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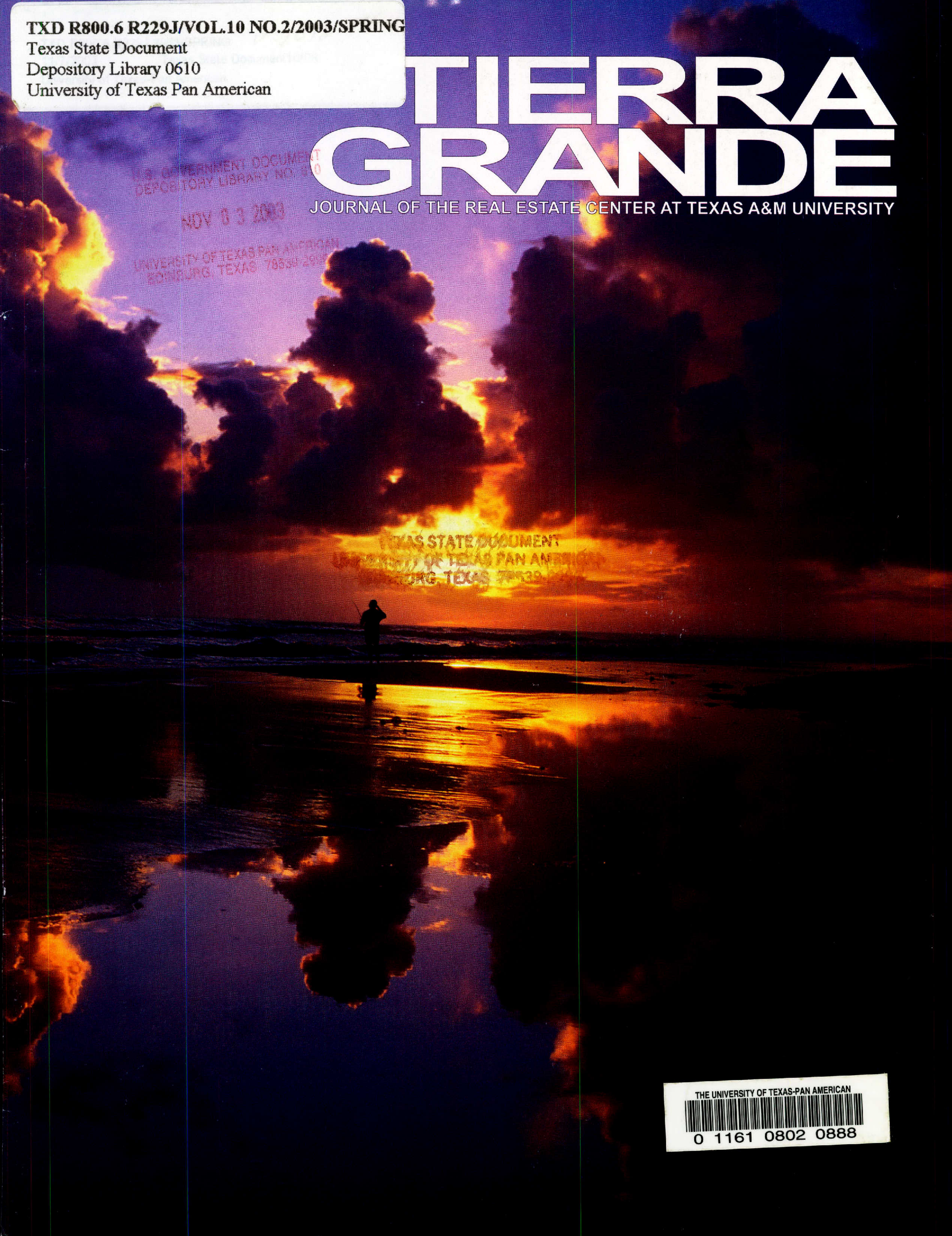

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APRIL 2003 VOLUME 10, NUMBER 2

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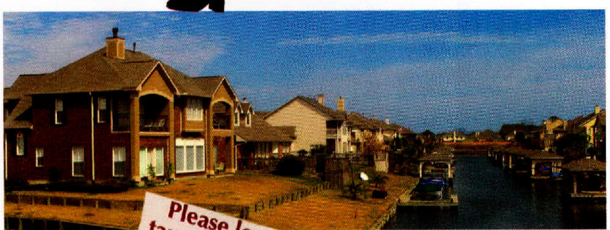

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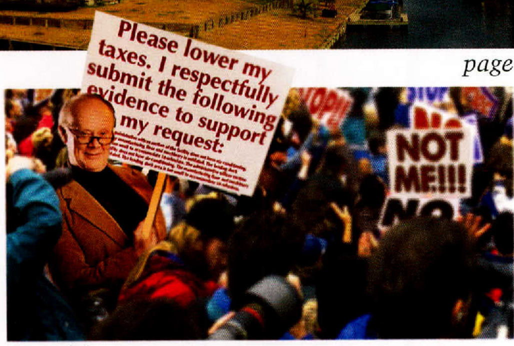

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On the Cover

A fisherman framed against sea and sunrise, Sea Rim State Park. **Photographer George Hosek**

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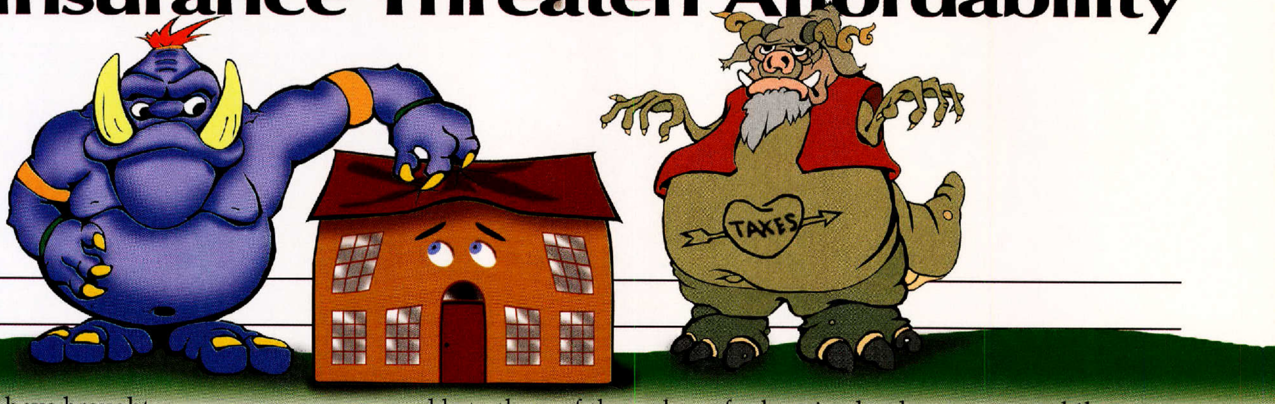
benchmarks

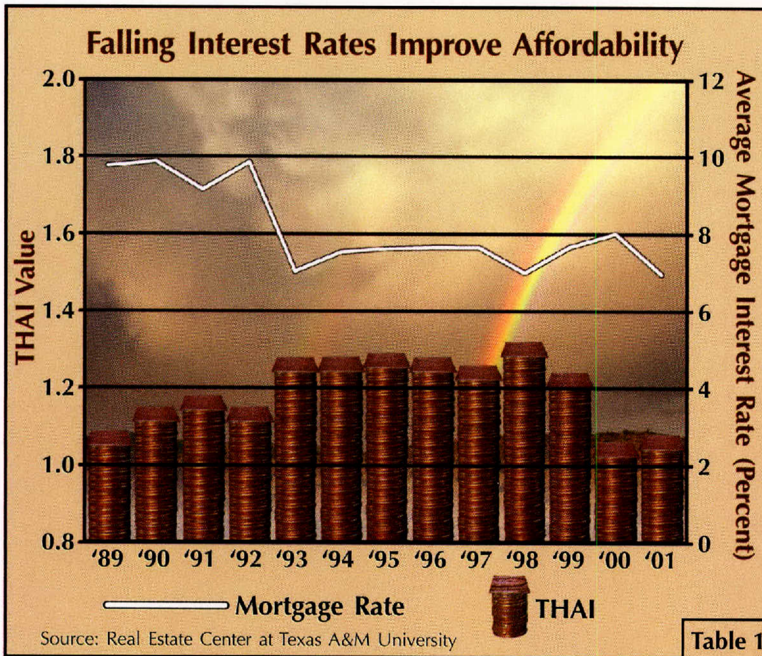
Taxes, Insurance Threaten Affordability



By Jack C. Harris

Low interest rates have brought homeownership within the grasp of almost anyone with a decent credit rating. Those who own their homes have reduced housing costs further by refinancing. Although some of the gains have been dissipated by higher prices, housing by and large has become more affordable.

The Texas Housing Affordability Index (THAI) tracks affordability by comparing the median household income in the state to the income needed to buy a median-priced home. Income needed to buy is determined by applying the criteria mortgage lenders use to qualify borrowers based on their income. A THAI value greater than 1.00 indicates that the median household income is sufficient to qualify households to purchase more than half of the homes sold, if a 20 percent down payment is made. (For a more complete explanation of the THAI, see *Texas Housing Affordability Index: 1989–2001* at http://recenter.tamu.edu/pdf/1592.pdf.)



Source: Real Estate Center at Texas A&M University

The chart shows THAI values and mortgage interest rate changes for the past 13 years. Note that THAI values tend to move in the opposite direction of interest rates — that is, when rates fall, affordability improves. From 1998 to 2000, however, the THAI slid much more than was warranted by the rise in interest rates. In fact, THAI levels in recent years are comparable to those of the early 1990s, despite interest rates more than 2 percentage points lower.

Interest rates are only one of the factors affecting affordability. Lenders qualify borrowers by comparing income to the total monthly payment the loan will require. That payment includes principal and interest payments plus contributions to an escrow account used to pay hazard insurance premiums and property taxes. In recent years, escrow contributions have significantly increased the total monthly payment. THAI values are calculated using the total monthly payment. As escrow contributions have risen, index values have been negatively affected.

Rising Escrow Expenses

Property taxes are based on a home's market value. In recent years, demand for housing has been strong, while supply has been somewhat restricted. The result has been a strong sellers market that sent prices rising to such an extent that some observers felt a market "bubble" was developing. Eventually, rising sales prices affect property tax assessments.

But rising property values alone do not cause higher property taxes. If the tax base is getting larger, local governments can reduce tax rates and collect just as much revenue. However, demands on revenues have been going up as well. School districts are being pressured to meet much of the increased cost of equalizing public school spending across the state.

Equalization is achieved by raising all districts to a minimal spending standard rather than reducing the high spenders to a lower, uniform level. The result is more school spending in the state, with revenues coming primarily from local property taxes. Tax rates are typically increasing

Table 1. Comparison of Property Tax Rates (Dollars per $100 of Property Value)

Metro Area	1990s*	2002**
Dallas	1.85 (1994)	2.13
San Antonio	1.20 (1995)	2.47
Houston	1.35 (1998)	1.87

*U.S. Census Bureau
**Property tax rates based on revenue and appraisal data reported by the Property Tax Division, Texas Comptroller of Public Accounts. Data represent entire metropolitan area, not just city jurisdiction.
Source: Real Estate Center at Texas A&M University

(Benchmarks continued on page 28)

b&bs

bringing home the bacon

by jennifer evans-cowley

More and more Texans are generating income by owning and operating bed and breakfasts (B&Bs), and real estate professionals are helping them find suitable properties. What factors are most critical in selecting a B&B property? An understanding of B&B basics offers answers.

A 2000 study by Lodging Resources Workshop/Lanier Publishing reports more than 15,000 B&Bs in the United States. Texas ranks sixth in the nation with 533 B&Bs. California has the most with 1,356, followed by New York with 822.

Varieties of B&Bs

How to Start and Run Your Own Bed and Breakfast Inn defines several types of B&Bs. A *bed and breakfast home* is a private home in which the owner offers lodging in one or more bedrooms. Breakfast is included. A *bed and breakfast inn* typically has four to 18 rooms. A *country inn* has between five and 20 rooms and serves meals in addition to breakfast.

A new type of B&B is the *unhosted B&B*, which is a guesthouse or country cottage where guests are surrounded with solitude. An unseen host stocks the refrigerator with breakfast and snacks.

The Lodging Resources study found that one-third of B&Bs have one to four guest rooms. Another third have five to eight.

The type of B&B may determine what type of financing owners can obtain. Homes with three or four bedrooms are likely to qualify for a residential mortgage because they could easily be converted back to a residence.

If a home is currently operating as a B&B and has five or more bedrooms, a commercial loan generally is required. Commercial loans are based on the business' ability to generate cash flow, so buyers with a business plan, feasibility study or both are more likely to be viewed favorably.

Building and Zoning Codes

Once a potential B&B property has been identified, the buyer will need to investigate local building and zoning code requirements to ensure that operation of a B&B is allowed. Some B&Bs are located in areas not covered by a uniform building code or with no building code at all. Guest parking requirements, fire codes, health department and business licensing requirements must be determined.

***BED AND BREAKFASTS** come in all shapes and sizes and can be found in metropolitan areas and small towns alike. The number of rooms for rent usually dictates what local, state and federal rules and regulations govern the establishment. Prospective B&B owners should check building and zoning codes, including those for food services and parking, before buying a property to convert into a B&B.*

Some cities consider renting a room in a residence to be a home business and require B&Bs owners to obtain a business license. Others regulate B&Bs separately. Still others classify B&Bs as hotels.

Fredericksburg has a significant number of B&Bs. The city defines a bed and breakfast as "tourist lodging services within rooms of the property owner's principal residence or one separate guest house . . . within a single property served by a single water and electrical meter and subject to the limitations of home occupations."

