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An International Real Estate Symposium

Sponsored by
Harvard Design School
The Counselors of Real Estate
Royal Institution of Chartered Surveyors

SPECIAL DOUBLE ISSUE

REAL ESTATE

1976 - 2002

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Global Cities in an Era of Change

An International Real Estate Symposium

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Harvard Design School
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September 4-6, 2002
Harvard University

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

Harvard paleontologist Stephen Jay Gould loved to write and lecture on the themes of diversity and adaptation in the natural world. These qualities characterize our economic world, and the place of real estate, just as fundamentally as they do the biological world. Probably this is true for many of the same reasons, for humans interact on many of the same principles of selectivity as do our companions of other species on this planet. We seek to survive, to pass on the best of ourselves, to seek habitats that are sustainable and sustaining, and to congregate both for protection and because social interaction promotes our evolutionary progress.

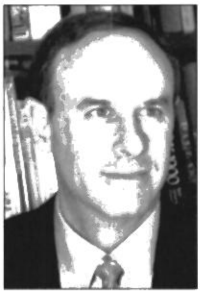
As Gould's academic home, Harvard was then a very appropriate locale for the September 2002 conference, Global Cities in an Era of Change. This three-day event was a notable collaboration among The Counselors of Real Estate, the Royal Institution of Chartered Surveyors, and the Harvard Graduate School of Design. Much of the value of the conference, of course, derived from the interaction of the participants on the scene, both during the formal sessions and in the many opportunities for "sidebar" conversations at meals and breaks. But certainly the content of the program itself was quite exceptional, rewarding those able to attend.

To make selected conference content available to a wider audience, and to expand the conference's theme through a series of related essays, *Real Estate Issues* and the *Journal of Real Estate Portfolio Management* committed to producing this special joint issue. Through a series of articles—some quantitative and others conceptual; some focused on particular cities and others thematic in scope—we look at urban economic and real estate issues around the world at the start of 2003. The world is becoming progressively more urbanized and, in the cliché, this presents both challenges and opportunities. Global cities, those conurbations at the top of the world economic hierarchy, are increasingly important as portals where the world's economic, social, and cultural diversity connect. Not coincidentally, such cities are also the places where real estate is developed most intensely and valued most highly. Real estate development also is a powerful force shaping the physical dimensions of cities, as it serves its function of housing economic activity.

A distinguished group of scholars and practitioners offer you their ideas in this special joint issue. They are an excellent example of a fruitful duality that Professor Gould aptly expressed as "richness in particularity and potential union in underlying explanation." We commend their efforts for your thoughtful consideration and application.

Hugh F. Kelly, CRE
Editor-in-Chief
Real Estate Issues

EDITOR'S STATEMENT - by Richard Peiser



The Global Cities Conference at Harvard Design School occurred almost exactly one year after 9-11. Up to the day of the conference, we along with our partners in the conference, the Royal Institution of Chartered Surveyors, the RICS Foundation and The Counselors of Real Estate, feared that a repeat terrorist incident would throw the world again into turmoil and cause the conference to be cancelled. Many flights were in fact cancelled and hotel rooms in Boston–normally very tight in the Fall–were available at bargain prices.

As we now know, the one year anniversary of 9-11 occurred without incident, and we all breathed an enormous sigh of relief. Still, the events of a year before had a profound impact on the substance of the conference. The long-term implications for urban development are just beginning to be recognized. The immediate impact, however, on real estate—from global investment to local confidence in urban redevelopment decisions—are being felt in every aspect of the industry.

The substance of the conference is reported in a series of articles in this volume. At the time of this writing, however, certain aspects stand out. The theme of the conference—competition among global cities—was brought home through a number of different dimensions discussed on the various panels. The term "global cities" refers to a select group of "world-class" cities that compete with one another for capital, investment, companies, sporting events, world fairs, art exhibits, and a host of other activities that give them prominence on the world stage.

The conference featured many more cities than the top one or two cities in each of the major countries represented. For example, New York City may hold the top spot in the United States, but Los Angeles, Chicago, Boston, San Francisco, and even Las Vegas, among others, are in competition not only within the U.S. but also with major cities around the world. As instantaneous communications, fluid capital, free trade, and more open markets make the world ever smaller, cities must work harder to create the kinds of environments that are attractive to companies. A number of speakers reiterated the relationship between the urban fabric and quality-of-life in cities—how certain cities, like London and Paris, have managed to preserve a special quality while remaining competitive.

Joel Kotkin created somewhat of an uproar by arguing that great cities today are not automatically destined to become even greater: "The real question for cities is what role they can play in this new economy. Those that find niches will thrive; those that don't are doomed to stagnate or decline. In the end, Cities are an act of Inspiration and Vision...where the Vision has failed, so has the city. Successful cities must inspire or die." Other speakers were much more upbeat about the future of cities. Certainly, Dame Judith Mayhew, head of the Corporation of the City of London, and Governor Ed Rendell of Pennsylvania, while recognizing the challenges that cities face, were optimistic about the many positive steps that well-motivated city leaders can take to improve the competitive positions of their cities. *(continued)*

Lawrence Summers, President of Harvard University, spoke about Harvard's own real estate expansion. Over the next twenty years, a substantial part of the university will be located across the Charles River in Alston on land owned by the university. He underscored the fundamental importance of creating a unique sense of place in order to motivate Harvard's graduate schools to move to a new campus. He also spoke of the implications for a sustained period of low inflation and low interest rates, and the special problems of managing an economy when interest rates are so low that monetary policy has little room to maneuver.

If there was a consensus to be heard among the participants at the end of the conference, it was that the ever-shrinking world makes our understanding of the forces that make cities rise and fall ever more important. We still have much to learn about the complex interaction between private investment and public policy–what cities can do to make themselves more attractive and more competitive. People in the real estate industry have a unique lens through which to view the growth and decline of cities. If the conference improved our understanding of the forces that influence urban futures, then it could be deemed a success.

This issue is a first-time collaboration of the American Real Estate Society, The Counselors of Real Estate, and the RICS Foundation to produce a joint issue of the *Journal of Real Estate Portfolio Management* and *Real Estate Issues*. It combines articles about the Global Cities Conference with related papers on international real estate investment. I am indebted to my colleague, Hugh Kelly, for managing the collection and assemblage of articles for The Counselors. Stephen Brown, Director of Research for the RICS Foundation, and I have worked together to assemble the articles for the refereed section of the journal. These articles have passed JREPM's standard blind review process for inclusion in the journal. We are particularly grateful to a number of reviewers for JREPM who have turned around reviews in a record-short period of time. We are also indebted to the authors who have responded in equally short time to requests for revision—some minor, some substantial.

The issue contains four articles that are part of the refereed-paper section. All four address aspects of international real estate investment. With the exception of Glenn Mueller and Randy Anderson's article, "The Growth and Performance of International Public Real Estate Markets," the articles focus on real estate in individual countries. Collectively, they provide new insights into important real estate issues in Europe and Asia.

Glenn Mueller and Randy Anderson assess the growth of public real estate markets around the world. They note that the U.S. market is by far the largest; other markets have yet to reach the size that give institutional investors sufficient liquidity. They conclude that public real estate markets for the most part offer investors attractive returns and low correlations. However, for a number of reasons cited in the paper, public real estate markets in most countries still have a long way to go to attract significant institutional capital.

Richard Peiser and Bing Wang focus on non-performing loans (NPL) in China – one of the most important problems that China must resolve as part of its entry into the World Trade Organization and imminent competition from western banks. Peiser and Wang evaluate fifteen major issues that must be addressed in order to reduce uncertainty and motivate foreign investors to enter the Chinese NPL market in force. They conclude that the Chinese have demonstrated a strong commitment at the national level to deal aggressively with the NPL problem, but it remains to be seen whether foreign investors will be able to get control of real estate assets quickly at the local level and convert them into cash – a necessity if China is going to realize higher NPL recovery rates and lower ultimate losses from bad loans.

Sofia Dermisi reports the results of a survey on how the Internet is currently being used by owners, brokers, and investors involved in the office market in Boston and London. She finds that the Internet is still being used primarily for information gathering and dissemination. It is significantly reducing the total processing time for lease and sale transactions, but it has yet to be used very much to consummate actual transactions. She concludes that a common online platform will enhance the transparency of transactions, but the major participants—brokers, lawyers, and appraisers—will resist the implementation of such a platform as long as they feel their income is threatened.

We trust that members of the American Real Estate Society, The Counselors of Real Estate, the Royal Institution of Chartered Surveyors, and the Harvard real estate community will find the Joint Issue of interest. Through better understanding of what is occurring in different parts of the world, meetings like the Global Cities Conference hopefully give each of us better insight into our own small part of the world, and how it fits into the larger picture.

Richard Peiser
Cambridge, Massachusetts

Stephen Brown
London, England

Global Cities in an Era of Change

An International Real Estate Symposium

Sponsored by
Harvard Design School
The Counselors of Real Estate
Royal Institution of Chartered Surveyors

September 4-6, 2002
Harvard University

How Can Cities of the World Compete for Capital and Economic Vitality?

A summary of the first international real estate symposium of its kind, sponsored by Harvard Design School, The Counselors of Real Estate, and The Royal Institution of Chartered Surveyors.

For three days in early September, they came to conquer the world, or perhaps more appropriately, to help the world conquer itself.

An international lineup of academicians, urban planners, and real estate practitioners converged on Harvard University to dissect the urban animal to its core and determine where cities will be headed in the brave new world. The real estate symposium, Global Cities in an Era of Change, also sought to identify the world's premier growth areas and to offer insights into what elements are required to ensure a city's success and overcome mounting challenges such as overcrowding, poverty, and pollution.

Attendees came "to find out how cities are moving forward," said speaker Angus McIntosh of London's King Sturge. The Counselors of

Real Estate (CRE), the Harvard Design School, and the Royal Institute of Chartered Surveyors (RICS) sponsored the symposium. Nearly three years in the making, symposium steering committee Chairman George Lovejoy, CRE, said the groups strived to present no less than "the consummate symposium on international real estate."

"We're enthusiastic about the capacity," Lovejoy said in opening the first of six panel discussions that focused on everything from identifying what makes a city global and how urban spaces are being designed in the 21st century to the influence of cross-border capital on developing nations. Impacts of migration, pollution, poverty—and even prosperity—on cities were also examined, while many weighed what fallout the World Trade Center attacks and other terrorism might have on the global expansion of cities.

"The terrorism threat is a serious threat," insisted Pepperdine University professor Joel Kotkin, who delivered the conference's keynote address and was among the most vocal in exposing the struggles faced by the modern city. Others disagreed with Kotkin's notion that the September 11th incidents will lead companies and others to shy away from the central city. Dame Judith Mayhew of the London Development Agency countered that European cities have coped with terrorism for decades, maintaining Americans will also strengthen their resolve.

Such interaction among speakers and audience members was common throughout the conference, engendering spirited debate about whether the urban model can survive given the mounting pressures of modern society. Among the most confident that it will endure was New York City developer Daniel Rose, CRE, who recalled that cities at the turn of the 20th century were deemed doomed because observers felt waste from ubiquitous horses would limit their growth. "The horses are gone, but New York and London are still there," Rose said. In a latter-day example, New York City's crime problem was also considered unsolvable, but Rose noted great strides have been made in that regard in recent years.

Rose also delivered the message that inhabitants of a city must act locally to keep problems from overwhelming a metropolis. He and others, such as speaker Bowen "Buzz" McCoy, said a level of personal involvement with schools and the underprivileged can ensure a city will remain relevant and livable into the future, stressing that, "it's not the amount of the check, it's the amount of time" donated.

In a similar vein, speakers called for greater reliance on sustainable design and rational urban planning in the development and operation of cities to protect dwindling natural resources. Indeed, one of the greatest threats facing cities worldwide, according to some at the conference, is the lack of water, among the most critical of all human needs. "Water is a very serious issue everywhere," said speaker Brett McCarthy of UBS Warburg. Almost as much as oil, water is among the most valuable resources in the Middle East, South Bank University professor Ali Parsa added, so much so that it has created constant conflict. McCarthy said private investment may soon enter the water utility business in an effort to capitalize on the need for better systems.

To no great surprise, the issue of capital influence on global expansion was a major topic throughout the conference, with a host of experts on hand to help decipher which markets are garnering the greatest interest and what elements are required to make a city popular among investors. Along with real estate users, such as PepsiCo, audience members heard from investment bankers, real estate developers, and economists who offered their insights on the cities they find most appealing and the factors influencing capital decisions.

PepsiCo, for example, has made substantial inroads into Istanbul, and company official Ken O'Gara offered reasons for entering that market and the steps taken to ensure it was a secure and fruitful initiative. But while PepsiCo was willing to put its capital there, real estate developer Hines Interests of Texas opted against doing so after taking a long look, representative Lee Timmins told the audience.

"For me, they are at the wrong end of the real estate clock, and it doesn't make sense for us to be there today," said Timmins, explaining his firm's capital typically has an eight-year investment horizon, whereas PepsiCo as a user has a longer view of the market. Others, such as real estate advisor Will McIntosh, said it has been difficult to get investors comfortable with the notion of putting their capital overseas, especially in developing countries.

"It's a real dilemma as real estate money managers are trying to invest internationally," said McIntosh of AIG Global. Conservative investors "look at you like you've got three heads."

Another aspect of the conference was the role that foreign governments can play to encourage private investment. Political upheaval, corruption, and an uneven legal system are among the leading reasons certain cities fail to pass muster, many of the speakers reported. Hines recently opted against buying an office building in Bombay, India, largely because tenant's rights are especially strong and legal recourse was deemed too risky, Timmins said. In Moscow and Paris, meanwhile, stringent land use laws have also been difficult for Hines to get comfortable with, he said.

Investor Jeremy Newsum praised politicians in Liverpool, England, for adopting a pro-business stance that provides the struggling city its best opportunity yet to emerge from the malaise enveloping it since World War II. "It is absolutely critical for any city that there be a good fusion of business and politics," said Newsum, a notion seconded by no less than Governor Edward G. Rendell of Pennsylvania, who outlined his efforts to overhaul Philadelphia as mayor of that struggling metropolis in the 1990s. Rendell said that strict attention to business interests enabled him to lure capital back to the mid-Atlantic metropolis.

Rendell was among several veteran city officials and planners who added to the heft of expertise at the conference. Mayhew provided an outline of London governmental efforts to address a 43% child poverty rate and mounting city health problems, while San Diego planner Peter J. Hall described how that California city has engaged for more than a quarter-century in a battle to bring back a community decimated by suburban flight in the 1970s. The initiative has yielded a seven-to-one ratio in private investment versus public financial input, Hall said.

The conference also relied on private sector input as well, with practitioners on hand who have traveled the world over to develop, acquire, or finance commercial real estate projects of every scope imaginable. London investment banker Paul Rivlin of Deutsche Bank delivered an in-depth look at how the European market is responding to global interest, while Warburg's McCarthy detailed why institutional capital is changing the formula for real estate investment in all corners of the earth. Australia, he said, is becoming a leading international financier, as are pension funds in Germany, the Netherlands, and the United States.

Australian real estate investment funds now comprise fully 7% of the country's equity market, compared to 1% for most countries, McCarthy said. Of the 7%, 24% is invested in U.S. real estate. Australians have developed a sudden appetite for real estate opportunities in North America, as witnessed by one such fund's current commitment to buy a downtown office building in Boston for $400 per square foot. In his presentation on "The Global City Today," McCarthy predicted institutional capital would become a prime driver of investment in undeveloped countries in the coming years, primarily to garner higher yields. Countries such as Germany and the Netherlands are already amassing funds to search the globe for opportunities, McCarthy said.

Investment strategies of all stripes were presented to the audience, with Lehman Brothers investment banker George Von Liphart bullish on buying non-performing loan pools as an efficient way to jump into a foreign market and get up to speed on the area encompassing the loans. Soros principal Richard Georgi reported sale/leaseback opportunities may be on the rise in Europe as corporations seek to raise quick cash. One overriding message among the investors and advisors was the invaluable need to find a competent, trustworthy local partner in an untapped market.

"You have to rely on local people on the ground that you have some sort of cultural affinity with," said Charles Wurtzebach, an investor who spoke at the Cross Border Capital Flows presentation. Devlin said that even that arrangement might be inadequate, advising foreign investors to "keep your money in your pocket."

"I don't believe in the global real estate industry," Devlin said. "You cannot run a successful real estate business from New York" focusing on international markets.

Ironically, Rose said one of the problems cities often encounter is a myopic outlook that prevents locals from investing. When his New York firm attempted to develop One Financial Center in Boston in the early 1970s, Rose said he could find no Boston bankers willing to finance the deal, forcing him to turn to New York lenders to back the project.

"It's fascinating to realize that the building boom in Boston was done with outside talent and outside capital," said Rose. That observation was shared by Hugh Kelly, CRE, who said "we tend to get close to our own markets."

"When we get very close, we tend to see a lot of the warts," Kelly said. "We see all the reasons not to do things and we don't see the reasons to actually step into action."

As for assessing specific cities throughout the world, leaders included the universal locations that immediately come to mind, such as Paris, Tokyo, and London. Such meccas were labeled "super-globals" by Newsum, but speakers also offered surprisingly solid praise of such cities as Moscow, Athens, and Berlin, while Georgi said Soros is even bullish on fiscally troubled Brazil and just closed a deal in volatile Buenos Aires, which Soros had abandoned in 1999.

Hines Interests has done several projects in Moscow, although Timmins said a leading reason for the improvement in that Russian city is a willingness among domestic players to invest in their own country. Bolstered by that self-confidence, Russia has begun to attract multi-national corporations, a key factor in where Hines opts to put its capital.

Berlin garnered particular interest, with both Devlin and Soros predicting the city has a solid chance of emerging from its current state of chaos, which includes insolvent banks, falling rents and a large amount of vacant office space under construction. "It's at the bottom right now," acknowledged Devlin, but "if I had to pick a city for a medium-term prospect, I think Berlin is a great place to go and will be a fantastic financial center when it is developed."

Placing Berlin at the top of his list, Georgi also bucked other speakers by voicing support for Tokyo. "It is the center of everything in Japan," he said, while acknowledging that the city's office market is in trouble at present, with 70 million square feet currently coming on line. Athens made several lists, partly because it recently joined the monetary union and because interest rates have settled down after several years in the mid-20% range.

Overall, the "Global Cities in an Era of Change" symposium fueled the sort of discussion The Counselors of Real Estate, the Harvard Design School, and The Royal Institution of Chartered Surveyors (RICS) sought when they began planning the program nearly three years ago. Lovejoy praised former CRE President Jonathan A. Avery and CRE executive vice president Mary Fleischmann for helping to initiate the program, which was launched after the three traveled to England in 1999 to meet with RICS.

"We were seeking to better serve our members and add global capacity through alliance with compatible organizations," Lovejoy said, adding he believes that mission has been accomplished with the Global Cities program. The addition of Harvard Design School bolstered the union, said Lovejoy, with its educational and research capabilities.

THURSDAY, SEPTEMBER 5, 2002

THE GLOBAL CITY TODAY

Panelists:
Frank Duffy, DRGW
Mark Steinitz, UBS Warburg
Dr. Ali Parsa, Southbank University

Moderator/Coordinator:
Angus McIntosh, King Sturge

Big corporations, institutional capital, strategic alliances, and agility cited as the key influences in today's Global Cities

Cities are a many splendored thing, offering an international variety as widespread as the people who occupy them, but to economist Angus McIntosh, one distinct element is beginning to inure itself in the fabric of urban centers everywhere.

"If you go somewhere like Shanghai, you will find Starbucks and Kentucky Fried Chicken on most corners," the head of research for London-based King Sturge said during a presentation at the Global Cities in an Era of Change symposium. "The design of buildings in cities is being dictated to us by some of these major global corporations."

In the panel presentation, "The Global City Today," McIntosh joined other economists and real estate professionals to outline the factors influencing metropolitan areas and the ways different cities are responding to the challenges. Among those speaking were Brett McCarthy of UBS Warburg, architect Frank Duffy of DEGW North America, and Dr. Ali Parsa of South Bank University.

The panelists voiced concerns that multinationals are over-influencing cultures worldwide. "These global corporations have tremendous impact on politics and politicians of every shade, of every color," said McIntosh. In the case of McDonald's entering eastern Europe, he remarked that, "the Cold War of tanks is being taken over by the hot war of hamburgers."

How that situation will play out is unclear, but McIntosh said there is little doubt globalization is making its mark on cities in other ways as well. In one recent study, it was revealed that leasing of office space in global European cities such as London, Paris, and even Frankfurt is booming, recently reaching a four-year high despite an overall economic downturn in other parts of the continent. "There is something going on there in terms of city consolidations and cities dominating regions," McIntosh said. "It's quite prevalent."

Beyond corporate finance, developed nations are sending institutional capital into third-world economies, said Warburg's McCarthy, a real estate analyst who tracks global capital flow. According to McCarthy, countries with aging populations are investing retirement funds into developing nations to finance infrastructure improvements. Especially in light of flagging equity markets, pension funds, and other sources of institutional capital are looking for higher-yielding investments, and McCarthy said Third World investment offers that opportunity.

"Clearly the capital is flowing into infrastructure, and this will have an impact going forward," he said. "The synergies are there and the matching (of capital to projects) is happening."

Two Australian funds have recently been formed to invest in toll roads, for example, including one that owns such thoroughfares in the United Kingdom, Canada, Spain, and Portugal. Another is gearing up to invest in airports. China is lobbying private capital to build 7,000 kilometers of railway and is now willing to provide legal protections to attract bidders for the $40 billion undertaking. Such assurances will be critical if countries want to be successful, McCarthy added. "It's a two-way street," he said. "You have to provide the conditions to make it attractive to investors."

Such has been the challenge in the United Arab Emirates, the federation of seven empires in the Middle East that is a major player in worldwide oil production. Parsa detailed a study on how the UAE has worked to become a global economy similar to that seen in Singapore. Parsa noted that both were former British colonies that only recently gained their independence, but said Singapore has taken greater strides to incorporate itself in the global economy, offering outsiders clear legal and regulatory protections and ensuring that its citizens are aware of the country's goals to be a dominant regional powerhouse.

In the UAE city of Dubai, officials have come a long way in a short time to become an international trading center, Parsa said. After not even being recognized 10 years ago as a regional transportation hub, Dubai today is linked by 78 airlines to 125 other cities, and has 12 million passengers traveling through the city's airport annually. On the down side, Parsa said there are strict federal laws, a lack of legal precedence and a time-consuming approval process throughout the UAE. If the country is to become a truly global region, Parsa said such cities as Abu Dhabi, Dubai and Sharjah must be more adaptable to outsiders, increase their business focus and be willing to work more closely together. "For the UAE as a whole, there is a strong need for inter-emirate and regional synergies," Parsa said.

The panel closed out with a speech by Duffy on what makes for an intelligent city, a topic which he admitted is difficult to pin down. Duffy noted that in the modern age, for example, a city needs the physical infrastructure such as fiber optics and bandwidth to compete in the technological world and to attract an educated workforce. In that regard, he said, "an intelligent city is one that has the ability to make changes over time," such as accommodating new growth engines.

Beyond that element, however, Duffy said a city needs a spiritual willingness to change, with its inhabitants eager to take on new ideas and cultures that will broaden their horizons even further. "Diversity, we believe, increases the agility of cities and provides the basis of flexibility in the context of rapid change," he said.

THURSDAY, SEPTEMBER 5, 2002

STRATEGIES FOR MANAGING URBAN GROWTH AND REVITALIZATION

Panelists:
Dame Judith Mayhew,
Corporation of the City of London
Gov. Edward Rendell of Pennsylvania, former Mayor, Philadelphia
Peter Hall, San Diego Center City Redevelopment
Commission/Moderator:
Nicolas Retsinas, Joint Center for Housing Studies, Harvard
Commentator:
Bowen "Buzz" McCoy, CRE, Buzz McCoy Associates
Coordinator:
Richard Peiser, Harvard Design School

Urban Revitalization Challenges Major Cities -- Capital And Cooperation Required

Governor Edward G. Rendell stressed the importance of infrastructure at the Global Cities in an Era of Change symposium. Lauded as "America's Mayor" for revitalizing Philadelphia in the 1990s, Rendell explained the city had to right itself through infrastructure improvements and other changes before the private sector would return.

"The free market is not anxious to put capital in most American cities until it feels they have turned the corner," Rendell said. "We need to create a nurturing environment and a good physical environment (for companies)."

Governor Rendell spoke at the "Strategies for Managing Urban Growth and Revitalization" panel. The panel was moderated by Nicolas Retsinas, assistant U.S. housing secretary under President Clinton, and also included Dame Judith Mayhew of the Corporation of the City of London and San Diego planner Peter Hall.

During Rendell's tenure from 1992 through 1999, Philadelphia increased convention space and opened new hotels to bolster tourism, while also helping traditional businesses. In one instance, a clothing manufacturer wanted to build a new plant, but required a cleanup of the parcel in advance. Rendell's administration ensured it was accomplished.

Equally important to physical upgrades is providing a stable revenue climate, Rendell added, maintaining Philadelphia lost 250,000 jobs in the years prior to his election partly because of 19 tax increases over an 11-year period. While acknowledging some political shrapnel in backing business tax abatements and focusing on the financial center, Rendell insisted such attention is critical.

"You can't shy away from the downtown," he said, adding the city is now embarking upon an extensive neighborhood improvement initiative fueled by a healthy budget. By the time he left office, Philadelphia had converted a $250 million shortfall into eight straight years of revenue surplus.

Rendell praised current efforts to foster life sciences research, and cited a migration among empty nesters and the young back into downtown Philadelphia, with commercial buildings being renovated for residential use. "One of the great roles going forward is to be a place where we can mingle with each other," Rendell said of improving cities.

Judith Mayhew discussed the ambitious London Plan. Concerned over increasing poverty and strains on housing, schools and public transportation, the mayor of the United Kingdom epicenter recently issued a forward-thinking document known as the London Plan. The initiative calls on the restoration of brownfields sites, upgrades to sewer and water systems and increased transit options to accommodate 700,000 people expected to pour into the city of 7.4 million during the next 13 years.

"It is, simply, London's way of managing urban growth and revitalization," Mayhew said of the London Plan. By current estimates, London will need another 25,000 homes and 130 schools in the next decade. Electrical networks will also have to be modernized to support London's place as a hub for telecommunications activity, Mayhew added.

A cornerstone of the London Plan is sustainable development to reduce environmental waste and efficiently use scarce resources. The effort is also aimed at "soft issues" such as better health care, education and expanded recreational activities. "Here as well, the Plan envisages growth and development of a full range of amenities to support and enhance the lifestyle as London grows," Mayhew said.

Back in the United States, San Diego has been engaged in a long-term initiative to overhaul its downtown. Hall, who joined the Centre City Development Corp (CCDC) in 1995, outlined its creation in 1975 as an effort of the San Diego business community to save a dying downtown. The CCDC's purview was a 1,500-acre swath where it worked to leverage public funds for enhanced private investment, a common theme at the Global Cities conference.

"Government action equaled public reaction," Hall said of the $445 million in public bonds issued to prime the pump, including $100 million for infrastructure improvements. After 27 years, the CCDC area has yielded more than 6,000 residential units, 4.7 million square feet of commercial space and 4,555 hotel rooms. San Diego is now garnering $55 million annually in tax revenue from the new development.

Hall acknowledged it has not been an easy road, with political clout in San Diego often misaligned with the CCDC's vision. Not only are residential issues more of concern to the city's councilors, who represent specific districts, Hall said term limits make it harder for them to adopt a forward-thinking stance. As a result, "land use policies in our region have taken on the context of a full-contact sport," Hall said.

London has encountered a similar problem, said Mayhew, with a decentralized power structure making it difficult for resources to be directed to long-term needs. The London Development Agency, for example, would like to raise municipal bonds, but currently is not allowed. It is an issue that must be resolved, according to Mayhew, in order to prepare London for the 21st century. "The city and the hinterlands are mutually dependent and we can't deprive one or the other," she said.

THURSDAY, SEPTEMBER 5, 2002

ECONOMIC AND WORKPLACE DRIVING FORCES

Panelists:

Mahlon Apgar, CRE, The Boston Consulting Group
Will McIntosh, AIG Global Real Estate Investment Corp.
Ken O'Gara, Pepsico
Lee Timmons, Hines Partners

Moderator/Coordinator:

John McMahan, CRE, Centerprise

Tracking Multi-Nationals Influences Real Estate Decision Making

It is spelled the same as always, but the concept of "location" is rapidly evolving worldwide, according to panelists at the Global Cities in an Era of Change international real estate symposium. Technology, globalization and other forces are "changing the paradigm" of where companies are expanding, said speaker Mahlon "Sandy" Apgar, CRE, whose Boston Consulting Group (BCG) helps firms find space internationally.

"Redefining the factors of location ... is an important challenge," Apgar said during the "Economic and Workplace Driving Forces" panel during the event. Unfortunately, he added, neither business schools, real estate educators "nor much of the theory and practice have yet grasped the magnitude of these changes."

Most of the 23 companies BCG is assisting internationally are industrial-era operations, which still seek inexpensive land, low-cost labor and bountiful natural resources. But the needs of BCG's information-related clients are dramatically divergent, said Apgar. While also labor-conscious, such players require an educated workforce, and depend on high-bandwidth and other telecommunications capabilities more so than physical infrastructure.

"When they cross that threshold (to the information age), you literally can look at the globe in terms of fundamental labor economics, but they are not defined any more by concentrations of traditional location criteria," said Apgar. "You're no longer moving the workers to work, you are moving the work to the workers."

Moderator John McMahan concurred, noting cities deemed knowledge centers have fared well, with one recent survey listing Helsinki, Stockholm, and Copenhagen as popular targets for foreign investment. Cisco Systems recently tabbed Amsterdam for its European headquarters, while Amazon.com has been active in the Netherlands as well. "The message seems to be that there are some new cities, new players in this game, and some of them are coming on very strong," said McMahan, executive director of the Center for Real Estate Enterprise Management, a California-based think tank, and who is also a member of The Counselors of Real Estate (CRE).

Panelists detailed why companies have moved into certain areas, and which cities are likely to garner capital interest going forward. Joining Apgar and McMahan were Kenneth O'Gara of PepsiCo, Hines Organization principal Lee Timmins, and AIG Global Investments Managing Director Will McIntosh.

PepsiCo has three real estate needs, said O'Gara, those being manufacturing, distribution and office space. Each has five or six unique criteria, he explained, with geography and a city's physical makeup important for distribution. An active port allows product to be shipped via barge, while office space must be close to core businesses, such as local bottlers. PepsiCo is currently developing its largest manufacturing facility in Ireland's County Cork, one that will produce concentrate for North America and Europe. A favorable tax agreement, good labor force and centralized location led PepsiCo to make the $100 million investment, according to O'Gara.

"What we do in a city depends upon what the city provides to us," said O'Gara, adding PepsiCo sees its primary growth coming overseas, which presently represents just 20% of its revenues.

AIG pays close attention to which countries multinational companies are entering, said McIntosh. Not only does it indicate stability, AIG's investment group aims to develop facilities for such companies. "A great deal of the research we do involves studying what the end users are looking for, and trying to make sure we're in those markets ready to provide the kind of product they want," said McIntosh. "If we do that and do that well, we're going to produce the returns our clients are looking for."

In the decade since becoming an overseas developer, Texas-based Hines has also reacted more to market demand than its own development strengths, Timmins said, making it important to track multi-nationals. Known at home for office and retail, two of Hines' earliest international ventures involved a residential component, while the developer has also completed several industrial projects in Mexico. "That's a real departure for us," said Timmins. Hines currently has 50 projects in 19 foreign cities.

Hines is also influenced by demographics and the strength of a city's real estate market, said Timmins, chiefly because its funds generally have an eight-year horizon. "If vacancy rates are above 20%, we're probably not going there," said Timmins. "If vacancy rates are maybe 10 or 12 or 15% and falling fast, that is a market that will look very good to us."

Investor appetite is key, said McIntosh, with capital often fearful of emerging markets. It can be frustrating, he said, explaining investors prefer established markets such as the United Kingdom, Germany, France, and Spain. But such capital incorrectly expects higher returns overseas, even in stable climates. "They don't want to go to the countries where we can get them the risk premiums that they want for their international investing," said McIntosh. "It's a real dilemma."

Both Timmins and McMahan defended investment in emerging markets, but acknowledged potential complications. In Moscow, a Hines plan to develop housing and sell to the U.S. government hit a snag when Russia became upset at the Clinton administration. Russia blocked the ownership transfer, leading to a summit showdown between Clinton and Russian leaders. "If you told me in 1992 I'd be dealing with a residential project in Moscow that was on the agenda for the summit, I would have said you are crazy," Timmins remarked. "But that is the type of political issue we encounter in all of these countries."

In the future, Hines plans to limit its exposure mainly to markets where it is already active. "The goal is to be deeper and deeper into the countries in which we are currently operational, to do more projects followed by more projects, and to have a long-term horizon," Timmins said.

AIG is bullish on Asia and ultimately hopes to expand into Latin America. At present, however, McIntosh said Mexico is the only Latin American country "we can get excited about," citing its improved credit rating, the ability to do dollar-denominated leases and the positive impact of the North American Free Trade Alliance.

PepsiCo favors Latin America, said O'Gara, with Brazil and Argentina seen as possible suppliers of juices for its Tropicana line. McIntosh said the demographics of 175 million people make Brazil a long-term gem, but stressed that economic woes make it too unstable at present. "There's just too much uncertainty among my investors," said McIntosh. "But we think it's going to be a big market going forth and we want to be there."

THURSDAY, SEPTEMBER 5, 2002

INNOVATIONS IN INFRASTRUCTURE

Panelists:

Peter Head, Faber Maunsell & AECOM
Joel Kotkin, Pepperdine University
Peter Lewis, CRE, MIT

Commentator:

Bowen "Buzz" McCoy, CRE, Buzz McCoy Associates

Moderator:

Barry Gilbertson, CRE, PricewaterhouseCoopers, CRE

Urban Population Surge Demands Attention To Economic, Environmental, And Transportation Issues

With the worldwide urban population growing by 180,000 daily, cities must stretch threadbare resources even further in the new millennium, stressed one panelist at the Global Cities in an Era of Change symposium. Experts in the "Making Cities Work" segment of the program offered ways municipalities can overcome that challenging dilemma.

"The answer is by supplying the right fabric," said moderator Barry G. Gilbertson, CRE. The PricewaterhouseCoopers principal "set the scene" by stating that 1.3 billion people live on fragile lands which cannot support them, fueling migration that will wedge two-thirds of the world's population into cities within 50 years. "Think of that in terms of the demand it places on energy and water," said Gilbertson. "Also think of what it is going to do for housing, and can we do anything sustainable with housing?"

So-called sustainable development, a topic raised throughout the conference, garnered particular attention by the "Making Cities Work" speakers, which included Pepperdine University professor Joel Kotkin, Massachusetts Institute of Technology Real Estate Director Peter Lewis and British planning consultant Peter Head.

Representing the Greater London Authority Sustainability Commission, Head detailed London's efforts to improve housing, transportation, health and education without overwhelming city resources. "Sustainable development needs to balance the Triple Bottom Line," he said, covering economic, environmental and social issues. While some feel a tradeoff is inevitable, Head disagreed. There is "a way of getting the three going together and creating win, win, wins," he said. "I'm quite radical in that sense, but I actually believe it's possible through very innovative approaches."

The cost is certainly daunting, with Head reporting London will require $110 billion pounds to accommodate growth over the next 15 years. Sixty percent is needed for public transportation investment, Head estimated, especially as population increases and rising costs for motorists add ridership. "The system is greatly overloaded and needs new capacity," Head explained.

In admitting past undertakings have failed, Head claimed the public and private sectors can effectively share in the upside by uniting resources. Office rents abutting a recent extension of London's Jubilee Line grew 14% above the norm, Head noted, while property values also rose disproportionately. If investors can enjoy a project's fruit, Head predicted they will buttress public investment. In London, he said a $50 billion public commitment should yield a $60 billion infusion of private capital.

"The great challenge in the issue of private/public sector benefits going in partnership is to try and get the risk/reward balance right," Head remarked, with private enterprise motivated by a return on equity, design and construction revenues from delivering the product and opportunities for entrepreneurial development in the upgraded area.

A common mistake for public/private partnerships is drawing up the contract before establishing performance requirements, according to Head. "You've got to have those targeted and fixed from the start," he said, outlining a three-step process that begins by forging a strategy "to deliver safety and value for money within a sustainability development framework." After setting performance goals, the next step is to contract it out to the necessary disciplines, and then to deliver the project.

"My experience is that if one follows that simple process from start to finish, you do get success, and almost invariably it's never done, which is very frustrating," Head lamented.

Despite past struggles, panelists vowed the effort must continue, with Head adamant that public transportation be addressed. "Governments worldwide do not still seem to understand the relevance and the connection between investment in public transport in dense cities and the benefits that can come from it," he said. "The only country that really understands it is France … which is why Paris really does work very well."

In his presentation, Lewis said institutions can assist host cities via investment in both the physical and social environment. "The city of Cambridge is inextricably linked to MIT and Harvard," said Lewis, estimating MIT has pumped $28 million into sewage and roadway improvements near the campus, built several hundred affordable housing units and features community education and tutoring programs.

"We're really trying to give something back," said Lewis, with the school contributing $18 million in taxes and fees to Cambridge in 2001. Greater Boston has been economically enhanced by more than 50 colleges and universities, Lewis opined, noting MIT's Cambridge First program has generated $38 million in goods and services revenue for local businesses. Universities contribute "on technology, health care and financial services," Lewis added, while acceding they also drive up housing costs, use city resources and exacerbate density. In recognition, MIT pays a special fee for its tax-exempt property and to offset services such as police and fire response.

Schools create jobs, Lewis continued, with MIT-related businesses employing 125,000 in Massachusetts alone. Those firms contribute $10 billion in income and sales of $53 billion, said Lewis, citing homegrown giants founded by MIT graduates such as Digital, Raytheon and Gillette. "An educated workforce is increasingly important in the shift from an agricultural economy to a manufacturing economy to a service-based economy," he said.

THURSDAY, SEPTEMBER 5, 2002

KEYNOTE ADDRESS

BY JOEL KOTKIN, PEPPERDINE UNIVERSITY

Terrorism, Global Migration, And Digital Revolution Cited As Key Challenges Facing Today's And Tomorrow's Cities

Joel Kotkin insists he is not "anti-city," but the Pepperdine University professor does forecast trouble ahead as the metropolitan model proceeds into the 21st century.

"I see a lot of scary trends," Kotkin said during his keynote address at the Global Cities in an Era of Change international real estate symposium. "There are many things to be concerned about."

Kotkin detailed three challenges cities face: terrorism, global migration, and the digital revolution. His view on terrorism was especially disconcerting, with Kotkin insisting the September 11th, 2001, attacks are prompting companies and residents to consider suburban relocation.

"People who had decided, 'I can live in New York or I want to live in New York' are now choosing to be elsewhere," Kotkin said. "I think you are going to see more of that."

Kotkin cited examples where employees, including senior management, have begged out of their urban offices, and noted that even with 13 million square feet destroyed or damaged in the World Trade Center attacks, the vacancy rate in Manhattan has risen. Those staying face higher occupancy costs, Kotkin said, with the insurance system particularly unsettled. Several trophy properties are technically in default due to a lack of terrorism insurance, he said, adding that workers compensation rates are rising in urban markets.

Some in the crowd disagreed, including Brookings Institute fellow Anthony Downs, who acknowledged a deconcentration movement but cited alternative reasons. "I don't think terrorism is a key factor," said Downs, a notion seconded by others. Kotkin remained firm, predicting more attacks might worsen conditions in cities worldwide.

"I'm not trying to scare people, but let's think of this as an issue because it is an issue," Kotkin said, adding, "I think there is an extreme possibility for [another terrorist attack] to happen."

Even without that influence, Kotkin said a stream of people are fleeing the urban lifestyle. In California, he said, whites are moving to the outer limits of the suburbs or even into the countryside. Upwardly mobile, educated minorities are enhancing the trend, with only the poorest residents left behind, said Kotkin.

"The vast amount of America's growth is happening in the suburbs," Kotkin said, while estimating that 30 to 50% of the population in Amsterdam, Marseilles and Paris are immigrants, often from poor countries such as Iraq and Turkey. In the Netherlands, 28% of the Dutch have reached the highest level of education, Kotkin said, while just 4% of Turkish and Moroccan immigrants had attained that level of degree.

"Rotterdam has decayed, and the white, middle-class people have moved to the suburbs," said Kotkin. Although immigration-legal and otherwise-is up sharply in the United States, Kotkin said the issue will be more daunting for Europe. "Their economy lacks the kind of dynamism we have to absorb immigrants," he said, with the overseas welfare system likely to be further burdened.

On the third challenge, Kotkin did say certain cities, including Boston, New York and London, have a leg up in attracting knowledge workers in the new millennium. But communities must remain vigilant to keep IT workers stimulated, said Kotkin, who overall sees virtuality leading to further dispersion of the public.

"The vast majority (of IT workers) don't want to live in the center city," he said. "The job growth continues to be . . . in lower density areas."

Kotkin concurred that some downtowns have seen inward migration, largely empty nesters and recent college graduates. But middle class families are key to a city's survival, Kotkin stressed, and claimed those fueling that trend are often simply going through "a phase." In one study of the latest New York City boom, 82% of the emigrants were 35 or less, only 57% were married and just 10% had children. "For the most part, [living in the city] is just something that people do between when they go to college and when they grow up," Kotkin said.

FRIDAY, SEPTEMBER 6, 2002

CROSS BORDER CAPITAL FLOWS

Panelists:
Ivo DeWit, ING Real Estate
George Von Liphant, Lehman Brothers
Richard Georgi, Soros Real Estate Partners
Paul Rivlin, Deutsche Bank

Coordinators:
Karen Sieracki, KASPAR Associates
Hugh Kelly, CRE, NYU Graduate Real Estate School

International Real Estate Investment Track Record Shaky

As a well traveled principal with Soros Real Estate Partners, Richard Georgi has homes on three continents and a watch sporting 22 time zones, moderator Hugh Kelly noted at a panel presentation here during the Global Cities in an Era of Change symposium. But while entrenched in the cross-border real estate industry, Georgi cautions that the infancy of the movement and a shaky world economy make for a challenging business pursuit.

"There is a very limited track record of successful international real estate investment," said Georgi, explaining his company pitches clients on buying property in foreign markets "with great care and humility." Georgi calls the expansion of such activity "inevitable," but said Soros is treading lightly at present.

"It's a very challenging time to identify places where one can invest with conviction," Georgi said. "There's so much uncertainty and so much dampened growth prospects, it's really difficult to see where in the world there are great pockets of growth."

Georgi's remarks came during the "Cross Border Capital Flows" panel, one seeking to explore "the who, what, when, where, how and why of moving money across borders," Kelly told the audience during the three-day event at Harvard University.

Other speakers concurred that market conditions are difficult universally. Yet even as cities such as London, San Francisco and Tokyo face erosion of rental rates and vacancy increases, capital continues to chase deals, with foreign sources often displaying more optimism than domestic funds. In London, there is "dysfunctionality between the letting market and the investment markets," said panelist Karen Sieracki, of KASPAR Associates, Ltd., an expert in European real estate, who said properties in the United Kingdom continue to attract investor ardor even though leasing is off sharply. Most buying in 2002 has been from overseas, said Sieracki, a point underscored by Paul Rivlin, the managing director for Deutsche Bank in London. Rivlin noted domestic property companies are divesting assets.

"The ones you would expect to know best about what the markets have in store are significant net sellers," said Rivlin. "That says to me that buyers must be buying pretty near the top of the market."

Such overheating could lead to a pricing bubble, Rivlin and several colleagues said, with Georgi maintaining that over-aggressive capital is already driving up values in the United States. "We saw this before in 1987 to 1989, exactly the same phenomena where the underlying occupancy dynamics in the property market in the United States are actually pretty weak," Georgi said. In markets such as Jacksonville, Fla and Oklahoma City, Georgi said effective rents have fallen to zero after accounting for commissions and concessions.

"You're basically giving away the space just to cover your operating expenses," said Georgi. "That we haven't seen for a decade."

Other speakers were less dismal. Henderson Global Investors Managing Director Charles Wurtzebach said the relative stability of real estate is driving capital in that direction. Aging populations of North America, Europe, and Asia are also prompting pension funds to pursue yield through real estate to support their growing list of beneficiaries, Wurtzebach added. "I don't really believe that in the next three years there's any big crisis that's looming," he said. "When you look at the underlying economy, I think fundamentally we're in fairly decent shape."

A critical element of investing globally is having the proper approach and infrastructure, panelists also advised. Along with tax and currency issues, local culture, property rights regulations, and the varying legal systems also offer potential challenges. In one ongoing situation, Lehman Brothers is among a consortium buying the first non-performing loan pool ever in China, but after having won the bid last November, the group is still awaiting approval from the Chinese government.

Not only is the approval process unclear, panelist and Lehman Brothers principal George Von Liphart said he discovered the Chinese government has little control over the provinces, making it hard to evaluate loans secured by property outside the major cities. The same uncertainty applies in Japan, he said, where "the rules change if the results aren't to the liking of the policy makers."

"They seem to find a way of moving the goal line every period to accommodate their larger policy concerns," said Von Liphart, calling that tendency "definitely pronounced in Asia." But as long as one proceeds with caution, they should be fine, Von Liphart asserted, with Lehman a major investor in Asia. Liquidity is not a problem, Von Liphart said, noting the firm recently securitized and sold two residential portfolios and two non-performing loan pools in Thailand. "You can basically exit just about anything through the capital markets," Von Liphart said.

No matter what experience a global investor has, it is imperative to connect with a local partner, panelists stressed repeatedly. In fact, many cited it as the leading requirement when pursuing a peripatetic investment strategy, including Ivo De Wit of ING Real Estate.

ING always seeks to join a local company when entering a given region, De Wit said. In the United States, Dutch-based ING has forged a solid relationship with Clarion Partners, through which they have acquired properties throughout the country.

"Our main goal is to keep it local," said De Wit, with ING favoring firms possessing a similar culture and appetite for investment-quality properties. "It's also looking at what they can add to your own organization, what are the strengths of these organizations and which is the knowledge that they can contribute to your own organization," De Wit said.

FRIDAY, SEPTEMBER 6, 2002

THE FUTURE VISION

Panelists:

Anthony Downs, CRE, Brookings Institution
Alex Krieger, Harvard Design School
Jeremy Newsum, The Grosvenor Office
Daniel Rose, CRE, Rose Associates
Bowen "Buzz" McCoy, CRE, Buzz McCoy Associates

Can Cities Cope? 60 Million People Streaming Into Urban Areas Annually

If Brookings Institute Senior Fellow Anthony Downs is right, one product seems a surefire investment in the 21st century: bumper stickers.

"It is my opinion that congestion is an inescapable part of living in a large and growing metropolis region anywhere in the world," Downs proclaimed during the Global Cities in an Era of Change symposium. "It cannot be eliminated."

Speaking on a program segment entitled "The Future Vision," Downs and other planning and real estate experts closed out the conference offering views of how cities will be cast in the new millennium, identifying challenges ahead and steps communities can take to ensure a place in the global economy. Other speakers included Harvard Urban Planning and Design chairman Alex Krieger, international real estate investor Jeremy Newsum of The Grosvenor Office of London, and U.S. real estate icon Daniel Rose, of Rose Associates in New York, who ended the program with a stirring defense of the modern city.

Downs warned that globalization will lead to an endless stream of automobiles, trucks and buses, fueled partly by humankind's thirst for self-mobility, and compounded by urban sprawl creeping endlessly outward. Political and fiscal pressures will make sufficient roadways and alternative transit options unattainable, said Downs, with the condition so acute that private toll roads may become an increasing, albeit inadequate, reality.

Author of the 1992 tome *Stuck in Traffic*, Downs said the inventory of vehicles has accelerated faster in percentage terms than the population. Between 1980 and 2000, total vehicle count rose from 380 million to 752 million, accounting for a compound annual growth rate of 3.5%. The human population in that time increased by 1.6 billion, or a compound annual rate of 1.6%. Although the United States continues to dominate in vehicle usage, Downs predicted the problem will worsen in developing countries, many of which lack the infrastructure to meet the rising tide of tailgaters.

Program moderator Bowen "Buzz" McCoy, CRE, of Buzz McCoy Associates in Los Angeles, seconded Downs's view that the third world is ill-equipped to handle the automotive age, and doing little to prepare for it, citing a China trip where he saw massive skyscrapers being developed with only a few dozen parking spaces. "They are building for the bicycle economy, and the buildings are going to still be there when they all have cars," Bowen said. "What's going to happen then, God only knows."

Public transportation is not the answer, said Downs, with usage actually tracking downward. In the U.S., only 4.7% of the working population takes public transit, and Downs said that figure drops to 3.5% when one factors out New York City, where 30% of the nation's transit riding occurs. "Congestion will happen no matter what anti-congestion tactics are adopted because of the rising population and rising incomes in all cities," Downs said. "Get used to driving in congestion."

But automobile use will not be the only excess global cities must cope with, Krieger advised in his remarks. The sheer expansion of the urban jungle puts into question how the world will be able to handle such concentrations, said Krieger, with 60 million people streaming into cities annually, representing a 20-fold increase of urban dwellers in less than a century. By 2050, there will be five billion people in cities, Krieger said. "The numbers are so extreme, they are hard to penetrate," he said, noting that in eight years, London will not be in the top 30 cities in population.

"That's just astounding," said Krieger, warning it is critical for planners and public officials to prepare for the onslaught and solve issues such as sharing limited resources, providing adequate housing and caring for an aging population.

As a global traveler working for private real estate investor Grosvenor, Newsum offered opinions on cities he enjoys and the elements critical to success. Most importantly, Newsum said, are intangibles that give a metropolis influence on other areas, both at home and internationally. While each city has the typical matrix of trade, education and work opportunities, Newsum maintained that "cities need to be emotional places" to stand out.

"You can examine statistics to the Nth degree, but still not get at the essence of what a city really is," Newsum said. "In the end, I do believe they need a heart and a soul and a character."

Equally impassioned for the city model was developer Daniel Rose, chairman of New York-based Rose Associates and member of The Counselors of Real Estate (CRE). Rose disputed theories that terrorism and other fears are diminishing the role of cities, assailing the notion that wealth and influence are abandoning urban centers en masse. Rose also derided opinions that technology will lead to decentralization.

"We have to take the negative forecasts of our social scientists with a grain of salt," said Rose, countering one quote offered earlier in the program from Herodutus that "human prosperity does not abide long in the same place" with his own from Aristotle that states "men first come to the city for safety. They stay on to earn a living and settle there permanently to live the good life."

"I think there always will be those of us who choose to live the good life in London, in Paris, in New York, and those of us are the ones to whom I would like to think the conference has addressed," said Rose, adding he believes Aristotle was "smarter and more accurate" than Herodotus.

Bowen H. "Buzz" McCoy, CRE

THE COMMENTATOR'S PERSPECTIVE: GLOBAL CITIES IN AN ERA OF CHANGE

On September 4-6, 2002, an international real estate symposium on the subject "Global Cities In An Era of Change" was held at Harvard University. The purpose of the symposium was to create a broad understanding of the urban landscape and the factors that impact it. It was co-sponsored by the Harvard Design School, The Counselors of Real Estate and The Royal Institution of Chartered Surveyors. There were approximately 150 attendees, including some thirty speakers or panelists. This article is an attempt to summarize the proceedings for those unable to attend.

THE GLOBAL CITY TODAY

Panelists reflected upon the homogenization of building design and culture which has caused the loss of local character of cities in general. Measures which might be utilized to gauge the quality of a city would include population, quality of life, economic power, commuter time and the cost of production. Cities have become places where complex work is accomplished face to face, while the suburbs have become the places where dispersed intellectual work is accomplished. There are huge price differentials among cities in terms of rents and wages. Environmental quality will be a major determinant of the success of cities in the future. Global warming could cause massive changes in coastal global cities.

Other factors impacting the future of cities include demographics and the ability to attract capital. In future years some 30% of Japan's population will be over 65, while only 10% of the U.S. population will be of that age. In Third World cities, the population is even younger. Major factors contributing to the ability to attract capital include the rule of law, transparency and trust. In order to attract capital, a city must align its processes for decision making with those of the capital sources. Capital controls the process; they must "think like us." This increasing globalization of capital also adds to the "McDonaldization" of global cities. It is also important for a global city to be a transportation hub.

There is an increasing imbalance between economic vision and social vision. Aspiring individuals in Third World countries wish their children to be educated at universities in the United States, but they resent our culture.

As a result of the impact of broadband and wireless communications, we can now speak of "intelligent cities." 21st century cities become strategic nodes, talking with one another. The gap between the haves and the have-nots widens. An integrated world economy leaves out 80% of the people. In a few years there will be 35 cities with over 10 million population. How do we deal with the "unintelligent cities"? How do we deal with the anger and resentment of those outside the global system? There will be an even greater need for broad access to good education.

Another issue is the overlapping government bodies which constitute a city. Global cities range from virtual city-states to sprawling urban areas with a multitude of overlapping government bodies and a weak central government.

REFLECTIVE PRACTITIONERS

A panel was constituted by Dame Judith Mayhew, policy director of the City of London, Governor Ed Rendell of Pennsylvania, and Peter Hall of a public-private development venture in San Diego. Dame Judith had just returned from the United Nations conclave on growth and the environment held in Johannesburg, South Africa. That group adopted the City of London principles of sustained finance and development. The "London Plan" deals with the realities of an "intelligent city" and a Third World city co-existing in the same space. Some 29% of the inhabitants of London live below the poverty line, and thus must deal with the needs of the "intelligent" as well as the needs of poverty.

The "London Plan" includes comprehensive and coordinated measures designed to deal with the issues of transportation, urban in-fill, public-private partnerships, volunteerism, education, health, social services, crime, affordable housing and a jobs-housing balance, with nodes of development activity.

Governor Rendell attributed his success in Philadelphia to the following: One must have a regional approach, including support from the state and Federal governments; an ability to work with both political parties in the name of good government; a view of the city as a place for celebration; a focus and prioritization on those areas which make a city great; a competitive development mentality to attract positive new business, including having available well located, entitled, cleared sites for development; an open communication with business; a recognition that cities must bear the heaviest social costs in America and a focus on education.

Peter Hall attributed San Diego's success to providing single stop shopping for developers, combined with a focus on which businesses to attract and a well orchestrated planning process. He emphasized the conflicts arising from the differing cycles for development and elections.

As is often the case, the ideas of the practitioners were deceptively simple. The elegance is in the execution.

