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(deadline for manuscript submission - August 15, 2003)

Spring 2003
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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' quarterly award-winning journal Real Estate Issues which offers decisive reporting on today's changing real estate industry. Recognized leaders contribute critical analyses not otherwise available on important topics such as institutional investment, sports and the community, real estate ethics, tenant representation, break-even analysis, the environment, cap rates/yields, REITs, and capital formation. Members also benefit from the bi-monthly member newsletter, The Counselor, and a wide range of books and monographs published by The Counselor organization. A major player in the technological revolution, the CRE regularly accesses the most advanced methodologies, techniques and computer-generated evaluation procedures available.

What is a Counselor of Real Estate (CRE)?

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

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

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

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

Users of Counseling Services

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

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

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

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EDITOR'S STATEMENT - by Hugh F. Kelly, CRE

CRE Hugh F. Kelly

It must have been sometime in the late Eighties that I overheard a conversation in the office lunchroom. The dramatis personae were two of the twenty-something staff of our company, and the subject was the upcoming Corporate Challenge race in Central Park. Said one to the other: "We have to get in shape for this. We can't let the old guys beat us again this year." Into my mind leapt the thought, "When did I get to be one of 'the old guys'!"

Come November, the Counselors of Real Estate will be gathering in Miami Beach to mark the 50th anniversary of our Society. Fifty years young, and still in our growth years. Nevertheless, the CRE organization can take considerable pride in the accumulated experience of our membership. That experience is not just the passage of time, but it is the assimilation of life into thought, the gaining of perspective, and achievement of a standpoint from which the future opens up.

I've long been guided by a research approach suggested by a Canadian Jesuit thinker, Bernard J.F. Lonergan, in a study entitled, *Insight: An Essay on Human Understanding* (Philosophical Library: New York, 1957). Lonergan, in this and other writings, proposes a four-level structure to intellectual activity: experience, understanding, judgment, and decision. In real estate research, experience and understanding entail working with historical information—data and analysis—to make sure we have a solid command of facts and trends. At these levels, technical proficiency is the greatest professional need. But, for Counselors, judgment and decision are obviously the key contributions we can offer clients, and these are always oriented to the uncertainties of the future.

This edition of *Real Estate Issues* covers all the bases. Our authors look at and analyze a variety of real estate counseling questions, ranging from John McMahan's case studies on Sprint and Jones Lang LaSalle, through Edward Canuel's analysis of NAFTA and Nick Captain's expert review of the Guam property market, to Ken Riggs and Jack Corgel's assessments of how a shifting world scene is affecting supply, demand, and real estate capitalization rates. Buzz McCoy contributes a resource review on Economics as Religion, with insights into such contemporary situations as the Enron and Arthur Andersen debacles.

Great philosophers often have a knack for putting fundamental issues into clear and simple language (but, unfortunately, not always!). One of my favorite examples is Immanuel Kant's distillation of the basics into three questions: What can I know? What should I do? What may I hope? My thanks to the authors represented in this issue for their attention to each of these three foundational questions.

Hugh F. Kelly, CRE
Editor in Chief

CASE STUDY 2: JONES LANG LASALLE

by John McMahan

This article represents the second in a series of case studies that began in Real Estate Issues, Summer 2002, Vol. 27, No. 2.

ABOUT THE AUTHOR

This case was prepared by ***John McMahan****, executive director of the Center for Real Estate Enterprise Management (Centerprise), a non-profit research and educational organization. The case is to be utilized as a basis for discussion and does not necessarily illustrate either effective or ineffective handling of a business situation. Funding for development of the case was provided by PikeNet, where this case has been previously published. John McMahan, CRE, © 2002, all rights reserved. (E-mail: jmcmahan@centerprise.org)*

Jones Lang LaSalle is a leading real estate services and investment management firm, operating across more than 100 markets on five continents. The firm was created through the merger of LaSalle Partners, a U.S.-based real estate services and investment management firm, and Jones Lang Wootton, a British-based provider of global real estate services.

Jones Lang LaSalle offers comprehensive, integrated expertise, including investment, advisory, corporate, and management services on a local, regional, and global level. Clients include real estate owners, occupiers, and investors. The firm is also an industry leader in property and corporate facility management services, with a global portfolio of approximately 725 million square feet under management.

LaSalle Investment Management, a member of the Jones Lang LaSalle group, has a global portfolio of more than $22 billion under management, and is one of the world's largest real estate investment managers.

REAL ESTATE SERVICES SECTOR

Jones Lang LaSalle operates in the highly competitive public real estate service sector, which includes investment banks, pension fund advisory firms, and consulting firms, as well as traditional real estate service providers such as Trammell Crow Company and Insignia Financial Group, Inc. Jones Lang LaSalle also competes with several national private firms such as CB Richard Ellis,[1] Cushman & Wakefield, Transwestern, Staubach, Studley and a wide range of smaller companies.

In the last few years, the sector has been under significant profit pressure, largely due to a combination of several factors:

- Highly competitive market environment
- Cyclical nature of real estate earnings
- Dependency upon contingent income (i.e., brokerage commissions)
- Lack of growth in reported earnings
- Record of earnings "surprises" during the past few years
- Structural problems in absorbing global acquisitions
- Downturn in global economies
- Downturn in the real estate economy

JONES LANG LASALLE MANAGEMENT STRATEGY

Jones Lang LaSalle places great emphasis on deepening and expanding client relationships to increase stable revenues derived from corporate strategic alliances, investor services, and investment advisory income. Success is measured by the firm's number of strategic alliances, square footage under leasing and management contracts, and growth in LaSalle Investment Management's assets under management.

In the services area, Jones Lang LaSalle's strategy is to become the "trusted real estate advisor" for global corporations. This includes not only traditional real estate services such as property management, facility management, project development, tenant representation, leasing and investment transactions, but also relatively new offerings such as data centers, mail and parcel delivery, security, employee feeding, and company transportation.

Jones Lang LaSalle's service delivery is best described by its "Client Service Model."

Figure 1

CLIENT SERVICE MODEL

"Our mission is to deliver exceptional strategic, fully integrated global services and solutions for real estate owners, occupiers and investors."

FINANCIAL PERFORMANCE

The firm's initial public offering occurred in late 1997, and the stock subsequently traded below its IPO price until recently. For the fiscal year ending December 31, 2001, Jones Lang LaSalle announced adjusted net income of $40.5 million or $1.31 per diluted share.[2] This was in line with First Call consensus estimates and matched the firm's record 2000 performance. For the last half of 2001 and in early 2002, Jones Lang LaSalle's stock price traded above the S&P 500 average, contrasting favorably with Trammell Crow and Insignia, both of which traded at or below the average.[3]

In announcing 2001 results, Chris Peacock, Chief Executive Officer, stated:

> "This performance shows that our business model is flexible enough to perform well even in a very difficult and demanding year. All of our segments experienced lower revenues for the year as difficult economic conditions translated into a significant slowdown in transaction activity."[4]

Peacock attributed this performance to the firm's business strategy:

> "We believe we have an unparalleled integrated global platform, the industry's best professionals, and clear strategic focus on core competencies and technology leadership. This combination has led to a strong backlog of business for the year and further expansion of our client base with major global engagements such as Microsoft and Rockwell Automation."

In terms of the future, he went on to say:

> "We are continuing our focus on containing discretionary costs following the successful implementation of our global restructuring program but are investing appropriately in strategic business areas of the firm that offer the strongest future growth potential. As a result, our 2002 plan, although assuming flat revenues, anticipates that we will grow our comparable earnings per share by seven to ten percent year on year."

In 2002, Jones Lang LaSalle announced a new contract with Motorola to provide worldwide real estate services, reflecting the firm's increasing presence as a major global service provider.

On March 14, 2002, Moody's Investor Services upgraded Jones Lang LaSalle's senior unsecured debt from Ba2 to Ba1. In supporting the upgrade, Moody's cited the firm's material improvement in credit fundamentals, relatively stable operating results, and slightly improved margins in a challenging environment. This came largely as a result of a debt reduction of $100 million over the prior two years.[5]

JONES LANG LASALLE AND THE USE OF TECHNOLOGY

Jones Lang LaSalle prides itself on client service and the use of best in class technology. With a focus on delivering solutions and developing integrated platforms, it has been innovative in working together with other members of the real estate services industry to build applications through Project Octane. Below is a description of Jones Lang LaSalle's technology value proposition, including involvement in Project Octane.

Project Octane—In March 2000, Jones Lang LaSalle, CB Richard Ellis, and Trammell Crow announced the formation of Project Octane (Octane), an alliance to develop comprehensive online services platforms, including e-procurement, data integration, and transaction services for the real estate industry. The partners in Octane had completed a combined 47,000 sales and lease transactions in 1999, and as of Fall 2000, they managed more than 1.5 billion square feet of properties in the United States. Insignia Financial Group joined Octane as an equal partner on September 21, 2000.

The transaction services platform to be developed was intended to be a hardware and software application service provider offering an Internet-based marketplace, communication, collaboration, and process management vehicle for the benefit of the entire commercial real estate industry.

Investments—During the next year, the Octane members made several investments in real estate-related technology efforts. The largest of these was $30 million in SiteStuff.com, an e-procurement firm. The concept was to have Octane's members purchase property management and maintenance, repair, and operations (MRO) products through

SiteStuff. According to an Octane spokesman:

> "Our goal has always been to provide a reliable and advanced information-sharing mechanism that aggregates best-of-class information for the benefit of the entire commercial real estate industry."[6]

The alliance also became a combined partner in a broadly based consortium called Constellation Real Technologies. Constellation had been established to:

> "… form, incubate and sponsor real estate-related Internet, e.commerce and telecommunications enterprises; acquire interest in existing 'best of breed' companies on a synergistic basis; and act as an opportunistic consolidator across property sectors in the emerging real estate technology area."[7]

The other partners in Constellation were AMB Property Corporation, Equity Office Properties Trust, Equity Residential Properties Trust, KB Home, Simon Property Group, Spieker Properties, JP Morgan Partners, and Morgan Stanley.

workplaceIQ—On June 13, 2001, Octane announced the selection of workplaceIQ as its Application Service Provider (ASP) for the Transaction Management Services platform. Established in 1991, the firm is headquartered in Waltham, Massachusetts, with technology development facilities in Tel Aviv, Israel and a predominately European-weighted customer base.

For more than a year, workplaceIQ had been developing a corporate solution technology that would ultimately become the foundation for Octane's transaction platform. Octane's spokesman, said:

> "workplaceIQ is the perfect choice to provide the key technology components for the exchange's transaction platform - they have developed the most advanced software technology in the industry."

For its part of the bargain, workplaceIQ received an immediate base of transactions to use in developing its platform.[8] John Fleming, the firm's CEO, noted:

> "The Octane exchange will provide an industry knowledge base that aggregates and integrates real estate information, promotes best practices, and fosters tenant, landlord, and broker collaboration on a new level."[9]

In order to fund the transaction, Octane members agreed to invest $2.5 million each in workplaceIQ and pay approximately $1 million a year in technology-licensing fees. For its part, workplaceIQ raised an additional $3 million in new capital from investors in its original financing round.[10]

Withdrawal from Constellation Funding—Octane soon announced that it was withdrawing from further funding obligations in Constellation, but that it would retain its initial investment. At the same time, eight new firms joined Constellation, bringing the total capital to $150 million.[11]

Concept of Octane Questioned—By Fall 2001, several of the high-profile real estate e.commerce sites targeting the leasing sector began to fail. These included Zethus, which burned through $15 million of Goldman Sachs' money; RealCentric, a tenant-oriented online business that lasted only 18 months; and Cubitz, which targeted the "do-it-yourself" tenant market and failed to move beyond its first round of financing.

With these failed efforts, the concept of Octane also came under scrutiny. Eileen Circo, writing in *Development Magazine Online,* asked several penetrating questions:

> "Naysayers are quick to argue that the complex risk parameters and dollar size of most real estate transactions make virtual trading on the Internet impractical. Then why on earth would the top commercial real estate service providers sink valuable resources into this endeavor, especially at a time when the changing economic tide is likely to hinder prosperity in 2001? What are the Octane/workplaceIQ members really trying to accomplish? Why would they want to cannibalize their own fee business? Are there analogies for success with a commercial-real-estate-wide platform in other industries? Can competitors really join together in industry-wide collaboration?"

Ms. Circo went on to conclude:

> " ... the success or failure of an industry-wide trading platform will rest with the collective efforts of the four Octane service providers to penetrate internally, provide incentives for their brokers, and set an enviable model of transaction behavior for their peers. It's not about lowering fees; it's all about delivering greater speed and market information accuracy to an ever-demanding client base."[12]

Six months later, Finn Johnson, Vice President of eBusiness at NAI, in Hightstown, New Jersey, was quoted in the March issue of *Real Estate Forum*:[13]

> " ... consortiums are not going to work because you've got very fierce competitors trying to band together to produce a result and, in the final analysis, each has to decide for itself what it's going to do."

Joseph B. Rubin, a partner and director of real estate e-business for Ernst & Young, concluded:

> "The (e-business) solutions that are working today, in lending or brokerage, are those that focus on the back office. It's not in-your-face stuff, or even stuff the customer will see. It's the guts of your business, all focused on cost reduction and process efficiency. The expectation that all transactions will get done entirely via the Internet, though, is not realistic."

This type of criticism is indicative of the sentiment among many industry players who forecasted that Project Octane would not be alive today. Yet, Project Octane recently celebrated its second anniversary and continues its steadfast commitment to deliver on its collaborative mandate.

JONES LANG LASALLE'S INTEGRATED INFORMATION PLATFORM

Jones Lang LaSalle believes that the use of technology and strategic solutions differentiate it in the marketplace. Technology in and of itself is not the key, but integrating sustainable, scalable applications with leading edge process is what benefits clients. To meet this objective, Jones Lang LaSalle delivers to its clients a comprehensive integrated solution known as the Integrated Information Platform (IIP). While Octane offerings are a small part of its overall technology initiatives, the IIP is the platform where new, integrated applications are regularly rolled out to better serve clients. The use of this platform was acknowledged in *Forbes* magazine's Best of the Web feature as the only real estate services company to partner with. The IIP is Jones Lang LaSalle's technology platform and utilizes many applications, tool sets, and a common Web services-based development and integration methodology. Jones Lang LaSalle continually reevaluates and enhances its integrated information platform to support all of its global real estate services. The platform is composed of three key elements:

- Web portal/knowledge management
- Business information warehouse
- Production systems (including Octane)

Jones Lang LaSalle's philosophy is that each element provides a vital function within the platform and ultimately will be fully integrated with the others through Web services technologies.

WEB PORTAL

This Internet-based portal provides the gateway into the world of information that Jones Lang LaSalle provides to its clients. The site offers online, real-time access to each client's transactions, project, property, and portfolio information. Information is displayed using Web capsules containing information culled from internal and external sources via Microsoft's .NET technology. Examples of information that can be accessed include:

- Executive summary information
- Portfolio information
- Portfolio/property performance
- Benchmarks
- Project status
- Research and market information
- Financial and operating reports
- Best practices
- Discussion forums
- Access to production systems
- Links to other sites

Through security authentication, designated users can be assigned to various levels of access rights to submit and retrieve information. To date, Jones Lang LaSalle has implemented more than 50 client extranet sites worldwide.

BUSINESS INFORMATION WAREHOUSE

Jones Lang LaSalle's business information warehouse populates capsules within the Web portal with real estate operations and portfolio information. Clients and account team personnel can view data at various levels of detail and from multiple vantage points. Information can be displayed graphically or in table format from the portfolio level down to the detailed transaction level. Jones Lang LaSalle believes that this allows users to better understand and analyze business trends and benchmark performance across a portfolio, geographic region or other areas for comparative purposes.

PRODUCTION SYSTEMS

The final element is a series of vendor-based and custom-developed solutions, linked through Jones Lang LaSalle's business information warehouse using standard technology tools to aid in analysis and consolidation. Choices between package solutions and those that are custom-developed by Jones Lang LaSalle are based on how they match the firm's best-in-class business process requirements.

Systems currently available through Jones Lang LaSalle's Web portal include:

Lease Administration: Jones Lang LaSalle uses its internally developed lease administration tool, CredoNet, to enable clients to monitor and receives reports on their property portfolios. CredoNet allows the user to drill down to detailed data on individual properties. The system also allows for benchmarking of key property cost data across the portfolio. CredoNet received the IDRC Global Innovator's Award for Corporate Real Estate.

Transactions Management: Working with Octane members, Jones Lang LaSalle will co-design and use workplaceIQ as its transactions management system. This tool allows Jones Lang LaSalle to build work processes that are specific to the needs of each client and transaction type. The system supports a collaborative database and secure environment that facilitate managing portfolio contracts, vendors, and operations.

Project Management: MAGNETÒ PTS project tracking system is used to support project management activities. The system maintains all project management activities including scope, schedule, and budget. It also allows the user to track vendors and employee time charges as well as milestone completion.

Property Management and Accounting: Jones Lang LaSalle utilizes J.D. Edwards for this production function. J.D. Edwards integrates all aspects of operations with financials including real-time balance inquiry, the ability to track an unlimited number of sub-ledgers, and custom alternative client chart of account reporting. Electronic purchase order entry, routing, and approval also are available. All J.D. Edwards reports can be downloaded to other applications through simple user tools and viewed on a real-time basis through Jones Lang LaSalle's Web portal.

