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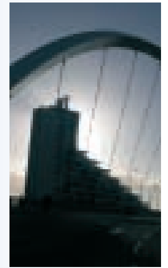

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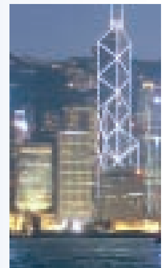

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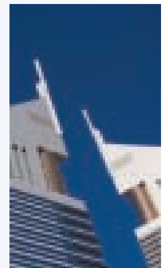

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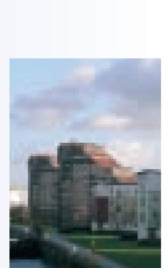

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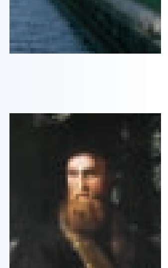

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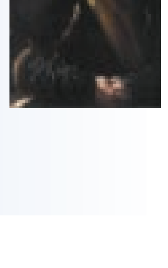

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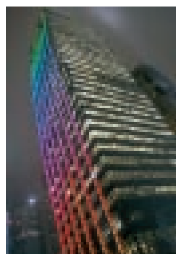

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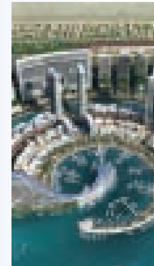

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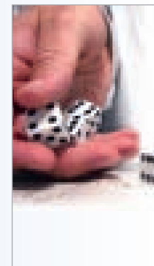

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Recession Road

Professor Mark Louargand FRICS considers how specific market and economic conditions have created a recession road paved with real estate challenges.

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We are now in a deleveraging or degearing phase. The big question is; will we suffer to the same degree as Japan did for so long?

The current recession in the United States reflects a global liquidity crisis. The crisis is beginning to have an effect on property performance and values in several countries. As is usually the case, this cycle will be different from the previous ones in several respects. We are now in what is being called a "balance sheet recession". Balance sheet recessions are quite different from the usual business cycle recessions which reflect imbalances between demand and supply sometimes caused by exogenous events, sometimes by animal spirits.

Japan suffered for a decade (1998-2006), mired in a deep balance sheet recession that was brought on by inflated property values that supported corporate debt levels that were not sustainable when the property bubble burst. Sound familiar? In the U.S. and elsewhere – notably the UK and Spain – a housing price bubble led to a far greater bubble and asset price collapse through the miracle of derivatives. We are now in a deleveraging or degearing phase. The big question is; will we suffer to the same degree as Japan did for so long?

Why Balance Sheet Recessions are Different

Recessions are typically described as a slowing of economic growth to a point of negative GDP change over two or more quarters. In the U.S. we have an official arbiter the National Bureau of Economic Research (NBER) that declares a recession some time after it has begun. Their actual definition is not the same as the commonly held belief, but neither reflects the defining variable in the average citizen's mind – employment. As the saying goes, when a neighbor loses their job it's a recession, when I lose my job it's a depression. People instinctively know that it's about jobs.

My view of the business cycle focuses on jobs. At the top of the cycle we have a certain number of people employed. Striking that number as 100%, the severity of the recession and its duration can be measured by how long it takes to get employment back to the same number. How many months did, or will, it take to regain 100% of the jobs we had at the cycle's peak?

The U.S. has only had one true balance sheet recession, the one called the Great Depression. That one took 93 months between 1929 and 1937 to regain 1929's peak employment. In the U.S., subsequent recessions have had shorter recovery periods, but the last two have taken the longest of all post-depression slowdowns to recover peak employment. Figure 1 shows that the 1990 recession took 33 months to recover peak employment, while the 2001 recession took 48 months to regain peak employment. We are currently in the eleventh

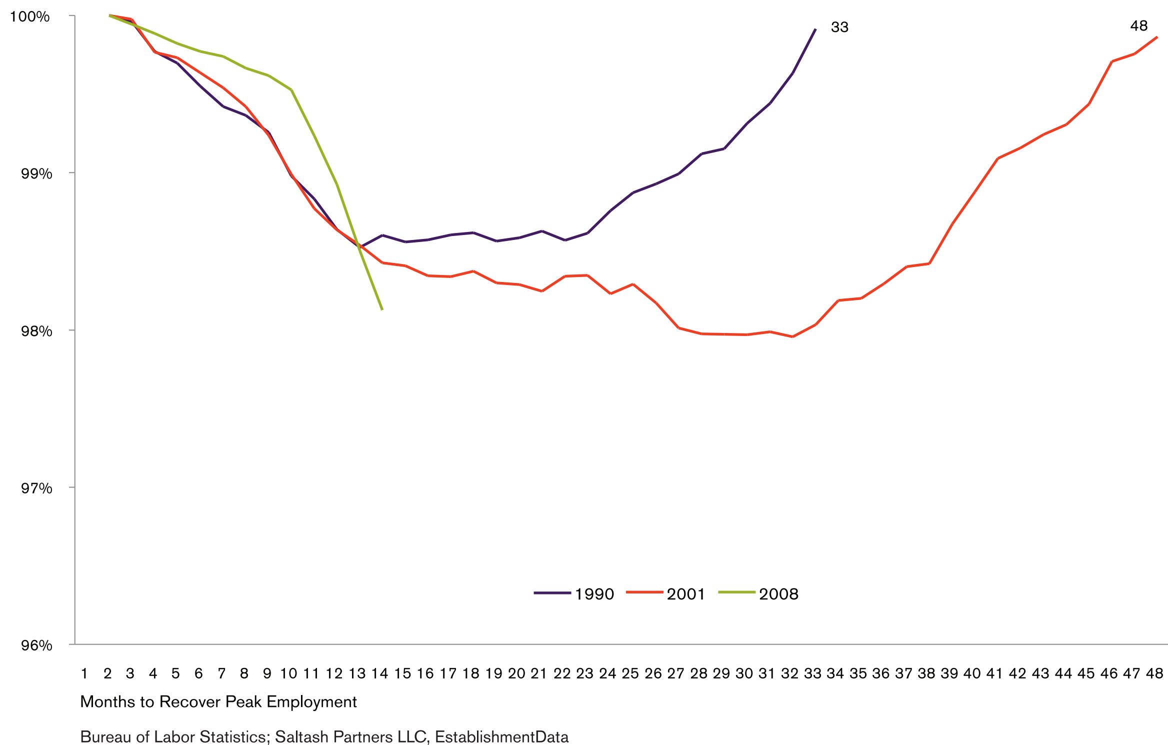


Figure 1: Recent Post-Recession Employment Recovery

But with delevering, people and firms don't borrow so the monetary expansion stays in the banking system, hence the term "liquidity trap".

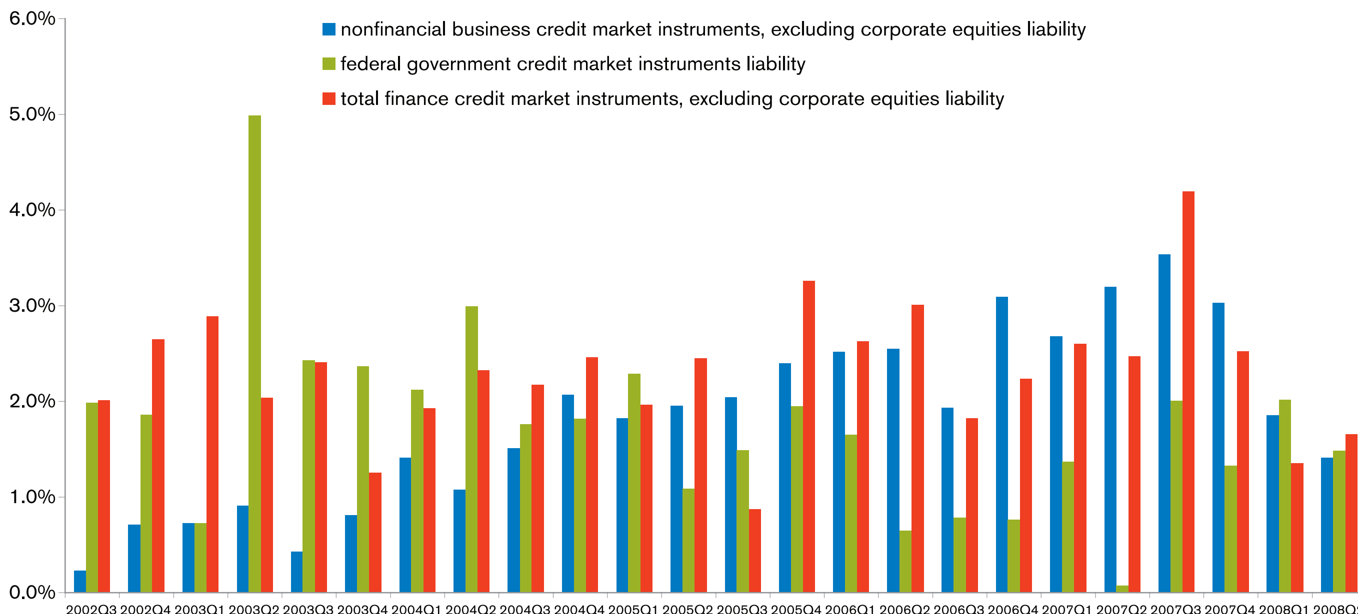
month of job losses. We can expect them to continue for some time. In addition to job loss, financial markets behave differently in a balance sheet recession.

Japan suffered from 1998 to 2006 while net issuance of equity and credit were both negative. What happens in a balance sheet recession is that firms degear and households degear. Traditional government responses focus on monetary policy and the creation of liquidity by increasing the money supply via the banking system. But with delevering, people and firms don't borrow so the monetary expansion stays in the banking system, hence the term "liquidity trap". Creation of liquidity in the absence of demand for credit drives interest rates down, so Japanese government bond yields approached zero on nominal terms and were well below zero in terms of global inflation. But in Japanese terms, real rates were higher than nominal rates because asset price collapse and reduced consumption by households created price deflation. People don't borrow when prices are in deflation since the real interest rate may be high. Property markets also tend to do better when real rates are low and often prosper when real rates approach zero.

What might happen in the U.S. and in other markets suffering from the same symptoms?

Figure 2 reveals that the U.S. had a clear pattern of liquidity expansion that progressed from the government though the financial markets to the corporate market. Figure 3 depicts the annual growth rate of household credit in both mortgages and consumer credit. During the six years pictured, household mortgage liabilities grew at an 11% annual rate. During the period 1995 – 2001 they had grown at an 8% annual rate. Some of that variance could be explained by demographics – baby boomers maturing into homeownership, but the data clearly indicate a mortgage boom that coincided with an expansion of liquidity following the 2001 recession and 2000 tech bust in the stock market. People voted with their feet to take cheap money and invest in hard assets. Why was the money cheap?

The entire globe experienced a wash of liquidity that created an excess supply of capital that subsequently competed for investment assets. The predilection for hard assets made the problem worse as they tend to have a more inelastic supply than financial assets. Thus prices were bid up as risk premia were lowered. In came the spreads, up went the values. Recall that this occurred during a period of business cycle recovery and expansion. Increasingly strong fundamentals in property markets partially masked the dramatic shrinkage of the risk premium. We saw risk repriced in two major ways. First, all spreads came in so that there was almost no premium for core assets and sharply reduced premium for riskier assets. Second, differential risk premia nearly disappeared. Such that an office, retail shops or apartment property in a secondary, volatile market



Federal Reserve Bank; Saltash

Figure 2: Nonfinancial business credit expansion versus financial markets credit expansion annual change

traded at roughly the same capitalization rate as a comparable property in a primary, growth constrained market. Today we see that risk has become pricey again as spreads widen and riskier assets are hardest hit in revaluations and the differential risk equation has begun to reassert itself.

How May this Affect the Property Markets?

Absent any market intervention, we can expect that the recession will lower demand for space thus putting market fundamentals on a downward path. We have already seen this in the U.S. and the UK simply from the shrinking occupancy of financial service firms and from the retail bankruptcies and store closings. At the same time, the financial markets have reintroduced risk premia such that any given level of property income will be revalued downward as capitalization rates rise. Transactions data from late 2007 and early 2008 are confirming this view. Cap rates have begun to rise and very little product has been brought to market of late. Global movement toward market value accounting will make reluctance to trade moot as assets get marked down based on the few sales available.

The first sharp effects of the recession have been felt in the hospitality market, the

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office market and the retail market. Warehousing and multifamily rentals are beginning to see a retrenchment but it is not yet as strong as in the other sectors. How is it likely to play out over the cycle?

Hospitality: The hotel market is dependent on business growth to survive and prosper. Full service hotels serve the business community for transient travelers and for group business. In a recession business transient travel is cut back immediately as we have already seen. Group business relies on three major drivers: training, new product introduction, sales incentive and association meetings. Only association meetings continue unabated during the downturn but they too may suffer from reduced attendance. Lower-rated properties that cater to leisure travelers suffer from the reduced expenditure of households. One potential bright spot is that consumption of travel and entertainment may drive out consumption of hard goods in an environment of price deflation. The hospitality market will begin to show signs of recovery about halfway through the job recovery period as we move off the bottom and begin to replace employees.

Office: The office sector in the U.S. and the UK has rising vacancies in most markets, not surprising since much of the growth in office employment during the last asset bubble was in financial services. Witness the emergence of London as the world's leading financial center and the rebound of lower Manhattan. Our experience in the U.S. in several cycles is that rent growth stops when vacancies reach about 15% and as they rise, rents decline. We are at or approaching that point now in many U.S. markets. In the UK, we may see a weakening of the landlord-friendly lease structure as we enter another down-cycle in the office sector. In Asia, the widespread use of ownership occupancy schemes may soften the blow in the rental market.

Retail: Shoppers in the U.S. have already shown their reluctance to spend for holiday gifts. The shrinkage in year over year sales is sharpest in the higher end but nearly all major retailers reported year over year same store sales declines in November, 2008. Only Wal-Mart among majors in the U.S. reported a modest, 3.4%, growth but the data includes gasoline sales so may be misleading. Internet retail sales have slowed but still show a modest growth and a continuing penetration into the total retail market. As internet sales represent over 3% of total sales and continue to grow they just add to the performance problems of property-based retailers. It is not lost on exiting retailers that shifting sales to their web presence lowers their operating costs. Only the landlord is ultimately bound to the bricks and mortar. Another somewhat unusual development is that many of the retail closings or announced closings are regional mall tenants. When anchor tenants suffer or go dark, the specialty shop sales may suffer. When the specialty shops go dark the landlord suffers much more. Expect retail property to suffer a slow decline in fundamentals as tenants struggle with the recession. Should we get into a Japan-style savings and deflation cycle there will be widespread tenant failures and significant store closings. We have already seen in some cases recently that the traditionally thinly capitalized retailers are unable and/or unwilling to continue rent payments on dark stores with remaining lease terms. As retail was the darling of the past cycle so may it be the goat in this one.

