PREMISES
NYUSCHACK Institute of Real Estate

Building for New York’s Future: What We Have and What We Need

Also in This Issue:
Mitigating Construction and Development Risk
The Federal Civilian Property Realignment Act
Making Sense of the Eurozone Crisis
# NYUSCHACK
*Institute of Real Estate*

## SAVE THE DATE FOR OUR UPCOMING EVENTS

### SPRING 2012

**Thursday, April 19th**

17th Annual REIT Symposium

The Pierre Hotel, Grand Ballroom
8:00 AM – 4:00 PM
scps.nyu.edu/reit

### FALL 2012

**Thursday, October 11**

42nd Annual Urban Leadership Dinner
Honoring Mitchell E. Rudin
Brookfield Office Properties

The Waldorf=Astoria, Grand Ballroom
6:30 PM – 9:00 PM
scps.nyu.edu/urbanleadership

**Wednesday, November 7**

45th Annual Conference on Capital Markets in Real Estate

The Waldorf=Astoria, Grand Ballroom
8:30 AM – 3:00 PM
scps.nyu.edu/capital
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Welcome from the Divisional Dean

In this third edition of Premises, the signature publication of NYU Schack Institute of Real Estate, our articles draw together a representation of authors from the faculty at NYU Schack, from our students, our distinguished alumni, and from leaders in the industry in New York City and its metropolitan area.

To me, this representation reflects the daily experience of the almost 800 graduate students during this academic year in our three Masters programs—Real Estate, Real Estate Development, and Construction Management—of their exposure to leaders in the real estate industry, to alumni of the school, and of course, to their faculty. We limit the size of our graduate classes so that the students benefit from a direct relationship with their professors. Our adjunct professors are working professionals in the real estate industry, experts in specific aspects of real estate such as finance, investment, development, construction, real estate law, or public policy.

In their senior thesis or “capstone” course, which all of our graduating students take as their final course of the curriculum, our students have the opportunity to bring to fruition their entire course of study. This could involve creating new ideas for a development project where they can demonstrate their understanding of market conditions and feasibility; or analyze the details of a complex financing; or evaluate the design and planning criteria required to make a sustainable project successful. In many cases, these experiences bring our students in close contact with the neighborhood under study, making them aware of how a development would fit within a community.

Our students also have the opportunity to attend and hear firsthand the leaders of the real estate industry who speak at the three major conferences we organize each year—Capital Markets in November, Sustainability in February, and the REIT (Real Estate Investment Trust) conference in April. Confirming the strong link with the real estate industry, this year’s Career Fair was attended by 60 firms, a harbinger of the economic recovery underway in the city. Representatives from industry stalwarts like BlackRock, Silverstein Properties, JP Morgan Chase, Met Life, Goldman Sachs, STV, and Young Woo & Associates were among those meeting our students at the Career Fair.

In this global city of New York and in an industry—real estate—that has gone global in these past three decades, more than 10 percent of our student body now come from countries outside the United States, a trend that is increasing. Additionally, our students are branching out to other countries to see and study the range of real estate development, meeting with real estate experts in the host cities. In this academic year, students traveled to Hong Kong for MIPIM Asia, (see the report in this issue by Nordee Saritvanich); to Mumbai for a weeklong study session of a major urban development project in its initial planning stage; to MIPIM Cannes in France and on to an introductory visit to the graduate program in real estate at Bocconi University in Milan; to Sao Paolo and Rio de Janiero in Brazil during spring break to view both residential and commercial developments in these major cities; and to Haiti to continue participation in reconstruction efforts following the major earthquake of 2010. In June we plan to send our students in the Green Building course to London to study the special types of sustainable construction used in building the facilities for this year’s Summer Olympics.

In May of this year we will welcome back the graduate students of the University of Amsterdam Real Estate School for a weeklong series of lectures and visits to new projects underway in New York. International attendees now participate in the 26 weeklong intensive courses offered by our large Continuing Education program, which also serves industry professionals throughout the city and metro area with a wide range of career enhancement and certificate programs.

All of this global exposure heightens the knowledge of our graduates as they seek careers in New York, elsewhere in the United States, or in other countries. International firms play a significant role in New York City real estate, of course, not only in the acquisition and management of major commercial buildings, but increasingly as investors and developers of major projects. New York’s leadership in much of this activity is highlighted in Mary Ann Tighe’s perceptive article.

Our graduates, now numbering over 2,500, remain closely attached to the school, and those in the New York area
remain actively involved with our students, speaking at career seminars, holding networking receptions, mentoring students, and sponsoring a featured event, “Monopoly Night.” The most recent of these annual events was held in September 2011 at the Central Park Zoo, attended by over 600 alumni, students, and leaders in the field who gathered under the stars to meet and network (and, for entertainment, to watch the nightly feeding routine of the resident sea lions). As one of our students observes, “Monopoly Night is a fantastic networking event; it gives a sense of the scale and depth of our program, of how far it reaches into the real estate industry in New York. One of my professors who attended guided me around to introduce me to several leaders of the industry.” Students report that the opportunity to build relationships with their peers is also a vital part of the Schack experience. “These are the people we will want to know throughout the rest of our careers.”

Looking forward, NYU Schack will honor Mitchell E. Rudin of Brookfield Office Properties at our Urban Leadership Dinner in October, always an impressive gathering of industry leaders. We watch with optimism as the economic recovery from this painful recession takes firmer hold in the New York area. Speaking at a recent panel sponsored by our Construction Management faculty, industry experts find increasing evidence for a rebound in building activity in these next two years. They note that with strengthening prices in multifamily rentals and sales, more construction of apartment buildings will follow, and that the reduction in costs of construction combined with growth in jobs will spur demand for new office buildings. These are all good signs as our NYU Schack graduates of 2012 take their well-earned credentials into the job market.

Rosemary Scanlon
Divisional Dean
NYU Schack Institute of Real Estate
Events and Programs at NYU Schack Institute

The calendar at NYU Schack Institute displays an active schedule throughout the year. The procession of events and programs teaches its own lessons about the Institute. Like real estate itself, we address virtually every imaginable scale. These begin with classroom-based programs, such as the Silverstein Lectures moderated by former Dean Kenneth Patton, and special presentations from our Center for the Sustainable Environment, such as the one on corporate facilities offered in February with Louise Matthews of Avon Products and Geraldine Szabo of JPMorgan Chase as guest speakers.

Larger scale events are hosted at the NYU Kimmel Center at Washington Square. In September, we convened this year’s New York-London dialogue, focused on maintaining competitiveness for these two great global centers. Speakers included financier Peter J. Solomon, NY Deputy Mayor Robert Steele, Chair of the Board of London Dame Judith Mayhew Jonas, and Hon. Marisa Lago, Assistant Secretary for International Affairs of the U.S. Treasury. In February, the Conference on Sustainable Real Estate drew hundreds of industry professionals, government officials, and academics. Topics addressed by panelists included the growing significance of energy performance and carbon emissions in real estate investments as well as the importance of data and information in scaling up energy-efficiency initiatives.

Then, of course, there are the Institute’s signature conferences: the Capital Markets Conference held in the Fall and the Real Estate Investment Trust Symposium in the Spring. These draw national and international attendees and are so large, they go off site to venues like the Grand Ballrooms of the Waldorf=Astoria and Hotel Pierre.

Always, the events reflect the NYU Schack Institute’s key position at the intersection of the...
fast-evolving real estate industry’s experience and the applied research leaders need to guide their judgments and decisions. All are open to students, who gain valuable insights as they listen to those leaders grapple with the day’s issues, the economy, and market conditions.

Students also find themselves able to experience the increased globalization of real estate. The Kimmel Center hosted a morning-long session titled “The Future of Latin American Markets” last October. During the past year, small groups of NYU Schack students have traveled with faculty to India, Hong Kong, Brazil, France, Italy, and other destinations to see worldwide development and gain knowledge from local experts.

Over all, our intention is to promote open-mindedness, high-quality analysis, information exchange, and forward thinking about real estate development and investment in the context of the economic, social, and environmental needs within which business must operate.
Building for New York’s Future:
What We Have and
What We Need

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e can’t consider real estate’s place in New York City without considering New York City’s place in the world. Let’s start with things that can’t be disputed: There’s been broad globalization of the economy. The marketplace for the best ideas, the smartest capital, the most valuable customers, and the top talent knows no geographic boundaries. And global business gravitates to locations with essential elements of success. What are those?

First is workforce. In the coming decades, the winning companies—and winning economies—will increasingly be defined by how well they attract and retain the best talent. The challenge here is a looming paucity of human capital. The war for talent is fierce, and growing, due to aging populations and slowing birth rates. At the same time, Millennials are entering the workforce. More so than earlier generations, Millennials will seek their professional bliss with little regard for geographic and organizational boundaries. They’ll go where the best opportunities intersect with their passions. Theirs will be, literally, a world of opportunity.

