

WORKING CAPITAL

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INTRODUCTION

WHAT IS “WORKING CAPITAL”?

Working capital is a financial term which refers to the funds businesses use to cover their short-term day-to-day expenses. A company's amount of working capital is generally calculated as current assets minus current liabilities. However, this investigation covers a broader range of issues related to money, finance and capital markets. We realize that even the terms used thus far can be alienating and intimidating to many readers, so we will define them first. Additional terms not defined in the text will be addressed in the glossary of this book.

Assets: anything of value owned by a company or individual (includes money and things).

Capital: any liquid (exchangeable) medium or mechanism that represents wealth.

Current: short term; disposable or payable within one year.

Debts: money owed to someone else; loans, liabilities.

Finance: the resources and activities associated with providing funds for capital.

Funds: financial resources and assets in the form of money.

Liabilities: anything owed to someone else; debts, loans.

Liquid: having an adequate amount of cash or assets that can be quickly converted to cash.

Markets: systems which facilitate the exchange of goods and services; i.e. exchanges, etc.

Money: a token commonly used to store and exchange value; usually created by government.

Securities: paper or electronic assets representing a claim on something of value.

Our discussion makes frequent reference to “financial products” or “financial instruments,” both of which describe methods of managing, organizing and exchanging (or trading) assets, capital and liabilities. Some have been in use for a long time, while others are quite new. These financial products, which will be defined later, include: Bonds; CMBS (Commercial Mortgage Backed Securities); Equity; Hedge Funds; Interest Rate Swap; Non Recourse Loan; Property Derivatives; REITs; and Securitisation.

OVERVIEW

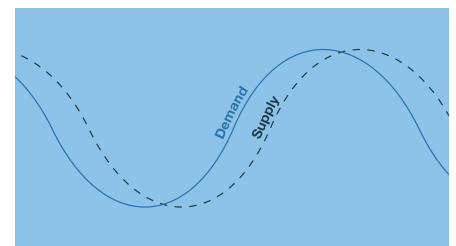
SPECULATIVE COMMERCIAL PROPERTY DEVELOPMENT

Since World War II there have been five reconfigurations of the UK speculative commercial property development, including two major boom/bust cycles. With each iteration, the actors involved adjusted their processes and relationships, attempting to reduce exposure to risk while securing access to capital flows necessary for continued development (Isaac, 2003. pp. 7-11). Over the same period, the final built product has responded to technological developments, government policies, the changing nature of work, aesthetic and design trends, financing structures, and more. The purpose of this chapter is to explain the role of capital, finance, financial markets, and financial instruments in the production of speculative office space. Our primary thesis is that utilization of recent innovative financial products will allow developers to manage assets and capital flows more effectively, reducing their exposure to risk and allowing them to bridge downturns in the real estate cycle with greater resiliency. Eventually, this could lead to greater stability in the industry, mitigating the effects of traditional demand and supply cycles and allowing for a steadier stream of production. Changes of this nature would allow more proactive and strategic business planning for the provision of office space, rather than the present mode of crisis-oriented reactive decision-making and rush to build associated with boom/bust cycles.

Critics have argued that rather than promoting stability, the new financial products induce greater market volatility. While it is true that the securities markets may be more volatile in terms of frequent rapid fluctuations, the evidence of the past three global financial crises indicates a decreasing likelihood that a crisis in one region will spread to others (Sassen, 2003). In fact, micro-volatility is viewed as necessary and beneficial in terms of maintaining macro-stability, as some new financial products (hedge funds) benefit from small, frequent market movements. Automatic controls also contribute to overall stability, though financial systems are still vulnerable to human error.

Our research has raised several questions that remain unanswered. These concern the relationship between the spaces – both public (exterior) and private (interior) – created by the speculative office development process; the economic, environmental and social sustainability of such development; and the role of innovative new financial instruments in creating a global property market. In some procedural respects, today's speculative property development bears resemblance to that undertaken 200 years ago by the likes of John Nash. The most significant differences are the number of direct and indirect actors, and the massive scale of development, whether considered locally or globally. In our analysis of the financial processes involved in production of speculative office space, we have observed an analogous dynamic to the dissociation described by social scientists referring to industrial capitalism. Many levels of intermediation separate actors, both from other similar actors and those in different roles: developers, architects, contractors, agents, tenants, workers, visitors, neighbours, and owners. Securitisation and property derivatives, in particular, allow for "liquification" of real estate assets, which can now be easily traded in financial markets. This means that a single building can have multiple unrelated (fragmentary) owners with no connection to place at any scale – from block to continent. Conversely, property derivatives are now being discussed which could concentrate on very narrow geographic areas and thereby reassert the importance of place. In either case, investor interest is purely in asset performance and financial returns. This phenomenon can subject securitised and similarly liquefied properties to both tenant and (possibly conflicting) investor demands.

One final note with respect to Bankside 123: Land Securities is a traditional and conservative developer. Their strategy is to build, operate and hold their properties for long periods of time. The innovative financial products we describe do not play as big a role in Land Securities' strategy as they do for British Land or Hammerson (their domestic competitors), or for developers in North America, Australia, and parts of Asia. However, REITs are being introduced in the UK effective in 2007 and we expect these will play an increasing role in the UK market. Additionally, since London is a global financial centre, Land Securities is operating in the context of a global property market. The unprecedented liquidity and mobility of capital means that global cities must remain competitive with other locations around the world, and this competitiveness extends to the office space on offer. Land Securities are therefore affected by these new financial products even though they do not make use of them.



The production of office space usually lags behind economic cycles.

MONEY AND FINANCIAL MARKETS

THE NATURE OF MONEY IN GENERAL

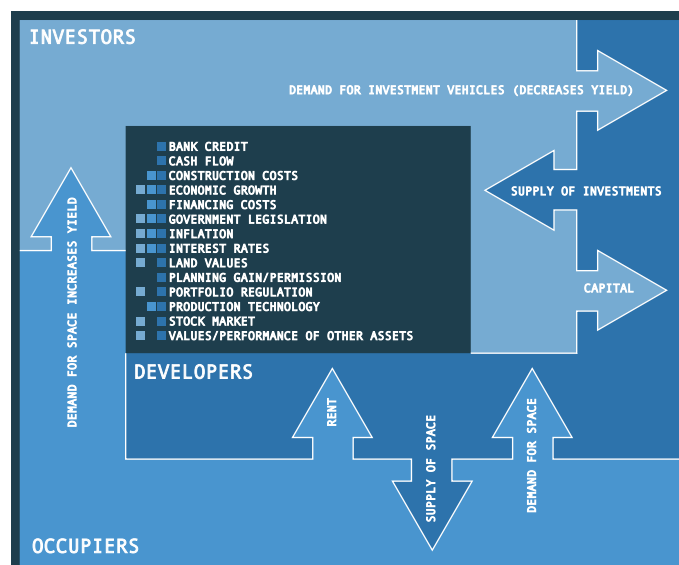
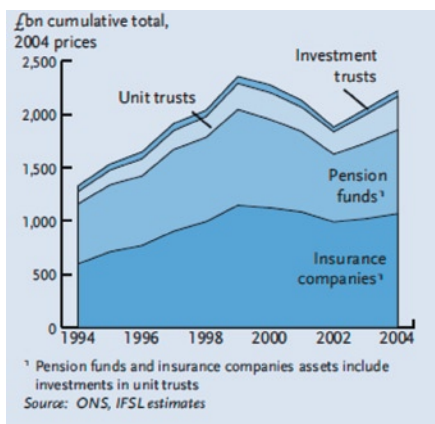
Money is any set of assets used to buy goods and services: a medium of exchange offering buyers and sellers a mutually recognized means of payment. Money is also a store of value: it can be reliably saved, stored and predictably used once retrieved.