Call Center: The vendor for call center activity and facility management is Clarify. The eFrontOffice and ClearHelpDesk tools integrate, consolidate, and route every customer touch point, including telephone, fax, mail, and e-mail. Clarify provides the vehicle to assign, route, and track service requests.

E-procurement: Working with Octane members, Jones Lang LaSalle uses SiteStuff as its e-procurement tool. SiteStuff provides online review and approval of invoices and automated entry into the Jones Lang LaSalle payables system. SiteStuff also provides an interface for field personnel purchasing MRO goods. Jones Lang LaSalle has found that, through volume aggregation, total costs for these goods have been reduced by 10 to 20 percent per transaction.

ISSUES AND CHALLENGES

Jones Lang LaSalle has more than 300 dedicated IT professionals in the firm working on this and other technology-related programs. To support this level of activity, the firm dedicates 10 percent of its annual revenue to investments in advanced hardware, software, and network and telecommunication systems.

Despite its strong commitment to technology, Jones Lang LaSalle is still faced with many challenges in the months and years to come. The major challenge is to complete the overall strategy and achieve a fully integrated program. This requires a determination by management to drive standards throughout the firm so that the strategy is fully embraced by Jones Lang LaSalle employees as well as various vendors supporting the effort. It also means a firm-wide commitment to product and service innovation as well as continuous investment in technology research and development. Finally, it involves the continuing support of Jones Lang LaSalle's existing clients and the willingness of new clients to try innovative approaches to solving old problems. To meet this challenge, Jones Lang LaSalle commits its operating and capital resources, but more important, it focuses project teams on innovation, integration, and change management, the most critical component. Through dedicated change managers, Jones Lang LaSalle looks to address shifts in behavior to further the effectiveness of technology.

While this may appear to be a Herculean task, most observers believe it is the only way that Jones Lang LaSalle can achieve its goal of becoming the "trusted real estate advisor" for global corporations.

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CASE STUDY 3: SPRINT CORPORATION

by John McMahan

This article represents the third in a series of case studies that began in Real Estate Issues, Summer 2002, Vol. 27, No. 2.

ABOUT THE AUTHOR

*This case was prepared by **John McMahan**, executive director of the Center for Real Estate Enterprise Management (Centerprise), a non-profit research and educational organization. The case is to be utilized as a basis for discussion and does not necessarily illustrate either effective or ineffective handling of a business situation. Funding for development of the case was provided by PikeNet, where this case has been previously published. John McMahan, CRE, © 2002, all rights reserved. (E-mail: jmcmahan@centerprise.org)*

Sprint Corporation (Sprint) is an Overland Park, Kan., based, global communications company serving more than 26 million business and residential customers in more than 70 countries. With 80,000 employees, the firm is a major user of a wide variety of real estate facilities throughout the world.

Sprint is widely recognized for developing, engineering, and deploying state-of-the-art network technologies, including America's first nationwide all-digital, fiber-optic network (FON Group). Sprint also operates the largest all digital, nationwide wireless network in the U.S., serving 16.7 million subscribers (PCS Group). Nearly 100 percent of Sprint's customers are served by digital switching technology, providing a platform for a portfolio of network-based voice, video, and data services.

MANAGEMENT STRATEGY

In November 2000, Sprint announced a series of key strategic initiatives to build its wireless business into a major world-class service provider and to transform its wired service into a data-centric operation.[1] This would be achieved by:

- **Wireless Operations:** Investment to increase Sprint's U.S. wireless network to third-generation capability. This would result in up to a doubling of voice capacity nationwide and dramatically increase data speeds. The upgrade also would allow Sprint to improve spectrum efficiency, which should lead to improved operating margins.

- **Wired Operations:** Growth in wired based products and services. This would primarily come from leveraging the company's Tier 1 Internet backbone, which should help to expand transport capabilities, Web hosting, value-added services (such as managed network services and applications), and global IP services.

FINANCIAL PERFORMANCE

The two Sprint tracking stocks, NYSE: FON and PCS, trade separately and both have come under the same financial pressures affecting the entire telecommunications industry — a combination of intense competition and the general slowdown in the overall economy.

FON Group: Sprint's FON Group outperformed the S&P 500 through most of 2001, but ended the year announcing a fourth quarter loss of $906 million. The Group came under additional pressure in early February as a result of the bankruptcy of Global Crossings Ltd, a customer of Sprint. Concerns also were developing about the debt structure of the telecommunications industry, largely because of short-term debt pressure on Quest Communications International. Most analysts did not expect the FON Group's operations to be affected, largely because it was not involved in similar accounting issues and seemed to have sufficient debt capacity. Sprint had been downgraded by Fitch Ratings, however, and was under review by Moody's and Standard & Poors.[2]

While revenue and net income were down in the first quarter of 2002, financial performance appeared to be stabilizing. Chairman and Chief Executive, William T. Esrey stated:

> "This quarter, the FON Group demonstrated its resilience in the face of a challenging marketplace. In our local operations, we continue to aggressively manage costs, improve operating profits, and sell our services in value-adding bundles."[3]

PCS Group: Sprint's PCS Group had incurred a loss of $328 million in the fourth quarter of 2001 and announced in mid-February that it was closing five of its thirteen call centers and laying off 3,000 people, approximately 9 percent of its workforce.[4] On a positive note, PCS announced a few days later a new technological breakthrough — an easy-to-use software solution that would allow Sprint customers to access corporate e-mail, calendar, company directory, and personal contacts without having to synchronize when they returned to the office. Best of all, the customer's computer did not have to remain connected to the network for the solution to work.[5]

PCS financial performance in the first quarter of 2002 continued to be strong. Revenue grew 41 percent as average monthly revenue per user climbed to $60. Sprint PCS also continued to add new subscribers. EBITDA more than doubled from the same quarter in 2001.

PCS continued to prepare for the introduction of its third-generation wireless service (3G), with launch projected for the summer of 2002. Mr. Esrey noted that:

> "3G offer greaters speeds and the applications that businesses and consumers need on a wide array of devices. With new data services such as e-mail and photo attachments, 3G will allow Sprint customers to stay connected with a broad range of applications."[6]

Regarding Sprint as a whole, Mr. Esrey said:

> "Despite a challenging economy, we are seeing improvements in our traditional wireline business and continue to deliver outstanding results in our wireless business. Nevertheless, we remain focused on improving the efficiency of our operations enterprise wide."[7]

SPRINT REAL ESTATE

Sprint Real Estate (SRE) is responsible for managing a worldwide inventory of real property assets and services supporting the company's operating and growth requirements. Assets include retail stores in most major cities; office facilities in regional and international locations; transmission and maintenance facilities in numerous locations; and warehouse facilities throughout the world.

SRE services include leasing, developing, and disposing of real property facilities, lease administration, payment of property occupancy costs, and providing building security services.

While human resources (HR) is not a direct management responsibility of SRE, there is a close working relationship with the HR group in making certain that the physical work environment is conducive to the highest level of employee morale and work efficiency. SRE also interface on a continuing basis with the financial reporting group regarding ongoing real property operations, cost control initiatives, and cash management.

As with the real estate groups of most US corporations, SRE view the line of business units (LOB) of the company as its major customers. The heads of these units have the option of utilizing local, non-Sprint real estate resources, which are generally viewed by SRE as being non-standardized, duplicative, slower in execution, and of generally higher cost to the corporation. As a result, the SRE group seek to provide "integrated, innovative, cost-effective, and profitable services for the business enterprise" and, by so doing, become the "sole provider of real property services" to each of the firm's business units.[8]

As an example, in providing space for the PCS Group's operations, SRE had to deal with the fast-moving world of technological product development and deployment. With the objective of achieving early market share penetration, the roll out of new products often required significant new physical infrastructure and facilities.

Some of these facilities came through the acquisition of existing firms, a portion was leased in the local real estate markets, and, in some cases, involved new building development. There also was pressure on SRE to consider the reuse of existing Sprint facilities that were no longer required for their originally intended use. Unfortunately, this often required more time to execute and/or involved getting mired in corporate red tape.

In all cases, the pressure on SRE to keep up with product deployment is intense. Given the high opportunity costs involved, no one wants a lack of real estate to become a bottleneck in the race to market. In some instances, this results in higher acquisition, development, and operating costs which, in turn, require greater financial resources if the effort is to be successful. In some cases, this situation is further complicated by business strategy decisions such as combining office and warehousing in the same building.

If a new product turns out to be unsuccessful, SRE is faced with the job of unwinding Sprint's real estate commitments. This could involve the sale of facilities, releasing to new tenants, or transferring employees to other Sprint operations. Again, this might result in higher costs and/or sublease revenue shortfalls, which could put additional strain on corporate financial resources.

Unlike most high growth technology firms, Sprint is faced with the additional uncertainty of operating within the constraints of government laws and policies that regulate the telecommunications industry. Even if a product is successful in the marketplace, there is always the possibility that a required license might not be obtained in a timely fashion or the merger of a competitor could lead to changes in regulatory requirements.

In addition, there also is the issue of how facility costs should be allocated within the corporation. Should they be charged to the independent business unit that is utilizing the facility or to "Mother Sprint" as an overall corporate allocation? This issue becomes particularly critical in situations where facility costs are considerably higher than budgeted due to the pressures for rapid product deployment.

Operating within this environment of market, regulatory, physical, and corporate constraints, SRE management knew that they had to develop a clear understanding of what they could and couldn't do.

PROJECT "EVOLUTION"

SRE leadership believed that a major key to improving their ability to deliver for their LOB clients was the development and integration of a Web-based real property information system. Beginning in 1996, Sprint corporate management sought to become "net ready" through a series of firm-wide technology based initiatives that provided the foundation for such a system.

In November 2000, management committed to the vision of transforming SRE operations through the development of a more robust end-to-end, automated and Web-enabled business model. Based on Cisco's "Net Ready" success factors of leadership, governance, technology and competency, Project Evolution ("Evolution") was launched.

The project addressed five key areas:[9]

- **Information Management:** Through Evolution, SRE sought to improve the timeliness and accuracy of information and intelligence needed to support better decision-making.

- **Streamline Processes:** Another objective was to streamline SRE's management processes. Targeted processes included space forecasting; facility planning; moving, adding, or changing operating facilities; project management; accounting; and tracking company real property assets.

- **Initiative Prioritization and Selection:** By establishing priorities, SRE expected to establish clear guidelines and insure better coordination of all Sprint property activities.

- **Accountability Metrics:** In order to establish greater employee and business group accountability, accurate and timely metrics would be required. These metrics would help to better align operations and support overall enterprise objectives.

- **Organizational Alignment:** Finally, Evolution was expected to better align the real estate function in terms of customer focus, communication, and efficient operations.

The plan was to implement Project Evolution in three phases:

Phase 1.0

Phase 1.0 began in early April 2001 with the formation of a project team and selection of a Big 5 consulting partner. Interviews with SRE associates, customers, and process partners were conducted and several areas of immediate improvement were identified. These areas included streamlining processes, improving customer touch points, and strengthening SRE's strategic positioning within Sprint. A roadmap was developed that outlined two major imperatives:

1. Focus on seven core areas for initial process improvements.

2. Identify key opportunities for SRE to focus its migration to a Web-enabled business model.

Between May and October, seven SRE teams explored the opportunities for improving existing processes, standardizing data, developing better performance metrics, and establishing a better understanding of the firm's real property assets.

On October 11, 2001, the teams presented their Phase 1.0 recommendations to the whole group in order to understand better each team's approach and to identify areas of synergy within SRE and other process partners within the corporation. At this meeting, near term implementation targets (Phase 1.5) were identified as well as longer-term (Phase 2.0) visions and recommendations.

Phase 1.5: Near Term Implementation

Phase 1.5 was kicked off in July 2001. It addressed the first imperative on the strategic roadmap, namely to develop a future vision of seven core areas and to identify and develop process improvement opportunities, which could be implemented independent of major technology investments. The seven areas targeted were:

Target	**Team**
Lease Administration	*(Project Habitat)*
Data Standardization	*(Project DNA)*
Resource Management	*(Project Globalization)*
Project Management	*(Project Lifecycle)*
Facilities Services/MACs	*(Project Ecosystem)*
Performance Metrics	*(Project Biometrics)*
Culture Process Team	*(Project Biosphere)*

Seven teams, comprised of cross-functional SRE managers and supported by director-level sponsors, completed detailed process maps and implementation plans.

In addition to the Phase 1.5 process teams, an analysis was begun in mid-December 2001 to develop an overall IT strategy that would integrate and align with the business plans and strategy of both SRE and the Sprint Enterprise as a whole. This strategy addressed the following areas:

- Architecture
- Applications
- Data
- Operations

Between October and March, the SRE team focused on Phase 1.5 implementation. This resulted in several key accomplishments:

- A **Project Initiation Form** was developed which would allow SRE customers (LOBs) to begin initiating projects electronically.

- A **High Level Project Cost Template** was rolled out for use in discussing cost and budget issues with the business units finance organization.

- **Livelink** was selected and implemented as the corporate wide repository to access business documentation. In addition, significant progress was made in reducing the number of signatures required to obtain fiscal approval of real estate projects.

- A **Project Tracking Tool** was developed and rolled out for immediate use. Approximately 45 SRE associates were trained in the use of this tool in late February

- In March, SRE rolled out a **Financial Tracking Tool** for use in coordinating activities between corporate finance managers.

- **Vendor Sourcing** strategies were developed to validate selection of service providers.

Phase 2.0: Longer Term Visions and Recommendations

Phase 2.0 was designed to address the recommendations from the IT strategy analysis, the strategic roadmap from Phase 1.0, and build upon the process and technology implementations from phase 1.5. Three major opportunities were identified:

- Project/Financial Management
- Self Service
- Robust integration of IT Infrastructure

There are two key aspects of the IT strategy; 1) a focus on "end-to-end" core real estate processes and 2) differentiation and education of the required technology components/layers required to achieve the overall SRE vision.

SRE executive leadership indicated that they wanted to manage the real estate business from an end-to-end process perspective to help eliminate the silos of information and reduce process handoffs. Additionally, the SRE vision calls for a "highly collaborative" organization that is "sought after" for real estate solutions. Standard end-to-end real estate processes and identifying new enabling technologies to help achieve the vision of a highly collaborative, sought after organization quickly became the core business drivers of the IT strategy.

ISSUES AND CHALLENGES

- As of mid-April, SRE leadership faced several challenges in the implementation of Project Evolution:

- As noted, the SRE organization operates in functional organizational "silos" with limited knowledge of the other processes required to deliver a complete real estate product (e.g. fully equipped office space). In the Evolution world of the future, people will be asked to be accountable for end-to-end processes that cover the entire real estate life cycle. The challenge will be to migrate solutions to support this fundamental change in organizational focus.

- New technical functionality will be required to meet the new business needs required by the changing organization. At the same time, SRE managers must ensure that they are leveraging existing technology investment as much as possible.

- In addition to changes in technology, enhanced leadership capabilities will be required to migrate to a new SRE business model based upon an end-to-end process view.

- Measurable accountability will have to be assigned to one person for each process function.

- Decisions involving project management, financial management, and self-service real estate operations will be critical in the success of the implementation effort.

- Decisions pertaining to integration of current user applications supporting the vision of Project Evolution and the selection of new solutions to address future Evolution process requirements.

- Decisions pertaining to managing the business based upon a "balanced scorecard" of measurements.

Most, if not all, of the SRE leadership know that they have their work cut out for them if they are going to be successful in utilizing technology to fundamentally change the way real estate is managed within the corporation. If they can pull it off, SRE will move a long way towards achieving its goal of becoming *"a valued partner by delivering innovative and competitive solutions"* and by so doing, becoming the *"sole provider of real property services"* to Sprint's operating divisions.

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PROPERTY INFORMATION: A GUAM CASE STUDY

by W. Nicholas Captain, CRE

ABOUT THE AUTHOR

W. Nicholas Captain, MAI, CRE, *is the president of the Captain Company, a real estate service corporation based on Guam. His firm specializes in providing valuation, consulting, brokerage and investment services. Mr. Captain is the only real estate expert in Micronesia to hold the prestigious Counselor of Real Estate, or CRE, designation. He also holds the Appraisal Institute's MAI designation and is licensed to appraise real estate in Guam, the CNMI and Hawaii.*

The Island of Guam, although small in size, presents many interesting examples of the boom and bust cycles experienced in real estate markets. In completing a Guam property information case study, we considered Guam's physical and demographic characteristics, economic forces, historic market overview, prevailing market conditions and future expectations. Guam's current real estate market, as compared with other great financial disasters, is presented in this paper. Through the detailed study and investigation of Guam's real estate market, property information can be used to support acquisition, disposition, lending, foreclosure, litigation and other important real estate decisions.

Information is defined by Webster's Dictionary as, "...knowledge obtained from investigation, study, or instruction." Real estate market knowledge (or property information) is the critical asset to real estate service companies. A thorough understanding of property information by valuers and consultants can lead to more stabilized and efficient real estate markets. Professional real estate experts continuously strive to gain a better understanding of property information, typically within selected geographic boundaries.

Exhibit 1

Regional Map

Exhibit 2

South Tuman Bay, Guam

The investigation of property data and the study of real estate markets in isolated locations can be both difficult and rewarding. The island of Guam, an unincorporated territory of the United States, involves a small, isolated real estate market which is highly susceptible to regional external forces; particularly from Japan. Although officially U.S. soil, Guam is "America in Asia" and U.S. economic influence is generally limited to interest rate policies and military activity.