Providing an attractive environment for these gifted professionals is critical. Where do they want to live, build their careers, raise their families, and invest in their futures? Global powerhouses—New York and London most prominent among them—are increasingly being challenged by places like San Francisco and Stockholm in terms of quality of life. What these latter cities may lack in economic dominance, they make up for in terms of attracting intellectual capital seeking innovation and opportunity. And the evolution of emerging economies has put cities from Shanghai to Dubai on the short list of top locations.

Ease of conducting business matters, too, and companies seek to operate in a way that strikes a balance between the
structure and security of rule of law, and flexibility that encourages the flow of ideas and capital. The U.S. remains one of the most politically stable and appealing countries in the world, making us a magnet for capital investment from Europe and Asia. These qualities are the foundation of our nation’s prosperity. Entrepreneurial drive functions best in an economic climate that respects rules and rewards creativity, and this is an essential balance for business.

Finally, there needs to be a density of both people and capital. Innovation and enterprise benefit when the best minds jostle against one another to collaborate and compete. By the same token, capital, too, needs to flow from a multitude of sources. New York has these in abundance: The five largest investment banks in the world are based in New York, as are nine of the world’s 18 largest hedge funds and five of the 10 largest private-equity firms.

A Roster of Strengths; a Lineup of Challenges

These are the elements of success in the 21st century, and when considering New York’s place in the world, there’s good news.

First, we’re the banner carrier for America in the world—the only U.S. city with the scale and capital resources to stand among global markets. The fortunes of New York have long been the bellwether for the entire U.S., and we’ve been a leader and model for the rest of the country on many fronts. New York was the first large city to adopt a zoning resolution, nearly a century ago, promoting public health and safety, and providing a balance between rules and structure, and entrepreneurial spirit. Later, the competition to build the world’s tallest building made us the city for all to admire and emulate. And, more recently, our creative drive and flexible zoning enabled us to transition from an industrial to a service economy more smoothly than many other cities.

Second, New York’s openness to people and ideas goes all the way back to the Dutch, and our City’s 8.2 million citizens today represent the world’s most dynamic and diverse population. Our job and population density are about four times that of the next-largest U.S. city. Our $1.3 trillion regional economy is second in the world only to Tokyo. And we remain a beacon for aspiration around the globe. In the Queens neighborhood of Jackson Heights alone, immigrants comprise more than 65 percent of the population.

Third, our City embraces excellence in every conceivable form. We’re home to more leading academic, medical, and research institutions than any other city in the U.S. And we’re getting better at converting our intellectual capital and research discoveries into business opportunities. On this point, New York is keen to challenge the likes of Boston and the Bay Area, particularly in the bioscience and tech sectors, as evidenced most recently by the selection of Cornell University and Technion to develop a new science and engineering campus on Roosevelt Island. At the same time, with many of New York’s key industries—financial services, media, and advertising among them—moving decisively into the online and mobile world, we’re growing as a leader in tech innovation.

These are some of our advantages, and we need only look to how well New York fared during the recent global economic downturn for evidence of our inherent strengths. But we cannot rest. Our competition is the world, and we need to address the issues impeding us in the 21st century.

First, our built environment—the mixed-use, mixed-income, transit-based cityscape that is New York City today—needs to be worthy of our global position.
The MTA system is the lifeblood of our region. But it’s old; really old. The technology we’re using to move 8.5 million riders every day, 24-7, dates back to the 1930s. At the same time, the system hasn’t kept pace with ridership growth, particularly outside of Manhattan. Many of the young professionals in New York today are living in the outer boroughs. That’s also where the middle class and families have been migrating. But the average commute time for places like Astoria, Greenpoint, Midwood, and Forest Hills is depressingly high. The frequency of subway service hasn’t gotten any better, and bus service has only been cut in recent years.

We need to reinvest, but we need to be smart about it. Exhibit A: The proposed No. 7 subway extension to Secaucus, NJ, gives us the same capacity of the shelved trans-Hudson ARC project, but for half the cost—connecting Midtown and even Long Island City directly to the New Jersey commuter shed, and facilitating economic growth in a fiscally responsible manner.

We need also look to the skies. In a ranking of the world’s 10 worst airport terminals, JFK’s Terminal 3 landed the top spot, with LaGuardia and Newark Liberty terminals not far behind. Consider the impressions of those arriving from gateway cities in Europe and Asia. But that’s just part of it. Our airports rank as the three worst in the country for flight delays, and they’re spoiling the ride for many others: 60 percent of delays nationwide trace their origins to one of our airports. True, we’re seeing movement to create new terminals at LaGuardia and Newark, and improvements at JFK are underway. Still, we need long-term solutions. There’s been talk of turning Stewart Airport into a new passenger hub. Let there be no doubt that, absent significant additional infrastructure providing high-speed and convenient connectivity to our City’s core, Stewart is not the answer to New York’s air-passerger-traffic woes.

It’s not just our infrastructure that’s creaky. Our office stock is old compared to most global cities. We’re the largest office market in the world, with 389 million square feet in Manhattan alone. Today, the average age of those buildings is 72 years. Shanghai’s office stock’s average age is 10 years. Hong Kong’s is 20. Singapore’s is 23. Even London’s is 60. And our City’s pace of building has slowed. In each of the decades of the 1960s, ’70s, and ’80s, New York added an average of 58 million square feet to its office inventory. In the 1990s, 9 million square feet was added, and in the first decade of the 21st century, just 22 million square feet was completed.

Make no mistake about the urgency of this. In 2001, Senator Schumer’s Group of 35 report found the City would need 60 million square feet of new office space by 2020 to keep pace with then-expected job growth. Yes, those 300,000 jobs aren’t materializing on the timetable expected, but the most we can hope for in new office stock, given what’s on the drawing boards now, is a total of 41 million square feet—and that includes everything built since 2000 plus a full build-out of the World Trade Center and Hudson Yards, as well as the various smaller efforts underway. That’s less than was built in the 1960s. And this doesn’t take into account the older office stock that is being subtracted from...
Grey executives attribute much of their agency’s renaissance—its buzzing hive of top-tier talent and activity—to their hip, and highly effective, new office space. 

the inventory by conversion to residential. For every 111 Eighth or 200 Fifth that has been repurposed by the likes of Google or Grey Group, there are numerous pre-World War II office properties that now provide much-needed housing.

New office space offers more than sustainability features, space efficiencies, and security advancements—all of which are now baseline considerations for tenants. The qualitative currency of modern office space is its ability to attract the top companies and talent, and help drive success. Consider Grey Group’s extraordinary space at the fully renovated 200 Fifth Avenue: Every year, industry bible Advertising Age publishes its “A-List” of the 10 hottest shops in the U.S. Grey made the list, and Grey executives attribute much of their agency’s renaissance—its buzzing hive of top-tier talent and activity—to their hip, and highly effective, new office space.

How Then to Revitalize Our Skyline?

New York’s prime office markets are the buildings of Midtown East. It isn’t an exaggeration to claim that two of the most valuable skyscrapers in the world are the GM and Seagram buildings. But the average age of a Midtown East office tower is 68 years, and every site is covered—due in no small part to the proximity of our City’s great transportation hub, Grand Central. No one is likely to tear down one of these properties and build a new one. Why? One reason is because the 1961 zoning resolution essentially downzoned Midtown East, making many of the pre-1961 structures overbuilt under current zoning. You can keep the existing floor area ratio (FAR) if 25 percent of the structural steel is saved, but then you’d end up with a compromised design, with slab heights and column spacing sacrificed so as not to lose valuable square footage.

Even many of the post-1961 Midtown East towers are tired. Today, the lowest rents in our central business district (CBD) are on Third Avenue from 59th to 42nd streets. The properties don’t match up with 21st-century tenant values. Yet who could afford to tear them down? To cut off cash flow for at least four years, only to rebuild a 21st-century version of the same square footage? Yes, rents would be exponentially higher and lease-up time likely swift. But the cost of that carry and the spike in real estate taxes that a new skyscraper must pay mean numbers on the teardown won’t compute.

The City is beginning to address the problems in the Midtown East market. Changes in zoning won’t produce immediate results, however. There are billions of dollars of office property here, and developers, investors, and lenders will proceed with caution should new Midtown East zoning become a reality. But, over time, Midtown would be reenergized by its 21st-century additions, visible testimony that New York isn’t resting on its 20th-century primacy.

Looking beyond Midtown East, we need to make new office construction more viable across the City. Currently, unless a skyscraper is built in an area with a special real estate tax program, like the World Trade Center or Hudson Yards, it’s impossible to know what taxes will be upon the tower’s completion. That means that investors and lenders can’t project returns with any reasonable certainty, and developers and tenants will forever argue over who assumes the risk on real estate taxes. Is it any surprise that only 19 percent of the office square footage built since 1990 included properties with “market rate” real estate taxes? And it’s no surprise that most of these were boutique buildings. The market is, in essence, saying that taxes north of 25-30 percent of rent are
New York is, has always been, the city of aspiration, the city that accepts all comers and demands energy and ambition from its people.

too big a gamble when added to all the other hurdles of new development.