Money usage has two aspects: on the one hand, those with surplus seek ways to increase its value; on the other hand are those looking to fund various projects. Banks and similar institutions have been the traditional intermediaries, able to meet the demands of both sides. A party seeking money, not having an adequate supply to meet their needs (borrower), must pay a provider (lender) for its temporary use. This cost is called interest and reflects the risk that the borrower might not pay back the lender (default), plus a rate that the lender expects to obtain by making money available in the borrowers' marketplace. Money is provided at different rates for different projects and borrowers. The difference in rates (therefore the amount of money available) is a reflection of the lender's sensitivity to, and appetite for, risk.

The biggest money lenders are banks which receive deposits from individuals. Banks can be borrowers when they seek to raise additional money to lend to their clients. The availability of money to commercial banks is controlled by a state's central bank. If rates are high, there is less demand since not many parties want to incur high costs. Likewise low rates increase demand.

Another way for companies to raise money is to sell partial rights over their assets to investors in the form of certificates (stocks, equities or shares). The share owner (or shareholder) can sell their shares through a designated stock exchange where those shares are registered, or they can sell them to a third party at an agreed price. Sometimes a company also chooses to buy back shares from investors. Although companies don't need to pay interest to shareholders, they do disburse a portion of their profits in the form of dividends.

Owners of money who have more than they require can either safely conserve their surplus or put it to work earning more money. The former can be achieved by depositing funds in a bank and the latter by investing in financial instruments such as shares. Investing money with the expectation of high profits can be rewarding but risky, and investors generally wish to minimize their risks. Investors' desires to maximize gains — through a tolerable exposure to risk — while at the same time minimizing losses resulting from such exposure has catalysed the development of a variety of risk-distributing financial products.



THE CAPITAL MARKETS: INDIVIDUALS & INSTITUTIONS

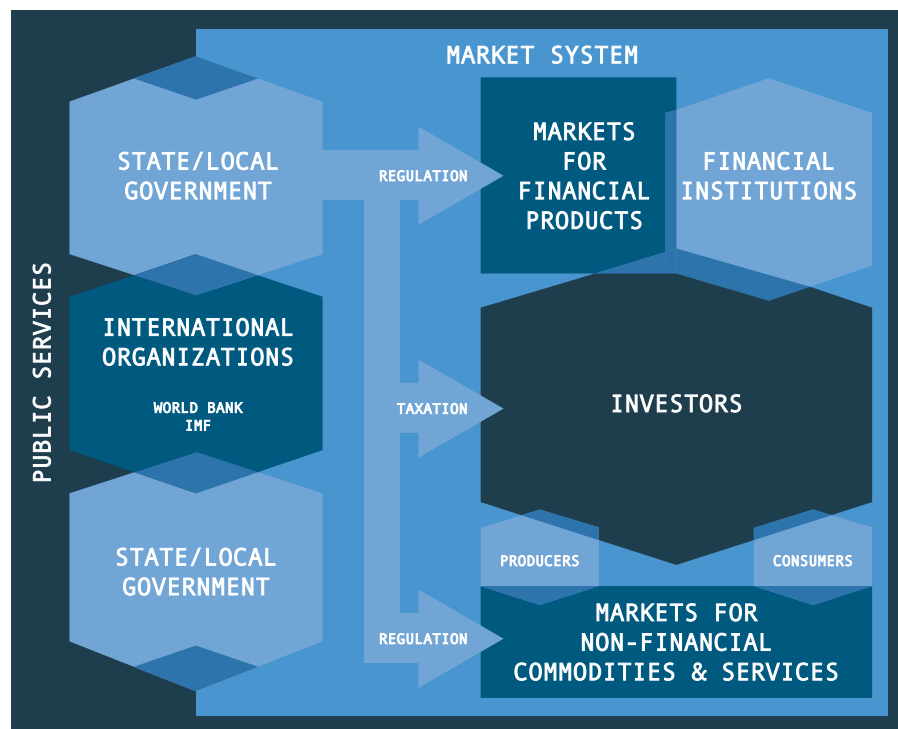
Capital markets are “places” (sometimes existing in purely electronic form) where actors wanting to profit by lending money and actors wishing to borrow at a reasonable cost come together. Because companies seeking to raise money in the markets must publicly disclose their business operations in order to gain investor confidence, the easiest way to raise money is still to borrow from banks. However, banks generally provide relatively small loans compared with the huge sums made available by investors through the capital markets. Historically, capital markets have experienced continued growth. This growth has recently been lead by inflows of investment from pension funds, hedge funds, private equity, etc., all of which have varying appetites for risk.

Although the markets aren’t necessarily embodied physically, and although their operation is far too complex to be directed by conscious intervention, it can be interesting to consider “the markets” as an actor in our scenario. In a broad sense, the capital markets have the “objectives” of high yield and acceptable risk opportunities, and of improving the investment atmosphere. They have traditionally been constrained by government intervention, although globalisation is making this increasingly difficult. They are also somewhat constrained by their very nature, which is inherently cyclical and prone to fluctuation. As already stated, it is unlikely that the markets could consciously employ any strategies. Instead, we can say that they are reactive and difficult to control.

MONEY AND THE DEVELOPER

To assemble the substantial funds required to build large-scale speculative office projects, developers must combine borrowed money (construction loans) with their own money (working capital). Construction loans, which are short-term and generally provided by banks, incur interest and must be paid back upon completion of each project. However, during the long construction phase, large development projects do not generate any income for the developer. While in this phase, developers would benefit from having access to money free of the short-term constraints associated with bank loans. This is why developers turn to the capital markets and employ various financial products and instruments to raise money.

THE MARKET ENVIRONMENT



Actors and dynamics of the market environment.

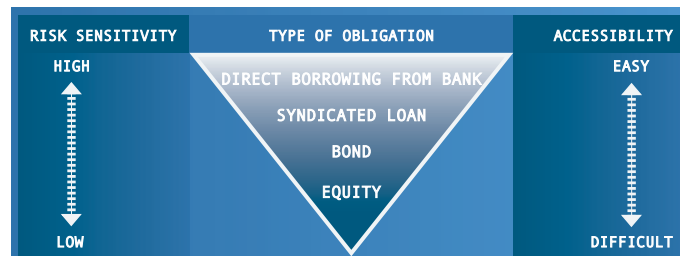
RISK

WHAT IS RISK?

Risk is a part of everyday life. All human activities involve some degree of risk, whether seen as the possibility of incurring damage in a particular context or just the notion that there may be other choices we could have made that might have produced more desirable outcomes than the choices we actually made. People make decisions about taking or avoiding risks when they do just about anything; avoiding risk usually means giving up the outcome of a particular activity, whereas people may choose to engage in that activity if the risk is acceptable to them. This is the idea behind the aphorism "nothing ventured, nothing gained." However, even when accepting exposure to risk, there are several strategies to reduce the likelihood and/or severity of damage. There will usually be someone willing to take any given risk if the reward is sufficient.

Developments in statistics and finance have enabled the creation of new products that provide monetary compensation for costs incurred due to risk-related damage, thus allowing more people to manage more types of risk. Bankruptcy, however, may still be unavoidable in certain cases because of the complex multiple independent and interdependent internal and external factors involved. Few people would therefore want to undertake risk under such circumstances. Nevertheless, the concepts of finance have increasingly been applied to risk management in areas that have historically posed threats of insolvency. Derivatives are one such application now being used in areas from financing to various phenomena of daily life (such as weather, etc.). Ever greater numbers of people and institutions are broadening their exposure to risk in a quest for higher monetary compensation. They use derivatives to mitigate, rather than simply accept, the impact of risks. Since the advent of financial derivatives, risks can now be allocated in exchange for monetary compensation.

RISK SENSITIVENESS OF OBLIGATIONS



Different types of debt have different sensitivities to risk, which determines how easily accessible they are.

RISKS AND MITIGATIONS

RISK	NATURE	MITIGATION STRATEGY
Business	Economic environment in sites. Recession	Diversification of segment and tenants. Maintaining Financial Strength.
Interest	Interest hike / cut by BOE. Property crisis.	Use of financial products (i.e. Interest Swap, Bond Issue). Refinancing.
Legislative	Negative impact of new legislation (i.e. Restriction for upward only rent).	Lobbying.
Financial	Fail to obtain adequate income to cover debt service.	Constant review of portfolio Asset & Liability management.
Liquidity	Difficulty in asset disposal.	Use of innovative financial products (i.e. Property Derivatives & CMBS). Strategic decision? (like sale of Bankside 1 to IPC).
Inflation	Dilution in rent value. Failure to meet required yield.	Contractual agreement.

