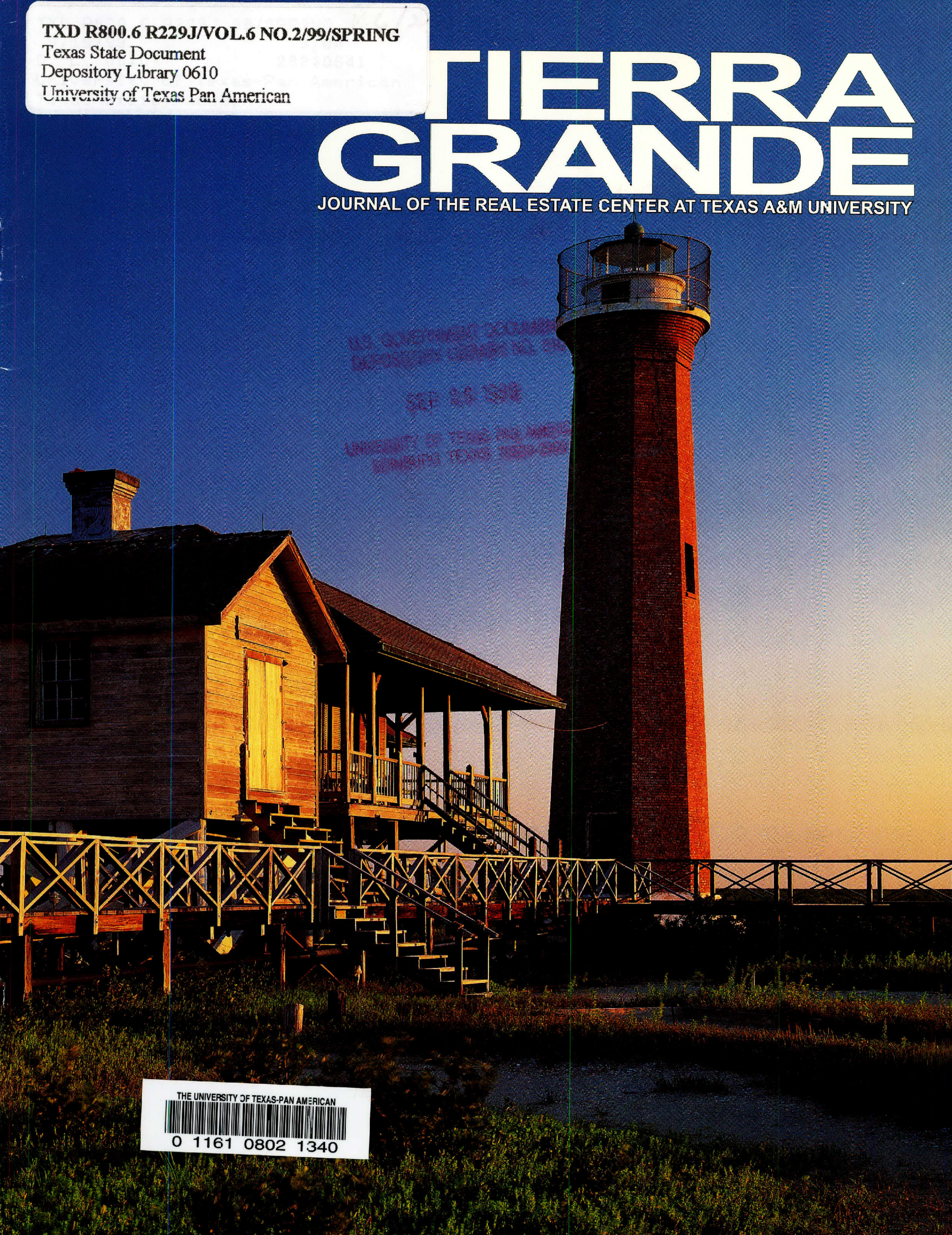

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On the Cover

Near Port Aransas, the Lydia Ann Lighthouse is one of the few active watchtowers remaining on the Texas coast. Built in the mid-1800s, the majestic edifice has changed hands many times and is now completely restored and privately owned.
Photographer Laurence Parent

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STUCTURING LIKE-KIND EXCHANGES CLARIFIED

By Jerrold J. Stern

Like-kind exchange rules allow commercial or investment real estate owners to trade one property for another and avoid part or all income tax liability on the transaction. If structured correctly, salespersons brokering these trades can earn commissions from multiple transactions. Plus, if they also act as like-kind exchange "intermediaries," salespersons earn sizeable interest on funds held between property transfers (see "Structuring Like-Kind Exchanges," *Tierra Grande,* January 1999).

As with any tax-motivated transaction, there are many complex requirements that must be met. To earn sales commissions **and** interest on funds held for property transfers, the salesperson is not allowed to be *related* to any of the parties involved in the exchange.

To avoid being *related,* the salesperson is precluded from having performed any services for the parties during the preceding two years except for services with respect to the exchanges of property intended to qualify for the like-kind exchange. For example, if a salesperson sells a personal residence for a taxpayer, the salesperson is considered *related* to that taxpayer for like-kind exchange purposes for the next two years.

Dr. Stern is a research fellow at the Real Estate Center at Texas A&M University and professor of accounting at the Kelley School of Business, Indiana University.

Keeping Up With the Jetsons

As America prepares to enter a new millennium, industry visionaries have examined the influence today's rapid-fire technology advancements will have on real estate. Their findings were released in the report "Keeping Up With the Jetsons: Housing Industry Trends and Influences."

Dragonette, Inc. prepared the report, in conjunction with the National Association of Real Estate Editors. Industry leaders discussed critical issues driving home products. In brief, they found:

- The $2 billion home automation industry will explode to $20 billion by 2005.
- More than 65 percent of homes with personal computers have Internet access.
- More than 59 percent of consumers building new homes state they would pay as much as $5,000 for advanced wiring.
- More than half of consumers are willing to pay premiums for systems and materials that promote a healthy home environment, with some willing to add as much as $3,000 to the purchase price.
- Security is high on consumers' wish lists. More than 79 percent of builders are responding by pre-wiring homes or installing home security systems.

You Be the Judge: Who Gets Title?

By Cindy Finley and Judon Fambrough

The December 1998 lead article in *Letter of the Law* is entitled "Deeds and Texas Recording Statutes." The article describes the application of the race-notice statute used in Texas to protect bona fide or innocent purchasers. These are buyers who pay valuable consideration for the property and take title without notice of a third party's claim to the property. "Race" refers to the competition (or race) to be first to record the deed correctly.

Based on the race-notice statute as described in the article, determine who gets the title in Texas. Select either Buyer No. 1 (B1) or Buyer No. 2 (B2). The correct answers can be found on page 24.

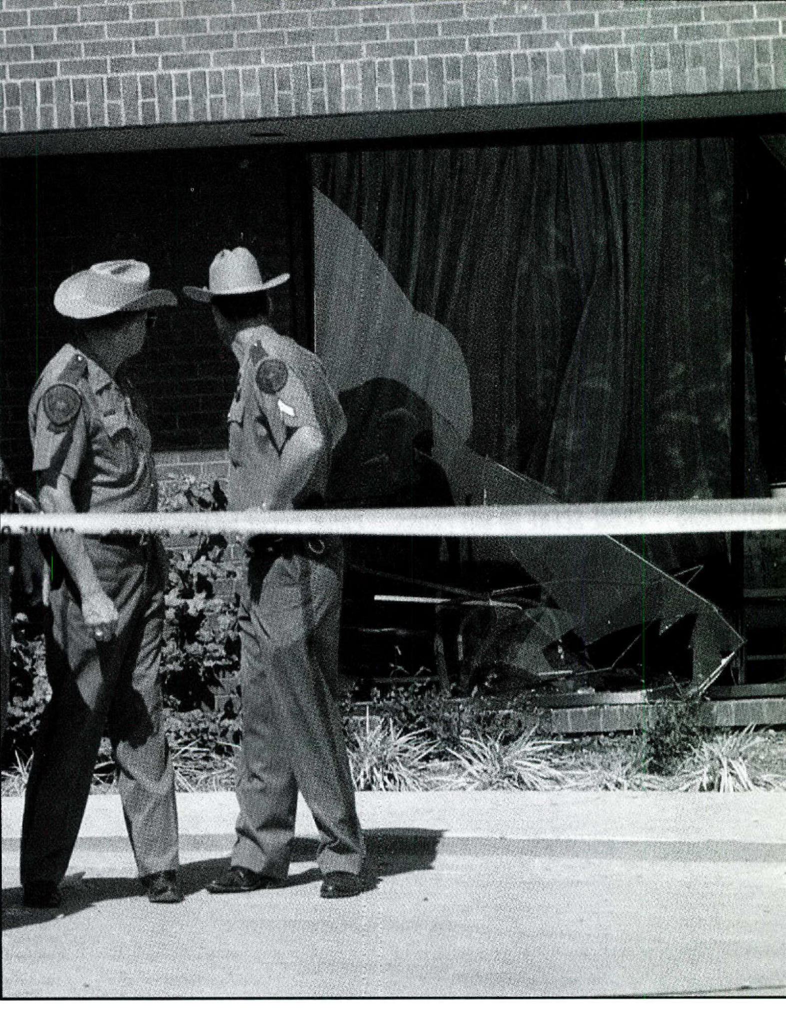
1. The seller conveys title to B1 via a warranty deed. B1 does not record the deed immediately, so the seller conveys the same property to B2 via a warranty deed. B2 is unaware of the prior conveyance **at closing**. B2 records the deed before B1.
2. Same facts except B2 becomes aware of the prior conveyance to B1 **after closing** but before recording the deed. B2 still records first.
3. Same facts except B1 learns of the second conveyance before B2 records the deed. B1 is able to beat B2 to the courthouse to record first.
4. The seller conveys title to B1 via a warranty deed. B1 does not record immediately, so the seller conveys the same property to B2 via a quitclaim deed. B2 records the deed before B1.
5. The seller conveys title to B1 via a warranty deed for full market value. B1 does not record immediately, so the seller conveys the same property to his sister (B2) via a gift deed without monetary consideration. B2 records the deed before B1.
6. The seller conveys title to B1 via a warranty deed. The property lies in two counties. B1 records in only one. The seller then conveys the same property to B2. B2 checks the records in the county where B1 did not record. B2 then records the warranty deed after closing.
7. Seller conveys title to B1 via a warranty deed. B1 does not record the deed but moves on to the property. The seller then sells the property to B2 while B1 is in possession. B2 records the deed before B1.
8. Seller conveys title to B1 via a warranty deed. B1 records the deed but the county clerk indexes it incorrectly. The seller then sells the property to B2. B2 does a title search before buying but does not discover the prior conveyance due to the clerk's error. B2 then records the deed after closing.
9. The seller conveys title to B1 via a special warranty deed. B1 does not record immediately, so the seller conveys the same land to B2 via a warranty deed. B2 is aware of the prior conveyance to B1 at closing. B2 records before B1.

Finley is a Dallas attorney, and Fambrough is an attorney with the Real Estate Center at Texas A&M University.

When Bad Things Happen to Good Properties

Taking Stigma out of Stigmatized

By Jenifer V. Hofmann



After a mass murder shooting spree, Luby's Cafeteria, in Killeen, Texas, let their employees off with pay for six months, reconstructed the damaged portions of the building, remodeled and reopened for business. Under similar conditions, a California McDonald's was demolished and another one built a couple of blocks from the original site that was later converted into a city park.

These restaurant sites share the unfortunate likeness of gunmen randomly shooting unsuspecting patrons inside, but how the companies dealt with the aftermath is quite different.

"One was handled in an ideal way and one was less than ideal," according to Randall Bell, MAI, and disaster property expert. Because it is extremely difficult to plan for catastrophes such as these, knee-jerk reactions are usually more the rule than the exception, resulting in companies handling similar situations in radically different ways. Given this, the question of how best to deal with stigmatized properties deserves a closer look.

The crimes committed on the Luby's and McDonald's premises rendered these properties stigmatized. Properties become stigmatized under two types of circumstances. One category, pure stigmas, deals strictly with psychologically based damage where no physical or environmental ramifications result from the event that produced the stigma. The second category consists of properties that contain physical detrimental conditions.

Pure Stigma

The National Association of Realtors (NAR) defines a stigmatized property—referred to here as pure stigmas—as one that has been psychologically impacted by a suspected or actual event that occurred on the property, resulting in no physical impact of any kind. Included in this category are crime scenes, particularly murder scenes, suicides, deaths and AIDS-related illnesses that render properties difficult to market and sell.

The building where Jeffrey Dahmer kept his victims is a case of pure stigma with no physical property damage. In that case, the "stigma goes to the entire site; it doesn't just go to the improvements," according to Bell, often dubbed "Dr. Disaster" for his pioneering work appraising disaster-struck properties.

"It's the site that's stigmatized," Bell says. In fact, the apartment complex was demolished and now sits vacant, surrounded by a fence. Because stigma goes to the entire site and not just to the improvements, "people in the building next door hung posters in their windows to block the view."