Residential: Rental apartments are viewed as the safest and least volatile property sector in the U.S. The combination of weak home prices, uncertainty about home value trends and continued economic weakness should be positive for the rental market. People who would normally be first-time home buyers in the next few years may hesitate, holding off on a purchase and remain renters. Demographic destiny is operating to grow the pool of renters as the baby boom echo generation continues to mature. 2008 will be the biggest college entry class in history in the U.S. and those numbers have been and will remain high for the next several years. Despite hard times, not all graduates will move back home or double up. The rental market will benefit from the demographic bulge to a greater extent than other property sectors. In the short run the market has softened due more to recent supply additions but those will be absorbed slowly by a weaker yet still growing pool of potential renters. Expect rental fundamentals to improve within twelve months or so.

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Industrial: Industrial properties fall into two broad groups, manufacturing and warehouses. Any decline in manufacturing as we are currently experiencing idles plants and leads to permanent closures. Unfortunately these properties are often difficult to repurpose and are subject to overarching corporate issues and environmental liabilities that keep them idle for a long time. The investment community typically focuses on warehouses as investments, not factories. The warehouse market has two striking characteristics. First, modern warehouses are "just-in-time" real estate. New warehouses can be built in only a few months as they are simple to construct and typically go where the land is already entitled and infrastructured. Thus, the market is usually less subject to the threat of excess supply that affects other property types since supply can be more readily responsive to demand. Second, modern warehousing is an artifact of the science of logistics, not simply a real estate play. As the science of logistics has evolved so has the warehouse structure. Increasing floor plates, building heights and racking technology have dramatically increased the cubic volume of the typical building resulting in increased efficiency and lower real rents per square foot. At the same time, distribution patterns have been dominated by import patterns and transportation networks so that the warehouse market is focused on a few major port cities in the U.S. By some estimates 60% to 70% of retail goods are imported to the U.S. In a balance sheet recession with reduced consumption, the largest national warehouse markets – northern and southern California, New Jersey – and the recently emerged secondary markets – Seattle,

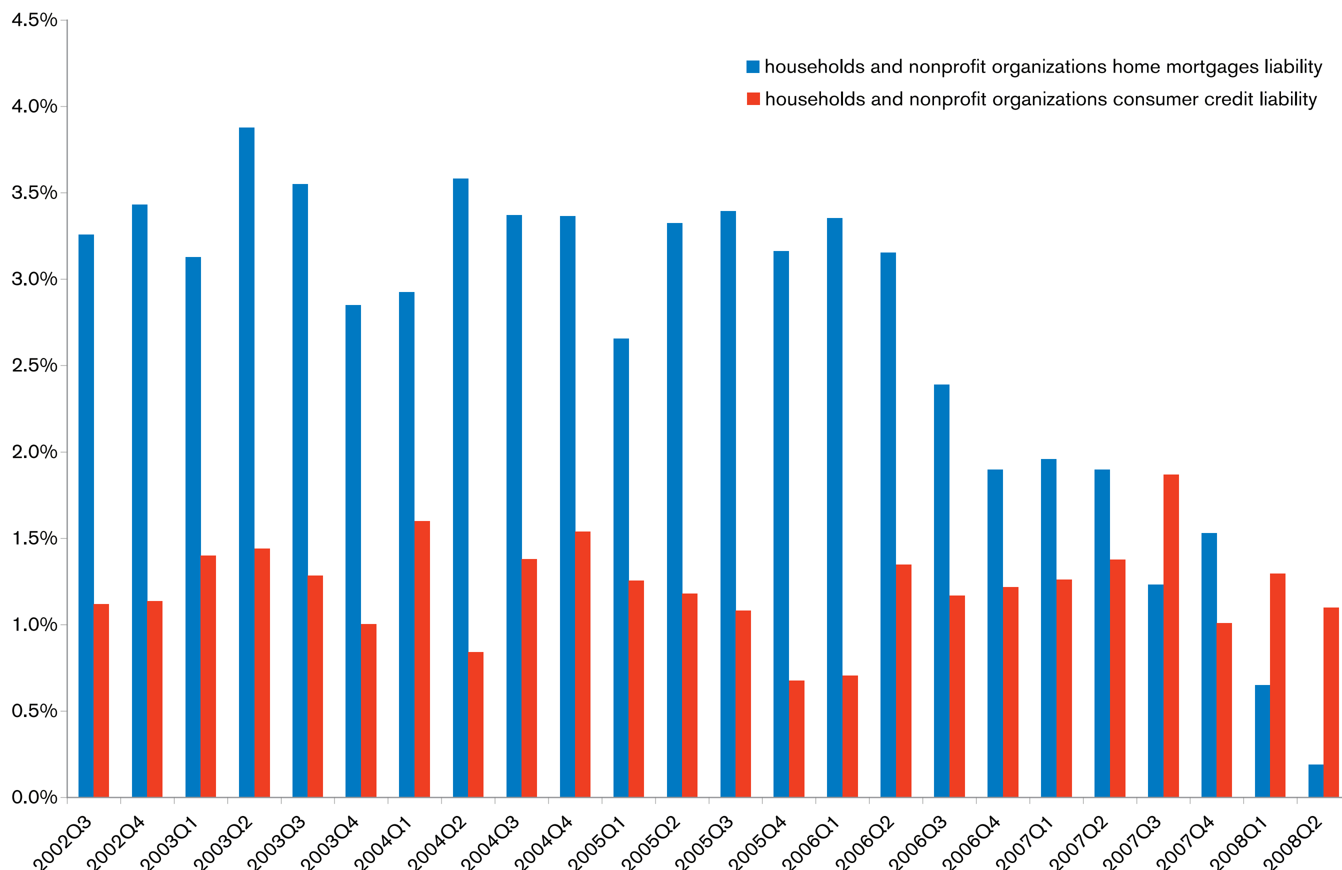

Figure 3: Household Credit Expansion

Charleston and others – will be hardest hit. Local distribution warehouse properties will also be affected but probably to a lesser degree. One wild card to consider is that in this scenario, there will be a glut of container ship bottoms. It would not be surprising to see these ships become de facto warehouses for imported goods, putting further pressure on the warehouse market. Warehouse properties will be affected only after existing inventories are sold off; then we can expect increased vacancies for an extended period.

What can the New Administration do?

The work of Robert Koo and others has created a two-economy model. The first is a traditional monetarist model. In an expanding economy monetary policy can "fine tune" the economy to extend the business cycle. In recent years this idea has appeared to work. But in a bubble cycle that leads to asset devaluation, we get the balance sheet recession that is believed to be responsive fiscal policy, not monetary. This argument is close to Keynesian but subtly different. The argument is that government should throw capital into the economy, not the banking system, to avoid the liquidity trap.

The Obama transition team has announced that their program will be exactly that; massive spending on infrastructure, technology, schools and the like. Critics of the policy point out that we are now a nation of office workers not laborers. While the U.S. employment mix has certainly changed dramatically since the Great Depression, we still have laborers, health care workers and teachers alongside office workers.

Additionally, a modern infrastructure project provides work for valuers, engineers, cost surveyors, attorneys, managers and others who don't work with a pick or shovel. Those people occupy homes and apartments; buy automobiles and shop for retail goods. If the well-publicized long-run inflationary forces attached to massive government spending remain in the public's minds the threat of a delevering balance sheet recession may be markedly ameliorated. If so, most of the discussion above regarding property sectors will be moderated. We will still see weaker fundamentals and write-downs across all sectors but the effect will be moderated and shorter in duration. The U.S. in particular has a dire need for infrastructure spending as much of its transportation network is not only old and ill-maintained but is also functionally obsolete. A massive program focused on transportation can improve productivity and quality of life in the long run while stimulating the economy in the short run.

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A Vision for Valuation: Building Valuation Standards

Joseph Vella FRICS suggests that despite the difficult global economic landscape there is reason for optimism due to the work of the International Valuation Standards Committee (IVSC).

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Last year saw many challenges and extremes all around the globe for many reasons, this is no less so than in 2009. Overwhelmingly, front and center on everyone's mind is the global financial crisis and how it has changed the economic landscape worldwide. But it is not all doom and gloom. There are accomplishments that promise a brighter future for all. For more than a quarter of a century the International Valuation Standards Committee (IVSC) has operated as a global standard setter providing a single voice for international valuation standards.

Challenges

During the past 30 years the challenges facing the valuation profession have been many: globalization and increased levels of cross-border economic activity; competition from other professions; the status of the profession; technology; fair value reporting, the financial crisis…the list seems endless. And at times the response of the international valuation profession has been fractured as professional organizations compete for members and promote their own agendas while struggling to find their own new role in this changing world and marketplace.

A Success Story

Amidst these challenges, the profession has a major success story to celebrate – the International Valuation Standards Committee (IVSC). The IVSC success in setting international standards has led to greater recognition of the valuation profession and wider understanding of valuation's importance resulting in a positive impact on every valuer worldwide.

The world has been searching for a true lingua franca for accounting and valuation to ensure the commercial integration among the world's many cultures and nations. Just as the Rosetta Stone became idiomatic as something that is a critical key to a process of decryption or translation of a difficult problem, the world's capital markets have long searched for a single set of high quality accounting standards buttressed with robust high quality valuation standards that could be used anywhere in the world. This should come as no surprise, because the promise of global standards is truly astounding. Investors could more easily compare issuers' disclosures, regardless of what country or jurisdiction they came from. They could more easily weigh investment opportunities in their own countries against competing opportunities in other markets, when there is a common valuation benchmark supporting accounting standards. And a single set of high-quality valuation standards would be a great bonus to emerging markets, because investors could have greater confidence in the transparency of valuations and of financial reporting.

Today, all of Europe and nearly 100 countries around the world require or permit the use of International Financial Reporting Standards or IFRS. The majority of companies that are currently reporting financial results based on IFRS have only been doing so for a few years. Robust, independent international valuation standards are critical.

From its inception, IVSC recognized the growing importance of the development of International Accounting Standards and later IFRS. As the world at large took these bold new steps to harmonize accounting and financial reporting standards, IVSC made an important strategic decision. That was to ensure that, whenever an asset was to be measured to fair value under IFRS, the measurement standard

to be applied should be the International Valuation Standards. How right that decision was.

Over 100 countries, including of course the European Union, have chosen to adopt IFRS. Brazil, Canada, India and Korea will adopt IFRS by 2011; Japanese GAAP and IFRS will have converged by 2011. At the beginning of 2007 China introduced a completely new set of accounting standards that are intended to produce the same results as IFRS.

But no system would be truly international without the participation of the United States. Cooperation between the International Accounting Standards Board (IASB), the Financial Accounting Standards Board (FASB), and the Securities and Exchange Commission (SEC) in the United States has now become an integral part of their work programs. The convergence of US GAAP and IFRS has great momentum and remains a leading priority with an objective of these organizations to make IFRS a passport to all of the world's capital market. Already the SEC has removed the requirement for foreign private issuers reporting under IFRS to reconcile their financial statements to US GAAP.

IVSC Responds To Change

Prior to 2000, the IVSC had focused on harmonizing the fundamental valuation principles and codified Generally Accepted Valuation Principles or GAVP. In 2000 IVSC launched its Standards Project to enhance and further develop a comprehensive set of robust international valuation standards that complemented standards being developed by other international standard setting organizations, most notably the IASB.

The IVS have had a profound impact on the valuation standards of many countries. In some countries IVS have been incorporated into law, in others adopted by national institutes/societies. At the same time international users and providers of valuation services are also demanding adherence to IVS and many companies reporting under IFRS now refer to use of IVS in the financial statements.

Success Breeds Success

In September 2005 the IVSC was invited to present an educational session to the IASB; following that the IVSC was invited to meet with the US FASB in March 2006. A number of messages came from those meetings:

1. The greater use of fair value had significantly raised the profile of valuations used for financial reporting purposes.
2. It was also obvious that IASB and FASB were uneasy with the structure of the IVSC as it existed, being a membership organization rather than an independent standard setter like themselves.
3. There was increasing pressure on the valuation profession to take responsibility not just for valuation standards but for the standards of valuation. Scott Taub (Deputy Chief Accountant, SEC) speaking in November 2005 expressed concern that "in contrast to the accounting profession, there is inadequate infrastructure to support valuations for financial reporting purposes. Whereas the accounting profession has a single accreditation and set of standards applied to all practitioners, valuation has multiple accreditations and standards and some practitioners have no standards to follow if not accredited."

Taking The Next Step – Restructuring The IVSC

During 2006 the IVSC began to debate major proposals for the restructuring of the IVSC. In the next two-year period IVSC had working groups and discussions regarding potential structures and established a Governance Restructure Group to refine the general concept.

At an extraordinary General Meeting held in San Francisco in April 2007 the restructuring plan was unanimously agreed and a target date for implementation of the restructured IVSC was set for January 2008. The IVSC set itself a very challenging task and aggressive timetable for transition so that the IVSC did not become preoccupied with a protracted governance transition, diverting resources and focus from the primary goal of standard setting. Revised Bylaws were approved in November 2007 and a period of transition began prior to the restructured IVSC becoming operational.

At the October 2008 IVSC AGM held in Kuala Lumpur, Malaysia, the restructured International Valuation Standards Council (IVSC was renamed while retaining the same acronym) was fully in place and operational. The AGM, by an overwhelming majority, elected the proposed slate of candidates as the first members of the IVSC Board of Trustees. The membership of the new International Valuation Professional Board and International Valuation Standards Boards was also formalised by the AGM. The new Board of Trustees includes leaders from the valuation profession and well respected senior figures from the international business, financial and regulatory world.

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The Financial Crisis – Quo Vadis

During the past year we have witnessed tremendous upheaval in financial markets around the world – a financial crisis not seen since the Great Depression of 1929 with a number of surprising twists and turns unanticipated by even the best and the brightest. All have been infected from the U.S. and Europe to the dynamic emerging market countries in Asia, such as China and India. The sting of the global financial crisis continues as countries cut and coordinate their short-term lending rates, inject capital to shore up a frozen financial system while bracing for a striking slowdown or recession.

