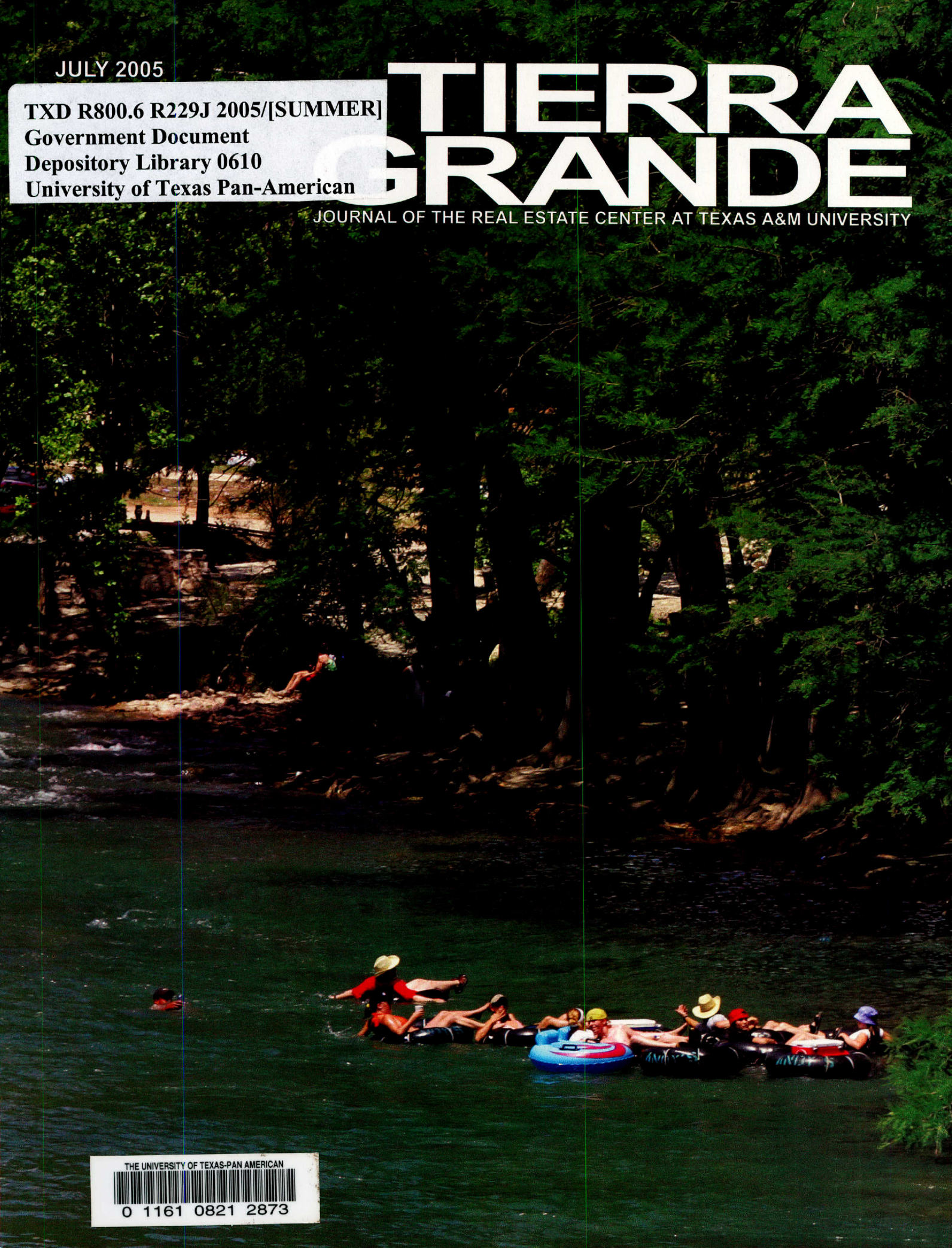


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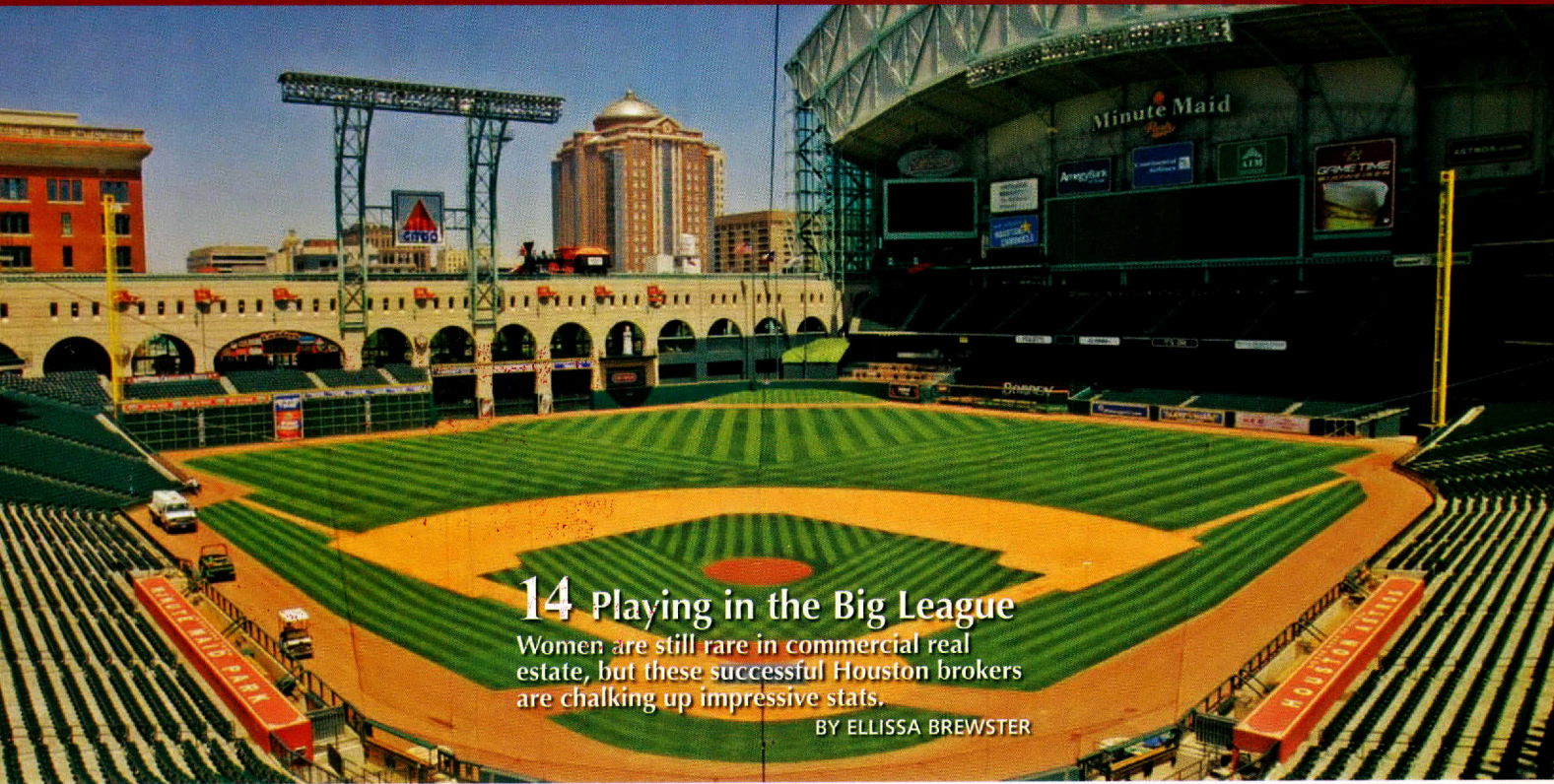
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Bubble Talk

Since 2001, the U.S. residential market has experienced a housing price boom unprecedented in residential real estate history. The average price of new homes in the United States rose from \$180,200 in December 2001 to \$229,700 in December 2004, a 27.4 percent increase. The median price of new homes increased 23.2 percent, from \$228,700 to \$281,900, over the same period.

More investment in residential real estate properties coupled with higher home prices has boosted household wealth in real estate. Homeowners' equity in all types of owner-occupied housing units, including farmhouses and mobile homes, rose from \$5.9 trillion at the end of 1999 to \$9.6 trillion at the end of 2004, an increase of more than 62 percent. Over the same period, household wealth in corporate equities fell more than 28 percent from nearly \$9.2 trillion to \$6.5 trillion.

Like those in the rest of the nation, Texas homeowners have benefited from the real estate boom. The average price of homes sold in Texas rose from \$132,200 in 1999 to \$164,400 in 2004, or 24 percent. During that period, the state's median home price increased from \$100,900 to \$129,600, or 28 percent.

While homeowners have every right to be exuberant about their wealth in residential real estate, remarks made by Allen Greenspan, chairman of the Federal Reserve, during the heyday of the stock market boom remind us that what goes up can come down. In a December 1996 address to the American Enterprise Institute, Greenspan asked "... how do we know when irrational exuberance has unduly escalated asset values ... ?"

Three years later, the S&P 500 Composite Index lost a quarter of its value, falling from 1,520.77 in September 2000 to 1,132.94 in September 2001. The decline troughed at 817.37 in February 2003, a fall of more than 46 percent from its peak.

Is the housing price boom that has been going on since 2001 in metropolitan areas of the United States likely to burst like the stock bubble did? It depends on whether higher home prices reflect housing market fundamentals or housing

investment speculation. Higher prices may be the result of fundamental changes, such as population growth, higher construction costs and lower interest rates. But increases in population and construction costs since 1999 have not significantly differed from previous periods. Further, lower interest rates in the past have not been associated with the scale of home price appreciation occurring since 1999.

There are reasons to believe that housing investment speculation has played an important role in pushing up house prices. Investors disappointed with the performance of the stock market have channeled a significant part of their investment funds to real estate properties. Increases in the flow of funds to real estate have been enhanced by historically low mortgage rates following the Fed's policy of lower Fed Funds rates.

What Factors Determine Home Prices?

The price of any asset, whether a house or a share of stock, is the discounted value of the future net cash flow that asset will generate. For stocks, the share price is equal to the discounted value of future dividends or earnings.

As an investment good, the price of a house is equal to the present value of future streams of actual or imputed net rents — that is, gross rents minus maintenance costs, taxes, depreciation and so forth. The ratio of the price of a house to its annual rent is like the P/E ratio (current price per share divided by current earning per share) for stocks.

When earnings per share are growing, competition among investors to buy stocks leads to higher stock prices. As long as the stock price growth rate is not much higher than the earnings growth, the P/E ratio for any stock remains stable. When stock prices grow faster than earnings, higher P/E ratios lead stockholders to expect higher earnings in the future.

Chairman Greenspan's comment on "irrational exuberance" reflected his concern about high P/E ratios, which later proved

Home Price Appreciation and Home Price/Rent Ratios

Figure 1
Dallas

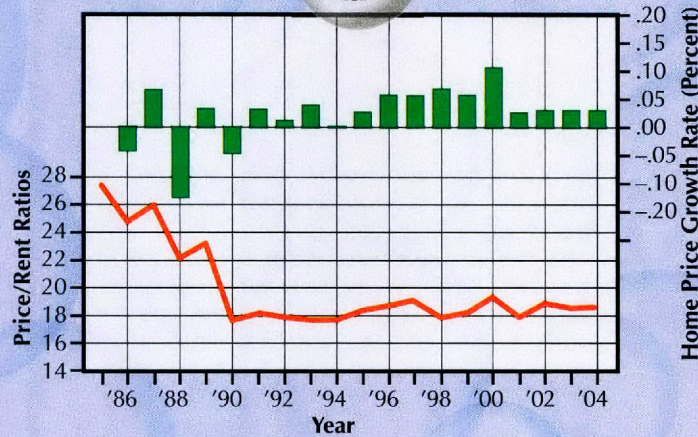


Figure 2
Houston

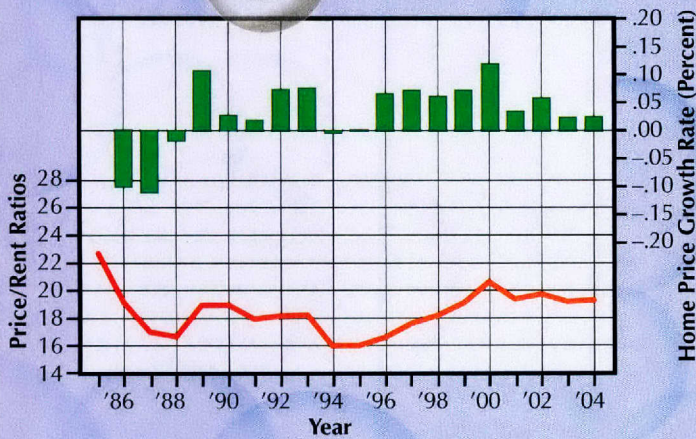
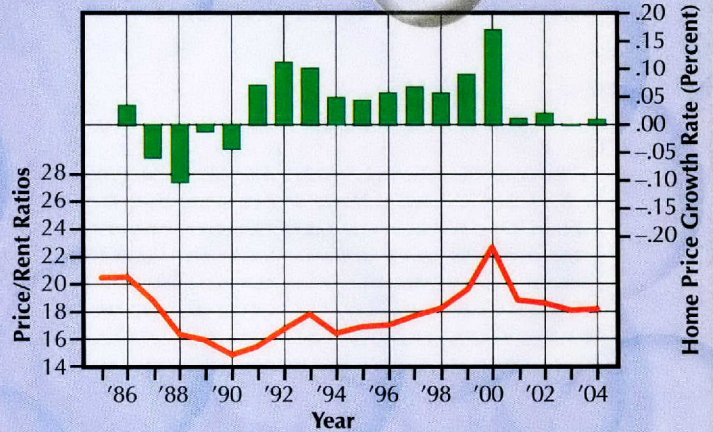


Figure 3
Austin



Sources: Real Estate Center at Texas A&M University and U.S. Department of Housing and Urban Development

to be unsustainable. The analogy between the P/E ratio for stocks and the price-to-rent ratio for houses suggests that high ratios of home prices to rents may be a sign of a housing price bubble in later periods.

The Real Estate Center researched whether a home price bubble exists in Texas residential markets. An analysis of home prices was conducted by comparing Texas home prices with home prices in the nation's residential markets. An analysis of the relationship between home prices, family income and rents in the state's residential markets also was performed.

Comparing
Sales Price to
Family Income

The table shows an analysis of home prices in select U.S. residential real estate markets using median home prices, average family incomes and annual rent data. Family income is used because the incomes of both spouses are normally used for buying homes.

The risk of a price bubble in the state's residential market is very low.

The ratio of the median home price to family income in U.S. cities in 2003 varied from a high of 8.95 for Santa Ana, Calif., to 1.47 for Pittsburgh, Penn. San Francisco had the highest median house price (\$597,493) but also one of the nation's highest levels of family income (\$67,809) with a resulting price-to-income ratio of 8.81.

On average, the ratio of home prices to family income was 3.59 in 2003. Taking this figure as the normal ratio of home prices to family income, all Texas cities posted a home price-to-family-income ratio of less than 3.59. Among major Texas cities, Austin had the highest ratio (3.16) while Corpus Christi was lowest with 1.58. Dividing the ratio of home price to income for each city by the average ratio (3.59) shows the extent to which the median home price for an area is higher or lower than the national average.