In Laredo, a B&B is "an owner-occupied, detached, single-family dwelling that provides tourist lodging services." It is managed and owned by the owner-occupant and no more than one other person other than members of the immediate family of the owner-manager can be employed on the premises. The owner-manager is required to maintain a guest register and provide proof of the collection and payment of state and local taxes.

Laredo B&Bs may have no more than six guest rooms, and guest rooms may not have cooking facilities. The exterior of the B&B must be indistinguishable from any other single-family dwelling of like design and character. Commercial displays, show windows, exterior storage areas and outside storage, with the exception of signs and outdoor advertising, may not be visible.

Lodging regulations applied to B&Bs are usually specified in terms of guests' length of stay, total number of rooms, total guest rooms and square footage. Owner occupancy is a frequent requirement. Wichita Falls limits a guest's stay to 14 consecutive days and limits a B&B to no more than ten guest rooms.

Some cities limit the number of B&Bs in a particular area. Wichita Falls limits B&Bs to one on each side of a street between two cross streets. While other cities allow B&Bs in residential areas, some require a conditional-use permit, which requires a public hearing to determine whether a B&B is appropriate on a specific site.

Parking, Signage, Food Services

City code may require a parking space for each guest room, although allowances may be given for suitable on-street parking. Some communities require off-street parking with sight barriers such as shrubbery or fencing to hide parking areas.

Laredo requires one parking space for each guest room plus one parking space for the owner and one space for each employee. The ordinance prohibits the use of the front yard for parking in the residential office district, but allows front yard parking in other zoning districts.

UNHOSTED B&Bs *let world-weary visitors get away from it all. At these cottages or cabins in the country, kitchens are stocked with breakfast fixings before guests arrive. If the bill is paid in advance, proprietors may hide the key in a prearranged spot, eliminating the need for check in and check out.*

Wichita Falls requires two parking spaces plus one space per guest room.

Communities may regulate size, location and illumination of signs. Fredericksburg does not allow signs advertising the B&B. Wichita Falls limits signs to two square feet and allows owners to have an attached wall sign or a ground sign no taller than three feet.

Some cities govern B&B food preparation and service in their health codes. Regulations are based on the definition of a meal, the time of day food is served and type of packaging, if individually wrapped, commercially prepared foods are served. In some communities, B&Bs may serve food only to overnight guests. Other regulations allow only breakfast to be served or limit the types of foods served.

Exemptions, Fire Safety

Larger B&B inns may be treated as commercial in nature with exemptions from certain requirements such as type of food preparation area, number of exits, bath facilities and hot water requirements.

B&Bs located in urban areas may be exempted from building codes if they were constructed before a specified date. The city may require such exempted structures to meet current building codes when the owner applies for a permit to remodel or reconstruct any part of the previously exempt structure.

Fire safety regulations may require the B&B to meet fire codes for residential housing, multifamily dwellings, rooming houses or hotels. B&Bs may be required to have a smoke alarm in each guest room and a fire extinguisher visible and accessible to guests. In some cases, a second exit or fire escape is required.

Because B&Bs often are in older, multistory homes, meeting fire safety standards can be costly. Many historic buildings that could make appealing B&Bs are passed over because of these cost considerations.

Picking a Winner

When it comes to picking a property that could be converted into a successful B&B,

the basic real estate principle applies — location is key. The property should be near places that draw visitors for business or recreation, such as downtown, an arts district or parks.

Buyers should never underestimate the importance of bathrooms. Guests may enjoy a quaint and cozy house that reminds them of grandma's, but they also want a private bath.

Does the house have a separate bedroom and bathroom for the owner? Does it have a large dining area that will accommodate all guests?

The grounds of the property should be attractively landscaped. Sufficient parking is a must, so properties with areas that can be converted to parking are preferred.

Although finding an appropriate property for a B&B can be a challenge, with careful screening, real estate licensees can help potential buyers make their B&B dreams come true.

Dr. Cowley (cowley.11@osu.edu) is an assistant professor with the Austin E. Knowlton School of Architecture at Ohio State University.

a tale of three BED AND BREAKFASTS

The Woodrow House

David and Dawn Fleming dreamed of owning and operating a B&B in Lubbock. Their search for an ideal property yielded homes too small, in the wrong location or too expensive to renovate. So they decided to build.

They found an empty lot in a perfect location across from Texas Tech University; however, the price was too high.

David, a real estate agent, decided to wait for the price to drop. Two years later the Flemings purchased the property for $75,000 and began construction of Woodrow House. The total cost of the B&B and land was $350,000. The B&B has been in operation for seven years and averages $108,000 in gross revenue per year.

The Texas White House

The Texas White House B&B is located near the medical district in Fort Worth. Grover McMains purchased the residence nine years ago for $130,000. He spent $20,000 on renovations to the main house and another $80,000 adding private living quarters. He chose the property because of its location, unaltered condition and interior layout.

Like many urban B&Bs, the Texas White House hosts numerous business clients seeking a refreshing change from the typical hotel environment. The B&B nets about $50,000 per year.

Auntie's House

Auntie's House is in a historic district near downtown Amarillo. The home was built in 1912 and is listed on the National Register of Historic Places. Corliss and Skip Burroughs purchased the three-bedroom residence because they wanted an older home they could fix up. They are financing the remodeling with room rental income.

The couple also built a separate 800-square-foot building known as the "Enchanted Cottage" in the rear yard. The cottage cost as much to build as the Burroughses paid for the original house, and the investment has paid off. The B&B is popular among couples looking for a special occasion getaway.

ham & regs

what to check out before guests check in

by judon fambrough

***LARGER B&BS** and those that serve food other than breakfast are subject to additional regulations governing food service.*

Anyone contemplating opening a bed and breakfast in Texas should be familiar with local, state and federal rules and regulations that govern B&Bs.

Check Local Rules, State Statutes

In addition to checking local city and county ordinances, prospective B&B operators must determine whether any deed restrictions prohibit B&Bs. Title insurance policies reveal deed restrictions and where they are located in deed records. Generally, subdivision deed restrictions prohibit commercial operations such as B&Bs.

Several Texas statutes and administrative rules deal directly with B&Bs. Most are in the Texas Administrative Code. One statute requires persons owning, operating or controlling a B&B to collect a 6 percent tax on room rentals. Another contains comprehensive rules that focus on public health issues related to B&B food service.

Determine Applicable B&B Category

Statutes and codes classify B&Bs in three categories. The *bed and breakfast limited* is a B&B with seven or fewer rooms to rent. Only breakfast is served and only to overnight guests. Owners and managers of these B&Bs must successfully complete a food manager's certification course accredited by the Texas Department of Health.

A *bed and breakfast extended establishment* has more than seven rooms to rent or provides food service other than breakfast to overnight guests. B&Bs in this category must comply with all requirements outlined in Section 229.174 of the code. These rules cover food supplies, food preparation and protection, food temperature requirements, cleaning and sanitizing utensils and equipment, application of pesticides and rodenticides, garbage receptacles, sewage systems and water supplies.

A bed and breakfast food establishment is essentially a restaurant. It provides food services to the public, not just overnight guests. These B&Bs must meet all rules and regulations applicable to retail food establishments found in Chapters 437 and 438 of the Texas Health and Safety Code.

The latter category of B&Bs is under the jurisdiction of the county or public health district and the local county commissioners court. They must secure annual permits and are subject to inspections. Owners may face civil or criminal sanctions for violations.

Consider Property Taxes, Background Checks

One statute affects B&Bs but does not mention them directly. It requires the taxation of all tangible personal property held or used for production of income. Thus, personal property such as beds, lamps and televisions used in the B&B must be reported to the chief appraiser.

Use of the home for a B&B should not disqualify the owner from receiving a homestead exemption for property taxes. A residence homestead includes a separately secured and occupied portion of a structure and the improvements used for residential occupancy. "Separately secured" is not defined.

The Texas Health and Safety Code grants employers operating a residential dwelling project (including B&Bs) the privilege of checking the criminal history of any applicant who may be reasonably required to access a dwelling.

Follow Federal, State Fair Housing Acts

B&B operators must be aware of federal and state fair housing acts when renting rooms. For the most part, the acts mirror each other and prohibit anyone from refusing to rent or otherwise make a dwelling available because of a person's race, color, religion, sex, familial status or national origin. There are, however, exceptions that may apply to B&Bs.

The Texas statute permits discrimination based on a person's conviction under federal or state law for illegal manufacture or distribution of a controlled substance. Neither the federal or state act applies to B&Bs when the owner maintains and occupies one of the living quarters as a residence. In such a case, however, the dwelling must be occupied or intended for occupation by no more than four families living independently of each other; this includes the owner. Structures outside the home used as B&Bs are subject to another more complicated exception.

Another federal statute prohibits racial discrimination without exception when renting rooms.

Comply with Disabilities, Architectural Barriers Laws

The Federal Americans with Disabilities Act (ADA) prohibits discrimination on the basis of disability and requires places of public accommodation and commercial facilities to be designed, constructed or altered to comply with accessibility standards. The Texas Architectural Barriers Act is intended to eliminate unnecessary barriers to persons with disabilities. The Texas statute duplicates the federal standards but is more restrictive in some instances.

Both laws contain an exception for B&Bs located within owner-occupied homes. The exception appears within the definition of a *place of public accommodation*. The term refers to a facility operated by a private entity whose operations affect commerce, including inns, hotels or other places of lodging. However, it does not include establishments

***B&B OWNERS** should be aware that personal property used in a B&B is subject to property taxes. Home insurance policies do not cover home businesses, so whether a B&B is in the home or in a detached building, a separate commercial liability policy should be purchased.*

located within buildings containing five or fewer rooms for rent and serving as the proprietor's residence.

When a place of public accommodation is located in a private residence and has six or more rooms for rent, the portion of the residence used exclusively as a residence is not subject to the ADA. However, the common areas used exclusively for public accommodation and for both public accommodation and residential purposes are covered. This includes the front sidewalk, door, entryways, hallways and portions of the interior or exterior available or used by customers or clients, including restrooms.

Texas law includes no other exceptions. However, the owner or operator of a place of public accommodation may request a variance. Owners of historic buildings, for example, are sometimes granted variances allowing partial compliance with the Texas Accessibility Standards if a building has historic architectural significance and full compliance would threaten or destroy its historic significance.

Review Internal Revenue Code, Insurance Needs

Compliance with the Internal Revenue Code is essential for B&B owners and operators. *IRS Audit Protection and Survival Guide: Bed and Breakfasts* by Bernard and Baran gives an excellent overview of key considerations, including:

- keeping separate records and receipts for items purchased for the B&B,
- making quarterly payments to the IRS for estimated income taxes,
- filling out Schedule C at the end of the tax year and filing it with the 1040 Form,
- filling out Schedule SE at the end of the tax year and filing it with the 1040 Form for self-employment taxes,
- withholding payroll deduction taxes with each payment to employees,
- filling out and giving each employee a W-2 Form at the end of the year and
- properly allocating deductions for mortgage payments, property taxes and other operating expenses.

Prospective B&B owners may be surprised to discover that their basic insurance policy does not cover business pursuits in the home or on their property. Consequently, whether the B&B is located in the home or in a detached building, a separate commercial liability insurance policy is required. Without the separate coverage, homeowners are exposed to a higher degree of personal liability. ✦

Fambrough (judon@recenter.tamu.edu) is a member of the State Bar of Texas and a lawyer with the Real Estate Center at Texas A&M University.

MATURE, MOTIVATED, WELL-EDUCATED INDIVIDUAL SEEKS NEW CAREER

BY JACK C. HARRIS

If the real estate profession were a housing market, it would be one dominated by repeat, "move-up" buyers. Most people entering the profession these days are changing careers or enhancing established careers; only a small percentage are starting right out of school. Consequently, newly minted Texas licensees are relatively mature and well educated.

Last summer, the Real Estate Center surveyed 13,000 individuals who had received Texas real estate salesperson or broker licenses for the first time. Participants could fill out the survey questionnaire online or complete a printed copy and mail it back postage-free. Over 1,300 responses were received, almost all of them by U.S. mail. This large sample provides a good portrait of people entering the profession.

The vast majority of new licensees are moving into real estate from other jobs. Some of these former jobs are real estate related, so many newcomers are not completely new to the industry. Few were starting their first careers.

Slightly more than two-thirds (68.8 percent) of respondents consider real estate sales their full-time profession. The rest indicated that a license gives them the credentials needed to do more in their primary jobs, which include teaching real estate courses, appraisal, property management or commercial leasing. On average, part-time real estate professionals plan to spend about 15 hours per week on real estate.

table 1

FORMER JOB

Sales	11.6 %
Management-administration	6.3 %
Teaching-education	5.5 %
Accounting-bookkeeping	4.7 %
Property management	4.1 %
Housewife-mom	3.9 %
Real estate investor	3.5 %
Student	3.3 %
Insurance sales	2.5 %
Computer sales-programming	2.4 %

Source: Real Estate Center at Texas A&M University

The jobs new licensees are leaving behind are diverse (see Table 1). Most bring skills or knowledge from their former jobs that should prove useful in real estate. Little more than 3 percent of new licensees are coming directly from school. Only 1.1 percent held a license in another state. Most appear to be switching to real estate to have a more satisfying and lucrative career.

With real estate markets hot for the past few years, one might expect the profession to be drawing people hoping to make a lot of money quickly. However, survey respondents appear more interested in the fundamental attributes of real estate sales, such as the opportunity to work independently and the rewards of helping people find new homes.