HARVARD'S PRESIDENT: LAWRENCE SUMMERS

The president of Harvard University honored us with an after luncheon address. He emphasized the importance of economic geography and urban economics as intellectual inputs, as well as the enduring nature of concentration in specialized places. President Summers discussed the acquisition by Harvard of substantial lands adjacent to the present campus, which will result in a doubling of the academic area, thus emphasizing Harvard's keen interest in urban economics. He expressed concern about the ongoing migration into Third World cities with their teeming slums. He predicted low global inflation and surplus capital for the next decade, resulting in lower interest rates and economic stability. He noted that high productivity results in poor pricing power.

In response to a query, president Summers stated that he questions whether real estate will become a separate academic discipline. To do so would require the notion that real estate has separate analytical tools, methodology and distinctive research separate from finance or geography. He stated it is more likely that real estate will remain a "subject," similar to manufacturing or tourism. A commentator noted the paradox between the desire to link real estate into the capital market asset allocation investment decision process with total transparency and the desire to have real estate as a separate academic discipline.

ECONOMIC FORCES

This panel raised the issue of why one would or would not invest in a particular city. Statistical data were presented concerning over 500 business relocation decisions and which cities were chosen. Primary issues bearing on the decision included rule of law, property rights, tenant rights, enforceability of the law, costs, "intelligent" infrastructure, stability, transportation logistics, quality of life, educated workforce, and capital availability.

Significant discussion occurred concerning doing business in places like Russia and China, where one has to know one's partner and develop a sense of trust. Often the rules are not known, or made known, by the local partner. Often the local partner is attempting to recycle flight capital. The agendas may be completely different.

THE FABRIC OF CITIES

In order to provide a sustainable environment for both the business and the host city, the business must become committed to environmental management, employee volunteering, community outreach and corporate philanthropy. There must exist an explicit or implicit public-private partnership.

An effective explicit public-private partnership requires a measurable budget for sustainable development. Such a public-private budget balances the needs for economic growth, environmental management, and social responsibility. Each side must agree upon the resources that they will contribute to the budget. One should not speak of trade-offs between economic growth and social costs, but of a balanced budget which sustains both.

A panelist attempted valiantly to describe the impact of major research universities on urban growth, utilizing the Massachusetts Institute of Technology's spawning of a bio-tech industry within its environs as an example.

JOEL KOTKIN, PEPPERDINE UNIVERSITY

As a panelist Mr. Kotkin described the traditional role of cities. Many cities are sacred in their origins. They create a perception of safety, often contained by protective walls. They are busy places, filled with celebrations. They create a "casbah economy" filled with various markets. A major problem with current cities is that the upwardly mobile immigrants move out. To sustain cities on a positive scale, the educated middle class must be attracted back in.

It is difficult to judge what makes such a symposium a success. The issues are often too ephemeral and complex for an individual to deal with. If each of the 150 participants were to become motivated by the event to become engaged in their own city, the symposium might be termed a success.

Mr. Kotkin also served as an after dinner speaker. His negative predictions as to the future of the global city awakened the participants to spirited rejoinders. Mr. Kotkin stated that several global cities are not intelligently located. The rising masses of under educated from the Third World will end urbanism as we know it. Terrorism undermines insurance, and thus the ability to finance cities. The elites are moving out of cities or into protected nodes in the few "intelligent" cities.

CROSS BORDER CAPITAL FLOWS

This panel discussed the state of the global real estate capital markets. It was emphasized that there is no such thing as a global real estate industry, but rather a series of local markets, each of which requires local partners and specialized knowledge. Real estate is above all local in nature. Real estate capital is a residual to the corporate capital markets. Capital will always flow into the higher return businesses. Over the next few years, real estate is perceived as offering positive returns on a risk adjusted basis, with good cash flow.

European investors do not see the need for foreign capital, although they seem to have plenty of it. Japan appears to be shutting down the market to foreigners through restrictive rules and regulations. The U.S. market is more disrupted than meets the eye. In certain cities, net effective rents are close to zero, after taking into account tenant improvements, free rent, commissions, and the like.

THE FUTURE VISION

The final panel attempted to bring the symposium to a close with a vision for the future. The problem of low density and long commutation times will be resolved by congestion. Congestion can be seen as a balancing mechanism. When it becomes intolerable, NIMBYs (not in my backyard) finally begin to relax and allow for higher densities. The only other solution is to travel with a CD player, a cup of coffee and a highly attractive seat mate.

We are currently urbanizing at the rate of 60 million persons a year. Urban areas will grow twenty fold in a single century. The average U.S. person requires 10 acres to sustain life; in the Third World it is a single acre per person. We each throw away 28 pounds of garbage a week. The solutions are to conserve the places we have already made, rather than building new places, and helping the poor to become rich.

Great cities have a soul. They are great markets, centers of learning and centers of entertainment. In England certain residential developments have lasted for hundreds of years. They tend to be nonlinear and surrounded by greenbelts. Two major threats to cities are the cost of housing and the threat of rising seas.

Neo-Malthusians have been nay-sayers forever. A hundred years ago the maintenance of enough horses was seen as the limiting factor in the growth of cities. What is required is leadership, entrepreneurship, volunteerism, and education.

A commentator mentioned two books. In *The Mystery of Wealth,* Third World economist Hernando De Soto makes the point that the Third World has substantial wealth. It just cannot be unlocked. This is so because there is no perfected title or deeds which can be financed or traded; no street addresses; no incorporated businesses and the like. Thus much of the Third World capital is dead. The way to make it alive and productive is through education. Robert Kaplan in *An Empire Wilderness* makes the same point about cities in the United States, choosing East St. Louis as an example. In these areas there are no deeds, no records, no energy, and no vision, much as in the Third World.

In many of our cities, such as New York, London, Chicago, Lisbon, Dallas Shanghai, and Los Angeles, we have co-mingled "intelligent" cities with Third World cities. The problems appear insurmountable. What can any single individual do? One example is that several of the panelists volunteer in their own cities with the disadvantaged in mentoring programs, to assist them in their education. Financial aid is always important, but far more important is one-on-one personal contact and mentoring. In the case of some "saved" children, the mentor has put in a ten-year commitment to assist the child. There are obviously a wide variety of ways in which individual symposium attendees can become involved in their cities in a pro-active manner.

It is difficult to judge what makes such a symposium a success. The issues are often too ephemeral and complex for an individual to deal with. If each of the 150 participants were to become motivated by the event to become engaged in their own city, the symposium might be termed a success.

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Daniel Rose, CRE

SERVICING THE GLOBAL CITY

By Daniel Rose, CRE

Remarks from the Global Cities Symposium
Harvard University, September 6, 2002

"Necessary but not sufficient" is how the relationship between oxygen and fire is often described, and the characteristics of great global cities fall into the same category.

Those cities are centers favorable for the international exchange of capital, ideas, goods, and people, and for the generation of economic value out of ideas. They nurture the communication and information technology that financial networks rely on; they reward high risk investments with even higher returns; and they attract the people that make the system work.

In an age of wondrous electronic communication, easy national and international travel, and remarkable professional mobility, middle and upper middle class populations that bring dynamism to a city and relate well to the world economy can live wherever they choose to live. And where those bright, educated, creative, and dynamic types choose to live and work greatly affects what takes place there, global networking included.

Experience has demonstrated that those who can, shun threats to their physical safety and avoid political jurisdictions with high local taxes and poor services. On the other hand, they are attracted to cities with good transportation facilities, with welcoming public spaces and social peace and, above all, with recreational and cultural activities that come under the heading of "quality of life."

With appropriate infrastructure, an educated population for support, and with an encouraging political climate, a critical mass of talented people will soon assemble. The stage is then set for an agglomeration of highly specialized legal, accounting, high-tech communication, consulting, advertising, forecasting, engineering, and other services which international financial centers require today.

Rudolph Giuliani's dramatic success in lowering crime rates and business taxes did not create the New York business boom of the '90s but it permitted it to land there rather than somewhere else.

Those cities which have followed his lead have benefited accordingly. Taking seriously small crimes ("the broken window" syndrome) and carefully analyzing current crime data (the Compstat program) really do pay off, and we now know that lowering taxes can indeed increase revenues.

Good retail outlets, good heath care facilities and a wide choice of housing are desirable; but in a free market economy, well-to-do populations can outbid others for choice housing; they can afford private doctors for what ails them; and they can purchase whatever goods they wish.

Good education should ideally be a universal free good; but sadly it isn't.

The widespread failure of public education is the greatest tragedy in American life today, not only for global city types but for all those who cannot afford private schooling.

The favorable experience of the nation's parochial schools with the same inner-city students failing in the public schools (and at a fraction of the per capita cost, too!) indicates that the solution lies in reversal of educational and social policies that our public refuses to recognize; but that can change.

Perhaps the day will return when New York's public schools again produce literate and numerate graduates and when our public colleges again produce Nobel Prize winners, as they did between the two World Wars.

For now, education is our greatest governmental failure; and New York's global workforce will tend to attract single or childless individuals and those who live in the suburbs or who can afford private schooling.

In other matters, Adam Smith's "invisible hand" will, if permitted, soon fill—for those who can afford it—whatever needs government does not. And we free market entrepreneurial types are the fingers of that "invisible hand."

The global city of tomorrow will have the gravitational pull to attract those with the skills and talents, education and mindset, that the cutting edge activities of our time demand; and human capital is acknowledged today as important as financial capital.

To perform successfully, we must understand, and anticipate and fill the needs of sophisticated clients with complex requirements.

If Tokyo is an exporter of capital, and London a processor of capital, and New York an importer and provider of services for capital, their agents must be in efficient contact. If Kuala Lumpur is an important market for financial futures and Singapore for currency trading (and they are), their agents must be in contact with colleagues in New York and London, Tokyo and Paris, Frankfurt and Boston.

In many types of financial activity, cooperation rather than competition is the order of the day and linkage rather than isolation is the goal. Cities may compete, but today individual firms often cooperate.

And we, the entrepreneurs, must help the global city participants meet their needs and at a charge to them greater than our cost. While they are involved in market-making, underwriting, mergers and acquisitions, risk management, and so forth, we supply the platform on which they operate.

We must provide them with physical premises, the varied services they rely on and a context in which they can operate successfully—for their benefit, for ours, and for that of the cities in which they operate. And we must work to make our respective cities more receptive to those business and professional activities.

For the urban generation of the 1960s to the 1990s, business was seen as a "cash cow" whose taxes paid for government-supplied social services for the urban poor; today, business more often is seen as the provider of jobs that permit people to earn incomes which enable them to take care of themselves.

In the previous generation, demagogic, or misguided politicians applied municipal revenues to subsidize short-term consumption rather than long-term investment; the clearest examples are New York's decision to "save the five cent fare" at the expense of building the Second Avenue subway or trading the benefits of the remarkable underground highway and river front park system called Westway for subway operating subsidies. Today, at long last, capital investment in infrastructure is back on the agenda.

Healthy cities today are seen not so much as vehicles for wealth transfer as for wealth creation, not so much as donors to those on the bottom as catalysts of upward mobility for immigrants and others, not so much as the home of static business activities as the incubator of new business enterprises, new ideas, new cultural forms that flourish in this new world of privatization, deregulation, and digitalization.

Although the first stage of the high-tech revolution took place in the shadow of universities, the next, explosive stage (designing software content and so forth), is taking place in the creative sections of dynamic cities, often in the recycled manufacturing premises of a previous economic cycle. It is not surprising to find that in New York, for example, the massive old Lehigh-Starrett freight warehouse is today the address of choice for cutting edge new-media companies.

Cities like Detroit or Philadelphia (before Governor Ed Rendell served as mayor), which imposed punitive taxes to support swollen public payrolls or which regarded their police departments as "part of the safety problem, not as a solution," witnessed painful economic and demographic decline in the same time frame in which cities like New York, which think and act differently, have flourished.

In America today, the beleaguered city of Cincinnati looks with wonder at nearby Indianapolis; sophisticates in Detroit are painfully aware of the positive developments in Cleveland, and the word is spreading. In Europe, everyone is aware of the exciting resurgence of Spain's Barcelona and of the fierce problems of Manchester, England. Copenhagen's triumph of the pedestrian over the automobile is well known, and Bilbao, whose Frank Gehry museum brought to the city in its first three years over $500 million in economic activity and over $100 million in new taxes (which recouped its cost), is there for all to see.

In New York, the quintessential global city, the combined impact of the World Trade Center disaster and (God willing) the 2012 Olympics could lead to changes making New York the world's first truly 21st century metropolis. Once we dismiss the equally ill-advised ideas of restoring exactly what was destroyed or of creating a 16-acre cemetery, something wonderful can emerge.

Thoughtful observers understand that Lower Manhattan has always had a relatively poor transportation network compared to that of midtown. We now have an opportunity to make the area a mass transit dream come true. Federally-funded improvement in mass transit will be the catalyst for the whole redevelopment effort, which can turn a former white-collar ghetto into a 24-hour, seven-day mixed-use paradise with office, housing, retail, hospitality, recreational, and cultural facilities in proper balance.

An appropriate memorial for the World Trade Center site is a sensitive subject because wounds are still raw and an unemotional exchange of views is not yet possible. Newly-bereaved families have little interest in the long-term aspects of urban design or regional planning, and significant time should pass before important irrevocable judgments are made.

The memorial models most often suggested are Oklahoma City, Pearl Harbor, Hiroshima, and the Vietnam Memorial in Washington, DC, the first conveying a deep sense of sadness, the second one of serenity, the third of the need for education, and the last of remembrance.

I believe the ideal model is Pericles' brilliant rebuilding of the Athenian Acropolis after its destruction by the Persian King Xerxes in 480 BC, since the Greek goal was both to remember and to create, to memorialize and to move forward. But even the Greeks let the idea simmer for a number of years.

Incidentally, even the biblical books of Noah, Daniel, and Job all end on an upbeat note, and it would be wonderful if the World Trade Center story could, too.

If New York does get Olympic approval, long overdue mass transit to our airports will be spurred, our 600 miles of under-utilized waterfronts will be activated, new housing for the Olympic athletes would be a lasting legacy for our under-housed middle class, and (even at a billion dollars a mile) a subway connection to midtown from an expanded Javits Convention Center and a major new athletic stadium would make sense. The eventual tax revenues from the redeveloped present wasteland would make the capital cost a good investment.

Cities like Atlanta have largely wasted their opportunities; but Barcelona showed how Olympic planning can take a city in the direction it wanted to go in creating a setting where civilized people can lead a satisfying and fulfilling life. The Olympic impact on New York would be exciting, and would make it even more attractive to global networking types.

The global city of tomorrow will have the gravitational pull to attract those with the skills and talents, education, and mindset that the cutting edge activities of our time demand; and human capital is acknowledged today as important as financial capital.

Local and regional populations will benefit, too, from having access to the urban strengths that create a global city.

Obviously, not all benefit equally, and in global cities worldwide we are witnessing increasing polarization of income and of wealth; and the ramifications of these great disparities are complex.

Precise calculation of costs and benefits is difficult in a setting in which manufacturing jobs evaporate, in which heavy foreign immigration clouds the statistical picture, and in which the benefits of formal education and appropriate credentials are crucial, and where their absence puts the uneducated and uncredentialed at a severe handicap.

Someday we will understand that the crucial question is not why some are poor but rather why some are not; and we should reflect on the role of education in the difference.

But make no mistake—the poor in a global city do not benefit if stockbrokers lose their jobs or if tax accountants or corporate lawyers move away. And we should ask if a Third World country is, or is not, better off if a First World country locates a manufacturing plant there.

This week's headlines proclaimed that fully one-third of the youngsters in the State of Washington will drop out before completing high school. Perhaps the protesters against globalization in Seattle last year should have focused their attention on public education instead. Indeed, improved education for women in the Third World is perhaps the single most important immediate goal well-intentioned groups should fight for.

The wealth creation of a global society is a positive, not a negative sum game; and everyone benefits to some extent.

Our challenge is to stimulate such wealth creation and also to spread its benefits widely.

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David S. Kirk, CRE

GLOBAL CITIES IN AN ERA OF CHANGE, A COMMENTARY

By David S. Kirk, CRE

I wanted to fast-forward technology and globalization trends and start to understand what these trends meant for me, for Boston. Was I still in a world-class city, and was I ever in one? I was looking for take-home that might serve me later rather than sooner but I was looking for some answers and some stimulating thinking from persons that typically were not accessible to me. Alex Kreiger, chairman of Urban Planning and Design at the Harvard Design School, obliged by remarking in the closing session that by 2050, there will be 5 billion people in cities and in eight years London will not be in the top 30 cities in population. And in between, the panelists and attendees fulfilled the promise and delivered surprises as well.

The Research Directors' panel started the deliberations with a matrix exercise which shared current ongoing efforts to characterize the global cities for the institutional investor. The threshold requirements of legal framework, political endorsement, cultural acceptance for real estate enterprise were added to geographic, economic, and demographic measurements. The related risk assessments were illuminated by the trench men on the Capital Flows panel on the second day. The roster included key acquisition/investor representatives from institutions: Lehman, Soros, Deutsche Bank, UBS Warburg, AIG, Henderson Global. Dubai of the United Arab Emirates and Berlin are on the radar screen and Brazil and Argentina are still considered prime real estate markets for well-timed investments. Ken O'Gara from PepsiCo and Lee Timmins of Gerald Hines Interests demonstrated the risk range by describing how the multinationals follow their markets, and how the international developer is more selective. Richard Georgi of Soros spoke for the group when he acknowledged that, "There is a very limited track record of successful international real estate investment," and admitted his firm pitched international investing "with great care and humility."

The pre-conference MIT tour led by Peter Lewis, CRE, showcased recent decades of campus development and investment, world-class in all respects. Along with an inside look at new Millennium Pharmaceutical biotechnology facilities joint ventured with Forest City, the tour included the multimillion-dollar real estate portfolio in biotech now controlled by MIT and the ever expanding campus facilities. Followed by a leisurely walk in Harvard Yard, participants were well prepared for Harvard President Lawrence Summers' informal remarks about his high priority job of promoting Boston as a global city and leading Harvard's future planning agenda. With Harvard as the only American urban university with a substantial capacity to expand (over 200 acres cross the Charles River in Boston), Summers articulated his personal feelings about humanity continuing to need a place to gather and its relevance in the new economy as well as old economy.

For political reality, former Philadelphia Mayor and now Pennsylvania Governor Ed Rendell, San Diego's planner Peter Hall and London's planner/manager Dame Judith Mayhew added some practical experience and visionary commentary. The keys to global cities in an era of change are education and public/private partnerships for stability and growth, themes echoed by global institutional investors later in the program. All three of these urban veterans were well moderated by Kennedy School Nick Retsinas and had war stories and dilemmas to relate and the focus was delightfully laser-like for this real estate crowd.

Joel Kotkin of Pepperdine University and author of *The New Geography* (Random House, 2000) was a panelist and keynote speaker and did not disappoint. Terrorism and other urban ills like the poor education and training for the next generation of unskilled, poor, and immigrant/migrant populations, will reinforce a tendency to decentralize and strengthen some new patterns of growth and decline among American cities. Dame Mayhew refuted Kotkin vigorously recounting Europeans' coping with terrorism for decades. Kotkin quoted Greek historian Herodotus, "Human prosperity does not abide long in the same place." Dan Rose, CRE of Rose Associates (New York, Boston, and Washington, DC) preferred Aristotle," Men first come for safety; they stay to earn a living; and they remain to enjoy the good life."

Anthony Downs, CRE, currently updating his 1992 book entitled *Stuck in Traffic* in which he counts cars and people, concluded we are not making progress in reducing congestion with mass transit or otherwise. His hope for emerging global cities in this battle was dimmer even still. Dan Rose, CRE, ended his visionary commentary on the last day with, "But, there will always be some of us attached to the dynamism, the vibrancy, the excitement and the stimulus of great cities." Jeremy Newsum of London-based Grosvenor Properties and a resident of Cambridge, England echoed the frequently mentioned threshold essentials of trade, work opportunities and education, and, like several participants, sought to recognize the human and emotional elements of soul, heart, passion which challenge measurement.

Rather than just a random romp with Dubai, Abu Dhabi, Berlin, Istanbul, Singapore, Buenos Aires, Amsterdam, and Moscow compared with London, New York, Tokyo and Paris, "Global Cities in an Era of Change" was an effort to capture the trajectory of technology and globalization, telecommunications, and diversity, and see what might survive and what might emerge and what might not. Education's role was spotlighted by many with Cambridge, England and Cambridge, Ma, receiving noted attention. Boston may not be a global city by all definitions but it certainly has many of the durable qualities that will make it a survivor and education is among them.

David Kirk, CRE, *is principal and founder of Kirk & Company, Real Estate Counselors of Boston, MA specializing in real estate valuation and investment counseling for institutional investors.*

Dame Judith Mayhew

STRATEGIES FOR MANAGING URBAN GROWTH AND REVITALISATION

By Dame Judith Mayhew

Remarks from the Global Cities Symposium, Harvard University, September 5, 2002

Thank you so much for inviting me to take part in this important seminar. It's great to have the opportunity to visit this eminent centre of learning and intellect at Harvard too. I have come here directly from attending the World Summit on Sustainable Development in Johannesburg. There I was one of a mere 65,000 delegates.

But I was privileged to address the audience at both the NGO day and the Business day on the London Principles of Sustainable Finance. This subject, which is an important part of sustainable development, certainly has considerable relevance to what we are all discussing here.

As Chairman of the Policy & Resources Committee of the Corporation of London, I am the Leader of the municipal authority for the district known as the City of London, the largest international financial centre in the world today.

I am also the financial and business advisor to the separate Mayor of London. He directs the strategic governance of Greater London, particularly in areas like economic development, urban planning, transport, and the environment.

LONDON TODAY AND THE LONDON PLAN

I would like to start this address with a brief look at the London of today. For it is a city at the forefront of technology and communications. It is the world's largest international financial and business centre. It has one of the most cosmopolitan populations in the world. Three-hundred and seven languages are spoken there daily, and there are sizeable resident communities from over 90 countries with a richness of culture, diversity, and experience from all around the world.

For many of these people, London is "the place to be." London is an attractive place in which to live and work.

But, like any major city, London is far more than the sum of its parts. Central London is a unique mix of cultures, people, and experiences. It is this blend that provides the critical mass of the city; it is this blend which draws people to London in ever increasing numbers.

London is also rich in amenities and boasts some of the best museums, libraries, and archives in the world, dating back many hundreds of years. And London itself boasts a rich heritage in architecture and resources.

Aside from its heritage, London today is the centre of the most international financial markets in the world. This financial industry is clustered together in a small area, thus creating considerable business efficiency.

This is complimented by a large presence of companies involved in supporting services such as accountancy, law, surveying and all forms of consultancy.

But it is not just in financial services that London is a leader. It is a major centre for the creative industries and a major hub for news, media, and broadcasting—international as well as British.

The presence of a vibrant property market with a large supply of international investors and developers allows the continuous renewal of office stock to the latest technical and environmental standards.

London is therefore a complex economy, with ever-changing patterns of economic activity and growth. Over the past decades, London has been an immense success story, and it has grown in economic, social and cosmopolitan terms as a consequence. It has a power and an influence far beyond the borders of the European Union.

But one must also add a dark side to London. Despite its great wealth and economic power, 29% of its households are below the poverty threshold. Child poverty stands at the distressing level of 43%. Some neighbourhoods experience a high level of crime.

But, like any major city, London is far more than the sum of its parts. Central London is a unique mix of cultures, people and experiences. It is this blend that provides the critical mass of the city; it is this blend which draws people to London in ever increasing numbers.

There are also areas that have a very high rate of unemployment—11% in the Borough of Haringey. And their residents suffer more health problems than those in more affluent places do.

There is also huge pressure on land both for business and housing. This has pushed up house prices to incredibly high levels whilst leaving some areas more deprived than ever.

The presence of talent alongside considerable poverty comes with a price. This has created strains that are now in need of resolution.

The Mayor of London is therefore in the midst of getting agreement for The London Plan. This is a new spatial development strategy for Greater London for the next 20 years. It is simply London's way of managing urban growth and revitalisation.

WHAT IS DRIVING GROWTH?

But before I discuss the London solution, I would like to say a few words about what the drivers are of this remarkable growth.

The first one is undoubtedly the financial and business centre in the City of London. The City is Europe's leading financial centre and the international financial centre. It differs from New York in that it deals in international finance and advice. The huge domestic market here largely sustains New York.

All the biggest international banks and financial institutions operate from London. Indeed many of them manage their entire overseas operations from there.

The presence of all these banks attract a very high quality workforce from all over the world. Financial services, particularly in areas like corporate finance are intellectually demanding and need the very best brains and the best managers.

Moreover international financial services are an expanding industry. Over the next 15 years they are expected to grow by 1.75% per annum. Employment in the industry will also grow in line with this.

Another significant driver of growth is population. London's population has increased by almost 600,000 since 1989. This is the equivalent of a medium sized city. We predict that this will continue to grow by a further 700,000, reaching 8.1 million by 2016.

Such a rapidly growing city just cannot function on the present resources. For instance, this increase in population will require a further 130 schools—with teachers.

A third driver is the need for new jobs to match this population growth. The continued expansion of financial services, as well as tourism, the creative industries and other service sectors will of course provide the bulk of these. By 2016 we estimate there will be more than 600,000 new jobs in London. Financial services alone will provide 140,000 of these.

And lastly I come to the increasing use of sophisticated technology, both in the office and in the home. London has a very high level of connectivity and is at the core of the global networks. E-tailing, E-commerce, and E-government will therefore impact on every aspect of life. Technology is also particularly important in financial and business services—which is in many ways the principal driver of change and innovation.

Technology, in its wake, brings the need for greater skills and the ability to use the information. That in itself places heavy demands on training and educational facilities.

PLANNING FOR THE FUTURE

In planning the strategy for this growth and revitalisation there is one overriding necessity. That is to preserve and sustain the centre of London. This is the great wealth-producing area. This is where the economic clusters are—be they financial and business services or creative industries.

It would be quite counterproductive if in the course of our future strategy we dispersed these industries around outer London and relied on telecommunications and public transport. For as I said earlier the economic cluster does bring real benefit. We need to foster that.

One of the characteristics of London is that it suffers from a shortage of land. It is not at all densely populated, like New York is. We also wish to preserve our green belt and so prevent London from expanding ever outwards.

London's density is 4,554 people per square kilometre, although there are a few small select areas of over 19,000. Paris on the other hand is 20,000 per square kilometre—and it does not have tower blocks.

So there is considerable scope in London for higher density development, as well as development of the so-called brownfield sites—derelict industrial land.

There is a huge brownfield area in east London—the Thames Gateway, as well as selected areas nearer the centre, that will support both high-density housing and industry to provide jobs for those who live there.

In the financial and business centre in the centre of London, there are also demands from international business for tower blocks. Not huge ones such as you have here in the United States, but smaller buildings up to 50 floors and perhaps one million square feet in size. These blocks can also increase density considerably.

Unsurprisingly international companies demand buildings—be they tower blocks or campus-style complexes, to the highest international standards. And so that is what we have got to build.

In the City, the Corporation of London also goes to great lengths to ensure that there are good out of office facilities as well. By that I mean restaurants, bar and shops.

Another area important to redevelopment is public transport—especially railways, or what you in the United States call railroads. In London public transport also embraces our Underground, or metro system, as well as the very extensive bus network.

At present the network to the centre is comprehensive, but hopelessly overcrowded. One million people commute daily into the centre of London, 320,000 of them into the financial centre.

But elsewhere it is not so good. London's transport system is highly radial, in and out to the centre from the suburbs. Intra-suburban and orbital traffic is left to buses, operating on congested roads.

This restricts the ability of people in outer London to get jobs away from where they live, or in an area where transport links are bad. The improvement of this is an important priority. And in doing it we need to take in to account three points.

> Firstly, transport must be integrated with new development. This means new transport links must be constructed to any large brownfield development, such as east London.
>
> Secondly, transport capacity must be matched with development. In other words do not construct the new development before the transport systems are ready.
>
> And thirdly, adequate land must be set aside for transport requirements—and terminals and feeder routes must also be in the right place.

The presence of public transport is directly related to the level of unemployment and to productivity. And this particularly applies to the poorer, run down areas that are in need of regeneration [revitalisation].

New transport links allow people to travel to work away from where they live. They also assist in bringing new industry to an area. Both these rapidly increase the wealth in the area. This in turn bring extra benefits such as better health, less reliance on social services and a lower crime rate.

And these so-called 'soft' issues bring me on to the things that make life bearable for residents and business alike. And again this is an area that is receiving much attention in the London Plan.

These issues also include the provision of good educational facilities. And these will be particularly important with London's rising population and the continuing march of technology.

With this goes the provision of the teachers for those schools. For along with policemen, municipal workers, nurses, and other essential workers these people often cannot afford to buy homes in the inner city where they may work.

The answer for London is the construction of what we are calling affordable housing for them. Latest projections for London indicate that we will need 23,000 additional homes every year; 10,000 of these would be affordable. And that entails an investment of some £6 billion [$9.3 billion].

SUSTAINABILITY

Overarching all these issues, hard and soft, is the need for sustainability.

This is a key question currently facing the planners of all big cities, none more so than London. As I have outlined, London is experiencing considerable pressures owing to huge growth—we need to work out how to tackle the problems of success.

First of all, this means that we must run them more efficiently. This can be done by utilising improved public transport; as well as by cutting down on the numbers of cars in the centre.

It is also essential to decrease the amount of waste, domestic as well as industrial.

Thirdly, energy efficiency must be promoted through more efficient buildings and sources of natural power.

Sustainable cities are a modern necessity. And we all need to work hard to make them a reality.

CONCLUSIONS

In conclusion may I say that, like many large cities, London is suffering from the problems of success. But it also has areas of poverty and unemployment. These must be alleviated.

London's very attraction means that new businesses, new industries; new public facilities and new jobs must continually be generated.

At the same time it will be absolutely essential that the provider of the greatest wealth, the financial centre of the City of London, be upheld into the future.

But the one area that will have to receive particular attention and funding is that of public transport. It is the key to regeneration and revitalisation in any city and any economy.

ABOUT THE AUTHOR

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Hugh F. Kelly, CRE

FOCUS ON THE ECONOMY

"With a Little Help From Our Friends"

by Hugh F. Kelly, CRE

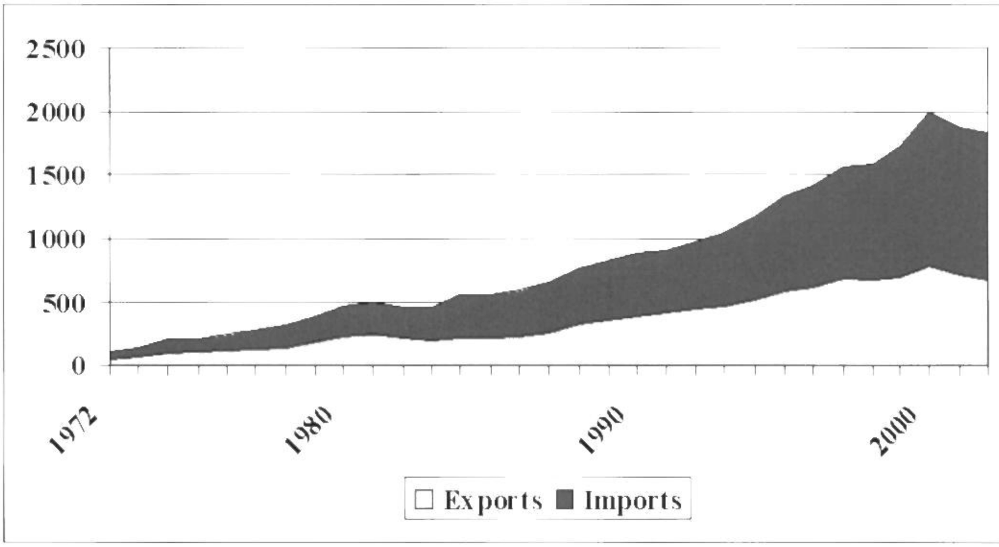
The previous three columns in this series looked at the contribution of the consumer, government, and private investment to the growth of the U.S. economy. There is one other very important element to consider, and that is the relation of the domestic economy to the rest of the world. As globalization has become more and more of a force during the past two decades, the linkages between nations has become tighter and, for good or ill, it is virtually impossible to separate any local economy—even down to the level of individual cities—from trends that are afoot on the far side of the world.

Of course, it is quite apposite to treat this subject in an edition of *Real Estate Issues* that is devoted to Global Cities in an Era of Change. Americans are so used to the international influence in the economy that it is almost totally transparent. We grew up with Bayer aspirin. We drive Toyotas or BMWs. We watched Monty Python on our Sony TVs. We've gotten used to eating Chiquita bananas and other tropical fruit on a year-round basis. At happy hour, there's whisky from Scotland, vodka from Russia or Finland, wine from Italy, France, or even Australia. Shoes from Italy; watches from Switzerland; cheese from Holland; movies from Bollywood. The computer that this article is being composed on came stamped "Made in Malaysia" even though, dude, it's a Dell!

Real estate, though often thought of as the most local of industries, has gone global as well (as the articles throughout this edition of *REI* amply demonstrate). Investors like Lend Lease, the Grosvenor Estate, TMW, RFR, GSIC, and Henderson Global Investors own substantial holdings of U.S. commercial property. More and more, financing is accomplished through entities like HSBC, Hypo-Vereinsbank, ING, and Caisse de Depot de Quebec. Capital, even more than goods, flows freely across borders in the contemporary economy. This affects price and terms, usually by driving the market to the most efficient and lowest cost source of funds.

Conventionally, there is a lot of hand-wringing about the impact of world trade on the U.S. economy. Every quarter the Department of Commerce international trade numbers spark a round of editorializing about the ballooning

Exhibit 1: Merchandise Trade Flows (Billions of Dollars)

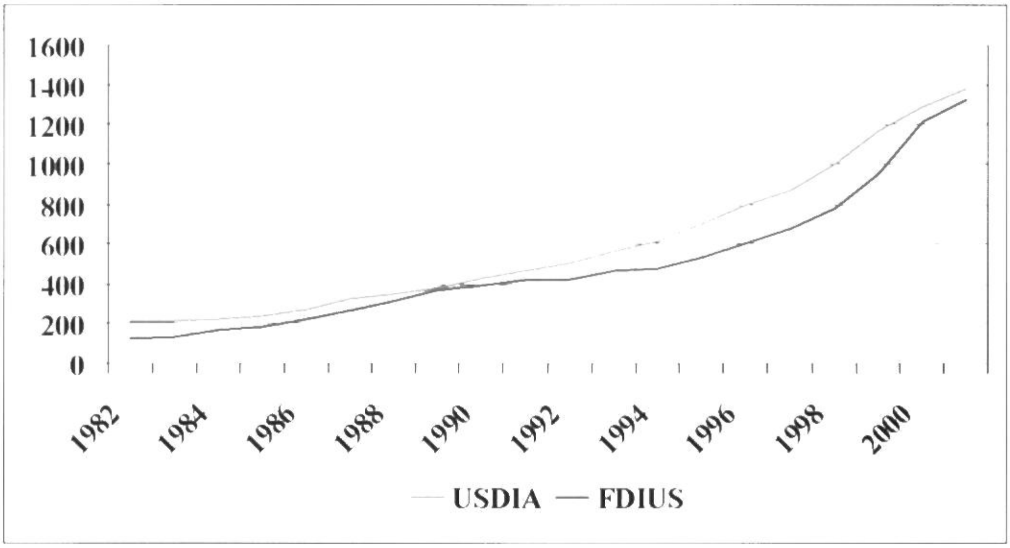


trade deficit, which was $427 billion in the merchandise sector for 2001 and looks like it will wind up at an even larger number in 2002, based on three quarters of data. The trade deficit, by definition, is a negative influence on GDP since it means we are consuming goods made elsewhere (i.e., not produced here—that's the "DP" in "GDP") and by extension sending U.S. dollars to our trading partners. Commentators keep saying "this can't go on forever" and, of course, they are right. But the ebbs and flows of the trade balance are just part of the picture, and the adjustment in its level depends upon many factors, including growth elsewhere in the world, the value of the dollar, savings rates that vary widely from country to country, and even the age-structure of national populations and other demographic features.

A few items seem worth mentioning. First, the trade deficit has to be put into the perspective of a U.S. economy that has grown above $10 trillion in size and that has been sustaining growth—with the exception of the recession period that saw contraction from the second to fourth quarter of 2001—since 1991: the exact period of the weakening trade figures. Second, in many ways the overall trade deficit disguises sectors of comparative strength and weakness that are very important to many U.S. economic regions. For instance, while we run substantial deficits in energy, automobiles, and most consumer goods, we are in trade surplus in agricultural and food products, and in capital goods: chiefly aircraft, semiconductors, industrial machinery, sophisticated instruments, and medical equipment. Third, from a real estate perspective the usual calculation of the trade deficit (exports minus imports) is fairly irrelevant. Demand for U.S. industrial space is more influenced by a figure rarely publicized: total trade (exports *plus* imports), because whether goods are coming into or going out of the country, they have to pass through the warehousing and distribution system. As Graph 1 shows, the trend in total trade has been rising steeply for a long time. And fourth, a trade surplus is not a guarantee or even a reliable sign of prosperity. Japan has been running large trade surpluses for the past decade, even as its economy has stagnated and its financial system brought to the brink of collapse.

The other side of the international transaction picture is capital investment. This has also been growing spectacularly for the past two decades, and in both directions. Foreign direct investment in the United States (FDIUS) has grown more than tenfold since 1982, while U.S. direct investment abroad (USDIA) has sextupled over the same period (see Graph 2). Direct investment flows consist of equity capital, debt including loans by parents to affiliate companies (or vice-versa), trade accounts, and reinvested earnings. Especially in the period of exceptional growth enjoyed by the United States in the late 1990s, tremendous volumes of foreign direct investment capital were attracted to the U.S., with Western Europe the principal source of new funds (especially Germany and the Netherlands, with Switzerland also high on the list due to debt structuring by Swiss-based multinational companies).

Exhibit 2: International Direct Investment Positions (Billions of Dollars; Historical Cost Basis)



Perhaps more than any other figure, the capital accounts on direct investment illustrate how tightly bound together the world economy is. Real estate has witnessed the degree to which cross-border investors compare the risk-reward profile of alternative acquisitions. It is not an accident that, as world stock markets have suffered, the volume of capital being directed into U.S. commercial property by foreigners has noticeably increased.

Much more could be said, though the limits of space constrain discussion in this column. For example, deflationary pressures overseas (particularly in Asia) have helped keep U.S. consumer prices down, thus supporting the Fed's efforts to stimulate our domestic economy by dropping interest rates to historically low levels. At the same time, the U.S. dollar has been kept very high (limiting our export potential) and it is likely that we will see downward pressure on the dollar in the coming year or so. This is not such a bad thing, despite the Bush Administration's dogmatic faith in keeping the currency high. After all, it was the G-7 Plaza Accord of 1985 that restored U.S. competitiveness on world markets by lowering the dollar that set the stage for our excellent economic performance thereafter.

In short, we are intimately networked with the rest of the world. U.S. economic policy (to the degree such a thing can be said to exist right now) cannot be set on purely domestic terms, and analyses of our economy must always keep an eye to the international influences on trends and the global ramifications of decisions. Real estate professionals, too, must be acutely aware of what is happening behind changes in the demand for space and in the capital market for our products.

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FOCUS ON INVESTMENT CONDITIONS

THE DAWNING OF A NEW ERA FOR COMMERCIAL REAL ESTATE INVESTMENT

Kenneth Riggs, Jr., CRE

The last 18 months have been arduous for even the most resilient among us. A recession, the September 11 terrorist attacks with continuing threats of terrorism, corporate accounting scandals and company bankruptcies, the tumbling stock market, and now the likelihood of military action with Iraq have taken their toll on our nation's psyche.

Most investors were hopeful that the economy would be back on a firm growth track by now but that is not the reality. Working off the excesses created during the tech bubble is taking more time than expected. Slow economic growth is killing demand for commercial real estate, and as a result, our outlook is more bearish now than it was just a few months ago.

Despite the slow growth, the U.S. economy has held up relatively well thus far, thanks to consumers and the aggressive low rates initiated by the Federal Reserve. Mid-term elections may be over, but there remains plenty of uncertainty ahead. The expectation is that 2003 will be the year that the business environment shows life beyond the tech run up, but we are not out of the woods yet. Commercial real estate markets will lag behind the economy by six to twelve months, which means that the space markets will not see improvement until 2004.

REAL ESTATE ATTRACTS INVESTMENT

With the debacles of Enron, Global Crossing, Adelphia, Tyco, and dozens of other company failures, the stock market gambling days are over for many investors—at least for the foreseeable future. Instead, investors have directed their investment dollars away from the volatility of the stock market and toward more stable and income-driven assets, like real estate.

However, until corporate earnings begin to increase and transparency and disclosure improve, expect disciplined asset allocations to public and private real estate investment trusts (REITs) and real estate limited partnerships (RELPs) to continue. Consistent cash flow and leveragability also make real estate attractive, but in the long run, demand from portfolios to invest in real estate will eventually help drive down returns.

Meanwhile, however, the low interest rate environment and low return expectations for investment alternatives have resulted in real estate returns becoming extremely attractive. As of this writing, 10-year government bonds are near 4.0% while expected real estate yields cling toward 11.4%, resulting in a yield spread of 7.4%—the widest gap ever witnessed in the 20-plus years that RERC has tracked this relationship. There are many theories as to why this spread is so wide today, but in the final analysis, the result is that real estate yield requirements are being lowered and compressed in the current economic and financial environment. Based on RERC's spread and competitive analysis, yields on solid assets that are properly underwritten should see total yields below 10%.

Buying right and adequately projecting cash flows and values have always been key to successful investing. Like other forms of investing, real estate investment comes down to the balance between risk and rewards. Hotels and office investment have historically offered strong upside potential, but also have been considered high-risk as vacancies can fluctuate greatly and eat away at the bottom line. Industrials and apartments, on the other hand, offer strong income growth but typically do not offer strong appreciation potential. Beyond diversification of one's portfolio, including the real estate portion, property value and pricing analysis should be viewed more quantitatively by separating out the components in order to reduce risk and increase overall reward.

There is plenty of capital chasing real estate, which is pushing up prices and reducing returns. However, this will change as stocks start coming back and real estate works through the lag factor.

WHAT DOES THIS MEAN FOR COMMERCIAL REAL ESTATE INVESTMENT?

We hate to be pessimistic, but it appears that a major paradigm shift—or the dawning of a new era for real estate investment—may be underway. Investment in most property types presently is characterized by low returns in an environment where deflation is more of a concern than is inflation. We're seeing slow economic and corporate growth, and a conservative posture in most companies. Perhaps more important is our concern about how the economy will bear the necessary and ongoing cost of homeland security required by the continuing war on terrorism.

Although certain real estate sectors have shown signs of stress for some time, the effects of our struggling economy are now becoming much more apparent. RERC's third quarter 2002 research indicates that **office** rents slipped another 5 to 10%, and rents and values/prices are expected to be weak throughout 2003 as the office market adjusts to the realities of a slower growth environment. **Industrial** properties are expected to be one of the first beneficiaries of an economic recovery, with rents and values/prices expected to decline further before beginning to show improvement in 2003. Asking rents for **apartments** have held but concessions are common in most markets, and effective rents and values/prices are expected to continue to remain flat in 2003. **Retail** rents and prices/values also look to remain flat through 2003. On the other hand, ADR for **hotels** is expected to increase 2 to 4% in 2003, with values/prices expected to strengthen in 2003. Owners will recognize necessary downward price adjustments which will continue into 2003.

Commercial real estate prices have peaked, and given real estate's lag on the economy, do not expect space markets to recover until 2004. We expect that real estate will lose its lustre in 2003, given current pricing levels, as the stock market stabilizes.

ABOUT THE AUTHOR

Ken 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)*

Dale Anne Reiss

FOCUS ON COMMERCIAL REAL ESTATE

GLOBALIZATION IS KEY TO REAL ESTATE INDUSTRY GROWTH

By Dale Anne Reiss

Put "global" in front of some words and the connection makes sense: global economy, global capital markets, global entertainment, or global sports. As for a global real estate market, it hasn't arrived—yet. What exists is mostly a patchwork of national real estate markets, some similar, but most strikingly different. The first guiding principle for real estate owners, investors and users is: "there is no global real estate market per se."

If a seamless, integrated global real estate market does not yet exist, it is not due to a lack of interest on the part of corporations, businesses, and other users of space, nor indifference on the part of real estate investors and owners. Companies see globalization as a means to find new markets, move closer to customers, and reduce manufacturing and other costs. Investors, too, are looking beyond their own borders, in part because some home markets are too small or too competitive and do not offer many investment opportunities. Investors are trying to realize higher returns by taking advantage of inefficiencies or unique opportunities in local markets, while owners are seeking to expand their existing portfolios of assets and build on the success of their domestic businesses.

Globalization offers these parties increased exposure to markets, more investment choices, access to global capital markets, and additional opportunities to increase deal flow to achieve greater geographic diversification, reduce dependence on a single market, and smooth or increase portfolio returns. For the host country, global investment means increased domestic employment, greater access to international capital to finance growth and compete internationally, access to global technologies, and other benefits.

In the global environment, the key to success for owners, investors and users of real estate is to really understand local real estate markets. Whether they're investing billions around the planet, or millions in a few countries, owners, investors and users should have a thorough knowledge of the markets in which they choose to invest or operate. They should know these markets as well as their home markets.

Even sophisticated real estate professionals can make the mistake of taking their knowledge of their home real estate markets and trying to apply it to other markets. But what's true in one market is not necessarily true in another. International best practices are developing but are not universally accepted and almost always have national twists. Often, these best practices are adapted to local traditions, cultures, and politics. As a result, every market has a unique set of obstacles or barriers to entry that, depending on one's viewpoint, can be pitfalls or opportunities; for example, laws favoring tenant rights may be an obstacle to investors and owners but an opportunity for multinational companies and businesses. The key is to recognize these obstacles or opportunities, consider the options for dealing with them, and develop strategies to mitigate or exploit them. To deal with barriers to entry and other issues, owners, investors, and users often utilize impartial, reputable local real estate resources, including accounting and tax advisors, attorneys, consultants, brokers, and capital partners.

Despite international efforts to reduce barriers to foreign investment, foreign ownership of real estate in many countries is often subject to specific domestic restrictions and prohibitions, and global investors often utilize specially tailored ownership structures to mitigate such restrictions. In Mexico, for example, direct ownership of real estate by a foreign individual or entity is prohibited within 100 kilometers of the border and within 50 kilometers of the coastline. A foreign-owned Mexican company, however, may acquire trust rights to real estate through the creation of a trust with a Mexican bank as trustee.

Real estate markets slowly but surely are moving toward globalization by removing barriers to entry, adopting global real estate standards, and developing the legal and professional infrastructure needed to attract companies, businesses and investment capital. Global investors, owners, and users are helping to drive this process by generally taking a consistent approach and using the same methodologies, valuation techniques, tax analysis, limited liability structures, metrics, and models to invest in or acquire properties or do business from market to market. The key to successful offshore investing is to make the right contacts with reputable local partners and local accounting, tax, legal, and other service providers, and to carefully develop the most efficient structures that limit investor liability and minimize foreign taxes and withholding obligations.

The Czech Republic is an example of a country that has made structural changes in its economy, including development of a private real estate market, to attract businesses and real estate investors from all over the world. Depending upon their risk, tax, and capitalization requirements, global investors in the Czech Republic can choose from a variety of ownership vehicles, including limited partnerships, limited liability companies, and joint stock companies. Lease provisions are fully negotiable and enforceable and real estate mortgages are common.

Countries differ considerably in their approaches to lease law and tenant rights. Many have established leasing guidelines that favor the tenant's rights over the landlord's. Although many countries limit such rights to residential real estate, a number have extended similar rights to commercial properties. Furthermore, tenant rights often vary by product type within a country.

In Brazil, early lease termination and automatic renewal rights are common in commercial leases. Leases are for a minimum term of 36 months, but tenants have the right to terminate a lease with one month's notice regardless of the contractual expiration date. Once a tenant has occupied the premises for more than five years, that tenant has the right to continue to occupy the space for a minimum of one month per year of occupancy. For multinational companies and other global users, tenant rights can be an advantage; however, for real estate owners and investors, tenant rights present a number of risks, the most important being the disruption of cash flows. There may be ways for owners to at least partly mitigate these risks, such as requiring tenants to pay higher security deposits.

One of the most common ways in which countries are lowering investment barriers is through international tax treaties, which are being changed to reduce foreign investor withholding taxes or double taxation of income or to achieve other tax-reduction measures. The structure adopted for the acquisition of direct or indirect interests in real estate outside the investor's country of residence almost always controls the extent of taxability of the profits, and the use of tax losses and deductions, from the investment. Depending on the countries involved, the use of tax haven entities can be beneficial or a disaster. The ownership and tax structure planning process must take into account the particular circumstances of the investor (for example, the investor's resident jurisdiction, whether the investor includes tax-exempt or pass-through entities or real estate investment trusts (REITs), and the investor's individual tax attributes).

Even with tax treaties in place, the issue of local taxation is a constant vexation for owners and investors. Property, income, and capital gains tax vary widely from country to country and sales and transfer taxes such as Value Added Tax (VAT) further complicate both the structural and fiscal position of offshore investments. In the area of taxation, as in so many other areas concerning overseas investment, there is no substitute for local knowledge.

The issue of how and where to finance real estate is also problematic for owners, investors and users. Most real estate markets provide some form of leveraged real estate financing. First, mortgages are the most established form. Also common are varying forms of second mortgage or mezzanine financing. In these countries, international real estate capital providers such as pension and opportunity funds are often the primary sources of mezzanine capital. In countries without an existing market for mezzanine financing, the legal infrastructure is usually sufficient to support such financing. Complex equity structures are also common. Large-scale real estate developments and trophy property acquisitions often lead the market with sophisticated deal structures that are designed to meet the respective needs of their investors. In some countries, complex equity structures are tailored to address market-specific issues.

In Argentina, for example, most commercial real estate transactions are made on a 100% equity basis. While commercial mortgages exist, Argentine investors generally favor increasing their equity stakes or utilizing preferred equity partners to borrowing from Argentine banks. When such partners are used, preferred, and subordinated equity structures in Argentina simulate conventional first mortgage financing and offer leveraged returns to subordinated equity holders.

CONCLUSION

In an era when virtually everything we come into contact with on a daily basis is either manufactured, assembled or produced outside the United States, it is clear that the era of globalization is here and here to stay. However, globalization moves at a differing pace depending on the demands of the economy and of the willingness of each industry to re-tool for global expansion. Real estate is, and always will be, essentially a local industry. Yet, the lure of globalization and the pressure placed on the real estate industry by its core clientele—Corporate (read *Global*) America—and also by an increasingly international clientele that is itself looking to globalize by expanding into new markets, including North America—is forcing new ideas, innovations, and best practices that will lead to a greater appreciation of the global market among owners, users and investors in the real estate industry. The global real estate market is likely to become reality sooner than we all might think.

ABOUT THE AUTHOR

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FOCUS ON THE ECONOMY AND REAL ESTATE

Benefits and Issues in Global Real Estate Investing: A Review of the Research

By Raymond G. Torto, CRE

Raymond G. Torto, CRE

Over the last two decades deregulation, growth, integration of financial markets, and significant political and economic reforms around the globe have propelled a dramatic increase in international investments. The level of international investment varies, however, significantly across countries. For example in 1993 U.S. pension funds had 4.5% of their assets invested in international equities (Bajtelsmit and Worzala, 1995) while U.K. funds had 25% of their funds in international investments (Sweeney, 1993).

Most international investments have focused on stocks and bonds and to a significantly smaller extent on real estate. Some institutional investors, particularly, from United Kingdom, the Netherlands, and more recently from Japan have established traditions in international property investment. The level of participation of U.S. investors in international real estate investments, however, has been minor although in the recent years there has been a growing interest in this type of investment. With financial deregulation, the integration of global markets, and the emergence of global real estate services companies, this perspective is changing and investors are taking a new look at the possibilities for international property investments.

BENEFITS OF INTERNATIONAL REAL ESTATE INVESTING

International real estate investments may help investors increase returns or reduce risk. U.S. investors may increase their returns by investing in international properties with prospects for better performance than domestic assets. For example, during the period 1985-1995 U.S. investors, had they invested in office properties located in U.K., Australia or Canada, as opposed to domestic assets, they would have earned a significantly higher return. Paggliari, Webb, Canter, and Lieblich (1997) found that office property investments in the U.S. during that period provided a zero average annual return while similar investments in U.K., Australia, and Canada provided an average annual return as high as 12.4%, 8.1%, and 4.5%, respectively.

International real estate investments can help investors reduce risk in two ways. First, by investing in foreign markets that are less risky. For example, Paggliari, Webb, Canter, and Lieblich (1997) found that office investment performance in the U.S and Canada was considerably less volatile than office investment performance in Australia and the U.K during the period 1985-1995. Second, investors can reduce risk simply by diversifying their portfolios with the inclusion of foreign assets whose performance is likely to be minimally correlated with performance of domestic assets. Such low correlations are attributed to differences in behavior over time stemming from different market structures and idiosyncratic economic shocks.

Research in the last thirty years has shown that international investing does provide diversification benefits. However, only recently has attention been turned towards international real estate investments within a mixed-asset portfolio. The results of the research with respect to the diversification benefits of direct equity investments are mostly encouraging.

Some researchers (Worzala and Vandell, 1995; Sweeny, 1993) have found that international real estate provides diversification benefits when included in mixed-asset portfolios. Such benefits were found to be reduced but not eliminated by exchange rate fluctuations. Chua (1999) also found that international real estate does have a viable role to play in global mixed-asset portfolios even after correcting for the higher taxes, transaction costs and management fees incurred when investing in real estate.

Torto Wheaton Research has prepared a study that also concludes that global real estate investments can help U.S. investors better diversify their portfolios. The study focuses on 21 cities on five different continents and uses historical rent series to calculate pair wise correlation coefficients in order to gauge the extent to which movements in these markets during the period 1975-1997 were synchronized.

Each annual series was first converted to U.S. dollars at its historical exchange rate to demonstrate what these income streams would mean to an American investor, thus incorporating the impact of exchange rate risk. To remove complications from inflation in other countries, all rent series were also adjusted for U.S. inflation. The estimated correlation coefficients are presented in Table 1. As seen from this table while the correlations among North American cities is quite high, the correlations among European and Asian cities is somewhat lower. The lowest correlations, however, are seen between North American cities and cities in Asia and Europe, demonstrating that these combinations would have provided the greatest diversification benefits.