There are six risks faced by developers, each with one or more mitigation strategies.

THE DEVELOPER'S SIX RISKS AND MITIGATIONS

There are six main types of risk that have to be negotiated when engaging in speculative office development: business, interest, legislative, financial, liquidity, and inflation. The developer uses a variety of strategies to mitigate these risks.

Business risk refers to the economic environment in the locations of development – recession, for example. The developer must first and foremost maintain financial strength in order to bridge any periods of low demand. It would also be prudent to diversify development both geographically and by sector (i.e. office, retail, public sector, etc.). Geographic and sector diversification will also lead to diversity of tenants, which are less likely to be equally impacted by economic conditions. Choosing the right types of tenant could also mitigate risk: if the tenants are government agencies, public institutions, blue chip companies, etc., they are more likely to remain stable over long periods of time. In the case of Land Securities, another important element of their diversification strategy is property outsourcing, which includes management and maintenance.

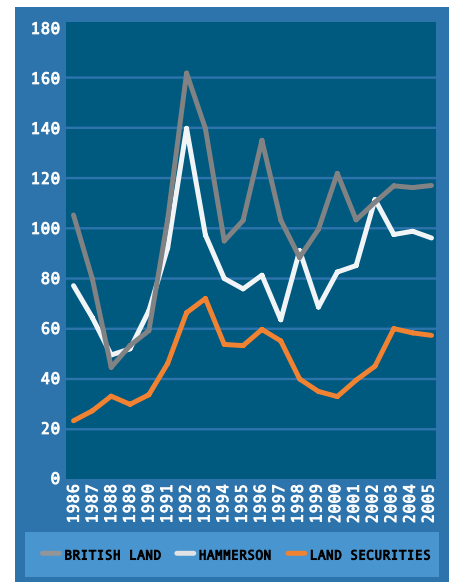
Interest risk is the chance that the cost of short-term access to borrowed money will change, with lower interest rates being somewhat less problematic than higher ones. The Bank of England might raise or lower interest rates in response to overall economic conditions, and banks might tighten their money supply by raising interest rates in response to a property crisis. The developer's traditional response to lower interest rates is refinancing. To make loan payments more predictable, developers use interest swap transactions to exchange variable-interest rates for fixed rates. To secure more reliable funds that are less sensitive to interest fluctuations, developers issue bonds. Land securities has pursued a strategy of massive capital accumulation. This somewhat obviates their requirement to borrow money, as was the case with the development of Bankside 123 (of course, they didn't have to purchase the land, so the initial capital requirements were considerably lower than for more conventional developments).

Legislative risk is basically the possibility that the government – from local authorities to national states – might enact laws which place constraints on some aspect of the developer's current operations. In the UK market, for example, this might be a restriction of upward-only rent reviews. The developer's response to this possibility is to lobby legislators. Land Securities is one of the largest 30 companies listed on the FTSE. They are important players in the national economy and have cultivated a reputation as a high-quality developer interested in long-term value and regeneration.

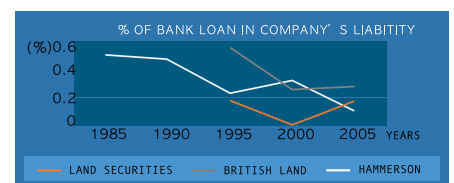
Financial risk is the chance that the developer will fail to obtain adequate income to cover their debt service, perhaps because they haven't found tenants for a building. The developer constantly reviews their portfolio, making sure they are offering the products their customers really want (or their agents are willing to sell). They also employ asset and liability management (ALM) techniques to exercise more control over their capital flows. In the case of Bankside 1, Land Securities faced little financial risk, having pre-let and subsequently sold to IPC, a subsidiary of Time Warner. This will certainly increase the attractiveness of Bankside 2&3 to future tenants.

Liquidity risk is the difficulty in disposing of an asset (i.e. selling a building). The easiest way to mitigate this risk is through a strategic decision, such as Land Securities' sale of Bankside One to IPC/Time Inc. Other mitigations of liquidity risk involve the use of innovative financial products like property derivatives and securitisation (CMBS), liquifying property and making it easier to own and exchange. Land Securities has yet to engage in one of these types of transactions. However, Hammerson and British Land, their largest domestic rivals, do so regularly. The securitisation of Broadgate Estates by British land is the subject of a case study in this chapter.

The last risk is inflation, which can dilute the value of rental income and result in the developer's failure to meet their required yield. This risk can be mitigated through lease clauses which stipulate that rents can be periodically adjusted for inflation.



Equity/Debt ratio for three UK property developers over the past two decades.



Bank loans as a percentage of total liabilities for 3 UK property developers.

FINANCIAL PRODUCTS

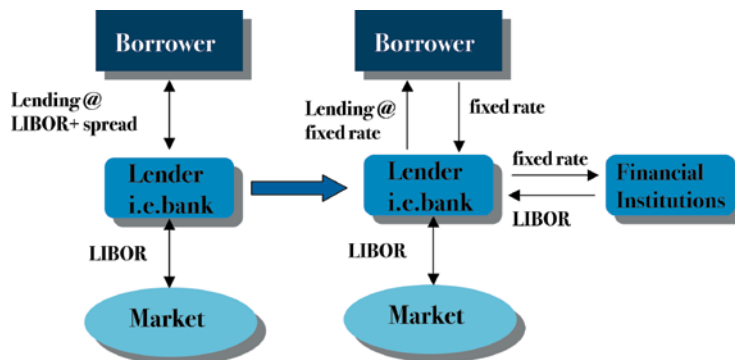
For most companies, raising funds is one of the most important operations for their day to day business. Except for a few companies, most don't have enough cash to run their operations and therefore need to rely on external financial resources such as bank borrowing. Lowering financing costs has been a crucial issue in terms of securing sustainable profitability. External borrowing presents a high degree of risk, as the cost of this type of financing is not always stable: unpredictable rises in the cost of financing may significantly impact companies' financial conditions.

Sources of finance have traditionally been limited to banks or similar intermediary institutions that profit by receiving deposits and then providing loans to their clients. When companies require large amounts of money not easily sourced from commercial banks, they turn directly to the capital markets to raise funds. In recent years, accessibility to capital markets has been eased by developments in financial technologies and diversification in funding providers. Today's companies have more diversified funding sources than those of the past.

This diversification in funding sources, however, has made companies sensitive to market fluctuations and somehow financially fragile. A greater degree of risk is now embedded in corporate finance. Companies therefore desired to minimize their exposure to risk, and in collaboration with financial institutions, have developed and implemented new risk management products. The principle of the most innovative products is to transfer risk to those desiring some exposure at reasonable cost and with the potential for higher than average returns.

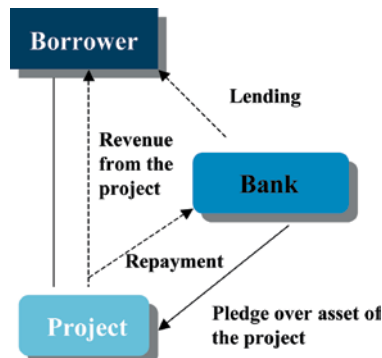
INTEREST RATE SWAP

Interest rate swaps are a form of financial derivative. Normally, bank loans are provided at floating rates. A generic type of this transaction involves the borrower exchanging (swapping) their floating rate for a fixed rate to better manage cash flow and to avoid higher payments resulting from rate hikes. Higher interest can be imposed by banks in response to deterioration of a company's financial condition or a poor general economic environment.



