

# The New World of Real Estate Finance

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**R**eal estate finance has undergone a significant structural shift, and it is not turning back. Real estate finance is segmenting, with new vehicles and structures designed to price the different slices of a property's real estate capital structure based on their specific risks. This change has significant implications for the industry. Many real estate transactions will require multiple layers of finance, bringing the complexity typically seen only in select large deals to a broader segment of the marketplace.

This dramatic shift in the marketplace is driven by growing equity requirements, but is possible today because of better information, more sophisticated underwriting, and the discipline and techniques learned from the CMBS and REIT industries. In the corporate world, "traunching" of bond risk, convertible debt, preferred equity, and numerous other finance techniques that "slice and price" the different layers of a company's capital risk have been common for years. In many ways, real estate is just naturally evolving to a more sophisticated finance foundation.

Growing real estate equity requirements have triggered this change. More equity is needed today than is available, necessitating creativity in finance. For example, new construction equity requirements have increased from 10% or less in the 1980s to 25% or more today, representing a 150% increase of equity needed. Put another way, \$100 million of

equity in the 1980s could support a billion dollars of construction, but only \$400 million today. Combined with higher equity requirements on refinancing, equity is at a premium.

These changes in the basic structure of real estate finance have been accompanied by changes in the sources of real estate capital. On the debt side, traditional long-term lenders like savings and loans are nearly gone. Life companies, the other reliable long-term lender, face a changing environment due to demutualization and changes in risk-based capital regulations that promote investment in alternatives to long-term mortgages. Commercial banks still dominate the construction-lending sector, but many have migrated to longer-term loans, high-yield mortgages, and other real estate banking activities.

Real estate equity sources, who have historically focused on the four major property types in the United States, are now presented with scores of opportunities including net lease deals, mezzanine funds, joint venture developments, REIT joint ventures, opportunity fund investments, real estate venture funds, and a full range of international investment opportunities.

The implications of these changes, whether you are accessing capital, providing capital, or part of the service industry, are that your relationships and knowledge need to be broader than they were in the past, to insure your relevance in the future. These changes have already stimulated mergers, acquisitions,

and alliances among service providers, finance companies, and investors, and such activities are expected to continue in the future.

The rest of this article provides an assessment of some of the current trends and information that is critical to keeping abreast of the changes under way in the industry today.

## ECONOMIC OUTLOOK

Perhaps the most important issue facing real estate finance today is uncertainty about the future of the economy and property markets. The feelings of uncertainty are based on individual experience and the widely varying forecasts of economists. The Economic Cycle Research Institute, a well-respected industry group, is perhaps the most negative, predicting a recession starting in the second or third quarter of this year. Alternatively, the Conference Board's Index of Leading Economic Indicators and the Recession Watch Index, compiled by Comerica Bank, both indicate a decline through early 2001 with a pick-up in the second half of the year. This more positive forecast is supported by the Urban Land Institute, which forecasts two to three quarters of flat gross domestic product (GDP) growth of 1.5% followed by a gradual increase to 2% for all of 2002.<sup>1</sup>

While there is a dispute about the depth and breadth of the economic downturn, there is consensus that the economy has turned significantly downward, even if GDP continues to grow at 1% to 2% per year. Accordingly, while we are not officially in a recession, it still feels like a significant downturn given GDP growth of 4%-5% in recent years. There is also no dispute that Nasdaq is down 50% from its peak and the S&P 500 is down 15% from its peak, significantly reducing wealth in the economy. Venture capital spending is also down from \$100 billion a year in 2000 to approximately \$50 billion projected for 2001. Perhaps of most concern is that two-thirds of the current economic growth is driven by consumer spending, and there continues to be speculation about the future ability of consumers to continue to spend. Despite this concern, consumer confidence has rebounded in recent months.<sup>2</sup>

The collapse of the telecom industry is a further area of concern, not only for real estate building owners, but also for the economy as a whole. Many companies, including key real estate telecoms such as OnSite Access and Broadband Office, have declared bankruptcy, and many others are expected to follow. The severity of telecom

problems is best illustrated by the huge numbers involved. With over \$800 billion invested in telecom, losses are expected to reach over \$150 billion, equal in magnitude to the S&L collapse. Tenants, building owners, carrier hotel investors, and major firms such as Cisco and Nortel are among those seriously affected. In the first quarter of 2001, for example, Nortel declared a \$19 billion loss. Perhaps the silver lining is that with a substantial oversupply of fiber-optic cable put in place, our economy will benefit from the infrastructure investment. However, in the short run, don't expect bargains due to the oversupply, because stable and successful telecom firms will be charging a "stability" premium.<sup>3</sup>