Another non-physical condition that adversely affects property value and marketability, for example, is a property that has housed an individual infected with the HIV virus or that had AIDS. A psychological stigma may be created in this

DISASTER STRUCK
Luby's Cafeteria in Killeen on October 16, 1991, when a gunman drove his truck through a window and fatally shot 22 lunch-time patrons inside. Luby's managers dealt with the ransacked property and the event's aftermath in an ideal way.

situation, but the Federal Fair Housing Act protects the handicapped, including AIDS patients. This means "it is illegal for agents to make unsolicited disclosures concerning whether sellers or property occupants have tested positive for HIV or have been diagnosed with AIDS. In some circumstances, this also can include honest responses to specific questions by buyers," according to the U.S. Department of Housing and Urban Development.

In fact, the Texas Real Estate License Act states that a licensee shall have no duty to inquire about, make a disclosure related to, or release information related to whether a:

1) previous or current occupant of real property had, may have had, has or may have AIDS, HIV-related illnesses or HIV infection as defined by the Centers for Disease Control of the U.S. Public Health Service; or
2) death occurred on a property by natural causes, suicide or accident unrelated to the condition of the property.

NAR further advises real estate practitioners to best respond to AIDS-related scenarios by stating: "It is the policy of our firm not to answer inquiries of this nature one way or the other since the firm feels that this information is not material to the transaction. In addition, any type of response by me or other agents of our firm may be a violation of the federal fair housing laws. If you believe that this information is relevant to your decision to buy the property, you must pursue this investigation on your own."

Physical Detrimental Conditions

The second category of stigmatization covers properties with physical or environmental detrimental conditions. Termite infestation, asbestos, electromagnetic fields (EMFs), underground storage tanks and landfills fall under this classification.

Stigma, as it applies to environmental problems, is generally defined as "an adverse public perception about a property that is intangible and not directly quantifiable," according to *The Appraisal Journal*. Environmental problems may often be remedied and have no lasting effect on the property. "The real estate impact of an environmental contaminant depends on how the substance is controlled, how it is spread, how many people are potentially affected, and the degree to which people may be affected," says *The Appraisal Journal*.

For example, high-tension lines (EMFs) and polluted waterways often lead to an unsalable property, otherwise known as economic incurable obsolescence, according to *The Real Estate Guide to the Environment* authors Barry Chalofsky and Joel Finestine. The real or imagined fear of health risks resulting from such exposure has a direct effect on marketability.

For example, studies show that values decreased most when waste sites were officially declared Superfund sites or when problems were first reported publicly, says Karl L. Guntermann at Arizona State University. Values rose after the sites were closed; demonstrating the extent of price effect is generally related to the public awareness of the problem, and it diminishes as the problem is eliminated.

Superfund legislation passed in 1980, creating a federal means to identify and clean up contaminated properties. The Superfund act called on the Environmental Protection Agency to identify the worst contaminated sites nationwide and provide assistance to clean them up.

In 1986, Congress introduced an "innocent property buyer" clause to the Superfund. The provision permits a buyer to conduct a due diligence investigation prior to completing a purchase. If the buyer discovers evidence of contamination or hazard-generating activity, they can legally void the transaction. This is now common practice for most commercial real estate transactions.

Often the investigation begins with a Phase I site assessment that typically involves documenting a site's history, reviewing all records and inspecting the site. If the Phase I investigation produces evidence of contamination, a Phase II is performed. This includes soil and water sampling and analysis. Phase III is the site cleanup, in the event that testing confirms significant levels of contamination. This procedure is most common for industrial sites.

'Stigma goes to the entire site; it doesn't just go to the improvements.'

In Texas, commercial real estate practitioners may encounter this situation with some frequency. For example, an abandoned gas station is for sale and a buyer is interested in purchasing it for development. First, the prospective buyer will need to make sure no underground storage tanks are present. If there are tanks, they will most likely need to be

removed as well as any gasoline, diesel fuel, kerosene or waste oil spillage. A rule of thumb is that underground storage tanks have a 25-year life expectancy, and when they corrode, unused hydrocarbons can leak into the soil and contaminate ground water or enter sewers and basements and become fire hazards, according to Guntermann.

What can real estate practitioners then surmise? Losses are related to the severity or potential danger (real or perceived) of contaminated properties as well as other factors that include the distance from the site, says Guntermann. Therefore, stigma may represent a large portion of lost value immediately after the contamination is identified and when uncertainty about the problem and its solution abound.

Also consider the 1970s asbestos scare. The fibrous material was commonly used in the construction industry for decades until studies began to demonstrate that the asbestos fibers could infiltrate the lungs—a potentially fatal condition. Hitting the papers, this news caused a near panic in some real estate markets. "Many properties containing asbestos were stigmatized, becoming unmarketable virtually overnight," says Guntermann.

With more scientific information available, public fear and concern in the real estate community dissipated and became more narrowly focused on a smaller sample of properties than originally suspected.

Referring to the Exxon Valdez oil spill in 1989 and the cleanup efforts that followed, "The appraisal profession has now come to recognize that environmental stigma can indeed be temporary rather than permanent," says Richard J. Roddewig in *The Appraisal Journal*. "Annual economic loss due to impairment decreased each year after the spill as a result of Exxon cleanup activities and natural cleaning by winter storms." In fact, by 1992, three years after the 10.8 million-gallon spill, impairment was reduced to 2 percent.

When Disaster Strikes

After studying disaster properties for more than ten years and working on cases such as the Oklahoma City bombing; the JonBenét Ramsey home in Boulder, Colorado; the "Heaven's Gate" mansion and the Nicole Brown Simpson condo in California, Bell is nationally and internationally recognized as an expert. He recommends that real estate professionals adhere to the following list of guidelines when dealing with stigmatized properties.

- First, forget about the real estate and address the needs of the victims and their families. Try to forget about inanimate objects like real estate and help the people that are impacted.
- Consult an attorney.
- Chronologically document all activity. Carefully videotape and photograph.
- Secure the property.
- Deal with the situation. Silence tends to invite negative speculation.
- Make proper disclosures.
- If the media gets involved, cooperate.
- Promptly implement a written action plan with stated goals and objectives.
- Depending on the situation, take the property off the market. Try to rent it before selling it at a large discount.
- Be considerate of neighbors and other tenants.
- Negotiate with lenders to get consideration or a moratorium on payments.
- File insurance claims.
- Be realistic about the price and any discounts.

Real estate professionals must understand that, more often than not, they are dealing with fears and not physical characteristics of a property.

"Perception, people say, is stronger than reality," say Chalofsky and Finestine. "Each person's history shapes his own view of the world. This personalized or distorted view is known as perception, and your view of everything is based on this perception, rather than reality."

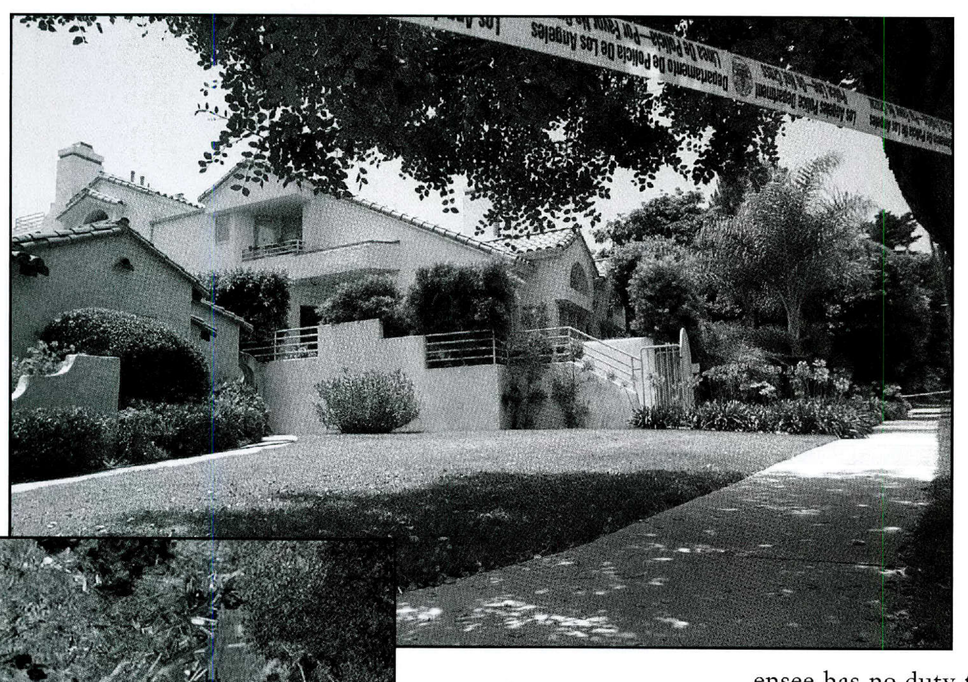
Picking Up The Pieces

Real estate practitioners must decipher whether the stigma is material to the real estate transaction. Is the stigma fact or fiction? If it is true and could affect the transaction, it is best to disclose the facts. Consider if the stigma is permanent or repairable.

Agents often find themselves in the precarious situation of balancing buyers' and sellers' needs and desires. They must protect a seller's privacy and civil rights while at the same time, work with the buyer's desire to know information not related to physical aspects of the listed property. The NAR legal department suggests considering these steps to establish materiality:

- Determine if fact or fiction. Investigate the source of information by talking with neighbors and checking

Stigma may represent a large portion of lost value immediately after the contamination is identified and when uncertainty about the problem and its solution abound.



***SITES ASSOCIATED WITH STIGMA** include (clockwise from top left) JonBenét Ramsey's home in Boulder, Colo., the Nicole Brown Simpson condo where she and Ronald Goldman were murdered, and O.J. Simpson's Rockingham Estates being bulldozed.*

newspapers. If the stigma is based on rumor rather than fact, agents are not obligated to disclose. Conversely, if the stigma is based on fact, as in the restaurant murders, proceed to the next step.

- Check state laws. In Texas, when a property defect is physical, disclosure is mandatory. When the defect is nonphysical, or emotional, however, disclosure becomes dependent on materiality to the transaction.
- Determine materiality. Agents should put themselves in the situation. Ask if knowing about the stigma would affect the willingness, or that of most people, to purchase the property or reduce the amount of money they would pay for the property. And, would a reasonable person be willing to buy the property knowing about the stigma?
- Discuss disclosure with the sellers. If the sellers decide to disclose the stigma, inform prospects judiciously. Not all interested in the property are ready, willing and able buyers. If the sellers refuse to disclose what is determined to be material to the property and transaction, forfeit the listing.

For information on Texas law regarding recovering damages, see Judon Fambrough's Real Estate Center October 1990 *Law Letter* article, "Recovery of Actual Damages and Stigmatization."

Duty to Disclose

So what can and should real estate agents disclose? A 1993 Texas law provides some answers. It states that a licensee has no duty to inquire about, make a disclosure related to or release information concerning a previous or current occupant having AIDS, HIV-related illness or an HIV infection. In addition, the Texas Real Estate Commission has enacted mandatory disclosure for all properties, stigmatized or not. This form is part of the standard promulgated sales contract and requires agents to accurately list details such as leaking roofs, faulty water heaters and cracked slabs.

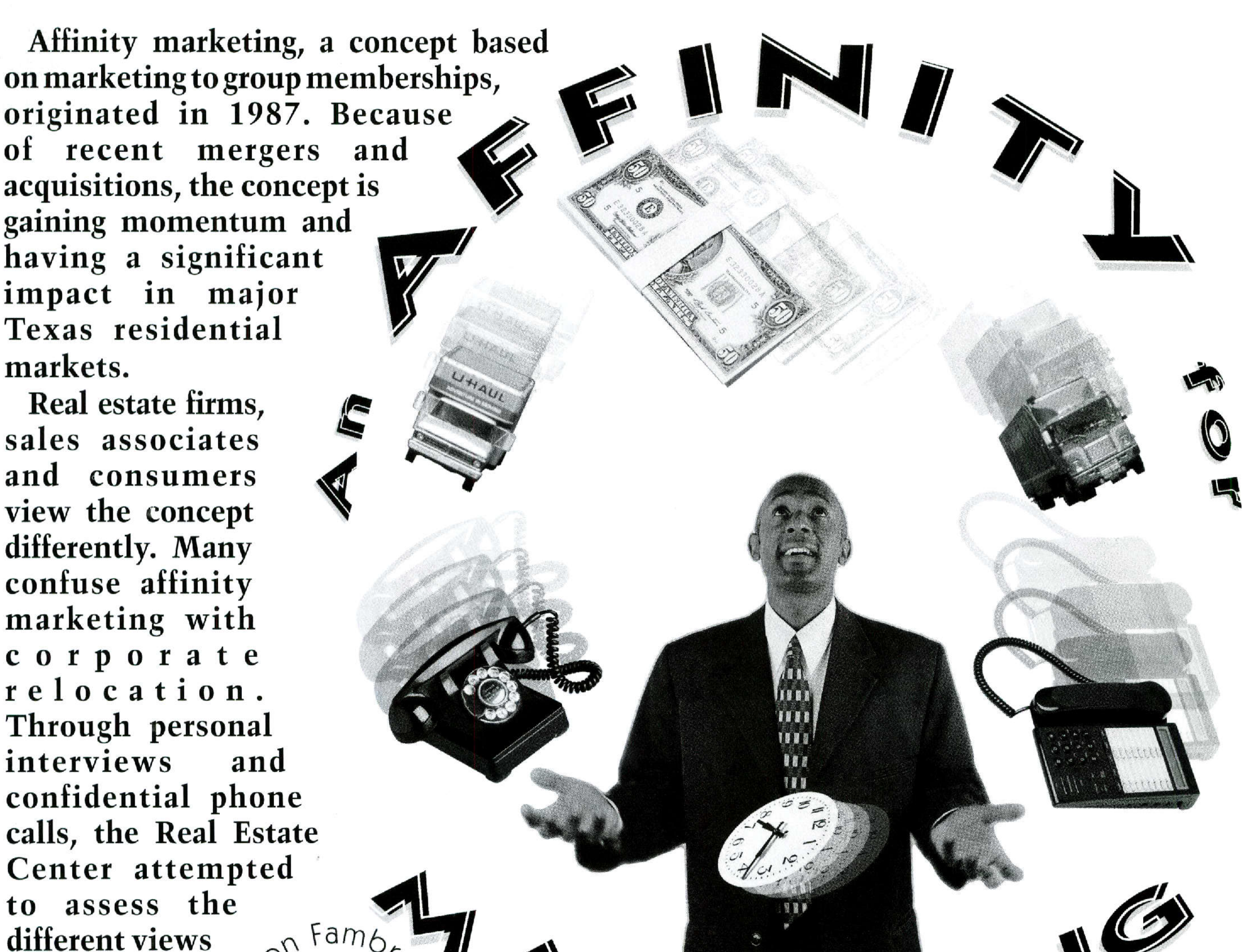
"I think that Luby's did everything right," says Bell. "Luby's is the quintessential case on how to handle a situation. The manager told me, 'It sounds corny but, they wanted to treat everyone affected by the situation as if they were a member of their family.'"