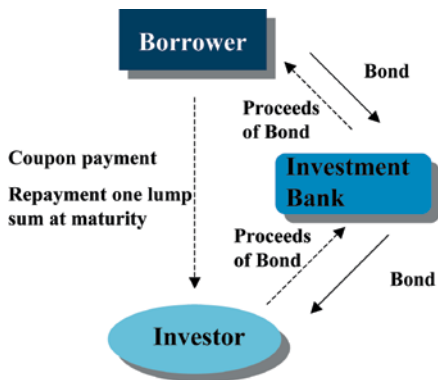
NON RECOURSE LOAN

A type of loan structured such that the lender is only entitled to repayment from profits generated by the specific project funded by that particular loan. This type of loan does not entitle the lender to any claim over the borrower's other assets.



BOND

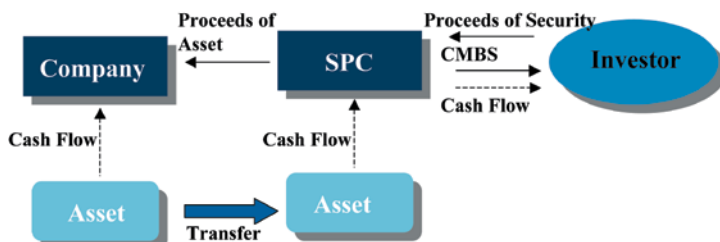
A bond is a fixed-interest debt instrument issued by an institution seeking to raise a relatively large amount of money for a certain period at fixed cost. Bonds pay their holders a fixed amount over a specified interval (month, year, etc.) until a maturity date, when the face value can be redeemed from the issuer.



COMMERCIAL MORTGAGE BACKED SECURITIES (CMBS)

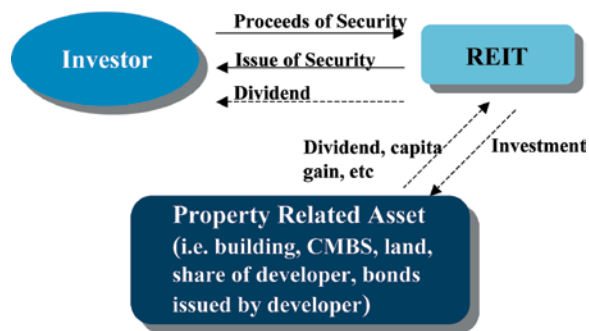
AKA SECURITISATION

A CMBS is an investment instrument that represents ownership of an interest (i.e. shares) in a mortgage or group of aggregated mortgages. These securities are issued by a type of company (usually a paper company) which is generally established solely to conduct this kind of transaction and is backed by the value of its owned assets (i.e. buildings). The rental income from tenants is payable to the holders of CMBS.



REAL ESTATE INVESTMENT TRUST (REIT)

A REIT is a corporation or trust that uses the pooled capital of many investors to purchase and manage income property and/or mortgage loans or any other types of products related to property. REITs are tradable on major exchanges just like stocks. They are granted special tax considerations, which makes them more attractive to some investors. REITs offer several benefits over actually owning properties. First, REIT shares are highly liquid, unlike traditional real estate. Second, REITs enable partial ownership of non-residential properties, such as hotels, malls, and other commercial or industrial properties. This allows more investors to participate in these property markets. REITs pay yields in the form of dividends.



FINANCIAL PRODUCTS / FUNDING METHODS

PRODUCTS \ PROVIDER	CAPITAL MARKETS		
	OTC INSTITUTIONAL	INSTITUTIONAL	INDIVIDUAL
Non Recourse Loan	✓	—	—
Bond	—	✓	✓
Equity	✓	✓	✓
CMBS	✓	✓	✓
REIT	—	✓	✓
Property Derivatives	✓	✓	—

CONTEXT

GOVERNMENT, DEVELOPERS, FINANCIERS, MARKETS

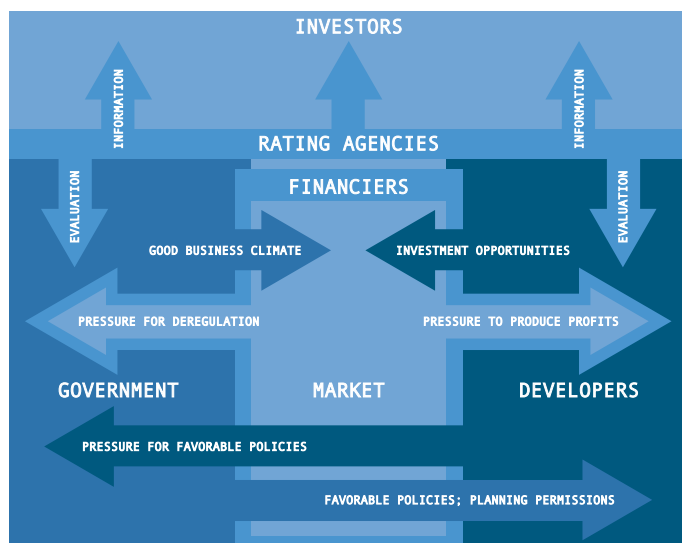
Of relevance to the capital markets, there are two main and two secondary actors involved in the fundamental processes of speculative office development. The main actors are the government and developers, and the secondary actors are financiers and rating agencies.

The government wants: ("sustainable") economic growth; a good business, social and natural environment; equitable (re)distribution of wealth and justice; and infrastructure investment. The government is constrained by: global competition, pressure for deregulation; trade group pressure; budget constraints; urban problems; and rating agencies, which can affect the cost and availability of money. To overcome constraints and achieve objectives, the government uses: public relations; political pressure on other governmental bodies (i.e. regional, national, etc.); incentives; policy; regulations and legislation; and infrastructure deployment.

Developers want: profit and income; investor confidence and community credibility; favourable legislation and policies; growth opportunities; and ego gratification. In their way are: government intervention, taxation, poor public opinion, requirement for corporate responsibility, market pressures, low demand, labour markets, and competitors. To overcome these obstacles they: use creative financing and public relations; maintain good relationships with influential actors; and negotiate skilfully with governments.

Financiers intermediate between markets and parties raising capital (governments, developers, etc.). They seek riches, as well as protection from and favourable treatment by governments. Market value is of less interest than micro-volatility and macro-stability so long as transactions are being made. Constraints are: government intervention, market regulation, taxation, and public opinion (exalted by some, demonised by others). Highly creative and innovative in achieving their goals, they are the inventors and producers of the new financial products and instruments discussed in this chapter. They use public relations, close relationships with influential actors, and pressure on governments, businesses, etc. to support their activities.

Rating agencies are the most neutral yet influential of all the actors. Their interest is in maintaining a good reputation by supplying accurate, objective, and reliable information about local and national governments, banks, companies, sectors, and anything else impacting investment decisions. Ratings changes can have a significant impact on the developer's cost of money and therefore access to capital, liquidity and solvency.



Actors and dynamics of speculative economic growth and development

A HYPOTHESIS

Developers have improved their resiliency in the face of unexpected property demand cycle fluctuations by implementing asset and liability management (ALM) strategies. Chief among these strategies has been the diversification of funding sources. The traditional methods for achieving this diversification have involved an appropriate combination of short term loans, long term funds raised by bond issuance, and equity finance. Recent product innovations in the finance industry have added to developers' funding diversification repertoire, and now include property derivatives and securitisation (CMBS).

The deployment of new financial instruments which allow ALM to be more finely controlled has not only increased developers' resiliency, but has also returned greater shareholder value. This has enhanced development companies' attractiveness to investors, resulting in increased capital flows to the property development market.

This new capital represents a diversification of risk, because it is partially brought in through CMBS and REITs — both vehicles for greater numbers of smaller investors. Eventually, the diversification of risk could result in greater stability both in the markets and in the production of speculative office space.

DEVELOPMENT CASE STUDIES: TRADITIONAL AND EMERGING MODELS

THE UK PROPERTY MARKET

In order to establish a basis for our research, it was necessary to understand the characteristics of the British commercial property market. In the UK, the institutional category lease is generally between 15 and 25 years, normally accompanied by a rent appraisal – usually upward-only – every five years. Lease lengths in the UK are considerably longer than those on the European continent. Rents are based on the open market value, which has generally tended to increase over time. This denotes a secure investment climate in the UK with significant added value in London's property market.