## REAL ESTATE MARKET OUTLOOK

The real estate markets are well positioned to withstand declines in the economy. Most important, due to better underwriting, more regulatory oversight, and the discipline brought on by the emergence of the CMBS and REIT sectors, the property markets are strong. Office vacancies, while rising in the first quarter to 9.5%, are still below levels near 20% at the start of the decade. Annual new construction has dropped to near 2% of total inventory and is forecast to stay low for at least the next two years. This compares to an average of 4% between 1998 and 2000 and sustained levels of 6%-7% in the mid- to late 1980s. A similar story can be told for the other major property types, providing confidence that dramatic market collapses are unlikely to emerge.

Reports by the Real Estate Research Corporation, LaSalle Investment Management, PricewaterhouseCoopers, Torto Wheaton, the Urban Land Institute, and others, all suggest a soft economic landing would have limited long-term negative effects on the real estate markets. Owners, due to much more significant equity cushions than in the past, are also well positioned to survive projected economic declines.<sup>4</sup>

Other positive signs for the real estate industry are found in recent surveys. Based on a survey of responses from leaders in the Urban Land Institute, 78% of all businesses thought that prospects for profits through mid-2002 were excellent, very good, or good, while only 8% thought the prospects for profits were fair or modestly poor. Bank of America Securities did a survey of 34 of the largest public real estate companies with an equity capitalization of \$105 billion and found that, combined, they have invested only \$230 million in technology ventures. This equaled approximately 0.2% of their equity capital-

ization, with most companies having invested less than \$10 million. They conclude that most real estate companies avoided the temptation to take the technology leap of faith; thus, negative financial effects have been minimal.<sup>5</sup>

## TRANSACTION ACTIVITY

The differences in the way buyers and sellers interpret market uncertainty have led to a significant slowing of transaction activity. By some reports, both sales and mortgage origination activity are down over 50% from highs during the last two years. Leasing activity has also stalled as tenants, hoping that they are finally back in the driver's seat, pause to consider the effects of the economy on their businesses and determine the point in time where they can extract the best deal from landlords. The one bright side in the transaction market is refinancing, where historically low interest rates and new mezzanine financing structures allow owners to extract significant capital without having to sell.<sup>6</sup>

The slowing of transaction activity is reflected in bid-ask spreads, which are the widest they have been in many years (bid-ask spreads measure the difference between what the buyers want to pay and sellers are asking as measured in differences in capitalization rates). Bid-ask spreads were over 100 basis points for hotels and power centers. Office buildings, industrial properties, and community shopping centers were centered around 70 basis points. Apartments had the lowest bid-ask spread of 50 basis points.

As might be expected, bid-ask spreads vary significantly by property type and geography. Property types with longer leases typically have wider spreads, as do markets which have seen accelerated rent increases in the last several years. If history is a guide, the wide gaps in bid-ask spreads should last 3-6 months, with sellers eventually moving to the buyer's position. However, the strong equity positions and financing options available to many owners are likely to extend slow transactions longer than has been the case historically.<sup>7</sup>

There are numerous indicators that transaction activity should rebound strongly in the next 12 months. First, buyers, sellers, and tenants should gain confidence as the direction of the economy and real estate markets becomes more clear. Opportunity funds, which have raised over \$50 billion in equity, and invested significantly more on a leveraged basis during the last five years, are under pressure to sell assets. While their financial strength will enable them to hold assets, they have significant selling pressure

due to internal rate of return hurdles and the detrimental effect of longer holding periods on internal rates of return.

Transaction activity from the REIT sector should also increase as REITs recapitalize through joint ventures and sales of marginal-quality assets. The REIT bond market has also been strong, enabling access to unsecured debt, providing further transactional liquidity. Other positive trends for transactions include expected increases in pension fund allocations to real estate in 2002, increased corporate activity as rents stabilize, and continuing healthy capital markets.