Why not create a special tax program for new office construction? Is there a fear of losing revenue for the City? In the last 10 years, New York has become increasingly dependent on real estate taxes, which are the most stable and predictable source of tax revenue. Over that period, the City budget has grown 60 percent, while real estate taxes have grown more than 100 percent. Today, real estate taxes are just shy of 50 percent of total taxes collected.

But, counterintuitively, it is precisely by giving tax incentives and stimulating new development that we can grow our tax base. Look at the new New York Times Building: Before the Renzo Piano-designed tower went up, there were 10 buildings on the site, paying, in total, about $1.2 million a year in taxes. Three years later, the skyscraper complete, the taxes on the site were $13 million. The Times and Forest City would never have built the tower without a tax package, which is basically a 29-year predictable program of taxes, representing about 50 percent of market-rate taxes. Did the City lose money on this deal? On the contrary.

### Elevating the Quality of Life for Residents and Workers

Issue three: We need housing for our workforce. The City has 3.3 million units of housing: 1.4 million are rent-controlled or -stabilized; 1 million are owned; 765,000 are market-rate rentals. A sluggish economy has kept would-be buyers in the rental market; at the same time, a drop in new inventory is only adding to the competitiveness of the market. In fact, 2012 will see the fewest new rental units come online—about 2,200—since at least the middle of the last decade. Meanwhile, the overall Manhattan apartment rental-vacancy rate fell below 1 percent in 2011, while the average rent rose north of $3,300.

We need to rethink what it means to be “middle class” in New York: According to a 2009 study by the Center for an Urban Future, nearly 28 percent of New Yorkers are “severely cost-burdened” in terms of housing—meaning they pay more than half their monthly income for a place to live. An annual salary of $40,000 to $60,000 technically qualifies as middle class, but what does that actually buy? More and more, only the higher earners can afford our sharply rising housing costs, not to mention child care and other expenditures—and even they are feeling stretched.

As for affordable housing, the developers keep adding to the supply via the 80/20 program, but, when the affordability clock runs out on the 20 percent, those apartments go to market rate—they have to, since real estate taxes represent 35 percent of gross rents collected. Without permanently affordable housing—and less onerous taxes on rentals so owners can afford to preserve their affordability—the City is caught in a losing cycle. It seems that out of concern that a developer might be making money on his or her efforts, we’re pushing our workforce out of the City. Without reforming real property-tax structure, we’ll continue to develop housing that only a few people can afford.

### Making Ourselves a More Hospitable Place to Do Business

Let’s start with the congestion on our streets and the multigenerational failure to confront the reality of vehicles in New York. To function as a global city, people and things need to move around. Despite all we’ve heard about the information economy, businesses have become more object-intense, particularly those businesses in Manhattan’s core industries. Today, the financial services industry represents 26 percent of all occupied space in Manhattan, down from about 30 percent in 2005—that’s 4 million square feet of office space that’s increasingly being occupied by media, tech, law firms, etc., and all of those environments are filled with stuff. Getting it into our buildings imposes an imputed tax on business.
Every day, delivery companies—UPS, FedEx—receive an average of 7,000 parking tickets and, over the course of the year, pay more than $100 million in fines in New York—which they charge back to whoever is getting the package. And while the delivery trucks are double-parked, black cars circle the block, waiting for their pickups. Overall, congestion in the region costs us more than $13 billion a year and results in the loss of as many as 52,000 jobs annually, according to a study by the Partnership for New York City.

Something needs to change. Let’s bring loading off the streets and into buildings; and let’s get over our phobia of prudently placed curb cuts. For new buildings, that means encouraging off-street accommodations—for instance, by deducting the space for these public benefits from the floor area. For existing buildings, it means examining how to use the scarce resource of curb space so that deliveries can be accommodated in a less intrusive way. For black cars, we need to provide holding areas such as lay-by lanes.

Next, we know that New York’s success is grounded in—and depends on—innovation and fresh ideas. The entrepreneurial spirit of our workforce both forms our foundation and drives our future. And yet, when small businesses attempt to operate in our City, they are confronted with a seemingly endless string of bureaucratic hurdles. The arduous approval process required to set up shop here has become a tangle of red tape, with a barrage of reviews and inspections by a long list of City agencies that don’t seem to speak to each other. Time is money, and no one—least of all the City—will be profiting as long as our entrepreneurs are waiting in lines. We need to focus on making it easier, quicker, and more efficient for new businesses to open their doors and to conduct business once they are up and running. Thankfully, we’re making some progress here. In its initial rollout, Mayor Bloomberg and Speaker Quinn’s New Business Acceleration Team has helped more than 500 restaurants open an average of 72 days early—helping generate $9 million in additional tax revenue and $50 million in additional sales revenue.

Focus: The Return to New York from Human Capital Investment

I’ll conclude where I began, by looking at the challenges of human capital in the 21st century. At a time when businesses and governments around the world are seeking to gain advantage by attracting scientists, entrepreneurs, engineers, and other job creators, our own federal visa restrictions on foreign knowledge workers put us at risk of stifling innovation here. In recent years, immigrants have accounted for one-third of the doctorates—and nearly 60 percent of post-doctorates—in U.S. science and engineering programs. Locally, New York leads the nation in the number of international students overall in its colleges and universities. However, a decreasing percentage of immigrants are able to stay after they graduate. This is due to immigration obstacles here, and growing opportunities back home. As a result, we’re educating many of the world’s best and brightest talent—at our top universities—and then we’re showing them the door to take their skills elsewhere.

The three-year H-1B visa gives us an idea of the scale of this issue. There’s a national cap of 65,000 H-1B visas annually. These visa holders represent the kind of high-skilled, innovative talent that we need now more than ever: Five additional jobs are created for every H-1B visa, according to the Partnership for a New American Economy, and nearly one-quarter of successful high-tech start-ups were founded by immigrants in the past decade. New York benefits from keeping our doors open to global talent. Banks, financial services firms, tech companies, universities, and medical centers throughout the region employ 20 percent of the foreign professionals in the U.S. on H-1B visas. But we need to do more to make it easier for talented knowledge workers—so many of whom want to be here—to come here, and stay.

New York is, and has always been, the city of aspiration, the city that accepts all comers and demands energy and ambition from its people. We’ve long considered ourselves at the crossroads of the world. Whether in Times Square, Jackson Heights, Fordham Road, Lower Manhattan or Greenpoint, at the core of New York is a fiercely entrepreneurial drive—a passion not just for setting the pace, but also for changing it altogether. In this new century, crossroads are going to be harder to pin down. Our competition is global, and we need to leverage our advantages and address those issues that impede us. To remain a global leader, we must remain the place where talent congregates, collaborates, and creates—where infrastructure, buildings, business, and quality of life come together to catalyze aspiration.

Many neighborhoods in New York’s boroughs contribute to the City’s international character and 24-hour service profile.
Mitigating Construction and Development Risk

Since 1981, IVI International, Inc., a consultancy of engineers, architects, project managers, and accountants, has specialized in providing services that protect the interests of real estate investors, owners, and mortgagees. One sector of the company focuses on construction and development consulting, project management oversight (PMO), and owner representation services.

Mitigating construction risks is a client-driven business decision contingent upon such factors as risk-tolerance level, the source and amount of money at stake, time constraints, end-user commitments, confidence in the development team, market knowledge, financing availability and loan-to-value ratio, and the need to deploy funds. You may wonder: What are the best risk-mitigation practices for an institutional mortgagee or equity investor? How does a loan-risk officer reconcile the cost of due diligence with risks that fall into the category of low frequency but high severity—risks that may neither be cost effective to identify nor manage? Is there a practice that serves as a standard of care for due diligence? Let’s take a look.

Lending institutions generally exercise less PMO due diligence than those taking an equity-at-risk position. That’s because institutional mortgagees have to strive for balance between protecting their interests and recognizing that they are not in a first-loss position while being sensitive to PMO fees that impact their borrower. Equity investors, due to their lower risk tolerance, generally exercise greater due diligence and oversight. In fact, it has been IVI’s experience that an equity investor may have his consultant spend two to four times as much time on a project as a mortgagee.

There are two paradoxes with respect to the due diligence exercised by an institutional mortgagee. Smaller projects are inherently riskier than larger projects, but the level and fees of due diligence are usually much lower due to lower development costs. These projects are usually characterized by undercapitalized developers, limited designer-of-record post-design services, cost overruns, smaller contractors, quality issues, and untimely completion. We also find that smaller projects are most often completed by an owner/builder, and that the documents are not as transparent as those provided on larger projects. Generally, the risk is lower for larger-scope projects, which often have well-capitalized developers who employ a sophisticated team of designers, constructors, and attorneys. They are also more apt to use best practices with regard to construction scheduling, marketing, paperwork management, reporting, and cost control. Too, there is a high degree of transparency that provides both a comfort level to those with salient positions and an insight to initial problem areas that hopefully can be mitigated. Therefore, larger projects generally exercise greater due diligence commensurate with their larger development costs and the potential for larger losses, but not always. There are a few lending institutions that require the same level of monthly due diligence on a $200 million project as on a $2 million project.
The other paradox occurs when the real estate market is frothy with activity—more specifically, during a market cycle when there are too many cranes in the sky, construction financing is readily available, and cap rates are low. During this period, there is a tremendous impetus among construction lenders to offer a commitment based on incomplete construction documents and direct-cost budgets that are insufficiently bought out or secured by a general contractor. Time is often of the essence in order to avoid the loss of a potential market position. Unfortunately, the momentum of the market and the corresponding underwriting often masks the construction-side risks. On the other hand, the same upward-market momentum may either accommodate or absorb the construction issues that would otherwise jeopardize a project in a less vigorous market environment.