Central banks everywhere have been offering extra liquidity on an almost daily basis for two months. World leaders have meet in Washington to discuss this crisis and brainstorm on how to begin overhauling the financial system as quickly as practically possible.

In the midst of the worst financial crisis in eight decades, all are trying to understand how this situation came about while looking for a “whipping boy” for this debacle. As Britain’s Queen Elizabeth rightly asked during a visit to the London School of Economics “Why did no one see it coming?” This is not the time for recriminations as there are many players that contributed to this situation, albeit at different levels, from the retail mortgage borrower to the mortgage broker, to banks, rating agencies, investment bankers, hedge funds, regulators, and the list goes on.

The one undisputable fact is the global impact this predicament is having, verifying the world is no longer made up of isolated economies, instead it is fully integrated or “globalized”. We’ve had 15 years of experience with globalization with over 3 billion new entrants to the workforce.

Prior to this crisis some were projecting the uncoupling of some economies, specifically in Asia. The current conditions indicate the world economies are more coupled than any other time in our history. There is no doubt that a full analysis of the causes will be conducted in order to repair and put in place circuit breakers to hopefully prevent a future reoccurrence. Yet amongst this havoc, regulators, standards setters, investors, accountants and valuers have had to defend fair value reporting. The discontent about fair value is mainly driven by the banking industry facing large write-downs and on-balance sheet reporting of all assets. Unfortunately the banking industry and their lobbyists exerting political pressure have the potential to erode the independence of international and U.S. standards-setters.

Investors rely on fair value to give them transparent, up-to-date information about the worth of their assets. Opponents insist that fair value requirements contribute to volatility and are subject to uncertainties and practical limitations when valuing assets in thinly traded or non-conventional markets. It is fascinating and richly ironic how non-valuers, whether for their own self interest or other reasons, seek guidance for assets trading or not trading in illiquid markets, down-cycle markets, but made no reciprocal request for guidance for assets trading in a hyperactive markets, up-cycle markets, markets Alan Greenspan referred to as “frothy” or “irrationally exuberant”. While mistakes are always obvious in retrospect, perhaps future collapses can be more readily avoided when the guidance of impartial and discriminating professionals is sought at all points of the economic cycle.

All parties have to deal with the markets they have, not the ones they would like. Intrinsic concepts such as supply and demand drive markets and we are currently in a market where there is an imbalance which in turn will affect prices and values. Market comes before Value and valuers have the training and expertise to study and understand markets as they cyclically move up or down and to derive competent, up-to-date, relevant, and capable market support to produce credible valuation results.

It is not often that markets are in equilibrium, as markets are always moving either up or down, albeit the velocity changes. It is in this environment, that valuers earn their keep by using their specialized training to take all into consideration to reflect a reasonable and supportable value, based on available data and sound judgment, not much different than the processes an informed buyer or seller would employ under the same conditions or circumstances, but without a vested interest. To report anything other than Fair Value is obscuring the truth rather than providing transparency. Valuers provide the value conclusion and accountants incorporate them and report the balance sheets – both are just messengers relaying the state or financial health of the entity. Whether it is a single-family house or a complex financially engineered instrument, reporting at anything other than what they could be sold for is “mark to fantasy”, as Warren Buffet aptly described it.

This is not to impute that fair value is perfect and without faults. Thomas Jones, Vice Chairman of the International Accounting Standards Board, at an industry meeting, asserted “It is a lousy system, but it is less lousy than any other system ... and I don't find that the people who criticize fair value have very good ideas for an alternative."

Some are critical of deregulation in financial markets, see it as the cause of this crisis, and there is validity to this argument. Others attribute this crisis to the cyclical nature of economies. Throughout history, financial markets have experienced bubbles, crashes and panics. Markets always manage to find a way to repackage or introduce new products, which they should, but without commensurate regulatory adjustments in response to new financial innovations, yesterday’s regulations and oversight are obsolete and ineffective.

The SEC says it is planning to move forward with its plans and the IASB remains supportive of the convergence plan moving ahead. IASB spokesman said "The current crisis has highlighted the need to avoid any accounting arbitrage and have a level playing field". Ironically, the financial crisis could lead to faster convergence as the regulators work to resolve problems by working more closely together and consolidating projects, and taking advantage of the existing impetus for a single global benchmark.

Conclusion

With all the challenges facing the valuation profession, valuers can no longer present themselves as a fractured profession with little or no synergy between the different valuation practices. The marketplace requires a unified, highly qualified, and multidisciplinary valuation profession. The realization has set in, that the profession has not been as proactive as it could have been in giving the types of training or orientation to acclimate valuers to the world of financial reporting changes or to understanding regulations relating to financial reporting. The profession is becoming aware that financial reporting is not limited to strictly valuations, but includes corporate counselling, involvement with financial and accounting teams who apply principles to accounting for current values, ability to assist corporations and others with market decisions where fair value accounting is involved, and much more.

The Roman philosopher Seneca said “Luck is what happens when preparation meets opportunity.” By a combination of luck and good judgment, the IVSC has restructured into an organization led by senior figures in the international financial and business arena at just the time when there is a sharp recognition that the need for valuation standards and guidance are crucial to financial markets in order to enhance their workings and curb their abuses.

The restructured IVSC is best positioned to meet these challenges by having in place:

- An independent, multi-disciplinary, global valuation standards board responsible for standards creation and its own technical agenda
- An Interpretations Committee from within the Standards Board to provide IVSC approved interpretations of the International Valuation Standards
- A respectful and mutually beneficial relationship with accounting standard setters and regulators including the IASB, FSB, FASB and SEC.
- An International Valuation Professional Board which surveys professional valuation organizations worldwide regarding their educational requirements, their Body of Knowledge and their Best Practices to become a repository of these data and to develop a model international education curriculum for professional valuers
- Ensuring the standards and best practices are available to developing nations; and
- Establishment and dissemination of education materials about IVS

Whether you fully share these views or not, there cannot be any dispute the valuation profession has had a wake-up call in the midst of the financial turmoil and is at a juncture for decisions that will impact the valuation profession of the future. What seemed unrealistic, even visionary impossible, a few years ago is now both necessary, possible and in place.

As I reflect back on the many significant successes and achievements of IVSC during the past 30 years, in the end, achieving these milestones not only makes the valuation profession more respected and recognized globally, but fulfills the main objectives – meeting public needs and maintaining the public trust.

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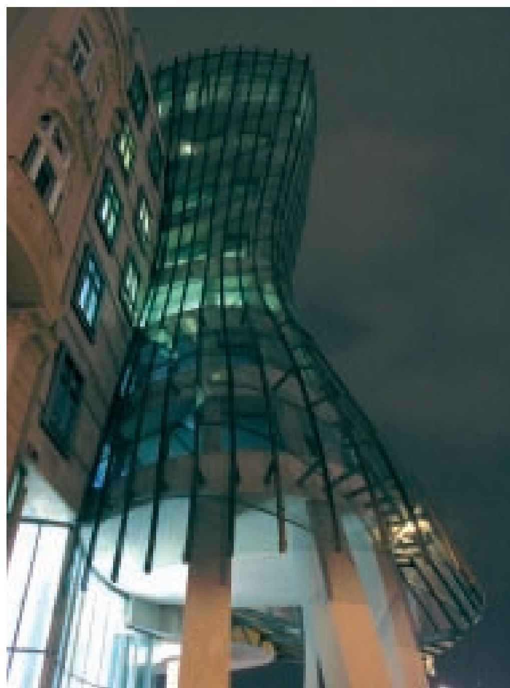

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Dubai's Way Forward

Heather Wipperman Amiji contemplates how the Dubai government can develop a sustainable property investment model.

No real estate market with active international investors has escaped unscathed from the global credit crisis. The primary questions today are: who will recover the most quickly, how strong will the recovery be and what will trigger the recovery. Within the Dubai Real Estate Market, which is more than 75% financed by foreign investors, these questions are particularly pressing.

In our view, the Government of Dubai should capitalize on this lull in market activity in order to put into place the required framework for medium to long term investors. Such measures will restore confidence, create stability and unlock liquidity.

In the short term, there has been a flight to U.S. Treasuries as evidenced by record sales of the government debt long considered a relatively riskless investment, and a five year low in U.S. treasury yields as a result of continuing concern over the state of global equities markets. This follows from the underlying phenomenon that in times of crisis, investors are irrational. In general they are not motivated by value but rather by security and liquidity. If the opposite were true, in the local market we would see investors trading real assets under construction with favorable payment plans (20% during construction and 80% on completion) rather than pulling back and eschewing new investment. And we would see a willingness to price in the value of financing such investment for the construction period rather than a deflation in premiums. Presently we are not only seeing no premium but we are seeing no trading.

The primary barriers to medium and long term investment in the Dubai market can be distilled into four main categories: i) demand, which must exist from tenants and investors, ii) product specifications, which must fit the needs of tenants and landlords, iii) the legal framework, which must provide clarity and enforceability in terms of future cash flows, ownership and title, and obligations of the various stakeholders, and iv) an increasingly outdated market model, which must be adjusted to reflect the shift away from a speculative market fuelled by short term investment towards a market governed by a long term growth strategy.

As recently as 2006, a long term commercial lease was defined as a three year term. From a tenant's

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perspective, this was outrageous considering that new stock was rented shell and core without raised floors or suspended ceilings. Fit-out costs hovered around 20% of the first year's rent and in many instances landlords would renegotiate the lease during the term at commercially unviable levels. Nevertheless growth in developed markets was slowing and multinationals began to seek new markets for top-line revenue growth and to reassess their supply chains to procure goods and services in the most economically viable location irrespective of geography. As such multinational corporations ("MNCs") began to infiltrate the market. Initially their demand was limited and their commitment to the region tenuous. As their local success supported their strategy, they reverted to their global models of acquiring suitable office space:

- Office space should be secured 2-3 years in advance of the requirement
- Space should conform to international grade standards in terms of layout, specification, IT infrastructure, health and safety, amenities and the like;
- Buildings should be professionally managed with single landlords and opportunities for expansion or contraction as and when required;
- Average floorplates should be open plan and 15,000+ sq.ft.
- There should be sufficient parking for employees and access for clients and customers
- Leases should provide for clear rent escalations and break clauses over 7, 10 or 15 year periods
- There should be transparency in terms of obligations of operating expenses including maintenance, facilities management, insurance, service charges, water and electricity
- Books should be open to tenants to provide clarity in terms of the correct appropriation of the above charges and there should be price stability to allow for budgeting and cash flow purposes.

Unfortunately, with most new stock under construction, MNCs were required to compromise and wait until delivery of new product. Regrettably, a careful review of the upcoming stock in the market is truly disappointing and there are very few locations that satisfy any

of the above specifications. In fact, many unsophisticated developers have ridden the speculative tide, designing products from the outside in rather than the inside out. In short, block work supports small units that can be sold to short term investors because of their attractive price points alone. Internal toilets create tremendous space inefficiencies and are expensive to dismantle in an effort to create clean floorplates. The number and speed of elevators are often inadequate to support the volume of activity, which is driven by the profile of tenants. As an example, an IT firm will have very few visitors where as a tourist authority will require heavy elevator usage. This creates a unique tension whereby in the short term, as long as a supply shortage persists and options remain limited, inadequate office space is taken up, but in the long term, as more sophisticated investors and developers enter the market we're left with an excess of inferior product and a persistent undersupply of high quality international grade office space.

The Government of Dubai can encourage the development of tenant friendly configurations by restricting ownership of single offices or floors to specific locations and or freezones that are more likely to support the demand for cellular space. In areas most likely to attract MNCs or larger corporations, ownership at the building level only should be enforced (as in DIFC). This will encourage build to suit investment and dramatically reduce the quantity and pace of undesirable office space under development. Furthermore, by its very nature it will require the implementation of sound capital structures before development commences and will reduce the speed of supply coming on-line.

The majority of medium to long term investors are pension funds, insurance companies and corporate institutions with projected future liabilities. Such firms have an appetite for real estate where they can match Net Property Income with these liabilities and also benefit from future capital appreciation. Though such firms tend to be more conservative in nature than financial institutions for example, many had been seeking to increase their exposure to emerging markets prior to the global credit crisis. In order to convince such discerning customers of the merits of income producing properties in the MENA region, clarity and consistency are required in the following areas:

- Assurances that rental step-ups that have been negotiated will be enforceable and not undermined by arbitrary rental caps;
- Clarity in terms of future outgoings and expenses: this means reliable forecasts from master developers on service charges, reasonable increases for insurance, facilities management and maintenance;
- Comfort that investment grade leases (typically governed by international norms) would be honored over three-page "non-negotiable" leases being mandated by government agencies;
- Assurances that the identity of a community that is promoted by Master-developers is upheld in terms of the quality and profile of other buildings, the quality and availability of infrastructure and the key environmental offerings will remain unchanged (examples include the internal tram system in DIFC that was canceled);
- Standardization in the measurement of building areas and ways that prices are quoted and rentals charged;
- Transparency in terms of comparable evidence, benchmarks and performance of assets and evidence of asset management opportunities for value enhancement.

Only when these investors feel more comfortable about the certainty that the base line of their investment analysis will not change and when the primary uncertainty is market conditions rather than changes in the legal framework and enforceability of contracts, will they too begin to enter the market.

Through the efforts of the government of Dubai, the emirate has established itself as a commercial hub within the region and a viable long term player in the global economy. However, in order to ensure the long term success of the commercial sector, the government will need to continue to focus its efforts on developing a sustainable model to attract international investors both in the short and long term. The global financial crisis has required corporations and economies to reassess their long term growth strategies and Dubai is no different. The only solution is to shift the focus away from a market dominated by short term investors and driven by heavy speculation to a market where sustainability, transparency and a consistent legal framework underpin a long term development strategy.

The global financial crisis has required corporations and economies to reassess their long term growth strategies and Dubai is no different.

And so we return to our original questions: who will weather the storm, how will recovery look and what can be done. Although it remains to be seen when the market will gain ground or to what extent, it is clear that the government can begin now to develop the legislative infrastructure necessary to improve investor sentiment, encourage foreign investment and re-inject liquidity into a faltering market.