Table 1 shows that diversifying investments only across major markets in North America still carries a high degree of risk that cannot be diversified away. The average correlation among markets in North America is 0.77. This high correlation is the result of somewhat similar construction cycles in the North American markets, as well as common economic influences. A relatively high average correlation can also be observed among major mar-

Table 1

	Los Angeles	*New York*	*Chicago*	*Dallas*	*Toronto*	*Amsterdam*	*Geneva*	*London*	*Brussels*	*Frankfurt*	*Madrid*	*Paris*	*Singapore*	*Hong Kong*	*Tokyo*	*Jakarta*	*Melbourne*	*Sydney*	*Auckland*	*Rio De Jainero*	*Sao Paulo*
Los Angeles	1.000																				
New York	0.939	1.000																			
Chicago	0.908	0.967	1.000																		
Dallas	0.801	0.745	0.768	1.000																	
Toronto	0.718	0.645	0.570	0.216	1.000																
Amsterdam	-0.498	-0.617	-0.633	-0.433	-0.220	1.000															
Geneva	-0.281	-0.226	-0.264	-0.777	0.366	0.217	1.000														
London	0.369	0.392	0.343	-0.149	0.794	0.047	0.691	1.000													
Brussels	-0.749	-0.802	-0.825	-0.853	-0.189	0.807	0.610	0.123	1.000												
Frankfurt	-0.603	-0.674	-0.728	-0.811	0.030	0.702	0.666	0.208	0.947	1.000											
Madrid	-0.034	-0.127	-0.195	-0.465	0.603	0.469	0.688	0.635	0.633	0.782	1.000										
Paris	-0.343	-0.390	-0.444	-0.748	0.345	0.568	0.855	0.559	0.829	0.909	0.911	1.000									
Singapore	-0.303	-0.404	-0.461	-0.174	-0.079	0.402	-0.061	-0.121	0.385	0.443	0.302	0.229	1.000								
Hong Kong	-0.611	-0.665	-0.704	-0.600	-0.274	0.646	0.321	0.080	0.654	0.551	0.281	0.437	0.497	1.000							
Tokyo	-0.285	-0.309	-0.376	-0.762	0.434	0.323	0.912	0.587	0.707	0.822	0.855	0.933	0.100	0.316	1.000						
Jakarta	0.612	0.424	0.395	0.540	0.536	0.086	-0.249	0.265	-0.252	-0.100	0.281	-0.033	0.359	-0.035	-0.119	1.000					
Melbourne	0.443	0.445	0.367	-0.125	0.897	-0.137	0.646	0.875	0.053	0.253	0.733	0.570	0.010	-0.047	0.648	0.366	1.000				
Sydney	0.159	0.071	-0.021	-0.277	0.702	0.193	0.576	0.729	0.335	0.485	0.804	0.653	0.442	0.365	0.671	0.428	0.831	1.000			
Auckland	0.341	0.473	0.468	-0.072	0.587	-0.247	0.589	0.862	-0.123	-0.105	0.240	0.255	-0.346	-0.116	0.346	-0.042	0.670	0.415	1.000		
Rio De Janeiro	-0.045	0.006	0.010	-0.451	0.487	0.212	0.763	0.830	0.401	0.426	0.655	0.681	0.154	0.377	0.634	0.035	0.725	0.725	0.721	1.000	
Sao Paulo	-0.280	-0.309	-0.345	-0.617	0.370	0.498	0.749	0.659	0.694	0.748	0.825	0.861	0.464	0.595	0.763	0.122	0.619	0.799	0.386	0.880	1.000

kets located within Europe. On the contrary the average correlation among markets in Asia is considerably lower—0.19.

The correlations in Table 1 suggest that there is more to be gained in cross-continental diversification, specifically North America and Europe or North America and Asia. For example, market performance in Hong Kong exhibits an average -0.57 correlations with market performance in the North American markets, while Frankfurt and the North American markets exhibit an average of -0.56. These statistics show that rents in many foreign markets do not move with rents in North American markets, yet again suggesting that holding assets in various global markets may help diversify away some systematic risk.

Contrary to these results that do advocate direct investments, a few other studies found that Japanese and British investors did not gain from diversifying their portfolios with U.S. real estate (Ziobrowski and Curcio, 1991) even after mitigating for currency risk (Ziobrowski and Boyd (1991).

Paggliari, Webb, Canter, and Lieblich (1997) studying the different components of equity real estate returns in four countries (U.S., Australia, Canada and United Kingdom) find that space markets display lower correlations between countries than do capital markets or capitalization rates. They attribute such lower correlations to the fact that space markets comprise more idiosyncratic risk as local customs, regulations, and business practices may cause space markets to behave differently from one country to the other, while the price of capital is increasingly set in international markets.

CONCLUDING REMARKS

Despite the significant degree of integration of world economies there is still significant cross-country and cross-continent divergence in real estate market and property performance. Thus, global property investing may provide considerable diversification benefits and opportunities for increased returns. As the world economy is becoming more and more integrated, the avenues of international real estate investing are becoming wider. Although many of the traditional risks associated with non-domestic property investments remain, the globalization of real estate services companies may help investors get a better handle of these risks and hopefully turn them into advantages.

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FOCUS ON LEGAL ISSUES

REFLECTIONS IN AN INTERNATIONAL EYE

by Edwin "Brick" Howe, Jr., CRE

Edwin "Brick" Howe, Jr., CRE

Just how is foreign investment in U.S. real estate doing these days, especially when compared to, say, 25 years ago?

Not all that well, I'd guess (or to look at it from another standpoint, not all that badly, since such investment is far from the fad it was some years ago). My point of view may be a little different from yours. As a real estate lawyer for 35 years, I've had to know a bit about real estate, just, as an international lawyer, I've had to know a bit about differences among cultures and bridging them. But I've seldom had the opportunity to occupy a forward position on the substantive real estate lines and therefore hope that I can regard matters like this in a more detached fashion than many CREs.

I start by asking a question that has been rattling around the back of my skull for many years: Why should a foreign institutional investor be interested in U.S. real estate? I'd ask the same question about *any* foreign investor. Or any domestic institutional investor.

As for non-institutional domestic investors, I'd ask the same question and say the answer is obvious: That is the way the Helmsleys, Silversteins, Greens, et al., of this world make their living—or lose their shirts—by being primarily in the real estate and related businesses and "knowing their respective territories," as a less folksy *Music Man* might have put it. If anyone is going to succeed, one would expect that it is this group of investors.

But why the others? Here is a small, and clearly non-exhaustive, sample of the answers I've heard over the years:

- "It's a hedge against inflation." Not true; real estate is as subject to inflation as any other part of the economy and actually is less well equipped than most other sectors to respond to inflationary conditions because leases, at more-or-less fixed rental rates, will remain in effect for some time to come. In fact, real estate can be a hedge against very *short-term* recession, though there must be very few real estate portfolios having a core strategy of capitalizing on short-term recession. Shorting stocks would seem a much more efficient way of implementing such a strategy.

- "It's a hedge against volatility." Yes, sometimes, especially when stock or other securities markets are behaving in a fashion that appears irrational to us mere humans. But think, for example, about the sudden 35% upturn in non-primary-market shopping center capitalization rates experienced over some six months during 2001. Think about what happened to real estate during the Asian financial crisis a few years back. That is very big-league volatility and positive turn-arounds in the real estate market are something like reversing the course of the Queen Mary, as compared to the experience of a rebounding securities market.

- "It's *real* estate, after all, assets I can touch, not just pieces of paper." Please. I will not put further ink into this one, except to note that, at least in the languages other than English with which I'm familiar, the word we translate as "real" is "immovable," a distinction that speaks for itself.

- "Maybe trends in real estate will, over time, counterbalance trends in other investments." Yes, maybe they will. The key word there is "maybe." To base portfolio management on this principle, I'd want a two-line graph, one line marked "Real Estate" and the other marked "Other," going back 100 years at least and adjusted for panics, droughts, wars, Great Fires, earthquakes, plagues, irrational exuberance, and insatiable greed. If those two lines didn't complement each other reasonably well, I'd drop this as a theory of portfolio management.

- "If managed with a careful eye to costs and with a creative leasing strategy, net cash flow can grow very substantially and capital value can grow geometrically." This one makes sense, subject to a carload of qualifications, and is something of a springboard into my own view of the matter, which differs from the viewpoint just stated not in concept but in the approach to the endeavor to be adopted by the spider at the center of the investment web.

My view, simply stated, is that the potential virtue of institutional investment in real estate is that a real-estate project is a *business* that is small enough for an institution to manage on its own free-standing basis, employing its own management and portfolio policies and exercising its own business judgment as to the timing of acquisition, financing and sale of the asset in question. Note that I say its *own* judgment, not that of Jack Welch, Hank Greenberg, Bernie Ebbers, Dennis Koslowski, or Martha Stewart (to mix the apparently OK with the apparently non-OK). As such, a real estate investment can be an appropriate counterweight to investments in assets, management and perhaps unsavory motives belonging to someone else.

The individual foreign investor can look upon U.S. real estate investment similarly, but the temptation to delegate the efforts on his part normally necessary to run the business properly to persons not worthy of his trust all too often is overwhelming, in consequence of which I can count on the thumbs of both hands the foreign individual investors whose U.S. real-estate programs I have witnessed succeed.

As for the institutional investors, it would seem that, if they are smart and prudent enough to run standard securities portfolios, they should be smart and prudent enough to add to the mix a few investments that can take direct advantage of their own business acumen. This is not to say, of course, that institutional investors who do not take such advantage are inadequate, but merely to suggest that putting together such a mix should not, in and of itself, be regarded as a negative so long as the institutional managers really do possess the necessary business judgment.

But, if a particular institutional investor or its manager cannot lay claim to that kind of ability, then the investor probably should stick to the program of "passive" investments that have traditionally been the concentration of such investors. If there's one thing that direct investment in real estate is, it's not passive—or, as an old colleague of mine once put it, "Real estate is *PROBLEMS!*" (Emphasis in original.) And, in particular, such investors should not look to REITs as "indirect" investment in real estate. REITs do invest in real estate and some of them very successfully, but over the years they have performed far more like stock than real estate and the movements of REIT shares are about as responsive as any other stock to the unknowable fashions, whims, misunderstandings and corruptions of Wall Street "analysts."

A rather benign example of how resistant Wall Street is to a true understanding of real estate occurred when a client of mine some years ago explored a public offering of its shares. A very distinguished Wall Street investment bank was engaged for the exercise, and my client was accorded the services of one of the bank's most skillful executives. At the first meeting with him (at which the lawyers were present for some long-forgotten reason), the executive said to the client, "Well, now, how do you manage your assets—for income or for growth?" The client quickly realized that some educational work would be necessary and the plan to market a new share issue did not long survive that incident. I do not accuse Wall Street of maintaining that antediluvian mind-set, but I do think many Wall Streeters haven't made it much beyond the Napoleonic Wars in their view of real estate.

So just how well have the foreign institutional investors done in U.S. real estate over the last two and a half decades or so? As with so many things, it's a mixed bag and one that I have to approach anecdotally, largely on the basis of my own knowledge of the records of some of my firm's clients, which number (though not exclusively) some of the larger and more distinguished foreign institutions, and of similar clients represented by other professionals whom I have known over the years:

- Most such investors should have kept entirely clear of U.S. real estate. (I concede, of course, that this statement is a lot easier for me to make today than it would have been fifteen years ago, when I earned much of my living that way, and I hasten to add that many of my current judgments are made only via 20-20 hindsight.) The lessons learned from these investments were by and large far greater than the profits they produced. One of those lessons is that one has to operate a real estate investment like a small business. Not many of the investors in questions did so, and I'd venture that not all of *them* did so competently.

- Having said the foregoing, I need to set the record straight: Many of these investors were lured into U.S. real estate investment in the mid-1970s and even the early 1980s because of U.S. tax policies in place at the time. If you think back to the early years of the Kennedy Administration, you will remember a weak U.S. dollar and an inability of this country to attract as much foreign investment, including both portfolio and direct investment, as it should have. This was in part the result of a tangle of archaic fiscal rules which the U.S. had applied to foreign investors (among others) with increasing vigor since the early days of the New Deal. The Foreign Investors Tax Act of 1966, a piece of legislation beautifully crafted by some of our most illustrious fiscal minds, was intended to do away with all that and in fact did do away with much of it. Indeed, as the "tax industry" moved into the 1970s, it was possible for any foreign investor who adopted the right tax planning to invest in U.S. real estate on a virtually tax-free basis. With such a fiscal background, the watchword became, "How can we afford *not* to invest in U.S. real estate?"

- Then, as time passed, as a certain xenophobia developed in the U.S., and as our legislators realized that foreign investors vote only with their feet, the fiscal screws on foreign investors were tightened again and again until their position was in some cases actually worse than their tax-paying domestic counterparts. But this is a message that somehow just didn't get through to foreign institutional investors. They needed to see some real, even abundant, losses in terms of actual greenbacks to break themselves of the habit.

- In retrospect, investment by foreign investors in U.S. real estate was very much a herd phenomenon, and typically those who were first in (say, 1975-77) and also first out were the winners, while many of the others were losers.

- When FIRPTA was enacted at the end of 1980, this legislation for the first time made it vastly more difficult, frequently impossible, for foreign investors in U.S. real estate to do so tax-free, and as a consequence the relevant market became stone-cold for about three and a half years. But there was a pent-up demand for U.S. real estate on the part of foreign institutional investors which evidenced itself in a second, utterly irrepressible wave of investment activity beginning about the middle of 1984 – ironically, just at the moment when the U.S. dollar was approaching its highest level vs. virtually all foreign currencies in decades. Far too many of these investments were big losers in terms of U.S. dollars and far greater losers when expressed in terms of home currencies, some of which had grown $2\frac{1}{2}$ times stronger vs. the dollar by the time of sale (or foreclosure).

- To be fair, when the first wave of such investment began in the mid-1970s and exchange rates were more like they are today, I observed to several foreign clients that they would probably end up making a fair profit, on repatriation, in terms of their home currencies. Invariably the reply was that this was in no way a currency play; a certain part of the portfolio had been allocated to dollar-denominated investments and a portion of that had targeted real estate. I never pursued this point, as I had no reason to doubt any client's candor. In retrospect, my best guess is that they foresaw selling U.S. Property 1 and investing the (tax-free) proceeds in U.S. Property 2 and so on.

- And one must not forget the security factor. For decades, investors have put some of their money in the U.S. because they found the physical environment here more favorable than at home. We have to bear it in mind that the Berlin Wall did not come down until 1989, when a great many of the investments in question had already been made. Today, of course, the reputation of the U.S. as a safe haven for real estate investment may no longer be what it once was.

- The investors whose programs (even if they were losers, and for sure not all of them were) outpaced the others invariably did their investing the "right" way, as did some but not all of the less successful investors. All of those who did it the "wrong" way, to the best of my knowledge, were in the "less successful" class.

- The "right" way in my judgment was *(1)* to rely on independent investment advisers, fee-driven as little as possible, and *(2)* not to think in terms of "having to get $X invested in U.S. real estate this year." On one occasion, when an investment offered a client turned out to be essentially fraudulent, the client actually said to me, "We are coming back to make more investments in two months and, Brick, *next time we must not fail!"* (Emphasis in original; and, by the way, that client's approach was manifestly the "wrong" way.) Many of the investors who did it the "right" way set up elaborate monitoring systems to track operations and some even set up representative offices in the U.S. All of this turned out to be pretty expensive of course, particularly when compared to investment in portfolio securities.

- While there are many other ways that didn't work out, one of the "wronger" ways was *(1)* to adopt a "house broker" or two, some of whom offered "guarantees" of cash flow for a few years, and *(2)* to visit this country two or three times a year, always with advance notice to the broker, who was by now acting as managing and leasing agent. With such diluted attention from abroad, it all too often happened that a shiny new office building, say, was built 250 yards away, to come on line just as the larger leases in the client's building were beginning to roll. This presented what the "house broker" normally referred to as "a fabulous leasing opportunity" from the client's viewpoint.

- The investors who went "wrongest" of all are those who made decisions, at their highest levels, to dispose of the entire U.S. real estate portfolio by X date. Invariably, the pressure on their operatives to sell was well known, and they got out at prices most of which were heart-breakingly low.

- And one final point: Much of the allure of foreign institutional investment in U.S. real estate probably had to do with the related perks, the trips to the U.S. to kick the tires and enjoy the Kansas City strip steaks. In that respect, those enjoying the perks were clearly no more venal than the author of this article. My only saving grace is that it was not my own attraction to perks that led investors into programs of investment that at first appeared very attractive but, certainly from 1982 onwards, did not stand much of a chance. Of course, as we have seen from recent revelations in certain divorce papers, even the most highly regarded among us have their little venalities.

To sum up, it appears that the vast majority of foreign investments in real estate were made on the basis of noble, and certainly not ignoble, motivations. That is true especially if you consider it noble for the real-estate manager of, say, a foreign pension fund to go looking in the U.S. after his boss has said, "*ABC* and *XYZ* are going into U.S. real estate in a big way; why aren't we?" Moreover, the fact is that there were—and are—a number of foreign-owned U.S. real estate portfolios that have been successful. To the best of my knowledge, they were all acquired in the "right" way and then managed, including in terms of timing of refinancing and sale, as businesses, some in recent times with innovative tax planning of the sort I have written about in a previous issue of this publication. The pity is that more of them haven't been handled that way.

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Introduction

As with every successful conference, participants each came home with a highly individual perception of how the knowledge gained could be applied. Real Estate Issues *invited a number of attendees to contribute their own thoughts on the applications of conference themes in their businesses. Not surprisingly, the range of reactions was wide. Here are four commentaries: two from the U.S., and two from abroad. Lorenz Reibling considers how best to partner in placing international investments. Jose Pellegrino turns a skeptic eye to the benefits brought by large banks and rating agencies in Latin America, as well as suggesting a "small is beautiful" approach to local planning. Roy Schneiderman takes a long historical perspective in suggesting that "globalization" is hardly a novelty. And Martha Peyton provides insights into the pricing of capital and its effects on property value in a mixed-asset world.*

Cross Border Capital Flows—Perspectives from a Mixed Asset Portfolio Investor

by Martha S. Peyton, CRE

One of the clearest points made during the Capital Flows session at the Global Cities conference was the abundance of capital pouring into real estate to escape unattractive return prospects in other asset classes such as stocks and fixed income instruments. The flow is having an unsurprising adverse impact on real estate prices. The rise in prices and decline in cap rates prompted some of the panelists to opine that prices have become too high in both U.S. and major European markets. The price increases were judged to be inconsistent with actual and expected deterioration in occupancy and rents associated with weak economic performance. One panel member diagnosed the price increases as the start of a bubble, implying that real estate buyers were nurturing unrealistic illusions regarding property market prospects.

There is another less alarming explanation for the rise in prices that draws from the increasing integration of real estate into global capital markets. Historically, real estate was in a world of its own. Cap rates responded slowly at best to interest rate changes; property values replied on appraisals; and real estate investment was most commonly done through separate account managers specializing in real estate. In this environment, real estate could be viewed as a separate world in which expected IRRs on cash flowing institutional quality property were always pegged at double-digit levels. If recent price movements are viewed through this historical lens, real estate is indeed priced dearly.

But the world has changed. Capital markets are much more closely integrated than ever before. Ready availability of market data and analysis lubricates the integration. As a result, real estate has lost a good bit of the mystery that historically reinforced its separateness. Unattractive returns in mainstream asset classes is a recent bit of stimulus accelerating the integration process. As a part of the global marketplace, real estate investment prospects are being examined alongside all other alternative investments. For good or ill, the comparison factors boil down to expected return, risk, liquidity and the unique ownership burdens associated with hard assets versus soft.

Capital is flowing to real estate because it is priced attractively when expected return, risk, liquidity and ownership concerns are weighed against similar measures for alternative asset classes. Stocks are coming up short because the market has no real sense of fair value exacerbated by erosion of confidence in corporate financial reporting. Bonds of untainted investment grade borrowers are more palatable but offer yields based on a Treasury rate that has not been this low since the early 1960s. High yield below-investment-grade bonds offer higher yields but suffer from volatile credit risk. Investment in cash flowing properties with investment grade tenants and long-term leases is nirvana compared with the travail of alternatives.

But, of course, the demand is driving up prices—as well it should. When are prices too high? When the expected risk-adjusted return is in line with alternative investments. When assessing risk-adjusted return, real estate investors need to acknowledge that the underlying riskless rate (i.e. Fed funds) is 1.75% and inflation expectations incorporated into the term premium brings the 10-year Treasury to the 3.6-4.0% range, absent an oil shock. Expected IRR=s in this environment will probably find an equilibrium below 10% for institutional quality property. How much below? Perhaps quite a bit given that medium quality BBB-grade corporate bonds are trading around 6.50%. But can a real estate buyer really use that 6.5% as a credible opportunity cost when it clearly represents an historically rock bottom and therefore temporary condition? Answering the question again requires that real estate buyers think like bond buyers. When considering a purchase of that 6.50% bond, a bond investor will mull over the duration bet attached to the bond. That involves evaluating how much value will be lost if interest rates rise, what is the risk of an interest rate rise, and again, what are alternative opportunities for my capital.

With all this said, I believe that the danger for real estate investors in the current environment is the temptation to take ever-greater risk in return for double-digit IRRs. For the market as a whole, the danger is that rising real estate prices might be misread as justifying significant new construction. A construction response to higher prices would indeed be a real estate "bubble."

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Counseling in an Era of Change

by Roy Schneiderman, CRE

In reflecting upon the theme Global Cities in an Era of Change, the first thought that struck me was that there is not really a lot new here. After all, there have been, (relatively speaking at least) "global cities" for thousands of years. And I suspect that there may never have been an era in the history of mankind that would not have been described by those living at the time as "an era of change."

So although the specific characteristics ("the details") that we see in our world today appear extraordinary in their complexity, sophistication, and richness, it is much less clear whether or not there is anything fundamentally different about our current world, society, culture, etc.

This is not to say that fundamental changes do not occur. They do. But those fundamental changes generally can only be seen in retrospect, and usually with a fair amount of distance and perspective. Or put another way, those who think that there is necessarily an inexorable march towards the globalization of the world's economy should note that the Euro does not mark the first time (or even the second time) that Europe has tried a unified currency. And only time will tell if the current effort is 1) the successful culmination of a long-term trend, 2) an unsuccessful experiment during a brief period of pan-Europeanism, or 3) something in between.

So against that backdrop, I offer up the following four thoughts with respect to how the current trend towards globalization and urbanization/suburbanization will impact the practice of real estate counseling:

- Successfully cultivating and nurturing relationships will continue to be the single most important element of a counseling practice. This has been true for a long time, and is likely to be true no matter how far technology, or globalization, or any other trend changes the "details" of our world and society.

- Integrity and reputation will become increasingly important. Of course, integrity and reputation have always been important in a counseling practice. However, accessing information about people has heretofore been a rather haphazard affair. But in a world where people can easily send out an e-mail to hundreds of people that they know personally asking "I am thinking of doing a deal with Mr. or Mrs. X, do you know them?" counselors are likely to find that their history, as embodied in the corpus of their work and their reputation, becomes increasingly important.

- There will continue to be a squeeze on mid-sized firms. Large firms will be able to achieve some scale in order to accommodate large projects. And small firms will remain nimble and flexible as conditions change. But mid-sized firms will find themselves in the worst of both worlds.

- Continued improvements in technology will allow for small firms to partner on a project basis or a product-line basis. The market acceptance of this type of ad hoc counseling partnership will continue to increase, with the key factor being the ability to successfully convey the message to the client that the people involved can (and have) successfully work(ed) together.

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Even in Global Cities, Think Locally

by Jose Carlos Pellegrino, CRE

Returning from the Global Cities in an Era of Change conference at Harvard University, I considered some consequences for the city and county of Saõ Paulo. Imagine, for instance, would be the organization of District Councils or Zone Councils, with representatives of main schools and colleges, professional associations, small commercial businesses and establishments, and ordinary men and women who would meet once a week or every other week to discuss priorities for the regions they belong to.

Of course, these Councils will not have political strength, but would have the ability to assert to mayors, planners, and politicians grassroots needs in the fields of development, health, and educational facilities, transportation changes, and things of that sort.

Within a short time these Councils would convert themselves into important political cells. This would be a natural consequence, if it is considered that the family is the cradle of everything and the Councils would the best representative of families in a given district or sector. Obviously, city and county governments would not want to see the creation of such Councils, specially the professional politicians, because in the long run the present system would be replaced by a better one. Here in Saõ Paulo this idea will not be accepted, especially at this moment when we have a radical leftist government. But that is no reason to dismiss such a democratic idea as a practical goal.

The second consideration concerns relates to the risk factors in my country, as it has been set or determined by some rating agencies all over the world. In fact, if you start to think just a little bit, you might suspect these agencies are self-perpetuating and not especially helpful to the very countries they purport to assist. Why? Because, in a way, they are all linked to financial complexes; that is, they all have direct interests in their own funds and other types of investments. Certainly the record of success in South America is not a strong one.

Large banks invest in some areas and then, all of sudden, right after selling their position with big profits, they proclaim that same investment "too risky." What a shame! Corporate and financial gamesmanship is becoming a plague, with companies acting with little or no ethics at all, resulting in significant losses all over the world. I see the rating criteria as applied here lacking good technical support and largely based on guesses and assumptions.

The common threat is this: As "macro" policy is made at the governmental or corporate level, there is a tendency to miss what is actually occurring at the level where most people live and work. Let's keep our eyes on the richness and complexity that are visible locally.

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PARNTERSHIPS IN GLOBAL REAL ESTATE

by Lorenz Reibling

At the "Global Cities in an Era of Change," International Real Estate Symposium, September 4-6, 2002 held at Harvard University, how to manage risk over diversified real estate pools was a much discussed topic. The main division was over single or multiple bets on real estate entrepreneurs operating in diverse markets. This discussion is not new, but in today's world of uncertainty surely has new value and deserves a fresh look. The guiding questions for assessing this topic should be:

1. How do you reduce the intrinsic risk of a real estate asset?

2. How does a global investor, such as an insurance company, a pension fund, or the truly wealthy family office most efficiently distribute capital over markets and risks?

3. The common denominator in these discussions is the recognition that real estate by definition is immobile. Most European languages use terms such as *immobilier, Immoblien, immobili* etc. that reflect this attribute better than the English term "real estate." How to deal with the local nature of real estate, particularly in regard to people and financing, is much disputed.

Put in a nutshell, the two camps are divided along the following fault line:

1. Group A trusts the "best" local partner or operator in each individual market and desires to maximize the return by actively searching for those partners or operators.

2. Group B trusts one diversified real estate partner, who in turn has operations in numerous markets under one set of controls and typically uses the same brand name as a business asset in all markets.

Conventional wisdom would suggest that, in theory, Group A should indeed harvest higher returns over a constant risk, assuming that Group and Group B would invest in the same type of real estate, at the same time, using identical leverage, operating costs, etc. Obviously, such conditions rarely if ever occur, but the distinction is useful in thinking clearly about the problem. It is indeed one indicator of the difficulties in executing a coherent investment strategy over a large number of operating entities.

The evident advantage of Group A is the higher degree of diversification. Group A is operating not only over different markets, but also different companies. If it is desirable to spread risk in the portfolio, it seems to be a fruitful approach to real estate investing.

But, offering a not far-fetched analogy, the likelihood of collecting a gallery of Van Goghs, Boticellis, Rembrandts, and Singers by simply visiting distant and exotic places while meeting interesting people is borderline absurd. Artists—and real estate operators—of this exquisite caliber are equally rare. Hence any investor should recognize the limited supply of such talent. Given this shortage of excellent and—today maybe most important—trustworthy partners, the strategy used by Group A is extremely time consuming. It also comes with a great intrinsic risk to this approach, one that is often overlooked: the more people you have to trust with your investments, the more likely you are to pick a bad apple out of the bunch. U.S. institutions are still nursing the wounds suffered by confusing superb, but unfortunately falsified replicas with the real thing. Remarks one major U.S. hedge fund investor about a transaction in Western Europe: "We could have never imagined how a bunch of pin-striped, serious-looking bankers pulled us over the table as if we were naive beginners."

Group B investors may avoid the worst mistakes predictably more often than Group A investors. Making a series of "good picks" in multiple markets is much harder, than building one good relationship with an operator active in the same markets.

The "people factor" is a risk widely underestimated in an industry driven by "deals," as if these individual transactions were virtually devoid of a significant management risk. But it should be apparent that the higher the expected returns, the higher also the "people risk." Managing real estate risks in repositioning, refinancing, or even developing and redeveloping is, by any measure, comparable with risks inherent in manufacturing procedures such as re-tooling, introduction of new products, or major capital events such as the issuance of debt or an IPO. Nobody in his right mind would leave the management of such risks to unknown characters with a merely parochial understanding of the world.

This by no means minimizes the value of the local operator. In fact, even an entity chosen by Group B might in certain well defined cases enter into joint-ventures with local operators. This would typically be in the first few years of breaking into a new market, or for specialty projects with complex technical, financing or political risks.

Group B investors rely upon the integrity, corporate governance, and standardized reporting systems of their relationship partner to make exact comparisons between various risk/return events across multiple markets.

The most prominent feature of a single entity is the ability to gather, format, and preserve input from numerous markets over various real estate cycles. Experience generates an important "gut feeling," a sense that "we have seen that before" or "they do this differently there." Such judgments can then be verified with independent market data.

The ability to compare notes and transfer know-how in assessing and managing risks requires a central brain or processing entity, distant enough from the micro-management issues of the local theater, yet still close enough and capable enough to interact decisively and authoritatively with local risks and opportunities. This indispensable know-how cannot be imbedded adequately within mammoth investment houses. The psychology of the top real estate minds runs counter to the notion of institutional domesticity. Rather than working with a toothless tiger, sophisticated investors need to interact with market opportunity.

Prudent investors have learned their lessons and adjusted their investment programs accordingly. Rather than investing in the best deals or the best people in a specific market, they invest in a competent real estate organization, a brain, with eyes, ears, and a nose that sees, hears, and smells beyond the local weather report. This relationship partner is defined by documented high integrity under duress, deep real estate know-how condensed into a relatively small number of top executives and the impeccable ability to not only perceive but report changes in risk. These type of organizations are few and far in between. Such a proven relationship partner can be invaluable in sorting out the true opportunities from the mountain of "irresistible" real estate deals presented to any large investor.

ABOUT THE AUTHOR

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DECONCENTRATION: A STRATEGIC IMPERATIVE IN CORPORATE REAL ESTATE

by Mahlon Apgar, IV, CRE

ABOUT THE AUTHOR

Mahlon Apgar, IV, CRE, *is a director of The Boston Consulting Group and advises major corporations on real estate and infrastructure. He received the James Felt Award for Creative Counseling in 2002. He was assistant secretary of the Army for installations and environment from 1998 to 2001. He created "The Apgar Score," the only patented system and method for evaluating real estate conditions, and authored "The Alternative Workplace," and numerous other publications. His* Harvard Business Review *series is a standard reference on managing corporate real estate.*

Since the Industrial Revolution, work has been concentrated in specific sites and facilities. The resulting workplace model—often defined in modern corporations by large, monolithic buildings in fixed locations—benefited employers and employees alike in the "steady state" world of the past century. Today, however, new needs, new norms and new capabilities are making the Industrial-era workplace a costly, inefficient drag on economic growth and organizational performance.

The Information era offers the opportunity to rethink, reposition and redesign the Industrial-era workplace. Advanced communications and information technologies—when coupled with flexible organization structures and work practices—allow companies to redistribute work to numerous single- and multi-purpose sites, within cities, across regions and globally, without compromising the collaboration and efficiencies of collocation in a specific facility. We call this strategy *deconcentration*. Carefully designed and executed, it may strengthen competitive advantage, improve customer service, increase employee productivity, and reduce total real estate costs.

Deconcentration is no fad. Indeed, it has been the underlying trend in urban development in the U.S. and Europe for more than five decades. The impetus began with manufacturers whose scale and search for efficiencies required vast, horizontal production floorplates. After World War II, corporations of all types began to migrate from cities to suburbs in search of large administrative, research and warehouse space. As a boy in the 1950s, I watched in awe as my father, a pioneer in assembling suburban sites for major companies such as AT&T, Ford, IBM, and Warner-Lambert, envisioned the transformation of farmland to the corporate campuses we now see throughout the metropolitan New York-New Jersey area. Suppliers and service firms quickly followed to support these large enterprises. Their executives and professionals, tiring of long commutes to the city, drove the parallel demand for suburban offices. Residential, retail and hotel development naturally ensued. Consequently, suburban growth has steadily outpaced center city growth, despite the impressive recent progress in revitalizing traditional downtowns in several major cities.

The terrorist attacks on September 11, 2001, accelerated and redefined this long-term trend in the New York region. Many firms' headquarters, branch office and back office operations, clustered in the Wall Street area, were demolished or severely damaged. Companies were compelled to restore operations within days and to relocate within weeks. Executives made quick, profound decisions in hours that would have entailed months of deliberation under normal conditions. Professionals and specialists in many fields learned how much they could accomplish from homes, hotels, and other remote locations. Meetings were hastily rearranged through videoconferencing, with large savings in time and travel.

Today, the sense of crisis within these companies has largely passed. Critical infrastructure has been restored and travel is being resumed. Managers have strengthened and institutionalized security and contingency plans. Workers displaced to back-up or temporary locations have returned to their former offices.

Still, there is—in a very real sense—no going back. Thousands of people learned that they could operate effectively from their homes and other remote locations, and could "meet" electronically with customers and colleagues alike. For the firms most directly affected, significant reductions in travel time and cost are now being built into business plans and budgets. For all others, the attacks forced reconsideration of long-held beliefs and revealed the potential for change in other metropolitan areas. Concerns about physical security and business disruption will linger. A recent BCG survey revealed that "business continuity" has now surfaced as a top management concern. And continuing economic uncertainty will ensure that global interest in workplace security as well as productivity will remain. As one CEO observed recently, "A year ago, facilities were not even on my radar; now they're right in the center."

For companies everywhere, the upshot is that deconcentrating the workplace is no longer an option, but an imperative. As a result, senior executives across industries and regions have found themselves re-examining their corporate infrastructure. As they do so, the key questions remain the same as ever—yet the answers are no longer as intuitive or straightforward as they once were. Consider:

- *Where should we locate—and what should we build?* Today, location is increasingly a matter of security and interoperability as well as customer service, cost, and convenience. Advances in wireless communications and computing can both liberate vast numbers of employees from their tethers to specific locations and allow firms to manage broadly dispersed operations. Yet these technologies also increase dependence on power and telecommunications grids. So in planning and building their workplace infrastructure, companies must find new ways to balance three interlocking and potentially conflicting tradeoffs: access (for customers and employees), layout (for efficient and effective operations), and mass (to minimize visibility and over-concentration).

- *How can we mitigate and manage infrastructure risks?* Financial and environmental risks have long been high on management agendas. Since September 11, physical threats to employee safety and infrastructure security have risen to paramount concerns. Firms must determine how to disperse employees and facilities not only for maximum benefit but also with minimum risk to the individuals, the company, and the community. Tradeoffs between physical and systems security (to pre-empt risk), back-up operations sites (for business continuity in the event of disasters), and insurance (to pay for disaster recovery) require especially robust and informed judgments, as the solutions affect every company stakeholder.

- *When and how should we transform the workplace?* Managers must decide how to organize functions and people to reduce risks while improving operational efficiency and effectiveness. There are no pat answers to basic questions, such as: Who *should* work in corporate facilities, and who *could* work elsewhere? How can we maintain team integrity, as well as the social and intellectual benefits of teamwork, when individuals and work units are dispersed across multiple sites and time zones? Which policies and practices—from removing executive suites to installing individual incentives—will cause employees to accept deconcentration without diluting the underlying values that determine the firm's culture and ensure its long-term success?

- *Which facilities should we keep and which should we sell?* Decisions to lease, buy, build, or dispose of corporate facilities can be made only after the above three questions are answered. The toughest choices usually involve disposition, simply because most line managers find it easier to acquire new space than to eliminate existing excess space. Therefore, it is up to senior executives to determine which current facilities should be maintained, both to sustain ongoing performance and to ensure business continuity, and which should be disposed. Then, they should move decisively to rationalize the facilities portfolio by separating surplus facilities from the company's mainstream real estate activities. Even large portfolios of "legacy assets" can be reconfigured through disposals and adaptive re-use, provided they are priced to the market and managed separately—but this takes a highly focused, disciplined effort.

Until recently, decision makers tended to ignore these questions about corporate infrastructure until they were confronted, periodically, by needs to relocate operations, build new plants, or reduce staff (and, consequently, realign the facilities that house them). Then, with little preparation, these executives either tried to become instant experts, or delegated the decisions to specialists several rungs down the organizational ladder, or outsourced the function entirely.

Such an approach is no longer tenable. In most organizations, infrastructure is the largest balance sheet asset and the second highest operating expense. It can help or hinder the achievement of organizational mission and objectives. And it is critically important to the organization's strategic positioning, competitive advantage and operating performance.

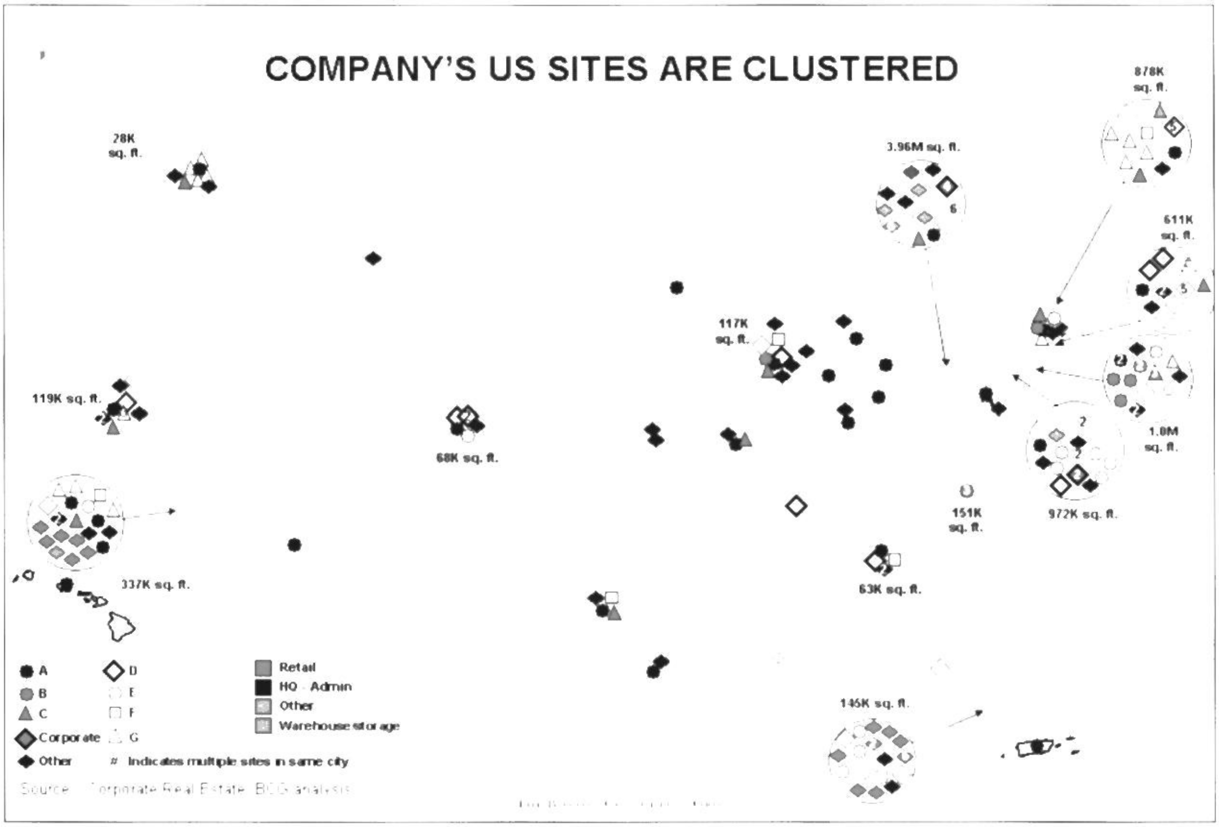
PRINCIPLES OF DECONCENTRATION

Deconcentration changes the paradigm for managing corporate infrastructure. Until recently, a company's infrastructure was defined both by its real estate and by its information systems. These two elements were, and in most firms still are, managed through separate, distinct decision processes and functional organizations. However, in the mid-1990s, several major companies, including American Express, AT&T and IBM began pursuing innovative organizational and systems concepts that fused the *places* where people work with the *technologies* they use to communicate and compute, wherever they are. Today, these two elements of the workplace are inextricably intertwined—witness the trend toward global "24/7" operations—and they form the foundation for three broad principles that will help executives to frame and execute deconcentration strategies.

First, the workplace can be anywhere. Deconcentration challenges traditional real estate location theory by allowing companies to move work to the workers instead of the workers to work. Many workplaces, like markets, are now global, not local. Work often is shared through technology, not dedicated in or dependent on specific locations. Time can leverage the redistribution of work, achieving "24/7" operations across geography, functions and business units.

Networks of people, information and resources—not buildings—define the new workplace infrastructure. These networks are linked *electronically*, through the Internet and phones; *spatially*, through "hotel-like" offices; and *socially*, through teams with shared interests and resources. This means that individuals and teams can be efficient and effective anywhere. And as workspaces shift from single locations owned by the company to multiple sites owned by others (including employee and customer homes), the workplace remains essential to production but its economics change radically. Leaders in organizations as diverse as American

Figure 1

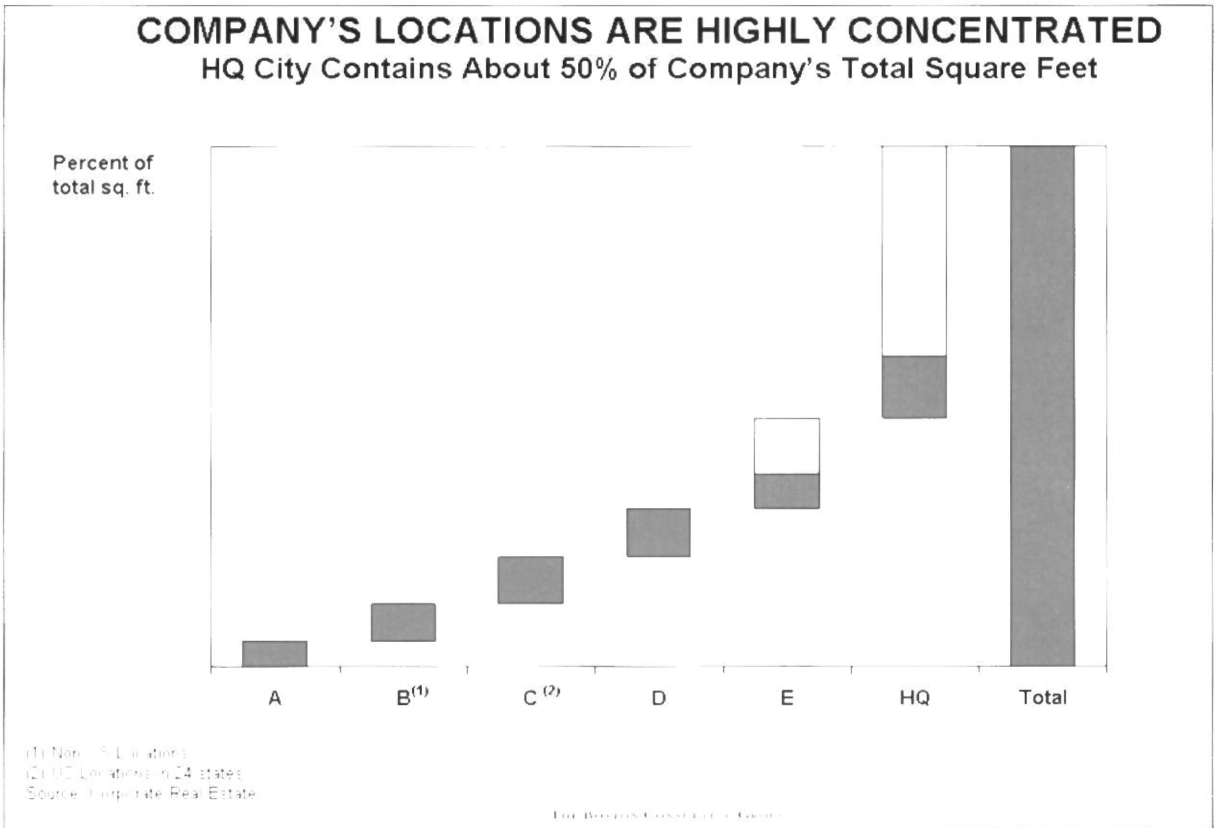


Express, IBM, and Sun Microsystems have championed this concept.

Figures 1 and 2 show the portfolio of one large company that typifies the situation faced by many. Its headquarters' city has about half of its total real estate, including large front office and operations functions. Many sites also are clustered in several other metropolitan areas—the inevitable result of both decentralized operations and multiple acquisitions that have yet to be rationalized. This firm is addressing two strategic issues: whether to consolidate "front office" and retail activities into fewer urban sites, and where to deconcentrate "mid-office" and "back-office" functions among the outlier locations it already has.

As a counterpoint, consider Sun's "anywhere, anytime" strategy. This combines employee and contractor homes, corporate "hubs," "drop-in" centers and satellite offices. Homes are for individual work, connected to the organization by phones and computers. "Hubs" have all of the facilities, furnishings and equipment of the conventional corporate office: individual executive, professional and administrative workspaces; dedicated conference rooms; high-bandwidth communications equipment and systems technology; full meeting support, travel and clerical services; and permanent paper file storage. "Drop-in centers" accommodate those who periodically need high bandwidth, sophisticated programs and focused teamwork, but they are housed in simple, low-cost, utilitarian buildings. On an average day, 30% of Sun's employees are "on the road." They do not have assigned, dedicated workspaces in hubs and drop-in centers, but can reserve offices, workstations, and meeting rooms as needed in those and numerous other locations that are provided either by Sun or by "shared office" suppliers and others. As Sun's CEO Scott McNealy says, "I'm paying rent, depreciation, and utilities on all kinds of office space just so someone can have a nice place to hang a picture of his dog. I include myself in this, by the way. The only tools I need are a browser, a wireless phone, and access to a network.... I tell CEOs to walk down the halls in some of their buildings on Wednesday at 10 o'clock in the morning and note to themselves what the peak occupancy is. It's usually 40%, at most. So why are they paying for all that unused space?" By deconcentrating its infrastructure, Sun expects to cut $240 million from its $800 million annual occupancy cost during the next few years.

Figure 2



Second, infrastructure is a strategic resource. Many executives still see infrastructure in simplistic terms—as a necessary (but sleeping) asset and as a fixed (therefore uncontrollable) expense. Meanwhile, line managers treat it as an administrative burden or as a commodity to be traded, not as a resource to be efficiently utilized and protected. They focus on objects, not assets, and price, not value. In such organizations, infrastructure is managed with one of two mindsets: ether technical and cost-driven or transactional and deal-driven. Executives focus on lease terms and financial engineering when location and layout decisions typically drive occupancy costs.

Until executives define, analyze, and convey the strategic implications of infrastructure issues, few have an immediate, intuitive grasp of the underlying factors that drive real estate costs, limit strategic moves, and cloud (or even eclipse) the options for improving their current situation. The keystone is to link "business" data on customer service, employee productivity, financial performance and operations with "facilities" data on locations, costs, utilization, design, construction, and value. These linkages, when combined with creative problem-solving, produce fresh insights for top management and build momentum for real estate initiatives. And the analysis of real estate profit economics and key success factors establishes enduring principles for a "business approach" to corporate real estate, and the strategies that are employed by successful entrants.

Figure 3 shows the information architecture that should frame corporate real estate management systems. It combines databases on business economics, operations, and staffing with facilities and real estate market data to reveal utilization, productivity and full occupancy cost. Applied to each business unit, function, and area, discrepancies within the company can be identified more effectively than external benchmarking. Using such metrics, Figure 4 reveals the mismatch between this company's branch locations and its customer base. Not only does it occupy three costly central city sites within a few blocks of each other; it lacks any presence in the very communities it has targeted for customer penetration and competitive success.

Third, mobility enables business continuity. Corporate executives can learn much from the military in preparing for the unexpected. In fact, the military is more advanced than business in many respects, adapting its strategies, structures, and

Figure 3

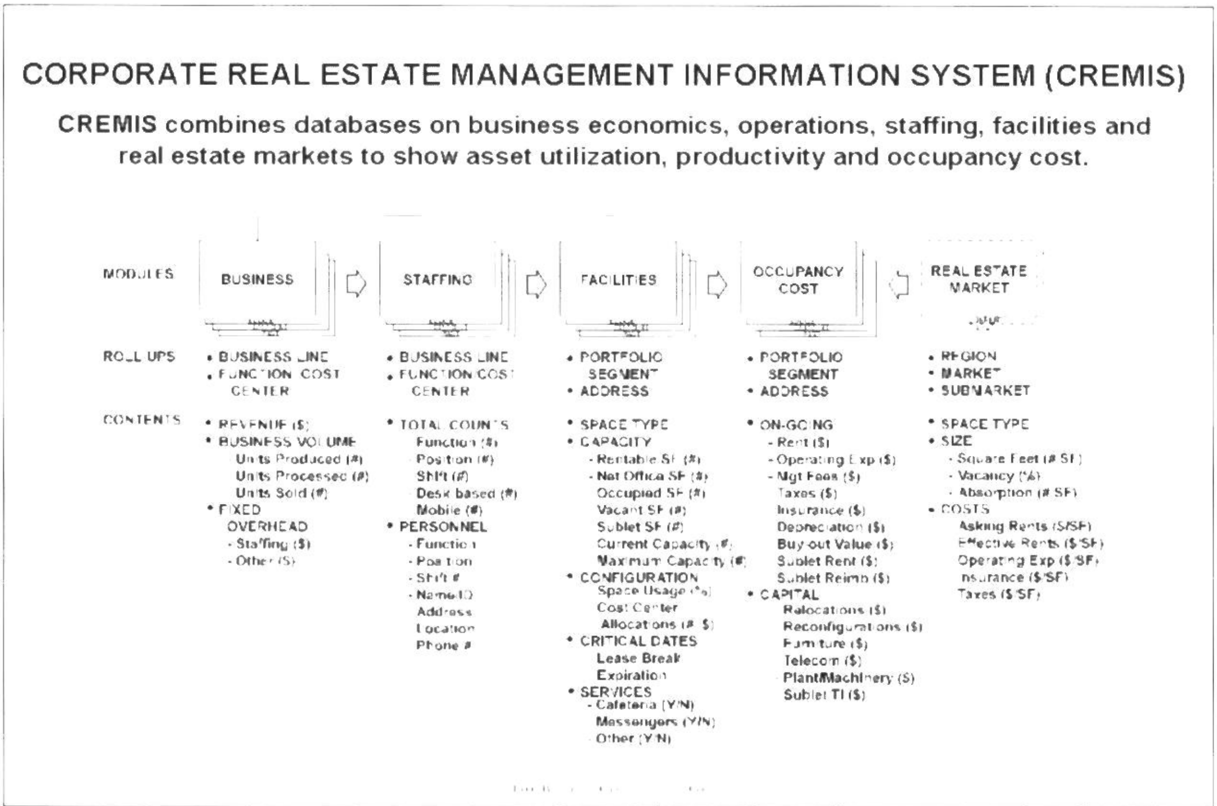
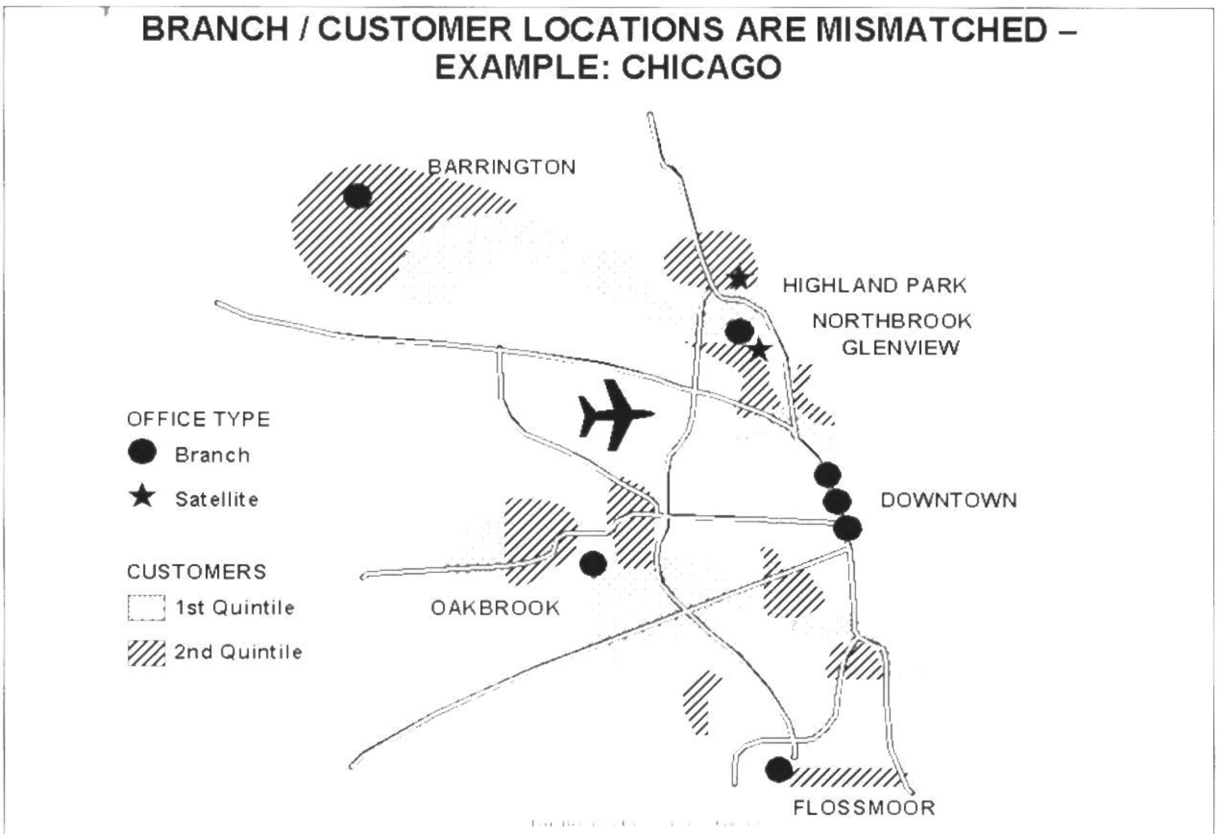


Figure 4



systems to the challenges of unconventional warfare, and employing non-linear thinking about its infrastructure—in particular, the links between mobile operations and contingency planning.

Military doctrine is rooted in "mobility." From the Romans' portable encampments to the current system of "expeditionary" and "special operations" forces, military officers have been imbued with the attitudes and know-how to balance permanent installations and "heavy," fixed, costly facilities with temporary sites and "light," flexible, low-cost structures. Today's strategy of frequent forays to distant lands from fixed home bases is rooted in four capabilities: satellite communications, "just-in-time" logistics, multi-unit platforms, and thorough training. While these capabilities can be found in many companies, few have invested equivalent time and energy in planning for the mobile workplace.