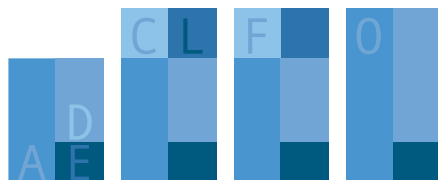
LONDON'S WORLD COMPETITIVENESS; KEY FACTORS CONTRIBUTING TO THE HIGH DEMAND FOR OFFICE SPACE

Its political stability, good air transport facilities and advanced telecommunication, as well as its unique position in the world's time zones allowing it to do business with the Far East and North America on the same day with easy access to their major financial centres, has greatly advantaged London's establishment as a world financial centre. London has also leveraged its good reputation, its worldwide legacy of contacts achieved through political and commonwealth links maintained in the post-war era, and the common use of the English language in banking and finance, to encourage large numbers of global foreign banks, security houses and insurance companies to establish operations within its borders. More recently, the 1979 removal of exchange controls and the 1986 Stock Exchange deregulation encouraged London-based financiers to seek business opportunities in overseas markets and also created favourable conditions for foreign capital to be invested in the UK. As the London market becomes more favourable to foreign capital investment, producer service firms, global headquarters and foreign subsidiaries are all competing for limited space, creating a demand which will result in further investment in office development.

SUCCESSFUL TRADITIONAL MODEL: BANKSIDE 123

Across industries, there has been a myth that expanding the size of a company's balance sheet by increasing assets and liabilities is evidence of growth. For the property development industry, it seemed especially plausible since under good economic conditions, the more buildings the developer builds, the more rental income is expected. Even though belief in this myth has led some developers to insolvency during periods of recession, their failures tended to be blamed on poor management or bad luck, and the myth remained intact.

Today's "shareholder's economy" has emphasized efficient capital utilization as a key principle for successful business operation, as it is a surer indicator of a company's fiscal health. Profitability measured by several key ratios is regarded as far more important to investors than earnings alone. Developers whose business growth is still attached to asset growth must be more strategic – acquiring sites in competitive locations at reasonable costs and then building attractive office facilities – in order to meet investor expectations under tighter constraints.



The developer's simplified balance sheet is made up of assets (A), debt (D) and equities (E). To begin construction (C), the developer takes out a loan (L), thereby increasing the size of the balance sheet – and the business. When the building is finished (F), the developer finds an occupant (O) and the building becomes yet another of the developer's assets.



Bankside 1, the Blue Fin Building developed by Land Securities and sold to IPC (a division of Time, Inc.).

UNSUCCESSFUL TRADITIONAL MODEL: CANARY WHARF 1987-1992

Due to the real estate market's cyclical nature, office developers have always faced the risk of suffering critical financial losses, which in the worst cases lead to bankruptcy. This has happened when low demand has forced developers to compete for lettings, leading to reduced rental prices. The speculative developer takes the risk of building office space without pre-letting, which means that in ill-fated cases, he could wind up producing empty



The Canada Place tower at Canary Wharf. This project was a catalyst for the failure of Olympia & York, the most aggressive property developer of its day.

office space with no tenants. The developer would not be able to collect any rent and would therefore have difficulty servicing his bank debt. Prolonged vacancies will eventually lead the developer into bankruptcy, with lenders taking over the insolvent company's property to liquidate it ASAP in an effort to recoup some of their money. During economic downturns, companies relying on access to short term credit would feel the strain as banks tightened the money supply by raising interest rates. Although today Canary Wharf is renowned as a successful world class business centre, our research is concerned with the period between 1987 and 1992, when its Canadian developer Olympia and York went bankrupt.

THE INITIATIVE

The UK's firmly established business district, the City of London, containing many historic buildings with obsolete floor plans, limited space and high maintenance costs, has been the only option for many leading global financial institutions settling in London. Consequently, the emergence of advanced office layout – large open-plan trading floors with higher floor to ceiling heights, raised floors to accommodate extra cabling to support the latest technology, and large units that could house operations under one roof – was indispensable to keep up with the modern complex functions of many firms and to maintain the city's standing as a world financial centre. The City's inability to meet the demand for modern space was due to limited opportunities for redevelopment given UK planning laws regarding historic buildings, as well as the multiplicity of site ownership. In the 1980s, an optimistic climate for the financial and business service sector, attributable to the financial deregulation undertaken by the Thatcher government, was established in London. The vision for new office development did not come from developers, but from potential tenants seeking enhanced office space in London. Initially, an American banker and the chairman of Morgan Stanley foresaw the potential of the Canary Wharf site and joined with G.Ware Travelstead, a Texas-based developer in proposing a one million sq.m. Office complex in 1982. That scheme was withdrawn due to its deficiency in funding. In 1987 the Canadian developers Olympia & York, owned by the Reichmann brothers, took over the scheme. From the beginning, Canary Wharf was envisioned as a competitive class-A office development which would deliver excellent attributes and good value.

THE SITE ASPECT/CANARY WHARF IN THE 1980S

Until the late 1960s, The London Docklands had been a thriving district for trade and shipping. However, rapid decline began with the introduction of containerization, with most shipping activity moving to new container ports such as Tilbury's. Located within London Docklands under jurisdiction of the London Docklands Development Corporation (LDDC), created by the local Government Planning and Land Act 1980, there were neither structural planning principles nor any kind of public scrutiny of the development process. The Isle of Dogs became an Enterprise Zone offering tax allowances. Hence, the site became favoured for investment as the government offered tax allowances, attractive subsidies and incentives to both private investors and private developers in order to revive the domestic economy. The Canary Wharf site was subject to less restrictive building regulations and lower land prices than those in the City of London. As a result, developers rushed to construct buildings within the Isle of Dogs district in order to benefit from its financial and planning incentives before they expired.