Heather Wipperman Amiji
Chief Executive Officer
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Dubai

Senior Housing & Healthcare Investment

Elaine Worzala FRICS and academic colleagues research the U.S. senior housing and healthcare sector in light of an aging U.S. demographic.

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A first attempt to establish appropriate risk premiums for alternative investments within the senior housing and healthcare sector is described in a research paper presented during the Real Estate Research Institute's Annual 2008 Research Conference in Cambridge, Mass. The authors identify and analyze the unique risks and uncertainties associated with the cash flows generated by properties in the various senior housing sectors, and assign risk premiums based on a comprehensive analysis of relevant data. The researchers also suggest ways investors might mitigate risks in senior housing investments.

Entitled 'An Exploration of the Risk and Return Spectrum For Institutional Investors in the Senior Living and Long Term Care Property Sector,' the research was a collaborative effort involving experts from the academic and business communities. The lead researchers were Jeffrey Davis, Chairman of Cambridge Realty Capital Companies; Elaine Worzala, Professor and Director of the Center for Real Estate Development at Clemson University; and Judith F. Karofsky, President of Real Estate Insites, LLC of Madison, Wisconsin.

In the current era, the senior living and long-term care property sector has expanded in response to changing demographics and the needs of an aging population. As baby boomers reach retirement age and move into the "sunshine years," the demand for real estate products designed with elderly end-users in mind will continue to grow. And the risk/return profiles of these investments will continue to shift. In the report, the research team examines the development of the senior housing marketplace as a hybrid real estate investment incorporating the characteristics of multifamily, hotel and medical office property investments.

The spectrum of senior housing investment alternatives ranges from independent living facilities (ILFs) to assisted living facilities (ALFs) to skilled nursing facilities (SNFs) and finally, to continuing care retirement communities (CRCCs). In recent years, capital flows to the broad real estate market have increased, resulting in a compression of returns in the more traditional sectors. For senior housing alternatives, risk and return parameters vary from investments similar to apartment complexes to those more akin to special purpose properties. For the senior housing sector, most of the unique risks focus on predictability of cash flow. An in-depth analysis of these variances produced suggestions on ways investors could mitigate these risks in

senior housing investments. Some initial conclusions reached by the research team include:

- Age-restricted apartments are not that different from apartment complexes, but moving up the risk spectrum of senior housing investment alternatives, needed services for the tenants become a larger part of the revenues and expenses. As tenant acuity increases, net cash flows become more variable.
- The most viable way to mitigate risks is to combine housing alternatives at a single location from a real estate perspective and have proactive management.
- Investors should examine their ability to provide for the service component/management of the assets, and must be prepared to dedicate significant resources to insure that the needs of residents are met and appropriately priced.
- Most investors should consider outsourcing to firms that specialize in the senior healthcare business and have the expertise to analyze these assets and properly underwrite them to both assess and mitigate risk.

Performance Data Examined

As part of their analysis, the research team examined current performance data for alternative senior housing investment opportunities, including occupancy rates, turnover, revenue growth, service component, profitability, expenses and management. Additionally, trend analysis of key financial performance statistics over the past year was summarized. Finally, capitalization rates from two separate surveys of senior housing experts were analyzed to compare the performance of the senior housing subgroup with more traditional real estate investment alternatives. Findings indicate that independent living and assisted living facilities fall toward the lower end of the risk spectrum, and nursing/long-term care investments generate the highest expected returns and also generate the highest level of risk compared to the other real estate investment alternatives.

The research investigated the extent to which the institutional investment community was interested in the senior housing sector. As part of the study, members of the Pension Real Estate Association (PREA) were surveyed and asked to evaluate the risks and returns of the senior housing sector vis-à-vis more traditional real estate asset classes. Interestingly, most of the 46 members responding to the survey were not holding or looking to hold the various sub-sectors in senior housing. Although indirect investments in independent living and assisted living assets were held by more than 50 percent of the respondents and age-restricted

Type of Senior Housing	Estimated Risk Premiums		Basic Point Effect		
All Seniors Housing except Age Restricted Apartments	Demographic	Aging population does not embrace seniors housing options	10		
	Dynamic	Psychological barriers of past industry distrust	20		
	Competition	Alternative options (home-health)	5		
	Financial	Economic uncertainty: Will the elderly be able to afford the product?	25		
		Inability to obtain/analyze data	10		
		Fragmented ownership	15		
		Baseline		**85**	
Independent Living	Physical	Constant need to upgrade services and amenities	10		
	Dynamic/ Lifestyle	Least need driven decision	5		
		Occupancy risk	5		
	Competition	Low barriers to entry	10		
		Naturally occurring retirement communities	5		
		Over 55 active-adult housing	5		
		Independent Living Risk Premium		**40**	
		Cumulative Risk Premium over Age Restricted Apartments			**125**
Assisted Living	Legal/Political	Regulation changes	15		
	Dynamic/ Lifestyle	Management reputation risk	15		
		Event risk	5		
	Management	Profit margins fall with acuity level	5		
	Financial	Difficult to estimate expenses as patients age	10		
		Assisted Living Risk Premium		**50**	
		Cumulative Risk Premium over Age Restricted Apartments			**175**
Independent Living/ Assisted Living	Dynamic/ Lifestyle	Portfolio diversification effect	-25		
		Independent Living/Assisted Living Risk Premium		**-25**	
		Cumulative Risk Premium over Age Restricted Apartments			**150**
Assisted Living/ Alzheimer's	Physical	Construction/safety issues	30		
	Dynamic/ Lifestyle	Event risk (patients wandering)	30		
		Assisted Living/Alzheimer's Risk Premium		**60**	
		Cumulative Risk Premium over Age Restricted Apartments			**235**
Skilled Nursing	Legal/Political	Highly regulated at state level. Certificates of need are required in most states increasing paperwork and ability to collect payment.	125		
		Litigation risk	45		
	Dynamic/ Lifestyle	Frail population	30		
	Financial	High demand for skilled labor	100		
		Skilled Nursing Risk Premium		**300**	
		Cumulative Risk Premium over Age Restricted Apartments			**535**

Exhibit 1: Calibration of Projected Institutional Risk Premiums Incorporating the Risk and Return Trade-offs from Investing in Alternative Seniors Housing Sub Sectors

In the current era, the senior living and long-term care property sector has expanded in response to changing demographics and the needs of an aging population.

apartments were held by slightly more than one-third of those surveyed, no other senior housing holdings were reported.

A large majority (89 percent) of the survey respondents said they were not considering holding any type of skilled nursing facilities. And everyone indicated that they believed senior housing alternatives are more risky than other investment types. In fact, the four highest mean ratings for risk were for senior housing investment alternatives. Considering returns, respondents indicated that international real estate investments and luxury lodging were likely to generate higher returns than senior housing alternatives. Presumably, these results explain why institutional investors currently target international opportunities over domestic senior housing alternatives.

Despite apparent institutional indifference, the senior living and long-term care property sector continues to expand in response to demographics and the needs of an aging population. The U.S. Census Bureau has projected that the population over age 65 will increase from 35 million in 2000 to more than 86.6 million by 2050, while the population over 85 will increase from 4.2 million in 2000 to 20.9 million people in the same period. Currently, 12.4 percent of the U.S. population is over the age of 65 and 1.5 percent is older than 85. However, by 2050, an estimated 20.7 percent will be older than 65, and 5 percent will be older than 85.

Because aging is typically accompanied by physical or cognitive impairments and/or functional disabilities, more specialized secure housing will be required. Currently, institutional investors aren't likely to be a significant factor in the capitalization of these specialized facilities. But this could change if more specific information regarding revenue sources and levels of expenses for the various senior housing/healthcare alternatives were available and if risk mitigation was better understood.

Establishing Risk Premiums

Establishing appropriate risk premiums for alternative investments within the senior housing/healthcare sector was viewed by the authors as a first step in understanding the unique attributes of senior housing and determining the similarities that some assets in this sector have with more traditional investments held by the institutional community. The researchers looked at financial and regulatory characteristics, licensure category, portfolio diversification, special purpose property nature and levels of care associated with each property type to calculate an estimate of the risk premium for each property type. Although these premiums will shift with location, condition, and management of the properties, this is the first attempt that we are aware of to quantify the levels of risks for each property type. The matrix in Exhibit 1 focuses on specific risks and allocates premiums based on the judgment of an experienced researcher in senior housing, Jeffrey Davis, a lender and investor in the senior housing marketplace since the early 1990s.

The basic senior housing asset class was determined to command an 85 basis point premium over age-restricted apartments. Progressing up the risk spectrum, independent living assets were assessed to have a combined premium of 125 basis points, while the independent/assisted living hybrid provides some diversification benefits because residents can move from one part of the facility to another and "age in place". This provides for more stable cash flows and occupancy levels. Therefore, the hybrid was allotted a risk premium of 150 basis points while the stand-alone assisted living sub-sector was estimated to command a 175 basis point premium over age-restricted apartments.

Additional risks associated with the assisted living/memory care hybrid afforded this investment a 235 basis point premium over age-restricted apartments. Skilled nursing homes, which are the most difficult and highly regulated to operate, were given a 535 basis point risk premium over age-restricted apartments. In summary, the researchers found that the senior housing property sector has different property types that fall along a risk spectrum. Independent living facilities and the hybrid of independent living and assisted living seem to require less service, and provide more stable incomes and perform more similarly to multifamily housing. Progressing up the risk spectrum, the variability in the needs/services required by tenants produces more variable cash flows and higher risks. Therefore, a higher return is expected for these investments, with skilled nursing facilities commanding the highest premiums. Although in theory, the risk/return spectrum makes sense, when investors were asked about their perceptions of senior housing compared to more familiar asset classes, there was a mismatch of risk and return levels in the authors' opinions. Presumably, this is due in part to a lack of understanding of the senior housing sub-sectors by many in the institutional investment community. Continued research will expand available data, particularly relating to revenues and expenses associated with the various sub-sectors of the senior housing market. With increased education and data about the performance characteristics of these properties and research into risk mitigation techniques, investors will gain a better appreciation for the industry.

*Note: The research and conclusions reflected in this article were produced with information obtained in early 2008. It was the authors' intention to publish the findings relative to the current senior housing market; however, the effects of the recent financial collapse and economic crisis have probably altered these market conditions significantly. The conclusions of the authors and the positioning of the senior housing market in relation to the national and international real estate markets have likely changed since this article was written.

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Jeffrey A. Davis is Chairman of Cambridge Realty Capital Companies, one of the nation's leading senior housing/healthcare lenders with more than 300 closed transactions totaling more than $2.75 billion since the mid-1990s. Cambridge is an FHA/MAP-approved HUD lender and also underwrites conventional loans. Also, the company has an integrated debt/equity strategy that includes direct property acquisitions, joint ventures and sale/leasebacks. Mr. Davis is a graduate of the University of Illinois, with a Master's degree in real estate finance from the University of Wisconsin-Madison.

Judy Karofsky is President of Real Estate Insites, LLC, in Madison, Wisconsin. She performs site, market, and feasibility studies for investors in senior housing. She holds a degree in economics from Bryn Mawr College, a Master's degree in American history from Brandeis University, and a Master's degree in Real Estate Finance and Urban Land Economics from the University of Wisconsin-Madison.

Global Art Investment Review

Barden Prisant FRICS reviews today's current art investment casualties and opportunities.

Girolami Da Carpi's 16th Century portrait of Bindo Altaviti

Recently, there has been talk that investors might liquidate their toxic equities and pump those funds into the markets for tangible investments, e.g., oil, gold, and other commodities. In the category of "other commodities" has traditionally fallen art.

Thirty years ago, the British Rail Pension Fund embarked upon one of the most ambitious attempts to integrate art into a traditional investment portfolio. The fund spent $70 million, and, in the end, earned a compounded annual return of 11.3% over the span 1974-1999. Not too shabby.

More recently, though, a high-profile enterprise named Fernwood Investments, which had bragged about amassing a $100 million war chest, opened in 2004 and closed its doors in 2006.

Part of the difficulty in implementing such programs is in choosing which works in which to invest. As the world of real property has its sectors, e.g. American vs. European real estate, new development vs. existing stock, mass market vs. high end, so does the world of art. There are separate markets for American and European art, Contemporary and Old Master, and prints and originals. In the coming year, RICS real property faculty members will be searching for safe havens in the world of real estate. We in the Arts & Antiques Faculty will be on a similar hunt.

Where should we put our money?

At this point, we can only try to divine what we can from the few tea leaves which have thus far fallen before us. Here, then, is a sampling of some of the data which have thus far been generated. For consistency, I will primarily be focusing on U.S. auctions. In days past, there used to be significant differences between the American and European secondary art markets, but the Internet has leveled the playing field. For example, one used to be able to "sharp shoot" the few 19th C. American paintings which appeared in sales in Europe and then sell them at a significant profit over here. Not any more. More often than not, any significant differences align with currency fluctuations rather than marketing nous. (The effect of currency fluctuations on the art market is a subject unto itself.)

The first sector I will analyze is the market for Contemporary art, as it is undoubtedly the sexiest. (Literally, as well as metaphorically; some actually come with warning labels therein.)

Let us initially consider the fate of November's "Evening Sale of Contemporary Art" at Sotheby's. This affair is practically black-tie, with the coveted seats awarded to those who have proven the depth of their pockets in the past.

This year, it seems that the profligates of the past kept their hands in their pockets. Approximately one-third of the works went unsold; worse yet, of those which did sell, fully 81% sold under-estimate. (The auction houses print pre-sale estimates indicating a range of values within which a work should typically sell.) The casualties came from all walks of life; even the tried-and-trues suffered. For example, two Roy Lichtenstein's failed to find buyers, one of which had been expected to fetch $15 million. Works with international appeal also lay bloodied- a $9 million Lucien Freud (the grandson of Sigmund) and a $4.5 million Gerhard Richter both went unsold. "New Favorites" fared no better. Of the two works by Damian Hirst on offer (he of the $100 million diamond-encrusted scull), one went unsold and the other sold below-estimate. It was indiscriminate carnage.

This is not entirely unsurprising; if any genre were to suffer in such a climate it would be Contemporary, as many of the high profile collectors of such pieces are tied to the world of finance. A case in point is Steven Cohen, founder of the hedge fund SAC Capital Partners, who has spent $300 million on his art collection. Further, ultra Contemporary art has a brief or minimal track record. While one can study, say, the price history of a particular Picasso over the last 50 years, there may only be three comparable data points for Maarten Baas charred chairs. The mere existence of such pieces as the Baas chair, though, raises yet another issue: Much Contemporary art is vulnerable to "The Emperor's New Clothes"/ "My Kid could Paint That" critiques. In this new age of re-examination and skepticism, it is improbable that such pieces will maintain their status.