In completing a Guam property information case study, we considered Guam's physical and demographic characteristics, economic forces, historic market overview, prevailing market conditions, and future expectations. Through the detailed study and investigation of Guam real estate market data, property information can be used to support acquisition, disposition, lending, foreclosure, litigation and other important real estate decisions.

PHYSICAL AND DEMOGRAPHIC CHARACTERISTICS

Guam is a tropical island located in the Western Pacific, almost due south of Tokyo and directly east of Manila (Exhibit 1). Guam is Micronesia's largest island and its land area of approximately 213 square miles is roughly the size of Singapore. Guam benefits from tropical weather, sandy beaches, clear water, and clean air. Geographically, the island involves two distinct areas: northern Guam involves a raised coral line plateau and the fairly level topography allows for intensive development, while southern Guam is mountainous and relatively rural in character. The island is located within the typhoon belt and earthquake zones, which provides occasional excitement.

The island population approximates 155,000 and includes a mix of indigenous Chamorros (43 percent), Filipinos (23 percent), and mostly other Asian ethnic groups. Guam's average household income in 2000 was a healthy US$45,091. Ninety-nine percent of the population speak English.

Tumon Bay, Guam's primary location of tourist related development, features warm, protected water and a sandy beach. These factors, along with close proximity to Japan, have resulted in the development of Guam as a tourist destination. Hyatt, Hilton, Marriott, Westin, Nikko, Holiday Inn, and other brands are found along Tumon Bay.

Guam also features one of the best deep-draft harbors in the Western Pacific (Exhibit 2). As a result of its geographic characteristics, Guam has historically attracted military interest. Most recently, the military presence has grown in importance as Japan's economy has waned and military activity related to anti-terrorist/"Axis of Evil" policy has grown significantly.

Guam's physical location characteristics combine to attract tourists and investment from Japan as well as a strong military presence. The island's demographics have allowed for development of both tourism and military industries. These factors, in extreme cyclical patterns, have shaped Guam's economic growth since the mid-1960s.

ECONOMIC FORCES

As an unincorporated territory of the United States, Guam's economy is structured under U.S. laws. A history of political stability has allowed for significant economic growth over the past 20 years. Gross Island Product ("GIP") for Guam increased from US$1.73 billion in 1988 (the first year analyzed) to US$3.42 billion in 2000, nearly doubling in 12 years. Since 2000, job losses, deflation and fiscal mismanagement have contributed to painful economic contraction.

Table 1

Historic Japanese Visitor Arrivals to Guam and Yen/US$ Exchange Rates, 1970-2000

Year	Visitor Arrivals From Japan	5-Year Periods	10-Year Periods	Yen/US$ Rate	% Change
1970	44,234	-	-	360	-
1975	163,557	270%	-	297	-17.5%
1980	221,910	36%	502%	227	-23.6%
1985	301,690	36%	184%	238	4.8%
1990	637,569	111%	287%	145	-39.1%
1995	996,219	56%	330%	94	-35.2%
2000	1,048,813	5%	165%	108	14.9%

Sources: Guam Visitor's Bureau, Guam Department of Commerce and Federal Reserve Bank (St. Louis).

Guam's physical and demographic characteristics have historically attracted significant tourism and military related investment. Tourism is the largest private sector industry on Guam and reportedly accounts for approximately 35 percent of GIP. Military (defense services) reportedly accounts for approximately 25 percent of GIP. The remainder of the economy is comprised of local and federal government activities, services, and related sectors. Since the Asian economic crisis in the late 1990s, the economic impact from tourism has declined while the importance of the military sector has grown sharply.

Less than four hours air-time from Tokyo, Guam benefits from direct airline service to thirteen cities in Japan and serves as a regional hub for Continental Airlines. Approximately 3.6 percent of Japanese outbound tourists visit Guam annually, peaking at nearly 1.05 million during 2000. Annual visitor counts from Japan typically reflect between 75 and 85 percent of total arrivals. Although the Korean market has grown in recent years, Guam's popularity as a Japanese visitor destination was the critical component of economic development since 1985. Historic Japanese visitor arrival growth, along with corresponding Yen/US$ exchange rates, are shown in Table 1.

In the late 1980s, hotel and golf course development exploded along with the booming Japanese economy. Guam's hotel room inventory more than tripled from 2,900 in 1985 to 9,002 rooms by 2000. Several luxury hotels were constructed between 1988 and 1993, at costs of up to US$400,000 per room. Three high profile golf courses were developed on Guam during the boom years. As pet projects of super-rich Japanese, these courses were constructed at costs of up to US$4.0 million per hole. Nearly 1,000 golf course memberships were sold to Japanese nationals, mostly in the US $200,000 range (current prices are significantly lower). During Japan's boom years, tourism appeared as the economic panacea for Guam.

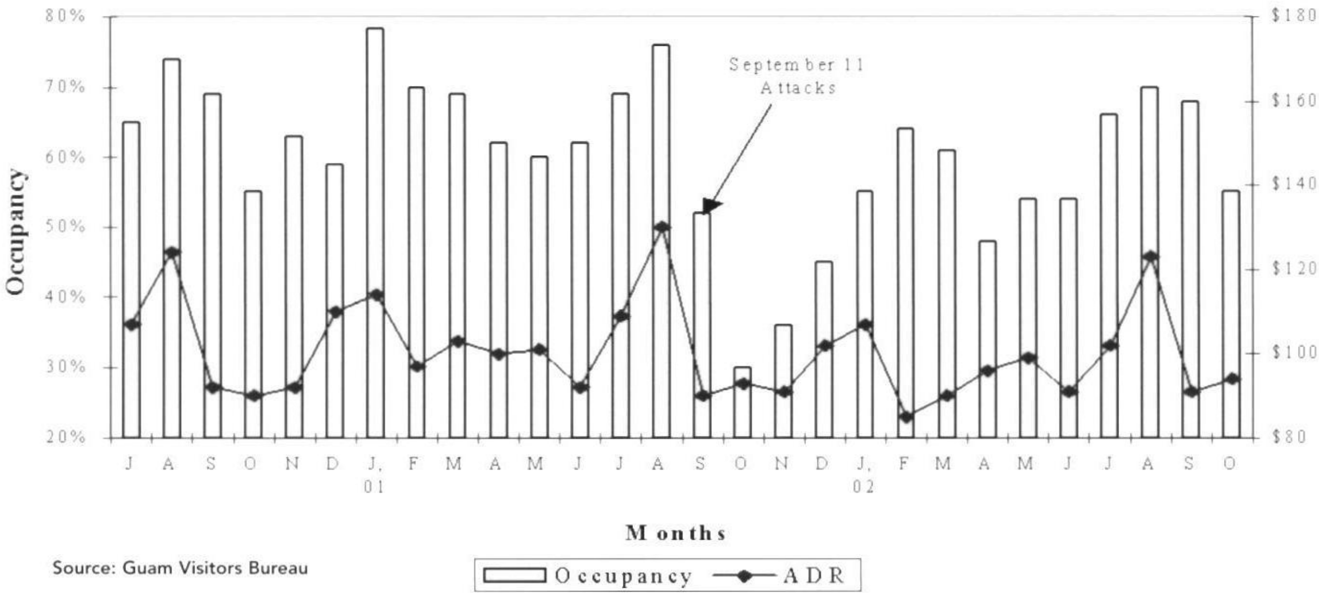
However, reliance on tourism as a primary component of an economy has significant risk; particularly when that tourism involves a single market. The combined effects of the sputtering Japanese economy, the Asian economic crisis, and the terrorist attacks of September 11 resulted in sharp economic declines in recent years. As an example, total private sector jobs declined by nearly 18 percent between 1996 and 2002, with most losses in the construction and retail trade sectors. The economic impact of the September 11 terrorist attacks on Guam's tourism industry, projected to hit $47 million by March 2003, is evident in occupancy and average room rate statistics summarized in Table 2.

Guam's physical characteristics have historically attracted military interest from the reigning regional powers. Mostly recently, proximity to North Korea, unique training facilities on strategic U.S. soil, and regional terrorist activity have combined to advance military initiatives in the region. Economic activity generated by the military sector on Guam involves its own set of risks and inherent negative consequences, but this component of the economy is far more stable than tourism.

Since 1995, annual federal expenditures have ranged from approximately US$800 million to US$1.0 billion. After a period of decline (there was strong objection to the military presence on Guam during the economic boom years) in the early to mid-1990s, Guam has generally experienced slow, but steady growth from the military sector. Most recently, massive supplemental budgets and long-term infrastructure projects allow for further, and potentially significant, personnel and military hardware increases. Economic forces on Guam,

Table 2

Impact of 9/11 Terrorist Attacks on Guam Hotels



Source: Guam Visitors Bureau

most notably from the tourism and military sectors, provide the foundation for the local real estate market.

HISTORIC MARKET OVERVIEW

Guam's modern real estate history dates back to World War II. Following the United States victory, the federal government acquired a substantial portion of the island for strategic military purposes. The federal government today retains control over approximately 30 percent of the island. The local government owns another 30 percent, leaving approximately 40 percent in the hands of private landowners. Fee simple ownership prevails and real estate ownership by foreigners is allowed.

Historically, Guam's real estate market has experienced extreme volatility resulting from external market forces. Land values remained extremely low from the period following WWII until the late 1960s (U.S. Navy restrictions on access to the island were lifted by President Kennedy in 1963). As an outpost for the Vietnam War, military activity supported strong economic growth beginning in the late 1960s. In the early 1970s, foreign investment sparked by political fears in Taiwan (Nixon's visit to Beijing), combined with a relative explosion in tourism on Guam from Japan, fueled an incredible rise in real estate prices. During this period of frantic activity, Guam experienced its first $1 million land deal, a surge in foreign investment (primarily from Japan and Taiwan), and an incredible short-term spike in real estate prices.

In 1974, OPEC pulled the global economy into recession through a series of oil price hikes and Guam's first major real estate bust began. The market remained depressed during the early 1980s as U.S. interest rates above 20 percent crippled economic growth. Between February 1985 and December 1987, the value of the Japanese yen vs. U.S. $ doubled and Guam real estate prices suddenly looked cheap. By 1988, real estate prices had increased back to pre-bust levels and Japanese foreign investment was beginning to fuel another spectacular rise in property prices on Guam.

During the peak of Guam's second real estate boom in 1990, the highest-demand land prices had increased nearly 10 times within a three-year period. The subsequent contraction of Japan's economy in the early 1990s started the longest downward spiral in real estate values in Guam's modern history. By 2002, numerous properties that sold during the 1989/1990 market peak subsequently resold at small fractions of original purchase prices. A summary of notable land resales on Guam during this last cycle is shown in Table 3.

In order to analyze the dramatic changes in Guam's real estate market over a 10-year period, we summarized aggregate market activity including total transactions, the US$ volume of all transactions, and the same categories for transactions

Table 3
Analysis of Land Price Declines, Island of Guam

Trans.#	Land Area (acres)	1989/90 Peak Sale Price	Recent Sale Price	Change from Market Peak $	%
Oceanfront					
1	24.7	$63,000,000	$7,500,000	($55,500,000)	-88%
2	1.0	$10,000,000	$3,500,000	($ 6,500,000)	-65%
3	10.4	$21,008,000	$4,201,600	($16,806,400)	-80%
4	20.2	$40,500,000	$2,000,000	($38,500,000)	-95%
Primary Road Frontage					
5	0.6	$ 5,582,000	$2,140,000	($ 3,442,000)	-62%
Interior					
6	2.5	$ 3,000,000	$1,087,000	($ 1,913,000)	-64%
7	1.0	$ 3,156,660	$ 680,000	($ 2,476,660)	-78%
8	1.2	$ 2,300,000	$ 130,000	($ 2,170,000)	-94%
9	1.0	$ 2,731,240	$ 500,000	($ 2,231,240)	-82%
10	14.7	$ 7,000,000	$ 500,000	($ 6,500,000)	-93%
Golf Course Potential					
11	605.4	$40,000,000	$5,000,000	($35,000,000)	-88%

Source: Department of Land Management and The Captain Company

reflecting prices over US$ 1.0 million. The data was summarized on an annual basis and compared at 10 year intervals for the 1989 to 1991, and 1999 to 2001 time frames as shown in Table 4.

To a great extent, as goes Japan, so goes Guam. The combination of close geographic proximity, tropical weather and U.S. soil has historically attracted investment from Japan. Guam's real estate values, to some extent, have tracked Japan's since 1985. The correlation between selected Japan and Guam real estate values (1990 Base Year) is shown in Table 5.

It appears from the table that the risk associated with changes in real estate prices on Guam may be half an order of magnitude greater than in Japan. Note that current identified land values in both Japan and Guam are lower than 1985 levels. The decline in Guam land values during the 1990s was so severe, it dominates some of the world's other great financial disasters as shown in Table 6.

Guam's real estate market is highly susceptible to volatility due to external pressure. The first boom in the early 1970s was fueled by Vietnam War activity, political and tourism-related factors, and ended with the global recession initiated by the OPEC oil price hikes. The second boom resulted from a spillover of Japanese economic growth and ended with the slowdown in Japan, the economic crisis in Asia and the terrorist attacks in the U.S. mainland.

PREVAILING MARKET CONDITIONS

Prevailing real estate market conditions on Guam remain relatively soft. The devastating impact of Supertyphoon Pongsona in December 2002 severely restricted economic and real estate market activity through the remainder of the year and into 2003. A summary of aggregate price activity by sector, since 1999, is shown in Table 7.

As Japanese property owners continue to dispose of assets and Japan's economy remains weak, prices are expected to remain low. However, the dramatic real estate price declines have attracted growing interest from foreign investors (including some from Japan). Investors from Indonesia recently acquired the Palace Hotel at a price of less than $10 million, a 90 percent discount off of the development cost, which was reported to be approximately $100 million. The $40 million Accion Guam hotel recently sold at under $2 million, and the buyer converted its use to a seminary. The Dai Ichi Guam hotel also sold recently at a leasehold price of under $8 million and more hotel sales are pending. Cocos Island Resort and a Saipan shopping center (La Fiesta) recently sold to Japanese billionaire Masafumi Miyamoto, developer of the popular

Table 4

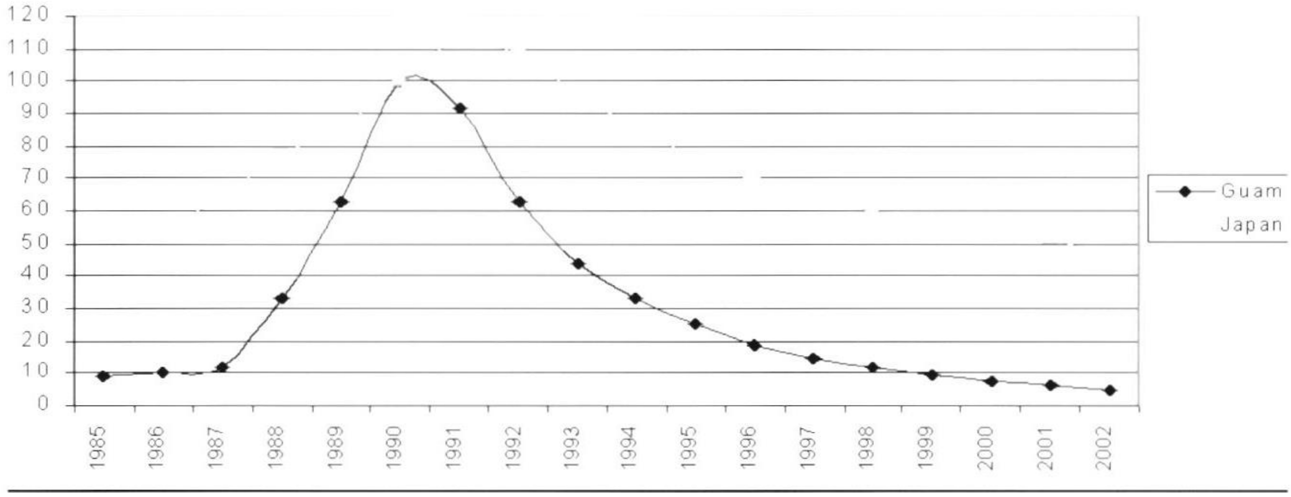
Analysis of Guam Real Estate Market Activity By Decade

	All Transactions		Transactions > $1.0 Million	
Year/Item	No. of Trans.	Total $ Volume ($ millions)	No. of Trans.	Total $ Volume ($ millions)
1989	1,448	$1,067	166	$ 795
1999	1,101	$ 173	11	$ 28
% Change	-24%	-84%	-93%	-96%
1990	1,771	$ 806	115	$ 464
2000	1,119	$ 128	11	$ 31
% Change	-37%	-84%	-90%	-93%
1991	1,554	$ 375	47	$ 145
2001	950	$ 143	9	$ 17
% Change	-39%	-62%	-81%	-88%
1989 to 1991 Aggregate Totals	4,773	$2,248	328	$1,404
1999 to 2001 Aggregate Totals	3,170	$ 444	31	$ 76
% Change	-34%	-80%	-91%	-95%

Sources: Department of Land Management and The Captain Company

Table 5

Correlation Between Japan and Guam Land Values; Base Year 1990 = 100



Source: Japan Real Estate Insitutue (all urban area, commercial land) and The Captain Company (Guam, Tumon interior Land

"Final Fantasy" video game. Many local market players that watched from the sidelines for over 10 years, are now getting back into the investment game, perhaps signaling a market bottom.