For Austin, this figure is slightly more than 88 percent. Thus, the median home price in Austin is about 12 percent less than the national average from the income viewpoint.

Comparing Sales Price to Rent

The ratio of median home price to annual rent in 2003 varied from as low as 11.45 for Philadelphia to 47.55 for Honolulu, with a national average of 22.04. Among Texas cities, Austin was the highest with a home price-to-annual-rent ratio of 20.07 while San Antonio was lowest (12.60). Based on the home price-to-rent ratio, the city of Austin is 8.95 percent less expensive than the national average.

More insight about home prices can be obtained by looking at the relationship between the growth rate of home prices and the price-to-rent ratio. Figure 1 shows that the Dallas residential market has been stable since 1990 following a drop in home price-to-rent ratio from 27.4 in 1985 to 17.6 in 1990. Dallas home price appreciation since 1990 reflects income growth as well as general inflation.

The Houston residential market experienced home price appreciation of more than 11 percent in 2000 associated with a price-to-rent ratio of 20.6, which proved to be unsustainable (Figure 2).

Austin's residential market is a classic example showing that high home price-to-rent ratios may signal negative or lower price appreciation in later periods or even a home price bubble (Figure 3). The city experienced home price appreciation of 43 percent from 1996 to 2000. During that period, the home price-to-rent ratio rose from 17 to 22.8. The ratio of home price to rent fell to 18.1 in 2004, and the city recorded a decline in home prices in 2003.

Center researchers developed a method for calculating maximum home price-to-rent ratios for Texas residential markets. If an area's home price-to-rent ratio for any period exceeds this maximum ratio, then home prices are expected to fall. Current home price-to-rent ratios for all Texas

metro areas are below the maximum ratios. Thus, the risk of a price bubble in the state's residential market is very low.

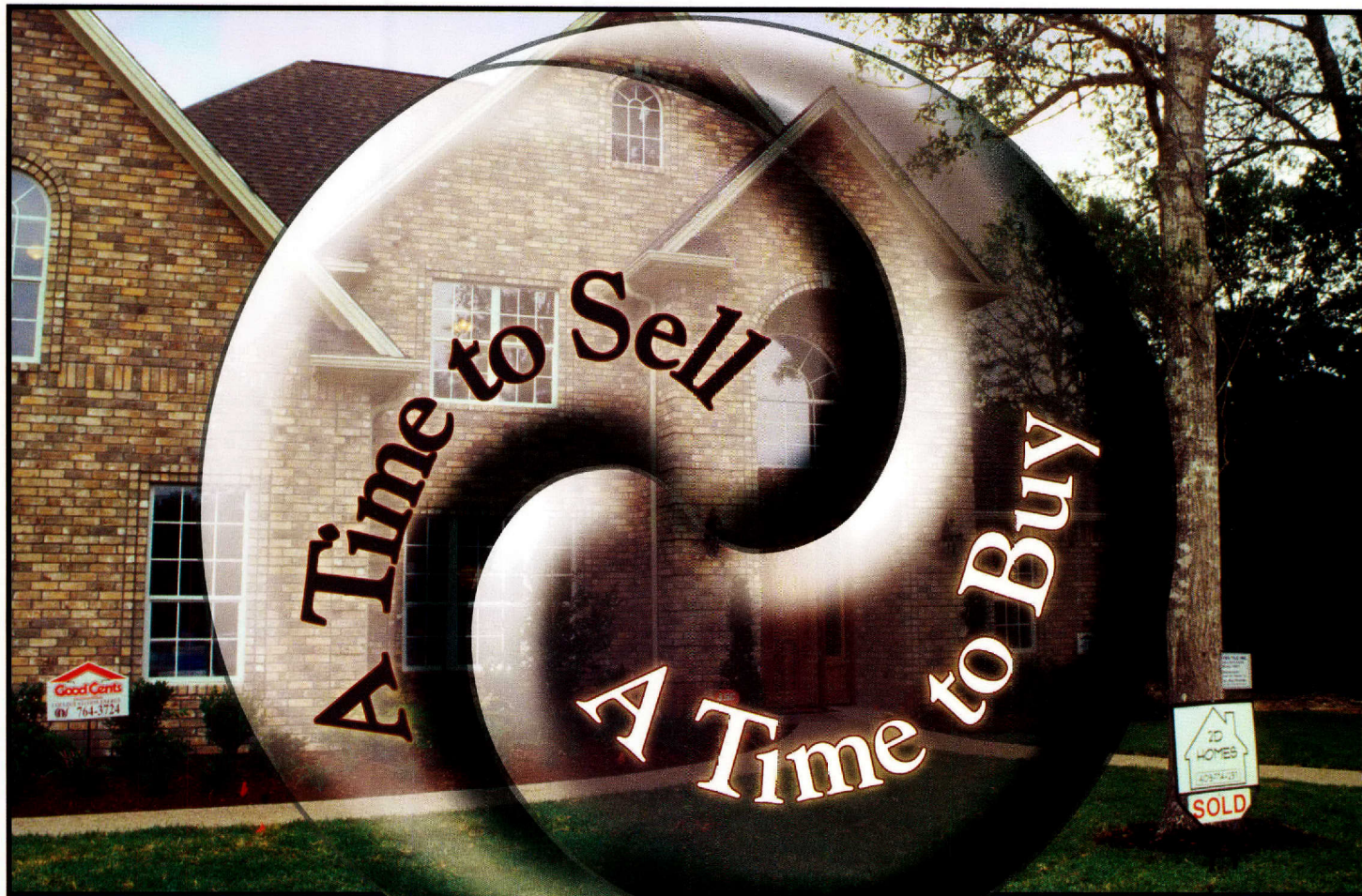
Houses are both investment goods and consumption goods. While a share of stock has no intrinsic value, people purchase houses to live in, as an investment or both. Home prices are determined not only by the present value of net rents but also by competition among homebuyers who want to live in the most desirable places (location, location, location!) and their willingness and ability to pay for their homes. Thus, in analyzing house prices, the relationship between rents and home prices as well as the relationship between family income and home prices must be considered. ♣

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Home Prices, Family Income, Annual Rents in Selected U.S. Cities, 2003

City	House Price	Family Income	Annual Rent	Price/Income	Price/Rent	Above or Below Average	
						Rent	Income
Anchorage, Alaska	\$195,209	\$67,884	\$9,420	2.88	20.72	-19.94	-5.97
Phoenix, Ariz.	140,072	43,872	7,140	3.19	19.62	-11.12	-10.99
Los Angeles, Calif.	345,737	44,479	8,700	7.77	39.74	116.40	80.31
San Francisco, Calif.	597,493	67,809	12,756	8.81	46.84	145.30	112.53
Santa Ana, Calif.	330,761	36,962	10,692	8.95	30.94	149.12	40.36
Denver, Colo.	225,337	51,686	7,788	4.36	28.93	21.37	31.28
Washington, D.C.	248,171	50,243	7,896	4.94	31.43	37.51	42.61
Miami, Fla.	183,808	28,623	6,432	6.42	28.58	78.77	29.66
Atlanta, Ga.	160,059	40,614	6,780	3.94	23.61	9.71	7.11
Honolulu, Hawaii	446,167	60,348	9,384	7.39	47.55	105.82	115.73
Chicago, Ill.	176,675	43,848	7,812	4.03	22.62	12.17	2.61
Indianapolis, Ind.	113,354	50,587	6,288	2.24	18.03	-37.62	-18.21
Louisville, Ky.	92,189	35,213	5,148	2.62	17.91	-27.12	-18.75
New Orleans, La.	79,838	38,510	5,772	2.07	13.83	-42.28	-37.24
Boston, Mass.	331,284	53,635	10,308	6.18	32.14	71.95	45.82
Detroit, Mich.	82,113	30,520	5,412	2.69	15.17	-25.10	-31.16
Minneapolis, Minn.	176,207	52,661	7,992	3.35	22.05	-6.85	0.04
St. Louis, Mo.	78,585	35,912	4,620	2.19	17.01	-39.08	-22.82
Las Vegas, Nev.	166,631	51,968	8,016	3.21	20.79	-10.74	-5.68
Albuquerque, N.M.	135,892	49,677	5,940	2.74	22.88	-23.85	3.8
New York, N.Y.	313,867	44,131	8,928	7.11	35.16	98.0	59.51
Columbus, Ohio	120,626	49,046	6,528	2.46	18.48	-31.53	-16.16
Oklahoma City, Okla.	94,856	44,565	5,124	2.13	18.51	-40.74	-16.01
Portland, Ore.	182,054	51,543	7,452	3.53	24.43	-1.67	10.85
Philadelphia, Pa.	72,716	41,577	6,348	1.75	11.45	-51.31	-48.03
Pittsburgh, Penn.	67,988	46,157	5,832	1.47	11.66	-58.99	-47.11
Memphis, Tenn.	83,104	35,309	5,832	2.35	14.25	-34.48	-35.35
Arlington, Texas	117,867	57,156	6,624	2.06	17.79	-42.59	-19.26
Austin, Texas	163,027	51,519	8,124	3.16	20.07	-11.91	-8.95
Corpus Christi, Texas	79,977	50,613	6,240	1.58	12.82	-56.01	-41.85
Dallas, Texas	116,266	41,049	7,284	2.83	15.96	-21.15	-27.58
El Paso, Texas	77,633	36,338	5,436	2.14	14.28	-40.52	-35.2
Fort Worth, Texas	92,530	45,492	6,264	2.03	14.77	-43.38	-32.98
Houston, Texas	101,639	40,043	6,756	2.54	15.04	-29.34	-31.74
Pasadena, Texas	87,740	40,632	6,120	2.16	14.34	-39.88	-34.95
San Antonio, Texas	77,722	44,329	6,168	1.75	12.60	-51.19	-42.83
Virginia Beach, Va.	153,619	60,611	8,184	2.53	18.77	-29.44	-14.83
Seattle, Wash.	334,423	66,752	9,480	5.01	35.28	39.47	60.06
Milwaukee, Wis.	95,674	39,443	5,976	2.43	16.01	-32.47	-27.36
U.S. Average	174,961	47,846	7,515	3.59	22.04		

Sources: U.S. Census Bureau and Real Estate Center at Texas A&M University



Real estate professionals know there are times when sellers can get their asking price, while at other times, they have to beg people to look at their properties. These swings are not the normal seasonal changes that depress sales in the winter and boost them in the summer. They are longer term, often taking many years to change from one mode to the other.

Periods when sellers have the upper hand are called "sellers' markets." These are ideal times to sell a home. When buyers have negotiating power, the market is called a "buyers' market." In buyers' markets, it is not uncommon for sellers to offer generous concessions.

Knowing whether sellers or buyers have negotiating power is important in pricing and marketing a property. This research gives real estate professionals a new tool to alert them when markets are about to change.

What Makes a Market Change

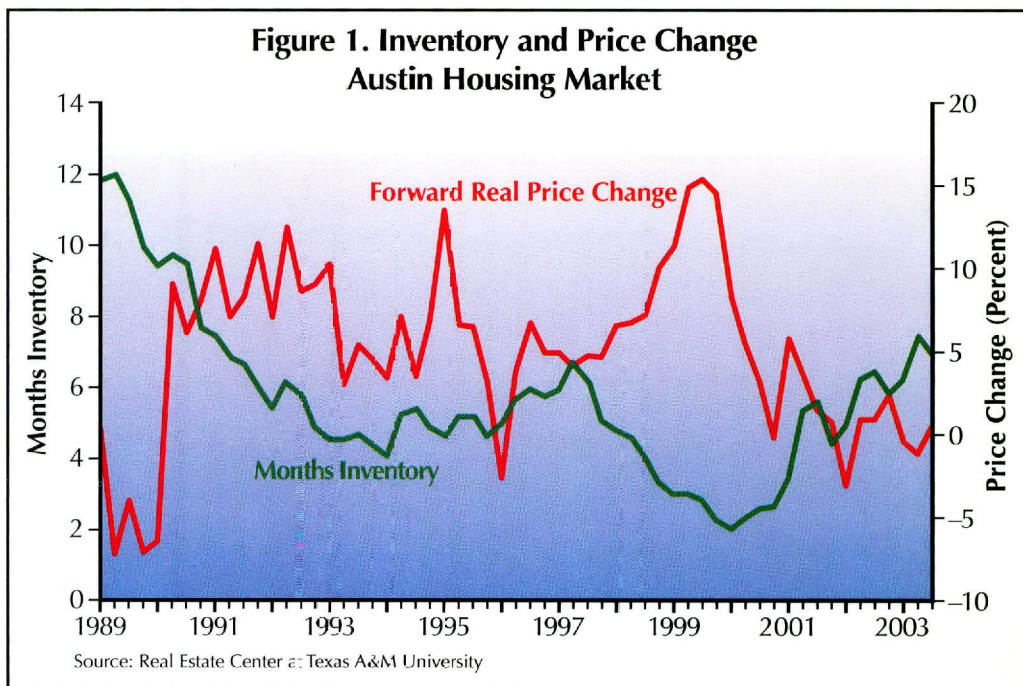
Prices are set by market supply and demand. Home builders and homeowners interested in selling their homes supply the market. First-time buyers, those relocating

and move-up buyers provide the demand. In most cases, demand is more sensitive to change than supply. A

plant opening or falling interest rates can boost demand almost overnight, while massive job layoffs and rising interest rates can dry up demand quickly.

Supply is more sluggish. It takes time to build new homes, and that is one of the main ways to expand supply. On the

Figure 1. Inventory and Price Change Austin Housing Market



other hand, it is difficult to withdraw supply already on the market.

As a consequence, housing markets tend to cycle between oversupply and shortage. Ordinarily, these swings take years.

Markets also can spend considerable time close to equilibrium, when neither buyer nor seller has a particular advantage. When a market is in equilibrium, prices are somewhat stable. This means homes appreciate at about the same rate as general inflation.

When demand increases faster than supply, housing becomes scarcer, and buyers tend to bid up prices. Home prices rise faster than inflation because each house becomes more valuable within the market.

In extreme cases, frenzied bidding by buyers may create a price "bubble," an unstable condition based on expectations of further price increases. When a bubble bursts, there may be no demand for homes until prices fall to a realistic level. These are disruptive periods, which is why market observers worry about price bubbles.

Usually, a sellers' market calms as it approaches equilibrium. When additional supply becomes available, it evolves into a buyers' market.

When supply is high and buyers are hard to find, prices rise slower than inflation and may even decline. Just as sellers' markets are difficult and trying times for buyers, buyers' markets present challenges to sellers.

Sellers in a buyers' market need to price and market their properties aggressively, perhaps offering warranties and paying buyers' closing costs. On the other hand, buyers in a sellers' market may need to make their offers more attractive by obtaining preapproval for financing.

Reading the Market

Examining price trends is one way to detect the existence of buyers' or sellers' markets. Trends must persist for several



THE ABILITY TO READ THE HOUSING MARKET gives real estate professionals an edge when it comes to marketing properties for clients. Knowing whether a buyers' or sellers' market is likely to continue or is on the way out may affect sales strategies and contract negotiations.

months (not just a one-month spike) before they signal disequilibrium. The problem with tracking prices is that it takes time for price data to become available, and they can be misleading for local markets over short periods.

