

Breaking the Transaction Gridlock

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All of those who are involved in the real estate business, whether as an investor, lender, or service provider, have been affected by the slowdown in transaction activity in the real estate industry that has been underway since the second quarter of 2001. Total transaction volume in the four main property types fell from a peak of \$24.6 billion in the second quarter of 2001 to \$15.2 billion in the first quarter of 2002, a drop of 38 percent based on information from the CoStar Comps Trend Report. Commercial mortgage originations were down at least 20 percent in the first quarter of 2002, with CMBS issuance down even further from prior year trends. Leasing activity, with substantial negative absorption across much of the office market also has dropped significantly.

The decline in activity has been blamed on many things, from the terrorist attack on 9/11 to intransigent sellers, economic decline, and record low interest rates that make refinancing an excellent alternative to a sale. Today, with the threat of a widening war in the Middle East, stock market decline and inconsistency, the possibility of a double dip recession as occurred in 1980 and 1982, and other uncertainties, there are plenty of reasons to suggest that transaction activity may continue to be slow.

Despite these negative trends, however, there are some positive indicators on the horizon. Preliminary information on transaction activity for the second quarter of 2002 indicates significant increases. Institutional real estate investments, for example, almost doubled their first quarter levels. There is a substantial amount of equity available for acquisitions, and with the relative advantages of real estate in the capital markets, buyers are beginning to gain more confidence that today's relatively low real estate capitalization rates will be sustainable in the future. Perhaps more importantly, some intransigent sellers are being forced through financial problems to begin liquidation of assets. An even bigger opportunity for increased transactions comes from sellers with performing assets that are looking to move their money into more opportunistic endeavors as the market starts to improve.

Possibly most challenging in the real estate capital markets today is the disparity between the availability of capital for higher quality cash flowing properties and lower quality properties with occupancy problems, capital expenditure needs, or other potential concerns. Lenders have maintained very rigorous underwriting, but for those able to pass the test, pricing is still at record lows.

DEBT MARKET ACTIVITY

Commercial mortgage-backed securities, such as the private debt and equities markets, have been slow in 2002. After reaching record highs of \$97 billion in 2001, total issuance during the first half of 2002 was approximately \$36 billion, and many analysts predict total issuance for the year in the \$50 billion range. Originations and profits are down at most conduits, and staff levels have been reduced.

Positively for borrowers, "all in" costs to borrow money in the securitized marketplace are as low as they have ever been. Spreads for AAA tranches were at 95 basis points, compared to 86 basis points in July 1998, their recent low. Also positively, delinquencies remain low. According to a recent report published by Morgan Stanley Securitized Product Group, delinquencies in CMBS transactions aged over one year were 2.06 percent of current balances.

Commercial mortgage securitization has been very positive for the mortgage finance industry. Even with a substantial drop to issuance in the \$50 billion range, securitization is a major force. According to a recent Federal Reserve Board report, almost \$400 billion of commercial multi-family mortgages had been securitized as of December 31, 2001, which is 22 percent of total commercial mortgages outstanding.¹

Securitization also has been positive in standardizing and improving underwriting in the industry, but the standardization has created holes for new financing products to fill. Although securitization forces lenders to focus on debt coverage and loan-to-value ratios, there are other risk factors that investors can consider in creating mortgage products. For example, the constraints imposed by securitization have left a void for long-term higher leverage permanent debt. Companies such as Greenwich Capital Markets are looking to provide higher leverage, fixed-rate debt at up to 85 percent loan-to-value ratios for properties that meet their criteria.

Multiple layers of subordinate debt have become a key feature of the large loan marketplace. This tranching first appeared in the A/B loan structure when different lenders took the senior and subordinate positions on a single issue of debt. This initial structure has evolved to where as many as four different lenders can be involved in a single large loan with four different risk categories created from a single mortgage.