From a valuation perspective, the dramatic real estate price declines require a detailed analysis of depreciation, or an abandoning of the cost approach as a reliable indicator of value. In most cases, support for economic and functional obsolescence involve esoteric analyses that are appropriate for academic, but not potential investor due diligence purposes. Sophisticated investors are focused primarily on potential income and, from our perspective, the cost

Table 6

Historic Global Financial Disasters

No.	Financial Disaster	Where	When	Price Increase	Subsequent Decline
1	Tumon Land	Guam	1985-90	1,100%	95%
2	Tulip Bulbs	Holland	1634-37	5,900%	93%
3	Silver	U.S.	1979-82	700%	88%
4	U.S. Stocks	U.S.	1921-29	500%	87%
5	Japanese Stocks	Japan	1965-89	3,270%	78%

Source: Forbes ASAP and The Captain Company

Table 7

Guam Aggregate Real Estate Market Activity, 1999-2002

	1999	2000		2001		2002	
Category	**Total $ Millions**	**Total $ Millions**	**% Change**	**Total $ Millions**	**% Change**	**Total $ Millions**	**% Change**
Land	$ 44.6	$ 42.9	-3.8%	$ 23.7	-44.8%	$ 30.7	29.5%
Commercial	$ 11.1	$ 12.9	15.5%	$ 9.1	-28.9%	$ 6.5	-29.2%
Industrial	$ 4.5	$ 7.8	73.9%	$ 5.7	-26.3%	$ 3.2	-45.0%
Apartment	$ 4.8	$ 4.0	-18.5%	$ 2.0	-49.0%	$ 3.4	67.5%
SFD	$ 81.5	$ 57.0	-30.1%	$ 69.6	22.1%	$ 64.2	-7.8%
Condominium	$ 21.8	$ 21.6	-1.1%	$ 18.6	-13.7%	$ 15.0	-19.4%
Totals:	**$168.4**	**$146.1**	**-13.2%**	**$128.9**	**-12%**	**$122.9**	**-4.6%**

Source: The Captain Company

approach has become temporarily obsolete, even for most recently constructed improvements.

FUTURE EXPECTATIONS

The near-term future of Guam's real estate market remains unstable and susceptible to external forces in the region. Although dramatic declines have already occurred in most sectors, economic support for a market bottom remains elusive. Economic problems in Japan and a growing trend toward domestic travel could further contribute to Guam real estate price declines. Most recently, deflationary forces emanating from China have contributed to further price declines. Global military conflicts and terrorism increase risk associated with investing in any substantially tourism-dependent economy. The recapitalization of real estate prices during a period of declining interest rates has effectively passed and risk associated with future increases has swelled. However, the fundamentals of Guam's real estate market will ultimately lead to recovery. Guam's market fundamentals, which may have lost some luster in recent years, include:

- U.S. Laws and Currency
- Close Proximity to Japan/Asia
- Political Stability
- Tropical Weather
- Adequate Tourist Infrastructure
- Strong Military Presence

The recent and proposed increases in military activity will generate badly needed economic growth. Foreign investment, although at low prices, will also contribute to the economy through renovation projects and capital infusions. The combination of Guam's fundamentals, military growth and foreign investment will lead to the long-term recovery of Guam's real estate market. We expect that Guam's next boom will occur between 2015 and 2020, as newly rich Chinese look for vacation properties, and Japanese, Korean, and Taiwanese investors return in earnest. As the century progresses, China will play an increasing role in local economics and real estate pricing models.

CONCLUSION

Through the detailed investigation and study of local real estate markets, property information can be obtained. Property information is the critical asset for real estate service organizations. Real estate market knowledge, or property information, provides a foundation for the analysis of real estate problems by valuers and consultants. Property information, or the knowledge obtained through detailed study of property data, can be used to support more stabilized and efficient real estate markets; particularly in isolated locations such as Guam.

Guam's physical and demographic characteristics have historically attracted tourism-related and military investment. The local real estate market is highly susceptible to volatility due to external pressures; particularly from Japan. Guam real estate values peaked in 1989/1990 and subsequently declined dramatically. Prevailing market conditions remain weak and recovery remains elusive. However, the fundamentals of Guam's real estate market, including military expansion and a return of foreign investment, will lead to long-term economic growth and real estate market recovery. Opportunistic investors, armed with this property information, should consider Guam as an attractive investment option.

ABOUT THE AUTHOR (*Continued*)

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CROSS-BORDER REAL ESTATE ISSUES: INVESTING IN CANADA AND MEXICO

by Edward T. Canuel

ABOUT THE AUTHOR

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Global political and economic instabilities have wreaked havoc upon world financial markets. United States real estate investors, seeking comparatively conservative investments, once confined themselves to "think locally," investing exclusively in domestic opportunities. Following the high technology crash, many investors diversified their portfolios, seeking cautious investments in other nations with established markets offering predictable, "safe" returns. The result: a growing interest in existing investment opportunities via the North American Free Trade Agreement ("NAFTA"). NAFTA provides U.S. investors with broad assurances of predictable, stable real estate investments in the other NAFTA trading partners, Mexico and Canada. The U.S. investor cannot proceed blindly without understanding that, despite the broad, liberal trading regime instituted under NAFTA, these countries have statutory requirements which may trap the unwary, causing project delays, necessitating timely and costly governmental approvals, or pose unexpected tax consequences. This article reviews several general issues an investor must consider when investing in cross-border real estate, particularly noting how NAFTA may affect such investments.

NAFTA AND INVESTMENT OPPORTUNITIES

NAFTA (or the "Agreement") is the most important factor to consider in analyzing any cross border real estate transactions. The Agreement was executed by the United States, Mexico, and Canada on December 17, 1992, and became effective on January 1, 1994. The Agreement is a comprehensive, multi-layered document which institutes numerous structures, guidelines, and rules relative to trade between all three countries. The objectives of NAFTA include the elimination of trade barriers, heightened investment opportunities, and the promotion of fair competition. Investors under NAFTA (e.g., "persons" who are nationals of a NAFTA country) have broad assurances against governmental interference and profit expropriation.

NAFTA has provided broad statistical fodder for its opponents and proponents. The creation of NAFTA established North America as the world's largest free trade block, which now contains approximately 400 million people, second only to the European Union. As of 2003, the NAFTA trade alliance produces more than $11 trillion worth of goods and services.[1] Since 1994, the total value of trade between the three NAFTA parties expanded from $109 billion to $622 billion in 2000, an increase of 109 percent.[2] Mexico, in particular, has reaped major benefits from NAFTA: Mexico exported $139 billion to its NAFTA partners in 2001, 225% more than in 1993, the year prior to the start of NAFTA implementation.[3] Additionally, from 1994-2001, export growth to the U.S. contributed to more than half of real gross domestic product in Mexico.[4]

The effect of NAFTA on U.S. exports and imports also has drawn much criticism. According to the United States International Trade Commission Report of 1997, the Commission could not quantify a noticeable effect by NAFTA on the United States gross domestic product. Alternate data notes, however, that the total trade of United States with Canada and Mexico has increased since January 1, 1994, from an annual average of $269 billion in 1991 through 1993, to an annual average of $384 billion in the period from 1994 to 1996.[5] Additional statistics note an increased U.S. trade deficit with Canada: Canada's trade surplus with the United States as of January, 2003 was $8.0 billion.[6]

The U.S. investor cannot proceed blindly without understanding that, despite the broad, liberal trading regime instituted under NAFTA, these countries have statutory requirements which may trap the unwary, causing project delays, necessitating timely and costly governmental approvals, or pose unexpected tax consequences.

CANADIAN REAL ESTATE OPPORTUNITIES

The Investment Canada Act of 1985—In addition to the requirements under NAFTA, foreign real estate investors in Canada must contend with the Investment Canada Act of 1985 (the "Act") with respect to creating holding entities controlling real property investments. For example, the Act provides for certain regulations concerning an "Investor," which, under Section 24(4), is defined as: (a) an "individual, other than a Canadian, who is a national" (as further defined under NAFTA), (b) a government of a NAFTA country (including a federal state or local government, or an agency thereof), (c) an entity that is not a Canadian controlled entity [which must comply with certain qualifications] and (d) a corporation, limited partnership, or trust which complies with certain control guidelines under the Act (e.g., limitations of contract by voting interests which, in turn, are controlled by "non-NAFTA" investors). Thus, there must exist an element of "control" retained by Canadian persons, or limited control by NAFTA member investors, in any foreign investment holding entity.

Part 5 of the Act (Rules and Presumptions) specifies comprehensive requirements regarding what constitutes the requisite Canadian "control" of real estate holding entities. Namely, Section 26 of the Act specifies a "Canadian controlled" entity (e.g., where a Canadian person or two or more members of a voting group who are Canadians own a majority of the voting interest of an entity) and non-Canadian controlled entities (e.g., one non-Canadian or two or more members of a voting group who are non-Canadians owning a majority of the voting interest of an entity). Section 26 of the Act further provides that an entity is "Canadian controlled" by focusing upon the majority voting interest (taking into account the voting interest of non-Canadian majority voting groups) which applies to a corporation's board of director composition and a limited partnership's general partnership composition. In the case of a holding corporation, not more than a third of the directors must be resident Canadians if the earnings in Canada of the holding corporation and its subsidiaries are less than five percent of the gross earnings of such corporation and/or subsidiaries.

Notwithstanding the complex "control" categorizations under the Act, investors face an additional level of governmental oversight. Specifically, the "Minister" under the Act (meaning the member of the Queen Privy Council for Canada) may, pursuant to Section 26(2.1), determine that the entity is not a Canadian-controlled entity after considering any information and evidence submitted by or on behalf of the entity or otherwise made available to the Minister or the Director of Investments (the "Director"). Further, when an entity has refused or neglected to provide, within a reasonable time, information that the Minister or the Director has requested and that the Minister considers necessary in order to make a decision, the Minister may declare that the entity is a Canadian-controlled entity. With respect to so-called "equal ownership" requirements, when two persons equally own all the voting shares of a corporation, and at least one of them is non-Canadian, the corporation is not a Canadian-controlled entity. Note also that under Section 27 of the Act, the Canadian government has broad requirements (and powers) in determining the identity of the beneficial owners of partnerships, trusts, or joint ventures. In essence, any voting shares of a corporation that are issued to a bearer are deemed to be owned by non-Canadians, unless the contrary is established. Additionally, similar provisions exist with respect to the acquisition of controlled entities, including provisions whereby the Minister may determine whether such entities are controlled by other entities. These layers of discretionary review process may prove daunting for investors.

NAFTA and the Act: Investment Requirements—With respect to NAFTA, Annex I (Schedule of Canada) also details certain investment requirements, harmonizing NAFTA with various requirements under the Act.[7] Certain acquisitions of Canadian businesses by "non-Canadians" are subject to review by the political body known as Investment Canada, including: (i) all direct acquisitions of Canadian businesses with assets of $5 million Canadian or more; (ii) all indirect acquisitions of Canadian businesses with assets of $50 million Canadian or more; and (iii) indirect acquisitions of Canadian businesses with assets between $5 million Canadian and $15 million Canadian that represent more than a 30% of the value of the assets of all the entities whose control is being acquired, in the subject transaction. Further, as noted in the Act, an investment subject to review under Investment Canada may not be implemented unless the Minister responsible for the Act advises the applicant that the investment is likely to be of "net benefit" to Canada, allowing various factors described in the Act (e.g., the degree and significance of participation by Canadians in the investment, and the effect of investment on competition within any industry or industries in Canada). With respect to the so-called "phase-out" of the Act under NAFTA, Annex I provides that the direct acquisition of control of a Canadian business will be reviewed only upon a certain monetary threshold being reached by the Mexican or U.S. investors in Canada.

Provincial Requirements—Each province of Canada promulgates laws relating to the acquisition and disposition of real property, which may confuse investors presuming provincial uniformity. For example, all provinces, except Quebec, have developed property law through the English common law process. Quebec derives its property law through the Napoleonic code. This divergence in legal development creates potential for vastly different provincial requirements. Additionally, as noted previously, NAFTA and the Act provide extensive regulations and review mechanisms related to foreign investment in Canada, which may inadvertently, or directly, affect Canadian real estate acquisitions by foreign entities. For example, with respect to Alberta, an "ineligible person" may only hold an interest in "controlled land" consisting of not more than two parcels of real property containing, in the aggregate, not more than 20 acres.[8] An "ineligible person" is: (i) an individual who is not a Canadian citizen or permanent resident; (ii) a foreign government or agency thereof; or (iii) a corporation incorporated elsewhere than in Canada.[9] "Controlled land," although not unambiguously defined, specifically excludes, among other things, mines and minerals.[10] Within the context of such controlled ownership, a non-resident includes the following: (i) an individual other than a Canadian citizen, who is not ordinarily resident in Canada; (ii) a corporation incorporated, formed, or otherwise organized outside Canada; (iii) the government of a foreign state or any political subdivision thereof; (iv) the corporation controlled indirectly or directly by non-residents; or (v) a trust either established by a non-resident (other than a trust for administration of pension funds in certain circumstances) or in which non-residents have more than 50% of the beneficial interests.[11]

With respect to Ontario, certain provincial laws require various tax reporting and registration measures. For example, the Extra-Provincial Corporations Act requires corporations incorporated outside Canada to obtain licenses to conduct business or hold property interests in Ontario.[12] Additionally, certain provincial rules exist regarding the disposition of less than the whole of a parcel of land held by any one owner. For example, an owner is not entitled to sell, mortgage, or lease for a term of more than 21 years, portions of that owner's holdings or retained abutting property, without first obtaining consent from the local planning committee.[13] Provincial land transfer taxes also exist, including taxes with respect to leases with terms in excess of 50 years (including renewals).[14]

Non-Canadians may be subject to increased tax rates on their Canadian land holdings. For example, in many Canadian provinces where land is zoned for agricultural and/or recreational purposes, such land is subject to a higher land transfer tax at the time of purchase by a non-resident.[15] Conversely, land zoned for residential or commercial purposes is generally not subject to a higher tax rate.[16] Certain Canadian provinces, including Quebec, also have different tax measuring systems. Further, the purchase by a non-resident person or an entity directly or indirectly controlled by a non-resident person generally gives rise to an additional tax, imposed at various rates (e.g., 20% of the purchase price in Ontario, and 33 1/3% in Quebec).[17]

Industry Canada: Interpreting the Review of a "Net-Benefit"—Real estate investors must additionally contend with another governmental agency, Industry Canada. This entity administers the Act through the Canadian Ministry of Industry, prepares a detailed report analyzing the requirements noted with respect to "Foreign Investors" under the Act and NAFTA, and the strict rules regarding investment in Canadian corporations. In its document entitled "An Overview of the Investment Canada Act," Industry Canada discusses ministerial review under the Act. For example, in determining whether a "net benefit" is achieved under a foreign investment, Industry Canada considers several factors, including the effect on the local economic activity in Canada, the degree and significance of participations by Canadians in the Canadian business or new Canadian business, the effect of investment on competition with any industry in Canada and the contribution the investment makes to Canada's ability to compete in more markets. The Overview also discusses the procedure with respect to challenging an application for review. Investors may need to deal with additional governmental agencies other than the Ministry of Industry or Industry Canada; transactions involving business activities relating to Canada's cultural heritage or national identity fall under the jurisdiction of the Cultural Industries Branch of the Department of Canadian Heritage.