Maarten Baas – Charred Chair

Now, let us set the clock back a century or so and consider how 19th C./20th C. works of art have been faring. In this realm, the market bifurcates into the European paintings sector and the American paintings sector. Starting with the former...

...there is no good news to share.

In the major sales held earlier this season, the results were quite disappointing. 56% of the items on offer failed to sell at Christie's, and Sotheby's posted a similarly unfortunate 51%. (To offer a sense of scale, in a normal climate, a typical "buy-in rate" would be 20%, and that might swing up or down by only five percentage points in the sales over the course of an entire year). Obviously, this eviscerated their totals. A year-on-year comparison indicates that the Christie's total was down 27%, while Sotheby's suffered a 43% drop.

One reason for the poor performance might have been the composition of the audience buying such works. While in the Contemporary realm, dealers can often strike bargains with the artists themselves or their estates, in the world of 19th C. art, they have to shop on the secondary market. (This is analogous to the difference between a developer being able to build from scratch and a broker having to deal with existing stock). Word has it that dealers were not in evidence this season, most likely because they, themselves, were having trouble moving stock. Hence, the market contracted.

Such behavior can unfortunately initiate a vicious cycle. The dealers let their stock get stale, the collectors consequently go to auction to buy the "fresh-on-the-market" pieces, driving up their prices, making them even harder for the dealers to buy, contributing to the dealers' inability to freshen their stock.

Whatever the reason, it is evident that 19th/20th C. European art is not a shelter from this economic storm.

Hence, let us next consider how the works of the American painters working over the same period have been faring.

Well, the major American art sales, which were just held, fared better in one way and worse in another than their parallel European art sales. The buy-in rates were modestly better, with Sotheby's posting 40% and Christie's 42% (still, recall that 20% used to be typical). However, as regards total sales volume, the figures were abysmal. Year-on-year,

Sotheby's suffered a 61% drop and Christie's posted a 71% decline. On a side note, the auction houses [and their investors] really hate to see a volume drop, as their profits are a direct percentage of the sales volumes.

Furthermore, the odds are not in favor of any of the above-referenced volumes significantly increasing anytime soon. There are now only six months until the next major sales (they are only held semiannually). As consignments need to be secured well before the actual sale date, (to allow for research, cataloguing, promotion, etc.), there really are only three to four months for the houses to gather up works for the next sales. Having seen this season's poor performance, what collector in his right mind would voluntarily consign over the next few months? Hence, there will be few top quality works in the next sales, practically ensuring another uninspiring season.

So much for that doom and gloom. Let us set the clock back two or three more centuries and consider, last, Old Master paintings.

Unfortunately, the NY sales of such items will not take place for another month or so. We do, at this time, however, have the data from the recently completed London sales.

I am, (at last), pleased to report on a glimmer of hope, or, as one dealer whom I consulted has put it, "sign of a pulse in the market". Though the Sotheby's sale posted figures, just as poor as many cited above, (a 42% buy-in rate and a 59% drop in sales volume), the Christie's sale fared quite a bit better. Only 24% of the works went unsold, and the total volume was down only 23%. This is the best performing sale of all of the ones studied above. Furthermore, a number of pieces far surpassed their estimates. For example, a 16th C. portrait of Bindo Altaviti, which had "only" been expected to fetch approximately $350,000-525,000 sold for a staggering $4.5 million. Before running out and buying the first portrait of Altaviti (who, ironically, was a banker) you can find, a word of caution.

The reason for its anomalous price might have lay buried in its catalogue entry, wherein one finds the line, "The attribution of this portrait (to Girolamo da Carpi) has been the subject of much scholarly discussion...." In other words, experts cannot agree on who painted it. It turns out that the sitter was a friend/patron of such titans as Raphael and Michelangelo, among others. Perhaps some audience members had their own reasons (inside information?) to believe that this work was not a da Carpi, but a long lost Raphael. This is why one should only wander into the Old Masters market

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warily. In this realm, getting a work authenticated is far more difficult that just getting Damian Hirst on the phone.

Considering all of the above, what conclusions can be drawn? Personally, I believe that a number of the Contemporary artists who have been riding high will never regain such heights again. One now has to search for the up-and-coming talents who will be the next high-riders. Not an easy task, but there could be worse ways to spend a Saturday than wandering from art opening to art opening. As for Old Masters, if the market for such items has not fallen as far as some others, and if there is a significant barrier to entry (e.g. the cost of scholarship), it may be hard to find bargains. That leaves 19th and 20th C. American and European art. Only next season's sales will tell.

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Energy for Change: Building our Alternative Energy Future

Mark Pomykacz FRICS analyzes the value and cost of alternative energy.

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In the coming decades, two different but equally powerful forces will converge and confront humankind. One is global warming, which will require a massive shift away from CO2 releasing technologies. The other is the increase in energy consumption as the developing world demands more energy. Do we have a response and can we afford it? Yes, to both questions. In fact the response could be profitable. In particular, green electricity will be a green business pasture in the next two decades. Here's how the major electricity generation technologies currently line up.

The Scope of the Issue

Americans use 13.75 megawatts hours (MWh) of electricity per person. In contrast, the Chinese only use 2.5 MWh. Furthermore, there are 1.6 billion people in the developing world that do not yet have any access to electricity. As these countries develop, world electricity production and demand will nearly double by 2030. Currently developing nations use three quarters of the electricity developed nations use, but by 2030 they will use nearly 50 percent more than developed nations (see Figure 1).

Traditional Electricity

Currently, the majority of the world's electricity is generated using non-renewable fuels: coal (41 percent), natural gas (20 percent), nuclear (15 percent), petroleum (6 percent). By 2030 coal and natural gas-fired electricity will increase to 46 percent and 25 percent, respectively. These rates vary from country to country and region to region.

Coal: While coal-fired power is fairly expensive to construct, coal as a fuel is inexpensive. On an internalized cost basis coal is the least expensive power. However, coal has significant external costs. Old coal technology causes acid rain, smog, mercury pollution, and mining collateral damage. Though new technology coal largely solves most of these problems, it still continues to be a green-house gas emitter. Technologies that sequester CO2 are in the laboratory phase, and are not likely to result in commercially viable processes for many years. The CO2 sequester technologies will be a future growth sector. Governments are continuing to ratchet up regulation on coal in order to motivate greener electricity from coal, and its alternatives. Coal is a base-load provider, meaning it runs non-stop for months at a time, which is very important to a well managed electricity supply system. While coal enjoys no direct subsidies, and suffers increasing regulations, it benefits indirectly from a well developed low-cost mining and rail transportation systems. As practical matter, modern life will continue to depend on coal power in one form or another.

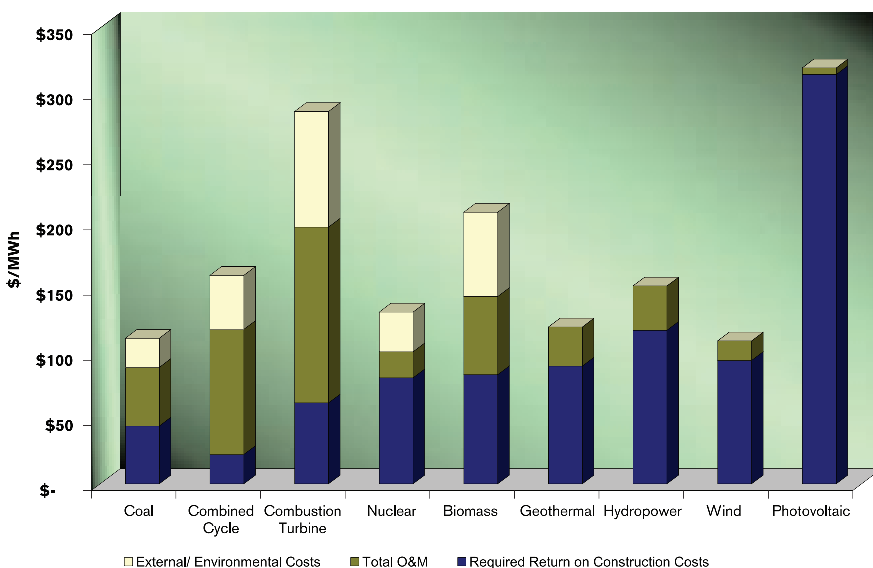

Figure 1: Electricity Consumption

Natural Gas: Natural gas-fired power is the least expensive to build. However natural gas prices make this power among the more expensive on an internalized cost basis. Except for the green-house gas emission problem, this power source has few external cost issues. Natural gas is a peak-load provider (it fills in for base-load plants and at peak demand periods). As a practical matter, a well managed power system must have peaking power, which will continue to be, mainly, gas. Natural gas supporting infrastructure is developed, and is growing with Liquefied Natural Gas.

Nuclear: Nuclear power is among the most expensive to build, but least expensive to operate, if externalized costs are excluded. In the U.S. the externalized costs are large. The United States government assumes all costs to dispose of spent fuel and radioactive waste, and local consumers pay indirectly and separately for plant decommissioning. Since it produces no CO_2, nuclear electricity generation is considered green, but this does not account for the potential damage from radiation accidents or incidents. Nuclear is a base-load provider. As a practical matter, modern life in several of the developed countries will continue to depend on the existing nuclear power fleet. In spite of the recent positive press, future nuclear development will be limited by high construction costs and the supply of fuel which is as exhaustible as oil, gas, and coal.

Oil: Oil is a peak-load provider and is fairly inexpensive to build but expensive to operate, as fuel oil is expensive. Also oil facilities are often older, and do not utilize modern clean technologies. Even though a well managed power system must have peaking power, oil will play a decreasing role in the future.

Hydro: Hydroelectric power is renewable energy. Unfortunately nearly all the good sites for hydro power have already been developed. The remaining sites are small, having inadequate economic efficiencies marginally feasible and/or the sites are ecologically undevelopable. New hydros will continue to be developed, but will contribute less to satisfying new demand, unless anti-hydro attitudes soften on the ecology issues. Practically speaking, hydroelectric power does not usually provide base-load power due to seasonal and daily dry periods.

The Green Need

Currently the U.S. Energy Information Agency (EIA) estimates that 18 percent of worldwide electricity is supplied by renewable sources. The EIA expects the contribution for renewable technologies to decline to 15 percent by 2030. However, EIA forecasts global demand will increase by nearly 100 percent, (3.5 percent annually) by 2030. This increase in demand will require the utilization of traditional non-renewable energy sources, because they are known technologies, and are more quickly and predictably deployed. The challenge to governments and investors in active green energy development will be to become knowledgeable and supportive of the new, renewable technologies, because the old traditional technologies enjoy direct and indirect support in the form of subsidies and externalized costs.

The Green Electricity Solutions

Wind: Wind will be a part of our future supply portfolio, because while it is a little expensive to build, it is inexpensive to operate and renewable. Problematically, wind power is not base load power or peaking power, which requires our continued use of gas and oil, and the development of new power storage and transmission technologies and infrastructure. On average, wind generates electricity only 30 percent of the time, and we cannot choose which times (peak or off-peak) it runs. Wind mills generate when there is wind, which may be at night (off-peak) or in winter (off-season). While similar to hydroelectric power in this respect, wind suffers a greater disadvantage. To help visualize the base-load/peak-load problem for wind, recognize that it would take roughly 2,000 1.5-megawatt wind mills to replace one 1,000 MW coal or nuclear plant, which generate about 90 percent of the time (1,000MW * .90%/30%/1.5MW = 2,000), and still we have not solved the energy on demand issue.

Presently, wind is only feasible with the aid of government supports, but within the next decade, as the price of fossil fuels continues to increase, driving electricity prices higher, wind power will pass into self-sufficiency. In addition to the construction cost support, governments will need to support the development of new wind technologies, and power storage and transmission technologies and infrastructure, in order to truly level the playing field and promote green energy societal goals.

Photovoltaic: Even though photovoltaic is the least expensive to operate, the cost to build is so expensive, that this is the least competitive supply of electricity. More work in the laboratory is needed, although some new technologies appear practical in the intermediate future. Increases in production would help reduce installation costs through improved economies of scale. Photovoltaic is not base-load, as it can not run half the time (at night) and on cloudy days. This drawback requires the continued use of gas and oil, and the development of new power storage and transmission technologies and infrastructure. Current power storage technology is not practical for community wide applications. This is the greenest of all power technologies, and has no external costs. It requires and deserves government supports to level the playing field.

Others: There are perhaps a dozen other green technologies under development, such as solar concentrators, rising hot air vortexes, tidal systems, wave systems, thermal differentials, bio-mass, bio-gas, bio-fuels, compressed air power storage, and efficient long distance transmission. To varying degrees, all of these suffer substantially from the difficulties of new technology. They are laboratory-proven, but not commercially/economically feasible. There is a lack of widespread know-how and experience. They suffer from limitations on scale (small sized plant which negatively impact economies), and very high construction costs. However, since nearly all are inexpensive to operate and have little to no external costs, they deserve government support to complete their development and to level the playing field.

The Real Cost and Value

Readers should note that while the prices of commodities like the fuels used for electricity generation are notoriously volatile, historically the costs of both plant construction and operation have been moderately predictable. However, in recent years, all fuels, beginning with gas, then oil, and now coal and uranium, have become increasingly volatile and inflationary. This appears to be the new permanent characteristic of the market. Additionally, the price of steel and concrete for plant construction has hit an all time highs. This will surely lead to new winners and

displacements among the competing energy technologies.

The following tables and graphs compute the cost/value of power from different sources, first on cost to build, then on a cost to generate power, for basic comparison. We then compute the external costs of the generated power to find the true cost of our alternatives and choices. While the cost to build and to generate reflects the realities of the developer and operator, this view does not encompass the total cost to humankind, as some costs are external to the developer and operator. The external costs include CO2 management and nuclear decommissioning (see Figure 2).

As expected those long lived assets with the longest construction periods and the newer technologies cost the most. Our analysis includes the cost of financing and other soft costs. This analysis appears to indicate that combined cycle and combustion turbines are the superior choice. However our analysis does not account for economies of scale, fuel costs and other operating costs.