Bell cites properly remembering the victims in a public place, such as at a city park, the best place for a memorial. "I think the community wants to remember those people, and I think that community issues belong at a community setting." In contrast, the McDonald's memorial was at the bulldozed murder site.

Luby's also provided counseling, did not go into a state of denial and faced the sad reality head-on.

"There was never any attempt to squelch or throw water on the issue," says Bell. "The incident was admitted to and dealt with in a very professional and courteous way by the company. They treated everyone very, very well and, in turn, they got a restaurant that still performs." ⊞

Hofmann is an assistant editor with the Real Estate Center at Texas A&M University.



Affinity marketing, a concept based on marketing to group memberships, originated in 1987. Because of recent mergers and acquisitions, the concept is gaining momentum and having a significant impact in major Texas residential markets.

Real estate firms, sales associates and consumers view the concept differently. Many confuse affinity marketing with corporate relocation. Through personal interviews and confidential phone calls, the Real Estate Center attempted to assess the different views within each group and to explain the variations. A brief overview follows.

Affinity Marketing Differs from Corporate Relocation

Affinity marketing begins with the existence of affinity groups. The primary affinity groups located in Texas that affect real estate marketing include USAA (United Services Automobile Association), American Airlines, Amway and Argonaut. Group membership is acquired by a certain status, in the case of USAA, or by enrollment in the case of American Airlines.

Third parties offer members of affinity groups discounted services, rebates or other benefits for participating in certain marketing programs such as real estate. Third parties also approach real estate firms giving them the opportunity to handle the participating affinity members.

For their efforts, the third parties (better known as Third Party Administrators [TPAs]) receive, among other things, a referral fee from the brokerage firm. In Texas, Cendant Mobility is the largest TPA.

The TPA seeks out and attempts to contract with the top real estate firms in each market so participating affinity group members receive quality service. Generally, the TPA contracts with firms as primary and secondary providers in each market. The TPA chooses the firms based on past market performance.

If an agreement is reached, the TPA exacts a fee from both the primary and secondary providers, ranging from a few hundred dollars for the secondary providers to several thousand for the primary provider, based on the size of the market. In addition, the TPA receives 30 to 35 percent of the commission for each referral that closes, except for special properties.

The brokerage firms may incur additional time and expense training their sales associates for the level of expertise acceptable to the affinity group. Salespeople attend periodic training sessions sponsored by the TPA at the real estate firm's expense. Once a referral is received, sales associates file regular status reports with the TPA. After closing, the client (consumer) grades the sales associate's performance.

As a general rule, qualified sales associates accept referrals on a voluntary basis within a firm. If they are busy with regular consumers or do not have time, the referral is assigned to another qualified associate.

Brokerage firms handle fee splits differently. Two methods were observed. Sales associates prefer that the referral fee be taken off the top with the associate's normal fee split on the remaining balance. A few firms, however, alter normal fee splits when dealing with affinity marketing groups (for particular sales associates).

Corporate relocation functions in much the same manner as affinity marketing, except the privilege of using the service occurs when a company transfers an employee to another community. As before, a third party, under contract with the employer, administers the program.

Employees receive benefits based on the number of the employer's relocation programs they use. For example, if they use the mortgage and real estate programs, all or a part of the closing costs may be paid by the employer. Generally, there are no cash rebates.

If the employee wishes to use the real estate program, the TPA contacts brokers in the respective cities where the sale and purchase will occur. If closing occurs, approximately 30 to 35 percent of the commission is paid as a referral fee. Problems arise when the TPA asks for an "after-the-fact referral" when employees seek and employ their own sales associate.

In some cases, real estate firms accepting relocation business pay an initial lump-sum fee to become a provider. Likewise, the sales associates may undergo special training. However, periodic paperwork must be prepared and filed.

Some relocation plans provide for the TPA or the company transferring the employee to purchase the employee's home if it is not sold within a certain period. Real estate sales associates may be authorized to fix up or repair the home on behalf of the company. Neither of these features exist under affinity marketing.

Do Real Estate Firms Benefit from Affinity Group Business?

A satisfied customer and monetary benefits to the real estate firm are the major factors in any real estate transaction. Brokerage firms reap financial benefits when costs associated with affinity marketing are more than offset with additional business. A different picture emerges in markets where the volume of referrals does not cover costs.

Some firms in less active markets continue their association with the affinity group hoping the market may change. Others continue because they feel the signs posted on property and the contacts they make with new clients create additional future business. These assumptions may or may not prove true.

Two suggested benefits, proffered before the survey, were that affinity marketing reduces advertising costs and carries a higher-than-average closing rate. Regarding the first point, no firm in the survey agreed. Firms must advertise aggressively to maintain their market position and retain the affinity group business.

Regarding the second point, the firms contacted agreed that corporate relocation referrals carry a higher closing rate than affinity group business. However, with the exception of USAA members, affinity group referrals produced a closing rate that was "no better" than other business.

One non-Texas firm withdrew its affiliation with an affinity marketing partner even though the economics indicated a benefit. The firm already dominated the market and the referrals represented business the firm would receive anyway. Furthermore, existing clients making local moves crossed over to use the affinity service for the rebates. Essentially, the firm received the same business but with reduced commissions.

Even in Texas, some firms weighed the "crossover" factor when considering an affinity relationship. Crossovers represent local clients who use the affinity group relationship for the fringe benefits, such as rebates.

Finally, a Chicago brokerage-owner welcomes all referral business for two reasons. First, the referrals generate a steady, dependable revenue stream. Second, by having the referrals come directly to the office, as opposed to being generated by sales associates, the owner felt more in control of the business and less dependent on agents. The referral business did not follow sales associates when they left the firm.

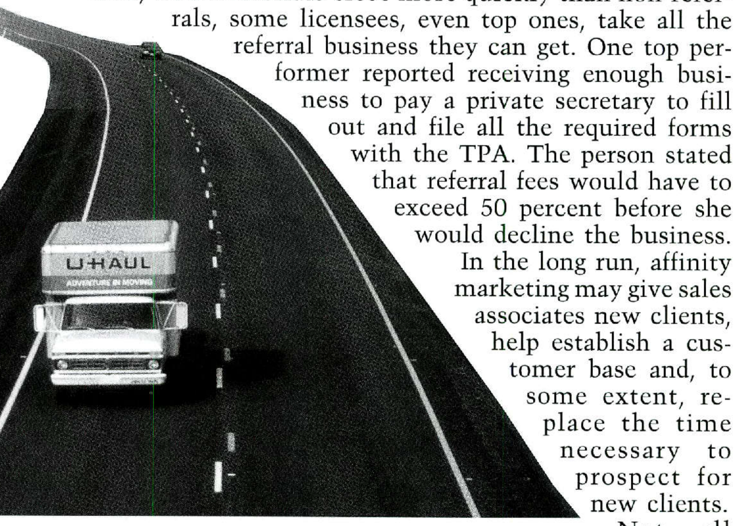
Because of the control factor, many brokerage firms consider assigning all affinity referrals to licensed, salaried employees. However, the negative impact on associates often negates implementation.

In the long run, affinity marketing may give sales associates new clients, help establish a customer base and, to some extent, replace the time necessary to prospect for new clients.

Do Sales Associates Benefit from Affinity Group Business?

The bottom line to sales associates in real estate transactions is customer satisfaction and profitability. However, sales associates incur lower fixed costs, but higher variable costs, than brokerage firms. Sales associates seek to maximize returns based on time expended.

As a general rule, sales associates who have the time and need new business take referrals. Referrals do not generate the same returns as non-affinity clients. However, in hot markets, where referrals close more quickly than non-referrals, some licensees, even top ones, take all the referral business they can get. One top performer reported receiving enough business to pay a private secretary to fill out and file all the required forms with the TPA. The person stated that referral fees would have to exceed 50 percent before she would decline the business. In the long run, affinity marketing may give sales associates new clients, help establish a customer base and, to some extent, replace the time necessary to prospect for new clients.

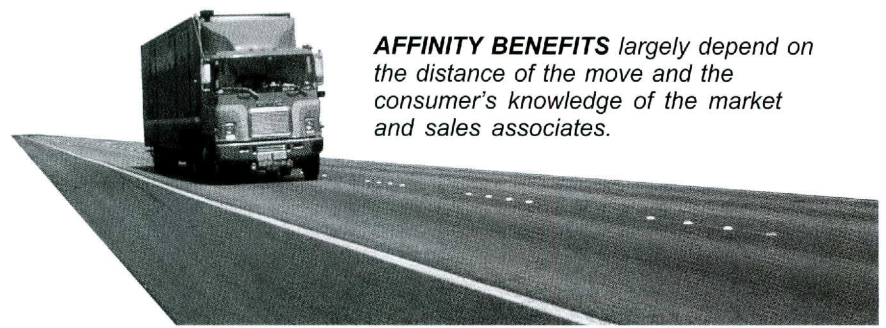


Not all comments about affinity marketing were positive. Here were some of the negative perceptions.

First, some of the personnel employed by the TPA lacked knowledge concerning local real estate markets. One broker related that a TPA employee told a client that Brownsville was located on the coast. Another broker bought lunch for all the TPA employees she worked with for the opportunity to explain the local market and the closing process.

Second, some sales associates felt pressured to promote the TPA's mortgages. The TPA sends periodic reports indicating the number of referred clients that purchase TPA's mortgages. Anything less than 50 percent is listed as "unacceptable." One firm declined affiliation with an affinity marketing group because the firm had its own in-house mortgage company.

Third, TPA referrals require more paperwork. Some sales associates feel the paperwork is never read.



***AFFINITY BENEFITS** largely depend on the distance of the move and the consumer's knowledge of the market and sales associates.*

Fourth, some sales associates dislike the discipline required by the TPA. They prefer to manage their clients using their own routines and schedules. They resist dictated deadlines. Affinity relationships threaten their independence.

Fifth, on more of an economic note, sales associates resist firms reducing the normal fee split after deducting the referral fee. This reduced split creates a negative attitude toward referrals within the firm. As might be expected, sales associates tend to embrace affinity business more positively when the normal fee split prevails.

On a similar note, the non-Texas firm that withdrew affiliation with affinity groups felt that the referral fees drove top performers to non-affiliated firms. Likewise, the affiliation hindered recruitment of top performers.

Do Consumers Benefit from Affinity Marketing?

What affinity relationships add to the transaction, apart from the rebate or mileage, largely depends on the distance of the move and the consumer's knowledge of the market and sales associates in the area.

Consumers, as a whole, voice favorable opinions about affinity relationships. One customer, who made a cross-country move, praised the level of service. The sales associate provided pertinent information about the area's schools, churches, and so forth and reduced the time needed to make an informed decision. The customer felt free to ask for another sales associate if dissatisfied or a conflict developed. In fact, she would use the service again, even if no rebates were offered.

Another customer, a crossover making a local move, was satisfied with the service because he knew and requested a particular sales associate. Having lived in the area for several years, he was familiar with the market. His primary reason for using the affinity group relationship was the rebate.

Consumers place high marks on accountability. Anytime they needed information about an area, the status of a pending contract or other pertinent details, it was provided in a timely manner. Of course, the customer's ability to rate the sales associate after closing heightened accountability.

When real estate firms and sales associates were asked whether consumers receive the assistance of top sales associates in a market, the response was "not necessarily." All agreed that consumers receive service from the top firm that contracts with the TPA. However, as noted earlier, even within the top contracting firm, consumers may receive the services of a mid- to entry-level sales associate. Top performers are more likely to have their own clientele to serve, and may choose to spend little time on referrals.

At the same time, receiving the services of a top performer may not be in the client's best interest. Other factors play an important role in a successful transaction. Brokerage firms take into account similarity of ages, backgrounds and interests, nationality, language and other individual traits when assigning a sales associate.