Statistical Overview of Canadian and U.S. Trade under NAFTA—Various statistics indicate, with few exceptions, that the trading relationship between Canada and the United States provides ample investment opportunities, despite the complex requirements of the Act, NAFTA and various governmental agencies such as Industry Canada. U.S. transactions with Canada reached $434 billion dollars in 1999, 53% more than those with Japan, which then formed the United States' second largest trading relationship.[18] Additionally, the United States sold $167 billion dollars worth of goods to Canada in 1999, a 7% increase over the previous year.[19] Also, as of 1999, Canada bought more U.S. goods than all 15 countries of the European Union combined.[20] From 1985-2000, U.S. merchandise exports to Canada tripled, with Canada being the lead foreign export market for U.S. goods since 1946.[21] Further, Canada ranks third in the consumption of U.S. services, with purchases of $21 billion dollars in 1999, while providing the United States with $16 billion dollars worth of services that year.[22] Two way trade between Canada and the United States grew 46% between 1994 and 1999.[23]

MEXICO AND REAL ESTATE TRANSACTIONS

The stringent private property ownership restraints (particularly for foreign investors) imposed under the Mexican Constitution have been ameliorated through the Agreement, although several foreign investment limitations and guidelines continue to exist. With respect to acquisitions in general, the right for the Mexican government to review the acquisition of more than 49% of a Mexican enterprise exists if the value of the gross assets of that enterprise exceeds certain levels which, under NAFTA, eventually increases to $150 million. Additionally, in the instances of real property acquisitions, investment by foreign nationals or enterprises (except as a beneficiary of a Mexican trust) is prohibited for real property within 50 kilometers of the coast of Mexico, or 100 kilometers of Mexico's border with the United States (so-called "Restricted Zones").[24] Notwithstanding the foregoing, and following the implementation of Mexico's New Foreign Investment Law of 1993, as amended (the "NFIL"), a foreign-owned Mexican company may directly acquire real property within the Restricted Zone to conduct non-residential activities (e.g., industrial commercial or tourism activities such as marinas, hotels, or restaurants).[25] Additional legal formalities also exist when foreign corporations acquire real property, including, among other things, the use of a public notary (depending on the value of the real property) and required permits from the Mexican Ministry of Interior (which may be obviated through the use of a local attorney-in-fact).[26] Further, investors should note that the lease of land for more than 10 years is deemed to be an "acquisition" under Mexican federal law.[27]

Foreign Investment: Residential Activities and Acquisitions—Trusts allow foreign investors a holding vehicle for real estate investments, while a certain level of review is retained by a Mexican governmental agency. Specifically, foreign nationals or enterprises may acquire certificates which grant beneficiaries the right to use and enjoy certain real property in the Restricted Zones, and to receive the profits that such nationals and/or enterprises may obtain from the profitable use of the property.[28] These certificates may be issued by a Mexican credit institution that has been granted authorization to acquire title to real estate residential activities in the Restricted Zone for a period not to exceed 50 years through a trust.[29] This duration may be renewable, depending on the satisfaction of certain requirements (e.g., if the beneficiaries of the existing trust continue as beneficiaries).[30] The Mexican Secretariat of Foreign Affairs will determine ambiguities of activities which are "residential" or "non-residential" in nature.[31] Annex I of NAFTA (Schedule of Mexico) also notes certain investment criteria and review requirements of the Mexican government's Comision Nacional de Inversiones Extranjeras (the "CNIE"). This organization must review certain investment criteria regarding foreign real property investors with respect to real estate transactions, including the effects on employment and training of the transaction, technological contributions of the proposal, or the proposal's contribution to increased Mexican industrial productivity and competitiveness. The CNIE will review certain acquisitions of real property in an "unrestricted sector" of Mexico, examining the amount of ownership interests held (or controlled by) Mexican nationals, while also reviewing if the value of the gross assets of the Mexican enterprise is not less than an applicable threshold set forth in NAFTA.

Maquiladoras and Tax Issues—The development (and operation) of maquiladora manufacturing centers have been greatly affected by NAFTA, allowing generous investment opportunities for foreign investors. The maquiladora program allows further processing or assembly in Mexico with a required duty to be paid only on the value added to components.[32] Mexican manufacturing wages, significantly lower on average than that of the United States, also continue to attract U.S. investment in maquiladoras. Additionally, under NFIL, foreign investors may own up to 100% of Mexican construction companies.[33] With respect to maquiladoras, it has been suggested that annual trustee fees associated with foreign investment in Restricted Zones may be saved as maquiladoras or any other Mexican entity with foreign shareholders may directly acquire non-residential real property without trusts as the holding entity.[34] Property acquisition taxes which occur when real property is transferred to a new owner are approximately 2% of the property value, calculated as the greater of the value assigned by tax authorities, or the transfer price. Accordingly, it is uncertain whether the cancellation of the trust and the transfer of the trust property in a maquiladora may be deemed a transfer of property for tax purposes, as the trust agreement is cancelled and the title to real properties consolidated in the beneficiary.[35] As such, some have questioned whether the value-added tax may be due only on the transfer of improvements, which may be further avoided if the maquiladora constructed the improvements and held direct title, as such improvements are already the property of the maquiladora, and the value added tax was previously paid by the construction company.[36] Given these potential tax qualifications, and the implications of various conveyances in terms of both NAFTA and the NFIL, joint ventures with Mexican companies as partners have been recommended. The economic impacts of NAFTA and maquiladoras in Mexico are substantial: a 1998 article in the *Wall Street Journal*, for example, cited that some 1,675 maquiladora plants existed, employing in excess of 500,000 Mexicans in 1997.[37] Recent statistics project that approximately 1.1 million Mexicans were employed in the maquiladora sector in 2001.[38]

Tax Matters—Specific tax allocations are also a complex matter with respect to any real property acquisitions in Mexico. For example, although both the purchaser and seller are responsible for taxes upon the purchase and sale of real estate located in Mexico, if a foreign individual company is the seller, such sale will be subject to a 20% capital gains tax on the gross amount of the operation.[39] Conversely, if the purchaser is a resident of Mexico or is permanently established in Mexico, this individual will likely be able to withhold such a tax.[40] There are other income tax nuances which may lead to serious tax consequences. For example, foreigners who conclude the sale of real property through a public deed may choose to pay 35% on the net profit obtained, which, if chosen, will mean that a public notary shall be responsible for calculating income tax and including it in a "public instrument" 15 days following the execution of such public instrument.[41] When a foreigner acquires beneficiary rights through a trust, and thereafter sells (or assigns) them, the foreigner will be subject to the payment of such income tax.[42] Income generated by foreign lessors of real estate in Mexico is also subject to a 21% income tax.[43] Also, if a foreigner is the purchaser of real estate assets, the local tax authority may make an appraisal, and, if the value of the appraisal is greater than the purchase price by more than 10%, the purchaser will be required to pay a 20% tax on the difference between the two amounts, due within 15 days following notification. [44]

THE FUTURE OF U.S REAL ESTATE INVESTMENTS IN ITS NAFTA PARTNERS

NAFTA's attempts to abolish trade restrictions and simplify real estate acquisitions has been met with much success, and spurred much controversy and debate. Complex Canadian statutory protections remain, however, limiting the ownership (and control) of entities that are determined as "non-Canadian." In addition, broad Canadian governmental control and layers of provincial requirements exist. Mexican regulations promulgated with NAFTA in mind have created bold new solutions with respect to the manner in which investors hold title and acquire real property, which were previously severely restricted (if not outright prohibited) by a strict interpretation of the Mexican Constitution. U.S. investors must also navigate Mexico's complex real estate tax laws.

Other domestic issues exist which further complicate the acquisition of real property. For example, so-called "Buy-American" requirements found in several U.S. state statutes traditionally prohibit preference of exported materials. These laws conflict with the liberalized trade regime instituted by NAFTA. Classic constitutional questions have arisen with respect to the direct conflict between the trade regime established by NAFTA, as compared to the various state tariff protections instituted under these so-called "Buy American" laws. Additionally, various telecommunications restrictions and prohibitions under Canadian provincial and federal laws may hamper cross-border investments under the NAFTA regime. For example, telecommunications towers directly utilize either leasehold or fee interest of the real property that is under the tower sites. Foreign telecom investors, focusing on unwinding the complex telecommunications standards in NAFTA, may therefore overlook the necessity to comply with the host country's complex real property laws, which may vary from NAFTA, resulting in project delays and/or unanticipated project costs.

The goals of NAFTA, to facilitate trade between its North American partners, have arguably been achieved. The future goals of NAFTA partners, contending with legal internal inconsistencies between the partners while endeavoring to foster a free-spirited trade regime, will continue to daunt investors for the foreseeable future.

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BROWNFIELDS REVITALIZATION LAW: INCENTIVES, EXCEPTIONS, AND CONCERNS

by Ram Sundar and Bea Grossman

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On January 11, 2002, President Bush signed the Small Business Liability Relief and Brownfields Revitalization Act (the Act) into law. The Act amends the Comprehensive Environmental Response, Compensation and Liability Act (CERCLA),[1] also known as the "Superfund Law," in a number of significant ways that may affect purchasers in certain real property transactions. This article will highlight certain aspects of the Act and will discuss how some of the Act's provisions may raise new issues of concern about which purchasers of real property should be aware.

CERCLA LIABILITY

A brief overview of the liability scheme under CERCLA is necessary for an understanding of how the Act may have an impact on purchasers of real property.

CERCLA authorizes the United States Environmental Protection Agency (EPA) to require cleanup of contaminated sites consistent with the National Contingency Plan.[2] Under CERCLA, potential responsible parties (PRPs) are liable for removal or remedial action by the government, response costs of any other person and damages for the destruction of natural resources.[3]

One of the prominent features of the Act is that it provides incentives for brownfield revitalization. By some counts, more than 500,000 abandoned brownfields sites are scattered throughout the country.

There are four categories of PRPs under CERCLA, as follows: (i) the current owners or operators of the facility, who are liable for their own disposal practices and that of past owners; (ii) the past owner or operator at the time of the disposal of a hazardous substance at the facility; (iii) generators of hazardous substances, who, by contract, agreement, or otherwise, arrange for the disposal or treatment of such substances; and (iv) transporters of hazardous substances who select the disposal site from which there is a release of hazardous substances (i.e., the selected site subsequently requires remediation).

CERCLA has been broadly interpreted since its inception in 1980 and, in the view of many, the results have been quite harsh. Liability under CERCLA has been held to be strict, so that a PRP may incur liability regardless of whether the harm was intended. Because liability under CERCLA is joint and several, one of many PRPs may be held responsible for the entire cleanup. Moreover, CERCLA has been imposed retroactively with the end result being that prior owners and operators may be held liable for the disposal of a hazardous substance during their ownership or use of the site even if it was performed in accordance with the applicable laws existing prior to the enactment of CERCLA.

Importantly, there are a very limited number of defenses under CERCLA. A PRP can escape liability only if that party can establish that the release of the hazardous substance was caused solely by (1) an act of God; (2) an act of war; or (3) act or omission of a third party other than employee or agent of the PRP, or other than one whose act or omission occurs in connection with a contractual relationship, existing directly or indirectly with the PRP (as long as the party exercised due care and took precautions against foreseeable acts of the third party).[4]

In addition, CERCLA also provides for the "innocent landowner defense," which absolves a party from liability when certain conditions are met. [5]

In order to jump-start brownfield redevelopment, the Act, among other things, clarified the "innocent landowner defense" and added an additional defense referred to as the "bona fide purchaser defense." These defenses are discussed in greater detail below.

OVERVIEW OF THE ACT

One of the prominent features of the Act is that it provides incentives for brownfield revitalization. By some counts, more than 500,000 abandoned brownfields sites are scattered throughout the country. The Act provides for financial assistance in the form of grants or loans to eligible entities for the purpose of promoting the cleanup and reuse of brownfields by authorizing $250 million to fund the cleanup of such sites for each of fiscal years 2002 through 2006. Individual sites may qualify for up to $250,000 in funding for investigation activities and $1,000,000 in funding for remediation work. Notably, these financial incentives are available for petroleum-contaminated properties otherwise normally excluded from the CERCLA liability scheme. Another brownfields incentive contained in the Act is that, subject to certain requirements, final listing of a site on the EPA National Priorities List will be deferred at the request of a State if the site is the subject of a State voluntary cleanup program.

CHANGES TO INNOCENT LANDOWNER DEFENSE

The "innocent landowner defense," one of the few defenses available under CERCLA, provides purchasers that acquire contaminated property after the disposal of hazardous substances with a shield against CERCLA liability.[6] However, in order to claim this defense, the purchaser has to demonstrate that it did not know and had no reason to know that any hazardous substances had been released at the site when the property was acquired. The purchaser must also demonstrate that it took all appropriate inquiry into the previous ownership and uses of the property consistent with good commercial practice in an effort to minimize liability. The "all appropriate inquiry" standard has now been clarified under the Act.

Under the amended innocent landowner defense, the purchaser must now demonstrate that it carried out "all appropriate inquiries" into the previous ownership and uses of the site in accordance with certain phased-in criteria.

The Act specifies that, for transactions occurring prior to May 31, 1997, a claim of an innocent landowner defense will be judged by general criteria regarding the level of experience of the defendant, the purchase price, commonly known information about the site, and the ability of the defendant to detect contamination. For transactions after May 31, 1997, but prior to the time EPA promulgates a new rule concerning due diligence, the Act provides that following ASTM Standard E1527—97 will entitle a defendant to the protection. Finally, EPA must, by January 11, 2004, establish regulatory standards for satisfying the innocent landowner requirement to carry out all appropriate inquiries. At the same time, the Act also adds new prerequisites that must be met in order to qualify for an innocent landowner purchaser defense. These include providing "full cooperation, assistance, and facility access" to persons conducting cleanup work, complying with land use restrictions relied upon in connection with cleanup work, and not impeding the effectiveness or integrity of institutional controls applied as part of the cleanup. This provision suggests an innocent purchaser may have no choice but to accept cleanup actions that leave contamination in place and permanently impose use restrictions on the property.

NEW BONA FIDE PURCHASER DEFENSE

Based on the conditions that had to be satisfied under the innocent landowner defense, the purchaser of a brownfield[7] site would, in all likelihood, not be able to successfully claim this defense since contamination at the site was likely to be suspected, or, in fact, confirmed prior to the acquisition (i.e., the innocent landowner defense would only be available where the purchaser's due diligence disclosed no contamination). As noted above, in order to encourage brownfield investments, the Act added a "bona fide prospective purchaser" defense to CERCLA, which now provides a brownfield purchaser with protection against CERCLA liability where known contamination requiring cleanup exists, so long as the purchaser does not impede any site response actions.

To qualify as a bona fide prospective purchaser, the disposal of the hazardous substances must have occurred prior to the acquisition of the site and the purchaser must, among other things, perform appropriate inquiries and due care in dealing with hazardous substances. Importantly, this defense is not limited to brownfield sites that are the subject of brownfield grants or loans or otherwise are in any formal brownfields program, nor does it require any EPA approval to take effect. Prospective buyers of potentially contaminated properties should carefully consider the protections contained in these provisions, but should also be aware of a number of possible pitfalls and nuances in the Act that may limit the applicability of the defense and, in certain cases, even increase the buyer's exposure to liability (e.g., the windfall lien and contiguous property owner provisions, discussed in greater detail below). Also, purchasers must be aware of the lack of any protection against state law liabilities.

Moreover, bona fide prospective purchasers should be aware that the Act creates a "windfall lien" up to the amount of unrecovered response costs incurred by EPA at a facility for which the owner is not liable as a bona fide prospective purchaser, and where the response action increases the fair market value of the facility. The Act provides that the windfall lien may not exceed the increase in fair market value attributable to the response action at the time of sale or other disposition of the property. The windfall lien arises at the time response costs at the facility are incurred by the government and continue until the earlier of satisfaction of the lien by sale or other disposition of the facility, or recovery of all response costs incurred at the facility.

PROSPECTIVE PURCHASER AGREEMENTS

EPA has been negotiating "prospective purchaser agreements" since 1989. These agreements provide a covenant not to sue for certain prospective purchasers of contaminated property. The goal of these agreements was to resolve the prospective purchaser's potential liability due to the ownership of the property prior to its acquisition. On May 31, 2002, EPA issued a memorandum addressing the availability of prospective purchaser agreements in light of the bona fide prospective purchaser provisions now contained in the Act (the EPA Memo). The EPA Memo states that given the protection provided under the Act, prospective purchaser agreements will, in most cases, not be necessary. It goes on to describe certain limited situations in which EPA will consider providing a prospective

The Comprehensive Environmental Response, Compensation and Liability Act provides an apparent double-edged sword with respect to owners of property contiguous to and affected by a property that is the source of a release of hazardous substances.

purchaser with a covenant not to sue following passage of the Act.

One situation in which EPA would consider entering into a prospective purchaser agreement is where there is likely to be a significant windfall lien. EPA recognizes that the prospective purchaser will need to resolve windfall lien issues prior to the acquisition, especially in situations where outside financing is required.

The EPA Memo also cites a number of other circumstances in which a prospective purchaser agreement may be necessary to ensure that the transaction is completed because the project is expected to provide substantial public benefits to the environment, a local community (where the project is expected to create jobs or revitalize a long blighted, under-utilized property) or where it will result in the promotion of environmental justice. The EPA Memo offers the following guidelines and examples on when EPA will consider execution of a prospective purchaser agreement, as follows:

- Where significant benefits will be derived from the transaction as a result of cleanup, reimbursement of response costs to EPA, or new use and there is a significant need for a prospective purchaser agreement in order to accomplish these goals. The EPA Memo provides two examples of situations under this category, as follows:
    - Where the purchaser is committing to perform a significant cleanup as the site is developed for a new use and the purchaser has concerns about facility "owner or operator" PRP liability; where there has been no facility cleanup, no viable PRP exists who can be required to timely perform the cleanup; and no potential developer is willing to undertake the entire cleanup in order to develop and use the facility so that, without the prospective purchaser agreement, the facility will sit idle for years.
    - Where the facility is involved in CERCLA litigation and a very real possibility exists that the person who acquires the site will be sued by a third party. The example offered in the EPA Memo under this category is a situation where the U.S. has an enforcement action under CERCLA pending against PRPs, and the primary defendants have sued an additional number of third party defendants, and/or where there is an ongoing private party contribution action and a prospective purchaser has been threatened with contribution litigation.
- EPA will also consider entering into a prospective purchaser agreement or other settlement in unique, site-specific circumstances when a significant public interest would be served by consummation of the transaction and the transaction would not be completed without the issuance of the prospective purchaser agreement.

In short, while the Act does explicitly provide protection to bona fide prospective purchasers, as discussed above, there are certain circumstances under which EPA would entertain the execution of a prospective purchaser agreement. If the proposed transaction falls within one of the categories noted in the EPA Memo, consideration should be given as to whether this additional comfort should be obtained, keeping in mind that additional resources are likely to be incurred in obtaining the agreement (i.e., the negotiation of the prospective purchaser agreement with EPA may be a time consuming proposition, thereby increasing the purchaser's legal fees).