Because market cycles are caused by shifts in demand relative to supply, a good advance indicator is one that compares these two fundamental quantities. The month's inventory indicator, which the Real Estate Center reports for most Texas markets, does exactly that — measures how many months it will take to sell off the current inventory, based on the average number of sales per month for the previous year.

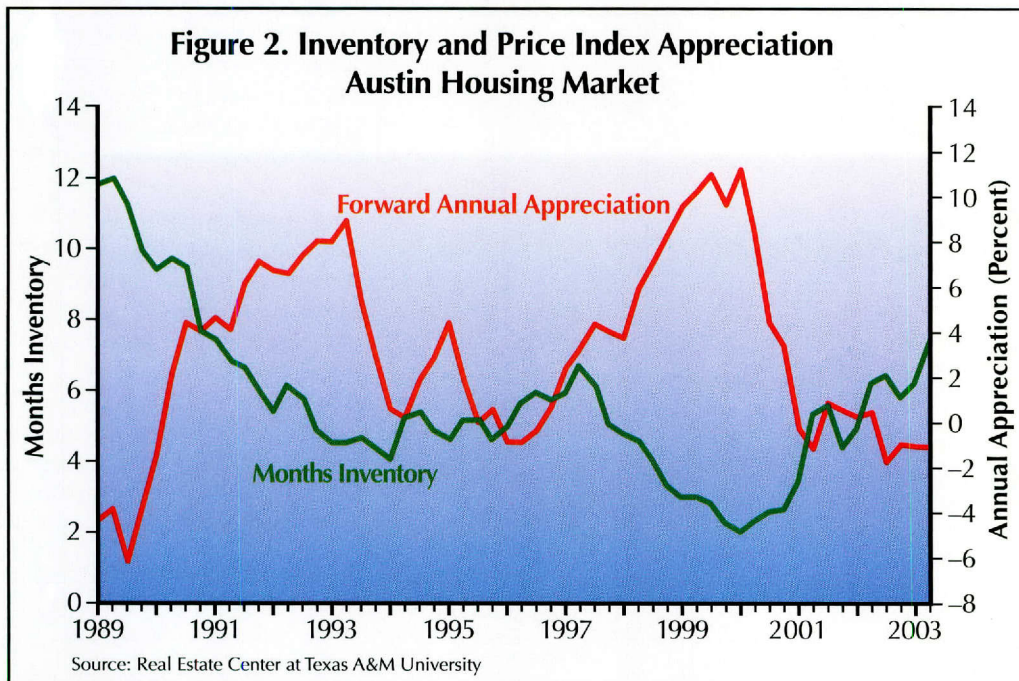
Inventory in a buyers' market tends to be high because the market is oversupplied. In a sellers' market, inventory is lower, corresponding to the scarcity of homes available. In between, inventory is consistent with equilibrium — that is, there are enough homes to allow buyers adequate choice but not so many as to cause prices to fall. The key to reading market

conditions is knowing the equilibrium inventory level.

Equilibrium inventory may be different for each market and may change over time for the same market. Sales volume is the key. In large markets and in times when sales are active, the equilibrium month's inventory can be lower. The higher number of average monthly sales means that each month of inventory will be larger. These larger numbers increase the odds that there will be a wider variety of homes available. A one-month's supply of homes in Houston might equal 5,000 homes, while in Abilene, it may only be 150 homes.

Real World Applications

How can anyone know what the equilibrium inventory level is for



a housing market? The only way is to examine the recent past and see how prices behaved at different levels of inventory.

The basic idea is to match periods when prices are falling and periods when they are rising rapidly to specific levels of month's inventory. When prices are falling, inventory levels are associated with buyers' markets and those for rising prices with sellers' markets. Because months inventory is used as a leading indicator, the change in price measure is based on change in the subsequent year. Therefore, price change is measured by the percentage change in real (adjusted for inflation) median price over the next four quarters.

The Austin market illustrates the method used to identify market phases. Figure 1 shows one-year forward price change compared to months inventory. Prices were falling in the late 1980s while inventory was nearly 12 months. As inventory fell in the early 1990s, prices began to grow by more than 10 percent a year. A mid-decade spike in inventory slowed price growth to near zero. From 1998 to 2002, inventory levels were extremely low and prices soared. The last several years have shown increasing inventory combined with low-to-negative price growth.

There is an obvious connection between inventory and price change. The chart identifies buyers' and sellers' markets and the inventory level associated with each. Although the price change series works well for the Austin example, there are problems associated with using aggregate prices to describe market conditions. Median prices are influenced by the mix of homes sold, and that can change from period to period.

The Office of Federal Housing Enterprise Oversight (OFHEO) price index, which takes into account changes in the characteristics of homes sold, is a better choice. Figure 2 compares forward annual change in the price index to Austin market inventory. The index change line is smoother and more consistent than the price line used in Figure 1.

Figure 2 and the underlying data series for price index change and inventory yield the following analysis. In 1989 and 1990, the price index fell by 3.5 percent per year and inventory was greater than eight months. This period was definitely a buyers' market.

For the next 1½ years, inventory fell from eight to six months, and the index grew by 5.3 percent per year. This suggests that eight months is the threshold for a buyers' market.

Until 1996, inventory stayed under six months, and the index grew by more than 5 percent per year. The index sagged over the next 18 months, as inventory rose above 5.5 months.

When it fell and stayed below five months from mid-1997 to the end of 2000, the index soared by 8.6 percent per year, indicating a strong sellers' market. The index has fallen slightly over the past four years while inventory has remained above the five-month mark. It appears that a sellers' market in Austin occurs when inventory falls below five months. A true buyers' market occurs at levels above eight months.

A similar technique has been applied to all Texas metrowide markets for which the Center has continuous inventory data for the period 1989 through 2004. The table provides the results, showing buyers' markets and sellers' markets and the inventory level associated with each.

Sellers' and buyers' markets significantly affect homeowners' abilities to sell their properties. Knowing when a market has shifted into or out of one of these phases can be helpful in setting sales strategies and negotiating contracts. This article is the first systematic attempt to identify the level of inventory associated with each phase. The author is interested in hearing from readers on the value of such a measure and how it applies to their markets. ♦

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Buyers' and Sellers' Markets in Texas Metropolitan Housing Markets

Market Area	Type	From Yr/Qtr*	To Yr/Qtr*	Average Annual Real Appreciation (percent)	Months Inventory
Abilene	Buyers'	1989:1	1990:3	-7.7	>8
	Sellers'	2002:3	2004:2	+1.9	<6
Amarillo	Buyers'	1989:1	1991:3	-2.0	>12
	Sellers'	1993:3	1996:2	+3.2	<6
Austin	Buyers'	1989:1	1990:4	-3.5	>8
	Sellers'	1997:3	2001:1	+8.6	>5
College Station	Buyers'	1989:1	1991:2	-2.4	>12
	Sellers'	1997:3	2000:4	+3.3	<5.5
Corpus Christi	Buyers'	1989:1	1992:2	-1.0	>12
	Sellers'	2001:3	2004:2	+2.9	<6
Dallas	Buyers'	1989:1	1992:3	-1.7	>10
	Sellers'	1997:3	2002:1	+4.2	<5
El Paso	Buyers'	1995:1	1999:1	-2.2	>7
	Sellers'	2002:2	2004:2	+2.6	<7
Houston	Buyers'	1989:1	1996:3	-0.1	>8
	Sellers'	1998:1	2002:1	+4.8	<5
Lubbock	Buyers'	1989:1	1990:3	-4.0	>10
	Sellers'	1999:3	2004:2	+2.4	<4.5
Midland-Odessa	Buyers'	1998:4	2000:2	-2.9	>7.5
	Sellers'	2000:2	2004:2	+2.0	<7.5
San Angelo	Buyers'	1989:1	1991:3	-2.5	>10
	Sellers'	2000:4	2004:2	+1.7	<7
San Antonio	Buyers'	1989:1	1990:4	-3.3	>15
	Sellers'	1998:3	2004:2	+2.0	<6
Sherman-Denison	Buyers'	1989:1	1990:4	-3.8	>20
	Sellers'	1998:2	2001:1	+3.1	<8
Tyler	Buyers'	1989:1	1992:3	-1.7	>10
	Sellers'	1999:2	2002:4	+2.6	<10
Victoria	Buyers'	1989:1	1992:2	-0.5	>9
	Sellers'	2001:3	2004:2	+2.7	<6

*Data series begins in 1989:1 and ends in 2004:2. Specific market phase may have begun before 1989 or continued beyond mid-2004, but that cannot be substantiated by the data available.

Source: Real Estate Center at Texas A&M University

TIC'S RENEWER

By Harold D. Hunt

A new method of syndicating commercial real estate is sweeping the country. This red-hot investment vehicle, known as a tenancy-in-common or TIC, creates an undivided fractional ownership interest in real property. These interests have become particularly attractive to real estate investors in search of properties qualifying for a 1031 tax-deferred exchange.

Unfortunately, the word syndication conjures up bad memories for many who lived through the 1980s real estate crash. Will this latest variation be "déjà vu all over again," or can TICs become an established, viable real estate investment vehicle? Can real estate licensees benefit from involvement in the purchase and sale of TICs? Will real estate licensees be allowed to receive a commission in some TIC transactions? At this point, there are as many questions as there are answers.

Small Investors Attracted

TIC transactions were first created in the 1990s by real estate syndicators, now commonly referred to as TIC "sponsors." Sponsors split the ownership of large income-producing properties into undivided shares, which give each investor an interest in the entire property as a tenant in common.

The TIC model offers several advantages. Investors who are financially unable to invest in a sizeable, high-quality commercial property can participate as part of a group. As a result,

small investors benefit from professional management and a stable cash flow.

These features are especially attractive to individuals attempting to separate themselves from the day-to-day management of their real estate assets. The purchase of TIC interests also allows for investment diversification by geographic region and property type.

Ruling Favors 1031 Exchanges

Probably the most important advantage of the TIC investment is that it qualifies for a 1031 exchange. Tax-deferred 1031 real estate exchanges have been recognized under the Internal Revenue Service tax code since 1921. However, whether TIC interests qualify for a 1031 like-kind exchange was unclear until the IRS issued guidelines in 2002 (Rev. Proc. 2002-22). Real estate partnerships do not qualify.

These guidelines fueled a dramatic increase in TIC investments. TIC equity volume exploded to \$1.8 billion in 2004 compared with just \$167 million in 2001, a 978 percent increase. More than \$4 billion in equity will be invested in 2005, based on information presented at the 2004 Tenant-in-Common Association (TICA) Symposium.

Increased availability of TIC properties should take pressure off investors attempting to secure an identically sized replacement property within the 45-day identification and 180-day closing periods mandated by the IRS for a successful 1031 exchange. With the use of a TIC, a sponsor can tailor the size of the undivided interest to meet the specific needs of investors seeking replacement properties.

IRS guidelines establish 15 conditions that should be considered when structuring a TIC interest to qualify as a replacement property for a 1031 exchange. However, the IRS may issue a private letter ruling determining whether a particular

TIC transactions are structured as real estate or as a security. However, there are no safe harbors or ironclad rules.

The National Association of Realtors has established a Tenants-in-Common Working Group to educate commercial brokers about real estate and securities issues surrounding TICs. The group concluded that there is "no clear guidance as to when the marketing and sale of TIC interests can be brokered as real estate only and not subject to applicable requirements of federal and state securities laws, when that activity must be treated as the sale of a security, or when persons holding real estate licenses may participate in and be compensated for the sale of TIC interests that constitute the sale of a security."

Presently, a real estate licensee can safely collect a real estate commission when the entire property is sold to a TIC sponsor. When a property interest is later transferred to or from the TIC, whether structured as real estate or not, collecting a commission is questionable.

In a March 2005 notice to its members, the National Association of Securities Dealers (NASD) stated that securities broker-dealers who pay a fee to the real estate agent or split a brokerage commission with the agent in connection with a TIC exchange have violated NASD Rule 2420, which prohibits payment of commissions and fees to entities operating as unregistered broker-dealers. Estimates are about 10 percent of all TICs are being structured as real estate and not securities.

The savings in front-end fees is a primary reason for structuring a TIC as real estate rather than as a security. When securitization fees are added to other costs, such as financing fees, sponsor commissions and due diligence costs, the front end "load" may exceed 25 percent of the investment in some cases. Reduced loads generally equate to higher investor return. Potential TIC investors should compare the load

costs against the tax benefits derived from conducting a 1031 exchange.

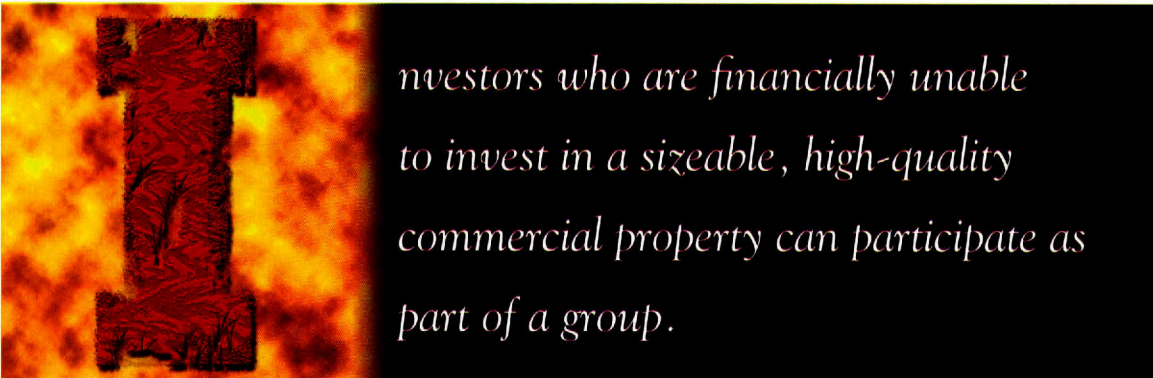
In return for their fees, sponsors take on the responsibility of creating a viable TIC investment. Potential properties must be identified and either put under contract or purchased outright. All aspects of sell-

ing and marketing the TIC interests must be arranged by the sponsor, usually through the services of one or more securities broker-dealers.

Sponsors work with lenders and mortgage brokers, putting together the information necessary to secure financing. Sponsors also are heavily involved in arranging for property management, disbursing payments to the TIC investors and coordinating the eventual sale of the entire property.

TIC Concerns

TIC investments are not risk free. Investors must consider liquidity and control risks along with market risk, management risk and economic risk. If the TIC interest is sold as a security, the risks will be specified in a Private Placement Memorandum (PPM) required by the SEC. A PPM is not



TIC agreement qualifies, even if all these conditions are not met. Likewise, an unfavorable ruling is possible even when all 15 conditions are met. In the final analysis, the sponsor's intent when structuring the TIC agreement plays a pivotal role in the determination.

Real Estate or Security?

For real estate licensees, a key question is whether a TIC is classified as a real estate transaction or a security investment covered by the Securities and Exchange Commission (SEC). The answer determines whether the real estate broker is entitled to a commission.

Although the IRS views TIC transactions as real estate transactions, the SEC views most as securities. Some TIC sponsors obtain legal opinions from attorneys to determine whether

required with TICs sold as real estate, although some sponsors choose to issue them anyway.

Liquidity risk (involving divestment of the TIC interest) should be a prime investment concern. A well-conceived exit strategy must consider the sale of both the individual TIC interest and the entire property.