The level of service may vary when the property is at either end of the price spectrum. If consumers seek to buy or sell property on the lower end, top or mid-performers may feel the reduced commission does not justify their time. Buyers and sellers on the upper end may find that the top firms specializing in that market decline affiliation with affinity groups for economic reasons.

When brokerage firms and sales associates were asked if the level of service given to affinity referrals differed from non-affinity consumers, they unanimously agreed that both groups receive the same treatment. However, they commented that the level of service demanded by the various affinity groups differs.

Are Firms and Sales Associates Legally Obligated to Pay After-the-Fact Referral Fees?

Occasionally, members of an affinity group want to use the group's real estate program but fail to follow proper channels. Instead of allowing the TPA to locate and contact a participating brokerage firm, the members make personal contact without informing the agent of the affinity relationship. The sales associate learns of the affiliation at closing when the TPA demands a referral fee.

In Texas, no legal precedents dictate the payment of after-the-fact referral fees. Sales associates generally pay the fee because of the TPA's threats to eliminate future referral business. Several states passed statutes prohibiting the practice. However, Texas has no statutory prohibition and evidently has no plans to address this issue in the 1999 legislative session.

Proponents of affinity marketing feel it is the sales associates' responsibility to quiz the potential customer regarding possible affiliation. Associates feel it is the customer's responsibility to disclose the fact when enlisting their services. To avoid the confrontation, prudent sales associates inquire upon first contact with a potential client about affinity relationships.

One argument can be made that not paying the after-the-fact referral fee violates the Canons of Ethics. Real estate brokers and agents cannot place personal interest above that of the client (Title 22 of the Texas Administrative Code [TAC] Section 531.1[3]). This could occur if the client is denied a rebate or other benefits because of the nonpayment of the referral fee.

An El Paso broker devised a unique approach. He offers to reimburse the TPA for the economic value it contributed to the transaction. He then offers to compensate the customer for any benefits they would have received under the program.

In summary, interviews conducted by the Real Estate Center brought to light the variety of opinions about affinity marketing. It is obvious there is no consensus, and the debate over its pros and cons will continue.

This article attempted to explain the concept of affinity marketing, identify the issues and promote a general understanding of the various viewpoints. The future of affinity marketing, however, will be determined in the marketplace.

Fambrough is an attorney, member of the State Bar of Texas and senior lecturer, and Hunt is an assistant research scientist with the Real Estate Center at Texas A&M University.

¡Yo Quiero Casa Grande!

Selling Property South of the Border

More than residents in any other state, Texans are uniquely positioned to benefit from the open relationships evolving between the United States and Mexico. The 1994 North American Free Trade Agreement (NAFTA) and the vast common border between Texas and Mexico have dramatically increased business opportunities, including real estate.

By Harold D. Hunt and Ari Feldman

While the majority of licensees have restricted their real estate activity to the Texas side of the border, in the future, completing real estate transactions in Mexico may be much more common as a significantly different process begins to emerge.

Currently, Mexico has no formal real estate licensing procedure at the federal, state or local levels. The National Association of Realtors® (NAR) and the Mexican Association of Real Estate Professionals, known as AMPI (Asociación Mexicana de

Profesionales Inmobiliarios, A.C.), have worked on this process, albeit unsuccessfully.

Agency, as known and regulated in the United States, does not exist in Mexico. Individuals representing themselves as real estate agents range from lawyers to taxi drivers to hotel concierges to shoeshine boys.

The concept of a fiduciary, single agent, dual agent or buyer's agent is not discussed, not even by AMPI. Often, the philosophy in Mexico is that the agent is operating his or her own independent business for their exclusive benefit and not that of the buyer or seller.

No Mexican real estate designations exist, although some private schools in Mexico City offer diplomas for completing real estate courses. Many college graduates use the title *Licenciado* after receiving a business or economics degree. Some AMPI members have a Certified International Property Specialist (CIPS) designation from NAR.

Commission rates are not fixed by law in Mexico. Rates typically range from 5 percent in Mexico City to as high as 10 percent in the resort area of Los Cabos. However, an agent without a strong commission agreement may receive a lesser fee at closing. In some cases, the seller may actually refuse to pay the commission, sighting little delivery of service.

"It may take as long as ten years to collect commissions owed if a suit is filed in Mexico," according to Juan Aribe, an El Paso broker who conducts extensive real estate business in Mexico. Negotiated fee splits between acknowledged and cooperating agents range from 30 to 50 percent of the total commission, depending on local custom.

'The important factor in being successful in Mexico is establishing yourself and your reputation. It took time to earn the Mexicans' trust, but it has been worth it.'

Referral fees are negotiable in Mexico. Generally, they range from 20 to 30 percent of the full commission. The major problem in referring a client to a Mexican broker is getting paid. Trust plays a major role in securing referral fee payment. If no trustworthy firm or individual is known, U.S. licensees can contact either a CIPS or a local member of AMPI to initially establish a Mexico connection.

A number of the North American real estate franchisers, including RE/MAX, Century 21, Realty World and ERA, operate in Mexico, but they do not dominate the market. In addition, Coldwell Banker Corporation has sold a master franchise in Mexico and expects to begin operations this year. Although the franchise influence is spreading, independents currently form the majority of firms. Resorts have a number of foreign nationals working as both broker-owners and sales agents.

Firms operating in the interior of the country where there are no large foreign populations are operated by Mexican nationals. Foreign clients typically prefer to conduct business with the franchises, while Mexicans prefer to deal with people they trust, regardless of their affiliation.

How do Texas licensees prefer to conduct business in Mexico? Those who have contacts on both sides of the border often rely on referrals.

According to Rosalinda Cordoba, an agent with a Brownsville real estate firm, "I like doing referrals. Now that I have established contacts in Mexico, I can send them clients. Over time, I have built an ongoing business relationship, and I don't have to operate in Mexico."

***AGENCY, AS KNOWN AND REGULATED** in the United States, does not exist in Mexico. Individuals representing themselves as real estate agents range from lawyers to taxi drivers to hotel concierges to shoeshine boys.*

Some agents choose to operate real estate firms on both sides of the border. Jacob Casanova, a San Antonio broker who also owns a real estate firm in Guadalajara, Mexico, says, "The important factor in being successful in Mexico is establishing yourself and your reputation. It took time to earn the Mexicans' trust, but it has been worth it. I enjoy having a real estate business in Mexico."

Listing a property for sale requires membership in the local private multiple listing service (MLS), if one is available. Similar to the United States, both smaller and larger MLS systems are used. MLS listings are generally limited to commercial, luxury residential or farm and ranch properties.

A high proportion of middle- and low-income residential properties trade without the aid of an agent. A popular method for advertising listings in major markets is to hang banners and flags in trees or across streets. Potential buyers look down secondary streets to see if any properties are for sale. Mexicans do not typically drive residential areas searching for properties the way Americans do. Other advertising methods include newspapers, Internet web pages and booklets of available properties.

Foreign nationals can obtain title to Mexican real property except in the "restricted zone" that lies within 60 miles (100 kilometers) from any border and 30 miles (50 kilometers) from the coastlines. Subsequent to the 1993 Foreign Investment Law passing, direct (fee simple) ownership by foreigners in the restricted zone has been allowed for commercial use only.

Foreign nationals purchasing residential properties within the zone must establish a beneficial trust (Fedeicomiso) by registering the property with an authorized national bank that acts as administrator. The cost is a minor fee for documentation and an annual fee of $500 to $800 to pay taxes and service the trust. The life of the trust is currently 50 years. Fifty-year renewals are available but must be applied for.

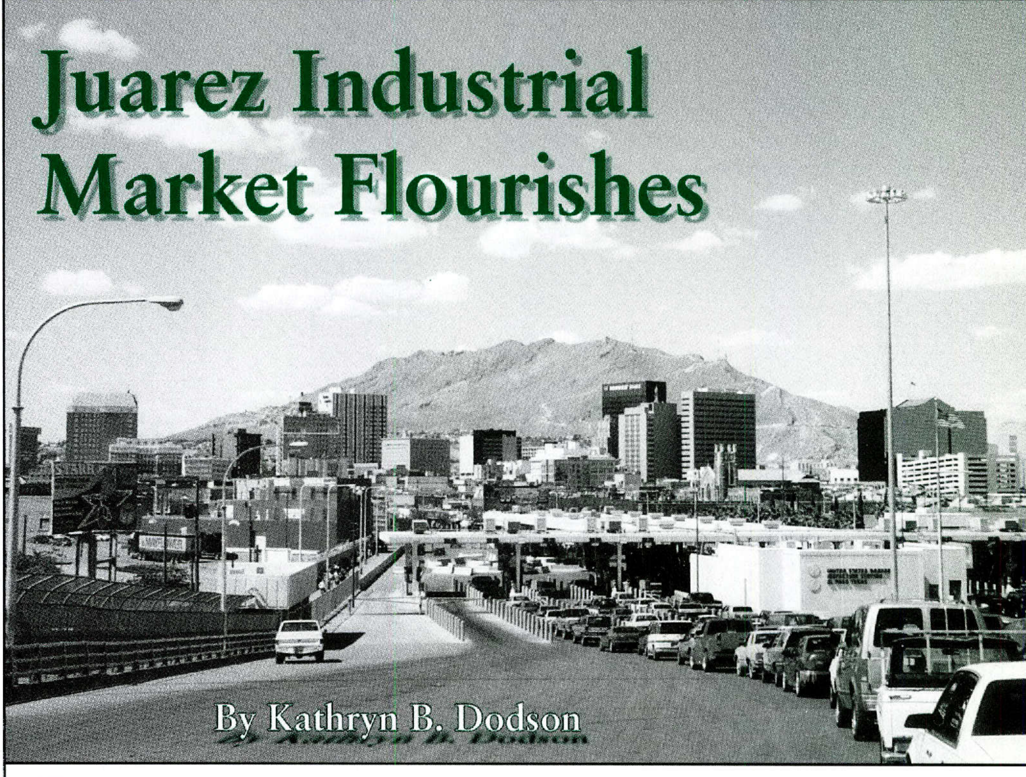
Although Mexico does not use promulgated forms, contract negotiations generally begin with a "letter of intention" outlining the price, agreement terms and conditions and a reasonable (5 to 10 percent) earnest money deposit. The selling agent holds these funds.

If the letter of intention is signed, a formal purchase and sales agreement (Convenio de Compra/Venta) is executed, and additional funds of as much as 50 percent are deposited. No secure escrow accounts exist, and agents comingle any funds received from buyers with their own personal funds.

Within a 90-day period, the formal deed (Escritura) is drawn up by, and signed in the presence of, a *notario publico* chosen by the buyer. Approximately 1,500 notarios currently operate in Mexico. Notarios act as both attorney and title company and are appointed for life to a specific district by the governor of each state.

Before closing, foreign nationals must obtain a letter of permission (basically a waiver) from the Foreign Ministry, obligating the purchaser to abide by the Platte Amendment. Under this amendment, purchasers must agree not to bring suit in foreign courts or ask foreign governments for assistance in Mexican land matters. The letter is largely a formality and can be secured by either a civil lawyer, a notario or the purchaser.

Sellers typically pay only the sales commission, while buyers pay all other closing costs. Taxes, legal fees and other closing costs can range from 5 to 15 percent of the purchase price.



Juarez Industrial Market Flourishes

By Kathryn B. Dodson

Just across the border from El Paso, the industrial real estate market in Juarez has been growing since Mexico started the 1960s maquiladora program of tax incentives. Today, the city has approximately 36 million square feet of industrial space used by more than 300 manufacturing facilities employing 250,000. Fifteen thousand people commute daily from El Paso to work in Juarez, making the Juarez-El Paso region one of the largest international manufacturing centers in the world.

In Juarez, companies represent a wide variety of industries, including the manufacture of televisions, automotive components, medical equipment, consumer electronics, wire harnesses and aerospace equipment. Philips, Thomson (RCA), Delphi (a subsidiary of GM) and Johnson & Johnson are some of the largest Juarez employers.

An increasing number of high-tech companies are opening facilities in this busy city, including Lexmark, Acer, Scientific Atlanta, Delta/Axxion and Toshiba. High-tech products include DSS satellite dishes, printer cartridges, cable boxes and computers. The number of high-tech and Asian companies in the region is expected to continue growing as companies take advantage of favorable NAFTA regulations.

Until recently, the industrial real estate market consisted primarily of build-to-suit facilities. Over the past two years, this has started to change as several Mexican developers and international development companies, such as Prologis and IDA, have built speculative manufacturing facilities. This trend is expected to continue.

Manufacturing growth in Juarez has spurred industrial development in El Paso as well. Most of the companies that manufacture in Juarez have warehouse and distribution facilities in El Paso to take advantage of the U.S. transportation network and lower real estate prices.

Competitive labor rates attract companies to Juarez, while warehousing and capital intensive manufacturing businesses often stay on the U.S. side of the border. The region is poised for more growth on both sides of the border, and this means the industrial real estate market will continue to strengthen.

Dr. Dodson is with Best de Mexico Real Estate in El Paso.

A major expense unique to Mexico is the 2 percent acquisition tax. Notarios typically receive an additional fee of approximately 2 percent for drafting the deed, searching the title and registering the property. Other mandatory closing costs involve expenses for the survey, an appraisal for tax purposes and title registration.

