Leadership Roundtable: The Real Estate Industry & the CRE Organization

Panelists:

RICHARD A. HANSON, CRE
2008 CRE Chairman of the Board
Principal – Mesa Development, LLC
Chicago, Ill.

A.C. SCHWETHELM, CRE
2008 CRE First Vice Chairman
(to serve as 2009 Chairman)
President – A.C. Schwethelm Associates, Inc.
Comfort, Texas

ARTHUR P. PASQUARELLA, CRE
2008 CRE Second Vice Chairman
(to serve as 2010 Chairman)
Executive Vice President, COO – BPG Properties, Ltd.
Philadelphia, Pa.

Moderator:

MAURA M. COCHRAN, CRE
Editor in Chief
Principal – Bartram & Cochran, Inc.
Hartford, Conn.

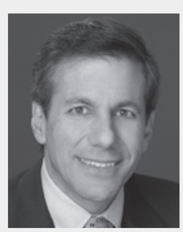
WHILE THE THREE COUNSELORS WHO ARE IN LINE TO SERVE AS CRE Chairman of the Board have many decades of experience in the real estate industry among them, each possesses a unique perspective on the many issues we face each day, including development, appraisal and investment.

How are these CRE leaders and their companies navigating the current real estate environment during this period of change? What challenges do they face? What role do all three see the CRE organization playing as a guiding force? Maura M. Cochran, CRE, editor in chief of *Real Estate Issue*, discusses these issues with the three CRE leaders.

About the Roundtable Participants

Richard A. Hanson, CRE, *is principal of Mesa Development, LLC, a Chicago-based national real estate developer and investor committed to developing significant residential and mixed-use developments in major cities and urban areas. His work is grounded by his belief in creating architecturally stunning urban settings located near civic and cultural centers, allowing individuals greater opportunity to contribute to society and enhance their lives.*

A.C. Schwethelm, CRE, *is president of A.C. Schwethelm Associates, Inc., of Comfort, Texas, a firm which specializes in counseling government entities and others on litigation strategy, eminent domain and taxes. Schwethelm is retained by state agencies, city and county governments, and attorneys for property owners for his appraisal expertise. Schwethelm is a past recipient of CRE's highest honor, the Landauer/White Award, which is presented annually to an individual who has furthered the ideals of The Counselors of Real Estate organization, who has advanced the position of the "CRE" designation and who has demonstrated outstanding professionalism in real estate.*



Arthur P. Pasquarella, CRE, *is a principal and chief operating officer of Philadelphia, Pa.-based BPG Properties, Ltd., a private equity value-added fund manager directly operating a diversified national property portfolio. Pasquarella oversees all of the firm's real estate investment and property activities. He holds a master's degree in real estate and investment analysis from the University of Wisconsin-Madison and a bachelor's degree in finance from The Pennsylvania State University.*

COCHRAN: ***What are the major projects you're working on right now?***

HANSON: We're in the process of constructing two buildings. One is a 72-story condominium in Chicago called the Legacy at Millennium Park. The second, in San Jose, Calif., is the 360 Residences, a 213-unit, 23-story condominium tower.

PASQUARELLA: We are a private equity real estate fund manager and just closed our eighth investment fund — at $850 million, our largest by far. In July, we commenced investing it, and we have three to four years to invest that capital in an intelligent way. Since it's a leveraged pool of capital, we'll wind up having to buy about $1 billion of acquisitions throughout the country in each of the next three years, diversifying among the main four groups — office, retail, industrial and multifamily.

SCHWETHELM: My work most recently has been in the courtroom as a result of appraisal issues. I recently testified as a consultant, not as an appraiser, for a property owner in a hearing critiquing the appraisal prepared for the condemning authority. The commissioners gave an award approximately five times the testimony of the appraiser, although I gave no opinion of value, merely an analysis of an appraisal that defied reason. The next day the attorney for the condemner called and hired me to "do for them what I did to them." I believe it will result in a lengthy assignment in which I can help the condemner avoid the kind of situation they faced in that case by careful examination of their appraisals before hearings or trials. Obviously, I will not be involved in any further consideration of the case in which I testified, nor any other parcels in that project.

COCHRAN: ***What is the impact of today's market volatility and credit crunch on your work and your business plans? It's a big news story.***

HANSON: The credit crunch has finally started to affect the business I'm in. Everything you've read in the papers is true — there was way too much credit and, unfortunately, too many people buying homes who couldn't afford them. Now we have to deal with it. For a long time, though, the effect was really only in the subprime market, the lower end of the housing market. However, that has now bubbled up to luxury condominiums.