One survey question asked respondents the primary reasons they decided to obtain a real estate license. They were allowed to select more than one answer. "Chance to work independently" was cited by 63.8 percent of respondents; 48.1 percent chose "like to work with people." These two reasons are fundamental attractions of real estate sales and were mentioned most frequently by those who planned to concentrate on home sales (69.2 percent and 52.1 percent, respectively) and farm-ranch sales (63.1 percent and 44.6 percent).

"Have friends-contacts in the industry" was cited by 35 percent of respondents. Twenty-three percent cited their "background in real estate." This response was more prevalent among those who plan to sell income property (45.8 percent).

"Currently active market creates opportunities" was a reason motivating 19.4 percent of respondents. "Other reasons" was selected by 25.7 percent of respondents, with written-in responses including "real estate business in the family," "needed a license to do current job" and "interest in real estate investing."

The real estate profession is still viewed mainly as the business of selling homes, and 72.1 percent of respondents intend to spend most of their time on residential sales. Only 5.3 percent will specialize in income properties and 4.8 percent in farms, ranches and land. However, 16.3 percent of respondents indicated that most of their time would be spent on a broad range of property types, on business related to real estate sales or on investing.

The average age of new licensees is 42.4 years, and almost 6 percent are over 60 (see Table 3). This compares with an average age of slightly over 50 for renewing licensees. There are almost as many new licensees over 60 as there are under 25.

New licensees are a well educated group, with more than 60 percent having a college degree and almost one-fourth having done some graduate work (see Table 4). This is not surprising considering the age of most respondents

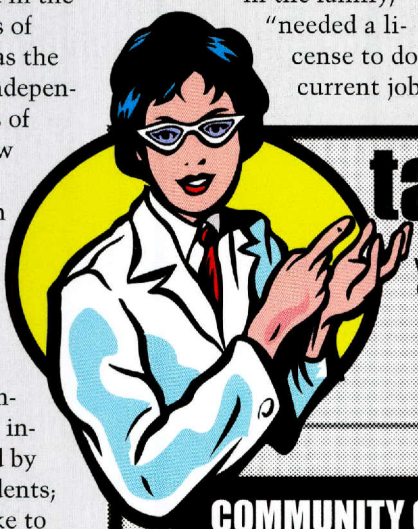


table 2

Where New Licensees Completed Education Requirements and Average Hours Spent Studying for Real Estate Exam

	Attended	Hours spent studying for exam
PROPRIETARY SCHOOL	68.5% attended	Spent 24.9 hours studying for exam
COMMUNITY COLLEGE	11.6% attended	Spent 30.8 hours studying for exam
OTHER*	8.6% attended	Spent 23.7 hours studying for exam
4-YEAR COLLEGE	8.4% attended	Spent 17.1 hours studying for exam
JUNIOR COLLEGE	2.9% attended	Spent 20 hours studying for exam

* includes correspondence courses, online courses and those offered through boards of Realtors

Source: Real Estate Center at Texas A&M University

table 3

AGE DISTRIBUTION OF NEW LICENSEES

≤25	6.5%
26–40	38.8%
41–60	48.8%
≥61	5.9%

Source: Real Estate Center at Texas A&M University

and the substantial amount of education required to apply for a license. Educational requirements were increased in January 2002. Most (62.9 percent) respondents applied before new requirements took effect. However, only 17 percent said they did so to avoid the new requirements. Given the high educational attainment of most applicants, the new standards may not have been an issue.

The majority (66.9 percent) of respondents had a sponsoring broker when they applied for a license. Most completed the required educational hours and prepared for the examination at a proprietary real estate school (see Table 2). While applicants spent an average of 24.2 hours preparing for the exam, individual preparation times ranged from zero to 800 hours. Tables 2 and 4 show how hours spent preparing varied according to where applicants completed the educational requirements and educational background. It appears that going to college may help a person study more efficiently, but too much college has the opposite effect.

The Internet's impact on the real estate business is clear. Almost all (94.6 percent) respondents have e-mail accounts. Those who do not tend to be a bit older, with an average age of 50.3. However, only 27.9 percent have personal websites.

Only 34.7 percent of respondents used the Texas Real Estate Commission's website to apply for a license. Of those who did not use the site, two out of five said they were unaware of the site and that they could apply online. One-third stated a preference for handling the application in person. Only a few respondents had problems with the site or lacked Internet access.

Few new licensees used the Internet to earn their required education hours. Only 12.9 percent reported taking courses online. Those who did completed 5.4 hours on average.

With housing markets doing so well, it is not surprising that the brokerage business is attracting people from other fields. However, real estate markets are notoriously cyclical. Will most of the newcomers bail out if markets slow?

Maybe not, based on the reasons they stated for getting into the business. Most are attracted to the nature of the job rather than the vigor of the market. Of course, if they cannot make a living, they may be forced to quit. Short of a wholesale contraction of the market, though, these folks should be around for a while.

The Real Estate Center staff thanks all survey participants for their time and for the information they provided. Such cooperation yields vital information for the industry. Best of luck on your new careers.

Dr. Harris (jharris@cgsb.tamu.edu) is a research economist with the Real Estate Center at Texas A&M University.

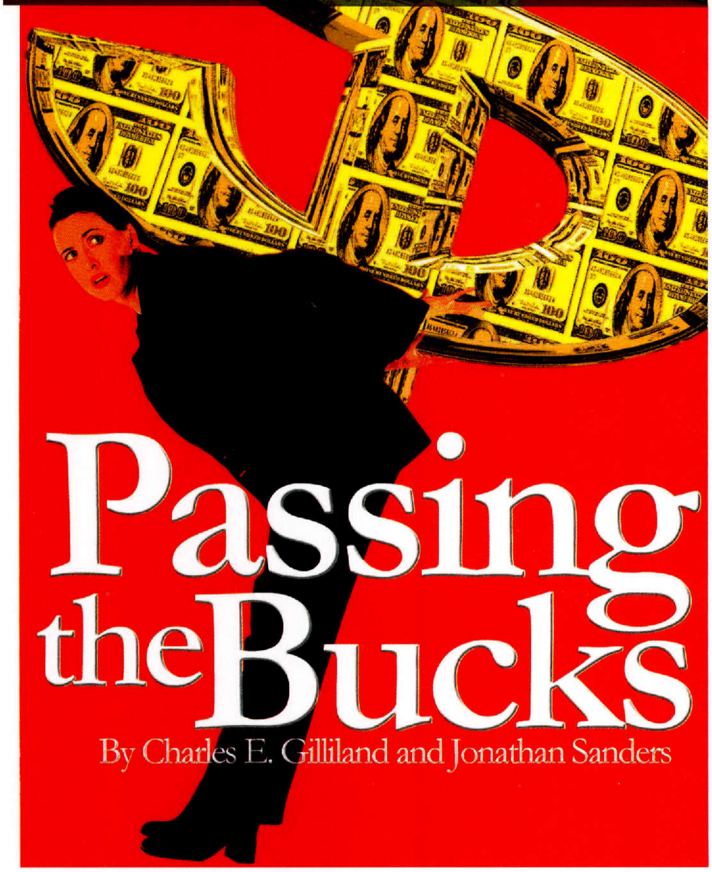
table 4

EDUCATION LEVEL - NEW LICENSEES

AVERAGE HOURS SPENT PREPARING FOR REAL ESTATE EXAM

Doctoral degree	1.6 %	25.8 hours
Master's degree	10.9 %	23.6 hours
Some graduate work	10.7 %	23.9 hours
Bachelor's degree	30.1 %	21.1 hours
Associate's degree	8.9 %	23.5 hours
Some college	28.3 %	26.3 hours
High school diploma	8.5 %	28.8 hours
Some high school	1.1 %	27.2 hours

Source: Real Estate Center at Texas A&M University



Passing the Bucks

By Charles E. Gilliland and Jonathan Sanders

Who really pays development fees? These fees typically are imposed to make up for perceived negative effects of development and are sometimes called mitigation or impact fees. They are generally charged to developers in the early stages of a project.

Advocates of development fees say this is only fair. Developers profit from subdividing land, so they should incur the cost. And they do, initially.

But it isn't that simple. In reality, market forces and competition shift this added development cost away from the developer, passing it to the owner of the raw land or the end user of the developed property. Here's how.

First, the tier of marginal developers, those who are just covering their costs before paying the fee, are forced out. This results in a reduced supply of lots, which allows the remaining developers to increase their lot prices. This increase in effect passes development fees on to builders, who ultimately pass the cost to homebuyers.

If developers cannot shift the entire expense to end users, they begin to factor the fee into projected costs when planning new projects. The added cost reduces the amount they can afford to pay for raw land and still achieve their required rate of return. Because developers pay less for land, owners of raw land indirectly incur the fee through a reduction in the market value of their property.

In markets with competitive developments, developers may not be able to increase prices, especially if competing subdivisions are not subject to development fees. By contrast, developments with highly marketable features like waterfront lots generally face little or no competition, so developers can increase the prices charged to the end users. These developers can afford to pay higher prices for raw land because they pass the development fees on to buyers of the developed lots.

Real Cost of Fees

Transforming a tract of raw land into a finished subdivision requires capital, labor and time. Although the process varies from one locale to another, small developers frequently purchase raw land with financing provided by the landowner. This arrangement allows developers to use available cash for development activities and allows landowners to earn interest on the financed amount.

Larger developers commonly borrow funds to complete improvements. Because development fees require cash at the inception of development, developers incur carrying costs by borrowing money to pay the fees. The cost to developers thus exceeds the face value of fees.

Subdivision Analysis, an Appraisal Institute publication, provides an analytical framework for determining the real cost of a fee imposed at the beginning of development. The model forecasts revenues and costs for a hypothetical development, with lot sales occurring over two years. The analysis includes both direct costs for infrastructure and indirect capital costs of development.

Applying Model to Texas

The following example applies the model to a hypothetical Texas development described in Table 1. The simulated subdivision involves one loan for purchase of raw land and one to cover development costs. Because mortgage lenders require clear title before they make a mortgage loan on a home, the developer's land loan agreement allows for title releases for individual lots as they are sold to homebuilders.

The developer accelerates principal retirement by making payments equal to 125 percent of the proportion of the debt applying to a specific lot when a builder buys it. For example, if the lot represents 10 percent of the acreage in the development, it also represents 10 percent of the land loan principal. But the developer pays 12.5 percent of the principal to obtain title for that lot. This practice ensures that the land mortgage is retired before the development completely sells out.

The developer also borrows capital to install infrastructure and prepare the land for homebuilding. That loan provides for accelerated debt retirement based on the same 125 percent convention.

This analysis includes the effects of development fees on raw land values and the cost of finished homes. Table 2 shows land values calculated using different scenarios.

Table 1. Hypothetical Texas Development

13.75 acres	55 lots
Construction period	6 months
Developer's target investment return	18 percent
Expenses	
Development fee imposed by government*	$41,250
Indirect costs (insurance, etc.)	$25,000
Engineering fees	$25,000
Development cost	$500,000
Loan Information	
Raw land loan interest rate	7.5 percent
Raw land loan-to-value ratio	75 percent
Raw land loan repayment rate	125 percent
Development loan interest rate	8.5 percent
Development loan repayment	125 percent

*$3,000 per acre. Dollar amounts taken from a development in the golden cheeked warbler zone 1 habitat in western Travis County. In that area, developers can take advantage of the regional incidental take permit held and administered by the City of Austin and Travis County. Mitigation fees collected support the Balcones Canyonlands Conservation Project.

Source: Real Estate Center at Texas A&M University

Table 2. Effect of Development Fees on Lot Prices and Housing Costs

	Typical Tract Homes	Resort Homes[1]	Upscale Homes[2]
	Homebuyers pay 0 percent of fees	Homebuyers pay 100 percent of fees	Homebuyers pay 50 percent of fees
Original raw land value, no development fees (Maximum price developers can pay and still achieve 18 percent return)	$527,667	$527,667	$527,667
New raw land value, with development fees	$482,268	$527,667	$504,968
Landowner loss (Reduction in sales price of raw land)	$45,399	–	$22,699
Homebuyer loss			
Added lot cost (alone)	–	$69,335	$34,665
Added lot cost plus "upscaled" development costs	–	$173,338	$138,662
Total loss (landowner + homebuyer)	$45,399 (110 percent of fee)	$173,338 (420 percent of fee)	$161,361 (391 percent of fee)
Added cost per home		$3,152	$2,521

[1]Lot represents 40 percent of home value
[2]Lot represents 25 percent of home value
Source: Real Estate Center at Texas A&M University

Typical Tract Homes Scenario

The *Typical Tract Homes* column represents an extremely competitive housing market in which developers cannot pass fees on to homebuyers. In this scenario, developers who are subject to the fee must compete with others who are not. For example, one city might impose high fees while neighboring cities do not. Owners of raw land bear the burden of development fees through reduced raw land values in these cases.

If land prices were not reduced, development would halt in the affected area because developers could not achieve an adequate return at current prices. Developers would shift to projects in other locales. Eventually, general price increases and a shortage of lots would likely make development profitable once again at the raw land prices landowners were originally asking. It might look as though land prices had remained stable; however, they would actually be lower than they would have been absent the fees' negative impact on development.

Ultimately, market forces and competition shift fees from developers to owners of raw land and to homebuyers.

Resort Homes Scenario

The *Resort Homes* column represents the opposite end of the spectrum — high-end homes in a luxury or resort setting that has no competition. In this scenario, 100 percent of the fees are passed through to the homebuyer.

This scenario also applies to regions where virtually all developers are subject to development fees. In these areas, developers can pass the full fee on to homebuyers. Owners of raw land incur no loss. However, the magnifying effect of carrying costs would impact the lot prices homebuilders pay. Developers would have to collect an added $69,335 to shift fees and carrying costs to homebuilders.