The IRS guideline states that "each co-owner must have the right to transfer, partition and encumber the co-owner's undivided interest in the property without the agreement or approval of any person." Investors wishing to sell an individual TIC interest not as a part of the entire property may encounter problems.

The guideline goes on to say, "restrictions on the right to transfer, partition, or encumber interests in the property that are required by a lender and that are consistent with customary commercial lending practices are not prohibited." As a result, lenders may include a number of limitations designed to protect their investment when an investor anticipates selling a TIC share. For example:

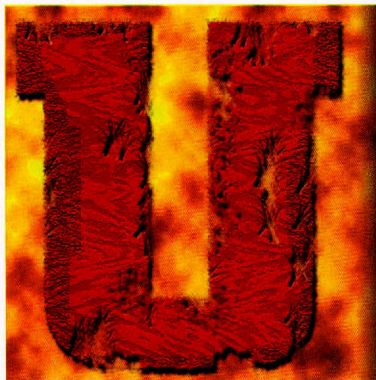
- Lenders may require their prior approval before an investor transfers a TIC interest.
- Lenders may attempt to restrict a TIC investor's ability to partition the property by demanding prior approval before modifying or terminating the TIC agreement.
- Lenders may mandate a minimum holding period for any large investors, especially in the case of recourse financing, which allows an investor's personal assets to be taken in a loan default.
- Lenders may require that 100 percent of the TIC investors agree to any single investor wishing to sell their interest.
- TIC loans are now being packaged and sold in the commercial mortgage-backed security (CMBS) market. As a result, some lenders may require that a rating agency confirm the creditworthiness of new TIC investors before they are allowed to buy in to reassure CMBS investors.
- All TIC interests sold as securities must be purchased by "accredited" investors as defined by the SEC. TIC interests sold as real estate are not bound by this rule. Even so, lenders may want to ensure the creditworthiness of investors before approving the financing of a TIC property.
- Although the IRS limits the number of TIC co-owners to no more than 35, some lenders may wish to further restrict this number to reduce their underwriting costs.

Even if a TIC investor can secure permission to sell the TIC interest, locating a buyer can be difficult. No secondary market exists for the sale of TIC interests. However, TIC agreements are generally structured to give the other investors in a TIC deal the first opportunity to buy an interest before it is offered to outsiders.

TICs are so new that most investors have owned their interest for only a short time. The relative newness of TICs presents valuation challenges as well. Although an appraisal of the whole property being sold to a TIC sponsor is fairly

straightforward, the valuation of an individual TIC interest may be more difficult because of lack of comparable sales data.

A TIC buyer's motivation could be another consideration in the valuation of a TIC interest. Some investors may purchase a TIC interest just to avoid capital gains taxes without adequately considering the strength of the underlying deal structure as an investment. As a result, an argument could be made that some TIC investors may be overpaying. Until more TIC interests are sold, appraisers may be reluctant to value an individual TIC interest.



Until the issue of commission payments to real estate licensees for the sale or purchase of TIC interests has been settled, licensees may want to consider acting as consultants to potential TIC investors for a fee.

In regard to control risk, a tenant-in-common relationship prevents control of the property by any one person. IRS guidelines state that "any sale, lease or re-lease of a portion or all of the property, any negotiation or renegotiation of indebtedness secured by a blanket lien, the hiring of any manager or the negotiation of any management contract (or any extension or renewal of such contract) must be by unanimous approval of the co-owners."

The practical result of this clause is the ability of any single TIC investor to veto major property decisions. Although this represents a loss of control by other individual investors, most TIC agreements employ a call option that allows a majority of TIC investors to buy out the TIC interest of any investors in opposition.

Opportunity for Consulting Fees

Until the issue of commission payments to real estate licensees for the sale or purchase of TIC interests has been settled, licensees may want to consider acting as consultants to potential TIC investors for a fee. Although sponsors generally conduct their own due diligence on the property, experienced real estate licensees could be hired to prepare an independent due diligence report for interested or unsophisticated investors. For example, some TIC investors may need assistance in examining the financial structure of the underlying deal, the fee structure and fee amounts, the financing documents, the sponsor's track record, the management company's track record and the property appraisal.

Although many important details need to be ironed out before the role of real estate licensees in TIC transactions is set in stone, TICs have already gained tremendous momentum in the marketplace. TICA is expecting to double their annual convention attendance to more than 1,200 in 2006. It is hoped the TIC industry will continue to develop in a way that is beneficial for both real estate investors and real estate licensees. ♣

Dr. Hunt (hhunt@recenter.tamu.edu) is a research economist with the Real Estate Center at Texas A&M University.

Mineral owners beware — mailboxes bearing large sums of money can mean trouble.

Crude oil and natural gas prices have reached record levels, making ownership of mineral rights and royalties more lucrative than ever. Recently, mineral owners, especially those with producing wells, have been receiving offers through the mail to purchase their mineral or royalty interest. Such offers can trap the unwary into transferring more rights than they realize.

Offers contain a cover letter, a deed and a sight draft, which looks like a check but is not funded until title is verified. To accept an offer, the owner signs the deed before a notary, endorses the sight draft and mails both documents to the purchaser.

Astute mineral and royalty owners must look beyond the amount of money being offered and the wording in the cover letter and focus on the deed.

The cover letter and the deed may contradict each other. Regardless of what the cover letter implies, the deed is the legal instrument that spells out the interest transferred. Most people read the cover letter because it is written in layperson's terms and addresses how to obtain the money. But it is more important that they read and understand the deed or have their attorney read it.

Typically, the cover letter states that the purchaser wants to buy the owner's future income from the current oil and gas lease on the described property. Supposedly, the value of the sight draft reflects the magnitude of the projected income stream. Legally speaking, the purchaser wants the owner to assign his or her royalty interest (right to receive revenue) in the present lease and possibly in all future leases on the property.

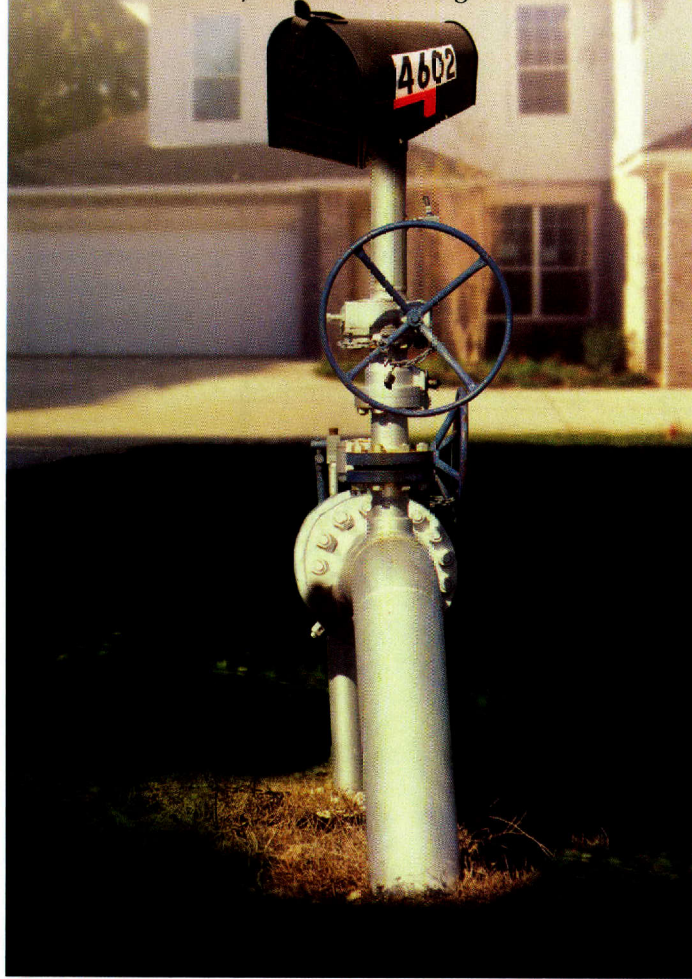
To understand the full ramifications of signing such documents, some knowledge of Texas oil and gas law is helpful. Three possible royalty or mineral interests may be conveyed by deed.

Royalty deeds take two different forms. One is an assignment of the right to receive future income (or royalty) from the present lease. When the lease expires, the assigned interests may revert to the owner, depending on the wording of the deed. Reversion is what the royalty owners expect but that is probably not what the deed provides.

The language would read something like, "The royalty owner (possibly the assignor or grantor) grants, sells and conveys

Risky Business Mineral Sales by Mail

By Judon Fambrough



(or assigns) its rights to receive royalty (or the right to receive proceeds from production) under the current Oil, Gas and Mineral Lease recorded at (volume, page number and county.)" A legal description of the property may be included instead of referencing the oil and gas lease.

The second type of royalty deed conveys a permanent royalty, which extends beyond the present oil and gas lease. The seller (or royalty owner) forever conveys the right to receive all or a part of his or her royalty from the present and all future leases. Two types of royalty conveyances fall into this category. One is a *fraction of royalty* and the other a *fractional royalty*.

A fraction-of-royalty deed reads something like, "The royalty owner (or grantor) grants, sells and conveys one-half (1/2) of the royalties payable under the existing lease and one-half (1/2) of the royalties paid under all future leases on the following described land (legal description.)"

Under this arrangement, the seller (present royalty owner) retains the right to negotiate and sign all future oil and gas leases but shares on a 50-50 basis the royalties reserved.

If the seller reserves a one-fifth royalty in a lease, the seller receives one-tenth of the production and the purchaser the other one-tenth.

A fractional-royalty deed, on the other hand, reads something like this. "The royalty owner (or grantor) grants, sells and conveys one-half the royalties under the following described property (legal description.) No preposition such as "of" appears between the numerical fraction specified in the deed (here the one-half) and the word "royalties."

Under this arrangement, as before, the seller (present royalty owner) retains the right to negotiate and sign the oil and gas leases on the property. No oil or gas company would lease the property in this situation. The recipient of a fractional-royalty deed has the right to receive the specified amount of production from the property regardless of the size of royalty negotiated in the lease. Here, the purchaser literally gets one-half of the total production from the property.

The grantor (the seller in this case) is entitled to receive a royalty only if he or she is able to negotiate a royalty greater than the one specified in the fractional royalty deed. Suppose, for example, the conveyance was for a one-sixth royalty, not a one-half. The grantor (seller) negotiates a one-fifth royalty in a lease. In this case, the purchaser gets the one-sixth royalty, and

the grantor receives the difference between a one-fifth and a one-sixth (or one-thirtieth of the production).

Most deeds attached to the offers, however, are mineral deeds, not royalty deeds. Although the cover letter describes purchasing some sort of a royalty interest, the deed is for a mineral interest.

Here is the distinction. In Texas, the mineral estate is made up of five separate and distinct interests. They include the:

- executive rights or the right to negotiate and sign a lease,
- right to receive a bonus,
- right to receive delay rentals,
- right to receive a royalty or a share of the production and
- right to enter the property to explore for and produce the minerals.

Royalty deeds involve the purchase and conveyance of all or a part of the royalty interest. The other four rights remain with the seller, assuming the seller owns all the minerals.

A mineral deed has language to the effect that, "The grantor hereby grants, sells and conveys to the grantee (purchaser) all rights, title and interest to the oil, gas and other *minerals* in and under and that may be produced from the following described property (legal description)."

By signing the deed, the owner conveys all the mineral interests owned beneath the described property. This includes the royalty interests as well as the other four interests comprising the mineral estate. The interest never reverts to the present owner(s).

There is another problem. While the cover letter references purchasing the seller's right to receive income or royalty from a lease or property, the mineral deed accompanying the offer letter conveys all the seller's mineral interest in the entire county. There may be a vast difference. A seller who reads only the cover letter and not the deed could be selling interest in properties not referenced in the cover letter.

Distinguishing a royalty deed from a mineral deed is difficult. The *Texas Real Estate Forms Manual* provides no promulgated forms as examples. Instead, the manual states, "Texas mineral law is complex and extensive . . . Attorneys who are not experienced in mineral law are urged to exercise caution and seek appropriate counsel when mineral law issues arise."

If attorneys have difficulty grasping this area of the law, what are laypersons to do?

The Texas legislature recognized the problem and passed a law effective September 1, 1999, giving owners some protection and advice. The law is found in Section 5.151 of the Texas Property Code.

The statute provides, "A person who mails to the owner of a mineral or royalty interest an offer to purchase only the mineral or royalty interest . . . and encloses an instrument of conveyance of only the mineral or royalty interest and a draft . . . providing for payment for that interest, shall include in the offer a conspicuous statement printed in a type style that

is approximately the same size as 14-point type style or larger and is in substantially the following form:

BY EXECUTING AND DELIVERING THIS INSTRUMENT YOU ARE SELLING ALL OR A PORTION OF YOUR MINERAL OR ROYALTY INTEREST IN (DESCRIPTION OF PROPERTY BEING CONVEYED)."

If the purchaser fails to give the prescribed notice in the offer and fails to resolve the matter after receiving a 30-day notice from the seller, the seller may sue for:

- the greater of \$100 or the difference between the price paid for the minerals or royalty and its fair market value at the time of the transaction,
- court costs and
- reasonable attorney's fees.

The lawsuit must be filed within two years after the seller (grantor) signs the deed.

The plaintiff may seek other remedies under existing law as long as they do not include rescinding the transaction or otherwise rendering the conveyance null and void.

The statute does not specify where the notice must be placed. Legislators probably envisioned placing the notice in the cover letter. However, in most cases, the notice appears in the deed.

Another easily overlooked problem deals with the substances conveyed by the deed.

The cover letter addresses purchasing the owner's mineral or royalty interest in oil and gas production. According to the Texas Supreme Court, the term "minerals" includes oil, gas and uranium. It does not include limestone, sand, surface shale, caliche, building stone, gravel and water. Coal, lignite and iron ore are not considered minerals when they lie on the surface or within 200 feet of the surface if any reasonable method of production will destroy or deplete the surface.

A proposed deed in one mailed offer used the following language:

The grantor grants, sells, assigns and delivers to the grantee all of the grantor's rights, titles, claims and interests to the oil, gas and other minerals, in, on and under and that may be produced, saved, marketed from any lands located in (blank) County, Texas.

This is standard language. However the deed goes on to say, "In this instrument, the term 'other minerals' includes coal, lignite, uranium, sulphur, iron ore and every other 'mineral' now or hereafter recognized as such under the laws of the State of Texas."

By signing this deed, the owner conveys not only his or her oil and gas interests but also the interest in coal, lignite, uranium, sulphur, iron ore and any other substances the Texas Supreme Court declares a mineral in the future. Apparently, the language in this deed conveys the coal, lignite and iron ore regardless of their depths or how they are produced.

For more on oil and gas interests, see Volume 10, No. 4 issue of *Law Letter* (recenter.tamu.edu/pubs/1140.html). ♣

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UP, UP & AWAY RURAL LAND PRICES SOAR

BY CHARLES E. GILLILAND, GREGORY PETTIGREW, DAVID CARCIERE AND ZACHRY DAVIS

Buyers focusing on recreation and investment have propelled Texas rural land prices into the stratosphere. The price of an acre of rural Texas soared 16 percent in 2004, rising from \$1,097 in 2003 to \$1,274 per acre (Figure 1).

The price surge is the largest single-year percentage increase since those registered from 1972 to 1974 and the third-highest annual gain in the past 38 years.