Occasionally, additional costs are incurred when bank mortgages or release of liens are necessary. Although bank mortgages are quite rare, especially when Mexican nationals purchase residential property, banks often require a second appraisal when issuing a mortgage. A number of U.S. mortgage firms, including Irwin (formerly Inland) Mortgage and Collateral Mortgage, have entered the resort markets with programs designed to specifically accommodate U.S. and Canadian citizens. The beneficial trust serves as the vehicle to assure payment.

Several U.S. companies currently offer title insurance to U.S. citizens who own property in Mexico, including Stewart Title and First American Title. The cost involves a preliminary, non-refundable fee for a title search, in addition to a policy premium based on the insured value of the property. For more information on Mexican title insurance, see "Viva Mexico" by Mitch Creekmore, *ALTA Title News*, July/August 1997.

"The notario is not obligated to help with resolving a title problem," according to Creekmore. "Recourse against the notario for a mistake by the notario or anyone else is not grounds for repayment unless there is proof of fraud, gross negligence or known misrepresentation in a Mexican court."

Mexican citizens use the notario's opinion of title as a perception of guarantee and have not embraced title insurance. However, the Mexican government and the banks have come

BUILT UPON ANCIENT AZTEC RUINS, *Mexico City is the world's second largest city with a population of 20.9 million. Even with its many modernizations, however, numerous residential transactions occur without the aid of a real estate professional. A popular method for advertising properties is to hang banners and flags in trees or across streets.*

to realize that, for the creation of a secondary mortgage market to recapitalize the banks, title insurance will be necessary.

Closings usually occur at the office of the notario. The time between the buyer signing the sales contract and receiving title is generally 30 to 90 days, depending on the notario's work load.

Concluding a successful real estate transaction in Mexico requires considerable attention to detail. As border relations continue to grow and Americans become more receptive to direct foreign investment, the number of Americans owning real property in Mexico should increase. Texas licensees who understand the procedures and risks may consider positioning themselves to take advantage of this trend. ◻

Hunt is an assistant research scientist with the Real Estate Center at Texas A&M University, and Feldman CCIM, CIPS, is a real estate consultant based in Mexico City and operating through the republic.

Tradition, Customs Dictate Success

By Adrian A. Arriaga

Mexico's market potential, especially in manufacturing and tourism, has enabled many U.S. firms to establish in Mexico. To make a successful transition, these companies need the assistance of real estate professionals willing to do business in Mexico.

Two characteristics are important when doing business across the border: an open mind and flexibility. In Mexico, tradition and customs dictate how business typically transpires. For example, personal relationships are more important than contractual ones It is necessary, therefore, to invest time in cultivating rapport and establishing trust with clients and prospects.

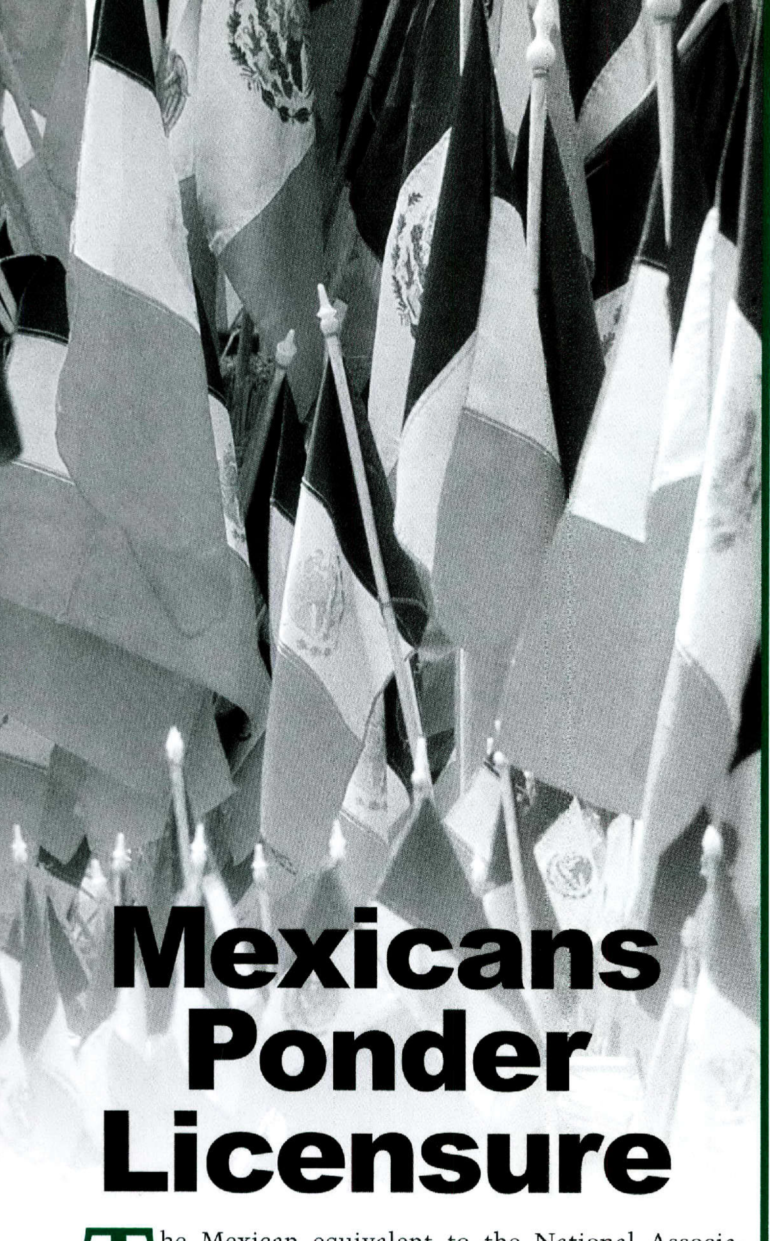
Enjoy lengthy business meals with Mexican colleagues. The long business lunch (comida) may seem inefficient to Americans, but it is an integral part of conducting business in Mexico.

Closing a business transaction usually takes longer and should not be expected after the first long lunch or breakfast meeting. In most situations, Mexican clients will want to get a sense of who they are dealing with before serious business is discussed.

Another essential tip: learn and use Spanish. A working knowledge of the language will further business dealings.

In Mexico, people often are judged by personal qualities more than performance. Common courtesy and manners, as well as appearances, are important qualities when making a first impression. ◻

Arriaga is the CCIM ambassador serving Mexico and Latin America as well as broker and owner of AAA Real Estate & Investments in McAllen.



Mexicans Ponder Licensure

The Mexican equivalent to the National Association of Realtors hopes to more closely mirror the U.S. organization in the near future. Established in 1956, the Asociación Mexicana de Profesionales Inmobiliarios, A.C. (known as AMPI) currently has approximately 1,200 members operating in more than 1,000 real estate firms across the country.

"In an effort to increase the educational standards and the industry's level of professionalism, the Mexican government and AMPI studied the possibility of licensing for the past ten years," says AMPI President César Paredes. With the passage of NAFTA's reciprocal licensing provisions, even more importance has been given to its implementation.

Progress has been made. In 1993, AMPI first proposed federal real estate licensing to the Mexican congress. In April 1998, the state of Sinaloa passed the first real estate services law—a major step toward licensing. Two additional states, Nuevo Leon and Guanajuato, are close to implementing state licensing as well.

"The law provides for examinations, standardized educational requirements and registration with the Procuraduria Federal del Consumidor (similar to the U.S. Consumer Protection Agency)," says Paredes. "Registry is now mandatory in the state of Sinaloa and voluntary in the remaining states."

AMPI plans to continue supporting passage of a broad federal real estate licensing law as well. It would offer a national license, while individual states could implement more specific licensing restrictions if desired.

Conduits A Source of Funds for Commercial and Multifamily Borrowers

By Wayne E. Etter, Chris Price and Candace Rhodes

The real estate market crisis of the 1980s caused a large number of commercial real estate assets and mortgages to fall into the hands of the Resolution Trust Company (RTC). The RTC was established by the 1989 Financial Institutions Reform, Recovery and Enforcement Act (FIRREA) to dispose of property acquired by the federal government when it acquired the assets of failed savings and loan associations. This agency was forced to seek alternative ways to dispose of billions of dollars of commercial real estate loans. Many of the mortgage loans acquired by the RTC were placed in pools and used as collateral for bond structures known as commercial mortgage-backed securities (CMBS). The principal and interest payments by the individual borrowers were passed through to the investors who purchased the CMBS.

This process, known as *securitization*, aided the disposal process by offering real estate investors a way to diversify their risk exposure, target specific risk/return levels and enhance their liquidity.

Pension funds, life insurance companies, commercial banks and saving and loan associations were, until the early 1990s, the only significant source of commercial and multifamily mortgage loans. Commercial and multifamily mortgage loans made by these lenders are normally held in that institution's own loan portfolio as an investment. Mortgage bankers sometimes facilitate the process by acting as intermediaries between borrowers and mortgage lenders.

Today, *conduits* are organizations that originate commercial and multifamily mortgage loans for the purpose of issuing a CMBS instead of holding these loans in their loan portfolio. Like mortgage bankers, conduits are intermediaries too, but they are intermediaries between real estate borrowers and investors that buy CMBS. Conduits are usually special capital market groups, subsidiaries of financial institutions such as commercial banks and security firms.

Conduits have greater flexibility than lenders that traditionally make loans for their own portfolio. Life insurance companies and pension funds, for example, often focus their mortgage lending activities on large, high-quality properties because these types of loans are consistent with their investment needs. Conduits, on the other hand, can focus on the needs of many

THE VOLUME of CMBSs has grown significantly in the last ten years with the establishment of more consistent underwriting standards, rating criteria and standardized security structures.

types of investors who have a wide variety of investment requirements. Consequently, they lend on large and small properties in a variety of geographical areas as well as a variety of property types. As long as there is investor demand for CMBS, conduits can continue to lend.

The volume of CMBS has grown dramatically in the 1990s (Table 1). Although the initial increase in activity was the result of RTC transactions in 1992, the RTC disposed of all its assets and had shut down by the end of 1995. During 1992-95, however, the establishment of underwriting standards, rating criteria, valuation techniques and standardized security structures paved the way for the recent growth in securitized mortgage lending. As reported in Table 2, CMBS represented 11.8 percent of 1997 mortgage originations.

Table 1: CMBS Loan Originations, 1990-98 (in millions of dollars)

Year	Volume
1990	$ 4,828.8
1991	8,196.7
1992	13,997.3
1993	17,504.6
1994	20,331.8
1995	18,970.9
1996	29,694.3
1997	43,998.7
1998	78,295.3

Source: *Commercial Mortgage Alert,* January 11, 1999.

How the CMBS Market Operates

Conduits originate commercial and multifamily mortgage loans with the specific intention of securitizing them. Because securing a rating for the CMBS is essential to the security's sale, rating agencies play a vital role in this process. To facilitate the loan's review by the rating agencies, the mortgage loan documention is somewhat standardized.

Each loan placed in the loan pool by the originating conduit is reviewed by one or more rating agencies as part of the process

Table 2: 1997 Mortgage Loan Originations (in millions of dollars)

Institutional Lenders	Amount	Percent of Total Originations
Life Insurance Companies	$ 25,277	6.7
Banks and Mortgage Companies	264,959	70.6
S&Ls and Mutual Savings Banks	24,788	6.6
Pension Funds	9,641	2.6
Total	$324,665	
Publicly-Issued Mortgage Securities		
Government Credit Agencies	$ 4,276	1.1
Commercial Mortgage Securities	44,269	11.8
Mortgage REITs and Public Real Estate Limited Partnerships	1,885	0.5
Total	$50,430	
Total Originations	$375,095	99.9

Note: Total does not equal 100 percent because of rounding.
Source: *Investment Property and Real Estate Capital Markets Report,* July 1998.

of readying the CMBS issue for sale to investors. Despite the standardization of the loan documentation, commercial and multifamily mortgages are not homogeneous products; the rating agencies must analyze each loan. The rating agencies estimate the effect of a depressed real estate market on each property's operating performance and expected ability to service its debt. The expected risk of default decreases as the debt service coverage ratio increases and the loan-to-value ratio decreases.

Based on this expectation, the rating agencies assign the loans to risk classes called *tranches.* For example, those properties with the largest debt service coverage ratios (say 1.25 or more) and the smallest loan-to-value ratios (say 70 percent or less) are placed in the lowest-risk tranch, *i.e.*, the tranch with the highest rating. In a depressed market, these properties are expected to have the lowest probability of default. Because there is some probability of default, the rating agencies also estimate the percentage of the mortgage loan that can be recovered in the event of default.

For example, assume that a $100 million loan has a debt service coverage ratio of 1.25 and a loan-to-value ratio of 70 percent. Further assume that the rating agency believes that 75 percent of the total value **can be** recovered in the event of default. In this case, only $75 million is placed in the tranch with the highest rating. If the rating agency believes that it is **probable** that an additional 15 percent will be recovered, this additional $15 million might be split between the two next highest rated tranches. The remaining10 percent has the **lowest probability** of recovery in the event of default and will be placed in the lowest rated tranch.

To illustrate the importance of this process to the issuer and the investor, a simple example will be used. Assume the individual mortgage loans comprising a CMBS issue are sorted into four tranches—A, B, C and D. Then, a complex process that is fully described in the prospectus for each CMBS issue is used to allocate the collected principal and interest payments to the four classes. This, in turn, provides investors with an array of risk/return choices.