IBM's "Mobility Initiative," launched in 1993, was a far-reaching attempt to simultaneously reduce high, fixed infrastructure costs, increase employee productivity and improve customer responsiveness. By capitalizing on the technical capabilities and entrepreneurial motivation of its vaunted sales force, IBM was able to deconcentrate some 25,000 employees (or 17% of its global workforce) over a four-year period. In addition to real estate savings totaling $1 billion, this program also enabled IBM to significantly improve the sustainability of its customer service operations and reduce the risks of over-concentration in specific downtown sites.

Mobility, supported by contingency planning, also made all the difference immediately after the September 11th attacks. Morgan Stanley (MS), with 3,700 employees in Lower Manhattan, had prepared evacuation and "back-up" plans during the Persian Gulf War, and had reinforced these after the 1993 World Trade Center bombing through disciplined organization, systematic training, and detailed manuals. The approach was developed by a former military officer and based on military experience and practices. MS established alternate facilities in three other New York City locations, with storage and communications systems support in Dallas. These plans were critical in saving nearly all MS employees and quickly restoring operations.

Similarly, Citigroup activated dormant facilities reserved for disaster recovery and "hot seats" for its critical trading functions. Thousands of professionals and administrators decamped to work from home and various company sites. Citigroup executives and staff continued nearly all of their scheduled meetings without delay, as video-conferencing seamlessly replaced hundreds of pre-planned trips that week. In the aftermath of September 11th, these and other firms took bold, decisive actions to reduce the risk of future business breakdowns and are now pioneering contingency planning for disaster recovery and business continuity—mainly by reconfiguring operations to accommodate immediate shifts in workload to distant sites if any one site goes down for any reason.

The regulators too are now weighing in on this issue. The SEC, Federal Reserve Board, and Treasury Department have issued a contingency plan requesting major Wall Street firms to establish backup facilities within a sweeping regional arc up to 300 miles from Manhattan, ranging from Southern Maine to Southern Virginia. These sites would eliminate the dependence of an entire industry that is critical to the global economy on a single power and telecommunications grid, yet would still be accessible within one day's drive of New York. Thus, at this writing, continuity is becoming a matter of corporate compliance as well as best practice.

Figures 5 and 6 illustrate the frameworks managers can use to assess their company's "mobility potential" for alternative workplace sites. By dissecting the linkages between Space, Functions, and Time within each business unit and across contiguous units, they can locate facilities that optimize human resource availability and cost with global time management. Then, they can determine how important "face time" is in the individual employee's work, both with customers and with colleagues, and decide on locations accordingly.

IMPLICATIONS OF DECONCENTRATION

Deconcentration speaks to a subtle yet profound shift in American values that now affects employers and employees alike. In a society where work is central to the culture and to individuals' self-esteem, the mobile, "24/7" workplace is a compelling notion in theory but a double-edged sword in practice. Technology is eroding the traditional boundaries between worklife and homelife. Employees are rebelling against the ever-increasing encroachments on their personal time. Baby-

Figure 5

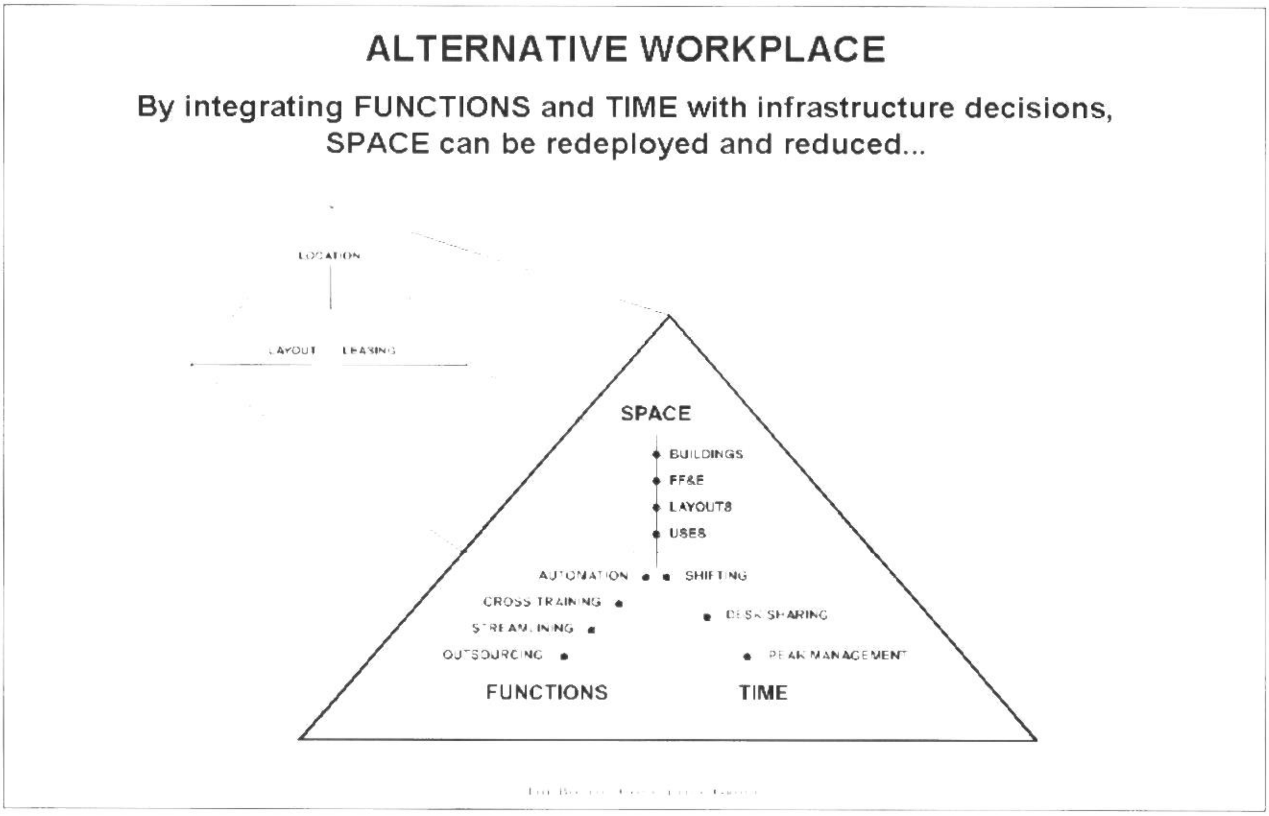
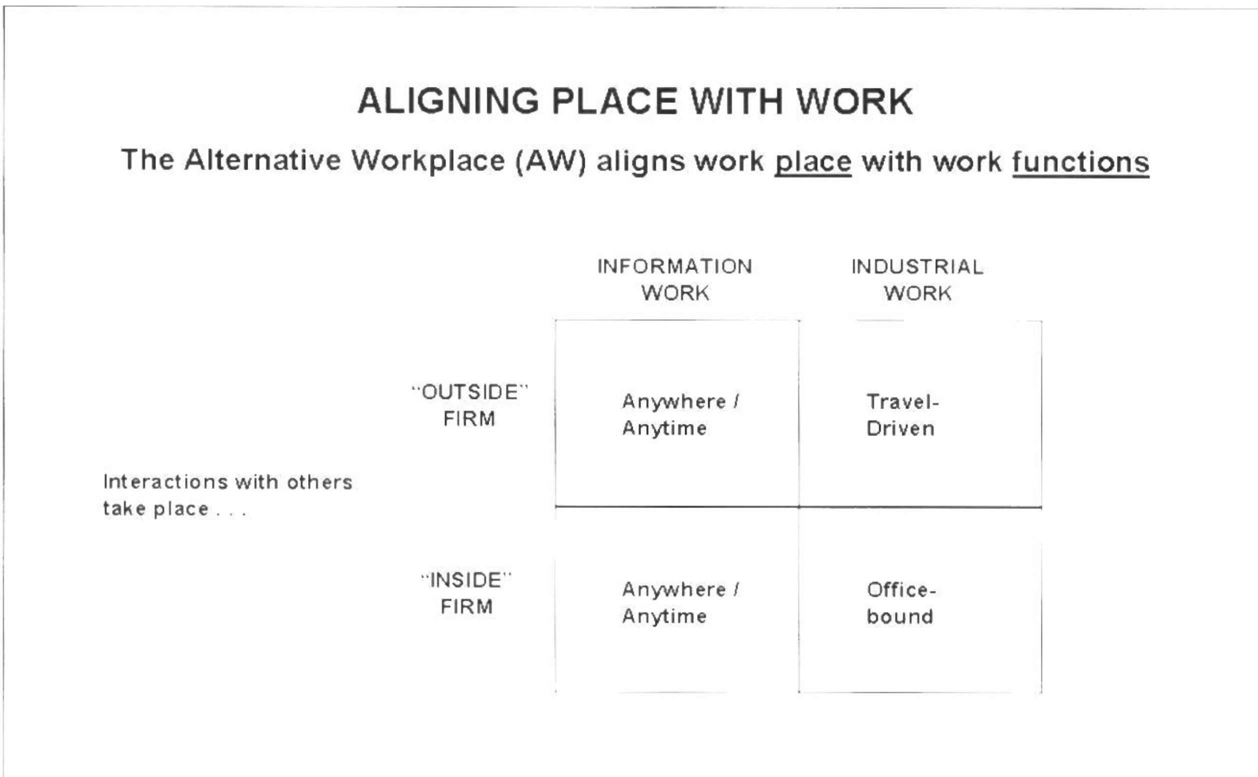


Figure 6



boomers score family pursuits higher than financial gain: two out of three would take two weeks of extra vacation time over two weeks of extra pay. Americans look with envy at Europeans and Japanese who routinely take six weeks of annual holiday. Astute employers are redesigning their work cycles, enabling employees to fit separate half-day blocks into 24-hour work packages and three-day workweeks. But along with the workplace redesign, they must also change corporate norms that heavily favor "face time" to emphasize more objective measures of individual output and productivity.

Deconcentration, in fact, carries far-reaching implications, not only for organizations and their employees but also for cities and communities that house the workplaces, homes, and myriad other facilities that frame people's lives. Consider these possibilities:

- Traditional definitions of the workplace—and, therefore, the norms and conditions of work itself—become obsolete. Face time is less relevant in individual advancement; instead, output, and productivity become the measures of performance and the triggers for promotion.

- Workers can live where they like; their assigned company locations no longer matter. Instead, workers' access to information and to co-workers through electronic media becomes paramount. Conversely, customer locations for sales and service gain in importance. From the Greek agora to the American mall, people still like to buy and sell face-to-face, and to congregate in marketplaces where entertainment facilitates their transactions. Companies that develop interactive communications and intuitive computing to leverage these intensely personal, highly predictable preferences gain a substantial competitive advantage through higher employee productivity in workplaces and shops alike.

- New norms liberate both workers and managers from standards that promote workspace entitlement (such as "the corner office") yet also are derided (such as Dilbert's "cubicle"). Yet managers are challenged to ensure that employees are productive wherever they are, requiring more fluid, flexible schedules, and seamless, "24/7" operations. And workers, while enjoying newfound independence, risk "burnout" if they allow work outside the workplace to overwhelm their lives. Companies will need to help employees balance work, family, and personal pursuits through effective use of their total time, and not simply leave this to chance.

- Through workplace redesign, companies transform the real estate legacies of command-and-control organizations. Space reductions and efficiency improvements save money, increase productivity, and foster innovation. In "hub" offices, space is reconfigured into "neighborhoods" to promote a sense of community. Large, open bays, interspersed with "huddle rooms," "cafes" and other impromptu meeting points, reflect flat hierarchies. Workstations are no longer relegated to secretaries. Managers, administrators and technical staff across many grade levels occupy individual workspace modules of varying sizes reflecting their functions instead of their ranks. Conference space is styled to stimulate creativity and teamwork. And even plant design increasingly reflects these same physical attributes.

- "Trophy" buildings lose their value, as functionality supersedes image and occupants perceive more risk in high-rise, high-visibility, high-rent structures. Building designs return to the fundamentals of "efficient" and "attractive," not dominant and imposing. The added costs of security—from terrorism insurance to back-up operations centers—weigh heavily on industrial, distribution and service firms, especially in older, built-up areas. While declines in asset values and increased operating costs ultimately will show up in pricing, they may impair short-term earnings for those who invest heavily in business continuity.

- "Significance" no longer requires skyscrapers. The office towers that dominate downtowns are triumphs of engineering but only a few excel as urban design. From the 1960s on, building size and visibility proclaimed corporate success. "Curb appeal" became architectural dogma; companies competed for naming rights. As security concerns prevail, occupants now prefer less visible buildings that not only are safer but assimilate better into their environments. The relationships among building height, shape and mass, and surrounding public spaces, reflect a balance of aesthetics and economics. Companies are the fulcrums, for they determine the market. Employees want to be closer to ground and less crowded. Washington, DC has a 12-story height limit, and public spaces occupy 40% of its land. The five-story Pentagon, though equivalent in size to one World Trade Center tower, suffered far less because of its distributed mass.

- Companies cash out of costly headquarters buildings and corporate campuses, recognizing that they don't have to own real estate to control it and can redeploy scarce capital more productively. Citigroup's recent billion-dollar sale of its New York headquarters spurred a significant quarterly earnings increase. AT&T sold its New Jersey headquarters for $200 million and McGraw-Hill is pondering a similar $700 million deal. Yet simultaneously, others such as Merrill Lynch, Nortel, and Lucent are unloading properties at fire-sale prices—one-half to one-third of their replacement cost.

- "Smart growth" policies, which concentrate roads, schools, sewers, and other public facilities in established communities with room to increase their densities, become more politically and sociologically acceptable. Employees, living long distances from their workplaces, increasingly lose valuable time in long commutes. While they enjoy urban density for many activities, they also like suburban living. When people and facilities are spread out and linked by instant communications, their safety is enhanced. This accelerates a trend that was spawned in the 1950s by the fear of nuclear attack and enabled by the Interstate Highway System. Now, trains are enjoying a renaissance and transit-oriented development is fueling the revival of older suburban town centers, capitalizing on their distinct community image and distinctive shopping areas around train stations. Cultural facilities complement commercial development and housing.

- "Trading down" takes prominence in companies' decisions to deconcentrate in the wake of recession and renewed attention to reducing their fixed costs of business. Already, cities like Baltimore, Denver, Des Moines, and Las Vegas attract employers looking for business-friendly communities, affordable housing and high-quality workforces. Those in high-cost cities like Boston, New York, Seattle, and Washington, DC are trading down to these second- and third-tier cities, not only for "mid-office" and back-office operations but for regional headquarters, distribution centers and specialty business units. Toyota recently established a 400-person administrative and operations center for its Financial Services unit in a Baltimore suburb. For businesses, the cost savings, recruiting, and productivity benefits are demonstrable. For cities, economic recovery, renewed growth, and local morale boosts are much needed.

- Corporate real estate enjoys new goals in knowledge-based businesses—frugal, functional, and fun. But to achieve these, new and more robust strategies are required. Large, lavish, specialized headquarters requiring long commutes to work are out. Small, simple, generic workspaces with high functionality and the capacity to telecommute are in. Real estate portfolios may actually increase in size and complexity while the costs per unit are sharply reduced. New conceptual and analytical techniques must be infused in the strategic planning process. The overall *global grid* optimizes space, functions, and time. The *facilities menu* offers a limited number of fixed-priced workplace selections for mainstream decision-making, with an a la carte menu of custom offices for special situations. The *knowledge box,* designed from the inside out, is shrink-wrapped around the functions and operations within. The *building skin* fits into the neighborhood, but does not seek to make an "architectural statement."

In the end, deconcentration requires top management commitment and bottom-up acceptance. While CEOs reacted immediately to September 11th, corporations now must sustain top-level attention on issues that go well beyond crisis management. There is much at stake. Through concerted management attention and creative deconcentration strategies, AT&T freed up $550 million in cash flow; IBM reduced total occupancy costs by $1.2 billion and redeployed $100 million in annual savings; and one American Express unit increased productivity by 70%.

Corporate leaders should rethink business infrastructure in terms of strategic advantage, productivity and morale. In their zeal to grow and change, many firms overlook the basic business risks of destroyed, impaired, and excessive infrastructure. And ingenious financing schemes, so prevalent in the 1990s bull market, divert companies from applying new technologies and work practices to their infrastructure and business processes.

As recently as 2001, rosy assumptions led many to add space at more than double the rate of job growth, creating a huge real estate overhang. Now they must shed that excess, and then some. As they do so, companies with strong balance sheets and cash reserves should take full advantage of the depressed market and low cost of capital to consider how to streamline and improve the workplace itself. By reinvesting in employee-centered, customer-friendly, cost-saving facilities and systems, they will improve employee safety, satisfaction and productivity.

NOTE ON SOURCES

While this article is based on my experience in consulting with a number of corporate clients, I have benefited from the following publications and research that may also be helpful to readers who are interested in further details about the forces that are driving deconcentration:

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International Real Estate Investment Risk Analysis

By Herve A. Kevenides, CRE

The late 1980s and early 1990s marked a burgeoning interest in international estate investment among United States institutions. Many investors believed that investment in international real estate could enhance overall performance by increasing returns and reducing portfolio volatility. During the late 1990s, the impetus for investing in international real estate came from the poor performance of American real estate during the 1987 to 1992 period. Investors were concerned about the difficulty of selling under-performing real estate assets during a period of significant over-production and weak demand.

By 2000, the Euro was beginning to have a remarkably beneficial effect on Europe. It integrated the 11 countries' financial systems, decreasing the cost of capital by creating a deeper, more liquid market. Many European Union (EU) countries support EU enlargement to include the current ten accession (2004) candidates—Malta, Hungary, Poland, Cyprus, the Czech Republic, Slovakia, Estonia, Latvia, Lithuania, and Slovenia. Other countries being considered for membership later on in the decade include Switzerland, Norway, Iceland, Bulgaria, Romania, and Turkey.

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Current EU countries would prefer that new members be wealthier nations, with Switzerland and Norway as the most popular candidates. This preference is linked to the common perception that admitting poorer countries to the EU could unleash substantial labor migration flows. The precise scale of migration flows from the accession candidates is difficult to predict. Estimates based on the post-war German experience suggest that about 3.5% of the population of the 10 new members (1% of the current EU population) will seek jobs in Western Europe.

Recently, the amount and cost of capital have respectively increased and declined. On average, European companies pay more than half a percentage point less for their capital that if the Euro did not exist. More than $600 billion were raised last year. This means that more Euro-denominated bonds were issued in 2001 than dollar-denominated bonds. A return to growing rents and overall economic health is likely to occur by 2005 in Paris, Milan, and Brussels. Markets like London, Frankfurt, Stockholm, and Madrid will continue to shift sideways during the next three years.

IMPLICATIONS OF THE NEW GLOBAL ECONOMY

The post-industrial age began soon after World War II in the United States and arrived in Western Europe and Japan in the 1960s. Its distinguishing characteristic is a declining emphasis on material goods and a growing interest in quality of life. Quaternary activities steadily expand, resulting in an elaborate division of labor and supplying a whole new set of societal needs. Service activities including banking, retail, telecommunications services, and public sector activities, such as education and medical care, have grown in importance. However, this does not mean that manufacturing is on the way out.

The key characteristic of the New Economy is increasing global interdependence. Rising trade fosters a cycle leading to greater competition and efficiency, more rapid diffusion of innovations, and greater productivity gains. However, the growing dependence of services on a sophisticated infrastructure of hardware and software has increased their cyclical vulnerability.

The New Economy reflects a willingness to undertake massive risky investment in innovative information technology. This, when combined with a

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decade of improvements in the U.S. financial markets, down-sizing of the Federal government, and efforts by corporations to cut costs and increase efficiency, has had a profound impact on the competitiveness of the American economy.

The Institute for International Economics, a Washington think-tank, expects that between 30% and 40% of global financial assets will end up denominated in Euros (with between 40% and 50% in dollars, and the rest in yen and a few other currencies). This would imply a shift of between $500 billion and $1 trillion into Euros, primarily out of dollars, as investors and central banks reshuffle their portfolios.

CHALLENGE OF INTERNATIONAL REAL ESTATE INVESTMENT

International real estate investment represents considerable decision-making, organization and managerial challenges above and beyond the problems of achieving the desired cash flows at the building level. These challenges are accentuated by the time-distance gap from the United States and the different socio-economic and cultural structures associated with individual national markets.

International real estate investment requires a concentrated scrutiny of the problems and opportunities linked to such decisions. A number of macro issues must be examined to reduce systematic risks for portfolio allocation across particular nations. By extension, international diversification assists, but does not remove, systematic risks.

One of the most popular means of international real estate investment is a country fund. Using country funds, investors can speculate in a single foreign market with minimal costs, construct their own personal international country portfolios using country funds as building blocks, and diversify into emerging markets that are otherwise inaccessible. Some of the most common variables in the initial winnowing process used to determine the economic desirability of a nation for real estate investment are gross domestic product (GDP), per capita income, and the percentage of GDP devoted to service industries.

CALCULATING AND ANALYZING VALUE AT RISK

Value at Risk (VAR) is the amount of money an institution could make or lose from changes in the price of the underlying assets. VAR reduces a firm's total market risk to a single number. In other words, VAR is a statistical estimate based on historical data. Most firms are more worried about what they can lose if the markets move against them. Consequently VAR has become a measure of potential losses rather than a measure of potential gains. The VAR concept incorporates two central elements of risk: (1) the sensitivity of a portfolio to changes in underlying prices and (2) the volatility of the underlying prices.

The former reflects how well the portfolio is hedged (the better hedged it is, the less sensitive to price changes) and the latter, the likelihood of large price fluctuations. The size of the price change is inextricably linked with the holding period. The longer the holding period, the greater the possibility that price changes will lead to a higher potential loss.

There are three main approaches to calculating value at risk:

1. The correlation method, a deterministic approach also known as the variance/covariance matrix method. According to the correlation method, the change in the value of the position is calculated by combining the sensitivity of each component to price changes in the underling asset, with a variance/covariance matrix of the various components' volatilities and correlation.

2. Historical simulation. This approach calculates the change in the value of a position using the actual historical movement of the underlying asset, but starts from the current value of the asset. It does not require a variance/covariance matrix.

3. The length of the chosen historical period has an impact on the results. If the period is too short, it may not capture the full variety of events and relationships between the various assets and within each asset class. If it is too long, it may be too stale to predict the future. The advantage of this method is that it does not require the user to make any explicit assumptions about the correlation and dynamics of the risk factors, since the simulation follows every historical move.

4. Monte Carlo simulation, a technique for dealing with complex resource allocation problems that cannot be solved by mathematical analysis. This technique involves creating a typical life history of a system that represents the actual problem and its rules of operation. Repeated runs of the simulation, slightly altering the operating rules each time, enable experimentation aimed at discovering methods of improving the performance of the system.

The Monte Carlo simulation method calculates the change in the value of a portfolio using a sample of randomly-generated price scenarios. In this approach, the user makes certain assumptions about market structures, the correlation between risk factors and the volatility of these factors. Unlike the historical simulation method, a Monte Carlo simulation requires the user to rely on his views and experience in evaluating risk.

All three methods include three basic parameters: a holding period, a confidence interval and a historical time horizon, over which the asset prices are observed. One way of evaluating the accuracy of a firm's VAR methodology is to compare the estimated (ex-ante) VAR number produced by its internal model with its actual (ex-post) profit and losses. A VAR number can be calculated for individual positions and for whole portfolios. If a firm has only one position, the VAR number represents the potential loss of that instrument, for a specified time horizon and confidence interval. Once it has two instruments, it will have two VAR numbers. To arrive at one number for both positions, it is necessary to evaluate whether and to what extent the positions offset or reinforce each other when the market moves.

These tendencies can be captured by the statistical measure of correlation that calculates the degree to which changes in two variables are related. It is normally expressed as a coefficient between plus or minus one. A +1 correlation means that the variables move in the same direction to the same degree while a -1 means that they move in opposite directions to the same degree. The statistical measure also depends on whether past correlation assumptions are valid for the future. Although in theory correlations should be stable, in reality they are not. They are at their most unstable level when markets are under stress. In short, correlations have a tendency to break down when they are the most needed.

A firm can use correlation offsets within a risk (asset) class, but not between risk classes. Similarly, banks can have capital relief for offsetting positions in a risk class, but not between classes. The VAR numbers for the various risk classes—interest rates, equities, currencies and commodities—must be added up to form the basis of a market risk capital calculation. The Bank for International Settlement (BIS) wants banks to have market risk capital to support their positions in a doomsday situation.

GREATER OPPORTUNITIES FOR DIVERSIFICATION

One means of mitigating risk is through the process of portfolio diversification. Diversification simultaneously pools and subdivides risks. Diversifiable risk is also referred to as unsystematic risk or idiosyncratic risk. It is the portion of the total risk of an asset that is not captured by its beta. Unsystematic risk is the risk unique to a particular asset. Since investors can eliminate unsystematic risk from their portfolios by diversifying, they are not rewarded for taking this risk.

One of the most compelling reasons for investing abroad is diversification. The passage of ERISSA (Employment Retirement Security Act of 1972) further reinforced the notion of diversification. International real estate investment portfolios revolve around how much investors can gain from international diversification and the effects of fluctuating exchange rates. Returns on real estate are much less correlated across countries than within a country, because of differing economic, political, institutional, and psychological factors.

There is a large amount of home bias in real estate portfolio holdings. The reasons for this bias include the belief that domestic securities provide investors with a hedge against domestic inflation, and a conception of formal and informal barriers against investing in real estate overseas, extra taxes, and transaction and information costs. Further, investors are more willing to invest in the United States than in less familiar countries.

A real estate portfolio consisting of different assets is not always less risky than one consisting of a single asset. A portfolio needs to comprise the kind of assets that will provide desired diversification. Once properly diversified, a portfolio is less exposed to risk, but consequently also closer to average rather than maximum returns. This tradeoff between risk and return is known as the risk-return frontier. Its shape is curvilinear with diminishing returns matched by an increasing level of risk. Since there are numerous market inefficiencies in real estate, only a few properties are available for sale at any given time. Consequently, an investment portfolio should consist not only of real estate, but also of common stock and other marketable securities.

Portfolios can be constructed in such a way that the overall risk of the portfolio is less than the weighted average of the standard deviation of the individual assets. Balance sheets have never really captured all the financial risks a firm faces. The function of balance sheets is to account for the historical performance of the firm. Credit and interest rate risks in a loan portfolio cannot be quantified without further information on maturities, counterparties, and the proportion of secured versus unsecured lending.

IDENTIFYING, DEFINING, MEASURING, ANALYZING, AND FORECASTING RISKS

Systematic risk is undiversifiable risk, market risk, or beta risk. Systematic risk cannot be avoided by diversifying among securities. Because of this, investors demand and, over the long run receive, compensation for bearing such risk in the form of an excess return. Market risk deals with the level and timing of absorption and the prices or rental rates at which this absorption takes place.

Political Risk—Country risk analysis involves an examination of a country's economic outlook and the stability of its government, as well as such factors as corruption, the crime rate, and the possibility of expropriation. In addition to these risks, real estate is also subject to numerous legislative and regulatory risks, such as changes in tax laws, rent control, zoning, and other government-imposed restrictions.

There is no unanimity yet on what constitutes political risk in a given country and how to measure it. Measures of political stability may include the frequency of changes of government, the level of violence, the number of armed insurrections, conflicts with other states, and so on. The basic function of such stability indicators is to determine how long the current regime will be in power and whether the regime will be willing and able to enforce its foreign investment guarantees. Most companies believe that greater political stability means a safer investment environment. From Canada to the Czech Republic, from India to Ireland, from South Africa to the former Soviet Union, and to Zimbabwe, which hosts the most prominent ethnic land disputes, political movements centered on ethnicity, national identity, and religion are reemerging to contest some of the most fundamental premises of the modern national state.

Companies differ in their susceptibilities to political risk depending on their industry, size, composition of ownership, level of technology, and degree of vertical integration. For example, expropriation or creeping expropriation is more likely to occur in the extractive utility and financial sectors of an economy than in the manufacturing sectors. Because political risk has a different impact on each firm, it is doubtful that any index of generalized political risk will be of much value to a company selected at random. The specific operating and financial characteristics of a company will largely determine its susceptibility to political risk and the effects of that risk on the value of its foreign investment.

In the large majority of countries, expropriation appears to be used as a fairly selective policy instrument. Rarely do governments, even revolutionary ones, expropriate foreign investment indiscriminately. In general, the greater the perceived benefits to the host economy and the more expensive its replacement by a purely local operation, the smaller the risk of expropriation.

One good indicator of the degree of political risk is the seriousness of capital flight. Capital flight refers to the export of savings by a nation's citizens, who doubt the safety of their capital. Capital outflows can be inferred by using balance of payment figures. These estimates suggest that capital flight represents an enormous outflow of funds from developing countries. This phenomenon occurs for several reasons relating to inappropriate economic policies, which include government regulations, controls, and taxes that lower the return on domestic investments.

Business Risks—Business risks involve changes in occupancy rates, the level of new construction, and zoning and permit regulations, as well as additions to the competitive supply. Other risks include labor problems and moratoria on various types of utilities, for example gas, sewers, water, and electricity.

Differences among customers and building practices may result in losses due to construction delays, the failure to obtain necessary permits, and the behavior of labor and supervisory personnel, which may be unacceptable to American investors and other stakeholders. Business people have to make subjective estimates. Economists refer to this situation as an incomplete market—one in which not all scenario payoffs are replicated.

Risks from Unsound Monetary and Fiscal Policies— Fiscal irresponsibility is a sign that a country is likely to be politically risky. The government deficit as a percentage of gross national product is a risk indicator. The higher this figure, the more the government is promising to its citizens relative to the resources it extracts in payment. The greater the deficit, the higher the possibility that the government will not be able to keep all its promises without resorting to expropriations of property.

Domestic policies play a critical role in determining how effectively a nation deals with external shocks. Asian nations, for example, successfully coped with falling commodity prices, increasing real interest rates, and rising exchange rates, because their policies promoted relatively low inflation rates and small current-account deficits.

The opposite was true for Latin America, where most countries believed that growth is best promoted by development strategies characterized by extensive state ownership and control. On the one hand, many of these countries took over failing private businesses, nationalized the banks, protected domestic companies against imports, ran up large foreign debts, and heavily regulated the private sector. On the other hand, the "East Asian Tigers" (Hong Kong, South Korea, Taiwan, and Singapore) demonstrated their ability to imitate and innovate in the international marketplace.

The lack of foreign competition has contributed to long-term inefficiency among Latin American manufacturers. Latin American producers were content with the exploitation of domestic markets, charging prices typically several times the international rate for their goods. At the same time, state expenditures on massive capital projects diverted resources from the private sector and exports. Much of this investment funded inefficient state enterprises, resulting in wasted resources and large debts. The decline in commodity prices and the simultaneous rise in real interest rates should have led to reduced domestic consumption.

Fearing that spending cuts would threaten social stability, Latin American governments delayed cutting back on projects and social expenditures. Borrowing overseas filled the gap between consumption and production, enabling them to temporarily enjoy artificially high standards of living. Latin American governments also tried to stimulate their economies by increasing state spending through high rates of monetary expansion. This response exacerbated their difficulties with high rates of inflation, combined with fixed exchange rates, boosting the real exchange rate and resulting in higher imports and lower exports.

The overvalued exchange rates, interest rate controls, and political uncertainties triggered massive capital flight from the region. The result was considerable balance of payment deficits that necessitated more foreign borrowing and higher debt service requirements. The amount of unproductive spending in the economy is an indicator of potential political risk. To the extent that capital from abroad is used to subsidize consumption or is wasted on showcase projects, the government will have less wealth to draw on to repay the nation's foreign debts and is more likely to resort to exchange controls and higher taxes.

Risks from Changes in the Country's Economic Base—The resource base of a country consists of its natural, human and financial resources. Other things being equal, a nation with substantial natural resources, such as oil or copper, is a better economic risk than one without those resources. However, nations such as South Korea or Taiwan turn out to be better risks than resource-rich Argentina or Brazil. Reasons for this include the quality of human resources and the degree to which these resources are put to their most efficient use.

The world economy still needs to make an enormous number of manufactured products. Each year, these products have to be made in greater variety with higher sophistication to meet increasingly stringent industrial and consumer demand. And yet, each year, they must cost less. Of the 47 largest manufacturing businesses in the United States, 19 specialize in chemicals, biotechnology and pharmaceuticals. If a country is serious about providing high-income employment, it needs to make sure it has a high concentration of knowledge-based and capital-intensive industries.

Manufacturing contributes some $6 trillion a year to the world gross domestic product of over $30 trillion. Moreover, it employs an estimated 350 million people and in most developed countries, it accounts for between a fifth and a quarter of the gross domestic product. That is down from 35% to 40% half a century ago.

A nation with highly skilled and productive workers, a large pool of scientists and engineers, and ample management talent has many of the essential ingredients to foster steady growth and development. The next decade is likely to be the era of the "sliver" company—manufacturing businesses that focus on a narrow set of products sold worldwide. Among the factors helping the evolution of such businesses are reductions in trade barriers, ease of international travel, and the role of the Internet in allowing small companies to produce and distribute their products worldwide.

Risks from Minimal Gains in Productivity—The United States has effectively regained its long-term productivity growth rate. During the first half of the 20th century—one of the most innovative periods in history—as well as in the 1990s, productivity averaged about 2% annually. The biggest productivity gainers are the computer and semi-conductor industries. More broadly, non-financial corporations have turned in average productivity gains of 2.7% a year, faster than the pace of the 1960s.

Productivity in the service sector has been basically flat. Service firms have not faced the same global competition as manufacturing companies and have had a ready supply of relatively cheap labor. This disparity in productivity is particularly serious because the service sector accounts for 75% of output. Policies that range from encouraging higher educational standards to supporting a few industry research consortia, help to achieve gains in productivity. Productivity growth is the single most important factor affecting American quality of life.

Risks Associated with the Localized Nature of Real Estate—Real estate is a local business because of the immovability of land and buildings. Investors take the risk that international, national, regional, state and local conditions will change. Two of the risks related to the localized nature of real estate are local area risks and site-specific risks.

Economic feasibility studies conducted for potential development projects focus on risks inherent in specific sites. Area-wide economic analyses address how risks relate to international, national, regional and metropolitan-area developments. They require a thorough understanding of the project's metropolitan area, because it is large enough to provide an overview of alternative market locations.

An understanding of risks inherent in the local area requires knowledge about its economic base. Some real estate analysts look at population, while others look at income or income per capita, others focus on retail sales, and still others use all of these variables. They then measure demand for various types of goods and services and prepare sensitivity analyses to determine the derived real estate demand.

Demographic Risks—The growth of the United States' population to 350 million people within a generation will have profound economic and real estate implications. This increase of 74.7 million people between 2000 and 2025 represents an annual rate of growth of 0.8%, a slight decline from the previous 30 years, which averaged 0.85% growth.

Projections of increases in the United States' population are a function of natural gains—births over deaths—and immigration. The population base is now so large that even a small percentage increase yields a very large number. During the 1940 to 1970 period, the population increased at the higher average annual compound rate of 1.2%. Yet, because the base was so much smaller, it resulted in a gain of only 71.1 million people. In certain periods, one of these two factors dominates. After World War II, the increase in long delayed births gave rise to the Baby Boomers, by far the single most important factor in the population growth.

The United States will remain an attractive destination for immigrants from around the world. Economic opportunities, political freedom, and a tradition of acceptance and integration of foreigners will continue to be powerful draws. Immigrant professional and technical workers will feel strong incentives to come to the United States, like relatively high salaries and opportunities to further develop their skills in an environment free of political and other restraints.

There will be significant opportunities for doctors, nurses, computer software technicians, electronic engineers, and scientists with experience in genetics. These opportunities will call workers and entrepreneurs from China, the Philippines, Russia, South Korea, India, Pakistan, and other parts of the world. On balance, immigration produces economic benefits for the receiving country. Immigrants are more economically active than the native population. They also tend to be paid less than natives with similar skills.

Risks from Different Values and Lifestyles—The pervasive trend in the past 500 years has been to separate church and state. In some parts of the world, powerful movements are insisting on a return to God-centered governments. Fundamental religious movements have entered the political arena. They are challenging the principle that government and other civic institutions should be predominantly secular and religion should be confined to the private lives of individuals and groups.

These movements are reacting against the secular nature of modern public culture and traditional values, although it is true that in many countries a close link between religion and government authorities exists. Egalitarian ideologies tend to downplay private success, while justifying public privilege and the pervasiveness of the state. This distorts the reward pattern and makes it easier to get rich by politics than by industry, by connection rather than by performance. One consequence is to make dealings between states and groups more volatile. Political violence, whether endemic to the system or occurring mainly at the change of a regime, has been measured worldwide through analyzing strikes, riots, and terrorist incidents. The implications of the resurgence of national, ethnic, and religious passions are profound.

The idea that diverse and even historically hostile people could readily be assimilated under larger political umbrellas in the name of modernization and progress seems to have failed. Similarly, the concept of the "melting pot" has become discredited. The latest idea, that of a "salad bowl" requiring a "tossing up" rather than a "melting" of backgrounds, remains to be tested. There is turmoil in the former Soviet Union and parts of China. These problems threaten to blow apart the last remnants of an imperial age that began more than 500 years ago. Stretching from the Gulf of Finland to the mountains of Tibet and beyond, the sheer scale of the potential instability is taxing the world's capacity to respond. Ethnic unrest is spilling into neighboring countries, old border disputes are re-igniting, and civil wars are erupting within two of the world's largest nuclear powers.

Generally, American investors are most interested in the duration of governments, orderly transitions between regimes, and the stability of economic policies pertaining to matters such as property rights and foreign investment regulations and taxation. At the same time as many states and societies are fragmenting over religion, ethnicity, and national culture, their people nourish hopes of achieving economic progress by allying themselves with one of the new trade blocks now taking shape. The challenge for business is to create profitable opportunities in a world that is simultaneous globalizing and localizing.

Bureaucratic behavior has not been subject to extensive quantitative analysis, but bureaucrats do interpret their roles in government very differently from nation to nation. The international real estate investment process requires extensive contact with bureaucratic elites, and, of course, governments are prime users of space for the most common international investment of all: office buildings. In certain European nations, for instance, bureaucrats view themselves as detached technicians and not as advocates for the positions they hold. Yet, these groups can be extremely powerful and can make important decisions about issues concerning urban planning, construction, government location, and even currency.

Risks from Changes in Income Growth and Distribution—Nationwide, from the late 1970s to the late 1990s, the average real income of the lowest-income families fell by more than 6% in real terms, while the average real income of middle-income families grew by about 5%. By contrast, the average real income of the highest-income families increased by more than 30%.

In the late 1990s, the average annual income of families in the top 20% of the income distribution was $137,500 for the United States as a whole. This is more than 10 times that of the poorest 20% of families, which had an average income of $13,000. In New York State, the highest-earning 5% of families gained nearly $108,000 per family over the past two decades, while the lowest-earning 20% of families lost $2,900.

Most Americans feel as if the New Economy's good-and-plenty train is passing them by. Real wages are barely budging and only 21% of Americans have stock market assets outside retirement funds. Growth in real hourly compensation has dropped from a 4.3% annual rate in the third quarter of 1998 to 2.3% in 1999. Annual raises in 1999 was estimated at 4.2%, down by 0.2% from 1990. The most striking development in the New Economy for many has been the end of the 40-hour week. Americans now log more hours on the job than workers in other industrialized nations.

The share of people working more than 49 hours a week rose significantly in the late 1980s and early 1990s across all occupations, according to the Bureau of Labor Statistics. Leading the trend and posting the longest hours were the highest-paid workers, managers and professionals, with as many as 29.5% logging marathon work weeks in the late 1980s and early 1990s, compared with about 24% in the early 1980s.

Income distribution is another source of frustration. While executives at Amazon.com in Seattle watched their paper-wealth mushroom, optionless customer-service representatives complained of toiling away for $10 an hour in cyber-sweatshops. The Center for Budget and Policy Priorities and the Economic Policy Institute recently listed nine states—led by New York—in which the richest 20% of households now earn at least 11 times the income of the poorest 20%. This points to a much sharper income disparity between the top and the bottom than existed two decades ago.

Liquidity Risks—Liquidity risk reflects the amount of time required to liquidate an investment. Real estate has a relatively high degree of liquidity risk. Even normally liquid markets can become illiquid when they experience extraordinary events, such as the break-up of the Exchange Rate Mechanism in September 1992, the equity market crash of October 1987 or the bond market crash of 1994.

The relatively large size of a real estate investment, the lack of homogeneity among properties, the large number of forces that affect the income stream, the variety of ownership alternatives, and the tax issues related to ownership, as well as high transaction costs, all act to keep liquidity at low level. However, the creation of secondary markets for real estate debt and equity has improved liquidity. Other factors providing greater liquidity include the broader securitization and institutionalization of the real estate markets.

Inflation Risks—Inflation risk demands a higher rate of return than an investment that is little affected by price increases. Historically, real estate has had a relatively small inflation risk, because the value of the land and buildings increases with reproduction costs. However, unexpected inflation can reduce an investor's rate of return, if the income from the investment does not increase as rapidly as the associated costs, including the cost of debt.

An increasing number of economists believe that eliminating inflation is not a priority, because the costs of living with inflation are not high relative to the costs of reducing it. They believe that, to a considerable extent, inflation is "neutral." The factors that hurt the economy are not higher prices but the acceleration in prices and increases in their volatility. These tend to distort decisions and reduce efficiency.

In countries where inflation is high and domestic inflation hedging is difficult or impossible, investors may hedge by shifting their savings to foreign currencies deemed less likely to depreciate. They may also make the shift when they or their governments expect that a devaluation of an overvalued currency will hold down domestic interest rates artificially. In an attempt to control inflation, Latin American governments imposed price and interest rate controls. These controls led to further capital flight and price rigidity. Distorted prices gave the wrong signals to residents, sending consumption soaring and production plummeting.

Management Risks—Most real estate investments require management to keep the space leased and maintained, in order to preserve the value of the investment. Another key issue in management risk is "moral hazard." Some managers are tempted to place their own interests ahead of those of the company or the investor.

Alternatively, local management may assume more risks than the company and/or the investors are prepared to take. A powerful conflict can occur if the local management has different risk aversions and opportunity costs than the home company and investors. There is an increasing demand for better intra-company communication and assurances that the home company management directions are carried out. At the very least, the local management needs to be aware of the need to retain all or part of the original investment, keep pace with inflation, and avoid any actions that are in conflict with local laws and regulations.

Interest Rate Risks—Real estate tends to be highly leveraged and thus the rate of return earned by equity investors can be affected by changes in interest rates. Furthermore, yield rates required by investors for real estate tend to move with the overall level of interest rates in the economy. The use of leverage in real estate transactions magnifies the risk. The investor essentially makes a bet on future land appreciation and development profits. Whether the use of financial leverage enhances or diminishes an investor's return on equity is determined by the interplay of the asset's unleveraged return and the effective cost of debt capital.

Changing inflation or deflation scenarios alter the level of real inflation-adjusted interest rates. As the inflation rate rises, the real cost of indebtedness drops, while as deflation increases, the real cost of indebtedness increases. These events in turn enhance the value of the properties and decrease the yield to the leveraged equity position. However, it is important to recognize that the cost of miscalculating leverage, or contracting a fixed rate of interest in a reduced-inflation environment, is greater than the benefit of correctly using leverage, or contracting a fixed rate of interest in a heightened-inflation environment.

Risks from Insufficient Capital Accumulation—The national savings rate is the sum of net domestic investment (in the capital stock) and net foreign investment (increases in the net claims of the nation on foreigners). Since the early 1980s, the United States has stopped investing abroad and has started selling huge quantities of its own assets to foreigners.

Recently, the United States has been saving 4% to 5% of its income, while other industrial countries have been saving an average of 10%. The ratio of domestic and foreign savings to GDP has declined from around 18% at the beginning of the 1980s to less than 10%. The main consequence of this decline, brought about by the Federal budget deficit and increased household spending, has been a growing dependence on foreign capital to finance American investment.

Currency Risks—A change in the value of the domestic currency relative to currencies of countries where a company has real estate investments involves transaction, translation, and economic risks. The equilibrium exchange rate between two currencies is theoretically equal to the ratio of the price levels between the two countries. The level of the exchange rate reflects the general price levels in the home nation and in the foreign nation. According to the law of one price, a given commodity should have the same price (so that the purchasing power of the two currencies is at parity) in both countries.

Purchasing power parity theory can be very misleading in part because it suggests that the exchange rate is completely independent of changes in the capital account. Another problem is that it does not take into consideration the existence of many non-traded goods and services, such as cement and brick, as well as services rendered by mechanics, hair stylists, family doctors, and many others.

International trade tends to equalize the prices of traded goods and services among nations, but not the prices of non-traded goods and services. There are also problems with the relative purchasing power parity theory, because of significant structural changes in the economy of various countries. Trade deficits have a cost: a gradual mortgaging of future U.S. income to foreigners. Moreover, international trade theory indicates that consistently large trade deficits, which are not offset by increased domestic savings or foreign investments, lead to downward pressures on domestic currency and a lack of confidence in the economy.

As the United States becomes a massive net debtor, it will be exposed to serious financial cycles all over the world. The other negative impact of the trade deficit is political. The trade deficit and the growing foreign stake in the United States tend to feed crude forms of economic nationalism at home, increasing the risks of a trade war.

Environmental Risks—The value of real estate is often affected by changes in the environment, some potentially hazardous. An analysis and forecast of economic and business cycles, as well as monetary, inflation, and interest rate conditions, can often assist an investor in mitigating these risks. In the United States, the National Environmental Policy Act of 1969 is the major "umbrella" law requiring Federal agencies to carefully assess the potential impacts of proposed real estate and infrastructure projects.

In both the United States and abroad, the process requires the analysis and use of a systematic interdisciplinary approach to determine the environmental impact of every proposed project. Impacts can be physical, visual, auditory, social, and/or economic. They include direct and indirect effects, as well as reasonably foreseeable cumulative effects. The first step in the process is to determine whether the project will have "No Effect," "No Adverse Effect," or an "Adverse Effect" on the environment.

THE MEASUREMENT OF RISK

Measuring risk factors is a tradeoff between building a matrix that can capture all the risks inherent in a portfolio and acquiring data that is manageable and quick to use. In general, the number of risk factors in each risk class, and the level of detail involved in defining each risk factor, should be greatest where the firm has a large and/or complex position. This is because the firm needs to know as precisely as possible the market risks emanating from those positions.

Another consideration is the depth and liquidity of the markets underpinning each risk factor. For example, liquid markets with different types of securities of varying maturities will provide more comprehensive information on risk factor behavior than less liquid, more thinly traded markets. For interest rates, there be will be a risk factor for every currency in which the firm has an interest-rate sensitive position. These factors must be calculated for various points on the government bond yield curve (to capture curve risk) as well as risk factors for non-government instruments such as swap rates (to capture spread risks).

For significant interest rate positions, the Bank for International Settlements (BIS) insists on a minimum of six maturity bands, each representing a separate risk factor. Equities, currencies, and commodities are less complicated and thus only require risk factors for every market in which the firm has a position. The resulting risk factor matrix is extensive and impossible to use without the aid of computers.

RISK MANAGEMENT THROUGH DERIVATIVES

Risk management is at the forefront of investors' minds. The evidence is clear that derivatives fulfill a fundamental economic function. Their use is being applied to an increasingly broad range of asset classes. Exchange risk management involves both the financing decision and the investment decision. Financial executives in multinational corporations face many factors that have no domestic counterparts. These factors include exchange and inflation risks, international differences in tax rates, multiple money markets—often with limited access, currency controls, and political risks, such as sudden and creeping expropriation.

If the derivatives industry did not exist, it would have to be invented. As is, the entire sector is booming. A notable feature of the market is a significant concentration among a small number of participating banks. This is one of the main differences between the current market volatility and the previous bout of turmoil. The credit derivatives market is an important part of users' ability to manage risk. Risk is taken on by the banks and then redistributed, for example through issuing bonds with attached warrants on particular companies to retail investors. JP Morgan is one of the biggest forces in the global derivatives market. Others include the Bank of America, CitiGroup, Credit Suisse First Boston, Deutsche Bank, Goldman Sachs, Merrill Lynch, Morgan Stanley, and UBS Warburg.

A recent survey (2002) conducted by the International Swaps and Derivates Association (ISDA) showed that the volume of outstanding interest rate and currency derivatives has reached $82,700 billion, having increased by 20% in the first six months of 2002. Equity derivatives have reached $2,300 billion, while interest rate swaps have become the most accepted instrument to hedge credit duration risk. An increasing number of actors in the market use interest rate swaps to customize their liability portfolio. For example, the Chicago Board of Trade recently launched five- and ten-year contracts.

Dealers and investors use swaps to adapt to changes in the economic and financial environment. In early September 2002, when the economic outlook had so deteriorated that no rise in interest rates was in sight, activity in the swaps market peaked. European pension and insurance funds, which need to extend debt maturities to match assets with liabilities, are using the interest rate swaps market.

The swaps market can provide protection against the falling equity market and declining interest rates, both of which have occurred since the bursting of the dotcom bubble. Government debt management agencies are employing interest swaps to reduce maturities and cut borrowing costs. Derivatives are being used far more frequently than in the past. This marks a fundamental change in the approach of European institutions. Insurance companies, in particular, are testing new means of risk management.

The fastest growing segment of the market is credit derivatives. While the market did not exist in the mid-1990s, the volume of outstanding contracts comprised $1,600 billion in mid-2002. Moreover, the British Bankers' Association believes that they will reach $1,952 billion by the end of 2002 and $4,800 billion by the end of 2004. This growth reflects investors' reach to the market that is marked by volatile share prices, profound uncertainty about fundamental economic and corporate trends, and acute risk aversion.

ESTIMATES OF RISK-WEIGHTED RATES OF RETURN

The asset allocation policy of an institutional investor should be guided by the basic philosophy that capital market behavior is ultimately a function of underlying economic fundamentals. The real "riskless" rate of return on an investment is the marginal rate at which people are willing to forgo present consumption in favor of uncertain future consumption. This rate depends on both the time preference for consumption and the marginal efficiency of investment.

Three concepts of financial economics have proven to be of particular importance in developing a theoretical foundation for international corporate finance:

1. Arbitrage: Arbitrage pricing theory (APT) involves the simultaneous purchase and sale or lending and borrowing of two assets or two groups of equivalent assets in order to profit from a price disparity. Arbitrage in foreign exchange markets ensures that comparable foreign exchange rates vary minutely, if at all, among different markets.

2. Market efficiency: This means that market prices of capital assets, like efficient markets, reflect all available information. This hypothesis has profound implications for investor behavior. If markets are efficient, all attempts to outperform market indexes will fail.

3. Capital asset pricing: The capital asset pricing model (CAPM) and arbitrage pricing theory (APT) are the principal pricing theories. In 1952, Harry M. Markowitz demonstrated a method of portfolio construction that minimizes risk for each level of expected return, called the "efficient frontier."

CONCLUSIONS

Accurate and frequent valuations of derivative portfolios are essential in determining value at risk (VAR). VAR is the amount of money an institution could make or lose due to price changes in the underlying market.

The implications of VAR on proper risk management cannot be over emphasized. Marked-to-market valuation reflects true portfolio value, which in turn implies proper hedging techniques. More frequent marking-to-market practices produce more up-to-date risk measurement information and therefore enable price risk management practices. Daily marking-to-market is essential for dealers.

The practice and methods of risk management in derivative portfolios are continually evolving. Risk measures such as VAR are replacing more rudimentary risk measures based on notional amounts, as more participants recognize the benefits of their accuracy.

The synthesizing of custom financial contracts and securities is for financial services what the assembly line production process is for the manufacturing sector. Options, futures, and other exchange-traded securities are the raw inputs applied to prescribed combinations over time, to create portfolios that hedge the various customer liabilities of financial intermediaries.

Other frequently-used indicators of political risks include inflation, balance-of-payment deficits or surpluses, and the growth rate of per capita GNP. These measures are thought to reveal whether the economy is in good shape or requires a quick fix, such as expropriation to increase government revenues or currency inconvertibility to improve the balance of payments. In general, the better a country's economic outlook, the less likely it is to face political and social turmoil.

More subjective measures of political risks are based on a general perception of each country's attitude toward private enterprise: whether private enterprise is actively welcomed or is considered a necessary evil to be eliminated as soon as possible. A country's attitude toward multinationals is particularly relevant and may differ from its views on local private ownership. In general, most countries probably view foreign direct investment in terms of a cost/benefit trade-off and are not either for or against it in principle. From an economic standpoint, political risk refers to uncertainty over property rights. If the government can expropriate either legal title to property or the stream of income it generates, then political risk exists.

Political risk also exists if property owners can be constrained in using their property. This definition of political risk encompasses government actions ranging from outright expropriation to a change in the tax law that alters the government's share of corporate income, to laws that change the rights of private companies to compete against state-owned companies. Each action affects corporate cash flows and hence the value of the firm.

Risk is closely correlated to uncertainty. Although real estate investment risks can often be mitigated, they can never be entirely eliminated. Moreover, the process of mitigating risks is seldom cost-less. The essence of risk management lies in identifying the risk, analyzing it, and finding the means to economically reduce its impact:

- A structure of incentives that rewards risk-taking in productive ventures: People have clearly demonstrated that they respond rationally to incentives, when information and resources are made available to them,

- A legal structure that stimulates the development of free markets: The resulting price signals are most likely to contain data that are essential to making efficient use of a nation's resources,

- Minimal regulations and economic distortions: Complex regulations are costly to implement and waste management time and other resources,

- Clear incentives to save and invest: in general, when such incentives exist, when the economic rules of the game are straightforward and stable, and when there is political stability, a nation's chances of developing are maximized,

- And an open economy: Not only does free trade increase competition and permit the realization of comparative advantage, it also constrains government policies and encourages them to support increases in living standards and rapid economic growth.

The most successful economies, such as South Korea and Taiwan, demonstrate the importance of aligning domestic incentives with world market conditions. Statism, the substitution of state-owned and state-guided enterprises for the private sector, on the other hand, has proven to be inefficient.

The essential element that distinguishes the true multinational corporation is its commitment to seeking out, undertaking, and integrating manufacturing, marketing, research and development, and financing opportunities on a global basis. A necessary complement to the integration of worldwide operations is flexibility, adaptability and swiftness. Speed has become one of the critical competitive weapons in the fight for global market share. The key maxim in real estate is no longer "Location, Location, Location," but "Timing, Timing, Timing."

WORLD WINNING CITIES — THE NEXT GENERATION

By Jeremy Kelly

INTRODUCTION— CITY COMPETITIVENESS AND REAL ESTATE

Cities are the framework of society, and their continuing existence has become an unquestionable part of world order. They provide the canvas for most real estate market activities, and understanding the factors that have led to the success or failure of cities is a vital part of the property process.