Like developers, homebuilders pass increased land costs on to homebuyers through higher home prices. Higher land costs prompt builders to create higher-end developments with larger, more expensive houses. Development fees thus affect the prices homebuyers pay in two ways. First, the lot price increase is added to the price of the home. And second, they encourage the "upscaling" of developments, resulting in higher-priced homes than would have been built if homebuilders did not have to try to recoup higher lot costs.

Upscaling has a two-pronged effect on local economies. First, higher home prices increase closing costs, including down payments, loan origination fees and insurance premiums. This makes houses less affordable by pricing marginal buyers out of the market.

Second, because higher mortgage payments use more of homeowners' housing budgets, upscaling limits expenditures on other items. This budget effect tends to limit the number of homes that can be cost effectively provided in an area's housing market. This supply effect could potentially result in a net reduction in a community's housing inventory.

These combined effects could affect the local government's tax base. Upscaling should result in higher taxable values per home. However, the reduced numbers of homes resulting from the supply effect could translate to a net loss of added value.

Factoring in the value of the public service provided by the fee further obscures the issue. The public expenditure may enhance property values by improving community marketability. If funds are diverted to activities not affecting homes, fees are an economic drain on development. Thus, the ultimate economic impact on the community remains unclear.

Upscale Homes Scenario

Between the extremes of the tract homes and resort homes scenarios, developers and homebuilders likely encounter markets that allow limited fee shifting to homebuyers. In these markets, the portions of development fees not shifted stifle development or reduce raw land values. The *Upscale Homes* column in Table 2 shows the effects of development fees in markets where the fee is split equally between landowners and homebuyers.

Analysis confirms that the actual cost of development fees always exceeds the face amount of the fees when developers are required to pay at the outset of the development process. In addition, this shifting of fees to homebuyers increases housing costs and reduces home affordability. Ultimately, landowners and homebuyers pay development fees, not the developers who were initially targeted.

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YOUR HOME AS AN Investment

BY JACK C. HARRIS

Dismal performances by stocks and mutual funds over the past several years have business and personal investors looking for alternative places to store their wealth. Many personal investors are buying bigger, newer homes or improving the ones they already own, encouraged by the fact that housing prices have continued to rise even as stock indexes slide.

Economists see housing more as a consumption good than an investment, primarily because homeowners usually purchase custom features and amenities that may not be valued fully on resale. Living in the asset also cramps a homeowner's ability to buy and sell at advantageous times. In most cases, a seller taking advantage of a seller's market gives up that advantage when buying replacement housing. Nevertheless, homebuyers expect their homes to be sound investments.

So how has the typical home performed as an investment in recent years? Real Estate Center staff computed average investment returns for median-priced homes purchased in Texas' largest metropolitan areas for each year since 1989. For comparison, average returns also were computed for the United States as a whole. Results indicate that:

- With moderate levels of borrowing, owner-occupied homes provide attractive returns that are relatively consistent from year to year.
- Homes in Texas' big cities generally perform better than the national median, primarily because it costs more to rent comparable housing in Texas.
- Housing returns have been especially high in recent years as homeowners have enjoyed strong appreciation rates and low mortgage interest rates.

To show how a typical home's investment performance changes each year, one-year returns were calculated based on the purchase of a median-priced home during the first month of each year from 1989 to 2001.

How Returns Were Calculated

Market prices alone are misleading as an indicator of investment return. For owner-occupants, investment return consists of net cost savings from living in the home and any increase in the value of equity. The cost savings component equals the rent that would have been paid for comparable housing minus the expenses of owning the home, including mortgage payments and routine maintenance.

The value increase component of investment return equals the value of the home at the end of the year less outstanding mortgage debt and the original equity investment. Return on investment equals the sum of the cost savings component and the value increase component divided by the cash investment (down payment plus transaction costs), or

$$\frac{\text{rent} - \text{debt payments} - \text{maintenance} + \text{end value} - \text{mortgage balance} - \text{cash investment}}{\text{cash investment}}$$

Table 1 compares annual investment returns for median-priced homes in selected Texas cities and the nation as a whole.

Note that, except for San Antonio, homes in Texas were consistently better investments than the typical American home. Returns were largely positive in the early 1990s compared

Table 1. First-Year Returns for Owner-Occupied Homes (in percent)

Year	U.S.	Dallas	Fort Worth	Houston	San Antonio
1989	4.5	(10.0)	0	29.8	(17.9)
1990	(20.2)	(8.1)	11.0	13.7	(10.5)
1991	(9.6)	7.9	19.9	21.8	22.8
1992	(12.3)	0.6	11.0	8.9	20.1
1993	(3.4)	11.2	11.7	16.2	21.2
1994	(10.3)	(7.9)	16.8	(1.0)	(3.7)
1995	11.9	26.2	39.1	28.2	19.3
1996	(1.4)	8.4	19.9	10.3	(17.5)
1997	11.1	23.6	35.2	39.3	2.8
1998	10.7	22.9	25.5	35.5	(2.2)
1999	21.3	33.4	23.9	54.0	15.8
2000	31.3	34.3	32.0	44.4	17.4
2001	22.9	9.3	20.6	10.2	(1.2)

Source: Real Estate Center at Texas A&M University

Table 2. Annual Returns for Multiyear Holding Periods Ending in 2002 (in percent)

Year of Purchase	U.S.	Dallas	Fort Worth	Houston	San Antonio
1989	5.0	6.5	9.2	16.2	7.1
1990	1.4	6.9	14.0	14.6	5.9
1991	2.3	11.9	21.2	15.5	12.1
1992	6.5	13.4	17.1	16.6	10.6
1993	7.3	16.1	17.0	20.8	8.0
1994	9.5	17.4	17.1	25.1	8.4
1995	10.4	19.4	28.5	25.0	6.3
1996	11.1	18.2	19.8	28.1	2.4
1997	10.9	19.7	24.4	26.7	1.0
1998	11.0	17.2	18.2	26.3	1.4
1999	11.3	14.7	14.8	26.0	1.6

Source: Real Estate Center at Texas A&M University

to the negative results nationwide. Fort Worth had positive returns in every year of the study.

The main reason for this relatively good performance is that comparable rents are higher in Texas cities than they are nationwide. For example, in 1994 comparable rent averaged $532 per month nationwide, but for Dallas it was $788, and for Fort Worth it was $663. Houston's 1998 comparable rent was $865 versus the national average of $633. The rent a homeowner saves by being able to live in the home is a big part of investment return. The higher comparable rent is, the higher the return.

Multiyear Holding Period Returns

Think of annual returns as similar to annual changes in the Dow Jones Index: they show which years were good and bad for homeowners. However, few homeowners own their homes for only one year. Returns calculated over a period more in keeping with a typical homeowner's tenure would be more indicative of a home's investment performance.

Most people own a home for ten to 11 years on average. Table 2 shows annual returns on homes sold in 2002, after various multiyear holding periods. For the most part, these returns compare well with other asset types held over the same periods.

As with the first-year returns, these returns are based on 80 percent financing. Given that they all are positive, borrowing more — as many homeowners do — should provide even higher returns. The problem with borrowing more is that it increases the monthly loan payments and decreases the amount of initial equity. Higher monthly payments also reduce the savings the owner nets from living in the house. On the up side, the return from price appreciation is magnified because the required cash investment is smaller.

If the value of the home decreases, that effect is magnified as well. Equity can be completely lost through decline in value.

Owning a home can be a great core investment for one's portfolio and has provided substantial returns for a number of years, not just during the recent hot markets. By borrowing at favorable interest rates, returns can be further magnified. Refinancing when rates fall is another option that could result in returns even higher than those indicated here.

For details on methodology or data sources used in this article, email info@recenter.tamu.edu.

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Deciding How Much to Borrow

When will a larger mortgage loan result in a bigger investment return?

It is impossible to know for sure whether borrowing more will be beneficial because it depends on how rapidly the home increases in value. It is possible, however, to estimate the rate of value appreciation needed to make additional borrowing worthwhile. Then buyers can decide how much to borrow based on how likely it seems that the home's value can grow that amount.

Example:

Home sales price	=	$129,000
Mortgage interest rate	=	6.25 percent
Rent for a comparable home	=	$1,000/month, $12,000/year
Property taxes	=	$3,600/year
Other costs (insurance, maintenance)	=	$1,800
Buyer's income tax bracket (marginal tax rate)	=	15 percent

To estimate the appreciation rate needed to justify borrowing more, first calculate net rent savings as a percentage of the home's value:

$$\frac{(\text{comparable rent} - \text{property taxes} - \text{other costs})}{\text{price}} = \text{Net percentage rent savings}$$

or

$$\frac{(12{,}000 - 3{,}600 - 1{,}800)}{129{,}000} = 5.1 \text{ percent}$$

Next, calculate the after-tax interest rate:

$$\text{Interest rate} \times (1 - \text{marginal tax rate}) = \text{After-tax interest rate}$$

or

$$6.25 \times (1 - .15) = 5.3 \text{ percent}$$

The annual appreciation rate needs to be higher than:

$$(\text{after-tax interest rate}) - (\text{net percentage rent savings})$$

or

$$5.3 - 5.1 = 0.2 \text{ percent.}$$

Because 0.2 percent is less than general inflation in most years, the home likely will appreciate by at least that amount. When comparable rents are relatively high and interest rates low, additional borrowing is beneficial even when low appreciation rates are expected.

Other issues must be considered when deciding how much to borrow. For example, homeowners should maintain a cash reserve to be used for maintenance and unforeseen expenses. Borrowing too little could leave the buyer without this financial "safety net."

Of course, borrowing more money means a higher monthly payment and less discretionary money to pay for other things. Also, a higher loan-to-value ratio may raise the interest rate the buyer is offered and, more importantly, may mean that the loan has to be covered by mortgage insurance. In such a case, this analysis should be conducted again with the higher interest rate and mortgage insurance premium included.

BAY AREA

By Harold D. Hunt

Nestled on the shore of Galveston Bay, the greater Clear Lake area has long been one of Houston's best-kept secrets. Ten cities and a slice of south Houston make up this diverse region, which boasts a population of 400,000. Often linked inextricably to NASA and the space program, Clear Lake is indeed about space — and more.

"More" is the concept behind the greater Clear Lake area's upcoming name change. "Our region now extends well beyond the shores of Clear Lake," says Jim Reinhartsen, president and CEO of the Clear Lake Area Economic Development Foundation. "We decided to change the name to Bay Area Houston, which gives a clearer image of our territory."

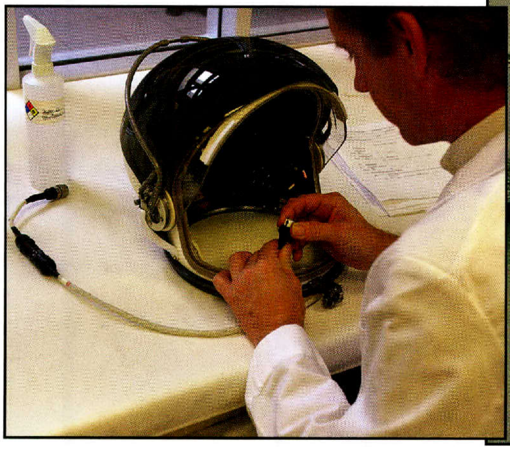
Lying within both Harris and Galveston counties, Bay Area Houston includes part of Houston along with the cities of Friendswood, Kemah, League City, Nassau Bay, Seabrook, Webster, Clear Lake Shores, El Lago, Taylor Lake Village and Pasadena.

Array of Economic Drivers

A recent report by Angelou Economics indicates that aerospace, technology and specialty chemicals have been the strongest contributors to Bay Area Houston's economy. However, tourism, recreational boating and biotechnology are broadening the region's economic base.

Since the Johnson Space Center opened more than 40 years ago, the aerospace industry has maintained a commanding presence in Bay Area Houston. NASA and more than 70 aerospace and defense firms currently employ more than 15,000 in the region. Bay Area Houston is home to 92 percent of Houston's aerospace jobs and 4.5 percent of Houston's total employment.

Technology employment in Bay Area Houston goes well beyond the aerospace industry. More than



***AEROSPACE** is the backbone of area business. United Space Alliance, a partnership between Boeing and Lockheed Martin, manufactures equipment for NASA's space shuttle program. (Right) Flight suits and helmet made for the next shuttle mission, on hold pending results of the Columbia accident investigation.*

HOUSTON

9,000 employees in the region work in software development and computer services firms.

The specialty chemical industry is an effective counter-balance to the area's aerospace and technology industries. Pasadena's oil refineries and the world-class Bayport Industrial Complex employ 8,000. Specialty chemical companies have invested more than $2.5 billion and have an annual economic impact of more than $1 billion on the region.

Tourism is expanding rapidly, with more than two million tourists visiting the Bay Area annually. The $68 million Space Center Houston, launched in 1992, attracts nearly one million tourists per year. The Kemah Boardwalk, a $25 million development, is rapidly becoming one of the state's premiere restaurant and entertainment destinations.

Recreational boating accounts for about 10 percent of all gross sales in the Bay Area — more than $200 million annually. Bay Area Houston's 19 marinas have more than 7,000 boat slips with the third largest concentration of pleasure boats in the United States.

Biotechnology is a steadily growing niche industry in Bay Area Houston. Located squarely between Houston's Texas Medical Center and Galveston's medical research facilities, the region employs more than 2,900 in biotech-related firms. Some biotech companies, such as Wylie Laboratories, are conducting

DIVERSE COMMUNITIES *with shared economic goals make up the area. (Top) A high-end community in Seabrook. (Above) Scientists consult inside the mock-up of the International Space Station at the Johnson Space Center. (Right) Map of Bay Area Houston.*

space-related research projects they hope will lead to advancements in cancer treatment and drug development. One such project involves studying the effect of weightlessness on cell tissue.