Cheat Sheet

Commercial mortgage-backed security (CMBS)—a bond or other financial obligation secured by a pool of mortgage loans.

Conduits—organizations that originate commercial and multifamily mortgage loans for the purpose of issuing a CMBS. They are intermediaries between real estate borrowers and investors that purchase CMBS.

Mortgage banker—organizations that originate and service commercial and multifamily mortgage loans.

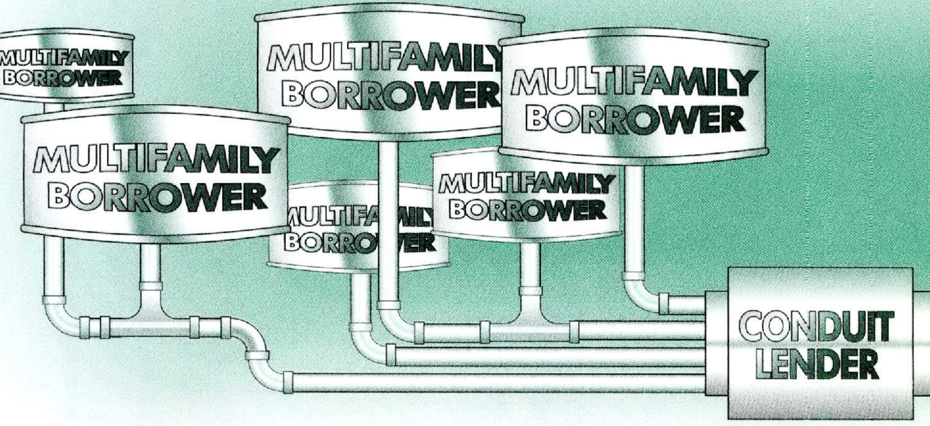
Securitization—the process of creating a security marketable in the capital markets and backed by a package of assets such as mortgage loans.

Subordination level—the amount of total loss required in lower-risk categories (tranches) before losses in the next highest category occur.

Tranches—categories that contain mortgage loans with similar risk of default.

Class	Pass-Through Interest Rate (Percent)	Ratings
Class A	6.525	Highest
Class B	6.734	2nd highest
Class C	6.881	3rd highest
Class D	7.117	4th highest

The Class A tranch receives the lowest pass-through rate because it has the lowest expected risk. This tranch has the lowest expected risk for two reasons. First, as explained previously, the mortgage loans believed to have a high probability of repayment were assigned to it by the rating agencies.



Second, the Class A certificate holders have the greatest access to the principal and interest payments made by all the individual borrowers to repay their individual loans, which comprise the collateral for the entire CMBS issue. On the designated dates for principal and interest payments to the certificate holders, the Class A, B, C and D certificate holders receive interest payments if there are sufficient funds available for this purpose.

If there are not sufficient funds available to pay the interest to all of the classes, Class A has the highest priority, Class B has the next highest priority and so on. Furthermore, until they are repaid, only the Class A certificate holders receive principal payments. This makes the Class A tranch less risky than the other tranches. When the principal and interest due the Class A certificates are repaid, then Class B certificate holders begin receiving principal and interest payments and so on until all of the classes are fully repaid.

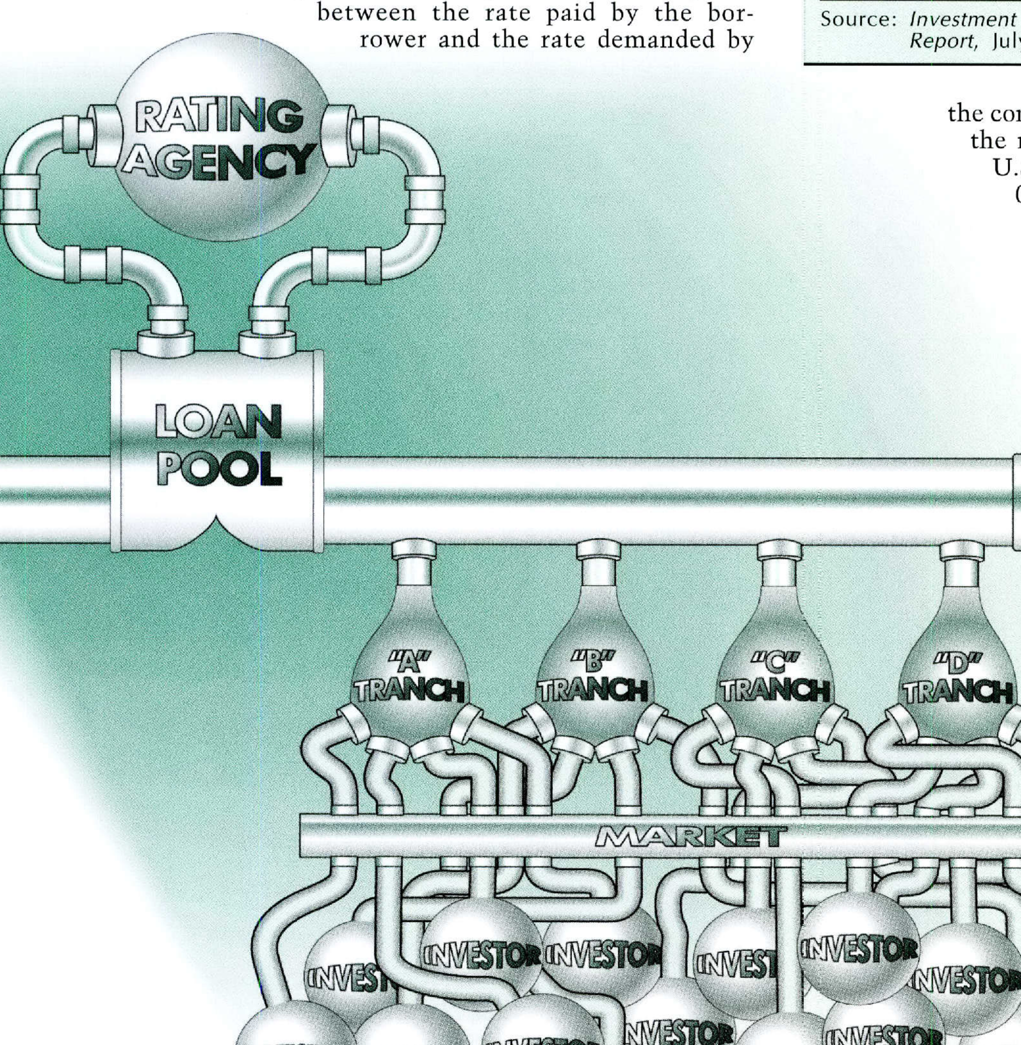
The effects of default on each of the classes are determined by the amount of default and the recovery percentage on the loan. If some of the mortgage loans default, the Class D certificate holders will not be fully repaid unless all of the loss that results from the default is recovered. If a sufficient dollar amount of the mortgage loans default and the recovery percentage is low enough, the Class D certificate holders might not recover any principal and the Class C certificate holders may lose as well. For the Class C certificate holders to be endangered, total losses must exceed the amount of mortgage loans that are placed in Tranch D. The amount of total losses required to endanger Class C certificate holders is called the Class C *subordination level.* For the Class B certificate holders to be endangered, total losses must exceed the amount of mortgage loans that were placed in Tranches C and D and so on. Thus, Class B subordination level is greater than that of Class C.

As described above, the CMBS market has developed mechanisms for matching CMBS to specific investors' risk and return

requirements. Those investors who demand low risk must accept a lower return; those investors who demand high returns must accept higher risk.

Underwriting Spread

The conduit also must negotiate a borrowing rate with the borrower. The borrowing rate is determined by two factors: the yield on U.S. Treasury securities and "the spread," established by considering the difference between the rate that CMBS investors will require to purchase the certificates in each of the tranches that make up the CMBS issue and the yield on a selected maturity of U.S. Treasury securities. The spread between the rate paid by the borrower and the rate demanded by the investor must be wide enough to provide the conduit an underwriting profit. Table 3 reports these spreads for ten-year U.S. Treasury securities for May and November 1998. If too many of the loans are classified as higher risk by the rating agencies and placed in the higher risk tranches, the conduit will have to offer investors a higher return to get the issue sold or the underwriting profit will be inadequate. Underwriters have no incentive to pursue the underwriting of new CMBS when underwriting profits are inadequate.



Obviously, underwriting conditions were splendid from 1996 through mid-1998. But, in mid-1998, the CMBS market was impacted by investor concern about the global financial crisis. World-wide stock market volatility and the Asian and Russian financial crisis in particular were important because they caused investors to seek the safety of U.S. Treasury securities (causing their prices to rise and their yields to decline). Because the conduits quote their lending rates in terms of the number of basis points over the yield on U.S. Treasury securities (one basis point equals 0.01 percent), borrowers expected their lending rates to fall.

Table 3: CMBS Spreads Over Ten-year U.S. Treasuries, May and August 1998

Rating	May 1998	August 1998
AAA	80 basis points	117 basis points
AA	90	127
A	105	145
BBB	135	200
BB	250	350
B	450	500

Source: *Investment Property and Real Estate Capital Markets Report*, July and October 1998.

On the other hand, CMBS investors became concerned about the possibility that the commercial property market was becoming overheated and demanded higher yields on new CMBS issues. To accommodate their demands, the spread between U.S. Treasury securities and mortgage lending rates widened (as reported in Table 3) because U.S. Treasury rates were falling and the demanded yields by investors were rising, but some borrowers balked at the higher spread. If the borrower balks at the higher rates, the conduit's only options are to accept a much smaller underwriting fee or not make the loans. Although these events slowed the CMBS lending during the last part of the year, 1998 originations were nearly double the 1997 volume. According to *Commercial Mortgage Alert*, experts predict that 1999 originations will be about $58.5 billion, a 25 percent decrease from 1998.

The explosive development of the CMBS market is a powerful advance in financing commercial and multifamily real estate. This market provides mortgage lending for a variety of commercial property types and sizes. It cannot function, however, in the absence of investor demand for these securities and terms that the borrowers are willing to accept.

The CMBS market grew rapidly during 1996, 1997 and 1998—despite the market's slowdown during the last half of 1998 because of the global financial crisis. This three-year experience indicates that commercial real estate finance has become a part of the broader world of Wall Street.

Dr. Etter is a professor with the Real Estate Center and of finance at Texas A&M University. Price is a graduate assistant with the Real Estate Center. Rhodes is employed by Univest Financial Services, Atlanta, Georgia, and was formerly a graduate assistant with the Real Estate Center.

My, How You've Grown

Texas Nears 20 Million Mark

By Steve H. Murdock

Texas is on the verge of a record-setting population explosion. More new Texans took up residence in the state during the year ending July 1, 1998, than any other year this decade. That sets the stage for what could send the 1990s into the record books as the decade with the largest numerical increase—ever.

In July 1998, Texas had nearly 19.8 million residents—nearly 374,000 more than lived here one year earlier. Only California added more people (484,000). Texas gained substantially more than did Florida (239,000).

Previously, the 1996-97 year had experienced the biggest growth of the decade. Roughly 353,000 joined the Texas population that year. As important as the level of growth is the balance in the sources of such growth.

Domestic migration—people moving into the area from outside the state—was responsible for 21.1 percent—about 79,000 persons—of the total 1997-98 population growth. International immigration accounted for 26.8 percent and natural increase (births minus deaths) for 52.1 percent.

Since the last census on April 1, 1990, Texas has added nearly 2.8 million, again second only to California with nearly 2.9 million. During the 1990s, Texas has had a 16.3 percent growth rate, the eighth fastest in the nation. Nevada has grown the most with a 45.4 percent increase.

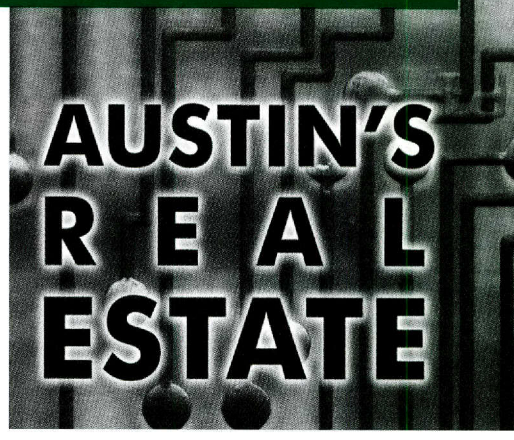
Put another way, the nearly 2.8 million new Texans is roughly equivalent to adding another Houston and another Dallas (1990 populations) to the state's total. The latest numbers suggest that under virtually any reasonable scenario the state will have 20 million residents by 2000.

The 1970s currently hold the record for the most people added in a single decade—slightly more than three million. Texas only needs to add 259,000 to break that record.

Texas population growth has been relatively balanced. Since April 1, 1990, 56.7 percent came from natural increase. Another 23.6 percent was the result of immigration from other countries. Other states contributed 19.7 percent. While Texas has been adding new residents by natural increase, international immigration and domestic immigration, other populous states have been hurt by the departure of large numbers.

Recent estimates suggest Texas will enter the 21st Century as a rapidly growing state with balanced sources of population growth. Although the characteristics of persons being added must be considered carefully when determining real estate implications, Texas has the ingredients to continue expanding its real estate market for years to come. ⊞

Dr. Murdock is a research fellow with the Real Estate Center and chief demographer of the Texas State Data Center, Department of Rural Sociology, at Texas A&M University.