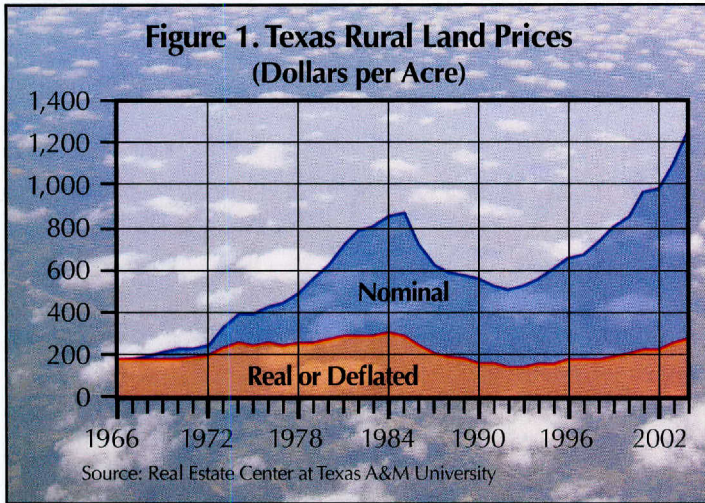
At \$273 per acre, real prices adjusted to reflect 1966 dollars reached 1980–1981 price levels but were below the 1984 peak of \$288 per acre. This strong price performance is a 62 percent five-year gain in nominal (actual) prices since 1999, a 10 percent annual compound return.

These market developments resulted from feverish land-buying activity totaling 8,073 sales in 2004. That activity level outpaced the 2003 record volume of 7,283 sales by 11 percent. Sales have exploded since 2001.

The typical tract size sold in Texas during 2004 was 102 acres (Figure 2). Today's market is driven by sales of smaller properties, a trend that began in 2001 when the median tract size fell noticeably.

Meanwhile, volume of sales for larger properties increased from 29 in 2001 to 87 in 2004. Concurrently, sales of small properties (fewer than 150 acres) increased from 1,864 in 2001 to 3,009 in 2004.

In years past, land prices strictly reflected the productive capabilities of the soil along with the ebb and flow of commodity markets. Now, nonagricultural buyers fuel activity



with investment and recreational considerations influencing markets all across Texas.

Research suggests that the link between nonagricultural personal income and land prices has strengthened. Analysis and anecdotal evidence suggest nonfarm buyers are dominating rural land markets like never before.

Regional median prices have risen sharply across Texas. From the high-priced Houston-to-Austin-to-Hill Country corridor to the lower-priced Panhandle and Trans-Pecos areas, markets thrived in 2004. For the first time ever, not one region registered a lower median price per acre than in the previous year.

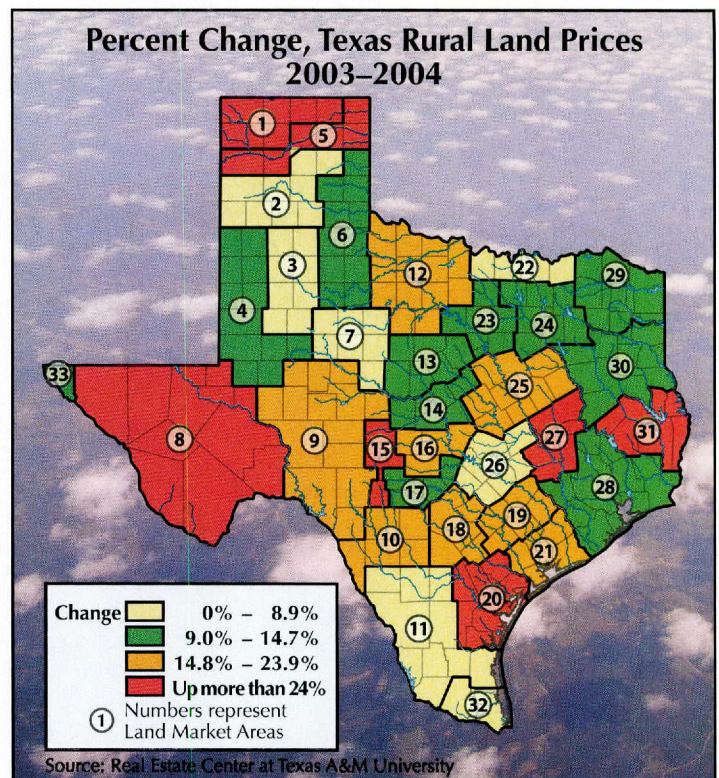
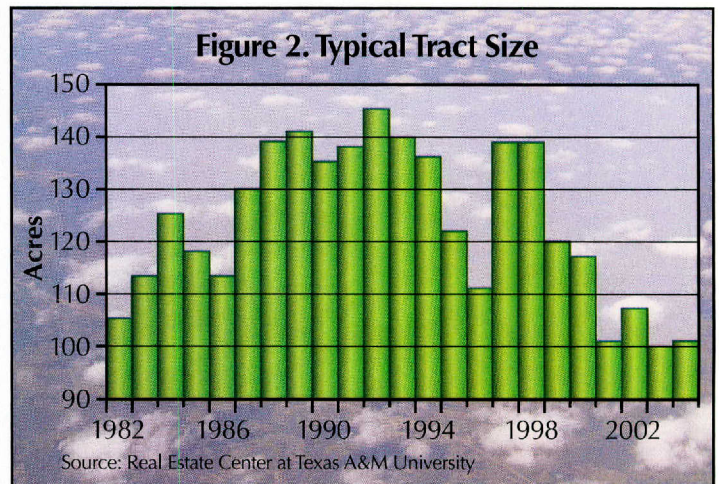
Ironically, Land Market Areas 1 and 5 registered two of the largest percentage increases while their cropland neighbors, LMAs 2 and 3, had prices remain steady. However, most areas of the state saw prices rise in 2004.

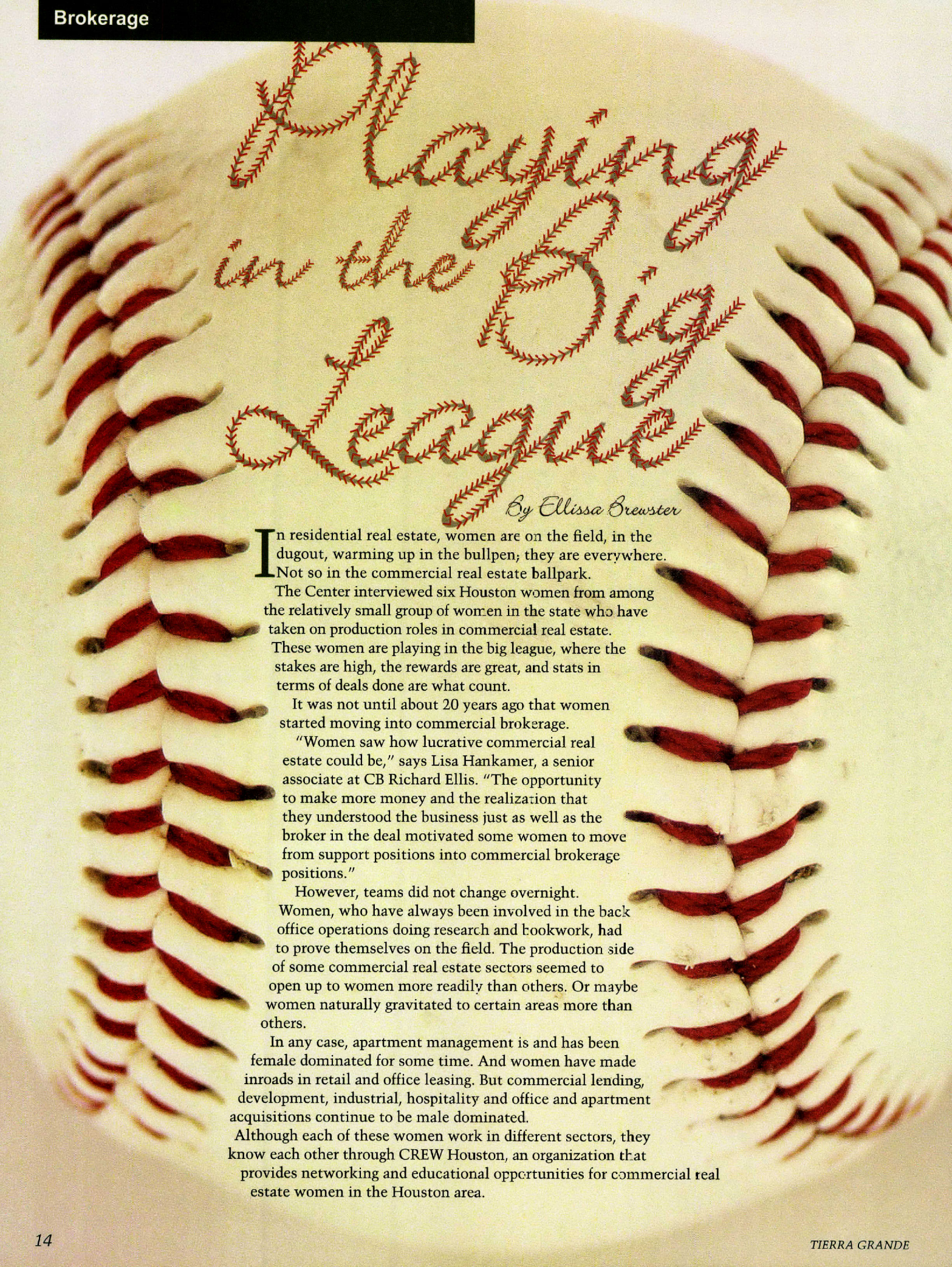
The forces sending prices upward continue to drive 2005 markets. A general lack of lucrative investment alternatives makes the decision to acquire land less costly than when stocks are booming. Currently, low interest rates continue to foster interest in all real estate. Recession is not a factor, and the economy appears to be thriving.

Danger signs have appeared, however. High oil prices, which are stubbornly refusing to drop despite an apparently abundant supply, may sabotage the current recovery. Interest rate hikes in the offing may also take a toll.

Still, economists are calling for robust farm income in Texas in 2005, and nothing has dampened enthusiasm for Texas land. Despite some anecdotal evidence of emerging price resistance, 2005 is shaping up to be another strong year in Texas land markets. By 2006, land prices may post another sizable increase. ♣

Dr. Gilliland (*c-gilliland@tamu.edu*) is a research economist and Pettigrew, Carciere and Davis are research assistants with the Real Estate Center at Texas A&M University.





*Women
in the
Big
League*

By Ellissa Brewster

In residential real estate, women are on the field, in the dugout, warming up in the bullpen; they are everywhere. Not so in the commercial real estate ballpark.

The Center interviewed six Houston women from among the relatively small group of women in the state who have taken on production roles in commercial real estate. These women are playing in the big league, where the stakes are high, the rewards are great, and stats in terms of deals done are what count.

It was not until about 20 years ago that women started moving into commercial brokerage.

"Women saw how lucrative commercial real estate could be," says Lisa Hankamer, a senior associate at CB Richard Ellis. "The opportunity to make more money and the realization that they understood the business just as well as the broker in the deal motivated some women to move from support positions into commercial brokerage positions."

However, teams did not change overnight. Women, who have always been involved in the back office operations doing research and bookwork, had to prove themselves on the field. The production side of some commercial real estate sectors seemed to open up to women more readily than others. Or maybe women naturally gravitated to certain areas more than others.

In any case, apartment management is and has been female dominated for some time. And women have made inroads in retail and office leasing. But commercial lending, development, industrial, hospitality and office and apartment acquisitions continue to be male dominated. Although each of these women work in different sectors, they know each other through CREW Houston, an organization that provides networking and educational opportunities for commercial real estate women in the Houston area.



Minute Maid
Pasta

Stethmate
The Methodist
Hospital
HOUSTON
CHRONICLE

Amegy Bank
of Texas

Continental
Airlines

ATM

GAME TIME
BY LECTURE & BETA

ASYROS.com

FOLEY

IT'S ONE

organChase

Pollard

2001 Houston Astros

All have become leaders in their fields of expertise and are role models to younger women entering the field.

Most of them started out in the 1980s when the commercial real estate market in Houston was overbuilt, and foreclosures were rampant.

Cyndee Smith got her start leasing retail centers for Friendswood Development and many institutional lenders that had foreclosed on retail properties.

"It was the mid-1980s, and Houston was in a recession, but I was too young to fully comprehend what that meant, so I kept leasing those retail centers with unbridled optimism," says Smith. "I had not experienced the 'good old days' of the 1970s, so I didn't realize how bad things were. It was hard, but I was too naïve to know how hard it was, and I was having fun. I only made \$5,000 the first year!"

Today Smith is a retail broker for Shelby/Estus Realty Group. She has been named a heavy hitter in the *Houston Business Journal* for three years in a row.

Where Are All the Women?

Susan Hill, a commercial broker at Holliday Fenoglio Fowler, says her business is definitely male dominated. She thinks her firm is more progressive than most in terms of promoting women. Yet, she says, of the 130 to 140 producers in the national company, only seven are women. Three of those seven happen to be in Houston.

Hill does not think this reflects discrimination; she simply does not see many women entering the commercial lending field. She thinks that is because it is a commission-based environment, and there is no salary.

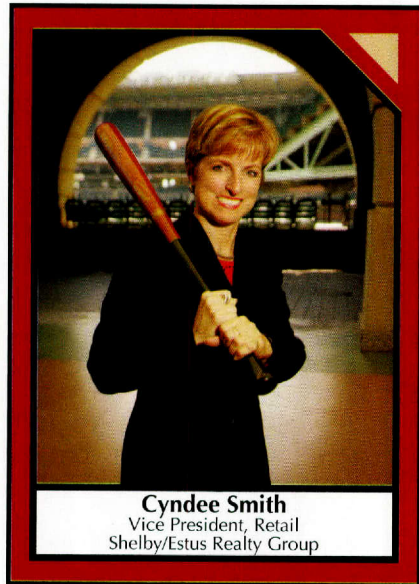
"The rewards are huge," Hill says, "but it's not easy, and

there is a huge time commitment."

Hankamer agrees with Hill, that the risk factor could be a deterrent to some women. She is one of only a handful of women brokers nationally who specializes in hospitality investment properties.

"Commercial deals take a lot longer to close than residential deals," she says. "The transaction size is greater, and therefore the risk is greater.

Unless you have a solid 'home base,' it is very



Cyndee Smith
Vice President, Retail
Shelby/Estus Realty Group

difficult to step into the commercial realm, as there is less security."

Susan Pohl, who buys apartment buildings for KC Venture Group LLC, says, "It just bothers me sometimes because I go into a meeting, and I am the only woman. I'm thinking, 'when is this going to change?'"

Getting in the Starting Lineup

Some of the women see plenty of opportunity for females in commercial real estate. It is competitive, but once you have

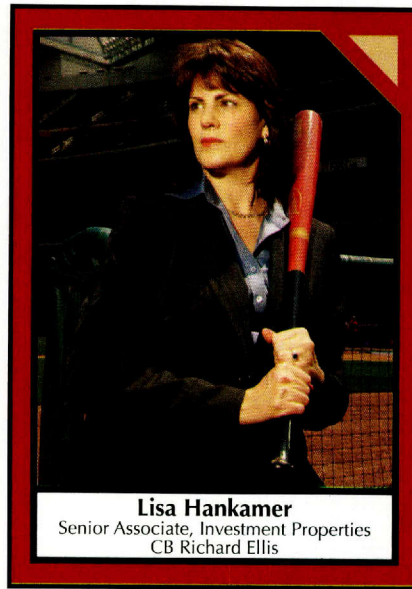
proven yourself, they say, gender is irrelevant. However, others say that entry-level positions are hard to come by for both men and women.