Healthy Commercial Market

Bay Area Houston's office market is relatively small in terms of total inventory compared with other Houston submarkets. The region's 80-plus office buildings, totaling 5.7 million square feet of space, represent a mere 3 percent of the Houston metro's total office space.

According to Coy Davidson, vice president of Colliers International, "The Bay Area office market is somewhat independent of the greater Houston market, which is affected more directly by national economic factors as well as business cycles in the energy and specialty chemical industry. The Bay Area's office market has remained relatively stable by comparison because of its ties to the aerospace industry." Davidson says aerospace-related tenants account for about 35 percent of the occupied office space in Bay Area Houston.

The region's warehouse and distribution properties are minimal. Excluding owner-occupied space, Bay Area industrial inventory is about 1.3 million square feet. However, Davidson reports that specialty chemical companies continue to move into the area and expand white collar engineering and management functions related to area manufacturing operations.

Vendors to the major specialty chemical firms are also relocating to the area to service their clients more conveniently. Demand for flex and light industrial space in Bay Area Houston should continue to grow.

Bay Area Houston residents earn some of the highest incomes in the Houston area, with 18.3 percent of households bringing home more than $100,000 per year. As a result, the region's retail market has performed well. Baybrook Mall is the number one suburban Houston mall with annual sales per square foot at $490.

Variety of Residential Options

Several Bay Area cities including Friendswood, Kemah, League City, Pasadena, Seabrook and Webster were founded in the late 1800s. Some, such as Nassau Bay and Taylor Lake Village, developed as the Johnson Space Center grew.

The disparity in the ages of communities, combined with the area's range of landscapes, has produced a surprising difference in character and feel among Bay Area Houston cities. Homebuyers can find new waterfront homes, older ranchettes and everything in between. Once they purchase a home, they can be duck hunting, sailing or at work in downtown Houston in half an hour.

Home sales prices vary widely in the region. More than 32 percent of the homes sold in 2002 through the Bay Area multiple listing service (MLS) were priced at more than $160,000. However, more affordable housing is also available. Almost 30 percent of MLS homes sold last year were priced less than $100,000.

__LIVING LARGE__ on land and sea. (Above) Recreational boats in the marina at South Shore Harbour Resort. (Right) Housing prices in the area vary from high-end to affordable. (Bottom) Private piers stretch toward the horizon near the Kemah Boardwalk.

Educational Opportunities

Bay Area Houston is served by three independent school districts (ISDs) — Clear Creek, Pasadena and Friendswood. San Jacinto College and the University of Houston both have campuses in the Bay Area.

The University of Houston–Clear Lake, with an average student age of 32, is a major educational resource for working adults. Computer science and teacher education are popular fields of study, with the master of business administration and master of health care administration degrees among the most favored. A master's level bioscience program is under consideration.

San Jacinto College has teamed with the Clear Creek, Friendswood and Pasadena ISDs to create the Aerospace Academy for Engineering and Teacher Education. The program aids students and teachers working in math and sciences through educational partnerships with businesses and government entities.

Many local firms steer employees toward continuing education programs as well. Scholarships, tuition reimbursement and release time to attend college classes are not uncommon.

Houston, We Have a Solution

The Space Alliance Technology Outreach Program (SATOP), a groundbreaking initiative started in 1998, offers free technical assistance to small business owners, entrepreneurs or inventors facing technical challenges, large and small. Directed out of the Clear Lake Area Economic Development Foundation office, the program was created to help save or create local jobs. SATOP is now a statewide initiative.

The program enlists engineers and scientists from area universities, NASA centers and NASA subcontractors who volunteer up to 40 hours of their time per request for help. These volunteers exercise their technical skills in solving down-to-earth problems faced by small business owners. SATOP's success stories include eliminating acoustical problems in a dance studio, increasing the energy efficiency of storm windows and developing an air filtration system for ceiling fan blades.

Bob Mitchell, SATOP's Texas executive director, says, "The program's goal is to speed transfer of space technology to the private sector. Small businesses are just a click away from tapping into the power of the space program." For more information or to request technical assistance, visit www.spacetechsolutions.com.

Bay Area Houston has evolved into a diverse, dynamic component of the greater Houston metropolitan area. With abundant business opportunities and a sought-after quality of life, the region that owes so much to space is clearly on solid ground.

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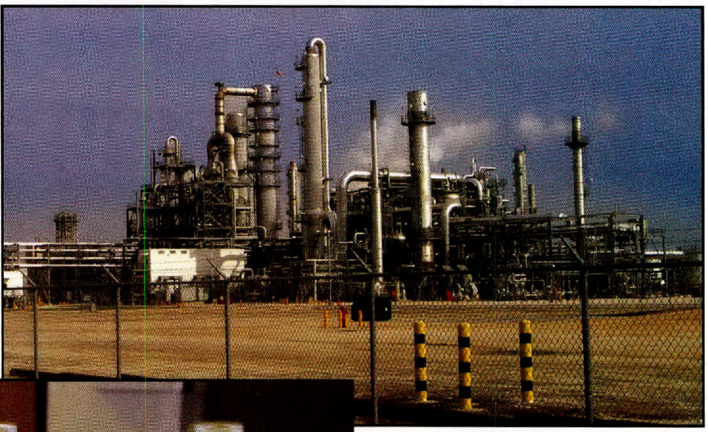
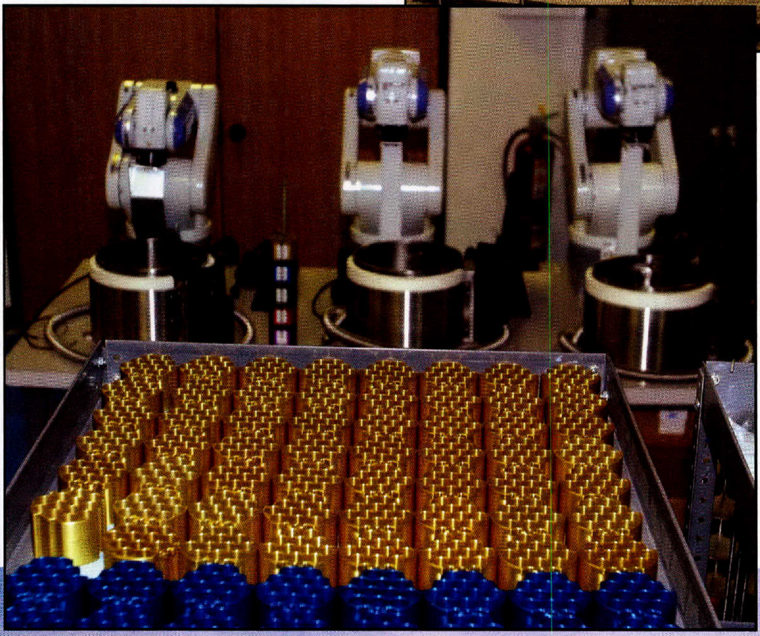
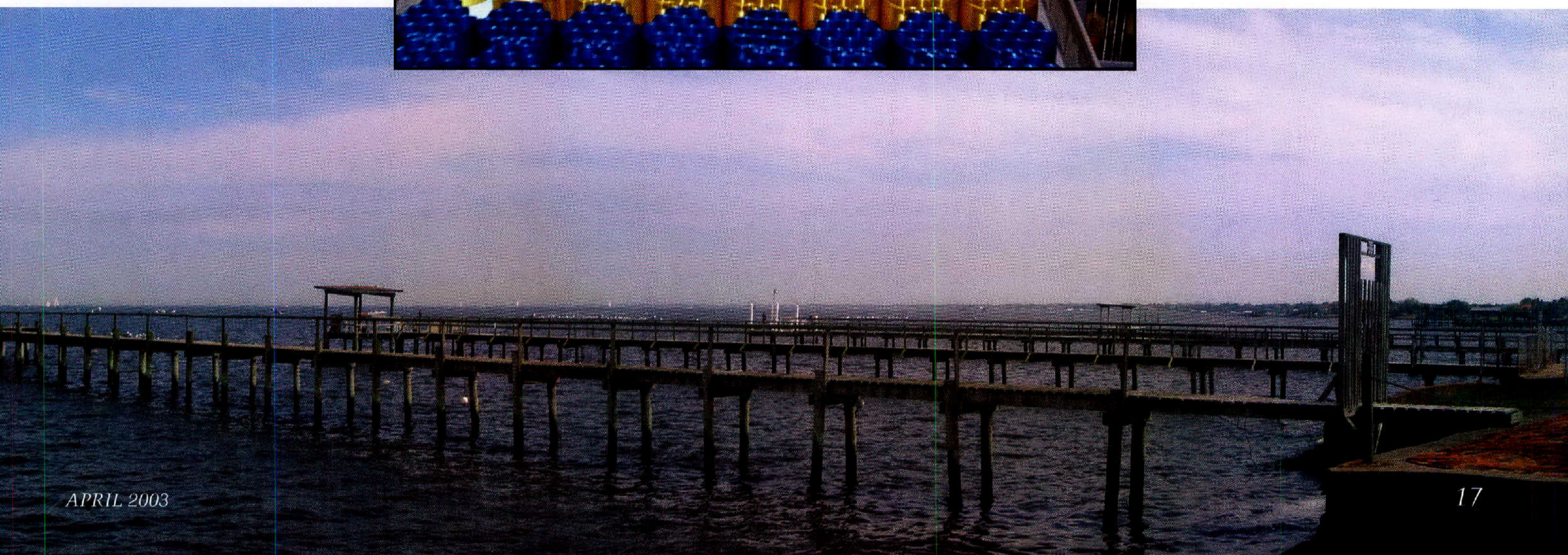




SOFTWARE AND COMPUTER *services, biotechnology, and chemicals and plastics are all major players in the area. (Above) The Bayport Industrial Complex is home to American Acryl, an acrylic manufacturing plant. (Left) A robotic transfer system for fragile frozen protein crystals, engineered by Oceaneering International, Inc.*



Medically Necessary

Medical Market Evolves to Survive

By Harold D. Hunt

FLEXIBILITY *is a selling point at Corporate Centre Kirby, where tenants lease space offering various finish-out options. (Top) Buildings have 26-foot ceilings, allowing for conversion to two stories. (Left) A dialysis clinic featuring a light, bright atmosphere and televisions at each patient station was among the center's first tenants.*

Will Rogers said, "Even if you're on the right track, you'll get run over if you just sit there."

The ultracompetitive medical industry exemplifies this conventional wisdom, with headline-making treatments and science-fiction-like surgical procedures introduced almost daily. In this field, innovation equates with survival; stagnation can be the kiss of death.

Real estate developers marketing to the health care industry are discovering that more than ever, they, too, must keep up with the specialized needs of their clients to stay competitive.

Developing Medical Space

Medical offices are typically more expensive to build than traditional office space, primarily because of the extensive plumbing, cabinetry and electrical capacity required. Although these finish-out costs are usually passed on to tenants, they drive initial project costs up.

Many medical professionals also look for the flexibility to expand their space without relocating because moving a medical practice is extremely expensive. In addition to the costs of moving medical equipment and fixtures, there are unknown indirect costs related to asking patients to adapt to a new location. Consequently, medical tenant turnover is generally low.

While this creates a stable environment for existing investor-owned properties, it negatively impacts the financial feasibility of new medical office construction. Lenders typically require extensive preleasing, usually 60 to 70 percent, before they agree to finance new medical space. As a result, construction of speculative space is limited.

Two recently built properties provide an interesting look into the latest trends in medical space.

Park Cities Medical Plaza (Dallas)

The predominance of managed care programs, which limit doctors' fees, has resulted in steady downward pressure on physicians' incomes. Some physicians are now focusing their practices on medical services that generate the highest income, such as surgery.

About two years ago, Cirrus Health Services, a subsidiary of the Dallas-based Cirrus Group, began working directly with local physicians to determine if there was a need for an outpatient ambulatory surgery center in the Park Cities area of Dallas. Project feasibility was based on demographic factors, such as potential patient population size and affluence, and the presence or absence of competing facilities. Cirrus then determined the overall tenant mix needed to provide the most practical bundle of medical services.

"This was one of the most critical steps in the development process," says Jason Dodd, director of real estate services and a partner with The Cirrus Group. "Without a strategic approach, medical deals like this are impractical. Our strategy is nothing like speculative office building."

The group decided that the Park Cities Medical Plaza (PCMP) would be a three-story, 39,000-square-foot facility with a day surgery center as primary tenant. The Texas Department of Health mandates that surgery patients in this type of facility be allowed a maximum of 23 hours to recover in the center, thus excluding trauma and intensive heart surgery patients.

Choosing a surgery facility, which requires sizeable square footage, to be the primary tenant meant that a large block of space would be preleased, increasing the property's financial viability. The surgical center occupies one-third of the building's leasable space; another third houses a full-service imaging center, including radiology, MRI and CATSCAN facilities, which supports the surgical facility.

Cirrus was able to accommodate the surgery center's cost-intensive and complex build-out requirements. The high income level generated by surgical services has allowed more of the development's cost to be shifted to the surgical center, which is effectively subsidizing the remaining tenants' rental rates.

Surgeons with office space in the building benefit from proximity to surgical facilities. Travel time typically required between surgery and seeing patients in the clinical setting has been significantly reduced.

The Texas Sports Medicine and Orthopaedic Group is an anchor tenant in PCMP. Previously located down the street, the group had been sending their surgery cases to other area hospitals. Now the group sends a steady stream of day surgery patients to the PCMP surgical center.

The Park Cities area is one of the most affluent in Dallas, so the other tenants chosen to round out the mix primarily service upper-end clientele. They include cardiologists, a Heart Health and Wellness Center, a plastic surgeon and a "boutique" physician who works on retainer and services a limited number of patients. In keeping with the upscale environment, valet parking is available to patients.