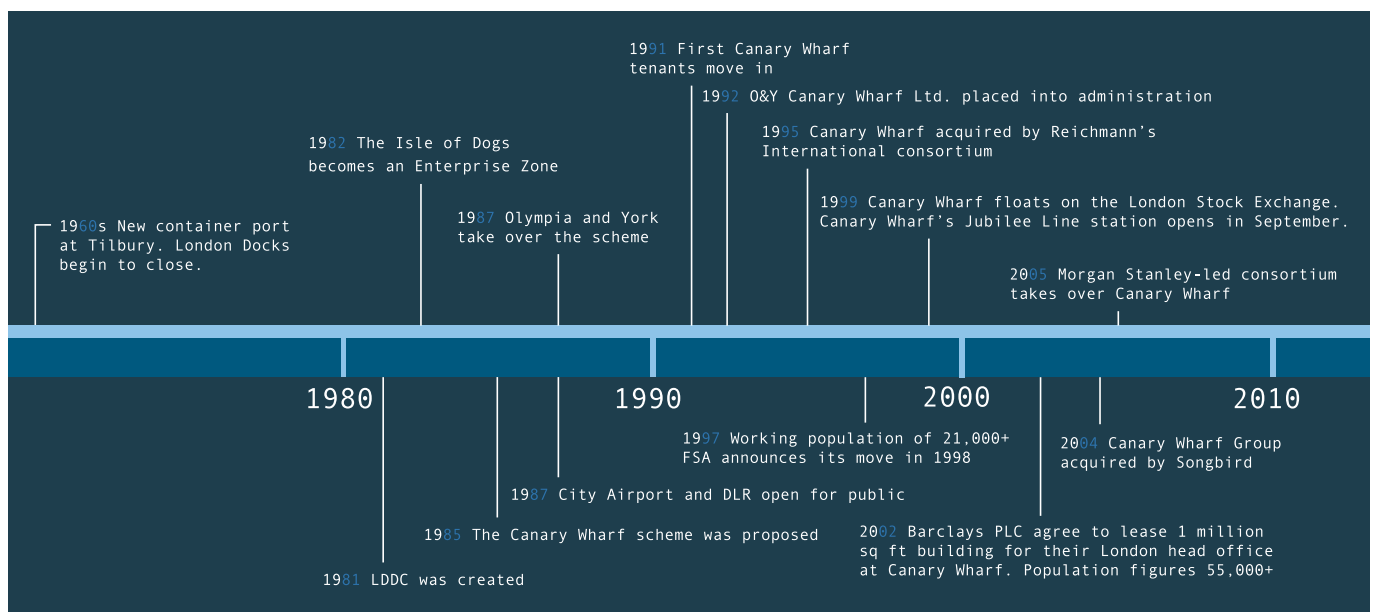
POLITICAL CLIMATE

The Conservative politician Margaret Thatcher became prime minister of the UK in 1979 and began introducing free-market policies into Britain. With high unemployment in inner cities and overall recession, the Thatcher government enacted policies of economic deregulation and privatization of state-run industries. In 1981 the Conservative Government formed the London Docklands Development Corporation (LDDC) to revive the then failing economy of the Dockland district. In 1982, the Isle of Dogs was declared an Enterprise Zone which offered tax allowances for investors and developers for a ten year period. In March 1998, the LDDC closed its bureau and handed over its job to the London Boroughs of Newham, Southwark and Tower Hamlets.

THE DEVELOPER

Olympia and York Developments (O&Y), once the most prestigious international property development firms, was a private Toronto-based company owned by the Reichmann family. O&Y established its reputation as a major international property developer during the 1980s through the success of First Canadian Place in Toronto and the World Financial Centre in New York City. The company took a gamble on Canary Wharf, the world's largest office development at 83 acres (336,000 sq. m.), in the late 1980s. In 1992, Olympia & York Canary Wharf Ltd. went into administration.

PROJECT TIMELINE



CAUSES OF FAILURE

Since real estate is a long term business, developers are often vulnerable to risk during the course of their development. As a classical case, Olympia and York failed because they did not reach their predicted market demand. As a closely (and privately) held enigmatic developer, they were over-confident in their performance due to their scale and large extent of financial independence. Olympia & York's projected development was to be constructed in phases over a period of ten years, where half of the financing would be provided by the developer and the other half would be accumulated from bank loans. The first phase of the construction which included the Canada Square was to be crucial for the developer, since its successful leasing would guarantee the ability to raise further financing for the subsequent phases. The company had indeed considered the possibility of a few minor property recessions during the ten year development period. Nevertheless, Britain's worst recession since the 1930s, the accompanying slump in London's office market from 1989 to 1994, and the further complicating factor of Black Monday's dramatic fall in equity prices in October of 1987, did not encourage any potential clients to move their firms from the City.

The unenthusiastic market response to Canary Wharf was further exacerbated by the lack of commitment from the UK Conservative government which had initially offered assurance of their support in funding the infrastructure. At the start, the government had considered moving the Department of Environment headquarters to the Canary Wharf estate, which would have been a major vote of confidence for the site. Furthermore, transport connections were not in place due to O&Y's delay of their \$69 million Jubilee Line extension payment. The government also withdrew financial support for the once-promised infrastructure when they realized O&Y would be incapable of covering its share of obligations.

In 1991, the first phase was completed and the first tenants moved in. However, confidence in future development was affected by the poor outcome in their first phase lease, leading investors to be more cautious in funding future phases. Meanwhile the City, acting in competition with Canary Wharf, had already loosened its building restrictions on office space, spurring a significant increase in office developments within the City district. Subsequently, as Britain entered a recession and British firms were unwilling to relocate from the traditional financial centre, the office space at Canary Wharf remained largely empty. Consequently, Olympia and York had to confront large vacancy rate and greatly decreased their rental price. The surplus supply of offices in the market occurred in the context of macroeconomic recession during the early 1990s, taking the property market into further decline. Despite the collapse in property value caused by oversupply, Olympia & York continued to invest in Canary Wharf with great exposure to risk.

The Reichmann family invested \$500 million of its family money in order to achieve liquidity, but their endeavour to rescue Canary Wharf from bankruptcy failed, as eleven banks with approximately £550 million in loans to the project refused to extend their loans, leaving the company with massive debt. Furthermore, the collapse in property value caused by the real estate downturn lead to a situation in which Olympia & York's liabilities exceeded their company assets. O&Y had actually attempted to diversify its business during the mid to late 1980s. It took over Abitibi-Price, the world's largest paper & newsprint producer, by purchasing 82% of its shares, and also acquired Gulf Canada, a large oil and Gas Company, with a 75% stake. In both investments they faced 1991 losses of \$64.52 and \$53.55 million respectively. As O&Y's major shareholder, the Reichmann family sacrificed huge assets which declined from \$6.89 billion in January 1991 to \$4.68 billion in May 1992, a 32% loss over 17 months. In March 1992, Paul Reichmann had to leave his position, and subsequently in May the company announced its bankruptcy, owing over 20 billion dollars.



The developer's simplified balance sheet is made up of assets (A), debt (D) and equities (E). To begin construction (C), the developer takes out a loan (L), thereby increasing the size of the balance sheet. When the building is finished (F), the developer fails to find an occupant and the building remains empty (E). If the developer receives no rent for a long enough period of time, they will have to service their debt by liquefying some of their assets. This would result in a diminishing value of equities, and ultimately in insolvency if the interest on bank loans couldn't be paid on time.



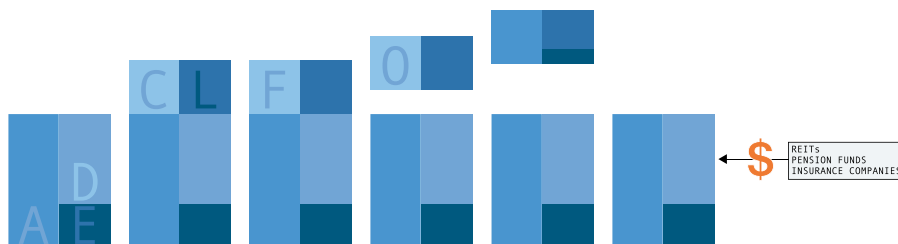
First Exchange House (Bishopsgate Project, Broadgate) London, England 1989

SUCCESSFUL EMERGING MODEL: BROADGATE

The eleven buildings making up the four Broadgate Estates were subjects of the first major UK securitisation transaction of office buildings in 1999. Learning from past failures in the UK commercial property market, British developers have become more resilient by managing the amount of debt they employ in their business. They still require much capital due to growth in the scale of development, yet the nature of the traditional demand and supply cycle remains unpredictable. Thanks to advances in finance technology, developers are now able to control their debt through the use of financial products — such as derivatives, to mitigate interest fluctuation risk — that can have significant impact depending on companies' amounts of debt. Developers have also strategically adjusted the proportion of bank loans (short and long term) and funds raised by debt instruments so that they can better navigate unexpected market turbulence.

British Land is one company that actively adopted finance technology to mitigate risk while remaining more leveraged than its competitors. As one of the UK's major developers, with annual turnover of £619.9 million (FY2005), the company has focused on development through acquisition of strategic sites and provision of attractive commercial facilities, office buildings, and retail spaces in major UK cities. From the early 1990s the company gradually acquired assets above and around Liverpool Street station in the City of London, including the ex Broadgate Station that was closed in 1986. Development on the 12 hectare site, called Broadgate, started under Thatcher in 1984 and was one of the major projects completed during that era in 1991. The developer was a collaboration between Rosehaugh and Stanhope, and British Land, first involved as part of a funding consortium for 1 Finsbury Avenue, a part of the site. British Land gradually purchased the assets in the site through a period which saw the bankruptcy of Rosehaugh and Stanhope, and completed the purchase of final portion of the site in 2003. According to the latest financials, the value of Broadgate Estates is £2.974 billion equivalent to 20% of the company's portfolio (FY2005). 11 buildings in the site have been occupied mainly by major financial institutions such as Lehman Brothers, UBS, Royal Bank of Scotland, etc.