Employers look for proven performance and a history of done deals, making it difficult for anyone just entering the field.

Rosanne Hunt, one of two people who lease properties in the United States for national retailer Bombay Company, explains that this is a relationship-based business. Who you know matters.

"I think there is a gender factor in the industry. But once a

person has established contacts and relationships and a track record of making deals, the gender factor goes away," Hunt says. "You have to be persistent. Success depends on relationships and production."



Lisa Hankamer
Senior Associate, Investment Properties
CB Richard Ellis

Strengths and Weaknesses

"I think that women intuitively have the ability to hold a client's hand all the way through the deal from beginning to end," Smith says. "I am very

detail oriented, and that's important in this business. It's attention to detail that gets a deal done."

Understanding the needs of both parties is essential for a successful negotiation. Smith says creating a win-win atmosphere instead of a confrontational one is critical.

"Women are pretty good at that," Smith says.

These women agree that customer service is a strength most females bring to the job. By focusing on providing excellent service and paying attention to their clients' needs, they build referral business.

But, Hankamer says, "Like it or not, men tend to package and promote themselves better. Guys have been playing the game a lot longer than women, and they are just much better at selling the package."

Pohl agrees; she says that two areas women need to work on are self-confidence and self-promotion.

Network Coverage

Most of these women agree that networking is an area in which men excel. Rewarding friends and contacts with opportunities is part of the game plan in the business world, and women are just learning these strategies.

Debbie Wilson, a vice president of leasing at Crescent Real Estate Equities, says, "Men have always considered networking an important part of their business, whether it is playing golf or going to the baseball game in the afternoon. That wasn't 'not working' for them; it was part of their workday.

"At the beginning of my career, I was very focused on doing my job and making sure I did an excellent job," says Wilson. "I thought that networking might be considered an extracurricular activity. Fortunately, I had great mentors who helped

me realize networking is an integral part of the real estate business."

Wilson takes her clients to sporting events, the theater, informational lunches or state-of-the-city addresses.

"When you meet with people out of the office, you have a chance to talk about a lot of things in addition to work. . . . In these types of surroundings, you get to learn about your clients and the issues they face when making decisions," she says.



Susan Hill
Managing Director
Holliday Fenoglio Fowler

Advice for Rookies

Hill was a young mother when she entered the working world. Her first job out of college was as a receptionist for Holliday Fenoglio Fowler.

"I was lucky to get with a company that let me learn the real estate business. They let me grow as they grew," Hill says.

However, Hill says that times are different now because the market is so efficient.

"If you really want to go into commercial real estate, you should go straight into a career position. I think there is a stigma attached to an administrative or an assistant position, and it is hard to get out of that role, especially for a woman," Hill says.

Most of the women agree that to get a foot in the door, a strong educational background is needed. Corporations and real estate investment trusts hire the best talent they can find.

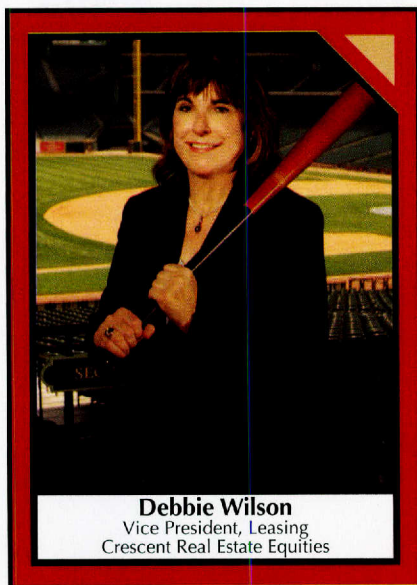
But there is no substitute for street smarts. Hill says that stumbling blocks always come up in a transaction.

"You've got to be able to handle those. And those are things you do not learn in a classroom," she says.

Learning from Franchise Players

All agree that having a mentor is essential.

Fankamer says, "When you are starting out, you should find someone who recog-



Debbie Wilson
Vice President, Leasing
Crescent Real Estate Equities

nizes that you are smart, quick, a high achiever and willing to pay your dues."

Smith says that although finding a good mentor may seem like an obvious first step, it might not be easy.

"In the brokerage world where people work on commission, if someone takes time out of their sales day to teach, that is nonproductive time for them," Smith says. "I was extremely fortunate to have people during the early days of my real estate career who gave their time to me and truly cared about my success."

Pohl describes Eileen Subinsky, one of her mentors, as a fascinating woman with many talents. Subinsky put herself through college by working in property management. She drove an 18-wheeler at one time; she edited *Humpty Dumpty* magazine, and she had been on a roller derby team.

Subinsky taught Pohl the importance of being assertive, doing her best, pushing herself to go that extra mile and always being ethical.

She also told Pohl, "Nobody is going to take anything you say seriously until you are at least 25." Pohl was 22 at the time.

Hunt's mentor was Jeanna Vaughn. In the late 1970s, Vaughn and Hunt worked together at Irby Simpkins Investments, which developed the first luxury apartments in the Woodway-Gessner area in Houston. Vaughn was vice president of property management, and Hunt was her assistant.

"Jeanna had so much confidence in me she promoted me to building manager of the little building we owned and had our offices in. She was also instrumental in referring me to Southwestern Savings & Loan, where I was hired as assistant vice president of administration. This position led to some really great opportunities that advanced my career," Hunt said. "Jeanna helped me see that the sky is the limit."



Susan Pohl
Vice President, Acquisitions
KC Venture Group LLC

Join a Winning Team

Joining a support and networking group, such as CREW Network (Network of Commercial Real Estate Women) goes hand-in-hand with finding a mentor. The organization has chapters throughout the United States and Canada. Texas chapters are in Austin, Dallas (www.crew-dallas.org), Fort Worth (www.gfwcrew.org), Houston (www.crewhouston.org) and San Antonio (www.crew-sanantonio.org). Local organizations give women a chance to network, build business by attending educational luncheons and conferences, and share enthusiasm for their careers with women who are just starting out.

What might these Houston women tell those who are just entering the field? Be ready to show what you are made of when an opportunity comes along. Not every transaction can be a home run, but to get on base you must swing at the good ones. ♣

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AS THE COMMERCIAL WORLD TURNS

BY MARK G. DOTZOUR

Institutional pension fund investors met in Chicago in spring 2005 to consider how the global environment is likely to impact commercial real estate returns in coming years. The conference was titled "America's Place in the World."

William S. Cohen, Secretary of Defense during the Clinton administration and now a business consultant, said two major models are operating in the global business world today.

First is the spread of democratic capitalism throughout the world, with many countries wanting to join the core group of globalized nations. Second is the clash of cultures whose people hate each other.

The United States, Cohen said, is migrating to a dominance of "hard power" — military might and technology. Europe is trying to lead in "soft power," such as human rights and the environment.

War on Terrorism Weakens Economy

"America is in a long twilight of struggle against terrorism that we'll never know when we've won," said Cohen. "The war on terrorism will not be won by the military but by the police."

Cohen admonished the audience not to equate freedom with democracy, and suggested that the United States cannot afford to fail in Iraq because of the message it would send to all terrorists.

Cohen called for support of global trade, recalling an old military saying, "If you don't allow goods to flow across international borders, soldiers will."

The U.S. economy appears to be outperforming Japan and Europe because government stimulus has been stronger in this country. Job growth remains slow worldwide. Japan appears to

be making a recovery after decades of stagnation, but its banking industry is burdened with massive amounts of bad loans.

So, Where's Inflation?

Adam Posen with the Institute of International Economics reported that problem bank loans worldwide have been reduced by 66 percent. He noted the savings rate in Japan is 30 percent, compared to near zero in the United States.

Jeremy Rifkin, president of the Foundation on Economic Trends, noted that the European economy is weak, and the job situation is bad. For Europe, job growth is likely to be slow until countries develop the political will to integrate their communities, transportation and finance.

The large decline in the value of the U.S. dollar has not yet led to inflation in the United States. Asian currencies have not changed much in relation to the U.S. dollar because China has its currency "pegged" to the dollar. Consequently, goods from China are still as cheap as they were a year ago. The dollar has fallen substantially against the Euro, making European goods more expensive to American consumers.

Because most of the goods Americans consume are made in China and not Europe, the dollar's fall against the Euro has had minimal impact on U.S. inflation. Rifkin noted that Saudi Arabia sells its oil in U.S. dollars, so the decline in the dollar has lowered Saudi purchasing power. He suggested that OPEC may try to keep oil prices at a higher level to make up for the lost purchasing power.

Jobs Lost in China

The Chinese economy continues to expand at a heated pace, leading to intense demand for oil, cement, steel and other

commodities. Rifkin speculated that China's growth is likely to plateau in the near future.

Despite the strength of China's manufacturing sector, the country has eliminated 50 percent of factory workers in recent years. Machines are replacing people. Rising unemployment among China's manufacturing workers is likely to cause political and economic problems in coming months.

Panelists suggested that oil prices could be high for a long time. In 2004, demand rose to 84 million barrels per day, meeting supply for the first time in 50 years. To meet this elevated demand, all cheap capacity was brought online. New oil supplies will be much more difficult to find.

High prices do not seem to have any effect on U.S. demand, which is expected to grow by 1.5 million barrels per day. Oil and gas prices must stay high to support new oil exploration. Most new supplies are in places like Kazakhstan and Africa, where oil is difficult to get, or in countries with uncertain political situations. While oil prices are at all-time highs, hitting \$60 per barrel in June, they are far less than the 1981 price, which would be the equivalent of \$92 a barrel today.

Grocers Fight It Out

Retail real estate continues to be buffeted by change. The grocery industry may be the most turbulent. Wal-Mart sold \$113 billion in groceries in 2004, about 20 percent of all grocery sales. Grocery store square footage growth is flat, and comparable store sales are up slightly because of increased gasoline and pharmacy sales. Further consolidation is expected, with regional and local grocers continuing to lose ground to Wal-Mart and Target. Extreme no-frills value grocers are managing to compete with Wal-Mart. Wal-Mart is cutting the cost of groceries by up to 30 percent.

Stand-alone pharmacies are evolving into convenience stores that happen to have a pharmacy. Walgreens and CVS are winning; RiteAid is losing. These pharmacies hope to draw a customer into the store to fill a prescription and then spend another \$10. However, more and more people are getting prescriptions filled through the mail. If this trend continues, it will be harder for pharmacies to compete.

Apparel sales appear to be an area of opportunity for retailers. Wal-Mart clothes are the company's weakest product line. That makes them a good bargain for parents who buy for kids.

Retailing has been good recently, said Scott Wolstein, CEO of Developers Diversified Realty. Malls have become the nation's fashion headquarters. Other products have moved into open-air centers or freestanding buildings. Department stores are becoming less relevant.

"Radical things are going on in our business," said Wolstein. "Specialty stores are migrating to open-air areas to take advantage of the traffic at Target."

He stated that more than one-third of regional malls are now out of commission. Retailers worry about deflation, not inflation. Prices of apparel and high-tech gadgets are dropping.

Consolidations Ahead

Joan Ellis, with U.S. Trust Company, said American banks are strong competitors in the global banking industry. U.S. banks comprise 60 percent of top ten banks in terms of market capitalization. Further disintermediation (movement of funds from low-yielding accounts to higher-yielding instruments) is expected.

Auto makers are now in the car loan business, and many companies are in the mortgage lending arena. Expect to see more consolidation in this sector, bringing down the cost of doing business.

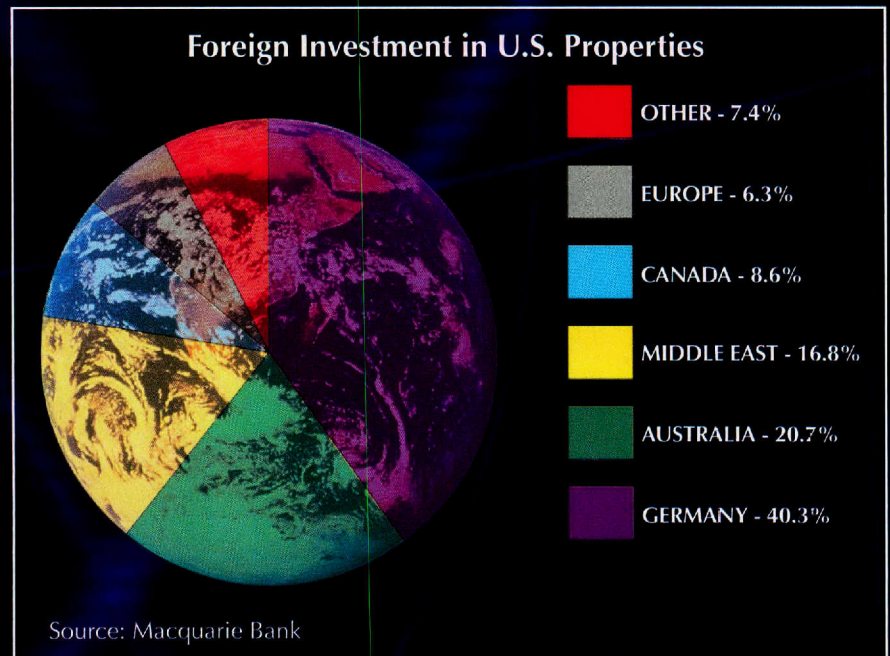
The number of banks in the United States has fallen from 17,000 to 9,000 in the past 20 years. Eighty-five percent of credit card volume is now handled by the top ten providers.

Foreign investors are active in the U.S. commercial real estate market. Marc Baillie of Macquarie Bank Limited showed the sources of foreign investment (see chart).

Global Investors Like America

Higher returns have attracted global investors to the United States. Returns in Europe are much lower. Apartments in Germany are being privatized and sold, providing a yield of around 3 percent. The German apartment cap rate is about 3 percent.

Australia has changed its "super annuation" policies, which allocate 9 percent of salary to the employee's pension fund. These funds are going to private accounts. The large amount of money flowing into super annuity programs has prompted them to look to the United States for conservative real estate investments. Australia typically buys with 50 percent leverage



in U.S. dollars, so half the deal is hedged against the currency volatility. They may hedge the currency as well. Australians also invest in Singapore, Korea and Japan.

Muhammad Abulhasan, executive director of Arcapita — an investment bank in Bahrain — represents Middle Eastern investors. He stated that 90 percent of Middle East real estate investment is allocated to dollar-based investments because their revenue comes from oil priced in dollars. Over time, these investors are likely to reduce their U.S. allocation and spread money into Europe and Asia.

Middle Eastern investors do not have an income tax, so they are not interested in tax benefits, just the fundamentals of the deals. Middle East investing is focused on industrial space, apartments, assisted living facilities and now residential development.

No Where to Go But Up

“The apartment sector has bottomed,” says Richard Campo, CEO of Camden Property Trust. After three years of declining net operating income (NOI), 2005 should show positive NOI growth between 1 and 3 percent. The strongest markets are on the coasts and in Las Vegas.