Another strong trend in the transaction market has been the growing activity of high-net-worth individuals. According to CB Richard Ellis, high-net-worth individuals and syndicates accounted for 44% of transactions in 2000, followed by life companies and pension funds at 25%, opportunity funds at 14%, and REITs at 11%. This trend of investment by high-net-worth individuals is expected to continue as wealthy individuals continue to diversify their stock market positions. Given the substantial wealth in the economy, even after drops in the stock market, small changes in individual investment decisions can result in significant new real estate equity investment. Proof of this trend can be found in a survey in the Spring 2001 *Real Estate Alert* that identified 78 active real estate opportunistic and value-added vehicles, operated by 60 different sponsors. These funds raised \$26.6 billion by the end of 2000 and were expecting to invest \$26.7 billion in 2001 at an average target leveraged return of 19.2%.<sup>8</sup>

## REIT TRENDS

REITs usually get press disproportionate to their influence in the real estate capital markets due to public disclosure requirements. In this case, REITs have earned their press with returns through the middle half of the year near 8% compared to returns of -17% for Nasdaq and -7.1% for the S&P 500. The strength of REIT performance is even more stellar when looking at the last 12 months where REITs have achieved 18% total returns versus a negative 46% for Nasdaq and a negative 16.1% for the S&P 500. The best REIT performers during the last 12 months have been those sectors of the market hurt the most previously, retail, hotels, net lease, and healthcare. Healthcare REITs led the pack with a 46.2% return during the last 12 months.

Despite the substantial increase in share prices during the last 12 months, average REIT net asset values

(NAVs), as a percent of total market capitalization, were 95% through the middle of 2001, up from 88% in June of 2000, but still far below the peak of 130% set in March of 1997.<sup>9</sup>

REITs have rebounded successfully from their poor performance in 1998 and 1999 when they experienced negative total returns of 16.9% and 4.6% respectively. The challenge today is to continue the strong performance and growth while limiting risks. As capitalization rates have declined and low-hanging fruit has been picked, it is more difficult to find acquisitions that generate growth at appropriate risk levels. REITs have responded by turning to development. Green Street Advisors, Inc., reports that the current development pipeline for public REITs and real estate operating companies is approximately \$18 billion. This represents almost 20% of the market equity of the companies undertaking development. So far, the market does not appear to be fully rewarding the additional growth brought on by development, unless it is adjusted for market, financial, and property risks.<sup>10</sup>

The REIT Modernization Act (RMA), which went into effect January 1, 2001, is one way that REITs are expected to push forward their growth. The RMA, which allows REITs to own taxable real estate subsidiaries, thus enabling them to provide real estate-related services to their tenants and third parties, has been underestimated in some circles as a driver of growth. While many REITs will only marginally use the powers of the RMA, other firms are contemplating substantial vertical integration including such ideas as apartment REITs owning furniture companies or offering single-family sales and brokerage services to tenants who are moving into the single-family market. Credit card companies for regional mall REITs or multifamily REITs going into condo conversion are a few of the many other ideas and actions being implemented today.

REITs need to be careful in their planning to take advantage of the RMA's power. The problem can be seen in the way the stock market has treated commercial real estate services companies that went public since 1996. These companies, which make up five of the 10 largest commercial real estate services firms in the country, have suffered dramatically falling stock prices and have been unable to raise sufficient additional capital to fund their growth. One reason for this, and why REITs have fared better, is that the market does not reward unpredictable transaction-based income. Accordingly, since REIT analysts look very carefully at the nature of income, and have a preference for asset-based income, any expansion of

activities due to the RMA should be evaluated based both on their ability to contribute to share price as well as the specific profitability of the subsidiary.<sup>11</sup>

REITs also continue to face the challenge of raising new capital. While O & Y Properties Corp recently filed for a \$98 million IPO to create O & Y REIT, the IPO market has otherwise been dead. Only two IPOs worth \$292 million were sold in 1999, and no IPOs have been done since. On the positive side, REITs have been able to access unsecured debt through public offerings during the last few years. Unsecured debt offerings exceeded \$7 billion per year in 1999 and 2000, and through the first five months of 2001 nearly \$5 billion in unsecured debt had been raised. Although a total of \$10.4 billion of offerings were completed in 2000, money raising paled compared to the average of over \$40 billion raised annually in 1997 and 1998.<sup>12</sup>