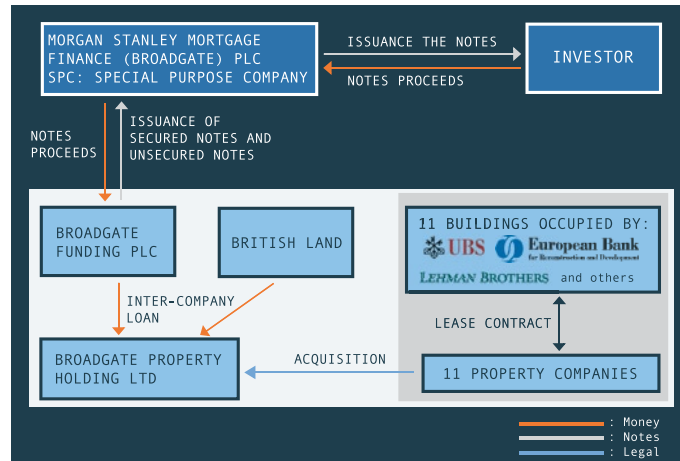
Even after the disastrous property market crash leading to Olympia and York's bankruptcy in 1992, developers' modus operandi for office development remained the same and therefore the risk they carried remained unchanged. In addition, as pension funds increased investment in the overall capital markets, their concerns with efficient capital utilization and high dividends placed heightened emphasis on asset quality. As we have noted in our case study for traditional property development, it has been conventional wisdom that an expansion in the size of a company's balance sheet achieved by acquiring sites and constructing buildings would be the only way for that company to sustain its business, even though this strategy would simultaneously escalate risk of insolvency in the event that demand in the market was stagnant. Securitisation, a finance innovation developed in the U.S. in the late 1960s, presented a solution to this contradictory situation by enabling developers to pursue continuous business expansion while maintaining good asset quality.



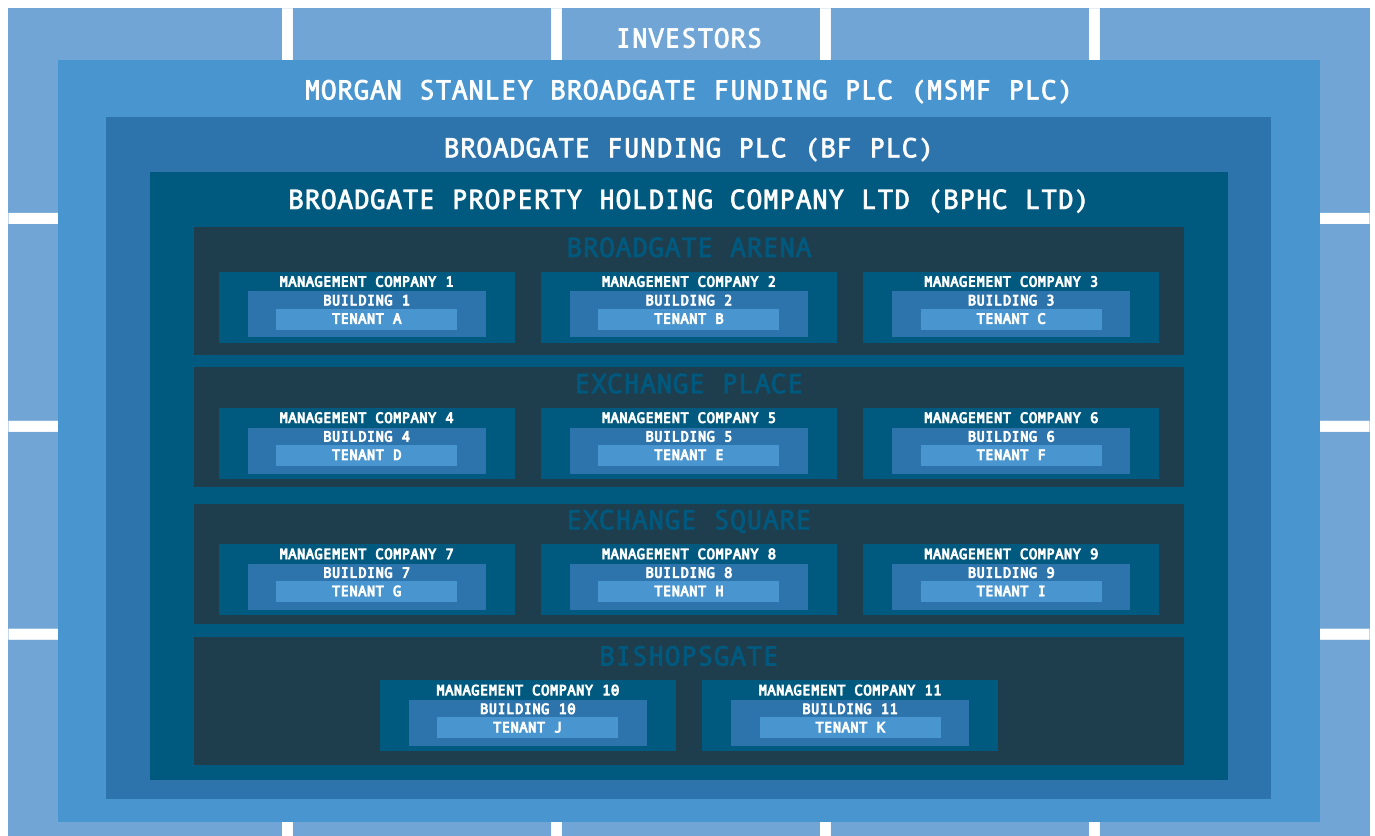
The developer's simplified balance sheet is made up of assets, debt and equities (A, D & E). To begin construction (C), the developer takes out a loan (L), thereby increasing the size of the balance sheet. When the building is finished (F), the developer finds an occupant (O) for the building. The building (i.e. asset) is removed from the balance sheet through the process of securitization. The result is two legally separate companies.

In a securitisation, the income-generating asset is separated from the initiating company's balance sheet to avoid affecting the company's solvency. The asset is then acquired by a paper company established by the initiating company solely for that asset-specific transaction. The function of the paper company is to issue securities (CMBS) to be purchased by investors. The value of the securities is backed by the value of the asset and the investors receive income generated by that asset (rent). The proceeds received by the paper company from investors are then paid to the initiating (parent) company, which was the former owner of the asset. Through entering this transaction, with some unique features of UK property market custom, the company can achieve two improvements in terms of finance: reducing cost of finance and obtaining extraordinarily long term finance. The former directly improves the profitability of the company while the latter will satisfy the company's long term financial needs with stable money. Usually the cost of raising funds is relative to the length of the period that the funds are employed; the longer the period that the company requires to borrow, the greater the cost that they need to pay. The cost is also affected by the financial condition of the company as we have mentioned earlier. In securitisation, the cost of money raised by the paper company is based on the quality of the transferred asset. This means the paper company's securities are likely to receive a higher rating than those of the parent company, which allows the paper company to pay cheaper interest. Thus, the parent company can achieve lower cost and longer term financing, which is contradictory to traditional common-sense in finance.