But, the nature of city competitiveness is changing rapidly. "Model" growth cycles in "model" world cities based on size, hierarchies, and economic wealth are being increasingly challenged by technology and by new thinking on what will constitute the winning urban dynamic in the 21st century. Emerging definitions of success are being based not on size but on connectivity, not on hierarchies but on networks, and less on wealth and more on environment, quality of life, culture, city governance, and marketing.

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And, competition between cities has never been more intense. City marketing is becoming a precise science and branding campaigns, trade missions, major infrastructure projects and the securing of prestige sporting and cultural events are key ingredients of city strategies. The role of property as a contributor to, rather than as a consequence of competitive advantage is a vastly under researched area and one which we believe will become increasingly vital to any city intent on making its mark on the world stage.

Our firm has therefore launched a major research programme "World Winning Cities," representing a multi-year quest to identify the winning cities of the future. Our aim is to draw together the essence of contemporary city competitiveness, and to better understand the extent to which property can drive the new city order. We are focusing on the trends that will impact on the business and economic landscape, in order to predict which cities will be the rising urban stars of the next decade, and equally importantly those cities that may lose in the battle for world city status.

The objective of this project is to develop an innovative methodological approach that will allow us to deconstruct cities and to define and explore the newly emerging principles of city competition and how they relate to real estate. In essence our project is focused on answering four fundamental questions:

(i) What does history teach us about recent winners?

(ii) Which indicators will be the best predictors of future success?

(iii) Where are the next generation of rising urban stars?

(iv) What will or could be real estate's contribution to a city's sustainable competitive advantage?

In this paper we contrast the results of our first phase analyses, addressing the lessons of history of winning cities over the period 1991-2001, with the much wider questions about the model of world order that will prevail over the emergence of the next generation of urban rising stars.

WINNING CITIES OF THE PAST DECADE

Although the past is not necessarily the best predictor of the future, it does give a baseline position from which to describe the nature of likely future change. In phase one of the project, the firm took a look at city performance over the last 10 years. We needed to know which cities, from both a general economic and property market's viewpoint, have been the most successful in recent years. This analysis was undertaken to throw light on the likely "winning formulae" for future city success, and to set benchmarks against which to measure future city performance.

Our search for the essence of competitiveness is routing us away from the traditional city, with its steady, reasonably predictable markets, to the fast vibrant, technology-rich city of the future where urbanisation and information go hand in hand to create new city forms and functions.

The firm analysed historic data covering 100 major metropolitan areas worldwide (see Appendix 1). These cities were selected on the basis of size, function and corporate representation, ensuring that the balance of cities in each continental region was broadly in line with each region's economic weight. We covered 40 cities in the Americas, 37 cities in the EMEA region, and 23 cities in the Asia Pacific region.

Annual data was analysed for the ten-year period, 1991-2001, for five key measures of city growth and real estate activity:

- Two Measures of City Growth:
  Population Change (% per year)
  Employment Change (% per year)
- Two Measures of Real Estate Activity:
  Office Net Absorption Rate (as % stock per year)
  Office Construction Rate (as % stock per year)
- One measure of Real Estate Performance:

  Prime Office Rental Change (real, % per year)

This historic data was analysed to build up a picture of city performance over the past ten years. Our aim was to identify those cities that have created the right circumstances to stimulate strong city economic growth, high levels of real estate activity and strong real estate performance.

Which cities were the rising urban stars of the past decade?

Figure 1

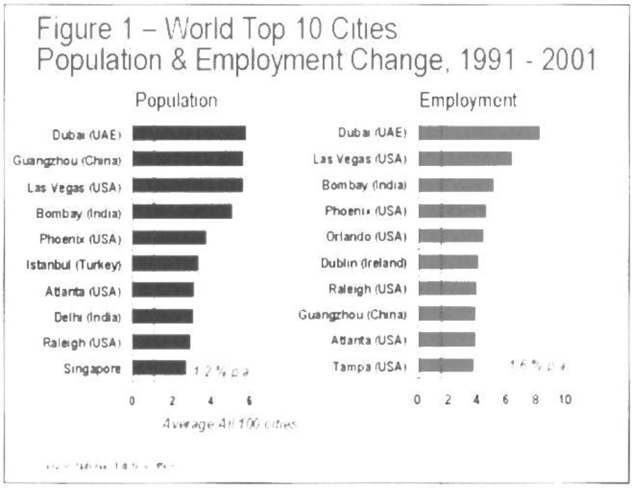
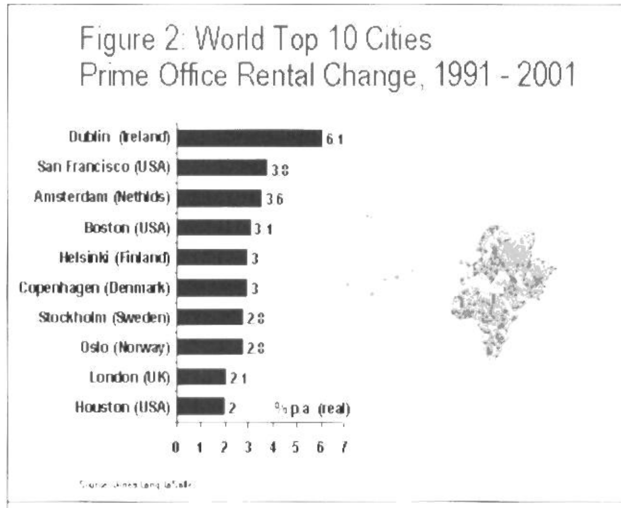


Figure 2



Our analysis of relative growth over last ten years shows that the strongest growth has been from smaller metropolitan areas of less than two million people.

Three cities stand out:

Dubai (in the United Arab Emirates) holds the top position worldwide for both population and employment growth, at 5.8% pa and 8.3% pa respectively (Figure 1). This rapidly expanding Emirate city-state has emerged over the past decade as a leading economic and trading hub of the Gulf States. Much of its success derives from a drive to create a favourable environment for business, and in providing the physical infrastructure to match. Dubai has been actively promoted on the international arena, and the city has been successful in attracting foreign companies. It has grown rapidly as a tourist destination, and is developing a high-tech image as an Internet hub city. However, the real estate market is still immature, and the building boom of recent years has translated into an oversupply of office space.

Dublin (the "Celtic Tiger") has emerged as probably the most successful city economy and real estate market of the last decade, and it is the only city to score consistently well on all five measures of performance. Strong employment growth (4.1% pa), and (by European standards) strong population growth (0.7% pa) translated into a very dynamic office market, characterised by high levels of take-up and high construction activity—the occupied office stock doubled in a decade. Dublin recorded the strongest real rental growth (at 6.1% pa) of the 100 cities analysed (Figure 2). The city's growth owes much to the success of the Irish national economy in creating one of Europe's most favourable business environments. Whilst external subsidy has been a factor, the economy's success has been built on private investment. Dublin has captured a significant proportion of Ireland's foreign direct investment (FDI), attracted by a favourable tax regime, low regulation, labour market flexibility, and access to a well-educated labour force. IT software and financial services have been particularly active. Dublin is now Europe's largest centre for the software industry, with five of the world's leading top ten software companies having their European centre in Dublin.

Las Vegas has been North America's fastest growing metropolitan area, and stands "head and shoulders" above the other North American cities in terms of population growth, employment growth, office net absorption, and office construction rates (Figure 3). The city's population has been growing by over 70,000 a year, and Las Vegas is now a city of 1.6 million people. Growth has been underpinned by a rapidly expanding leisure sector, but as the city has grown its economy has diversified, and low taxes and low regulation have succeeded in nurturing new business and attracting new companies and labour.

Why have these cities been winners? These cities have created a compelling cocktail of attractions that has stimulated strong economic growth, and all three share a number of common features:

- Size—with metropolitan area populations of 1.6 million in Las Vegas, 1.1 million in Dublin, and 0.9 million in Dubai.
- Attractive business environments, light regulation, and favourable tax regimes for business,

Figure 3

Figure 3 - North American Top 10 Cities 1991 – 2001 (% pa)

	Population Growth	Employment Growth	Office Net Absorption	Office Construction Activity
1	Las Vegas (6.7%)	Las Vegas (6.4%)	Las Vegas (7.7%)	Las Vegas (9.0%)
2	Phoenix (3.8%)	Phoenix (4.7%)	Charlotte (5.6%)	Charlotte (6.7%)
3	Atlanta (3.2%)	Orlando (4.5%)	Orlando (4.4%)	Orlando (4.8%)
4	Raleigh (3.0%)	Raleigh (4.0%)	Atlanta (4.0%)	Raleigh (3.9%)
5	Orlando (2.7%)	Atlanta (3.9%)	Raleigh (3.6%)	Atlanta (3.8%)
6	Dallas (2.6%)	Tampa (3.8%)	Phoenix (3.6%)	Phoenix (3.4%)
7	Denver (2.6%)	Dallas (3.7%)	Sacramento (3.3%)	Seattle (3.1%)
8	Vancouver (2.4%)	Denver (3.6%)	Vancouver (3.1%)	Sacramento (3.0%)
9	Charlotte (2.4%)	Charlotte (3.5%)	Seattle (3.0%)	Vancouver (2.8%)
10	Houston (2.2%)	Portland (2.8%)	Baltimore (2.8%)	Portland (2.5%)

Source: Jones Lang LaSalle, U.S. and Canada Statistical Office

which has led to high levels of inward investment.

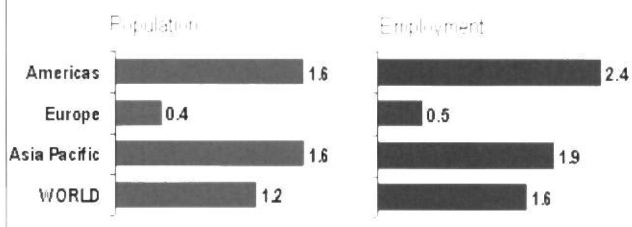
- Strong in-migration and a successful record of attracting skilled and educated labour.
- Leisure—both Las Vegas and Dubai are underpinned by leisure activities, whilst Dublin has emerged as an important European short-stay tourist destination.
- Branding—All three cities have developed a high profile on the international "stage."

The top city "winners" are spread across the Globe (in Asia, Europe and America), but our analysis has identified significant differences in city growth between continental regions. Figure 4 shows average population and employment growth in cities in North America, Western Europe, and Asia Pacific. North American cities have been the best generators of new employment; Asian cities have shown strong population growth, whilst European cities have shown the weakest growth in both population and employment terms.

However it is the ratios between these indicators that are one of the most revealing aspects of our analysis. It shows that the last decade was good for large cities with the rate of employment growth exceeding the growth in population by a ratio of 1.3 to 1. In Europe and Asia Pacific, on average cities generated 1.2 new jobs for every additional resident. In the Americas the ratio was a striking 1.5 to 1, with employment growth far outperforming population growth. So on this measure and as a broad regional generalization, the cities of North America were the biggest winners in the past decade.

Figure 4

Figure 4: Population & Employment Change by Region 1991 – 2001 (% pa)



Source: National Statistical Office

The strength of the North American cities is also illustrated when looking at the geographical spread of "winning cities." Our analysis shows that individual cities are linking together into clusters to provide sub regional ecosystems of "winning cities."

A number of clusters were identified from our analysis:

Southern U.S.—Whilst the North American continent as a whole has been a significant generator of new employment over the past decade, as Figure 3 shows, it is in the metropolitan areas of Southern U.S. where growth has been strongest—in a band running from Nevada to Florida—and including the cities of Las Vegas (Nevada), Phoenix (Arizona), Denver (Colorado), Dallas (Texas), Atlanta (Georgia), Raleigh and Charlotte (North Carolina), and Orlando and Tampa (Florida). These nine metropolitan areas grew in population by an average rate of 3.1% pa, and have generated new employment at over 4.2% pa over the past decade.

Northern Europe—European cities have, in general, recorded relatively weak population, employment, and absorption rates, although rental growth has been amongst the strongest worldwide (reflecting inherent supply constraints). Cities in Northern Europe embracing the Nordic countries, the British Isles, and the Netherlands have been the strongest performers in the region (Figure 5).

The Nordic capitals (Stockholm, Copenhagen, Oslo, and Helsinki) all recorded strong rental

Figure 5

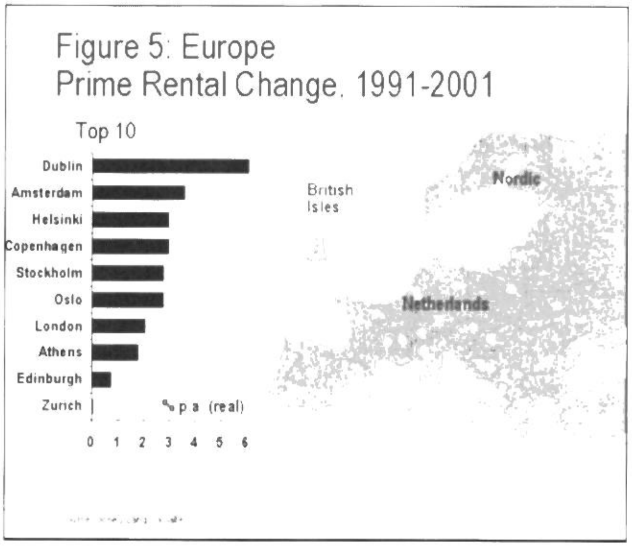
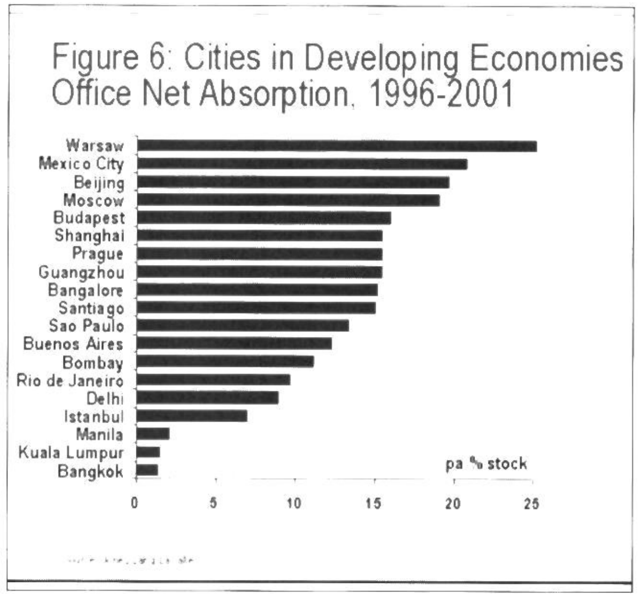


Figure 6



growth (amongst the highest worldwide), strong population in-migration (from rural areas), and more recently, strong employment growth, underpinned by IT. On almost every measure of technological progress, the Nordic region scores amongst the highest worldwide. This serves to highlight the emergence of the Nordic Region over the last decade as a major force in advanced telecommunications and IT, capitalising on a highly educated workforce and several world-class technology companies.

The main commercial centres in UK and Ireland (London, Dublin, and Edinburgh) have also performed well on a number of measures. All three cities have recorded strong "employment-rich" growth, which has resulted in significant pressures on their commercial and residential property stocks.

Amsterdam, the main centre of the highly urbanised Randstad region has been particularly successful in attracting footloose companies from across Europe. The Netherlands is also considered to have one of the most favourable business operating environments worldwide, as well as being supported by an excellent transport and technological infrastructure.

Coastal/Southern China—The Asian cities, in general, have had a difficult decade, and the weak performance of most cities has been a legacy of the Asian financial crisis of the late 1990s. The notable exception is China, and coastal and southern China in particular. The changes that have taken place in the last decade in this region have been striking, and have been epitomised by Guangzhou, which has emerged in less than a decade into a fully functioning city.

Guangzhou is at the apex of one of the fastest growing regions worldwide. Together with Hong Kong, Shenzhen, and several smaller cities, the city forms part of the Pearl River Delta Mega City, (which has a combined regional population of more than 46 million people). The region has seen rapid urbanisation initially with illegal immigrants who have now been absorbed formally (leading to strong population and employment growth). The region accounts for a thi rd of China's FDI, which is in part a reflection of high cultural and economic links with Hong Kong and overseas Chinese. But, growth has come at great environmental cost. What was once a fertile agricultural region has been transformed into a sprawling industrial zone. In addition, the commercial real estate market was over-supplied for much of the 1990s, with the city going through an emerging market boom to bust in office rents, as new construction took place.

Guangzhou typifies the often patchy and contradictory evidence of "winning cities" within the developing economies. In most cases, "developing" cities have been characterised by strong population and employment growth, which have fed through to high rates of office market activity. However, property speculation and over-supply have translated into sharp falls in rents in most of these cities over the past decade.

Figure 7

Figure 7: City Employment vs Office Rents

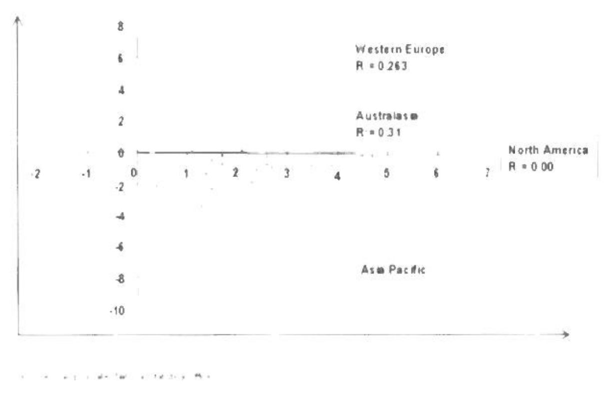


Figure 8

Figure 8: City Performance

1991 – 2001 % p.a.	Top 10 Corporate Cities	All Cities
Population Change	0.9%	1.2%
Employment Change	1.0%	1.6%
Office Net Absorption	2.7%	3.3%
Office Construction	1.9%	4.3%
Prime Rental Change	-2.4%	-1.6%

Our analysis showed that cities in China (Beijing, Shanghai, and Guangzhou) and Central and Eastern Europe (Warsaw, Moscow, Budapest, and Prague) were the most active markets in "developing" economies in terms of both net absorption (Figure 6) and construction activity. Other relatively active markets were Mexico City, Santiago (in Chile), and Bangalore (in India).

The cities in "developing" economies illustrate that a city's economic performance is no guarantee of strong property performance. Our analysis shows a positive relationship between population change and employment change in most cities, feeding through to office net absorption and construction rates. However, the link with property performance is tenuous. As Figure 7 shows, whilst there is some evidence of a positive relationship between city employment growth and real estate performance in Western Europe and Australasia, in North America any relationship is difficult to prove and in Asia there is a negative correlation. Guangzhou, for example, had one of the strongest population and employment growth rates worldwide, but has shown one of the sharpest falls in rents over the same period.

WINNING CITIES OF THE NEXT DECADE

This analysis inevitably raises the question of how a "winning" city is measured, and it highlights that "winning" has different meanings for different stakeholders. For real estate investors, a "winning city" is usually defined narrowly in terms of real estate performance, determined not only by a strong city economy, but also critically, issues of real estate supply constraints and market liquidity. These supply-side and liquidity factors need to be built into any future model of city performance. Real estate investors also need to focus more on how the corporate sector defines a "winning city," in order to identify cities ahead of the "curve." For the corporate sector "winning" is increasingly based on finding the next high-growth consumer market or low-cost, well educated workforce, which tends to be in cities with a yet unproven economic track record—the Indian call centre phenomenon in cities such as Bangalore, Mumbai, and Delhi is a classic case.

So are the next generation of rising urban stars yet on the corporate radar screen? Our analysis helps to throw light as to the likely characteristics of the future "winners." The winning cities of the future may well exhibit light regulation, favourable tax regimes, labour market flexibility, high inward investment, in-migration of skilled workers, and leisure, but in what combinations, in what strengths, and with what other qualifiers?

Will the criteria for success change in the 21st Century? There are many agendas that may influence the future of cities and here we suggest a number of competing forces as to the future drivers of city form:

Aggregation Economists—The aggregation economists believe that critical mass and grounded capital in real estate and infrastructure will enhance the value of centrality. The existing successful global cities will grow and prosper, despite worsening congestion and security concerns. We analysed the performance of the world top ten cities as measured by corporate representation of high order services. The roll call of cities in the top 10—New York, London, Paris, Tokyo, Chicago, Los Angeles, Frankfurt, Milan, Hong Kong, and Singapore—has few surprises, as the inertia of size and the critical mass has helped to maintain their positions. However, what is particularly interesting is that although they get top scores for volume growth, these high-order cities have under-performed the worldwide average on all variables over the past decade, including real estate activity and performance (Figure 8).

The leading position of these cities is certainly not assured. The relationships and dynamic within and between these global cities is becoming increasingly subject to competitive price pressures, to quality of life issues and, as are many places, to skill shortages. As we get richer so the balance between income and opportunity and health, culture, and leisure pursuits becomes more important. Their desire to achieve cultural success will change the nature of their occupier and investment profile.

Looking forward, it would be easy to be still influenced by size. The rapid growth in urbanisation has given rise to "mega cities," with populations of more than 10 million people. In 1950 there was only one city with a population of 10 million or more—New York. Now there are 16 cities, and by 2015 (according to the United Nations) there will be 21 cities. With three-quarters of the mega cities in the developing world, most are not currently even on the corporate or investor radar screen, but they will offer considerable opportunities in the future for global companies from their potential consumer base and abundant labour supply.

Digital Economists—The digital economists conversely believe that communications technology will significantly dilute the need for centralised physical proximity, and commercial activity will disperse and decentralise into science parks, "silicon valleys," and informated communities. However, the consequence of improved communications technologies will be an increased need for face-to-face meetings, with cities playing an even more crucial role as host for these activities.

Over the past decade we have seen the emergence of "technology-rich" cities in North America, such San Francisco/Silicon Valley, Boston, Seattle, San Diego, Raleigh-Durham, Minneapolis, Dallas, and Austin. In Northern Europe, a similar trend has emerged, led by the Nordic cities—Stockholm, Helsinki, and Copenhagen, but also characterising London/Thames Valley/Cambridge and Munich. In the advanced economies of Asia—Tokyo, Osaka, Seoul, Singapore, and Taipei all have well developed technology sectors.

"Evolution Leapfrogger" Theorists—The ability to innovate will play a key role in the continued development of technology-rich cities, and the world's existing technology clusters have a good head start. But significantly, a number of cities in developing and transition economies have strong innovation bases. Tel Aviv is one of the best examples, but Moscow, Beijing, and even Tehran all have well educated populations, high levels of R&D expenditure, and large number of researchers and science graduates, which combined with the appropriate communications infrastructure and business environment could potentially propel them to economic lift-off.

"Evolution Leapfrogers" believe that cities in developing and transition countries will use technology to leap frog the conventional requirements of physical transport and communications infrastructure to create a new breed of competitive city. Where the major IT multi-nationals place their manufacturing and R&D facilities can often provide the catalyst for technology-led growth. For example, in 1989 Intel's choice of Greater Dublin for its largest manufacturing plant outside the U.S., was a contributory factor to the growth of the IT sector in Dublin during the 1990s. We are seeing the same happening in San Jose in Costa Rica, which was chosen in 1996 for Intel's main microchip plant in Latin America, and most recently in 2000 the opening of a major software development centre by Intel in Nizhni Novgorod (Russia's third largest city, formerly known as Gorki) could impact on this city in the same way.

But what will drive the performance of cities in an era where technology is abundant but where skills are in short supply? Cities in some developing economies have a competitive advantage in this respect. India, for example has developed a degree of originality in the fields of technology and intellectual research, and at the same time has an abundance of low-cost, skilled, IT-trained manpower. As a result, cities such as Mumbai (Bombay), Delhi, Bangalore (the Silicon Valley of India), Hyderabad, and Chennai have been successful in recent years in attracting IT and contact centre activities.

Post Capitalist Economists—Finally, the post capitalist view may be that the Western model of globalisation and growth is unsustainable, and that commerce will revert to local growth and local control, and therefore fragmenting property markets. The issue of sustainable development has been brought into sharp relief by the Johannesburg World Summit 2002, and many developing countries, most recently in Latin America, are questioning the free-market model of economic development, while a number of Northern European cities (such as Helsinki, Stockholm, and Copenhagen) have actively promoted, and are trying hard to deliver, the advantages of social and environmental sustainability.

Our analysis and its results, so far have been unashamedly economically based. Economic prosperity has been the understandable mainstay in a city's armoury in attracting investors and occupiers, but the property sector should be questioning the traditional one-dimensional assumptions about success. A new class of city may emerge encouraged by a different set of drivers where wealth and economics are a consequence rather than a pure objective of growth.

NEXT STEPS OF "WORLD WINNING CITIES" PROJECT

It is likely that the different theories of urban development will not be mutually exclusive, and understanding the new evolutionary models for different cities in different countries is crucial to optimising location and investment decisions. Understanding the role of property to a city's future becomes even more important.

The firm is currently building a proprietary database of Key Performance Indicators to provide the context for forward-looking analysis. We are testing the predictive abilities of many different clusters of measures. We are looking to reveal new relationships between indicators that are critical to a city's success—new insights for the real estate investor, occupier or developer—reflective not just of a one-dimensional Western model of city growth, but of the richness of factors that drive urban dynamics across the world. So we can capture the essence of success for world cities, which fully acknowledge their diverse stakeholder interests and their different development objectives.

The "World Winning Cities" project will develop a new set of metrics, benchmarks, and analytical tools to allow us to:

- Describe and map future changes in city fortunes.
- Model and predict the next generation of rising stars and their promotion to the world city stage.
- Predict the inevitable relegations that will occur for some cities.
- Analyse the consequences for real estate markets of changing city fortunes and to predict them ahead of the curve.

Our search for the essence of competitiveness is routing us away from the traditional city, with its steady, reasonably predictable markets, to the fast vibrant, technology rich city of the future where urbanisation and information go hand in hand to create new city forms and functions. And from which we may all be surprised about the future identity of at least some of the World's "winning cities" of the 21st Century.

Appendix 1—City Coverage

Americas

1	Atlanta
2	Baltimore
3	Boston
4	Charlotte
5	Chicago
6	Cincinnati
7	Cleveland
8	Dallas
9	Denver
10	Detroit
11	Houston
12	Indianapolis
13	Kansas City
14	Las Vegas
15	Los Angeles
16	Miami
17	Milwaukee
18	Minneapolis
19	Montreal
20	New York
21	Orlando
22	Philadelphia
23	Phoenix
24	Pittsburgh
25	Portland
26	Raleigh
27	Sacramento

28	St Louis
29	San Diego
30	San Francisco
31	Seattle
32	Tampa
33	Toronto
34	Vancouver
35	Washington DC
36	Buenos Aires
37	Mexico City
38	Rio de Janeiro
39	Santiago
40	Sao Paulo

Asia-Pacific

41	Bangalore
42	Bangkok
43	Beijing
44	Delhi
45	Guangzhou
46	Hong Kong
47	Kuala Lumpur
48	Manila
49	Mumbai/Bombay
50	Osaka-Kobe
51	Seoul
52	Shanghai
53	Singapore
54	Taipei
55	Tokyo
56	Adelaide
57	Auckland
58	Brisbane
59	Canberra City
60	Melbourne
61	Perth
62	Sydney
63	Wellington

Europe, Middle-East and Africa

64	Amsterdam
65	Athens
66	Barcelona
67	Berlin
68	Birmingham
69	Brussels
70	Cologne
71	Copenhagen
72	Dublin
73	Dusseldorf-Ruhr
74	Edinburgh
75	Frankfurt am Main
76	Geneva
77	Glasgow
78	Hamburg
79	Helsinki
80	Istanbul
81	Lisbon
82	London
83	Luxembourg
84	Lyon
85	Madrid
86	Manchester
87	Milan
88	Munich
89	Oslo
90	Paris
91	Rome
92	Stockholm
93	Vienna
94	Zurich
95	Budapest
96	Moscow
97	Prague
98	Saint Petersburg
99	Warsaw
100	Dubai

GLOBAL CITIES SYMPOSIUM: THE GLOBAL CITY TODAY

By Angus McIntosh

This article is based upon the talk given at the Global Cities conference in Boston, Ma, in September 2002. It looks at how we measure cities and the impact of Asia-Pacific on urban change. What is the role of cities today and are urban regions consolidating? Environmental sustainability is increasingly important and relate to various scenarios for the future. However, the city, and its place in history, is as important today as it was 2000 years ago.

One image of the city of the future is one dominated by global brands such as McDonald's, Coca Cola, Starbucks Coffee, and Kentucky Fried Chicken. All the residents drive global brand cars such as Ford or General Motors or Nissan or BMW and fly to and from cities in global brand aircraft designed by Boeing or the Euro Airbus.

Such images replace those of the cold war years between 1950 and 1990; thousands of land tanks facing each other across Europe or Asia have been replaced by the image of an invasion of corporate capitalism in every country of the world.

ABOUT THE AUTHOR

Angus McIntosh is *partner and head of research with King Sturge and is a specialist land economist.*

MEASURING CITIES

The simplistic way to measure cities is by their population. However, this raises various issues, such as defining what is the boundary of a city. Table 1 lists an economist view of the largest cities in the world, but ignores the concept of city regions. Both London and Paris are part of city regions exceeding 20 million people.

What is noticeable from the above is that the ranking of quality of life, with Vancouver being the attractive city in terms of quality of life, does not appear in large cities. Is there is an inverse correlation; large cities are not necessary good places to live?

ASIA-PACIFIC AND URBAN CHANGE

During the 1980s and 1990s "the Asia Tigers" cities grew enormously in terms of population and wealth including Mumbai, Calcutta and Shanghai shown above. As a result of financial deregulation and globalisation, Asia-Pacific saw extraordinary economic growth which resulted in their property markets growing in parallel. In the mid 1990s this process came to a halt. Several countries experienced a property slump and currency devaluations plus a series of banking crises. As a result, property rents fell. As Table 2 shows, in real terms industrial rental values are today considerably lower than they were seven years ago.

Further analysis from the King Sturge Global Trends Survey (Table 3) shows major rental differences for both the office and industrial markets across the world.

As Tables 2 and 3 show, industrial property has fallen in value in the Asia-Pacific region; it is nowadays seven times more expensive to rent an industrial building in London (next to Heathrow Airport) compared with Shanghai. However, even within Europe there are one or two areas, such as Lille, where industrial rents are moderately low. Likewise, in the office market it is much cheaper to rent an office building in Kuala Lumpur than in the UK.

This analysis tells us two things; certain major financial cities such as London and Hong Kong can command enormous rents relative to other locations in the world. Secondly, the cost differentials of certain locations in Asia-Pacific make them the obvious location targets for low cost manufacturing facilities. Asia-Pacific is increasingly becoming the manufacturing zone of the global economy, with manufacturing employment downsizing in many North American and European countries.

This reasoning is reflected in the King Sturge analysis of global workplace locations (Figure 1).

As the chart shows, routine manufacturing can be in any part of the global economy where costs are cheap. There is no particular need for face to face interaction. Heavy manufacturing increasingly takes place in China and Asia-Pacific.

By contrast, complex face to face negotiations, often requiring legal documentation, needs to be done in major cities such as London and New York.

The development of software is another phenomenon of the global economy. This does not necessary require face to face contact, but requires "thinking" time.

This proximity-work function matrix helps us understand the role of different cities in different parts of the global economy.

CONSOLIDATION OR URBAN REGIONS

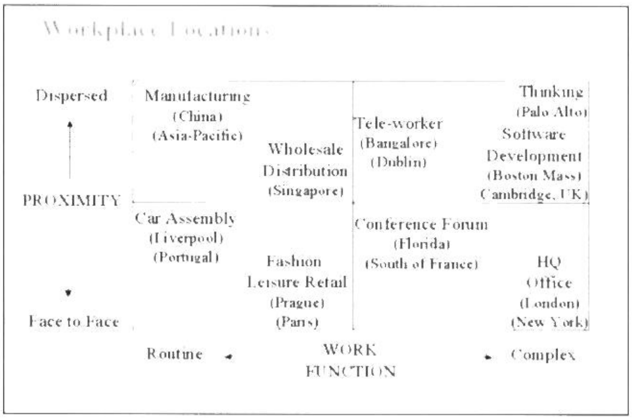
As a result of globalisation, and the strive for cost efficiency and greater productivity, certain city states are becoming more important. Increasingly, it is not countries but city regions which form the economic network of the global economy. As the earlier table demonstrated, Lille is far less important and commands much lower rents than Paris, despite both cities being in Northern France.

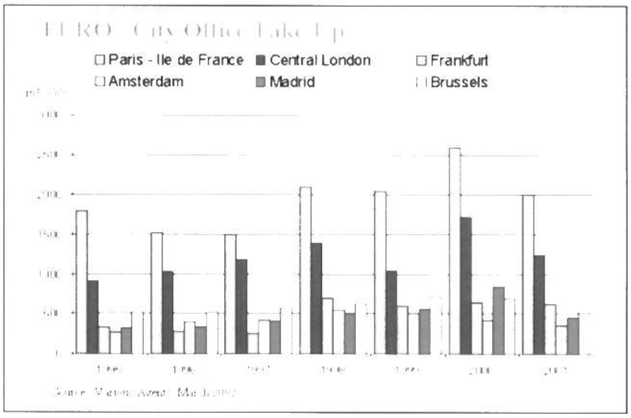
The take-up of office space in major cities including Paris in Europe (even during 2001) over the last four years has been much higher than in the early 1990s. As the following forecast table suggests (Table 4), this trend is likely to continue. Cities, not countries, and city regions will increasingly become the focus of economic activity as the global economy becomes increasingly dependent on the service sector.

Table 4: Euro—City Office Take-up pa: million m²

	10 Year Avg. to 2001	5 Year Avg. from 2002
London—Central	1.0	1.2
Paris—Ile de France	1.6	1.7
Frankfurt	0.4	0.5
Amsterdam	0.3	0.32
Madrid	0.4	0.42

Figure 1





Brussels	0.4	0.56

Source: Real Estate Forecast Ltd & King Sturge, January 2002

The consolidation of cities, and the growth of the service sector at the expense of the manufacturing sector, will result in the greater need for not only office buildings, but also residential buildings and good transport systems. Indeed, the whole infrastructure of cities will need to be improved if this consolidation is to be successful. Such consolidation involves schools, hospitals, and leisure facilities. And linked to this consolidation is the need for industrial distribution facilities to support these mega city region complexes.

ENVIRONMENTAL SUSTAINABILITY

The consolidation of cities leads on to one of the major challenges of the global economy, that of environmental sustainability.

A simple definition of environmental sustainability is that "a building must be capable of fulfilling today's needs without prejudicing future generations." This simple statement is easy to make but harder to justify. It is clear today that global warming is an increasingly important issue. The following table demonstrates this trend.

One image of the city of the future is one dominated by global brands such as McDonald's, Coca Cola, Starbucks Coffee and Kentucky Fried Chicken . . . Such images replace those of the cold war years between 1950 and 1990; thousands of land tanks facing each other across Europe or Asia have been replaced by the image of an invasion of corporate capitalism in every country of the world.

Temperature: Deviation from Average
(Degree Celsius—Global)

1860	-0.4
1880	-0.2
1900	-0.2
1920	-0.3
1940	-0.05
1960	0.0
1980	0.0
2000	+0.4

Source: Intergovernmental Panel on Climate Change

One of the causes of global warming is the increasing emissions of carbon dioxide. Although there are a number of gases which can be taken into account, the one which is increasingly important is carbon dioxide when considering the issue of environmental sustainability.

Carbon Dioxide

Year	% Atmosphere
1900	0.028
2000	0.035

Source: Intergovernmental Panel on Climate Change

Some work undertaken at King Sturge, looking at the energy used by buildings, divides energy consumption to three elements; embodied energy used in constructing a building, energy in use day to day and energy used transporting employees to and from an office building.

Energy and Offices: per person Kg CO2 per 10 m² over 20 years

	Embodied	In-Use	Transport	Total
Air-Con out-of-town	10,000	40,000	14,112	64,112
Air-Con in-town	10,000	40,000	7,584	57,584
Old Non Air-Con in-town	2,000	14,000	7,584	23,584

As the table above shows, a new air-conditioned building in Northern Europe, outside the traditional town centre, relying on road transport is a gas guzzler. It generates a vast amount of carbon dioxide over a 20-year period.

By contrast, a non air-conditioned refurbished old building, in a town centre, generates less than half the carbon dioxide of a brand new out-of-town office building over a 20-year period.

It is this type of analysis which will be increasingly important to understand the future. Even so, increasing carbon dioxide will increase atmospheric water vapour, create greater climatic change and weather instability. This volatility and global warming impact will create more droughts and flooding (such as in Prague during 2002) and will result in sea levels rising as the polar ice caps melt. That will then lead to the following:

Flooding: High Risk Regions

Venice, Italy
Tokyo, Japan
South Texas, U.S.
Bangkok, Thailand
Abu Dhabi, UAE
Dubai, UAE
London, UK
Netherlands
New York, U.S.
Source: James Morrell "How to Forecast" 2001

It is interesting that certain cities which have grown enormously in recent years, either in terms of population or in terms of wealth, (or both) are also cities which are most vulnerable to changes in the global environment.

GLOBAL SCENARIOS AND CITIES IN HISTORY

International research undertaken by King Sturge in connection with the Dublin Institute of Technology suggests that there may be three ways of looking at the future, but each of these scenarios is over-written by the issue of environmental sustainability discussed above.

One scenario is that the world will become more unruly. The "Lords of Misrule" scenario suggests that, in 15 years time international terrorism and urban crime will both become far more important and more widespread than they are today. In parts of the world, such as Johannesburg or Moscow, urban crime is already a major problem.

A second scenario is that the "Bazaar" will take over the world. The world is increasingly dominated by a market place. Major global brands, referred to in the introduction to this article, including McDonald's, Boeing, Lockheed, Exxon, Shell Oil and BP will, dominate not only the economy of the world but also politics. Those who earn most will pay the politicians and expect politicians to cooperate with the ambitions of these global companies.

A third scenario is that of "Socratic systems" where by we all learn together and follow the thoughts of the Greek philosopher Socrates. Making use of the internet, we learning together; we generate a better world which is both safer and creates a better quality of life for all mankind.

Which ever of the three scenarios dominate cities of the future, and the reality is that a mixture of these scenarios and others may transpire, the ancient world has much to teach us. Some of the building blocks of the ancient world such as Rome are set out as follows.

Ancient Rome: Important Buildings

The Forum
- Religious Buildings
- Political Buildings
- Judicial - Administrative Buildings

Agora - Marketplace
Sports Stadia
Odeon - Smaller Theatre
Baths and Gymnasium - sport centre
Library ("mens sana in corpore sano")

In any major city in the world today, the building blocks of Ancient Rome can be seen. All major cities need religious buildings whether they be Buddhist stupors, Islamic mosques or Christian cathedrals.

Parliamentary buildings are equally important and some countries such as Malaysia are building a whole new city to accommodate the political and judicial buildings for the future. City governance, country governance and global governance will require administrators and buildings for those administrators.

All cities are market places in the sense that they are where people meet to exchange ideas and goods. Shopping centres and shopping streets (both in-town and out-of-town) will be an increasingly important part of a thriving city.

Sport is alive today as it was in the ancient Olympic era. Sports stadia such as the Olympic Stadium in Sydney or the new sports facilities in Cleveland, Ohio or the venue for the recent football world cup in Northern Paris, will remain part of the urban fabric.

Leisure and entertainment will be an on-going theme of all cities, including cinemas and theatres. In recent years there has been the development of multiplex cinema locations, often incorporating other facilities including sports facilities. Health and fitness is a theme which runs through cities over many millennia.

The role of culture, and the concept of a healthy mind within a healthy body will prevail, to a greater or lesser extent, over this generation and for many generations to come.

The global city today, whilst experiencing a number of changes, is based on the global city of yesterday. The success and failure of cities like Rome or Athens still have much to teach us in the 21st century.

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WHERE DID THE "WITHER AWAY" GO?

By Alan R. Winger

Several years ago this journal published an article of mine entitled "Wither Away Office Space as We Know It Today?"[1] The concern in the article was with the potential impact of the developing information technologies on office space. Implicit in the title was the notion that this technology could make office space as we know it today irrelevant to the needs of tomorrow's business organizations. The conclusion was that while nothing likely was to happpen over the next couple of decades, significant change was possible and, indeed, very likely beyond that time.

A number of things have happened since the time this article was published, one of which was the publication of a number of substantive analyses of how businesses are or should be responding to the technology as it develops.[2] A careful review of these studies might suggest to some that I underestimated the time that it will take for this "withering away" to take hold, as well as overestimating the amount of withering that will occur. I agree that there is growing body of evidence that suggests no hint of any diminution in the spatial clustering of information-intensive activities, something that bodes well for the office space market as we know it today. Nevertheless, I still see no reason not to expect significant change some time in the future. It may take more time to get

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there than I expected earlier, but the likelihood that long-term structural changes in the economy will bring about significant structural changes in the office space market has not in my view diminished. What follows spells out why I hold on to this conclusion.

THE NEW ECONOMY: IS IT A MYTH?

The recent bursting of the dot.com bubble in the nation's stock market combined with the disappearance of many if not most of those dot.com firms raised questions in the minds of many as to the reality of what was once called the new economy. The reality, of course, is that there never was a new economy in the sense often described in the hype that accompanied the emergence of the dot.com firms. There is certainly a lot that is new going on right now, but what's happening in the economy can in no sense be characterized as a radical departure from the past.

In the hype that surrounded the rapid growth in dot.com firms, there surfaced notions that were taken by some as the basic elements of such change. One of these was the weakening of brand identification. Another was the disappearance of middlemen. Being first in a world of fast-paced innovation was also considered to be a critical key to success because it was believed that the business world was fast becoming one in which winners take all.

While the business world is changing as it responds to the opportunities being provided by our rapidly changing information technologies, there are no such indications of radical change. Brand identification has not weakened. There are still middlemen and ample illustrations of the disappearance of those who were first in the business implementation of some of the emerging information technologies.[1]

There are also numbers that belie any kind of radical change in the structure of the economy. Employment data broken down by type of industry and occupation give us a rough reading of the structure of the economy and in neither case do we see any indication of radical change. Employment in the nineties continued to shift away from manufacturing into services, but the changes were no greater than those that occurred in the 1980s and denote the continuation of a trend going back a half century or more. Of course, some of the recent shift into services was in activity generally considered to be a key part of the new economy—knowledge-oriented activity. But a careful examination of the data indicate that close to 75% of the nation's workforce remains in occupations that aren't in that class, e.g. personal services, factory workers, artisans of various kinds, and low-order white collar positions.

The quest for something new and better, especially in its early stages, leads one into a world filled with haziness; a world loaded with ambiguities. There are no manuals to provide the needed guidance. There are few books that offer much in the way of concrete help. What is required is insight and imagination, much of which can only be found the minds of able individuals, who for reasons just discussed, usually work things out in co-located teams.

Furthermore, activity in which the economic revolution is taking place—in the area of information technology—is still small relative to the total, currently accounting for only a little over 5% of the nation's employment in year 2000.

There is no new economy as envisaged by some at the height of the dot.com boom in the late 1990s. Yet there are, at the same time, visible signs of important changes taking place throughout the economy. Innovation lies at the core of what's been happening in the economy. While innovation in business has long been a part of our economic history, the pace of such activity accelerated during the last part of the 20th century. This shows up in business research and development activity which more than doubled during the decade of the nineties, increasing from 1.4% of GDP in 1990 to 1.8% by year 2000. It is also reflected in patent data, which shows that the number of patents being issued almost doubled in the 1990s and increased significantly in terms of the number being issued per 1000 firms.

There are also literally tens of thousands of reported changes in how firms now do business with their customers and other businesses, the main thrust of which has been in the development of communication systems. These are changes that have had the effect of reducing transaction costs with both customers and other firms; bringing about increased management efficiencies that so far have been concentrated in supply chains; making markets more competitive; and fostering innovation as the competitive tool of choice. Most firms are now more exposed to competitive pressure and devote more of their resources to knowledge-oriented activities aimed at generating more innovation. Illustrations of how this is working out in industries that constitute roughly 70% of the total are to be found in a Brookings task force report on the Internet.[4] That our economic world is changing clearly shows up in what is reported here. But this report also makes clear that what's happening is a part of a process of change that is in its early stages. Much of what we now do as actors on the economic stage is not much different from what we have been doing for sometime now. But there can be no doubting the fact that what we are doing is changing and in time we will probably be able to talk about radical change or operating in a new economy.

ORGANIZING INFORMATION-INTENSIVE ACTIVITY WHEN INFORMATION COSTS ARE DIMINISHING

In an economy in which information costs are diminishing, one would expect dispersion in information-intensive activity. The earlier spatial concentration of such activity, as noted in my earlier paper, was largely the result of efforts to minimize information costs. Given the information technologies of the times, being close to one's co-worker was the cheapest and most effective way of getting and using much of the needed information.

Reductions in information costs, of course, are not new, and have resulted in the dispersion of information-intensive activity in times past. What's happening now to those costs hints at the possibility of dispersion, the likes of which we have never seen.[5] But, as noted in my earlier paper, this won't happen quickly largely because of the setting in which more and more firms now operate. The environment is one of fast-paced change and growing complexity. Dealing with the many problems that arise in such a setting apparently requires collaboration, with collaborators working in close physical proximity to one another.

What we have been given from recent research and interpretations of its results is more insight into how firms are responding to these problems with the new tools our technologies are providing. Clearly those activities that can be carried out on the basis of instructions written into computer codes are being dispersed. They are headed to where non-information costs are less. There is nothing new about this. Our current information technologies have just accelerated the movement. But there is much activity that continues to be geographically concentrated and housed in office buildings as we know them today for what we are now told to be several good reasons.

The first of these has to do with the mechanisms being put in place to connect people, the most important of which is the Internet. Through the Internet folks in business now have many more connections with many more people over much greater distances. Significantly, these are also connections that are both quick and cost efficient. But to make such connections, there must be standards that enable the computers or any other media involved to connect up with one another. There must also be rules or standards that foster efficient use of the hardware and software that underlie these connections. And then there is the matter of the rapid pace of change in the technologies that underpin these connections. Incorporating such changes into the infrastructure requires effort and vigilance. What firms have apparently found is that all this activity involves work that is best done when carried out at some centralized place.

A second reason has to do with the perceived need to focus more on the consumer. This need arises partly out of the ever growing complexity of the operations of business. Complexity in business, of course, is nothing new and what emerged from it earlier were operations that had many disparate parts running separately from one another—the silo effect. More recently, silo-driven operations began to encounter difficulty in markets with intensified competition and in businesses where the complexities of operation continued to grow. Most have now apparently come to believe that the solution to the problems these conditions create is the disassembly of those silos. Many firms are now attempting to do just that through a new found focus on the consumer. Those in the silos are being encouraged (or forced) to realize that what's important in today's world is connecting the consumer to all parts of a business operation. This cries out for some kind of centralized operation through which the proper messages are developed and gotten out, feedback is dealt with effectively and the activities associated with such efforts are properly coordinated.

In both instances, the underlying reason for the push towards centralization stems from the simple fact that much of what has to be done raises questions that do not have straightforward answers—matters that involve ambiguities that can only be worked through with discussion and debate that draws heavily upon knowledge that resides in the minds of those involved—tacit knowledge. In a world of rapid paced change induced by quickly developing technologies, there will be lots of this kind of knowledge-based activity involving teams of people. The majority belief now is that this can be best done if it is carried out in a setting in which there is community which is characterized as one in which there is a good deal of social capital. While social capital is a collective term that can be defined in different ways, most consider it to be things that bind people together in ways that make cooperative action possible. And the things most often talked about are trust, mutual understanding and shared values and behaviors. The presence of such capital, in turn, is thought to be most likely found in settings in which there is a good deal of face-to-face communication. Thus the argument is that for a growing number of their concerns, businesses choose settings in which face-to-face communication is possible because that means operating in a setting that is likely to yield the best results. Since more and more of the activities of business fall into the category where such capital is important, this bodes well for those places that house that activity, which is office space as we know it today.

WILL IT GO ON FOREVER?

Studies based on the real-life experiences of firms undergoing changes precipitated by technological innovation suggest that these technologies are pushing us into an economic world that, in time, will be significantly different from what we have today. They certainly do raise serious questions about the likelihood of movement into a world in which people live and work whereever they choose. That they raise such questions, however, should not obscure the fact that there are elements in the current situation that, in time, could reduce significantly the economic importance of the co-location of knowledge-based workers in centralized locations.

Consider first the setting in which these concentrations of employment occur. They are settings in which costs are high relative to alternative locations. High-density areas are places where rent and labor costs are high, which is reflected in the private costs of operation. They are also places in which social costs are high because of congestion and pollution. This means there is, to begin with, a built-in incentive to movement away from these places.

Movement away from high cost locations, of course, happens all the time in market economies. As the cost pressures build from economic growth in these locations, competitive factors in markets force firms to look elsewhere for operating sites. When such movement makes economic sense, it's done. That we have many urban agglomerations in which there are concentrations of knowledge-based activity apparently reflects the fact that it doesn't make sense to do it in many instances. And, of course, there are the reasons just noted for believing this.

BUT WILL IT ALWAYS BE SO?

There are two reasons for believing that the glue currently holding things together in our cities could lose some of its strength. The first of these lie in the information technology itself. Face-to-face communication currently has many advantages over electronic means of communicating because current communication technologies represent only the early stages of development in what these technologies are going to give us. As the emerging multimedia technologies develop, we will have an infrastructure that will more readily allow us to simulate face-to-face communication. Surely, if the markets in which this takes place are competitive, more and more of the knowledge-based activity now co-located in areas of geographic concentration will move to lower-cost locations. How much of this will occur and what location patterns will emerge is, at this point, a matter of speculation. What we might expect is that the upcoming changes in technology will, in time, result in movement away from locations in cities—perhaps a good deal of movement.

Another factor may be changes in the volume and kind of knowledge-based activity in most businesses. Innovation has become such an important tool of competitive advantage, and more than a few statistics suggest that knowledge has become an increasingly important input in the production process.[8] Innovative activities, in turn, require knowledge inputs from qualified individuals who deal with extraordinarily difficult problems. The quest for something new and better, especially in its early stages, leads one into a world filled with haziness; a world loaded with ambiguities. There are no manuals to provide the needed guidance. There are few books that offer much in the way of concrete help. What is required is insight and imagination, much of which can only be found the minds of able individuals, who for reasons just discussed, usually work things out in co-located teams.

If we believe that this kind of activity, which has increased substantially in business over the past decade, will continue to grow, or at least be sustained in the foreseeable future, then there is reason to argue that much if not most of the knowledge-based activities of business will remain concentrated in our cities and metropolitan areas.

BUT IS THIS A REASONABLE BELIEF?

The question is much easier raised than answered. It's also one about which reasonable people disagree. The answer depends in part on one's assessment of the opportunities for innovative activities and the incentives to engage in them. The matter of opportunity is important because ideas, the guts of innovation, just don't drop from the heavens. What's happening now in most firms has roots in the various sciences. Innovation is not necessarily a linear process that starts from science and works it way through to the commercialization of some product, but scientific knowledge is the bedrock of the process. The opportunities for innovation are very much tied into basic scientific ideas. Prior to the recession in year 2000 and the faltering path of the economic recovery since then, there was much optimism about these opportunities. Areas such as software, hardware, the World Wide Web, biotechnology, materials technology, and nanotechnology were touted as areas of opportunity that would keep innovation growing forever at an ever-increasing rate.[9]

It's not difficult to be taken in by the arguments of those who optimistically summarize the technological opportunities coming out of what's happening in that incredible maze of involved and complicated activity we call science. But trying to anticipate what's going to flow out of the scientific discovery that underpins much of our technology is difficult if not impossible to do. There are nevertheless reasons for tempering some of this optimism.

One of these is the recent cutbacks in government funding for R&D. While private industry efforts has more than taken up the slack here, industry efforts are more geared toward development rather than research. This shows up in a number of ways, including the shift in the R&D to activity closer to the market, at such firms as Bell, Dupont and Xerox, firms that were at one time in the forefront of industrial research.[10]

Second, there is the matter of history. The reservoir from which we draw the ideas that underpin innovative activities has by no means been continuously filled to the brim. Throughout history, there have been periodic dry spells in innovation. The economic booms and busts that some believe cover periods of 50 years or more have, in the eyes of some, been the result of waves or a time clustering of innovations.[11] While history doesn't have to repeat itself, the possibility of future cyclical movement is there. And if it comes into fruition it will amplify the effects created by what appears to be a current emphasis on the "D" in R&D. The opportunities for innovation could, in time, dwindle, which if it happened would lead to some slowdown in the pace of innovative activity.

There is also the matter of incentives. This is partly a matter of being able to appropriate the benefits from innovative activity. The problem here is that the ideas that give rise to innovation, if not protected in some way, can be easily borrowed by others. The fruits of the labor, in other words, can be appropriated by others if they are not protected. There are, of course, remedies that have developed, including patents, copyrights, and operating stealth. Such measures introduce monopoly elements in the market, and market restriction of some sort must be present if there is to be innovation, especially in the early stages of the process. But competition is equally important in moving from innovation to commercialization.

In most instances, our legal infrastructure provides firms with reasonable protection against the theft of the ideas that are developed in research. Appropriating the returns from their investment is not a serous problem. Moreover, worldwide economic developments over the past several decades have provided the competitive incentive necessary to push the process to its conclusion. Markets worldwide became much more competitive as Western nations privatized and deregulated industries and socialist economies scrapped their economic plans and adopted market solutions for large chunks of their economy. The globalization of many markets during this period intensified the competitive pressures, thereby adding to the incentive to innovate.

While there is no reason to believe that much will happen to alter the incentives to innovate at the research end of the process, some questions are raised about the competitive factor at the development end. The movement toward markets and the deregulation of markets appear to have pretty well run their course. Moreover, there are political uncertainties in some parts of the world that hint at movement in a counter direction. Whether this happens or not depends in part on the performance of the world economy.

The difficulties affecting most economies over the past several years raise more questions about the incentive to innovate. What has become increasingly clear recently is that the early notions about a new economy that moves along in a perpetual boom-like condition just don't hold up. There is now reason to argue that we are in the throes of a recovery that will be slow and arduous compared with what we experienced in the 1990s. If this turns out to be case, it implies demand conditions that will bring forth less innovative activity than experienced during the go-go years of the 90s.

While my training in the dismal science of economics predisposes me to look at the glass as though it were half empty, I don't think it can be denied that there are reasonable arguments that can be made that the bloom will, in time, come off the flower of innovative activity. The concerns of business, while still focused heavily on gaining competitive advantage through innovative effort, could, in time, shift toward activities that attempt to consolidate the benefits of outcomes from earlier and current efforts. This implies activity that emphasizes less creative effort and the need for discovery and focuses instead on the more mundane concern with the validation and rationalization of what has and is coming out of innovative effort. This means activity that is likely to involve less tacit and more codified knowledge, which could have bearing on the issue of the location of the people providing the knowledge inputs into the operation of the firm.