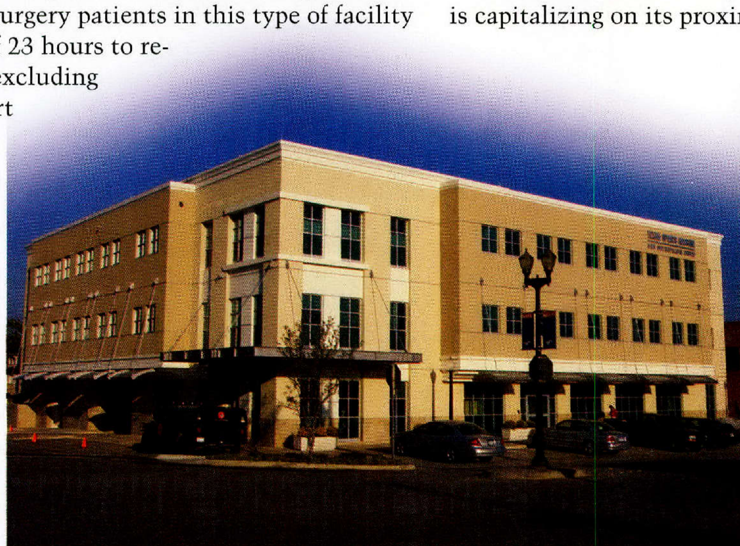
Building medical developments with a specific focus — in this case, a surgical center — has worked well for Cirrus. The company is currently developing four other medical office properties in the Dallas-Fort Worth area and has completed 12 other health care facilities in the Dallas-Fort Worth and Houston markets.

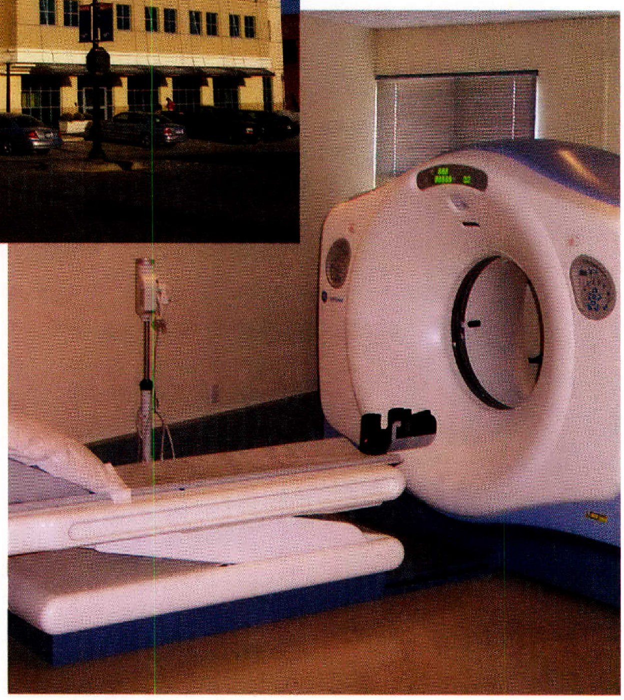
Corporate Centre Kirby (Houston)

The Texas Medical Center (TMC) in Houston employs more than 61,000 on its 700-plus acre campus. It is the largest concentration of medical facilities in the world. The complex boasts 22 million square feet in physical plant space with projections for an additional 10 million square feet to be developed during the next decade.

In June 2001, during tropical storm Allison, the center sustained an estimated $2 billion in flood damage. Insurers are now hesitant to insure property in the basements of TMC buildings, creating increased demand for space near the complex.

Warehouse Associates, a Houston-based development firm, is capitalizing on its proximity to the TMC by building a new





***AN AFFLUENT CLIENTELE** was the driving force behind Park Cities Medical Plaza's elegant design (left) and hand-picked tenant mix. (Below) Top-of-the-line imaging facilities support the surgical center and private practices in the building, as well as those nearby.*

flex/service center. Corporate Centre Kirby, the development's first phase, is 107,800 square feet of space in two buildings on seven acres of a 60-acre tract fronting South Kirby Drive.

"The idea for Corporate Centre Kirby was to achieve a high level of design aesthetics," says project architect Mark Verrett of Verrett Architects. "The property has the look of a high-end, two-story property although it's basic tilt-wall technology."

A color consultant was used to determine the most attractive color mixes and proportions for the exterior walls. Such attention to detail is unusual in flex-service center space, but Verrett considered it necessary to attract higher-end medical tenants. Corporate Centre Kirby also offers less traffic congestion and more convenient parking than the TMC for both medical employees and patients.

David R. David, the project's developer, originally felt that support services such as labs or medical suppliers would show the most interest in the property. Instead, more traditional medical clients, including a dialysis clinic, medical offices and a home health care firm are among its first tenants.

The property's 26-foot ceilings appeal to prospective tenants because they offer a range of finish-out options. Businesses get a "mezzanine-ready" shell space that can be converted from one-story to two-story space for about $14 per square foot before move-in. This essentially equates to a rent-free second floor. Other attractive design options are available, including dramatic two-story entrances.

"LEAVE OUTS" IN FOUNDATIONS *at Corporate Centre Kirby accommodate the added plumbing medical offices need.*

Corporate Centre Kirby buildings were designed to accommodate a wide variety of uses with maximum flexibility. "Not many buildings can be converted from warehouse to medical lab or complete office without major changes," says Steve Salverino of Rosenberger Construction. "Here, parking is not a problem, columns were oversized to facilitate the mezzanine construction option, and a 10-foot wide "leave-out" (space) was left in the foundation to allow cheaper and more efficient installation of the extensive plumbing medical tenants require."

Finally, the property is gated, with controlled access only. A custom security package known as "Virtual Guard" combines two security systems. One component electronically monitors the property. When sensors are tripped, off-site law-enforcement takes control of a camera system transmitting over the Internet.

The system offers one-way visual and two-way voice communications with intruders or with clients exiting the property. Another component provides automated electronic gates and access card readers. Although this system has been used extensively in gated residential communities, Corporate Centre Kirby is one of the first to apply it in a flex-space setting.

Demand for state-of-the-art medical treatment will no doubt continue to increase as the baby boom generation nears retirement. This in turn will drive demand for state-of-the-art medical space. Although the risks in developing such specialized space are significant, innovative developers can also find opportunities for profit.

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Medical Space Ownership Models

Hospital-owned

Hospital-owned medical office space provides doctors space near a particular hospital with the objective of getting patients to use that hospital for treatment or services.

Because a hospital's primary profit center lies in servicing patients, not leasing office space to doctors, maintaining a high occupancy rate is less important to the hospital than to most commercial leasing operations. In fact, hospital-leased space is much like a "loss leader" item at a grocery store — its purpose is to provide a steady stream of patients seeking hospital services.

Doctors such as podiatrists or allergists, who rarely admit patients to a hospital, may even be discouraged from leasing office space in favor of neurosurgeons, cardiologists or others who admit patients more frequently.

Physician-owned

Physicians and other medical professionals may choose to purchase their own office space. Some expect a long-term benefit from building equity in real property rather than paying rent. Others simply desire more control over this aspect of their business. Many doctors want to provide patients with a conveniently located office away from medical centers, because dealing with a large hospital complex can be daunting.

Because doctors desire face-to-face communication with colleagues on a regular basis, they typically form practice groups. If member doctors are specialists who see many critically ill patients, they may choose to locate close to a hospital for liability reasons and convenience.

Investor-owned

In contrast to the other ownership types, development of investor-owned medical space is based solely on financial feasibility. Facilities must offer the types of space medical professionals want in locations that serve the needs of both doctors and patients.

Protesting Makes Cents

Lowering Property Tax Assessments

By Charles E. Gilliland

If the word "protest" makes you think of angry, placard-carrying mobs confronting police in riot gear, crank your imagination down a few notches. Think instead of business owners peacefully protesting their property tax assessments in an effort to minimize their property tax liabilities.

The Texas Property Tax Code allows businesses and individuals to protest property valuations they consider inaccurate. Most businesses that take advantage of the protest process do so to correct clerical errors or to document physical deterioration that lowers a property's market value.

While physical deterioration is important, other factors may have a greater impact on value. Negative environmental factors and design flaws, for example, often go unreported or are inadequately described in a protest or appeal. Appraisers routinely identify these influences as *obsolescence*, which can be either *external* or *functional* depending on the source of the problem. To convey the importance of these negative influences, business owners must describe the problems in detail and convincingly quantify their effects on the property's value.

External Obsolescence

External obsolescence arises from factors beyond the owner's control, such as negative environmental influences. Negative effects can be direct, like pollution-producing neighboring properties, or indirect, such as too many suppliers of a particular product or service in the area. In most business settings, external obsolescence results in lost property income, which in turn reduces market value. Standard cost-based tax appraisals seldom adjust for this kind of devaluation.

For property to be assessed at a lower taxable value, the owner must convince the local appraisal district that the property's value suffers from a negative external influence. If the problem stems from a neighboring property, the owner must clearly describe the problem and offer evidence to substantiate a lower value.

Visual evidence such as photos can dramatically convey the nature and extent of problems. Any available statistical evidence on income loss or overcapacity in the market can bolster the case. Facts and figures in chart or graph format are effective. After establishing external obsolescence, the owner must provide an objective estimate of its effect on the property's value.

Functional Obsolescence

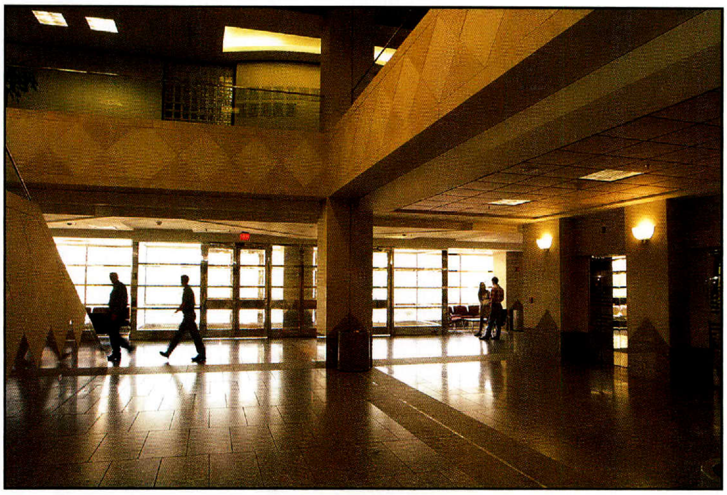
Functional obsolescence results from flaws within a property that limit its market appeal. Defects become apparent when the property is compared with other properties of the same type. Buildings that have been converted from one use to another frequently suffer from functional obsolescence.

Buildings that were state of the art when they were constructed frequently suffer obsolescence as new designs and technologies emerge. Buyers are unwilling to pay as much for older properties as they would for modern, fully equipped facilities.

Functional obsolescence can stem either from *deficiencies* or *superadequacies*. Lack of central air conditioning in an office building is an example of a functional deficiency. A large atrium in an office building is an example of a superadequacy, an expensive addition not present in more typical, cost-efficient properties. Superadequacies diminish property value by reducing market appeal, resulting in lower net income and a lower market value.

This particular superadequacy reduces value in two ways. First, a modern office building would not have the large atrium, which is unrentable square footage. The difference between the cost of constructing the building with the large atrium and that of building a modern replacement without a large atrium is an excess cost. When this excess cost is included in an appraisal, it adds to the property's valuation without producing any offsetting income.

Second, the superadequacy raises operating costs because the unrentable space in the atrium must be heated and cooled. A modern building with the same amount of rentable space and a standard entry would not require this expenditure. Maintenance of the unrentable space further reduces the cost-derived value estimate. Presumably, potential buyers would factor this into their offers.



OBSOLESCENCE CAN BE BEAUTIFUL, *as in this oversized lobby. But costs to maintain such nonincome-producing space are significant.*

Estimating Obsolescence

Both external and functional obsolescence reduce property net income. Documenting the negative effects of obsolescence helps property owners measure the dollar amount of value lost to obsolescence. Once the amount of net income loss suffered because of an obsolescent feature is determined, that figure can be used to quantify obsolescence for the local appraisal district.

For example, a poorly designed workspace that results in diminished productivity will result in deficient output. Property owners can demonstrate such inefficiency using a statistical analysis of typical industry income standards for that kind of business operation. By converting the difference between actual income and typical income into an estimate of income shortfall, the owner can quantify how much a poor design has reduced the value of the property.

Property tax deductions for obsolescence are subject to limitations. If a deficiency can be rectified by remodeling the property, the deduction for obsolescence cannot exceed the remodeling cost. For example, suppose a property contained an old-fashioned single-compartment sink instead of a double-compartment sink, which is now the standard. The owner could eliminate the deficiency by replacing the sink with a modern one. The cost of purchasing and installing that new sink is the figure used to measure obsolescence if that cost is less than the *capitalized income loss* (the present value of expected annual losses over the life of the investment). However, if the cost of correcting the deficiency exceeds the capitalized income loss, the deficiency is considered incurable, and the amount of capitalized income loss is the figure to present to the appraisal district as evidence of overvaluation.

If functional obsolescence is caused by the absence of a feature that is standard in comparable properties, measuring obsolescence becomes more complicated. In the sink example, an existing but deficient feature was replaced with its modern equivalent. If the feature had been missing entirely, adding it would represent an *improvement* to the existing property, not a remedy for obsolescence. Because current value is based on the existing property in its current configuration, the cost of adding a missing element cannot be used effectively to argue that a property has been valued incorrectly.