TRANSACTION DIAGRAM



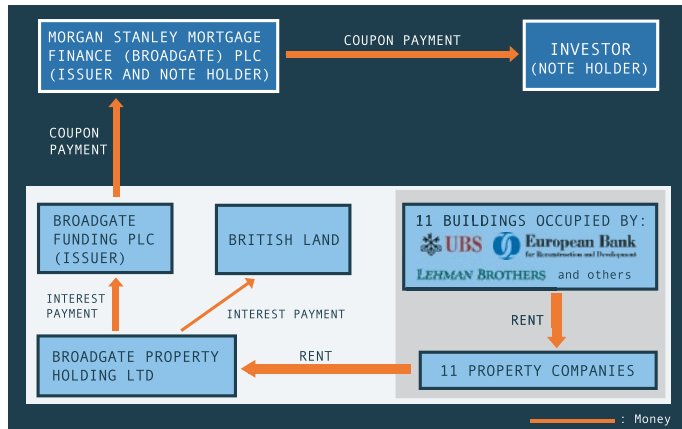
ORGANIGRAM OF BROADGATE SECURITISATION



British Land's securitisation of Broadgate was conducted as follows:

1. Ownership of the 11 companies, each holding one of the 11 respective buildings in Broadgate is transferred by British Land to a single newly created paper company: Broadgate Property Holding Company Ltd ("BPHC").
2. Broadgate Financing PLC ("BF PLC"), another paper company which is also established for this transaction, issues seven kinds of securities differentiated by the degree of risk and maturity date of each security, which together determine the coupon rate (equal to interest payable to borrowings). Each note is rated by a rating agency (i.e. Standard & Poor's) which reflects on the quality of the asset and length of period until the maturity date of the security.
3. Morgan Stanley Broadgate Finance PLC ("MSBF PLC"), another paper company created by Morgan Stanley, the arranger of this transaction, undertook all the securities issued by BF PLC and issued securities-backed notes to investors. The proceeds of the sale of the notes were paid to BF PLC.
4. BF PLC provides a loan, which is funded by the proceeds paid by MSBF PLC, to BPHC. Semi-annually, BPHC needs to pay BF PLC the interest which is essentially the rent paid by the tenants of 11 buildings. Upon receipt of the interest, BF PLC uses it for their payment of interest to MSBF PLC. MSBF PLC then pay the coupon to the holder of the note. In this structure, the rent paid by the tenants is the source of the coupon.

CASH FLOW DIAGRAM



DETAILS OF ISSUED NOTE

Class	Rating	Amount (unit: million)	Maturity	Interest
A1	AAA	325.00	April 2024	3 month LIBOR + 55bps
A2	AAA	310.00	April 2031	5.927%
A3	AAA	150.00	April 2029	5.912%
B	AA	225.00	October 2031	6.287%
C1	A	175.00	April 2014	3 month LIBOR + 130bps
C2	A	175.00	April 2033	6.651%
D	NR	180.00	N/A	N/A

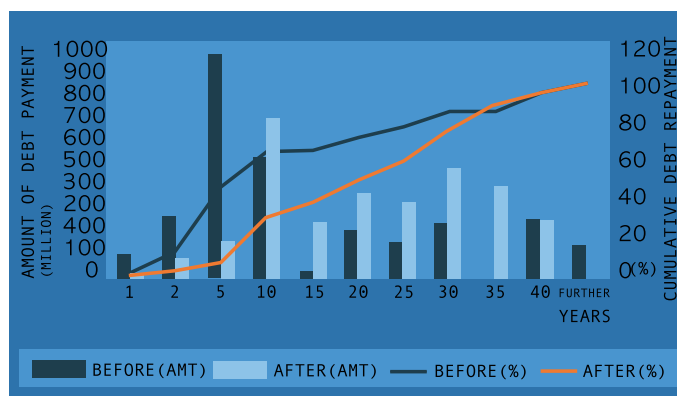
In this transaction, British Land has realized two major accomplishments: reduction in average finance cost by 14% to 7.3% from 8.4%; and extension of the average life of existing debt from 19.8 years to 23 years.

TRANSACTION ACHIEVEMENTS

SECURED DEBT	BEFORE	+/-	AFTER
BOND		97.3	97.3
	246.4	0.0	246.4
	197.0	0.0	197.0
	12.6	0.0	12.6
	20.4	0.0	20.4
	109.1	0.0	109.1
SUBTOTAL	585.5	97.1	682.6
UNSECURED DEBT			
BOND		73.0	73.0
	218.9		218.9
	145.9		145.9
	301.5		301.5
	316.1		316.1
	170.2		170.2
	175.1		175.1
	150.0	0.0	150.0
	147.6	0.0	147.6
	1.7	0.0	1.7
	97.8	0.0	97.8
	3.5	0.0	3.5
BANK LOAN	1,379.9	-1,230.0	149.9
	1,780.5	-1,379.9	400.6
CONVERTIBLE BOND		0.0	
	315.9	0.0	315.9
	146.5	0.0	146.5
SUBTOTAL	462.4	0.0	462.4
		0.0	
TOTAL	2,828.4	-1,282.8	1,545.6

The developer's simplified balance sheet is made up of assets, liabilities and equities (A, L & E). To begin construction (C), the developer takes out a loan (L), thereby increasing the size of the balance sheet. When the building is finished (F), the developer may fail to find a tenant, leaving the building vacant (V). The developer's resilience in enduring the period of vacancy is enhanced by new funding sources and finance technologies which enable more effective ALM.

TRANSACTION ECONOMICS



After entering the transaction, British Land repaid their existing debt with the funds obtained from this transaction and they achieved the above-mentioned accomplishments. The reduction of the finance cost was made possible by the fact more than half of the securities obtained higher ratings than those given to British Land's own bonds. The higher rating was given due to 1) quality of tenants in the buildings: internationally renowned financial institutions, legal firms, international organizations, etc, even though it is possible that any one of them might become insolvent (meaning that there is always some degree of risk) and 2) the legal remoteness of the two paper companies from the initiating company, meaning that payment made by BHLC to BF PLC, and then from BF PLC to MSBF PLC will not be affected by any insolvency experienced by British Land. The longer maturity dates of the securities are allowed by long lease contracts between the owners and the tenants. Furthermore, the asset's quality is enhanced by its premier office location in London, as it can be predicted that the owner will easily find new a tenant when any existing tenant terminates their contract. For these reasons it is foreseeable that the asset will generate income over next three decades.

UNSUCCESSFUL EMERGING MODEL: HYPOTHETICAL (& UBIQUITOUS)

From the developer's perspective, owning a vacant building is almost equivalent to losing money since huge expenditures must be made for site acquisition and construction over the years it takes to complete a project. In addition, the developer had to commence office development in expectation of meeting demand inevitably influenced by unpredictable economic trends. In most cases, bankruptcy would result from a developer's inaccurate prediction of demand in combination with a weakened financial condition partly resulting from past expenditures for the development project. Therefore, finding good tenants for a building is still a critical issue for developers.

Innovations in finance sometimes challenge the orthodoxy of common-sense business practices in a particular industry. The property derivative represents one such challenge as it allows the developer to receive income without having a tenant in their building. The mechanism is to transfer the risk of vacancy — which also includes the possibility of receiving rent once the building captures a tenant — to those who willing to take such risks. Yet the first Property Derivative just introduced last year was a tailor-made transaction and hence remains illiquid because a market for this type of instrument has yet to be formed. However, an increase of investors seeking property income through derivatives rather than purchasing property directly may encourage the formation of a property derivatives market and may provide a solution for developers who are facing difficulties in attracting tenants.



CONCLUSION

Speculative office development in London has been continuously fuelled by the Corporation of London and the Greater London Authority in their drive to maintain London's leading position among World City league table. The major UK developers have engaged in speculative office development in this context.

Traditional demand and supply cycles driven by unpredictable economic trends still remain the major challenge for developers. In the past, as we have observed, the London property market cycle swallowed what was once the world's aggressive developer. This correction in response to unlet space temporarily halted speculative office development in London.

New instruments of finance technology enable developers to employ a wider array of ALM strategies to maintain robust balance sheets. This represents a greater degree of control, allowing developers to remain more resilient in the face of unexpected market downturns that dampen demand and increase financial constraints.

Resilient developers offer more attractive investment opportunities because they return greater shareholder value. Investors' response to better stability and returns will bring more capital into the property market. As capital flows expand and new investors enter the market, there will be more demand for products like CMBS and REITs — both products that allow greater numbers of smaller investors to participate and thereby diversify risk. The outcome of expanded use of these products will theoretically be greater stability in the production of speculative office space.

Another outcome of having more investors in a market where the use of CMBS, REITs and newer property derivatives is prevalent will be ownership of individual buildings by multiple unrelated (fragmentary) non-occupiers with little or no non-financial connection the building's actual location.

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