By Harold D. Hunt

Once a small settlement along the Colorado River, the city of Austin has evolved into a dynamic metropolis of more than 500,000 residents. The population of the metropolitan Austin area, including Round Rock, Westlake, Cedar Park, Buda and Manor, exceeds one million.

In the past, Austin's economy was based primarily on higher education, state government and tourism. More recently, Austin has gained recognition as a global high-tech center by attracting such companies as Dell Computer Corporation, Motorola and Texas Instruments. According to a study by Dynamic Resource Solutions, the 70,000 employees of Austin's 1,750 technology firms comprise approximately 12 percent of the area's total work force, ranking eighth in the nation on a percentage basis.

Austin's high-tech employment has grown at an impressive 7 percent per year, nearly tripling over the last decade. Although the ongoing Asian economic crisis may somewhat reduce this rate, analysts believe the growth will continue. Total employment in the Austin MSA increased by approximately 25,000 jobs in 1998, a 4 percent increase from 1997.

Residential: Boom Goes On

Austin has a white-hot, single-family market. The combination of significant job growth and low mortgage rates has led to a housing boom. Annual new home construction has doubled since 1995. The number of existing home sales increased more than 23 percent in 1998 alone. The result has been a steady decline in the inventory of single-family homes available for resale since mid-1997.

The multifamily market also has been strong with consistent increases in occupancy and rental rates. Austin's overall rental rate of approximately 85 cents per square foot is the highest in the state, and the overall occupancy rate exceeds 96 percent. According to M/PF Research, lower job growth, combined with an additional 9,000 new apartment units during the next two years, may reduce

the multifamily occupancy rate to 92 percent and level off rental rates.

Industrial: Absorbing Space

In the industrial market, demand continues to keep pace with new construction. Even with a world-wide slowdown in the semiconductor industry, Austin absorbed approximately 1.9 million square feet of space in 1998, the most ever. More than half the absorbed space was located in the north Austin and Round Rock sectors.

More than one million square feet of warehouse space and 500,000 square feet of flex space will be completed in 1999, according to The Source, an Austin market research firm. The current overall industrial vacancy rate is approximately 7 percent.

Retail: Rates Higher, Vacancies Fewer

A growing population and solid consumer spending have produced a strong Austin retail market. According to Jerry Quick of Quick & Co. Commercial Realty, only 7.5 percent of Austin's 23 million square feet of retail space is vacant. A mere 130,000 square feet was completed in 1997 in the Austin area. More than 700,000 square feet was completed in 1998 while more than two million square feet is scheduled to be completed in 1999. Retail rental rates are expected to increase 5 to 6 percent in 1999 while the overall vacancy rate may tighten to as low as 5 percent.

Office: Overbuilding Unlikely

Although office space demand has been steady, the financing crisis that began in late summer 1998 has been a major factor in limiting new office construction. Austin's rigid zoning and environmental protection policies also continue to keep office supply in check, thus reducing the risk of overbuilding. Rental rates remain strong, with new construction rates approximately 17 percent higher than the overall average rate of $25.53 per square foot, according to The Source.

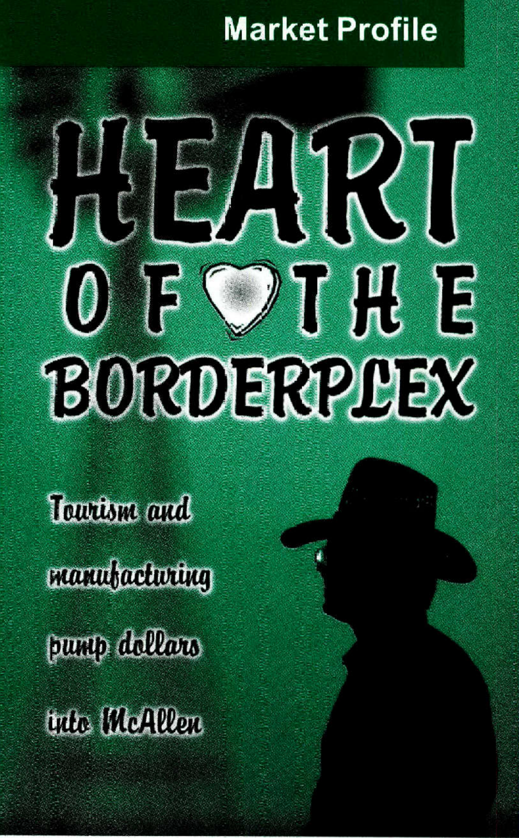
New office space is being absorbed steadily. Although an additional 750,000 square feet of office space was added during 1998, the city-wide occupancy rate increased to 95 percent by year's-end, an 18-year high. More than 2.4 million square feet of new office space are scheduled for completion in 1999, with 75 percent of it located in the northwest sector.

Downtown rental rates increased 20 percent in 1998, leading all other market sectors. Although the vacancy rate for downtown Class A buildings has fallen to 3 percent, that could change if there is a glut of suburban space on the market, according to Mike Kennedy of Michael Kennedy Interests. Access to downtown should worsen as construction begins on new properties. Companies with the option of moving to a more convenient suburban project may choose the suburbs.

Hunt is an assistant research scientist for the Real Estate Center at Texas A&M University.

***AUSTIN'S SAMSUNG EMPLOYEES CELEBRATE** the many accomplishments of 1998, the company's first full year in operation, including the production of 20 million chips in that time.*

Market Profile



Heart of the Borderplex

Tourism and manufacturing pump dollars into McAllen

By Mark G. Dotzour and Jennifer S. Evans

Encompassing all of Hidalgo County, the McAllen metropolitan area includes the major cities of McAllen, Edinburg and Mission. McAllen is located along the Texas-Mexico border, the heart of an area now referred to as the "Borderplex." At the center of international economic activity between the Americas, with three international bridges, the area is poised for explosive economic growth.

McAllen, as well as Hidalgo County, benefit from growing diversity in manufacturing facilities located in the McAllen MSA and in nearby Reynosa, Mexico. Until five years ago, the economy was largely agricultural. The primary crops include citrus fruits, vegetables, cotton and sugar cane. Spurring growth, NAFTA has had a major impact on the area's manufacturing and distribution facilities on both sides of the border.

Employment growth has been significant in this decade. The total number of jobs in the McAllen MSA increased from 128,600 in 1990 to more than 160,000 in late 1998, with the largest increases in service and trade. Unemployment rates traditionally are high in border cities, and in McAllen an unemployment rate of 16.3 percent was recorded for October 1998. Reynosa, Mexico, just south of the border from McAllen, is a major manufacturing center with steady employment growth.

According to Solunet's *Complete Twin Plant Guide*, nearly 70 manufacturing facilities are located in Reynosa, employing approximately 50,000. The area is a major center for manufacturing

of automobile parts, electronic components and television sets. This manufacturing trend is expected to continue.

Manufacturing growth in Reynosa creates corresponding employment increases on the Texas side of the border. NAFTA has had a significant impact on growth of the maquiladoras, Mexican assembly plants. Before NAFTA, no Pacific Rim companies operated in the area. Now there are more than 20 such companies in this market.

McAllen's population has grown as quickly as the economy. In 1997, the population reached 507,400. The annual growth rate since 1990 has averaged more than 4.5 percent. In addition, McAllen has a large number of "winter Texans." It is estimated that 130,000 people move to the area for the winter, creating additional demand for retail sales and services.

Area higher education facilities have recorded tremendous enrollment growth. South Texas Community College has grown more than 2,000 percent in the past three years, to 6,000 students. The University of Texas-Pan American has grown to 13,000 students, added new engineering and science buildings and plans to add a new student union and expand the library.

Local home sales in 1998 were strong but slowed from 1997 numbers when 965 homes were sold through the local MLS. Through November 1998, 617 homes sold, with an average selling price of $92,400. New home construction continues at a fast pace. In 1997, 4,155 new single-family home permits were issued, compared with 4,445 through November 1998. The need continues for affordable single-family housing.

During the past three years, McAllen has steadily added to the number of apartment units. In 1997, 1,121 permits were issued. Through November 1998, 796 apartment units were permitted, and the current apartment occupancy rate is at 91 percent, according to Apartment MarketData Research Services.

McAllen is a retail center for South Texas and Northern Mexico, drawing from a population of more than ten million within a 200-mile radius. Of the top 100 retail outlets in the United States, 24 can be found in McAllen. In the past ten years, retail sales have more than doubled from $1.7 billion in 1987 to $3.6 billion in 1997. The completion of a Foley's store added 180,000 square feet of retail space. Since 1997, 79,000 square feet of retail space has been permitted in McAllen, with a value of more than $2 million. During the same period, 23,000 square feet of restaurant space was permitted.

An estimated 130,000 'winter Texans' move to the area to escape colder climates. They create demand for additional retail sales and services.

Border-crossers and the "winter Texans" make a major contribution to retail sales. McAllen is unique for a city of its size because it has three viable retail shopping districts. Traditional mall shopping and modern shopping centers are located on the town's north side near up-scale housing and on the south side near the airport and Mexico.

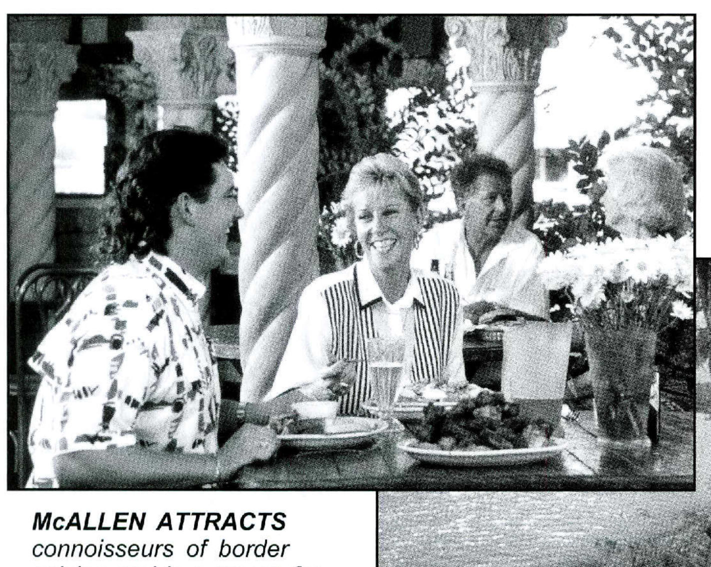
McAllen has a vibrant downtown retail district as well. All districts serve not only the Texas surrounding areas but also an active market of shoppers from Mexico, who find Texas prices less expensive than those at home. Bus service to and from Monterrey provides a steady stream of shoppers into the area.

McAllen is one of the few smaller metropolitan areas to record office construction in the past two years. Between January 1997 and May 1998, more than 222,000 square feet of office space, valued at nearly $8 million, were permitted. This new construction was spread throughout the city.

According to Michael Blum, president of NAI Rioco Realty, city-wide occupancy rates for Class A office space are at 80 percent. Class A occupancy rates are down from the 1997 rate of 98 percent because of a new high-rise bank and office building that opened in July 1998. The Class B office vacancy rate is 20 percent. Average rental rates for downtown office space are $15.50 per square foot, and new suburban office space rents at $13 per square foot. Class A suburban office space rents for $14 per square foot, and Class B space rents for $9 per square foot.

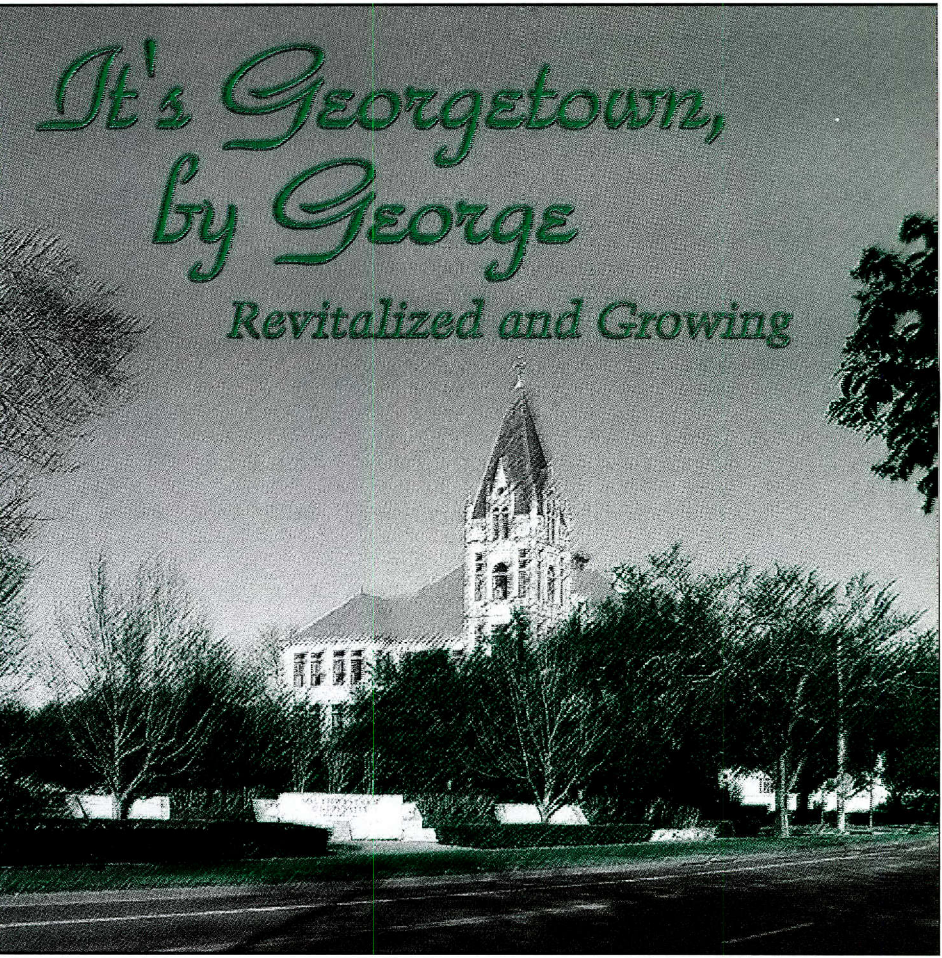
The area is poised for substantial industrial growth. Two major business parks are being added to McAllen. The Sharyland Business Park is on the south side of town and offers 900 acres of world-class industrial development potential. Part of a mixed-use development of nearly 6,000 acres, the park offers foreign trade zone (FTZ) status and double freeport tax exemption.