WHAT DOES IT ALL MEAN?

Certainly as the "information revolution" unfolds, there is evidence of a considerable amount of activity that entails knowledge-based people working in teams in the same geographic location. The changes that this revolution brought to us have, thus far, not melted the glue that holds knowledge workers collaborating in office buildings as we know them today. The reason, of course, is that most of what we do that brings about change is knowledge-based activity concerned with problems and situations filled full of ambiguities. Many of the knowledge inputs required such as discovery and creativity come out of the heads of those involved. And what is needed when this is so is best elicited when the work is done by teams of co-located people. As long as the revolution continues in this way, there is no reason to expect these working arrangements will change. The implication is an absence of radical change in the way in which we house this work.

There could, of course, be radical change for other reasons. An unsettled political environment giving rise to terrorist attacks of the kind experienced on the World Trade Center could precipitate some significant changes in these housing arrangements. That possibility aside, it remains true that a fundamental underlying reason for the kind of arrangement we have today is the importance of co-location in the knowledge-based component of businesses.

The question raised in this paper is whether that importance will continue.

To raise this question is, in effect, to ask whether the technologies emerging today will continue to sustain, indeed even elevate, the importance of co-located knowledge-based activity. As I have presented the reasons for this importance, the answer depends in part on what happens to the pace of future innovation. There are reasonable arguments that can be made to the effect that what we observed in the last decade of the 20th century will return after the economy regains the growth path it lost during the early years of the 21st century. There seems to be much on the opportunity plate that would keep the pace of business innovation high for as far out as the eye can see.[12] As I see it, this view of the future is too optimistic. The well of opportunity is not a bottomless pit. If there is a slowdown at some point in time, as I expect, efforts to consolidate what we have been given through innovation will lead to activity that will be more susceptible to geographic dispersal. And there will be dispersal because of the relative costs of current arrangements. As I see it, in general terms, the office building market will, in time, continue to become more dispersed in geographic space, a trend that has been there for more than a half century. The precise details of the pattern that evolves, however, is by no means clear. It will depend on matters that are not now an important part of the equations we currently have to explain the current spatial configuration of this market.

Of course, my view of the future may be tainted by the self-admitted inclination I have to looking at the water glass as being half empty. What I have tried to do in this paper is to point the reader in the direction of those developments that are most likely to have important bearing on the outcome. Since reasonable people can disagree about the future direction of these developments, those concerned with outcomes cannot avoid the responsibility of taking a position with respect to these directions. Now it's your turn.

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EMERGING GLOBAL CITIES: COMPARISON OF SINGAPORE AND THE CITIES OF THE UNITED ARAB EMIRATES

by Ali Parsa, Ramin Keivani, Loo Lee Sim, Seow Eng Ong, Bassam Younis

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Globalization processes and responses to them have important consequences for the growth and development of cities. This, however, is not a uniform process. The outcome at the regional and local level is highly path-dependent on inherited social, economic, and regulatory structures and relationships. This development path is heterogeneous and the path to regionalization and globalization of a city is influenced by multiple factors such as its geographic location, resource availability, and local productions and service advantages, to name only a few.

Singapore is often quoted as an exemplary city to have successfully embedded its development strategy within the global economic circuit while the main United Arab Emirate (UAE) cities, Abu Dhabi, Dubai, and Sharjah are among many urban regions in the developing countries that hope to emulate Singapore as an emerging global city. Although there has been extensive research examining the impact of the globalization process on urban and regional development in various geographical areas including Singapore, there is a distinct lack of studies on the Middle Eastern region, particularly the UAE cities. In view of this, the following study delves into the very path that each of the subject cities has employed and is an attempt to evaluate both the past development and the present and future capacity of their milieu, through an institutional study approach, to accomplish their respective "development visions" and emerge as economic centres of the global supply chain.

PROCESSES OF GLOBALIZATION AND THEIR IMPACT ON CITIES

There are many different approaches to the study of globalization and global cities, but some important concepts that have emerged from the body of literature are complementarities and competition. As networks develop, they engage in complementary activities; at the same time, they compete with each other to attract investments as illustrated in the studies reviewed in the following sections.

In their efforts to secure international investment, countries and cities today are increasing their operations in conditions of changing comparative advantage. As a result, rather than relying solely on traditional concepts of comparative advantage in terms of lowest production costs or highest investment incentives; cities are forming urban alliances and economic synergies within and across national boundaries in order to utilise different urban/regional functions and factor advantages towards accomplishing common economic objectives.

Network functionality and competitive co-operation creates synergistic effects for a win-win situation. Success is often dependent on the ability to offer institutionalising processes to attract flows of investment and entrepreneurship and to offer a variety of external economies of sufficient scope and scale to business.

One significant aspect that emerges from these studies is the recognition of the increasing importance of the business environment as a determining factor in the competitiveness of a city. Central to this is the role of policy factors and institutional design of a city. As a result, the institutional approach has gained importance in explaining the competitive and comparative advantage of cities.

THE INSTITUTIONAL APPROACH

The institutional approach has gained importance for analyzing the diversity of economic formations in different regions in recent years. Institutions have been defined as "rules of the game" in a society. Organizations, whether political, economic, or social, behave and perform within a framework defined by institutions, which are regarded as both formal and informal rules. Formal rules are laws and regulations while the informal rules are norms, conventions, traditions, and customs.

Thus, the institutional approach does not emphasize the presence of institutions per se but rather the process of institutionalization—the institutionalizing processes that both encourage and support diffused entrepreneurship—a recognized set of conduct, supports, and practices.

The questions to ask therefore—are cities up to the challenge of creating the kind of institutional thickness required? Are existing and inherited institutional structures and interest groups an obstacle to the kind of innovative milieu that is required for embedding entrepreneurship and international capital?

RESEARCH METHOD

The methodology underpinning this research draws upon the institutional school of urban analysis and academic work on world cities and global urban networks. In essence this is an examination of rules, regulations, conventions, and structures that shape processes and resultant interactions vis-à-vis the city's capacity for attracting and embedding international business.

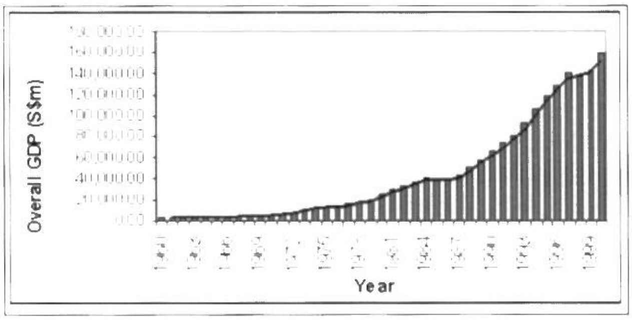
In evaluating institutional capacities in the studies, a series of semi-structured interviews were conducted. These involved senior policy makers from different government departments and agencies, concerned with the formulation and implementation of economic and urban policy. International private sector participants were drawn from economic sectors that have been identified as being central to the economic globalization process in terms of higher value added functions as well as the more traditional sectors of comparative advantage in each case study city. Overall a total of 118 interviews were carried out in the four cities encompassing 15 different private categories.

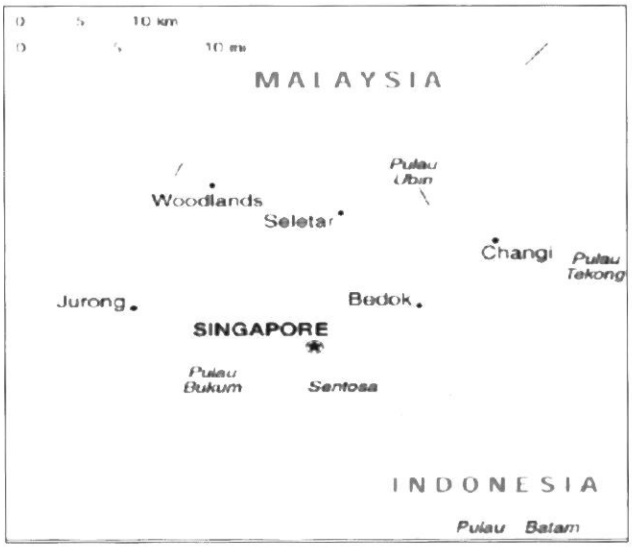
The questionnaires and the interview programme were designed to enable detailed exploration of perceptions and actual experiences of both public officials and international firms in respect of a range of institutional processes and capacities framing and facilitating the business environment in the studied cases. These include general development vision, the stability of the business environment, security of investment, impact of specific regulations, and the quality of spatial development and infrastructural capacity.

Exhibit 1

Singapore's GDP at Current Market prices: 1960- 2000

Data Source: Singapore Department of Statistics different years





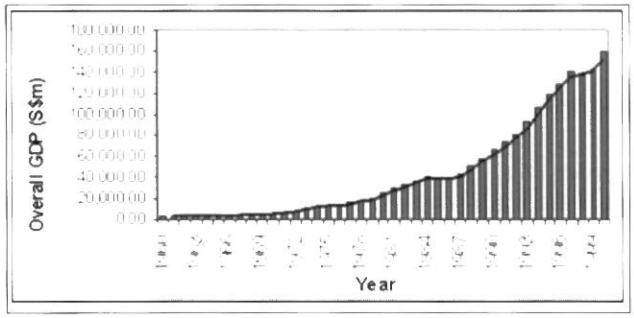
SINGAPORE

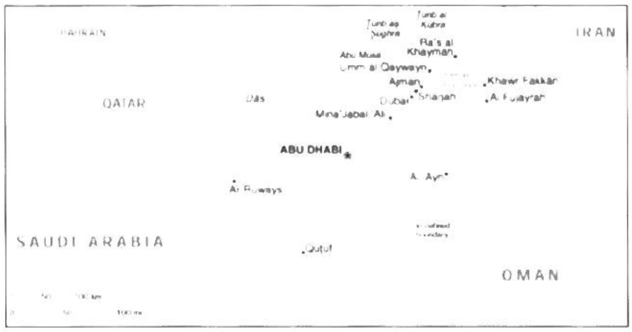
The competitive city of Singapore (Exhibit 1), as we know it today, has developed through rapid economic and socio-cultural transformations. This development model is built on the recognition by the public administration for value addition and adaptation of an export-oriented growth model, a strategy employed by most emerging markets in Asia. Singapore transitioned from a manufacturing base in the late 1960s and 1970s, to a knowledge intensive sector in the 1980s. This led to an advancement in the value chain in this sector in the 1990s, to reach the platform of a highly recognized regional city of the 21st century, demonstrating the strong fundamentals of the institutional system. The Economic Development Board (EDB) and the Trade Development Board (TDB) are the key drivers for taking Singapore in the regional and global marketplace and are the statutory bodies

Exhibit 2

UAE GDP at Current Market prices: 1975—2000

UAE Annual Economic Accounts different years





that aim at attracting businesses through fiscal incentives, sound business policies and environment.

Moving towards the new century, the institutions have initiated the Singapore 21 plan. This includes Tourism 21, Industry 21, and Construction 21, which are mandates to establish and achieve goals within these sectors.

To date, more than 5,000 international companies operate in Singapore, with about half having regional operations. This growth has been contributed to a significant extent by the 20% foreign workers that reside in Singapore. This large population base of expatriates reiterates the demographic effects of globalization on cities.

UNITED ARAB EMIRATES

United Arab Emirates (Exhibit 2), hereon UAE, a federation of seven emirates—Abu Dhabi, Dubai, Sharjah, Ajman, Ras al Khaimah, Umm al Qawain and Fujairah, was established in 1971. Of these seven emirates, Abu Dhabi and Dubai account for 60% and 25% of UAE's Gross Domestic Product and have been the frontrunners in the economic growth in the decade spanning 1990-2000, when the UAE recorded a growth of over 80%. Today, the country is a major regional centre for trade and shipping, and business and IT services. A report by Emirates Industrial Bank (EIB) issued in May 1999 ranks the UAE as the third most important re-export center in the world (after Hong Kong and Singapore respectively).

With its low custom tariffs, no personal income tax, low corporate tax, and secure business environment, UAE has become a preferred business location in the Middle East market. UAE citizens account for a little over 20% of the population, which further emphasizes the need to study an institutional system that caters to economy and its development.

Abu Dhabi is the largest of the seven emirates and the federal capital. It is the biggest oil producer in the UAE, controlling more than 85% of the UAE's total oil output capacity and over 90% of its crude reserves. Abu Dhabi's primary strategy has been the privatization of the manufacturing sector, a notable example of which is the Taweelah A-1 Independent Water and Power Project. At the same time Abu Dhabi has diversified its economic base particularly aiming at developing oil related petrochemical industries as well as producer services and tourism.

Dubai: The Emirate of Dubai, world renowned for the Burj al-Arab 7-star hotel, is built along the edge of a narrow 10-kilometres long, winding creek which divides the southern section of Bur Dubai, the city's traditional heart, from the northern area of Deira. Dubai's oil reserve has reduced over the past decade and is now expected to be exhausted within 20 years. Given the depleted natural resources, this emirate has diversified its strategy for development with added emphasis on providing a service base for financial services, IT, tourism, sporting events, and transit trade, in its bid to become the financial, business, and high tech centre for the region. In the aftermath of September 11, 2001 and the U.S. government's decision to clamp-down on funds and investment from the Middle East, according to the Financial Times about $200 billionn of Arab funds have been withdrawn from the U.S. Much of this will be reinvested in Dubai strengthening the city's position as a global financial and business center in the Middle East North Africa region.

Sharjah: The Emirate of Sharjah extends along approximately 16 kilometres of the UAE's Gulf coastline and is a major industrial base for the UAE. Sharjah is the junior partner to Abu Dhabi and Dubai in terms of contribution to overall GDP. As with the other two main emirates Sharjah has also made a concerted effort to diversify its economy in to trade, retail, tourism as well as its capacities in producer service functions. The government has sought to boost foreign investment and trade in several ways, including the setting up of the Sharjah Airport International Free Zone (SAIF Zone) and the development of the Hamriyah Free Zone (HFZA). Sharjah was recognized by UNESCO as the Cultural Capital of the Arab World in 1998.

The overall institutional set up in the UAE is a two tier system comprising the federal level and individual emirate levels. The rulers of the seven emirates in the UAE comprise the Federal Supreme Council which elects the country's President and Vice President at five-yearly intervals from amongst its members. The different emirates, however, have a large degree of independence in deciding and implementing their social and economic development strategies and policies.

KEY FINDINGS

The most important message emanating from this work is to reconfirm the central role of institutions in economic development and competitive position of cities in the world economy. In Singapore a clear definition and openness of the intended goals for the country along with the initiatives that are made available to both public and private organizations through a focused, harmonised, transparent and accountable institutional structure has allowed the regulations and business markets to align their interests. This unification has resulted in Singapore attaining immense growth and global recognition.

Active feedback with the international business in developing policies has allowed businesses to realign their respective objectives, thereby avoiding shocks and increasing adaptability. This two fold advantage of effective implementation and continuous dialogue on policies is set to be taken further with the establishment of the Singapore Business Federation, whose primary mandate is to cater to the business community in Singapore. Notably, the responses from public and private organizations bore similarities that reflected the transparency and openness in the business culture. This is one of the keys to a successful city, where interests and aspiration of the business community are in line with the institutions and vice versa.

As a result of the strong institutional participation in business facilitation and efficient servicing, there is an air of business security created. This is further substantiated by a strong legal sector. Singapore has been commended by all respondents for its ability to maintain a just legal framework that is pragmatic and highly efficient. The move by an international company to include Singapore laws for any arbitration in their regional assignment is an adequate reflective of the same. In addition to the sound legal environment, the regulations for conducting businesses were also seen as highly adequate. Except for the rising property prices, the availability of local finance and over regulation, all other issues ranging from the policy stability, corruption and business set up were seen to be pro-business. The accountability and openness of the institutional structure, moreover, allows for early identification of problem areas and implementation of strategies for rectifying the situation, be it in terms of enhancing the city's cultural and leisure facilities or liberalization of the banking sector.

The most important issues facing Singapore in terms of its future development strategy is ensuring the supply of high calibre knowledge based workers and managers for the expansion of its corporate services and knowledge based services as well as fostering greater innovation. The former is dependent on maintaining the city's attractiveness to foreign talent as well as expanding training of home grown talent through its well developed education system. The latter on the other hand can be partially explained by the stage at which the country has entered this innovation train. ADB (Asian Development Outlook 2001) outlines that areas such as Singapore and Taipei relied on initial acquisition of technology, through collaborative R&D and joint ventures with multinationals to seed the innovation. It then marketed this innovation through the development of necessary physical infrastructure and telecommunications for firms to practice the same and sustain. Therefore the actual cultivation of R&D ventures is restricted. Another aspect to nurturing innovation may be sought in a cultural change to set the mind free and allow expression of individual initiatives outside the current tendency for "in the box" and secure work culture and practices.

In the case of UAE, Dubai is clearly the most dynamic and institutionally most developed of the three examined cities. Similar to Singapore it has a focused economic vision built around its traditional role as the trade and transport hub of the Middle East which it now wants to expand to regional higher value added functions in corporate and IT services, niche research and development activity and tourism. Abu Dhabi is also following a similar development strategy but with a greater focus on the development of capital intensive petro-chemical industries and services. Sharjah has a substantially smaller economy. Its economic vision is in the first instance based on the more modest objectives of exploiting niche markets for establishing itself as a regional manufacturing base relying on its lower cost factors to attract largely small and medium enterprises. At the same time the city is also aiming at expanding its gas and oil industries, developing a niche cultural tourism industry as well as its higher value added functions for capturing at least a part of the market for regional corporate services and HQ functions. This is parallel to its desire for becoming the higher educational hub of UAE and the greater region while maintaining its strong local cultural and identity.

In terms of their regional ambitions and international investment all three UAE cities have to some degree a privileged position as none of their potential competitors can match the combination of incentives offered by their political and economic stability, high level of infrastructural development, business support facilities and quality of life. Indeed, all three cities and particularly Dubai have succeeded in exploiting this advantage in establishing themselves as the premier regional HQ and corporate service location as well as tourist destination. Based on the Singaporean experience, however, their long term success and further growth as regional centres for higher value added functions is dependent on addressing certain institutional concerns/issues highlighted in this research. These can be divided into common areas of concern emanating from federal regulations and structures and those that are specific to the individual emirates. The former relates to the need for reform of federal regulation in certain areas such as local partnership and agency requirements, labour laws and property ownership as well as enhancing the quality of the legal system. To a certain degree imminent UAE entry into WTO will enforce reform of the more restrictive federal regulations such as the local partnership requirement.

One area of specific emirate concerns that is common to all three UAE cities is the shortage of human resource capacities to enable greater instiutionalization of the decision making and implementation process, business facilitation and efficient servicing. Similar to the case of Singapore, this issue must be tackled through a twin strategy of training local capacity and attracting foreign talent of the highest caliber. In addition innovative schemes could be developed to enhance the efficiency and knowledge base of existing personnel as well as fostering greater inter-institutional coordination and creating a sense of common purpose and understanding. A good example here is the "fire-fly" scheme used in Singapore. To this must be added weaknesses in terms of robust feedback mechanisms with international business for policy development and implementation. Clearly there are differences between the three cities. Dubai is by far institutionally the most developed and focused. Abu Dhabi on the other hand has emerged as institutionally the weakest. Not only in the areas outlined but also in its lack of institutional awareness, unnecessary bureaucracy and the prevalent gift oriented work culture which leads to excessive personalization of government/business interface and therefore creates uncertainty and the scope for increased corruption. The most important area of concern specific to Sharjah stems from a lack of sufficient clarity in its economic objectives and its effective circulation as well as a perceived imbalance between social and economic objectives.

Finally, a major issue of concern relates to the solitary go-it-alone attitude evident in all three cities. The Singaporean example has highlighted the benefits of creating synergies for full utilization of potentials and complementary factors endowments. In the case of UAE the most logical starting point for creating such synergies is between the different emirates themselves. Clearly none of the emirates can afford to be hampered in pursuing its developmental objectives by the conflicting interests and development strategies of the other emirates. Nevertheless, there are major interconnections and complementary functional activities which should be harnessed to greater effect. Nowhere is this more evident than between Dubai and Sharjah which from a regional perspective can be considered as part of the same urban conurbation. This was clearly evident from our interviews with firms in both cities highlighting the complementarities between the two cities as benefiting their regional competitive positions. Moreover the logic and imperative for creation of such synergies has increased, given the stated objectives of Dubai and Sharjah in becoming regional centres for niche research and development and educational activities. The most important element in the success of R&D regions is the creation of a highly innovative and networking milieu. Such innovative networks are in turn more likely to be created in a growing urban agglomeration which utilises all of its innovative potential including existing industries and academic institutions. Here there is a clear case for encouraging greater synergetic development between Dubai and Sharjah particularly in terms of academic and industrial links to harness and direct the innovative potential towards creating a sustainable R&D environment. This of course would have to be a long term objective building up research capacities through an interconnected programme of industrial and academic development in both locations.

As can be seen, there is an increased understanding among nations and cities of the competition that they must endure in order to link their economy to the global value chain. The development strategy is a formal order of just that, where in the city defines its role in this value chain and utilizes its resources and comparative advantages to position itself as the peer for the product. However, this accomplishment can easily fall short with the lack of effective institutional thickness and nimbleness. As the 'rules of the game' these institutions establish a framework for achieving the set vision and create an urban environment that physically and economically helps in sustaining its competitiveness. Singapore has achieved significant success in the last four decades, from a small city to a regional and an Asian city. It now aspires to become a global city for business functions and the above study explores the potentials and shortcomings that it possesses in its stride. As for the three UAE cities, the intra city functions and inter city functions are presented in the study.

Whether Dubai will be successful in emulating Singapore, or whether Dubai and Sharjah will work complementarily, or if Sharjah can formulate a clearer vision, Abu Dhabi a more sophisticated institutional set up, or for that matter Singapore a global city in the future, is an aspect that will have to be seen. But one thing that clearly stands out for all the subject cities is the need to recognize and implement strategies that support, exploit and benefit the socio-economic status of the city and the human capital that builds it. Therefore, for the UAE cities, Singapore may stand as an exemplary example of a city, but for Singapore the need to launch further in the global economy rests on the same principle as required in the UAE cities, the human capital and their capacity to build, foster and add value to the knowledge based economies of the world.

OUTLET MALLS ON THE HORIZON—A VIEW FROM THE MIDDLE EAST

By Simon Thomson CRE; FRICS

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The shopping center market in The Arabian Gulf Co-Operation Council member states (Bahrain, Kuwait, Oman, Saudi Arabia, Qatar, and United Arab Emirates) has reached a level of maturity that is commensurate with the U.S. and European Union. So much so that clearly defined sub markets are now emerging. These are about to be joined by another exciting concept new to the Middle East, the outlet mall.

REGIONAL CENTERS

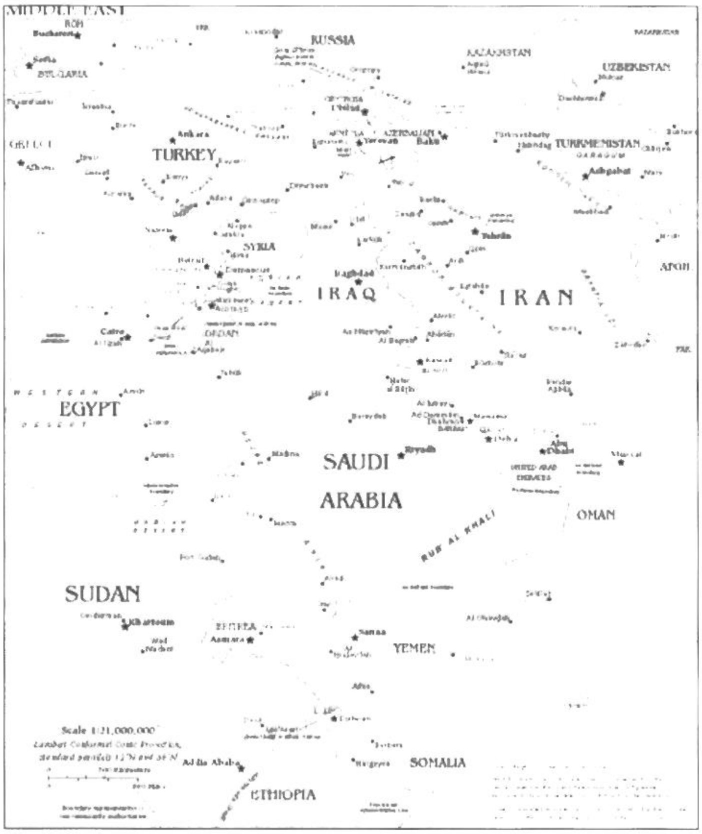
At the top end of the scale are the major regional department store anchored speciality centers such as Al Faisaliah and Kingdom Mall in Riyadh, Al Rashid Mall in Al Khobar, New BurJuman and Wafi Mall in Dubai, and Seef Mall in Bahrain.

HYPERMARKETS

Next come the hypermarket/supermarket-anchored centers typified by the City Centre format of the Majid Al Futtaim Group of Dubai and Carrefour of France and now being joined by Géant-owned by Casino also from France and Fu-Com of Bahrain in the Gulf. These centers range to up to 130,000 sq m (approx. 1,400,000 sq ft).

"STRIP" CENTERS

A third category comprises smaller centers typically in the 7,500 sq m (approx. 81,000 sq ft) to 15,000 sq m (approx. 161,000 sq ft) GLA range. These may well be of high quality but without any significant department store or big box-type anchor. Usually located in strip type locations such as Jumeirah Beach Road, Dubai; Qurm, Muscat; and Olaya, Riyadh, these centers provide a modern high street-type speciality offer.



MIXED-USE CENTERS

An increasingly important category embraces a broad range of mixed use projects in which retail plays a significant role. This may take the form of overall space such as Al Ghurair City, Dubai and in others where the shopping center provides a key critical component element to the success of the overall scheme. In the former both elements—retail and non-retail—in effect become 'mutual anchors' of the scheme, while in the latter the non-retail will assume many of the facets of an anchor. These typically will comprise a substantial residential and/or office content that have the effect of generating regular footfall from a virtually 'tied' audience.

Existing examples include Emirates Towers Boulevard, Dubai and Fotouh Al Khair Centre and Abu Dhabi Mall in Abu Dhabi. It is over the next few years, however, that significant projects of this type will be completed. In Dubai these will include Dubai Marina, Festival City and Palm Islands. In Cairo, Stars City, in Kuwait the Millennium Waterfront, and in Bahrain the Amwaj Island and Durrat Al-Bahrain projects. These are significant projects in international terms with the Dubai Festival City, providing 248,000 sq metres (approx. 2,668,500 sq ft) of retail and occupying a site of 1,200 acres.

AIRPORT AND RAILWAY RETAILING

The duty-free reputation of the Gulf's leading airports is legendary; however, the overall retail offer has failed to keep pace with other leading world class airports. The opening of the new terminal in Dubai and development of another this year coupled with others under redevelopment across the Middle East will present an unrivaled opportunity, enhanced by privatization, to create an airport retail offer representative of the range and quality available in the region's leading malls. So far, airport retailing has mostly been confined to air-side duty free. The opportunities for the development of landside shopping to include convenience and supermarket shopping for arriving passengers, airport staff and other non-travelling visitors are open to be exploited.

The recent announcement that construction will start this year on the first phase of a public transport railway system in Dubai with the main rail station located near the Municipality HQ will be the focal point of new development including shopping malls, theatres and cinemas. Once again Dubai will be setting the trend for others in the region to emulate in future years.

OUTLET MALLS

All of this retail space—some 6.5 million sq meters (70,000,000 sq ft) Gross Leasable Area ('GLA') in modern shopping centers across the region by 2005—estimated by Retail International—with some 250 cross border brands, is generating an urgent requirement for the development and provision of outlet malls.

These shopping centers offer a combination of famous brands at discount prices often incorporating leisure activities in an exciting environment targeted at visitors of all ages. Such centers not only appeal to bargain hunters but also provide a convenient outlet for retailers to shift slow-selling merchandise, facilitating frequent turnover of stock and a constantly refreshed image.

Several developers in the region are known to be planning a series of outlet malls across the Middle East with details soon to be announced.

In Europe market leaders include Freeport and McArthurGlen with, in North America, The Mills Corporation, now also moving into Europe.

In the U.S. such centers are typically well over 100,000 sq meters (approx. 1,100,000 sq ft) GLA and require a catchment population in excess of 500,000 within a ten to fifteen minutes drive.

In Europe outlet centers may be much smaller with 25,000 sq meters (say 270,000-sq ft) GLA typical but the trend toward U.S. dimensions is growing. Apart from quality and value an ingredient essential for the success of any such center is acres of car parking often averaging at the ratio of 1 car space per 10 sq meters or around 100 sq ft GLA.

RENTAL VALUES

The Middle East is no different from many other multinational markets with a wide disparity of rental values across the region. The issue can be clouded too by the payment of "key" money or premium by tenants to secure shop units in particularly sought after locations. This is particularly prevalent in Kuwait where at one time a secondary market developed in trading vacant shop units as a commodity rather than for normal retail purposes.

In more recent years with the ever-increasing sophistication of shopping center management techniques, the introduction of turn over rents, service charges and legally enforceable leases the practice of tenants being able to trade on their units without returning them to the landlord is dying out.

Rents are always payable in advance and may range from monthly, three monthly, bi-annually, or in buoyant markets, annually. The Arabian Gulf States with the exception of the United Arab Emirates operate the metric system of measurement, whereas the UAE still uses Imperial (feet and inches). All of the Gulf currencies are fixed to the U.S. Dollar that makes comparison relatively easy. However with some quoting rents in square feet per annum, some in square meters per month and others in square meters per annum, a spreadsheet and PC can be useful!

The division of shop units into zones for the assessment of rental value such as is the norm in the United Kingdom is not practiced in the Gulf with an overall standard rate being charged.

The most expensive location in the Middle East is Dubai where top retail rental values are between the equivalent of U.S.$100 to U.S.$150 per square foot per annum. Retail rents in Dubai will however come under extreme pressure in the next few years as the growth of new shopping centre space seems unabated. Lowest rates at around U.S.$50 to U.S.$100 are likely to be found in cities such as Muscat, Oman.

INVESTMENT RETURNS

The basis of comparing real estate investments in the Middle East varies considerably from that conventionally known in the west. In many cases land value may not be included because either it has been held in the family for generations or may have been gifted by a ruling family. Equally it is only rarely that a shopping center will change hands. This may only come about due more to a rearrangement of ownership internally between two members of an owning family or in times of a severely distressed market when the lender may be forced to foreclose on a loan.

If Western valuation techniques are applied average investment returns or capitalization rates are generally in the region of 10%.

FUNDING

Shopping center developers, who are also almost always the owners, finance their projects from a variety of resources. Some may come entirely or

Exhibit 1

Middle East
Estimated completed and planned shopping centers by gross leaseable area in square meters

Source Retail International® ©2002

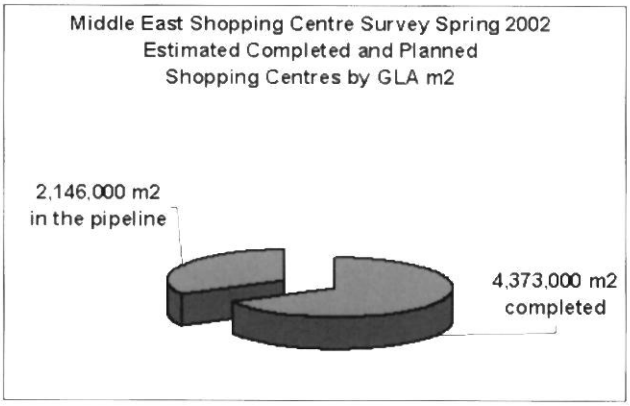
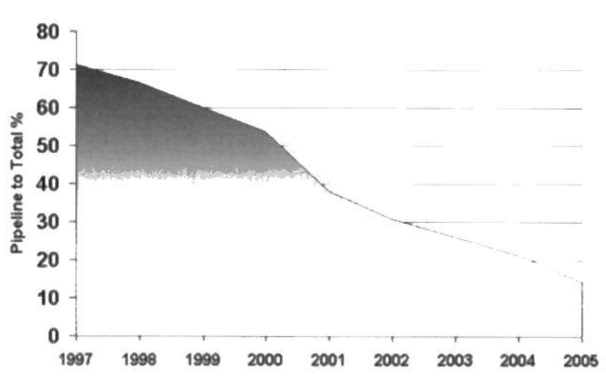


Exhibit 2

Middle East Total Shopping Center Space planned as a proportion of the total.

Source Retail International® ©2002



substantially from internal equity, some may be provided by conventional bank loans or mortgages from either local or international banks. These depending upon the size of the project may be syndicated to a number of banks. Project costs up to U.S.$ 1 billion are not unknown. Local and international banks may also provide borrowings using Islamic banking principles that eschew the concept of interest and although too detailed to develop in this paper, generally involve the lender taking some form of equity ownership in the project for a specified period at the end of which the ownership is 'sold' back to the borrower at a pre-determined price to show the lender a margin for the provision of finance.

Retail Sales Figures

Unlike North America such information is a closely guarded secret among the Gulf retailers. Experience however indicates that high-end fashion apparel in top locations such as Dubai may average in the order of U.S.$500 per square foot. Sales of jewelry, gold and perfume however are likely to substantially exceed this figure. Many shops also operate as showrooms with wealthy customers having merchandise sent to their homes for private viewing and purchase rather than in mall. Transactions such as these may be large and may not feature in the trading returns for individual shop units.

GEOGRAPHY

The Arabian Gulf (or Persian Gulf as its is known in the West) lies in west Asia on the east of the Arabian peninsula. With Kuwait at its head it divides the countries of Iraq and Iran on the east from Saudi Arabia and the other Gulf States on the west.

The leading Gulf countries are The Kingdom of Saudi Arabia, The United Arab Emirates, The Sultanate of Oman, The Kingdom of Bahrain, The State of Qatar and the State of Kuwait. Although each is entirely independent and a member of the United Nations and World Trade Organization, they are each a member of the Arabian Gulf Co-Operation Council. This is somewhat similar to the European Union aimed at increasing integration in terms of trade and monetary union between the member countries.

With minimal personal taxation the region enjoys enormous wealth due to the vast deposits of natural carbons (oil & gas) and other minerals. Gross Domestic Product per capita ranges from about $10,000 in the less well off regions to well over U.S.$25,000 in the wealthiest cities and states, such as Qatar, Kuwait and UAE.

The population of the region is rapidly expanding with one of the youngest demographic profiles.

The total is estimated at around 40 million of which over half are in Saudi Arabia. The population is predominantly urban with cities such as Riyadh, capital of Saudi Arabia, reported to have a population of around 5 million. Other principal cities are Jeddah (Saudi Arabia), Kuwait City (Kuwait), Dubai (UAE), Abu Dhabi (capital of the UAE), Sharjah (UAE), Manama (capital of Bahrain), Doha (capital of Qatar) and Muscat (capital of Oman). Apart from Jeddah, the former capital of Saudi Arabia, with a population of around 3 million, these other cities range from around 500,000 to 750,000.

The indigenous populations are boosted by large numbers of expatriate workers and their families including, many from South and East Asia and from the West.

The environment therefore is totally multicultural providing not only for exciting and vibrant communities but opportunities for retailers with a unique range of trading opportunities.

COMMERCIAL REAL ESTATE IN DUBLIN 2003 — AFTER THE BOOM

Dr. Brendan Williams, Stephen Walsh, and Sean O'Neill

SECTION 1
INTRODUCTION AND MARKET CONTEXT

The demand for commercial real estate in the Dublin market in recent years has been driven by several main factors—continued strong growth in the general economy, high levels of inward investment particularly in the IT sector, expansion of the financial services sector and growth in urban tourism. The dominant role of Dublin and its surrounding Greater Dublin Area (GDA) can be illustrated by a comparison of the GDA to the rest of Ireland. The GDA, incorporating Dublin and surrounding counties of Kildare, Meath and Wicklow contains 1.53 million inhabitants, representing almost 40% of national population (CSO, 2002). Approximately 47.5% of all immigrants into Ireland come to this region and 49% of all employment growth in Ireland is located there (Williams and Shiels, 2002). This growing dominance of the Greater Dublin Area and Dublin city in particular places particular pressures on urban land markets and is clearly evidenced in emerging constraints in the GDA including problems of accessibility and congestion, infrastructure constraints and affordable housing difficulties.

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A critical appraisal of the Dublin urban land development pattern indicates a major surge in outward infrastructure led development with a notable absence of inter-suburban transport links and essential services infrastructure. In summary, the Dublin urban land market is a clear example of the difficulties involved in managing rapid economic growth in an urban area in a sustainable manner. The analysis, which follows, includes research conducted under the European Union Group for European Metropolitan Areas Comparative Analysis, Second Project (EU GEMACA II, 2001) and the Quarterly Reports on Property Investment undertaken by the Dublin Institute of Technology (DIT) and Lambert Smith Hampton (LSH) during 2001 and 2002.

The structure of this article comprises of an introduction and analysis of the Dublin market context in Section 1, an examination of the changing economic driving forces for real estate demand in Section 2 and an overview of current sectoral investment patterns in Section 3, followed by conclusions.

DEMAND FOR REAL ESTATE

There is clearly a strong correlation between economic growth, employment trends and demand for real estate. Over the period 1990 to 2002 the economic profile of Dublin has changed from one of the weaker urban economies of Northwest Europe to one of the strongest. Growth in Dublin currently accounts for over 38% of Irish GNP, which has been increasing by approximately 8% per annum in the years to 2001. This compares with the stagnant economy of the middle to late 1980s and an emergence from recession in the early 1990s. Employment trends show that employment growth of 34% or 127,000 new jobs was evidenced over the period 1995 to 2000 (Dublin Chamber Of Commerce, 2000). Unemployment has reduced from 12% in 1996 to 4% in 2000. Financial services, the IT industry, construction and general business services have shown the strongest growth over the period. The weakening international and local economy is reflected in the more modest growth rate of 3% expected in 2002.

RESULTING COMMERCIAL DEMAND

As a result of the region's economic activity there are over 40,000 businesses in the city, 37,000 of which are service companies, and 1,300 manufacturing companies along with the state and semi-state sector (GEMACA II, 2001). Commercial activities in the city are centered on the old commercial business district, the new urban renewal areas adjacent to the commercial core and the new peripheral areas particularly to the west of the city. Examples of traditional industry in Dublin included the Food and Drinks Sector such as Guinness, Irish Distillers and Cadbury while a dominant force in new demand has been inward investment in the Electronics/Computer Software Sector whose significance to the region is illustrated by their employment levels (e.g.: Intel 4,000+ and IBM Ireland 3,500+).

The Financial Services sector has experienced strong growth in demand for Real Estate over the 1990s with over 30,000 employed in the sector compared to approximately 15,000 in the 1980s. These activities are centered on Dublin's International Financial Services Centre developed with the assistance of urban renewal incentives and preferential taxation regimes. Projects in this scheme qualified for a 10% rate of corporation tax until the end of 2005 after which they will be subject to the new standard 12.5% Corporation Tax Rate. This low tax system has been considered essential in the attraction of foreign direct investment of all types. Other strong growth sectors include telecommunications, teleservices and pharmaceuticals.

THE ROLE OF PUBLIC POLICY

The Regulatory and Public Policy framework within which real estate development operates is an essential contributory factor to shaping urban land markets. Since 1963, a statutory planning process has evolved in Dublin which involves the responsible local authority (e.g. Dublin City Council) preparing a legally enforceable development plan for the area under its responsibility. Such development plan includes zoning and segregation of various land uses and proposals for infrastructure including roads, water and sewage. Each development plan includes a policy statement and a set of land use maps. Once adopted, all proposals for development other than exempted development (below certain sizes etc.) must be approved by the local planning authority and must conform to the development plan. The local planning authority does not have the financial resources or powers to implement the development plan. It is dependent on its regulatory function to ensure that developer proposals comply with its requirements. The existing financial basis of urban government gives a dominant role to central government agencies with regard to public infrastructure provision. Essential infrastructure development in the urban areas, while planned at local level, can only be implemented with the commitment of central government resources. This effectively produces a planning system, which is regulatory and reactive to development proposals rather than proactive. A speculative market approach to urban development dominates in all sectors with developers and investors anticipating future demand within the regulatory constraints of the development plan.

A significant aspect of the Dublin policy experience, which is viewed as innovative and relatively successful, is urban renewal policies. In the Planning Act of 1963 powers were given to local authorities to identify obsolete areas or areas in need of renovation. Special powers including the right to compulsorily acquire land interests were available to achieve renewal of such area. While initial schemes met with limited success, only since 1986 and the introduction of specific urban renewal areas have serious policy initiatives in this area been launched. It can now be seen that such polices, adapted over time in view of the cyclical movement in economic trends, have contributed to the modern development of Dublin in a significant manner.

URBAN RENEWAL AND LAND MARKETS IN DUBLIN

Globalization and the economic restructuring of the 1970s and 1980s necessitated the development of a variety of urban management and renewal initiatives over the period to 2002. Urban development and renewal programs in Dublin have developed from taxation-based programs encouraging development activity to a broader integrated area plan approach encompassing social and economic objectives. Grants and complex fiscal incentives guide land uses towards specific forms of development. This stimulation of construction and investment in a stagnant economy resulted in the successful physical redevelopment of designated inner-city areas, albeit with problems in displacement and a narrow scope of social and economic benefits.

The major successes of the designated area schemes are often cited as: The International Financial Services Centre developed at the Custom House Docks and the Temple Bar Project. The Temple Bar project involved the conservation and renewal of a historic district of the City with a land use emphasis on cultural, leisure and tourism uses. This pattern of successful physical redevelopment contributed to, and was assisted by, the major improvements in economic confidence in Dublin during the 1990s.

The new approach to urban renewal since the 1998 urban renewal guidelines involves a more holistic approach to urban development with integrated physical, social and economic regeneration. Integrated Area Plans are prepared by local authority targeting areas in need of renovation in consultation with local representative groups. Such plans include issues such as urban design, local economic development, education and environmental improvements. A selective use of incentives and public funding can be used to assist implementation and progress is monitored on an annual basis to ensure physical, economic and social progress.

An example of this new approach is the Dublin Docklands Development Area. An extensive development area of 520 hectares (1,285 acres) have been included in the master plan since 1997 with a total investment of €6.3 billion[1] envisaged over the period to 2012 by public and private sources. Targets set include the creation of 30-40,000 new jobs, population increase from 16,500 to 45,000 and 11,000 new homes including 20% social and affordable homes. Permission for development within these areas is based upon the contribution of such developments to the general aim of the plan and can involve planning gain type agreements where developments agree to specific community gains in returns for permissions. With strong economic growth in the late 1990s significant development activity levels continue to be achieved in the various renewal areas of central Dublin.

URBAN GOVERNANCE

The framework within which the urban land development market operates has been a major focus of ongoing policy discussions in the Dublin context. The fragmented nature of local urban governance, with competing local authorities within the Dublin area and separate agencies having important responsibilities with regard to essential infrastructure and services, requires a transformation to take account of the rapid and partly uncoordinated expansion of the city region in the past six years. The region faces a specific problem in dealing with the problems of scattered urbanization characterised by low population densities and automobile dependency. A strategic development plan for the entire region has been developed, giving statutory guidelines to the local authorities involved and promotes development in strategically chosen transportation corridors. Full implementation of this or alternative regional strategies are dependent on the adoption of the new national spatial development plan and the development of a regional agency to implement a strategy for the Dublin area. Proposals with regard to improving these issues are currently being debated at the national political level.

SECTION 2
COMMERCIAL PROPERTY MARKETS AND INVESTMENT IN 2002-2003

DOMESTIC CLIMATE CHANGING

The overall economic outlook for Ireland has weakened in 2002. There is now an official government recognition that the boom is over and that a less benign climate than we have experienced in recent years has emerged. All participants in the economy are being prepared for a tougher regime ahead. This will be particularly clear in a much tighter budget in December 2002 as the public finances deteriorate leading to cutbacks in spending in 2003.

A further major implication of the deteriorating finances is a suggested pay freeze in the public sector. This opens up the possibility of industrial unrest within the public sector and the associated impact that this would have on the economy as it stands but also on the prospects for the flow of foreign direct investment (FDI) into the country. The Irish Equity Market has continued to perform poorly losing 19% in the third quarter 2002 and has damaged confidence among investors and also among the wider public.

Against these negative developments, the passing of the referendum in 2002 on the Nice Agreement has clarified the position in relation to the future expansion of the EU and removed a divisive and potentially damaging issue from the economic landscape.

Despite the negatives, investors view that selected properties can offer a safe haven due to concerns about the volatility of the equity markets.

ECONOMIC INDICATORS

Despite the growth in retail sales in August 2002, the most recent measure of consumer confidence is not encouraging. The Irish Intercontinental Bank/Economic and Social Research Institute (IIB/ESRI) Consumer Sentiment Indicator (2002) shows that sentiment weakened in September by over 4% since August and by over 15% since September 2001. The fall in confidence is partly due to expectations as to labor market conditions over the next year and consumers view of their own current and future financial prospects.

On the industrial front the Irish Business Employers Confederation (IBEC)/ESRI Monthly Industrial Survey for September 2002 shows somewhat mixed results. In the capital goods industries, expectations as to production, home sales, exports and employment are generally better than a month previously; while for intermediate goods and consumer goods the trends are mostly negative. The IBEC/ESRI survey results are consistent with the data on industrial production, which shows manufacturing output up 10.1% in the year to August 2002 but down 4% in the period June-August against the previous three months (Central Statistics Office, 2002). The most significant increases were in Publishing & Printing and in Pharmaceuticals and Medical products. Indeed the growth occurring in the latter sector may be providing a somewhat misleading picture of the health of the overall industrial sector. The sector is largely overseas-owned, capital intensive and with a lower value-added contribution to the economy than other sectors.

Reflecting the mixed performance of the sector, industrial employment fell by 10,300 (3.8%) in the year to June 2002, with the electrical equipment sector alone losing 8,300 jobs over the period. Other sectors, which lost jobs, included Textiles (-1,500), and Paper and Publishing (-1,700).

RETAIL SALES

Provisional data for August 2002 shows that the volume of retail sales (excluding motor trades) rose by 4.8% over the previous 12 months. The value increase over the same period was 7.8%. However, when the data is examined using the rolling three-month index up to July 2002, the annual increase is only 2.2%. In addition, the detailed sectoral information available to July 2002 shows significant variation across sectors. It also indicates that a number of sectors, which have had strong growth over the 12-month period, actually experienced decline in the most recent three-month period.

CONSUMER PRICES AND INFLATION

Consumer prices rose by 0.5% in the month and by 4.5% in the year to September 2002. While the annual increase is above the July and June levels, it has not increased on the August level and is slightly below the annual increases experienced earlier in the year. This may suggest that the inflation rate has peaked and may slowly decline as the economy slows down.

Ireland remains at the top of the EU inflation league at well over twice the EU average and is the only country with an inflation level above 4%, although 4 other countries are very close to this level. This prolonged period at the top of the inflation band serves to damage the regions competitive position against other countries within the Euro zone. Combined with a somewhat stronger Euro affects Irish competitiveness against non-Euro zone economies.

Table 1
Economic Indicators (% change per annum)

	2002	2003
GDP	4.0	4.0
GNP	3.25	3.5
Personal consumer spending	3.0	3.0
CPI	4.6	4.5
Employment (%)	1.0	1.0
Employment Total (000)	20	20
of which:		
■ Industry (000)	-15	0
■ Services (000)	35	20
Unemployment (000)	95	100+
Unemployment rate %	5.0	5.3
Exports	5.0	7.0
Imports	5.0	6.0

Sources: Central Bank of Ireland, ESRI, and DIT estimates.

PUBLIC FINANCES

Tax receipts for the first nine months of 2002 are well below the target set in last December's budget. In particular, income tax revenue is down almost 11% so far this year against a target growth for the year as a whole of 1%. Corporation taxes have risen in the first nine months, but at only about 30% of the projected level. Current spending has run ahead of target, over 20% to end September compared to a target for the year as a whole of just over 14%. The overshoot in capital spending is of the same order of magnitude.

The implications of this combined trend in spending overruns and tax shortfalls are for spending cutbacks. This could include curbs in employment in the public sector, with the consequent impact on service delivery, and capital spending cuts with longer-term implications for the efficiency of the economy.

COMPARATIVE INVESTMENT CLIMATE

Total returns on the Irish equity markets this year (to end September 2002) shows a loss of over 30%, with a loss of almost 19% in the third quarter alone. The bond market has benefited from some flight from equity. Total return on the Irish bond market to end September was over 6.5%, with the long end of the maturity range showing the greatest return. Total returns for Irish property for the third quarter of 2002 were 1% with overall returns for the last 12 months being just under 3%. In 2002 it was speculated that property might act as a safe haven for capital moving from equity or indeed fresh investment funds looking for a home. As regards the institutional investment market this does not appear to have happened. Property's weighting within portfolios had automatically grown as property values increased over the past few years and institutions are divesting of some property assets in order to re-establish its weighting in portfolios at about 7%. The bond market would appear to be fulfilling the role of a safe haven. This may reflect investors' unwillingness to commit funds to the less liquid asset of property in order to have funds available to facilitate a return to the equity sector in the future.

Both the office and industrial markets recorded negative capital growth with yields rising and rental values falling; however, the income return in both these sectors managed to maintain slightly positive overall returns. The retail sector continues to perform well recording an overall return of 3.1% for the quarter, which was the result of a slight drop in yields and a significant uplift in rental value. It is expected that property returns will remain positive for the remainder of 2002 supported by the strong performance from the retail sector. Given the recent rental evidence emerging now on Grafton Street, increasing rental values in the retail sector will push capital growth although it is likely that yields will bottom out. Rental values in both the industrial and office sector may continue to fall however again with the exception of out-of-town offices it is likely that yields will stabilize.

DIT/LSH research (2002) indicates that investment spent over the third quarter of the year was approximately €32.5 million. The level of investment in the market has continued to fall from €135 million during the first three months of the year to €81.6 million during the second quarter and now just €32.5 million. The total spend therefore for the year to date is €249 million which is well down on the €460 million expended in the market at the end of September 2001. Much of the reason for the low spend has been the shortage of product in the market so far this year. However given the significant increase in the supply experienced since the end of September a much increased level of expenditure for the final quarter of the year is expected.

An analysis of the market spend by sector shows that industrial accounted for approximately 58% of the second quarter total with approximately 36% placed in offices and the balance of 6% placed in retail product.

SECTION 3
SECTORAL INVESTMENT PATTERNS

OFFICE INVESTMENT PROPERTY

Investors placed just €11.8 million (approximately 36% of market spending) in the office sector during the third quarter of the year. This is down on the €30 million and €15.4 million spent during the first and second quarters of the year respectively. The overall level of spending so far this year at €57.2 million is significantly down on the €181 million spent this time last year. Almost all of the market spending between the last quarter has been in the city center of Dublin and this again reflects the nervousness felt by investors in the out of town market.

DIT/LSH research indicates that the current supply of office accommodation in the Greater Dublin Area remains at approximately 650,000-sq. m (7 million-sq. ft) with 64% of this supply located in out of town areas. Of the total amount of space available, approximately 210,000-sq. m (2.26 million sq. ft) is proposed and unlikely to be constructed without pre-lets having been obtained. Leaving aside space proposed, current availability therefore stands at approximately 440,000 sq. m (4.73 million sq. ft), of this amount just 300,000 sq. m (3.23 million sq. ft) is available immediately with the remainder of 140,000 sq. m (1.5 million sq. ft) being space under construction.

LSH research indicates that take up for the third quarter of the year amounted to 34,600-sq. m (373,000 sq. ft). This is down slightly on the figures recorded for the first and second quarters of the year at 37,000 sq. m (398,000 sq. ft) and 43,500 sq. m (468,300 sq. ft) respectively. Therefore the total take up for the year to date stands at 115,000-sq. m (just less than 1.24 million sq. ft). The take-up figure for the full year 2001 amounted to approximately 93,000-sq. m (1 million sq. ft) and therefore already during the first three-quarters of the year, this has been exceeded. In a significant turnaround on the previous quarters of the year approximately 80% of take-up levels was situated in out of town locations. Activity in the office sector has improved; however, tenants seeking space have a significant amount of choice of properties at their disposal and can negotiate very competitive rental levels. This continues to have an impact on the market.

As at the end of September there was approximately €147 million worth of office investment property available on the market. This is a significant increase on the €57 million worth of investments available at the end of the last quarter and is made up mainly of the €70 million lot size Garda Headquarters on Harcourt Street brought to the market in early September. 74% of the investments now available are in the €10 million + size range. Since the end of September a further €90 million worth of investments has come to the market increasing the average lot size available from €4.7 million at the end of June to €11 million. It is likely that city center investments will be in demand with yields unlikely to drift however as we have said before the outlook for out of town market is much more uncertain.

RETAIL INVESTMENT PROPERTY

DIT/LSH research indicates very little activity occurring in the Dublin retail market, as there was a significant shortage of product. Just €1.8 million, 6% of the total spending was placed in retail property during the third quarter of the year. The total amount invested in retail property for the first 9 months has amounted to approximately €120 million; just over 48% of total market spending.

During the year prime Dublin retail yields continued to fall mainly as a result of the shortage of investment product and the perceived rental growth possibilities. Following the letting of the property at 1 St. Stephen's Green and a number of rent review settlements, which have followed, Zone A rental levels have now shifted towards the €5,500 per sq. m mark (IR£400 per sq. ft). The view is now that although there continues to be a demand for retail accommodation in prime locations the rate of rental growth going forward is likely to slow down significantly. This will obviously have an impact on the yields which investors are prepared to accept from investment product. Also given that there are a number of investment properties in Dublin's central business district on Grafton Street and Henry Street available the laws of supply and demand would indicate that some impact on yields must be the result.

INDUSTRIAL INVESTMENT PROPERTY

Investors placed approximately €18.8m (58% of market spending) in the industrial sector over the past 3 months. It is slightly up on the €17.6m spent during the second quarter with the total spending in industrial property for the year to date now standing at €79.4m. Again this is an increase in the €60m placed in industrial property by this time last year. Industrial is traditionally viewed as a defensive stock given its higher income return and this combined with the greater availability of industrial investments so far this year is attracting investment in this sector.

End user take up in the industrial market had stabilized during the second quarter of 2002. This trend appears to have been maintained with third quarter take up of 83,800 sq. m (902,000 sq. ft) being almost identical to that for the second quarter. Total take up for the year end to September 2002 is 334,930 sq. m (3.6 million sq. ft.) a marginal increase of 2.85% on the year end figure recorded to June 2002.

