7 percent. With increasing occupancies, the average daily rate is expected to finish 2000 at 4.9 percent, the fastest since 1997.

The very strong performance of the U.S. lodging industry is primarily the result of the strength in the overall U.S. economy over the first half of 2000. Quarter-over-quarter annualized U.S. real GDP growth averaged 5.2 percent in this period.

U.S. real GDP growth for 2000 is expected to be 5.0 percent according to the January 2001 Macroeconomic Advisers' forecast, the highest since 1994. The year 2000 is expected to end with inflation of 3.4 percent, the highest since 1991.

Economic growth already started to slow in the third quarter of 2000 with real GDP growth of only 2.2 percent. The contribution to growth from fixed investment fell to 0.6 from 1.9 in the second quarter and 2.7 percent in the first quarter. Government consumption in the third quarter reduced real GDP by 0.2 percentage points, while it had added 0.9 percentage points in the previous quarter. The ratio of real inventories to real sales increased in the past two quarters. This implies that inventories have accumulated and production will have to slow, placing downward pressure on GDP growth.

However, there are emerging signs that the U.S. economy will recover beginning in the third quarter of 2001. Capital expenditures are expected to recover as firms internalize the interest rate cuts and as excess inventories are depleted. Benign inflationary pressures, excluding energy, will leave room for further Fed rate cuts if necessary to boost aggregate demand. Moreover, energy prices are expected to decline in the spring of 2001. Also, the continuing downtrend in the conventional mortgage rate will help bolster private fixed investment.

Given these, Macroeconomic Advisers forecast GDP growth of 2.4 percent in 2001 and 3.7 percent in 2002. Inflation is forecast to remain relatively tame over the next two years; 2.7 percent and 2.3 percent in 2001 and 2002, respectively.

U.S. LODGING INDUSTRY FORECAST

The performance of the U.S. lodging industry for the year 2000 reflected the remarkable pace of the U.S. economy. As of January 2001, PwC forecasts room demand growth for 2000 to be 3.7 percent, the highest since 1989. At the same time room supply growth has declined as construction activity has slowed. PwC forecasts RevPAR growth of 5.5 percent for 2000, the strongest since 1996. (See Table 1.) Occupancy is expected to rise in 2000 to 63.5 percent, marking the first gain since 1995.

For the year 2001, PwC forecasts room demand to grow by 2.1 percent. However, room supply growth is also expected to ease to 2.6 percent. PwC forecasts the average

Table 1

RevPAR Growth (Percentage Change from Prior Year)

	RevPAR Growth (%)			
	1999	2000	2001	2002
U.S.	3.1	5.5	3.1	4.3
Upper Upscale	4.2	7.0	2.3	6.1
Upscale	0.4	4.8	2.4	4.2
Midprice with F&B	2.4	4.1	2.1	3.2
Midprice without F&B	2.2	4.1	4.2	5.0
Economy	2.9	3.1	2.9	3.7

Source: PricewaterhouseCoopers L.L.P. (2000 to 2002), Smith Travel Research (1999)

daily room rate to rise by 4.0 percent in 2001. Overall our forecast calls for a slowdown in RevPAR growth to 3.1 percent in 2001.

In 2002, PwC forecasts growth in room demand to increase to 2.7 percent and room supply growth is expected to slow further to 2.3 percent. Therefore, occupancy is expected to rise close to 0.3 occupancy points to 63.3 percent. PwC forecasts room rates to increase by 3.9 percent and RevPAR growth is expected to regain some of its momentum in 2002 and reach 4.3 percent.

CHAIN SCALE SEGMENT FORECASTS

As of January 2001, PwC forecasts demand growth to decrease across all the five chain scale segments in the year 2001 compared with 2000, with the largest percentage point decrease occurring in the midprice without food and beverage (F&B) segment. Growth in room supply is also expected to fall in 2001 across all the segments, again with the sharpest decrease in the midprice without F&B segment. Therefore, PwC forecasts RevPAR growth in this segment to improve slightly in 2001 while occupancy is expected to be flat. In the other segments, RevPAR growth is expected to slow or remain flat for 2001. (See Table 1.) Occupancy gains are only expected in the economy and midprice without F&B segments as demand growth is expected to outpace supply growth in 2001.