To avoid these pitfalls, language needs to be tailored to address the desired level of construction quality at the construction agreement drafting stage.

There is no recognized standard of care for such services. Many lending institutions have developed their own standards. However, some of these standards are often characterized by an unrealistic reallocation of risk to the consultant that is neither commensurate with the time allotted nor the resources expended.

**Best Practices in Risk Mitigation**

A robust level of risk mitigation begins with an evaluation of the development team support staff and representatives, designers, key construction personnel, and the construction delivery method that will be used with an eye toward determining the track records of the organizations and people involved. Any evaluation should also take into consideration whether the parties have experience working with each other, the asset type, and in the locale. Over the last 40 years, there have been projects with well-coordinated and complete drawings that have failed not because of design errors or insufficient budgeting, but rather as a result of inappropriate and inexperienced staff, sponsor-enacted scope and design changes, and inadequate cost-control procedures, bringing to mind a paraphrase of Tolstoy’s quote, “Successful projects are all alike; every unsuccessful project is unsuccessful in its own way.”

To avoid these pitfalls, language needs to be tailored to address the desired level of construction quality at the construction agreement drafting stage. At the same time, the amount of retainages and their release mechanism; construction-schedule milestones; construction fee and general condition disbursement mechanisms; procedures and pass-through language for stored material funding; change-order approval process; scope, schedule, and certification of anticipated cost reports; and final acceptance by pertinent parties should also be nailed down. If safeguards are not integrated at this stage, control and adherence to disclosure requirements shifts from mortgagees and investors to the developer or constructor. Keep in mind that no matter how complete the construction documents, the contract can diminish the developer’s control vis-à-vis the contractor. A skilled contractor and his attorney can strengthen the contractor’s position by crafting the document to shift risk to the developer.

On behalf of equity-participation clients, a “right-to-audit” clause, complete with clear language as to audit procedures, significantly enhances transparency and financial control. Many equity participants are now insisting that all costs, those that have been incurred prior to their involvement and those going forward, be audited throughout their investment hold. In the past, costs were only audited if a financial dispute arose, and then only if the agreement allowed it. Previously, auditing was usually triggered by cash calls on the equity party as a result of cost overruns and/or suspicions of misappropriation of funds in the event that the developer self-performed certain trades or had a controlling interest in a subcontractor used on the project. Today, construction-costs auditing is frequently used as a management tool. Once it is known that all costs are subject to monthly auditing, more diligence is exercised to guard against double invoicing, charging inappropriate payroll rates and labor burdens, missing credits for purchased tools and equipment, inappropriate personal expenses, and charges incurred on other projects.
Due Diligence Beyond the USA

With the exception of certain high-profile domestic assignments, IVI’s most interesting assignments have taken place abroad. Projects have ranged from conducting due diligence on an 11-property Kempinski Hotel portfolio in such diverse locations as Hanover and Pattaya to evaluating an acquisition in Varadero, Cuba, to consulting on an equity investment on behalf of an Italian private-equity firm to complete the construction of a hotel in Beirut.

Initially, the Beirut assignment seemed challenging due to its location, its perceived lack of a functioning and transparent legal system, and various cultural differences. However, reaching a comfort level with the development team, site, and construction systems, the differences proved insignificant. The drawings were detailed and coordinated as best practices would dictate in any Western project, and the delivery process was the same, with the exception of certain contractual laws and the absence of lien laws.

After reviewing the documents and listening to presentations by the developer, the design team, and the quantity surveyor, IVI advised the client against a $7 million Beirut hotel-equity transfusion. The construction risks were simply not commensurate with the client’s desired internal rate of return (IRR) lookback of 20 percent over a 10-year hold. The submitted cost-to-complete was insufficiently detailed with respect to furniture, fixtures, and equipment (FF&E); operating budgets were low; the capital expenditure (CapEx) reserve schedule submitted was neither thorough nor did it incorporate planned obsolescence; and some of the utility connections were lacking even though the seven-story building was topped out and 90 percent clad.

One of our more recent consulting assignments concerned a proposed Las Vegas-type resort/casino in Hungary. IVI represented the bond underwriter and would eventually work for the bond trustee. This assignment was notable because the developer and designers were based in Austria but the financing was coming largely from the U.S. What’s more, the entire site was subject to an unexploded ordinance (UXO) detection survey. As a result of the nationalities of the various parties involved, the documents were translated into three languages, which led to some delays and questions of interpretation. Part of IVI’s role was to help the U.S.-based financing group understand the construction risks and mitigation techniques peculiar to Hungary and to educate the developer and his team in the nuances of a U.S.-style bond financing transaction.

Another interesting aspect of the assignment: Hungarian law requires projects above a certain direct cost threshold to have the construction funds deposited into an escrow account that is held and disbursed by the government as the job progresses. This practice was established to protect the contractor from losses that could occur from a project failure not of its own making, and to provide a mechanism to prove funds in lieu of pursuing a litigation remedy. However, this system did not provide the comfort level sought by the bond investors, who prefer the U.S. approach of using a disbursement agent and a construction consultant like IVI to determine the amount of funds to be disbursed on an as-occurred basis. Eventually, we worked with our U.S.-based client and the Austria-based developer to modify the process to everyone’s satisfaction. We also educated the client on the Austrian approach of using a “bank guarantee” in lieu of bonding and large deposits—as much as 25 percent of the contract—to start the work.

IVI’s Varadero assignment consisted of identifying development conditions and other constraints that would pose a hurdle for future development or disposition of a 15-hectare Cuban beachfront parcel. Varadero, a popular beach and diving destination for Canadians and Western Europeans, is a high-security, 13-mile-long peninsula studded with about 50 full-service Caribbean-style resorts. At first, the price—$40 million per hectare for a 99-year lease—seemed reasonable. After renting a car from one of Havana’s only two car rental agencies and driving 90 miles east along the coast, our initial challenge was simply locating the site! Subsequent meetings with Cuban officials—who referred to the sale as “socialist property” instead of private property—were held to discuss vehicular access, utilities, easements, the development process, and the method for profit repatriation. (There is a common work-around for the latter, which typically consists of conducting a simultaneous closing outside of Cuba for the additional proceeds.) In the end, our client did not proceed with the transaction due to existing easement encumbrances.
Construction Quality

Construction quality control is another area that should be addressed. It is not uncommon for institutional mortgagees to overlook the role that designers can play in ensuring quality. All designers-of-record, as well as the architect, are usually appropriate choices to assure compliance with their design documents. Sometimes, this post-design role is curtailed by developers in the interest of reducing design fees or to prevent designer interference with developer-initiated changes. However, key language within a building loan or participation agreement can ensure designer involvement and the preparation of field reports to keep parties informed of defects or noncompliance issues with the drawings and specifications. On more complex assignments, it may also be appropriate to bring in specialty consultants, such as curtain-wall experts or geotechnical engineers, to better protect an investor's interests or for peace of mind. Should the space be pre-leased and subject to the lessee's acceptance, safeguards can be written in to require periodic acceptances of the work at certain phases of the construction or at build-out.

Bonding and Contingencies: Take Your Time

Bonding and establishing a contingency budget are the areas of construction-risk mitigation that take the most time to analyze and address. There is a great deal of misunderstanding as to what bonding will accomplish, what trades and entities require bonding, and the additional costs that will be borne by the developer as a consequence.

When initial discussions about bonding begin, the first question that needs to be addressed is whether the contractor is bondable. It is important to note that being bondable at the time the contract is executed does not ensure the contractor will be so during the project. A downturn in the economy and a few failed projects can affect the contractor's financial standing, which can in turn affect bonding. There is also the fallacy that, should a project not realize completion due to managerial issues or cost overruns, a surety will immediately take over and complete the project. This rarely happens. Sometimes, there is a two- to three-month analysis period while the project lags. During this time, the surety may find the developer or designer at fault, rather than the bonded contractor. For these reasons, the use of an adequate letter of credit, with its provisions to immediately access cash, is attractive—if it can be obtained in lieu of bonding.

Establishing an appropriate contingency budget is another misunderstood aspect of mitigating risk. The contingency is established for the unknowns that may occur. It is not established for known items that have a potential to occur. These can be mitigated by budgeting outside of the contingency. Many developers also misconstrue a contingency's purpose and use: It is not established to accommodate scope upgrades.