CONTIGUOUS PROPERTY OWNER PROVISIONS

The Act provides an apparent double-edged sword with respect to owners of property contiguous to and affected by a property that is the source of a release of hazardous substances. Previously, such an owner implicitly had potential recourse to a defense that the contamination was caused solely by an act or omission of a third party. The Act explicitly provides a CERCLA defense for such a contiguous property owner, but in so doing also imposes new burdens.

In particular, the Act specifies that to qualify for the defense, among other things, the person must take reasonable steps to (i) stop any continuing release; (ii) prevent any threatened future release; and (iii) prevent or limit exposures to hazardous substances on the contiguous property. Furthermore, of potentially great significance, through the incorporation by reference of a 1995 EPA policy, the Act provides that in certain circumstances, a contiguous owner can have liability imposed with respect to groundwater contamination beneath its property, particularly if the property contains a groundwater well.

Additionally, the contiguous owner must make a due diligence showing with regard to the purchase of the property, must comply with EPA information requests to qualify for the defense, must provide access to the property, and may have to comply with land use restrictions relied upon in the cleanup. Thus, an innocent contiguous owner may be put in the position of having to agree to the imposition of permanent limitations on his property use in order to avoid CERCLA liability. In short, under the guise of providing new protection to a contiguous owner, these provisions may impose a whole new range of requirements and risks.

CERCLA EXEMPTION

The Act also creates two exemptions from CERCLA liability that apply only under very specific circumstances. These exemptions are referred to as the "de micromis exemption" and the "municipal solid waste exemption."

Under the de micromis exemption, liability under CERCLA will not attach if it can be demonstrated that the (1) total amount of the material containing hazardous substances sent to the site in question was less than 110 gallons of liquid materials or less than 200 pounds of solid material; and (2) all or part of the disposal, treatment or transport to the site occurred before April 1, 2001.

There are certain exceptions to de micromis exemption. Among other things, the exemption will not apply in a case where (1) it is determined that the hazardous substances in question contributed significantly, either individually or in the aggregate, to the cost of the response action or natural resource action or restoration with respect to the site; (2) the party in question has failed to comply with an information request or administrative subpoena with respect to the site or has impeded the performance of a response action or natural resource restoration with respect to the site; or (3) the party has been convicted of a criminal violation for the conduct to which the exemption would apply.

Under the municipal solid waste exemption, liability under CERCLA will not attach for municipal waste (as specifically defined in the Act) disposed of at a facility if the party can demonstrate that it is (1) an owner, operator, or lessee of residential property from which all of the party's municipal solid waste was generated; or (2) a business entity that employed on average not more than 100 full-time individuals and that is a small business concern during the three taxable years preceding the date of notification of potential liability under CERCLA; or (3) an organization exempt from tax under Section 501(c)(3) of the Internal Revenue Code during the taxable year preceding the date of potential liability under CERCLA that employed not more than 100 paid individuals at the location which generated the municipal solid waste. There are certain exceptions to the municipal solid waste exemption, which are similar to those applicable to the de micromis exemption.

The Act also added a new section to the already existing Section 9622(g) that addresses the use of expedited de minimis settlement agreements with certain PRPs whose activities involve only a minor portion of the response costs at the site. The new section provides for a reduction in the settlement amount based on a limited ability to pay. The factors considered in this determination include the ability of the person to pay response costs and still maintain its basic operations, including consideration of the overall financial condition of the person and demonstrable constraints on the ability of the person to raise revenues.

PROJECTED IMPACT

The Small Business Liability Relief and Brownfields Revitalization Act may provide meaningful liability relief in the case of brownfields purchasers who carefully scrutinize its provisions. The Act's revisions to the innocent landowner defense and provisions on contiguous property owners should provide refuge to liability but also contain pitfalls that warrant careful analysis. Finally, the Act may allow a limited number of parties to avoid being subjected to the CERCLA process where their contributions were de micromis or where small businesses have disposed of municipal solid waste. Given the financial incentives and liability reduction provisions in the Act, we should see an increased interest in brownfield sites. As a result, we should begin to see a rise in real estate and corporate transactions that include such sites.

REFERENCES

1. 42 U.S.C.A. §9601 et seq.
2. 42 U.S.C.A. §9604(a)(1).
3. 42 U.S.C.A. §9607(a).
4. 42 U.S.C.A. §9607(b)(1)-(3).
5. Id.
6. 42 U.S.C.A. §9601(35).
7. The Act defines a brownfield site as real property, the expansion, redevelopment, or reuse of which may be complicated by the presence or potential presence of a hazardous substance, pollutant or contaminant, with certain exceptions (e.g., among the exceptions are facilities that are listed on the National Priorities List).

Tax Credit Survey Reveals Strong Market Sector

By Fred H. Copeman and Richard A. Floreani

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Since its inception in 1986, the low-income housing tax credit program has been perceived as both a highly effective rental housing development tool and a sound real estate investment. The vibrancy of the tax credit program within the multifamily sector is evidenced by the statistics: it is estimated that the LIHTC program has been responsible for creating over one million apartment units. Until recently, however, there has been little information available regarding the performance of this program.

A recent study, Understanding the Dynamics: A Comprehensive Look at Affordable Housing Tax Credit Properties, has begun to address this problem. Ernst & Young created the largest database of housing credit property performance ever assembled, representing approximately half of all housing credit properties ever developed. Year 2000 financial data from over 7,800 properties representing more than 500,000 apartment units was evaluated. Data sources consisted of investors in and syndicators of housing credit properties, including direct and fund investors, guaranteed and non-guaranteed investments, for-profit and non-profit syndicators, and a wide variety of portfolio sizes. Following are key observations regarding the property performance excerpted from the study.

PROPERTY OPERATING PERFORMANCE

Occupancy, cash flow and hard debt service coverage ratios suggest that the program is producing properties that are performing well in general. Physical occupancy averaged 94%, which is consistent with the 93% to 95% rates typically used for underwriting purposes. The average hard debt coverage ratio (defined as net operating income divided by "must pay" debt service) was 1.35. This exceeds the current 1.15

underwriting standard, although we note that properties are underwritten to a range of coverage ratios.

Several observations emerged from our analysis, including some that are at odds with conventional wisdom about housing credit properties. First, high occupancy does not guarantee strong financial performance. Of those properties experiencing operating difficulties (which we defined as either operating below 90% occupancy, below 1.0 hard debt service coverage, or with negative cash flow), half had below 1.0 debt coverage despite strong occupancy rates. Whether this phenomenon is attributable to lower rental income or higher operating expenses was not determinable by the data provided.

The study data also indicated that older properties did not report higher debt service coverage ratios than more recently developed properties. We expected to see an increase, since net operating income typically grows over the life of the property while debt service remains constant. It is possible that this is due to sluggish financial performance. More likely, though, is that the industry has changed its underwriting standards considerably since the early years of the program, and particularly since conventional debt sources have replaced government sources of permanent financing.

Also to our surprise, the study revealed that housing credit properties financed through the Rural Development Services (formerly Farmer's Home Administration) program, which finances rural properties, tend to operate well above break-even. These properties are generally underwritten to operate at 1.0 hard debt coverage. The average reported for these properties was 1.34.

The performance of properties targeted to families versus senior citizens is a perennial question for many in the housing credit industry. Many believe that properties targeted to the elderly perform better financially because they encounter less unit turnover and require less physical upkeep than those properties that are targeted to families. Study data indicates that occupancy averages were 94.0% and 94.9% for family and senior properties, respectively. Financial performance proved not to be significantly different for these property types, with family properties reporting 1.36 debt coverage and senior properties reporting 1.34.

The study also found that urban properties tend to have a larger hard debt coverage ratio than those in other areas. The average hard debt coverage ratio for urban properties was 1.52, compared to 1.28 for suburban and 1.31 for rural properties. This difference presumably reflects the prevalence of so-called "soft debt" present in urban developments. (Soft debt financing consists of loans, usually from government sources, that are payable only from available cash flow until the loan matures.) Occupancy rates for properties in all three areas ranged from 93.5% to 95.3%.

The study also examined the incidence of property underperformance. As noted above, we defined this as either operating below 90% occupancy, below 1.0 hard debt service coverage, or with negative cash flow. Despite the strong average performance figures, a surprising number of properties have operating issues: 18% were below 90% occupancy, 29% operated below 1.0 debt coverage, and 31% operated with negative cash flow. The causes of these issues were not addressed by the study; however, issues typically center around two factors: underwritten rents are not supportable in the market, or operating costs exceed underwriting estimates. We also note that some properties experience temporary operating issues and others are chronic. Since the survey data was for one year only, this important distinction could not be measured from this data.

FORECLOSURE RISK

One of the most significant data points analyzed was the incidence of foreclosure in housing credit properties. Foreclosure of a housing credit property by its lender represents a tax credit recapture event for investors. Though foreclosures in housing tax credit properties were thought to be rare, no published data was available to support this belief. The survey indicates that only ten of the surveyed properties were foreclosed upon, or tendered a deed in lieu of foreclosure, since the program's inception. This represents 0.14% of the properties since the program's inception, or an annualized foreclosure rate of 0.01%. This compares very favorably to other asset classes. Data from the American Council of Life Insurers indicates that the next lowest foreclosure rate was for 1-4 family market rate properties, which have a 0.42% foreclosure rate. Retail property was 0.9%, office property was 1.94%, industrial property was 0.91%, and hotel property was 1.41%.

Perhaps the most paradoxical finding was the low incidence of foreclosure coupled with the high incidence of below 1.0 debt coverage. Intuitively, one would assume that having insufficient income to pay expenses and debt service would ultimately lead to more foreclosures, but this clearly has not occurred. We suspect that this is due to several layers of financial protections along with other factors that are not captured in the data. These include the following: property management fee deferrals, maintenance deferrals, operating reserves, operating deficit guarantees, investment tier working capital reserves, and debt workouts.

CONCLUSIONS

Overall, housing credit properties appear to be operating well as a class in terms of occupancy and financial measures. Foreclosure rates have been demonstrated to be remarkable low. An unexpectedly large number of properties, however, are operating with low occupancy or are encountering operating deficits.

As noted, significantly more study needed in this area. Understanding and quantifying the true magnitude and significance of the operating problems, their impact on investors and lenders, and the methods by which properties receive financial support would be helpful places to start.

DEALERS IN REAL ESTATE: AT LEAST THREE BIG TAX PROBLEMS

by Dr. Mark Lee Levine and Dr. Libbi Rose Levine

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Even the novice in real estate tax issues has heard the warning that one normally does not want to be classified as a "dealer."

A "dealer" is probably best defined as one who is involved in the sale of goods, not with the intent to hold those goods. That is, they are primarily inventory items, or goods primarily for resale—they are not for purposes of holding the assets for trade or business or for investment.

This is the basic approach that is utilized in the Internal Revenue Code, 26 U.S.C.A. §1221(1). However, technical definitions aside, the more basic question is: "Why is it important if one is a dealer?" And then the question: "Who cares?"

This short Note emphasizes three of the many important reasons why most real estate practitioners and taxpayers generally would not like to be classified as a "dealer" for tax purposes for a given piece of property.

1. Capital Gains vs. Ordinary Income
2. Installment Sales and the dealer question
3. Tax Deferred Exchanges

No person is necessarily a dealer for all property held by that individual.

AN EXAMPLE

As an example, Taxpayer X may hold liquor bottles in a liquor store owned by X, or real estate lots owned by X, for sale to the general public. These are inventory items. However, that does not make X a dealer for all assets that X may own.

Each item that X owns or handles as X's property, and disposes of the same, would be questioned as to the intent and use of the property by X. This is to determine whether the intent by X was to hold the property primarily for sale (inventory) or whether the intent was to hold the property for longer-term investment or for use in a trade or business.

To contrast the situation, if X also owns a liquor store and had a cash register, the cash register is not dealer property. That is, X is not holding the register primarily for resale, even though X is holding the liquor bottles for resale.

Likewise, the equipment used in the trade or business of construction by X is not dealer property, even though the lots that X might hold for sale can be and would normally be "inventory" in the circumstances described.

Why is it important that one is a "dealer" of the liquor bottles that X held, or the lots that X held? This article refreshes the reader on this issue, and the continued import of the classification of one as a "dealer" in many settings.

THREE GOOD REASONS NOT TO BE A "DEALER" (NORMALLY)

A "dealer" is generally a status or position that one, as a taxpayer, would not normally wish to hold. Why is the dealer status a disadvantage and shunned by most taxpayers?

The answer to this question, at least in three primary cases, is easily addressed. As noted below, there is concern as to whether one is a dealer in circumstances where one will receive income ("capital gain" as opposed to "ordinary income"), and the ability to postpone that income ("installment sale") or exchange property.

These are three areas of concern to taxpayers relative to the dealer question.

CAPITAL GAIN VS. ORDINARY INCOME

A fundamental concern for taxpayers is the impact of selling "dealer property," mentioned earlier, not with the intent to hold, when a gain is generated. A gain is taxed for Federal tax purposes at the tax bracket that the taxpayer is in for the given year.

Although the highest tax bracket for ordinary income received by a taxpayer in the year 2003 is 38.6%, that rate is reduced to a maximum of 20% (subject to change by the most recent Congressional changes), under most circumstances, for the sale of unimproved ground.

As an example, X sold a lot for a gain of the $400,000. This gain could be taxed at a maximum ordinary rate of 38.6%. However, the maximum capital gain rate in this setting would be 20%. Which rate to use depends on whether the taxpayer was a "dealer," or not. IF classified as a dealer, the sale could generate the higher taxable rate of 38.6%. But, if the taxpayer was holding the property for "investment," it could generate the long-term capital gain maximum rate of 20%.

There are some exceptions and qualifications in the Examples and rules stated. However, the basic idea illustrates that long-term capital gain, which is generally property held in excess of one (1) year, is taxed at a lower rate than property that is deemed to be "dealer property," as defined earlier. Thus, taxpayers would not want to appear to be dealers in most gain circumstances.

INSTALLMENT SALES AND THE DEALER QUESTION

If the taxpayer is deemed to be a dealer on the property in question, such as X in the lots that were sold, the taxpayer would not be able to use the installment sale method. The reason is very simple: The Internal Revenue Code, Code §453, dealing with installment sales, specifically prohibits the use of the installment sale technique for a taxpayer who is a dealer, on most real estate transactions. Thus, Mr. X, in the example of selling lots, would be disqualified from the use of the Installment Sale Method.

To back up a moment, the Installment Sale Method allows the taxpayer to spread the gain, or payments received, over a number of years, if payments are received over a number of years.

However, Code §453(b)(2) provides that the installment sale does not include "dealer dispositions."

Code §453(l)(1)(B) provides that a dealer disposition is one where the real property is held by the taxpayer for sale to customers in the ordinary course of business.

Although there are a few exceptions to this rule, where the Installment Sale Method can be used, most of the time taxpayers cannot use the Installment Sale Method if they are a dealer.

If the taxpayer cannot use the Installment Sale Method to spread the gain over a number of years, the Taxpayer must pick up all of the gain in the tax year in which the sale occurs.

To illustrate this point, assume that X sold a lot for $1 million. If X's adjusted basis (normally cost) is $600,000, the $400,000 gain would be taxed to X in the year of sale, even if X was receiving payments for the purchase price over a 5-year period.

Thus, this is one of the most basic illustrations of why taxpayers do not want to be a dealer for the sale of real estate: They cannot use the Installment Sale Method in most circumstances, and, therefore, the gain that is generated must be taxed immediately, even if payments are received over a number of years.

THIRD REASON NOT TO BE A DEALER: TAX-DEFERRED EXCHANGES

Under the Internal Revenue Code, under Code §1031, taxpayers, if they can qualify under this Section, can defer the gain on an exchange of qualified trade or business or investment property.

To illustrate this point, assume that X, owning X-1 land, exchanges this land with Y, with X acquiring the Y-1 property.

Although gain could exist, such gain would not be taxed, currently, if X took the Y-1 Property and otherwise qualified under Code §1031 for an exchange, which defers the tax.

The problem for X, related to the subject at hand in this Note, is that X cannot qualify for the deferral of the gain when X acquires the Y-1 property, if the property that X transferred, X-1, is property that is deemed to be inventory, or property held primarily for sale in the hands of X. That is, as to the X-1 property, X is a dealer. In such case, X cannot use the tax-deferred exchange rules of Code §1031. (X is also disqualified for the use of §1031 if the Y-1 property is acquired by X for resale.)

Thus, this is the third example of why one does not wish to be classified as a dealer: Use of the tax-deferral Section, Code §1031, would be excluded.

CASE STUDY

This short Note acted as a mere tax baedeker to emphasize the importance of determining whether a taxpayer is or is not a dealer relative to a property in question.

Under one recent case, Raymond v. Comm., T. C. Memo 2001-96, the Tax Court concluded that the taxpayer in question was a dealer for the purpose of selling homes. As such, the Tax Court specifically denied the use of the Installment Sale Method, emphasizing that a taxpayer under Code §453(a) is disqualified from the use of the installment sale technique if the taxpayer is a dealer as to the property in question. In that case, the Court cited numerous decisions supporting the position of denying the installment sale treatment and denying capital gain treatment.

The Court said the determination as to whether one is or is not a dealer is a "facts and circumstance" test, looking to the intent of the taxpayer at the time of disposing of the property.

