>> Education: Public-Private Partnerships
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Are educational public-private partnerships the newest untapped real estate market?

Potentially as much as $1 trillion of new opportunities exist

Though few people think of it this way, it's no secret that every state owns and operates a huge real estate enterprise in its public educational system. Curriculum initiatives, teacher salaries (ironically, real estate represents a significant portion of the country's largest teacher retirement programs), and scholarship programs get all the press, but none of these things can properly occur without buildings that are dry and warm and that have adequate space to accommodate an ever-burgeoning population of students. Why, then, is there comparatively little cooperation between federal, state, and local governments and the private real estate sector, especially in the educational arena, which is at once cash-strapped and politically vital? Shouldn't there be more opportunities to marry the public good with the profit motive? If corporations can leverage their real estate assets to free up capital , then ought not school systems—and, for that matter, government entities in general—be doing the same? Is owning and managing real estate really the best use of capital for school systems? These kinds of questions provide the backdrop for some noteworthy activities in niches of today's real estate universe.

Tradition vs. Need

In recent years, tax-exempt bonds have been the primary vehicle through which the "brick-and-mortar" portion of the nation's educational infrastructure has been funded. This arrangement has many advantages, not the least of which is the low cost of capital for state and local governments. Since the public is generally amenable to educational spending, bond referendums routinely garner taxpayer approval, and new facilities are built.

But in many instances, this traditional approach is not sufficient to meet pressing needs. Sometimes school systems simply do not have the borrowing capacity to issue the level of debt necessary to build a new school or bring an old one up to modern-day standards. In other cases, even if a bond could be issued, tax revenue would be insufficient to cover both the bond payments and the day-to-day operations of the district.

This is the predicament that faced the Washington, DC school district in the late 1990s. In a case study highlighted by the National Council for Public-Private Partnerships (http://ncppp.org), the James F. Oyster Bilingual Elementary School was able to put together a development deal in which a private company built a luxury apartment complex on a parcel of the school's previously unused land. At the same time, an entirely new school building was constructed. The owner of the apartment complex agreed to pay the bond payments on the school in return for the land and instead of paying local taxes. Rather than being saddled with debt, the school system is enjoying a modern elementary school built at no marginal cost.

Mechanisms for Partnerships

The neighboring state of Virginia is among the pioneers in creating an environment for these kinds of partnerships. In 2002, the state legislature passed the Public-Private Education Facilities and Infrastructure Act, or PPEA. In effect, this measure allows elected school boards to accept solicited and unsolicited bids from private construction and development companies to build school buildings and other education-related facilities. If the school board can put together a qualified deal, then it can move forward without additional voter approval or oversight from the legislature.

This legislation is not without its pitfalls, however. For the most part, school board officials are fairly inexperienced at evaluating construction proposals and complex terms of financing agreements. Since deals under the PPEA typically involve decades-long relationships, there's a real possibility that some developers may not be around to fulfill their end of the bargain. This alone is enough to scare a lot of school systems. "Twenty years is an eternity for a developer. When it comes to education, you can make the same mistakes 10,000 times with no problem, but God help you if you make a new one!" says Rick Ott, Sr. Executive Vice President of MB Kahn Construction Company.

Still, there is vast potential in the PPEA as well. As head of MB Kahn's construction management division, Ott has overseen a variety of these projects, which can be funded through tax-exempt bonds issued by the school district or through traditional private capital sources, with schools paying lease payments out of operating funds. "In five years, either all or none of these kinds of projects will be done this way. This is an extremely powerful piece of legislation. It has allowed us to cut through a lot of the normal regulations and red tape."

Monetizing Public Real Estate

The Oyster Bilingual School and the PPEA are fascinating examples that illustrate the possibilities for public-private partnerships in the world of education. But they also underscore the fact that such partnerships are still very rare. Is there really an opportunity to do this on a large scale?

Greg Eden, of newly founded Eden Polk & Company, thinks so. His firm is focused on attracting private investment into public higher-education real estate. The ultimate goal is to establish a REIT to acquire a wide variety of college campus real estate, from classroom and administration buildings to student health and athletic facilities. These assets would then be leased back to the colleges who use them. "Our thinking is, why not monetize a football stadium?" says Eden.

Monetizing assets is nothing new. In commercial real estate, this has been going on for years. Corporations often want to free up capital for investment. One way to do that is to liquidate real estate assets that may have very little book value anyway. A very similar concept has exploded onto the consumer market in recent years in the form of home equity loans and other mortgage re-financing products. Need to pay off high-interest debt? Buy a car? Take a trip? Just use the value of your real estate (your home) to fund it.

Eden believes there are some big incentives for colleges and universities in particular to explore monetizing. Enrollment is as high as ever, with the bulk of the "Echo Boom" generation just about to enter the college years. At the same time, campuses are becoming dilapidated, especially along the East Coast, where many state university buildings are 30, 40, even 100 years old. In many cases, just the deferred maintenance on these buildings is an unbearable expense, let alone the prospect of renovations to make the buildings effective for educating the modern student. Eden cites one prominent public university where the cost of deferred maintenance is estimated to be nearly half the replacement value of the entire campus! And yet, with state legislatures still feeling the pain of budget shortfalls, these buildings sit still, especially since issuing bonds for maintenance expense is not a politically palatable notion.

If there are attractions to monetizing public real estate assets, then there are also barriers. One of the biggest is that in certain states there are constitutional restrictions that prohibit the transfer of title of state-owned buildings. At the K-12 level, many local ordinances do the same. There are creative ways around provisions like this, but actually implementing them can be a challenge when dealing with educational and governmental entities. This stems from the fact that the decision makers often come either from academic or public finance backgrounds and have limited exposure to the ins and outs of private sector real estate. "There needs to be a lot of educating of these officials, who just aren't used to doing this sort of thing," says Eden, echoing Ott's point. Navigating through the web of state constitutions and lobbying legislative officials is a big part of scaling up any kind of public-private real estate partnership idea.

Sourcing Deal Flow

Even assuming that the unique hurdles of putting together deals with public entities can be cleared, there's still a big unanswered question: Is there really a critical mass of capital to provide the catalyst for large-scale private ownership of public real estate? To this point, the answer has been no. But people like Eden think that is changing. "In the last six months, three student housing REITs have gone public," he points out. "The public sector is all about word of mouth. There's some reluctance, but there's no reason why bookstores, food services facilities, utility plants, and other buildings on college campuses shouldn't make good investments."

There's certainly no shortage of opportunity. Eden relates that by some estimates, the total campus replacement value at the nation's approximately 3,600 institutions of higher learning is somewhere around $300 billion. Not all of this belongs to public entities, of course, but adding in the value of K-12 campuses, which serve nearly ten times as many students, and the value of education real estate could exceed $1 *trillion*.

The prospect of receiving stable lease payments from government entities, who are extremely unlikely to default, would appear to be alluring to at least some investors. In Virginia, relates Ott, entities from developers to banks to private individuals own schools, but on an *ad hoc* basis. Coordinated institutional capital is another animal altogether. Still, with cap rates on core deals continuing to be historically low, perhaps the public sector, with all its intricacies, could become an alternative avenue for investment managers with cash to place.

Obviously, ideas like the PPEA and a college campus REIT are at the cutting edge of public-private real estate partnerships. "This is all still emerging," admits Eden. "The single biggest issue for us is sourcing deal flow." If initiatives like these are successful, they could open the floodgates to much more activity on this front. On the other hand, they could also end up being test cases for business school students that illustrate why it won't work. For real estate investors, the situation is intriguing and merits careful observation—even if, for right now, that means looking on from the sidelines.

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