Investor demand for both investment grade CMBS and sub-investment grade CMBS has been strong. Demand for

investment grade CMBS is driven by its relative advantage to corporate bonds and the equities markets in today's environment. The demand for sub-investment grade CMBS has been enhanced by collateralized debt obligations and collateralized bond obligations. These new vehicles, which merge CMBS and real estate investment trust (REIT) debt, have grown from \$1 billion in 1999 to more than \$3 billion in 2001. So far in the first quarter of 2002, three deals totaling \$1.4 billion have been issued. These new vehicles provide a source of long-term financing for sub-investment CMBS, providing greater liquidity in the marketplace.²

Mezzanine financing also has become a substantial market because of the holes created by securitization. Prudential Real Estate Investors estimates that new originations from mezzanine loans are likely to fall to between \$13 billion and \$27 billion annually.³

Other evidence of decline in real estate activity is the 15.7 percent drop in commercial loan commitments from \$8.9 billion in the first quarter of 2001 to \$7.5 billion in the first quarter of 2002, according to a survey of members of the Mortgage Bankers Association. The drop was due primarily to a decline in the size of deals, with office and hospitality loans dropping the most. Retail lending was actually up one percent and multi-family loans remained relatively strong.⁴

It looks as if some progress has been made in making the commercial mortgage marketplace more efficient. Although efficiency would seem to be a common goal on which all could agree, in a competitive market with proprietary information and procedures, it is difficult to achieve. One example that appears to be moving forward is MortgageRamp's Deal Central product. MortgageRamp has the advantage of being owned by major players in real estate finance, including GMAC, Bank of America, Deutsche Bank, Fannie Mae, Goldman Sachs, Moodys, and Standard and Poors. They have used their ownership foundation to develop Deal Central, a platform for managing the loan life cycle. Other products include Multi-Track, an underwriting process for multi-family loans, and Fast Trac services, delivering tools for underwriting loans in 10 days or fewer.

As of mid-July, six major financial brokers, including GMACCM, LJ Melody, and Rainmaker; and 10 lenders, including Archon/Goldman Sachs, CIBC Mortgages, Fannie Mae, Merrill Lynch and Neumann Financial, have implemented or are rolling out the Deal Central platform. It has been a huge effort to take it this far, and it is going to take a lot of additional effort to insure adoption at the user

level, but this looks to be one technology example that seems to be moving forward positively today.⁵

Delinquency rates for commercial mortgage loans continue to be low. According to the American Council of Life Insurance, delinquency rates for commercial and multi-family mortgages were 0.22 percent of outstanding balances as of March 31, 2002. This compares to 7.53 percent of outstanding balances reached during the second quarter of 1992.⁶

According to analysts at Holliday Fenoglio Fowler, the debt markets in 2002 are very little changed from 2001, when low interest rates and abundant mortgage capital confronted a wide bid-ask gap in the equity market that triggered more refinancings. However, in 2002, virtually every lender is significantly behind “planned” in production. They also see increased flexibility of life companies and securitized lenders: “The range of options to allow prepayment, release of assets and substitution rights is truly staggering.” They believe these trends will continue as these lenders begin to take more market share from banks and bank-like entities. On the downside, most, if not all, lenders are requiring terrorism coverage, yet there are no set standards. Given the competition for good loans, lender concessions are not uncommon, and this should be an up-front discussion in all negotiations.⁷

EQUITY MARKET ACTIVITY

In a clear sign of the substantial availability of real estate equity capital, institutional investors report that they now have more capital to invest in real estate than they have had in the last 15 years, according to a survey of 512 institutional investors by Chadwick, Saylor & Company. From the survey, the firm estimates that \$70 billion to \$75 billion is set to flow into real estate during the next 12 to 18 months.