The Court said that to determine if one is a dealer, there are a number of factors that should be considered. The Court listed some of these:

1. The taxpayer's purpose when acquiring the property;
2. The taxpayer's purpose when holding the property;
3. The extent to which the taxpayer makes improvements to the property;
4. The frequency, number and continuity of the dispositions in question;
5. The extent and nature of the taxpayer's effort to try to have the property sold;
6. The activity or degree of action by the taxpayer in trying to sell the property;
7. The number, extent and nature of transactions in which the taxpayer is involved;
8. The taxpayer's business on an everyday basis.

These factors, and others, have been named in many cases. The Court noted that no single factor controls whether one is a dealer.

CONCLUSION

There are many other considerations for dealers. For example, there are issues as to whether losses can be currently deducted, the character of the loss (capital or ordinary) whether expenses can be currently deducted, and other implications to being a dealer. However, the three areas noted above are among the most crucial considerations for taxpayers who are concerned with the issue of whether they will have a capital gain, whether they wish to use the installment sale method, and whether they can use the tax-deferred exchange method under Code §1031.

All of these factors hinge, at least in part, on whether the taxpayer will be deemed to be a dealer on the subject property.

For more in this area, see Levine, Mark Lee, *Real Estate Transactions, Tax Planning*, The West Group, St. Paul, Minnesota (2003).

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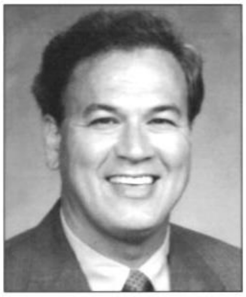


Kenneth Riggs, Jr., CRE

The world has always been an uncertain place, but the confidence of even the most sure-footed among us has been shaken during the last few years. The tech fall-out of the late 1990s, a recession, and a tumbling stock market were just the beginning. Then there was the loss of life on September 11, which has forever changed us as security against additional threats of terrorism takes center stage. With last year's accounting scandals, we lost trust in the financial markets as well as the review mechanisms charged with corporate oversight. And for the last 6 months, concerns about a war with Iraq and other geopolitical risks have disturbed us all.

It is clear that this uncertainty has had a serious effect on the U.S. economy. Poor corporate outlooks have prevented business from spending, and unemployment, while still relatively low, has been increasing. Although consumers continue to invest in housing, they remain cautious about other spending. There is fear that the uncertain economy will continue its malaise, even though the situation with Iraq has been addressed.

It is expected that the Federal Reserve will lower interest rates again in an effort to get the economy moving and that some version of the President's fiscal stimulus package eventually will be approved by Congress. For present, however, the slow economy continues its chokehold on the commercial real estate market, and until profit and loss statements begin improving and businesses begin hiring, hotels, office, apartment, and industrial properties will bear the brunt of low demand.

Office vacancies are already 20 percent or higher in certain areas, including central Florida, Dallas-Fort Worth, Memphis, Phoenix, Salt Lake City, San Francisco, and Boston. Real Estate Research Corporation (RERC) expects further cuts in rental rates and more concessions in 2003, with little or no growth for the near-term as companies continue to contract.

The stress of the space markets is showing up in commercial real estate's realized reported returns (NCREIF) that are single digit, at best, as the broad market takes value write-downs. Ironically, RERC's recent independent research shows expected return requirements for institutional grade commercial real estate continue lower. In fact, as detailed in the Winter 2003 *RERC Real Estate Report, A World in Transition,* this is the third consecutive quarter that RERC's expected one-year pre-tax yield rates have been flat to down for warehouses, R&D properties, CBD offices, suburban offices, regional malls, power centers, neighborhood/community centers, and apartments. Expected yield rates for hotels are up slightly over last quarter. The message here is that return prospects for all types of investments are not very promising and return requirements are being lowered and compressed as we enter a new economic and political era.

RERC strongly believes prices have peaked for most property types and it may be time to take a more contrarian approach by looking for investment potential among those properties that have been beaten down and out of favor. Surprisingly, the places to look for re-priced assets are where delinquencies are the highest. Despite low interest rates, reports show that hotel loan delinquencies, especially among older, poorly located hotels, are the highest they've been since the early 1990s. Besides hotels, retail and suburban office properties in distressed areas have been taking a beating, and greater pressure can be applied for repricing. Apartments and industrial properties may still be overpriced, but can offer greater income stability for the future.

With respect to demand, RERC believes that the worst is yet to come since real estate lags the economy by up to 12 months, as demonstrated by the decline in profits for real estate investment trusts (REITs) last quarter—the first yearly decline in profits since 1993. This was led by multifamily REITs that had an average decline of 9.8 percent in the fourth quarter 2002, with an average of 1 percent for all REITs.

Rent and value growth expectations have dropped for all of the property types RERC tracks each quarter. One-year expected rental growth, after increasing last quarter, dropped 1.0 percent for suburban **office** and 0.9 percent for CBD office. Investors have lowered their required returns for office for those assets that have extremely strong, consistent cash flow. Overall office values are down in most markets, but continue to rise in some areas as investors continue to take advantage of lower interest rates. In fact, a couple CBD office properties in New York and Chicago recently traded at the highest price per square foot ever recorded.

Industrial properties remain high on investors' lists of go-to investments, but due to the contraction of business and the decrease of inventory, revenues will be down for the short run. RERC's current research shows one-year expected rental growth dropped 1.3 percent for R&D properties and 0.7 percent for warehouse properties. Required returns generally are steady or have seen an approximate 0.5 percent decrease due to lower interest rates.

Weak **retail** demand is anticipated for the rest of the year, and expected rental growth dropped 0.9 percent for regional malls, 0.8 percent for neighborhood/community centers, and 0.2 percent for power centers. With the slowdown in consumer spending and increased costs for security and terrorism insurance, expect retail vacancies to rise and more stores to close.

Despite weak demand due to the increase in homeownership and overbuilding during the last five years, investors still tend to look favorably upon the long-term outlook for the **apartment** market. For the present however, occupancy levels are at least 5 to 10 percent lower than a couple years ago. As a result, rental growth expectations for apartments fell 50 basis points.

Demand from the corporate segment is still weak for **hotels,** but rental growth expectations for hotels dropped only 0.1 percent. Luxury and the more independent urban boutique hotels continue to exhibit the greatest risk, as consumers remain conservative with their disposable income. Still, an active market exists for quality full-service properties, and based on revenue and occupancy expectations for 2003, values are expected to increase somewhere near inflation.

RERC sees this as a time of transition for the commercial real estate markets. We are adapting and beginning a period of correction, but unlike past corrections, the current real estate market appears fairly resilient. The year will be a trying time for real estate, but the lack of financial alternatives and the need for diversification makes commercial real estate extremely attractive in the short-term outlook. The long-term outlook will become less appealing as the stock market recovers and the economy gets back on track.

ABOUT OUR FEATURED COLUMNIST

Kenneth Riggs, Jr., CRE, *is chief executive officer of Real Estate Research Corporation (RERC). RERC offers research, valuation, portfolio services, corporate advisory services, litigation support, and other real estate-related consulting services. RERC also provides research, analysis, and investment criteria (cap rates, yield rates, expense and growth expectations, recommendations, etc.) for nine property types on a national and regional level and for 31 major U.S. markets through the quarterly* RERC Real Estate Report, *the annual* RERC Industry Outlook: 2003, *and the RERC DataCenter. (E-mail: riggs@rerc.com)*

FOCUS ON HOSPITALITY ISSUES

How to Determine the Future Direction of Hotel Capitalization Rates

John (Jack) B. Corgel, Ph. D

For many in the hotel industry, the ratio of property-level operating income and asset market pricing - the capitalization or 'cap' rate - provides an important foundation for rational investing and financing decisions.1 During periods, such as the recent past, when both the numerator and denominator of the ratio experience different magnitudes of movement, hotel cap rate interpretations become especially difficult for all in the industry. As the markets for hotel room sales now appear headed toward more stability, hopes are rising that the wide bid/ask spreads now in the hotel asset market will narrow, leading to more normal transaction volume and returning property development to pre-2001 levels.

The topic addressed in this article is the near-term direction of hotel cap rates. If the rate increases, then the pace of property transaction activity and development will be slower than if rates decline. Based on the conceptual arguments presented below, the probability of hotel cap rates declining in the short run exceeds the probability of rates increasing.

HOTEL CAP RATES APPEAR COUNTER CYCLICAL

Exhibit 1

Quarterly Hotel Capitalization Rates, 1992 I 2002 IV

Data Source: Real Estate Research Corporation

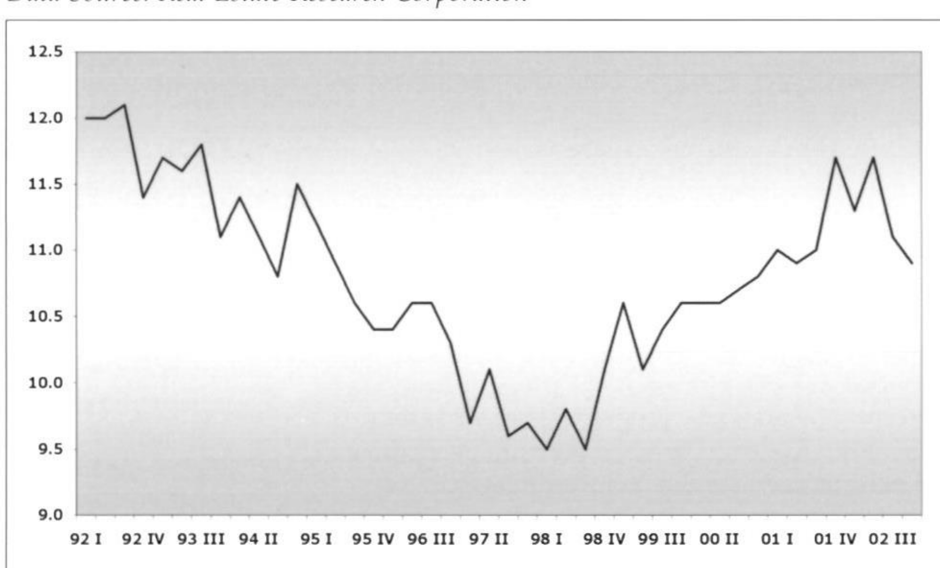


Exhibit 1 presents a ten-year history of full-service hotel cap in the U.S. The information comes from the Real Estate Research Corporation (RERC). The RERC conducts quarterly surveys of institutional real estate investors and lenders to assemble consensus estimates of key market performance indicators. The hotel cap series from RERC dates back to 1992.

The consistency of RERC's administration and application of definitions for their surveys results in a reliable time series. In fact, the RERC data represent the only historical data of hotel cap rates available for each quarter of the last ten years.2 These estimates come from averages of expert opinions, and not directly from market transactions, which constitutes the major criticism of the RERC reports.

Hotel cap rates appear to move in a counter-cyclical pattern. The highest rate of slightly above 12% occurred at the end of the early-1990s recession. The average rate reached 11.7% during the recent recession, but fell sharply over the past two quarters. Hotel cap rates moved downward and broke through the 10% barrier for several quarters in 1997 and 1998 when the economy was rapidly expanding. In theory, hotel cap rates should conform to the counter-cyclical pattern they followed during the past ten years because hotel property values logically decline (rise) as incomes fall (increase).

CURRENT SPREADS ARE WIDE

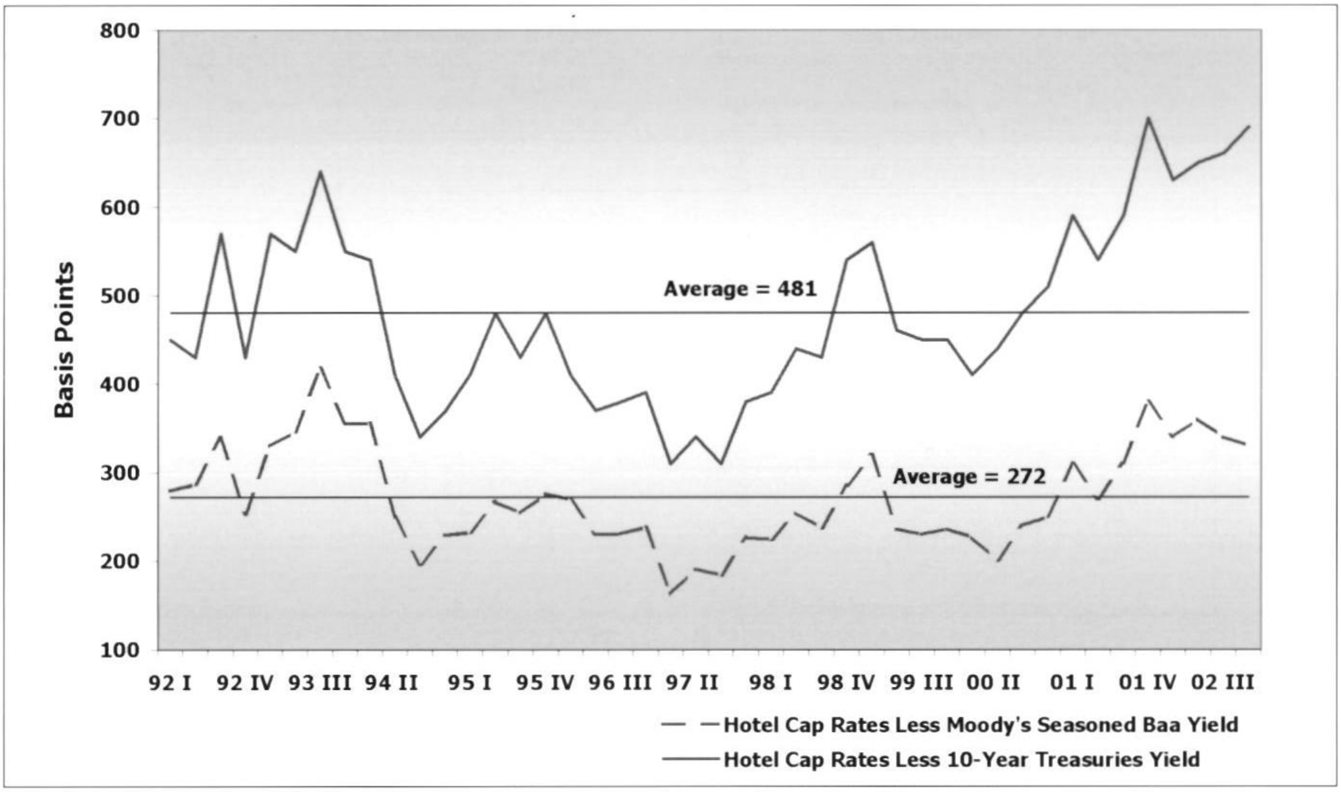
Another perspective on hotel cap rates comes after examining historical spreads between this rate and other capital market rates. Exhibit 2 shows hotel cap rates relative to ten-year Treasuries and the Moody's Baa corporate bond series since 1992. As with rate levels, the spreads appear counter-cyclical. This means that hotel risk premiums move above the long-run average during recession and below the average during periods of economic expansion. Average spreads equal 481 bps above ten-year Treasuries and 272 bps over Moody's Baa bonds. In 2002 IV, hotel cap rate spreads stood at or near the ten-year historical highs.

Cap rates for full-service hotels declined from a peak of 11.7% in 2002 II to 10.9% by the end of 2002.

Exhibit 2

Spreads Between Hotel Capitalization Rates and Selected Market Capital Rates, 1992-2002

Data Source: Real Estate Research Corporation



The current rates almost equal the ten-year average of 10.8%. Assuming mean reverting behavior, further decline in hotel cap rate of more than a few bps may not occur until the next expansion of the economy is well underway. Notwithstanding, the wide spreads between hotel cap rates and capital market benchmarks indicates that these rates could fall by more than a few bps to bring spreads back in line with historical average spreads.

JUDGING THE DIRECTION OF HOTEL CAP RATES

Guidance about the direction of hotel cap rates may come from two sources. First, it is often useful to return to basic principles. The review that follows begins with an identification of cap rate components, then continues with an examination of how the components should behave given current macroeconomic forecasts and forecast of lodging demand and supply conditions. Second, the future direction of hotel cap rates may be econometrically modeled using a set of variables that both demonstrate statistically significant relationships with hotel cap rates and for which objective forecasts are available.

The current article is the first of a two-part series on the future direction of hotel cap rates. The emphasis here is on the expected rate movements based on conceptualization. The second article will appear in a future edition of Real Estate Issues and will present an econometric model of hotel cap rates and model forecasts. This article continues with a presentation of real estate cap rate theory.

REAL ESTATE CAP RATES

The real estate cap rate (R) converts the net operating income of a property to an estimate of the property's value by simple division. If the income is assumed to grow at a constant rate, then R equals the discount rate (r) minus the assumed growth rate (g).3 Stated symbolically,

$$R = r - g. \quad (1)$$

This means that relatively slow (fast) income growth rates result in higher (lower) capitalization rates, and consequently lower (higher) real estate values.

Exhibit 3

Discount and Capitalization Rate Directional Movements Given Alternate Market Conditions

Data Source: The Hospitality Research Group

Panel A - Discount Rates

Market Condition	r	=	r_f	+	r_p
1	↑		↑ or ↔		↑ or ↔
2	↓		↓ or ↔		↓ or ↔
3	?		↑		↓
4	?		↓		↑

Panel B - Capitalization Rates

Market Condition	R	=	r	-	g
A	↓		↓		↑
B	?		↓		↓
C	↓		↔		↑
D	↑		↔		↓
E	↓		↓		↔
F	↑		↑		↔

The discount rate equals a risk-free rate, such as the return on T-notes, plus a premium return for risk, which represents the expected volatility of the income stream(s). In equation form,

$$r = rf + rp. \quad (2)$$

Equation (3) presents the capitalization rate in "full view."

$$R = (rf + rp) - g. \quad (3)$$

Simultaneous changes in its components cause R to change, sometimes in unpredictable ways. This problem is exacerbated during unstable times, such as the recent past and now, characterized by recession, catastrophic events, war, and human viruses. Tracking the directional pattern of R, and attempting to judge turning points, requires an understanding of how and why the components of R change.