Clients often assume that there is a standard contingency percentage for various asset types and construction-delivery methods. However, many data points have to be considered when determining an appropriate contingency, including the developer and his team's experience; cost-control system and change-order-approval processes; the end user—governmental/public, private/corporate, speculative or build-to-suit—or home owner; the quality and completeness of the drawings and specifications; design attributes and the designer; the size and scope of the project; site conditions and logistics; the amount of the direct-cost budget under contract; the quality of the contract; the specific trades under contract; the amount of allowances; whether the project is ground-up construction or a gut renovation, etc.

All of these items and more go into the equation of determining an appropriate, albeit subjective, contingency percentage. The basic lesson is this: The more elements of risk that can be mitigated, the lower the contingency percentage needs to be.

Outlook

Based on our current assignment level and the inquiries we field on a daily basis from foreign and domestic investors, we are confident that an economic recovery is underway, and that it will continue provided there are no dramatic geopolitical events. However, given the extremely low yield on Treasuries and the corresponding low construction and acquisition financing rates, we suspect another wave of low-cap-rate investments along with a corresponding reduction in due diligence. With all the cycles that we have gone through since the mid-'70s, both mortgagees and investors seem to be immune to Santayana's admonishment, “Those who cannot remember the past are condemned to repeat it.”
AN UPDATE ON THE DISPOSITION OF FEDERAL REAL ESTATE:

The Civilian Property Realignment Act

Every two years, the U.S. Government Accountability Office (GAO) as part of its High-Risk Program reports to Congress major government-wide problems that are at a high risk for fraud, waste, and abuse of public funds and in need of broad reform. In January, 2003, GAO for the first time designated in its High-Risk Program the federal government’s inability to prudently manage and dispose of its massive domestic and international real estate portfolio. That portfolio in fiscal year 2009 consisted of 429,000 buildings, 40 million acres of raw land across all 50 states and territories, and 482,000 nonbuilding structures, including, for example, airfield runways, docks, piers, hydroelectric grids, dams, pumping stations, and monuments and memorials, among other types of structures. In addition to buildings, unimproved lands, and structures, the government’s property portfolio included 635 million square feet of leased space.

In the tristate area, the most recent data shows the federal government’s portfolio of 158.4 million square feet of space. In its High-Risk Program Report, GAO found underutilized and excess real estate assets no longer aligned with or responsive to the changing needs and missions of federal agencies. The Department of Veterans Affairs (VA), for example, shifted its core mission from traditional medical care to a network of outpatient services, leaving behind an inventory of deteriorating and functionally obsolete hospitals. Similarly, after the Cold War, the Department of Energy (DOE) no longer needed much of its real estate to produce nuclear weapons in support of the Manhattan Project and U.S. Atomic Energy Commission. Abandoned DOE sites were located in Maywood, Middlesex, and Wayne, New Jersey, and in Colonie, New York, with contaminated building surfaces and soil deposits showing low levels of uranium, radium, and thorium.

In February 2004, President George W. Bush signed Executive Order 13327, titled “Federal Asset Management Reform,” creating the Federal Real Property Council to assist federal agencies in the development and implementation of asset-management plans. The Federal Real Property Council defined underutilized real estate as properties being used by a federal agency at a percentage of space less than full-design capacity. Excess real estate was defined as functionally obsolete buildings no longer being used, and in many cases, properties that have been abandoned by a federal agency.

At any given time, opportunities for the private-sector acquisition of underutilized or excess federal property exist in almost all 50 states and territories. The types of properties for sale vary across all product sectors. In Sunset Park, Brooklyn, for example, the General Services Administration (GSA) identified as excess an eight-story, 1.1 million-square-foot warehouse built in 1916 for the Department of the Navy. The warehouse, referred to only as Federal Building Two, sat vacant since 2000 and was sold in 2011 to the New York City Economic Development Corporation (EDC) for $10 million. The EDC concurrently selected a private developer as part of a $35 million plan to refurbish the warehouse into an industrial center. GSA recently also identified an 800,000-square-foot warehouse in Binghamton, New York, and in Connecticut, GSA listed for sale a 51-foot,
Acquiring excess federal property is a three-step process: finding properties for sale on GSA's website, propertydisposal.gsa.gov, obtaining an Invitation for Bid, and ultimately bidding via public “live-outcry” auction, online auction, or by sealed bidding. The Invitation for Bid package includes the property location, property description, maps, and pictures; zoning regulations; environmental conditions; and general terms of sale, such as initial bid deposit and a minimum opening bid. Online auctions take place at realestatesales.gov or govsales.gov.

The Civilian Property Realignment Act

In early 2011, Congress revisited federal real estate asset-management reform as a means to reduce the national deficit and to curb wasteful spending to operate and maintain underutilized and excess federal real estate. Less than two years earlier, the Federal Real Property Council reported 45,190 federally owned and underutilized real estate assets at a cost to taxpayers of $1.6 billion in annual operating costs. Separately, 10,327 federally owned real estate assets were reported as excess with annual operating costs of $134 million. The Federal Real Property Council includes within annual operating expenses all recurring maintenance and repair costs; utility costs; cleaning and janitorial costs, such as pest control and garbage collection; and groundskeeping costs.

Congressional Republicans, with renewed vigor following midterm elections in November 2010, set out to shrink the federal government’s physical footprint. The culmination of this effort is a bill introduced in May 2011 by Congressman Jeff Denham (R-CA) known as the Civilian Property Realignment Act (CPRA). CPRA is modeled after the military’s Base Realignment and Closure (BRAC) Act of 1990. The Act’s purpose was for the Department of Defense to downsize its military facilities found obsolete after the Cold War. BRAC, now in its fifth round of base closures and realignments since being adopted, is expected to achieve approximately $10 billion in savings from fiscal year 2010 to fiscal year 2012. Almost half of those savings will come as result of reduced operating and maintenance costs.

The legislative intent behind CPRA is twofold: first, to reduce future spending on government real estate by consolidating and realigning underutilized and excess assets, and second, to dispose of high-value government properties so that net sales proceeds may be earmarked for deficit reduction. CPRA mandates that no less than 60 percent of all net sales proceeds generated from disposal actions shall be allocated to the general fund of the U.S. Treasury for purposes of driving down the deficit. The remaining sales proceeds shall be allocated to federal agencies for reimbursement for up-front costs to prepare a federal asset for sale, such as environmental remediation.

If adopted, CPRA will establish an independent nine-member commission. The commission's members, culled from the private and public sectors, are to be chosen by the president with the consent of the Senate based on experience in commercial redevelopment, government management, and community development. The commission’s function is to reduce the number of properties and unnecessary leasing arrangements in the federal real estate inventory. That process requires four steps. First, federal property-holding agencies shall identify and collect relevant property data for all underutilized and excess real estate owned, leased or controlled within their respective portfolios. Relevant property data includes property age and condition, gross and usable square footage, operating costs, history of capital expenditures, sustainability metrics, and the number of federal employees and functions housed in the respective property. Second, federal agencies shall submit property data for review to the Administrator of the

The U.S. Postal Service has lost $20 billion over the past four years, and is proposing to close 3,700 of its 32,000 facilities nationwide. Some 85 percent of all its facilities fail to cover their operating costs.
General Services Administration and to the Director of the Office of Management and Budget. Personnel from both agencies will review the property data and make recommendations to the independent commission guided by a set of criteria, including but not limited to:

- The extent to which a federal asset can produce the highest value and best return for taxpayers;
- The extent to which operating and maintenance costs are reduced; and
- The extent to which the utilization rate is consistent with private industry standards.24

The Department of State must also collect and submit property data for federally owned real estate located outside the United States under the control of the Office of Overseas Buildings.

Third, the independent commission conducts its own analysis of the government’s underutilized and excess real estate inventory. It develops final recommendations for property reductions for submission to the president. Property reductions may take the form of real estate consolidations, exchanges, reconstructions, lease reductions, sales, and redevelopments. The president may approve or disapprove of the commission’s recommendations within a 30-day timeframe and submit his approval to Congress.25

Lastly, Congress has 45 days from receipt of the president’s approval to enact a joint resolution disapproving of the commission’s recommendations. Congress may refer disapproved actions for debate and resolution to the Committee on Transportation and Infrastructure in the House or the Committee on the Environment and Public Works in the Senate. If Congress fails to pass a joint resolution, federal agencies must initiate property reductions and complete all actions within a six-year period.26

**CPRA’s Future, Maybe**

GAO stated in its 2003 High-Risk Program Report that to effectively reform the management of federal real estate, “a major departure from the traditional way of doing business is needed.”28 Whether CPRA represents a new paradigm in managing and disposing of federal real estate is very much open to debate. For investors and developers, passage of CPRA into law may mean an avalanche of valuable sales and acquisitions. In a depressed commercial real estate market, CPRA may represent the only opportunity for deal-makers. Federal properties in 24-hour gateway cities, much like the Old Post Office Building in Washington, D.C., may present intrinsic value for redevelopment.

On February 7, 2012, the General Services Administration selected the Trump Organization to redevelop the Old Post Office structure into a luxury hotel with over 250 rooms, restaurants, a spa, and conference facilities.