REIT merger and acquisition activity declined significantly in 2000. Only 7 REIT to REIT mergers occurred in 2000, compared to 14 such deals in 1999. While merger, acquisitions, and consolidation activities are expected to continue in the future, most observers do not expect the pace to pick up significantly in the near term.<sup>13</sup>

## DEBT TRENDS

Commercial mortgage interest rates have remained relatively constant since the start of the year, at historically attractive rates of approximately 7.5%. However, while prices are good, borrowers are experiencing difficulties in obtaining acceptable loan to value ratio coverage, particularly with construction loans or other properties with higher risk positions.<sup>14</sup>

Tight underwriting practices by banks have been in place for some time. Based on the most recent survey by the Federal Deposit Insurance Corporation of bank underwriting practices, covering the October 2000 through March 2001 time period, underwriting practices for commercial real estate loans tightened further. The same report showed that banks active in construction lending actually increased their frequency of making speculative construction loans (that is, projects without meaningful presale, prelease, or takeout commitments). Approximately 29% of those making construction loans participated in this practice.

Bank underwriting will not tighten excessively as it did in the early 1990s if Alan Greenspan has his way. In early June, Greenspan, the Federal Reserve chairman, told the Senate Banking Committee that banks should not

tighten lending standards despite some erosion in loan quality in U.S. banks. He felt that an overreaction to problem loans could create a credit crunch, which could be devastating to the sluggish economy, hurting bank shareholders and their profits.<sup>15</sup>

The CMBS market is showing surprising resiliency so far in 2001. Based on year-to-date performance, issuance for 2001 is expected to reach \$75 billion, only \$3 billion less than its peak of \$78 billion in 1998. This is up from \$60.9 billion in 2000 and average issuance of less than \$20 billion in the early to mid-1990s.<sup>16</sup>

The resiliency of the CMBS market is reflected in its ability to adapt. While the market grew initially with large offerings of Resolution Trust Corporation assets, it then adapted to incorporate multiasset class pools, a broader array of property types, international securities, and finally today more customized offerings with unusual underlying collateral features including leaseback structures, single borrower loans, and short-term loans.

With international issuance reaching \$12 billion in 2000 as banks throughout the world restructure their assets, and estimates of \$20 to \$25 billion of international securities in 2001, this segment has become important. However, there are still some questions as to whether this international component of the market will be a long-term feature or disappear like RTC issues did in the U.S. during the mid-1990s.

CMBS spreads continue to tighten. AAA spreads over 10-year Treasuries were 126 basis points as of June 2001, 40 basis points less than a year ago. This tightening is a result of continuing healthy demand for CMBS issues by investors and declining 10-year Treasury rates, which decreased 60 basis points during the same time period. Noninvestment grade tranches did not see their spreads reduce, as BB spreads remained constant at 525 basis points and B spreads actually rose from 815 to 825 basis points.

There appears to be hope for additional B-piece buyers to enter the market, eliminating a potential bottleneck for CMBS issuers. This is important because historically the market for the highest-risk CMBS tranches has been thin, and these investors shoulder the majority of the delinquency and default risk in CMBS securities. B-piece buyers wield power despite representing only approximately 5% of a typical pool. They have had the ability to throw out loans arbitrarily and make other demands.

There is evidence that new B-piece buyers are entering the marketplace. With the dot.com meltdown and the

high-return expectations in the tech sector, B-pieces, with 20% to 30% return expectations, are attracting greater interest. ARCap REIT, Inc., a private trust that is an active B-piece buyer, completed an offering raising \$121.5 million. They also issued \$236 million in senior notes, providing additional capital to invest in the market. Cremac Capital Partners also recently closed a \$100 million fund to invest in subordinate tranches. A team consisting of Alliance Capital Management and the Global Capital Markets Group of CB Richard Ellis also recently announced plans to raise approximately \$200 million of equity capital to invest in BB and below quality CMBS. GE Financial Assurance and Anthracite Capital, Inc., are two other companies that have recently raised fresh capital for the sector.<sup>17</sup>

The CMBS market is also heading towards greater activity over the Internet. Recently, a group of companies and organizations led by the Mortgage Bankers Association (MBA) and the Commercial Mortgage Securities Association initiated a process to develop standards for commercial mortgage transactions conducted over the Internet. Another task force of the MBA and the Commercial Mortgage Securities Association recently released a report that dealt with the problem of missing loan documents. This task force spent eight months developing recommendations to insure fewer delays and more complete reporting in the mortgage markets.