According to the McAllen Economic Development Corporation, 700 acres also are available inside the FTZ at below-market prices. Warehouse and office space is ready for leasing in the FTZ, located southwest of the airport and adjacent to the Sharyland Business Park. As these parks expand, McAllen is well poised to participate in the future growth of economic activities between the Americas.



***McALLEN ATTRACTS** connoisseurs of border cuisine and is a mecca for birdwatchers.*

Dr. Dotzour is chief economist and Evans is a research associate for the Real Estate Center at Texas A&M University.



It's Georgetown, by George

Revitalized and Growing

By Jennifer S. Evans

FOUNDED IN 1873, *Southwestern University is home to many of Georgetown's historic buildings. The Culen building, a campus landmark since 1900, is listed on the National Register of Historic Places.*

While I-35 was under construction, one of Georgetown's main attractions was discovered. Innerspace Caverns, a unique Texas cave site, hides beneath the city of Georgetown, the county seat of Williamson County.

While Innerspace Caverns is a major tourist draw, the above-ground real estate is the hot property.

Georgetown and Williamson County had an estimated 1998 population of 24,000 and more than 204,000, respectively. Unemployment has remained low for the last several years with an average unemployment rate of 1.8 percent in November 1998.

In 1997, Georgetown received the Great American Main Street Award for downtown revitalization efforts. The square downtown is vibrant with active businesses. According to Bruce Barton with the Georgetown Industrial Foundation, many of the stores on the square were boarded up during the late 1980s, but today the square has many restaurants, antique stores and other retailers.

The community economic development efforts have focused on diversifying the local economy. Barton says, "Our recruiting efforts are focused on 50- to 250-employee companies." These efforts have paid off. Since 1996, Georgetown has attracted more than 2,300 new jobs to the area. Barton believes that by attracting small-to-medium-sized companies the business owners are more likely to become involved in the community.

In addition to new employers, Southwestern University, a private liberal arts college, is an important source of qualified workers in Georgetown. The school has 1,200 students. The Multi-Institution Teaching Center on campus offers classes provided by a number of participating colleges. Six of these colleges, offering 33 degrees, hold courses throughout Williamson County. These institutions assist employers and employees in creating an educated workforce.

In 1997, Williamson County added 3,063 new single-family units at an average value of $100,700. Of those, 779 were in Georgetown. New single-family construction was down from 1996. One of the newest planned communities is Georgetown Village and is beginning to sell units.

Apartment construction has been strong since 1994 with more than 500 new units added since then. Apartment construction has been concentrated around I-35.

Sun City Georgetown, a Del Webb community, has had a huge impact on the number of retirees in the area. The deluxe, upscale retirement community has space for 9,500 homes, with 18,000 residents, and approximately 1,500 units already have been constructed. This west-side community plans to provide four 18-hole golf courses, hike and bike trails, a recreation center, pools, a fitness center, tennis courts and a ballroom. According to Leane Heldenfels with the Georgetown Development Services Department, "Sun City acts as a magnet, with other development coming in around it."

A few in-town projects with smaller lots and some zero-lot-line developments also have been started. Heldenfels notes that the demand for in-town smaller lots is exceeding the supply and suggests that retirees and county dwellers are looking for convenient housing closer to downtown.

Although some barriers to growth exist, for example, Lake Georgetown and a rock quarry to the south, Georgetown has several areas primed for development. Proposed Texas Highway 130 will join I-35 on the north side of the city. Heldenfels also adds that there are several large single-owner parcels available near the center of Georgetown.

New retailers include grocery stores and chain restaurants. Much of the new retail activity has been concentrated along I-35 and Williams Drive. Demand for office space has been limited within Georgetown. As increased industrial and office space is constructed in Round Rock, just to the south, demand for Georgetown office space may increase.

The outlook for the Georgetown area is positive. I-35 is one of the fastest growing corridors in the state. As the growth of the Austin area spreads to the north, Georgetown will continue to benefit and prosper.

Evans is a research associate for the Real Estate Center at Texas A&M University.

Huntsville Stands Tall

By Jennifer S. Evans

Huntsville is home to the world's tallest statue of an American hero. The 30-ton statue of Sam Houston, which is as tall as the pine trees surrounding it, can easily be seen from Interstate 45. While the statue lures tourists off the interstate, Huntsville leaders are exploring other ways to turn heads. Real estate plays an important role in that plan.

Tourism is a hot industry for Huntsville, especially throughout the spring and early summer. October, however, is typically the busiest month for tourism. In one month, the Chamber of Commerce reported visitors from 13 different countries. People travel from near and far to see such attractions as the Sam Houston statue, the Sam Houston National Forest and Park and the historic downtown area.

According to Dee McFarland, executive director of the Chamber of Commerce, the downtown is busy every weekend with tourists. Private businesses, with assistance from city government and grants, have improved the facades on the downtown square.

Huntsville had an estimated 1998 population of 34,500. Walker County had an estimated population of more than 56,500. These numbers also include the 9,000 inmates housed in the Texas prison system.

Huntsville has a stable employment base. The top employer, with more than 7,000 on its payroll, is the Texas Department of Criminal Justice headquartered in the city. Sam Houston State University (SHSU) is the second largest employer with more than 2,200 employees. Unemployment has remained low over the last several years. The average unemployment rate in August 1998 was 2.4 percent in Walker County, and the 1997 average rate was 2.6 percent.

The economic development efforts of the community have focused on industries and businesses that serve the prison system. When asked how Huntsville entices new companies, Stan Saucier, president of the Economic Development Corporation, responded, "through trade shows to attract prison-related businesses."

SHSU also has been key in attracting new businesses to the area. SHSU had a fall 1998 enrollment of more than 11,000, a figure down slightly from 1997. The university has the federally funded Center for Environment Studies. This research group attracted A.P.T. Catalysts, a polymer research and development center, which will work with the university's chemistry department. The university is in the process of completing a $6 million expansion for the Bill Blackwood Law Enforcement Institute.

In addition to the university and prison systems, Huntsville's medical center has built new facilities. New health clinics and a surgical center have been added to the local area.

Economic development efforts have focused on industries and businesses that serve the prison system.

In 1997, Walker County added 219 new single-family units, at an average cost of $84,800. By September 1998, 150 new units were under construction. The primary subdivision where construction is currently underway is on the south side of Huntsville near I-45. Elkin's Lake subdivision provides an 18-hole golf course, swimming pools and fishing lakes. The homes range from $80,000 to $300,000. Sales are primarily to retiring people and families looking to upgrade housing.

Other residential growth is developing in rural areas. According to James Bartosh of B&B Properties, many people moving to Huntsville are looking to get away from the urban setting of Houston. These customers are looking for a home with land.

Apartment construction has been active for the last two years. In 1997, 232 apartment units were added, and 220 units were planned for completion in 1998.

Retirement housing also is new for Huntsville. The Carriage Inn, an 84-unit retirement center was recently constructed. A new assisted-living facility, The Lexington, is slated for the near future.

The Sam Houston National Forest provides a permanent natural greenbelt along the south side of the city. This natural barrier protects Huntsville from becoming an uninterrupted part of the northern sprawl from Houston. There also are areas for potential growth. There are plans for a state and local road to be extended on the west side of Huntsville to help assist the traffic flow. J.D. Schindler, director of general services for Huntsville, reports that the city has recently completed a $14 million wastewater treatment facility in preparation for westward growth.

New retailers include Chili's, Blockbuster, drug stores and fast-food restaurants. Much of the new retail activity has been concentrated along State Highway 30. A new post office also is on the way.

Demand for small office is strong, although there has been no new office space construction in recent years. Much of the new demand is because of the Texas Department of Criminal Justice, which leases office space throughout the city. According to Bartosh, many professionals are looking for 400- to 1,800-square-foot spaces. There also are numerous inquiries about warehouse space, but the city currently does not have any available.

The outlook for the Huntsville area is positive. Tenaska has plans to build a large power-generating facility less than 30 miles away. Huntsville officials expect to see an economic spin-off in the community as a result of this new facility, including new residents and businesses. Houston is expected to continue to have a positive impact on the area as growth continues northward.

Evans is a research associate for the Real Estate Center at Texas A&M University.

Family limited partnerships can provide significant tax and non-tax benefits for families with real estate investments. Yet, as with any business decision, tax and non-tax benefits must be compared first with tax and non-tax costs.

COLUMN BY JERROLD J. STERN

COLUMN BY JERROLD J. STERN

ALL IN THE FAMILY

FLP offers financial benefits

A typical family limited partnership (FLP) consists of parent and children partners. The children acquire their partnership ownership interests as gifts from the parents. Because partnerships pay no tax to the federal government, each partner reports their share of partnership net profit or loss on their own tax return. In all limited partnerships, at least one partner (a general partner) is required to have unlimited liability—meaning they have unlimited personal liability with respect to potential lawsuits.

A limited liability company (LLC) used as a FLP should provide all the benefits and features of partnership taxation plus provide limited liability for all owners. The IRS, however, has not yet ruled on LLCs used as FLPs.

Tax costs and benefits. FLPs can provide tax savings from the income tax and the estate tax. To achieve these savings, parents first gift an FLP interest to a child. The gift, however, may be taxable. Assuming two parents, gift taxes are avoided if the gift's *discounted fair market value* is less than the sum of $20,000 ($10,000 annual gift tax exclusion per donee per parent) and the $1,300,000 (in 1999) lifetime combined gift/estate tax exclusion of the parents.

The discounted fair market value aspect is a major attraction of FLPs. For example, assume parents own income-producing real estate valued at $6 million. They form an FLP with their only child and gift the child a one-third partnership interest. What is the gift tax value of the child's interest? Because the interest is a minority (non-controlling) interest and does not have ready marketability, its value is substantially less than the value of the underlying real estate. The IRS allows the value for tax purposes to reflect a 20 to 50 percent discount.

Using a 40 percent discount, this transaction completely avoids gift tax: $2 million (1/3 of $6 million), less $800,000 (40 percent discount), less $20,000 combined annual gift tax exclusion, less $1,180,000 (of the $1,300,000 lifetime combined gift/estate tax exclusion).

Once the gift is made, tax advantages are that the parents' taxable estate is reduced by the $2 million real estate value transferred to the child plus all of the future appreciation on the one-third share of the real estate. Further, the interest remaining to the parents may be subject to larger discounts as each parent's community share is only one-third. Moreover, income tax on net income produced by the property is reduced if the child is more than 13 years old and his marginal income tax rate is less than the parents' marginal income tax rate. For example, assume the property generates taxable income of $300,000 per year. One-third, or $100,000, is taxed at the child's tax rate (an average rate perhaps as low as 25 percent) rather than the parents' tax rate (possibly 40 percent or higher), potentially saving $15,000 or more per year.

Non-tax benefits. Children can be formally brought into the family business without the parents giving up control (because they still retain more than 50 percent ownership). Family assets are protected from third parties and the spouses of family members.

Consolidating family assets may prevent them from being sold by disgruntled family members. This is accomplished by including buy-sell type provisions in the partnership agreement. FLPs also simplify future gift giving. For example, the parents' partnership interests can be gifted to children over a period of years rather than all in one year.

A general advantage of FLPs is that they can take advantage of flexible treatment offered by partnership tax rules. For instance, under the partnership agreement, deductions (or income) can be specially allocated to high (or low) tax bracket partners, as long as the allocation has economic substance, for maximum tax advantage.

Additional costs and caveats. Experienced legal and tax advisors must be used because the IRS carefully reviews FLPs, especially the valuation rationale for discounted gift values of partnership interests. One key requirement for defending an FLP transaction is that there must be a business (non-tax) purpose for establishing the FLP. The IRS has recently attacked FLPs established shortly before the death of one of the parents because it viewed the FLP to be nothing more than a vehicle to reduce the parent's estate tax. In the words of one tax commentator, "Family limited partnerships today are not for the faint of heart." ⊞

Dr. Stern is a research fellow with the Real Estate Center at Texas A&M University and a professor of accounting in the Kelley School of Business at Indiana University.

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