PwC forecasts the year 2002 to be characterized by a moderate recovery in demand growth across all the chain scale segments. Supply growth is expected to pick up in the upscale and midprice without F&B segments. In 2002, occupancy gains are forecast for all segments with the exception of the midprice with F&B segment. RevPAR growth is expected to rise in all segments following the RevPAR growth slowdown in 2001.

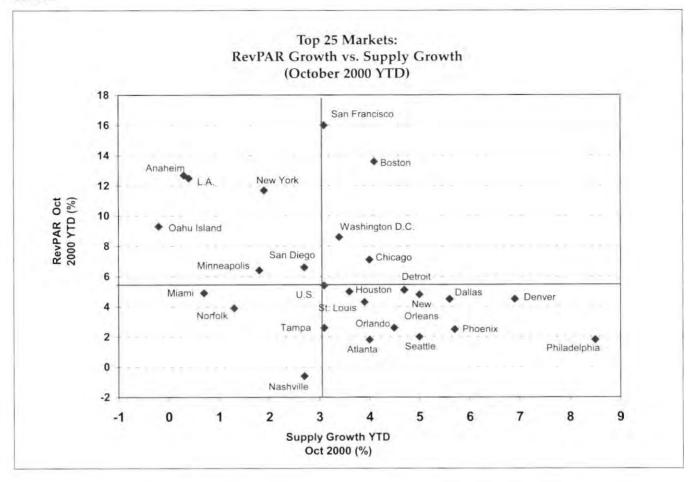
PERFORMANCE OF THE TOP 25 MARKETS

In the January to October 2000 period, among the 25 markets followed by STR, five posted "double-digit" RevPAR growth. Three are in California (San Francisco-San Mateo, Anaheim-Santa Ana, and Los Angeles-Long Beach) while two are in the Northeast (Boston and New York). (See Chart 1.) RevPAR growth in these markets was largely driven by strong growth in room rates, ranging from 5.7 percent in Anaheim-Santa Ana to 11.2 percent in San Francisco-San Mateo.

Seven MSAs (Nashville, Atlanta, Philadelphia, Phoenix, Orlando, and Tampa-St.Petersburg) experienced RevPAR growth below inflation of 3.2 percent, as of year-to-date October 2000. Nashville is the only market that recorded negative RevPAR growth (-0.6 percent). Most of these markets are characterized by relatively high room supply growth. For example, Philadelphia saw supply growth of 8.5 percent while Phoenix and Seattle posted 5.7 and 5.0 percent supply growth, respectively.

Over the next 12 months as the U.S. economy slows, the long-standing business centers are expected to fare better than the other smaller markets in general. Based on supply and demand trends, the outlook appears favorable for the New York, Washington D.C., San Francisco, Los Angeles, San Diego, and Tampa markets over the period 2001-2002. Most

Chart 1



of these markets are expected to see modest supply growth. With the exception of Los Angeles and Tampa, all of these markets have posted occupancy above 75 percent in the year-to-date ended October 2000.

The U.S. lodging industry is poised to finish 2000 at a record-setting rate. The PwC forecast calls for year-end RevPAR growth of 5.5 percent. However, a slowing U.S. economy in the first half of 2001 is expected to restrain RevPAR growth as room demand growth wanes despite slowing supply growth. In 2002, RevPAR growth is expected to regain some of its momentum as the U.S. economy improves and as supply growth continues to decelerate.

NOTES

 This forecast assumes another 25 basis-point cut of the federal funds rate target at the January 30-31 FOMC meeting in addition to the January 3, 2001 cut of its target rate by 50 basis points to 6.0 percent.

ABOUT OUR FEATURED COLUMNIST

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REAL ESTATE DAMAGES: AN ANALYSIS OF DETRIMENTAL CONDITIONS

&

Brownfields: Redeveloping Environmentally Distressed Properties



As Reviewed by Jack P. Friedman, CRE



by Randall Bell, MAI The Appraisal Institute, ©1999 350 pages



by Harold J. Rafson & Robert N. Rafson McGraw-Hill, ©1999; 592 pages

hese two books provide entirely different treatment of similar subjects. Their titles offer clues to what they are about. Bell's book is principally on estimating damages caused by a wide variety of detrimental conditions. It is primarily concerned with financial matters. The Rafsons' book is about redevelopment of "brownfields," providing a strong background of the legal and political framework.