The last graph (see Figure 3) converts the construction costs to an annual required return, which accounts for the capacity factor of the technology. This graph adds in the operating costs, including fuel costs. On a combined capital and operating cost basis (and before accounting for external costs), coal and nuclear are the best buys. Surprisingly, wind is getting to be competitive. In future years, as fuel expenses rise, wind may carry the day. After accounting for the external costs of CO2 management and nuclear decommissioning, wind is already the winner. Governments must provide modest supports for wind development (and the other green technologies) to internalize value and costs against the traditional technologies, and level the playing field.

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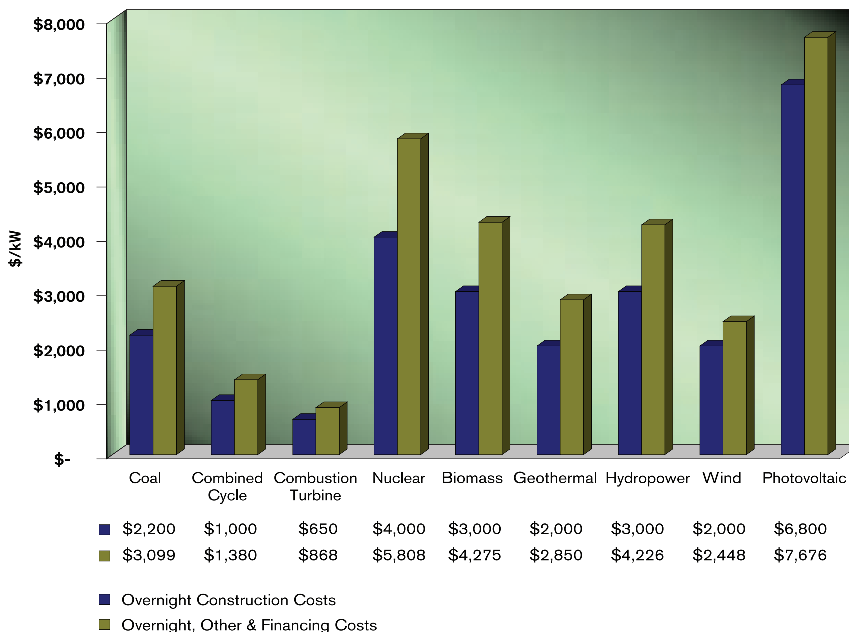

Figure 2: Overnight vs Total Construction Costs to Build

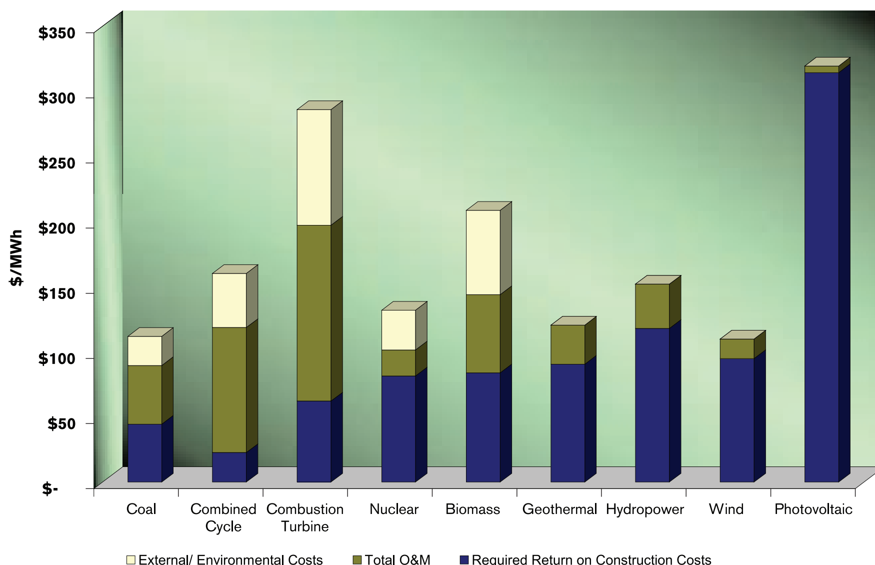

Figure 3: Total Internal and External Costs

Sustainable Buildings and the Valuation Process

Professor Richard Reed MRICS reviews the issue of sustainable valuations in the context of commercial property.

The importance of communication between all stakeholders about sustainability and commercial buildings can not be over-stated. In this context the role of the valuer is quite diverse and has a different relationship with each stakeholder, where the underlying goal is to quantify the relationship between sustainability and the value of a commercial building such as from a tenant's or an investor's perspective. Considering their knowledge about commercial buildings and the market within which they operate, valuers are ideally suited to provide guidance about the relevance of sustainability. This interpretation would relate to the incorporation of sustainability into the commercial building, and the effect on the overall capital value and/or the operating expenses. This paper raises the profile of the valuation process with regards to sustainability and commercial buildings.

The valuation process and sustainability

Owners and investors in the property market make decisions about the future of a commercial (or income-producing) building in-line with their individual objectives or goals, which most often are based largely on financial considerations. For example, this decision may be based on the goal of maximising both the level of rent (i.e. income less expenses) and/or the market value of their building. As the underlying goal of most organisations (as individual or collective owners) is to 'increase shareholders' wealth' then a building-related decision often seeks either to make a higher return (e.g. increased final sale value) or to avoid a perceived cost (e.g. via lower operating costs). Therefore, a decision about incorporating sustainability into a commercial building equation must fit within these parameters. The investor and/or owner in most cases must be able to understand and quantify such benefits to themselves and, importantly, justify to their shareholders why a certain level of sustainability has been adopted. Often this is undertaken by referring directly to the value of a sustainable commercial building.

It is accepted by most lenders that the valuer assumes a large proportion of the risk in a property transaction. The valuer will take all the necessary steps when assessing the current market value of the building, as opposed to relying exclusively upon actual cost of construction which can be higher for a sustainable commercial building. Note the actual cost will vary depending on the amount of innovation and the cost of construction associated with the building. For example, if a borrower defaults on loan repayments for a commercial building loan, then the property could potentially be sold at the hypothetical market value identified by the valuer. With regards to the risk component, the lender may seek to recover from the valuer (or their insurer) any monetary difference between the final sale price and the assessed market value identified by the valuer. In this scenario the market value identified by the valuer will limit the funds available to the owner/investor. It is important to remember that a sustainable commercial building must operate within the parameters of market value rather than the actual construction cost.

The process required to undertake a valuation of a commercial building has been a relatively straightforward procedure that has changed little over time. The underlying goal is to reflect the value of the building by evaluating the present and future risks associated with the commercial building as at the date of valuation. The primary steps are to confirm the level of income, deduct expenses and then compare this return with the recent market sales (via a market-derived capitalisation rate or via a discounted cash flow) to assess the overall capital value of the building. However, sustainable commercial buildings are

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claimed to offer improved value through creation of both real and intangible benefits, and these benefits are not always easily incorporated into traditional valuation techniques. For example, it is possible that the additional costs of providing sustainable features in a commercial building and the derived benefits are not fully reflected in the valuation of sustainable buildings. At times this may hinder the take-up of sustainability by owners, developers and investors.

It can be argued there is a level of controversy in respect of the value of sustainability in commercial buildings. In turn this has resulted in two schools of thought, namely:

a) it is the role of the valuer to recognise sustainable features in a building and then allocate that added value to the building; or
b) valuers will recognise and value the sustainable features only after they are recognised by the market, such as when higher prices are paid for commercial buildings with sustainable features (in comparison with a non-sustainable commercial building).

Over time there is growing belief that sustainable buildings will become the 'norm' or benchmark, whereas those buildings without sustainable features will have accelerated levels of depreciation and obsolescence. These non-sustainable buildings will then result in a shorter building life due to the effect of factors such as lower rents and higher vacancy rates. Nevertheless this trend will become clearer over the course of time.

At all times it is important that valuers keep abreast of changing market perceptions; this is one area in which the market is changing and creating conditions for a rethink of traditional valuation considerations.

Drivers of sustainability considerations in valuation

Climate change has an increasingly high profile in our global society and is perceived to be directly related to greenhouse gases and CO2 emissions. For example, it has been acknowledged that buildings are substantial greenhouse gas emitters as they produce more greenhouse gases than all the cars on Australian roads (ABCB, 2001). Previous research concluded that although readily available means of reducing energy consumption currently exist, the 'business as usual scenario' will not deliver sufficient reductions to meet the Kyoto protocol (Australian Greenhouse Office, 1999; ABCB, 2001). Clearly steps need to be taken to promote wider acceptance and uptake of measures to reduce CO2 emissions from the built environment. These factors have collectively increased the profile of and demand for sustainable commercial buildings.

Valuers seek to reflect the state of the market at the date of valuation, including recent trends in influencing factors such as sustainability. This must consider the views of all stakeholders in the market-place and their changing perception about the value of sustainable commercial buildings. Climate change, droughts, and perceived social inequities are all bringing an increased focus on sustainability, and this in turn is influencing stakeholders in the commercial buildings industry. The main influencing factors require further discussion.

Tenant demand

Increasingly, tenants are seeking sustainable accommodation, with many requiring particular ratings for the buildings they are to occupy, and for their tenancy fit-outs. This is being driven by the opportunity for reduced operating costs (if the lease is 'net' where the tenant pays outgoings) and for wider benefits such as reduced employee absenteeism, lower staff turnover and a healthier working environment, as well as enhancing their corporate social responsibility (CSR).

In addition, many companies are actively undertaking and promoting sustainability in their day-to-day operation since they have become increasingly accountable for their actions or lack thereof.

Investor demand

Increasingly more investors in commercial buildings are seeking a 'point of difference' using sustainability to market their building resulting in benefits such as associated increased demand, especially since many private and government tenants are increasingly demanding sustainable accommodation. Furthermore, this is accompanied by perceived higher CSR by shareholders of the company as well as in the wider marketplace. For example with 'gross' tenancies (where the owner pays outgoings) the investor will benefit from lower running costs. In addition a lower level of obsolescence in the building will likely ensure it retains a higher future value.

Government specification of sustainability in leasing contracts

A distinct trend has developed where governments are continuing to set minimum criteria for leasing commercial buildings based on a sustainability rating tool e.g. based on a minimum 'Green Star' rating. Also there has been the development of green leases for new accommodation including energy, water and waste performance (for example in Australia see www.greenhouse.gov.au/government/index.html). This automatically limits the market for potential suppliers of accommodation to the government who are traditionally perceived as a premium tenant, which in turn forces non-complying buildings to compete at the middle and lower end of the market. Alternatively they can be upgraded to a higher level of sustainability. This needs to be factored into acquisitions, and certain companies are clearly leading the property market in this area.

Socio-economic change including adoption of CSR

Conforming to conventional supply and demand principles, tenants will most likely pay a premium for accommodation in a sustainable commercial building that will provide direct and indirect benefits to their business, such as corporate social responsibility (CSR). At the same time the building owners/investors will incorporate sustainability in their commercial buildings if there is an opportunity in the local market to achieve increased rents as a result of the higher demand for their accommodation, or alternatively they will seek to avoid having their rent discounted if the accommodation is perceived to be non-sustainable. In addition there are other considerations such as undertaking a socially responsible investment (SRI).

Lower operating costs and increased accountability

Today more than ever shareholders are focused on the attitude of their company (e.g. tenant, investor) towards sustainability and what steps they are consciously taking, if any, towards decreasing their operating costs and addressing environmental concerns. Achieving lower operating costs will increase net operating income, which in turn will increase the overall value of the commercial building. In addition, many companies are actively undertaking and promoting sustainability in their day-to-day operation since they have become increasingly accountable for their actions or lack thereof.

Increased performance measurement

There have been large advances in sustainable technology and the availability of user-friendly rating tools has greatly enhanced the ability to measure the level of sustainability in a commercial building. For example there are an increasing number of global industry bodies (e.g. the Property Council of

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Australia or PCA) incorporating sustainable features in their latest building matrix, which now allows different buildings with varying levels of sustainability to be compared.

Improved rating systems

The increased knowledge about and wider availability of user-friendly rating tools has greatly enhanced the use of such tools in the marketplace, rather than being restricted to only engineers and sustainable experts. These tools evaluate a broad range of building characteristics for a different land uses, which in turn increases the reliability of the rating tools and improves the knowledge and perception of intangible benefits of sustainability in commercial buildings.

Retention of staff

This aspect is a major reason why companies are seeking to provide the best available accommodation for their staff. At the same time as the labour pool is reducing there has been an increased workload, so retaining staff is now a high priority especially when considering the large investment in attracting/training new staff and the risk of loss of corporate knowledge.

Conclusion

This paper has provided a brief insight into some of the drivers of sustainability that valuers are being increasingly aware of when seeking to accurately identify the value of a sustainable building. By increasing knowledge about the approach to valuing sustainable office buildings it is envisaged there will be benefits for three groups:

1. It will equip valuers, financiers, investors/owners and other stakeholders with a better understanding of the varying levels of sustainability and how they affect the level of risk and subsequently the value associated with a commercial building;
2. It will allow owners, investors, and tenants to appreciate the role of a valuer, their exposure to liability, and their challenging task of assessing the current and future risk, and subsequently value, of a sustainable commercial building; and
3. Through this higher level of understanding it should mean that the benefits of sustainability will be fully reflected in the valuation process, therefore contributing to support for the stakeholders who are leading in the provision of sustainable solutions.

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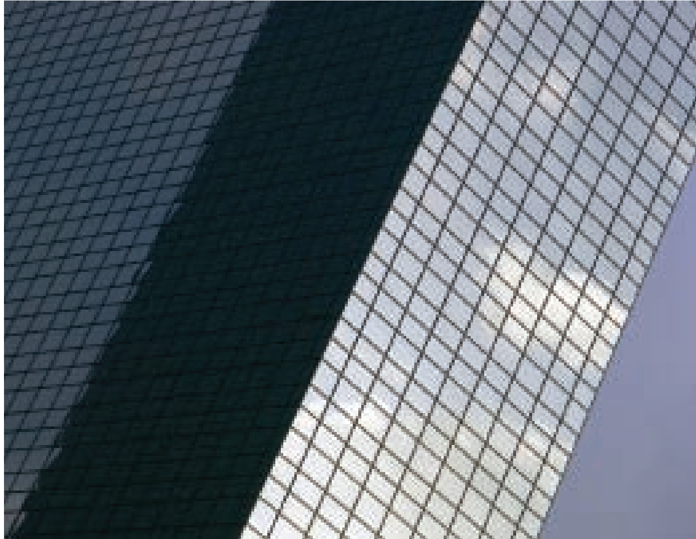
Urban Mobility: An Essential Part of Urban Planning

Sander Scheurwater champions the case for public transportation and urban land use planning.