Las Vegas has a negative supply because many apartments have been converted to condominiums. Also, house prices have risen so rapidly that they are less affordable, and apartments are in higher demand. The baby-boom echo generation should be good source of demand over the next three to five years.

Tim Callahan, CEO of Trizec Properties, stated, “The office market should feel better, but it doesn’t yet.” But he feels that the sector has turned a corner. Overall vacancies are finally starting to decline.

Absorption was tremendous in 2004, especially in the fourth quarter. New construction has fallen by 75 percent from 2000 and may fall further in 2005. Rents have finally stopped falling, yet vacancy still hovers at 16 to 17 percent nationally.

Ten to 20 percent of buildings are rented at rates higher than today’s market rents. NOI growth should be good in 2007–08; 2005 and 2006 will still see NOI flat or falling.

Tenants have leverage in the market, and 2009 may be the year 90 percent occupancy is achieved and rents start to rise again. Cap rates have fallen substantially in the past year. There is still pressure on cap rates, even on riskier properties. Premiums for office properties are definitely a lower risk.

Good Year for Hotels

Lawrence Geller, CEO for Strategic Hotel Capital, stated that terrorism, the SARS outbreaks and a slack economy combined to create a “perfect storm” for hotels after 2000. High-end hotels have been the first to come back. The strongest market is on the east coast, which is recovering fast.

Occupancy growth has led to room rate growth. Supply growth is pretty slow and likely to grow 1 percent next year.

Some supply is taken up by condo converters. With GDP up and travel on the upswing, 2005 should be good year for hotels.

Perceptions of Investor Risk

Members of the pension fund industry identified key risks they perceive to be influencing commercial real estate owners in today’s market.

Short-term risks include:

- terrorism in the United States,
- the potential for the huge fiscal and trade deficit to come home to roost,
- possibility of cap rates rising,
- concern over sustaining current property values and
- impact of rising interest rates on property values.

Long-term trends that might impact real estate investors include:

- loss of U.S. global dominance in the economy;
- increased long-term reinvestment opportunities in China, India and elsewhere;
- terrorism;
- global diversification of real estate purchased by large pension funds; and
- currency exchange risks resulting from investment in foreign real estate.


The fundamentals of U.S. commercial real estate appear to be improving. Vacancy rates are starting to decline, and rental rates are likely to increase over the next several years. Despite this optimistic scenario, anxiety persists.

Will the high U.S. trade deficit lead to higher interest rates? Will high oil prices lead to more inflation and higher interest rates?

What will happen to commercial property values when interest rates start to rise significantly? Are real estate investors vulnerable to shocks in the economy from a domestic terrorist attack?

The U.S. economy is still the dominant driver in the world economy, but growth is most likely to occur in other countries, specifically China and India. Will this have a positive or negative impact on U.S. real estate demand?

Overall the pension fund industry still is heavily focused on investing in commercial real estate inside the United States, where political stability and rule of law create a predictable investment climate. Most have 75 to 95 percent of their real estate dollars invested in the United States. While most suggested they would increase their Asian holdings over the next ten years, they predicted that by 2015 they would still have between 60 and 90 percent of their real estate portfolios invested in American properties. ↘



The U.S. economy is still the dominant driver in the world economy, but growth is most likely to occur in other countries, specifically China and India.

Dr. Dotzour (dotzour@tamu.edu) is chief economist with the Real Estate Center at Texas A&M University.



A Walk on the Supply Side

Texas Residential Rental Market

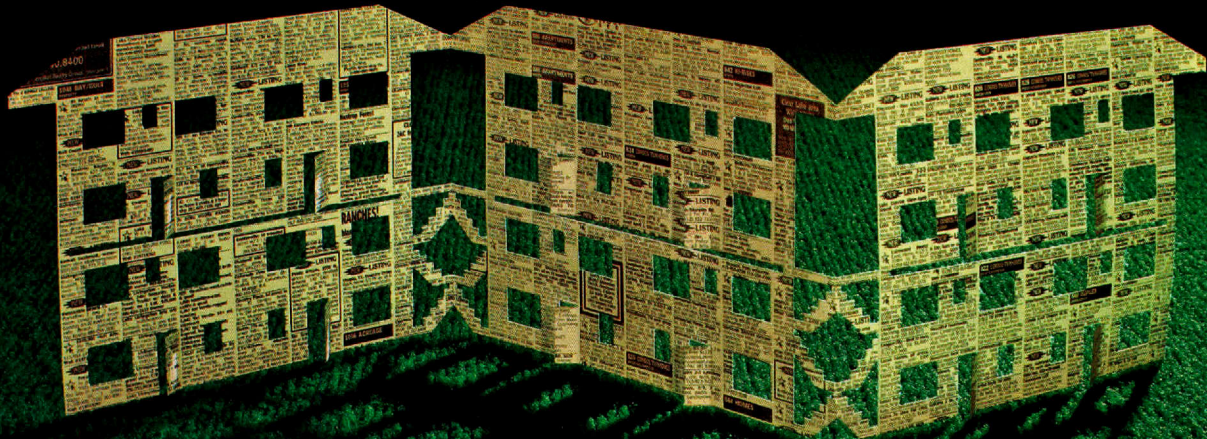
By M.A. Anari

The Texas residential rental market supplied **3,073,295** rental units in **2003**, up from **2,986,940** in **2002**, an annual growth rate of **2.8** percent. Occupied rental units numbered **2,716,903**, or **90.1** percent of total rental units compared with **90.3** percent in **2002**.

Apartments (properties with more than five residential units), constituted the largest segment of the state's residential rental market, accounting for 48.8 percent of units in 2003. This compares with the national average of 44.2 percent (Table 1). Single-family attached or detached units made up 31.8 percent of the Texas residential rental market, close to the national average. But the state had a smaller proportion of two-to-four unit residential rental units (duplexes, triplexes, fourplexes).

Texas' rental market generated more than \$1.4 billion aggregate contract rent and more than \$1.7 billion aggregate gross monthly rent in 2003. Contract rent is the monthly rent agreed to or contracted for excluding costs of any furnishings, utilities, fees, meals or services that may be included. Gross rent is the amount of contract rent plus estimated average monthly cost of utilities.

The industry suffered a mild contraction in the economic slowdown of 2001-02 but is recovering. Total aggregate monthly gross rent fell to \$1,666.87



A 10 percent increase in rent is expected to be followed by a 10 percent increase in rental units.

Table 1. Residential Rental Units, United States and Texas, 2003

	United States		Texas	
	Total Units	Percent of Total	Total Units	Percent of Total
Renter occupied units	36,000,844	100.0	2,716,903	100.0
Single unit, detached or attached	10,836,403	30.1	863,869	31.8
Two to four units	7,587,774	21.1	398,744	14.7
Five or more units	15,896,297	44.2	1,324,617	48.8
Mobile home, boat, RV	1,651,362	4.6	128,062	4.7

Sources: U.S. Census Bureau and Real Estate Center at Texas A&M University

Fort Worth and Austin (Table 3). These five metro areas account for more than 64 percent of total rental units in the state. Dallas has the largest proportion of apartments, followed by Houston and Austin. The McAllen-Edinburg-

million in 2002 from \$1,688.18 million in 2001, a decline of 1.2 percent.

Over the same period, the aggregate monthly gross rent for the United States rose slightly, from \$24,005 million to \$24,112 million, or an annual growth rate of 0.4 percent. The state's residential rental market accounted for 6.9 percent of the nation's residential market in 2003.

Apartments with five to 19 units produced the largest amount of rent income in Texas, accounting for 32.8 percent of total rents in 2003 compared with 24.9 percent for the United States. Single-unit housing units accounted for 32.4 percent of gross rents received compared with 30.4 percent for the nation (Table 2). Duplexes, triplexes and fourplexes produced 13.4 percent of rents for Texas and 20.6 percent for the United States.

Texas Metro Areas' Residential Rental Markets

Houston has the largest number of residential rental units followed by Dallas, San Antonio,

Mission metro area ranks first in proportion of single-family rental units followed by Brownsville-Harlingen and Killeen-Temple. McAllen also has the largest proportion of mobile home rental units. Corpus Christi has the largest proportion of two-to-four unit properties followed by Killeen-Temple and Lubbock.

Major Texas metro areas produced the bulk of rent income from residential properties in 2003. Dallas-Fort Worth accounted for more than 31 percent of rent income, followed by Houston-Galveston-Brazoria, Austin-San Marcos and San Antonio (Table 4). These four metro areas accounted for 72.4 percent of total 2003 rental income.

Table 2. Monthly Gross Rent by Source, United States and Texas, 2003

	United States		Texas	
	\$Million	Percent of Total	\$Million	Percent of Total
Total gross rent:	24,965	100.0	1,728	100.0
Single unit, detached or attached	7,598	30.4	559	32.4
Two to four units	5,140	20.6	232	13.4
Five to 19 units	6,215	24.9	566	32.8
20 to 49 units	2,174	8.7	127	7.3
50 or more units	3,097	12.4	183	10.6
Mobile home, boat, RV	742	3.0	61	3.5

Sources: U.S. Census Bureau and Real Estate Center at Texas A&M University

Table 3. Rental Housing Units, Units per 1,000 Population and Average Monthly Rent, Texas Metro Areas, 2003

Metro Area	Total Units	Percent of Total				Units per 1,000 Population	Average Monthly Rent
		Single Units	2 to 4 Units	5-plus Units	Mobile Homes		
Austin-San Marcos	198,748	21.4	14.0	60.9	3.7	148	\$667
Beaumont-Port Arthur	42,010	41.8	11.7	40.6	5.9	115	405
Brownsville-Harlingen	27,957	51.9	17.1	23.2	7.9	78	356
Corpus Christi	52,315	44.3	22.3	32.5	0.9	136	506
Dallas	506,117	21.4	12.0	63.7	2.9	135	614
El Paso	81,549	34.2	12.7	47.9	5.2	118	439
Fort Worth-Arlington	221,747	27.9	15.6	52.3	4.2	122	565
Galveston-Texas City	38,964	30.3	16.5	44.9	8.3	148	559
Houston	591,548	24.2	10.5	63.2	2.1	134	574
Killeen-Temple	44,371	48.4	21.2	23.7	6.8	149	513
Lubbock	43,356	31.9	21.1	40.5	6.5	180	461
McAllen-Edinburg-Mission	44,515	52.6	11.7	18.0	17.7	71	339
San Antonio	228,755	31.9	17.6	46.6	3.9	139	517

Sources: U.S. Census Bureau and Real Estate Center at Texas A&M University

Apartments with five to 19 units produced the largest share of residential rental income in major Texas metro areas. They produced 39.6 percent of rental income in Houston, 38.2 percent in Dallas and 34.6 percent in Austin (Table 5). Single-unit attached or detached residential units generated the largest proportion of rent income in San Antonio and are the second highest source of rent income in Dallas, Houston and Austin. Duplexes, triplexes and fourplexes were the third highest source of rental income in Dallas and San Antonio.

Larger metro areas generally have higher average rent as well as higher ratios of rental units to population (Table 3). A Real Estate Center study of the relationship between the number of rental units per 1,000 population and average rent shows an increase of 10 percent in rent is expected to be followed by a 10 percent increase in the supply of rental units in the long run. Thus, higher rent growth rates in larger metro areas can be expected to have a positive impact on the supply of residential rental units. ♦

Dr. Anari (m-anari@tamu.edu) is a research economist with the Real Estate Center at Texas A&M University.

Table 4. Aggregate Monthly Gross Rent, Major Texas Metropolitan Areas, 2003

Metro Areas	\$Million	Percent of Total
Dallas-Fort Worth	541	31.3
Houston-Galveston-Brazoria	416	24.1
Austin-San Marcos	154	8.9
San Antonio	141	8.1
El Paso	42	2.4
Corpus Christi	32	1.9
Killeen-Temple	26	1.5
Lubbock	23	1.3
McAllen-Edinburgh-Mission	20	1.2
Beaumont-Port Arthur	20	1.2
Brownsville-Harlingen	12	0.7
Other Metro Areas	301	17.4

Sources: U.S. Census Bureau and Real Estate Center at Texas A&M University

Table 5. Sources of Rental Income, Major Texas Metro Areas, 2003

	Dallas	Houston	Austin	San Antonio
Single unit, detached or attached	25.4	27.2	24.8	35.8
Two to four units	13.0	9.6	13.0	15.5
Five to 19 units	38.2	39.6	34.6	32.0
20 to 49 units	9.1	6.8	13.5	5.7
50 or more units	11.7	15.4	11.3	8.6
Mobile home	2.6	1.4	2.9	2.4

Sources: U.S. Census Bureau and Real Estate Center at Texas A&M University



BY ROBERT R
EVERSBERG & PAUL R
GOEBEL



As of March 2003, the Texas Comptroller of Public Accounts reported 37 Texas cities with at least one Tax Increment Investment Zone (TIRZ). Cities and counties create these special districts to encourage new investment in areas that otherwise

When money is tight and financing development projects gets tough, the tough get creative. More and more municipalities are partnering with private entities to address local development needs using tax increment financing (TIF). Established by state law in 48 states, TIF provides a taxing process that benefits both its public and private partners. It has grown increasingly popular because of its flexibility, local control and freedom from debt caps.

might not attract development. When developers make improvements, property values increase. In a TIRZ, the taxes on the increase in property values are set aside to finance public improvements in the zone. For example, the City of Houston has created zones to address inner city deterioration, to develop raw land in suburban fringe areas and to address the decline of major activity centers.

Defining the zone's geographical boundaries is the first step in creating a TIRZ.

To establish a baseline, the assessed value of properties in the TIRZ are frozen, and any taxes on the increased or incremental value during the zone's term are captured as TIRZ revenue (see figure).

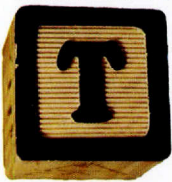
TIF Fundamentals

Tax increment financing is both a financing and an economic development tool. It was first used in California in response to federal funding cuts for inner urban infrastructure improvements and taxpayer protests

over property tax increases. TIF allowed the state to increase tax revenues without raising taxes.

Under the first TIF-enabling statutes, cities sold bonds secured by the incremental tax revenues to obtain funds necessary for redeveloping blighted areas. Funds generated from sale of the bonds were used to pay for infrastructure (streets, sidewalks, lighting, sewers), and bondholders were repaid from the incremental tax revenues as further value was added to the development, primarily by private developer partners.

Texas TIF Laws



Three features distinguish Texas' legislation from that of other states. Usually, only cities or governmental entities can designate an area as a TIRZ. In Texas, however, owners of properties constituting at least 50 percent of the appraised property value in the proposed district may petition for the creation of a TIRZ. This allows private owners-developers to initiate creation of a district rather than depending on a city to do so.

Second, the law allows taxing units within the zone, such as water districts, to negotiate on a case-by-case basis with the city the percentage (0 percent to 100 percent) of incremental tax revenue they will contribute to the fund. Nationally, one of the most significant criticisms of TIF has been that overlying districts are required to give up part of their tax revenue without having any say in how the money is spent. Texas law addresses this criticism.

Third, in Texas, there are no onerous minimum requirements for finding blight within the zone and few other restrictions on what types of property can be incorporated. The board of a TIRZ may expend TIF funds to pay the costs of replacement housing in or out of the zone, but if the project is city-initiated only 10 percent of the zone may be residential. Zones initiated by petition have to dedicate at least one-third of their areas to residential uses and one-third of their tax revenues to low-income housing in cities of 2.1 million people or more.