Finally, the idea of online marketing of bonds is not new. In 2000, five investment banks including Goldman Sachs, Merrill Lynch, Morgan Stanley Dean Witter, Deutsche Bank, and Salomon Smith Barney banded together to launch an online marketplace for bonds. This new company, called BondBook LLC, is being designed to trade corporate, junk, and municipal bonds on the Internet. While the CMBS industry is not quite there yet, the steps being taken and this initiative in the bond market are leading the way towards greater liquidity in the commercial mortgage-backed securities marketplace.<sup>18</sup>

## INTERESTING OPPORTUNITIES IN THE MARKET

Huge opportunities with brownfields (former industrial and commercial facilities where development is complicated by real or perceived environmental contamination) have become more realistic given recent market changes. First, the Brownfields Revitalization and Environmental Restoration Act passed 99 to 0 in the Senate in April 2001 and is going to the House. This act provides liability relief

for innocent property owners and increased funding for brownfields cleanup and redevelopment and recognizes the finality of successful state hazardous waste cleanup efforts. Bush's budget also makes permanent a special exception that brownfield sites currently have that allows them to deduct all cleanup costs immediately, rather than amortizing them over time. Finally, in a federal district court in San Francisco, the city of Emeryville received a favorable ruling that they are not responsible for any cleanup cost because of environmental contamination in a property they acquired under eminent domain. This ruling enables cities to more freely use their eminent domain power to push forward brownfield site redevelopment.<sup>19</sup>

For those people who have longed to buy a cheeseburger at their local REIT, the IRS in early June issued Revenue Ruling 2001-29, which clarified an earlier ruling in 1973 that held that REITs were not engaged in the "active conduct" of a trade or business. This new ruling clarifies that REITs are engaged in the "active conduct" of a trade or business providing a "safe harbor" for non-real estate companies to distribute or spin off on a tax-free basis real estate assets in the form of a real estate investment trust whose shares are distributed to the company's existing shareholders. This presents opportunities for companies like McDonald's to spin off their real estate holdings on a tax-free basis.

Opportunities in the 1031 like-cut exchange marketplace expanded with a September 15, 2000, IRS ruling which enables "reverse" like kind exchanges. This ruling, Revenue Procedure 2000-37, enables property owners to reverse the existing steps in a 1031 exchange, enabling them to buy a property first, then have 180 days to sell existing assets. This added flexibility should make the \$30 billion 1031 exchange market even more attractive. To assist this marketplace, LoopNet, in partnership with Asset Preservation, Inc., Investment Property Exchange Services, Inc., and LandAmerica Exchange Company, recently launched an online program for tax-deferred investment property exchanges. This exchange will provide resources, current information, and a variety of tools necessary for 1031 transactions.<sup>20</sup>

Succession planning and related activities present a huge opportunity for service providers and investment managers during the next two decades. Projected wealth transfers during the next two decades are massive. Twenty-six million estates with an aggregate value of \$12 to \$18 trillion will be probated by 2017. Seven to ten trillion dollars of this will go to personal heirs, as opposed to charities or trusts. The opportunities exist because of the large

amount of this money that will be in the form of real estate, or real estate companies, as well as the investment opportunities presented by this wealth transfer. Succession planning has always been a critical issue for real estate companies, and with many REITs today, it is an important issue in retaining the confidence of investment analysts.<sup>21</sup>

Another significant growth area to watch is the biotech industry. The cost of bringing a new drug to market is approximately \$400 million, and biotechnology can significantly reduce this cost. The industry, just 25 years old, has helped a quarter of a billion people, and this number is expected to grow significantly. Over 350 biotech medicines targeting 200 diseases are in the late stages of development. With substantial research budgets and growing marketing and business strength, the biotechnology industry will be a huge user of real estate within the United States, Europe, and other countries.<sup>22</sup>

## CONCLUSION

The changes under way in the segmentation and sophistication of real estate finance are important changes that should be with us for some time. While real estate finance does go through cycles, such as the REIT debacle in the 1970s, public and private syndication in the 1980s, varying waves of foreign investors in the 1990s, not to mention tax law changes too numerous to cite, its move towards greater sophistication and complexity has been constant. Better information, underwriting, and legal strategies have enabled recent structural changes in real estate finance that should become part of the new financing environment for many years.

## ENDNOTES

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