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The successful integration of land use and transport can play a key role in reducing many of the difficulties posed by modern urban development.

Let's start with stating the obvious; today's society needs transport, or in another word: mobility! Increased mobility has brought great enhancements to the quality of our lives, where good transport can provide easy access to jobs, shopping, leisure, facilities and services. A safe, efficient and integrated transport system is needed to support a strong and prosperous economy.

Unfortunately, the way people currently travel and continued growth in road traffic are damaging towns, harming the countryside, increasing congestion, causing safety issues and contributing to global warming. Travelling in cities is becoming more and more difficult. Here roads and parking spaces already occupy a large proportion of the land.

Sustainable transport is about giving priority to people over traffic and more road space to pedestrians, cyclists and public transport and thus improving the quality of life within urban areas. Sustainable transport needs to be promoted, while at the same time unsustainable transport needs to be discouraged.

RICS believes a modal change towards public transport can be achieved. The car might, in some ways but certainly not all, provide more comfort over public transport, but as time and cost are important elements of travel, much can be gained by improving the alternatives and making the more attractive to citizens.

Transport has an important role to play in producing sustainable communities. The successful integration of land use and transport can play a key role in reducing many of the difficulties posed by modern urban development. Providing mixed-use areas (comprising jobs, shops, leisure and housing) around public transport nodes, thereby creating self reliant sub-centres within wider metropolitan areas, are important factors in reducing the need to travel, and encouraging the use of more sustainable public transport modes. It can contribute to the goals of reducing urban sprawl, promoting a shift towards public and non-motorised forms of transport and reducing car use.

What is needed is an integrated approach:

- Within and between different types of transport
- With policies for the environment
- With land use planning
- With policies for education, health and wealth creation

A stronger link is needed between transport planning and land use. Over the past few years, RICS has been promoting the concept of Transport Development Areas (TDAs). A TDA is a means of securing well designed higher density development around good public transport modes in towns and cities.

In essence, a TDA is a means of securing well designed higher density development around good public transport modes in towns and cities. It is an integrated land/use planning approach operating around urban public transport interchanges. In practical terms they involve making sure that new developments are based around good transport links.

Actions at European Union (EU) level

The EU is very active in the field of mobility. In September 2007 it presented its Green Paper on Urban Mobility, titled 'Towards a New Culture for Urban Mobility'. The aim of this Green Paper was to "open a debate on the key issues of urban mobility: free-flowing and greener towns and cities, smarter urban mobility and an urban transport which is accessible, safe and secure for all European citizens". A White Paper with concrete action items is expected over the next couple of months.

In the mean time, cities across Europe are joining forces within the so-called 'URBACT' programme of the EU. URBACT, funded by the EU, aims to foster the exchange of experience among European cities and the capitalisation-dissemination of knowledge on all issues related to sustainable urban development.

The current programme, running from 2007 till 2013, has two so-called 'thematic networks' dealing with urban mobility. These are SIMPLUM and STUCA TEAM.

The AES programme has been more successful at maintaining bio-diverse habitats than rehabilitating degraded sites

Sustainable Integrated Models for Planning Urban Mobility (SIMPLUM)

This network wants the optimisation of urban mobility planning as a function of its integration within the overall urban development process and the related urban planning context, which is currently not the case. The main shortcomings identified are:

- A limited relation between the overall urban planning process and the majority of urban mobility practices.
- The evaluation of urban mobility practices is usually uni-dimensional and very seldom takes into account the actual social distribution of benefits and losses.
- Alternative mobility practices are growing in importance but their contribution to urban development is still limited due to the hesitant steps taken and the dominance of private transport modes.
- The participation of citizens in urban mobility planning is not supported by genuine information provision.

RICS is following this programme with interest as it is closely related to the Transport Development Area-concept.

Sustainable Towns and Urban Core Areas Through Enhanced Accessibility and Mobility (STUCA TEAM)

The main objective of this network is to identify how the provision of enhanced accessibility, offered by modern transport systems (tramways, light rail, IT-based traffic and mobility management), can contribute to a substantial upgrading of central areas in the city. The local authorities participating are highly concerned about the complexities of integrated urban planning while, at the same time, acknowledging that the integrated approach is the optimal way to ensure sustainability, social benefits and acceptance and a sound implementation process.

These types of projects and actions taken should show us the way forward. The real challenge will lie in mainstreaming new ideas. Cities of today often revolve around cars and getting from A to B. It is time that cities start once again to revolve around people.

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A Common Approach

Nick Curran MRICS discusses a case study of how best practice contractor's project controls have been implemented in the Middle East.

The lack of effective project controls in the construction industry is a major contributory factor as to why final outturn costs are often not accurately forecast and result in disputes, higher costs for clients and reduced margins for construction companies.

There are however, established methods and processes that can be followed to improve cost predictability and forecasting, and there are processes and systems available that, if implemented properly, will support this.

One example of where this has been achieved is the Al Raha Beach Development in Abu Dhabi, United Arab Emirates (see panel), which is being undertaken by ALDAR Laing O'Rourke, a joint venture between Laing O'Rourke and UAE developer, ALDAR Properties PJSC. Realising the common potential problems with cost and value management, the ALDAR Laing O'Rourke JV team recognised they needed strong project controls to bring together budget, time and cost to ensure the successful delivery of the project. The main business needs of the new system were:

- one system, removing the need for other spreadsheets, databases and associated rekeying of data which increases the risk of errors
- a construction-specific software solution
- ability to capture data in the same format/WBS across many projects allowing accurate performance reporting/benchmarking, KPIs, earned value analysis, etc.
- use of cost data to identify trends and use of this data to forecast 'costs to completion'
- satisfy the client's forensic cost analysis requirements.

The contract is being managed under an NEC 3 form and is largely cost reimbursable; the openness of the project controls solution lends itself perfectly to this type of procurement.

The development is split into three main divisions: logistics, infrastructure and building works. This top-level structure is mirrored in the way the structure of the project controls are set up in as much that all three areas have their own common WBSs (see Table 1):

- logistics works include the temporary site accommodation and the provision of labour camps for the initial 15,000 site operatives
- infrastructure works include dozens of individual projects to deal with, for example, the dredging in the Arabian Gulf for materials for land reclamation, the land reclamation itself, widening of the existing Abu Dhabi to Dubai highway, seven new intersections, 35 new bridges, a light railway system, water features, Boulevard Road, marinas and the provision of a complete network of new drainage and services for the development
- building works consists of seven different precincts in the East (masterplan yet to be decided for the West) each with a number of large multi-million dollar mixed use commercial, leisure and residential construction projects.

The full design of the project controls solution was undertaken in a matter of weeks before any software development or configuration was performed.

The 'common analysis' approach was taken on Al Raha Beach – the project plan level 2 WBS from the Primavera project plan has been adopted as the common analysis and not only are the individual tasks from the plan rolled up to it, but the BoQ estimates are linked to it and costs allocated to it.

The decision to have only three WBS templates (see Table 1) was made in the interests of simplicity. It is against the common analysis that all projects are consistently tracked and measured from cost planning through estimating, project planning, procurement, change management and through to final account.

The Al Raha Beach Development

The 500+ hectare Al Raha site is located on the highway between Abu Dhabi and Dubai. Formed of 11 precincts across a total development area of 12 million m^2 along 8.5km, the mixed use Al Raha Beach development will have an estimated residential population of 120,000 with approximately 200,000 people on the development during the day. It is divided into a number of smaller communities, each offering a different mix of lifestyle, entertainment and business facilities. The project's total development value is U.S.$18bn and it is due for completion between 2014-2016.

At the earliest stages of each project, elemental cost plans are produced against the common analysis. As the design is finalised and the projects pass through the defined approval gateways, the estimates are firmed up from outline BoQ to full BoQ estimates.

During the system design, a common library of resources was also agreed and adopted by all the commercial and financial disciplines from day one.

For example, the same item selected by an estimator to build up a unit rate is then selected by the project administration team to raise a requisition. The item is also used by the procurement team to raise a purchase order with supplier invoices and payments being posted into the system against this item for later approval.

Although the library is not fixed, its management is closely controlled and the JV team has procedures in place to protect its integrity. Experience has shown that a clean list of items on day one can become totally corrupt very quickly if not properly controlled.

As well as facilitating good business management, one of the key benefits of this approach is that core data is keyed directly into the solution and that data is then reused by all stakeholders further down the line. It does not consist of items collected in other systems and then re-keyed or even copied into the solution thereby increasing the validity of the data and eliminating inefficiencies and potential for errors.

As a by-product of this, it also provides improved management reporting through a complete top to bottom view of the project, allowing project directors, project leaders, commercial managers and even the clients' auditors (EC Harris) to take a holistic view or drill down into the detail where they feel necessary.

LOGISTICS

WBS	DESCRIPTION
01PREL	Preliminaries
02DESN	Design
03PROC	Procurement
04BLDG	Offices
04GRND	Ground Works
05CAMP	Camp & Service Bldngs
06SERV	Services & Utilities
07RDTR	Roads & Traffic
08SECY	Security
09TRAN	Transportation
10CONS	Consumables

INFRASTRUCTURE

WBS	DESCRIPTION
01PREL	Preliminaries
02DESN	Design
03PROC	Procurement
04GRND	Ground Works
05PILE	Piling
06SUBS	Substructures
07SUPS	Superstructures
08MEPS	MEP Works
09BRFN	Bridge Finishes
11LIFT	Elevators & Escalators
12SBAS	Carriageway
13TEST	Test & Commission
14DLPC	Hand Over & Completion
15UTIL	Utilities
16RDFN	Road Finishing
17RETW	Retaining Walls
18TWKS	Temporary Works
19LAND	Landscape Finishes
19STST	Structural Steel
20SFLD	Soft Landscaping
20TRCK	Track
21HDLD	Hard Landscaping
22FNTN	Fountains
23MOOR	Moorings
25DISA	Disallowed Costs
90UNAL	Unallocated

BUILDING WORKS

WBS	DESCRIPTION
01PREL	Preliminaries
02DESN	Design
03PROC	Procurement
04GRND	Ground Works
05PILE	Piling
06SUBS	Substructures
07SUPS	Superstructures
08MEPS	MEP Works
09FINS	Finishing Works
10ENVE	Envelope
11LIFT	Elevators & Escalators
12EXWK	External Works
13TEST	Test & Commission
14DLPC	Hand Over & Completion
25DISA	Disallowed Activities
90UNAL	Unallocated

Table 1: An extract from the WBSs

The contract is being managed under an NEC 3 form and is largely cost reimbursable

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Lessons learned

The design of the solution benefited from the early involvement of experienced professionals who knew their roles and how they interfaced and impacted upon others in the process. To enhance the chances of success, detailed workshops were held to agree how the different business processes relating to estimating, procurement, cost collection and budget management disciplines would operate considering the bigger picture of project controls, and also how coding hierarchies would be put together – taking into account stakeholders from each discipline.

A pragmatic approach was taken to the level of detail that the common analysis would go down to using lessons learnt from previous experiences; the temptation is to set the level too low, making it almost impossible to collect the actual cost information and results in data that is inaccurate and almost meaningless.

Another key lesson was to link how the solution was used to the established Laing O'Rourke processes and gateways (particularly the production of detailed estimates and the collection of costs on site). On a number of occasions, the Laing O'Rourke controls were an invaluable tool for senior management to identify who had not followed the correct processes. For example, a forecast report by WBS showing a cost without a budget allowance can often be explained by something as simple as a requisition not being allocated to the correct WBS. system can be interrogated to identify this and any related root cause, allowing the data to be collected and any underlying process issues to be resolved.

The main stakeholders are the members of the commercial team who are perceived to have failed if cost, budget and margin are not accurately forecast. As such, they have become the parties responsible for ensuring the processes are followed, that estimates are produced from the common library and allocated to the correct WBS, and that requisitions from the delivery team and purchase orders to suppliers are raised against the correct allowances and WBS.

A massive change for the commercial team is that much of their work is now performed up front rather than after the event, e.g. understanding the allowances, resources and WBS allocations while proactively tracking costs and re-budgeting as the month progresses, rather than retrospectively reviewing the previous month once costs have been closed off and published.

The key factors in the success of the implementation were the buy-in from all levels, management of the change, and the management of the people who would ultimately be relied on to drive the system and produce the results. Even before they were trained on their own functionality, great effort was made to engage interested staff from all departments. They were presented with the big picture solution and given the opportunity to challenge what was happening and how the solution would work in practice.

Part of this process was to explain to staff that they would probably be using a computer system to do something they had only ever done in Excel before, and that they may need to input more data than previously so it could be used by everyone in the process. Providing an approachable, 'people friendly' person was also a key factor in the initial implementation.

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Adaptations

The solution was implemented largely using off-the-shelf software linking the Causeway Estimating solution with their Project Accounting software and the Primavera project planning tool. Causeway made some enhancements to their solution (e.g. increased field sizes, improved usability generally, integrated the processes and compliance with the ALDAR Laing O'Rourke Gateway process), however these were relatively small. A solution roadmap is being maintained by the JV team and the solution will continue to evolve.

The implementation and use of such processes and systems is not simple however, which is the main reason why they are not yet common in contracting organisations. A clear vision, the definition of the requirement, coding hierarchies and touch points is the first step; selection of the correct systems, while crucial, is only about 20% of the answer. What is more important are solid business processes to underpin the solution and discipline within the company/project to follow them. In addition, there needs to be buy-in from all stakeholders and a clear message from the top that project controls are crucial to the success of the project.

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Further information

The Al Raha Beach project can be viewed at www.alrahabeach.com

Leave nothing to chance

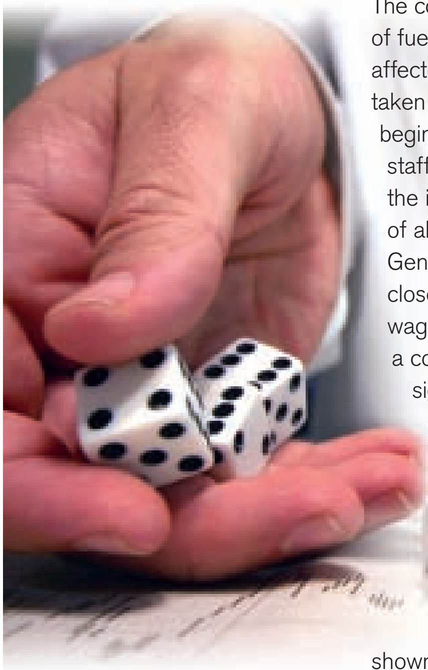
Andrew Smith FRICS provides an overview of the construction market and offers advice to the supply chain on preparing tenders in these uncertain times.