Past legislative attempts to reform the government’s property portfolio have for the most part failed. Between 2000 and 2005, six bills were introduced in Congress seeking to reform federal real estate in some capacity. None of those bills were enacted in their respective congressional sessions. The Federal Asset Management Reform Act, similar in nature to CPRA, was introduced in Congress three times without success; in the Senate in 2000 and in the House in 2002 and 2003.28 Whether CPRA shares the same fate is unknown at this time.

On February 7, 2012, CPRA passed in the House of Representatives with amendments by a roll call vote of 259 to 164. The bill gained the support of 238 Republicans and 21 Democrats.

On February 9th, CPRA was received in the Senate and read twice before being referred to the Senate Committee on Environment and Public Works.

This is a bill deserving the close attention of the real estate community and public policy interests alike. CPRA has the potential to make a significant impact on the commercial property markets, as well as the power to alter the economic profile of local communities across the country.
When looking at the broad economic landscape of the USA and Western Europe, several patterns, common to a certain degree, are starting to become apparent. We are witnessing the slowly emerging effects of over 30 years of deindustrialization and the shift towards a service-based industry, plus an accelerated transfer of skills and knowledge to the emerging economies, together with an aging population trend in most parts of the world.

If these were not enough, subtle yet long-lasting shifts are also occurring in the structure of our social organization. The feminist revolution opened the door to massive participation of women in the labor market, enlarging their horizon. The results are increasing levels of education for women and generally higher levels of wealth for the entire family (factors that we now know are negatively related to birth rates). One repercussion is a transformation of the social patterns leading to family formation. Additionally, we notice a larger dependence on international migration to replenish the labor force, with immigrants now expected to pay, through their current tax contributions, pensions to a general population with increasing life expectancy.

Accelerating Changes in the Developed and the Developing Economies

A defining feature of the developed economies is the steady increase in productivity across most of the sectors of the economy. The widespread use of technology in both manufacturing and services has risen to a level not witnessed before in economic history. For the first time we use only a very small fraction of the active labor force to produce basic necessities in the majority of developed economies. The tremendous delocalization of midsized and large manufacturing companies is redefining the global economy. Meanwhile, the changing requirements for space and location in the services sector, which is not simply taking over the space left vacant by the manufacturing sector, are altering the face of our urban areas. If we also factor in the fading American dream of a white-picket-fence spacious house away from the tumultuous city, we could be witnessing an epochal shift in the geography of our metropolitan areas. This urban rebirth may be accelerated by rising costs in home ownership, energy, and transportation.

The situation is of course different in the emerging economies. The aspirations and the path to growth they are taking are very similar to the ones the developed economies took historically. The ensuing race for resources hasn’t yet been translated in higher commodity and goods prices mainly thanks to the lower costs of manufacturing in the developing nations. Signs indicate that this era may soon be over.

Against this landscape one is able to distinguish since the late 1990s a frenzy of investment in technology-based industries. Such investment has added value mainly through the service sector but also injected considerable volatility into the economy. Thus, for example, we saw the dot-com euphoria and bust. The volatility spilled over from the service component to manufacturing companies. Combined with ever-increasing amounts of liquidity and decreasing standards of lending, this led to a flourishing real estate industry, which added too much space given the objective ability to pay of some of the consumers. One may be tempted to attribute today’s situation primarily to the excesses from the property market but the defining forces were the social and macro-
economic ones just discussed. Lax lending standards and overbuilding coincided unfortunately with the acceleration of the deindustrialization process and the replacement of human labor through technology. Real estate becomes a financial asset only after it fulfills its function as shelter, and shelter is needed only where the worker is able to trade his time and skills for the product of his undertaking. This picture may very well be recognized in the majority of the developed economies. Differences remain though, and those differences are crucial to understanding the impact of the European sovereign crisis on the U.S. real estate outlook.

What Happens When Credit Grows Faster than Productivity?

The fall of the Iron Curtain and of the East European communist regimes belonging to the Comecon allowed the European Union to expand eastwards into a region with highly skilled workers and a market long deprived of free enterprise. Geographical proximity and cultural affinity, together with the reorientation of these governments to market-based economies, permitted monetary capital to flow in and human capital to flow out.

Basically, the EU exported a good deal of its industry to the outskirts of the continent while the center attracted most of Europe’s intellectual and creative workers. The rapid transformation of the Central and Eastern European economies was sustained through flow of capital and financial innovation brought in by established Western European banks. In retrospect, financing growth primarily through western banks while designing export industries around the needs of western economies created a dangerous linkage.

Once the economies in the West faltered and risks in the peripheral sovereign debt became apparent, some of the large banks were planning to withdraw their capital from the East. The Vienna agreement fortunately prevented this up to a certain degree as this could have had very unfortunate repercussions. The Central and Eastern European (CEE) economies saw their GDP drop double digits due to shrinking exports (mainly to western EU countries), disappearing Foreign Direct Investment, and restrained credit from the classical banking sector. An initially harmless financial squeeze exploded into an economic crisis.

The geographical and economical expansion of the Union eastwards corresponded to an economic invigoration of southern Europe. This process, sadly, was accompanied only to a limited degree by additional measures that would increase competitiveness, encourage research, education and entrepreneurship, and reduce the reliance on direct foreign investment. These deficiencies were masked in the South by the adoption of a strong currency, the euro. The common currency allowed increased consumption in the South on the back of the productivity of the core economies such as Germany and France. There was, furthermore, a lack of real comparison of the viability of the peripheral economies against the ones in the core. The lack of reform in the labor markets of Spain, Italy, and Portugal allowed the more flexible market in Germany to keep real labor costs down while increasing exporting to the entire EU.

Real estate played a prominent role as well. If we speak of the explosive increases in asset prices in Ireland, the tremendous expansion in construction volume in Spain, or the 10-fold increase in land prices in some parts of Eastern Europe over a period of 15 years, real estate was at the heart of the boom. One illuminating case is the vast number of residential apartments initially purchased on credit in Spain by immigrants. These apartments were simply abandoned to the banks once no more work was available and return to their home countries was the only option left to the workers.

The Spanish regional banks specialized in mortgage lending have managed, up to now, to hold these assets well above their actual value, which will not be possible for much longer. The same is true also for French, Italian, and Austrian banks with vast exposures to nonperforming consumer and residential credit in CEE and for German and English banks holding assets of the above-mentioned banks and sovereign entities. This is a confluence of potentially dangerous developments. Taken alone, each would provoke some brief concerns; their convergence on the other hand may have far-reaching implications. Just like medication, it’s the mix and timing that can make the difference between a providential recovery and a painful seizure.

The Regulatory Straw Breaking the Back of the Refinancing Camel

The regulatory changes envisioned as a result of the 2008 crisis are meant to increase the capital cushion that institutional investors must hold and, if implemented in their current form, will lead to a complete transformation of the business model of many of the financial institutions operating in the market. These changes are encapsulated in the Basel III accord (see Box on p. 21) and in the Solvency II (see Box on p. 21) and are supposed to be implemented starting with 2014 with certain requirements having a grace period of 10 years.
**Basel III** is a set of recommendations of the Basel Committee on Banking Supervision aimed at creating a homogeneous international standard of banking regulation. The main focus is the calculation of the risk capital banks need to hold in order to withstand a financial crisis (a severe drop in asset prices, a sudden withdrawal of deposits, etc.). The amount of capital is computed based on the bank’s assets and liabilities, appraised at market value. The defining feature of the calculation is that the amount of risk a bank faces (due to either risk in assets or liabilities or both) is directly proportional to the capital buffer.

**Tier 1 Capital** is one component of the capital buffer. It is composed primarily of the bank’s equity and disclosed reserves.

**Solvency II** is an EU directive aimed at regulating the insurance industry across Europe. Like Basel III, its aim is to impose certain risk management practices that insure consumer protection through appropriate capital buffers. Should an insurance company default, the policy holders face tremendous losses. If enough capital buffer (computed quite similarly to the one for banks under Basel III) is available then the company may be taken over by another entity and the policy holders continue receiving their payments.

Solvency II features a fundamental shift in the risk-assessment philosophy: For the first time insurance companies will be required to hold an amount of risk-based capital computed using a short-term measure of investment risk (the one-year volatility of asset returns) and no longer based on the long-term liquidation value. Also important is the preference for shorter maturity assets and the lack of capital charges for any of the EU sovereign bonds (that’s right, 7 percent yield-to-maturity (YTM) Italian sovereign bonds are the same as 2 percent YTM German bonds. Real estate investment ends up with a 25 percent capital charge; a several-fold increase as compared to now. Many institutional investors have therefore scaled back their property investment or halted altogether any large portfolio acquisitions. The established view that property delivers a healthy inflation hedge to match liabilities will now also have to cover the opportunity cost of its capital charge.