Texas property tax code does not require a blight finding, but it does apply a variation of the "but for" test (see TIF-Enabling Statute Elements). To be properly constituted, the code requires that the area's condition must "substantially impair the city's growth, retard the provision of housing or constitute an economic or social liability" because of dilapidated structures, unsafe conditions, a delinquency that exceeds the value of the land or because obsolete platting or other factors have kept the land "open."

The city must affirm that the TIRZ will significantly enhance the value of all taxable real property in the zone. Further, the city must certify that development will not occur solely through private investment in the foreseeable future.

In Texas, the city or petitioner need only submit a preliminary development plan and a preliminary finance plan before the TIRZ is established. Copies of these plans are sent to the local taxing units with notice of a hearing on the proposed zone and a request that representatives meet with the city. The city then makes formal presentations to other city and county taxing units in the zone to educate them on all aspects of the plan.

At the public hearing, the governing body evaluates the proposed zone benefits, and interested persons are allowed to speak. Once these preconditions have occurred, regardless of the support of the other taxing units, the city can pass an ordinance establishing the zone and its governing board.

One of the board's most important functions is to execute a formal financing plan that includes:

- a detailed list of estimated project costs;
- a list of all proposed public works or improvements within the zone;
- an economic feasibility study;
- the estimated amount of bonded indebtedness to be incurred;
- the timing for incurring costs or monetary obligations;
- the methods for incurring all the estimated project costs and the expected sources of revenues, including the percentage of tax increment to be derived from the property tax of each taxing unit;

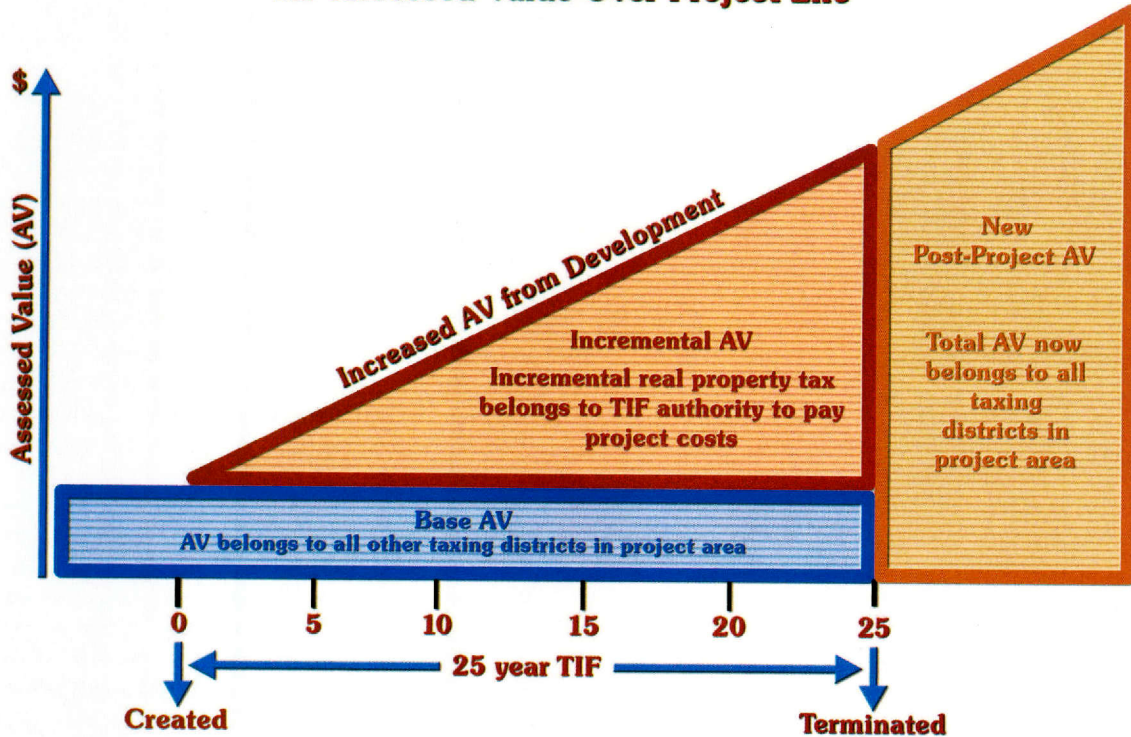
In Texas, owners of properties constituting at least 50 percent of the appraised property value in the proposed district may petition for the creation of a TIRZ.

- the current total appraised value of taxable real property in the zone;
- the estimated captured appraised value of the zone during each year of its existence; and
- the duration of the zone.

Once the board approves the plan, it is passed as an ordinance by the city. The overlying taxing units then decide what percentage of their tax increment they will dedicate to the fund, or they can elect to retain all of it for themselves.

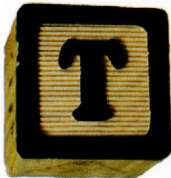
Houston has 20 TIRZs. The city participates at 100 percent of its incremental base in each of these and is the sole participant in one. Other taxing units, such as the Houston ISD, Harris County, Houston Ship Channel, and Houston Water District have opted in at percentages ranging from 50 percent to 100 percent of their incremental base or have opted out completely.

TIF Assessed Value Over Project Life



Source: Craig L. Johnson, Indiana University

Public-Private Collaboration



exas' TIRZ creation process facilitates collaboration between public and private partners. Development of the TIF plan requires the public and private partners to define their roles and the scope of the project and determine whether the development would occur solely through private investment, without need for TIF. The mandatory meeting between the city and the various taxing entities fosters goodwill and awareness, as does the law allowing them to determine their level of participation in the zone. They also provide an avenue for mediating potential disputes before the plan is formalized.

School districts in particular have been vocal critics of TIF zones, charging that they deprive districts of substantial operating funds as growth occurs while simultaneously requiring them to furnish more services. Texas law originally allowed school districts to reduce the value of taxable property reported to the state to reflect any increase in appraised value that was diverted to a TIRZ.

In some cases, this created a loophole for school districts to avoid their payments under the "Robin Hood" school financing laws. That possibility has been eliminated now by the law allowing school districts to contribute from zero to 100 percent of the tax increment revenue, just like other taxing units. Although school districts have elected to participate in many TIFs, this change in the law may affect the number of new TIF zones created.

Voter approval is not required to implement TIF, a fact most cities consider one of TIF's greatest advantages. However,

many criticize reallocation of tax dollars without taxpayer approval.

Public hearings offer citizens an opportunity to present their input and allow city officials to gauge public opinion on the proposed TIF.

Financing Revitalization Projects

The forming of public-private partnerships is crucial to urban revitalization in this era of constrained federal funding. In such partnerships, the predominant share of the total investment would typically come from the private sector. The public sector would provide a smaller, although critical, share for the infrastructure improvements needed to make the TIRZ profitable for investment.



Studies have shown that in Texas, on average, the public sector participates at a rate of less than eight to one. One notable exception is a \$40 million El Paso project funded entirely by the public sector. Conventional wisdom holds that the range of near-term private to public investment leverage a TIF authority should seek is from eight to one to 12 to one.

States' enabling laws generally authorize the taxing entity to issue bonds secured by tax increment revenue so that large amounts can be generated quickly to fund infrastructure. This does not increase taxes but reallocates them to a fund targeting a specific geographic project.

The first Texas TIRZs were financed by bonds, with 75 percent of the projects adopted before 1990 initiated by and built within small cities. This dispels the expectation that only large cities would take advantage of TIF. However, the Texas

comptroller, citing annual reporting data submitted by TIF districts, concludes that of the 39 reporting districts, only ten (five of which are in Houston) have any level of debt financing. The remaining districts are using “pay-as-you-go” or developer reimbursement methods.

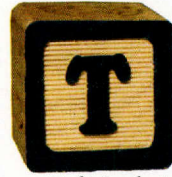
“Pay-as-you-go” allows tax increment revenues to accumulate with the authority before a project is begun. The City of Arlington, for example, had more than \$600,000 in its TIF fund prior to signing an initial redevelopment agreement that called for \$90,000 in infrastructure. This option allows the infrastructure to be tailored to specific businesses. Developers of most larger projects in Texas provide up-front funding and are reimbursed for defined infrastructure costs over the TIF term.

Relying solely on TIF revenue to repay the bonds can be risky. Revenue shortfalls can occur when development does not progress on a timely basis, or the projected level of development does not occur. Private developers and their financing sources may weaken over the term of the TIF, thus failing to produce the projected development activity.

The single most significant risk is a decline in assessed value. The TIF property’s assessed value may decline because of recession or natural disaster. Property can be acquired by tax-exempt entities, or a state may redirect accumulated TIF revenues. Assessment appeals made by major landowners may negatively affect the assessed value.

To buoy the reliability of TIF bonds, various forms of security are sometimes offered. These may include a guaranty from a developer or a secondary revenue stream — incremental sales tax revenues derived from the new businesses — and, in rare cases, a full faith and credit guaranty of the city. Although a city has no legal obligation to repay the bonds, some have argued that allowing default would affect the municipality’s bond rating.

Determining Success



The traditional measure of a successful development is whether it is profitable. However, a project also is a success if it accomplishes what city leaders wanted it to accomplish, such as removing a health or safety concern.

Political risk must be considered when predicting the success of a development project. The more controversial the project, the less likely it is to succeed.

A healthy economy may be a strong predictor of success, although an undertaking can be successful in a weak economy if it has wide-based support. Cities going through economic downturns generally should not undertake projects unless those projects have broad support, are routine in nature and have a purpose apart from revenue generation.

Some observers maintain that to be both viable and efficient, a TIRZ must not only fully repay its borrowing and administrative costs but must generate tangible or intangible incremental benefits (such as enhanced tourism) that exceed the basic revenue growth that would have occurred without the TIF. Desirable spillover effects to adjacent non-TIF areas contribute to the efficiency of the TIRZ and to the public good.

Ultimately, a TIF project needs to be a win-win situation for the public and private sectors. Texas boasts several developer-initiated projects that have resulted in sweeping revitalization efforts. In an era of strained municipal budgets, public investment is not always feasible. Using TIF to allow the private sector to undertake community redevelopment projects is often the best alternative. ♦

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TIF-ENABLING STATUTE ELEMENTS

Establish Authority — Authority to manage the TIF district is normally delegated to a municipality or county and can be further delegated to a commission or an authority.

Assess Needs — Most states require a “qualitative” or a “quantitative” blight finding. Additionally, states often require that applicants show the redevelopment would not occur “but for” TIF, with some also requiring some form of cost-benefit analysis.

Draft a Plan — Most statutes require a formal development plan that tells the community the purposes for which TIF may be used. These can include costs of land assembly and building demolition, rehabilitation and repair of buildings, costs of relocation of persons and businesses, and the costs of infrastructure.

Adopt a Redevelopment Plan — Notice and a public hearing are generally required.

Draft a Finance Plan — The plan must detail exactly what form the financing will take. Traditionally, it has been either TIF bonds, which are like revenue bonds, or developer up-front funding repaid with the incremental revenues as they accrue.

Set Monitor Function — Statutes often require some form of accountability, such as an annual report to the state, to assure that the TIRZ is following plan objectives and that those objectives are still viable.

Plan for Termination — The statutes provide that a TIRZ is in existence only as long as necessary to accomplish its purpose.

Source: Johnson, Craig L., Cole and Thompson Law Firm, “Report to the National Association of Realtors,” *Realtor*, November 2000.

Vacation Home Deductions

RELAX AND SAVE TAX BY JERROLD J. STERN

Recent low mortgage interest rates have enabled more people to own vacation homes (including boats with sleeping accommodations). Vacation homes can reduce income taxes under certain circumstances.

General Rules for Deductions

Vacation homes fall into one of three categories of rules.

Nominal rental rules. If the rental period is less than 15 days, ignore rental income and rental expenses for tax purposes. All property taxes and mortgage interest are generally deductible in full but other expenses are probably not deductible.

Residence rental rules. If the rental period is longer than 14 days, either the residence rental rules or the rental property rules apply. Residence rental rules apply if personal use is greater than 14 days and also greater than 10 percent of rental days.

For example, if the taxpayer uses the residence as a vacation home for 20 days and rents the residence to others for 190 days, residence rental rules apply. The 14-day test is met (20 days are more than 14) and the 10 percent test is met (20 days are greater than 19 days or 10 percent of 190 days). Consequently, rental property expenses are deductible up to the amount of rental income.

Losses cannot reduce income tax. If expenses exceed income, the excess can be used in a future tax year but only to

the extent that future rental income exceeds future rental expenses.

Rental property rules. If the rental period is longer than 14 days and residence rental rules do not apply, rental property rules go into effect. For example, suppose that the rental period from the previous example was 210 days instead of 190 days. Rental property rules would apply because the 10 percent test is not met (20 personal days are less than 21 days, or 10 percent of 210 rental days).

The significance is that the rental property rules enable the taxpayer to deduct losses if rental expenses exceed rental income, but only if certain other conditions are met. These other conditions pertain to the passive activity loss (PAL) limitation rules and the at-risk limitation rules. Both sets of rules can delay or eliminate loss deductions in certain situations depending on the taxpayer's level of active involvement with the property and the manner in which the property is financed. The elimination of the loss deductions may cause taxpayers to prefer the residence rental rules rather than the rental property rules. However, if taxpayers can meet these hurdles and their income is not over \$150,000, they may be able to deduct up to \$25,000 of passive losses.

New Tax-Planning Perspectives

Choice of allocation method. In the previous examples, the actual number of rental days is the denominator according

to IRS rules. For instance, the denominator in the first example is 190 days. This results in the 10 percent test being met, which requires residence rules to be used. However, two appellate courts have given taxpayers the choice of using 365 days as the denominator, thereby giving taxpayers a better chance of failing the 10 percent test, allowing them to use the rental property rules. The full-year denominator in the first example results in a personal-use percentage of only 5.5 percent (20 days divided by 365 days).

Increasing the interest deduction. As noted, if the rental property rules apply, the PAL, at-risk rules or both may limit deductions, such as the mortgage interest deduction. The amount of interest that is deductible can be increased if the taxpayer can borrow on a line of credit secured by the principal residence ("home equity indebtedness"). Interest on up to \$100,000 of home equity indebtedness is generally fully deductible regardless of how the borrowed funds are used.

The rules and tax planning strategies for a vacation home are complex if the home is rented for any part of the year. Thus, vacation homeowners are always advised to consult with a tax accountant or tax attorney to maximize the tax benefits from vacation home rentals. ♦

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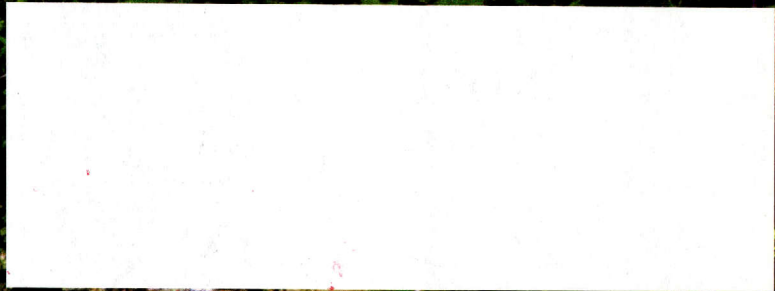
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