The current construction marketplace is potentially perilous for cost consultants if the wrong decisions are taken when preparing estimates and cost plans. This caution applies equally to contractors and sub-contractors who are preparing estimates and tenders.

So, what is so difficult about the current marketplace and why? Essentially, the supply side of the industry is still experiencing high levels of cost inflation while also experiencing expectations from clients that prices should fall because available workload is falling. Some commentators are referring to this as 'differential inflation'. A deeper analysis reveals how this could become a self-fulfilling prophecy.

Business success and survival demands a mixture of excellent customer service and a clearly defined risk profile

The unprecedented levels of cost inflation experienced in recent years continue within the industry. This is particularly the case with materials such as concrete, glass, copper and other commodity-linked products. The construction industry is also a large consumer of fuel for plant and equipment and has been heavily affected by the huge rises in oil prices that have taken place this year, increases which are only now beginning to abate. People costs, both labour and staff, are becoming less pressured as demand in the industry softens, but this is against a backdrop of above inflation increases in recent years. General inflation in the economy, now running close to 5%, will serve to keep some pressure on wages and salaries. All this paints a picture of a cost base that remains strong and shows little sign of a major reduction.



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The dichotomy is that, as demand for construction work softens in some sectors, there is a perception that contractors should be submitting lower tenders to secure work. This is a worrying position for the industry at large and history has shown many of us that this approach serves neither the client nor contractor well in the longer term.

Paying the right price for a product or service is essential to securing the quality expected. It is therefore important that we do not, as an industry, take ourselves into a zone where our long-term success, survival and prosperity is compromised.

While demand for new projects is clearly lower than it was a year ago, this comparison is against the fiercely overheated marketplace that has been experienced until quite recently. Many contractors, consultants and sub-contractors will comment that they currently have a more acceptable and manageable portfolio of work. Their major concern going forward is that demand will weaken further, however there is still a lot of construction work to flow from major projects such as the Olympics, Crossrail and further airport expansion projects.

At the same time, there is increasing demand in foreign countries such as Poland, where migrant labour is returning to the booming home economy, and further international markets such as India, China and Dubai. These international demands are drawing potential spare capacity from the UK marketplace.

Economic factors

Demand is being controlled by two factors at present. Firstly, there are some indications that economic recession looms as GDP growth hovers around 0%. This is causing many clients to put schemes on hold and wait to see what happens. While this may seem a sensible approach, it serves to help drive the economic downturn.

The second, and probably more important factor, is the reduced availability of debt finance from banks and other lending institutions. This is a particular problem for the residential and commercial sectors, which are being hit exceptionally hard in an unprecedented way.

There is still a good level of demand for residential assets from the marketplace but a lack of finance to allow purchasers to complete transactions. This is also a problem for major developers who are having to resort to greater levels of equity funding to secure debt funding from banks.

So, how should the supply chain respond to these challenges? It needs to keep a cool head but remain

competitive. Business success and survival demands a mixture of excellent customer service and a clearly defined risk profile. More easily said than done? Consideration of the following areas will serve to increase the chances of success:

1. Understand the risk profile of the contract. How is the scope of works determined at tender and what are the obligations for accommodating changes later in the project? Pressure on costs means that there can be no room for unexpected non-recoverable scope increases through design development
2. Be willing to engage at an early stage with advice to assist with pre-construction, value engineering and buildability. These services are often essential to ensure the viability of a scheme
3. Elements of the price that are subject to volatility should be kept provisional and adjustments for price fluctuation should be done at agreement of the contract sum and, if appropriate, treated as adjustable in the final account. If risk transfer to the contractor does take place, then these risks should be debated openly and included in the project risk register
4. The overheated market has led to an inconsistency in the quality of people across the industry. We should be rigorous in the use of professional employees and ensure we allocate people with the right skills sets to deliver projects. Management and executive support is also important at the right time
5. If margin levels are under pressure, then consider linking some of the margin recovery to the supply chain meeting agreed targets around programme, cost or quality. The NEC suite of contracts has a long-established precedent for rewarding the supply chain by sharing in savings under cost targets. There is no reason why such rewards cannot be extended to other aspects of projects
6. A tighter marketplace could lead to unsustainable and uncertain levels of risk transfer. Successful projects are often formed from all parties having an understanding of the whole project risk register and then agreeing who takes contractual and practical responsibility. This discipline should be encouraged across all projects
7. Programmes should be realistic with appropriate lead-in periods for procurement, off-site work and CDM planning. A project with the wrong programme will rarely be a success. Contractors stand more chance of winning a project with a well-developed programme and logistics strategy.

Another factor is ensuring that contracts contain appropriate security of payment mechanisms. It is no good getting the price, reimbursement mechanism, programme and contract conditions agreed if there is a prospect of not getting paid. There are several ways of dealing with this, all of which stand a realistic chance of agreement. We should, however, be careful in the current market to scrutinise the covenant of funders offering guarantees.

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Funder guarantees
This is where the funder undertakes to settle certificates directly with the contractor if the employer defaults in making payments by the final date for payment (FDFP).

Guaranteed funder step in
This would obligate the funder to effectively become the employer and complete the works if the employer defaulted in payments past a long stop duration.

Advanced payment
An advanced payment bond could be provided by the contractor in return for an advance payment equivalent to two months' work. This protects the contractor in the event that payment is not made by the FDFP. Payments could alternatively be paid into an escrow account.

Parent company guarantee
Contractors have long been asked to provide PCGs, effectively underwriting the performance of their subsidiary businesses. It is becoming more common for employers to provide these to contractors, especially where the corporate entity acting as the employer under the contract is a Special Purpose Vehicle with no covenant.

The industry faces some uncertain times over the next few months and probably beyond. It is important that everyone keeps their nerve, acts in a collaborative way and with mutual trust, respect and co-operation. One thing is certain, we are all a very resilient bunch of professionals, however leaving things to chance is not an option for guaranteed success.

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It is no good getting the reimbursement mechanism, price, program and contract conditions agreed if there is a prospect of not getting paid.

Facing Certain Death

Martin Darley FRICS, provides a personal account of living through Hurricane Ike, a Category Four storm which caused widespread flooding, property damage and economic disruption.

Many people have lived through hurricanes and other major natural disasters so I am not claiming to be unique, special, lucky or unluckier than others; I am simply pleased to be able to express my thoughts and points of view. As a former RICS Americas Board member and a Director of Turner & Townsend Inc I have to include the usual disclaimer that this article is not representative of either organization.

My activities with RICS have occasionally led to those late night discussions at the bar. I recall one about the time of the Tsunami, that revolved around why people live on the coast where natural disaster is lurking around the corner, just waiting to wipe out their livelihood. Conversation revolved around typhoons in the Far East, hurricanes in the Gulf, etc.

I argued the reason people lived close to the coast was historical, they were close to source of food, transport, trade, etc. As 91% of Americans live in moderate to high risk of earthquake, volcanoes, tornados, wildfires, hurricanes, floods, terrorism, and high winds, I wondered what was the ideal solution?

I settled in Houston, Pearland to be precise several years ago. It is a town to the south east of Houston, lying West of Interstate 45. Galveston is to our South on the USA's third coast. Pearland was named after the Pear orchards which grew there, until the great storm of 1900, which wiped out Galveston. Prior to that event Galveston had welcomed more immigrants to the USA than Ellis Island. The island was rebuilt but the port was moved inland, via the Ship Channel, to Houston. Galvestonians slowly raised the elevation of their island behind a sea wall that was designed to prevent a recurrence of that disaster.

Houston's strength was forged from the disaster that consumed Galveston in 1900; it has a diverse economy and has in recent years become the center for excellence for the global energy industry. And is one of the world's fastest growing cosmopolitan cities; providing a rich environment for business, and a work-life balance for its workers that are hard to match. That success has spurned a reinvigoration of Galveston as a vacation and weekend destination. Investment in Houston and Galveston real estate in recent years has been to the tune of tens of billions of dollars. Over half of Galveston's income was generated from high dollar housing to the west of the city

We have become accustomed to the frenzy that each storm causes in the media. I had only been in Houston a few weeks when Tropical Storm Alison killed dozens of people during the Friday rush hour. Three years ago, post-Katrina (cat 5) we endured the mandatory evacuation of the Galveston coast for Hurricane Rita (cat 4). That hurricane moved relatively harmlessly to the east of us. However, more than a hundred people lost their lives in the evacuation for Rita; a man made disaster. Many of the lessons so painfully learned during Rita were applied to Ike. The Rita frenzy was a direct consequence of the then fresh images of unnecessary suffering in New Orleans caused by hurricane Katrina. Again that was a man made situation. The levies, designed to protect New Orleans, failed as an indirect consequence of Katrina.

2008 saw a relentless hurricane season, as Ike tracked slowly across the Atlantic it was one of four major storms heading towards the states. The initially forecasts were that it would harmlessly make landfall in the Western Gulf, and even bring much needed rainfall into central Texas. During those early days of September there was a general air of complacency. As the storm intensified, predictions varied but Galveston began to crop up more frequently in the computer models.

Meetings were convened at work to discuss hurricane preparedness, and we prepared, like we had so many times before. By Tuesday Galveston had made the decision to start voluntary evacuation. Landfall was still forcecast to their South West. Not a real issue; the storm was less organized and had dropped to a cat 2. On Wednesday we had another meeting at work to go over business continuity in the event that we shut down for a day, or two. In meantime preparations continued. On Thursday morning rumor had overtaken all other forms of communication, and several people opted to leave, or not even turn in, for work. At lunchtime we were instructed to go home, and follow instruction from the Mayor's office. We were given numbers to call post storm for directions on when to come back to work.

As I rode the elevator out of a Downtown building I was asked "why was I not leaving town?" I replied "I am not in a mandatory evacuation zone" commenting that "Ike is only a cat 2" and concluded with the prophetic words, "If Pearland is in trouble, then the whole of Houston is going to be in big trouble!"

We finalized preparations on Thursday evening, fully expecting Ike to continue tracking east. By this time the wall to wall media coverage had everyone an educated to the level of Subject Matter Experts.

Sandwiched between remembrance of 9/11 and Lehman Brothers announcing the start of our financial crash, Ike rolled in as a cat 2. That was one of Mother Nature's greatest deception; a storm some six hundred miles from front to back; it had strength of unimaginable magnitude.

As Friday came there was a growing realization that Ike was so big that it did not matter if he moved east or stayed west, it was going to roll over the entire Texas/ Louisiana coast and cause mayhem. Breakfast TV was showing the storm surge cutting off road access to the barrier islands, yet Ike was still two hundred miles offshore and more than twelve hours from landfall. Experienced islanders who were waiting until the last minute to leave suddenly found themselves trapped. They were told by city officials that they were "facing certain death".

All we could do was watch and wait. In this situation fear is less like panic and more like numbness.

Most major storms come in at night, Ike was no exception. It pushed around the seawall into Galveston bay, and much like movement pushes water in a bathtub, what goes in must also go out. After the storm surge into the bay the waters flowed back into the unprotected side of Galveston Island, back into the Gulf, and causing even greater damage.

Early in the storm's progress we lost TV, then power. We huddled around a handheld 2 inch screen on Saturday to see the news that almost three million people were without power. Life moved into recovery mode. People were in the streets meeting, and working, with their neighbors; many for the first time. Without phones, TV, or computers, children had to rediscover the traditional ways to entertain themselves.

'Generator envy' was the talk of every neighborhood. The man with the generator became king. I managed to buy one five days after Ike, and had to learn generator etiquette. Driving in Houston has always been 'interesting', but without power traffic junctions became a four way hell. Curfews were imposed for obvious safety reasons. Word of mouth replaced IM's and a new word; 'hurrication' was added to our vocabulary.

I still did not have power when I returned to work a week after Ike. Business continuity at Turner & Townsend had been maintained by using our global presence to back up downed operations in Houston. Similarly one of my major clients in the energy business had maintained business critical operations by moving key resources to remote backup locations. One of the first things we did on returning to work was a 'lookback'. The fundamental lesson learnt was that our individual preparations were totally inadequate.

Sure I had stocked up on water, batteries, canned goods, propane, gas, etc, which kept us going for a few days, but when all infrastructure fails, as with Ike, then you are into a different scenario.

Next time we get a warning I decided that I will ride out another storm, but have a contingent plan to leave after a storm if conditions were similar to the post-Ike situation. In reality I will lapse into my four stages of denial.

Houston's power failure is likely to be less widespread in the future with the introduction of 'intelligent grids". This is considered the preferred option over a reinforced grid, or an underground grid (remember the flooding during Alison) which are too expensive and do not present a risk vs. value solutions.

Galveston's future is the bigger question on everyone's mind. Building codes meant that the newer buildings fared well but Galveston's renaissance remains at risk. Individual decisions will have a serious fiscal consequence for the area. The Mayor is confident the island will rebuild better and stronger. The work by the Mississippi Renewal Forum, post Katrina, is testament to that. However, the geologists are more pessimistic quoting the rapid rate of coastal erosion, and loss of the coast's natural barriers, as the major problems to viable reconstruction. Redevelopment will also have to be compliant with the Open Beaches Act; in many cases it will not be possible to rebuild due to the changed coastline. Factor in ever changing insurance requirements and it is unlikely things will return to how they were. It should be noted that all of these factors are a consequence of our decisions.

Meteorologists are meeting, post hurricane season, in Miami. Top of their agenda is "How to classify storms". The current well-known scale of 1 through 5 only gives indication of wind speed, and excludes consideration of storm surge, or the size of the storm. The information given to coastal residents in 2009 will be different from previous years.

For many Houstonians Hurricane Ike was not a disaster, just an enormous inconvenience. However, for many others Ike has changed their lives, and will change the way that we all react to future storms.

Only a cat 2, Ike still registers as the third most costly storm in history. It may yet turn out to be the 1900 storm of our generation.

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