Almost all housing is a move-up market. You buy your first home, you sell it, buy a better home, sell it, and buy a better home, and so on. So, if someone is moving up from their house in the suburbs to buy a luxury condominium, down the housing chain they need the entry-level people. Our buyers have now realized how much trouble they're having selling their homes, and so they're hesitant to buy a condo downtown.

PASQUARELLA: On the commercial front, I don't see earth-shattering changes, but market volatility and the credit crunch *are* having an impact on my business. I think it actually helps me and my firm. It's keeping out of the game the real estate investor who would borrow 90 to 100 percent of the purchase price from a whole host of financing sources.

The real estate market in many ways is relatively efficient and, despite the media reports to the contrary, is rather orderly. On a macro level, the markets throughout the country among the different property types are all relatively healthy and improving, primarily because new supply has been kept to a relative minimum. Certain markets have more speculative commercial development than others, but they're few and far between. Most U.S. markets have improving occupancy and improving rental rates among the different property types. So, things continue to stabilize and improve and it's increasingly expensive to build new products, so to see rampant overbuilding would be very surprising.

COCHRAN: ***What about the impact on financing?***

HANSON: The jumbo mortgage market (any mortgage for more than $417,000 which makes it ineligible for purchase by Fannie Mae and Freddie Mac) is feeling the adverse effects of the credit crunch. Since each of our condos is averaging around $1 million, the investor appetite for our type of mortgage loan has dropped significantly. Our typical buyer who usually enjoys a very high credit score is finding it difficult to secure a loan due to the lack of federally-sponsored guarantees.

In addition, from talking to our banking sources, we're beginning to see that project underwriters are taking a much closer look at the whole condo business, getting much more particular on what projects they'll finance, hiking their requirements for presales in order to start to fund the debt and scrutinizing location and competitors much more thoroughly. They're certainly going to developers with track records, developers they have a relationship with. I'd say, if you are relatively new to the business, you'll have a much more difficult time.

PASQUARELLA: The adage in the real estate business definitely applies that when you use other people's money, you don't have any skin in the game. People become very undisciplined with their capital and injudiciously acquire assets just to make deals and get fees. That being said, we're only looking for lenders to finance two-thirds of the cost, not 80, 90 or 100 percent. In today's financing environment, the net effect is that some of the higher leveraged investors, buyers and competitors are kept out of the game. In turn, that lessened competition means less demand and slightly more attractive pricing for me. We were seeing some extraordinarily crazy pricing and deals that you scratch your head and say, "This doesn't make sense." Even lenders were doing some pretty outrageous things. If they go back to the fundamentals — reasonable loan underwriting, requiring borrowers to invest some cash, making sure that there are loan-to-value covenants and strict debt cover ratio covenants — it brings sanity to the market. And that's healthy for the industry. It's not good for any investment class when there's rampant speculation and an undisciplined, excessive supply of capital.

COCHRAN: ***Foreclosures have been a big item in the news recently. How important do you see that being?***

PASQUARELLA: It's mostly limited to the residential sector, but it does affect investment real estate, particularly in the multifamily market. I recently went on a multi-city tour in Florida, and they were talking about "re-version." A few years ago developers came in *en force* to convert apartment houses from rentals to condos. Then the market fell apart. They're reacting by converting back, reverting, to rental products. It's a local phenomenon, by no means national; yet it is occurring in pockets around the country. It's a good lesson to keep in mind: Real estate doesn't always develop linearly, and smart real estate professionals always have to adapt.

COCHRAN: ***Globalization is clearly an intriguing subject in today's market. Are your firms moving into the international arena?***

PASQUARELLA: Our fund's strategy is to create a diversified pool of U.S.-based real estate assets, probably a third of our acquisitions or development will be in office space, another third in multifamily property and a third a mix of industrial and retail. Likewise, in terms of location, everything else being equal, we'd like to be highly diversified. But that being said, it never happens that way; you go with where the opportunities are at that point when you're looking to make an investment.

Being based in Philadelphia, our investments 10 years ago were more east coast-oriented. But over the last seven years, we've opened up several offices, including a large one in Chicago. So our portfolio has shifted towards the midwest and now the west, as we opened an office a year ago in Los Angeles. When we complete assembling this portfolio in three or four years, you'll see a pretty diverse *national* portfolio.

HANSON: Is my firm moving into the international scene? In one sense, no. In another sense, definitely yes. At this time, we would not consider building outside of the United States. If I can't get to a site on a plane in four hours, I don't want to do a development there. We're in a business that requires an amazing amount of attention to detail. Either you have to be a very big company with resources wherever you're going to build or you don't do it.

As the saying goes: "You make money in your own backyard and you lose it in other people's." For instance, in San Jose, we opened an office, hired full-time people, and we've bought a second lot to build a second building. We didn't just go to San Jose to build one building. We went to start a business. It links back to the earlier comment about lenders wanting people with a track record and people with a relationship.