Turning to Basel III, the new set of rules demands longer maturity financing while at the same time increasing the Tier 1 capital to 9 percent (from an average of 4 percent in Basel II). Up to now the insurance and pension plans matched their policies and pension payments using long-date bonds issued by banks without being subject to penalizing capital charges—this provided banks with the much needed financing they have to compete for in order to increase their Tier 1 capital and allows insurance companies to acquire assets matching their long-dated liabilities. McKinsey & Company estimates that by 2019 the new regulation will create a gap of 1.1 trillion euros in Tier 1 capital, 1.3 trillion in short-term liquidity, and about 2.3 trillion of long-term liquidity.

Understanding the interaction effects emerging from the concomitant implementation of the new rules is essential. One such effect is the implicit restriction placed by Solvency II on insurance companies to buy long-dated bonds while at the same time requesting banks to almost double the risk-based capital using long-dated financing sources. On top of this, property investment has been frozen by the expected 25 percent capital cushion. Some institutional investors may be expected to liquidate a good deal of their real estate holdings in the process of re-optimizing their portfolio allocation. This mix of medications may not be all that fortunate.

How about the timing? Figure 1 below shows it would be at the worst-possible time for the European commercial real estate industry with close to 800 billion euros in commercial property debt needing refinancing in the exact time frame when most of the new regulations should be put in place.

Figure 1: The debt maturity profile of European commercial real estate Industry (according to CB Richard Ellis)

Does the figure look familiar? It should, because we have a similar one for the U.S. commercial mortgages (see Figure 2 below). One may be tempted to think that the peak for the U.S. mortgage exposure was 2011, but many of these loans have had their conditions amended to allow the lender to build enough capital to absorb the actual losses in the

Figure 2: The debt maturity profile of the U.S. commercial real estate Industry (according to Morgan Stanley)
In retrospect, encouraging Western banks to operate in the developing Eastern countries while enhancing the export strength of their home markets created a dangerous linkage.

future. Only recently have we started observing transactions driven by liquidations. Beyond this, the debt markets need to accommodate the large volume of nonperforming residential loans.

**The D in CDS Stands for Domino**

Given the weak recent macroeconomic data of the Euro Area and the vast amount of refinancing amounts needed both by commercial and sovereign entities in the EU, the proposed regulatory updates simply act as a pro-cyclical accelerator reinforcing the downturn.

The actual quantitative specification of Solvency II may be expected to change or be postponed given some of the tenuous assumptions used in the Quantitative Impact Study (QIS5). Nevertheless the need for refinancing is still there in an environment with increasing rates and deteriorating credit quality. The biggest danger for the U.S. resides within the balance sheet of some of its largest banks. These institutions sold credit default swaps (CDSs) and took on the default risk of both commercial banks and sovereign governments in the EU. According to the Office for the Comptroller of the Currency (as of the beginning of 2010), CDSs represented 97.96 percent of the total credit derivatives sold by U.S. banks. The difficulty is not the tremendous concentration of CDSs but the percentage of total credit exposure to the risk-based capital. The five banks dominating the U.S. derivatives industry (amounting to well over $200 trillion) have an average of 300 percent credit exposure to risk-based capital, with some institutions reaching 800 percent. If everybody in the neighborhood is buying insurance against your home burning down, you might start to wonder if they really don’t want you there.

The Acropolis is burning now and neither the home owner nor the sellers of the insurance seem to have worried about the large number of neighbors buying insurance against this misfortune.

Assume Greece defaults and, as a consequence, one or more EU commercial banks run into trouble due to nonperforming commercial loans in the East and sovereign bonds in the South. The CDSs are (officially) triggered on both. Some of the U.S. banks may find themselves paying several times the nominal loss—a pretty uncomfortable thought given the amount of deleveraging and refinancing needed nowadays. These are several “ifs” to be satisfied at the same time, true, but recent history shows us that black swans like to fly in flocks.

**Epilogue**

In most of the EU we currently witness reluctance in purchasing property due to the regulatory uncertainty and motivations to sell given the portfolio balancing acts required by the same regulatory changes. There is also a potential sell pressure caused by the refinancing needs of the global financial institutions. These factors are slowly tilting the balance towards a potentially favorable market for buyers who might find some appealing deals as long as they themselves don’t have to rely on debt too much. The “fear factor” is still present in the day-to-day operation of the markets as we now hear the word “contagion” and its synonyms more often than during the bird flu years.

A Greek default, aside from the very poor macroeconomic constellation, opens the door to moral hazard for Portugal and Ireland as well (“If the Greeks got their debt cut in half, why shouldn’t we?”). The coming years will bring deleveraging in a faltering economy, and the core European nations are not at all as insulated as some believe. Thus primary markets are likely to be overbid whereas secondary and tertiary are going to carry a disproportionate macro and political risk premium, not only in Europe but also in the United States.

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**CDS** stands for credit default swap. It is an insurance that an investor can buy to protect against the chance of default. This type of product is may also be used as a speculation instrument, where one can take a position if he sees the chances of default higher than those implied by the market.

A CDS is triggered when a default occurs and the seller must pay the buyer the amount lost in default.

The CDS market is, by and large, unregulated. This means that a financial institution may sell as many CDSs as are demanded in the market, regardless of the amount of the outstanding debt.
EUROZONE DEBT CRISIS and FISCAL REFORM:

One Size Does Not Fit All

As skeptics predicted, the period of accelerated European integration that began with the Maastricht Treaty in 1993 has resulted in increased national tensions. Events now threaten sustainability of the European Union (EU) and its self-proclaimed triumph, the euro. The sovereign debt crisis has renewed fears that economic and monetary integration would create economic dislocations, as poorer, less-developed member states would divert resources away from wealthier, developed member states. For many years, critics questioned the sustainability of a monetary union across nation states at different stages of development, with diverging public finances. How can a single currency based on one monetary policy and 17 disparate fiscal policies succeed without effective political governance?

Originally, wealthier countries such as Germany and France with generous welfare states feared less-developed member states would attempt to attract or hold on to employment by competing for business investment with ever-lower taxes on capital assets, including property. Now, these fears are exacerbated by the specter of a credit contagion that, sparked by countries with poor fiscal discipline, could derail the entire Union.

In an unprecedented cession of national sovereignty meant to shore up the single currency, eurozone countries must now submit national budgets to Brussels and amend their constitutions or enact equivalent legislation to require balanced budgets. Countries exceeding debt and deficit limits must now agree to ambitious and binding austerity measures to be drawn up by the EU Commission. Still fighting to establish credibility since its inception 12 years ago, the European Central Bank (ECB) has argued that the eurozone must move toward a deeper coordination of fiscal policies.

However, the fiscal compact ratified by 25 of the 27 members in early 2012 is seen as just a first step to make the rules of budget discipline binding on all eurozone members. The next phase contemplated by Berlin would be more intrusive, including tax coordination or harmonization with budget supervision at the supranational level. As the Union’s largest creditor and principal financier of the European Stability Mechanism, Germany has been reluctant to increase the size of the 500 billion euro bailout fund in order to significantly lower borrowing costs and facilitate the introduction of Eurobonds. Germany would be willing to guarantee debts of its EU partners, but in exchange, insists upon a stronger political union to provide confidence that active participation in debt markets will produce long-term growth.

Austerity Policy Assumptions Are Questionable

Claims that that the EU cannot overcome disparities across member states rest on some very important assumptions, including the supposition that entrepreneurs care little about what other capital is present in areas under consideration for investment. In the EU, business investment has generally been concentrated in areas that have been wealthy for some time and are endowed with highly developed infrastructures, pooled markets of appropriate labor, and positive information spillovers that create cost-reducing economies.
of scale and scope for old and new firms alike. These positive pecuniary externalities, or agglomeration economies, increase investment returns and demonstrate the key role of geography in economic development. Decreasing unit costs and increasing productivity of a wide array of economic activities, agglomeration creates location values and argues for spatial concentration in business investment.

Within limits, governments can attract and hold on to investment even while imposing higher tax burdens because location benefits may exceed the improvements to be gained through mobility. If Chancellor Merkel is to convince the Bundestag to pay for eurozone rescue plans, she needs a persuasive narrative for her skeptical supporters at home. A persuasive and accurate narrative that demonstrates the role economic geography plays in supporting healthy public finances would provide valuable insight. This could serve as a guide to how the Union might look in 10 years if reforms made now are based on accurate insight and actual experience.

**Don’t Dismiss the Lessons of Experience**

EU experience demonstrates that investment concentration increases with the development of positive pecuniary externalities and that tax revenues increase in proportion to these externalities. For example, the geographic concentration of financial services in London provides companies operating there with an average cost savings of 17 percent, which significantly offsets relatively high capital income taxes in the UK. In the less affluent eurozone members, experience shows that as they developed, so did their capacities for taxation in general and corporate taxation in particular. A near doubling of total tax burdens in the periphery countries from 20 percent in 1975 to 36 percent in 2007 increased average tax burdens for both regions from 33 percent in 1975 to 37 percent in 2007. This means that the tax gap between the two regions narrowed considerably before the global credit crisis unfolded as shown in Figure 1.