Of the approximately \$62 billion that is expected to be invested in the next 12 months, \$22.5 billion is expected to go to private equity core investments, \$13.9 billion to REITs, \$12.5 billion to value added investments, \$9.9 billion to co-mingled opportunity funds, and \$2.7 billion to co-mingled funds focused on foreign real estate investment.⁸

Perhaps as a result of the substantial available capital, institutional real estate investment, tracked by Institutional Real Estate’s investment property database, increased to \$13.3 billion in the second quarter of 2002, twice the amount tracked in the first quarter. More than half of the invest-

ments, roughly \$7.5 billion, were office acquisitions, but retail transactions showed the largest quarter-to-quarter increase, going from nearly \$600 million in the first quarter to nearly \$2 billion in the second quarter.⁹

Although it does not come as much of a surprise, the real estate asset class has been a big winner so far in 2002. Through July 18, 2002, REIT returns have been 1.3 percent compared to the S&P 500 at -22.6 percent, the NASDAQ composite at -29.4 percent, and the S&P small cap 600 at -14.5 percent. The NCREIF property index return, a measure of private equity returns, performed at an annualized rate of 6.3 percent during the first quarter. Given the substantial day-to-day volatility in both the S&P 500 and REIT markets, these numbers may move around by the time this article is read, but the clear trend, particularly with the private equity returns from NCREIF, is that real estate has continued its significant out-performance of the stock market. During the last three years, looking just at a comparison between REITs and the S&P 500, real estate has been even more impressive, with a 34 percent return compared to a -35.4 percent return for the S&P 500.¹⁰

The Enron, WorldCom, and other corporate financial debacles also are affecting REITs. One of the major reforms impacting REITs is a recommendation that the majority of the board of directors be comprised of independent directors, with a much stricter definition of what being “independent” means. In addition, members of the audit, nominating, and compensation committees must be exclusively independent directors. The role of the audit committees also is expected to be expanded significantly, and CEOs must personally attest to the accuracy, completeness, and understandability of all information provided to investors.¹¹

The key issue for REITs is sustaining gain from the first six months of the year. Although many analysts expect REIT returns to slow, at least they have earnings and continue to pay high dividends relative to other equity and even debt investments. Accordingly, although REITs suffered significantly in July, their high-income returns and the relatively limited impact of stock option reform on the sector should sustain their relative advantages. Their dividends also appear fairly well protected by low dividend payout rates. Overall, REIT debt to total market capitalization remains well below 50 percent, with high debt service coverage ratios.¹²

In what today seems a somewhat prophetic article, the Federal Reserve Bank of San Francisco’s May 24, 2002, Economic Letter provided a somewhat sobering analysis of

the prognosis for the stock market. As of the year-end 2001, the S&P 500 price-to-earnings ratio stood at 46, far exceeding the ratio of 28 that prevailed at the market peak in March 2000 and three times higher than the average PE ratio of 15.2 going back to 1926. This historically high PE ratio is a result of both the 28 percent drop in value of the S&P 500 stock index since March 2000 and a drastic 50 percent drop in corporate earnings from \$50 in 1993 to \$24.69 at the end of 2001.

The author of that article argued the importance of the price-to-earnings ratio in determining the growth of the S&P 500 index. For example, since 1982, there has been a six fold expansion (from 7.5 to 46) in the price-to-earnings multiple that helped produce an extraordinary compound return on stocks of 15.2 percent over the period.

Based on value prediction models put together by the author and other analyses that he cited, he concluded that over the long history of the stock market, high PE ratios have been a “transitory phenomenon.” Sooner or later, the PE ratio tends to adjust back to its long-run average. These adjustments have taken place mainly through changes in stock prices rather than through changes in earnings. Although neither the author nor other analysts that he cited expect a complete return of the PE ratio to its long-run average, they did predict “poor returns from stocks in the coming years.” More specifically, absent further PE ratio growth, stock prices can rise only as fast as earnings. Since 1926, earnings have grown by an average compound rate of 5.8 percent. If this figure is added to the current dividend yield on stocks of about 1.2 percent, one comes to a forecast of total returns on stocks of 7 percent per year, only about one half the average compound returns since about 1982.¹³

IMPROVING DEVELOPMENT PROFITABILITY

Developers looking for new ways to finance and build multi-family units should make sure to consider historic tax credits. The National Park Service administers the Federal Historic Preservation Tax Incentives Program. The National Park Service works closely with each state’s historic preservation officer.