So, internationally, if I were to go storming into, name a country, they would say, who the heck is he? What do we know about him? But there is another aspect to your question and that is buying our buildings' parts and materials overseas. Our second biggest cost, after the concrete frame, for the Legacy at Millennium Park is our curtain wall — the whole cladding on the building, plus all the glass and windows and frame. We're buying it all from China, and that's created a whole set of interesting questions about currency fluctuations, insurance, warranties and payment procedures in the United States.

COCHRAN: ***Is that what's happening across the board if you went to almost any developer these days? They would be getting most of their curtain wall materials from China?***

HANSON: I think it's a new trend. We're buying our curtain wall from a company called Yuanda, and when we did that a year ago, we were the company's second North American buyer. Now they have more than 20. And the glass is coming from a company called China Glass. They're using brand new facilities, state-of-the-art machinery and equipment, and our architects and contractors, who have visited two, three, four times, are very pleased so far. Of course, there are added delivery challenges. We have to ship 700 crates from China and store them, but so far so good.

COCHRAN: ***How do you compare the most recent years in the real estate industry with the real estate cycle from 20 years ago?***

PASQUARELLA: They're not even close, for some fundamental reasons. This market aberration and the adjustments are capital driven, not supply driven. Back in the mid- and late '80s, we had a period of about four to five years of explosive development — you name the property type, as an industry, we were building it. And underwriting was being done on ridiculous premises. In hindsight, it was like you were drinking too much and you woke up and said, "What did we do?" People were underwriting and capitalizing office building rents pretending that they were $20 per square foot, when in reality tenants were getting two years free rent on a five-year lease, so the real net rent, the effective rent, was overstated by 40 percent. The whole thing was a house of cards.

Now, the industry is much more transparent. The presence of public REITs (Real Estate Investment Trust) in the market has added to that. True, REITs are getting hammered right now, but the advent of securitized mortgage products has helped create additional transparencies in the market. I think funds like ours provide a lot of transparency to our investors as to the real conditions of their investments; what the real prospects of new investments look like. The industry is much more mature now in how it operates. Even though many companies are still private, including mine, we all operate more publicly than ever.

COCHRAN: ***Do you foresee potential trouble, as in the late '80s, when Japan was moving in on the U.S. real estate market so much that people were starting to get concerned about the Japanese having too much control over the U.S. market?***

HANSON: No, it's different, though not an entirely right-field concern. Where we might have to worry is China's level of purchases of U.S. Treasuries. China is responsible for our interest rates being so low because it takes all its surplus and buys our Treasuries. So we depend on them in a totally different way, but still in a significant way. However, the Chinese aren't here buying our office buildings, hotels and golf courses. No one is saying about China what we said in the late '80s, when we were saying that Japan would own all of New York and San Francisco . . . which, in any case, didn't happen.

PASQUARELLA: Recently, Bloomberg.com published a prediction that commercial real estate prices will drop something like 15 percent over the next 18 months. I don't see that at all. That's headline grabbing. What people fail to understand is that the real driver of value in any asset is its earnings potential. And in that regard the underlying fundamentals of real estate remain sound.

Most property types and most regions are seeing increasing rents, which means there are increasing earnings. And when you have increasing earnings in any investment, whether they are stocks or real estate, you're seeing valuation grow in the long term. There will always be some aberrations bouncing around because of capital market swings, but long term, it's growing in value. So I think such predictions are a bunch of nonsense.

Everybody is talking about dislocations in the financial markets, but no one is talking about the fact that Treasury rates have fallen probably 75 to 100 basis points over the last few months, and that has a huge impact on the borrowing cost of real estate because all of our debt instruments are ultimately tied to spreads over Treasury bills. So when you look at the 10-year Treasury rate and see that it's down to 4.5 percent from 5.2 or 5.3 percent just 60 days earlier, the cost of money has come way down, and it has a significant impact on how you value your assets.

COCHRAN: ***A major point of conversation recently has been about green concerns. How are you responding to green development issues?***

HANSON: We made the decision that all our buildings will be LEED-certified. I think green is terrific. Having said that, it can also go too far or get ahead of itself. Cities such as San Francisco, Seattle and Boston are now mandating that all new buildings be green. That's okay in today's environment of what it takes to be green, but if these cities continue to mandate this and if the green standards continue to go up in a crazy way, it will get very difficult and very expensive.

PASQUARELLA: I think that's why there's a continued allure to mixed-use development. I keep remembering back when I first came out of school in the early '80s, the talk was all about urban living, 24/7 environments, being able to work and play within a few blocks of where you live. Maybe that vision was ahead of its time then. But I see that vision now getting legs. Some of it is just the convenience, of course, but the concept of the 24/7 environment also ties very nicely into the green movement. There's a lot to be said for keeping people out of their cars, where they consume fuel and contribute to today's worsening congestion.