When a feature is added to a property to remedy obsolescence, the cost of installing it during construction of a similar new building is subtracted from the estimated cost of adding it to the existing building. That difference is a measure of obsolescence. For example, suppose a property is cooled with floor fans whereas the standard building has central air conditioning. Adding central air to this existing facility will cost more than building it into a new structure because ducts and wiring must be added to the existing structure.

In this case, obsolescence would be quantified as the cost of adding central air to the deficient building minus the cost of including central air in a comparable new building. If that figure is less than the capitalized income loss, the property owner could request that the property appraisal be reduced by that amount.

Once obsolescence is established, the tax savings realized in the first year should continue each year for as long as the problem exists. These tax reductions may represent substantial savings for property owners.

The examples used in this article are simplified but illustrate the complicated nature of estimating obsolescence. Although property owners may easily identify obsolescence, quantifying value loss can be both difficult and time consuming. However, given current property tax rates, the amounts at stake may be substantial. Owners may find it cost effective to engage property tax and valuation experts to assist in developing a convincing case.

For more complete information about estimating obsolescence, see *The Appraisal of Real Estate: Twelfth Edition* published by the Appraisal Institute.

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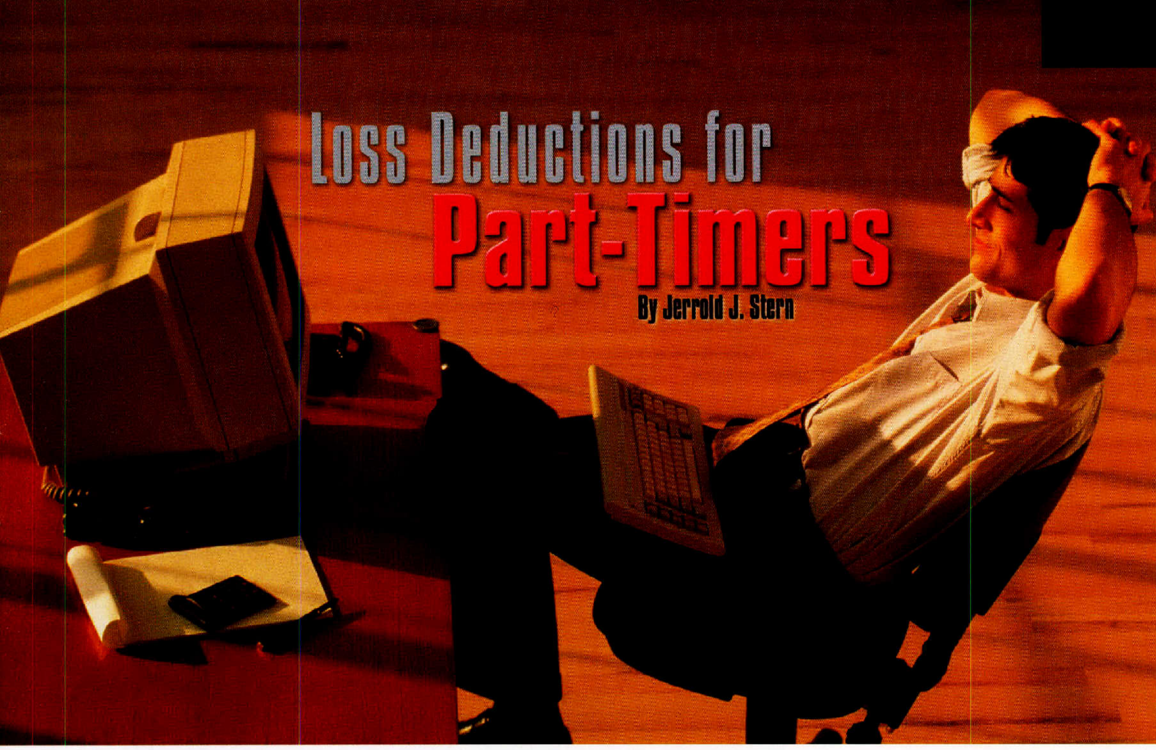

Since 1994, real estate brokers, sales associates and other real estate professionals have been able to deduct unlimited real estate activity losses from their other sources of income, such as self-employment, salaries, interest and dividends. However, a new U.S. Tax Court case demonstrates how part-time real estate professionals can lose deductions if key requirements are not met (*Jahina*, TC Summary Opinion 2002-150).

Under the general rules, individuals are eligible to deduct unlimited real estate losses if two conditions are met. More than half of all personal services they perform during the year must be for real property trades or businesses in which they materially participate. Real property trades and businesses include real estate brokerage, management, rental, operation, leasing, development, construction, reconstruction, acquisition or conversion. Material participation requirements are met if the taxpayer is involved in real estate operations on a regular, continuous and substantial basis. Limited partners typically do not materially participate because active involvement could cause them to lose their limited liability status.

Individuals also must perform more than 750 hours of service per year in those real estate activities. Married couples filing joint returns meet the eligibility requirements as long as at least one spouse meets both the material participation and 750-hour requirements.

An example based on the facts of the new court case helps illustrate real estate loss rules and computations for part-time real estate professionals.

Birgit Jahina's rental properties comprise five apartment buildings with a total of 109 units and three single-family condominiums. She has an undergraduate degree in English and an MBA. Prior to 1996, she had six years' experience working in the fields of financial accounting, auditing and banking. She does not have expertise in taxation.

During the two tax years in question, 1996 and 1997, she worked 18 months full time and six months part time in accounting and banking. Her husband, Karl, worked full time as a structural engineer and spent no time on work related to the rental properties or any other real estate activities.

Part-timers should keep detailed documentation of time spent on real estate activities.

In addition to working in her full-time and part-time jobs, Birgit was actively engaged in managing the rental properties. She often worked in the early morning hours, prior to her salaried employment, on her rental property financial statements, tenant correspondence and other paperwork related to the rental properties. In her own words, she monitored "every phase of the business."

Birgit stated that she devoted more than 1,800 hours annually (more than 35 hours per week) to the rental activities. While there were resident property managers at three of the properties, Birgit made all the decisions affecting the properties.

The Jahinas claimed they were entitled to deduct their real estate losses against their non-real estate income because Birgit was a real estate professional, and the rental properties made up a trade or business in which Birgit materially participated.

Two factors caused the Jahinas to lose the court case and the ability to deduct the real estate losses. First and foremost, the Jahinas did not file an election (a one-paragraph statement) with any of their tax returns to treat their rental properties as one rental activity rather than multiple ones. A tax professional would not have overlooked this technicality. Without the election, Birgit had to satisfy the 750-hour requirement for each rental property, and this was not possible.

Second, Birgit's documentation of her time spent on the rental units was not complete or precise. Birgit admitted in court that her summaries of time spent were overstated. She said the summaries were hurriedly prepared for the IRS audit based on her calendars, phone records, correspondence, bills and other records.

As a result of the court case, the Jahinas were not allowed to deduct real estate losses of \$128,168 for 1996 and \$95,553 for 1997. They were required to pay \$19,336 and \$26,084, respectively, for 1996 and 1997 taxes owed, plus interest.

Real estate investment activities typically have a variety of tax complexities. Consultation with a competent tax accountant or tax attorney is recommended.

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WHERE THE WILD THINGS ARE

WILDLIFE MANAGEMENT REAPS PROPERTY TAX SAVINGS

BY JUDON FAMBROUGH

It's a fact — today's rural land buyers are more likely to have hunting and fishing on their minds than cows or cotton. Recreation is the primary motive fueling the rural Texas land market.

Fortunately for recreationally motivated buyers, it is no longer necessary to demonstrate a legitimate farming or ranching practice to get a property tax break on rural land. If the land being purchased is classified as "open space" for appraisal purposes, converting it to wildlife management use can maintain that status and the favorable property tax treatment that goes with it.

What is Open Space Appraisal?

Rural landowners can receive substantial tax savings through either an agricultural use appraisal or an open space appraisal. Under agricultural use, the landowner must qualify based on his or her primary occupation and sources of income. For an open space appraisal, the land, not the landowner, must qualify based on its current and past usage. Rural land purchased by urban landowners is more apt to qualify for open space appraisal than agricultural use appraisal.

To qualify for open space appraisal, the land must have been devoted principally to agricultural use or the production of timber or forest products for five of the preceding seven years. The owner must file an application with the chief appraiser of the local appraisal district providing all necessary information before May 1.

Land uses that qualify for open space appraisal fall into five categories: planting and producing crops; raising or keeping livestock or exotic animals; devoting land to floriculture, viticulture and horticulture; producing or harvesting logs and posts for agricultural improvements; and **wildlife management** (Section 23.521, Texas Tax Code). The last category allows recreational landowners to qualify for open space appraisal without actively participating in farming and ranching.

According to the statute, wildlife management status requires the following.

- The land must qualify for open space appraisal when the application for wildlife management is filed.
- The land must be used primarily for the management of one or more indigenous wild animals (targeted or managed species), not farming or ranching.
- The targeted species must be used for human consumption, medicine or recreation.
- The land must be managed "to the degree of intensity typical for the area" and must properly sustain the targeted species.
- In some cases, tracts must be a minimum size if they were a part of a larger qualifying tract the previous year.

At the time the landowner applies for wildlife management status, at least three of the following seven management practices must be in use to sustain a breeding, migrating or wintering population of indigenous wild animals.

Habitat control (habitat management). Using the land to create or promote an environment beneficial to wildlife. This includes any beneficial manipulation of plants, ground cover or shelter for the managed species.

Erosion control. Employing practices that attempt to reduce or keep soil erosion to a minimum for the benefit of wildlife.

Predator control. Engaging in practices designed to manage predators. This is necessary only when the number of predators is harmful to the managed species.

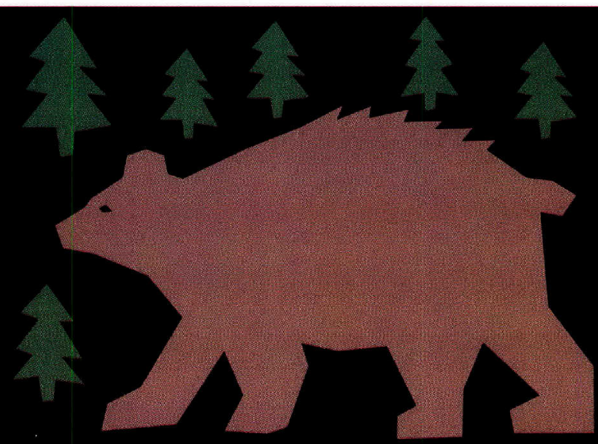
Providing supplemental water. Supplying water in addition to natural water sources.

Providing supplemental food. Supplying food or nutrition in addition to that produced by the land.

Providing shelter. Creating or maintaining vegetation or artificial structures that shelter the targeted species during nesting and breeding and protect them from the weather and predators.

Conducting census counts. Periodically taking surveys and inventories to determine the number, composition and other relevant information about the targeted wildlife population to see if the objectives of the management practices are being met.

Open space appraisal requires the land, not the landowner, to qualify based on current and past usage.



Managed species must be indigenous to the area and present in sufficient numbers to ensure successful breeding.

What Land Qualifies?

The Texas Parks and Wildlife Department (TPWD) and the Texas Comptroller of Public Accounts develop standards for determining when land qualifies for wildlife management. Comptroller Office guidelines clarify some statutory requirements. For example, the statute states that land must qualify for open space appraisal before the landowner applies for wildlife management status.

The guidelines, however, state that the land must qualify for open space appraisal **the year before** the application is filed. Landowners applying for wildlife management status in 2003 must have received open space appraisal status on that land in 2002. Only open space appraisal status qualifies, according to the guidelines — agricultural use does not.

The targeted species must be indigenous to Texas. The guidelines define indigenous animals as those originating in or naturally migrating through an area and capable of living there naturally. Animals such as hummingbirds or waterfowl that live in an area seasonally qualify. Fish, whether indigenous or not, do not. The species cannot be imported or introduced to an area by man. Exotics, feral hogs and emus are among those that do not qualify.

The mere presence of an indigenous species is not sufficient to qualify land for wildlife management status. There must be a sufficient number of animals, including an adequate breeding population, to ensure a viable group for several generations. Does this rule disqualify land managed for an indigenous species such as bobwhite quail, which are steadily declining in some areas, or black bear, which have practically vanished from Texas?

Beyrl Armstrong, a property tax consultant with Plateau Integrated Land & Wildlife Management, Inc., and a member of the committee that developed the standards for the TPWD, says that managing land for a declining population of northern bobwhite by eliminating predators, improving food sources and providing cover should qualify. This should be true even if the population decreases for reasons beyond the control of the land manager, such as a prolonged drought.

According to Armstrong, "If the habitat exists, there will be a place for the population to recover and sustain itself. However, if the population decline is due to inappropriate land management practices, then either the plan needs to be changed or a different species targeted."

The statute states the targeted indigenous species must be managed for human food, medicine or recreation. The guidelines provide that the first two (food and medicine) require active management, while the third (recreation) can be either active or passive. Bird watching, hiking, hunting, photography and other hobby-type activities qualify as recreation. The owner's mere enjoyment in owning and managing the land for wildlife fulfills the test.

The statute requires wildlife management to be the primary use of the property. Land devoted to wildlife management may be used for other purposes, but those uses must be subordinate to wildlife management. The chief appraiser gathers and considers all the relevant facts to determine the land's primary use.

Updated Guidelines

Updated guidelines issued in July 2002 offer additional standards to assist tax appraisers in determining when property qualifies for wildlife management status. Four qualifications were added. These include a written wildlife management plan, implementation of the plan, accomplishment of certain practices annually and dedication of a minimum percentage of the land to wildlife management in some cases.