Although the process to access the program can be somewhat daunting, involving three separate applications and an attention to paperwork and process, the program provides a one-time tax credit equal to 20 percent of qualified con-

struction expenditures, which includes hard construction cost, interest on construction related debt, and real estate taxes. Because the return is supplemented by tax credits, buyers of historic tax credits are typically satisfied with a 3 percent cash return. When they exit the partnership, they typically are bought out with only a percentage, about 35 percent of the original investment. The economic results can be quite positive for both investors and developers.

Despite some of the access challenges, many developers have begun to take advantage of the program. The number of projects approved by the National Parks Service has more than doubled over the last eight years to 1,276 projects in 2001.¹⁴

Maximizing profitability today in master plan communities demands that developers integrate new consumer expectations, such as a sense of community and greater attention to aesthetics. An interesting article in the May 2002 *Urban Land* identified four tried-and-true methods to increase profits:

1. Take complete control of the sales and marketing efforts;
2. Develop soft infrastructure amenities;
3. Deliver an aesthetically pleasing environment to the consumer; and
4. Integrate architecture to permit adaptability to changed market conditions.

Taking complete control of sales and marketing efforts includes such things as coordinating the marketing of the home builders to whom land is sold, maintaining control of the “vision” for the new community, converting the welcome center into the central sales office for the entire community, and gaining economies of scale of the coordinated marketing and effort.

Soft infrastructure amenities include such things as mandatory broadband connections and a secure computer intranet site, community sponsored clubs and sports leagues, voluntary programs and initiatives, and alliance relationships with local providers of health, education, banking and other services. These soft amenities complement the jogging paths, swimming pools, and other hard infrastructure amenities that already are expected in master planned communities.

An aesthetically pleasing environment has become an expectation for many consumers. Consumers expect things to function well and now are looking for the added advantages of an aesthetic environment. Better aesthetics can be

practiced in sales centers, in individual units, and through important attention to visual details.

The fourth point mentioned is integrated architecture to permit adaptability to changing market conditions. Integration of different prices and sizes of homes is a key example. If the design of the architectural detailing is complementary, putting a \$400,000 home next to a \$1 million home can make sense. The smaller home is more valuable because it borrows a sense of space from the neighbor, while the larger home can have a better sense of dimension and context while avoiding the impression it is a glorified tract home.¹⁵

One of the best ways to improve profits is, as the Music Man so eloquently said, to “know the territory.” In this spirit, The National Association of Home Builders recently conducted a comprehensive survey of renters, the first such comprehensive survey since 1992. It was no surprise that cost was the most important reason for renters choosing their apartments, as 96 percent of the respondents indicated. However, the importance of cost is up from only 73 percent 10 years ago. Other key reasons for selecting an apartment include location, neighborhood, the immediate availability of the apartment, and its design or size. Perhaps predictably, 38 percent of renters mentioned safety as a priority, up from only 12 percent in 1992.

Surprisingly, energy efficiency is the most frequently listed feature, at 94 percent, which renters say they look for in an apartment. The next most important issue was apartment size, with 68 percent saying they would want a larger unit if they were to move. Perhaps as a reflection of this, the availability of closet and other storage spaces was one of the most important features that renters wanted, even above dishwashers and central air conditioning. As a sign that people do tend to stay pretty much the same, the rankings for features were very similar to those in 1992.

The community amenity that topped the list was parking. Cable or satellite television, a garage, and a storage room all were rated next, although significantly below parking. Internet access outscored an outdoor swimming pool, fitness facilities, tennis courts, and other amenities on renters’ priority list.¹⁶

Given the extreme difficulty in profiting from predicting short-term stock market or economic changes, reflecting on longer-term forecasts over the next 25 years somehow seems appropriate. Some interesting predictions from the World Future Society include:

- The “echo boom” generation, comprising some 80 million people born from 1977 to 1997, soon will wield even more economic power than their baby boomer parents.
- Tissue engineering will become one of the hottest growth areas of biotechnology, given its ability to tap the \$400 billion health care market as well as its use in making food, clothes, and other products.
- By the year 2009, fuel cells will be in common use, powering cars, homes, and appliances.
- Fish farming will overtake cattle ranching as a food source by 2010.
- Most of the major cities in the developing world will face severe water shortages in the next two decades, and by 2040, at least 3.5 billion people will run short of water.
- Finally, the 10 most important technologies for the next 10 years are genetic mapping, super materials, high-density energy sources, digital high-definition television, miniaturization, smart manufacturing, anti-aging products and services, medical treatments, hybrid fuel vehicles, and “edutainment.”

Although it is hard to project how such long-term forecasts can influence current decisions, it is eye-opening to think about such issues given the drastic changes even some of these forecasts will have on the types of investments and geographic markets that will be the leaders in the world economy tomorrow.¹⁷

CORPORATE REAL ESTATE INSIGHTS

Corporate real estate has been an area of extreme focus for real estate service providers given the tremendous potential to add value to corporations and the huge size of the market. Although the early focus of most major service providers was on outsourcing brokerage and asset management functions, there also has been significant work on technology-based transaction and asset management platforms. In an interesting new approach to assisting the industry, Jones Lang LaSalle is one of the first to promote a comprehensive process to manage real estate financing decisions.

Jones Lang LaSalle has developed a patent-pending methodology it calls financial alignment and optimization (FAO)[®]. Essentially, FAO is a decision-making process that

measures the relative impact of different real estate financing decisions and helps companies optimize their decisions on a portfolio-wide basis. Most importantly, the key innovation is a carefully crafted and systematic approach to gathering the information, analyzing it, and presenting it in a consistent and effective way for the different users of the information (such as CEOs, CFOs, division heads, and accountants).

Clearly, this type of methodology is needed. Many corporations face problems with inconsistent net present value methodologies between businesses or regions or focus on net present value to the exclusion of earnings per share, return on assets, or other important measures of performance. Poor exit strategy planning and limited understanding of new financing alternatives are other problem areas.

Although the FAO approach appears to be designed for the larger and even global corporations, the type of sound systematic thinking that is the essence of the FAO methodology needs to be applied, at an appropriate scale, to all corporate real estate decisions given the number, and complexity, of financing options available to corporations today.¹⁸

The challenge to many retail outlets from Wal-Mart is expected to continue and grow in the future. Whereas, historically, Wal-Mart stores have been fixtures of the rural suburban landscape, they now also are looking for growth in urban markets. An example of this is its move into a three-story former Macy's building that was an anchor tenant in the Baldwin Hills Crenshaw Plaza, an enclosed mall in Los Angeles. Wal-Mart has become more flexible in forgoing its traditional building program for locations and markets it likes.¹⁹

The sale-leaseback market is expected to grow from its current size of approximately \$6 billion per year due to the tight underwriting environment for mortgages and the likely possibility that new synthetic lease standards being considered currently by the Financial Accounting Standards Board (FASB) will slow the synthetic lease marketplace. Given the current synthetic lease market of \$6 billion to \$8 billion per year and an estimated current universe of existing synthetic leases of \$75 to \$120 billion, there is substantial potential for growth in the sale-leaseback market.

To understand why these changes are occurring it is important to understand the differences in these vehicles. In a sale-leaseback, a company owns real estate, sells it to another company, and net leases it back. Cash replaces the asset on the company's balance sheet. With a net lease trans-

action, a company in need of an asset leases the property from a net lease provider, which finances the purchase. In both cases, the company receives effective control over an asset it does not own under a long-term lease and makes the lease payments off-balance sheet. Accounting rules prohibit leases from including a purchase option, allowing both sale-leaseback and straight net lease transactions to remain off-balance sheet. This is where synthetic leases are problematic. Synthetic leases require the purchase of the asset at the end of the lease term unless the company is able to negotiate another synthetic lease. This requirement makes the synthetic lease look like a loan that should appear on a company's balance sheet.