The supply trend again appears to have been maintained with the total supply recorded at the third quarter at 435,000 sq. m (4,682,000 sq. ft) being unchanged from the previous quarter indicating that the increase in supply has now leveled off. Therefore with supply having peaked at end user take up having now bottomed out it would appear that significant over supply is unlikely to occur.

The supply of industrial investments at the end of the third quarter stood at approximately €83m which again shows a reduction on the figures of €95m and €100m recorded at the end of the second and first quarters respectively. Having said this, approximately €78m worth of industrial investments has come to the market during October 2002, significantly increasing the supply. Once again, as with the other sectors, much of the supply is in the higher lot size investments with the proportion of investments with values in excess of €10m standing at approximately 70%. The proportion of investments of less than €5m in value has decreased significantly from 48% at the end of June to just 25% at the end of October. Given the higher income return available from industrial property this sector is seen as an attractive short to medium term prospect.

Table 2
Economic Driving Forces—
The Balance of Positives and Negatives

Factor	Impact on Economy
Deteriorating Public Finances	
■ possibility of tight budget	—
■ borrowing may be necessary	—
■ capital spending may be reduced	—
■ pay freeze and job curbs in public sector	—
Ending of National Wage Agreement PPF	
■ danger of industrial unrest	—
■ further period of stability if new deal reached	+
EU Enlargement	
■ increased competition for FDI	—
■ Ireland to be net contributor to EU Budget	—
■ expanded export market for Irish goods	+
Political Uncertainty Globally	
■ general risk to economic recovery	—
■ danger of oil price rises	—
Slow Recovery in U.S. and European Economies	
■ little pick-up in demand for Irish exports	—
Interest Rates	
■ likely to remain low	+
Inflation at top of EU Band	
■ damage competitiveness	—
Slower progress in National Development Plan	
■ prolonged infrastructure deficiencies	—

CONCLUSION

As Table 2 suggests, the balance of factors impacting in the Irish economy and property markets is weighing on the negative side. With the exception of low and possibly falling interest rates, most other variables are more likely to present threats rather than opportunities in the short term.

Political uncertainty internationally remains a critical issue in the prospects for the Irish economy. Recent terrorist attacks and the ongoing threat of a war in Iraq, indicate that the global economy is susceptible to unexpected shocks and economic performance cannot be taken for granted. Against this the recent passing of the Referendum on the Nice Agreement has removed an element of political uncertainty.

On the domestic front, the forthcoming Budget is likely to be conditioned more by the need to address the deteriorating public finances rather than as an instrument of economic management. A critical issue in this regard will be the commitment to a number of key infrastructure projects, e.g. the Dublin Port Tunnel, the Luas (light rail system) and the M50 (orbital motorway/beltway), all in Dublin, and the other major road projects elsewhere in the country.

The uncertain economic climate is likely to influence investors' decisions. Combined with the continued volatility in the equity markets investors may look to assets that offer some defensive qualities. Despite the various threats facing the economy, well-selected property offers the investor at least a defensive position with prospects for renewed growth as the economy improves.

Predictions throughout this year have been that overall property investment returns would remain flat and this will continue to be the case for the remainder of the year. It is possible that the investment disposal programs currently underway by some of the institutions will have a positive impact on overall return as there remains significant private investor demand for properties. Whilst a significant amount of property investments have been brought to the market in 2002 most of this has consisted of higher value lot sizes and there remains a significant shortage of smaller scale property investment opportunities. It is likely therefore that yields for the smaller lot sizes will remain at keen levels as demand will be in excess of supply. In the higher lot sizes as yields rise there will be demand from private investors for industrial and city center offices where yields of 6%+ make them an attractive finance play. Overall the market for city center office investment and industrial product is stronger than the office sector where excess supply at suburban locations exists.

In summary, the commercial real estate market in Dublin demonstrated a very strong supply-side response during the recent development cycle. This contrasts markedly with the less volatile supply-side responses in the more regulated markets in other European commercial centers such as Amsterdam. This can be seen as a response to Dublin's economic growth and ongoing structural changes in the Irish economy. The tendency towards oversupply noted in 2002/2003 is linked to the speculative development of the new "edge city" or suburban districts, as is happening in many cities. Over the 1990s property prices such as office rentals in Dublin have risen dramatically and now exceed those prevailing in cities such as Amsterdam and Brussels. By 2003, lenders in Dublin, as in the main European centers have become reluctant to lend for further speculative development with an increasing emphasis on preletting. Given the greater level of economic uncertainty prevailing, it is likely that this more cautious market approach will prevail in the short term.

Endnote

[1] 1.00 Euro (€) = $1.08 USD

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NON-PERFORMING LOAN RESOLUTION IN CHINA

By Richard Peiser and Bing Wang***

Executive Summary. *China, like with other Asian countries, is closely following the approach used by the United States through the formation of the Resolution Trust Corporation (RTC) to resolve its non-performing loan problem. The purpose of this article is to review China's progress in attracting foreign investors to purchase the NPLs, and to evaluate a long list of factors that affect investor perceptions of uncertainty. These factors must be addressed before investors are likely to enter the Chinese market in force—a necessary requirement for the government to see higher NPL recovery rates and lower losses on loans made by the state-owned banks.*

The article discusses three broad categories of uncertainty that affect investor perceptions about China's NPL market. Of these, it is in the area of execution that foreign investors face the greatest uncertainty. The government has been moving forward to resolve key issues with respect to repatriation of capital and tax rates for foreign buyers. Other issues depend more on what happens at the local level or on property-level negotiations such as laid-off employee liability. While these areas would benefit from strong national direction, only experience in resolving actual loans is likely to reduce investor uncertainty.

The success of the RTC in the United States hinged primarily on the speed with which NPL assets were brought to market and securitized. Investors responded creatively to the opportunity, and prices, which were initially low, rose quickly, thereby reducing the losses to the government. The Chinese government has

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attempted to apply the lessons of the RTC by creating four Asset Management Corporations (AMCs) to speed the loan resolution process, and by encouraging foreign investors to buy the NPL portfolios. Whether or not prices in China will rise rapidly as they did in the United States depends on whether foreign investors are able to get control of NPL assets quickly and to realize higher recovery values than they currently project, especially from loans originally made to the state-owned enterprises.

China, like every other Asian economy, is dealing with a mountain of bad loans. The total clean-up cost is estimated by Standard & Poor's to be some $518 billion, or 43% of this year's gross domestic product (*Business Week*, 2002, p. 18). China has begun the long process of resolving its non-performing loan (NPL) problem by establishing four Asset Management Corporations (AMCs) to resolve some $169 billion of non-performing loans (NPLs) made to the four major state-owned policy banks. Resolution of the NPLs and recapitalization of its banks are of fundamental importance to China as it enters the World Trade Organization, and prepares its banks to compete head-on with Western banks. Toward this end, China is attempting to attract foreign investors to purchase the NPL portfolios.

The purpose of this article is to review China's progress in attracting capital to invest in its budding NPL market, and to evaluate a long list of factors that affect investor perceptions of uncertainty. These factors must be addressed before investors are likely to enter the Chinese market in force—a necessary requirement for the government to see higher NPL recovery rates and lower losses on loans made by the state-owned banks.

In establishing the four AMCs to work out the bad loans of the four major state-owned banks, China has closely followed the United States' experience with the Resolution Trust Corporation (RTC). The RTC's aggressive sales of NPLs has become a model for the rest of the world. Despite predictions of loan losses in excess of $400 billion, the final cost to the United States government was under $100 billion—one of the must successful government interventions into the U.S. financial markets.

To be sure, China has its own unique set of problems in dealing with its NPL situation. Unlike the United States, many of the loans are not real estate backed. Furthermore, many of the loans were made to state-owned enterprises (SOEs) that have assets of questionable value. Great uncertainty surrounds the ability of foreign investors to foreclose on delinquent loans and to collect much money from the sale of collateral. However, like the United States, China is using the NPL resolution process to introduce a new set of institutions into the market place. The success of the RTC depended on opportunity investors' bringing massive amounts of capital into the real estate markets and led to the first securitization of non-performing loans. Similarly, China is looking to Wall Street and other global capital markets to resolve the NPL crisis through the first major foreign direct investments into Chinese financial markets.

The article has three main parts. It begins with a discussion of the RTC's experience in resolving the United States' NPL problem and a review of the literature on NPLs in Asia. The second part presents the NPL resolution process in China. This section begins with a brief discussion of China's banking system. It proceeds with a discussion of the classification and magnitude of China's NPLs, and ends with the government's approach to loan resolution by establishing the four AMCs. The third part evaluates fifteen factors that affect foreign investor perceptions about risk and uncertainty for investing in China's NPL market. The article concludes by highlighting the changes that must occur in order for prices on China's NPLs to rise—key to the government's objective for bringing in foreign investors to help reduce the ultimate cost of NPL resolution. The article's main contribution is to add to the literature about non-performing loan resolution—one of the most important financial restructuring issues throughout the world over the last decade—and to illuminate the challenges facing China as it attempts to resolve its NPL problem.

PART I: BACKGROUND AND LITERATURE REVIEW

There are two strands of literature that are important for understanding China's NPL resolution process. The first strand describes the experience of the Resolution Trust Corporation (RTC) in the United States. The second strand relates to China's NPL problem and the fundamental financial restructuring that China's economy is undergoing. For both strands, the serious academic examination is only just beginning. Journal articles are sparse, so we have had to rely more than we would like on articles in the financial press.

The FDIC and the RTC Resolution Process

For understanding the RTC, two important compendiums of articles and forum discussions have been assembled by the Federal Deposit Insurance Corporation (FDIC). *History of the Eighties: Lessons for the Future* (FDIC, 1997) examines the formation of the RTC and the U.S. government's response to the banking crisis of the 1980s and early 1990s. A second two-volume publication by the RTC, *Managing the crisis: the FDIC and RTC experience, 1980–1994*, (FDIC, 1998) reviews the resolution methods and techniques used by the RTC during the Savings and Loan banking crisis and the RTC's performance.

The primary success of the U.S. resolution process was that despite the magnitude of the crisis, there were no serious bank runs or credit flow disruptions at federally insured institutions and, more importantly, no evidence of depositors losing their insured deposits (FDIC, 1998, v.1, p.6). In the resolution process, the FDIC performed its essential role as a deposit insurer of banks and savings associations and as a receiver. Its primary objective was to preserve the overall stability of the U.S. financial system and maintain public confidence. The RTC, on the other hand, had a narrower focus; its duty was to maximize net present value returns from the disposition of failed institutions and their assets.

One of the RTC's earliest challenges was to deal with the requirement of selling assets quickly without being accused of "dumping" them for prices that were considered to be too low. Initially, FIRREA (the Financial Institutions Reform, Recovery, and Enforcement Act of 1989) required that the RTC sell real estate for no less than 95% of its appraised (market) value. In 1991, however, in response to growing criticism of its slow sales and congressional concern over the cost of maintaining a rapidly growing inventory of properties, FIRREA was amended, and the minimum sales price was reduced to a stipulated figure of no less than 70% of the appraised value (FDIC, 1998, v.1, p.9).

Due to its limited life span, the RTC had neither the time nor the resources to develop an experienced staff, but by establishing working relationships and partnerships with large private asset management and disposition firms, it was able to acquire as much expertise in NPL resolution as it needed. It was also able to set up national sales centers and successfully sell assets in bulk.

Resolution of assets

Methods used by the RTC to dispose of assets previously owned by failed institutions include auctions and sealed bids, securitization, equity partnerships, and the use of asset management contractors. About $400 billion in assets were handled in one of these ways. Most of the RTC's assets were secured by real estate mortgages, and their disposition was further hampered by a nationwide decline in the real estate market. To meet this challenge, real estate-backed loan portfolios were stratified and placed in pools in accordance with such criteria as geographic area, asset type, asset quality, and asset maturity. In addition, the RTC also adopted the use of seller financing as a convenient tool for portfolio sales (FDIC, 1998, v.1,p.30).

> "The FDIC began holding real estate auctions periodically in the late 1980s to dispose of large inventories of smaller, distressed, and labor-intensive real estate properties, such as condominiums and vacant lots. Because of this, real estate auctions connoted the image of 'fire sale' in which the seller was willing to accept heavily discounted prices to liquidate undesirable real estate" (FDIC, 1998, v.1., p.34).

"Consequently, in the early stages of the RTC's existence, real estate auctions were prohibited for fear that they would aggravate already distressed markets and damage the financial standing of banks and thrifts that were heavily invested in the real estate market" (FDIC, 1998, v.2, p.62). This prohibition was later lifted when it became apparent that it was inhibiting the rapid disposition of assets and increasing the cost of resolution.

In fact, the two distinctive asset disposition techniques used by the RTC in its successful handling of NPLs were (1) the creation and sale of large asset pools; and (2) the use of securitization. Nearly 500,000 loans were packaged for securitization. To accomplish this, a variety of collateral types were used: e.g., home mortgages, commercial mortgages, manufactured housing loans, leases and installment contracts on personal property. 71 of these transactions, out of a total of 74, performed extremely well (Glassman, 1998).

The RTC's effectiveness in the crisis can be attributed to the following five principles: (1) Throughout the entire process, the efforts of the RTC were coordinated with those of legislators. (2) Clearly defined roles and objectives for the FDIC and the RTC helped both agencies to remain focused. The RTC's resolution process was based largely upon the prior experience of the FDIC. (3) The RTC gradually adopted an evolutionary approach to resolution methods. (4) By using private-sector resources whenever possible, it saved a lot of time and money in the disposition of the NPLs. (5) By going to the public capital markets through securitization, it was able to achieve unprecedented results.

Over its seven-year life, the RTC succeeded in disposing of more than $410 billion in NPLs and other assets. While the pricing of early pools was low, prices rose quickly as investors became comfortable with the process of resolution and recovery. In the end, the government's losses on NPL resolution were much lower than originally predicted.

China's NPL Problem

The second relevant strand of literature for this paper is on the subject of Asian NPLs. Most work in this area has focused so far on the macro-economic or political and legal aspects of the debt resolution process [Olson (1999), Dornbusch and Giavazzi (1999), *China Daily* (2001)]. The micro-pricing aspect of the loans has yet to be given serious analysis. This is not surprising since the transactions that by definition would underlie any econometric analysis have occurred only over the last couple of years.

Two systemic studies of Chinese NPLs are worthy of note: 1) a survey report entitled "China's Non-Performing Loan Problems," (Watanabe, 2000); and 2) a working paper entitled "China's Asset Management Corporations," (Ma and Fung, 2002). The first of these fully explains the macro-mechanisms that have generated the bulk of China's NPLs. The second focuses on their scope and offers a theoretical deduction of the actual amount of the loans, as well as an analysis of the financial shortcomings of the resolution process presently being implemented by China's four AMCs.

In addition to the above two academic publications, there have been a number of articles in the financial press that trace the sequence of events in the NPL resolution process. These articles focus on the establishment and development of China's four Asset Management Corporations (AMCs) and the groundbreaking international auction of NPLs carried out by the Huarong AMC (*Dow Jones International News*, 2001; *Financial Times*, 2001).

The cover story of the February 2002 edition of *EuroMoney Magazine* was the first to offer an in-depth report on the auction process and to discuss the opinions of the various foreign investors and government officials regarding the value of the NPLs being auctioned.

PART II: NPL RESOLUTION IN CHINA

The underlying causes of China's NPL situation have to do with the way China has traditionally financed its multitude of state-owned enterprises (SOEs). The trials and errors resulting from the country's efforts to return to a market economy have complicated NPL resolution. The current NPL dilemma is the product of a legacy of central planning, and the main players in the drama are Chinese government officials, particularly members of local governments; in most decisions, third parties are conspicuously absent. The banks involved have acted primarily as government agents, disbursing funds to a variety of pre-determined projects without any preliminary credit analyses. Such analyses were never performed, nor was there thought to be any need for them, since all credit terms—the amount of the loans, loan maturity, interest rates, and so forth—were pre-determined by the government. Such a system could not help but generate irrational investment decisions, and these decisions frequently resulted in non-performing loans.

Moreover, in China's transition to a market economy, there remain institutions that inhibit the maintenance of capital and traditions that have long since outlived their usefulness. Of these, the most serious is the lack of attention given to the maintenance of capital. This, more than anything else, can be blamed for the current NPL problem. In essence, State-owned enterprises (SOEs) have treated their share of credit allocations as government grants and used them to finance working capital and fixed investment. In too many cases, these disbursals have not been thought of as debt obligations that had to be repaid. Though state enterprises have been able to shift the consequences of their lack of foresight to Chinese banks, the banks have had no way to pass the burden on.

The overly optimistic expansion of credit that China experienced in the early 1990s was an additional source of NPLs. It overheated the economy and created runaway inflation. Domestic credit grew at the rate of 30% per year between 1991 and 1995, a rate significantly higher than the average growth rate of 21.3% in the 1980s. During that same period of time, real estate lending increased rapidly and fueled property development that was far beyond the limits of the country's demands. Many of the problem loans that now plague China's banks were created by the credit boom in the 1990s and by subsequent asset price bubbles. The majority of the country's NPLs are the survivors of loans to, and assets of, failed SOEs. This is a significantly different NPL scenario from that of the United States.

The Banking System in China

Since the banking reforms of the mid-1980s, the People's Bank of China (PBOC) has been turned step-by-step into a central bank. Three policy banks have been established to take up the job of policy lending, and the four state-owned specialized banks are being gradually transformed into commercial banks. Meanwhile, thirteen shareholding commercial banks and four public-quoted banks have been set up. 75 credit cooperatives were turned into city commercial banks, and 65 foreign banks have set up 155 branches and 248 representative offices.

The three policy banks are:

- The China Development Bank (CDB)
- The Export and Import Bank of China (Chexim)
- The Agricultural Development Bank of China (ADBC)

Policy banks, with mandates from the national government, use their capital to support infrastructure construction, develop basic and mainstay industries, release bottlenecks, and adjust industrial and local economic structures. After the 1994 bank reforms, three policy banks started to issue Policy F-bonds to commercial banks and other non-bank financial institutions.

The "Big Four" dominant state-owned commercial banks are:

- The Industrial and Commercial Bank of China (ICBC)
- The Agricultural Bank of China (ABC)
- The Bank of China (BOC)
- The China Construction Bank (CCB)

Because the "Big Four" hold a crucial position in China's national economy, the central government has required them to sort out their assets and restructure into "true commercial banks" within the next five years. By that time, they will have to compete in a market that will be fully open to foreign financial institutions.

The "Big Four" face disadvantages and advantages for competing against Western banks. Their disadvantages include the current overhang of huge bad loan portfolios; they lack modern banking products; they have many uncreditworthy customers (SOEs); and they are overstaffed and overbranched. Their advantages are that they are too big to fail: they dominate about 80% to 90% of China's banking assets. They retain profitable customer bases, widespread branch networks, and government support for building competitive infrastructures. The government is using AMCs to purchase the banks' bad loans at apparently full-book value with bonds guaranteed by the state.

Over the next five years, the Chinese government wants to transform the "Big Four" into modern strongly competitive commercial banks. Some state-owned commercial banks will be restructured to become state-controlled shareholding commercial banks. Cutting down on the number of NPLs has become a reform priority, with impressive results having been achieved. In April, the ICBC became the first to make public its NPL rate, and it was followed by the CCB and the BOC.

Moreover, commercial banks are now competing for the efficient resolution of NPLs in an effort to prepare themselves for competition with foreign banks and to obtain a better chance to go public through an IPO before their peers do. Chinese central bank chief Dai Xianglong has urged the four big banks to reduce their bad loan rations from 28% to 13% of their total lending over the next five years.

Non-state-owned Banks

In addition to the state-owned banks, there are two types of non state-owned banks: One is called a shareholder-owned bank and is actually owned by investors, private citizens, and corporations: the CITIC, the Bank of Communication, and municipal commercial banks, such as the Beijing Commercial Bank and the Bank of Shanghai are all banks of this kind. The other type includes four banks that trade on the stock exchange: they are the Shanghai Pudong Development Bank, the Minsheng Bank, the China Merchants Bank, and the Shenzhen Development Bank, the previous Hainan Development Bank, etc.

In June 1998, the PBOC ordered the Hainan Development Bank (HDB) in Hainan Province to be closed. This was the first bank failure since the establishment of the People's Republic of China (PRC), and it signaled the end of the myth that "China's banks never fail." Immediately before HDB's failure, there was a run on the bank, the first instance of a run on a PRC bank triggered by worries about its credit. This demonstrated that the stability of the credit system, which had been maintained by the commitment of central and local governments, was changing: it indicated that Chinese banks were now exposed to much greater liquidity risks. To avoid a liquidity crisis within the financial system, the government injected 270 million RMB into the "Big Four" in 1998.

Classification and magnitude of NPLs

The PBOC, the central bank of China, required commercial banks to introduce a newly defined five-category asset classification system in 1998, which is modeled on the United States' system (Figure 1).

Table 1: Loan Classification

	Loan Categories
Performing Loans	normal loan
	watch list loan
Non-Performing Loans (NPLs)	inferior loan
	problem loan
	loss loan

The system is set forth in the Guiding Principles on Lending Risk Classification issued by the PBOC. Although these guiding principles detail the criteria that should be used in loan classification, the system for monitoring loan performance in China remains substandard. Chinese banks do not appear to adequately grade the quality of their loan assets and, when compared to international banks, it can be seen that they understate their NPLs. Although the PBOC announced that 25% of all its loans are NPLs, S&P estimates that the NPLs may account for up to 50% of all lending done by the four big state-owned banks. They claim that even in the Bank of China, the best of the "Big Four," NPLs account for 39% of the bank's loan portfolio.

Government Approach to NPL resolution and establishment of the AMCs

Government involvement in NPL resolutions in China has taken various forms. From the mid-1990s, the government began to separate commercial lending from policy lending. It established three policy banks to handle all policy-related lending, in the hopes that wasteful lending to failing companies from the four commercial banks would decline and that internal and external competition would intensify within them. Since Prime Minister Zhu Rongji took control of the financial reform, a number of reform measures have been put forward to deal with NPLs and to guard against risks in the banking system. These included (1) injecting equity to recapitalize state-owned banks; (2) compelling banks to adopt international standards when classifying NPLs; (3) requiring banks to make loans on a commercial basis; (4) for-bidding local governments to interfere with the lending decision of banks; (5) creation of four Asset Management Corporations (AMCs) to take over and liquidate the NPLs from the "Big Four" state-owned banks; and (6) debt to equity swaps.

The AMCs in China are largely based on the RTC model successfully used in the U.S.. They are government-sponsored agencies with limited life (10-year). China's four AMCs are responsible for the disposal of approximately 1.3 trillion-RMB (US$169 billion) in NPLs injected into them from the four State commercial banks. NPLs in the four AMCs consist largely of corporate loans to SOEs. Among these, it is estimated that around 25% to 30% are real estate loans. Outside of the AMCs, another $220 billion in NPLs are estimated to be held by other banks. This figure excludes bad loan holdings by large SOEs, insurance companies, and non-bank financial institutions.

Cinda, the first AMC in China, was established in April, 1999, after the State Council's decision to experiment with the disposal of NPLs. Cinda received 373 billion-RMB (book value) as a lump sum financial asset transfer from the China Construction Bank and the State Development Bank. Most of these assets were in the form of loans to key capital construction projects and large-scale state-owned enterprises, with 203.8 billion RMB concentrated in 1,050 enterprises. Cinda's assets were also largely concentrated in basic industries, among which 16.1% (61.2 billion RMB) were in the energy industry, 13.1% (50 billion RMB) in real estate, 6.2% (23.5 billion RMB) in the metallurgical industry, and 5.4% (20.5 billion RMB) in the construction material industry. Loans in the amount of some 144 billion RMB (40.8%) were concentrated in the developed Eastern region.

Technically, Cinda assumed only that portion of NPLs which had been incurred prior to 1996. NPLs incurred after 1996 stayed on the China Construction Bank's balance sheet and were categorized as results of the bank's own mismanagement and not the result of government policies. Loans deemed irrecoverable (i.e. recognized loan losses) were also not transferred to Cinda instead, they were written off by the government.

Following Cinda, three other AMCs were established in 1999. These were the Huarong AMC, the Great Wall AMC, and the China Orient AMC. In terms of their legal status, the four AMCs are wholly state-owned, non-bank financial institutions under the supervision of the Ministry of Finance (MOF) and the PBOC. Each of them had/has registered capital of RMB 10 billion (approximately US$1.2 billion) and was/is directly funded by the MOF. In 2000, to finance the purchase of the commercial banks' assets that had been transferred to them, each AMC issued ten-year bonds, guaranteed by the MOF, to their respective "partner" in the Big Four. Cinda purchased assets valued at RMB 375 billion; the Great Wall purchased RMB 345 billion in assets; China Orient acquired assets valued at RMB 264 billion; and Huarong bought assets valued at RMB 407 billion.

Under applicable law, the four AMCs are authorized to deal with all three types of assets: debt, equity and real property. By far the largest proportion of the AMC assets are comprised of unconverted debt in the form of NPLs. Most of these NPLs are unsecured. A comparatively small proportion of the debt now held by the AMCs is secured by physical collateral or pledges. The equity of SOEs that the AMCs hold is the result of debt-to-equity swaps.

By July 2002, China's four asset-management companies (AMCs) had disposed of 210.36 billion RMB (US$25.4 billion) in nonperforming loans (NPLs) and recovered 45.45 billion RMB (US$5.5 billion) in cash. The recovered cash accounted for 21.6 percent of the face value of the NPLs that were disposed. Within slightly more than two years since the four AMCs were established, Huarong has disposed of 38.85 billion RMB (US$4.7 billion) in NPLs and recovered 12.426 billion RMB (US$1.5 billion) in cash (31.98%). China Great Wall has disposed of 76.04 billion RMB (US$9.2 billion) in NPLs and recovered 6.6 billion RMB (US$793.4 million) in cash (8.64%). China Orient has disposed of 31.96 billion RMB (US$3.9 billion) in NPLs and recovered 7.41 billion RMB (US$895.2 million) cash, accounting (23.19%). China Cinda has disposed of 63.5 billion RMB (US$7.7 billion) in NPLs and recovered 19.04 billion RMB (US$2.3 billion) in cash (29.98%).

Attracting foreign capital to help resolve China's NPLs and raise the recovery rates has become a principle objective of the government. Following the successful experience of the RTC in auctioning off NPL assets in the United States, China Huarong AMC carried out the first auction to foreign investors in November 2001. The cover story of the February 2002 edition of *EuroMoney Magazine* was the first to offer an in-depth report on the auction process and to discuss the opinions of the various foreign investors and government officials regarding the value of the NPLs being auctioned. As the article points out, the pricing of these non-performing assets is extraordinarily difficult. In fact, there are so many unknowns that a number of the parties involved consider the available assets to be worthless: *"We used the normal criteria we use elsewhere but we just couldn't compute a value."* There are others, however, who still think the assets are investment-worthy.

Among the divergent opinions, there remains a single consensus that the involvement of foreign investors will help China to speed up the disposal process and improve its rate of recovery as measured by the ratio of sales proceeds to outstanding principal balance (OPB). The estimated recovery rate for the Huarong auction was about 22%, according to an insider foreign financial adviser. This figure is much higher than the average existing recovery rate under the present bankruptcy laws (less than 10%). The target recovery rate for the four AMCs has been set at 30% of the total value of all of the outstanding loans that have been taken from China's four major commercial banks.

PART III: FACTORS AFFECTING FOREIGN INVESTOR'S PERCEPTIONS OF UNCERTAINTY ABOUT CHINA'S NPL MARKET

While the bids by foreign investors in the first auction for NPLs by China Huarong AMC were higher than the other current recovery rates, they were still below the target recovery rate set by the government. The low pricing was largely due to the presence of many loans by SOEs. Uncertainty relating to whether foreign investors will be able to get control of the underlying assets of the SOEs, and the value of those assets if and when they do so, have caused the foreign investors to give little value to the SOE assets.

While China has taken a number of critical steps to deal with its NPL problem, many of the rules and regulations necessary to resolve the NPLs are just now being passed. Although the opportunities are enormous, foreign investors have demonstrated considerable reluctance to plunge into China's NPL market. This reluctance reflects the uncertainty that investors have about their ability to resolve NPLs, convert them to cash, and repatriate the proceeds in a timely manner. The speed with which investors can accomplish the various steps necessary to take control of assets used as collateral for NPLs directly affects their willingness to pay more money for the NPLs—a principal objective of the Chinese government, and a necessary condition for reducing the losses associated with NPLs.[1]

There are three broad areas that affect investors' uncertainty and reluctance to plunge in the Chinese NPL market:

A. Political and social will to get the job done

B. Legal environment

C. Execution

Below we assess fifteen different factors that must be in place if China is to succeed in attracting significant foreign investment in NPLs at prices and recovery rates that they hope to achieve.

A. Political and social will to get the job done

1. *National level.* There is general agreement that China's leaders have been aggressive in tackling the need to perform major financial restructuring. Under Prime Minister Zhu Rong Ji (1992-present), the government recognized the NPL problem before it became a major crisis.[2] The government has demonstrated its commitment to change by establishing the AMCs and by having the four major state-owned banks sell loans to them. They passed rules that tackled fundamental issues such as letting foreigners own leasehold interests and repatriate their capital. So far, the central government's will to get the job done seems to have been strong.

2. *Local Level.* While China has done the structural work to set up the AMCs, it is unclear whether they have the political and social will to push deals through the system. The problem is that

politics are very local, and the national government has less authority than most Americans assume to command local politicians to carry out their policies. While the national government has demonstrated its will to get the job done, it has not been proven yet whether they will be able to force local politicians to go along with the hard decisions that must be made. Will local politicians, for example, allow foreigners to take over and close down local factories, putting a lot of people who supported the local party officials out of work?

3. *New leadership.* The other big political unknown is what the new leadership will do. Will they take the same aggressive stance in support of financial reform as the previous leadership did, or will they bow to pressures as in Japan to go more slowly with financial restructuring?

4. *Social security.* Fear of social upheaval make China's national government ambivalent about giving foreign investors full reign to take action against SOEs that may cause people to lose their jobs. SOEs have provided many aspects of social security, including housing, and education for workers and their families. As SOEs are restructured or closed, the social services that they provided must be replaced by a broader social security system that has yet to be fully developed. The absence of a safety net increases investor concerns that the political will to get the job done will fade quickly if foreclosures by foreigners lead to even hints of social unrest.

B. Legal environment

In order for a market in NPLs to flourish, the legal framework must provide for foreclosure, orderly bankruptcy resolution, established creditor rights, and ownership rights for foreign investors.

5. *Foreclosure laws.* The foreclosure laws in China are similar to those in the United States. They give creditors all the powers they need to foreclose on debtors for non-payment of loans and to go after their assets. Creditor are allowed under the law to (i) institute civil proceedings and enforcement against the debtor and/or guarantor and their assets; (ii) realize the value of collateral through sale at auction or agreement or by transfer of the creditors' rights; (iii) realize creditors' rights through negotiation with debtors and guarantors to restructure the enterprise; (iv) to petition for bankruptcy of the debtor or guarantor; and (v) to go to court to foreclose where no agreement is reached between the creditor and debtors. The court will decide whether the mortgaged property will be auctioned or sold.

6. *Bankruptcy laws.* Bankruptcy laws also operate in a similar manner to those in the United States, both for private enterprises and SOEs. Upon petition for bankruptcy, which may be initiated by the creditor, the debtor is required to submit a plan of reorganization after the creditors and the court have approved the plan of reorganization. The SOE has up to two years to complete the reorganization, which can be terminated by court order sooner if the debtor's financial situation deteriorates or if he fails to implement the settlement plan.

7. *Creditor rights.* Priority of creditors-rights are well-established. Protection of secured creditors and payment of liens is enforced in the order in which the loans were registered.[3] Collateral includes land-use rights, buildings, machinery and equipment, and transportation vehicles. Mortgages of all these forms of property are permissible under PRC Security Law. The four state-owned banks have been actively working their NPL portfolios to resolve as many loans as possible. Foreclosure and bankruptcy laws and processes as well as creditor's rights seem to be functioning in a similar manner to those in the United States, although they have not been tested yet by foreign investors.

8. *Foreign investor rights and ownership.* All private property ownership is in the form of leasehold interests ranging from 50 to 70 years depending on the land use. Foreign investors are able to assume the leasehold rights on property. More complicated are restrictions on foreign ownership in certain industries including financial institutions. A complex set of legal entities and special joint ventures has been established to deal with servicing issues on the Morgan Stanley consortium that purchased the first China Huarong portfolio. They have established the first foreign-owned independent company for holding and servicing the NPLs for their disposition (Yang, 2002). Receiving government approvals for these unique arrangements has taken much more time than originally anticipat-

ed, but such approvals are now in place, opening the way for similar arrangements by other purchasers in the future.

C. Execution

The third area, execution, presents the greatest uncertainty for NPL resolution because there simply has not been enough experience yet in China to see if the process of NPL resolution will go smoothly. Some areas are clearer than others in terms of having rules in place or tested. For space reasons, the list below emphasizes only the highlights.

9. *Court enforcement.* Court enforcement is the ultimate weapon that investors have to force borrowers to pay up or hand over collateral quickly. How local courts will treat foreign investors as they attempt to exercise their creditor rights is untested. Will local courts enforce the laws regarding foreclosure and bankruptcy? The vast majority of borrowers are SOEs or joint ventures with SOEs. Will the courts enforce laws that lead to closure of local factories, especially where the general manager of the factory may be related to the judge? Considerable uncertainty surrounds the interpretation of legal processes and how local courts will behave. Although the central government supports enforcement of the laws, political power is more decentralized than westerners expect. Thus, even though strong national pressure for courts to enforce the laws may be present, no one knows how local courts will respond.

10. *Level of fees to transfer assets.* It is unclear whether unpaid taxes follow a property or stick with the individual who sold it. Do unpaid taxes become an obligation of the new buyer? When one buys property, what should bidders assume about these obligations?

11. *Laid-off employee liability.* Is the new owner subject to a company's liability for employees who have been laid off? In principle, the answer is "yes." When SOEs cease operations, they have obligations to compensate laid-off employees. Whether or not NPL buyers who become the leaseholders of property must assume these obligations is a matter of negotiation between the SOE and the creditor (NPL buyer). If the creditor must assume the obligation, it is unlikely that he/she will want to take over the collateral. In many cases, the price to settle laid-off employee liability claims is determinable in advance and thus becomes a factor in valuing the NPLs.

12. *Repatriation of capital.* Previously, Chinese law required foreign investors to complete a transaction in order to repatriate capital. NPL investors want to repatriate capital as each loan is resolved in order to boost interim cash flows and IRRs on their invested capital. A November 2002 approval by the Ministry of Foreign Trade and Economic Cooperation (MOFTEC) gives investors the right to repatriate capital (net cash flow after profit tax) as loans are resolved rather than waiting until the entire transaction for a given loan portfolio is completed (Yang, 2002).

13. *Favorable tax rates.* The government has established Business Development Areas (BDAs, similar to enterprise zones) such as Pudong in Shanghai that offer foreign companies favorable tax rates. If the companies are set up in BDAs, they are entitled to the tax benefits given to the BDA. In addition, companies set up by foreign investors in China to dispose of NPLs are subject to taxes under the current tax structure. However, it is not known yet whether they will be exempted from the business tax that financial institutions now pay. The combination could reduce taxes from 33% to 15%, significantly boosting returns to foreign investors

14. *Processing time.* Investors price assets based on the time it takes them to get their hands on assets. Buyers of NPLs have yet to go through the process of seizing and getting control of assets. As mentioned above, the processing time depends heavily on the attitudes of local courts. Some cities like Shanghai have more commercially oriented court systems. What will happen in other areas?

15. *Land-use rights.* The option to convert to another land use provides the NPL servicer a "big stick" to get something out of settlement. (Investors in most cases don't want to get a factory back.) In order for investors to do anything other than the current land use with property they acquire through loan resolution, the property must have a *granted land use right*. Many SOEs have *allocated land use rights* which

must be converted to *granted land use right* by payment of a conversion fee to the local authority of approximately 20-40% of the leasehold value (present value of 50-70 year lease).[4] The processing time and actual fee for making this conversion has not been tested and is likely to differ between jurisdictions. The need to pay high conversion fees will leave little loan recovery value to many collateralized properties where the market value of the property with the granted land use right is not much higher than the conversion fee.

The issues listed above must all be resolved if China is going to realize higher prices on the sale of the NPLs to foreign investors. In addition to these issues, bidders must rely on local partners for information. The collection of reliable and detailed information is difficult, because contact with borrowers and guarantors is prohibited and public sources of information are not readily available.

The legislation that will allow the market in China to develop as rapidly as they desire is just now being passed. The State Council is working on a variety of regulations that will encourage foreign investments in China. While bankruptcy and foreclosure laws to enforce creditor rights have been established, Westerners have yet to experience whether or not local courts will enforce the laws. Critical regulations with respect to repatriation of foreign capital and setting up foreign investment enterprises to work on NPLs through joint ventures with the AMCs had just been passed at the end of 2002.

The explanation for the system's slowness to change lies in the fact that the government is both a debtor (in its capacity as the owner of SOEs) and a creditor (in its capacity as the owner of state banks). Its ambiguous financial position has created a plethora of conflicting economic incentives.

Furthermore, because of the social and political disruption that would result from "overly aggressive" restructuring and the liquidation of moribund SOEs, it is hard to get AMCs to accept significant discounts on the book values of their NPLs, although there are signs this is changing.

At the present time, there is active disagreement in the Chinese government and in the academic community over the speed and methods needed to resolve China's NPLs. Some argue that since the resolution of NPLs is associated with the stability of SOEs and employment rates, the government and its regulators should be wary of opening conduits for private sector investors, either domestic or foreign. On the other hand, this apparent failure to address China's NPLs may well result in a financial crisis that could lead even the "big four" to bankruptcy.

Table 2
Assessment of Investor Uncertainty

	level of uncertainty		
	little	some	considerable
Political and social will			
1 National Level	■		
2 Local Level			■
3 New Leadership			■
4 Social Security			■
Legal Environment			
5 Foreclosure Laws	■		
6 Bankruptcy Laws	■		
7 Creditor Rights	■		
8 Foreign Investor Rights		■	
Execution			
9 Court Enforcement			■
10 Fees to Transfer Assets			■
11 Laid-off Employee Liability			■
12 Repatriation of Capital	■		
13 Favorable Tax Rates	■		
14 Processing Time			■
15 Land Use Rights			■

SUMMARY AND CONCLUSION

China is pursuing a course to resolve its NPL problem that follows closely out of the United States' experience with the Resolution Trust Corporation. They have established four AMCs, which have similar powers and responsibilities to the RTC. The AMCs are in the midst of overcoming a number hurdles to bring in foreign investment to purchase some of the NPL portfolios. The auction by China Huarong AMC has brought these efforts to a head, since many of them must be resolved in order to close the first sale to the Morgan Stanley consortium.

Table 2 summarizes the fifteen factors discussed above that affect investors' perceptions about the Chinese NPL market.

Of the three broad areas above, the legal environment is the most developed. Laws with respect to seizing property, getting control of collateral, and realizing value for creditors through foreclosure and bankruptcy appear to be in place to support a favorable resolution of NPLs. On the surface, the system supports orderly transfer of assets and has been used by the four AMCs to resolve a number of NPLs already. The leadership at the national level has demonstrated a strong commitment politically, but there is still considerable uncertainty about reactions at the local level. In addition, the strong commitment of the new national leadership to address with the hard issues surrounding NPL resolution especially with respect to closing down factories and job losses has yet to be confirmed.

It is in the third area, execution, that investors face the greatest uncertainty. The government has been moving forward to resolve key issues with respect to repatriation of capital and tax rates for foreign buyers. Other issues depend more on what happens at the local level or on property-level negotiations such as laid-off employee liability. While these areas would benefit from strong national direction, only experience in resolving actual loans is likely to reduce investor uncertainty.

It is revealing in that more than half of the above factors are a source of considerable uncertainty for investors. If the experience of the early foreign buyers of NPLs is positive, then many of the uncertainties in Table 2 will be quickly reduced. The long list, however, helps to explain why it has taken over one year to close the first auction sale by China Huarong to the Morgan Stanley consortium. As China Huarong's president, Yang Kaisheng has emphasized, however, the situation has not been static. In fact, over the past year they have been extremely active in addressing the fundamental issues that must be resolved before significant foreign investment will occur.

The success of the RTC in the United States hinged primarily on the speed with which NPL assets were brought to market and securitized. Investors responded creatively to the opportunity, and prices, which were initially low, rose quickly, thereby reducing the losses to the government. The Chinese government has attempted to apply the lessons of the RTC by creating the AMCs to speed the loan resolution process, and by encouraging foreign investors to buy the NPL portfolios. Whether or not prices in China will rise rapidly as they did in the United States depends on whether foreign investors are able to get control of NPL assets quickly and to realize higher recovery values than they currently project from the real estate assets and other collateral of the state-owned enterprises.

Endnotes

1. It should be noted that any losses associated with the NPLs were deferred when the government issued 10-year bonds to enable the AMCs to buy the assets from the Big Four state-owned banks. The losses will be recognized only when the bonds are retired and there is insufficient capital from the NPL resolution to pay off the bonds. Presumably the difference will be made up by the government.
2. William Overholt, speaking at a forum on Asian Financial Restructuring (Harvard Kennedy School of Government, December 13-15, 2002), stated that among Asian countries, only China acted before the crisis hit. "The system had a strong leader who could rally the nation and get acceptance of difficult measures."
3. In cases where loans are not registered, then lien priorities are determined by the order in which loan documents were signed and dated.
4. This conversion fee is in essence the state's payment for selling the leasehold right to develop or use property to the tenant.

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THE GROWTH AND PERFORMANCE OF INTERNATIONAL PUBLIC REAL ESTATE MARKETS

by Glenn R. Mueller and Randy I. Anderson

Executive Summary. *This paper looks at the growth in size of public capital markets around the world and analyzes the returns that have been achieved. Monthly data from Global Property Research (GPR) for periods 1984 through 2002 mid year is used for the study. The paper describes the number of firms and market capitalization found in 16 countries then examines the return correlations of the major real estate indices around the world along with their growth and performance. We conclude that while the reasonable returns and low correlations of most public real estate markets around the world should attract institutional investors, but the relatively small size of most markets has made them less attractive. The U.S. market cap is $170 billion; but all other markets are much smaller with France, Hong Kong, and Japan averaging around $40 billion being the next closest tier. Thus the public real estate markets around the world still have a long way to go and grow to attract significant institutional capital.*

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I. INTRODUCTION:

Access to capital is a major component of every real estate investment decision and access to public capital markets has been a major problem for capital hungry real estate investors since the beginning of time. However, the last decade of the 1900s bought a new era of access for real estate to the public capital markets around the world. This paper looks at the growth in size of public capital markets around the world and analyzes the returns that have been achieved. We examine the growth and performance of public market real estate in an international context using monthly data from Global Property Research (GPR) for periods 1984 through 2002 midyear. With the poor performance of the general equity markets around the globe and the lowest interest rates in 50 years, many investors have decided to add to their real estate allocation in both private and public form investments. Another reason for investors to consider real estate is that there has been an increasing correlation between international stock and bond market return indices, causing investors to look for additional portfolio diversifiers. This paper also examines the return correlations of the major real estate indices around the world along with their growth and performance.

II. LITERATURE REVIEW

There is a vast literature that has examined the size, growth, and performance of the international debt and equity markets. Beginning with the seminal work of Solnik (1974), practitioners and academics have espoused international investing due to the low correlation in returns across countries, providing diversification opportunities. However, recent studies have suggested that due to the increasingly global, open economy, the cross listing of securities, and the rapidly advancing technology that international debt and equity markets are becoming more correlated, thus reducing the benefits of international diversification (Conover, Friday, and Sirmans, 2002).

On the domestic side, there are numerous studies that have examined the size, growth and performance of both public and private real estate investments. Like international debt and equity, real estate allocations have been advocated due to their low correlation with domestic stock and bond returns (Conner, Hess, and Liang, 2001). With the recent downturn in the general equities market, the increasing correlation of international stocks and bonds, and the relatively strong performance of real estate, investors are becoming increasingly interested in international real estate. However, there are very few studies that have examined the international real estate markets. Stevenson (2000) points out that few studies exist because there is relatively little data and the data that does exist is only for a limited number of countries.

In general, most of the international real estate studies that have been completed have tried to determine if international real estate investing provides diversification benefits. The majority of the studies find that international real estate has a role in a mixed asset global portfolio. However, none of these studies have used current data, with most data stopping in the mid to early 1990s. The latest study Gordon and Canter 1999, used a 14-year period through 1998 on 14 countries and found that high dividend paying companies (such as REITs) had lower correlations with their domestic stock markets. This is problematic as strong growth in public real estate occurred after this time frame. Additionally, the prior studies looked at only a handful of the largest countries. In the current study we are able to use data from 1984 to the present and examine three major regions—America, Europe, and Asia, and thirteen countries within each of these regions. This allows us to be able to ascertain, for the first time, if diversification exists between regions or within the individual countries in those regions. Moreover, we provide the first comprehensive study that examines return performance, return volatility, returns relative to risks, growth in the number of public real estate firms, growth in the market capitalization of the public real estate firms, in addition to their return cross correlations. The next section examines the evolution and development of the public real estate markets.

III. THE GROWTH AND DEVELOPMENT OF PUBLIC REAL ESTATE COMPANIES

There has been a dramatic increase in the number of public real estate firms across the globe in the last two decades. Exhibit 1 shows the change in the number of public real estate companies broken down into three major geographic regions around the world: America, Europe, and Asia. The trend line shows that Europe was first with the number of companies growing quickly in the late 1980s, flowed by the America region in the early 1990s and then the Asian region in the late 1990s. Note that the large jumps in both the European and American statistics are not due to a major change in one given year in the actual marketplace, but the addition of those companies to the GPR index in that given year as GPR developed their database (although the inclusions were lagged by only one or two years).

Analyzing the countries within the 3 geographic regions, we see that within America there are 4

Exhibit 1: The Number of Public Real Estate Firms by Major Region
Source: GPR

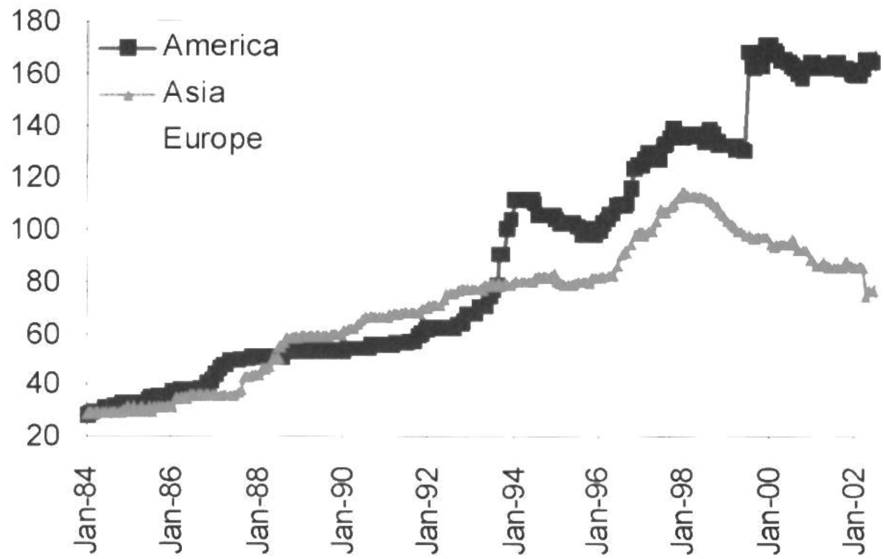
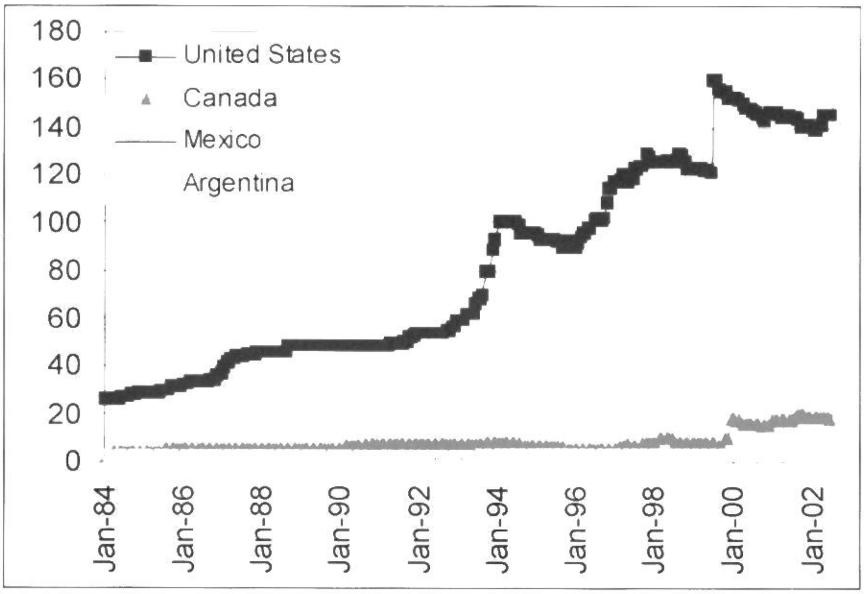


Exhibit 2: Public Firms in America
Source: GPR



countries with public markets. America started out with the fewest firms of any region and now, due to the growth of public real estate firms in the United States, has the largest number of firms (Exhibit 2). Mexico and Argentina have only a few companies and Canada has managed to grow to 20 companies, but the U.S. market dominates the Americas with over 150 companies.

Europe, France, and the UK have the largest number of public real estate companies. The UK experienced the majority of its growth in 1997 and 1998 but has lost firms since that time period. France,

Exhibit 3: The Number of Public Companies in Europe Source: GPR

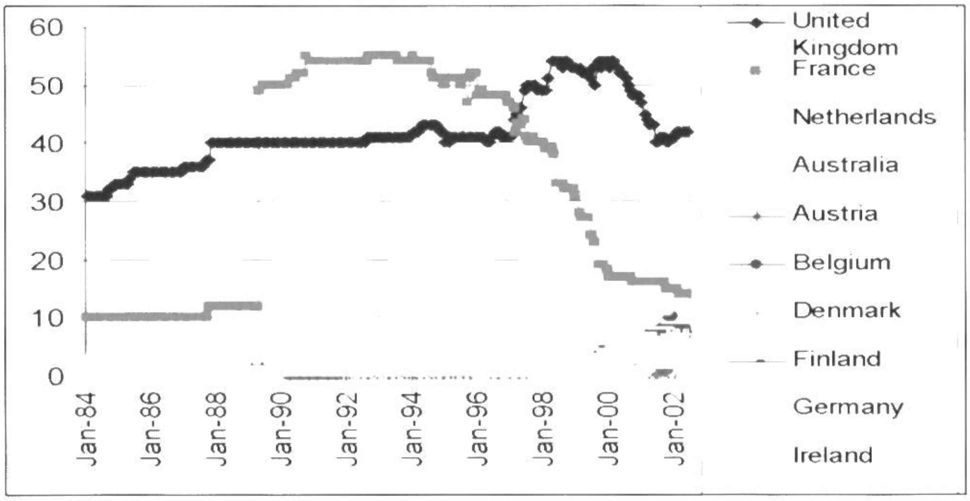
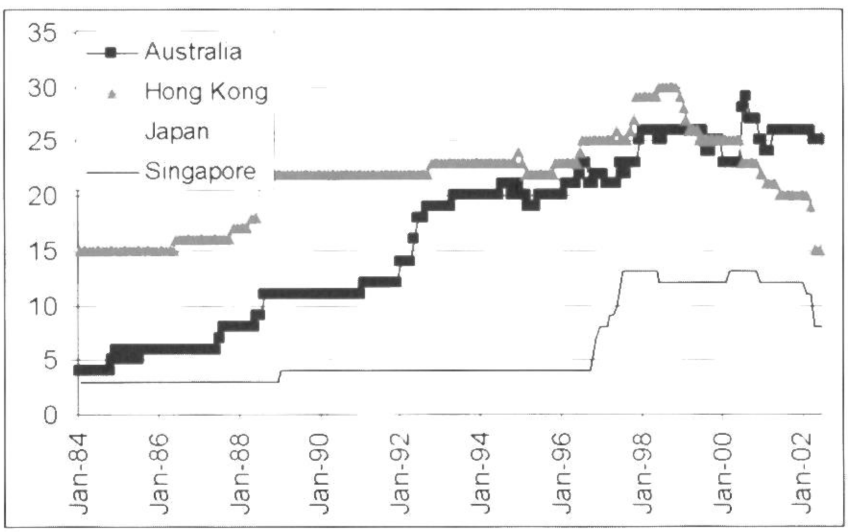


Exhibit 4: The Number of Public Firms in Asia Source: GPR



experienced rapid growth in the number of firms in 1989, remained steady for several years, and has been on a recent downward trend due to consolidation (Exhibit 3). All other countries have less than 10 firms.

Examining the number of public real estate firms in Asia reveals that Australia, Hong Kong, Japan, and Singapore have the largest number of firms. For the most part, the major increases occurred in the late 1980s and early 1990s while the number of firms fell in 2002 for all countries (Exhibit 4).