A written wildlife management plan must be submitted to the chief appraiser on a TPWD-supplied form before May 1. Described activities and practices must be consistent with TPWD recommendations for the region where the property is located. The plan must describe:

- the ownership of the tract and its past and current uses,
- the targeted indigenous animal(s),
- the goals for the property and
- the wildlife and habitat management activities and practices that support the targeted species.

The wildlife management plan must be implemented at the time the application is submitted, and a minimum of three of the seven management practices described earlier must be carried out each year.

A minimum percentage of the acreage within a tract must be dedicated to wildlife management if the tract was part of a larger tract that qualified for either ag use, open space or wildlife management appraisal the prior year. The minimum percentages, which translate into minimum required acreages, vary depending on the location of the tract.

Statewide, the minimum sizes range from 12½ acres in East Texas to 100 acres in the Trans Pecos. The appraisal district board of directors for each county makes the determination of the exact acreage needed within the statutory guidelines.

Plan, Implement, Document

Landowners and chief appraisers alike are perplexed by the statute's requirement that land granted wildlife management status be managed "to the degree of intensity typical for the area." How can this be measured? Because wildlife management is relatively new, there is little data to measure compliance. For this reason, TPWD divided the state into ten ecological areas and developed wildlife management guidelines and practices for each. Landowners may access these regional planning recommendations and other pertinent documents at TPWD's website (www.tpwd.state.tx.us/conserve/private_lands/agricultural_land/).

Armstrong considers these regional guidelines indispensable in preparing a written plan. The guidelines help the landowner select management practices appropriate for the region and applicable to the targeted species.

According to Armstrong, the key factors in getting the application for wildlife management accepted are:

- carefully crafting a plan based on the regional guidelines;
- designating the required minimum number of acres for the area; and
- presenting the plan to the chief appraiser in a timely, orderly fashion.

Once the application is accepted, minimum levels of intensity for each practice outlined in the guidelines are necessary to maintain the land's wildlife management tax status. The appraisal district requires periodic inspections and reports to document compliance. Reports may include photographs, receipts, aerial pictures, surveys and other data evidencing compliance. Landowners should maintain good communications with the appraisal district and promptly supply all required information.

Tax Neutral Status

Because land must be appraised as open space before it can be converted to wildlife management use, neither landowners nor appraisal districts achieve any additional tax benefit from the conversion. In this respect, wildlife management status is tax neutral.

Those who benefit from a wildlife management classification are landowners who no longer want to use their land primarily for agriculture or new landowners who have no agricultural intentions or skills. Some ranchers, for example, have discovered they can make more money from deer leases than from cattle. These people are freed from the burden of engaging in farming or ranching for tax purposes only.

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(continued from page 1)
despite the gains in the tax base, and homeowners are receiving larger tax bills. Table 1 shows how property tax increases have affected housing costs.

Homeowners are paying more for hazard insurance coverage as well. Insurance companies collect premiums and invest the proceeds until they are needed to pay claims. Generally, a company does well if current claims are approximately equal to premium revenue; earnings come from investment income. But claims have been abnormally high from storms and the "toxic mold" scare. In addition to raising premiums, some companies have reduced risk by raising the criteria for offering new policies and renewing existing policies.

The dismal performance of the stock market in the past three years also has taken a toll on insurance companies' investment returns. Consequently, premiums need to more than offset claim payouts. That means premiums probably would have gone up even without increased claims.

Table 2. 2002 Estimated Rates for Insurance and Property Tax (Dollars per $100 of Property Value)

Area*	Insurance	Property Tax	Escrow Rate
Abilene	.9	2.02	2.92
Amarillo	.7	2.14	2.84
Arlington	.9	2.21	3.11
Austin	.5	1.95	2.45
Bay Area	1.0	2.06	3.06
Beaumont	.9	3.32	4.22
Brazoria	.9	1.90	2.80
Brownsville	.9	2.19	3.09
Bryan-College Station	.5	2.17	2.67
Collin County	.8	1.92	2.72
Corpus Christi	1.1	2.38	3.48
Dallas	1.0	2.13	3.13
Denton	.8	1.78	2.58
El Paso	.6	2.26	2.86
Fort Bend County	.8	2.00	2.80
Fort Worth	.9	2.00	2.90
Galveston	1.0	2.69	3.69
Garland	1.0	2.51	3.51
Harlingen	.9	2.49	3.39
Houston	.8	1.87	2.67
Irving	1.0	1.77	2.77
Killeen	.5	2.70	3.20
Longview	.7	1.90	2.60
Lubbock	1.0	2.05	3.05
Lufkin	.7	1.69	2.39
McAllen	.8	2.08	2.88
Montgomery County	.7	1.72	2.42
Nacogdoches	.7	1.47	2.17
Northeast Tarrant County	.9	2.04	2.94
Odessa-Midland	1.2	2.21	3.41
Palestine	.7	1.56	2.26
Paris	1.0	1.71	2.71
Port Arthur	.9	3.62	4.52
San Angelo	1.2	1.88	3.08
San Antonio	.7	2.47	3.17
Sherman-Denison	1.0	1.66	2.66
Temple	.5	2.20	2.70
Texarkana	1.0	3.21	4.21
Tyler	.7	1.54	2.24
Victoria	.8	1.96	2.76
Wichita Falls	1.11	2.06	3.17

*For definitions of areas, see *Texas Housing Affordability Index: 1989–2001*.
Source: Real Estate Center at Texas A&M University

Adjusting THAI for Escrow Costs

Previously, the THAI used national data on insurance and property taxes to estimate escrow costs. However, a localized benchmark is now used because Texas insurance premiums and property taxes tend to be higher than the national average.

Starting in 2002, THAI includes estimates of insurance premium and tax rates for each jurisdiction covered by the index (the state, most metropolitan areas, some nonmetropolitan cities and subdivisions of metropolitan areas). Insurance rates are based on Texas Department of Insurance guidelines reported by county. Although these rates do not apply to 95 percent of the policies written in the state, they are the only available local rates. They understate actual costs, but do reflect how the rates differ by locality.

Estimating property taxes is more difficult. The Texas Comptroller's Office reports the total appraised property value and tax revenue for each taxing jurisdiction in the state. Unfortunately, these include separate data for each school district, city and special district in the county. Value and revenue, therefore, are aggregated for these jurisdictions to match the boundaries of the area used for each THAI measure. The ratio of revenue to assessed value indicates the effective tax rate for the area. The rates for insurance and property taxes used to calculate 2002 THAI values are shown in Table 2.

Comparable data are not available for previous years. Therefore, an escrow rate was arbitrarily set at 2 percent for all areas prior to 1998. For years 1998 through 2001, rates were graduated evenly up to the 2002 rate as shown in Table 2. For all areas in all years, the monthly payment amount is estimated by multiplying the escrow rate by the median market price and adding that to the principal and interest payment.

Affordability in Near Future

The bottom line is that homes are not as affordable as they might seem from looking at prices and interest rates. Insurance and tax costs have risen enough to nullify much of the benefit of low interest rates. Of course, affordability would worsen if interest rates rise.

Of the four main influences on costs — home prices, interest rates, insurance premiums and property taxes — insurance premiums are the most likely to provide relief for buyers. As the mold scare abates and security markets produce more consistent returns, there should be less urgency for premium increases. In fact, premiums may decline a bit as consumers do more comparison shopping. Home prices could actually decline, or at least not rise as fast as inflation as markets appear to be correcting for the recent "sellers market."

Slower price increases could slow property tax increases, but lower tax rates are highly unlikely. The cost of funding education will continue to go up with few alternative sources of revenue. As more districts bump up against statutory limits on maintenance and operating tax rates, some may repeal the optional homestead exemption, thus increasing the effective tax rate.

Indications are that interest rates have bottomed. The Federal Reserve will begin raising rates when the economy shows signs of recovery. Investment money should begin flowing out of the bond market as the stock indexes rise. The Fed rate and the stock slump have kept interest rates low for some time, but they may well work in the opposite direction in the future.

Affordability will suffer somewhat in the next several years. However, THAI values remain in the affordable range for most localities and should not decline enough to cause a substantial drop in home sales.

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POSTCARDS FROM TEXAS PHOTO CONTEST

Howdy!

The Center's editorial staff is SO ready for a vacation. That's why we're excited about our Postcards from Texas photo contest. We figure it's the next best thing to being there.

So grab a camera, and take a good look around. Drive out to Granny's farm or visit a metropolitan paradise. Head for the beach or hike the mountain trails. Capture the state's big skies and vast expanses.

Relish the beauty of your own personal Texas, then share your "postcards" with us. We just know we'll wish we were there.

After we've gotten our fill of vicarious vacationing, we'll select 12 photos to feature in the Center's next annual report-calendar. The names of winning photographers will be published in the October 2003 issue of *Tierra Grande*. Ten copies of the annual report-calendar will be mailed, hot off the press, to each winner.

Rules

- Entries must be received at the Center (not just postmarked) by August 1, 2003
- All photos must be taken in Texas within the past two years
- No more than six photos per person may be entered
- Acceptable formats are color prints, slides and digital [3.2 megapixels or 2000 x 1600 ppi]
- Only horizontal color photos will be judged
- Only entries with signed entry forms will be considered
- Negatives must be sent with prints
- Only entries with self-addressed, stamped envelopes will be returned

to enter

- **Go to http://recenter.tamu.edu/pdf/photocontest.pdf or call 800.244.2144 for an entry form**
- **Attach a label to the back of each print with your name and a brief description of the photo, including location. Do not write on photos with ballpoint pens or hard lead pencils.**
- **Digital photos may be sent by e-mail to ebrewster@recenter.tamu.edu but entry forms must be mailed or faxed [979.845.0460].**
- **Mail prints, slides and disks to Real Estate Center, Texas A&M University, 2115 TAMU, College Station, TX 77843-2115. If shipping by courier, send photos to the Real Estate Center, 313 E.L. Wehner Building at the mailing address. Our telephone is 979.845.2031.**

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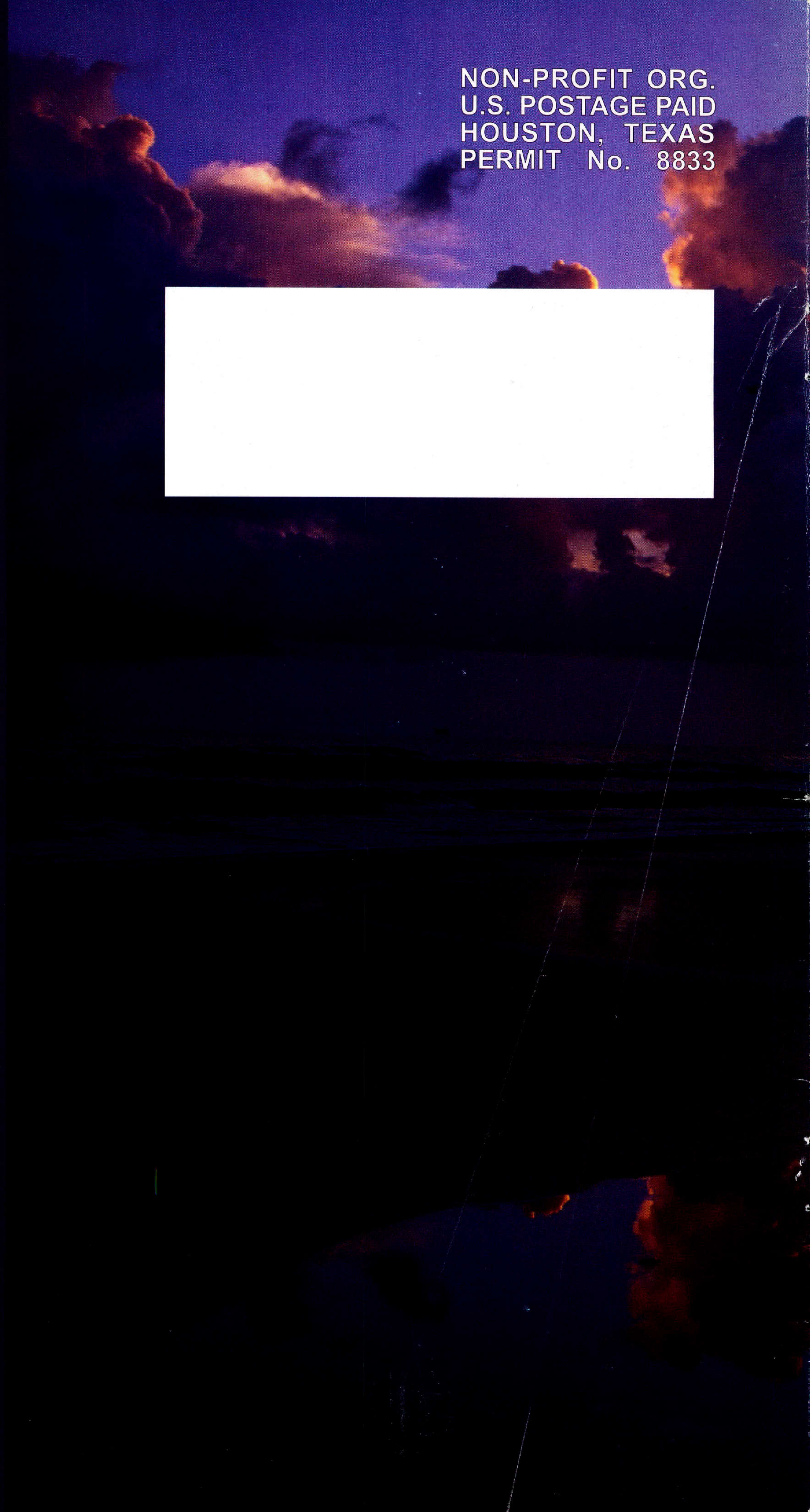

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