Net lease and sale-leaseback transactions typically are used to acquire property or generate cash. Subsidiaries or divisions of larger companies are initiating sale-leasebacks to generate capital for new plants or equipment, rather than having to go to their parent companies. Private equity firms doing management buyouts also are actively combining sale-leasebacks with their buyout deals. In this way, firms with insufficient equity to complete a management buyout can obtain equity through a sale-leaseback to complete buyout transactions.

Fundamentally, net lease and sale-leaseback deals are best for those companies that think that they can earn a higher rate of return in their core business than by owning real estate. With the many specialist firms and professional asset managers in the market today, this type of an option is a realistic choice for many corporations.²⁰

RETAIL TRENDS

Retail investment continues to be a favorite target for investors, but finding the right property at the right price is still a challenge. Well-located grocery-anchored centers and single-tenant net lease properties with high-quality credit tenants are most in demand. However, with owners able to refinance these strong cash flowing centers at low interest rates, the availability of these properties has remained slim, increasing their pricing.

Retail investors today must choose between the more costly and solid cash flowing anchor shopping centers and valued-added opportunities where intelligent capital expenditures, securing the new anchor, or repositioning of the tenant mix can turn around a property that might have been under-performing. Clearly, the buying opportunities in

Class B and C Malls, and marginally performing power centers, exist in abundance, but with the economy sputtering ahead, the risks can be high given that more marginally performing properties take the brunt of the reduction in consumer spending if it declines.²¹

The retail outlet industry, which has gone through some transition in recent years, reports both good and bad news. On the downside, industry outlet data for 2001 show a decline in sales, but positively most centers and chains were making profits. The number of outlet centers has dropped to 261, the lowest in 10 years. This decline was primarily due to a reclassification of outlet centers when their outlet occupancy fell below 50 percent. Significant transitions have been underway in the outlet industry, with higher quality outlet centers now common within major metropolitan areas complementing the traditional outlet malls in tourist locations. Outlet centers have become more of a mainstream retail option, as retailers address conflicts in their product lines and distribution channels, enabling both traditional mall retailers and outlet retailers to co-exist profitably.²²

The fight for America's stomach has become more interesting as supermarkets, restaurants, warehouse clubs, dollar stores, convenience stores, and even drugstores fight for the \$850 billion spent each year on food in the United States. According to AC Nielsen, grocery stores still dominate the trips that shoppers take to retail properties to buy food, with more than 75 trips a year compared to 10–18 trips a year for super centers, drugstores, convenience stores, dollar stores, and warehouses. However, the annual trip to grocery stores is the only sector that has declined in the last four years, dropping from 85 trips in 1998 to 75 today.

Speed and ease of preparation are among the most important considerations for consumers in deciding what foods to buy and where to buy them. Given this trend, spending in food service establishments (restaurants) increased 23.5 percent between 1990 and 2001. Similarly, after taking into account inflation, consumer spending in grocery stores declined 8.1 percent between 1990 and 2001.

In addition to convenience, super centers also have eaten into the sales of traditional food retailers. Since 1995, total sales through super centers have grown from \$26 billion to \$96 billion, and food sales have grown from \$11 billion to \$44 billion. This represents a cumulative annual growth rate

of 26 percent, significantly higher than the 2.1 percent for traditional food retailers.

As this recent research suggests, grocery-anchored retail properties still remain viable, dominating more than half of the annual trips by consumers for food purchases, but to remain successful, grocery stores will have to address competition from convenience-oriented food outlet and super centers by updating their formats to meet current needs and relying on the positive traffic that can be generated through intelligent tenant mix at grocery-anchor centers.²³

SUMMARY

These continue to be chaotic times. The strengths and breadth of the real estate capital markets have enabled it to weather the chaos and present some strong opportunities for investors and lenders in the coming years. Although buyers and sellers and borrowers and lenders still are far apart in many cases, as both the economy and real estate markets improve during the next few years, improved transaction activity and liquidity for all sectors of the markets can be expected.

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