COMPONENT ANALYSIS

Panels A and B of Exhibit 3 show alternative scenarios under which changes in R could occur from one period to the next. As presented in Panel A, the discount rate (r) changes in accordance with the direction and magnitudes of changes in its two components, rf and rp. Under Market Condition 1, r increases because one or both components increase and neither decrease. Similarly, Market Condition 2 has r decreasing because one or both components decline and neither increase. Ambiguous changes in discount rates may occur under Market Conditions 3 and 4 because of the opposite directional changes of the components. During times when such conditions exist, knowing the prevailing direction of changes in the components of r is not enough information because the relative magnitude of the changes in rf and rp must be known to predict the future direction of r.

Is it likely for rf and rp to move in opposite directions? The answer to this question is a *qualified* yes. Component rf changes with macroeconomic movements, including fiscal and monetary policy changes. Component rp adjusts as the risk of the specific asset class adjusts. Some of this risk adjustment is undoubtedly systematic in nature, but a substantial portion occurs because of asset class repricing due to changes in the risk relative to other asset classes. Consequently, interest rates may fall while the *relative* risks of a particular asset class increase, as long as the assets' incomes are not entirely fixed over the long run (*i.e.,* a pure bond). Hotel asset income streams are the least similar to bond incomes among property types. Thus, the pricing of hotel assets should be less interest-rate sensitive than office, retail, and other unsecuritized real estate investments. Before taking a closer look at recent historical movements of hotel cap rate components, let us see how all real estate cap rates behaved over the last five years.

REAL ESTATE CAPITALIZATION RATE COMPONENT TRENDS

From 1996 through 2002, returns on 10-year T-notes (i.e., rf) steadily declined from 6.6% to 4.7%. According to RERC survey results, the average pre-tax yield for the nine property segments covered in the survey stood at 11.62% during the second quarter of 1996 and 11.40% at the beginning of 2003.4 Thus, the bp increase in rp during this period was enough to almost neutralize the effect of the declining interest rates on r. The net result was only a slight drop in r. This evidence suggests that real estate discount rates from 1996 until now behaved like Market Condition 4 in Exhibit 3 (Panel A).

Exhibit 3 - Panel B shows outcomes for R assuming market conditions that produced alternative changes in r. Real estate analysts would probably agree that g is equal to or slower today than in the mid-1990s. Thus, the only feasible alternatives in Panel B are Conditions B, D, E, and F. If r decreased slightly and g also decreased, as in Condition B, then the change in R depends on the magnitude of the decline in g relative to r. If g declined and the change in r is inconsequential, as in Condition D, then R should have increased by roughly the same number of bps as g declined. Conditions E and F are self-explanatory.

The RERC data for R computed in the same manner as above show that the average R for all properties decreased insignificantly during the period 1996 through 2002 from 9.3% to 9.2%. This means that the decrease in r and the decline in g since 1996 nearly cancelled each other with respect to how they influenced R across all real estate property types.

HOTEL CAP RATE COMPONENT MOVEMENTS:

Past and Future

During the first quarter of 1996, the pre-tax yield for full-service hotel investments equaled 13.1%. In the last quarter of 2002, the yield was 13.6% - an increase of 50 bps above the 1996 I level. Unlike all real estate investments, hotel yields increased by a noticeable amount, thus indicating that the unobservable rp increased by more than the rf declined. Hotel R also experienced a 50 bp increase from the beginning of 1996 to the end of 2002. This increase is solely due to the increase in r. Surprisingly, g remains at the same level in 2002 IV as in 1996 I.

FORECAST OF HOTEL CAP RATES BASED ON CONCEPTS

Econometric models can generate objective, point estimates of future real estate cap rates and other market indicators.5 Sometimes only the future direction of market indicators is needed. In these instances, breaking down the performance measure into its component parts may form the basis for conclusions about which way the market will likely move. Several insights came from the decomposition of hotel cap rates. These are:

The r for hotel investment, as for other real estate investments, equals an observable rf plus an unobservable rp. While rf declined over the past few years, the r for hotel investments has risen somewhat. This indicates that the increase of r has been due to a sizeable increase in rp, sizeable enough to offset the declines in rf - and then some!

The hotel R is comprised of r minus g. Hotel R moved upward by the same number of bps as r during the past few years suggesting that g remained stable. The reason for the stability is that g refers to the change in NOI and not the change in revenues. NOI has been much more stable during this recession than previous ones due to hotel managements' ability to reduce costs quickly in response to falling revenues.

The future direction of the hotel R partially depends on the forecast of general interest rate movements that would cause rf to change. Most macroeconomic forecasting firms envision a fairly level near-term interest rate pattern. Thus, movements in r will depend on how rp behaves.

The rise in hotel investment risk premiums has been dramatic in recent years. This is likely due to investor perceptions about hotel performance during economic downturns relative to safer investments. As indicated in Exhibit 1, hotel R now stands slightly above the historical average. As indicated in Exhibit 2, the spreads in 2002 between hotel rates and other capital market rates reached the highest levels recorded since 1992. These spreads should narrow as the hotel markets climb back out of the trough. With g remaining somewhat stable over the last several years, expected income growth rates may not improve much during recovery, as some anticipate.

In conclusion, the hotel R should experience a modest decline over the next year. This will be due to a decline in rp as the level returns to the historical average. Even if rf increases, the movement should not offset the decline in rp as hotel investments are not highly interest rate sensitive. Changes in the expected growth of hotel NOI are not expected to be a major factor in the near-term determination of R. Returning to Exhibit 3, the market will likely behave as in Market Condition E of Panel B.

1 The ratio has little meaning to others. During a recent discussion, the CEO of a prominent hotel company told me, "We never consider capitalization rates."
2 Several organizations and firms such as American Council of Life Insurers, Cushman & Wakefield, CB Richard Ellis, PricewaterhouseCoopers, and Hospitality Valuation Services report hotel cap rates. None of the series available from these sources extend back as far in time as the RERC series.
3 Real estate capitalization rates also contain a component for return of capital to account for the economic depreciation of long-lived, non-land assets. This component is relatively small, given the long life of buildings, and thus often ignored.
4 RERC, Real Estate Report, Real Estate Investment Survey.
5 See, for example, Petros Sivitanides, Jon Southard, Raymond G. Torto, and William C. Wheaton, "The Determinants of Appraisal-Based Capitalization Rates," *Real Estate Finance* (Summer 2001): 27-37.

ABOUT OUR FEATURED COLUMNIST

John "Jack" B. Corgel, Ph.D., joined the Hospitality Research Group (HRG) of PKF Consulting in 1999 as managing director of applied research. There, he is developing new products for the hotel industry based on property-level financial performance information. Prior to joining HRG, he was a member of the Cornell Hotel School faculty for 10 years and served as the first director of the Center for Hospitality Research from 1992-1994. He is widely published in academic and professional journals and is a fellow of the Homer Hoyt Institute. (E-mail: jc1616@pkfc.com)

RECOMMENDED READING

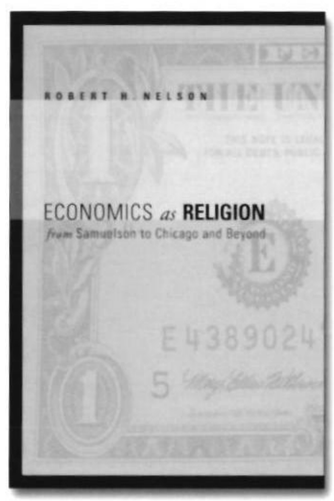
Economics As Religion: From Samuelson to Chicago and Beyond

by Robert H. Nelson (Pennsylvania State University Press, 2001, 378 pages.)

as reviewed by Buzz McCoy, CRE

Buzz McCoy, CRE

The university system in America was originally designed to train Protestant ministers. Religion was a dominant force in our culture, and it encouraged us to express our altruistic tendencies. In the late nineteenth century new universities such as Cornell, Johns Hopkins and the University of Chicago were created to supply professional experts with technical skills, and the older universities were retooled to educate the corps of professional experts. In an increasingly secular society, altruism was replaced by self-interest.



Robert H. Nelson's book, *Economics as Religion,* is a history of modern economic theory, presented as a new form of secular religion in our society. His thesis is that the economics profession constitutes the new priestly class in the modern, materialistic, scientific world. Nelson, who has wide government experience as well as being a professor of public policy at the University of Maryland, states that in medieval Europe Christianity was the one universal government. It had a central bureaucracy in Rome, an organization with priests and churches in every village and its own universal language, Latin. The Church oversaw birth, education, marriage, all professional activity, sickness, old age, death, burial and society's moral character. The Church did all the things that the State does today.

He argues that economics has replaced the Church in modern society, with its emphasis on the self-interested behavior of the scientific "economic man." Such a man, he asserts, is best described by the late M. I. T professor Paul Samuelson in his widely used textbook *Economics.* The scientific school of economics is based on the utter rationality of man. Utilitarian models can be constructed to analyze human behavior. Examples might include the use econometric models to ration the number of kidney dialysis machines. Not everyone in need will receive the benefits of a machine, but the number produced will be "optimized" from society's point of view. For purposes of distributing dollars raised in support of September 11 victims' families, the value of a human life can be readily computed by analyzing the number of years of expected remaining life, multiplying by the expected annual earnings power and discounting the income stream at an appropriate interest rate. Such "rational" analysis ignores the equality of pain and suffering and such distinctions as number of dependents.

Nelson contrasts what he terms the "Samuelson approach" to that of the school of economics founded at the University of Chicago with such Nobel laureates as Milton Friedman, George Stigler and Gary Becker. Their mentor was Frank Knight, who doubted there could be any possibility of the scientific management of society through the manipulation of self- interest. He felt human reason was frail, often corrupted by the baser elements in human nature. Knight felt the economic problem in society was a religious problem. The defense of freedom must rest upon an adequate moral and philosophical foundation. Human beings must be grounded in some cultural system, historically including religion as a main source of group identity. The market provides a place where people of different creeds can come together for voluntary exchange and mutual benefit.

Moreover, self-interest cannot dominate secular culture, as a culture of trust is an essential element in maintaining a successful market economic system. Nelson quotes Nobel laureate Kenneth Arrow as stating that the working of the economic system depends on the existence of invisible institutions---the implicit acceptance in society of certain principles of ethics and morality. These agreements constitute implicit mutual contracts, often unconscious, to supply mutual benefits. Without the existence of social bonds grounded in shared ethical principles, the functioning of the economy would be grievously impaired. In a trust-based economic system one is spared the costs of rule writers, enforcers, interpreters and the like

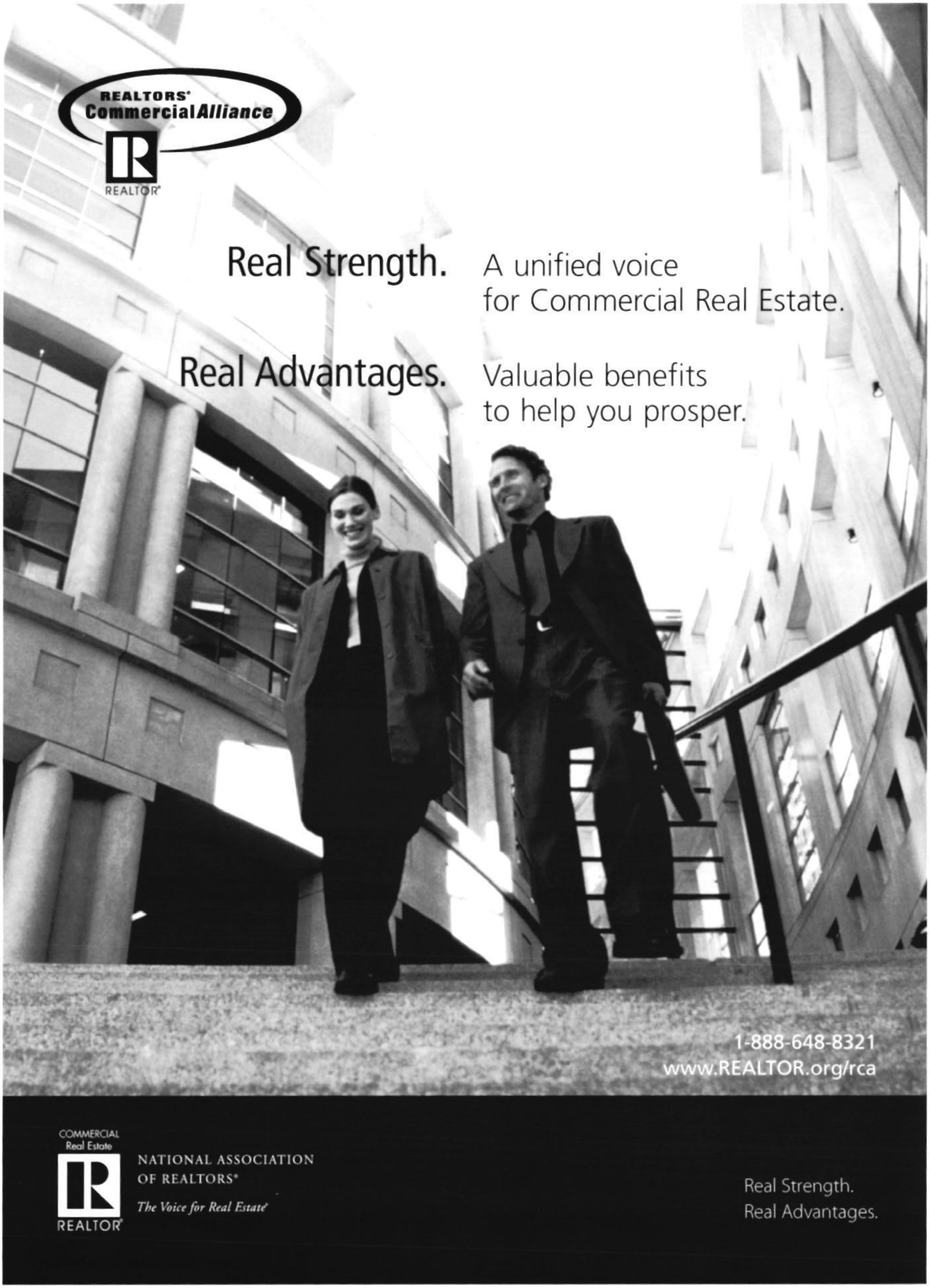
The U. S. lives out of a fundamentally trust-based system. The freeways work efficiently at speeds of 65 miles an hour. The person who cuts us off is the exception, not the rule. Stocks and bonds trade with a three-day settlement date. Prices continue to fluctuate, and on the settlement date, someone has made an extra profit and the other party a loss. Yet, the settlement almost always takes place. When we feel the basic underlying trust has been broken, we react with extreme urgency, sending those guilty of possible insider trading violations to prison and taking down a major accounting firm almost over night. An ethical system that promotes trust can be an immensely valuable economic asset for a society. Traditions of hard work, honesty and integrity lower the costs of transacting business.

The notion of trust as a social commitment rather than an act of individual self-interest inevitably leads to the subject of religion as a possible input in the formation of social beliefs that could sustain trust. The modern economic notions of "rational choice" and "efficient markets" ignore these inputs. Nelson concludes that perhaps economists committed to promoting a more efficient economic system may also have to think about how they might act to promote a more "efficient" religion. The kind of religion most likely to promote economic development should encourage the expression of individual self-interest while at the same time muting tendencies toward increased corruption and other "illicit" actions that have the potential to undermine the efficient working of the market system.

Nelson provides a large service by putting modern economic theory in conversation with traditional theological concepts. His topic is provocative and timely. The more one thinks about the function of market economics in modern society, the stronger the case gets for reintegrating it with its traditional religious antecedents. Society's strong reaction to the scandals of Enron and others is illustrative of the strong religious values imbedded in our culture.

ABOUT THE AUTHOR

Bowen H. "Buzz" McCoy, CRE, *is president of Buzz McCoy Associates, Inc., in Los Angeles, and a past president of The Counselors of Real Estate. He was the principal commentator for the symposium. (E-mail: bbuzzmccoy@aol.com)*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1). Manuscripts **must be submitted via e-mail or 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 a 50- to 100-word abstract* and a brief biographical statement, including author's e-mail address. Computer-created charts/tables should be in separate files from article text.**
*(*If the manuscript is accepted for publication, the abstract/brief synopsis would appear on the table of contents page.)*
2). Graphics/illustrations are to be considered as "Exhibits," numbered consecutively and submitted in a form suitable for reproduction. Graphics must either be submitted camera-ready or computer-generated as PC compatible ONLY. DO NOT submit colorized computer files—the graphics must be created in grayscale or black and white only. If possible, save in all of or at least one of the following formats: .emf; .eps; .wmf.
3). Number all graphics (tables/charts/graphs) consecutively. All graphics should have titles.
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6). Article title should contain no more than eight to 10 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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