IV. TRENDS IN MARKET CAPITALIZATION

The trends in market capitalization, for the most part, mimic the patterns observed when looking at the changes in the number of firms. Exhibit 5 shows that both America and Asia have had very

Exhibit 5: Market Capitalization of the 3 Major Regions
Source: GPR

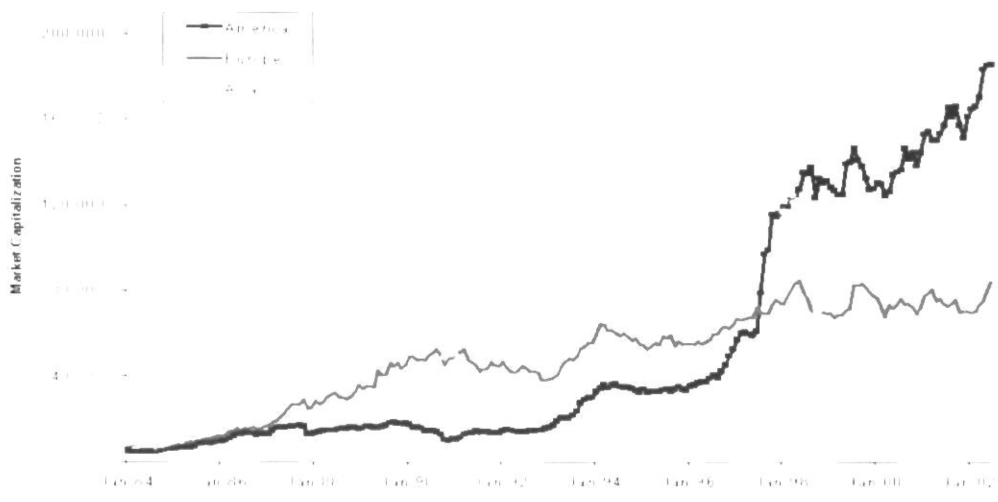
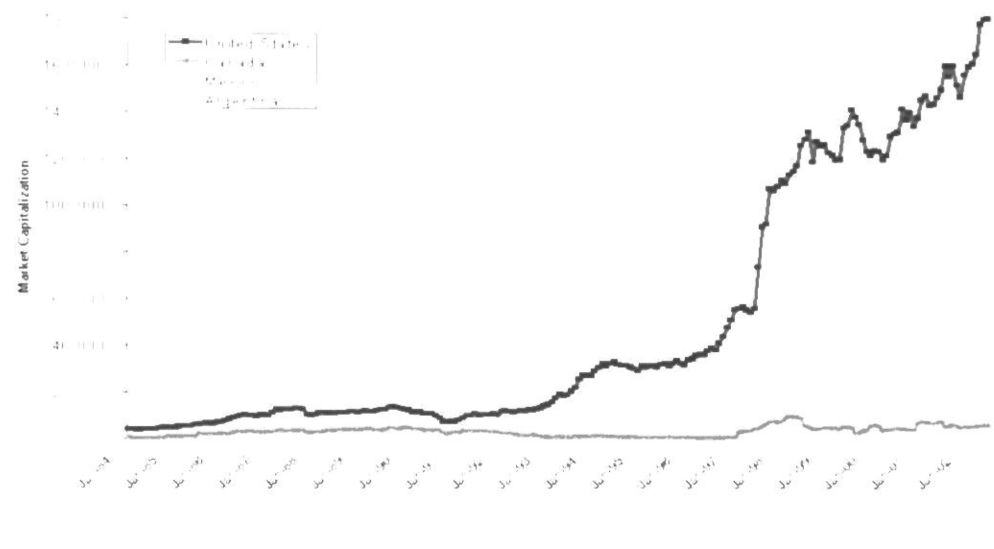


Exhibit 6: Growth in Market Capitalization in America
Source: GPR



rapid growth in market capitalization over the sample period. The noted difference of course is that the U.S. has shown steady improvement in market capitalization exhibiting exponential growth in recent years, where Asia saw a dramatic increase in the 1995-1997 period with dramatic declines, due to the Asian financial crisis dropping market capitalization back to 1993 levels. Europe has been less volatile, experiencing a slower steadier increase in overall market capitalization than either the U.S. or Asia.

Exhibit 7: Market Capitalization in Europe
Source: GPR

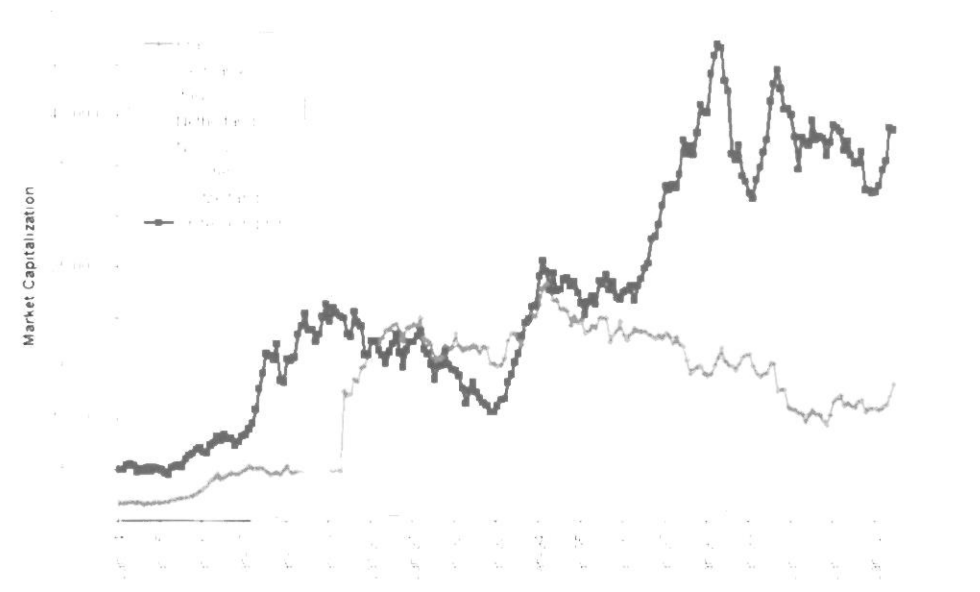
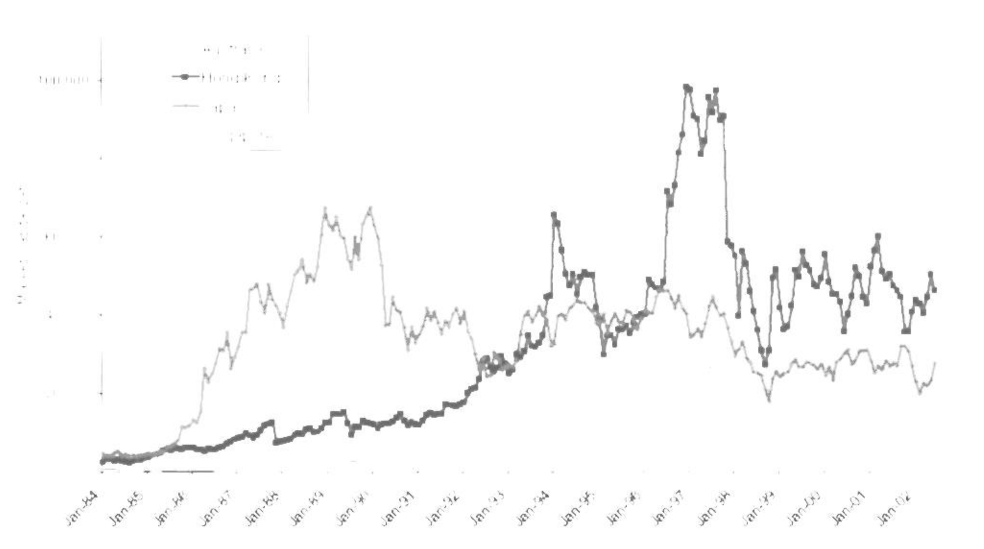


Exhibit 8: Market Capitalization in Asia
Source: GPR



Examining countries of the major regions reveals some interesting trends. For America, the increase in market capitalization is the sole result of the growth in the U.S. markets as Canada, Mexico and Argentina remained flat and there are no other major contributors (Exhibit 6).

Europe experienced the most rapid increase in market capitalization from the UK market with most of the growth occurring between 1996 and the first quarter of 1998. France had grown in the early 1990s but then experienced dramatic declines

Exhibit 9: Total Return Index of the Major Regions
Source: GPR

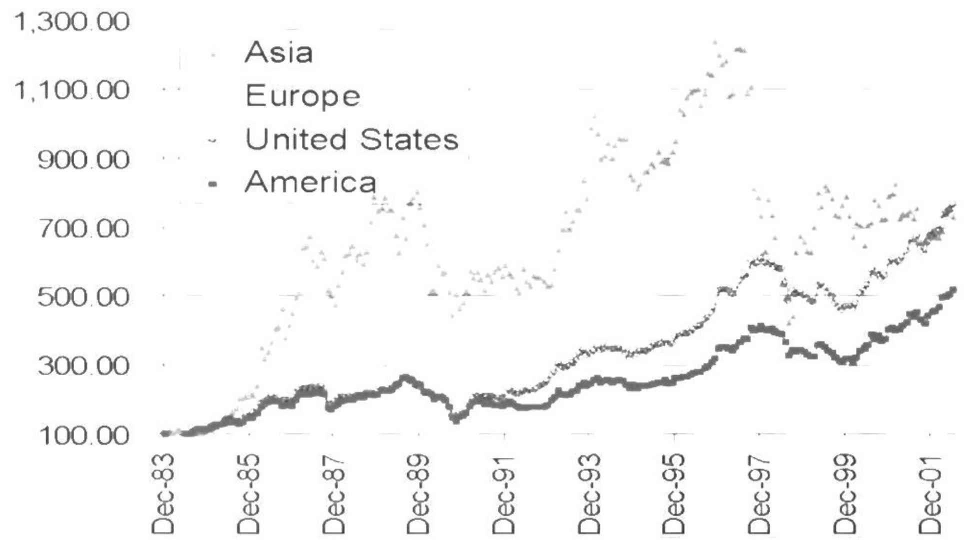
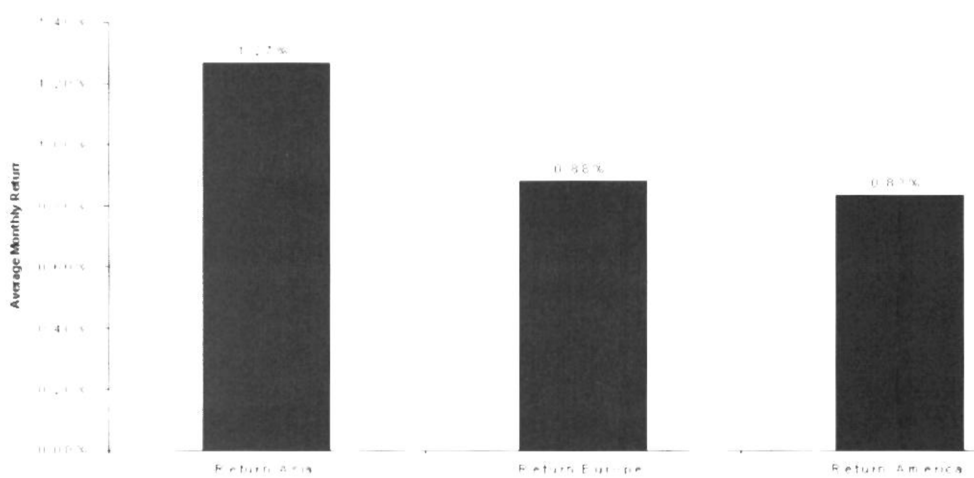


Exhibit 10 Average Monthly Returns by Region
Source: GPR



in market capitalization during the second half of the 1990s as the number of firms shrank. The Netherlands had a slow and stable increase in market capitalization across the sample period (Exhibit 7), while most of the other five European countries had almost insignificant growth. Note that European market capitalizations are only a fraction of the U.S. capitalization.

The market capitalization for the Asia region has been very volatile over time. Japan had strong growth in market capitalization during the early to mid-1980s, which was consistent with their overall

Exhibit 11: Standard Deviation of Returns by Region
Source: GPR

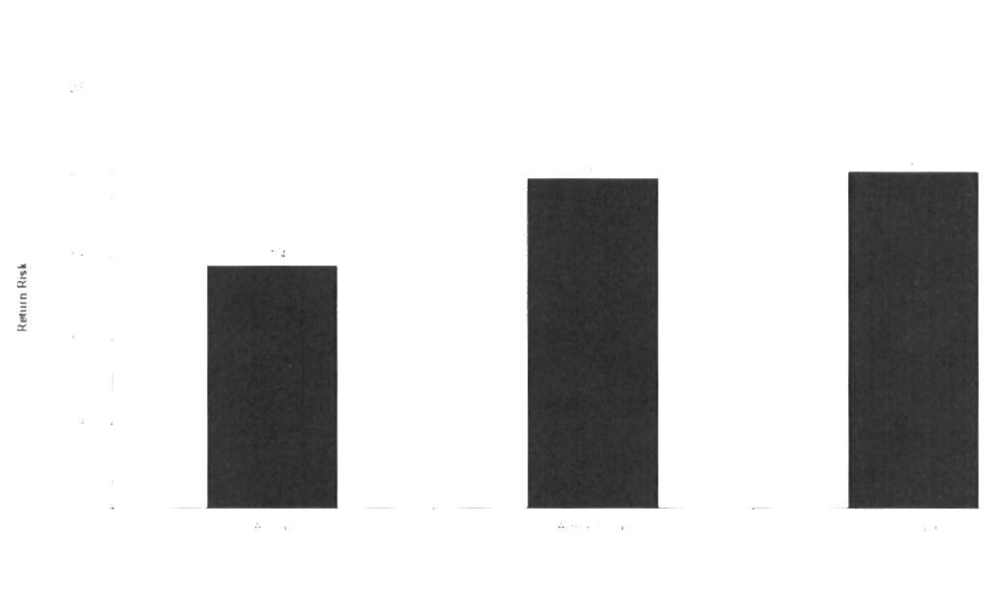
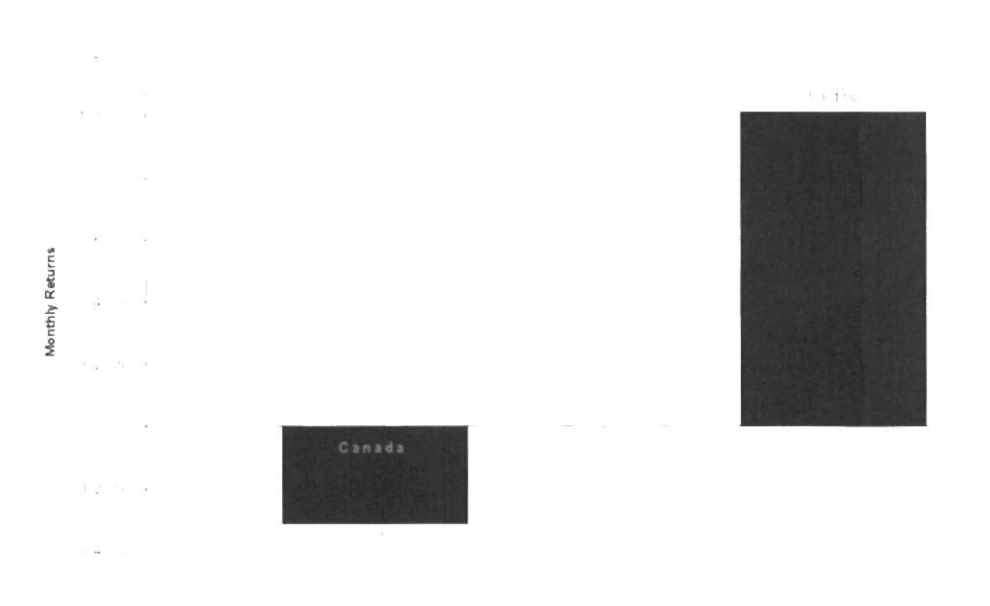


Exhibit 12: Returns for America's Region Countries
Source: GPR



economic situation. Hong Kong had dramatic increases in market capitalization from 1984 until midyear 1997, which followed their securities market bubble, then had a major decline bringing current market capitalization back to 1994 levels. Singapore exhibited similar trends to Hong Kong, but on a much smaller scale. Australia has experienced slow but stable market capitalization growth over the sample period, but the market still remains small (Exhibit 8). Asian market capitalizations are similar to European market capitalization and still a fraction of the U.S. market capitalization.

Exhibit 13: Returns for Asia's Region Countries
Source: GPR

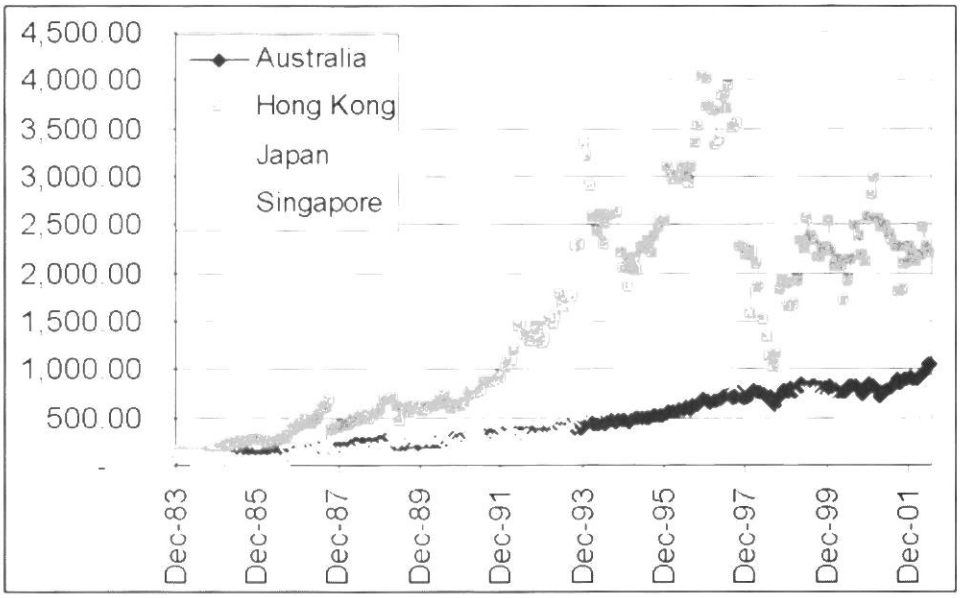
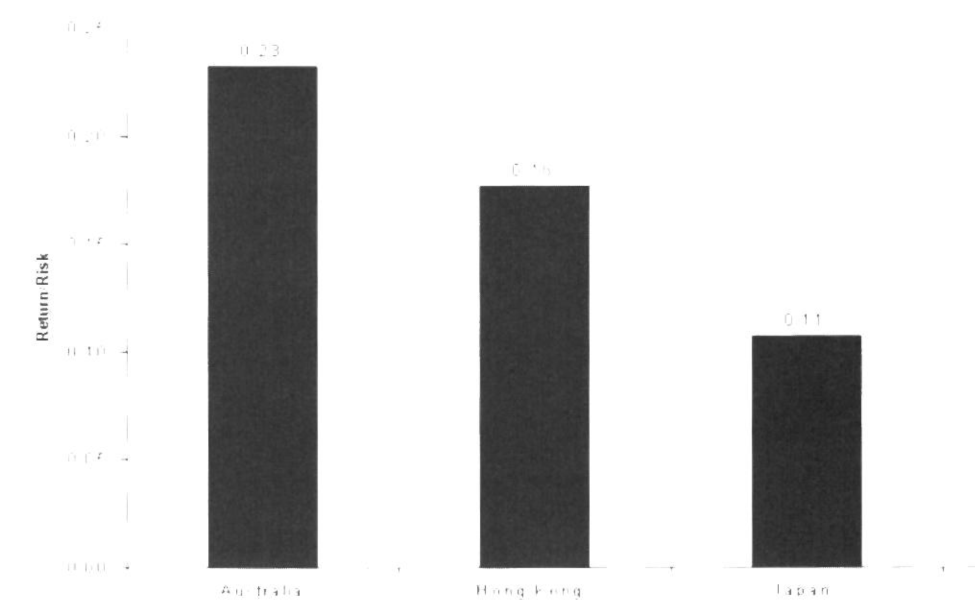


Exhibit 14: Standard Deviations for Asia Region Countries
Source: GPR



V. INVESTMENT RETURNS AND VOLATILITY

For the international public real estate markets to evolve and grow rapidly, they need to be attractive to investors by generating strong returns. Return performance and volatility of the three major regions in Exhibit 9 shows that both Europe and America had steady positive returns producing a 500% increase over 20 years with low volatility, while Asia had extremely high returns from the mid-1980s through the mid-1990s but then had substantial losses in the second half of the 1990s bringing investors back to a mid-1980s return

Exhibit 15: Europe Region Country Returns

Source: GPR

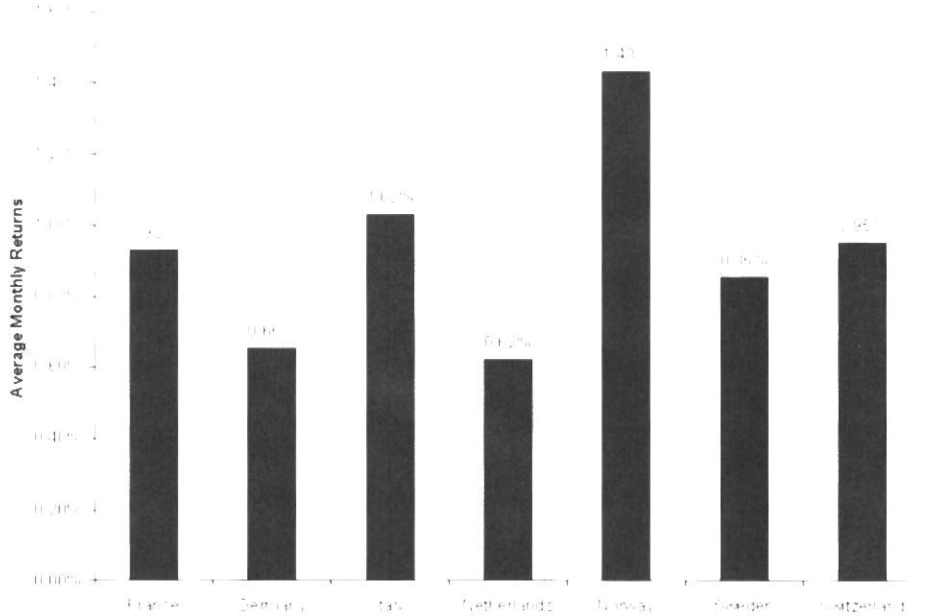
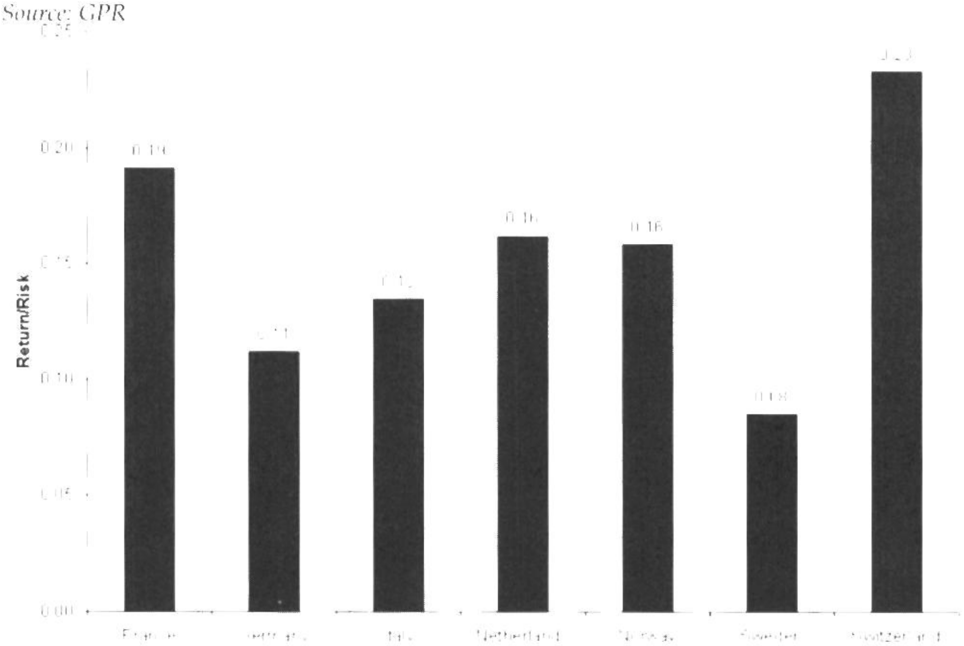


Exhibit 16: Europe Region Country Standard Deviations

Source: GPR



position. The U.S. market is also added to the graph to show that U.S. returns were significantly higher in the 1990s from the America region composite.

The average monthly returns and returns to standard deviations are shown in Exhibits 10 and 11.

So, while Asia looked good on a total return basis, on a risk-adjusted return level, both America and Europe performed much better.

Examining the individual countries revel that there are dramatic differences in performance within

Exhibit 18 Cross Country (within Region) Return Correlations

	France	Germany	Italy	Netherlands	Norway	Sweden	Switzerland
France		0.443	0.442	0.644	0.267	0.182	0.619
Germany	0.443		0.323	0.424	0.153	0.019	0.376
Italy	0.442	0.323		0.288	0.140	0.047	0.193
Netherlands	0.644	0.424	0.288		0.327	0.175	0.559
Norway	0.268	0.153	0.140	0.327		0.247	0.109
Sweden	0.182	0.019	0.047	0.175	0.247		0.096
Switzerland	0.619	0.376	0.192	0.559	0.109	0.096	

	Australia Return	Hong Kong Return	Japan Return	Singapore Return
Australia Return		0.375	0.202	0.316
Hong Kong Return	0.375		0.064	0.611
Japan Return	0.202	0.064		0.134
Singapore Return	0.316	0.611	0.134	

geographic regions. For example, average monthly returns in the U.S. just over 1%, while the average monthly return in Canada was negative. (Exhibit 12)

In Asia, all of the firms showed positive total returns for the sample period, With Australia producing a similar 500% return to the American and European regions over the 2 decades of the 1980s and 1990s. It was Hong Kong alone that produced the substantially higher returns and volatility that drove the index for the Asia region. (Exhibit 13)

Due to its low volatility Australia produced the best risk adjusted return of the Asian region. (Exhibit 14)

In Europe, Norway and Italy produced the highest level of total returns (Exhibit 15), but Switzerland and France had the highest level of risk adjusted returns (Exhibit 16).

VI. RETURN CORRELATIONS:

Modern portfolio theory states that anytime assets that have less than perfect positive correlation are combined into a portfolio, there are risk reduction benefits. In fact, both the major rationale for real estate investing and international investing stem from their low correlation with other investments in a portfolio allowing for better risk-adjusted returns. Recently, the general international equity markets and debt markets have been moving in relative tandem as indicated by the increasing return correlations. However, real estate in general and international real estate markets in particular, have exhibited relatively low correlations with the other asset classes and also have shown low correlation across the three regions (Exhibit 17).

Exhibit 17 Cross Region Return Correlations

	Return America	Return Asia	Return Europe
Return America	0.33	0.40	
Return Asia	0.33		0.38
Return Europe	0.40	0.38	

Examining the correlations within each of the major regions (Exhibit 18) shows that there exist diversification benefits even within any one of the major regions. Return correlations for the period 1982 through 202 are very low with only a few countries having correlations above 0.50. Thus local and not global factors would appear to be driving public real estate company returns.

	U.S. Returns	Canada Returns
U.S. Returns	1	
Canada Returns	0.431	1

VII. CONCLUSION

Investing in international real estate is a new challenge that is being considered by more and more investors today. The substantial efforts, risks and costs associated with purchasing direct real estate can be reduced by investing in publicly traded real estate companies around the globe. Public real estate companies have only become a viable option in the last 20 years and their performance (analyzed here) shows positive results. Most countries' public real estate markets have shown relatively steady returns, with the exception of the highly volatile Hong Kong market.

As most public markets grow, a major force in capital flows is the institutional investor entering the market. Institutional investors need liquid markets in order to invest and this is a function of the size of the market. While the reasonable returns and low correlations of most public real estate markets around the world should attract institutional investors, the relatively small size of most markets has made them less attractive. While the U.S. market cap is $170 billion, all other markets are much smaller with France, Hong Kong and Japan averaging around $40 billion being the next closest tier. Smaller and less liquid markets keep many investors away. A few large investors see investments in smaller public markets as similar to making a private investment, due to the low liquidity. Thus the public real estate markets around the world still have a long way to go and grow to attract significant institutional capital.

Currency risk is also a major factor in assessing return volatility in the home country currency of the investor. Real estate poses a different type of risk from other stock investments as there can be a large portion of the return coming from annual dividends, while stock investments provide mostly appreciation as the major component of their returns. This annual cash flow from real estate investments means that investors have to develop different currency hedging strategies to manage the annual cash flows. Thus international real estate investments can provide a different challenge as well as a different value to the portfolio.

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IMPACT OF THE INTERNET ON INTERNATIONAL REAL ESTATE OFFICE MARKETS

*by Sofia V. Dermisi**

Executive Summary. *The present study examines the impact of the Internet on the real estate office market through a survey of real estate professionals in traditional companies in Boston/U.S. and London/U.K. This survey captures professionals' opinions on the use of the Internet and how it affects their business. The results from both cities indicate differences when using the Internet versus traditional practice. The Internet seems to affect the role of the transaction participants, the length of the process but not the participants' earnings or transaction steps. It is currently used as a listing service, information-gathering resource and communication tool.*

INTRODUCTION

The Internet is a recent expanding medium of economic and social exchange. It is most effective at breaking down barriers, improving information flow, and speeding up the decision-making processes (Hartung C.J., et al., March 2000). Two factors significantly contributed to the increase in Internet adoption among real estate brokerage companies: increased computer use throughout the population as well as companies, and the downturn in commercial real estate. This downturn led brokerage companies to list properties online to reach a wider market (Rebuz.com, 8/8/01). Similar to the retail industry and Web-based marketing (Baen J., 2000; Miller N., 2000) the real estate industry is expanding its online listings by con-

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tinuously advertising additional properties, thus providing property seekers with a variety of options.

The Internet use in the U.S. and the U.K. can provide a context of the Internet's adoption in the two countries where the survey took place. Nielsen/Net Ratings estimated that more than 62% of the U.S. population had Internet access in 2001 either at home or at work in comparison with 57% the year before (Stellin S., 2001). According to the U.S. Department of Commerce, in 2000 51% of all U.S. homes had a computer and 41.5% had Internet access. High per-minute charges have prevented people in the U.K. and other European countries from browsing the Internet, leading to a lower growth than in U.S. (Wickham R., 2000). In the U.K., household PC penetration was 46% (Nielsen, 2001). The U.K. government's E-envoy indicated that Internet penetration in the United Kingdom was still less than 60% (Holmes M., 2001). The housing market transactions have been more easily facilitated through the Internet compared to office transactions. Studies in the U.S. show that the numbers of homebuyers searching for housing on the Internet are between 40% [Forrester research, 2000; Farnsworth C. & Evans B., 2000] and 56% (Murray M., 2000). In general 79% of agents claim they do not think the Internet threatens their job (Gomez Research, 2000). However, the search for housing in the U.K. is mostly conducted through traditional methods because of limited Internet use.

This study was motivated by the limited research on the Internet's impact on the Real Estate Office Market (REOM). A survey of traditional real estate companies was conducted in Boston and London in order to capture the "real-world" views on Internet adaptation and especially its impact on the office properties transaction process. Boston was selected because of its small office market size compared to other major cities in the northeast U.S. and what brokers see as a tight, relationship-driven office market. London, however, was selected because it is the largest and most representative office market throughout U.K. What could the survey results indicate for these cities in two continents? This survey tries to identify how Internet use affects the role, time, and earnings of the key participants involved in the transaction process of office properties as well as the transaction process length. This survey of traditional real estate companies in Boston and London indicates that the Internet affects the roles of the transaction participants allowing the real estate business to remain competitive.

LITERATURE REVIEW

The traditional real estate industry has been characterized as fragmented and technophobic (Hartung C.J., et al., 2000). A recent literature review (Dermisi S., 2002) shows that although the Internet Real Estate has made significant steps in its advertisement side, the transaction process has not shared the same growth. Adaptation of the Internet, as a new medium in a traditional "relationship driven" sector, was slow in the mid-1990s but has increased exponentially in the past few years (Baen J., and Guttery R., 1997). From the 1995 onwards, real estate Web sites evolved from static brochures to comprehensive online property listing sites with various information on the property, location, demographics, and statistics for the area and finally to process management sites that create efficiencies in the workflow process along with providing information (Harvard Design School, 2000; Bond M., Seiler M., Seiler V., Blake B, 2000).

As in other industries, views vary on the Internet's use and impact on the real estate sector. Some real estate professionals believed that traditional real estate companies could not easily adopt the Internet. Others argued that "in the new information technology paradigm of place and space, the classic location, location, location mantra of real estate decision-making is replaced by information, communication, location"(Roulac S., 1996). In recent years another thought has been that "although real estate is not very technology-oriented, people are beginning to appreciate that technology can be relationship-oriented" (Pike P., 1998). The relationship between brokers and the Internet is not mutually exclusive, but allows technology to complement them in order to produce more valuable services (Devine A., 2001). Bond M., et. al. (2000) reported that most of the firms they surveyed either operate their own Web sites or list their properties on larger industry sites. While the Internet cannot replace relationships, brokers' roles will likely be redefined as more emphasis is placed on financial and analytic services (Hartung C.J., et al., 2000). Brokers and clients still need to communicate but they are meeting face to face less and "talking" electronically more. Brokerages must distinguish themselves in other ways mainly by their ability to help companies make increasingly complex decisions about real estate (Moore P., 1999).

In the real estate business using a common online platform that functions as a repository for documents and information is a vital first step toward simplifying the complex transaction process (Carpenter S., 2000). The combination of commercial real estate's limited transparency and information sharing as well as the variety of deal clauses are significant obstacles to the use of a common standardized platform (Miles M., 2000; Bergsman S., 2001). Consortia, like Constellation and Octane, have been formed to overcome these obstacles. Although it is cheaper and more flexible for consortia to merge with other companies, the challenge is to pool all listings together in a comprehensive and meaningful way on a neutral platform for all players (Harvard Design School, 2000; Bergsman S., 2001). Along with consortia, portals have begun to evolve presenting a new medium for possible future transactions. The portal evolution has led to trends that consolidate and globalize existing markets by developing a comprehensive procurement platform service, enabling business practices (Harvard Design School, 2000).

DATA COLLECTION

The real estate data were obtained in 2001 from a survey of companies in the U.S. and London/U.K. chosen to meet the following criteria: a) national coverage in terms of listings as a real estate agency; b) largest real estate companies in Boston and London in terms of broker numbers; and c) well-established research and investment departments. The population (all companies meeting the criteria) was determined through the Internet, financial/consulting organizations, local chambers of commerce and real estate organizations such as BOMA and NAREI. This search led to the conclusion that the Boston population consisted of ten real estate companies: CB Richard Ellis, Spaulding & Sluye (Colliers), Prudential, Jones Lang Lasalle, Cushman & Wakefield, Grubb & Ellis, Insignia, Prudential, CRESA partners, and Meredith & Graw Inc. A similar search in London revealed a population of ten companies: DTZ, Jones Lang Lasalle, CB Hillier Parker, Lambert Smith Hampton, Healy Baker, Henderson, Prudential, Cushman and Wakefield, Coldwell Banker, and GVA Worldwide.

Probability sampling (DeVaus A., 1996) was selected because of its random sampling principle in a population and its effectiveness even in small population sizes (Lyberg L., and Kasprzyk D., 1991). Finally, representatives from four major brokerage companies in Boston (CB Richard Ellis, Spaulding & Slye, Prudential and Jones Lang Lasalle) and seven in London responded to the survey (DTZ, Jones Lang Lasalle, CB Hillier Parker, Lambert Smith Hampton, Healy Baker, Henderson, and Prudential). All these participating companies are among the most representative in terms of certified brokers and deals in each city, indicating that they are very knowledgeable about both the market as well as the best practices for a property transaction.

QUESTIONNAIRE DEVELOPMENT AND ADMINISTRATION

The questionnaire was designed to capture the views of real estate professionals working in traditional companies on how and if the use of Internet facilitates office market transactions.

An effort was made to formulate questions that were self-explanatory and would gather most data. The respondents' answers would allow the better understanding of what the companies believed to be the impact of the Internet on the real estate office market. Since close-ended questions could create a bias leading the respondent to answer in a specific way, a combination of closed and open-ended questions was utilized. The close-ended questions required from the respondents to select their answer based on a grading system (i.e., very significant, significant etc.). Respondents could also add other observations they thought significant.

The method chosen for the questionnaire administration was "face-to-face interviews" (DeVaus A., 1996; Lyberg L., and Kasprzyk D., 1991). However, some of the respondents requested additional time to consult with colleagues in their organization. Ultimately, for both Boston and London companies, the responses were a product of more than one person within the company.

The questionnaire consists of three conceptual areas based on 8 questions (Exhibit 1):

a) *Company information* (questions 1 and 2): such as name and year of establishment. The purpose is to identify the company's experience in the market.

b) *Information on the real estate transaction process and participants* (questions 3 through 6): such as grading participants in the transaction process based on their role significance, earnings, and time spent with and without the use of the Internet. In addition they aimed to measure the difference between transaction length with and without the Internet.

c) *The Impact of the Internet on the office market transaction steps* (questions 7 and 8): Identification of transaction steps conducted traditionally and using the Internet.

DATA ANALYSIS AND DISCUSSION

The effect of the Internet on REOM was evaluated through the surveys in Boston and London, which attempted to answer the following question: *How does the use of the Internet affect the role, time and earnings of the key participants involved in the transaction process?* The question is answered by testing the following two hypotheses:

H1: The Internet reduces the significance and earnings of the key participants involved in the transaction process.

H2: The Internet reduces the time spent by key participants on each transaction and also reduces the transaction process length.

The questionnaire's three conceptual areas are analyzed quantitatively (questions 3 through 6). Tables 1,2,4,5, and 6 were developed to agglomerate data from the answers to the questions. Qualitative data were derived from the transaction process steps defined by the respondents. The agglomeration of these steps with comments made by respondents on the use of Internet were used as a vehicle for answering the question, *"How can the Internet be used between searching for a property and its transaction?"* The transaction in the Internet era refers not only to the actual transaction, but also to the process of submitting a property for lease or sale online.

Boston survey

In the traditional market, the broker seems to be the most important "key" participant in the transaction process preceding the lawyer, whereas brokers using the Internet lose some of their power (see Table 1 for lease and sale properties). This occurs for a few reasons:

a) Consumers have the flexibility to search through the Internet for properties without consulting brokers until they identify a property that interests them.

b) The literature review acknowledges that Internet allows faster decision-making because of real time exchange of information by all the parties involved in the deal, possibly decreasing the broker's significance. In order to remain competitive, the Multiple Listing Service (MLS) portals are continuously evolving to offer better and quicker services to the lessees/buyers. Therefore, lessees/buyers are more easily empowered and aware of property market availability.

c) Part of the brokers' ability to identify property opportunities is replaced by the MLS.

The time spent by each of the "key" participants in the transaction process is also presented in Table 1. Comparing time spent on traditional and Internet transactions, respondents' answers show a decrease in time spent by the broker on lease properties' deals using the Internet. This can be caused by the quicker flow of information among parties on the Internet and the more standardized agreements compared to sales. For sales, however, the broker's time increased when using the Internet. One possibility is that clients are usually more demanding from their brokers because they use the Internet as a information-gathering resource and then request additional research from their broker, taking more time from them. Another possibility is that the sale of a property is a long-term investment and future owners, aware of the Internet, explore a number of investment opportunities with or without a broker, before they finalize their decision. Thus, the Internet informs the future buyer of multiple available investment opportunities, which he can simultaneously evaluate and bid on, increasing the time the broker needs to prepare with the counter party another proposal for the future owner.

In examining if the Internet reduces the earnings of "key" participants in the transaction process all the

Exhibit 1

SURVEY OF INTERNET'S IMPACT ON REAL ESTATE OFFICE MARKET

1) What is your company's name?

2) What year was your company established? (year)

3) Identify "key" participants ("key" is identified as i.e., broker, lawyer, mortgage company etc.) involved in office market transaction process and state their significance by the following point system:

1:very significant, 2: significant, 3: not significant 4: don't know

Traditional transaction (without Internet use)			***Internet Era Transaction (with Internet use)***		
Role	Lease	Sale	Role	Lease	Sale
Broker			Broker		
Lawyer			Lawyer		
Appraiser			Appraiser		
Mortgage comp.			Mortgage repr.		
			Web MLS		

4) What are the key participants' earnings in office market transaction process?

Traditional transaction (without Internet use)			***Internet Era Transaction (with Internet use)***		
Role	Lease	Sale	Role	Lease	Sale
Broker			Broker		
Lawyer			Lawyer		
Appraiser			Appraiser		
Mortgage comp.			Mortgage repr.		
			Web MLS		

5) What is the time spent by key participants involved in office market transaction process?

Traditional transaction (without Internet use)			***Internet Era Transaction (with Internet use)***		
Role	Lease	Sale	Role	Lease	Sale
Broker			Broker		
Lawyer			Lawyer		
Appraiser			Appraiser		
Mortgage comp.			Mortgage repr.		
			Web MLS		

6) What is the average transaction process length?

Traditional transaction (without Internet use)		***Internet Era Transaction (with Internet use)***	
Lease	*Sale*	*Lease*	*Sale*

7) Please identify all the transaction steps of a traditional office property transaction.

8) Please identify all the steps of an office property transaction carried out with the use of Internet.

participating respondents answered that the broker receives from 1-5% per deal no matter whether executed traditionally or via the Internet. Lawyers are paid hourly. Mortgage company fees are tied to the amount of the actual mortgage. The Web MLS usually has a monthly fee for participating brokers and thus does not add directly to the consumer's cost. Therefore, the use of the Internet can reduce costs only if the participants spend less time during the transaction process.

The Internet's impact on the mean length of the transaction process is presented in Table 2. For lease properties a reduction of 19 days[3] was found, which represents a 22%[4] reduction in time length. However, for sale properties the mean reduction is

15 days[ii] that is only a 10%[ii] reduction in time. The respondents also indicated a 25% decrease in the properties for lease transacted in 2 months or less. For sale properties the decrease is the same, but for properties transacted in 4 months or less.

The qualitative section of the survey questions 7 and 8 (Exhibit 1) identified 24 steps in a typical traditional lease transaction (Table 3). According to respondents, the use of the Internet cannot significantly reduce these steps. There are some exceptions, such as a "property walkthrough," where the Internet is used for "virtual tours." Other steps that might take less time are negotiations, lease reviews, and the construction overview. Using the Internet (i.e., email, chat rooms) participants can communicate immediately about changes, thereby decreasing the time involved in the decision process.

The Boston results validate the first hypothesis that the Internet reduces the significance of the key participants. However, they do not validate the second part of the hypothesis referring to the participants' earnings. The first part of the second hypothesis, reducing the time spent by key participants was validated with some exceptions, as was the second part of the question referring to reduced transaction length.

London survey

In the traditional market, the broker seems to be the most significant participant in the transaction process followed by the lawyer and the appraiser who are equally significant for lease and sales properties (Table 4). With the use of the Internet the broker shares the same significance with the Web MLS for lease and sales properties. Brokers and appraisers are the key participants whose power decreases with Internet use. The reasons for this are the same as in Boston. One additional reason is that the appraisers' work can be partially substituted via the Internet (i.e,. estimation of property values based on other properties listed online) as in the case of brokers, which is a significant difference compared to the U.S. market.

The time spent by each "key" participant involved in the transaction process is also presented in Table 4. Appraisers' time decreases but brokers' increases by 1%. The impact on appraisers is more significant because they are estimating property values. The Internet provides information about comparable properties for free, with the click of a mouse and without involving an appraiser requiring a fee. On the other hand, the broker's time appears to increase by 1% possibly because they must be aware of the continuous information flow available from the Internet.

The respondents' answers whether the use of the Internet reduces the earnings of key participants in the transaction process is presented in Table 5. Among these participants the brokers' and appraisers' earnings decrease by 2.5% and 0.25%, respectively, when they use the Internet. Clients are now aware of more resources available to them and the broker, making them more demanding and in less time. In general, Internet use reduces earnings only for those participants who spend less time on the transaction process. In addition, the Web MLS usually has a monthly fee for the participating brokers, which does not add to the consumer cost directly.

Internet's impact on the mean transaction process length is presented in Table 6. For lease properties a reduction of 20 days[iii] is found, which represents

Table 1. Key participants' role in an office property transaction in Boston

Participants	*Significance of involvement*				*Time spent*			
	Traditional process		Internet era process		Traditional process		Internet era process	
	Lease	Sale	Lease	Sale	Lease	Sale	Lease	Sale
Broker	43%	30%	37%	24%	37%	36%	35%	39%
Appraiser	14%	20%	13%	17%	25%	29%	21%	25%
Lawyer	29%	30%	24%	25%	13%	21%	17%	20%
Mortgage comp.	14%	20%	13%	17%	25%	14%	24%	13%
Web MLS	-	-	13%	17%	-	-	3%	3%

a 39%[10] time length reduction. For sale properties the mean reduction is 18 days,[8] only a 23%[9] reduction. It also appears that Internet use reduces by 14% the transaction time for lease properties transacted in 1 month or less. For sale properties the decrease is the same, but for properties transacted in 2.5 months or less.

Table 2. Transaction process time (months) in Boston

Months	***Traditional process***		***Internet era process***	
	Lease	Sale	Lease	Sale
1	-	-	25%	-
2	50%	-	50%	-
3.5	25%	-	-	-
4	25%	25%	25%	50%
4.5	-	25%	-	25%
6	-	50%	-	25%

In terms of the qualitative part, questions 7 and 8 (Exhibit 1—Table 7), some comments are presented based on respondents' answers. Parts of the transaction process are facilitated via the Internet allowing a small but not significant decrease in the length of the process. The respondents indicated that the actual transaction steps are not reduced. However, they use the Internet for e-mail, quicker communication between parties and setting up password-protected chat rooms on the brokerage company's network or on other mutually agreed Web site (extranets). These techniques allow discussion and viewing plans, etc., achieving transparency or monitoring of information between participating members.

Table 3. Traditional transaction process steps for lease properties in Boston

1. Client contact	9. Initial space fit plans	17. Negotiate lease
2. Client pitch to get hired	10. Counter proposals	18. Finalize pricing for tenant work, pick general contractor
3. Client retained	11. Final choice	19. Sign lease
4. Prepare survey	12. Final negotiations	20. Oversee construction (some cases)
5. Property tours	13. Letter of intent	21. Coordinate move (some cases)
6. Request for proposal	14. Detailed space planning begins	22. Punch list (some cases)
7. Evaluate proposals	15. Draft lease review	23. Furniture installation (some cases)
8. Determine finalists	16. Pricing of plans for tenant construction	24. Move (some cases)

Source: CB Richard Ellis brokers

Combining the results of the London survey the same hypotheses as in Boston were validated. That is, respondents said the Internet reduces the significance of the key participants, but not their earnings. Their time consumed is reduced with one exception, and the transaction length is also reduced.

CONCLUSIONS

This study surveyed views of real estate professionals on the Internet's impact on the Real Estate Office Market (REOM) in Boston and London. Although the survey was conducted among various real estate professionals and not only brokers, the participating companies were brokerage and investment firms, which might have influenced the brokers' self-importance.

The results for both cities indicated more commonalties than differences in the Internet's impact on the REOM. The Internet affects the roles of the transaction participants, especially brokers in both cities and appraisers in London. It is forcing participants to redefine their roles, from information providers to strategists for risk reduction, towards a more knowledgeable audience, thus leading to a transformation of the real estate business to remain competitive. However, participants indicate that the Internet's impact on their earnings is currently not substantial and there is no actual reduction in the number of steps in the transaction process or the time they consume closing a deal. The use of Internet in the length of the transaction process indicates a mean reduction by 22% for lease properties and 10% for sale properties in Boston. Similarly, in London the Internet use reduced the length of the transaction process for lease properties by 39% and for sale properties by 23%. The

Table 4. Key participants' role in an office property transaction in London

Participants	***Significance of involvement***				***Time spent***			
	Traditional process		Internet era process		Traditional process		Internet era process	
	Lease	Sale	Lease	Sale	Lease	Sale	Lease	Sale
Broker	50%	50%	33%	33%	33%	33%	34%	34%
Appraiser	25%	25%	17%	17%	50%	50%	33%	33%
Lawyer	25%	25%	17%	17%	17%	17%	11%	11%
Mortgage comp.	-		-	-	-		-	-
Web MLS	-		33%	33%	-		22%	22%

Table 5. Earnings of transaction process participants in London

Participants	***Traditional transaction***		***Transaction with Internet use***	
	Leases	Sales	Leases	Sales
Broker	5-10%	1-5%	7.5%	1.5%
Lawyer	3-4%	0.5-1%	3-4%	0.5-1%
Appraiser	.25-0.5%	.25-0.5%	.25-0.5%	.25%
Mortgage company		1%		1%

Table 6. Transaction process time (months) in London

Months	***Traditional process***		***Internet era process***	
	Lease	Sale	Lease	Sale
Less than 1	-	-	40%	-
1	66%	-	40%	-
Less than 2	-	-	-	20%
2	-	34%	20%	60%
2.5	-	33%	-	20%
3	17%	-	-	-
3.5	17%	33%	-	-

Table 7. Traditional transaction process steps for lease properties in London

1.Client contact	8. Terms of bidding
2. Confirmation of instructions	9. Bidding
3. Agree fees	10. Choosing selected party
4. Due diligence/understanding the product	11. Instructing solicitors
5. Market research	12. Reviewing agreement terms
6. Marketing material preparation	13. Exchange contracts
7. Viewing/inspection	

reduction in the total time length, which seems to contradict the limited reduction in the time spent by the key participants, is due to quicker decisions made by the owners and space seekers as well as the quicker dissemination of information among participating parties.

The Internet is currently used in the REOM as a listing service (i.e., loopnet etc.), a rapid information-gathering medium (i.e., area/city information for investment opportunities & risk assessment) and a communication tool among deal participants (i.e., email, extranet etc.). The next step has been already taken with the effort to develop an online transaction platform. Although consortia (Octane, Constellation) have tried to introduce such a platform they have not been yet successful and brokerage companies seem reluctant to adopt them. One main reason is that office property transactions cannot be easily standardized because most deals are unique with different clauses and cannot be described by one simple format. However, the effort made to develop an online transaction platform indicates the willingness to utilize also the Internet to facilitate quicker and easier real estate transactions in the future similar to e-retail.

The results indicate that the Internet may enhance the transaction process transparency among participants with the use of a common online platform. However, this can not be accomplished if participants' such as brokers, lawyers, and appraisers income is threatened.

Appendix

Boston's mean traditional transaction process for lease properties is: $3.5*0.25+4*0.25+2*0.5=2.87$ months or approximately 86 days. The mean transaction process using the Internet is: $1*0.25+2*0.5+4*0.25=2.25$ months or 67.5 days. Therefore, the mean weighted transaction time of properties for lease is 0.62 months or about 19 days. The mean reduction of the property transaction time length is: 19/86.2=22%.

Boston's mean traditional transaction process for sale properties is $6*0.5+4*0.25+4.5*0.25=5.12$ months or approximately 154 days. The mean transaction process using the Internet is: $6*0.25+4.5*0.25+4*0.5=4.62$ months or 139 days. Therefore, the mean weighted transaction time of properties for sale is 0.5 months or 15 days. The mean reduction of the property transaction time length is. 15/154=10%.

London's mean traditional transaction process for lease properties is: $3*0.17+3.5*0.17+1*0.66=1.76$ months or approximately 53 days. The mean transaction process using the Internet is: $1*0.4+2*0.2+0.7*0.4=1.08$ months or approximately 32 days. Therefore, the mean weighted transaction time of properties for lease is 0.68 months or about 20 days. The mean reduction of the property transaction time length is: 20.5/52.8=39%.

London's mean traditional transaction process for sale properties is: $2*0.34+2.5*0.33+3.5*0.33=2.66$ months or approximately 80 days. The mean transaction process using the Internet is: $1.8*0.2+2*0.6+2.5*0.2=2.06$ months or approximately 62 days. Therefore, the mean weighted transaction time of properties for sale is 0.6 months or 18 days. The mean reduction of the property transaction time length is: 18/79.8=23%.

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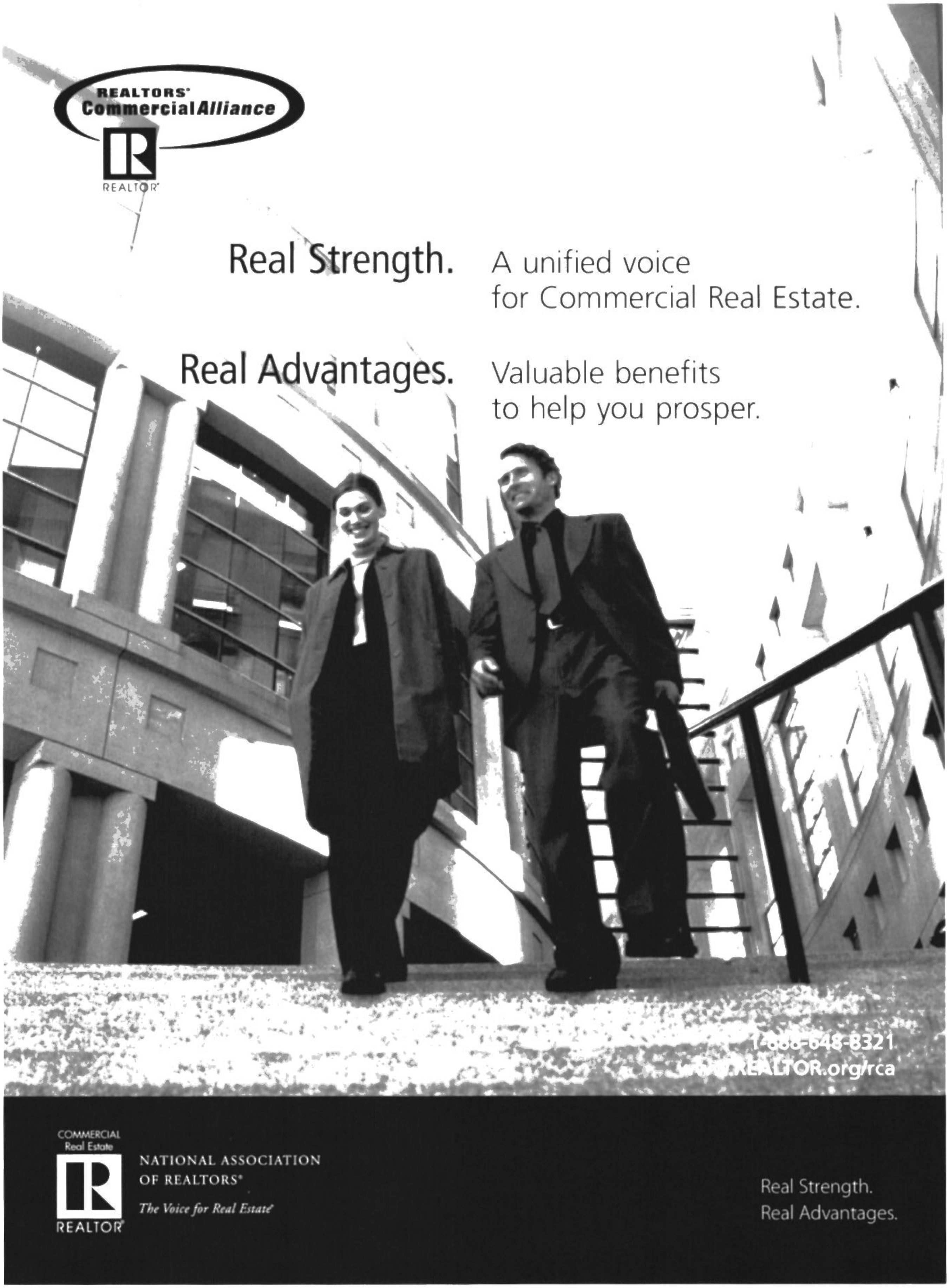
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