Despite the different focuses, there is crossover. In Bell's book there are discussions of Superfund, CERCLA, and other environmental legislation, plus references to, and lists of, federal and state agencies that deal with contaminated properties. In the Rafsons' book, there are a few case studies and a particularly informative section by Noah Shlaes, CRE, on appraising brownfields. But these crossover sections take up only about 10 percent of each book. To stay current professionally, a reader would do well to read both books or at least get a good overview, identifying in each book reference material for a possible future assignment, from the sections that would need to be read in their entirety.

Bell, whose name is coincidentally the same as a certain statistical curve, has taken that coincidence to extremes. He has prepared "The Bell Chart," which catalogs various classes of conditions and groups specific detrimental conditions. Each type of condition is

analyzed with an accompanying chart. The charts visually help explain, for each negative condition, the reason for each "hit" in value; how a deficiency may be overcome with time; and whether it is a temporary or permanent value impairment. The shape of each chart can help one to organize thoughts and articulate possible future value shifts, whether linear or curved, whether changing in discrete steps or more smoothly over time.

Bell begins with a lengthy (46-page) introduction that reviews principles of appraisal. Such material is provided perhaps for the real estate generalist, though it wouldn't hurt a consultant to review it.

Following the introduction are 10 major cases and 21 shorter ones. About half of the case studies were prepared by Bell himself and half by an assortment of others. Detrimental conditions include just about everything you can think offrom murder scenes to chemical, biological, or nuclear releases. Many are notorious: Love Canal, Three Mile Island, the Exxon Valdez. Others are less well known.

Most important in each case study is the thought process used to identify and often quantify the source of value diminution, and the process of physical remediation with potential value restoration. These case studies are useful to understand the thought processes of participants in the market and as

potential reference material should the reader be faced with an assignment.

Brownfields is principally concerned with redeveloping that type of land, specifically, abandoned, idled, or underused commercial or industrial sites where redevelopment is complicated by additional time or costs required to mitigate environmental contamination.

Though a U.S. overview is offered, much of the book focuses on projects in the Chicago and Cook County areas. Approximately half of the contributions are by the Rafsons, with half by a variety of others. The principal target audience is the private developer, with major sections devoted to a developer getting started, due diligence, remediation, and closure. The emphasis is on political, legal, and social aspects; financial analysis is seldom provided.

The bottom line is that the planner or lawyer will be more at home with *Brownfields*, whereas the number-crunching financial analysts will prefer Bell's book. Both provide valuable current information and are especially useful references. REIZE

ABOUT OUR REVIEWER

Jack P. Friedman, CRE, is president of Jack P. Friedman & Associates, in Dallas, where he specializes in litigation support/expert witness; investment analysis/ad valorem tax appeals; market/feasibility studies; and complex appraisals. Jack was invited to Counselor membership in 1993 and is a member of the Real Estate Issues Editorial Board. (E-mail: JackFriedman@prodigy.net)

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- 1). Manuscripts must be submitted on disk (along with hard copy) in IBM or PC format only--Mac files cannot be accommodated: .txt (text) file format or Word for Windows 6.0. All submitted materials, including abstract, text and notes, are to be double-spaced. Number of manuscript pages is not to exceed 25 single-sided sheets (approx. 7,000 words). Submit five copies of the manuscript, a 50- to 100-word abstract* and a brief biographical statement. Computer-created charts/tables should be in separate files from article text. (* An abstract is a brief synopsis. If the manuscript is accepted for publication, the abstract would appear on the table of contents page.)
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- 6). Article title should contain no more than eight to ten words including an active verb.
- 7). For uniformity and accuracy consistent with our editorial policy, refer to The Associated Press Stylebook.

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ABOUT THE COUNSELORS OF REAL ESTATE...



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

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

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

Enrichment Through Networking, Education & Publications

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

CRE members benefit from a wealth of information published in The Counselors' tri-annual award-winning journal Real Estate Issues which offers decisive reporting on today's changing real estate industry. Recognized leaders contribute critical analyses not otherwise available

on important topics such as institutional investment, sports and the community, real estate ethics, tenant representation, break-even analysis, the environment, cap rates/yields, REITs, and capital formation. Members also benefit from the bi-monthly member newsletter, *The Counselor*, and a wide range of books and monographs published by The Counselor organization. A major player in the technological revolution, the CRE regularly accesses the most advanced methodologies, techniques and computer-generated evaluation procedures available.

What is a Counselor of Real Estate (CRE)?

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

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

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

and fiduciary responsibility of the clientcounselor relationship.

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

Users of Counseling Services

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

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

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



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