COCHRAN: ***What are the most challenging issues facing your business?***

HANSON: We have a housing market that's very soft, which affects people's ability to buy on the revenue side of our equation. Then on the expense side, we have ever-increasing costs, at a rate of 1 percent per month — in some places a bit slower at 10 percent per year and in many places you'll hear 15 and 20 percent. It's amazing how fast costs are increasing and that's frankly why we are turning to China and other places; even with the cost of transportation and added storage costs, it's still net less expensive.

Then we have a demographic factor driving the multi-family market on the positive side. The empty-nest baby boomers — an enormously wealthy generation of people who are now in or approaching their 50s who I've heard have $2 trillion of cash lying around and who want to live in cities. They're astute and much more urban than their parents. They want to be near the orchestra and the museums and restaurants and work. We aren't selling them shelter; we are selling them choice. We don't sell to somebody who just needs a roof over his or her head; we sell to somebody who already has a roof overhead but who wants a different roof … or a second one. How much are those people who have that choice going to be affected by the current economy? Right now, not much. Our Legacy building is 83 percent sold with two years to go, and our San Jose building is 50 percent sold, four months after opening the sales office.

SCHWETHELM: When I became active as an appraiser for eminent domain some 45 years ago, I assumed that, since eminent domain had been going on for so many years, the legal procedures were well established and static. How naïve that was. I soon learned that the eminent domain process is ever changing. Increasingly, appraisers are being asked to critique appraisals made for the opposing side. During my early years in the business, the appraisal organizations very strongly opposed this. The appraiser was to appear in court, testify to his or her opinion — without concern for what the other side testified to — and leave the courtroom. If there were disparities between opinions, the appraisal organization would address that issue through its ethics procedures. As time went on, however, this position was relaxed. As long as the appraiser acted as an independent expert without bias for the client, or against the opposition, it was considered all right to consult with the attorney about the opposing appraisals, the theory being that you were an advocate of your position, not of the client.

As my reputation grew as an expert witness, the attorney general's office requested offices of the Highway Department to engage my services for cases in many parts of the state. More and more I was asked to involve myself in reviewing the other appraisals and advise the attorneys about weaknesses and errors in them. I was also asked to help prepare other witnesses to testify. Through that process, I become more of a consultant than an appraiser, although I was very careful to remain objective in performing my appraisals.

PASQUARELLA: For my firm, developmental approval processes in many municipalities are becoming more cumbersome, more expensive and very, very time consuming. There's more study required, and in some respects, of course, I understand. Interestingly, that ties back to what I said in talking about going green. These days we often ask, "Can we add amenities — such as retail or a hotel, or both, on an office complex site — to make it more attractive in today's environment?" If I can't get the threesome of live, work and play, can I get two of the three? That still sets my project apart from the projects competing with me and fits in with the green movement.

COCHRAN: ***How do you see CRE helping its members meet today's challenges?***

SCHWETHELM: There is a great opportunity for Counselors in eminent domain. I sincerely believe that attorneys should be engaging Counselors solely for the purpose of providing consulting services instead of using the appraisers who appear as witnesses. I do not contend that appraisers necessarily become advocates by providing these ancillary services, but there is that appearance to judges, juries and commissioners.

I believe the CRE organization should make a concerted effort to illustrate the importance of these services on a very frequent basis. This can be done through our members who specialize in eminent domain and Counselors who are also attorneys. When appropriate, Counselors can assist the attorney in helping the client understand the case, the likelihood of prevailing and the probable range of compensation, which can result in the settlement of cases at considerable savings. When settlement is not accomplished, the services Counselors provide can assist in trial preparation and during trial.

PASQUARELLA: To some degree, I see the CRE organization helping its members just as it has in the past. There is tremendous value and high gain to be had from simply associating with the best people working in our business, and CRE provides many networking opportunities, both formal and casual.

In my 16 years as a Counselor, the professional makeup of the CRE membership has become more diverse, as has the real estate industry in general. Years ago, the real estate community was made up of lenders, appraisers and brokers. Today, you have all sorts of specialty groups, and we have Wall Street involved in real estate in a big way. CRE includes developers, investment fund managers such as myself, tenant specialists, consultants, investment consultants, etc. It's a very broad membership base, which I think is fabulous. The skill set of the organization has expanded to meet today's needs very, very well.

HANSON: I believe the CRE organization can best help its members through education. The whole concept is that we're an organization of professionals, that we and our fellow CREs are leading-edge thinkers and will bring best practices to one another's discussions. That, in summary, is why I like CRE. I like going to meetings and conventions, and networking in general, because I think the people here are incredibly smart and the conversations you have make the difference. ■