Even during the crisis, the gap remained considerably lower than when the periphery joined the euro. Corporate taxation nearly quadrupled in the periphery countries from 1.1 percent in 1975 to as high as 4 percent before the debt crisis unfolded. Corporate tax burdens in the core countries increased, but
just by slightly more than a quarter over the same period. Consequently, as shown in Figure 2, the tax gap between the core and periphery narrowed and then actually reversed in 2000. In other words, the older, wealthier members have not subsidized the weaker economies at the expense of poor budgetary discipline in the periphery, now at the center of the crisis debate. Instead, regional tax gaps decreased or even reversed as economic geography created pooled markets of appropriate labor, local production of specialized inputs, and positive information spillovers similar to the core economies. Economic geography increased tax capacity for development of infrastructure and other locational advantages to attract and hold on to business investment without supranational budget controls or tax-setting.

Flexibility Is Not Inconsistent with Fiscal Discipline

Budgetary discipline is indeed necessary to launch a virtuous cycle of fiscal consolidation and growth and put an end to the unproductive cycle of austerity, deficits, and misguided structural reforms. However, EU experience demonstrates that new fiscal rules to curb government borrowing and spending should be flexible to allow periphery economies to continue building healthy public finances, knowing that as they develop, their public finances will look more like the older, established members. In fact, the rationale for institutional flexibility is equivalent to the rationale for economic efficiency. Tax and spending flexibility improves opportunities for economic and credit stability by permitting a diverse platform of alternate agglomeration economies to meet the global marketplace.

Thus, the issue of tax harmonization in the EU is inextricably linked to the challenges globalization poses for governance in the Union. Globalization has increased the importance of economic geography. The World Bank found that whereas technology may diminish the role of geography in activities such as telecommunications, it increases the role of economic geography as a source of economic efficiency and local competitiveness.

As globalization opens new possibilities, it also increases economic volatility and heightens competition among cities, countries, and regions.

In principle, the rules of the fiscal treaty would set uniform ceilings for national spending and borrowing but would not interfere with tax and spending choices. Belgium was recently nonetheless rushed to meet EU budget requirements by making substantial cuts in infrastructure expenditures on transportation. Such expenditures are capitalized into higher real estate values that strengthen public finances, an opportunity lost when Belgium was pressured to scrap needed transportation improvements. While budget discipline is key to long-term success in the EU, budgetary flexibility need not increase intra-EU tensions, if it remains consistent with policies attracting and maintaining long-term investment and employment.

Rigid Political Thinking Just Amplifies and Extends Europe’s Troubles

In sum, building healthy public finances across the eurozone is not a zero-sum game. Economic dislocations in the absence of supranational unification are not an inevitability. Threats of contagion have raised conflicting proposals but none considers the role geography plays in economic development. As globalization compels the European Union to consider new implications for governance structures and mechanisms, institutional flexibility that permits members to match budgetary needs to local circumstances is key to the success of the world’s largest economic bloc.

EU experience shows that in the absence of fiscal unification, accelerating integration and globalization have triggered the current European problem of economic dislocation through weak public finances. In the present circumstances, enforcing fiscal unification runs the risk of introducing a prudence paradox that could stall or reverse growth for all, if developing members cannot make the investments any economy needs to build local competitive advantages for a global marketplace.

The fundamental role of agglomeration economies should be considered as critical to public finance. By ignoring this, political leaders fail to appreciate that resolving the European crisis requires more than simply policies about debt. Harmonizing the wrong policies may, in fact, prove much worse than allowing national fiscal policies to differ within the European Union.
Once thought of exclusively as a local industry, real estate has evolved into a truly international business. Over the past decade, real estate practitioners have increasingly expanded their businesses beyond their core markets, resulting in ventures that cross countries, continents, and cultures. Recognizing this trend, 19 graduate students from the NYU Schack Institute of Real Estate, with three faculty members, embarked on a 10-day study tour to the vibrant city of Hong Kong from November 11–20, 2011.

Led by the Global Real Estate Group, the 2nd Annual NYU Schack Asia Outreach Program sought to meet the following objectives:

- Gain insight into the real estate markets and development/investment activities in Asia
- Network with real estate industry professionals and alumni in Asia
- Learn from a real estate academic institution in Asia

The trip began with a building tour of the International Commerce Centre (ICC Tower) developed by Sun Hung Kai Properties, Hong Kong’s largest property developer. Completed in 2010, the ICC Tower is the tallest building in Hong Kong and contains the world’s highest hotel, The Ritz-Carlton Hong Kong. The group was able to take advantage of the awe-inspiring views from the 100th floor as well as the expertise of Assistant General Manager Filipe Leung, who discussed the ICC Tower in relation to the Hong Kong real estate market.

Property rights are a compelling topic of discussion in Hong Kong. Except for the land beneath St. John’s Cathedral, the International Commerce Center was designated a platinum-level building under the Building Environmental Assessment Method (BEAM) and was named an “Intelligent Building” in 2011 by the Asian Institute of Intelligent Buildings.
the government owns all land in Hong Kong. Land leases are typically long-term here, and can range from 75 to 150 years. Additionally, each lease mandates exactly what is to be built on a respective plot of land. In other words, land-use regulations are incorporated into each land lease. In the case of the ICC Tower, the corresponding lease required office, hotel, and retail components to be constructed. The lease document also dictated other details such as space allocation, building-area requirements, height specifications, etc. The developer for a given project is selected via a bidding process that involves submitting not only an acquisition price, but also a thorough development plan. Land rights in Hong Kong, and similarly in Mainland China, are in stark contrast with the United States, where freehold estates dominate ownership rights and as-of-right development is commonplace.

Next up on the group’s itinerary was a joint lecture with the University of Hong Kong (HKU), a highly regarded and top-ranked academic institution in Asia. The joint lecture was intended to provide a platform to exchange ideas in a scholarly setting, and HKU afforded NYU Schack a perfect partnership due to its virtually identical Master’s program in Real Estate Finance, Development and Construction Management.

Mike C.W. Wong, HKU Honorary Professor and Executive Director of Sun Hung Kai Properties, discussed key challenges of real estate development in Mainland China. Mr. Wong raised the issue of the Chinese government’s ongoing regulatory changes as a main challenge. For example, the government recently started collecting property taxes on a trial basis in Chongqing and Shanghai in an effort to cool the heated housing market and will potentially expand the pilot project to other cities. As the government continues to refine its system in response to the marketplace, investors will face unexpected regulatory reforms. Additionally, Mr. Wong examined quality of construction and pointed out that there is a “gap” in perception of quality-control standards between local construction companies and reputable developers. Although high-profile buildings, such as the Shanghai World Financial Center, are built to international development expectations, reform of workmanship standards needs to be adopted throughout.

Meetings with industry leaders served as another building block of the Asia Outreach Program. The group visited 10 companies, including the Blackstone Group, KPF, Pramerica, Gaw Capital, UBS, Hilton Worldwide, Great Eagle Holdings, Pinnacle State Group, the Link REIT, and Baring Private Equity Asia.

During the meetings, executives discussed business strategy in China. Relationships, or guanxi, resonated throughout each meeting as the most important factor. Developing strategic relationships and establishing an equity joint venture with trustworthy local partners is essential to successful operation and is critical to mitigating risks associated with doing business in China. In an emerging market like China, where the system is still evolving, knowing the right people becomes indispensably important.

Transparency was another key discussion point for the group. Contrary to common perception, transparency is no longer a major concern for company executives. Regulatory changes have provided progress toward a more transparent system, where there has been improvement in access to title records and land-registry information, as well as more consistency and predictability in the enforcement of local laws and contracts.

The company executives were very optimistic about the Chinese market. Some of the companies’ growth plans are astounding. Hilton Worldwide, which is controlled by the Blackstone Group, currently operates 28 properties in China and plans to expand to more than 110 in the next five years. Gaw Capital is also very bullish on China. It currently manages three funds that focus on investments on the Mainland with a total equity of $1.5 billion.

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Rounding out the trip, the group participated in the MIPIM Asia Real Estate Conference, which attracted almost 2,000 individual participants and 860 companies from all over the world. Some notable companies in attendance included: Deloitte, GE Capital Real Estate, ING Real Estate Management, AET, DTZ, and Knight Frank. The conference provided an excellent opportunity for the group to network with industry professionals, as well as NYU Schack alumni who work in the region. Aside from the conference, the group was also able to tour several real estate projects in the city, including a multi-story shopping mall development and an office-to-serviced-apartment conversion project. These building tours gave the group a property-level perspective of Hong Kong real estate.

Hong Kong’s connection with China and its progressive Western business culture made it a perfect destination for NYU Schack graduate students to learn about Asia’s real estate markets. Beyond the professional, academic, and networking objectives, participants were able to experience the cultural vibrancy of Hong Kong and bond with their classmates. In sum, the trip exceeded expectations and the students anticipate that NYU Schack will build upon its success in subsequent visits to Asia.

Newmark Knight Frank is proud to support the NYU Schack Institute of Real Estate for its 44th Annual Conference on Capital Markets in Real Estate